Pay-to-Play Doctrine

A Practical Guidance® Practice Note by George H. Singer, Ballard Spahr LLP

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This practice note provides an overview of the pay-to-play doctrine as it pertains to Chapter 11 bankruptcy cases. The pay-to-play concept arose in response to secured creditors' desires to use bankruptcy to liquidate their collateral in sales under Section 363(b) of the Bankruptcy Code.

Pay-to-play generally means that a secured lender, as the often-sole beneficiary of the Chapter 11 process and Section 363 sale, should at least pay the costs of the bankruptcy process from the petition date through closing as a matter of fairness. In a pay-to-play scenario, the secured lender strikes a deal with the debtor early in the bankruptcy where the debtor agrees to quickly sell its assets and waives its right to surcharge the collateral under Section 506(c) and waives any other claim against the lender. The lender agrees to carve out from its collateral certain amounts to pay the administrative expense claims of the bankruptcy (such as paying professionals retained by the debtor and the creditor's committee) subject to a cap. As part of the negotiations with the debtor and the committee, the lender may also agree to a gift plan arrangement whereby the lender agrees to give a portion of its recovery under a Chapter 11 plan to a junior creditor class or to the equity holders, over the objection of an intermediate creditor class that is not being paid in full in accordance with the plan.

This practice note addresses the pay-to-play doctrine as follows:

- The Rise of Section 363 Asset Sales
- Basis of the Pay-to-Play Doctrine
- The Path to a Pay-to-Play Scenario
- Current Case Law
- The Future of the Pay-to-Play Doctrine in Bankruptcy

For information on gifting, see Gift Plans.

The Rise of Section 363 Asset Sales

"At its most fundamental level, a business bankruptcy case is designed to maximize the returns to creditors holding claims against the estate . . . . Maximizing creditor recoveries may be done with a reorganization of the business or with its liquidation, but it is a fundamental requirement." In re Moody Nat'l SHS Houston H, LLC, 426 B.R. 667, 675 (Bankr. S.D. Tex. 2010).

For a large number of companies in financial trouble, the traditional corporate reorganization has become increasingly rare. The collective forum envisioned by the drafters of Chapter 11 in which creditors and their common debtor work together to fashion a future that involves the preservation of the firm has been increasingly supplanted by a sale process conducted in Chapter 11. In bankruptcy, a debtor's assets can be sold in two different ways: through a sale of assets pursuant to Section 363 of the Bankruptcy

Code or pursuant to a Chapter 11 plan. Section 363(b) of the Bankruptcy Code provides that during a bankruptcy case, the trustee or debtor in possession may, after notice and a hearing, use, sell, or lease property of the debtor outside of the ordinary course of business (referred to as Section 363 sales). In the Second Circuit and other jurisdictions, courts may approve Section 363 sales of substantially all of a debtor's assets provided that there is a "good business reason for the sale."

Over the years, the time and cost of administering a Chapter 11 bankruptcy case have increased. During difficult economic times, debtors find it more difficult to raise capital outside of Chapter 11, to maintain adequate levels of liquidity, and/or to obtain significant value for their assets. Typically, auctioning off assets at a Section 363 sale is a much faster mechanism for disposing of a debtor's assets and allowing the company to more quickly emerge from Chapter 11. With the added costs and burdens of formulating a plan and negotiating its terms among a variety of key case constituencies including the creditors' committee, the debtor-in-possession (DIP) lenders, the first and second debt lienholders, the bondholders' committee, and others, Chapter 11 debtors frequently choose to liquidate their assets through an expedient Section 363 sale rather than devote the additional costs and time associated with a formal, prolonged plan process.

In a case in which the sale of assets yields sufficient proceeds to pay secured and administrative claims in full (which the Bankruptcy Code requires in order to confirm a Chapter 11 plan), the Section 363 sale may be the quicker, cheaper alternative to achieving the fundamental goals of Chapter 11. On the other hand, if an asset sale generates insufficient proceeds to pay secured and administrative claims in full (thereby leaving general unsecured creditors without any recovery whatsoever), significant issues arise. The general unsecured creditors are out of the money as that concept relates to being legally entitled to a recovery from the debtor's prepetition assets.

