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Third Circuit Permits Purchaser in Section 363 Sale to Make Payments to Interested Parties, Deviating from Bankruptcy Code Priority Scheme

By Brad Eric Scheler, Alan N. Resnick, and Michael R. Handler*

The U.S. Court of Appeals for the Third Circuit decision in In re ICL Holding Company, Inc. *enlarges the list of appellate decisions upholding the rights of parties in various contexts to enter into settlements that result in distributions that are inconsistent with the Bankruptcy Code's priority scheme. The authors of this article discuss the decision.*

The U.S. Court of Appeals for the Third Circuit held in *In re ICL Holding Company, Inc.* that in the context of a sale of all the debtor's assets to a secured creditor group, as purchaser, under Section 363 of the Bankruptcy Code for an amount less than the secured debt, payments (i) of the debtor's wind-down costs, (ii) of the professional fees of the debtor and the official committee of unsecured creditors, and (iii) to general unsecured creditors to settle objections to the sale, were not property of the debtor's estate and, therefore, did not have to be distributed according to the Bankruptcy Code's priority scheme.[1]

BACKGROUND

After struggling financially, LifeCare Holdings, Inc. ("LifeCare"), once a leading operator of long-term acute care hospitals, agreed to sell all of Lifecare's assets to its secured lenders in consideration for a credit bid in the amount of $320 million of the total of $355 million of secured debt owed to the lenders. To effectuate the proposed acquisition, an acquisition vehicle formed by LifeCare's secured lenders called Hospital Acquisition LLC (the "Purchaser") and Lifecare entered into an Asset Purchase Agreement (the "Purchase Agreement"). In addition to the $320 million credit bid, the Purchaser agreed to pay the legal and accounting fees of LifeCare and the Official Committee of

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[1] *In re ICL Holding Co., Inc., et al.*, 14-2709 (3d Cir. Sept. 14, 2015).

Unsecured Creditors (the "UCC") and to pay for LifeCare's wind-down costs. The dollar amount of each was deposited into respectively separate escrow accounts. One day after entering into the Purchase Agreement, LifeCare's 34 subsidiaries (including 27 long-term acute care hospitals) commenced voluntary petitions for relief under Chapter 11 of the Bankruptcy Code in the U.S. Bankruptcy Court for the District of Delaware.

Among the motions filed by Lifecare at the inception of the case was a motion for authorization and approval to sell substantially all of Lifecare's assets through a court-supervised auction under Section 363(b)(1) of the Bankruptcy Code. After receiving approval from the bankruptcy court, LifeCare marketed its assets to more than 106 potential strategic and financial bidders. These efforts notwithstanding, the Purchaser's $320 million credit bid was determined to be the highest and best offer. The UCC and the United States government both objected to the motion to approve the sale (the "Sale Motion"). The UCC argued that the proposed sale was a veiled foreclosure that would leave LifeCare's estate insolvent such that administrative expenses would not be paid. The government argued that the sale would result in a capital-gains tax liability of $24 million, giving the government an administrative expense claim that would not be paid. LifeCare, the Purchaser, and the UCC entered into a settlement agreement whereby the UCC would withdraw its objection to the Sale Motion in exchange for the Purchaser agreeing to deposit $3.5 million in trust for the benefit of LifeCare's general unsecured creditors (the "Settlement Agreement").

LOWER COURT PROCEEDINGS

On April 2, 2013, the bankruptcy court entered an order approving the Sale Motion (the "Sale Order"). At the hearing on the Settlement Agreement held at a later date, the government argued that funds paid under the Settlement Agreement to the general unsecured creditors violated the Bankruptcy Code's priority scheme. The bankruptcy court rejected this argument and approved the Settlement Agreement, reasoning that because the Settlement Agreement "permits a distribution directly to the unsecured creditors" from the Purchaser, it is "an indication that [the funds] are not property of [LifeCare's] estate[,] and as such, the absolute priority rule . . . is not implicated."[2]

The government then appealed the bankruptcy court's approval of the Settlement Agreement and the Sale Order and requested that the bankruptcy court stay the effect of those decisions pending the government's appeal. The request for a stay was denied.

[2] *Id.* at 11 (internal citations omitted).

