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So Long as It's Your Own Money — Third Circuit Allows Secured Creditors to Gift Value to Junior Creditors to Resolve Sale Objection Even When More Senior Creditors Receive Nothing

In a decision that may ease the resolution of future bankruptcy proceedings, the Third Circuit Court of Appeals recently affirmed a Delaware bankruptcy court's approval of a sale of substantially all of debtors' assets that was predicated on a settlement in which the secured creditors gifted funds to general unsecured creditors, while bypassing creditors holding more senior claims.[1] Despite the obvious tension with the "absolute priority rule" that is at the core of the Bankruptcy Code's distribution scheme, the Court held that because the funds came directly from the secured creditors without ever becoming estate property, the absolute priority rule could not be invoked to block the payment.

Often, to settle objections from a junior creditor to a sale or a plan of reorganization, in a consensual plan context, secured lenders may make a "gift" of a portion of their distribution to the objecting creditors in order to obtain their support. Many bankruptcy practitioners consider the ability to make such a gift a critical and necessary tool which serves to streamline the bankruptcy process.

Still, courts have resisted allowing gifts to be made over the objections of other creditors where such payments would violate the absolute priority rule, which requires senior creditors be paid in full prior to more junior creditors receiving a distribution. For example, in *In re DBSD North America, Inc.*, 634 F.3d 79 (2d Cir. 2011), to resolve an objection to confirmation, secured lenders proposed ceding to equity holders a portion of their cash distribution, even though creditors senior to equity had not been paid in full. In that instance, the Second Circuit prohibited the gift, holding that all distributions of estate resources must be made in accordance with the absolute priority rule, and that senior parties could not direct payment of a portion of their distributions in contravention of the Bankruptcy Code's distribution hierarchy. The Second Circuit did not, however, address whether a senior lender could distribute *non-estate* property as a gift to resolve an objection to a lower-ranked creditor, leaving this issue open. By affirming the Bankruptcy Court's decision in *ICL*, however, the Third Circuit has now determined that a distribution of non-estate property is permissible.

This holding is important as it may provide a future framework for secured lenders to consensually resolve objections to sales or plans of reorganization without running afoul of the Bankruptcy Code, offering parties an important tool to streamline future cases and resolve disputes. It remains to be seen whether the Second Circuit, which decided *DBSD North America,* will agree with the Third Circuit's distinction between settlement funds sourced directly from creditors rather than via the chapter 11 estate, or whether it would instead view that distinction as the elevation of form over substance.

The Facts of the Case

LifeCare Holdings, Inc. ("*ICL*"),[2] was a leading operator of long-term acute care hospitals and owed $355 million to its secured creditors. Facing financial difficulty, ICL determined to restructure its balance sheet and/or engage in a sale transaction. However, ICL was unable to find a suitor willing to pay more than the total value of its secured debt or come to an agreement regarding a restructuring with its creditors. ICL's secured lenders therefore decided to purchase the company themselves through a section 363 sale process, whereby the secured creditors agreed to submit a $320 million credit bid for all of ICL's assets, including all of its cash. Because the sale proceeds would not leave any money for the administrative costs of the bankruptcy case, the secured creditors agreed to put aside funds in an escrow account to pay administrative claims of the professionals of the debtors and the Committee of Unsecured Creditors (the "*Committee*").[3] To memorialize the terms of the sale, the parties entered into an Asset Purchase Agreement (the "*APA*") in December 2012, prior to, and in anticipation of, ICL's chapter 11 filing.

The next day, ICL and its 34 subsidiaries filed for bankruptcy in Delaware. Immediately thereafter, ICL sought permission of the Bankruptcy Court to sell substantially all of its assets through a Court-supervised auction pursuant to section 363(b)(1) of the Bankruptcy Code. Despite marketing its assets to over 106 potential strategic and financial counterparties, the secured lender group's $320 million credit bid remained the most attractive offer. Given that the secured lenders' bid for all of the debtors' assets did not exceed the total amount of secured debt, pursuant to the terms of the absolute priority rule, the debtors' other creditors stood to receive no recovery from the sale.

The Committee and Tax Division of the Department of Justice (the "*Government*") each objected to the sale. The Committee criticized the sale as a "veiled foreclosure" that would leave the bankruptcy estate insolvent and unable to pay its administrative expenses (other than those fees provided for in the APA). The Government argued that the sale would result in an administrative claim of approximately $24 million in capital-gains tax liabilities that would go unpaid. The Government also argued that the provision to pay the only certain administrative claims was unfair, because other administrative creditors, including the Government, would go unpaid.

In order to resolve its objection to the sale, the Committee and secured lender group struck a deal. In exchange for the Committee's promise to drop its objections and support the sale, the secured lenders agreed (the "*Settlement Agreement*") to deposit $3.5 million in trust for the benefit of the general unsecured creditors.

The Bankruptcy Court approved the proposed sale on April 2, 2013. Addressing the Government's objection, the Bankruptcy Court held that the administrative fee monies put in escrow by the purchaser was not property of the estate and thus the Government had no claim to any of it.

