NORTON BANKRUPTCY LAW ADVISER

Monthly Analysis of Important Issues and Recent Developments in Bankruptcy Law

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IN THIS ISSUE:

IN RE ICL HOLDING CO.: ROADMAP FOR AVOIDING THE ABSOLUTE PRIORITY RULE

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In *In re ICL Holding Co.*,[1] the United States Court of Appeals for the Third Circuit affirmed the bankruptcy court's approval under 11 U.S.C.A. § 363(b) of the sale of all of the debtors' assets to the secured lender group and the allowance of payments to the unsecured creditors, notwithstanding nonpayment of the administrative tax claim arising out of the sale. The case may provide a roadmap for approval of § 363 bankruptcy sales without regard for the absolute priority rule and prohibitions against unfair discrimination. According to the Third Circuit in *ICL*, if the sale is structured so that funds used to pay junior creditors or selected administrative claimants are not "property of the estate," then the priority rules of the Bankruptcy Code are not implicated. The *ICL* ruling leaves open whether the absolute priority rule and unfair discrimination prohibition are even applicable in the § 363 sale context. Additionally, the court's mootness analysis should make all parties to a transaction or settlement concerned about the potential for mischief at the hands of courts that review bankruptcy transactions or settlements.

Background

The debtors operated long-term acute care hospitals.[2] They

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had secured debt of approximately $355 million. Financial difficulties struck following Hurricane Katrina's destruction of several of their facilities. Additionally, the debtors cited growing federal regulations as an impediment to growth. To address their substantial debt load and financial struggles, the debtors sought a sale of assets outside of bankruptcy, but were unable to garner offers that would clear secured debt. The secured lender group agreed to purchase the debtors' assets by credit bidding $320 million of the secured debt in a § 363 bankruptcy sale.[3] The secured lenders formed an acquisition company and executed an asset purchase agreement with the debtors. The asset purchase agreement provided that the lenders would pay the legal and accounting fees of the debtors and the official committee of unsecured creditors ("Committee") and some wind-down costs of the business. The secured lenders deposited cash in separate escrow accounts to cover these administrative costs.[4]

Immediately following execution of the asset purchase agreement, the debtors filed bankruptcy and promptly sought to sell substantially all of their assets pursuant to § 363(b)(1). Although the assets were marketed to numerous strategic and financial parties, no offer exceeded the secured lenders $320 million credit bid. The secured lender bid was then accepted by default.

The Committee and the United States objected to the proposed sale. The terms of the sale offered zero payment to unsecured creditors or to the government. The Committee characterized the sale as a bankruptcy court foreclosure. The Committee pointed out that the sale would leave the estate administratively insolvent and provide nothing for the general unsecured creditors. The Committee wanted the secured lenders to pay the freight in the form of a distribution to unsecured creditors for the privilege of utilizing the bankruptcy court to conduct the sale.

The government's objection was based on the fact that the sale would create $24 million in capital gains tax liability, creating an administrative expense that would go unpaid under the terms of the sale. The government argued that this violated the unfair discrimination prohibition[5] of the Bankruptcy Code because the professionals would be paid as administrative claimants while the government would receive no distribution for its claim of equal priority to the administrative claims of the professionals.

The Committee reached a settlement with the secured lender group: The withdrawal of its objection and support of the sale in exchange for payment of $3.5 million to unsecured creditors. This settlement was approved by a separate motion and order from the bankruptcy court. No deal was reached with the

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government. The government objected to the Committee settlement, contending that it violated the absolute priority rule, which requires as part of plan confirmation that all senior claimants be paid in full prior to any junior claimants receiving anything on account of their claims.[6]

The bankruptcy court approved the sale and the settlement over the government's objections. The government was unable to obtain a stay of either order, and the sale closed. The government appealed both decisions, which were affirmed by the district court, then further appealed to the Third Circuit.

Mootness

The Third Circuit first addressed whether the appeal was moot. In light of the government's failure to stay the sale order or the settlement order, the Committee and the debtors argued that the government's appeal was moot in accordance with the doctrines of constitutional, statutory, and equitable mootness. The Third Circuit addressed all three doctrines of mootness before moving to the substance of the appeal.

