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The Seventh Circuit Expands Scope of Absolute Priority Rule to Protect Creditors

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In a recent decision, *In re Castleton Plaza, LP*, 2013 WL 537269 *1 (Feb. 14, 2013), the Seventh Circuit held that the absolute priority rule – which requires that creditors be paid in full before equity holders receive anything on account of their equity interests under a plan of reorganization – applies equally to the "insiders" of a debtor. In so holding, the Seventh Circuit is accused of extending the scope of the absolute priority rule to the point that it threatens the ability of debtors to reorganize. However, the Court's holding merely requires that any non-consensual reorganization plan that leaves creditors unpaid and proposes to distribute equity to insiders be subject to competition, as mandated by the U.S. Supreme Court in *Bank of American National Trust & Savings Ass'n v. 203 North LaSalle St. P'ship*, 526 U.S. 434 (1999). This competition requirement preserves the Bankruptcy Code's priority scheme to ensure that creditors are paid before equity holders, and protects creditors from creative efforts by equity holders to funnel value to insiders in the face of creditor dissent.

The so-called "absolute priority rule" prohibits equity holders from retaining or receiving anything under a plan of reorganization "on account of" their pre-petition equity interests unless all senior classes of claims have consented or until any dissenting creditors have been paid in full. 11 U.S.C. § 1129(b)(2)(B)(ii). However, under the "new value exception," equity holders can receive equity in a reorganized entity if they contribute "new value" post-petition to the debtor's bankruptcy estate. For this exception to apply, the Supreme Court has held that the opportunity to contribute new value cannot be made available exclusively to equity holders without any competition. *LaSalle*, 526 U.S. at 453-55.

In this case, *Castleton Plaza*, whose sole asset was a shopping center in Indiana, filed for bankruptcy protection after defaulting on a $10.2 million secured loan. Its proposed plan of reorganization (the *"Plan"*) reduced the secured claim to $8.2 million (the value ascribed to the shopping center by the Bankruptcy Court), with the rest treated as an unsecured claim (to be paid 15 cents on the dollar). The Plan cancelled all equity interests, including those of Mr. George Broadbent, who held 98% of the pre-petition equity, but transferred the equity in the reorganized entity to Mr. Broadbent's wife in exchange for a "new value" contribution of $75,000 (later increased to $375,000). EL-SNPR Notes Holdings, LLC, the secured creditor, objected to the Plan and, believing the assets had been undervalued, offered to purchase the equity for $600,000. No other creditor objected. The debtor rejected the offer, and the Bankruptcy Court confirmed the Plan over the secured creditor's objection, finding that the debtor was not required to subject Mrs. Broadbent's new value acquisition of the equity in the reorganized company to competitive bidding.

On direct appeal, the Seventh Circuit reversed the Bankruptcy Court, holding that the debtor could not avoid the requirements of the absolute priority rule and the associated restrictions upon new value plans by arranging for the new value to be contributed by, and the equity in the reorganized company to go to, an "insider" of the debtor. The Court reasoned that the competition requirement of *LaSalle* was meant to "curtail evasion of the absolute-priority rule" and that a plan that granted equity to an investor's spouse could violate the absolute priority rule to the same extent as a plan that granted the equity to the original investor. Mr. Broadbent would receive value under the Plan by virtue of the opportunity offered exclusively to his wife to purchase the equity in the reorganized debtor, and, consequently, the Plan had to be subjected to competitive bidding.

On March 7, 2013, the debtor filed a motion seeking rehearing of the Seventh Circuit's decision *en banc*. Essentially, the debtor argues that the Court has improperly expanded the absolute priority rule to apply to insiders, and has misconstrued the *LaSalle* market test to make competitive bidding the only means of evaluating new value. The debtor also takes issue with the Court's finding that creditors can bid the value of their loans during such bidding. Instead, in order to address concerns about an insider paying a fair price for the equity, the debtor suggests that a bankruptcy court be required to either evaluate the transfer with stricter scrutiny (like the Bankruptcy Court did here) or terminate the debtor's exclusivity to permit competing plans to be filed.

The Seventh Circuit's decision addresses the dangers of permitting a debtor's insiders to obtain new equity without competition and emphasizes that regardless of who contributes new value to a plan of reorganization, such a plan must be subject to competition. In addition, the decision suggests that terminating a debtor's exclusivity is insufficient competition -- *Castleton Plaza* had permitted exclusivity to terminate, yet the Court found that the Plan had not been tested and remanded the case to the Bankruptcy Court for competitive bidding. In doing so, the Seventh Circuit makes a strong statement to creditors that their priority in payment will be protected.

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