AMERICAN BANKRUPTCY INSTITUTE

2017 Midwest Regional Bankruptcy Seminar

Commercial Track

How Will *Jevic* Change Chapter 11 Practice?

CONCURRENT SESSION

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Jevic Holding Corp.- The Supreme Court Issue and Ruling, and the Impact on Future Chapter 11 Cases

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Chapter 11 Primer

- Three ways for a company to exit Chapter 11:
  1. Plan of Reorganization or Liquidation
  2. Conversion to Chapter 7
  3. Dismissal of the case
- Short Glossary of Terms simplistically defined used in this presentation:
  - Absolute Priority Rule- statutory sequence of order by which creditors are paid in a bankruptcy
  - Rule 9019 Settlement- bankruptcy rule that provides for Debtor to settle counterparty disputes
  - CRO or Chief Restructuring Officer- a financial professional employed by the Debtor who assumes interim responsibility for Debtor's financial affairs and restructuring
  - DIP or Debtor in Possession- company in Chapter 11 which manages itself without the appointment of a Chapter 11 Trustee
  - Fraudulent Conveyance- a transaction by the Debtor such as a sale, recapitalization, etc. where the Debtor did not receive fair economic value or which was consummated that left the Debtor insolvent
  - WARN Act Claim- a federal labor law that protects employees in the event of a sizeable plant closing or mass layoff where employees are entitled up to 60 days notice of imminent job loss or the payment of up to 60 days pay and benefits in lieu of notice
  - Doctrine of Necessity- Bankruptcy Court construct to support common sense rulings not specifically allowed by Bankruptcy Code
  - Structured Dismissal- Bankruptcy Court construct to resolve and dismiss administratively insolvent cases

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Overview of Jevic Generally

- Jevic Transportation, Inc., the operating sub of Jevic Holdings, (Jevic) was a $200M annual revenue New Jersey trucking company employing over 1,900 employees. Jevic was acquired by a subsidiary of Sun Capital Partners (Sun) in a leveraged buyout in 2006. Sun bought the business for a small investment. Jevic had been incurring significant losses and the business would have been liquidated if not sold to Sun.
- CIT agented a 5 bank financing which was in excess of $50M to fund the acquisition.
- Jevic management was unable to turnaround the company despite assistance from various outside performance improvement consultants and Sun's expertise.
- The trucking industry faced a significant increase in oil prices in 2008 (diesel $4+/gallon) and had not yet instituted across the board industry-wide weekly fuel surcharge adjustments.
- Sun purchased a $2M last out participation of the CIT loan as part of one of several loan amendments.
- CIT and the other lenders were concerned about Jevic's continuing losses and the general trucking industry deterioration, so CIT required that Jevic hire a restructuring and financial advisory consulting firm (FA) to monitor cash, assist with ongoing turnaround efforts, and to prepare a contingency liquidation plan as it was believed that Jevic may not be saleable.
- Company hired MorrisAnderson as FA in February 2008. MorrisAnderson supported the company, kept the bank group fully advised, and prepared a contingency liquidation plan.

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Overview of Jevic Generally (Continued)

