

## Seventh Circuit Upholds Right of Secured Creditors to Credit Bid Under a Chapter 11 Plan

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On June 28, 2011, the United States Court of Appeals for the Seventh Circuit became the latest circuit to weigh in on the hotly contested question of whether a debtor can deny a secured creditor the right to credit bid as part of a Chapter 11 plan providing for the sale of assets encumbered by the secured creditor's liens. In *In re River Road Hotel Partners, LLC*,<sup>1</sup> the Seventh Circuit upheld the right of secured creditors to credit bid, a decision that runs directly contrary to recent opinions in the Third and Fifth Circuits. The River Road decision is a significant victory for secured creditors, one that calls attention to this high-profile circuit split over the right to credit bid in an asset sale under a Chapter 11 plan.

### Background

Credit bidding refers to the ability of a secured creditor to apply up to the full amount owed to that creditor as a bid in connection with an auction and sale of collateral encumbered by its liens. Credit bidding provides secured creditors with the option of taking possession of collateral rather than accepting sale proceeds from that collateral, a flexibility that may be especially crucial in the context of a severely distressed market environment, in which sale prices often fail to reflect the real or expected future value of collateral.

In a Chapter 11 case, sales of the debtor's property outside of the ordinary course of business are conducted through either a sale under section 363 of the Bankruptcy Code, or pursuant to a plan of reorganization. Under section 363(k), a secured creditor has the express right to credit bid in connection with a section 363 sale of the secured creditor's liens.<sup>2</sup> However, two recent opinions in the Third and Fifth Circuits have held that a secured creditor does not have the right to credit bid in the case of sales conducted under a Chapter 11 plan. In *In re Philadelphia Newspapers, LLC*, (Third Circuit)<sup>3</sup> and *In re Pacific Lumber Co.* (Fifth Circuit),<sup>4</sup> the Third and Fifth Circuits held that a Chapter 11 debtor may sell its property free and clear of a secured creditor's liens without being required to provide the secured creditor with the right to credit bid.

Section 1129 of the Bankruptcy Code sets forth the requirements for Chapter 11 plan confirmation. Among these requirements, in the event that a class of impaired secured creditors votes to reject a plan,<sup>5</sup> a Chapter 11 debtor must satisfy the “fair and equitable” provisions of section 1129(b)(2)(A) to obtain plan confirmation. Section 1129(b)(2)(A) sets forth three alternative methods for meeting the “fair and equitable” requirement with respect to a secured creditor: (i) a secured creditor must retain its liens, whether or not its collateral is sold; (ii) if the secured collateral is sold free and clear of the secured creditor's liens, the sale must be subject to section 363(k) (which provides the right of the secured creditor to credit bid); or (iii) the plan provides the secured creditor with the “indubitable equivalent” of its secured claim.<sup>6</sup>

At issue in *River Road* and in the Third and Fifth Circuit cases before it, was whether a plan can be confirmed that provides for the sale of collateral without allowing a secured creditor to credit bid its claim by relying upon the third prong of the “fair and equitable” standard, the “indubitable equivalent” test, even though the text of the second prong expressly refers to a sale of a secured creditor's collateral and the third “indubitable equivalent” prong does not.

### **In re River Road Hotel Partners, LLC**

The debtors in *River Road* owned and operated the InterContinental Chicago O'Hare Hotel and affiliated space and the Radisson Hotel at Los Angeles International Airport. In order to finance the construction of the hotels, the debtors borrowed a combined amount of nearly \$300 million from lenders. As part of their Chapter 11 plans, the debtors sought to sell substantially all of their assets, including the hotel projects, free and clear of the secured creditors' liens. Amalgamated Bank, in its capacity as agent, objected to the debtors' bid procedures, arguing that they impermissibly denied the secured creditors the right to credit bid. In reply, the debtors relied on the *Philadelphia Newspapers* and *Pacific Lumber* cases, arguing that the debtors' plans were confirmable because they satisfied section 1129, including the “fair and equitable” standard of 1129(b)(2)(A), because the debtors' plans provided the secured creditors with the “indubitable equivalent” of their secured claims by virtue of the allocation of sale proceeds to the secured creditors.

