This paper will attempt to advance some theoretical justifications for recent bankruptcy decisions that have denied the existence of a right for secured creditors to credit bid in the course of a reorganization under § 1129 of the Bankruptcy Code. § 363 of the Bankruptcy Code specifically grants secured creditors the right to bid their credit in a sale of their collateral as part of a going concern sale.\footnote{"At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property." Title 11 § 363(k). Subsection (b) includes the administrative requirements with which the trustee must comply to effectuate a sale of an asset of the firm.} However, in a reorganization under § 1129, secured creditors are not necessarily permitted to participate in an auction of the collateral underlying their liens. This paper will attempt to forward some economic justification for why the rights of creditors may be limited in this fashion.

Instead of protecting their interests by bidding their credit, secured creditors in a § 1129 reorganization are entitled to a “fair and equitable” disposition of their claim. § 1129(b)(2). As a term of art, “fair and equitable” is
understood to incorporate the absolute priority rule. Thus, it is settled that
the value of the creditor’s claim is to be frozen at the moment of the firm’s
bankruptcy filing, and that the secured creditor must be paid this amount in
its entirety before any interest junior to the creditor may be paid any amount. However, the mechanism for arriving at the claim’s valuation at the moment
of filing is not explicitly outlined by the terms of § 1129. Fair and equitable
treatment of the secured creditor’s claim includes granting secured creditors
the right to bid their credit in a sale of the underlying collateral that they
would enjoy under 363(k). § 1129(b)(ii). However, recent court decisions have
held that while granting a secured creditor the right to credit bid in a
collateral asset sale is certainly sufficient to satisfy the “fair and equitable”
standard, credit bidding is not necessary since the “fair and equitable”
standard may also be deemed satisfied so long as the secured creditor is paid
“the indubitable equivalent” of the value of its claim. § 1129(b)(3). The
outcome of this reasoning is that a debtor may dispose of collateral by sale as
part of a § 1129 reorganization plan that relies entirely of judicial valuations
without allowing creditors the same right to bid their credit that they would
enjoy under a § 363 sale.

Before jumping down the rabbit hole to grapple with the validity of
prohibitions on credit bidding from an auction theory perspective, the author

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submits that we must be willing to first accept at least one critical, but by no means self-evident assumption. Namely, we must assume that a court’s decision denying the creditors request to credit bid at an asset sale operates effectively as a bar not merely to bid its credit but rather as a bar on the creditor from auction participation generally (or, more accurately, a steep tax on auction participation). That is to say that for our purposes the creditor may not win the auction even if she has both sufficient cash and the highest valuation of the asset. This is certainly the case where the plan of reorganization calls for a planned sale to a pre-selected buyer. However, we call for a further assumption that this remains the case where the plan of reorganization calls for a scheduled public auction. The author fully acknowledges that there is no doctrinal justification for this assumption. Indeed, there is little doubt that doctrinally the secured creditor is per se as entitled to tender a cash bid at an auction of the collateral asset as any other bidder and at no additional cost. However, there may be reason to at least humor the assumption that a denial of a creditor’s request to bid her credit could be plausibly considered as a bar on entry.

The court’s decision may be characterized as a court imposed transaction cost unique to the secured creditor that renders auction participation for the creditors unprofitable from the outset. In other words,

