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Feature

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Life After *Jevic*: An End to Priority-Skipping Distributions?

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Last spring, in *Czyzewski v. Jevic Holding Corp.*, the U.S. Supreme Court held that a bankruptcy court cannot authorize a nonconsensual "structured dismissal" of a chapter 11 petition that ends the case by distributing assets in a manner that deviates from the Bankruptcy Code's priority scheme.[1] While the *Jevic* Court arguably framed the question before it as a narrow one focused on permissible distributions upon *dismissal* of a chapter 11 petition, its reasoning, borrowing from sale and *sub rosa* plan cases, suggests that the requirement that in-case distributions observe the Code's priority scheme and other substantive and procedural protections might reach beyond structured dismissals.

Not surprisingly, a number of recent bankruptcy court decisions have begun to extend *Jevic*'s reach. These decisions relied on *Jevic* to deny other types of interim and final distributions — contained in settlements, sales and a critical-vendor motion — that sought to deviate from the normal priority rules in the absence of, for example, evidence "that disregard of the priority scheme will promote 'a significant Code-related objective.'"[2]

Jevic's full reach may not be known for some time. However, this much is clear: Prudent practitioners should be prepared to offer evidence that priority-skipping distributions, whether on an interim or final basis, serve an overriding reorganization purpose, or they will run the risk that the relief will not be granted. While such a showing is necessary, whether it is sufficient is an open question.

The Court's Decision in *Jevic*

The facts of *Jevic*, which have been discussed previously in the *ABI Journal*,[3] followed a familiar pattern of a leveraged buyout (LBO) leading to a bankruptcy. As is often the case, the LBO transaction in *Jevic* gave rise to preference and fraudulent transfer litigation during the chapter 11 case. More specifically, the official committee of unsecured creditors alleged that the LBO buyer and LBO lender had burdened the debtor with too much debt for the company to service, which accelerated its demise.[4] Meanwhile, the chapter 11 case was also the forum for litigation brought by some of the debtor's former employees: A group of truck drivers, who alleged that the debtor and LBO buyer violated state and federal labor laws when the debtor terminated them on the eve of the bankruptcy filing without sufficient notice.[5]

What happened next propelled the case to the Supreme Court. The LBO buyer, the LBO lender, the debtor and the committee reached a settlement that included a dismissal of the fraudulent-transfer case in exchange for the LBO buyer allowing a distribution to general unsecured creditors, and for dismissal of the chapter 11 case.[6] However, the truck drivers' claims were left out of the settlement distributions "because [their ...] suit ... was still pending and [the LBO buyer] did not want to help finance that litigation."[7] Despite this, the bankruptcy court approved the settlement because it "predicted that without the settlement and dismissal, there was 'no realistic prospect' of a meaningful distribution for anyone other than secured creditors."[8]

1 137 S. Ct. 973 (2017).
2 *In re Fryar*, No. 1:16-BK-13559-SDR, 2017 WL 1489822, at *6 (Bankr. E.D. Tenn. April 25, 2017) (quoting *Jevic*, 137 S. Ct. at 985).
3 Anna Haugen, Courtney A. McCormick and Kathryn Z. Keane, "Re-'Structuring' Dismissal Flexibility: An Analysis of the Supreme Court's *Jevic* Decision," XXXVI *ABI Journal* 5, 12, 71-73, May 2017, *available at* abi.org/abi-journal.
4 *Jevic*, 137 S. Ct. at 981 (quoting *In re Jevic Holding Corp.*, 787 F.3d 173, 176 (3d Cir. 2015) (describing committee's argument)).
5 *Id.* at 980. The truck drivers alleged that they were entitled to at least 60 days' notice before their termination pursuant to 29 U.S.C. § 2102 and N.J. Stat. Ann. § 34:21-2.
6 *Id.* at 981. The LBO buyer claimed a lien on the property to be distributed pursuant to the settlement.
7 *Id.*
8 *Id.* at 982 (quoting *Jevic Holding Corp. v. Group/Business Inc. (In re Jevic Holding Corp.)*, Bk. No. 08-11006 (BLS), Adv. No. 08-51903, 2011 WL 4345204 (Bankr. D. Del. Sept. 15, 2011)).

The truck drivers' claims were allegedly out of the money, and the general unsecured creditors would benefit, so what was the harm, and what standing did the truck drivers have to object to the settlement? The Supreme Court quickly dispensed with this issue.

