EQUITY AUCTIONS AND THE NEW VALUE COROLLARY TO THE ABSOLUTE PRIORTY RULE

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I. THE STATUTORY TEXT

The absolute priority rule applies when the proponent of a chapter 11 reorganization plan cannot satisfy the requirement in section 1129(a)(8) of the Bankruptcy Code (the "Code") that each impaired class of creditors has voted to accept the plan. When an impaired class of creditors rejects a debtor's plan, if all of the other requirements of Code section 1129(a) have been satisfied, then Code section 1129(b)(1) of the Code provides that the bankruptcy court, at the request of the plan proponent, shall confirm the debtor's plan notwithstanding the failure to satisfy Code section 1129(a)(8) " . . . if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that has not accepted the plan." Confirmation of a reorganization plan over the dissent of an impaired class of creditors or equity security holders is known colloquially as "cramdown." The requirement of Code subsection 1129(b)(2)(B)(ii) that a plan be "fair and equitable" to a dissenting class of unsecured creditors represents a partial codification of the absolute priority rule requiring that creditors be paid before shareholders. That subsection provides, in pertinent part, as follows:

> (b)(2) For purposes of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:
>
> . . . .
>
> (B) With respect to a class of unsecured claims-
>
> (i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or
>
> (ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of

> such junior claim or interest any property, except that in a case in which the debtor is an individual, the debtor may retain property included in the estate under section 1115, subject to the requirements of subsection (a)(14) of this section.

Few, if any, debtors can provide creditors with property having a value on plan's effective date equal to the allowed amount of each claim in an impaired class of claims. As a result, this article will focus on chapter 111 reorganization plans that attempt to satisfy the requirement that "the holder of claim or interest that is junior to the in a dissenting class "will not receive or retain under the plan on account of such junior interest, any property."

II. THE HISTORICAL BACKGROUND

A. Railroad Receiverships

The absolute priority rule emerged from a series of late 19th and early 20th century Supreme Court decisions involving federal equity receiverships of railroads *.See, e.g., Louisville Trust Co. v. Louisville N.A. & C. Ry. Co.*, 174 U.S. 683, 19 S.Ct. 827, 43 L.Ed. 1130 (1899); *Northern Pacific Railway v. Boyd*, 228 U.S. 482, 33 S.Ct. 554, 57 L.Ed. 931 (1913). In those cases, secured bondholders and stockholders would place a railroad in receivership. Those parties would arrange for a sale of the insolvent railroad's assets to a new company that would be jointly owned by the insolvent railroad's secured bondholders the stockholders. The sale price would be sufficient to satisfy only a portion of the secured bondholders' claims, and would leave nothing for unsecured creditors. For example, in the *Northern Pacific Railway* case, pursuant to an agreement between an insolvent railroad's secured bondholders and stockholders, the railroad's assets were sold to the new company for $61 million, far less than the $157 million of secured claims and the $14 million of unsecured claims against the insolvent railroad. Immediately after the sale, the purchaser issued $190 million of bonds and $155 million of stock, a significant amount of which was sold to stockholders of the insolvent railroad. An unpaid unsecured creditor of the insolvent railroad appealed the order approving the foregoing transaction. The Supreme Court held that an unpaid unsecured creditor of the insolvent railroad could assert his claim against the purchaser of the insolvent railroad's assets:"[t]he invalidity of the sale flowed from the character of the reorganization agreement regardless of the value of the property, for in cases like this, the question must be decided according to a fixed principle . . ."

id., at 507. The Supreme Court had stated that "fixed principle" in the *Louisville Trust Co.* case, *supra.*:

> If a bondholder wishes to foreclose and exclude inferior lienholders or general unsecured creditors, he may do so; but a foreclosure which attempts to preserve any interest or right of the mortgagor in the property after the sale must necessarily secure and preserve the prior rights of general creditors thereof. This is based upon the familiar rule that the stockholder's interest in the property is subordinate to the rights of creditors. Any arrangement of the parties by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights of either class of creditors comes within judicial denunciation.

Id., 174 U.S. at 684.

In its *Northern Pacific Railway* decision, the Supreme Court went on to state that:

> If the value of the road justified the issuance of stock in exchange for old shares, the creditors were entitled to the benefit of that value, whether it was present or prospective, for dividends or only for purposes of control. In either event it was a right of property out of which the creditors were entitled to be paid before the stockholders could retain it for any purpose whatsoever.
>
> This conclusion does not, as claimed, require the impossible, and make it necessary to pay an unsecured creditor in cash as a condition of stockholders retaining an interest in the reorganized company. His interest can be preserved by the issuance, on equitable terms, of income bonds or preferred stock. If he declines a fair offer, he is left to protect himself as any other creditor of a judgment debtor; and, having refused a fair offer, he is left to protect himself as any other creditor of a judgment debtor; and, having refused to come into a just reorganization, could not thereafter be heard in a court of equity to attack it.

