First (Post-) Impressions: Insider Distribution Violates Absolute Priority Rule, and Competition Is Essential Element of New Value Corollary

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Until 2013, no circuit court of appeals had weighed in on the implications of the U.S. Supreme Court’s pronouncement in the *203 North LaSalle* case that property retained by a junior stakeholder under a cram-down chapter 11 plan in exchange for new value “without benefit of market valuation” violates the “absolute priority rule.” See *Bank of Amer. Nat’l Trust & Savings Ass’n v. 203 North LaSalle Street P’ship*, 526 U.S. 434 (1999), reversing *Matter of 203 North LaSalle Street P’ship*, 126 F.3d 955 (7th Cir. 1997).

That changed when the Seventh Circuit Court of Appeals recently handed down its ruling in *In the Matter of Castleton Plaza, LP*, 2013 BL 40570 (7th Cir. Feb. 14, 2012). The court reversed a bankruptcy court ruling that a proposed plan under which an “insider” of the debtor would receive 100 percent of the equity in the reorganized company in exchange for a cash contribution passed muster under the absolute priority rule despite less than full payment of senior creditors. As a matter of first impression, the Seventh Circuit ruled that: (i) a distribution under the plan of new equity to the insider (the sole former shareholder’s spouse) conferred a benefit on the former shareholder; and (ii) the sufficiency of the “new value” proffered by the insider had not been tested by competition and thus violated the absolute priority rule.

Cram-Down and the “Fair and Equitable” Requirement
If a class of creditors or shareholders votes to reject a chapter 11 plan, it can be confirmed only if the plan satisfies the “cram-down” requirements of section 1129(b) of the Bankruptcy Code. Among those requirements is the mandate that a plan be “fair and equitable” with respect to dissenting classes of creditors and shareholders.

Section 1129(b)(2)(B) of the Bankruptcy Code provides that a plan is “fair and equitable” with respect to a dissenting impaired class of unsecured claims if the creditors in the class receive or retain property of a value equal to the allowed amount of their claims or, failing that, in cases not involving an individual debtor, if no creditor of lesser priority, or no equity holder, receives or retains any distribution under the plan “on account of” its junior claim or interest. This requirement is sometimes referred to as the “absolute priority rule.”

Three principal areas of controversy have arisen concerning the absolute priority rule. The first concerns the legitimacy, as a strategy to broker plan confirmation, of senior-class “gifting” under a chapter 11 plan to a junior class of creditors in cases where an intervening class is not being paid in full. The genesis of the second is 2005 amendments to the Bankruptcy Code that ignited a dispute as to whether the absolute priority rule continues to apply in individual chapter 11 cases. The third involves what is commonly referred to as the “new value” exception or corollary to the absolute priority rule. The Castleton Plaza decision focuses on the new value debate.

**History of the Absolute Priority Rule**

The U.S. Supreme Court first formally articulated the absolute priority rule, originally referred to as the “fixed principle,” in *Northern Pacific Railway Co. v. Boyd*, 228 U.S. 482 (1913), a case involving the equity receivership of a railroad. According to this precept, stockholders could not
receive any distribution in a reorganization case unless creditor claims were first paid in full. The Supreme Court continued to apply this principle in equity-receivership cases throughout the early 20th century, emphasizing that it should be strictly applied.

In 1934, Congress amended the former Bankruptcy Act to introduce the words “fair and equitable” to the bankruptcy lexicon. Section 77B(f) of the Act provided that a plan of reorganization could be confirmed only if the bankruptcy judge was satisfied that the plan was “fair and equitable and does not discriminate unfairly in favor of any class of creditors or stockholders, and is feasible.”

The provenance of this restriction was the “fixed principle.” As later expressed by the Supreme Court in *203 North LaSalle*, “The reason for such a limitation was the danger inherent in any reorganization plan proposed by a debtor, then and now, that the plan will simply turn out to be too good a deal for the debtor’s owners.” The “fair and equitable” requirement endured as part of chapter X of the former Bankruptcy Act when Congress passed the Chandler Act in 1938. As applied, the absolute priority rule prohibited any distribution to the holders of junior interests if senior creditors were not paid in full. This was so even if senior creditors agreed to the arrangement.