During the course of the appeals, the bankruptcy court entered summary judgment for the truck drivers, "leaving them (and *this* is the point to remember) with a judgment that [they] say is worth $12.4 million."[9] Of that amount, $8.3 million was a priority-wage claim that had to be paid before the debtor's general unsecured claims.[10] According to the Court, the bankruptcy court's approval of the structured dismissal cost the truck drivers their "chance to obtain a settlement that respected their priority," which was sufficient to give them standing.[11]

On the question of whether a bankruptcy court can "approve a structured dismissal that provides for distributions that [violate] ordinary priority rules without the affected creditors' consent," the Court grounded its statutory interpretation on the text of §§ 1112(b) and 349(b) of the Bankruptcy Code and the Code's priority-based distributive policies.[12]

Section 1112(b) authorizes a chapter 11 case to be dismissed, after notice and a hearing, if doing so is in the best interests of creditors. As the Supreme Court emphasized, § 349(b) governs the effect of such a dismissal and seeks "a restoration of the prepetition financial status quo."[13] The *Jevic* Court stated:

> The Code gives a bankruptcy court the power to "dismiss" a Chapter 11 case. [Section] 1112(b). But the word "dismiss" itself says nothing about the power to make nonconsensual priority-violating distributions of estate value. Neither the word "structured," nor the word "conditions," nor anything else about distributing estate value to creditors pursuant to a dismissal appears in any relevant part of the Code. Insofar as the dismissal sections of Chapter 11 foresee any transfer of assets, they seek a restoration of the prepetition financial status quo. Section 349(b), we concede, also says that a bankruptcy judge may, "for cause, orde[r] otherwise." But, read in context, this provision appears designed to give courts the flexibility to "make the appropriate orders to protect rights acquired in reliance on the bankruptcy case."[14]

While the Court went to great lengths to clarify that it was expressing "no view about the legality of structured dismissals in general," it distinguished orders approving *final* distributions in violation of the priority rules from orders approving priority-skipping *interim* distributions, such as *In re Iridium Operating LLC*,[15] a case relied upon by the Third Circuit in the decision on appeal.[16] The *Jevic* Court stated:

> Courts, for example, have approved "first-day" wage orders that allow payment of employees' pre-petition wages, "critical-vendor" orders that allow payment of essential suppliers' pre-petition invoices, and "roll-ups" that allow lenders who continue financing the debtor to be paid first on their pre-petition claims. In doing so, these courts have usually found that the distributions at issue would enable a successful reorganization and make even the disfavored creditors better off. By way of contrast, in a structured dismissal like the one ordered below, the priority-violating distribution is attached to a final disposition; it does not preserve the debtor as a going concern; it does not make the disfavored creditors better off; it does not promote the possibility of a confirmable plan; it does not help to restore the status quo ante; and it does not protect reliance interests.[17]

Not only did the Court distinguish these types of interim distributions, it also then analogized the structured dismissal that it was reviewing to a number of "proposed transactions that lower courts have refused to allow on the ground that they circumvent the Code's procedural safeguards."[18] By way of example, the Court cited *In re Braniff Airways Inc*.[19] and characterized it as prohibiting an asset sale under the *sub rosa* plan doctrine; *In re Lionel Corp*.[20] and characterized it as reversing approval of an asset sale and holding that "§ 363 does not 'gran[t] the bankruptcy judge carte blanche' or 'swallo[w] up Chapter 11's safeguards'"; and *In re Biolitec Inc*.,[21] and characterized it as "rejecting a structured dismissal because it 'seeks to alter parties' rights without their consent and lacks many of the Code's most important safeguards.'"[22] The Court also cited *In re Chrysler LLC*,[23] in which the Second Circuit observed that "the bankruptcy court demonstrated 'proper solicitude for the priority between creditors and deemed it essential that the [s]ale in no way upset that priority.'"[24]

Bankruptcy Courts Applying *Jevic*

The Court's reliance on *Braniff*, *Lionel*, *Bioletic* and *Chrysler* paved the way for several recent bankruptcy court decisions withholding approval of certain interim and final distributions of estate assets based on *Jevic* — not only sales and settlements, but also at least one critical-vendor motion when there was no evidence that the proposed distribution would have served a reorganization purpose.