Id., 228 U.S. at 508

In *Kansas City Terminal Rail Company v. Central Union Trust Co. of New York*, 271 U.S. 445, 46 S.Ct. 549, 70 L.Ed. 1028 (1926), the Supreme Court elaborated on its statement that there might be circumstances under which stockholders could retain some interest in a new owner of an insolvent railroad's assets, even if unsecured creditors of the old railroad's were not paid in full. In the *Kansas City* case, unsecured creditors of the Kansas City Terminal Railway objected to a receiver's sale of the railway's assets to a new company. In connection with that sale, preferred and common shareholders of the Kansas City Terminal Railway received common stock and bonds issued by the new company, while unsecured creditors received in exchange for their claims one of two different package of securities in the new company. In rejecting the unsecured creditors' claim that the "fixed principal" stated in *Northern Pacific Railway* required unsecured creditors be paid in full before stockholders could retain any interest in the reorganized company, the Supreme Court stated as follows:

> . . . . [T]o the extent of their debts creditors are entitled to priority over stockholders against all the property of an insolvent corporation. But it does not follow that in every reorganization the securities offered to general creditors must be superior in rank or grade to any which stockholders may obtain. It is not impossible to accord to the creditor his superior rights in other ways. Generally, additional funds will be essential to the success of the undertaking, and it may be impossible to obtain them, unless stockholders are permitted to contribute and retain an interest sufficiently valuable to move them.

Id., 271 U.S. at 455-456

B. <u>Section 77B and Case v. Los Angeles Lumber Products Co.</u>

In 1934, Congress amended the Bankruptcy Act of 1898 to by adding Section 77B, which provided for corporate reorganizations. 11 U.S. C. §205(e) (1934 ed., Supp. I)(repealed 1938)That section required, *inter alia*, reorganization plans to be "fair and equitable." Thereafter, in *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939), bondholders appealed an order confirming a plan that gave stockholders of an insolvent debtor equity in the reorganized company without requiring in return a contribution of new money from those stockholders. The lower court found that stockholders' financial standing and influence in the community, and their ability to provide continuity of management, were a sufficient basis for their receipt of stock in the reorganized company. Supreme Court reversed the lower court's decision. The Court held that Section 77B's requirement that a reorganization plan be "fair and equitable" incorporated the “fixed principle” from the *Louisville Trust* and *Northern Pacific Railway* cases that creditors must be paid in full before stockholders can receive or retain any interest in a reorganized company. *Case, supra,* 308 U.S at 117. However, *Case,* also recognized the acknowledgment in those earlier cases “that there are circumstances under which stockholders may participate in a plan of reorganization of an insolvent debtor” without first paying unsecured creditors in full. *Id*. at 121: “[W]e believe that to accord ‘the creditor his full right of priority against the corporate assets’ where the debtor is insolvent, the stockholders’ participation must be based on a contribution in money or money’s worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder.” *Id*. at 122. The Supreme Court held that neither ”financial standing in and influence in the community,” nor providing “continuity of management” constituted a contribution of in money or money’s worth reasonably equivalent to the equity in the reorganized company being given to debtors’ stockholders. As a result, the Supreme Court reversed the lower court’s decision confirming the debtor’s reorganization plan.

In 1938, Congress passed the Chandler Act, which repealed Section 77B and replaced with a chapter X (11 U.S.C. §621(2)(1934 ed., Supp. IV)(repealed 1979) which provided for reorganization of public companies.

C. <u>Survival (Or Not) of the New Value Corollary in the Code</u>

The Bankruptcy Code, which became effective in 1979, combined chapters X (corporate reorganizations of public companies), XI (reorganization of non-public companies) and XII (real estate cases) of the Bankruptcy Act of 1898 into a single chapter – chapter 11 – governing reorganizations. Shortly thereafter, the commercial real estate market suffered one of its periodic crashes. Owners of commercial real estate frequently filed chapter 11 cases (in which a single piece of commercial real estate was the debtor’s only asset) in order to prevent mortgagees’, whose claims exceeded the value of the real estate constituting the mortgageees’ collateral, from foreclosing on their mortgages. In addition to causing debtors to lose their properties, a successful foreclosure would also cause the debtors’ equity holders to recognize “phantom” taxable income, in the form of recaptured depreciation, while simultaneously leaving those equity holders without the real estate whose sale proceeds would have provided funds with which to pay the resulting income taxes.

In the foregoing circumstances, after filing a chapter 11 case, a debtor would file a reorganization plan that preserved both the debtor's ownership of its real estate and the interests of the debtor's equity security holders. Such a plan generally used section 506(b) of the Code to bifurcate the undersecured mortgagee's claim into a secured claim equal in amount to the value of the debtor's' property, and an unsecured deficiency claim in an amount equal to the difference between the value of the debtor's property and the face amount of the mortgagee's loan. The plan proposed payments on the mortgagee's secured claim that would, it was hoped, satisfy the secured creditor cramdown requirements prescribed in Code section 1129(b)(2)(A)(i), *i.e.*, that the mortgagee retain its lien and receive a stream of future payments having a present value equal to the amount of the mortgagee's secured claim. Depending on the court in which the debtor's case was filed, the plan would place the mortgagee's deficiency claim either in its own class, or in the same class as unsecured trade claims. In either event, a vote by a class of unsecured creditors to reject the debtor's plan would prompt the debtor to attempt a cramdown on the dissenting class under Code section 1129(b)(2)(B)(ii). Anticipating such a vote, the debtor's plan would provide for equity holders to contribute new capital to the reorganized debtor in exchange for equity holders' receipt or retention of an equity interest in the reorganized debtor. Relying on the *Case* decision, the debtor would argue that the foregoing contribution of new capital permitted confirmation of the plan despite Code section 1129(b)(2)(B)(ii)'s prohibition against equity holders' receipt or retention of an interest in the reorganized debtor when a class of unsecured creditors that received less than payment in full voted to reject the plan. The debtor would argue that its equity holders were receiving or retaining an equity interest in the reorganized debtor "on account of" their new value contributions, and not "on account of" their equity interests in the debtor. In response, the secured creditor would argue that the plan could not be confirmed because (a) the new value corollary to the absolute priority rule had not survived enactment of Code section 1129(b)(2)(B)(ii), and (b) even if the new value corollary survived, one or more of the requirements for its application was missing.

