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An Insider’s Guide to Evading Absolute Priority? Seventh Circuit: New Value Competition Requirements Apply to Insiders

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In Chapter 11 bankruptcy cases, the absolute priority rule requires a debtor’s creditors be paid in full before equity investors receive any value. However, existing equity investors occasionally seek to invest new money in the plan of reorganization process and argue that such investment justifies retention of equity in the reorganized company; equity which otherwise would pass to impaired creditors. In 1999, the Supreme Court examined this “new value” argument, holding that valuing a new investment requires competition: if a reorganization plan rewards a new investment with equity in the reorganized company, other potential investors must be allowed to bid to determine the market value of that equity. *See Bank of America National Trust & Savings Ass’n v. 203 North LaSalle Street Partnership*, 526 U.S. 434 (1999). So long as the equity is valued through an auction and the equity investor pays the market-set rate, the absolute priority rule is not violated.

Since *203 North LaSalle*, Bankruptcy judges have disagreed on whether the absolute priority rule bars insiders from purchasing equity absent this competitive process. The argument: absolute priority requires creditors be paid in full before *equity investors* receive anything, an insider is not an equity investor, therefore the rule does not apply and an auction is unnecessary. In *In re Castleton Plaza, LP*, 2013 U.S. App. LEXIS 3185 (7th Cir. 2013), the Seventh Circuit clarified the reach of the competitive process and the absolute priority rule, requiring insiders bear the same burdens as equity investors.

The facts of ***Castleton Plaza*** are simple. George Broadbent (“George”) owned 100% of Castleton Plaza (the “Debtor”). The Debtor had one secured creditor, EL-SNPR Notes Holdings (the “Creditor”), which had extended a roughly $10 million loan (the “Loan”). The Debtor defaulted on the Loan, declared bankruptcy and George proposed a plan which modified the Loan and provided 100% of the equity go to Mary Clare Broadbent (“Mary”), George’s wife, upon her investment of $75,000 (eventually increased to $375,000). The Creditor argued that the equity was undervalued and offered $600,000. The Bankruptcy Court confirmed George’s plan, holding that the $375,000 investment need not be subjected to the competitive process; Mary did not previously own an equity interest, therefore absolute priority was not violated as contemplated in 203 North LaSalle. The Creditor objected.

On appeal certified directly to the Seventh Circuit, the court overturned the bankruptcy court’s decision and explained that the competition requirement exists to curtail evasion of the absolute priority rule. While Mary was not an equity investor, other areas of bankruptcy law treat insiders the same as equity investors, and a new-value plan which bestows equity on an investor's spouse certainly has the same evasive effect. If auctioned, the equity would have fetched more than $375,000 (as evidenced by the Creditor's $600,000 offer) and the difference between the higher bid and the $375,000 paid was value the Broadbents gained at the expense of the estate. "It 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."

Ultimately, this decision is unsurprising; the direct link between husband and wife highlights the abusive nature of non-competitive insider "new value" equity purchases. However, query whether the decision went even further by implying that the absolute priority rule requires a competitive process regardless of the equity recipient.

In bolstering its conclusion that the debtor cannot direct its equity to an insider without first having undergone a competitive process, the Seventh Circuit targeted analogous rules of tax and trust law to categorize George's *power to direct* the equity in his plan as value, explaining that "[s]ince the exercise of a power of appointment is treated as income in tax law, it should be treated as income for the purposes of §1129(b)(2)(B)(ii) [the absolute priority rule]. Thus, under the plan of reorganization, George receives value on account of his investment, which gave him control over the plan's details." The court pinpoints the value George received: "power of appointment" and "control over the plan's details." The question becomes: by virtue of this measure of value, must a debtor have a competitive process any time it proposes a plan that does not purport to pay creditors in full? Only time will tell.

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