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Alert

Secured Lender's Full Credit Bid Barred Later Recovery From Guarantors

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The U.S. Court of Appeals for the Fifth Circuit held on Feb. 28, 2013, that a secured lender's full credit bid for a Chapter 11 debtor's assets at a bankruptcy court sale barred any later recovery from the debtor's guarantors. *In re Spillman Development Group, Ltd.*, ___ F.3d ___, 2013WL 757648 (5th Cir. 2/28/13). A "credit bid" allows a creditor to "offset its [undisputed] claim against the purchase price," a right explicitly granted by Bankruptcy Code ("Code") § 363(k). 3 Collier, *Bankruptcy*, ¶ 363.06[10], at 363-59 (16th rev. ed. 2010). According to the Court, the lender's "credit bid . . . had the effect of retiring the Senior Indebtedness . . .." *Id.*, at *6.

Noteworthy subsidiary holdings in *Spillman* are the following:

- The bankruptcy court had "related-to" jurisdiction (28 U.S.C. § 1334 (b)) over the third-party dispute between the lender and the guarantors. *Id.*, at *2–*3.
- The bankruptcy judge had statutory authority (28 U.S.C. §157(b)) to enter judgment in this "core" proceeding based on the effect of the lender's "credit bid, … purely a creature of the Bankruptcy Code, … without reference to the district court" for entry of judgment. *Id.*, at *3.
- The bankruptcy court's exercise of jurisdiction was constitutional because the lender's claim was "inextricably intertwined with . . . federal bankruptcy law," unlike the counterclaim in *Stern v. Marshall*,131 S. Ct. 2594, 2600-01, 2611 (2011) (*held*, unconstitutional for bankruptcy court to issue judgment on state-law tortious interference counterclaim "independent of . . . federal bankruptcy law…."). *Id.*, at *4.
- The bankruptcy court properly declined "to enforce the forum selection clauses" in the guarantees because this dispute was "a core proceeding involving the adjudication of the effect of [the lender's] exercise of its right to credit bid, a right created by the Bankruptcy Code." *Id.*
- The district court's transfer of venue of the dispute to the bankruptcy court was the proper exercise of a lower court's discretion. *Id.*, at *5.
- The bankruptcy court properly granted summary judgment against the lender because its senior secured claim had been "paid in full" by the lender's credit bid, "a cash equivalent." *Id.*, at *5–*6.
- The bankruptcy court properly declined to assess "the fair-market value of the assets" purchased by the lender with its credit bid. *Id.*, at 11.

The facts of the litigation, set forth below, are important.

Relevance
This case shows the practical effect of a lender's credit bid on its rights to proceed against third-party guarantors. Equally important, it shows how a classic third-party dispute between a lender and a guarantor can be litigated in the bankruptcy court, ordinarily a rare event.

Facts
The debtor was a developer of a golf course that had borrowed $8.1 million from the lender, secured by liens on its assets and eight separate guarantees. An unsecured creditor with a claim of $4.1 million eventually bought the senior secured claim found by the bankruptcy court to total $9.3 million. After the bankruptcy court ordered the sale of the debtor's assets under Code §363(b), a prospective purchaser bid $9.2 million for the assets. The lender made a competing bid of $9.3 million, leading the bankruptcy court to hold later that the lender's full credit bid caused the underlying indebtedness to be paid in full, eliminating any deficiency claim against the debtor's estate.

The debtor, joined by seven of eight guarantors, promptly sought a declaratory judgment from the bankruptcy court that the guarantors had been released from their guarantees because of the sale. Although the lender moved to dismiss the suit in the bankruptcy court on jurisdictional and other grounds, it then sued the remaining eighth guarantor in a Louisiana federal court. That court transferred the suit to the bankruptcy court in the Western District of Texas, where the guarantee litigation had already been pending. In both the bankruptcy court litigation and in the Louisiana litigation, the lender argued that its credit bid "had not paid in full" the senior secured debt and that it "could therefore still collect against the guarantees." *Id.*, at *1. The bankruptcy court granted summary judgment to all the guarantors, and the district court affirmed. *Id.*, at *2.

Jurisdiction
Citing 28 U.S.C. §1334(b) (bankruptcy court jurisdiction extends to "all civil proceedings arising under *title 11*, or arising in or related to cases under *title 11*.") (emphasis added), the court explained that "related to" jurisdiction turns on whether the "outcome" of a dispute "could conceivably have any effect on the estate being administered in bankruptcy." *Id.*, at *2, quoting *In re Bass*, 171 F.3d 1016, 1022 (5th Cir. 1999). To have a "conceivable effect," the outcome need only "alter the debtor's rights, liabilities, options, or freedom of action (either positively or negatively) and . . . *in any way* impact . . . upon the handling and administration of the bankrupt estate." *Id.*, quoting *In re Majestic Energy Corp.*, 835F. 2d 87, 90 (5th Cir. 1988); (emphasis added); *Pacor, Inc. v. Higgins*, 743 F.2d 984, 994 (3d Cir. 1984).

Despite the "attenuated, hypothetical effect of third-party litigation, 'related-to'" bankruptcy jurisdiction existed here, held the Fifth Circuit. It reasoned that if the lender "were to succeed on the merits of this suit and proceed to recover against the guarantees . . . such a recovery would presumably diminish [the lender's] deficiency claim against the bankruptcy estate, conceivably allowing a greater recovery for other unsecured creditors against the estate." *Id.*, at *3. *Accord*, *In re Stonebridge Techs., Inc.*, 430 F.3d 260, 266-67 (5th Cir. 2005) (*held*, related-to jurisdiction existed over third-party claims when collection could affect "need for [a third party] to seek reimbursement from . . . bankruptcy estate").