Bankruptcy Courts and Courts of Appeal disagreed about whether the new value corollary survived enactment of the Code. *See, e.g., Bonner Mall Partnership v. U.S. Bancorp Mortgage Co (In re Bonner Mall Partnership)*,2 F.3d 899, 910-916 (9th Cir.1993); cert. granted, 510 U.S. 1039, 114 S.Ct. 681,126 Led.2d 648 (1994); vacatur denied and appeal dismissed as moot, 513 U.S. 18, 115 S.Ct. 386, 130 L.Ed.2d, 126 L.Ed.2d 233(1994)(recognizing division among courts about survival of the new value corollary, but holding that value corollary survived enactment of the Bankruptcy Code); *Coltex Loop Center Three Partners, L.P v. BT?SAP Pool C Associates (In re Coltex Loop Center Three Partners, L.P.*, 138 F.3d 39 (2d Cir. 1998)(new value corollary did not survive enactment of the Code).

The Supreme Court has not definitively resolved the foregoing dispute, despite having several opportunities to do so. In *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 204-06, 108 S.Ct. 963, 99 L.Ed. 2d 169 (1988), the Supreme Court held that even if the new value corollary survived enactment of the Code, a cramdown plan under which a farmer proposed to retain his ownership interest in exchange for a contribution of labor, experience and expertise did not satisfy that corollary. Thereafter, the Supreme Court granted a certiorari petition in the *Bonner Mall* case on this issue. However, the parties settled the case before it could be argued. As a result, the certiorari petition was dismissed as moot. The most recent case in which the Supreme Court addressed the issue of the new value corollary's continued existence under the Code is *Bank of America National Trust and Savings Association v. 203 North LaSalle Street Partnership*, 626 U.S. 434, 119 S. Ct. 1411, 143 L.Ed. 2d 607 (1999). Here, too, the court declined to decide whether the Code contains a new value corollary or exception to the absolute priority rule, but held, as discussed in greater detail below, that the plan did not satisfy such an exception or corollary even if one existed. *Id.*, 526 U.S. 141. Nevertheless, in the 15 years since the *203 North LaSalle* decision, courts that have addressed the new value corollary have assumed its continued existence. *See, e.g.*, *In re NNN Parkway 400 26 LLC*, 2014 WL 309734 at *2 (Bankr. C.D. Calif. 2014); *In re Red Mountain Machinery Company*, 448 B.R. 1 (Bankr. D Az. 2011).

D. 203 North LaSalle Street and the Requirement that Purchaser of Equity in a Reorganized Debtor Pay "Top Dollar."

In the *203 North LaSalle Street* case, during the period when it had the exclusive right to file a plan, the debtor filed a plan that provided for debtor's limited partners to pay $6.125 million for the equity in the reorganized debtor. The plan also bifurcated Bank of America's $93 million claim into a $54.5 million secured claim and a $38.5 million deficiency claim and placed that deficiency claim (which would not be paid in full) in a class separate from the class of unsecured trade claims. Bank of America voted its unsecured deficiency claim to reject the plan. The bankruptcy court confirmed the debtor's plan under Code section 1129(b)(2)(B)(ii), holding, among other things, that the plan satisfied the new value corollary to the absolute priority rule. The District Court and the Seventh Circuit each affirmed the confirmation order.

The Supreme Court reversed. Even if the Code's absolute priority rule contained a new value corollary (an issue that the Court again declined to decide), the Court found that Debtor's plan failed to satisfy that corollary. Specifically, the Court held that the debtor's plan gave equity holders the exclusive opportunity to contribute new value to the reorganized debtor, and that such an "option" constituted property that those equity holders received "on account of" their equity interests. *Id.*, 526 U.S. at 454-456. The Court held that, in order to prevent old equity holders from acquiring the reorganized debtor's equity at a bargain price, debtor should have either given others an opportunity to (a) bid for the reorganized debtor's equity, or (b) propose their own competing reorganization plan. *Id*., 526 U.S.at 454. Only under one of those circumstances would there be certainty that the debtor's equity holders had obtained the reorganized debtor's equity "on account of" their new capital contribution, *i.e.,* had paid "top dollar" for the equity of the reorganized debtor (*Id*., 526 U.S. 457), and ensured that their new value contribution provided the greatest possible addition to the bankruptcy estate. *Id.*, 526 U.S. at 453.