- 3 months after MorrisAnderson was retained, CIT advised Jevic that they would only continue to provide funding in a Chapter 11 proceeding with the company to be liquidated and Dan Dooley of MorrisAnderson to become CRO and manage the process with management and the MorrisAnderson team. Dan Dooley became CRO in late April 2008.
- MorrisAnderson prepared a DIP liquidation budget. Jevic had over 1,000 tractors and 3,000 trailers spread over 30 states and 10 Jevic terminals all across the USA. MorrisAnderson took the position that in order to assure return of $40M of tractor and trailer assets that DIP money had to be set aside for employee issues to pay all accrued vacation and most of the self insured health insurance plan run-off charges. After much argument, CIT and the lenders consented to $3M of incremental DIP budget expense for this in the DIP budget.
- On Monday May 19, 2008, Jevic publicly announced to customers, suppliers and employees that Jevic would be shut down and liquidated and that a Chapter 11 filing was imminent. Jevic gave the WARN notice and terminated a large number of people except employees needed for the liquidation, terminal management and drivers who we had scheduled to complete all loads. Jevic told customers that we would deliver all loads that Jevic had accepted. Since much of Jevic's business was less-than-truckload (LTL) business, that meant we would have to deliver all LTL shipments that were currently sitting in Jevic warehouses waiting for shipment consolidation. Jevic promised all employees that they would get paid for their hours, get a bonus for returning their tractor and trailer, plus get any accrued vacation pay, and that we would pay most, if not all, of the healthcare plan run-off charges.
- The objective was to get all trucks and trailers returned in good condition and to not cause any damages with customers by interrupting their in-shipment freight to protect subsequent AR collections.
- On Tuesday May 20, 2008 (the next day), Jevic and related legal entities filed for Chapter 11 in Delaware. Jevic was a liquidating case from the start with no intention of pursuing a sale or Plan of Reorganization.

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Important Underlying Facts

- Over the next 3 weeks all Jevic business operations were shut down and all assets were marshalled for sale, and all employees except a small wind down group had been terminated. So virtually all employee terminations occurred less than 60 days from the date of the WARN Notice.
- Jevic and Sun, as owner, were served with multiple WARN Act class action suits shortly after filing Chapter 11; all eventually were consolidated into one class action lawsuit in the bankruptcy court
- CIT was owed approximately $53M on the Petition Date, secured by a first priority lien on all assets, primarily AR, tractors and trailers
- Every single Jevic tractor was returned without significant damage. 95% of the trailers were found and returned. AR was collected at over 98%
- After its formation, the Committee requested and was granted by Bankruptcy Court (with consent of the Debtors) approval to file lawsuits on behalf of the Jevic estate for an alleged fraudulent conveyance against both Sun and CIT (and the bank group) arising from the LBO. The Committee vigorously pursued this lawsuit
- MorrisAnderson liquidated all the assets of Jevic in the Chapter 11 over 2008-2010 including the prosecution and collection of all preference claims

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Important Underlying Facts (continued)

- CIT was eventually fully paid as secured creditors and approximately $2M of secured debt remained, which was a last out participation in the CIT facility by Sun, and coincidentally the Debtor had approximately $2M of cash in the bank subject to the secured creditor interest
- Claims were approximately: $1M of unpaid administrative professional fee claims, $300K of combined administrative claims, priority tax claims and 503(b)(9) claims, $12M of alleged WARN claims ($8M would have priority status), and unsecured claims were also $10M
- The Secured Lender (Sun Capital now) was entitled to full payment on its last out secured debt position. There were two unresolved litigation cases (WARN which had to be defended by Jevic and Fraudulent Conveyance which the Committee was pursuing for the Debtor) with no unencumbered assets to fund defense or prosecution. There was $1M of unpaid Administrative professional fees
- Case was clearly administratively insolvent without the parties agreeing to some type of a negotiated settlement
- The option of converting to a Chapter 7 would have left the estate with no unencumbered assets except the Committee's fraudulent conveyance lawsuit, but there was no cash to fund future litigation

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Important Underlying Facts (continued)

- Debtor's professionals organized all parties into a Debtor led self-mediation where the Committee, Sun, CIT as agent for the banks, and the WARN plaintiffs participated. The hope was that CIT/banks and Sun would provide enough funding to resolve the two open issues- fraudulent conveyances and WARN lawsuits, and that the various major claimants (Administrative, WARN and Unsecured) could agree on a fair way to split up a pot of money. We felt that everyone should be motivated to avoid the alternative of all parties getting nothing upon a Chapter 7 conversion.

- The Debtor convened two in-person meetings of all parties. Between Sun and CIT and the bank groups a pot of $3.7M was accumulated which could be used to resolve all matters. The WARN claimants participated in the mediation meetings but declined to accept anything but a full $14M payment.