The pay-to-play doctrine has emerged in response to the ever-growing number of quick asset sales under Section 363, many of which yield inadequate proceeds to fund any distribution to general unsecured creditors. Nothing in the Bankruptcy Code requires a secured creditor to "pay to play" in Chapter 11. Instead, the idea behind the pay-to-play doctrine is that a secured lender, as the often-sole beneficiary of the Chapter 11 process and Section 363 sale, should at least pay the costs of the bankruptcy process from the filing date through closing as a matter of fundamental fairness. Additionally, some courts suggest that the secured lender should also offer certain concessions to unsecured creditors through gifting or a carve-out from the collateral securing the lender's debt.

Currently, there is no clear authority as to whether a secured creditor must pay to play in Chapter 11. As a result, the issue is largely in the hands of the courts pending intervention by Congress. Only time (and an accumulation of written decisions) will reveal the extent to which the pay-to-play doctrine may become a standard, uniform practice in bankruptcy.

Basis of the Pay-to-Play Doctrine

One of the most intriguing questions involves the type and extent of relief potentially available to a secured creditor whose debt is not satisfied in full by the proceeds of a bankruptcy sale under Section 363. Some intertwined questions include:

- Can a secured creditor use the Chapter 11 bankruptcy process for its own purposes to liquidate collateral solely for its own benefit?
- If a Section 363 sale will only (or primarily) benefit the secured creditor, should that creditor be required to pay for the costs of using the bankruptcy process to liquidate its collateral (i.e., to carve out of its collateral funds for the benefit of general unsecured creditors)?
- More specifically, if general unsecured creditors have no chance of receiving a distribution from proceeds of the debtor's prepetition assets after the secured creditor is paid, should the secured creditor be required to make some concessions for the benefit of unsecured creditors in order to keep the case in Chapter 11? In other words, should the secured creditor be required to pay the costs of liquidating the collateral in Chapter 11 and pay a portion of unsecured claims in exchange for being permitted to "play" in Chapter 11 by liquidating its collateral and/or bid (or credit bid) for the debtor's assets at a Section 363 sale?
- If the secured creditor should pay to play, when are the secured creditor's payment obligations triggered and when do they end? Similarly, what are the specific expenses for which the secured creditor should be responsible? In that regard, should a secured lender who is the sole beneficiary of a Section 363 sale be required to fund a liquidating plan, or is conversion or dismissal of the case following the sale appropriate?

- Even if the stalking horse bidder at the auction is not the secured creditor, should the stalking horse nevertheless be subject to the pay-to-play doctrine as well, such that the stalking horse bidder should absorb some (or all) of the costs of administering the debtor's bankruptcy case?
- Should the pay-to-play rules be modified or expanded when the purchaser of the debtor is an insider, as opposed to an outside third party or secured lender? Similarly, should all of the protections of the Bankruptcy Code be fully available to an insider who, along with the secured creditor, stands to solely benefit from the Section 363 sale?

The Path to a Pay-to-Play Scenario

Generally, pay-to-play issues arise when a debtor proposes to sell substantially all of its assets before a plan is formulated, and the proceeds will be less than the value of the debtor's total secured debt, thus precluding any recovery to general unsecured creditors from prepetition assets. In this situation, the creditors' committee will often object to the proposed Section 363 sale, arguing that:

- The secured creditor that is the sole or primary beneficiary of a sale is in reality controlling a process that ignores (or even harms) other stakeholders as a creditor in possession.
- The use of Section 363 should not be a substitute for the plan process.
- The case is or is likely to become administratively insolvent.
- The sale should be delayed because the assets have not been adequately marketed.
- The timing of or process related to the sale is not adequate to maximize value.
- Given that the secured creditor is the sole or primary beneficiary of the sale, it is only fair for the creditor to be responsible for some of the costs of using the Chapter 11 process for its own advantage.

Most cases that are likely administratively insolvent address such objections through negotiations. Often, to reach a consensual resolution that enables the auction or a liquidating plan to proceed, the debtor may require the beneficiary of the asset sale to backstop the administrative insolvency up to a certain amount. In other situations, the debtor may require the beneficiary to fund a wind-down budget through conversion of the case or confirmation (and implementation) of a liquidating plan. Frequently, the secured creditor may offer to carve out or gift some portion of its sale proceeds for distribution to unsecured creditors in order to obtain the committee's (and the court's) support for the sale and, in turn, expedite the process.

