By Susan E. Trent

Castleton Plaza: May an Insider Equity Investor Sidestep the Absolute-Priority Rule and *LaSalle*?

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Generally speaking, the absolute-priority rule requires that senior creditors be paid in full before equity investors can receive anything.[1] A chapter 11 can create situations where a reorganized business has both significantly decreased debt (by virtue of a cramdown) and assets with increasing value. These circumstances can result in the creation of significant equity in the emerging, reorganized business.

A reorganization plan can provide for new investment in exchange for an equity position in the reorganized company.[2] In *203 North LaSalle*, the U.S. Supreme Court considered whether a chapter 11 plan that provided pre-petition owners with "exclusive opportunities free from competition and without the benefit of market valuation" to purchase equity in the reorganized business violated the absolute-priority rule.[3] In short, the answer was "yes": Those sorts of "exclusive" arrangements violate the absolute-priority rule.[4]

In 2013, the Seventh Circuit Court of Appeals considered a related issue *In re Castleton Plaza LP*.[5] The issue before the Seventh Circuit in *Castleton* was whether "an equity investor can evade the competitive process by arranging for the new value to be contributed by (and the new equity to go to) an 'insider' as [defined in] 11 U.S.C. § 101(31)."[6] In accepting the direct appeal, the Seventh Circuit noted that no court of appeals had addressed after *LaSalle* whether competition is essential where an "insider [has] an option to purchase equity in exchange for new value" and further observed that bankruptcy judges had disagreed on the answer.[7]

203 North LaSalle: Background

Bank of America National Trust and Savings Association (the "bank") made a nonrecourse loan in the amount of $93 million to the 203 North LaSalle Partnership (the "debtor") on the debtor's principal asset: 15 floors of an office building in downtown Chicago and the rents associated therewith (the "real estate").[8] The debtor ultimately defaulted on the loan, and foreclosure proceedings ensued.[9]

The debtor filed for chapter 11 relief.[10] In addition to the benefit of the automatic stay, the debtor's principal purpose in filing the chapter 11 case was to retain ownership of the real estate in order to avoid approximately $20 million in personal tax liabilities that would become due if the bank foreclosed.[11]

The debtor's chapter 11 plan was structured as follows.[12] First, the bank's $54.5 million secured claim would be paid in full between seven and 10 years after the original repayment date.[13] Second, the bank's $38.5 million unsecured claim would be discharged for an estimated 16 percent of value.[14] Third, the remaining unsecured claims to trade creditors in the approximate amount of $90,000 would be paid in full, but without interest on the effective date of the plan.[15] Fourth, the former partners of the debtor would contribute $6.125 million in new money over five years in exchange for the partnership's entire ownership of the reorganized debtor.[16]

Critical to the Supreme Court's analysis in *LaSalle* was the final condition: *Only the old equityholders could contribute new money*.[17] This requirement, however, was crucial to maintaining the personal tax shelter for the partners.[18] The bank objected to the treatment proposed, and as it was the only impaired, rejecting class, it blocked confirmation.[19] In response, the debtor sought to invoke § 1129(b) and cause the plan to be confirmed over the bank's rejection.[20]

1 11 U.S.C. § 1129(b)(2)(B)(ii). Unless expressly noted, all citation references are directed to the Bankruptcy Code as found in title 11.
2 The new value corollary or exception.
3 *Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 436 (1999). Senior classes were not paid in full.
4 *Id.* This article will provide a more detailed summary of *LaSalle*.
5 *In re Castleton Plaza LP*, 2013 U.S. App. LEXIS 3185 (7th Cir. Ind. Feb. 14, 2013); *see also In re Castleton Plaza LP*, 2011 Bankr. LEXIS 3804 (Bankr. S.D. Ind. Sept. 30, 2011) (thoughtful discussion from Indianapolis Bankruptcy Court concerning its consideration of value); Case No. 11-01444-BHL-11 (Southern District of Indiana, Indianapolis Division).
6 *Castleton*, 2013 U.S. App. LEXIS 3185, at *2, *appealed from In re Castleton Plaza LP*, 2011 Bankr. LEXIS 3804 (S.D. Ind. 2011).
7 *Id.* at *4.
8 *203 North LaSalle*, 526 U.S. 434, 437-38 (1999), which was an appeal of a Seventh Circuit decision found at 126 F.3d 955.
9 *Id.* at 438.
10 *Id.*
11 *Id.*
12 *Id.* at 440. The bank sought to file its own plan to liquidate the real estate, but its motion was denied.
13 *Id.* The debtor proposed an approximate cash payment of approximately $1.2 million and a secured, seven-year note extendable at the debtor's option.
14 *Id.*
15 *Id.* Some of the former partners purchased some trade claims, thereby garnering acceptance for the nonbank, unsecured claimants. For further discussion on claims purchasing, *see* Susan E. Trent and Mark A. Warsco, "Buying Votes in Chapter 11," XXX *ABI Journal* 1, 38-39, 61, February 2011.
16 *Id.*
17 *Id.* The plan eliminated the interest of noncontributing former partners.
18 *Id.* at 440, n.11.
19 *Id.* at 440-41.
20 *Id.* Section 1129(b) is commonly referred to as the "cramdown" provision of the Code.

