

# Alert

## Third Circuit Approves Use of Escrow Agreements Funded by Acquirers to Pay Junior Creditors Before Senior Creditors

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An asset purchaser's payments into segregated accounts for the benefit of general unsecured creditors and professionals employed by the debtor (i.e., the seller) and its creditors' committee, made in connection with the purchase of all of the debtor's assets, are not property of the debtor's estate or available for distribution to creditors according to the U.S. Court of Appeals for the Third Circuit — even when some of the segregated accounts were listed as consideration in the governing asset purchase agreement. *ICL Holding Company, Inc., et al. v. United States*, \_\_ F.3d \_\_, 2015 WL 5315604 (3d Cir. Sept. 14, 2015) ("*ICL Holding*," f/k/a LCI Holding). In so holding, the court upheld the bankruptcy court's prior orders that permitted unsecured creditors to receive a recovery and provided for the debtor's and committee's professionals to be paid in full despite the fact that a \$24-million administrative expense claim went unpaid. The court ruled that, even if the Bankruptcy Code's priority rules — which require equivalent distributions to similarly-ranked creditors and prohibit junior creditors from being paid before senior creditors — applied to Section 363 sales, neither was violated. This decision could have a far-reaching impact on the structuring of future Section 363 sales, at least in the Third Circuit.

### Background

In 2012, LifeCare Holdings Inc. ("*LifeCare*"), formerly a leading operator of long-term acute care hospitals, was in financial trouble due to, among other things, an overleveraged balance sheet. To address its financial woes, LifeCare's management began to explore a sale of the company's assets.

The sale process was unsuccessful, as none of the bids exceeded — or even approached — the amount of LifeCare's secured debt. LifeCare's secured lenders then offered to purchase all of its assets — including its cash — by credit bidding \$320 million of the \$355 million they were owed. The sale was to be accomplished in the context of a Chapter 11 case for LifeCare. In addition to their credit bid, the secured lenders agreed to pay (1) professional fees for LifeCare and the unsecured creditors' committee (the "*Committee*"); and (2) LifeCare's wind-down costs. Rather than create a carve-out in a cash collateral order for these amounts, as is typically done, the secured lenders placed these sums in separate escrow accounts (the "*Escrow Funds*"), with the agreement that any unused amounts would be returned to them. LifeCare and an acquisition vehicle established by the secured lenders (the "*Purchaser*") entered into an asset purchase agreement ("*APA*"), which listed the Escrow Funds as part of the consideration for LifeCare's assets.

Immediately after entering into the APA, LifeCare commenced its Chapter 11 case and promptly sought authorization to sell its assets to the Purchaser.<sup>1</sup> LifeCare's robust post-petition marketing effort failed to generate a bid that exceeded the Purchaser's offer, and the Purchaser was selected as the successful bidder.

The United States government and the Committee objected to the sale. The government asserted that the sale would result in millions of dollars of capital gains tax for LifeCare that was entitled to administrative expense priority but would go unpaid under the proposed sale arrangement. According to the government, when the sale closed, the Escrow Proceeds would become property of LifeCare's estate because they were listed as consideration in the APA and were paid in exchange for LifeCare's assets.<sup>2</sup> As a result, argued the government, the Escrow Proceeds should be distributed pursuant to the Bankruptcy Code's priority scheme (e.g., equally ranked creditors must receive equal payouts). Otherwise, some administrative expense claimants (i.e., the professionals) would be paid, while others (i.e., the government) would not.

The Committee argued that the sale was a "veiled foreclosure" that benefitted only the secured lenders and would leave the bankruptcy estate administratively insolvent. Prior to the sale hearing, however, the Committee settled with the lenders, agreeing to support the sale process in exchange for the lenders depositing \$3.5 million into a trust for the benefit of unsecured creditors (the "Settlement Proceeds").

