

# Management Alert



## Seventh Circuit mandates an “auction process” in “new value” Chapter 11 plans.

### The Issue

In *In re Castleton Plaza, LP*, the Seventh Circuit became the first court of appeals to (1) address the “new value” exception to the “absolute priority rule” since the U.S. Supreme Court in *Bank of America Nat. Trust and Sav. Ass’n. v. 203 N. LaSalle St. Partn.*, 526 U.S. 434 (1999) (“203 N. LaSalle”) and (2) mandate competitive bidding - through an auction process - when an insider proposes a “new value” contribution. As such, the *Castleton* decision strengthens a secured lender’s ability to contest undervalued, “new value” chapter 11 plans, while creating additional roadblocks for debtors seeking cramdown over an objecting secured lender. As discussed below, these kinds of plans are typically offered by debtors seeking to protect their equity owners in single asset real estate (“SARE”) cases. Coupled with the United States Supreme Court’s decision in *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065 (2012) (upholding a secured lender’s absolute right to credit bid the full amount of its secured claim), this Seventh Circuit decision offers secured lenders additional strategies to maximize recoveries in chapter 11 bankruptcy cases.

### The Legal Precedent

The absolute priority rule found in Bankruptcy code section 1129(b)(2)(B)(ii) precludes a holder of a junior claim or interest, such as an existing equity holder (“Old Equity”), from receiving any distribution under a nonconsensual chapter 11 plan on account of its claim or interest unless all objecting senior creditors are paid in full. A judicially developed exception to the absolute priority rule, called the “new value exception,” allows Old Equity to purchase the newly-issued equity interests in the debtor (“New Equity”) under a nonconsensual plan, so long as Old Equity contributes “new value” in the form of a capital contribution to the debtor.

The Seventh Circuit previously addressed these issues in *In re Wabash Valley Power Ass’n*, 72 F.3d 1305 (7th Cir. 1995) and as the appellate court of record in *203 N. LaSalle*. In *Wabash Valley*, the Seventh Circuit noted that “[t]he common thread running through cases involving the absolute priority rule is a refusal to allow prior equity owners to trade on their ‘insider’ status to acquire new equity for less than its value.” *Wabash Valley*, 72 F.3d at 1315. In *203 N. LaSalle*, the Supreme Court clarified that a new value, chapter 11 plan - involving contributions by Old Equity - must include an opportunity for competitive bidding in order to satisfy the absolute priority rule. See *203 N. LaSalle*, 526 U.S. at 454-55. As the Supreme Court expressly held, “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, renders the partners’ right a property interest extended ‘on account of’ the old equity position and therefore subject to an unpaid senior creditor class’s objection.” *Id.* at 456. Consequently, under *203 N. LaSalle*, a new value contribution that is not tested by exposure to the market will be found to have been granted “on account of” the equity holder’s prior interest and therefore would violate the absolute priority rule (following a senior creditor’s objection).

### Background

In *In re Castleton Plaza, LP*, the debtor owned a shopping center in Indiana and was controlled by an individual who held 100% of its Old Equity through direct and indirect investments. During its case, debtor proposed an amended chapter

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11 plan that, among other things, called for the sole owner's spouse to have the exclusive right - with no auction - to "purchase" the debtor's New Equity in exchange for a \$375,000 new value contribution. After the debtor rejected the secured creditor's offer to purchase the New Equity for \$600,000, the secured creditor objected to debtor's amended plan. The bankruptcy court overruled the objection, finding that competitive bidding was not required because the spouse, although an insider, was not Old Equity. Therefore, the bankruptcy court concluded that the absolute priority rule did not apply because Old Equity was not receiving or retaining any property under the plan. The bankruptcy court certified the matter for direct appeal to the Seventh Circuit.

## The Decision

The Seventh Circuit, in reversing the bankruptcy court, held that competitive bidding is required under *203 N. LaSalle* in any "new value" plan. In arriving at this conclusion, the Seventh Circuit noted that insiders are often treated the same as Old Equity under the Bankruptcy Code. The Seventh Circuit then analyzed several factors and concluded that *Castleton's* sole equity-holder would receive or retain property by permitting his spouse to purchase the New Equity without a market test. Accordingly, the Seventh Circuit concluded that the sole equity-holder's control over the plan's details was akin to receiving or retaining property under the plan in violation of the absolute priority rule. Finally, the Seventh Circuit also clarified that the plan must be amended to permit competitive bidding (rather than just competing plans), which in light of *RadLAX Gateway Hotel*, would allow secured creditors to credit bid the full amount of their secured claims to purchase their collateral.

## Implications

The *Castleton Plaza* decision represents a major victory for secured creditors in SARE cases. In those cases, Old Equity often seeks to maintain ownership and control of debtor's real property to the detriment of debtor's secured and unsecured creditors. To satisfy the absolute priority rule, many SARE debtors formulate chapter 11 plans predicated on Old Equity offering "new value" in exchange for the New Equity. These plans often propose: (i) retention of real property collateral with little or no equity; (ii) extension of maturity dates, reduced interest rates, and interest only payments to secured lenders; (iii) a limited recovery to unsecured creditors, including the deficiency claims of secured creditors; and (iv) retention of New Equity in a reorganized debtor in exchange for *de minimus* new value contributions.

In response, objecting creditors typically argue that Old Equity cannot acquire the New Equity in a reorganized debtor without competitive bidding. In the face of these objections, the *Castleton* decision should force competitive bidding and potentially eliminate Old Equity's control over the process. In sum, we expect *Castleton* to provide solid legal precedent favoring secured creditors in SARE bankruptcy cases across the country.

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