Jevic - A Paradigm Shift for General Unsecured Creditors? Only Time Will Tell

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Introduction

In its March 2017 decision in *Czyzewski v. Jevic Holding Corp.*,[1] the Supreme Court of the United States (the "Supreme Court") held that case-ending structured dismissals which circumvent the absolute priority rule and do not have a significant Bankruptcy Code related justification are impermissible. Because creditors' committees rely heavily on structured dismissals and related gifting provisions to obtain a recovery for holders of general unsecured claims ("GUCs") where a recovery would not otherwise be possible, practitioners and commentators have expressed concern over the long term implications of the *Jevic* decision.

This article provides an overview of *Jevic* and its progeny, and predicts that courts are more likely to adopt a narrow reading of *Jevic* in recognition of the challenges faced by GUCs and the need for flexibility to encourage consensual bankruptcy case resolution. Accordingly, courts will likely be hesitant to further erode general unsecured creditors' limited leverage by extending *Jevic's* holding to other contexts, such as postpetition financing orders, global settlements, or gift plans. While *Jevic's* prohibition on case-ending, class-skipping, structured dismissals was relatively clear, the extent of its impact on other aspects of Chapter 11 cases is unclear.

Power and Priority in a Chapter 11 Case

General unsecured creditors—who generally only receive distributions once secured creditors and administrative and priority creditors are paid in full—oftentimes face an insurmountable uphill battle to obtain a meaningful recovery in a bankruptcy case. The rising number of debtors that seek bankruptcy protection with bala In re Petersburg Regency LLC, 540 B.R. 508, 532 (Bankr. D.N.J. 2015) (noting a structured dismissal would prevent a more expensive alternative). nce sheets overwhelmed by secured indebtedness has increased the prevalence of cases in which debtors and their secured lenders exercise a disproportional amount of control and influence over the Chapter 11 process. Likely due to the cost and significant time it takes to confirm a Chapter 11 plan[2], this dynamic has recently been exacerbated by the popularity of expedited section 363 sales of substantially all of a debtor's assets. In section 363 sales, it is quite common for a debtor to be unable to pay off its secured creditor, or ensure administrative solvency, let alone provide sufficient funds for a distribution to general unsecured creditors.

This has forced creditors' committees to formulate alternative (and often, creative but controversial) methods to enhance their constituency's chance of a distribution. Popular methods relied upon by creditors' committees include the use of a structured dismissal and/or gifting provisions.

What is Structured Dismissal?

A structured dismissal is an exit strategy that includes elements of both a confirmation order and dismissal order. A structured dismissal typically results in the dismissal of a bankruptcy case and includes, among other things, provisions (i) specifying the manner and amount of distributions to creditors; (ii) granting certain third party releases; (iii) enjoining certain conduct by creditors; (iv) approving claims reconciliation procedures; and (v) approving senior creditor carve-outs and "gifting" provisions, whereby, as consideration for a consensual structured dismissal, a senior secured creditor agrees to carve out a portion of its collateral from the sale proceeds and then "gift" it to GUCs[3].

[1] *Czyzewski et al., v. Jevic Holding Corp., et al.,* 137 S. Ct. 973 (2017).

[2] *In re Petersburg Regency LLC*, 540 B.R. 508, 532 (Bankr. D.N.J. 2015) (noting a structured dismissal would prevent a more expensive alternative).

[3] *See Jevic* at 979 (citing American Bankruptcy Institute Commission To Study the Reform of Chapter 11, 2012-2014 Final Report and Recommendations 270 (2014)).

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Although gifting provisions often appear in structured dismissals, they also appear in a variety of other contexts, including plans and 9019 settlements. As their name implies, gifting provisions provide an avenue for creditor recovery even where the debtor's balance sheet would not otherwise allow for such distribution. Both structured dismissals and gifting provisions are particularly appealing to debtors seeking an inexpensive and efficient exit strategy, to secured creditors who can use gifts to facilitate a settlement with dissenting creditors, and to general unsecured creditors who can use these tools as leverage to obtain a recovery that would not otherwise be available. These mechanisms, however, have been the frequent subject of challenge.

Ironically, many of the Bankruptcy Code provisions that were codified with an eye toward protecting GUCs — such as the absolute priority rule[4] — actually interfere with the alternative strategies relied upon by creditors' committees. The absolute priority rule, which generally works to ensure that claims of a higher priority level are paid in full before any claim in a lower priority level is satisfied, is one of the primary obstacles faced by creditors' committees seeking approval of structured dismissals and/or gifting provisions.

