AMERICAN BANKRUPTCY INSTITUTE

2019 Bankruptcy Battleground West

PLENARY SESSION

Crossfire

Paul D. Buie, Moderator
Onyx Asset Advisors; Los Angeles

Hon. Martin R. Barash
U.S. Bankruptcy Court (C.D. Cal.); Woodland Hills

Hon. Sheri Bluebond
U.S. Bankruptcy Court (C.D. Cal.); Los Angeles

Hon. Julia W. Brand
U.S. Bankruptcy Court (C.D. Cal.); Los Angeles

Whitman L. Holt
Klee, Tuchin, Bogdanoff & Stern LLP; Los Angeles

Eve H. Karasik
Levene, Neale, Bender, Yoo & Brill L.L.P.; Los Angeles

Hon. Margaret M. Mann
U.S. Bankruptcy Court (S.D. Cal.); San Diego

Robert S. Marticello
Smiley Wang-Ekvall, LLP; Los Angeles

Kyle J. Mathews
Sheppard, Mullin, Richter & Hampton LLP; Los Angeles

Elissa D. Miller
SulmeyerKupetz, APC; Los Angeles

Hon. Erithe A. Smith
U.S. Bankruptcy Court (C.D. Cal.); Santa Ana

Robyn B. Sokol
Brutzkus Gubner Rozansky Seror Weber LLP; Los Angeles

Hon. Scott H. Yun
U.S. Bankruptcy Court (C.D. Cal.); Riverside

2019

ABI BATTLEGROUND WEST 2019
CROSSFIRE PANEL

DISCUSSION TOPICS

I. Value is in the Eye of the Beholder

- Do parents receive reasonably equivalent value for tuition payments?
- Must new value remain unpaid to serve as a defense to an avoidable preference?

A. Issue: Are Tuition Payments Avoidable Preferences?

Pro – Yes, parents receive reasonably equivalent value in exchange for tuition payments whether it be in the form of satisfying a societal or familial obligation or receiving the future economic benefit of self-sufficiency for their children.

Con – No, parents do not receive reasonably equivalent value in exchange for tuition payments because they do not receive any economic, quantifiable or concrete benefit or value in exchange (*quid pro quo*) as required based on the definition of new value in the Code or under state law.

B. Supporting Cases:

Tuition Payments Do *Not* Provide Value

In re Knight, 2017 WL 4410455 (Bankr. D. Conn. 2017)
Matter of Dunston, 566 B.R. 624 (Bankr. S.D. Ga. 2017)
In re Leonard, 454 B.R. 444 (Bankr. E.D. Mich. 2011)
In re Lindsay, 2010 WL 1780065 (Bankr. S.D.N.Y. 2016)

Tuition Payments Provide Value

In re Sterman, 2018 WL 6333588 (Bankr. S.D.N.Y. Dec. 4, 2018)
In re Lewis, 574 B.R. 536 (Bankr. E.D. Pa. 2017)
In re Palladino, 556 B.R. 10 (Bankr. D. Mass. 2016)
In re Oberdick, 490 B.R. 687 (Bankr. W. D. Pa. 2013)
In re Akanmu, 502 B.R. 124, 132 (Bankr. E.D.N.Y. 2013)
In re Cohen, 2012 WL 5360956 (Bankr. W. D. Pa. 2012)

C. Issue: Must New Value Remain Unpaid to Serve As a Defense to An Avoidable Preference?

Pro: Yes, of course new value must remain unpaid to serve as a defense to a preferential transfer. Paid new value does not cancel out or offset the prior preferential payment, which is the whole point of the defense.

Con: No, new value does not need to remain unpaid to serve as a defense to an avoidable preference. Requiring that new value be "unpaid" is inconsistent with the plain language of the Code. New value may be paid provided the new value was not paid with a transfer that is not otherwise unavoidable.

D. Supporting Cases:

New Value Need Not Be Unpaid

In re BFW Liquidation, LLC, 2018 U.S. App. LEXIS 22504 (11th Cir. 2018)
In re JKJ Chevrolet, Inc., 412 F.3d 545 (4th Cir. 2005)
In re Jones Truck Lines, Inc., 130 F.3d 323 (8th Cir. 1997)
In re IRFM, Inc., 52 F.3d 228 (9th Cir. 1995)
In re Toyota of Jefferson, Inc., 14 F.3d 1088 (5th Cir. 1994)

New Value Must Remain Unpaid

Matter of Kroh Bros. Dev Co., 930 F.2d 648 (8th Cir. 1991)
In re Prescott, 805 F.2d 719 (7th Cir. 1986)
In re P.A. Bergner & Co., 140 F.3d 1111 (7th Cir. 1998)
In re New York City Shoes, Inc., 880 F.2d 679 (3d Cir. 1989)

II. Fair or Foul: Should Carve-out Orders that result in payment in full of administrative expense claims for estate professionals while other holders of administrative expense claims receive a nominal (if any) distribution be upheld?

A. Positions:

Pro: Yes, carve-out orders that result in payment in full of administrative expense claims for estate professionals while other holders of administrative expense claims receive a nominal (if any) distribution should be upheld under *Czyzewski v. Jevic Holding Corp.*, 137 S. Ct. 973, 197 L.Ed. 2d 398 (2017). *Jevic* only applies to structured dismissals. DIP financing or cash collateral orders with carve-outs for professionals are final orders and such orders facilitate a Bankruptcy Code objective. Also, carve-out funds are not property of the estate, and to the extent the orders are final orders all objections to the orders containing the carve-outs are settled or overruled.

Con: No, carve-out orders that result in payment in full of administrative expense claims for estate professionals while other holders of administrative expense claims receive a nominal (if any) distribution should not be upheld under *Jevic*. *Jevic* is not limited to structured dismissals. When there is a liquidation rather than a reorganization, the carve-out provisions do not facilitate a Bankruptcy Code objective. Carve-out funds flow through and are property of the estate. Disparate treatment among administrative expense creditors violates the Bankruptcy Code priority scheme. Overruled objections to carve-out orders or lack of objection cannot be deemed to be consent to the disparate treatment of administrative expense creditors.

B. Supporting Cases:[1]

*In re Old Cold, LLC, 879 F.3d 376, 388 (*1st Cir 2018)
In re Veg Liquidation Inc., 583 B.R. 203, 2011 (B.A.P 8th Cir. 2018)

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[1] The panelists thank Jeffrey N. Pomerantz who agreed that his materials could be used for the American Bankruptcy Institute Bankruptcy Battleground West 2019 Crossfire Panel on *Czyzewski v. Jevic Holding Corp.*, 137 S. Ct. 973, 197 L.Ed. 2d 398 (2017).

Hinson for Broughton v. Bank of Am., N.A., No. 5:16-CV-00958-RE, 2018 WL 4289316, at *1 (E.D.N.C. Sept., 7, 2018)
In re Daily Gazette Co., 584 B.R. 540, 543 (Bankr. S.D.W. VA. 2018)
Hargreaves v. Nuverra Envtl. Sols., Inc. (In re Nuverra Envtl. Sols., Inc.) No. 17-10949-KJC, 2017 WL 3326453, at *3 (D. Del. Aug. 3. 2017)
In re Constellation Enterprises, No. 16-bk-11213 (Bankr. D. Del. May 16, 2017 (oral ruling)
In re Pioneer Health Services, 570 B.R. 228 (Bankr. S.D. Miss. 2017)
In re Hansen, 2017 Bankr. LEXIS 1120 (Bankr. D. N.H., Apr. 25, 2017)
In re Fryar, 570 B.R. 602 (Bankr. E.D. Tenn. 2017)
In re Short Bark Industries, Inc. et al., Case No. 17-11502 (KG) (Bankr. D. Del. September 14, 2017)
In re LCI Holdings Co., 802 F. 3d 547 (3d Cir. 2015)

See Addedum attached for additional analysis.

III. State Law vs. Public Policy • Can Creditors Block the Right to File Bankruptcy with Golden Shares?

A. Positions

Pro: Yes, from 1945 to 2018, both the Supreme Court and the Ninth Circuit have consistently held that state law determines who has the authority to file a voluntary petition on behalf of a debtor. A creditor may obtain and exercise voting rights in a manner consistent with state law even if in doing so it controls whether a company has the necessary authority to file a bankruptcy case.

