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EXPERT ANALYSIS

# *Castleton Plaza* — A Range of Implications for 'New Value' Plans

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In 1999 the U.S. Supreme Court held in *Bank of America National Trust & Savings Association v. 203 North LaSalle St. Partnership* that any "new value" equity holders' offer to re-vest their ownership interest under a plan of reorganization must be subject to competition in order to comply with the "absolute priority" rule under Section 1129(b)(2)B(ii) of the Bankruptcy Code.[1]

The 7th U.S. Circuit Court of Appeals recently expanded on the new-value competition concept in *In re Castleton Plaza*, where it found that any new equity interest to be taken by an insider under a Chapter 11 plan must also be open to competition.[2]

The conclusion was undoubtedly appropriate in *Castleton*, which dealt with the spouse of the debtor's owner taking equity in the reorganized debtor. However, the holding has broader implications because it:

- Indicates that a right to bid on equity is definitively necessary to satisfy the absolute-priority rule in circumstances where prior owners offer a contribution for equity in the reorganized debtor.
- Increases the potential evidentiary issues for new-value plans.
- Potentially chills interest of new investors who might have ties to a debtor's prior ownership.

## FACTUAL BACKGROUND AND THE COURT'S REASONING

Castleton Plaza owned a shopping center in Indiana. A single individual, George Broadbent, directly held 98 percent of the equity in the company and held the remaining 2 percent indirectly.[3]

Castleton filed a plan of reorganization that sought to cram down on its senior secured lender by:

- Paying $300,000 of the lender's secured debt immediately.
- Writing down the balance of the secured debt to roughly $8.2 million, secured by a 30-year note with a lowered interest rate and removing additional security features (such as a rental lockbox and approval rights).
- Giving the lender an unsecured claim for the balance of the indebtedness.[4]

Castleton's plan also provided that all equity in the reorganized debtor would go to Broadbent's wife for an initial investment of $75,000. The plan provided that Broadbent would not retain any equity in the company and disclosed that the reorganized Castleton would continue to operate under a management contract with an entity wholly owned by Broadbent's wife, and through which Broadbent received an annual salary of $500,000 as the company's CEO.[5]

The lender objected to the plan, claiming the $75,000 investment price was too low, and instead the lender offered $600,000 for the equity in the reorganized debtor.[6] Although Broadbent's wife ultimately raised her proposed new-value investment to $375,000 under the plan, the lender still objected to the plan and instead argued that the equity interest in the reorganized debtor should be open to bidding.[7]

Despite the lender's objections, the Bankruptcy Court held that competition for the equity in the reorganized Castleton was unnecessary under the guidelines of *203 North LaSalle* because Broadbent's wife did not previously own any equity in the debtor.[8] The Bankruptcy Court further found that "Congress easily could have explicitly included insiders in the statute's detailed language" but chose not to do so.[9]

Accordingly, the Bankruptcy Court determined "[t]he exclusive sale of equity interests in a reorganized debtor was neither addressed nor prohibited in *LaSalle*, and is not contrary to the plain language of Section 1129(b)(2)(B)(ii). The court concludes that the absolute-priority rule does not apply to insiders who are not prepetition owners."[10]

The 7th Circuit disagreed with the Bankruptcy Court's reasoning and found that *203 North LaSalle* "devised the competition requirement to curtail evasion of the absolute-priority rule. 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."[11]

*"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," the 7th Circuit said.*

The appeals court pointed out that Broadbent himself would receive value from the equity his wife would obtain under the plan because he would continue to receive his salary as CEO of the company that managed the debtor's operations; the family's wealth would increase based on his spouse's equity interest; and Broadbent set the investment price and offered it only to his wife, which gave value to the family because it was less than the investment would cost in a competitive market.[12]

Thus, for the *Castleton* plan to go forward, the reorganized debtor's new equity had to be subject to bidding.