Congress partially codified the absolute priority rule into section 1129 of the Bankruptcy Code in 1978. Unlike prior law, however, the rule now applies only if a senior class deprived of payment in full does not vote to accept the plan. Thus, under the Bankruptcy Code, the absolute priority rule would be an obstacle to confirmation only if a class of senior creditors is “impaired” by, for
example, receiving less than full payment under a chapter 11 plan; the senior class votes to reject the plan; and the plan provides for some distribution to junior creditors or interest holders.

The New Value Exception

In 1939, the Supreme Court made explicit the connection between old equity-receivership cases and bankruptcy practice by holding in Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106 (1939), that under section 77B(f) of the former Bankruptcy Act, the requirement that a plan of reorganization be “fair and equitable” meant application of the absolute priority rule. In Case, the debtor’s existing shareholders sought to retain an ownership interest in the company, even though senior creditors were not to be paid in full. The shareholders argued that retention of their interests was important to the company’s future success, given their familiarity with business operations and the advantages of continuity in management. The Supreme Court ruled that continued shareholder participation in the ownership of an insolvent company may be acceptable under certain circumstances. From this pronouncement evolved the controversial “new value” corollary or exception to the absolute priority rule.

Under the new value exception, a junior stakeholder (e.g., a shareholder) may retain an equity interest under a chapter 11 plan over the objection of a senior impaired-creditor class, provided that the junior stakeholder contributes new capital to the restructured enterprise. According to some courts, that contributed capital must be: (i) new; (ii) substantial; (iii) necessary for the success of the plan; (iv) reasonably equivalent to the value retained; and (v) in the form of money or money’s worth.
In *In re Bonner Mall Partnership*, 2 F.3d 899 (9th Cir. 1993), *motion to vacate denied, case dismissed sub nom. U.S. Bancorp Mortg. Co. v. Bonner Mall Partnership*, 513 U.S. 18 (1994), the Ninth Circuit held that “if a proposed plan satisfies all of these [five] requirements, i.e. the new value exception, it will not violate section 1129(b)(2)(B)(ii) of the Code and the absolute priority rule.” Such a plan, the court wrote, “will not give old equity property ‘on account of’ prior interests, but instead will allow the former owners to participate in the reorganized debtor on account of a substantial, necessary, and fair new value contribution.”

Some courts have concluded that the new value exception did not survive the enactment of the Bankruptcy Code in 1978 because, among other things, the concept is not explicitly referred to in section 1129(b)(2) or elsewhere in the statute.

Since the enactment of the Bankruptcy Code, the U.S. Supreme Court has only obliquely addressed the legitimacy of the new value exception. In *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988), the court held that, even if the new value exception survived the enactment of the Bankruptcy Code in 1978, the new value requirement could not be satisfied by promised future contributions of labor. The U.S. Supreme Court was similarly reluctant to tackle the issue head-on in the other two cases to date in which it had an opportunity to do so. In 1994, the court declined to vacate on appeal the Ninth Circuit’s *Bonner Mall* opinion, and in 1999, it similarly declined to overrule the Seventh Circuit’s interpretation of the corollary in *203 North LaSalle*. Instead, in the *203 North Lasalle* case, the court held that one or two of the five elements of the new value corollary could not be satisfied when old equity retains the *exclusive* right to contribute the new value—i.e., without a market test of the new value.
“It is enough to say, assuming a new value corollary,” the court wrote in 203 North LaSalle, “that plans providing junior interest holders with exclusive opportunities free from competition and without benefit of market valuation fall within the prohibition of § 1129(b)(2)(B)(ii).” According to the court, the absolute priority rule is violated if a plan provides for “vesting equity in the reorganized business in the Debtor’s partners without extending an opportunity to anyone else either to compete for that equity or to propose a competing reorganization plan.”

In Castleton Plaza, the Seventh Circuit addressed two of the issues that have arisen in connection with new value plans. Specifically, the court examined whether the absolute priority rule precludes proposed plan distributions to insiders and whether the absence of competition to test the adequacy of new value is fatal to confirmation of a chapter 11 plan under the new value exception.