Con: No, it is against public policy for a debtor to waive the protection of the Bankruptcy Code. According to the Ninth Circuit, this "has to be the law[.]" Allowing creditors to obtain and exercise voting rights in order to prevent a bankruptcy filing is tantamount to a waiver of the right to file contrary to public policy.

B. Supporting Cases:

State Law Controls

Price v. Gurney, 324 U.S. 100 (1945)
In re Sino Clean Energy, Inc., 901 F.3d 1139 (9th Cir. 2018)
In re Franchise Services of North America, Incorporated, 891 F.3d 198 (5th Cir. 2018)

Violates Public Policy

In re Huang, 275 F.3d 1173 (9th Cir. 2002)
In re Lake Michigan Beach Pottawattamie Resort LLC, 547 B.R. 899 (Bankr. N.D. Ill. 2016)

In re Intervention Energy Holdings, LLC, 553 B.R. 258 (Bankr. D. Del. 2016)
In re Lexington Hospitality Group, LLC, 577 B.R. 676 (Bankr. E.D. Ky. 2017)

IV. <u>Have We Been Priced Out Of The Market?</u>

- Recent increase to the Office of the United States Trustee Fees

- Does *Baker Botts L.L.P. v. ASARCO LLC,* 135 S. Ct. 2158 (2015), provide interested parties a litigation tool?

- Are professional fees out of control?

A. Positions

<u>Pro</u>: Yes, we have been priced out of the market. The increase in the Office of United States Trustee Fees, along with high billing professionals and multiple professionals addressing a single issue has made it exceedingly costly to reorganize. In addition, *Baker Botts* has forced law firms to fend off objections to their fees for which they may not receive compensation. Bankruptcy professional fee structures often account for the risk of non-payment, reduced payment and delayed payment.

<u>Con</u>: No, we have not priced ourselves out of the market. The Office of the United States Trustee Fees are critical to ensure sufficient funding for necessary oversight by the Office of the United States Trustee. Secured Creditors and debtors are often closely aligned so unsecured creditors require separate representation to ensure fairness. There may be ways to obtain payment of actual and necessary legal fees despite *Baker Botts.*

B. Notable References:

In re Cranberry Growers Coop., 592 B.R. 325 (Bankr. W.D. Wis. 2018) (addresses increased Office of the United States Trustee fees)

In re Millennium Lab Holdings II, LLC, et. al., Case no. 15-12284 (LSS)(Bankr. Del. March 23, 2018)(memorandum of decision providing a work around the Office of United States Trustee Fees by closing the case while appeal from plan confirmation pending).

Baker Botts L.L.P. v. ASARCO LLC, 135 S. Ct. 2158 (2015) and its progeny (see addendum of cases)

Office of the United States Trustee Chapter 11 Quarterly Fee Schedule as of October 1, 2018

V. Should I (Waive the) Stay or Should I Go (to Court) Now: Pros and Cons of Prepetition Waivers of the Automatic Stay*

Con (against enforceability of waivers of the automatic stay):

Prospective, prepetition[2] waivers of the automatic stay should be unenforceable in most circumstances. Although the first cases[3] that addressed waivers of the automatic stay approved such waivers, these cases were doctrinally and practically unsupported and contrary to stated public policy.[4]

There is a strong argument that prepetition automatic stay waivers are *per se* unenforceable because an entity that ultimately files for bankruptcy cannot, prepetition, bind a debtor in possession that has a fiduciary duty to the estates, particularly where the right being waived is as fundamental as the automatic stay.[5] Similarly, prepetition waivers of the automatic stay should be specifically unenforceable in the context of single asset real estate cases, because such automatic stay waivers amount to effectively waiving the protections of bankruptcy,

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* A special thank you to David M. Riley from DLA Piper LLP (US) for his contributions to these materials.

[2] Where prospective stay relief is granted in a prior bankruptcy, it should be honored and implicates different policy concerns. *In re A. Hirsch Realty, LLC*, 583 B.R. 583, 601 (Bankr. D. Mass. 2018) ("The Court agrees with those decisions in which courts have upheld contractual provisions waiving the protections afforded by the automatic stay when they are incorporated in court orders approving settlement agreements or orders confirming Chapter 11 plans while employing a multi-factor approach."); *In re Alexander SRP Apartments, LLC*, No. 12-20272, 2012 WL 1910088, at *6 (Bankr. S.D. Ga. Apr. 20, 2012) ("In cases where a waiver has been approved by the court, the court was able to review the agreement in advance and third-party creditors had an opportunity to object."); *In re Bryan Rd., LLC*, 382 B.R. 844, 848 (Bankr. S.D. Fla. 2008) (". . . stay relief provisions in prior chapter 11 plans are entitled to great respect because they have been negotiated in a plan context and approved after notice to all parties in interest . . .").

[3] The line of cases that initially supported enforcement of waivers of the automatic stay derives from the U.S. Bankruptcy Court, Middle District of Florida. *See In re Citadel Properties, Inc.*, 86 B.R. 275, 276 (Bankr. M.D. Fla. 1988) and its progeny.

[4] These cases largely relied on a prepetition waiver in connection with a factual determination that a bankruptcy case was filed in bad faith or that there was no likelihood of an effective reorganization. Importantly, the debtor's circumstances and market conditions may have changed, rendering such a factual stipulation no longer relevant. *In re Jenkins Court Assocs. Ltd. P'ship*, 181 B.R. 33, 36 (Bankr. E.D. Pa. 1995).

[5] *In re DB Capital Holdings, LLC*, 454 B.R. 804, 816 (Bankr. D. Colo. 2011) ("However, the Court agrees with the Court in *Pease* that the waivers, unless they were part of a previous bankruptcy proceeding—for example, part of a confirmed plan or stipulation resolving an earlier motion for relief-appear to conflict with the policies and purposes of the Bankruptcy Code, and should not be enforced."); *Matter of Pease*, 195 B.R. 431, 433 (Bankr. D. Neb. 1996) ("The debtor certainly has capacity to enter into agreements which define the rights and obligations of the debtor under applicable non-bankruptcy law, and those agreements are generally given force and effect in bankruptcy cases. However, I conclude that the pre-bankruptcy debtor simply does not have the capacity to waive rights bestowed by the Bankruptcy Code upon a debtor in possession, particularly where those rights are as fundamental as the automatic stay."); *see also In re Alexander SRP Apartments, LLC*, No. 12-20272, 2012 WL 1910088, at *6 (Bankr. S.D. Ga. Apr. 20, 2012) ("When a waiver adversely affects other creditors, offending the underlying purpose of the automatic stay to treat creditors equally, courts generally refuse to uphold the waiver."); *In re Sky Grp. Int'l, Inc.*, 108 B.R. 86, 89 (Bankr. W.D. Pa. 1989) ("To grant a creditor relief from stay simply because the debtor elected to waive the protection afforded the debtor by the automatic stay ignores the fact that it also is designed to protect *all creditors* and to treat them *equally*.") (emphasis in original).

generally, which is universally agreed to be against public policy.[6] Moreover, although freedom of contract is fundamental to debtor-creditor relations, it is not absolute – "the Bankruptcy Code extinguishes the private right of freedom to contract around its essential provisions" including the protections of the automatic stay.[7] Additionally, Congress did not include prepetition waivers of the automatic stay as an exception to the automatic stay in Bankruptcy Code section 362(b).[8] This omission suggests that Congress chose not to intend such prepetition contractual provisions from being automatically enforceable.