3 Scotia Pacific Co., LLC v Official Unsecured Creditors’ Committee (In re Pacific Lumber Co.), 584 F.3d 229 (5th Cir. 2009) (Although even in this case there may have been the pretense of some pre-petition period of shopping the assets for alternative buyers that, for whatever reason, did not materialize).
the moment the creditors’ request to bid their credit is denied, their effective entry fee into the auction becomes greater than the surplus that the creditors could possibly achieve by placing the successful bid. Though never empirically tested, this is at least a plausible assumption. In fact, the validity of this empirical assertion is inherent to the strongest defenses of the practice of credit bidding. As Keller and Buccola have demonstrated, assuming liquid credit markets and ignoring transaction costs, credit and cash bids are perfect economic equivalents. Put simply, there is no difference between purchasing an apple by giving a dollar to the store clerk or instead by tearing up a one dollar IOU from the store clerk. Therefore, by denying a creditors request to bid her credit, the court is creating arbitrary hurdles for parties that now have to pass cash back and forth when they will ultimately net out all of their outstanding transactions. However, if credit bidding were in reality the equivalent of cash bidding, then what could be lost in its prohibition? Furthermore, why would creditors bother to request the right to bid credit when they could be out lining up the cash they need to win the auction? In practice, all parties understand that the collective action costs associated with organizing creditors to finance a cash bid are are significantly greater than the costs the creditors face to credit bid.

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4 We grant, for the sake of this simple hypothetical, that the IOU is absolutely enforceable at any time at the creditor’s request. The principle here is irrefutable. It is essentially an illustration of the transitive property in algebra.

5 The extent to which the credit bidding represents a savings over the cost of securing short-term financing for a cash bid is an empirical question that has yet
The logical inference to be drawn from this state of affairs is that in the case of denials of request to credit bid, the hurdles are the point. A cost is being judicially imposed on the creditor intentionally. The denial operates as an official determination that the creditor should pay an entry fee to participate in the auction, and that the participation of the creditor in the auction is somehow legally undesirable. Whether or not there may be some potential underlying justification for that judicial determination from an auction theoretic perspective is the fundamental point at issue in this paper.

The economics of settling collateral auctions in bankruptcy may be distinct from the ordinary netting of transactions that frequently takes place between parties outside of bankruptcy. It is possible (indeed, likely) that the auction of the collateral securing a loan may result in a sale price that is lower than the amount that the debtor owes to the secured creditors. In this case, the creditors are said to be under-secured. Their claim will be treated as secured only up to an amount equal to the value of the collateral. For the remainder of the amount owed, the creditor is entitled to a deficiency judgment that would entitle the creditors to a pro rata share of their

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6 164 B.R. 132, 145 (Bankr. C.D. Cal. 1994) (“Chapter 11 expressly contemplates the stripping down of liens to the value of the collateral at the effective date of the plan pursuant to Section 1129.”).
remaining debt with the same priority as the debtor’s unsecured creditors. It is further possible (indeed, likely) that the creditors deficiency claim will be valued at cents on the dollar owed or even at nothing, as the estate of the debtor may be fully depleted by the recoupment of secured creditors. Therefore, a set of circumstances exist whereby what the creditors receive for their debt in bankruptcy is the sale price of the collateral at auction, nothing more and nothing less, regardless of the amount of the antecedent debt. Unlike netting transactions, the neutral process by which debts running back and forth between two parties are set-off against each other, the position of the creditor in credit bidding is tied to the sale price of the collateral asset.

Without doubt, this means that the incentives of the creditors at auction are aligned with the aim of the bankruptcy court generally, namely to maximize the auction sale price, thereby maximizing recovery for creditors. However, if the default rules set in bankruptcy were to systematically grant strategic advantage to creditors at the expense of third party participants in asset auctions, and the default rules are further set in such a way that it becomes difficult or impossible for actors to credibly opt-out, then the aim of maximizing recovery for creditors may be nonetheless frustrated. Though

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7 11 U.S.C. § 506(a)(1) (“An allowed claim of a creditor secured by a lien on property in which the estate has an interest … is a secured claim to the extent of the value of such creditor’s interest in the estate’s interest in such property … and is an unsecured claim to the extent that the value of such creditor’s interest … is less than the amount of such allowed claim.”).

