AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
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Feature

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Castleton: 7th Circuit's Answer to *203 N. LaSalle*'s Market Test

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A U.S. Supreme Court decision often leaves more questions than answers in its wake, and newfound issues can take years to fully evolve and be addressed. Such is the case with *203 N. LaSalle*, in which the Court initially granted *certiorari* to resolve a circuit split regarding the validity of a "new value corollary" to the absolute priority rule.[1] Not only did the *203 N. LaSalle* Court refuse to definitely decide the new value corollary question[2] (assuming that this corollary existed), but the Supreme Court articulated a market test for any new-value plan, and overtly left unanswered how such a test should be conducted or satisfied.[3]

Not surprisingly, lower courts have subsequently provided varying answers. Many have advocated that a creditor's ability to file its own plan, assisted, if necessary, by the termination of a debtor's plan exclusivity, could by itself satisfy the market test, as competing plans, or even the ability to offer one, sufficiently tested the market for the reorganized debtor's equity. However, the Seventh Circuit rejected this approach in its *Castleton*[4] decision, holding that the need for competition and requirement that the reorganized debtor's equity garner top dollar compel that the equity be subjected to an auction. This article provides an overview of *203 N. LaSalle*'s market test and the divergent approaches taken by courts to satisfy it, culminating with the *Castleton* decision.

The *203 N. LaSalle* Market Test

In *203 N. LaSalle*, the debtor proposed a plan during the initial 120-day plan exclusivity period that allowed its pre-petition equityholders to contribute $6.125 million in new capital in exchange for ownership of the reorganized debtor, while extending its pre-petition lender's secured claim and proposing to pay that lender's unsecured claim at roughly 16 percent of its present value.[5] The bankruptcy court denied the lender's motion to terminate the exclusivity period in order to offer a plan that would liquidate the underlying property and extend the debtor's exclusivity period.[6] The lender also objected to the debtor's plan, requiring confirmation through a "cramdown" under 11 U.S.C. § 1129(b).[7] The bankruptcy court confirmed the debtor's plan, and the Seventh Circuit affirmed, holding that the phrase "on account of" in 11 U.S.C. § 1129(b)(2)(B)(ii) permits a "new value corollary" to the absolute priority rule.[8]

The *203 N. LaSalle* court determined that it was unnecessary to decide the validity of the new value corollary because the plan failed to satisfy the absolute priority rule because the plan exclusively offered the opportunity to acquire the equity in the reorganized debtor to old equity.[9] Likening this exclusivity to the property interest held by an option-holder, the *203 N. LaSalle* court determined that under the plan, old equity impermissibly received this exclusivity "on account of" its pre-petition equity interest, in violation of the absolute priority rule.[10] Moreover, this exclusivity also impermissibly protected old equity's acquisition from market scrutiny, and the debtor could not adequately demonstrate that it had paid the full value for its acquired interest, as "[u]nder a plan granting exclusive right, making no provision for competing bids or competing plans, any determination that the price was top dollar would necessarily be made by a

1 *Bank of Am. Nat. Trust and Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 443 (1999).
2 *Id.*
3 *Id.* at 458.
4 *In re Castleton Plaza LP*, 707 F.3d 821 (7th Cir. 2013).
5 526 U.S. at 440.
6 *Id.* at 439.
7 *Id.* at 441.
8 *Id.* at 442.
9 *Id.* at 443, 454.
10 *Id.* at 456.

judge in bankruptcy court, whereas the best way to determine value is exposure to a market."[11]

Still, although the *203 N. LaSalle* court articulated a market test that must result in top dollar, it refused to specify whether this test could be satisfied by "an opportunity to offer competing plans" or "a right to bid" on the reorganized debtor's equity.[12] Thus, not only did the Supreme Court avoid definitively deciding the validity of the new value corollary, it also left to the lower courts the task of determining the parameters of its newly offered market test, assuming that the new value corollary even existed.