Even if waivers of the automatic stay are enforceable, they should not be self-executing[9] and relief from stay should still be required to be granted by the bankruptcy court.[10] Similarly, a bankruptcy court is not bound by the parties' prepetition stipulation regarding applicability of the automatic stay, or whether any conduct constitutes 'cause' for relief from the automatic stay.[11]

<u>Pro (in favor of enforcement of prepetition waivers of the automatic stay)</u>:

While courts should be skeptical of any attempt by a prepetition creditor to interfere with a prospective debtor's rights, the argument that any prepetition waiver of the automatic stay should be *per se* unenforceable is misguided. There are several circumstances under which courts have recognized that prepetition waivers should be a factor in determining whether "cause" has been shown such that relief from stay should be granted under Bankruptcy Code section 362(a).[12]

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[6] *In re Jenkins Court Assocs. Ltd. P'ship*, 181 B.R. 33, 37 (Bankr. E.D. Pa. 1995) ("As a practical matter, there may be little significant distinction between the enforcement of a pre-petition waiver of the automatic stay in a single asset case and the enforcement of a provision prohibiting the filing of a bankruptcy case in the first place.")

[7] *Matter of Pease*, 195 B.R. 431, 434 (Bankr. D. Neb. 1996) ("Third and finally, the Bankruptcy Code extinguishes the private right of freedom to contract around its essential provisions. This conclusion follows from the comprehensive nature of the Bankruptcy Code and its underlying purpose of providing a nationally uniform collective remedy to debtors and creditors. The judicial enforcement of a contractual waiver of the automatic stay would permit a single creditor to opt out of the collective process mandated by the Bankruptcy Code to the potential detriment of the debtor and other creditors. This should not be permitted.").

[8] *In re Stringer*, 847 F.2d 549, 552 (9th Cir. 1988) ("Congress clearly intended the automatic stay to be quite broad. Exemptions to the stay, on the other hand, should be read narrowly to secure the broad grant of relief to the debtor.").

[9] *In re Sky Grp. Int'l, Inc.*, 108 B.R. 86, 89 (Bankr. W.D. Pa. 1989) ("Although waiver of a stay by the debtor apparently was possible under the old Bankruptcy Act, such a waiver is not self-executing under the Bankruptcy Code.").

[10] *See In re Bryan Rd., LLC*, 382 B.R. 844, 848 (Bankr. S.D. Fla. 2008).

[11] *See generally In re Sky Grp. Int'l, Inc.*, 108 B.R. 86 (Bankr. W.D. Pa. 1989).

[12] *See In re Alexander SRP Apartments, LLC*, No. 12-20272, 2012 WL 1910088, at *6 (Bankr. S.D. Ga. Apr. 20, 2012) ("I now hold that waivers of the automatic stay are not per se unenforceable, but the party opposing enforcement of the waiver has the burden of proving that the waiver should not be enforced."); *In re Bryan Rd., LLC*, 382 B.R. 844, 848–49 (Bankr. S.D. Fla. 2008) (setting out various, non-exclusive factors considered by bankruptcy courts in considering whether to honor a prepetition waiver of the automatic stay including "(1) the sophistication of the party making the waiver; (2) the consideration for the waiver, including the creditor's risk and the length of time the waiver covers; (3) whether other parties are affected including unsecured creditors and junior lienholders; and (4) the feasibility of the debtor's plan.") (citing *In re Desai*, 282 B.R. 527, 532 (Bankr. S.D. Ga.

Despite the claims on the "con" side of the debate, some of the strongest arguments for enforcing waivers of the automatic stay occur in the context of single asset real estate cases. Typically in these situations, when a debtor is facing the prospect of foreclosure they will negotiate an out of court restructuring. As courts have recognized, out of court restructurings should be encouraged as they often result in the best outcome for all parties in interest.[13] Often times, after failing to abide by the terms of a negotiated resolution and on the eve of foreclosure, a debtor will file a bankruptcy petition in an attempt to stop the pending foreclosure. There is precedent for dismissing these types of cases as "bad faith" filings.[14]

In such cases (which are essentially a two-party dispute between a secured creditor and a debtor), the court should not intervene. To do so, reduces the incentive for parties to enter into out of court restructuring. So long as third-parties are not adversely impacted, parties should have the right to enter into enforceable contracts in connection with a post-default restructuring, including the waiver the automatic stay.[15]

2002)); *In re Powers*, 170 B.R. 480, 484 (Bankr. D. Mass. 1994) ("My view is that the waiver is a primary element to be considered in determining if cause exists for relief from the automatic stay under § 362(d)(1). ").

[13] *In re* Cheeks, 167 B.R. 817, 819 (Bankr. D.S.C. 1994) ("Perhaps the most compelling reason for enforcement of the forbearance agreement is to further the public policy in favor of encouraging out of court restructuring and settlements."); In re Club Tower, 138 B.R. at 312 ("Workouts and restructurings should be encouraged among debtors and creditors . . . . In order to facilitate this goal, pre-petition agreements should be enforced against a borrower who later files for bankruptcy. To hold otherwise could make lenders more reticent in attempting workouts with borrowers outside of bankruptcy.").

[14] *See, e.g. Matter of Little Creek Development Co.*, 779 F.2d 1068, 1072-73 (5th Cir. 1986) ("Determining whether the debtor's filing for relief is in good faith depends largely upon the bankruptcy court's on-the-spot evaluation of the debtor's financial condition, motives, and the local financial realities. Findings of lack of good faith in proceedings based on §§ 362(d) or 1112(b) have been predicated on certain recurring but non-exclusive patterns, and they are based on a conglomerate of factors rather than on any single datum. Several, but not all, of the following conditions usually exist. The debtor has one asset, such as a tract of undeveloped or developed real property. The secured creditors' liens encumber this tract. There are generally no employees except for the principals, little or no cash flow, and no available sources of income to sustain a plan of reorganization or to make adequate protection payments pursuant to 11 U.S.C. §§ 361, 362(d)(1), 363(e), or 364(d)(1). Typically, there are only a few, if any, unsecured creditors whose claims are relatively small. The property has usually been posted for foreclosure because of arrearages on the debt and the debtor has been unsuccessful in defending actions against the foreclosure in state court. Alternatively, the debtor and one creditor may have proceeded to a stand-still in state court litigation, and the debtor has lost or has been required to post a bond which it cannot afford. Bankruptcy offers the only possibility of forestalling loss of the property. There are sometimes allegations of wrongdoing by the debtor or its principals.")

[15] *In re A. Hirsch Realty, LLC*, 583 B.R. 583, 601 (Bankr. D. Mass. 2018); *In re Atrium High Point Ltd. P'ship*, 189 B.R. 599, 607 (Bankr. M.D.N.C. 1995) ("Although an order of this court granting relief from stay may debilitate the Debtor somewhat, the Debtor accepted that risk when it agreed to the prepetition waiver of the automatic stay.").

CASES AND COMMENTARY FOLLOWING BAKER BOTTS

3 Collier on Bankruptcy P 328.02(10) (16th 2018)

"Frequently Asked Questions (FAQS)—Professional Compensation" (Updated September 25, 2015), available at http://www.justice.gov/ust/Prof_Comp/FAQ_Prof_Comp (discussing how the United States trustee program will "object to professionals seeking a pre-approved term of employment that permits the payment of fees-on-fees otherwise disallowed" under Baker Botts, including because the Supreme Court's analysis supposedly "is relevant to all Bankruptcy Code sections dealing with employment and compensation").

Case	Facts	Holding	Analysis
In re Stanton, 559 B.R. 781 (Bankr. M.D. Fla. 2016)	Attorney sought fees for supplementing fee application in response to objection by the U.S. Trustee requesting a further break down and narrative.	Fees allowed.	Under *Baker Botts*, the key question is the nature of the work. Work "in service to the estate" is compensable. Providing additional detail benefited the estate and is more akin to fee application preparation, which is compensable under § 330(a)(6) of the Code, as opposed to a dispute over the amount of the fees.
In re Macco Prop., Inc., 540 B.R. 793 (Bankr. W.D. Okla. 2015)	Two persons, the owner and the president of the debtor, objected to the fee applications of the trustee and his professionals. The objecting parties argued that no compensation should be allowed based on alleged affirmative claims, such as, breach of fiduciary duty, negligence, and gross mismanagement.	Fees allowed.	The court distinguished *Baker Botts* because, in that case, the objecting party was the debtor. Allowing Baker Botts to collect "defense-fees" from its adversary, the debtor/estate, violated the American Rule. In contrast, in *Macco Properties*, the "estate," via the trustee, supported the fees requested, and the objections were by third parties. The objections also went beyond the mere amount of compensation sought because the objecting parties asserted affirmative claims. The court found that the American Rule did not prevent the professionals from being compensated by the *estate* to defend against the objections and claims of third parties. Moreover, the court found that the liquidation of the professional fees was necessary to completing the administration of the estate.

