Feature

KEY POINTS

- The US Bankruptcy Code sets forth a basic system of priority, which ordinarily determines the order in which the bankruptcy court will distribute assets of the debtor's bankruptcy estate.
- The Code makes clear that distributions of assets in a Ch 7 liquidation must follow this prescribed order. It provides somewhat more flexibility for distributions pursuant to Ch 11 plans, which may impose a different ordering with the consent of the affected parties.
- In *Czyzewski v Jevic*, the US Supreme Court considered whether certain creditors and representatives of the debtor's estate could, effectively, contract around the Bankruptcy Code's statutory priority scheme to dispose of assets of the debtor's estate via a so-called "structured dismissal," all over the objections of non-consenting creditors.
- While not disapproving of "structured dismissals" *per se*, the court held that "structured dismissals" may not be used to effect non-consensual, priority-violating distributions.

Author Michael D Good

Czyzewski v Jevic Holding Corp: some "priority" rules for "structuring" bankruptcy dismissals

In this article, Michael Good considers the implications for Ch 11 case administration of the Jevic ruling and the implications for settlements in bankruptcy. The ruling is of interest to non-US entities considering a Ch 11 filing.

In sophisticated commercial jurisdictions, courts must frequently balance the commercial stability and predictability necessary for robust credit markets with the flexibility required for risk-taking innovation and the creation of wealth. But this balance is challenging for courts to manage, and one that exists in inherent tension.

The US Supreme Court's recent decision in *Czyzewski v Jevic Holding Corp* (*Jevic*) illustrates this tension – and judicial attempts to balance it – within the context of bankruptcy.

Jevic primarily concerns the balance between the repayment expectations of creditors (who bargain for and extend credit on commercial terms that incorporate a well-understood system of prioritised distribution in the event a borrower is unable to pay) and the repayment efforts of insolvent debtors (who have a statutory – and, under US law, a fiduciary – duty to distribute as much as possible to as many creditors as possible). *Jevic* presents this balance in a case involving a creditor who, without any apparent benefit to be derived from prioritised distribution, nevertheless employed the distribution scheme to block payments to other, lower-priority creditors.

Jevic's resolution of this balance offers insight into (and questions regarding) how it is maintained through the Ch 11 administrative process and, further, how that process affects the dynamics of settlement.

THE CODE'S PRIORITY SYSTEM

To appreciate *Jevic*'s balancing act, some background on the payment priority scheme imposed by the US Bankruptcy Code is necessary:

> "The [US Bankruptcy] Code . . . sets forth a basic system of priority, which ordinarily determines the order in which the bankruptcy court will distribute assets of the [debtor's bankruptcy] estate. Secured creditors are highest on the priority list, for they must receive the proceeds of the collateral that secures their debts . . . Special classes of creditors, such as those who hold certain claims for taxes or wages, come next in a listed order . . . Then come low-priority creditors, including general unsecured creditors . . . The Code places equity holders at the bottom of the priority list. They receive nothing until all previously listed creditors have been paid in full . . .
>
> The Code makes clear that distributions of assets in a Chapter 7 liquidation must follow this prescribed order . . . It provides somewhat more flexibility for distributions pursuant to Chapter 11 plans, which may impose a different ordering with the consent of the affected parties. But [even in Chapter 11], a bankruptcy court cannot confirm a plan that contains priority-violating distributions over the objection of an impaired creditor class . . ." *Czyzewski v Jevic Holding Corp.*, 2017 WL 1066259, at *5 (U.S. Mar. 22, 2017) (citations omitted).

At issue in *Jevic* is whether certain creditors and representatives of the debtor's estate may exploit the flexibility inherent in Ch 11 to, effectively, contract around the Bankruptcy Code's statutory priority scheme to dispose of assets of the debtor's estate via a "structured dismissal" of the debtor's Ch 11 case, all over the objections of other, non-consenting creditors. *Id.* ("The question here concerns the interplay between the Code's priority rules and a Ch 11 dismissal.").

