ALERTS

Seventh Circuit Extends Competition Rule to Insider in New-Value Reorganization Plan

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The U.S. Court of Appeals for the Seventh Circuit, on Feb. 14, 2013, held that an insider of a Chapter 11 partnership debtor cannot avoid the "competition rule" in a new-value reorganization plan. The debtor's equity owner arranged for his wife, also an "insider," to contribute new value to obtain the equity of the reorganized debtor. *In re Castleton Plaza*, LP, — F.3d –––, 2013 WL 537269 at *1 (7th Cir., Feb. 14, 2013). In so holding, the Seventh Circuit overruled the bankruptcy court and confirmed that a competitive process is "essential" whenever a plan leaves an objecting creditor unpaid but distributes an equity interest to an insider. *Id.*

The Competition Rule

The Supreme Court established the so-called competition rule in *Bank of America Nat'l Trust and Savings Ass'n v. 203 N. LaSalle Street P'ship*, 526 U.S. 434 (1999) (*203 N. LaSalle*). Applying the absolute priority rule embodied in § 1129(b)(2)(B)(ii) of the Bankruptcy Code ("Code"),[1] the Court held that current equity holders of a debtor cannot, over the objections of impaired senior creditors, contribute new capital and receive ownership interests in the reorganized entity when that opportunity is given exclusively to those equity holders without consideration of alternatives. *See203 N. LaSalle*, 526 U.S. at 435. As the majority explained, "it is that the exclusiveness of the opportunity, with its protection against market 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 objections." *Id. at 456.* Accordingly, "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) [in violation of the absolute priority rule]." *Id. at 458.*

The Seventh Circuit in *Castleton* expanded *203 N. LaSalle* to apply to insiders of the debtor, not just equity holders.

Who is an Insider?

The Seventh Circuit held that its holding applied to insiders, as that term is defined in the Code. *SeeCastleton*, 2013 WL 537269 at *1. "Insider" is defined in section 101(31) of the Code to include officers and directors, but does not purport to be exhaustive. In particular, paragraph (C)(ii) of section 101(31) includes as an insider a "relative of a general partner in, general partner of, or person in control of the debtor."11 U.S.C. 101(31)(C)(ii). Thus, the wife of the person owning 100 percent of the debtor's direct and indirect equity interests is, under Code § 101(31), an insider.[2]

Facts

The debtor, Castleton Plaza, was a single-asset real estate entity that owned a shopping center in Indiana. *Castleton*, 2013 WL 537269 at *1. The equity owner, an individual, held 98 percent of Castleton's equity directly and two percent indirectly. *Id.* The debtor had one secured lender ("Lender"). Lender held a $9.5 million note that had matured before the debtor's bankruptcy filing. *Id.* The debtor did not pay and instead filed a Chapter 11 petition. *Id.*

The debtor proposed a reorganization plan proposing to pay Lender $300,000 on the plan's effective date, writing the balance of the debt down to about $8.2 million and treating the difference as unsecured. *Id.* The $8.2 million secured loan would be extended with a reduced interest rate, but with virtually no repayment for about eight years. *Id.* Any extra security features of the note (e.g., lockbox arrangements) would be abolished. *Id.*

The plan nominally left the equity holder with nothing, presumably recognizing the absolute priority and competition rules from *203 N.*

LaSalle that would require an auction before he could receive any equityon account of a new investment. *Id.* The debtor's plan provided, however, that 100 percent of the equity in the reorganized debtor would be issued to the equity holder's wife for an investment of $75,000. *Id.* The wife also owned all the equity in a corporation (of which the equity holder was the CEO) that managed the debtor under a management contract. *Id.*

Lender, believing that the debtor's assets were undervalued by the plan, offered $600,000 for the equity and to pay all other creditors in full. *Id. at *2.* In contrast, the debtor's plan offered a 15 percent recovery for unsecured claims. *Id.* The debtor rejected the offer, but revised the plan to increase the wife's investment to $375,000. *Id.* Lender asked the bankruptcy court to subject the wife's bid to an open competition process and to condition confirmation on her winning that process. *Id.* The bankruptcy court held that competition was unnecessary and confirmed the debtor's revised plan. *Id.*

Issue and Ruling

On direct appeal to the Seventh Circuit, the issue was "whether competition is essential when a plan of reorganization gives an insider an option to purchase equity in exchange for new value." *Id.*

The bankruptcy court had held that competition was unnecessary because the wife owned no equity interest in the debtor and because Code § 1129(b)(2)(B)(ii) deals only with the "holder" of a claim or interest that is junior to the impaired creditor's claim. *Id.* In reversing this decision, however, the Seventh Circuit noted that the competition rule meant "to curtail evasion of the absolute priority rule." *Id.*

> 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 new investor. For many purposes in bankruptcy law, such as preference recoveries … an insider is treated the same as an equity investor. Family members of corporate managers are insiders under § 101(31)(B)(vi). In 203 N. LaSalle the Court remarked on the danger that diverting assets to insiders can pose to the absolute-priority rule … 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.

Id. (internal citations omitted; emphasis added).

The Court then reviewed various ways in which the equity holder himself would receive value from the equity to be issued to his wife. *Id. at *2-3.* Because the equity holder would receive value on account of his investment, he would also have control over the plan. *Id. at *3.* Therefore, the Court explained, "[t]he absolute-priority rule therefore applies despite the fact that [the wife] had not invested directly in [the debtor and] [t]his reinforces our conclusion that competition is essential." *Id.*

Application of the competition rule from *203 N. LaSalle* did not depend on the debtor's proposing the plan during its exclusivity period or on the identity of the plan proponent. Instead, said the Court, "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." *Id.*

Conclusion

In sum, a new-value plan granting equity to insiders contributing new capital, but leaving creditors impaired, cannot be confirmed by a court over the objection of creditors unless the insider's contribution is subjected to a competitive process. *Castleton* expands the competition rule soundly to insiders. Proponents of new-value plans (whether the debtor or another interested party) cannot skirt the competition rule by merely channeling the new value through an insider.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] The absolute priority rule, described by the Supreme Court in *203 N. LaSalle*, has at its "core" Code § 1129(b)(2)(B)(ii). Specifically, "[a]s to a dissenting class of impaired unsecured creditors … a plan may be found to be 'fair and equitable' only if the allowed value of the claim is to be paid in full, § 1129(b)(2)(B)(i), or, in the alternative, *if 'the holder of any claim or interest that in junior to the claims of such [impaired unsecured] class will*

not receive or retain under the plan on account of such junior claim or interest any property,' § 1129(b)(2)(B)(ii)" (emphasis added). *203 N. LaSalle*, 526 U.S. at 441-2.

[2] For purposes of its opinion, the Court apparently viewed the distinction between a corporation and partnership as immaterial. *SeeCastleton*, 2013 WL 537269 at *2 ("Family members of corporate managers are insiders under § 101(31)(B)(vi).").

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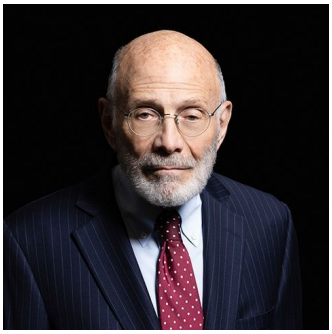

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