For example, in *In re Fryar*, a bankruptcy court refused to approve a settlement that would have authorized a priority-skipping distribution without the consent of the affected creditors.[25] Relying on *Jevic*, the court reasoned that the settlement not only had to be "fair and equitable," but also that its approval required evidence "that any deviation from the priority scheme for a portion of the assets is justified because it serves a significant Code-related objective."[26] The court detailed the proof required as follows:

> The proposed settlement should state that objective, such as enabling a successful reorganization or permitting a business debtor to reorganize and restructure its debt in order to revive the business and maximize the value of the estate. The proposed settlement

9 *Jevic*, 137 S. Ct. at 980 (emphasis in original).
10 *Id.*
11 *Id.* at 983.
12 *Id.* at 983-84.
13 *Id.* at 984.
14 *Id.* (internal authorities omitted).
15 478 F.3d 452 (2d Cir. 2007).
16 *Jevic* at 985.
17 *Id.* at 985-86 (internal authorities and quotations omitted).
18 *Id.* at 986.
19 700 F.2d 935, 940 (5th Cir. 1983).
20 722 F.2d 1063, 1069 (2d Cir. 1983).
21 528 B.R. 261, 269 (Bankr. D.N.J. 2014).
22 *Jevic* at 986.
23 576 F.3d 108, 118 (2d Cir. 2009).
24 *Jevic* at 986.
25 *See supra* n. 2 at *6 (quoting *Jevic* at 985).
26 *Id.*

should state how it furthers that objective and should demonstrate that it makes even the disfavored creditors better off.[27]

However, the settlement before the court "fail[ed] to meet this standard."[28] The case — the debtor's second, after an earlier dismissal for failure to propose a plan — had lingered on the docket for months, and the court was "hard pressed to determine what business remains to be revived or reorganized."[29] In other words, the proposed settlement was akin to a "*sub rosa* plan or a precursor for conversion or dismissal in which the Code's priority scheme is ignored" and could not be approved.[30]

In *In re Constellation Enterprises*, another recent case applying *Jevic*, a bankruptcy court denied the approval of a settlement that would have distributed the proceeds of a sale of substantially all of the debtor's assets in violation of the absolute priority rule and the rule against intra-class discrimination.[31] The court reasoned that the settlement was proposed "at the end of this case's" life, and assumed that "the case [was] either going to dismiss or convert very shortly."[32] Thus, like *Fryar*, the bankruptcy court found no evidence that the proposed distribution of sale proceeds promoted a reorganization purpose.[33]

The *Constellation* decision is also notable for its critical observation that *Jevic* involved non-estate assets. Thus the court suggested that *Jevic* could apply to an out-of-priority distribution, or one that discriminates unfairly, regardless of whether it involves non-estate property, such as assets of a purchaser or creditor, or where a nondebtor entity controlled or dictated the distribution. According to the bankruptcy court:

> [T]here were non-estate property elements of that settlement that were not ... approved, and the Court really didn't delve into it one way or another, but a distinction that simply says *Jevic* doesn't apply because none of the property here is property of the estate, I think that goes too far. I don't think we can say with certainty that's the distinguishing factor that would rule. *Jevic* wasn't pure, estate property versus non-estate property.[34]

The bankruptcy court in *In re Hansen* faced a slightly different issue of whether to grant a trustee's motion to sell certain assets to the trustee's preferred buyer with an incorporated settlement, or approve a competing offer that did not settle the same claim.[35] On the one hand, the trustee sought approval of a settlement that promised a full recovery for general unsecured claims, a nearly complete recovery for administrative creditors, and a dismissal of litigation against the party making the offer.[36] On the other hand, another creditor made an offer that would have paid all creditors in full and then provide the debtor with value — but the payments depended on a favorable outcome in speculative litigation against the party that submitted the trustee's preferred offer.[37] In light of *Jevic*, "the Court finds that the certainty of payment to creditors through [one offer] over the uncertainty of payment to creditors and a surplus to the Debtors through [the other offer] warrants a finding that this ... [settlement] factor weighs in favor of approving the [trustee's preferred offer]."[38] Thus, for this reason and others, the court granted the trustee's motion and rejected the competing offer.

[A]ny distribution ignoring the priority rules or other protections, including the prohibition against intra-class discrimination, must serve "a significant Code-related objective," such as having a direct nexus to the reorganization of the debtor.

