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ALERTS

Finance, Insolvency & Restructuring Alert - Barnes & Thornburg Lender Client Wins Appeal Before The Seventh Circuit Benefiting All Creditors In Bankruptcy

February 15, 2013 | Atlanta | Chicago | Columbus | Delaware | Elkhart | Fort Wayne | Grand Rapids | Indianapolis | Los Angeles | Minneapolis | South Bend

The United States Court of Appeals for the Seventh Circuit issued its groundbreaking decision *In the Matter of Castleton Plaza*, LP on Feb. 14, 2013, delivering a valentine of sorts to Chapter 11 creditors. The decision ultimately protects creditors who are faced with being shortchanged by a reorganization plan proposed by a debtor who has significant equity in the enterprise or engineers the transfer of that equity to a family member without first putting that equity interest up for auction as required by earlier United States Supreme Court precedent.

The lender in this appeal—from a decision of the bankruptcy court below—was represented by Barnes & Thornburg LLP, with a team of bankruptcy and litigation attorneys led by Alan Mills of the firm's Indianapolis office. Mr. Mills is the primary contact for the lender and made the oral argument in the Seventh Circuit that convinced the court to reverse the decision below and remand the case to the bankruptcy court with direction to open the proposed Chapter 11 plan to competitive bidding. In this unanimous decision, authored by renowned jurist Frank Easterbrook, the Seventh Circuit emphasized that any plan that attempts to preserve, directly or indirectly, the equity interest of the owner by means of transfer to a relative or otherwise may not be confirmed over the objection of a class of creditors that is impaired under the plan. Such a plan violates the absolute priority rule of § 1129(b)(2)(B)(ii) of the Bankruptcy Code and the dictates of the United States Supreme Court in its decision of *Bank of America National Trust & Savings Ass'n v. 203 North LaSalle Street Partnership*, 526 U.S. 434 (1999).

In Castleton Plaza, the borrower, an Indiana limited partnership, owned a single asset—a shopping center in Indianapolis. The borrower's equity was owned by an individual, George Broadbent. A lender advanced $9.5 million to the borrower, which debt was secured by a first mortgage lien in the shopping center and related collateral. The borrower, unable to make the required installment payments due under the loan, filed for bankruptcy relief under Chapter 11. At that time, the indebtedness due to the lender exceeded $10 million. In its Chapter 11 case, the borrower proposed a reorganization plan whereby the borrower would (i) write down the balance owed to the lender to $8.2 million; and (ii) assign to George Broadbent's wife the right to purchase the "new" equity in the reorganized debtor in the absence of any valuation, marketing, or competitive bidding for $75,000. At the confirmation hearing in the United States Bankruptcy Court for the Southern District of Indiana, the lender objected to the borrower's plan on various grounds, including the plan's violation of the absolute priority rule codified at 11 U.S.C. § 1129(b)(2)(B)(ii). This rule

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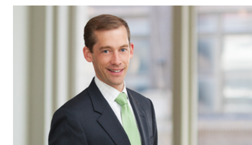

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prevents equity holders from retaining any benefits on account of their equity ownership unless all classes of unsecured claims objecting to confirmation of the plan are paid in full pursuant to the plan. In other words, if an objecting unsecured creditor class will be shortchanged under the plan, the equity holders must forfeit any interest in the reorganized debtor. The lender presented evidence at the confirmation hearing that it was willing and able to pay at least $600,000 for the equity in the reorganized borrower and requested that the court subject George Broadbent's equity to competitive bidding. In response, the borrower submitted evidence that Mr. Broadbent's wife would up the ante by paying $375,000 for this equity and argued that the absolute priority rule did not apply because Mr. Broadbent himself would receive nothing under the plan. Over the lender's objections, the bankruptcy court confirmed the borrower's plan and the lender appealed this decision directly to the Seventh Circuit.

In an opinion written by Chief Judge Easterbrook and issued on Feb. 14, 2013, following briefing by Alan Mills, David Powlen, Mike Rosiello, and Jonathan Sundheimer and then oral argument by Alan Mills, the Seventh Circuit reversed the Bankruptcy Court's determination, remanding the case with directions to open the proposed plan to competitive bidding. At the oral argument, this opinion was hinted at by Easterbrook, who indicated that the power of appointment is a property right recognized in both tax and trust law. Easterbrook went further to note that if the borrower's plan was confirmed, it would render the U.S. Supreme Court's decision in *Bank of America National Trust & Savings Association v. 203 North LaSalle Street Partnership*, 526 U.S. 434 (1999), meaningless. The Seventh Circuit, relying on the 203 North LaSalle Street decision in its opinion, held that competition is the best way to determine if maximum value is being received for the new equity. "Competition is essential whenever a plan of reorganization leaves an objecting creditor unpaid yet distributes an equity interest to an insider." The Seventh Circuit emphasized that unpaid creditors normally receive the equity in the reorganized business but that the borrower's plan went in the opposite direction. Regarding the absolute priority rule, the Seventh Circuit agreed with all points made by the Barnes & Thornburg team and held that Mr. Broadbent retained substantial benefits resulting from the transfer of equity to his wife. The retention of these benefits, however, violated the absolute priority rule, thereby resulting in the downfall of the debtor's plan. First, Mr. Broadbent continued to receive an annual salary of $500,000 as the CEO of the property management company owned by his wife, which company would continue to manage the shopping center if the Broadbents retained control of the borrower and its sole but valuable asset. Second, Mr. Broadbent would benefit from his wife's ownership of the borrower because the family's collective wealth would increase. Third, the power of appointment and its exercise by Mr. Broadbent in favor of his wife as purchaser of his equity in the borrower was a valuable right retained by him. The value of such a power of appointment is explicitly recognized by American income tax law as a valuable asset and is taxed as such. The same theory applies under bankruptcy law and the absolute priority rule.

The decision in Castleton Plaza, as the only circuit court opinion on this topic since 203 North LaSalle Street, goes a long way toward resolving the split among bankruptcy courts on whether equity owners of a debtor can avoid application of the absolute priority rule and continue to control

the debtor post-bankruptcy through transfers to insiders. This decision protects all unpaid creditors, ensuring that an equity holder cannot continue controlling the debtor indirectly after confirmation of a plan without first permitting an auction of that equity with competitive bidding. Marketing the equity and competitive bidding ensure that maximum market value is received for that property interest, which can, in turn, result in greater distributions to creditors in the bankruptcy case. More specifically, this decision benefits lenders of single-asset real estate borrowers, allowing senior secured lenders to bid for the new equity in a reorganized debtor and ultimately assume control of the real estate in lieu of a foreclosure proceeding. Although other unsecured or undersecured creditors must be paid in accordance with a debtor's plan, the senior secured lender will be in a position to control its former collateral and to operate that business for the lender's future benefit.

To obtain more information or a copy of the decision, please contact the Barnes & Thornburg attorney with whom you work or the following attorneys: Alan Mills at (317) 231-7239 or alan.mills@btlaw.com, David Powlen at (302) 300-3435 or dpowlen@btlaw.com, or Jonathan Sundheimer at (317) 231-7319 or jsundheimer@btlaw.com.

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