II. THE ABSOLUTE PRIORITY RULE AFTER 203 NORTH LASALLE STREET

A. DOES THE PLAN PROVIDE FOR THE DEBTOR'S EQUITY HOLDERS TO RECIEVE OR RETAIN PROPERTY ON ACCOUNT OF THEIR EQUITY INTERESTS ?

In the years after the Supreme Court opinion in the *203 North LaSalle Street*, most cases considering whether a reorganization plan violated the absolute priority rule had to decide if the entity acquiring the reorganized debtor's equity did so "on account of" the entity's equity interest in the debtor, or on account of the entity's new value contribution.

For example, the plan in *In re PWS Holding Corporation*., 228 F.3d 224 (3d Cir. 2000), released fraudulent transfer claims against the debtor's equity holders and others arising from a leveraged recapitalization. A class of unsecured creditors rejected the plan. The dissenting creditors argued release of the fraudulent claims violated Code section 1129(b)(2)(B)(ii) by allowing equity holders of property on account to receive property under the plan on account of their equity in the debtor. The Third Circuit affirmed a bankruptcy court order overruling the foregoing objection and confirming the debtor's plan. In doing so, the Third Circuit held that (a) there was no direct evidence that the equity holders persuaded the debtor to release fraudulent transfer claims against those equity holders "on account of" their status as equity holders; (b) the released fraudulent transfer claims would be costly to pursue as a result of the equity holders' indemnification rights against the debtor; (c) an examiner found that the fraudulent transfer claims had little or no value; (d) the examiner's finding represented an appropriate surrogate for a market test of the fraudulent transfer claims' value notwithstanding a dissenting creditor's offer to purchase the fraudulent transfer claims from the debtor for $100,000 plus a percentage of any recovery on those claim; and (e) in the judgment of the plan's proponents, release of the fraudulent transfer claims "was the approach most likely to provide the greatest possible addition to the bankruptcy estate." *Id*. at 242.

Based on the Supreme Court's stated preference in *203 North LaSalle Street* for utilizing a market test rather than a judge's determination to establish the value of property (which seems indistinguishable from an examiner's determination *See, 203 North LaSalle Street, supra*., 526 U.S. at 457 (" it was, after all, one of the Code's innovations to narrow the occasions for courts to make valuation judgments").

In *In re Zenith Electronics Corp*., 241 B.R. 92, 106-107 (Bankr. D. Del. 1999), appeal dismissed, *Nordhoff v. Zenith Electronics Corp*., 250 B.R. 207 (D. Del. 2000), the debtor's pre-packaged plan eliminated pre-petition equity and gave the debtor's majority shareholder the exclusive right to purchase one hundred percent of the reorganized equity in exchange for paying $60 million in cash and waiving $200 million of debt. Rejecting a creditor's objection that the plan violated the absolute priority rule, the bankruptcy court held that the purchaser received the exclusive right to purchase the reorganized debtor's equity on account of his status as a creditor, and not on account of his status as the debtor's majority shareholder.

Zenith, too, is difficult to reconcile with the *203 North LaSalle Street* decision. If the debtor's plan (which was likely drafted with input from the debtor's majority shareholder) had permitted competing bids for the reorganized debtor's equity, it is possible that a third party would have paid more than the debtor's majority shareholder for the reorganized debtor's equity.

The debtor's plan in *Beal Bank v. Water's Edge Limited Partnership*, 248 B.R. 668 (D.Mass.2000) provided for a sale of the reorganized debtor's equity to an insider – a relative of one of the debtor's partners. The bank that held a mortgage on the debtor's property, and whose claim the plan bifurcated into secured and unsecured claims, voted its unsecured claim to reject the plan. The bank also objected to the plan on the grounds, among others, that the plan's provision for sale of the reorganized debtor's equity to an insider violated the absolute priority rule. The bankruptcy court overruled that objection, and found that the foregoing insider was not acting as a mere straw man for the debtor's equity holders. Nor were those equity holders financing the insider's purchase of the reorganized debtor's equity. As a result, the bankruptcy court held that the debtor's equity holders were not receiving or retaining any property on account of their equity interests in violation of the absolute priority rule, and confirmed the debtor's plan. Notably, the bankruptcy court rejected the bank's argument that, as a secured creditor with a lien on the debtor's real estate (the debtor's sole asset), the bank should be allowed to purchase the reorganized debtor's equity by credit bidding the bank's secured claim. The bankruptcy court held that the bank was not entitled to credit bid for the reorganized debtor's equity, because the bank's lien only covered the debtor's real estate (which was not being sold under the plan) rather than the equity of the reorganized debtor. The District Court affirmed the bankruptcy court's holding that the debtor's plan did not violate the absolute priority rule.