Pre-*Castleton* Cases Favor the Termination of Exclusivity in Response to *203 N. LaSalle*

Faced with defining the contours of this market test, some courts held that the mere opportunity for creditors to offer a competing reorganization plan provided the answer. This stemmed, at least in part, from a line of cases in which bankruptcy courts automatically terminated a debtor's plan exclusivity upon the filing of a new-value plan. For example, in *Situation Management Systems*,[13] an unsecured creditors' committee moved for the termination of the debtor's plan exclusivity period because the debtor filed a new-value plan, even though the plan proposed a mechanism to auction the equity interest in the reorganized debtor. Noting that there was a split in the pre-*203 N. LaSalle* case law regarding whether the proposal of a new-value plan required the termination of a debtor's plan exclusivity, the *Situation Management Systems* court held that the filing of such a plan warranted termination for two reasons.[14]

First, since the plan placed the debtor's equity interests up for competitive bidding, the debtor had forfeited its right to exclusivity because any party could subsequently bid on and, if successful, assume control of the debtor.[15] Second, competing plans — rather than an equity auction — provided a better method for valuing the reorganized equity interest because an approved disclosure statement would provide creditors and equity with better information to make their decisions.[16]

Taking such reasoning one step further, the expiration of plan exclusivity in and of itself was viewed by some bankruptcy courts as satisfying the *203 N. LaSalle* market test. In *Red Mountain*,[17] after the debtor's plan exclusivity had expired, the debtor proposed a new-value plan that failed to pay unsecured creditors in full but allowed its old equity to exchange the $480,000 payable to it under an administrative claim for all of the equity in the reorganized debtor.

At the confirmation hearing, expert testimony established that under a balance-sheet analysis, the reorganized debtor would be insolvent, even with the new-value contribution. The pre-petition lender objected to the new-value contribution as violating the absolute priority rule, claiming that it was insufficient, while failing to challenge the valuation evidence. The *Red Mountain* court overruled this objection, noting that because the plan was proposed after the debtor's plan exclusivity had expired, the debtor could rely solely on the uncontroverted expert testimony showing insolvency. Accordingly, the plan satisfied *203 N. LaSalle*'s "top dollar" requirement, as the new-value contribution exceeded the value of the reorganized debtor's equity.[18] In doing so, the court held that "once exclusivity has expired, the value of the interest being retained should be determined based on either a *pro forma* balance sheet of the reorganized debtor or a capitalization of the reorganized debtor's projected income."[19]

Similarly, the *Cypresswood* court held that the expiration of the debtor's plan exclusivity satisfied the market test when old equity offered uncontroverted testimony that it was paying "more than anyone else would pay."[20] The court reasoned that the objecting creditors' refusal to file their own plans or to even submit offers to purchase the property satisfied the market test, noting that these creditors "chose to sit on their hands and remain inactive despite having ample notice and opportunity to act."[21]

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Not all courts require the termination of plan exclusivity to satisfy the market test. For example, the *Union Financial* court found that a comprehensive alternative bidding process during the debtor's exclusivity period alone satisfied the market test, when this process included (1) two years of pre-petition test marketing, (2) an agreement by all parties that an auction would have been inappropriate, (3) independent directors managing the marketing process with the assistance of independent counsel and professional financial advisors, and (4) the solicitation of bids from 137 firms, all of which resulted in multiple bids reviewed by an independent special committee and financial advisors that determined that no offer was better than the new value proposed in the plan.[22] Given these measures, the *Union Financial* court concluded that the market test "must be evaluated on a case-by-case basis," holding that the plan passed since the extensive alternative bidding process showed that "the market had a reasonable opportunity to outbid [old equity]."[23]

Castleton Court Requires Competitive Auction

In its opening paragraph, the *Castleton* court announced that the Seventh Circuit Court of Appeals's answer to