8 Creditors deemed critical vendors and unsecured creditors with statutory priority will also be paid ahead of an ordinary deficiency claim.
each creditor-participant may always act in her best interest at any given auction, if the perception existed amongst potential outsider asset auction participants that the auction rules favored creditor-participants to the detriment of outsiders, outsiders may be deterred from participation ex ante, thereby driving down the amount recovered at auctions generally.⁹

As an explanation of why credit bidding requests should ever be denied, we acknowledge that this argument may be both under and over inclusive. To the extent that creditors are capable of credibly signaling to others that they wish to opt out of auction participation, the explanation is over-inclusive because that party does not need the judiciary to consider ex ante auction participation on her behalf. However, to the extent that creditors are able to marshal competing cash bids at auction, the argument is under-inclusive because those creditors will be as able to participate in the auction in the same manner as if they had been permitted to bid their credit.

It is critical then that we clearly define what types of strategic advantage that may run to creditors at auction and why these advantages should arguably be avoided. The ease and convenience of bidding debt at auction is not an unfair advantage running to creditors at the expense of outside bidders. Credit bidders do enjoy a pool of ready powder to fire at auction, whereas outside bidders have to go through the more difficult steps of securing independent financing to back their bids. This line of reasoning

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⁹ Courts have differed in determining whether credit bidding deters outside auction participation. For a rejection of the bid chilling argument, see In re Morgan House General P’ship, 1997 WL 50419 (E.D. Pa. 1997).
seems entirely unsound. If the luxury of credit bidding means creditors enjoy cheaper access to financing than their competitors then that advantage can only go towards creditors having the highest valuation of the asset at auction. Where the court can efficiently provide some saving in the incremental cost of securing financing, and thereby give creditors the highest valuation of the asset at auction, this is not a result to be avoided. Furthermore, if raising cash is some special rite of passage that 1129 bidders should have to go through, then creditors have still not been advantaged. The creditors raised cash at the time that they made the secured loan and have already transferred that cash to the debtor.

Another potential objection to credit bidding is that the creditors enjoy a special advantage running against outside bidders because the creditors already underwent the costly process of valuing the underlying asset at the time that they extended the original loan. Some commentators have argued that creditor-specific knowledge about firm collateral leads to underinvestment in management human capital.\(^\text{10}\) Once again, it would seem that the creditor can only extract any savings in valuation costs if the creditor is the highest valuing user of the auctioned asset since the savings that accrue to the creditor in the form of lower valuation costs and greater familiarity with the collateral asset are likely to frequently make creditors the highest valuing users of the collateral securing their loans. Therefore, leaving aside optimal firm-specific investment, if maximizing creditor

recovery is the underlying goal allowing creditors to costlessly enjoy the advantage of familiarity with the collateral securing their loans is entirely desirable.

If we are not concerned about creditors leveraging their advantages in information and convenience, then what exactly should concern us about credit bidding? Those objections only come into play when the creditors are the highest valuing user of the auctioned asset, but when that is the case it stands to reason that the creditors should win the auction. Difficulties will only arise, if they arise at all, when credit bidding interferes with the normal operation of an auction sale creating allocation inefficiency.

Permitting credit bidding may lead to inefficient outcomes if creditors could see their expected return on the asset increase by opting out of collateral auctions but the Bankruptcy Code fails to provide a mechanism for the creditor to credibly do so. We may reasonably ask then, if bidding credit is the equivalent of bidding cash, why would the auction possibly generate higher prices in expectation by allowing the creditor to opt out? Ordinarily, increased auction participation is understood to equate to higher sale

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11 Maximizing creditor recovery is a goal of bankruptcy, though we submit that the preservation of going concern value is and additional goal of Chapter 11 Bankruptcy process that must be considered.
prices. However, the creditor’s participation may not be equivalent to that of an ordinary bidder.