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There are essentially two elements that must be satisfied under § 1129(b) to succeed in plan confirmation: (1) all the elements of § 1129(a) must be met, and (2) under § 1129(b)(1), the plan must not "discriminate unfairly, and [must be] fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan."[21] The bank objected to the plan on the basis of a plain-meaning interpretation of the absolute-priority rule under § 1129(b)(2)(B)(ii) because the old partners would receive property even though the bank would not be paid in full on its unsecured claim.[22]

In considering the issues, the Court noted that the majority of a divided Seventh Circuit panel determined that there was ambiguity in the absolute-priority rule and had identified a new value exception to the absolute-priority rule.[23] The new value exception provides that the objection of an impaired senior class does not bar a junior class from "receiving or retaining property interests" if they contribute "new capital in money or money's worth, reasonably equivalent to the property's value, and necessary for successful reorganization."[24] The Court concluded in *LaSalle* that whether the new value exception existed, "*any* reading of the [debtor's] proposed plan fails to satisfy the statute," and so it reversed the Seventh Circuit.[25]

The Supreme Court discussed the historical context of the absolute-priority rule, noting that the reason for the limitation was the "danger inherent in any reorganization plan proposed by the debtor, then and now, that the plan will simply turn out to be too good a deal for the debtor's owners."[26] The Court further observed that Congress had the ability to expand and/or to clarify the new value exception—including, but not limited to, introducing the concept of allowing nonmonetary new value contributions—but did not do so.[27] In short, the Court stated that "for the purpose of plumbing the meaning of...a possible statutory new value exception, the lesson of this drafting history is equivocal."[28]

The Supreme Court "plumbed the meaning" by identifying three possible interpretations of the "on account of" language found in § 1129(b)(2)(B)(ii).[29] The first interpretation was quite permissive in that a "plan would not violate the absolute-priority rule unless the old equityholders received or retained property in exchange for the prior interest, without any significant new contribution."[30] The second interpretation was much more stringent, prohibiting an original equityholder from taking property under the plan if the creditors are not paid in full.[31]

The third interpretation was intended to "reconcile the two recognized policies underlying Chapter 11, of preserving going-concerns and maximizing property available to satisfy creditors" through an examination of value.[32] Ultimately, the Supreme Court declined to decide which of the three interpretations should control.[33] The Court simply found that the plan was "doomed" because it failed to "extend an opportunity to anyone else either to compete for that equity or to propose a competing reorganization plan."[34]

The *LaSalle* plan failed because it only proposed "the benefit of equity ownership" for "no one but old equity partners."[35] The Supreme Court found that it was the "exclusiveness of the opportunity, with its protection against the market's scrutiny of the purchase price by means of competing bids or even competing plan proposals," that was objectionable under the absolute-priority rule.[36] While the *LaSalle* decision stands for the proposition that "plans providing junior interest-holders with exclusive opportunities free from competition and without benefit of market valuation" violate the absolute-priority rule, it does not address whether a "market test would *require* an opportunity to offer competing plans *or* would be satisfied by a right to bid for the same interest sought by old equity."[37]

Castleton Plaza: An Expansion of the Absolute-Priority Rule under *LaSalle*?

In *Castleton*, the Seventh Circuit was faced with the issue of "whether an equity investor can evade the competitive process by arranging for the new value to be contributed by (and the new equity to go to) an 'insider.'"[38] The U.S. Bankruptcy Court for the Southern District of Indiana certified a direct appeal following confirmation, which the Seventh Circuit accepted because "no court of appeal[s] has addressed, after *203 North LaSalle*, whether competition is essential" in this context.[39]

The facts are relatively straightforward. Castleton Plaza LP (the debtor) owned a shopping center in Indiana. George Broadbent owned 98 percent of the corporation directly and the remaining 2 percent indirectly.[40] EL-SNPR Notes Holdings (the creditor) was the only secured creditor of the debtor and was owed approximately $10 million. The creditor's note matured, but the debtor defaulted and a chapter 11 case ensued.