The Bankruptcy Court rejected the debtors' argument, holding that the debtors could not sell their assets free and clear of the creditors' liens under the “indubitable equivalent” prong of section 1129(b)(2)(A). Rather, any plan sale of the secured creditors' collateral was required to satisfy section 1129(b)(2)(A)(ii), which provides that secured creditors have the right to credit bid under section 363(k). The debtors appealed the Bankruptcy Court's decision to the Seventh Circuit.

### **The Seventh Circuit Opinion**

The Seventh Circuit affirmed the Bankruptcy Court's decision and declined to follow *Philadelphia Newspapers* and *Pacific Lumber*, holding that where a plan called for the sale of encumbered property free and clear of all liens, and where the “fair and equitable” standard must be satisfied, the requirements of subsection (ii) of section 1129(b)(2)(A) must be met.

Drawing from Circuit Judge Ambro's dissent in *Philadelphia Newspapers*, the court found that reliance solely upon subsection (iii) (the “indubitable equivalent” test) in a sale context would render subsection (ii) superfluous, and would therefore violate “a cardinal rule of statutory construction.”<sup>7</sup> Thus, the “infinitely more plausible interpretation of Section 1129(b)(2)(A)” would interpret each of the subsections as “conclusively governing” the category of proceedings addressed by that subsection.<sup>8</sup> Under the Seventh Circuit's reading of the statutory text, subsection (iii) would only apply where a Chapter 11 plan “proposed disposing of assets in ways that are not described in [s]ubsections (i) and (ii).”<sup>9</sup> Accordingly, where a Chapter 11 plan provided for the sale of encumbered collateral free and clear of all liens, and where secured creditors voted to reject the plan, subsection (ii) of the “fair and equitable” test of section 1129(b)(2)(A) must apply, and secured creditors must therefore have the right to credit bid.

The court further supported its decision by emphasizing the dubious protections provided by the “indubitable equivalent,” an undefined term that if used as the debtors intended, could actually deny creditors a “crucial check against undervaluation” in the sale process.<sup>10</sup> Such a statutory application would also run counter to the extensive statutory protections afforded to secured creditors in other areas of the Bankruptcy Code.

## **Implications of River Road**

The Seventh Circuit's decision is significant in that it represents a strong counter to the decisions of the Third and Fifth Circuits. Furthermore, in the context of restructuring negotiations outside of the Third and Fifth Circuits, secured creditors can now make a stronger case for requiring credit bidding rights in a sale of their collateral under a Chapter 11 plan. Indeed, the emerging high-profile split in the circuits over this core right of secured creditors will likely require an ultimate resolution before the United States Supreme Court.

<sup>1</sup>*In re River Road Hotel Partners, LLC*, Case No. 10-3597 (7th Cir. June 28, 2011). Attorneys from Katten Muchin Rosenman LLP, Morrison Foerster LLP and Wildman, Harrold, Allen & Dixon LLP led the effort for the victorious secured creditors in the case.

<sup>2</sup>Section 363(k) provides, “[a]t 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.” 11 U.S.C. §363(k).

<sup>3</sup>*In re Philadelphia Newspapers, LLC*, 599 F.3d 298 (3d Cir. 2010). For more information, see the [Katten Client Advisory regarding Philadelphia Newspapers](#).

<sup>4</sup>*Bank of N.Y. Trust Co., N.A. v. Official Unsecured Creditors' Comm. (In re Pacific Lumber Co.)*, 584 F.3d 229 (5th Cir. 2009).

<sup>5</sup>Generally, a class of secured creditors would vote to reject a plan that provided for the sale of encumbered property yet denied the creditors the right to credit bid on that property.

<sup>6</sup>11 U.S.C. § 1129(b)(2)(A).

<sup>7</sup>*In re River Road Hotel Partners, LLC*, Case No. 10-3597 at 21 (7th Cir. June 28, 2011).

<sup>8</sup>*Id.* at 23.

<sup>9</sup>*Id.*

<sup>10</sup>*Id.* at 20

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