Right of First Refusal

Suppose that an outside buyer (“OB”) is the highest valuing user of a collateral asset \(X\) because OB has special skills \(S\) in using the asset. We can set \(S = .5X\). So, OB’s valuation is \((X + S)\). The creditor has no special skills and values the asset at the market price of \(X\). However, the creditor is owed an amount far exceeding the value of the collateral asset, (say \(3X\)) and due to the existence of other secured liens on all of the bankrupt firm’s other property, the creditor is certain that her deficiency claim (the unsecured portion that she is still owed after she is payed the value of her collateral) is worthless. At auction, could we plausibly see the creditor bidding up the price above the value \(X\) or else negotiating directly with OB in order to capture part of the surplus \(S\)? In other words, for any sale price below the amount secured by the asset (here \(3X\)), we may say that the creditor is in the same position as a party who holds a right of first refusal. By dipping into her worthless deficiency claim, the creditor can block the market auction and assume the asset.

There is an extensive theoretical and empirical literature on the pernicious effects of the right of first refusal in an auction setting. In a

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seminal article on auction theory, Riley and Samuelson analyze the right of first refusal as what they deem “matching auctions.” In that paper, they use a single round, private value auction with two bidders. Id. at 387. Riley and Samuelson determine that such matching auctions are “inefficient from the point of view of the seller. In fact, in some circumstances [the right of first refusal] permits a buyer who values the item less highly than his opponent to obtain the good. Thus, it may produce an allocation of the good that is inefficient ex post.” Id. at 388. The problem is not merely one of inefficiency in allocation but also, consequently, a loss in expected revenue. Id. Since the estate is in a position equivalent to the seller in the case of an auction involving credit bidding, the finding that a right of first refusal may potentially result in lower sale revenue may be a relevant objection to the right to credit bid in bankruptcy.

Bikchandani, Lippman, and Ryan analyze the effects of the right of first refusal on the seller and potential buyers. Employing a second price auction model, they conclude that the right of first refusal may result in inefficient asset allocation, and a lower expected surplus for sellers, even in a more open auction setting involving multiple potential buyers, “First, the special buyer might purchase the asset when her valuation for the object is not the highest among all potential buyers. Thus, the outcome under a right-

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of first refusal is inefficient. Second, when byer valuations are correlated, the right of first refusal exacerbates the winner’s curse for the regular (i.e. non-special) buyers, causing them to bid less aggressively, thereby not only reducing their own surpluses but also increasing the inefficiency of the auction.”

They find that in a private value setting, the right of first refusal leads to inefficient allocation whenever the special buyer’s asset valuation is between the highest and second highest value of the regular buyers. The intuition here is simple. In an ordinary ascending second price auction, the highest valuing bidder wins the auction at a price equivalent to the second highest valuing user because that is the price point at which competitive bidding tapers off. To the extent that the highest valuing user values the asset above the second-highest valuation price, that is surplus retained by the winner. However, where a party with an intermediate valuation holds a right of first refusal between the second and first highest valuation, the party will exercise its right to take the asset at the price at which the highest valuing user would have won. Thus, instead of the highest valuing user winning the auction at the second highest valuation price, now the second highest valuing user wins the auction at the third

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15 “The seller is always worse off when a buyer has been granted the right of first refusal.” Id. at 14.
16 For our purposes, the special buyer is the credit bidding secured creditor who, as mentioned above, in effect holds a right of first refusal.
17 Id. at 3.
highest valuation price.\textsuperscript{18} Of course, this allocation is less efficient and a lower net surplus will result.\textsuperscript{19}

\begin{quote}
\textbf{[A] ROFR converts the second price auction into something better than third price auction for the special buyer. Upon winning the object, she pays the second highest among the others’ ids; moreover, she may win the object even if her signal is less than the second highest signal of the other buyers. Second, from a regular buyer’s standpoint, the presence of a special buyer converts a second price auction with \(n+1\) buyers into something worse than a second price auction with \(n\) buyers . . . . Third, the allocation of the object may be inefficient because, as already noted, the special buyer may purchase the object even when she does not have the highest signal . . . .}