Like the plan in the *Beal Bank* case, the debtor's plan *In re Global Ocean Carriers Limited*, 251 B.R. 31 (Bankr. D. Del. 2000) gave the debtor's equity holders the exclusive right to determine, without the benefit of a public auction or competing plans, that the daughter of one of those debtor's equity holders could purchase the reorganized debtor's equity at a price determined by the debtor. A class of unsecured creditors rejected the plan, and argued that the plan's provision for sale of the reorganized debtor's equity to an insider violated the absolute priority rule. The bankruptcy court declined to follow the *Beal Bank*, decision, and agreed the objecting creditor that the debtor's exclusive right to determine both the identity of the new equity holder and the price to be paid for the reorganized debtor's equity represented receipt by the debtor's equity holders of property on account of their equity interests in violation the absolute priority rule. Consequently, the bankruptcy court denied confirmation of the debtor's plan. *See, also, H. G. Roebuck & Son, Inc. v. Alter Communications, Inc.*, 2011 WL 2261483 (D. Md. 2011)(refusing to confirm plan that relied on expert's valuation of reorganized debtor and did not provide for a market test of the proposed new value contribution); (*In re Mj Metal Products, Inc.*, 292 B.R. 707 (Bankr. D. Wyoming 2003)(plan giving existing shareholders the exclusive right to submit sealed bids for the reorganized debtor's equity violated the absolute priority rule).

In the Matter of Castleton Plaza, L.P., 707 F.3d. 821 (7th Cir. 2013), cert. denied, __U.S.__, 134 S. Ct. 146, 187 L.Ed.2d 39 (2013) is the only Court of Appeals decision that has decided whether an equity holder received property on account of its equity interest under a plan that, without competitive bidding, issued the reorganized debtor's equity to an insider in exchange for a contribution of new capital. *Id*., at 822.

Castleton Plaza was a single-asset real estate case. The debtor's plan bifurcated the undersecured creditor's claim into a secured claim equal in amount to the value of the debtor's real estate – as determined by the bankruptcy court – and an unsecured deficiency claim. George Broadbent owned, directly or indirectly, one hundred percent of the debtor's equity. The plan (which appears to have been filed while the debtor had the exclusive right to file the plan) eliminated that equity and provided for Mr. Broadbent's wife to receive all of the reorganized debtor's equity in exchange for her contribution of $75,000 in new capital. Mrs. Broadbent owned all of the equity in The Broadbent Company, Inc., which operated the debtor under a management contract. Mr. Broadbent was The Broadbent Company's chief executive officer, in which capacity he received an annual salary of $500,000. The plan provided for assumption of that management contract.

The secured creditor offered $600,000 for the reorganized debtor's equity The debtor rejected that offer, but Mrs. Broadbent increased her new value contribution to $375,000. The debtor's offered to subject Mrs. Broadbent's $375,000 new capital contribution to competitive bidding. However, the bankruptcy court ruled that competitive bidding was unnecessary because Mrs. Broadbent owned no equity in the debtor. The bankruptcy court confirmed the debtors' plan, after which the secured creditor took a direct appeal to the Seventh Circuit.

The Seventh Circuit reversed, stating as follows:

> This appeal presents the question whether an equity investor can evade the competitive process by arranging for the new value to be contributed by (and the new equity to go to) an "insider," as 11 U.S.C. defines that term. The bankruptcy judge answered yes; our answer is no. Competition is essential whenever a plan of reorganization leaves an objecting creditor unpaid yet distributes an equity interest to an insider.

Id. at 821-22.

The Seventh Circuit noted that the plan not only gave the debtor the exclusive opportunity to designate the recipient of the reorganized debtor's equity (an opportunity that the court analogized to a power of appointment that the Internal Revenue Code treats as income), but also the right to determine the amount of Mrs. Broadbent's new value contribution. The Court also found that Mr. Broadbent received property in the form of the continued right to receive a $500,000 yearly salary from The Broadbent Company.

The Seventh Circuit also rejected the bankruptcy court's ruling that competition for the reorganized debtor's equity was unnecessary because Mrs. Broadbent owned no equity in the debtor. The court pointed out that Mrs. Broadbent was an insider of the debtor, and that, "[f]or many purposes in bankruptcy law, such as preference recoveries under 11 U.S.C. §547, an insider is treated the same as an equity investor." *Id.*, at 823.

Castleton Plaza's holding that a reorganization plan violates the absolute priority rule when it gives the debtor the exclusive opportunities to (a) designate an insider as the recipient of the reorganized debtor's equity and (b) to set the amount of the new capital contribution, is consistent with *203 North LaSalle Street*'s holding that a plan violates the absolute priority rule when the plan gives the debtor's pre-bankruptcy equity holders the exclusive opportunity to contribute new capital and receive ownership interests in the reorganized debtor without allowing competition. However, the *Castleton* decision also contains dicta that potentially expands the scope of the *203 North LaSalle Street* decision. For example, *Castleton Plaza* contains a statement that "[n]one of the considerations we have mentioned depends on whether Castleton proposed the plan during the exclusivity period." *Id*., at 824. If this statement means that a new value plan cannot satisfy the absolute priority rule even if the debtor's plan exclusivity period has terminated, thereby permitting a dissenting creditor to file a competing plan, then *Castleton Plaza* effectively negates a debtor's ability to satisfy the new value corollary to the absolute priority rule by permitting dissenting creditors to file a competing plan.. Rejecting competing plans as a means of market-testing a new value contribution by a debtor's equity holders also disregards the Supreme Court's suggestion that competing plans are an appropriate way to test a new value contribution. *203 North LaSalle Street Partnership, supra,* 526 U.S. at 454 (debtor's plan was "doomed . . . by its provision for vesting equity in the reorganized business in the Debtor's partners without extending an opportunity to anyone else either to compete for that equity *or to propose a competing reorganization plan.*")(emphasis added).