Case	Facts	Holding	Analysis
			Thus, the court found that the services in question were for the administrator of the estate.
In re Boomerang Tube, Inc., 548 B.R. 69 (Bankr. Del. 2016).	Committee counsel sought approval to be employed under § 328 of the Code with a provision that entitled the estate to compensate it for fees arising from the successful defense of its fees.	Approval of fee-defense provision denied.	The court found that the counsel's agreement with the Committee to require the estate to pay for counsel's defense of objections from third parties did not fit within the contract exception to the American Rule. Furthermore, the estate was not bound by the counsel's agreement with the Committee and any estate professional retention terms must comply with the Code. The proposed fee-defense provision was not a "reasonable" term of employment for purposes of § 328 because such provision does not relate to services the counsel would perform for the Committee, but for itself. In short, the court was unwilling to approve employment terms to get around *Baker Botts*.
In re Rose, 561 B.R. 70 (Bankr. W.D. Mich. 2016)	Attorney sought fees for analyzing and defending against objections by the U.S. Trustee and the trustee to the attorney's fee application.	Fees not allowed.	The fees in question were incurred to further the applicant's interests and not the debtor's interests, and, therefore, the allowance of such fees is prohibited by *Baker Botts*. The estate is not bound by the applicant's retention agreement with the debtor, which provided for fee-defense costs.

Case	Facts	Holding	Analysis
In re River Rd. Hotel Partners, LLC, 536 B.R. 228, 239–41 (Bankr. N.D. Ill. 2015), aff'd, 2016 U.S. Dist. LEXIS 102884 (N.D. Ill. Aug. 4, 2016	Professional sought reimbursement of fees based on retainer agreement which provided that fees were its expenses and based on litigious vexations litigation which it was forced to defend. Debtor and U.S. Trustee objected.	Fees not allowed	Fees are not properly included in a professional's expense reimbursement, at least when expenses remain subject to review under section 330(a). Professional should have moved for sanctions.
In re Capitol Litho Printing Corp, 573 B.R. 771, 2017 Bankr. LEXIS 2209, 64 Bankr. Ct. Dec. 129	Real estate broker sought recovery of fees it incurred in defending against challenge to its commission.	Denied	Good discussion of *Baker Botts* and its progeny
In re Hungry Horse, LLC, 574 B.R. 740, 2017 Bankr. LEXIS 3183	UCC objected to a Debtor's counsel's employment application under 328(a) on, among other grounds that the employment agreement included that the debtor must pay fees incurred in defending fee application	Approved subject to modification as set forth in opinion.	Court May approve a carefully drafted fee defense provision as part of initial employment. If so, fees may be compensable

Life After Jevic: How will the Supreme Court's decision affect chapter 11 practice?

American Bankruptcy Institute

Annual Spring Meeting

April 20, 2018

Jeffrey N. Pomerantz
Pachulski Stang Ziehl & Jones LLP

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LIFE AFTER JEVIC: HOW WILL THE SUPREME COURT'S DECISION AFFECT CHAPTER 11 PRACTICE?

BY JEFFREY N. POMERANTZ[1]

"Once again, the Supreme Court screws up our bankruptcy world". That is how one commentator[2] has characterized the recent decision in *Czyzewski v. Jevic Holding Corp.,* 137 S. Ct. 973, 197 L. Ed. 2d 398 (2017).

Whether one agrees or disagrees with this description of *Jevic*, the decision indisputably raises more questions than it answers. Its application to structured dismissals with different fact patterns and its potential impact on numerous other, more common, aspects of a case—from first day motions to asset sales—will only unfold over time through decisions, published and unpublished, by courts across the country.

The Case

The United States Supreme Court issued the *Jevic* decision on March 22, 2017, effectively reversing decisions of the bankruptcy court, the district court and the Third Circuit Court of Appeals. At its core, *Jevic* holds that a court cannot approve a structured dismissal[3] which provides for distributions different from the standard priority scheme in a chapter 11 or chapter 7 case without the consent of affected parties.

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[1] Jeffrey N. Pomerantz is a partner and Co-Chair of the creditors' committee practice at Pachulski Stang Ziehl & Jones LLP, the nation's leading corporate restructuring boutique, resident in the Los Angeles office. He sits on the Executive Committee of the American Bankruptcy Institute and served as its President from April 2016-2017. Mr. Pomerantz would like to acknowledge the contributions to these materials by Jeffrey Kandel, Of Counsel at Pachulski Stang Ziehl & Jones LLP.

[2] In re Jevic: Once Again the Supreme Court Screws up our Bankruptcy World—And Justice Thomas is Wise in his Dissent, Donald L. Swanson, Mediatbankry (March 30, 2017), https://mediatbankry.com/2017/03/30/. The reference to previous times the Supreme Court "screwed up" the bankruptcy system is primarily to *Stern v. Marshall*, 564 U.S. 462 (2011).

[3] "Structured dismissals" are mechanisms to conclude a chapter 11 case which provide for distributions and address other issues without a plan or a conversion to chapter 7. They are most commonly used following a sale of assets which leaves the chapter 11 estate with insufficient assets to distribute to general unsecured creditors.

Factual Background

Jevic Transportation, Inc. ("Jevic"), a New Jersey trucking company, was acquired by Sun Capital Partners ("Sun") in 2006 through a leveraged buyout financed by the CIT Group ("CIT"). Within less than two years, Jevic ceased operations, terminated its employees and commenced a case under chapter 11 of the Bankruptcy Code, owing $53 million to senior secured creditors Sun and CIT and in excess of $20 million to the taxing authorities and general unsecured creditors.

Two lawsuits were filed in the bankruptcy case. First, ex-employee truck drivers filed suit alleging violations of state and federal Worker Adjustment and Retraining Notification ("WARN") Acts. The Bankruptcy Court granted judgment in favor of the truck drivers in the amount of $12.4 million, $8.3 million of which constituted a priority wage claim under Bankruptcy Code §507(a)(4).

Second, the Official Committee of Unsecured Creditors appointed in the Jevic chapter 11 filed a fraudulent conveyance action on behalf of the bankruptcy estate against Sun and CIT, alleging that they had "'hastened Jevic's bankruptcy by saddling it with debts that it couldn't service'". The Committee and Sun and CIT reached agreement for the following structured dismissal of Jevic's chapter 11 case: (1) the fraudulent conveyance action would be dismissed with prejudice; (2) CIT would deposit $2 million in a segregated account earmarked to pay the Committee's legal fees and administrative expenses; (3) Sun would assign its lien on the debtor's remaining $1.7 million of cash to a trust; (4) thereby permitting the trust to use the funds to pay taxes and administrative expenses, with the remainder to be distributed pro rata among general unsecured creditors; and (5) Jevic's bankruptcy case would be dismissed. *Jevic,* 137 S. Ct. at 981. However, no funds were permitted to be paid to the WARN plaintiffs on account of their judgement, including on account of their wage claims which held priority over general unsecured creditors. Sun insisted on this provision in order to deprive the ex-employees of funds to bankroll further litigation against Sun.[4] *Id*.

The Lower Court Decisions

While acknowledging the proposed settlement's divergence from the Code's priority scheme, the bankruptcy court approved the settlement, including the structured dismissal embedded therein, in recognition of the "dire circumstances" present in the case, finding that neither priority nor general unsecured creditors would receive any recovery absent approval of the settlement. *See id*. at 981-82. The district court and the Third Circuit both affirmed, with the Third Circuit holding that Congress had only "'codified the absolute priority rule . . . in the specific context of plan confirmation'" and that in "'rare instances'" such as these, structured dismissals which did not adhere to the Bankruptcy Code's priority scheme could be approved. *Id.* at 9.

