In re ICL Holding, Co. and Payment of Professionals and Key Creditors in Administratively Insolvent Cases

Bankruptcy Bar Association for the District of Maryland, Baltimore Chapter
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In re ICL Holding Co., 802 F.3d 547 (3rd Cir. 2015)

1. Factual Background

    a. LifeCare Holdings, Inc. operated long-term acute health care hospitals.

    b. The company, along with its 34 subsidiaries, was struggling financially. By 2014, LifeCare's debt was approximately $484 million, $355 million of which was secured.

    c. The company investigated its options and looked to either sell the company or restructure its balance sheet. There were multiple offers to purchase the company, but none exceeded the debt obligations.

    d. Ultimately, the secured creditors offered to credit $320 million of the $355 million debt they were owed to purchase LifeCare, including all of its cash and assets.

    e. The secured lenders formed Hospital Acquisition, LLC and entered into an Asset Purchase Agreement with LifeCare. In addition to the credit bid, the purchaser agreed to pay the legal and accounting fees of LifeCare and the Committee of Unsecured Creditors, and also to pay for the company's wind-down costs. To do so, the purchaser created a separate escrow fund where they deposited money for this purpose. Any money that was not spent on the fees and wind-down costs would be returned to the purchaser.

    f. The next day, LifeCare and its subsidiaries filed for bankruptcy and requested permission to sell substantially all of its assets through an auction under 11 U.S.C. § 363(b)(1).

2. Objections to the Sale

    a. Both the Government and the Committee of Unsecured Creditors objected to the sale.

    b. The Committee settled with the purchaser and withdrew its objection to the sale prior to any hearing. The purchaser deposited $3.5 million into a trust for the benefit of the general unsecured creditors in exchange for the Committee withdrawing its objection and supporting the sale. The parties submitted the Settlement Agreement to the Court for approval.

c. As a result of the sale, the Government would be owed roughly $24 million in capital-gains tax liability. Under the terms of the sale and the settlement, this would result in an unpaid administrative claim. The Government argued in its objection to the Sale Motion that the outcome of the sale would result in equally situated administrative claimants receiving unequal treatment. In objecting to the Settlement Agreement, the Government again argued that the absolute priority rule of the Bankruptcy Code would be violated as lower ranked creditors would receive distributions ahead of the Government.

d. Relevant Statutory Provision:

   i. The condition that a plan be fair and equitable with respect to a class includes the requirement that, with respect to a class of unsecured claims –

   "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…"

   11 U.S.C. § 1129(b)(2)(B)(ii)

3. <u>Procedural History</u>

   a. The Sale Hearing in the Bankruptcy Court

      i. The Court approved the Sale Motion from the bench in April 2013.

      ii. The Court applied the "sound business purpose test[1]" and determined the sale was the only way to avoid liquidation and allow the company to continue as a going concern.

      iii. In response to the Government's argument, the Court found that the money put in escrow by the purchasers to pay the administrative fees was not property of the estate and therefore did not need to be distributed to LifeCare's creditors.

   b. The Settlement Hearing in the Bankruptcy Court

      i. The Court approved the Settlement Agreement in May 2013.

      ii. The Court determined that the agreement was both fair and reasonable using a four factor test[2] which weighs the "value of the claim that is being

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[1] In re Montgomery Ward Holding Corp., 242 B.R. 147, 153-54 (Bankr. D. Del. 1999).

[2] In re World Health Alternatives, Inc., 344 B.R. 291, 296 (Bankr. D. Del. 2006) (Courts analyze a settlement by determining (1) the probability of success in litigation; (2) the likely difficulties in collection; (3) the complexity of

compromised against the value to the estate of the acceptance of the compromised proposal."

iii. The Government's argument assumed that the settlement money was part of the bankruptcy estate, which was rejected by the Bankruptcy Court.

c. First Appeal and Motion for Stay Pending Appeal

i. In its first appeal, the Government did not want to stop the sale altogether, but wanted to alter the distribution of money to comply with the absolute priority rule. The Bankruptcy Court denied the appeal of the sale order.

ii. The Bankruptcy Court again disagreed with the Government's arguments and denied the stay request in June 2013. Specifically, the Court found that "it begins and ends with the court's determination that these funds are not property of the estate, and there's been no proof to the contrary..."

d. District Court Appeal - United States v. LCI Holding Co. (In re LCI Holding Co.), 519 B.R. 461 (D. Del. 2014) (Sue L. Robinson, US District Judge).

i. The District Court found no error with the Bankruptcy Court's decision that the funds at issue in both the sale order and settlement agreement were not property of the estate and not subject to the Bankruptcy Code's distribution rules.

ii. The District Court cited the fact that the Bankruptcy Court made its decision based on a "voluminous and uncontested record supplemented by the argument and testimony presented at several hearings" and that no factual evidence was presented to the contrary in determining that there was no error with the decision.

iii. The District Court also concluded that a stay pending appeal was not warranted, primarily because the Government did not demonstrate a likelihood of success on the merits.