With respect to constitutional mootness, the Third Circuit stated that as long there is any possibility that the court can grant the appellant some effectual relief, the case is not constitutionally moot. The debtors and the Committee contended that even if the orders were overturned, the government could not obtain any effectual relief because the secured lenders' remaining claim would take any excess funds.[7] Essentially, the government could prevail but the secured lenders would utilize their remaining lien claim to prevent the government from obtaining any payment on its claim. Thus, either way, the government would receive zero payment.

The court disagreed. The Third Circuit did not expand on what relief the government could obtain under these facts, but it did find that some relief was possible. Conceivably, the Third Circuit could have ordered that the funds escrowed for the professionals be divided pro rata with all administrative claimants, including the government, thus providing some relief.

Next the Third Circuit addressed statutory mootness and specifically, § 363(m) of the Bankruptcy Code. This provision moots appeals that would "affect the validity of a sale" to a "good faith" purchaser when a stay of the sale is not obtained.[8] The Third Circuit again boiled its analysis down to whether it could provide effective relief to the government. In this context the issue was whether the Third Circuit could order a redistribution of the funds without disturbing the sale, and the Third Circuit again said "yes." According to the Third Circuit, § 363(m) is designed to protect "good faith purchasers" from a challenge that would "claw back" the sale.[9] The implication is that § 363(m) is not meant to protect the debtors or the Committee and does not protect every term of a sale agreement,[10] potentially allowing a court to redistribute the funds at issue without upsetting the sale to the purchaser and without undermining the intent of § 363(m).

With respect to equitable mootness the Third Circuit stated that this doctrine only exists in bankruptcy cases after a plan has been confirmed.[11] The Third Circuit declined to extend the doctrine to sales under § 363. The Third Circuit recognized that it may seem harsh for the Committee to lose its bargained for consideration without being able to resurrect its sale objection but justified that outcome with the observation that unsecured creditors stood to receive nothing if they were successful in thwarting the sale. So, the loss of their sale objection, in reality, put them in no worse position.

The Absolute Priority Rule and Unfair Discrimination Prohibition

After finding that the government's appeal was not moot, the court moved on to the substance of the appeal. The two doctrines at issue are found in the Bankruptcy Code at § 1129(b) dealing with confirmation of a non-consensual Chapter 11 plan. The absolute priority rule has been referred to as a "vertical test" to ensure that junior creditors and interest holders do not receive any consideration under a plan prior to more senior creditors being paid in full. The unfair discrimination prohibition is a "horizontal test" to ensure that similarly situated creditors (creditors of the same priority) receive equal treatment under a plan.[12]

The government's absolute priority rule argument focused on the settlement reached between the unsecured creditors and the lender, which ultimately gave the unsecured creditors a $3.5 million payment while the government received no consideration on account of its $24 million administrative tax claim. On its face the payment to the unsecured creditors violates the vertical test which would require that the government's priority tax claim be paid in full prior to the unsecured creditors receiving any consideration.

The unfair discrimination argument centers on the fact that the secured lenders agreed to deposit funds in escrow only to cover certain professional fees and designated wind-down expenses. The government's tax claim is an administrative claim on par with the professionals' claims. Thus, using the escrowed funds to pay the professionals but not the government violates the horizontal test which would have required both to be paid equally or at least in a manner that is not "unfair."

The Third Circuit framed the arguments with a two part analysis. The first part of the analysis was whether the funds escrowed by the secured creditors pre-bankruptcy for the professionals or the settlement payment to the unsecured creditors constituted property of the estate. According to the Third Circuit, if these funds were not property of the estate, then the vertical and horizontal priority rules of the Bankruptcy Code do not apply, and the government is out of luck. The second part of the analysis was whether the absolute priority rule and the unfair discrimination prohibition, both of which are rules for confirmation of a plan, apply in the context of a § 363 bankruptcy sale. The Third Circuit suggested, without deciding, that those rules may be properly limited to plan confirmation. The Third Circuit never reached the second part of the analysis, ending its inquiry with the finding that neither the escrowed funds for professionals nor the settlement payment to the unsecured creditors were property of the estate.

Property of the Estate

Property of the estate is defined broadly and includes "[p]roceeds, product, offspring, rents, or profits of or from property of the estate."[13] The government contended that both the escrowed funds and the settlement funds were part of the consideration for the sale and thus "proceeds" of estate property. As proceeds of estate property, the funds would classify as estate property and then be subject to all priority rules of the Bankruptcy Code.