The Supreme Court Decision

The Supreme Court first considered and dismissed the argument that the WARN claimants did not have standing. Noting that even a small financial interest is sufficient to establish standing, the Court found that if the present settlement was not approved a different settlement which provided a recovery to the WARN claimants remained a "reasonable possibility" and that appellants might be able to find an attorney to pursue the fraudulent conveyance action on a contingency basis. *Id*. at 982-83.

[4] Separate from the WARN claims filed against the Jevic estate, the WARN plaintiffs also asserted state court claims against Sun on the grounds that Sun was a statutory employer. Sun was not willing to allow the WARN plaintiffs to receive part of the distribution being made through the bankruptcy estate while at the same time retaining their rights to pursue the WARN claims against Sun in state court. Because Sun and the WARN plaintiffs could not reach a global resolution, the settlement contemplated distributions skipping over the priority WARN claims. Subsequently, Sun prevailed in the state court action with the WARN plaintiffs.

Addressing the merits, the Supreme Court turned to the core issue of the case: can a bankruptcy court approve a structured dismissal providing for distributions that deviate from the ordinary priority rules of the Bankruptcy Code without the consent of the affected party. The Court's "simple answer to this complicated question" was "'no'". *Id.* at 983. The Court noted that the Code's distribution priority scheme was "fundamental," and that something more than "simple statutory silence"-- an "affirmative indication of intent"-- would be expected if Congress intended to permit dismissals which allow for a major departure from the scheme. *Id.* at 984.

The Court then addressed respondent's contention that Code §349(b), which authorizes a bankruptcy judge to dismiss a case "for cause," permits courts to approve a dismissal which does not comport with the standard priority distribution scheme. The Court concluded that this provision, "read in context", merely granted courts the "flexibility to 'make the appropriate orders to protect rights acquired in reliance on the bankruptcy case'". *Id.* at 984 (citation to legislative history omitted). As nothing in the Code authorizes a court to make "end-of-case" distributions of estate assets that violate the chapter 11 and chapter 7 priority schemes, that do not restore the *status quo ante* as is normally required in a dismissal and that do not protect "reliance interests acquired in the bankruptcy", the Court held that "the word 'cause' is too weak a reed upon which to rest so weighty a power." *Id.* at 984-85.

The Supreme Court's basic ruling appears to be unequivocal, though limited:

> A distribution scheme ordered in connection with the dismissal of a Chapter 11 case cannot, without the consent of the affected parties, deviate from the basic priority rules that apply under the primary mechanisms the Code establishes for final distributions of estate value in business bankruptcies.

Id. at 978.

However, in what one bankruptcy court has termed "dicta" (*see* discussion of *In re Fryar*, below) *Jevic* also contrasts the structured dismissal before the Court with certain permissible wage and critical vendor payments, and even lender "roll-ups" which allow lenders who provide postpetition financing to be paid first on their prepetition claims, all of which have been approved by courts:

> We recognize that *Iridium* is not the only case in which a court has approved interim distributions that violate ordinary priority rules. But in such instances one can generally find significant Code-related objectives that the priority-violating distributions serve. Courts, for example have approved "first-day" wage orders that allow payment of employees' prepetition wages, "critical vendor" orders that allow payment of essential suppliers' prepetition invoices, and "roll-ups" that allow lenders who continue financing the debtor to be paid first on their prepetition claims [citations omitted]. 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." *In re Kmart Corp,* 359 F.3d 866, 872 (CA7 2004)…. By way of contrast…[the structured dismissal] 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 confirmed plan; it does not help to restore the *status quo ante*; and it does not protect reliance interests.

Id. at 985-86.

<u>The Dissent</u>

Justice Thomas, joined by Justice Alito, dissented in favor of dismissing the writ granted by the Court, because the majority "answer[ed] a novel and important issue of bankruptcy law…without the benefit of any reasoned opinions on the dispositive issue from the court of appeals…and with briefing on that issue from only one of the parties." *Id*. at 987. Justice Thomas was upset at what he thought was a bait and switch by the appellant. The Supreme Court granted certiorari to decide "whether a bankruptcy court may authorize the distribution of settlement proceeds in a manner that violates the statutory priority scheme." With respect to that issue there was a clear circuit split. However, in the briefing to the Supreme Court the appellants reframed the question to be "whether a Chapter 11 case may be terminated by a 'structured dismissal' that distributes estate property in violation of the Bankruptcy Code's priority scheme." With respect to that issue there was no circuit split. Justice Thomas noted that the field of structured dismissals was "rapidly developing" and that the Court would benefit from further lower court opinions on the topic before taking up the issue. Justice Thomas objected to the Court permitting the appellant to change the question presented to the Court, especially since respondents appropriately "declined to brief the question that the majority" decided. *Id*. at 988. Accordingly, the Court was prematurely deciding a "novel and important issue" with insufficient input regarding the issues involved.

Decisions Subsequent to *Jevic*

Several opinions of note have cited the "priority" portion[5] of *Jevic* in reaching decisions. Notably, none of them relates to structured dismissals, demonstrating that *Jevic*'s application will likely extend to many other issues which arise in a case.

In *In re Pioneer Health Services*, 570 B.R. 228 (Bankr. S.D. Miss. 2017), a Mississippi bankruptcy court cited *Jevic* in determining that increased scrutiny was required in assessing a request to pay prepetition amounts owing to alleged critical vendors. Noting that the Supreme Court distinguished critical vendor motions from structured dismissals, the bankruptcy court quoted *Jevic*'s contrast of the structured dismissal before the Supreme Court with other, permissible, deviations from standard distribution priorities, but understanding *Jevic* to require "increased scrutiny" of even these permissible deviations. *Pioneer*, 570 B.R. at 235.

"Mindful of the increased scrutiny required by *Oxford Management, CoServ,* and *Kmart*, and, apparently, by *Jevic*", the court found that the debtor hospital had failed to establish that payments to three emergency room doctors qualified as critical vendor payments because the debtor had presented no evidence that the doctors were irreplaceable or that they would leave if prepetition amounts owing to them were not paid. *Id*. The bankruptcy court further noted that if the debtor could establish that the doctors were leaving because the debtor would not pay them

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[5] Several other cases have cited *Jevic* for its holdings regarding standing and other issues.

prepetition amounts owing, the debtor could threaten the doctors with an action for violating the automatic stay for failure to perform under their employment agreements. *Id*. at 236[6]

In *In re Hansen*, 2017 Bankr. LEXIS 1120 (Bankr. D. N.H., Apr. 25, 2017), the chapter 7 trustee brought a motion to sell certain patent assets which involved the settlement of litigation and which the court deemed to be a compromise of controversy. The trustee accepted an offer which compromised litigation and provided funds for payment in full of all prepetition claims, but left no surplus for the debtor. *Hansen*, 2017 Bankr. LEXIS 1120 at *4. The objections to the sale-settlement argued that the trustee should instead have opted for a different offer which contemplated pursuing, rather than settling, pending litigation, because success in the litigation could result in a surplus for the debtor.

In overruling the objections to the settlement, the court cited *Jevic* for the unremarkable proposition that the Code gives priority to payment of creditors over payment of debtors. *Id.* at *32. The court described *Jevic* as holding that a bankruptcy court may not approve structured dismissals which "do not follow the Bankruptcy Code's ordinary priority rules without the affected creditors' consent". *Id*. at fn. 17.

In *In re Fryar*, 570 B.R. 602 (Bankr. E.D. Tenn. 2017), a motion seeking approval of the sale of real property which included a compromise of controversy was denied where (1) the settlement distribution scheme did not follow ordinary Code priorities, (2) three creditors and the Office of the United States Trustee objected, which required the court to consider whether significant Code-related objectives existed to justify deviation from ordinary Code priorities, and (3) the debtor failed to establish sufficient Code-related objectives.

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[6] If this logic is accepted, it might prohibit debtors from including anyone working pursuant to an employment agreement in a first day motion, though this factor is only one among several mentioned by the *Pioneer Health* decision.

