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Absolute Priority Rule: How Absolute is Absolute?
Navigating the New Value Exception, Competitive Bidding and Gifting Strategies in Business Bankruptcies

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ABSOLUTE PRIORITY RULE: HOW ABSOLUTE IS ABSOLUTE?

Navigating the New Value Exception, Competitive Bidding and Gifting Strategies in Business Bankruptcies

Presented by:
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Background on Absolute Priority Rule

- Absolute priority rule: principle codified in section 1129(b)(2)(B) of Bankruptcy Code that a reorganization plan may not give “property” to the holders of any junior claims or interests “on account of” those claims or interests, unless all classes of senior claims either receive the full value of their claims or give their consent. See Bank of America Nat. Trust and Sav. Ass’n v. 203 N. LaSalle Street P’ship, 526 U.S. 434, 441-42 (1999).

- Purpose of the rule is to protect creditors from collusion by the debtor’s current equity, who often have significant influence in a chapter 11 case.
Background on Absolute Priority Rule (cont’d)

• Developed in response to Nineteenth Century railroad reorganizations, where senior creditors and old shareholders often colluded to control the reorganization process at the expense of unsecured creditors. See *In re DBSD North America, Inc.*, 634 F.3d 79, 94 (2d Cir. 2011).

• Today, it often arises in single asset real estate cases, where relevant players are usually limited to secured creditors and debtor/equity.

• Relevant to confirmation of all non-consensual chapter 11 plans, including individual chapter 11 cases.
Case Summaries

- **Bank of America Nat. Trust and Sav. Ass’n v. 203 N. LaSalle Street Partnership, 119 S.Ct. 1114 (1999)**

  - **Facts**
    - 203 LaSalle Street Partnership, an Illinois real estate limited partnership, filed for chapter 11. A $93 million loan by LaSalle’s prepetition lender was insufficiently secured by the lender’s mortgage on LaSalle’s real property.
    - Under proposed plan of reorganization, lender’s unsecured deficiency claim would be discharged at 16% and certain former partners of LaSalle would contribute new capital in exchange for the entire ownership of the reorganized debtor.
      - Old equity holders were the only parties eligible to contribute new capital under the proposed plan.
Case Summaries (cont’d)

• Bank objected on the ground that plan violated the absolute priority rule.

• Bankruptcy court approved the plan and the district court and Seventh Circuit affirmed.
  – Seventh Circuit stated that language of section 1129(b)(2)(B) was ambiguous and did not bar junior interests from receiving property interests in the debtor if they contribute new capital in money or money’s worth, reasonably equivalent to the property’s value, and necessary for a successful reorganization.

  – **Holding**

    • The Supreme Court reversed and remanded.
    • Former partners could not, over lender’s objection, contribute new capital and receive new ownership interests in reorganized entity when the opportunity was given exclusively to the former partners without consideration of alternative. *Id.* at 1417-1424.
Case Summaries (cont’d)

- Declining to decide whether Bankruptcy Code includes a “new value” corollary to absolute priority rule, but statutory text did not disparage possibility of a corollary. *Id.* at 1417-1419.

- “On account of” language best interpreted to mean “because of”.
  - Causal relationship between holding prior claim or interest and retaining or receiving property is trigger for absolute priority rule. *Id.* at 1419-1422.
  - Causal relationship disqualifies prior equity holder from receiving or retaining property when this would fail to provide estate with greatest possible value.