The bankruptcy court approved the sale, reserving judgment on the Committee's settlement until a later date and overruling the government's "unequal treatment" objection. Specifically, the court held that the Escrow Funds were not property of LifeCare's estate; accordingly, LifeCare's creditors, including the government, had no claim to them.

The government then objected to the Committee settlement on the same grounds. The bankruptcy court overruled the objection and dismissed the government's further contention that the Settlement Proceeds were property of the debtors' estates subject to the Bankruptcy Code's priority scheme. The court held that because the settlement agreement permitted the secured lenders to pay the Settlement Proceeds directly to a trust for the unsecured creditors, rather than through the debtors, they were not property of the estate and thus, the Bankruptcy Code's priority scheme was not implicated.

The government appealed both the sale order and the settlement approval order and sought a stay pending appeal. The district court denied the requested stay, concluding that the government did not make the threshold showing of a sufficient likelihood of success on the merits. The government then appealed to the Third Circuit.

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<sup>1</sup> LifeCare and its 34 subsidiaries, which operated 27 long-term care facilities and employed approximately 4,500 employees, filed for bankruptcy. For purposes of this *Alert*, LifeCare and its subsidiaries are referred to collectively as "LifeCare."

<sup>2</sup> Section 541 of the Bankruptcy Code defines "property of the estate" as, among other things, "proceeds ... of or from property of the estate." Thus, the government argued, if the Escrow Funds are "proceeds of or from property of the estate," they would qualify as property of LifeCare's estate.

### The Third Circuit's Decision

On appeal, the Third Circuit upheld both lower courts' decisions, reasoning that the Settlement Proceeds and Escrow Funds were not property of LifeCare's estate.<sup>3</sup>

#### *The Settlement Proceeds*

The government argued that secured lenders' payment of the Settlement Proceeds to a trust for the benefit of the unsecured creditors was essentially an increase to the Purchaser's bid for LifeCare's assets required to close the sale. As such, the Settlement Proceeds should be treated as property of the estate. The government further argued that settlement violated the priority scheme by paying junior creditors (i.e., the unsecured creditors) before senior creditors (i.e., the government), relying on *In re Armstrong World Indus., Inc.*, 432 F.3d 507 (3d Cir. 2005) (gifting of estate property by senior creditors to junior creditors pursuant to contested plan of reorganization violated the Bankruptcy Code's priority scheme).

The Third Circuit disagreed, holding that the Settlement Proceeds were not given as consideration for the purchased assets. The court noted that the Settlement Proceeds were not paid at LifeCare's direction, and were paid with the secured lenders' own funds directly to the unsecured creditors via a trust. Differentiating *Armstrong*, the Third Circuit noted that here the secured lenders were not providing an impermissible gift of *estate* property to a junior creditor over an intermediate creditor's objection, reasoning that the Settlement Proceeds were not proceeds of the secured lender's liens, did not at any time belong to LifeCare, and would not become part of LifeCare's estate even if the settlement were not approved. Thus, because the Settlement Proceeds never passed through the debtor they were not property of LifeCare's estate or subject to the Bankruptcy Code's priority scheme.<sup>4</sup>

#### *Escrowed Funds*

The Escrowed Funds presented a tougher question for the Third Circuit because, unlike the Settlement Proceeds, they were expressly listed in the APA as part of the purchase price for LifeCare's assets. This, argued the government, qualified the Escrowed Funds as property of LifeCare's estate.

The Third Circuit again disagreed, holding that because the secured lenders acquired *all* of LifeCare's assets, including its cash, once the sale closed "there technically was no more estate property." 2015 WL 5315604, at \*20. Because LifeCare agreed to surrender all of its cash, and because the Sale Order provided that any of the remaining Escrowed Funds were to be released to the secured lenders (which

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<sup>3</sup> On appeal, LifeCare and the Committee contended that the Third Circuit need not consider the government's appeal, which, they argued, was moot on several grounds. First, LifeCare argued that, even if the government had a claim, the secured lenders retained a \$35-million deficiency claim that made any recovery by administrative claimants remote. Second, LifeCare argued that Section 363(m) moots any challenge to 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." Finally, the Committee contended that the appeal was equitably moot because the government had been unsuccessful in obtaining a stay of its settlement and more than \$2 million in proceeds had already been distributed to unsecured creditors.