In simplification of a complicated fact pattern, the following are the relevant facts: Pinnacle Bank was an undersecured creditor. Part of the unsecured portion of its claim was being paid concurrently with the sale under the settlement, when other unsecured claims, and even a priority claim, was not. The court found that even though a sound business purpose exists for the sale of the property, because the "sale also involve[s] a settlement and a payment of one unsecured creditor ahead of other prior parties and other unsecured creditors, the court must also review the standards for approval of a settlement" and determine whether the compromise is "fair and equitable". *Fryar*, 570 B.R. at 607-08.

The bankruptcy court reviewed case law in the area, noting that the Fifth Circuit holds that a settlement cannot be used to circumvent the Code priority scheme but that the Second Circuit is more flexible, allowing "a settlement reordering distribution from some assets [where] necessary to allow the estate to pursue its most significant assets and where the nature and extent of the estate and the priorities were not fully resolved." *Id*. at 608.

Turning to *Jevic* and its holding regarding structured dismissals, the bankruptcy court noted that courts sometimes allow distributions other than in accordance with the priority scheme under a chapter 11 plan or in a chapter 7 case, as in the case of certain first day orders regarding wages and critical vendors, but only where the distributions would assist in a reorganization and make even dissenting creditors better off. As the court noted, Pinnacle jumping ahead "might be acceptable if all of the creditors were consenting; however, three creditors and the U.S. Trustee have objected, so the court must consider whether there are Code-related objectives being served that are so significant that deviation is justified." *Id*. at 609. But the debtor failed to demonstrate promotion of significant Code-related objectives. Thus, even though the failure to approve the compromise may result in unsecured creditors ultimately receiving nothing, the court held that it is "their decision to make if they want to see if they can find a better deal". *Id*. at 610.

The court directly based its ruling on *Jevic*:

> In 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" based on the factors to be considered by the Sixth Circuit, *Bauer*, 859 F.2d at 441, 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. 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 should state how it furthers that objective and should demonstrate that it makes even the disfavored creditors better off.

Id.

In a September 2017 case from the Delaware bankruptcy court, Judge Kevin Gross approved a settlement among the debtors, the postpetition lender and the creditors' committee as part of final approval of DIP financing/factoring which provided for the priority-skipping distribution of proceeds upon the contemplated sale of substantially all of the estates' assets. The facts presented a sympathetic case for approval of priority-skipping.

In *In re Short Bark Industries, Inc. et al*., Case No. 17-11502 (KG) (Bankr. D. Del. September 14, 2017), the committee withdrew its objection to entry of a final order approving a factoring arrangement between the debtors and undersecured lender LSQ after an agreement was reached that all proceeds of a pending sale of the debtors' assets would be paid to LSQ, which would escrow at least $110,000 of such proceeds and use the funds to make pro rata distributions to general unsecured creditors. The settlement (but not the underlying financing) was opposed by an alleged priority creditor and by the Office of the United States Trustee.

The debtor and the committee filed a joint motion and argued before the court (*see* transcript of hearing, docket no. 209 in the case), *inter alia*, the following: that *Jevic* applies by its terms only to case-ending distributions while here (*i.e.,* in *Short Bark*) the issue was before the court on a financing motion; that *Jevic* involved disposition of proceeds of estate assets while here the secured creditor was first being paid all proceeds and thus was using its own funds to make distributions to unsecured creditors; that *Jevic* mentioned a financing roll-up as a situation where priority-skipping might be allowed and this matter was before the court on final approval of financing;[7] and that creditors being passed over in *Jevic* had no other means of recovery, while here most or all administrative claimants were expected to paid from the proceeds of the financing and of potential avoidance action and D&O claims.

The UST filed what the court termed a "very strong objection" which primarily raised *Jevic*-based objections to the proposed settlement and its deviation from the Code-mandated distribution priority scheme. In oral argument (repeating its strongest points in its written objection), the UST argued, *inter alia*, as follows: *Jevic* was not limited to case-ending distributions, and in any event the contemplated distribution here was to happen upon a sale of substantially all the assets of the estate—the practical equivalent of a case-ending distribution (even if certain causes of action potentially remained). Further, *Jevic* noted that critical vendor motions and the like which proposed potentially permissible priority-skipping distributions "have usually found that the distributions at issue would enable a successful reorganization, and even make the favored creditors better off". Neither circumstance is found here since all assets were to be sold. In addition, "[i]n this case, the settlement motion [as cautioned by *Jevic*]…changes the bargaining power of creditors, such as administrative priority creditors, non-favored creditors left out of the money, even if this case does not end in a structured dismissal. And it evinces that teaming up between LSQ and the committee to squeeze out priority unsecured creditors". The UST pointed out that the Third Circuit's decision in *LifeCare* (discussed below) expressly noted that its result would have been different if, as is the case here, the proposed distribution was of proceeds upon which the secured creditor has a lien, rather than its own assets, explicitly

[7] The Court interjected that while approval was being sought as part of a financing motion, the proceeds in question were from the sale of estate assets.

distinguishing use of proceeds of a sale of estate property subject to a lien. Further, the debtors are providing releases of causes of action which are estate property; in *LifeCare* they were not parties to the agreement and no estate claims were relinquished.[8] In any event it is likely that *LifeCare* did not survive *Jevic*.[9]

Judge Gross did not publish an opinion or issue detailed findings of fact and conclusions of law addressing these issues. Rather, from the bench, he noted that he initially was inclined to rule in favor of the UST and to not allow the settlement, and that the decision was a difficult one, but that he changed his mind after re-reading *Jevic*. The court found *Jevic* distinguishable on two fundamental bases. First, *Jevic* was "all about a structured dismissal" and end of case distributions, pointing out that SCOTUS distinguished its facts from those in *Iridium* [10] which noted that "it 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". And [even though the distribution was to be made only when all assets were sold], that's what we have here. (transcript, docket no. 209, at 107:11-15). Further, *Jevic* found no "offsetting, bankruptcy-related justification", but here approval would save 500 jobs "while preserving the committee's rights to bring actions against insiders" (transcript at 107:16-22), and administrative creditors would still likely be paid in full. Perhaps in its most telling statement (which appeared to ignore *Jevic*'s admonishment against making "rare case" exceptions), the bankruptcy court observed that the settlement

[8] The UST also argued that (1) the settlement was a sub rosa plan, and one which could not be confirmed because the equivalent of "votes" in favor (*i.e.*, support for the settlement) had not been procured in good faith because payments by a third party were made to the parties voting (here, general unsecured creditors), violating §1129(a)(3); (2) distributions to general unsecured creditors were to be made without an adequate claims assessment and procedure for determining which claims should be allowed, and (3) not all employees—priority creditors who were the victims of the priority-skipping distribution—received notice of the proposed settlement, which was a violation of due process. The court considered and rejected each of these arguments.

[9] See discussion below regarding this issue.

[10] *In re Iridium Operating, LLC*, 478 B.R. 452 (2d Cir. 2007).

preserves the business with "some, but not great offense to administrative claimants" (transcript at 108:10-12).[11]

The Third Circuit's *LifeCare* Decision

At about the same time that the Third Circuit was deciding *Jevic* it also decided *In re LCI Holdings Co*., 802 F. 3d 547 (3d Cir. 2015) ("*LifeCare")*. In *LifeCare*, the Third Circuit affirmed an order of United States District Court for the District of Delaware, granting a 363 motion for the sale of the debtor's property which included the payment of claims outside the standard Code distribution scheme. The stalking horse (and winning) bid was made by the (under)secured creditor, which credit bid 89% of the amount of its debt and deposited funds into an escrow to pay legal and accounting fees of the Committee. The Committee objected to the sale because the proceeds were insufficient to provide a recovery to unsecured creditors or even to pay all administrative expenses. The United Sates objected because it would be owed $24 million of capital gains taxes as an administrative claim if the sale were to be consummated, but all cash from the sale was to be used solely to pay other administrative expenses (fees of the Committee's professionals) with which its claim had equal priority. Eventually the Committee withdrew its objection when the secured creditor agreed to escrow monies to fund a partial return to general unsecured creditors. Not surprisingly, the United States now objected to payment of not only other, *pari passu*, administrative claimants to its exclusion, but also to lower-in-the-priority-scheme general unsecured creditors.