- Assuming new value exception, plans providing junior interests with exclusive opportunity free from competition and without benefit of market valuation are barred by absolute priority rule. *Id.* at 1422-1424.
Case Summaries (cont’d)

– Receiving or retaining property by old equity was “on account of” existing equity if that opportunity was protected from market scrutiny. *Id.*

– Best way to determine value is exposure to a market. *Id.*

– Bankruptcy Code’s preference for market testing ought to extend to valuations of old equity’s proposed contribution in administering absolute priority rule. *Id.*

• *In re Castleton Plaza, LP, 707 F.3d 821 (7th Cir. 2013)*

  – Facts

  • Husband owned 100% of equity in debtor, which operated a shopping center in Indianapolis, Indiana. Husband was also CEO of company that managed Castleton (Broadbent Company), from which he earned a $500,000 salary pursuant to a management agreement with the Debtor.
Case Summaries (cont’d)

- Castleton’s only secured creditor held a $10 million note secured by Castleton’s interest in the shopping center, including rents.
- Castleton failed to pay the note when it matured and subsequently commenced a chapter 11 bankruptcy proceeding.
- During its exclusive period to file a plan of reorganization, Castleton proposed a plan that would write down the note’s balance by almost $2 million, cut its rate of interest from 8.37 to 6.25 percent, extend the loan for 30 years and eliminate the note’s additional security features.
- In addition, unsecured creditors would be paid 15 percent on their allowed claims and the management contract between Castleton and Broadbent Company would be assumed, including Husband’s $500,000 salary.
The plan also proposed that 100 percent of Castleton’s new equity would go to Wife on account of an investment of $375,000 in the reorganized company.

Secured creditor objected, arguing that Castleton’s assets had been undervalued, and offered to pay $600,000 for the new equity, as well as paying the unsecured creditors in full. The secured creditor also asked the bankruptcy court to require that Wife’s offer to purchase the new equity be subject to a competitive auction process.

Bankruptcy Court denied the request and approved the plan as proposed. The Court reasoned that competition was unnecessary because the Wife did not own an equity interest in Castleton, and section 1129(b)(2)(B) deals only with the “holder of any claim” that is junior to an impaired creditor’s claims.
Case Summaries (cont’d)

– **Holding**

  • Opinion by Chief Judge Easterbrook
  • Reversed the bankruptcy court’s decision
  • Castleton’s plan of reorganization should have been submitted to competitive bidding under the U.S. Supreme Court’s 203 North LaSalle decision. 707 F.3d at 822-23.
  • “New-value” plan that channeled new equity to an insider of an old equity investor, here the investor’s spouse, would potentially circumvent the absolute priority rule just as effectively as conferring new equity on the investor himself. *Id.*
  • Husband would receive value from Wife’s investment in reorganized Castleton, retention of his $500,000 salary as CEO of Broadbent Company and an increase in his family’s wealth due to Wife’s new ownership of Castleton. *Id.*
Case Summaries (cont’d)

• Analogized to tax law, noting that the indirect benefits to be received by Husband would be considered as income under the Internal Revenue Code and thus would qualify as “value” for purposes of the absolute priority rule. *Id.* at 823-24.

• Specifically, under the plan confirmed by the bankruptcy court, Husband received value on account of his old equity interest because it permitted him to control Castleton and thus propose a plan of reorganization that provided a valuable opportunity for his wife to purchase Castleton on the cheap.

• This outcome could not be squared with *203 North LaSalle’s* competition requirement, which “helps prevent the funneling of value from lenders to insiders . . . .” *Id.* at 824.

• Need for competitive bidding was particularly compelling where, as here, the secured lender believed the debtor’s assets were undervalued and its secured claim was being substantially impaired. *Id.*
Case Summaries (cont’d)

- **In re DBSD North America, Inc., 634 F.3d 79 (2d Cir. 2011)**
  - **Facts**
    - Debtor DBSD North America, Inc., which had operated a mobile communications network, filed for chapter 11 bankruptcy. DBSD’s secured lenders were undersecured. DBSD’s plan of reorganization provided for (1) first lien debt to receive new obligations and second lien debt to receive shares of the reorganized debtor, (2) unsecured creditors to receive shares worth between 4% and 46% of their claims, and (3) the debtor’s parent to also receive shares and warrants.
    - Unsecured creditor Sprint Network objected to plan on ground that it violated the absolute priority rule because parent received equity although unsecured creditors were not satisfied in full.
Case Summaries (cont’d)

- Bankruptcy court disagreed and confirmed plan. It characterized parent’s receipt of shares as a “gift” from holders of the second lien debt, who were senior to unsecured creditors and who also were not receiving the full value of their claims. Senior lien debt was entitled to the full residual value of the debtor and could therefore “gift” some of its value to the existing shareholders as it saw fit.