1. A party moving for a stay pending appeal has the burden of showing:

a. Likelihood of success on the merits;

b. Irreparable injury absent a stay;

c. Whether the stay will cause injury to other parties interest in the proceeding; and

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the litigation involved and the inconvenience and delay it would cause; and (4) the paramount interest of the creditors.).

d. Where the public interest lies.

2. The Court must balance all of these relevant factors to determine if a stay is warranted and the court found each factor weighed in favor of denying the stay.

4. Opinion in the Third Circuit

   a. Issues on Appeal:

      i. Did the Bankruptcy Court err in approving a provision of the sale of LifeCare's assets under which the secured lender group agreed to pay some administrative claims but not others of equal priority?

      ii. Did the Bankruptcy Court err in approving the distributional terms of the Committee and purchaser's settlement, which resulted in $3.5 million for the unsecured creditors while the Government received nothing?

   b. Mootness

      i. LifeCare and the Committee argued that the Government's appeal was Moot.

      ii. Constitutional Mootness: Third Circuit found that even though it would be unlikely the Government could receive the relief it requested, it was not impossible, so the issue is not constitutionally moot.

      iii. Statutory Mootness: LifeCare and the Committee argued that the challenge was moot under § 363(m). This provision moots any action that affects the validity of a sale under § 363(b) so long as the purchaser acted in good faith and appellant failed to obtain a stay of the sale. Using a broad interpretation of § 363(m), the Third Circuit found it could still grant the government the relief it sought without disturbing the sale.

         1. Relevant Statutory Provision:

            "The Reversal or modification on appeal of an authorization…of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal."

            11 U.S.C. § 363(m)

      iv. Equitable Mootness: The Third Circuit found this doctrine is only applicable after a plan of reorganization is approved.

c. Government's Argument on Appeal

i. The Government maintained that the escrowed funds and settlement monies were proceeds paid to obtain LifeCare's assets, and thus qualified as estate property. Estate funds should be distributed according to the priority scheme in the Code and equally ranked creditors must receive equal payouts prior to lower ranked creditors receiving any distributions.

1. Relevant Statutory Provision:

An estate is comprised of:

"Proceeds, products, offspring, rents, or profits of or from property of the estate, except such as are earnings from services performed by an individual debtor after the commencement of the case."

11 U.S.C. § 541(a)(6)

ii. The escrowed funds were listed in the APA as part of the purchase price, and were listed as consideration for LifeCare's assets. Under Bankruptcy Code § 541(a)(6) this would be "proceeds" of the debtor's asset sale.

d. The Third Circuit's Findings

i. The Third Circuit recognized that the government's argument may be factually correct, but it could not "ignore the economic reality of what actually occurred." The Court refused to put form over substance, and found that both the settlement funds and the escrowed funds were never part of the estate.

e. The Settlement Sums were not property of the estate

i. The funds were paid directly to the unsecured creditors from a trust funded by the purchaser. The funds were not given in exchange for estate property.

ii. The funds were not part of an increased bid for LifeCare's assets, as argued by the Government.

iii. In evaluating circumstances under which other courts had found funds to be part of the estate, the Third Circuit determined that the funds were not proceeds from the creditors' liens and would never have become part of the estate, even if the Court did not approve the settlement. Accordingly, the case law the Government relied on was not applicable and the funds were not property of the estate.

f. The Escrowed Funds were not property of the estate

i. Pursuant to the APA, the secured lenders purchased all of LifeCare's assets, including cash. After the sale closed, there was no more estate property. The Government's argument fails because it assumed any residual cash from the sale would become property of the estate.

ii. The funds that remained in escrow after paying the professionals and winding down the company would be returned to the purchaser.

iii. Despite the language in the APA, the Court considered the economic reality of the transaction and found the funds were never part of the estate.

g. Holdings of the Third Circuit:

i. The settlement sums paid by the purchaser were not proceeds from its liens, did not at any time belong to the debtor's estate, and would not become part of its estate even as a pass through.

ii. The escrowed funds were not estate property because whatever remained of the escrow went back to where it came from, which was the secured lender's account.

iii. The purchaser's payments were from its own funds and not the debtor's bankruptcy estate.

h. Third Circuit's Analysis of Funds as Carve-Outs

i. The Third Circuit suggested that the Government should have argued that the funds resembled ordinary carve-outs and were therefore part of the estate.

ii. A carve-out is an "arrangement under which secured creditors permit the use of a portion of their collateral [that is, *estate property*] to pay administrative costs." Secured lenders often do this to facilitate a higher net recovery.

iii. The Government could have argued that if the escrowed funds resemble ordinary carve-outs, the funds should be considered estate property for that reason alone.

iv. The Third Circuit recognized even this argument would fail, because the escrowed funds do not deal with collateral, but with the purchaser's own individual funds. The funds were never part of LifeCare's estate.