The bankruptcy court overruled the government's objection and approved the sale, finding that the credit bid was the best and only bona fide bid, and that the alternative to the sale was a liquidation of assets which could endanger patients and would provide no recovery

[11] The UST appealed the court's ruling. But when the proposed sale did not yield additional proceeds over the $110,000 generated for general unsecured creditors from the stalking horse bid, the UST and the committee stipulated that the $110,000 would to go to the estate instead, in order to investigate claims against insiders. The UST appeal was dismissed so the case could be converted. *Short Bark*, Docket No. 305.

whatsoever to any creditor including the government. *LifeCare,* 802 F. 3d at 551. Moreover, the court found that because the escrowed funds came directly from the secured creditor/purchaser and never passed through the estate, such funds were not sales proceeds and thus not property of the estate. *Id*. Accordingly, the Code distribution priorities did not apply to them.

In affirming, the Third Circuit rejected the government's argument that the Committee itself had conceded that its settlement with the purchaser "'allocate[d] proceeds from the sale'" and therefore implicated property of the estate, declining to "elevate form over substance and give legal significance to the Committee's description of the settlement funds". *Id*. at 556. Further, the originally-escrowed funds to pay professional fees were likewise not property of the estate even though the Asset Purchase Agreement referred to them as "consideration" for the debtor's assets and part of the purchase price. Because the purchaser was buying, among other assets, all of the debtor's cash and thus the excess over professional fees would be returned to the buyer, these funds could not be termed property of the estate. *Id*. Rather, these were funds to assure a smooth transfer of assets and to resolve objections to the sale rather than as partial consideration for the debtor's assets. *Id*. at 557.

The United States did not appeal the *LifeCare* decision. As discussed below, it is unclear whether *LifeCare* remains good law after *Jevic*.

Beyond *Jevic*

The holding in *Jevic* directly addresses a structured dismissal to which parties objected. The narrow circumstances of *Jevic*, however, should not obscure the more fundamental and commonly-occurring circumstances to which it may—or may not—be applied, as well as several other issues.

(1) Issue: Is *Jevic*'s holding limited to structured dismissals, or do its principles and analysis apply to any potential distribution made during the course of a chapter 11 case which does not comport with the absolute priority rule (or to distributions in a chapter 7 case contrary to the distribution priorities set forth in the Code)? For example, does it apply to a proposed settlement which includes a distribution of proceeds or to first day motions seeking to pay certain prepetition obligations?

Analysis: It is as of yet unclear from the limited number of post-*Jevic* cases addressing these issues to what extent *Jevic* will have broad application. *Jevic* explicitly contrasts structured dismissals with first-day motions and the like by identifying the former's deficiencies (*e.g.,* doesn't preserve the debtor as a going concern, doesn't promote reorganization). But the bankruptcy courts in two subsequent cases (discussed above) clearly apply *Jevic* beyond structured dismissals. In *Pioneer Health Services,* the court explicitly cites the *Jevic* list of deficiencies in evaluating (and denying) a critical vendor motion, noting that *Jevic* "apparently" requires increased scrutiny of such motions. And in *Fryar*, the court cited *Jevic* in refusing to approve a settlement which involved a distribution of proceeds which deviated from the standard Code priority scheme. In contrast, however, the court in *Short Bark* (unpublished, ruling from the bench) focused heavily on the fact that *Jevic* "was all about a structured dismissal" in refusing to deny a priority-skipping settlement, noting that *Jevic* cited with approval the Second Circuit's decision in *Iridium* for the proposition that it is "difficult to employ the rule of priorities" early in the case when the "nature and extent" of claims have not been fully resolved.[12] Thus, whether, and to what extent, *Jevic* will be more widely applied—including whether courts will require a more robust evidentiary showing to support first day motions seeking to pay prepetition claims (ala *Kmart*)--remains to be seen.

[12] The *Short Bark* court also rested its decision on the fact that a "significant, offsetting, bankruptcy-related justification" existed since the settlement would save the debtors' business and the employment of 500 people.

(2) Issue: If *Jevic* applies beyond structured dismissals (which almost always, by their nature, have most of the deficiencies identified in *Jevic*), can a court approve a deviation from the standard distribution scheme if "Code-related objectives" are achieved even if the affected creditor objects?

Analysis: On the one hand, *Jevic* appears to state a bright-line holding: a deviation from standard Code distribution priorities can only be approved with the consent of the affected creditor. Perhaps this bright line applies to other situations as well. On the other hand, *Jevic* contrasts its circumstances with those of potential first day orders, reciting its laundry list of deficiencies which go well beyond the fact that the affected creditor has not consented. As noted above, post-*Jevic* cases *Pioneer Health* and *Fryar* apply *Jevic*'s more nuanced analysis. Indeed, *Fryar* explicitly analyzed whether Code-related objectives were being achieved only once it noted that creditors had objected. *Fryar*, 570 B.R. at 609. However, *Fryar* also noted that the Supreme Court's listing of deficiencies under the facts of *Jevic* was dicta to *Jevic*'s fundamental, narrow holding applicable to structured dismissals. *Id*. at 608-09. The context of *Jevic* made it difficult to argue that the settlement was achieving Code-related objectives—the company had shut its doors pre-bankruptcy and all that was happening through the settlement was a resolution of estate owned fraudulent conveyance actions. But the more typical context of a class-skipping structured dismissal involves a creditors committee giving up its rights to object to a sale or DIP financing in exchange for a fund earmarked to its constituency. In those cases, the elimination of potential sale or DIP litigation often paves the way for a going concern sale without the attendant costs and risks of litigation. Since the Code promotes value maximization one could argue that such a fact pattern is distinguishable and that *Jevic* does not apply. Indeed, this largely was the fact pattern in *Short Bark*, wherein the court distinguished *Jevic* and approved a settlement which included a priority-skipping distribution of future sales proceeds. Whether other courts will take that view remains to be seen.

(3) Issue: As noted by the Supreme Court, affected parties objected to the structured dismissal in *Jevic*. Presumably if all affected parties consent, a deviation from distribution priorities would be permitted. *Cf. Fryar*, 570 B.R. at 609 (analysis of whether Code-related objectives have been met undertaken after noting that parties have objected, though states only that the plan "*might* be acceptable if all of the creditors were consenting." (emphasis added)). Does the lack of an objection after notice and opportunity to object constitute consent?

Analysis*:* *Jevic* sheds no light on the issue; the affected parties affirmatively objected, as they did in *Short Bank*. In *Fryar*, the bankruptcy court noted that creditors were not consenting, that three creditors and the UST objected. This *may* imply that had no objections been filed, consent would have been inferred. *Pioneer Health* did not address the issue of consent at all.

Even if consent can be inferred through failure to object, first day motions are of course heard on an emergency basis following limited notice. Perhaps debtors, where possible, should bring critical vendor and similar motions on regular notice sent to all creditors.

(4) Issue: Can a priority-skipping payment be authorized over an objection if there is evidence of "significant Code-related objectives" even if the payment will not benefit the affected party? For example, if unsecured creditors would be paid in full on a liquidation, can a critical vendor motion be granted over an objection by such a creditor, who has nothing to gain but whose recovery in full is put at risk by an authorization based on Code objectives of reorganization and preserving the debtor as a going concern?

Analysis: In rejecting the class-skipping payments in *Jevic* the Court reasoned that the structured dismissal pursuant to which they were proposed to be made "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." *Jevic*, 137 S. Ct. at 985-86. That language would imply that if the class-skipping payments further fewer than all —or perhaps even any one— of those Code-related objectives then the payments can be approved even if the payments do not benefit the objecting party. However, the bankruptcy court in *Fryar* appears to go further than the Court in *Jevic*, stating that a settlement which deviates from Code distribution priorities should state how it is serving code related objectives "and should demonstrate that it makes even the disfavored creditors better off." *Fryar*, 570 B.R. at 610 (and at 609, quoting *In re Kmart Corp*., 359 F. 3d 866, 872 (7th Cir. 2004) discussing justifications for critical vendor motions). Although benefit to the objecting creditor was not stated as a requirement, the bankruptcy court in *Short Bark* observed that the objecting administrative claimant would "participate in the settlement to a small degree" and that there was no guarantee that skipped-over administrative claimants would receive any distribution if the settlement was disallowed, thereby finding that the settlement thus involved "some, but not great offense to administrative claimants" (*Short Bark* transcript at 108:6-12). Although inconclusive, *Jevic*'s laundry list implies, at a minimum, that not all of the listed elements must be met.

