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Third Circuit Allows Debtors' Funds Purchased in Section 363 Sale to Bypass IRS and be Distributed to Administrative and Unsecured Creditors

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October 28, 2015 - The Third Circuit has affirmed the Delaware Bankruptcy Court's approval of a section 363 sale and related settlement agreement over IRS's objection to provisions in the sale and settlement agreements that provide payments to unsecured creditors and other administrative creditors while leaving the IRS with no recovery. While the IRS argued that the sale and settlement violated the absolute priority rule by favoring creditors with an equal or lesser priority under the Bankruptcy Code's distribution scheme, the Third Circuit found that neither the funds set aside to make payments to unsecured creditors nor the funds set aside to pay other administrative creditors constitutes property of the debtor's estate. As the Bankruptcy Code's creditor-payment hierarchy is applicable only to property of the debtor, therefore, it was not implicated by the provisions in the sale and settlement agreements.

Prior to the petition date, and after failing to attract purchase offers that exceeded its debt obligations, LifeCare Holdings, Inc. entered into an asset purchase agreement with an acquisition vehicle made up of its secured lenders—who were undersecured due to the falling value of the company—whereby the secured lenders credited $320 million of the $355 million debt they were then owed in return for the cash and assets of LifeCare. In addition, the lenders agreed to pay the legal and accounting fees of LifeCare and the Committee of Unsecured Creditors, as well as the company's wind-down costs, and to deposit funds into separate escrow accounts for the purpose of paying those amounts. The day after entering into the asset purchase agreement, LifeCare and its subsidiaries filed for bankruptcy and asked for permission to sell substantially all of its assets through a section 363 auction. Ultimately, the secured creditors' "credit bid" remained the most attractive offer. After an objection to the sale by the Committee, the secured lenders' group entered into a settlement agreement with the Committee whereby the secured lenders agreed to deposit $3.5 million in trust for the benefit of the general unsecured creditors.

The US Government, representing the IRS, objected to the sale and the settlement and sought a stay on the distribution of funds to creditors, arguing that the sale would result in a large capital-gains tax liability, thereby giving them an administrative claim, and that the proposed sale and settlement agreements therefore violated the absolute priority rule by providing for payments to be made to equally situated administrative creditors—primarily bankruptcy professionals—and to unsecured creditors.

In determining that the sale and settlement were properly approved by the Bankruptcy Court, the Third Circuit described the central issue as "whether certain payments by a section 363 purchaser . . . in connection with acquiring the debtors' assets should be distributed according to the Code's creditor-payment hierarchy." The court focused on its view of the substance of the sale over form and found that the money in question was not paid at the debtors' direction, consisted of the purchaser's own funds, and never entered the estate.

The Third Circuit's ruling may provide incentive for undersecured lenders to make similar credit bids, and for debtors to accept such bids. While potential purchasers, debtors, and creditors may be tempted to use the decision as a map to altering the Bankruptcy Code's distribution scheme and a avoiding the tax implications of section 363 sales, the adoption of this approach by other circuits is not certain. For now, creditors should be warned that they risk being bypassed by such sale arrangements.

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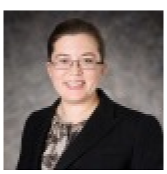

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