In contrast to the Seventh Circuit's dictum regarding the irrelevance of plan exclusivity to satisfaction of the absolute priority rule's new value corollary, the bankruptcy court in *In re Red Mountain Machinery Company*, 448 B.R. 1, 17-18 (Bankr. D. Ariz. 2011) held that once plan exclusivity has expired, the "option value" that the *203 North LaSalle Street* opinion found to be property that the debtor's equity holders received on account of their interests in the debtor ceased to exist. As a result, the bankruptcy court in *Red Mountain Machinery* held that it could determine whether the debtor's plan satisfied the elements of the new value corollary without having to conduct an auction. *Red Mountain Machinery Company, supra.,* at 19 ("Because exclusivity has expired long ago, the Court finds as a fact that there is no 'option value'(or any other value within the contemplation of *Boyd*, *Case*, *Ahlers*, or *203 North LaSalle*) to the exclusive right to propose a new value plan or to be the contributors to that plan). *Accord, In re Reid Properties, LLC,* 2012 WL 54629219 (Bankr. D. Az. 2012)

The *Castleton* decision also states that "[a]n impaired lender who objects to *any* plan that leaves insiders holding equity is entitled to the benefit of competition. *Id.*, at 824 (emphasis in the original). If the Court's reference to an impaired lender includes an impaired secured creditor, then the Seventh Circuit's statement is troublesome because it ignores the plain language of Code section 1129(b)(2)(B)(ii). That section requires satisfaction of the absolute priority rule only when an impaired class of *unsecured* creditors that has not been paid in full votes to reject a plan. Notably, the Seventh's Circuit's statement also ignores the plain language of Code section 1129(b)(2)(A), which prescribes the requirements for confirming a reorganization plan over rejection by a class of secured creditors, and which does not include the absolute priority rule. Allowing a dissenting secured creditor to insist on compliance with the absolute priority rule partially codified in Code section 1129(b)(2)(B)(ii) would not only be inconsistent with the plain language of the statute, but would also vastly expand the scope of the absolute priority rule beyond the boundaries established by Congress.

Finally, *Castleton Plaza* states that: "[a] plan of reorganization that includes a new investment must allow other potential investors to bid. In this competition, creditors can bid the value of their loans. *RadLAX Gateway Hotel, LLC v. Amalgamated Bank,* __ U.S. ___, 132 S.Ct.2065, 182 L.Ed. 2d 967 (2012)." *Castleton Plaza* at 821. However, it is well-settled that only secured creditors may credit bid, and only when bidding for their collateral. *See,* 11 U.S.C. §363(k)(holder of claim secured by lien securing an allowed secured claim may bid at sale and offset such claim against the purchase price of such property); 11 U.S.C. §1129(b)(2)(A)(ii)(plan is fair and equitable to a class of secured creditors when the plan provides for sale, subject to section 363(k), of any property that is subject to the liens securing such secured creditor's claims, free and clear of liens, with liens to attach to the sale proceeds is fair and equitable to secured creditor); *In the Matter of Homestead Partners, Ltd, 197 B.R. 706, 719, fn, 15 (Bankr. N.D. Ga. 1996); In re Bjolmes Realty Trust,* 134 B.R. 1000, 1010 fn.22 (Bankr. D. Mass. 1991)(secured creditor can credit bid only for its collateral, and not for equity in reorganized debtor). Consequently, it is reasonable to assume that the *Castleton Plaza's* dictum regarding credit bidding is simply incorrect. Indeed, the *RadLAX* case cited by the Seventh Circuit in support of its statement regarding credit bidding involved the right of a *secured creditor* to credit bid its debt at a sale of its collateral under Code section 1129(b)(2)(A)(ii). If the Seventh Circuit meant to suggest an unsecured creditor credit bid for a reorganized debtor's equity, then *Castleton Plaza* represents a significant and legally unsupported extension of both the Supreme Court's holding in *203 North LaSalle Street* and in the right to credit bid.