Current Law

There is no clear answer as to whether there must be a distribution to general unsecured creditors in the context of a Section 363 sale. The Bankruptcy Code does not require a distribution to unsecured creditors.

Few reported cases address pay-to-play concepts in the context of Section 363 asset sales. Instead, as a practical matter, secured creditors usually choose to grant concessions to creditors' committees in order to resolve objections and achieve consensus on the Section 363 sale. As a result, the research on this emerging issue in bankruptcy is generally limited to comments by parties in interest in connection with hearings involving objections to a proposed asset sale, DIP financing facility, or other first-day hearing motions and, occasionally, to a liquidating plan. Nevertheless, a handful of reported decisions provide some guidance and delineate two different approaches on the issue of whether a secured creditor must pay to play in Chapter 11.

The Encore Healthcare Rationale

The first approach holds that secured creditors must pay to play in Chapter 11. See In re Encore Healthcare Associates, 312 B.R. 52 (Bankr. E.D. Pa. 2004). In *Encore Healthcare*, the debtor sought to sell the estate's assets, valued at $2.5 million, and to use all of the proceeds to pay a portion of the secured lender's $8.4 million claim. No party objected to the sale, but the bankruptcy court, sua sponte, raised concerns. The court explained that debtors do not have an absolute right to sell assets under Section 363 outside of a Chapter 11 plan. The court reasoned that, instead, a Section 363 sale is appropriate only if some business justification exists for the sale such as improving the debtor's prospects for reorganization, generating proceeds to pay administrative and unsecured claims when the debtor otherwise lacks liquidity, or when the proceeds exceed the value of all liens.

Applying these principles in *Encore Healthcare*, the court noted that none of the above circumstances existed. Instead, the court pointed out that the sale proceeds would be used only to pay the secured lender and would provide no benefit to general unsecured creditors. Additionally, the business would not be able to continue operating or employing personnel after the sale closed, and the debtor intended to convert the case to Chapter 7 immediately

thereafter. The court reasoned that in this situation, the lender could just as easily foreclose and sell its assets outside of Chapter 11, or the debtor could simply abandon its assets to the secured lender who could then sell them outside of Chapter 11, thereby negating any need or justification for a Section 363 sale or the bankruptcy process.

As a result, the court ultimately denied the debtor's sale motion. See also In re Gulf Coast Oil Corp., 404 B.R. 407 (Bankr. S.D. Tex. 2009) (rejecting Section 363(b) sale presumed to solely benefit the senior creditor because "the essence of the proposed transaction is [the senior creditor's] foreclosure supplemented materially by a release, by assignment of executory contracts (but only the contracts chosen by the secured lender), by a federal court order eliminating any successor liability, and by preservation of the going concern. Congress provided a process by which these benefits could be obtained. That scheme requires bargaining, voting, and a determination by the [c] ourt that Bankruptcy Code § 1129 requirements are met.")); In re Golf LLC, 322 B.R. 874, 878 (Bankr. D. Neb. 2004) (recognizing that there is no reason to approve a Section 363 sale unless some equity, after payment of secured creditors, will be left behind for the benefit of the estate and unsecured creditors); In re Fremont Battery Co., 73 B.R. 277 (Bankr. N.D. Ohio 1987) (finding no sound business purpose to approve a Section 363 sale since the sale would not benefit unsecured creditors as a whole and noting that approval of a Section 363 sale where no funds would remain to propose a plan would be contrary to the policies of Chapter 11); In re Au Natural Rest Inc., 63 B.R. 575, 581 (Bankr. S.D.N.Y. 1986); In re Duro Indus., Inc., 2004 Bankr. LEXIS 1235, at *16 (Bankr. D. Mass Aug. 26, 2004) (finding liquidation of assets in Chapter 11 not appropriate where unsecured creditors will not receive a recovery).

The *Encore Healthcare* decision reflects the idea that while Chapter 11 is a proper vehicle through which to liquidate assets, there are limits as liquidations must still comply with the requirements of the Bankruptcy Code. This line of authority holds that in order to satisfy the sound business purpose and justification standard required for the approval of a Section 363 sale, a debtor must demonstrate that some portion of the sale proceeds or value is benefitting unsecured creditors. In other words, counsel should be aware that courts subscribing to Encore Healthcare rationale will generally expect secured creditors to offer certain concessions to general unsecured creditors as the price for being able to benefit from a Section 363 sale in Chapter 11—"most secured creditors understand the necessity of making some distribution available to other creditors as the price of a court-approved sale." Encore Healthcare, 312 B.R. at 57 n.10.