- As a result the Debtor and the Committee created a 9019 Settlement where the two secured lenders (Sun and CIT as agent for the bank group) would settle the fraudulent conveyance litigation, all parties involved in the settlement would get releases, CIT would pay $2.0M and Sun would assign $1.7M of their secured cash to pay 1. professional fees, 2. administrative and priority claims, with 3. with a small dividend paid to the unsecured creditors, and 4. the Chapter 11 case would end as a structural dismissal. The WARN claimants received nothing but retained their rights to pursue their litigations against Jevic and Sun. Of course Jevic had no unencumbered assets, so it was judgment proof.

- This 9019 Settlement became the issue that the WARN claimants appealed, with further support from the US Trustee and DOJ offices, that eventually came before the US Supreme Court.

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Procedural History of the Case

- The WARN plaintiffs and the U.S. Trustee objected to the combined 9019 Settlement and the structured dismissal motion, because the settlement skipped the WARN plaintiffs with priority claims and priority tax claimants, but made distributions to junior class unsecured creditors, it violated the Absolute Priority Rule.

- The U.S. Trustee also contended that structured dismissals are not permitted under the Bankruptcy Code.

- The 9019 Settlement and structured dismissal motion were modified to also pay tax priority claims

- The Bankruptcy Court overruled both objections and approved the what he termed as the "least worst alternative" which was the proposed 9019 Settlement and structured dismissal.
  - The court acknowledged that the Code does not expressly authorize structured dismissals, but found that the relief was justified by dint of the "dire circumstances" present in the case.
  - There was "no prospect of a confirmable Chapter 11 plan" and conversion to Chapter 7 was not a viable option because the trustee would lack the resources necessary to fund the case.

- The court rejected the U.S. Trustee's and The WARN plaintiffs argument that the court could not approve the settlement because it violated the Absolute Priority Rule, reasoning that the Bankruptcy Code's priority scheme does not extend to settlements.

- The WARN plaintiffs and U.S. Trustee appealed to the District Court, which affirmed the Bankruptcy Court's decision. The WARN plaintiffs and U.S. Trustee appealed to the Third Circuit. No stay pending appeal was requested at any level except in the Bankruptcy Court which denied a stay

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Issues the 3rd Circuit Considered on Appeal

- The Third Circuit hearing the appeal addressed two issues:

(1) Whether a structured dismissal is permissible under the Bankruptcy Code and

(2) If so, whether a settlement in the context of a structured dismissal must follow the Absolute Priority Rule.

- The Third Circuit noted conflicting case law from other Circuits: *In re AWECO, Inc.*, 725 F.3d 293 (5th Cir. 1984) and *In re Iridium Operating LLC*, 478 F.3d 452 (2d Cir. 2007)

- As to (1), the Third Circuit explained that while section 349 "contemplates that dismissal will typically reinstate the pre-petition state of affairs … it also explicitly authorizes the bankruptcy court to alter the effect of dismissal 'for cause'—in other words, the Code does not strictly require dismissal of a Chapter 11 case to be a hard reset."

- The Third Circuit highlighted that even the WARN plaintiffs acknowledged that both a liquidating plan and Chapter 7 were not viable options.

- Accordingly, it held, "absent a showing that the structured dismissal has been contrived to evade the procedural protections of the plan confirmation or conversion process, a bankruptcy court has discretion" to order a structured dismissal.

- As to (2), the Third Circuit adopted the Second Circuit's *Iridium* standard, a multi-factored approach in which the most important factor is that a settlement be "fair and equitable" but under which a noncompliant settlement could be approved if "the remaining factors weighed heavily in favor" of approving a settlement.

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Issue Presented Before the US Supreme Court

- Oral argument was heard by the 8 justice court in December 2016

- The ONLY ISSUE presented to the Supreme Court for consideration is:
  - Whether a bankruptcy court may authorize the distribution of settlement proceeds in a manner that violates the statutory priority scheme (i.e. the Absolute Priority Rule)?