In re Union Financial Servs. Grp.,Inc., 303 B.R. 390, 425- 426 (Bankr. E.D. Missouri 2003), aff'd, 155 Fed. Appx 940 (2005) takes a very expansive view of the nature of competition required to satisfy the absolute priority rule's new value corollary. In that case, the bankruptcy court confirmed a new value plan under which, among other things, the debtor's senior secured lenders converted a portion of their $475 million debt into 72.5% of the reorganized debtor's equity (and wrote down that secured debt to $175 million), Also, the debtor's largest shareholder would pay $10 million for preferred stock convertible into 20% of the reorganized debtor's equity and would obtain a loan conduit facility essential to the debtor's continued existence. Competition consisted of efforts by the debtor's investment bankers and a special committee of the debtor's independent directors to find a purchaser for the reorganized debtor's equity through two separate solicitations of 137 firms conducted over a two year period. That process failed to produce a bidder willing to pay more for the reorganized debtor's equity than the amount offered by the debtor's largest shareholder. The bankruptcy court found that the "methodologies and processes used in the marketing and alternative sales processes were specifically designed to test the market . . . while protecting the Debtor's business [outsourcing receivables management and collection services and collecting receivables purchased at a discount] and preserving going concern value." *Id*, at 425. The court further found that, due to the nature of the debtor's business, a section 363 sale process or auction, whether by sealed bids or otherwise, "likely would have had significant negative effects on the value of the Debtors' businesses and assets." *Id.* In short, special circumstances justified a process to test the market for an insider's new value contribution that did not involve a classic open-outcry auction.

B. <u>MECHANICS OF THE AUCTION PROCESS</u>

Several bankruptcy court cases, decided both before and after the *203 North LaSalle Street* decision have discussed the need for an auction in cases involving new value plans to ensure that the debtor's equity holders are not purchasing the reorganized debtor's equity at a bargain price. None of those cases discuss the procedures to be used in conducting such an auction. As discussed below, however a debtor conducting an auction of a reorganized debtor's new equity will encounter obstacles to a successful auction.

In *In re Bjolmes Realty Trust*, 134 B. R. 1000 (Bankr. D. Mass. 1991), the bankruptcy court considered a disclosure statement describing a plan under which the debtor's principals would retain their equity interests in exchange for a $17,000 new value contribution. The debtors' plan earmarked that money for payment of a 10% dividend both to general unsecured creditors, and to the FDIC on account of its deficiency claim. The bankruptcy court assumed that the FDIC would vote its deficiency claim again the plan, thereby invoking the absolute priority rule. The bankruptcy court acknowledged the existence of the new value corollary to that rule, but held that "the only way to measure the proposed contribution against actual market value is to offer 100 % of the reorganized debtor's stock for sale." *Id.*, at 1010. The court stated that conducting such an auction would be a condition for confirming the debtor's plan. The auction's participants would be the debtor's shareholders, the FDIC and any other creditor interested in purchasing the reorganized debtor's stock. The court also required the debtor to amend its plan to provide that the proposed 10% dividend to unsecured creditors be increased to the extent that the winning bid exceeded $17,500. Notably, as mentioned above, the court held that the FDIC had no right to credit bid for the reorganized debtor's stock because the FDIC's lien only covered the debtor's real estate. *Id.* at 1010, fn. 22. The bankruptcy court recognized, that, as the prime beneficiary of the new capital contribution, and because its deficiency claim was so large in relation to the debtor's other unsecured claims the FDIC would an advantage at the auction. The court noted, however, that the FDIC's advantage was "merely a reflection of its overwhelming financial interest." *Id., at* 1011.

In the Matter of Homestead Partners, Ltd., 197 B.R. 706 (Bankr. N.D. Ga. 1997) addressed the issue of whether termination of plan exclusivity or an auction of the reorganized debtor's equity provided the best means of testing whether an offer by the debtor's equity holders offer to pay $500,000 for ownership the reorganized debtor's equity represented the full value of that equity. The bankruptcy court recognized that terminating plan exclusivity and thereby permitting competing plans would "foster alternate bids for control of the reorganized debtor, and would thereby dispel any concerns regarding the necessity and value of the shareholders' offer." *Id.*, at 716-717. Relying on law review articles arguing that auctions provided the best way for bankruptcy courts to honor the letter and spirit of the absolute priority rule when considering confirmation of a new value plan (*See,* Anthony L. Miscioscia, Jr., Note, *The Bankruptcy Code and the New Value Doctrine: An Examination into History, Illusions, and the Need For Competitive Bidding,* 79 Va. L. Rev. 917, 946 (1993); and John T. Bailey, *The "New Value Exception" in Single-Asset Reorganizations: A Commentary on the Bjolmes Auction Procedure and its Relationship to Chapter 11,* 98 Com. L.J. 50, 66-70 (1993)), and determining that "a confirmation-point equity auction" would inject the necessary element of competition into the new value process . . without otherwise disrupting the plan negotiation process" I*d.,* at 719, the bankruptcy court chose an equity auction instead of terminating plan exclusivity as the best means of assuring that the debtor's shareholders were ;paying top dollar for the reorganized debtor's equity.