THIRD CIRCUIT DECISION

On appeal, the government raised two issues: (i) whether the bankruptcy court erred in approving a provision of the Sale Order under which the Purchaser agreed to pay some administrative claims (i.e., the legal and accounting professionals' fees) but not others of equal priority and (ii) whether the bankruptcy court erred in approving the distributional terms of the Settlement Agreement, which provided for the funding of a $3.5 million trust by the Purchaser for the benefit of the general unsecured creditors even though a senior creditor, the government, would be receiving nothing.

Mootness

LifeCare argued that the government's appeal was constitutionally moot because the government would not be entitled to relief even if the escrowed funds were deemed estate property since the funds would have gone to the secured lenders rather than the government. The Third Circuit rejected this argument because the prospect of the government's recovery was not impossible, and "[a]s long as the parties have a [concrete] interest, however small, in the outcome of the litigation, the case is not moot."[3]

The Third Circuit also rejected the argument that the government's appeal was statutorily moot under Section 363(m) of the Bankruptcy Code, which moots any appeal of an order approving a Section 363 sale that "affect[s] the validity of [the] sale" so long as "the purchaser acted in good faith and the appellant failed to obtain a stay of the sale."[4] The Third Circuit explained that "[t]o give effect to § 363(m)'s purpose, some courts 'limit[] the appealability of a Section 363 sale order . . . to the issue of the purchaser's good faith.' Under that view, if the objecting party fails to obtain a stay of the sale, appellate review 'is statutorily limited to the narrow issue of whether the property was sold to a good faith purchaser.'"[5] However, based on Third Circuit precedent, the court rejected this approach, and noted that the Third Circuit "[I]nterpret[s] subsection 363(m) more broadly and will review any sale-challenge that doesn't 'affect the validity of the sale.'"[6] The court further concluded that the relief sought by the government—"a redistribution" of the escrowed funds for administrative expenses and settlement proceeds to unsecured creditors—could be effected without disturbing the sale.

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[3] *Id.* at 14 (citing *Knox v. Serv. Emps. Int'l Union*, 132 S. Ct. 2277, 2287 (2012)).

[4] *Id.* (citing 3 COLLIER ON BANKRUPTCY ¶ 363.11 (16th ed. 2013)).

[5] *Id.* at 15 (quoting *In re Motors Liquidation Co.*, 430 B.R. 65, 78 (S.D.N.Y. 2010)).

[6] *Id.* (citing *Cinicola v. Scharffenberg*, 248 F.3d 110, 128 (3d Cir. 2001)).

Finally, the Third Circuit rejected the UCC's argument that the government's appeal was equitably moot because it was too late to undo the compromise between LifeCare, the Purchaser and the UCC since more than $2 million of the settlement funds had already been distributed to the general unsecured creditors. The Third Circuit commented that the doctrine of equitable mootness comes into play in bankruptcy only after a Chapter 11 plan is confirmed and that "[o]utside the plan context, we have yet to hold that equitable mootness would cut off our authority to hear an appeal . . . ."[7]

Violation of Priority Scheme

After concluding that the appeal was not moot, the Third Circuit addressed the government's argument that the escrowed and settlement funds were proceeds paid to obtain LifeCare's assets and thus qualified as estate property that should have been distributed in accordance with the Bankruptcy Code's priority scheme.

The Third Circuit agreed with the bankruptcy court's holding that, because the settlement funds were paid directly to the unsecured creditors from a trust funded by the Purchaser and not given in exchange for any estate property, those funds were not property of LifeCare's estate. In support of this point, the Third Circuit cited to the decision of the U.S. Bankruptcy Court for the District of Delaware in *In re TSIC, Inc.*,[8] in which the bankruptcy court overruled the U.S. Trustee's objection to a Section 363 purchaser's payment to the unsecured creditors to settle the objection of the creditors' committee to the sale on the basis that the settlement violated the proscription against paying lower-priority creditors before senior creditors. In support of its objection, the United States Trustee relied principally on the Third Circuit's decision *In re Armstrong World Indus., Inc.*[9] The bankruptcy court held that in contrast to *Armstrong*—which dealt with a gift of estate property from a senior creditor to a junior creditor over an intermediate creditor's objection—"the purchaser's 'funds [were] not proceeds from a secured creditor's liens, do not belong to the estate, and will not become part of the estate even if the Court does not approve the Settlement.' And the trustee presented no evidence that the settlement funds 'were otherwise intended for the Debtor's estate.'"[10]

Rejecting the government's argument that the Purchaser's payment of the settlement funds was in substance an increased bid for LifeCare's assets, the

[7] *Id.* at 16.