Castleton Plaza

Castleton Plaza, LP (“Castleton”) owns a shopping center in Indiana. George Broadbent holds 98 percent of Castleton’s equity directly and the remaining 2 percent indirectly. The shopping-center property is encumbered by a lien securing approximately $10 million owed to EL-SNPR Notes Holdings (“EL-SNPR”). After defaulting on the loan in September 2010, Castleton filed for chapter 11 protection in Indiana early in 2011.

In its chapter 11 plan, Castleton proposed to treat EL-SNPR’s claims by: (i) replacing the original $10 million secured note with a secured note in the principal amount of $8.2 million maturing in 30 years at a significantly reduced rate of interest and with none of the original
covenants; (ii) paying $300,000 in cash to EL-SNPR on the effective date of the plan; and (iii) classifying the remaining debt to EL-SNPR as an unsecured deficiency claim that would share pari passu in the 15 percent cash distribution (over five years) to general unsecured creditors. Although George Broadbent was nominally to receive nothing under the plan, the plan provided that George’s wife, Mary Clare Broadbent, was to receive 100 percent of the equity in the reorganized Castleton in exchange for an investment in the reorganized debtor of $75,000 in cash.

Mary Clare is the sole stockholder of the Broadbent Co., Inc. (“BC”), which runs Castleton under a management contract and pays chief executive officer George Broadbent $500,000 annually. Castleton’s proposed chapter 11 plan provided that the BC management agreement would be assumed.

Claiming that Castleton’s assets were undervalued in the plan, EL-SNPR offered $600,000 for the equity and promised to pay other creditors in full. Castleton rejected the proposal but submitted an amended plan in which Mary Clare’s investment in the reorganized company was increased from $75,000 to $375,000 in exchange for all of the reorganized equity. EL-SNPR requested that the court condition confirmation of the plan on a competitive bidding process for the equity. The court denied the motion and confirmed the plan, holding that competition was not necessary because Mary Clare was not the existing equity holder, and thus, the plan did not implicate the absolute priority rule. However, the bankruptcy court certified a direct appeal of the confirmation order to the Seventh Circuit, which accepted the appeal “because no court of appeals has addressed, after 203 North LaSalle, whether competition is essential when a plan of reorganization gives an insider an option to purchase equity in exchange for new value.”
The Seventh Circuit’s Ruling

A three-judge panel of the Seventh Circuit reversed. It faulted the bankruptcy court’s determination that competition for Castleton’s equity was unnecessary because Mary Clare was not an existing equity holder, and consequently, section 1129(b)(2)(B)(ii) did not apply. According to the Seventh Circuit, the Supreme Court devised the competition requirement in *North LaSalle* to “curtail evasion of the absolute-priority rule,” and “[a] new-value plan bestowing equity on an investor’s spouse can be just as effective at evading the absolute-priority rule as a new-value plan bestowing equity on the original investor.”

A family member of a corporate manager, the Seventh Circuit explained, is an “insider” of the debtor under section 101(31)(B)(vi) of the Bankruptcy Code. The Seventh Circuit wrote that “[i]t follows that plans giving insiders preferential access to investment opportunities in the reorganized debtor should be subject to the same opportunity for competition as plans in which existing claim-holders put up the new money.” According to the court, George Broadbent would clearly receive value from the equity that Mary Clare was to receive under the plan in the form of: (i) continuation of his salary as CEO of BC; and (ii) an increase in the family’s wealth.

Because the value of Castleton’s equity was not tested by competitive bidding, the Seventh Circuit ruled that the chapter 11 plan violated the absolute priority rule:

> 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. If, as Castleton and the Broadbents insist, their plan offers creditors the best deal, then they will prevail in the auction. But if, as EL-SNPR believes, the bankruptcy judge has underestimated the value of Castleton’s real
estate, wiped out too much of the secured claim, and set the remaining loan’s terms at below-market rates, then someone will pay more than $375,000 (perhaps a lot more) for the equity in the reorganized firm.

**Outlook**

The Seventh Circuit is not the only court of appeals post-203 North LaSalle to consider the impact of the Supreme Court’s decision in connection with the absolute priority rule. In *Dish Network Corp. v. DBSD North America, Inc. (In re DBSD North America, Inc.)*, 634 F.3d 79 (2d Cir. 2011), the Second Circuit rejected senior-class gifting as inconsistent with the absolute priority rule. In ruling that a plan proposing to give existing owners shares and warrants despite less than full payment of a senior class violated the absolute priority rule, the court wrote, “Given that the Supreme Court [in 203 North LaSalle and Ahlers] has hesitated to allow old owners to receive new ownership interests even when contributing new value, it is doubtful the Court would allow old owners to receive new ownership without contributing any new value, as in this case.”