Parties that oppose structured dismissals and "gift" type settlements argue that such arrangements constitute *sub rosa* plans, violate the absolute priority rule, amount to unfair discrimination, swallow up Chapter 11's safeguards, and are not fair and equitable.[5] Moreover, as structured dismissals are not expressly permitted under the Bankruptcy Code, it is not surprising that *Jevic* made its way to the Supreme Court.

The Jevic Decision

In *Jevic*, an administratively insolvent debtor proposed a structured dismissal to settle certain litigation between the main stakeholders in the Chapter 11 proceedings. The creditors' committee had commenced certain avoidance actions against the purchaser and lender (the "LBO Defendants") in connection with the debtor's leveraged buyout transaction, alleging the transaction saddled the debtor with more debt than it could carry. At the same time, certain of the debtor's employees commenced litigation against the debtor asserting that they did not receive proper notice of their termination under the WARN Act.[6]

The debtor, the creditors' committee, and the LBO Defendants agreed to a structured dismissal that provided for a dismissal of the creditors' committee's fraudulent conveyance action in exchange for an infusion of cash by the LBO Defendants that would be used to: (a) pay the creditors' committee's legal fees; (b) pay the debtor's administrative expenses and tax obligations; and (c) make a distribution to general unsecured creditors on a *pro rata* basis. The structured dismissal, however, did not provide for any distribution to the employees that commenced the WARN litigation and held a priority wage claim (a higher priority claim than the claims held by GUCs) totaling $8.3 million.

Although the bankruptcy court[7] held the structured dismissal did not violate the absolute priority rule because the rule was inapplicable in the context of pre-plan settlements, and the Third Circuit Court of Appeals adopted a "flexible approach" to find that a deviation from the absolute priority rule was warranted in light of the "dire circumstances" of the case[8], the Supreme Court found the structured dismissal was impermissible.

The Supreme Court held that a bankruptcy court cannot approve a case-ending structured dismissal of a Chapter 11 case which seeks to distribute assets in a manner that deviates from the Bankruptcy Code's priority scheme. Accordingly, *Jevic* requires strict compliance with the statutory priority scheme where a structured dismissal is contemplated. The Supreme Court also noted that, although various courts have approved interim distributions outside of the Bankruptcy Code's priority

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[4] *Jevic*, 137 S. Ct. at 983 ("Distributions of estate assets at the termination of a business bankruptcy normally take place through a Chapter 7 liquidation or a Chapter 11 plan, and both are governed by priority. In Chapter 7 liquidations, priority is an absolute command—lower priority creditors cannot receive anything until higher priority creditors have been paid in full.").

[5] *See, e.g., In re Braniff Airways, Inc.*, 700 F.2d 935, 940 (5th Cir. 1983); *In re Lionel Corp*., 722 F.2d 1063 (2d Cir. 1983); *In re Biolitec, Inc.*, 528 B.R. 261, 269 (Bankr. D.N.J. 2014).

[6] 29 U.S.C. § 2102.

[7] *Jevic Holding Corp. v. Group/Business Inc. (In re Jevic Holding Corp.)*, 2011 WL 4345204 (Bankr. D. Del. Sept. 15, 2011).

[8] The Third Circuit noted that the dire circumstances included the absence of any unencumbered estate assets to pay for litigating a fraudulent transfer action, the inability to confirm a plan, and the lack of any prospect of a recovery by any party other than the secured creditors upon conversion of the case to chapter 7.

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scheme, such as distributions made under wage orders and critical vendor orders, in those cases, courts "have usually found that distributions at issue would enable a successful reorganization and make even the disfavored creditors better off."[9] The Court added that such orders must have a "significant offsetting bankruptcy-related justification."[10]

In *Jevic's* wake, bankruptcy practitioners and commentators questioned whether the decision would increase the burden for debtors seeking approval of distributions in violation of the absolute priority rule or vitiate a debtor's right to seek such relief altogether. Others wondered if courts would rely on the decision's flexible and subjective language which seemingly gives a wink and a nod to class-skipping distributions so long as they are deemed to have a significant offsetting bankruptcy-related justification.[11] While any attempt to determine the full scope of *Jevic's* eventual reach would be premature, certain post-*Jevic* decisions are particularly helpful in at least starting to understand its influence.