The court first looked at the settlement payment noting that it was an easier call to make. In reviewing the court's analysis of the settlement payment, it is important to understand the mechanics of the settlement between the lenders and the creditors committee. The secured lenders funded the settlement payment by paying their own separate funds directly to the unsecured creditors via a trust. The settlement funds were not first paid into the bankruptcy estate, and the debtors had no involvement in seeing that the funds were paid over to the unsecured creditors. Based on these mechanics, the court was able to distinguish *In re Armstrong World Industries, Inc.*,[14] noting that in *Armstrong* estate property that would have been distributed to a senior creditor was actually gifted to a junior class over the objection of an impaired senior claimant. Here the funds were never in the bankruptcy estate. The court found it equally important that the funds the lenders used for the payment were not proceeds of the lenders' collateral and thus, not proceeds of estate property. The funds were truly separate funds of the lenders.

The government made a compelling counter that in reality the settlement payment was additional consideration for the sale. The secured lenders sought to purchase the assets through a credit bid of 90% of their debt, but when faced with the Committee's objection, the lenders increased their bid by the amount of cash they had to pay to the unsecured creditors to resolve the objection. Declining "to elevate form over substance" and re-characterize the settlement payment as consideration for the sale, the Third Circuit held that funds used in the settlement were handled in a manner such that they were not treated as consideration for the sale and thus never became estate property. The settlement payment was accomplished separate from the sale transaction and the funds came directly from the lenders.

Determining whether the escrowed funds used to pay the fees of the professionals were estate property was a closer call. These funds were actually listed in the asset purchase agreement as "consideration" for the purchase.[15] The Third Circuit had just held that the absolute priority rule had not been violated by finding that the settlement funds were not consideration for the sale and the Third Circuit refused to characterize them as such. With the escrowed funds, the debtors and the lenders had already agreed in writing that they were part of the consideration. The Third Circuit was not phased, noting that the language of the asset purchase agreements may be part of the facts, but the reality of what occurred does not make the escrowed funds part of the sale consideration. Indeed the Third Circuit pointed to the "economic reality" surrounding the escrowed funds.[16]

The asset purchase agreement included the Debtor's cash as an asset being purchased. After the sale closed, the Debtor would therefore have no cash. The funds for the professionals were escrowed at the beginning of the case and per the sale order would go back to the lenders at closing. So, any cash used to pay the professionals would be paid directly by the lenders. The Third Circuit found that these funds never became estate property. The Third Circuit also distinguished the escrow arrangement from a traditional carve-out where lenders allow a portion of their collateral to be used for certain administrative expenses. As collateral, it is necessarily property of the estate. However, in this case the carve-out analogy does not work because the escrowed funds were not part of the lenders' collateral but rather separate funds put up by the lender to cover the expenses.

Having held that neither the escrowed funds nor the settlement funds were property of the estate, the absolute priority rule and the unfair discrimination rule were not implicated and the Third Circuit made no ruling on those issues.

Observations

The Alternate § 363 Route. Those who dwell in the land of Chapter 11 bankruptcy reorganizations, especially those whose identity and livelihood are wrapped up in the fortunes of Chapter 11, fret about the fall off of Chapter 11 cases and the apparently decreasing attractiveness of the Chapter 11 process.[17] Once upon a time, confirmation of a Chapter 11 plan of reorganization was perceived as a reasonable goal that could be and was obtained in a fair number of cases, and there was at least a perception that the plan process worked and that the fundamental fairness statutorily mandated under § 1129(b) was worthy of protection via the prohibition of "sub-rosa" plans through the side door of § 363. For a variety of reasons, not the least of which is the ever increasing expense of the process, the smooth old road to the promised-land of Chapter 11 confirmation, has become filled with potholes and dangerous intersections, leaving the participants scrambling for alternative routes.

The primary alternative route is § 363, by which the parties sell all or substantially all of the assets of the debtor, often as a going concern, without the procedural and substantive restrictions governing confirmation. There are certainly advantages to this route, *e.g.,* it is faster and cheaper, but this case and others highlight its perils and raise some fundamental issues about its use.

The § 363 sales process, now virtually unfettered in many circuits by the old *sub-rosa* plan prohibition, needs rules by which to live. In tension with this need for rules is the desire for an efficient, flexible means to dispose of assets.

One approach is the "pay to play" approach, which usually involves a going concern, an under-secured creditor, unsecured creditors, and administrative claimants. Under this approach, the secured creditor and the debtor are allowed to utilize § 363 to sell assets, and often to preserve a going concern, so long as all administrative claims are paid. Counsel for the unsecured creditors' committee may be entitled to payment for its valuable role in insuring that the secured creditor is indeed perfected and under-secured, but the unsecured creditors are not entitled to hold the case hostage and demand ransom as a condition of § 363 approval.