  - Holding

- Reversing the bankruptcy court in part on the ground that the “gifting” plan violated the absolute priority rule.

- Parent’s receipt of shares was “on account of” its equity interest because parent did not contribute additional capital to the reorganized entity.
Case Summaries (cont’d)

• DBSD argued that the shares and warrants rightfully belong to secured creditors to do with them as they choose, and that the Bankruptcy Code’s distributional priority scheme (as embodied in the absolute priority rule) was not implicated until the debts of the secured creditors are paid in full (which was not the case with DBSD).

• Court rejected this argument because plain language of section 1129(b)(2)(B) applied to “any property,” not just property not covered by secured lender’s lien.

• DBSD cited for support In re SPM Mfg. Corp., 984 F.2d 1305 (1st Cir. 1993), in which the First Circuit held unsecured creditors could share in proceeds of a chapter 7 liquidation at the expense of a creditor that would otherwise take priority over the unsecured creditors.
Case Summaries (cont’d)

– Court distinguished *SPM* on the ground that it was a liquidation under chapter 7, not a reorganization under chapter 11. *Id.* at 97-98.

• Court recognized policy arguments that gifting leads to an efficient and consensual reorganization and that enforcing the absolute priority rule may encourage hold-out behavior by objecting creditors. *Id.* at 100.

– Court responded that absolute priority rule protects creditors from shareholders, who retain substantial control over the chapter 11 process and thus have significant opportunity to self-enrich. *Id.*

• *In re Armstrong World Industries, Inc.*, 432 F.3d 507 (3d Cir. 2005)

  – Facts

  • Debtor Armstrong World Industries (AWI), which manufactured flooring products, filed for chapter 11 bankruptcy due to asbestos litigation liabilities.
Case Summaries *(cont’d)*

- Unsecured creditors were composed of personal injury claimants and the Official Committee of Unsecured Creditors.

- AWI proposed a reorganization plan in which (1) personal injury claimants would receive $1.8 billion through a trust and the unsecured creditors would receive approximately 60% of $1.6 billion in claims, and (2) in the event the unsecured creditors rejected the plan, a “deathtrap” would be triggered whereby the parent company would receive warrants to purchase AWI’s new common stock, estimated to be worth $35 to $40 million, by an automatic transfer from the class of personal injury claimants.

- The UCC objected on the ground that the plan violated the absolute priority rule by entitling the parent company to receive equity if the plan was not accepted by unsecured creditors.

  - **Holding**

    - The district court denied confirmation and the Third Circuit affirmed.
Case Summaries (cont’d)

• AWI argued that the absolute priority rule didn’t apply because the objecting class (the unsecured creditors) were co-equal with a consenting class (the personal injury claimants), and hence were not being squeezed out by the personal injury claimants’ transfer of warrants to the parent.

• Court ruled that the plain language of section 1129(b)(2)(B) does not require that the objecting class be an intervening class and that the legislative history of section 1129 supported this reading. Id. at 513.

• Court distinguished SPM on the ground that it was a liquidation under chapter 7. Id. at 514. Court also distinguished cases in which property subject to the senior creditors’ liens was “carved out” for the junior claimants. Id.
• AWI next argued that warrants were not “on account of” the parent’s equity interests but rather as consideration for settlement of intercompany claims. Court rejected, arguing that warrants had much higher value ($35 to $40 million) than intercompany claims ($12 million). AWI could not explain the difference in value, and so the Court concluded that the warrants were “on account of” the parent’s equity interest. *Id.* at 516-17.