\textbf{A regular buyer will win only if the special buyer does not exercise her ROFR, i.e. when, after drawing inferences from the auction price about regular buyers’ information and also based on her own private information, the special buyer concludes that the object is over-priced. If valuations of buyers are correlated, then a ROFR exacerbates the winner’s curse for the regular buyers. This suggests that the regular buyers will bid less aggressively and the average selling price will be lower than if the seller did not grant a ROFR to buyer \(n+1\). We demonstrate that this suggestion is indeed true. ” Id. at 9-10.}
\end{quote}

\textsuperscript{19} One might assume that this type of auction distortion could only occur in the case of a traditional right of first refusal and would not result from an auction involving credit bidding. The argument would be that the credit bidder is forced to bid at auction just like the outside bidders, and, therefore, would have to keep bidding up the price of the asset just as an ordinary bidder would, until the asset does indeed go to the highest valuing user at the second highest valuation. The reality is significantly more complicated. First of all, if there is no fixed auction increment and the creditor is significantly under-secured, as in my original model, then as soon as the third bidder dropped off at a price below the credit bidder’s true valuation, then the credit bidder could place an exorbitant bid using her
For the inefficient allocation observed by Bikchandani, et al. to hold, the valuations would necessarily have to be private, otherwise the highest valuing user would continue to bid against herself until she had cleared the valuation of the rightholder (the second highest valuing user of the asset). Thus, in a pure common value setting, they find no efficiency loss, as all potential buyers will bid their true valuations. However, even in a common value auction, they find support for the theory that outside bidders will be deterred from participating in an auction with a buyer holding a right of first refusal, resulting in a lower sale price, “It is unrealistic to assume that all regular buyers who would otherwise elect to participate in the auction when there is no special buyer in fact do participate when there is a special buyer with a right-of-first refusal.” Id. at 3.

The risk of deterring outside bidder participation is thoroughly examined in Walker.20 Walker determines that the grant of a right of first is

valueless deficiency claim to force out the highest valuing user and take at the price of the last bid by the third highest valuing user. If instead there is a fixed increment, then the asset may indeed go to the highest valuing user at the second highest valuation price (that of the credit bidder), although there is also a possibility that the credit bidder will continue to bid above her true valuation based on a probabilistic judgment as to whether additional surplus can be extracted from the highest valuing user or the asset could be efficiently resold post-auction. Determining the credit bidder’s optimal bidding strategy under these conditions may bear further examination using a model based on these variables.

20 D. Walker (1999), “Rethinking Rights of First Refusal,” 5 Stan. J.L. Bus. & Fin. 1, 14 (“In providing for the right [of first refusal], the contracting parties decrease the expected realization from the sale of the property.”).
costless in the case of a single outside bidder (Id. at 25-26) but will nonetheless result in a drop in aggregate joint surplus between both buyers and sellers due to the deterrent effect on additional bidders. Walker proposes a “commitment to auction” clause as a superior alternative to the right of first refusal, however he does not envision the scenario we face in which an excess deficiency claim operates as a right of first refusal within an auction. More relevant for our purposes is Walker’s repeated exhortation against the grant of a right of first refusal by statute. Walker is concerned that a legislature may inaccurately treat the right of first refusal as merely distributive and thereby sanction the de facto grant of a right of first refusal without justification – precisely the concern we face with automatically sanctioned credit bidding.

Walker’s comparison of a bidder’s optimal strategy when bidding at auction against only ordinary buyers versus against a right of first refusal is

21 “[I]f the presence of a right of first refusal discourages the entrance of bidders, as it should given the reduction in a bidder’s expected return, then the parties to a right of first refusal contract reduce the potential realization from disposition of the property by adopting the instrument.” Id. at 26.

22 Id. at 40-42

23 “[L]egislatures generally should refrain from mandating true rights of first refusal.” Id. at 52. “Given the deleterious impact of the right of first refusal on the value of encumbered property the statutory grant of such rights is particularly troubling.” Id. at 53.