Another approach has been to re-interpret § 363(k) by denying the secured creditor's right to credit-bid with no "cause" other than that a sale should occur and by so doing create more sales opportunities, especially where secured creditors have no ability to provide additional cash. This approach so far has not gotten much traction, which is understandable given the violence done the rights, including the constitutional rights, of secured creditors.

If one is looking to *ICL* for further development of guidelines for the alternative route of § 363 sales, there is some disappointment but also a means of circumvention. The Third Circuit's conclusion that the $3.5 million settlement and the payment from escrow were not property of the estate, either initially or as proceeds from the sale of assets of the estate, even though: (i) the credit bid was enhanced by a $3.5 million cash payment; and (ii) the parties themselves described the payment from escrow as consideration for the assets, is hard to swallow. Parties in future cases, however, may have been given a roadmap to circumvent priority and fairness issues. By reaching this very strained conclusion, the Third Circuit avoided addressing the issues that could have been addressed by it: under what rules will § 363 be governed? Is there a priority rule? Is there a fairness rule? Is a capital gains tax claim that would likely have been incurred and not paid outside of bankruptcy to be treated differently under a "pay to play" approach than other administrative claims that arguably would not have been incurred outside of a Chapter 11 case?

Mootness

The Third Circuit in *ICL* ducked § 363 issues that needed addressing, and it launched into a mootness analysis that will provide no comfort to those trying to utilize methods short of plan confirmation to resolve disputes with any hopes of finality. Citing *Samson Energy Resources Co. v. SemCrude, L.P. (In re SemCrude, L.P.)*,[18] the Third Circuit held that equitable mootness "comes into play" only after a plan of reorganization is confirmed. Although this seems to be the commonly held view, it is not unassailable.[19]

If bankruptcy courts and the bankruptcy process are to be attractive to those who have the ability to choose the means of dispute resolution, the ability of those parties to structure transactions and settlements that will not be rewritten in whole or in part, even without plan confirmation, would seem to be critical to their choice of forum and their behavior once in the forum. The Third Circuit's limitation of statutory mootness under § 363(m) to the sale transaction itself, only one component of the transaction, and its determination that equitable mootness arises only in the context of Chapter 11 plan confirmation, should make those involved in the process shudder. Litigation is an uncertain business, that is understood, and that uncertainty is what drives parties to settle matters. When the settlement itself, the product of substantial give and take, can be rewritten by a court, the motivation of a party to enter into the forum and to then compromise and settle a matter will be significantly adversely affected.

Regardless of the merits of the legal rulings in *ICL*, the result may have produced the most value for the greatest number of constituents. If the sale had been canceled and the lenders had resorted to a nonbankruptcy foreclosure, no claimants other than the lenders would have realized any value. That may have been the correct outcome for an under-secured creditor, but the lenders paid a relatively modest sum for a great benefit: a § 363 sales order. The Third Circuit's opinion cited to an article by the prominent bankruptcy practitioner, Harvey Miller.[20] Mr. Miller's article was somewhat critical of the Third Circuit's ruling in *Armstrong* and stressed the importance of creativity and flexibility in resolving complicated bankruptcy matters. The Third Circuit at once defends its position in *Armstrong* but by its ruling seems to say, "we get it, sometimes it helps to stretch the bounds of the Bankruptcy Code to reach a result that provides the greatest benefits for the greatest number of parties." The *ICL* result may support the importance of creativity and flexibility, but the Third Circuit's strained § 541 resolution in lieu of tackling priority and fairness issues and its signal that neither mootness nor respect for the bargained-for exchanges of the parties will likely restrict it from rewriting transactions and settlements do little to improve, and may prove injurious to, the evolving alternative route of § 363 sales.

ENDNOTES:

[1]In re ICL Holding Co., No. 14-2709, 2015 WL 5315604 (3d Cir. Sept. 14, 2015).

[2]In re ICL Holding Co., 2015 WL 5315604, at *1.

[3]In re ICL Holding Co., 2015 WL 5315604, at *1.

[4]In re ICL Holding Co., 2015 WL 5315604, at *2.

[5]The "unfair discrimination prohibition" is codified at 11 U.S.C.A. § 1129(b)(1).