In *Alabama Dept. of Economic & Community Affairs v. Ball Healthcare-Dallas, LLC (In re Lett)*, 632 F.3d 1216 (11th Cir. 2011), the Eleventh Circuit discussed 203 North LaSalle in ruling that objections to a bankruptcy court’s approval of a cram-down chapter 11 plan on the basis of noncompliance with the absolute priority rule may be raised for the first time on appeal. However, after noting the existence of the new value exception, the court specifically declined any “further discussion of this exception to the absolute priority rule, as it is not at issue in this case.”
The Third Circuit could have considered the issue in *In re Armstrong World Industries, Inc.*, 432 F.3d 507 (3d Cir. 2005), but the parties never raised it, opting instead to rely on other “equitable considerations to allow an exception to the absolute priority rule” that would justify the distribution of warrants under a plan to existing equity holders despite less than full payment to a senior class. In an earlier ruling, *In re PWS Holding Corp.*, 228 F.3d 224 (3d Cir. 2000), the Third Circuit construed 203 North LaSalle in rejecting a challenge to a plan on the basis that releases of affiliates of junior equity allowed the equity holders to receive or retain property “on account of” their junior interests violated the absolute priority rule.

Finally, in *Carrieri v. Jobs.Com Inc.*, 393 F.3d 508 (5th Cir. 2004), the Fifth Circuit cited 203 North LaSalle in affirming lower court rulings that shares of stock (with a redemption provision) and warrants (with a repurchase provision) are properly characterized as “equity securities” instead of “claims,” such that the absolute priority rule precluded any distribution under a plan to the shareholders absent payment in full of creditor claims.

In *Castleton Plaza*, the Seventh Circuit broke new ground by explicitly expanding the scope of the absolute priority rule to preclude plan distributions to parties closely affiliated with members of a junior class and by expressly applying 203 North LaSalle’s mandate that the adequacy of proposed new value be subject to competition.

Several lower courts previously have addressed the competition element of the new value exception. For example, in *H.G. Roebuck & Son, Inc. v. Alter Communications, Inc.*, 2011 BL 147642 (D. Md. June 3, 2011), the court ruled that a “new value” chapter 11 plan without any
market valuation of equity to be retained by existing shareholders and without any opportunity for a competing plan violated the absolute priority rule, consistent with *203 North LaSalle*. *See also In re RTJJ, Inc.*, 2013 BL 31910 (Bankr. W.D.N.C. Feb. 6, 2013).

According to *203 North LaSalle* and *Castleton Plaza*, competition means: (i) a competitive bidding process for new equity to be distributed under a chapter 11 plan; or (ii) the opportunity for other stakeholders to propose a competing plan (presumably by termination of exclusivity if it has not already expired). At this juncture, the ramifications of this approach, if adopted by other courts, are unclear. At the very least, it may open the door for enhanced creditor recoveries by subjecting the adequacy of new value contributions to the market—to the extent there is one. In addition, it is not clear exactly what it means to expose the equity to a competitive process. What affirmative measures does a debtor need to take in order to satisfy the requirement? Is there a requirement to make such a showing in the absence of an absolute priority objection?

A bankruptcy court in the Seventh Circuit has already applied *Castleton Plaza* to preclude confirmation of a new value plan providing for distribution of new equity to an insider without competition. *See In re GAC Storage Lansing, LLC*, 2013 BL 53422 (Bankr. N.D. Ill. Feb. 27, 2013) (“In light of the *Castleton* decision, the Court determines that the absolute priority rule applies, despite the fact that Schwartz is not a direct owner or investor. The Debtor’s Plan proposes to give Schwartz, an insider of the Debtor, preferential access to an investment opportunity in the Reorganized Debtor and is therefore subject to competitive bidding, as the holding in *Castleton* instructs.”), vacating and superseding *In re GAC Storage Lansing, LLC*, 2013 BL 8095 (Bankr. N.D. Ill. Jan. 10, 2013).