24 “Legislatures may believe that the rights they are granting are innocuous or that they only transfer value from grantor to grantee . . . this assumption may be quite mistaken.” Id. at 54.
instructive. “In an (ordinary) auction, the bidder’s strategy is simple: she raises her bid following each successively higher bid of the rightholder until she wins or reaches her indifference point. In this case, the bidder is learning something about the rightholder’s value with each successive bid.” Id. at 21-22. However, in bidding against a right of first refusal, “the bidder loses the information generated by the auction.” As a result, rather than bidding up to her indifference point, the bidder’s optimal strategy is to generate a bid based on a probabilistic assessment of the rightholder’s valuation, resulting in a much reduced expected surplus for the bidder. An outside bidder squaring off against a creditor who can draw bids from the well of a valueless deficiency claim may be at risk for exactly this type of loss. Should the outside bidder truly infer that the creditor is only bidding up to her true valuation of the asset? Due to the distortion created by the deficiency claim, the information stream runs in only one direction – the outside bidder’s true valuation is communicated to the credit bidder with each successive bid but the return message is garbled.

25 In Walker’s model, that the outside bidder values the good at 100 and does not know the rightholder’s valuation but estimates that value is normally distributed with a mean of 100 and standard deviation of 5, then the bidder maximizes her expected gain by bidding at 96.25 (the rightholder’s mean value less .75 standard deviations), and has 23% chance that the the rightholder’s value will be lower. The bidder’s best-case expected surplus is reduced from 2.0 in an ordinary auction to .85, and may be reduced further still due to inaccuracies in estimation. Id. at 22-23. This is precisely the problem we encountered in our analysis of Bikchandani, et. al. See FN15.
Choi argues that while it may indeed be the case that the existence of a right of first refusal suppresses sale price, the existence of the right may in fact raise joint surpluses between buyer and seller and, therefore, may be beneficial for the parties to negotiate ex ante.\textsuperscript{26} Provided a single outside buyer, Choi’s results are robust to any auction form (first-price/Dutch or second price/English, private valuations or public). “The paper shows that, compared to a more even-handed auction, the joint profit of the right-holder and the seller will always be higher. The argument is consistent with the larger theme of using a bilateral contract to exert an externality on a third party.” Id. at 263. Their model relies on a single outside buyer and does not address the issue of bidder deterrence—either the deterrence of the single outside bidder from costly auction participation or that of potential additional outside bidders. The absence of attention to the deterrence concern is notable, particularly because Choi’s results are dependent on the existence of a single outside buyer whose participation is taken as a given.\textsuperscript{27} However, even where

\textsuperscript{26} A. Choi, 2009, “A Rent Extraction Theory of Right of First Refusal,” \textit{The Journal of Industrial Economics}, Vol. LVII, No. 2, 252-264 (“[T]he right of first refusal can be used by the contracting parties to extract more rent from a future, third party.” 263).

\textsuperscript{27} Bikchandani et al. anticipated Choi’s ex ante, joint-surplus analysis. Unlike Choi, Bikchandani et. al. note the problematic nature of conducting this analysis without including deterrence of outside bidders. Bikchandani 14. Even granting this problematic assumption, Bikchandani, et. al found the picture decidedly mixed, “We are able to delineate instances in which the net benefit to the pair of granting this right is positive . . . But we also find instances wherein the pair’s net benefit is negative.” Id. at 15.
Choi does apply, meaning that joint surplus between buyer and seller is improved by inclusion of a ROFR, it is not clear that we can draw a straight line in favor of automatic credit bidding. Where Choi applies, credit bidding would logically result in better credit terms for a firm in the initial period before bankruptcy is on the horizon because the right to extract additional rents from an outside buyer in the event of a collateral asset auction would be priced-in to the initial loan. However, while the introduction of that right creates value as between the two contracting parties, it does so not only at the cost of a later outside buyer, but also with an accompanying cost to social welfare and efficiency of allocation. Id. at 263. Furthermore, to the extent that Choi applies, the ability of a credit bidder to opt out will not solve the problem of social loss. The initial terms of the loan that allow credit bidding to occur in the event of a future collateral auction act as a bilateral contract to appropriate future rents from any outside bidder, and an opt-out option will do nothing to scuttle the conspiracy. Only by treating the practice of credit bidding as a potential restriction on alienation could the welfare loss brought on by inefficient allocation be perfectly avoided.28