Bankruptcy Court's Statutory Authority
Citing 28 U.S.C. §157(b) (bankruptcy judge "may hear and determine all cases under *title 11* and all core proceedings arising under *title 11*, or arising in a case under *title 11* . . . and may enter appropriate orders and judgments [in such core proceedings]" (emphasis in original), the court found the dispute with the guarantors here to be core, enabling the bankruptcy judge to enter judgment "without reference to the district court." *Id.* It viewed the litigation with the guarantors to turn on "a right created by the federal bankruptcy law," and thus found it to be "a core proceeding." *Id.*, citing *In re Wood*, 825 F. 2d 90, 97 (5th Cir. 1987). As the court explained, the dispute turned on whether the lender's "credit bid had the effect of extinguishing" the lender's senior secured indebtedness. *Id.* "[B]ecause the right to credit bid is purely a creature of the Bankruptcy Code," the proceeding was core. *Id.*

Bankruptcy Court's Constitutional Authority
The court found the lender's claim against the guarantors to be "inextricably intertwined with the interpretation" of a federal bankruptcy law right — a credit bid. *Id.*, at *4. "[T]here was [thus] no constitutional

bar" to the bankruptcy court's taking jurisdiction over the dispute. *Id*. As the court explained, the Supreme Court's *Stern* decision was easily distinguishable because the counterclaim in that case was "a state law action independent of the federal bankruptcy law and not necessarily resolvable by ruling on the creditor's proof of claim in bankruptcy." *Id.*, quoting *Stern v. Marshall*, 131 S. Ct. at 2611.

Forum-Selection Clause

The forum-selection clause in the *Spillman* guarantees provided for litigation to be brought in the Eastern District of Texas, but the bankruptcy court for the Western District of Texas adjudicated the dispute. Despite judicial precedent ordinarily enforcing forum-selection clauses, "a bankruptcy court may decline to enforce" those provisions when "a core proceeding involves adjudication of federal bankruptcy rights wholly divorced from inherited contractual claims . . . ." *Id.*, citing *In re Nat'l Gypsum Co*., 18F.3d 1056, 1068 (5th Cir. 1997). Again, because the dispute here was a core proceeding turning on the exercise of the lender's right to credit bid — a federal bankruptcy issue —, the Fifth Circuit found a "sufficiently strong public-policy interest in justifying the non-enforcement of" the forum-selection clause. *Id.*

Venue

The Court of Appeals relied heavily on the debtor's first-filed declaratory judgment proceeding against the lender in the Western District of Texas, joined in by all but one of the guarantors. The lender's later suit against the remaining guarantor in the Eastern District of Louisiana had been properly transferred by the Louisiana court to the bankruptcy court, explained the Fifth Circuit. ". . . [W]hen related cases are pending before two federal courts, the court in which the case was last filed may refuse to hear it if the issues raised by the cases substantially overlap." *Id.*, at *5, quoting *Cadle Co. v. Whataburger of Alice, Inc*., 174 F.3d 599, 603 (5th Cir. 1999). Because the later Louisiana suit against one guarantor "presented precisely the same, purely legal dispute," the court easily found that the Louisiana district court had properly transferred venue to the Texas bankruptcy court, the forum in which the dispute had originated. *Id.*

Effect of Credit Bid On Guarantees

The court rejected the lender's final assertion that its credit bid had not resulted in the senior secured debtor's "being paid in full." *Id.* Nor did the court require the bankruptcy court to "assess . . . the fair market value of the assets [the lender] purchased . . . ." *Id.*, at *6.

The Fifth Circuit found that the "credit bid did in fact pay in full the Senior Indebtedness," giving at least three reasons. *Id.*, at *5–*6. First, the lender's credit bid was the "equivalent to a cash payment for the assets purchased." *Id.*, at 6. Second, because the senior secured debt "was in fact repaid in full with cash or a cash equivalent," the case was distinguishable from those cases holding that "modification or elimination of a debt" in a bankruptcy reorganization case will not affect the rights of a lender with a guarantee. *Id.*, at *6. Finally, nothing in Code § 363(b) requires "an assessment of the fair-market value of the assets" purchased by the lender with its credit bid. *Id.* Although other provisions in the Code, such as § 506(a), do provide for valuations of the kind sought by the lender, at least one other Circuit has held that it was not required in the context of a credit bid. *Id.*, citing *In re SubMicron Sys. Corp.*, 432 F.3d 448, 461 (3d Cir. 2006).

Comments

1. Despite the breadth and relative novelty of *Spillman*, the court's reasoning is sensible. The court's seemingly broad interpretation of a bankruptcy court's jurisdiction either on statutory or constitutional grounds is hardly surprising.
2. The debtor's preemptive declaratory judgment action effectively kept the dispute in the bankruptcy court, defining it as a dispute turning on applicable federal law. Had the debtor not moved quickly, the guarantors would have run the risk of a non-bankruptcy court holding them liable on a different, novel approach.
3. *Spillman* is unusual only in the sense that the lender had not moved quickly to prosecute the guarantors outside the bankruptcy court. The lesson for lenders here is move quickly in a non-bankruptcy forum to enforce a guaranty of payment.
4. One more lesson for lenders with a third-party guaranty is to assess the dollar amount of your credit bid wisely. It may be better to take partial payment from the debtor's sale of your collateral to someone else. You may then be able to preserve a deficiency claim against the guarantors instead of buying the debtor's assets with a full credit bid.

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