Jevic's Progeny

Certain courts have interpreted *Jevic* as imposing a more stringent burden on courts deciding whether to authorize any relief that deviates from Bankruptcy Code's priority scheme. For example, in an April 2017 decision in *In re Pioneer Health Services, Inc.*[12], the Bankruptcy Court for the Southern District of Mississippi denied a debtor's critical vendor motion because Jevic required stricter scrutiny of any distribution that violates the Bankruptcy Code's priority scheme. In so ruling, the court suggested that the proposed distributions to unsecured creditors (certain doctors the Debtors wanted to employ post-petition) served no significant offsetting bankruptcy-related justification.[13]

Another recent decision illustrating the potential wide-reaching scope of *Jevic* is the Bankruptcy Court for the Eastern District of Tennessee's April 2017 opinion in *Fryar*.[14] In *Fryar*, an individual Chapter 11 debtor sought approval of a settlement in connection with a sale motion that provided for a sale of the debtor's 50% interest in companies to his business. The debtor proposed that the settlement proceeds would be distributed to satisfy the deficiency claim of the undersecured secured lender that funded the sale process, ahead of both a creditor with a security interest in the debtor's stock and the Internal Revenue Service (a priority creditor). The bankruptcy court, relying heavily on *Jevic*, denied the debtor's settlement motion because it contained a nonconsensual deviation from the Bankruptcy Code's priority scheme. Significantly, the court added: "[i]n light of the Supreme Court's recent ruling in *Jevic*, parties who seek approval of settlements that provide for a distribution in a manner contrary to the Code's priority scheme should be prepared to prove that the settlement is not only 'fair and equitable' . . . but also that any deviation from the priority scheme for a portion of the assets is justified because it serves a significant Code-related objective."[15]

Similarly, *In re Constellation Enterprises*,[16] the Bankruptcy Court for the District of Delaware, in May 2017, held that a settlement agreement that proposed to distribute the proceeds of a section 363 sale to GUCs ahead of certain priority creditors violated the absolute priority rule and constituted unfair discrimination. The court reasoned that the settlement was proposed at the end of the case's life, and found no evidence that the proposed distribution to GUCs served a Bankruptcy Code related purpose. While typically in the Third Circuit gifts are permissible where they only involve a distribution carved out from the secured creditor's collateral (as opposed to estate assets), the *Constellation* court relied on *Jevic* even though *Constellation* primarily involved a distribution of non-estate assets.[17] Thus, the *Constellation* decision could mark a significant erosion of gifting rights.[18]

Another line of more recent cases, however, has applied *Jevic* in a more flexible manner. In *In re Short Bark Industries, Inc. et al.*[19] , decided

[9] *Jevic* at 985.

[10] *Jevic* at 986.

[11] *See id.*

[12] 570 B.R. 228, 235 (Bankr. S.D. Miss. 2017).

[13] *Id*. at 235.

[14] *In re Fryar,* No. 1:16-BK-13559-SDR, 2017 WL 1489822, at *6 (Bankr. E.D. Tenn. April 25, 2017).

[15] *In re Fryar*, 570 B.R. 602, 610 (Bankr. E.D. Tenn. 2017).

[16] *In re Constellation Enterprises LLC*, Case No. 16-11213 (Bankr. D. Del. 2017).

[17] The proposed settlement would have resolved the creditors' committee's right to derivatively pursue estate claims against a group of noteholders, the proceeds of which would be estate assets.

[18] The creditors' committee has appealed the *Constellation* decision. The appeal is currently pending before the Delaware District Court, at Case No. 17-757.

[19] Case No. 17-11502 (KG) (Bankr. D. Del. Sept 11, 2017).

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in September 2017, the debtors, the official committee of unsecured creditors, and the prepetition secured lender reached an agreement to resolve objections to the debtors' postpetition financing motion. Under the settlement, the parties agreed that after the section 363 sale of the debtors' assets, certain proceeds of the sale would be used for a distribution directly to general unsecured creditors. The office of the United States Trustee (the "UST") filed an objection[20] , asserting that under *Jevic* the settlement constituted an impermissible priority-skipping distribution, because it did not provide for a distribution to the holders of administrative or priority claims. After acknowledging that *Jevic* was decided in the specific context of a case-ending structured dismissal, the UST argued that the scope of the *Jevic* decision is not limited to such context, but rather, applies "whenever a bankruptcy court is presented with distributions of estate assets in a Chapter 11 case that would be flatly impermissible even if they were proposed in a plan because they violate priority without the impaired creditors' consent."[21]