Chouinard finds that a determination by the National Park Service to eliminate ROFR clauses from service concession contracts as a means to achieve a higher level of consumer service at park concessions has theoretical

28 It bears repeating that this particular result is dependant on all of the conditions of Choi being met, notably that there be only one outside bidder, and that the existence of the right to credit bid have no deterrent effect.
justification.29 Using methods similar to Bikchandani, et. al, Chouinard models service levels resultant from first price auctions both with and without the right of first refusal. In reaching her conclusion that better concession services will result from removal of right of first refusal clauses, Chouinard shows that while the existence of the right may benefit rightholders, it does so only be insulating them from competitive bidding and at the expense of sellers and potential entrants. Her focus on service levels raises an additional question as to whether collateral held by debtors subject to future credit bidding will be put to their most efficient use.

Reservation Price

An alternative way of conceptualizing the position of the under-secured creditor at a collateral auction is to equate the creditor’s position to that of an auction seller selling an item with an undisclosed reservation price. It may seem more intuitive to think of the debtor in possession as having the rights traditionally associated with that of the seller. The debtor is the party positioned to initially propose the terms of the auction, for example. However, deeper analysis suggests that the under-secured creditor, as the residual owner of the collateral, more closely resembles the seller. Following this line of logic, the creditor’s behavior at auction should not conform to that of an ordinary buyer but should correspond instead to that of a seller to the extent

29 H. Chouinard, (2005) “Auctions with and without the Right of First Refusal and National Park Service Concessions Contracts,” Amer. J. Agr. Econ. 87(4) (“[E]liminating the right of first refusal will always result in equal or higher contracted concession services.”)
those two behavior types diverge. Therefore, instead of bidding only up to the creditor’s true valuation, the creditor would be expected to bid up to the optimal reservation price (if that price is above the true valuation level).\textsuperscript{30}

Riley and Samuelson\textsuperscript{31} first determined that, where a seller cannot charge an entry fee to auction participants,\textsuperscript{32} a seller could gain higher expected revenues by employing a reservation price at the expense of creating a risk of inefficient allocation. Under their model, the seller should set a reservation price above the seller’s true valuation by a small amount that does not depend on the number of bidders but only the distribution of valuations. Id. at 385-86.

Levin and Smith\textsuperscript{33} also conclude that setting a reservation price above

\textsuperscript{30} The Swedish Bankruptcy system contemplates that creditors will act as effective sellers in going concern auctions but gives creditors the opposite set of rights. In Sweden, a controlling creditor, as the residual claimant to the assets of a firm, is entitled to administer the going concern auction but is not permitted to set a reservation price. At least one paper has found that Swedish banks use side deals with outsiders to bid on their behalf, resulting in the same problem of allocation inefficiency. B. Espen Eckbo and Karin S. Thorburn 2008, “Creditor Financing and Overbidding in Bankruptcy Auctions: Theory and Tests,” Tuck Business School, Dartmouth University, Journal of Corporate Finance, available at http://mba.tuck.dartmouth.edu/Pages/Faculty/Karin.Thorburn/publications/EckboThorburn-JCF09.pdf

\textsuperscript{31} Supra at note 13.

\textsuperscript{32} Of course, a creditor is in no position to charge other bidders an entry fee.