The GPA Rationale

In contrast to the *Encore Healthcare* decision, some other courts take the approach that Chapter 11 may in fact be used for the sole benefit of a secured creditor. See In re GPA Technical Consultants, Inc., 106 B.R. 139 (Bankr. S.D. Ohio 1989). In *GPA Technical*, the debtor filed a liquidating plan under which it sought to liquidate its assets. The U.S. Trustee moved to dismiss or convert the case, arguing that the only parties who stood to benefit from the liquidation were the secured creditor and counsel for the debtor. The U.S. Trustee contended that under the circumstances, it was more appropriate for the debtor to abandon its assets to the secured creditor and convert to Chapter 7 than to burden the estate with additional expenses related to Chapter 11.

Rendering its decision, the bankruptcy court denied the U.S. Trustee's motion. In doing so, the court held that Chapter 11 is a proper mechanism for a liquidation even if the secured lender is the only party that will benefit financially while general unsecured creditors receive nothing. "[T] here need not be any unsecured creditors in a bona fide reorganization, and thus the only creditor interests to be taken into account may sometimes be secured creditors." GPA Technical, 106 B.R. at 143. The court pointed out that in this case, the secured lender was funding the debtor's payroll and administrative expenses from its cash collateral and had established a carve-out to pay professional fees. As the court added, any losses were being offset by asset liquidations, the collection of accounts receivable, and the future prosecution of avoidance actions. The court pointed out that, as a result, certain creditors stood to benefit from the bankruptcy process and specifically from a Section 363 sale, even though general unsecured creditors were "out of the money." In further justifying the propriety of the sale, the court noted that unsecured creditors stood to receive nothing regardless of whether the debtor's assets were sold at a Section 363 sale in Chapter 11, in a Chapter 7 liquidation, or out of court.

Under the circumstances, the *GPA Technical* court concluded that a quick Section 363 sale would maximize the value of the estate and distributions to administrative creditors, adding that the sale would not harm equity holders or unsecured creditors. In its ruling, the court clarified that a recovery to unsecured creditors is not a prerequisite to justifying a Section 363 sale in bankruptcy and that maximizing the return to a secured creditor is a legitimate interest to consider when deciding whether to convert or dismiss a Chapter 11 case. The court went so far as to note that because the secured lender's claim exceeded any possible recovery, there was no estate as far as unsecured creditors were concerned. See In re Western Pacific Airlines, Inc., 218 B.R. 590 (Bankr. D. Colo. 1998) (holding that even if the only reason for the Chapter 11 is to maximize the return to the secured creditor through liquidating assets and seeking to recover avoidance actions, the interests of the secured creditor are legitimate interests); In re Whitney Design, Inc., Case No. 09-51928-705, Docket No. 89 at pp. 24-28 (Bankr. E.D. Mo. Jan. 29, 2010) (finding based upon the facts before it that no party was being improperly prejudiced by the secured creditors essentially "buying" relief available under the Bankruptcy Code); see also In re Rausch Mfg Co., 59 B.R. 501, 503 (Bankr. D. Minn. 1985) (approving a sale is warranted when the continuation of jobs and promotions of commerce in the community, leading goals of Chapter 11, are achieved). A mandatory tax on an undersecured creditor's collateral that would be imposed by a pay-to-play rationale in all cases engrafts a statutory requirement on Chapter 11 where none currently exists.

The Trend in Delaware

As objections to Section 363 sales and related settlement discussions abound, the pay-to-play doctrine continues to grow. At this point, the general rule in Delaware seems to be that Chapter 11 is an appropriate vehicle for a secured creditor to liquidate its collateral or for a potential purchaser or insider to gain a sole benefit so long as, at a minimum, the beneficiary pays 100% of the administrative costs of the bankruptcy case from the petition date through the closing of the Section 363 sale. These costs include rent, U.S. Trustee fees, wages, professional fees, vendor payments, insurance, and utility charges. In other words, secured creditors must be willing to "pay the freight" to obtain the benefits of bankruptcy. See Hr'g Tr. at 100:17-20, In re NEC Holdings Corp., Case No. 10-11890 (KG) (Bankr. D. Del. July 13, 2010) (indicating that secured creditors have "got to pay the freight, and the freight is . . . certainly an administratively solvent estate"); Hr'g Tr. at 23:25-24:9, In re Townsends, Inc., Case No. 10-14092 (CSS) (Bankr. D. Del. Jan. 21, 2011) (initially refusing to approve DIP financing, indicating in response to statement of debtor's counsel that certain priority claims would not be paid in full, the court stated: "Well, we've got a problem. Not going to run an administratively insolvent estate.").