Finally, the bankruptcy court's decision in *In re Pioneer Health Services Inc*. provides another data point on *Jevic*'s reach.[39] In that case, the bankruptcy court denied a health care debtor's request to treat certain physician creditors as critical vendors who could be paid on account of their pre-petition claims.[40] While the debtor argued that the physicians would refuse to continue providing medical services to patients without payment of their pre-petition claims, the bankruptcy court found this *argument* to be unpersuasive due to insufficient *evidence*.[41] *Pioneer Health* is notable because the *Jevic* opinion apparently blessed most critical-vendor payments as having a reorganization-related purpose. This case suggests that the conclusion is not a given, but a matter of proof.

Unresolved Questions

The common thread tying these cases together is their application of *Jevic*'s apparent requirement that a nonconsensual, priority-skipping transfer be supported by evidence that it furthers a reorganization objective. With that being said, *Jevic*'s ultimate reach is still unknown.

On the one hand, it is safe to say that settlements and asset sales providing for final distributions of estate assets must either follow the Bankruptcy Code's priority rules or have consent from affected parties — and that this was foreseeable given the Court's reliance on and characterization of *Braniff*, *Lionel*, *Bioletic* and *Chrysler*. On the other hand, it is too soon to tell if *Pioneer Health*'s application of *Jevic* to interim distributions makes it an outlier. Perhaps it is, or perhaps it isn't. Either way, the prudent practitioner will be prepared with evidence, not just an argument, when seeking approval of critical-vendor motions, wage motions and borrowing motions involving a pre-petition roll-up.

27 *Id.*
28 *Id.* at *7. The court's refusal to approve of the compromise doomed a sale motion based on the compromise. *Id.*
29 *Id.* at *6.
30 *Id.* at *7.
31 No. 16-bk-11213, Order Denying Joint Motion Approving Settlement, entered at Docket Entry 963 (Bankr. D. Del. May 16, 2017). The court's reasoning was set forth orally. A copy of the transcript is available from the authors upon request and will be cited as "Tr. of Hr'g, [page]:[line]."
32 Tr. of Hr'g, 252:9-18.
33 Tr. of Hr'g, 251:11-252:18.
34 Tr. of Hr'g 248:16-251:4.
35 Bk. No. 12-11907-JMD, 2017 WL 1491765 (Bankr. D.N.H. April 25, 2017).
36 *Id.* at *1-2. The trustee agreed to a slight reduction in her claim.
37 *Id.* at *2-3. The debtor was not going to get paid. Rather, there was a stipulation that payment to another party was to be treated as value attributable to the debtor for purpose of the motion.
38 *Id.* at *11.
39 Case No. 16-01119-NPO, 2017 WL 1279030 (Bankr. S.D. Miss. April 4, 2017).
40 *Id.* at *5.
41 *Id.* at *6-7.

Another unanswered question is whether carve-outs of a secured creditor's collateral can continue to be used in class-skipping "gifts" without implicating the absolute priority rule and *Jevic*. The practice has become accepted in some districts following *Official Comm. of Unsecured Creditors v. Stern (In re SPM Mfg. Corp.)*,[42] a chapter 7 case in which the First Circuit held that "the distribution scheme of section 726 (and, by implication, the priorities of section 507) does not come into play until all valid liens on the property are satisfied." The First Circuit reasoned that while the lender's collateral was property of the estate subject to the Bankruptcy Code's priority rules, "once the court lifted the automatic stay and ordered those proceeds distributed to [the lender] in proper satisfaction of its lien, that money became property of [the lender], not of the estate."[43]

Is relief from stay all it takes to avoid *Jevic*'s reach, or does that merely elevate form over substance? Early decisions applying *Jevic* arguably do not distinguish between priority-skipping distributions based simply on whether the estate has title to the assets. Thus, *Jevic* might spell the end of "gifting" — both inside and outside of plans, and particularly in all asset-sale transactions. Selling first, and settling distributions later, might not work either, as *Constellation Enterprises* suggests.

Conclusion

Practitioners can certainly argue to limit the reach of *Jevic* to the structured-dismissal context. However, the Court's reasoning strongly indicates that, at a minimum, any distribution ignoring the priority rules or other protections, including the prohibition against intra-class discrimination, must serve "a significant Code-related objective," such as having a direct nexus to the reorganization of the debtor. Sales of all assets, case-determinative settlements and other transactions that preclude a bootstrap restructuring and substitute a "sale model of reorganization" might just have to follow all of the rules. abi

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42 984 F.2d 1305, 1312 (1st Cir. 1993).
43 *In re SPM Mfg. Corp.*, 984 F.2d at 1313.