The Third Circuit held that the government's appeal was not moot. First, even if the government's prospect of recovery in the shadow of a large deficiency claim was remote, that fact alone did not moot the appeal. Second, the Third Circuit noted that it interprets Section 363(m) broadly and would consider any sale-challenge that does not affect the "validity of the sale." The court held that, here, it could grant the government the relief it sought (a redistribution of the sale proceeds) without affecting the sale to the Purchaser. Finally, the court held that the appeal was not equitably moot because, outside of a plan of reorganization context, the Third Circuit had yet to hold that equitable mootness would cut off its authority to hear an appeal.

<sup>4</sup> The Third Circuit also dismissed the government's argument that the settlement agreement contained an admission that the Settlement Proceeds were estate property. The settlement agreement provided that the parties' compliance represented "an agreement between the Buyer, the Lenders and the Committee to allocated proceeds derived from the sale" (emphasis in original). The court declined to elevate form over substance to give legal significance to the description of the Settlement Proceeds in the settlement agreement.

had already happened prior to oral argument before the Third Circuit), “as a matter of substance” the court could not conclude that the Escrowed Funds were estate property.

### Takeaways

This decision could have a profound effect on the structure of Section 363 sales, particularly within the Third Circuit, in cases where there are creditors with significant claims entitled to priority treatment. Using escrows to pay certain constituencies, such as professionals and unsecured creditors, with new cash while essentially freezing out similarly ranked, or even senior, stakeholders provides acquirers with even more flexibility when purchasing assets in Section 363 sales. This flexibility stands in stark contrast to the limitations imposed on acquirers who purchase assets pursuant to plans of reorganization or liquidation, where, for example, all allowed administrative expense claims must be paid in full in cash on the plan effective date. Thus, reorganization plans may become even less attractive for debtors and acquirers than they already are.

Conversely, holders of priority claims — even administrative claims — are now on notice that they may be forced to watch as other priority claims (or even general unsecured claims) get paid while theirs do not. For example, it is conceivable that a debtor and acquirer could utilize a similar strategy to seek to freeze out the administrative claim of a landlord whose lease was assumed during the case, or the actual and necessary costs of closing a health care business.

The *ICL Holding* decision is in line with the Third Circuit’s decision earlier this year in *Official Committee of Unsecured Creditors v. CIT Group/Business Credit Inc. (In re Jevic Holding Corp.)*, in which a divided panel of the Third Circuit held that a settlement providing for dismissal of a Chapter 11 case and distribution of estate property “that deviates from the Bankruptcy Code’s priority” scheme is permissible. 2015 WL 2403443, at \*1 (3d Cir. May 21, 2015).<sup>5</sup> In *Jevic*, the Third Circuit authorized a settlement that provided a recovery for general unsecured creditors but no recovery at all for an excluded group of terminated employees holding priority wage claims. The Third Circuit held that bankruptcy courts have more flexibility in approving settlements than in confirming reorganization plans, and refused to strictly apply the Bankruptcy Code’s priority scheme to settlements.

Unlike *ICL Holdings*, the *Jevic* case involved a settlement that distributed estate property, rather than new cash paid by a purchaser directly to a favored stakeholder. Nevertheless, *Jevic* and *ICL Holding* are indicative of the Third Circuit’s apparent belief that parties should be provided significant flexibility to resolve disputes consensually where the resolution will provide a greater overall recovery to creditors — even when those settlements are at the expense of creditors otherwise entitled to better treatment under the Bankruptcy Code’s priority scheme.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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<sup>5</sup> See our *Alert* on the *Jevic* case, “[Divided Third Circuit Approves Structured Dismissal That Provides Class-Skipping Distribution.](#)”

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