## *CASTLETON'S* IMPACT

The *Castleton* decision[13] will most certainly impact new-value plans going forward by:

- Expressly requiring an open bidding process to determine the propriety of a prior equity holder's proposed contribution.
- Raising the evidentiary bar for proponents of a new-value plan in certain circumstances.
- Possibly chilling new investors' interest in a reorganized debtor.

### *Bidding on new contributions from old equity is likely necessary*

One impact of the *Castleton* decision is requiring that new-value plans provide for an open process for bidding on the equity in the reorganized debtor, regardless of whether an opportunity was given to offer a competing plan.

The Supreme Court's decision in *203 North LaSalle* did not resolve whether the need for a "market test" for an equity holder's proposed contribution could be satisfied by giving other parties the opportunity to offer a competing plan.[14]

This question was implicitly answered in *Castleton*, however, when the court stated it was irrelevant whether the plan was proposed during the exclusivity period or who proposed the plan.[15]

The 7th Circuit made it clear that "[c]ompetition 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."[16]

 

The court, therefore, seemingly dismissed the opportunity to file a competing plan as a way to satisfy the "market test" requirement set forth in *203 North LaSalle*.

### *A higher evidentiary requirement for new value plans*

*Castleton* also influenced the confirmation process for new-value plans by requiring an analysis of whether any proposed equity holder is an insider of the debtor. The insider status of the new equity holder was unquestionable in the *Castleton* case, but the answer will not be as clear-cut in future cases.

A substantial evidentiary showing could be necessary in many instances because the 7th Circuit has previously stated the insider analysis is a case-by-case decision based on the totality of the circumstances. An insider can include anyone with a "sufficiently close relationship with the debtor [such] that his conduct is made subject to closer scrutiny than those dealing at arm's length with the debtor."[17]

A debtor must be cognizant of this requirement when proposing a new-value plan and determine whether the plan should include a bidding process for equity in the reorganized debtor. Similarly, creditors should scrutinize any proposed outside investor under a new-value plan to determine whether the investor would be considered an insider. Finding the answer to this question could be a long and tedious exercise, but it may determine whether a proposed plan satisfies the absolute-priority rule.[18]

### *Potential chilling effect for new investors with ties to old equity*

The 7th Circuit's ruling in *Castleton* was undoubtedly appropriate under the facts in that case, as the debtor's principal was attempting to circumvent the absolute-priority rule by giving the equity in the reorganized debtor to his spouse.

But the decision could have the unintended consequence of chilling investors' interest in reorganized debtors if they have ties with the company's existing ownership, because the contribution of *any* insider must be subjected to a competitive bidding process.

Investing in a company that is in bankruptcy is inherently fraught with risk and requires an investor to become comfortable with the unsettling prospect of owning a company that has already failed once. The potential investor may accept the level of risk because of a historical familiarity with the debtor's operations, as a customer, competitor or some other relationship with the company or its ownership.

If a prior relationship is such that the potential investor could be considered an insider of the debtor, *Castleton* dictates that the investor's proposed investment must be subject to an open auction. This requirement could deter potential investors because of the possibility of being outbid for the equity. Understandably, an investor does not want to commit valuable time and resources to the process if there is a realistic prospect of being outbid.[19]

On the other hand, courts must protect creditors against the possibility that a creative debtor will try to satisfy the text of the absolute-priority rule while still retaining its equity interest in the reorganized debtor.

This concern can be addressed without exposing all insider investments to the market by focusing on whether the old equity holders are receiving or retaining anything on account of their prior equity, which was a central focus of *203 North LaSalle*.

The value of old equity derived from the transaction was also analyzed in *Castleton*, and the court found that old equity was receiving value in three ways: a sizeable salary from a management company that would continue to operate the debtor, an increase in the family's wealth from the spouse's equity in the reorganized debtor, and the right to set the investment price and choose to whom it would be offered.