The *Homestead Partners* court noted a significant obstacle that must be overcome in order in order to conduct an auction of a reorganized debtor's equity. Specifically, such an auction involves the sale of securities. A public offering of securities cannot be conducted without either registering those securities, or finding an exemption from Federal and State securities laws requiring such registration. *Id.,* at 717. Section 1145(a)(1) of the Code provides an exemption from registration of a debtor's public offering of securities, but only when those securities are offered either in exchange for claims against, or interests in, the debtor or an affiliate of the debtor, or principally in such an exchange and partly for cash or property. A sale of securities to be issued by a reorganized debtor for cash does not come within the scope of that exemption. Nor does the exemption in Code section 1145(a)(3) for the offer or sale, other than under a plan, of a security of an issuer, other than the debtor or an affiliate, that files reports under section 13 or 15(d) of the Securities Exchange Act of 1934, cover a sale of a reorganized debtor's shares. As a result, the *Homestead Partners* bankruptcy court concluded that participation in an auction sale of a reorganized debtor's securities must be "limited to existing creditors of the reorganizing debtor . . . [to] qualify as an exempted private placement of stock for the purposes of securities' laws registration requirement." *Id.*, at 718. The *Homestead Partners* court was confident, however, "that a *Bjolmes*-type auction, with participation limited to existing creditors of the reorganized debtor, would qualify as an exempted private placement of stock for purposes of securities law's registration requirements." *Id.*, at 718. However, neither the *Homestead* nor the *Bjolmes* courts considered whether an auction whose participants are limited to existing creditors, the debtor's equity holders, and other insiders – a small number in a single-asset real estate case - can effectively test the market for a reorganized debtor's equity.

In *Polite Enterprises Corporation PTY Ltd. v. North American Safety Products (In re Polite Enterprises PTY Ltd.),* 2014 WL 321668 (N.D. Ill. 2014), the district court affirmed an confirming a new value plan under which the debtor scheduled an auction of the reorganized debtor's equity. The debtor's plan provided that daughter of the debtor's controlling shareholder would purchase that equity for $35,000 unless she was outbid at the auction. The daughter purchased the reorganized debtor's equity for that price when no other bids were submitted. In addition, the debtor's plan exclusivity period expired before the date scheduled for the auction. No one filed a competing plan. The debtor adopted the following procedures for the auction, which the bankruptcy court approved after noting that "neither *LaSalle* nor its Seventh Circuit progeny dictate any particular set of procedures for inviting competition." *Id.*, at *7: "Here, North American twice published notice of the sale in the Chicago Sun Times (once for its original plan and once for its amended plan). All creditors were notified of the auction and invited to recruit outside bidders or to bid on the reorganized equity themselves." *Id*. The bankruptcy court held that the debtor had satisfied the absolute priority rule. The district court affirmed on the grounds that the bankruptcy court's decision was not clearly erroneous. Notably, no one raised the issue of whether the debtor's advertisement of the auction sale constituted a public offering of the reorganized debtor's securities.

The absence of reported decisions discussing procedures governing the auction of a reorganized debtor's stock suggests that debtors proposing such an auction are most likely using procedures similar to those used when a debtor sells property under section 363(b) of the Code

In addition to (a) credit bidding, (b) choosing between terminating plan exclusivity and holding an auction of a reorganized debtor's securities as a means of obtaining the highest value for the equity in a reorganized debtor, and (c) the need to either register those securities or to find an exemption from registration, conducting an auction to determine whether an offer by a debtor's equity holder to purchase the stock of a reorganized debtor represents "top dollar" for that stock raises the following additional issues:

1. How will money in excess of the price that a debtor's equity holders offer to pay be distributed?

It is certainly possible that a debtor contemplating the need for an auction of the reorganized debtor's stock might provide in its plan for distribution of excess proceeds. If the plan fails to do so, can the bankruptcy court follow the *Bjolmes* court and require a plan amendment specifying the distribution of excess proceeds as a condition of approving a debtor's disclosure statement? Can any the reorganized debtor retain any excess proceeds to use as working capital? If the reorganized debtor does so, how will that affect a pending objection that the plan is not feasible?

2. Even if a bankruptcy court requires such a pre-confirmation plan amendment specifying how excess sale proceeds will be distributed, can a successful competing bidder, such as an undersecured creditor holding a deficiency claim, cause the reorganized debtor to modify the confirmed plan before substantial consummation pursuant to Code section 1127(b). so as to (i) increase the distribution to itself as the holder of an unsecured claim, (ii) require a sale of the reorganized debtor's property, or (iii) provide for liquidation of the reorganized debtor ?

3. Can a debtor's equity holders add provisions to a debtor's plan that will discourage competitors from bidding for the reorganized debtor's stock by, for example, requiring large payments to officers, directors or managers if (a) they are terminated post-confirmation without cause, or (b) their responsibilities or compensation packages are reduced post-confirmation? What will be the result if the debtor's plan provides for assumption of pre-petition employment contracts that provide for large severance payments?

4. Would the presence of such provisions in a debtor's plan cause the bankruptcy court to deny confirmation on the grounds that the debtor did not propose the plan in good faith?

5. Would proposing a plan containing such provisions constitute a breach of the debtor-in-possession's fiduciary duty to maximize the value of the debtor's estate and justify the appointment of a chapter 11 trustee?

6. Would the appointment of a chapter 11 trustee be appropriate if a debtor entered into prepetition contracts with managers containing such provisions in anticipation of bankruptcy

7. Will an auction of a reorganized debtor's equity occur at the beginning or at the end of a confirmation hearing? If the auction occurs at the beginning, will a winning competing bidder withdraw its objections to confirmation? If the auction occurs at the end of the confirmation hearing, will the auction be cancelled if the bankruptcy court sustains objections to confirmation filed by a potential bidder?

These and other issues involving new value plans will undoubtedly be the subject of future bankruptcy opinions.