At a subsequent hearing, the Court approved the Settlement Agreement, finding that because it "permits a distribution directly to the unsecured creditors" from the purchaser, it is "an indication that [the funds] are not property of [debtor's] estate[,] and as such, the absolute priority rule . . . is not implicated."[4]

The Government appealed both the sale order and the Court's order approving the Settlement Agreement and sought to stay the effect of those decisions. Specifically, the Government sought to (i) alter the portion of the sale order providing for the payment of professional fees so that all administrative claimants were paid equally their *pro rata* share of such amount; and (ii) modify the distributional terms of the Settlement Agreement to require the $3.5 million gift to unsecured creditors follow the Bankruptcy Code's absolute priority scheme. Upon a review of the issues, the District Court denied the Government's appeal. (*See* D.C. Civil Action No. 1-13-cv-00924 (Robinson, J.)) (deferring to the Bankruptcy Court's ruling, which found "… that the sale was warranted and the funds at issue belonged to the purchaser [and] not the estate"). The Government next appealed the approval of both the sale order and the Settlement Agreement to the Third Circuit.

The Third Circuit Opinion

Before the Third Circuit, the Government contended the secured lenders' payment to the professionals was in substance an increased bid for debtors' assets and therefore property of the estate.[5] The Third Circuit rejected this argument, finding that the money never made it into the estate nor was it paid at the debtors' direction. Rather, relying on *In re TSIC*, 393 B.R. 71 (Bankr. D. Del. 2008) (holding that proceeds of a secured creditors' liens were non-estate property), the appellate court found that "[i]n this context, we cannot conclude here that when the secured lender group, using that group's own funds, made payments to unsecured creditors, the monies paid qualified as estate property." Decision at 18.

The Court was similarly unpersuaded that the Settlement Agreement "represents an agreement between the Buyer, the Lenders and the Committee to allocate proceeds derived from the sale" (*id*. at 19) and found that the settlement proceeds were not given as consideration for the assets bought at the § 363 sale but rather "to facilitate . . . a smooth . . . transfer of the assets from the debtors' estates to [the secured lenders]." *Id*. at 20. Finding the issue of the escrowed funds designated for professional fees to be a "more difficult question" (primarily because they were specifically referenced in the APA), the Third Circuit found that, because any unused portion of the escrowed funds would revert to the secured lenders, such funds also were not property of the debtors' estate.[6]

Importantly, in reaching its decision, the Third Circuit distinguished *In re DBSD North America, Inc.*, finding that while in that instance, secured creditors wanted to gift *estate* property to junior creditors, it did not address gifts of *non-estate* property to a lower-ranked creditor.

Conclusion

The Third Circuit's decision in *ICL* may allow secured creditors to resolve sale and plan objections in the future by making payments directly to an objecting party in return for its silence. It is important to note, however, that to the extent ICL is limited to allowing only *non-estate* assets to be gifted – in line with DBSD – *ICL's* effectiveness as a tool may be limited to situations involving a sale and payment of purchase price or the infusion of new funds in support of a plan. In addition, on the flip side, the decision has the potential to cause junior creditors to make ever-increasing demands of "gifts" in return for dropping spurious objections. While it is uncertain the exact ramifications the *ICL* decision will have, it does, at a minimum, provide secured creditors with another tool to use in order to streamline cases, reward creditors who cooperate, and punish those that do not.

The decision is separately notable because of the Court's willingness to entertain an appeal in the first place, given that the sale and the settlement already had been consummated. This would seem to follow a recent trend. After many years in which decisions relating to consummated sales and plans of reorganization were virtually non-appealable, the pendulum has started to swing the other way, and courts are increasingly willing to reach the merits of such appeals and consider partial remedies, even where a sale or plan confirmation cannot be entirely undone.[7]

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1 *In re ICL Holding Company, Inc.*, No. 14-2709 (3d Cir. Sept. 14, 2015) (*"ICL"* or the "*Decision*").

2 While in Chapter 11, the debtor was referred to as "LCI." Per its plan of reorganization it became "ICL."

3 The APA provided that any funds remaining in the escrow account at the end of the case would be returned to the secured creditors.

4 *Hearing Tr.* at 75:4–8.

5 As an initial matter, the Third Circuit held that, even though the sale had been completed and the $3.5 million amount distributed to unsecured creditors, the Government's appeals were not moot because: (i) a recovery, while remote, was not impossible for the Government (constitutional mootness), (ii) a redistribution of the escrowed funds for administrative expenses and settlement proceeds to unsecured creditors was possible without effecting the validity of the sale in contravention of §363(m) (statutory mootness), and (iii) the issues did not arise in a plan or reorganization context (equitable mootness).

6 Finding that the Bankruptcy Code's creditor-payment hierarchy only becomes an issue when distributing estate property, the Court did not address whether the absolute priority enforcing rules of the Bankruptcy Code applied. *Id*. at 23.

7 *In re Transwest Resort Properties, Inc.*, 791 F.3d 1140, 1142 1 (9th Cir. 2015) (2-1) (court would consider appeal where reversal would not "entirely unravel the plan"); *In re One2One Communications LLC*, 2015 WL 4430302, at *6 (3d Cir. July 21, 2015) (reversed district court's dismissal of confirmation order appeal on equitable mootness grounds); *In re Tribune Media Co.*, 2015 WL 4925923, at *9-*10 (3d Cir. Aug. 19, 2015) (allowing appeal of plan where reversal would not harm third parties); *In re Sagamore Partners, Ltd.*, 2015 WL 5091909, at *4 (11th Cir. Aug. 31, 2015) (determination of secured lenders' entitlement to default rate interest could be made post-consummation of plan where third parties would not be injured).

For More Information

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