\textsuperscript{33} Dan Levin and James L. Smith, 1994, “Equilibrium in Auctions with Entry” American Economic Review, Vol. 84, 585-599; Dan Levin and James L. Smith,
the seller’s true valuation is a strictly dominant strategy, although according to their model the amount by which the reservation price exceeds the seller’s true value does depend on the number of bidders. According to Levin and Smith, the theoretically optimal reservation price converges to the seller’s true valuation as the number of auction participants increases. Id. This is the case because the reservation price only translates into higher sale revenue under certain conditions – if it is between the first and second highest valuation in a second-price auction, for instance. Id. at 1271-72. Assuming a normal distribution of private values, the probability that the reservation price will fall within these parameters decreases and thus the margin between the seller’s true valuation and the reserve price should narrow. Id. Under Levin and Smith’s model, the creditor would once again be in a position to deter outside auction participation because it is only after observing the level at which the reservation price is set that outside bidders determine whether or not to incur the cost of participating in the auction. However, regardless of whether the optimal reservation price is dependent or independent of the number of outside bidders, Levin and Smith agree with


35 If the reservation price is the highest price, there will be no trade. If below the second-highest valuation, it will be irrelevant to the auction outcome.

36 This cost cannot be an entry-fee, but it is reasonable to assume that determining a valuation and structuring a bid requires some expenditure on the part of the potential bidder.
Riley and Samuelson that the optimal reservation price should exceed the seller’s true valuation by some margin.\textsuperscript{37}

While efforts have been made to calculate the optimal reservation price based purely on buyer valuation distributions,\textsuperscript{38} the theoretically optimal reservation price must be marginally above the \textit{seller’s valuation}.\textsuperscript{39} As we observed in our analysis of rights of first refusal, the incentive for the secured creditor to bid above her true valuation creates the risk of inefficient allocation. Empirical testing conducted by Cox\textsuperscript{40} based on observation of EBay auctions of Kruggerrand coins support Levin and Smith’s claim. Because of the robust secondary market in the coins that closely tracks the price of gold, Cox infers the seller’s true valuation using gold prices as a proxy. Id. at 5. Auctions structured to open with a reservation price slightly higher than the seller’s inferred valuation resulted in higher revenue. Id. at 24.

\textsuperscript{37} Although in either case, the margin by which the seller’s optimal reservation exceeds the seller’s true valuation is either small (Riley and Samuelson) or fleetingly small as the number of bidders is increased (Levin and Smith), so the risk of the seller creating allocation inefficiency is relatively small.


In the case of credit bidding, the risk of inefficiency driven by an above-value reservation price may be greater than that observed by Cox if the sale is structured as a sealed bid auction. This is because the reservation price used by a credit bidder is hidden from outside bidders in a sealed bid auction. Traditionally, hidden reservation prices have been understood as a means to deter bidder collusion or to increase bidder participation. However, Li and Tan show that hidden reservation prices operate to extract higher revenues from risk-averse bidders, since “a hidden reserve price by the seller serves as a competing bid since the winning buyer has to out-bid the seller as well as other buyers. As the buyers become more risk-averse, they bid more aggressively under both [public and hidden reservation price] policies, but even more so when a hidden reserve price is used.”

CONCLUSION

Recent court decisions have denied secured creditors the right to credit bid in § 1129 reorganizations. Through analogy to the auction theoretic literature on rights of first refusal and reservation prices, this paper attempts

44 Li and Tan, supra 4.
to show that credit bidding may be inefficient under certain conditions. Assuming that secured creditors are incapable of credibly opting out of an auction of the collateral securing their claims and that financing a cash bid poses a barrier to auction participation, disallowing the practice of credit bidding may be economically efficient. The right to credit bid may be the economic equivalent of a right of first refusal or a reservation price from the perspective of the under-secured creditor. In either case, the credit bidder may have an incentive to bid above her true valuation in a collateral auction with results that may create allocation inefficiency, deter bidder participation, and lower expected revenues.