The debtor proposed a reorganization plan that provided the creditor with a cash payment of $300,000 with the remaining balance crammed down to $8.2 million and paid over an extended term of 30 years (with little to be paid until 2021). The plan also proposed a reduced interest rate with the remainder of the creditor's claim treated as an unsecured deficiency.[41]

21 *Id.* at 441. *See* 11 U.S.C. § 1129(b)(2)(B)(i) and (ii), which require either payment in full or that any junior claimant shall not retain any interest in property on account of a junior claim (the "absolute-priority rule").
22 *203 North LaSalle*, 526 U.S. at 442.
23 *Id.*
24 *Id.* at 442.
25 *Id.* at 443 (emphasis added). Analysis of *LaSalle* has been the subject of numerous publications.
26 *Id.* at 444 (citing to H.R. Doc. No. 93-137, pt. I, page 255 (1973)).
27 *Id.* at 446-47 (citing to H.R. 6, 95th Cong., 1st Session §§ 1123 and 1129(b) (1977)).
28 *Id.* at 448.
29 *Id.* at 449.
30 *Id.*
31 *Id.* at 451.
32 *Id.* at 453.
33 *Id.* at 454.
34 *Id.* at 454.
35 *Id.* at 454.
36 *Id.* at 456.
37 *Id.* at 458 (emphasis added). Justice John Paul Stevens dissenting.
38 *In re Castleton Plaza LP*, 2013 U.S. App. LEXIS 3185 at *2 (7th Cir. Feb. 14, 2013).
39 *Id.* at *4.
40 *Id.* at *2.
41 *Id.* at *3.

Consistent with *LaSalle* and the absolute-priority rule, it was clear that Broadbent as an old equity owner could not retain any equity interest in the reorganized debtor because the creditor received less than full payment.[42] The Seventh Circuit noted that *LaSalle* required an auction before Broadbent could receive equity on account of any new investment.[43] What was interesting, however, is that the plan provided that Broadbent's wife would retain the equity in exchange for a $75,000 new value contribution.[44]

The creditor believed that the debtor had undervalued the assets and that as a result of the cramdown, the equity in the debtor far exceeded the $75,000 (later increased to $375,000) being paid by Mrs. Broadbent.[45] The bankruptcy court initially found that the *LaSalle* competition requirement did not extend to a nonequityholder and confirmed the plan.[46]

The Seventh Circuit disagreed, noting that the Supreme Court "devised the competition requirement to curtail evasion of the absolute-priority rule."[47] Moreover, the Seventh Circuit found that a plan proposing to provide "an investor's spouse [with equity] can be just as effective at evading the absolute-priority rule."[48]

The Seventh Circuit also advanced certain analogies in the Bankruptcy Code supporting its position, including noting that under § 547, insiders are treated the same as equity investors, and that § 101 provides that family members of corporate managers qualify as insiders.[49] To illustrate its position further, the Seventh Circuit discussed that if Broadbent directed, under a general power of appointment, some of his salary to go to his wife, child or anyone else, the money was still taxable as income to Broadbent.[50] Similarly, the court highlighted that the same result would occur if assets were directed to Mrs. Broadbent under a trust.[51] The court further commented upon Broadbent's receipt of a benefit from the arrangement independent of the fact that Mrs. Broadbent retained the equity (and the family's wealth was increased): Broadbent would continue to receive $500,000 in annual salary due to the continuation of the management contract with The Broadbent Company Inc.[52]

Given all of the above, the Seventh Circuit concluded that competition *in the form of an auction was essential* and that the Supreme Court's decision in *LaSalle* must govern.[53] The *Castleton* decision, however, does not clarify whether or not the submission of competing plans can satisfy the market-test requirement; rather, it simply instructed that an auction occur. The Seventh Circuit stated that "competition helps prevent the funneling of value from lenders to insiders, no matter who proposes the plan or when. An impaired lender who objects to any plan that leaves insiders holding equity is entitled to the benefit of competition."[54]

What's Next in *Castleton*?

On March 7, 2013, debtor's counsel filed a *Petition of Castleton Plaza LP for Rehearing En Banc*.[55] The petition makes several arguments, including, but not limited to, (1) that only Congress can extend the absolute-priority rule to nonholder insiders and it chose not to; (2) the *Castleton* decision dramatically expands the absolute-priority rule; and, (3) the holding that an auction is the only way to satisfy the competition requirement is contrary to *LaSalle*.[56] *Castleton* will be a case to watch in understanding *LaSalle*, the absolute-priority rule and the new value exception. abi

42 *Id.*
43 *Id.*
44 *Id.* at *4. Mrs. Broadbent owned 100 percent of The Broadbent Company Inc., which operates Castleton under a management agreement. Mr. Broadbent was the CEO of The Broadbent Company and received a salary of $500,000. The management contract was proposed to continue. Mrs. Broadbent had no equity interest in Castleton.
45 *Id.* at *4-5.
46 *Id.* at *5.
47 *Id.*
48 *Id.*
49 *Id.* at *5-6.
50 *Id.* at *6-7.
51 *Id.*
52 *Id.* at *6.
53 *Id.* at *8.
54 *Id.* at *9.
55 Case No. 11-01444, Southern District of Indiana, Indianapolis Division, Docket No. 343.
56 *Petition of Castleton Plaza LP for Rehearing En Banc*, Doc. No. 343, Case No. 11-01444-BHL-11, S.D. Ind., Indianapolis Division at page 3.