• Court also rejected argument that equitable considerations should allow an exception to the absolute priority rule. AWI had relied on the Third Circuit’s decision in *In re Penn Central Transportation Co.*, 596 F.2d 1127 (3d Cir.1979), in which the Third Circuit had stated that the absolute priority rule should be applied flexibly to a reorganization of a prominent railroad. *Armstrong* Court distinguished *Penn Central* on the ground that the *Armstrong* case did not involve similar “exigent circumstances” as *Penn Central*, “where Congress intervened in the reorganization process to avoid a rail transportation crisis of national import.” *Id.* at 517.
Lessons Learned—New Value Exception

- New value corollary after *Castleton*
  - New value exception and *LaSalle*'s market-testing requirement are alive and well.
  - *Castleton* showed that the new value corollary recognized in *LaSalle* (1) applies to insiders (not just actual equity holders) if the old equity holders would receive “value” from insider treatment under plan, and (2) requires competitive bidding in those situations. *LaSalle* left these questions open.
  - *Castleton* has begun to be cited by cases applying *LaSalle* to insider bids. See *In re GAC Storage El Monte*, LLC, 489 B.R. 747 (Bankr. N.D. Ill. 2013) (denying confirmation of a plan in which impaired secured creditor objected, insider of debtor would receive equity in exchange for new investment, and insider bid was not market-tested).
  - *Castleton* Court adopted a broad reading of “on account of.”
    - Court reasoned that “value” can be “on account of” an old equity interest even when the value was intangible, e.g., an ability to maintain control.
    - Court analogized to tax law. However, it is not necessarily the case that because something is treated as “taxable” under the Tax Code that it equates with “value” outside of the tax context.
    - Effect on single-asset real-estate cases.
Lessons Learned—Gifting

- Are gifting strategies outside the plan context still viable after DBSD and Armstrong?
  - Gifting outside context of plan: settlements, structured dismissals, 363 sales
  - Would court have jurisdiction over a post-confirmation contractual gift?
Lessons Learned—Absolute Priority Rule

• Viewing the new value and gifting plan cases together reveals emerging trends about the absolute priority rule.

• Emerging trend of interpreting absolute priority rule to require competitive bidding and strictly construing elements to confirm a non-consensual plan

  – *Castleton* endorsed competitive bidding as a market check on “new value” plans. Similar in effect with U.S. Supreme Court’s ruling in *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S.Ct. 2065 (2012), that secured creditors may not be precluded from credit bidding their claim under a plan of reorganization in an auction for the debtor’s assets. Credit bid serves as a baseline to measure incremental value as it sets floor for any auction or competitive process.
Lessons Learned (cont’d)

– Has strict enforcement of absolute priority rule, whether by skepticism over new value plans or gifting, discouraged rather than encouraged reorganizations?

– Do bad cases make bad law? Facts of Castleton fairly egregious. Should plan have been denied on grounds of bad faith instead?
Lessons Learned (cont’d)

• Has recent absolute priority rule jurisprudence in the new value or gifting contexts favored or disfavored creditors?

  – Answer is mixed.
  
  – On one hand, the “new value” cases (LaSalle / Castleton) support strong protections for secured creditors.
  
  – On the other hand, the gifting cases limit secured creditors’ rights to do with their collateral as they wish, but likewise enforce the absolute priority rule on behalf of unsecured creditors.
  
  – Trends seem to indicate that courts will enforce the absolute priority rule equally whether it is the secured lender or old equity seeking to control the reorganization. The former by favoring certain junior creditors or interests over others. The latter by attempting to retain control of the debtor by choosing to favor some parties in interest over others.
Lessons Learned (cont’d)

• Should the absolute priority rule be interpreted more flexibly in mega-reorganizations of national importance?
  – *Penn Central* compared to GM and *Chrysler*