THE FACTS

Jevic's facts are relatively straightforward.

Jevic Transportation, Inc. was a trucking company headquartered in New Jersey that in 2006 was purchased by a subsidiary of Sun Capital Partners. In 2008, Jevic filed for bankruptcy under Ch 11 of the Bankruptcy Code; at that point, it owed about $53m to its first-priority senior secured creditors and about $20m to its tax and general unsecured creditors. Two lawsuits ensued in bankruptcy court: One was the truck drivers suing Jevic for violating federal and state Worker Adjustment and Retraining Notification Acts, which required 60 days' notice to workers before

they were laid off. The other was a fraudulent conveyance action on behalf of the unsecured creditors, alleging that Sun Capital's purchase of Jevic's assets through a leveraged buyout (LBO) deprived the creditors of value.

In March 2012, the parties to the fraudulent conveyance action negotiated a "structured dismissal" settlement that disposed of many of the claims and provided for a small payment to general unsecured creditors, but left out the drivers. The drivers objected to the settlement because it distributed property to creditors of lower priority than the drivers, according to the Bankruptcy Code's priority scheme for the confirmation of Ch 11 plans.

The bankruptcy court overruled these objections and approved the proposed settlement. The federal district court and the US Court of Appeals for the Third Circuit affirmed and held that the bankruptcy court had the discretion to approve a distribution, via a settlement outside of the Ch 11 proceedings, that did not comply with the Bankruptcy Code's Ch 11 plan distribution scheme.

THE TENSION

Proponents of *Jevic*'s approach argued that the settlement was simply an innovative extension of commonly-understood exceptions to the Bankruptcy Code's priority scheme. Moreover, because Jevic's assets were over-encumbered, any alternative to a settlement would have left objecting drivers with nothing in any event. Therefore, the settlement left non-participating (and objecting) creditors in no worse position than they would have been otherwise. For them, a "structured dismissal" that skipped the Code's priority scheme under the unique circumstances of that case was a pragmatic, *ad hoc* resolution of litigation that brought money into Jevic's Ch 11 estate and, concurrently, furthered one of the Code's central policies: providing the maximum distribution to the maximum participating creditors.

The appellants – and various supporting *amici* – begged to differ. The lower Court of Appeals characterised the Code's priority-driven alternatives to settlement as "a bridge to nowhere." But in the appellants' view, the resolution of a bankruptcy case by contract (via a "structured dismissal") rather than by the Code's priorities was in fact "a bridge too far." As observed by the lower Court's single dissenter:

> "The settlement reallocated assets of the estate in a way that would not have been possible without the authority conferred upon the creditors' committee by Chapter 11 and effectively terminated the Chapter 11 case, but it failed to observe Chapter 11's 'safeguards of disclosure, voting, acceptance, and confirmation'. … This settlement then appears to constitute an impermissible end-run around the carefully designed routes by which a debtor may emerge from Chapter 11 proceedings."

In re Jevic Holding Corp., 787 F.3d 173, 188 (3d Cir. 2015), *as amended* (Aug. 18, 2015), *cert. granted sub nom. Czyzewski v Jevic Holding Corp.*, 136 S. Ct. 2541, 195 L. Ed. 2d 867 (2016) and *rev'd and remanded sub nom. Czyzewski v Jevic Holding Corp.*, 2017 WL 1066259 (U.S. Mar. 22, 2017) (Sirica, J., dissenting).

