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Supreme Court Declines to Review Seventh Circuit's Decision in *Castleton Plaza* Requiring Competitive Bidding for "New Value" Plan Benefiting an Insider Who Does Not Hold an Equity Interest in the Debtor

On October 7, 2013, the United States Supreme Court refused to review a Seventh Circuit decision[1] in the Castleton Plaza, LP case, which held that a new value plan proposed by the debtor in which an equity-holder's spouse would provide a cash infusion to the debtor in exchange for 100 percent of the reorganized debtor's equity must allow for competitive bidding to satisfy the absolute priority rule. The Seventh Circuit's decision provided circuit-level guidance for the first time on two unique issues that often arise in cases where a debtor seeks to keep control of a business: whether providing value under a plan to an "insider" that is not an equity-holder, but that indirectly benefits an equity-holder, violates the absolute priority rule; and whether terminating a debtor's exclusive period to propose a plan of reorganization is sufficient to address such a violation if it does.

The Supreme Court's refusal to hear Castleton Plaza's appeal comes as a victory for creditors as the Seventh Circuit's opinion is the first appellate-level opinion to address whether a competitive auction is required when a debtor's plan of reorganization provides an "insider" that does not hold an equity interest in the debtor with an exclusive option to purchase equity in exchange for new value since the Supreme Court's landmark decision in *203 N. LaSalle*[2] more than a decade ago.

In *203 N. LaSalle*, the Supreme Court analyzed the "absolute priority rule" found in § 1129(b)(2) of the Bankruptcy Code,[3] which essentially provides that to be fair and equitable to a non-consenting class of creditors, a plan of reorganization cannot provide "value" to the holder of a junior interest unless and until all senior interest-holders are paid in full. The plan at issue in *203 N. LaSalle* provided existing equity with the exclusive right to purchase the equity in the reorganized debtor. The Supreme Court made clear in *203 N. LaSalle*, however, that plans that provide exclusive opportunities, such as the opportunity to purchase the equity in the reorganized debtor, free from competition and without benefit of market valuation are prohibited by § 1129(b)(2)(B)(ii) of the Bankruptcy Code.[4]

In *Castleton Plaza*, the debtor sought to avoid having to subject the sale of the new equity to the market to see if another party would agree to contribute more, thereby benefitting creditors, by having the equity in the reorganized debtor issued to the equity-holder's wife, instead of the equity-holder himself. The debtor's largest creditor, who the debtor was looking to cram down under the plan, objected to

[1] *See In re Castleton Plaza, LP*, 707 F.3d 821 (7th Cir. Feb. 14, 2013).

[2] *See Bank of America Nat. Trust and Sav. Ass'n. v. 203 North LaSalle Street Partnership*, 526 U.S. 434 (1999) ("*203 N. LaSalle*").

[3] References herein to the "Bankruptcy Code" are to title 11 of the United States Code.

[4] *203 N. LaSalle*, 526 U.S. at 454-55.

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confirmation and urged the bankruptcy court to allow competitive bidding for the equity in the reorganized debtor and that failure to provide for competitive bidding would be a violation of the absolute priority rule. The bankruptcy court held that competition for the equity of the reorganized debtor was unnecessary because the plan did not propose to give any value to the equity-holder himself in violation of § 1129(b)(2)(B)(ii) of the Bankruptcy Code.

The Seventh Circuit disagreed, reasoning that the Supreme Court intended the competition requirement to curtail evasion of the absolute priority rule. Analogizing the "value" being received by the equity-holder to other forms of value recognized under tax law as "income," the Seventh Circuit extended the reasoning in *203 N. LaSalle* to the proposed investment of new value by an insider that does not hold an equity interest in the debtor if the current equity-holder would benefit as a result.[5] This conclusion is consistent with other circumstances under the Bankruptcy Code where a statutory insider is treated in the same manner as an equity investor.

The Seventh Circuit, however, ventured a step further than the Supreme Court in *203 N. LaSalle* and concluded that not only is competition essential prior to confirmation of a new value plan, but such competition should also come in the form of an auction for the new equity. In *203 N. LaSalle*, the Supreme Court refused to decide whether a competitive market test would "require an opportunity to offer competing plans [of reorganization] or would be satisfied by a right to bid for the same interest sought by old equity."[6] Without providing a lengthy analysis on the issue, the Seventh Circuit remanded the case back to the bankruptcy court with instructions to open the proposed plan to competitive bidding at an auction to ensure that the debtor's estate and creditors maximized their recoveries.

In its court papers, Castleton Plaza argued that the Seventh Circuit's holding contradicts the Supreme Court's ruling in *203 N. LaSalle*. The Supreme Court's refusal to entertain the appeal leaves the Seventh Circuit's decision in *Castleton Plaza* the only circuit level opinion applying *203 N. LaSalle*, suggesting, at least to some degree, tacit approval of the Seventh Circuit's analysis.

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[5] *Castleton Plaza*, No. 707 F.3d at 822.

[6] *203 N. LaSalle*, 526 U.S. at 458.

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