In approving the settlement and overruling the UST's objection, the bankruptcy court distinguished *Jevic*, emphasizing that (i) *Short Bark* did not involve a structured dismissal,[22] (ii) *Short Bark* involved a non-case-ending postpetition financing order that would be entered at a point in the case in which "[t]he extent of the estate, and the claims against it [we]re not yet fully resolved"; and (iii) the *Short Bark* settlement met significant, offsetting, bankruptcy-related justification because it would enable the debtors to continue "their business and the employment of 500 plus people, while preserving the committee's rights to bring actions against insiders."[23]

Likewise, in *In re Nuverra Environmental Solutions, Inc.*,[24] decided in June 2017, because the debtors' secured creditors were owed approximately $500 million and the debtors' business was only valued at $300 million, general unsecured creditors were "indisputably out of the money" under the dictates of the absolute priority rule. To facilitate confirmation, secured creditors made a gift to certain unsecured bondholders that would provide a recovery of between 4% to 6%. In what was categorized as an attempt by new owners to curry favor with trade creditors with whom they wished to continue doing business, the plan also proposed to provide a gift to trade creditors (a class with equal priority to unsecured bondholders) that would provide 100% recovery.

The unsecured bondholders objected to the plan,[25] arguing that notwithstanding the debtors' classification of the distribution to trade creditors as a "gift," the plan favored one similarly situated creditor body over another without advancing any Bankruptcy Code related objectives, and thus violated *Jevic's* holding.[26] In overruling their objection, the court rejected the arguments that the gift was from estate property and violated the absolute priority rule, holding that the treatment of the unsecured bondholders was reasonable because trade creditors were critical to the success of the reorganized debtors. On appeal, the district court, in August 2017, denied the unsecured bondholder's motion for a stay pending appeal noting the gift at issue in *Nuverra* was a voluntary carve out from the senior creditor's liens, and the plan did not technically violate the absolute priority rule because there were no class-skipping distributions, as unsecured bondholders and trade creditors shared co-equal priority.[27]

Conclusion

The precedent established by cases like *Pioneer*, *Fryar*, and *Constellation* is troubling to creditors' committees and their constituents who rely on structured dismissals and gifting provisions to gain leverage in cases where debtors would otherwise be unable to make distributions to GUCs. Despite these decisions, and consistent with the more recent decisions construing *Jevic*, like *Short Bark* and *Nuverra*, it seems more likely that bankruptcy courts will adopt a more flexible interpretation of *Jevic* that either limits its reach to structured dismissals or allows priority scheme deviations so long as there is a Bankruptcy Code related purpose. If this is the

[20] Case No. 17-11502 (KG) (Bankr. D. Del. Sept 11, 2017), ECF No. 196.

[21] *Id*. (internal quotations omitted).

[22] Final DIP Hr'g Tr., *In re Short Bark*, Case No. 17-11502 (KG) (Bankr. D. Del. Sep. 11, 2017), 106:18-21.

[23] *Id*. at 107:17-22.

[24] *Hargreaves v. Nuverra Environmental Solutions, Inc. (In re Nuverra Environmental Solutions, Inc.)*, Case No. 174-1024 (D. Del., August 3, 2017).

[25] Unsecured Bondholders Objection to Confirmation, *In re Nuverra Environmental Solutions, Inc.*Case No. 17-10949 (KJC) (Bankr. D. Del. June 30, 2017), ECF No. 290.

[26] Unsecured Bondholders Objection to Confirmation, *In re Nuverra Environmental Solutions, Inc.*Case No. 17-10949 (KJC) (Bankr. D. Del. June 30, 2017), ECF No. 290 ¶ 29.

[27] *Hargreaves v. Nuverra Environmental Solutions, Inc. (In re Nuverra Environmental Solutions, Inc.)*, Case No. 174-1024 (D. Del., August 3, 2017).

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case, creditors' committees will continue to be able to rely on these important tools that provide a counterweight to the inherent power of debtors and secured lenders in a bankruptcy case.

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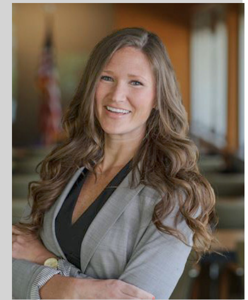

***Nicole Fulfree's** practice focuses on the representation of debtors, creditors' committees, trustees, individual creditors, and investors in a variety of complex bankruptcy matters. Her extensive experience translates into a clear understanding of the right strategies for clients looking to restructure.*

Before joining Lowenstein Sandler, Nicole clerked for the Honorable Donald H. Steckroth, United States Bankruptcy Court for the District of New Jersey. Previously, she served as a judicial law intern for the Honorable Anne Patterson, Supreme Court of New Jersey.

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