[6]11 U.S.C.A. § 1129(b)(2)(B)(ii).

[7]After application of the secured lenders' credit bid, the lenders still retained a $35 million first priority claim to all assets.

[8]See 11 U.S.C.A. § 363(m)

[9]In re ICL Holding Co., 2015 WL 5315604, at *6.

[10]In re ICL Holding Co., 2015 WL 5315604, at *6.

[11]In re ICL Holding Co., 2015 WL 5315604, at *6.

[12]Harvey R. Miller & Ronit J. Berkovich, The Implications of the Third Circuit's *Armstrong* Decision on Creative Corporate Restructuring: Will Strict Construction of the Absolute Priority Rule Make Chapter 11 Consensus Less Likely?, 55 Am. U.L. Rev. 1345, 1347 (2006).

[13]11 U.S.C.A. § 541(a)(6).

[14]In re Armstrong World Indus., Inc., 432 F.3d 507 (3d Cir. 2005) (finding a violation of the absolute priority rule).

[15]In re ICL Holding Co., 2015 WL 5315604, at *8.

[16]In re ICL Holding Co., 2015 WL 5315604, at *8.

[17]See, e.g., American Bankruptcy Institute Commission to Study the Reform of Chapter 11: Final Report and Recommendations (Dec. 8, 2014).

[18]Samson Energy Res. Co. v. SemCrude, L.P. (In re SemCrude, L.P.), 728 F.3d 314 (3d Cir. 2013).

[19]See Technology Lending Partners, LLC v. San Patricio Cty. Cmty. Action Agency (In re Patricio Cty. Cmty. Action Agency), 575 F.3d 553, 558 (5th Cir. 2009).

[20]See Harvey R. Miller & Ronit J. Berkovich, The Implications of the Third Circuit's *Armstrong* Decision on Creative Corporate Restructuring: Will Strict Construction of the Absolute Priority Rule Make Chapter 11 Consensus Less Likely?, 55 Am. U.L. Rev. at 1347.

From the Appellate Courts

RECENT DECISIONS FROM THE APPELLATE COURTS

Alexandra E. Dugan

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Bradley Arant Boult Cummings, LLP
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Birmingham, AL

SUPREME COURT

Baker Botts L.L.P. v. ASARCO LLC, 135 S. Ct. 2158, 192 L. Ed. 2d 208 (2015). Section 330(a)(1) does not authorize an award of attorney fees for work performed defending a fee application. "Reasonable compensation for actual, necessary services rendered" under § 330(a)(1) neither specifically nor explicitly authorizes bankruptcy court to shift the costs of adversarial litigation from one side to the other—in this case, from the attorneys seeking fees to the administrator of the estate.

Bank of America, N.A. v. Caulkett, 135 S. Ct. 1995, 192 L. Ed. 2d 52 (2015). Debtors in Chapter 7 case cannot "strip off," or void, wholly unsecured junior mortgage.

Wellness Intern. Network, Ltd. v. Sharif, 135 S. Ct. 1932, 191 L. Ed. 2d 911 (2015). Parties can cure the constitutional deficiencies of an Article I bankruptcy judge issuing a final judgment after *Stern* through knowing and voluntary consent.

FIRST CIRCUIT

In re Charbono, 790 F.3d 80 (1st Cir. 2015). Bankruptcy court has inherent power to impose a punitive non-contempt sanction on a party for noncompliance with court orders. The $100 sanction against the debtor for failure to timely comply with the tax return production requirement was appropriate given the bankruptcy court's careful assessment of the circumstances, including cash-flow problems of the debtor, extending the payment date and the importance of sending a message regarding timely compliance.

THIRD CIRCUIT

Official Comm. of Unsecured Creditors v. CIT Grp./Bus. Credit Inc. (In re Jevic Holding Corp.), 787 F.3d 173 (3d Cir. 2015). In rare cases, bankruptcy courts may approve structured dismissals of Chapter 11 cases that deviate from the Bankruptcy Code's priority scheme if the structured dismissal is not intended to evade the procedural protections and safeguards of plan confirmation or conversion. The bankruptcy court had discretion to approve the proposed structured dismissal because there was no reasonable expectation that a plan could be confirmed, conversion would result in secured creditors taking the remainder of the estate's assets, and there was at least some payment to unsecured creditors under the settlement. The estate had few assets remaining when the parties settled the committee's lawsuit regarding