[8] 393 B.R. 71 (Bankr. D. Del. 2008).

[9] 432 F.3d 507 (3d Cir. 2005).

[10] *ICL Holding*, slip op. at 19 (quoting *In re TSIC, Inc.*, 393 B.R. at 76, 77).

Third Circuit found that the cash used by the Purchaser to resolve objections to the sale of LifeCare's assets "never made it into the estate."[11] The court noted that the settlement funds were not paid at LifeCare's direction, were not proceeds from the Purchaser's liens, and never became property of the estate "even as a pass-through."[12] A reader of the opinion might surmise that valuation of LifeCare's assets as determined by the bid price was critical to the court's analysis. In essence, it appears that the Third Circuit embraced the assumption of the court below that LifeCare's assets were worth no more than the $320 million credit bid.

The Third Circuit commented that the issue of whether the professional fees and wind-down expenses (which made up the escrowed funds) qualified as property of the estate was "a more difficult question." The government urged the Third Circuit to reverse the bankruptcy court's ruling that the funds were not property of the LifeCare's estate because they were listed in the Purchase Agreement as part of the purchase price. Despite that language in the Purchase Agreement, however, the Third Circuit wrote that "we cannot ignore the economic reality of what actually occurred."[13] The court explained that as a matter of substance the escrowed funds were not property of LifeCare's estate because under the Purchase Agreement, in exchange for crediting $320 million of debt, LifeCare agreed to surrender all of its property, including its cash, to the Purchaser. Thus, once the sale closed there technically was no more estate property. In addition, as per the Sale Order, whatever remains of the escrowed funds goes back to the secured lender's account.

Notably, the Third Circuit explained that an "interesting argument" that the government could have made, but did not, is that the escrowed funds resemble elements of an ordinary carve-out "best understood as 'an arrangement under which secured creditors permit the use of a portion of their collateral [that is, estate property] to pay administrative costs, such as attorney fees.'"[14] However, according to the Third Circuit, this argument would have failed, as here the escrowed funds were not part of the lenders' collateral but rather the Purchaser's property. Again, it appears that valuation as fixed by the credit bid was critical to the analysis.

CONCLUSION

The Third Circuit's decision's in *ICL Holding* enlarges the list of appellate

[11] *Id.* at 18.

[12] *Id.* at 19.

[13] *Id.* at 20.

[14] *Id.* at 21 (internal citations omitted).

decisions upholding the rights of parties in various contexts to enter into settlements that result in distributions in a manner that is inconsistent with the Bankruptcy Code's priority scheme. For example, in *In re SPM Manufacturing Corp.,* a liquidation case under Chapter 7 of the Bankruptcy Code, the U.S. Court of Appeals for the First Circuit upheld a secured lender's distribution to general unsecured creditors from proceeds of the sale of collateral without paying priority tax claims.[15] In *In re Jevic Holding Corp.*, the U.S. Court of Appeals for the Third Circuit recently upheld a settlement and dismissal of a Chapter 11 case (commonly referred to as a "structured dismissal") which provided for distributions to general unsecured creditors without paying certain employee wage claims entitled to priority under the Bankruptcy Code.[16] When deciding *Jevic Holding*, the Third Circuit was influenced by a decision in *In re Iridium Operating LLC*, in which the U.S. Court of Appeals for the Second Circuit stated that a settlement agreement presented for court approval apart from a Chapter 11 plan can be approved by a bankruptcy court even if its distribution of estate property deviates from the Code's priority scheme if other factors weigh heavily in favor of approving the settlement.[17]

The *ICL Holding* decision is important because it provides flexibility for a secured creditor that credit bids for the debtor's assets under Section 363(b) of the Bankruptcy Code to consider transferring its own funds to other parties in interest for the purpose of settling objections to such sale without the need to pay claims entitled to priority under Section 507(a) of the Bankruptcy Code or otherwise comply with the Bankruptcy Code's priority scheme.

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[15] 984 F.2d 1305 (1st Cir. 1993).

[16] 787 F.3d 173 (3d Cir. 2015).

[17] 478 F.3d 452, 464 (2d Cir. 2007).