(5) Issue: Are there creative ways to structure a dismissal which do not run afoul of *Jevic*? Does the methodology and do the principles enunciated in *LifeCare* survive *Jevic*, *i.e.,* do the *Jevic* requirements apply to funds which are not property of the estate? Recently, the United States Bankruptcy Court for the District of Delaware approved a credit bid sale to a junior lender under Section 363 which sale included an assumption of $750,000 of prepetition general unsecured claims on a pro rata basis in *United Road Towing Company, et al*., case no 17-10249 (LSS). Although the buyer was also paying known administrative and priority claims, would the

assumption of liabilities construct work even if certain priority or administrative claims were not satisfied?

Analysis: The issue of whether *LifeCare* survives *Jevic* was hotly contested in *Constellation Enterprises, LLC, et al*., case no. 16-11213 (CSS) pending in the Delaware bankruptcy court (*see,* primarily, docket nos. 944-948, 955 & 956). Among the arguments put forth that *LifeCare* did not survive *Jevic* were the following: (1) The assets at issue in *Jevic* were also not estate property: $2 million was contributed by secured creditor CIT (clearly not property of the estate) and a lien on $1.7 million was "contributed" by secured creditor Sun. (2) If the assets being used are so divorced from the estate that *Jevic* does not apply, then the court does not have subject matter jurisdiction over such assets and can neither approve nor disapprove their use.

The Committee replied that no portion of *Jevic* addresses or overrules *LifeCare*. $1.7 million of the funds being used in *Jevic* were estate funds even though they were subject to a lien. And despite that the CIT $2 million was not property of the estate, *Jevic* refused to hold that the use of *any* estate assets which are to be distributed outside the standard distribution scheme is improper. In fact, *Jevic* acknowledged the permissible use of such funds in certain first day and settlement motions. Further, the alleged jurisdictional Catch-22 is merely a red herring, as the settlement resolves numerous disputes in the case regarding, for example, previous objections to DIP financing orders.

In declining to approve the settlement in *Constellation*, Judge Sontchi, for the most part, avoided this issue, finding that though the property in question was currently owned by the purchaser of the estate's assets, the property had once been property of the estate and the parties always contemplated that it would be transferred back. Accordingly, the property in question was considered property of the estate, *LifeCare* was thus inapplicable and the settlement would be disallowed under *Jevic*. Judge Sontchi acknowledged that the Supreme Court in *Jevic* wasn't focused on the issue of property vs. non-property of the estate. Since he concluded that *Constellation* dealt with estate property he was able to sidestep the issue. Accordingly, it is unclear how the Court would have ruled had the property involved been unequivocally non-estate property. Nevertheless Judge Sontchi did reason that "if [*LifeCare]* hasn't been overturned by *Jevic* altogether, and I'm not ruling that it has been, I think it probably has been significantly narrowed…". Transcript of May 16, 2017 hearing in *Constellation*, at 247-48. Elsewhere, however, Judge Sontchi noted that if faced with a true *LifeCare* scenario where unequivocally only non-estate property was being used, "I think I'd be constrained to follow or enforce [it]". *Id*. at 250.

In a post-*Jevic* world, can the partial assumption of liabilities in *United Road Towing Company* be utilized in a circumstance where higher priority creditors are not being paid in full? If *LifeCare* survives *Jevic*, a sale including *United Road Towing*'s partial assumption of liabilities likely does as well. In the parlance of the *LifeCare* decision, non-estate property is being used to "smooth" the transfer of assets by resolving objections to the sale, rather than to purchase assets.

One can argue that *United Road Towing*'s assumption is even more removed from use of estate assets than the funding of a creditor trust in *LifeCare* with non-property of the estate. No assets whatsoever—estate or non-estate owned—are being transferred. Moreover, it is common practice for a purchaser of assets to selectively assume liabilities. Just as a purchaser is allowed to select which liabilities to assume based on its future business necessities, so too a purchaser should be permitted to select liabilities to assume based on the business necessity of garnering support for the proposed sale transaction.

However, if the purpose of an *United Road Towing*esque partial assumption of liabilities is clearly to bypass the standard Code priority scheme, the issue may still come down to whether *LifeCare* survives or not. A court may either determine that the approach is permitted because estate assets are not being used in violation of Code distribution priorities, or will instead view the structure as form over substance, focusing on the fact that funds paid (as in *LifeCare*) or to be paid (as in *United Road Towing*) are monies the purchaser is willing to pay for the debtor's assets, which monies are being used to pay the debtor's liabilities.

American Bankruptcy Institute Bankruptcy Battleground West 2019

MATERIALS SUPPLEMENT FOR CROSSFIRE PANEL

Topic: *Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973, 197 L.Ed. 2d 398 (2017)*

Additional Post-Jevic Transactions Approved by Courts

1. *In re Old Cold, LLC,* 879 F.3d 376, 388 (1st Cir. 2018) – court did not set aside sale order that included elements of priority skipping where there was a Bankruptcy Code section 363(m) good faith finding. In addition, buyer was permitted to assume certain junior liabilities (such as important vendors and suppliers) and no other liabilities, including senior liabilities as part of a sale. The court noted that the ability to assume junior debt is an important feature of Bankruptcy Code section 363 sales and limitation of this feature would impact on the utility of 363 sales.
2. *In re Veg Liquidation Inc.,* 583 B.R. 203, 2011 (B.A.P 8th Cir. 2018) -- court did not set aside a sale order, which the chapter 7 trustee asserted included elements of priority skipping, as there was a Bankruptcy Code section 363(m) finding, no appeal of the sale order and no stay of the sale. The court stated, "[s]ince this case does not arise from the appeal of the Sale Order, *Jevic* has no application."
3. *Hinson for Broughton v. Bank of Am., N.A.,* No. 5:16-CV-00958-RE, 2018 WL 4289316, at *1 (E.D.N.C. Sept., 7, 2018) – court approved a settlement between the chapter 7 trustee and the single secured creditor and holds that *Jevic* is not applicable to a compromise of the one secured creditor's claim in an individual debtor's chapter 7 case.
4. *In re Daily Gazette Co.,* 584 B.R. 540, 543 (Bankr. S.D.W. VA. 2018) –court approved a sale of substantially all of the assets to a successful bidder pursuant to Bankruptcy Code section 363. In a second motion filed after the sale order was entered, the debtors

requested authority to pay all proceeds to the single secured creditor with an uncontested secured claim subject to a holdback to fund a wind down of the debtors affairs and payment of administrative expense claims. The court held that *Jevic* was not applicable as it involved a structured dismissal rather than "the Code-sanctioned sale and distribution process herein involved." The court also stated, "[a] vast expanse separates, on the one hand, the proposed distribution to United Bank, which holds an uncontested security interest in the underlying assets, and on the other, the priority shell game of sorts involved in *Jevic*."

5. *Hargreaves v. Nuverra Envtl. Sols., Inc. (In re Nuverra Envtl. Sols., Inc.)* No. 17-10949-KJC, 2017 WL 3326453, at *3 (D. Del. Aug. 3. 2017) – court confirmed a cram down plan that provided 100% to general unsecured trade creditors and 4% to 6% to general unsecured note holders where noteholder class voted to reject plan. *Jevic* was not addressed by objecting 1% noteholder or the court, and was only raised by creditors committee, which argued that *Jevic* did not apply in the plan confirmation context.

<u>Additional Post-Jevic Transactions Not Approved by Courts</u>

1. *In re Constellation Enterprises*, No. 16-bk-11213 (Bankr. D. Del. May 16, 2017 (oral ruling) – court denied settlement by which the debtor would have transferred property to a secured creditor, and then the secured creditor would have transferred assets for the benefit of general unsecured creditors while skipping higher priority clams.