The bankruptcy courts in Delaware have even approved sales in certain circumstances where not all priority claims will be paid and the primary beneficiary is the debtor's secured creditor. In In re Allen Family Foods Inc., the court approved a quick sale process even though it was "troubled" by the prospect of the debtors' administrative insolvency and the probability of insufficient funds to fully pay all Section 503(b)(9) administrative-priority claims. Hr'g Tr. at 44:6 – 45:3, Case No. 11-11764 (KJC), Docket No. 225 (Bankr. D. Del. Aug. 3, 2011). The secured lender agreed, however, to fund the payment of post-petition trade payables and other operating expenses, pre-petition claims of critical vendors and professional fees. The court allowed disparate treatment among administrative priority claims, finding that creditors asserting Section 503(b)(9) claims made no "ongoing contribution" to the Chapter 11 case in contrast to other administrative claimants. While disparate treatment would be an issue were a pending Chapter 11 plan before the court, it would not prohibit the court from approving a sale. Hr'g Tr. at 27:3 – 27:14, Allen Family, Case No. 11-11764 (KJC), Docket No. 225 (Bankr. D. Del. Aug. 3, 2011).

While not required by the Delaware courts, the beneficiaries in pay-to-play scenarios often also provide for the establishment of a pot funded either by cash, proceeds, or avoidance action recoveries through which general unsecured claims may be paid. What this shows is that in Delaware, as long as the bankruptcy process does not create new exposure or liability (or worsen a creditor's current position), it is a proper vehicle to use, even if general unsecured creditors stand to receive nothing through the Chapter 11 process.

The Future of the Pay-to-Play Doctrine in Bankruptcy

As the pay-to-play doctrine continues to expand, new issues have begun to emerge. One such issue involves whether an insider who seeks to purchase assets at a Section 363 sale where the proceeds will be insufficient to make a distribution to unsecured creditors should be entitled to all of the protections that a third-party purchaser

would generally receive. Many parties argue that when the sole beneficiary of the sale is an insider, the insider's stalking horse bid should provide more favorable terms to the estate than if the bid were submitted by a third-party purchaser. For example, the pay-to-play doctrine could preclude an insider's stalking horse bid from including certain protections generally afforded to third-party bidders, such as a breakup fee or expense reimbursement provision, which in turn would preserve value for the estate and unsecured creditors.

A second issue involves whether the pay-to-play obligations imposed on a beneficiary should include the payment of pre-petition vendor claims that have administrative priority under Section 503(b)(9) of the Bankruptcy Code. Some courts seem willing to fund these claims through the proceeds of avoidance actions while other courts seem to support the beneficiary of the Section 363 sale paying such claims in cash.

Another issue is whether courts will approve gifting arrangements in settlements, sales, or plans where the secured creditor reaches an agreement to allow proceeds of its collateral to fund a distribution to a class of creditors. For a full discussion of such issues (which is directly relevant to the pay-to-play doctrine), see Gift Plans.

At this point, there is no clear authority on the question of whether a secured creditor must pay to play, as a rule. There is nothing in the Bankruptcy Code that obligates a secured creditor to make sacrifices simply to pacify unsecured creditors that have no other prospect of recovery. As a practical matter, these issues may not yet be clearly delineated, but this lack of clarity has some advantages. For example, because the pay-to-play rules remain unclear, secured lenders are generally encouraged to make concessions to unsecured creditors in exchange for support from the creditors' committee, which in turn results in distributions to junior classes and brings certainty and efficiency to the bankruptcy process. Similarly, while the approaches articulated by *Encore Healthcare* and *GPA Technical* are different, the two positions can likely be reconciled rather easily based on the facts of particular cases going forward.

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