*The insider status of the new equity holder was unquestionable in the Castleton case, but the answer will not be as clear-cut in future cases.*

These findings alone were sufficient to conclude the plan violated the absolute-priority rule and may have avoided the need to determine that all insider investments under new-value plans must be exposed to the market.

## CONCLUSION

The *Castleton* decision will undoubtedly affect the crafting and confirmation of new-value plans. Both debtors and creditors should be aware of the new issues arising from the decision when dealing with such plans.

## NOTES

[1] *See Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship,* 526 U.S. 434, 456-58 (1999).

[2] *In re Castleton Plaza LP*, 707 F.3d 821, 822-23 (7th Cir. 2013).

[3] *Id.* at 822.

[4] *Id.*

[5] *Id.*

[6] *Id.*

[7] *Id.*

[8] *Id.* at 822-23.

[9] *In re Castleton Plaza LP*, No. 11-01444-BHL-11, Docket No. 285, ¶ 95 (Bankr. S.D. Ind.).

[10] *Id.*

[11] *In re Castleton*, 707 F.3d at 823.

[12] *See id.*

[13] Castleton has filed a petition for a writ of *certiorari* with the U.S. Supreme Court, but the high court has not yet reached a decision on that request.

[14] *203 N. LaSalle*, 526 U.S. at 458 (stating "[w]hether a market test would require an opportunity to offer competing plans or would be satisfied by a right to bid for the same interest sought by old equity is a question we do not decide here").

[15] *See In re Castleton*, 707 F.3d at 824.

[16] *See id.* (emphasis in original).

[17] *See In re Longview Aluminum LLC*, 657 F.3d 507, 509 (7th Cir. 2011); *see also In re Three Flint Hill LP*, 213 B.R. 292, 298 (D. Md. 1997) (citing *In re Chas. P. Young Co.*, 145 B.R. 131, 136 (Bankr. S.D.N.Y. 1992), and stating that bankruptcy determination as to whether a person or entity is an insider is a fact-intensive, ad hoc analysis that hinges on the closeness of the relationship of the parties).

[18] The potential for a complicated factual inquiry can be demonstrated by an opinion that was published shortly after the 7th Circuit's ruling. *In In re GAC Storage El Monte LLC*, 489 B.R. 747, 767 (Bankr. N.D. Ill. 2013) (internal citations omitted), the Bankruptcy Court cited *Castleton* when evaluating a potential new-value plan and then analyzed the insider issue by stating:

> The current ownership structure of the debtor is as follows: The debtor is owned by GAC Storage LLC which holds a 50 percent membership interest, and GAC Storage El Monte Holding Co. LLC which holds the remaining 50 percent membership interest. GAC Storage LLC is owned by D.M.S.I. LLC, Sunset Storage Partners LC, and Silver Valley Investments LLC. GAC Storage El Monte Holding Co. LLC is owned by JAND Investments, D.M.S.I. LLC, David Dahan & Yaffa Dahan, TAD 1993 Family Trust, Drorit Investments Ltd., Orit Sprecher, Ofra Kestenbaum, Erez Schwartz, Ronit Alkalay and Mike Mercer. Ronnie Schwartz is the secretary of Great American Capital Inc., which is the manager of D.M.S.I. LLC. Ronnie Schwartz, who will be the sole and managing member of the reorganized debtor, holds a beneficial interest in the TAD 1993 Family Trust.
>
> Given the ownership structure of the debtor, it is clear that Schwartz is an insider within the meaning of Section 101(31)(B)(iii) as a person in control of the debtor. He is partial owner of GAC Storage El Monte Holding Co. LLC through the TAD 1993 Family Trust in which he holds a beneficial interest as the trust is an owner of GAC Storage El Monte Holding Co. LLC.

[19] Of course, the same is true in a sale process, but the opening "stalking horse" bidder is oftentimes protected through mechanisms such as breakup fees and expense reimbursements that are largely foreign in the context of new value plans. These concepts could theoretically be incorporated into a plan confirmation process, but would add time and expense to an already complicated procedure.

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