THE RULING

The Supreme Court reversed the Third Circuit Court of Appeals. The 6-2 majority's succinct, 11½-page decision explained that:

- Given the importance of the Bankruptcy Code's priority system, a major departure from that system requires an affirmative indication of Congressional intent to do so.
- Insofar as the dismissal sections of Ch 11 foresee any transfer of assets, they seek a restoration of the prepetition financial *status quo*. Those provisions of the Code which permit a change from this *status quo* do so only to protect reliance interests acquired in the bankruptcy, not to make general end-of-case distributions that would be flatly impermissible in a Ch 11 plan or Ch 7 liquidation.
- Cases in which courts have approved deviations from ordinary priority rules generally involve interim distributions serving significant Code-related objectives. That is not the case here, where, eg the priority-violating distribution is attached to a final disposition, does not preserve the debtor as a going concern, does not make the disfavoured creditors better off, does not promote the possibility of a confirmable plan, does not help to restore the *status quo ante*, and does not protect reliance interests.
- Despite the compelling economics of a structured dismissal in this case (ie a settlement which leaves priority creditors no worse off than they would have been without one), Congress authorised no "rare case" exception to the Code's priority scheme that permits courts to disregard priority in structured dismissals for "sufficient reasons". In fact, the lack of precision inherent in the concept of "sufficient reasons" threatens to create an exception to the Code's priority scheme which would swallow the scheme. To find a "rare case" exception where Congress never specifically articulated one would result in uncertainty that has potentially serious consequences – eg departure from the protections granted to particular classes of creditors, changes in the bargaining power of different classes of creditors even in bankruptcies that do not end in structured dismissals, risks of collusion, and increased difficulty in achieving settlements.

IMPLICATIONS FOR CH 11 CASE ADMINISTRATION

Importantly for practitioners, *Jevic*'s holding appears limited to: (i) dismissals; with (ii) with problematic features such as the ones identified here. This is simply another way of saying that, despite *Jevic*.

"Interim" orders intended to further the progress of a Ch 11 case (as opposed to orders, such as the one under review in *Jevic*, purporting to dispose of the case on a final basis) may, under certain circumstances, be acceptable even when those interim orders violate the Code's priority scheme

Jevic's majority was careful to distinguish the case before it from the Second Circuit's earlier decision in *In re Iridium Operating LLC*, 478 F.3d 452 (C.A.2 2007) – in which the Court of Appeals approved a similar settlement that violated the Code's priority scheme – because that earlier decision "does not state or suggest that the Code authorises nonconsensual departures from ordinary priority rules in the context of a dismissal – which is a final distribution of estate value – and in the absence of any further unresolved bankruptcy issues." *Czyzewski v*

Feature

Biog box

Michael D Good is a practitioner with over two decades of experience in corporate bankruptcy and insolvency work, and is managing principal of South Bay Law Firm in Los Angeles County, California. He is also Of Counsel at Alvarado Smith, a Professional Corporation, with offices in Orange County, Los Angeles and San Francisco, California.
Email: mgood@southbaylawfirm.com

Jevic Holding Corp., 2017 WL 1066259, at *12 (U.S. Mar. 22, 2017).

The court's language identifies some specific "red flags" to be avoided in connection with any proposed distribution that would violate the Code's priorities: Departure from the protections granted to particular classes of creditors, changes in the bargaining power of different classes of creditors even in bankruptcies that do not end in structured dismissals, and risks of collusion. Conversely, a priority-violating distribution may be acceptable in a Ch 11 case if it:

- is *not* attached to a final disposition;
- *does* preserve the debtor as a going concern;
- *does* make the disfavoured creditors better off (as opposed to merely leaving them no worse off, as was the case in *Jevic*);
- *does* promote the possibility of a confirmable plan;
- *does* help to restore the pre-bankruptcy *status quo ante*; and/or
- *does* protect reliance interests obtained during the bankruptcy.

Structured dismissals are generally permissible, so long as they avoid the problems identified here

Importantly, the court was careful to avoid comment on the general concept of structured dismissals. *See Czyzewski v Jevic Holding Corp.*, 2017 WL 1066259, at *12 (U.S. Mar. 22, 2017) ("We express no view about the legality of structured dismissals in general"). This lack of comment arguably suggests acquiescence in them, under the considerations just outlined.