11 *Id.* at 457.
12 *Id.* at 458.
13 *In re Situation Mgmt. Sys.*, 252 B.R. 859, 860-61 (Bankr. D. Mass. 2000).
14 *Id.* at 864.
15 *Id.*
16 *Id.* (citing *In re SM 104 Ltd.*, 160 B.R. 202, 225 (Bankr. S.D. Fla. 1993)); *see also H.G. Roebuck & Son Inc. v. Alter Commc'n. Inc.*, 2011 U.S. Dist. LEXIS 59781, *25-26 (D. Md. 2011) (reversing bankruptcy court's denial of motion to terminate exclusivity and approval of new-value plan while reasoning that termination of exclusivity was prefereable to an auction because it offered creditors ability to acquire debtor and ensured adequate information for all interested parties).
17 *In re Red Mountain Mach. Co.*, 448 B.R. 1 (Bankr. D. Ariz. 2011).
18 *Id.* at 16-17.
19 *Id.* at 17-18.
20 *In re Cypresswood Land Partners I*, 409 B.R. 396, 439 (Bank. S.D. Tex. 2009).
21 *Id.* at 440.
22 *In re Union Fin. Servs. Grp. Inc.*, 303 B.R. 390 (Bankr. E.D. Mo. 2003).
23 *Id.* at 426.

the market test would focus on promoting competition: "[C]ompetition is the way to tell whether a new investment makes the senior creditor (and the estate as a whole) better off. A plan of reorganization that includes a new investment must allow potential investors to bid."[24] In *Castleton*, roughly a year into the case, the debtor proposed a plan that would write down its secured debt and extend it over 30 years, treat the remainder as an unsecured debt, and allow the wife of the debtor's pre-petition equityholder to acquire the equity in the reorganized debtor for $75,000. The secured lender objected to the new value contribution, contending that the equity would be worth significantly more given the modification to its loan, and proposed a plan that offered $600,000 for the equity.

In response, the debtor increased the new value contribution to $375,000. The secured lender then asked the bankruptcy court to require the debtor to subject the equity to a competitive auction. The bankruptcy court refused, holding that such competition was unnecessary because the absolute priority rule did not apply because an insider, and not old equity, was contributing the new value, and confirmed the debtor's plan as proposed. Direct appeal to the Seventh Circuit was certified pursuant to 28 U.S.C. § 158(d)(2)(A), and the circuit court accepted the appeal.

The Seventh Circuit reversed on two separate grounds. First, it held that the absolute priority rule applied, even though an insider made the new value contribution rather than old equity.[25] The *Castleton* court reasoned that bankruptcy law often treats insiders the same as equity investors such that "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 claimholders put up the new money."[26]

Second, the *Castleton* court reversed the bankruptcy court's rejection of a competitive auction, holding that an auction was indeed the best way to ensure that the proposed new value contribution represented the value of the equity in the reorganized debtor.[27] In doing so, the *Castleton* court explicitly rejected the proposition that a creditor's mere ability to propose a competing plan could satisfy the market test.[28] Instead, the court emphasized that competition was particularly important to maximize value in a scenario where insiders were the proposed party contributing the new value, as "[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."[29]

Conclusion

The *Castleton* court's approach drastically differs from prior court decisions that focused on the termination of plan exclusivity as the answer to the market test. Moreover, *Castleton* arguably refocused the market test on the top-dollar requirement and the importance of ensuring that new-value plans result in the highest price for the equity and the greatest recovery for the estate.

To the extent that creditors believe that a new-value plan is undervaluing the reorganized debtor's equity, these cases broadly demonstrate the peril that awaits if creditors offer only an objection to plan confirmation. Instead, creditors should consider any or all of the following actions: (1) offering their own plan that ensures a mechanism to obtain the greatest value for the reorganized debtor's equity; (2) requesting a competitive bidding process or auction to ensure that the reorganized debtor's equity garners "top dollar"; (3) making an offer for the reorganized debtor's equity that more accurately reflects market value; and (4) offering expert testimony and evidence at the confirmation hearing that shows the new value contribution to be artificially low or the debtor's failure to adequately market the equity. These steps will be particularly important in courts that view the termination of plan exclusivity as sufficient to satisfy the *203 N. LaSalle* market test. abi

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24 707 F.3d at 821.
25 *Id.* at 823.
26 *Id.*; *see also* Susan E. Trent, "*Castleton Plaza*: May an Insider Equity Investor Sidestep the Absolute-Priority Rule and *LaSalle*?," XXXII *ABI Journal* 4, 20, 86-87, May 2013, *available at* abi.org/abi-journal.
27 *Id.* at 823.
28 *Id.* (internal citations omitted).
29 *Id.* (emphasis in original).