Moreover, *Jevic*'s limited holding seems to leave open at least the theoretical (albeit remote) possibility of a priority-violating dismissal where another significant offsetting bankruptcy-related justification exists, or where the Code's procedural safeguards are preserved. *Id.* ("In short, *we cannot find in the violation of ordinary priority rules that occurred here any significant offsetting bankruptcy-related justification* . . . . Rather, the distributions at issue here more closely resemble proposed transactions that lower courts have refused to allow on the ground that they circumvent the Code's procedural safeguards") (emphasis supplied).

Jevic's tacit acquiescence in "structured dismissals" as an acceptable means of disposing of Ch 11 cases also raises further questions about them: How will the consent of a so-called "skipped class" be obtained? And, how are its members determined, given that there is no plan on file that classifies creditors? Does the movant/petitioner need to classify all creditors in its dismissal motion and then affirmatively go out and obtain their approval? And, is that approval determined by the Code's voting rules applicable to plans? Since structured dismissals are sought by motion, it is likely that parties seeking approval of structured dismissals will argue that failure to object constitutes the necessary consent. Indeed, this has some basis in the *Jevic* opinion, as the court in distinguishing a "priority-skipping settlement" case from the Northern District of Texas noted that there, no one with an economic stake in the case had objected. Thus, the issue of how to determine the consent of a skipped class will likely only arise if a party in that class does lodge an objection.

IMPLICATIONS FOR SETTLEMENTS IN BANKRUPTCY

Jevic is noteworthy in another, related respect: Despite the court's desire to avoid "increased difficulty in achieving settlements," settlements in cases involving terminating estates may now, in fact, be more difficult to achieve. This is because potential (or actual) defendants won't settle if they are required by the Code's priorities to fund constituencies adverse to themselves.

This was precisely the case in *Jevic*, where Sun Capital had refused to make a distribution to the debtor's estate that would undoubtedly have been used to fund priority creditors' ongoing litigation against it. *Czyzewski v Jevic Holding Corp.*, 2017 WL 1066259, at *7 (U.S. Mar. 22, 2017) ("Apparently Sun insisted on a distribution that would skip petitioners because petitioners' WARN suit against Sun was still pending and Sun did not want to help finance that litigation."). In situations such as *Jevic*, where the estate has no unencumbered assets except for litigation claims, similar dynamics are likely to prevail.

There may be increased pressure to resolve disputes "globally"

Alternatively, there may be increased pressure to resolve *all* litigation claims, at once – and not piecemeal. As in *Jevic*, this may prove much more difficult – or impossible – in cases where one or more litigants (such as taxing authorities, who commonly hold priority status) perceive their own bargaining position to be improved because of "holdout" or "veto" power.

Failing a global settlement, it remains to be seen whether secured parties will push for conversion to Chapter 7 of an administratively insolvent debtor when they can no longer dictate the terms of a structured dismissal.

There may be increased pressure to resolve individual disputes early in the case

Finally, there may be increased pressure to resolve individual litigation claims early in the case, since the majority's language in *Jevic* suggests that timing may be an important factor in evaluating settlement terms that run afoul of the Code's priority scheme. *Czyzewski v Jevic Holding Corp.*, 2017 WL 1066259, at *12 (U.S. Mar. 22, 2017) (distinguishing *Iridium*) ("The *Iridium* court observed that, when evaluating this type of preplan settlement, '[i]t is difficult to employ the rule of priorities' because "the nature and extent of the Estate and the claims against it are *not yet fully resolved*."').

CONCLUSION

Jevic illustrates the careful balance courts employ to manage commercial tension between predictability (sought by creditors) and innovative wealth creation (sought by debtors). By defining new parameters and raising new questions about structured dismissals in bankruptcy, *Jevic* also suggests that this balance, no matter how careful, will always be unstable. ■

Further Reading:

- What's next for insolvency law reform in Europe: a pan-European insolvency law? [2015] 7 JIBFL 435.
- Cram-down in European restructurings [2010] 3 JIBFL 177.
- LexisNexis RANDI blog: Skadden comment on Chapter 11 reforms proposed by the ABI.