- The layman's basic argument "for" affirming is simply that the Bankruptcy Code does not prohibit distributing proceeds not in conformance with the Absolute Priority Rule when dismissing a case if there are exceptional circumstances "for cause" supporting such distribution

- The layman's basic argument "against" affirming is simply that the Bankruptcy Code does not specifically allow distributing proceeds not in conformance with the Absolute Priority Rule (APR) in any situation and Chapter 11 Plan and Chapter 7 distributions explicitly must follow the APR

- The U.S. Trustee Office took up the Appeal (as amicus curiae) because of its belief that the Absolute Priority Rule is key foundation of bankruptcy law and as a matter of policy it must be strictly followed in all cases

- However, it's common practice to violate the Absolute Priority Rule in bankruptcy cases? Examples:
  - Pre-petition wage and tax payments
  - Loan Roll-ups and Professional Carve-outs
  - Critical vendor payments and Gifting

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The Supreme Court Ruling

- Plaintiffs successfully recharacterized the issue before the Supreme Court as follows:
  - Whether a bankruptcy court has the legal power to order this priority-skipping kind of distribution scheme in connection with a Chapter 11 dismissal?
- This is a much narrower issue than broader issue upon which certiorari was granted and was not subject to a "Circuit Split" in opinions
- The Supreme Court Ruling decided by a 6-2 vote to Reverse and Remand as follows:
  - Bankruptcy courts may not approve structured dismissals that provide for distributions that do not follow ordinary priority rules without the consent of affected creditors (same standard as Chapter 11 Plans)
  - This is essentially the same rule as applies in Chapter 11 Plans of Reorganization (or Liquidation)
  - Two Judges dissented based upon the plaintiffs recharacterization of the issue before the court as 1. the recharacterized issue not subject to a Circuit Split, so certiorari would not have been granted on it and 2. this potentially opens the door for future litigants to recharacterize issues before the court in a more favorable way to their case

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Key Comments in the Supreme Court Opinion

- Acknowledged that there are only three ways to end a Chapter 11 case- Plan or Reorganization (or Liquidation), Conversion to Chapter 7 or Dismissal
- Acknowledged that the Code does not identify whether the priority system must be followed under a dismissal where a total case reset to the beginning is impossible (i.e. a structured dismissal), such as Jevic
- Although the Court specifically did not sanction the use of Structured Dismissals, it acknowledged that they are increasingly used and referenced the American Bankruptcy Institute's definition of a structured dismissal
- Discussed that interim case distributions (as opposed to final case distributions) that deviate from the priority rules can be permissible if they serve other Code objectives. Specifically listed were first day wage orders, critical vendor orders and roll-up financings
- Found that the non-priority case ending distributions in Jevic did not serve other Code objectives
- Concerned that granting bankruptcy courts the ability to use discretion to skip priorities over an objecting creditor in a case ending distribution could become a more general rule in the future. The reasoning was that it is difficult to give precise content to the concept of "sufficient reasons" to not follow the priority system
- Priority system has long been considered fundamental to final case distributions and Congress wouldn't have been silent of how to make distributions in a (structured) dismissal case if it intended to authorize a major departure from this fundamental

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Implications of the Decision on Future Chapter 11's

- The Jevic case "had" the potential to really disrupt Chapter 11s:
  - A broad reversal of the original issue before the Supreme Court could have dramatically impaired a company's ability to function effectively in a Chapter 11 by limiting a company's ability to fund essential payments
  - A broad reversal of the original issue before the Supreme Court could have made it more difficult for lenders to use Chapter 11 to liquidate collateral thru a 363 sale process or a liquidation
- Appears to sanction use of the Doctrine of Necessity to make non-priority following distributions that are not final case distributions if done to address other Code objectives
- Appears to have sanctioned Structured Dismissals while being careful to specifically not do so
- It seems quite possible that Supreme Court saw the Plaintiff's recharacterization of the issue before the court as a way to address a much narrower issue and deal with the broader priority scheme issue that had the potential of dramatically changing Chapter 11s via implication and not direct ruling

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So What's Going to Happen to Jevic Now?

- How will the Bankruptcy Court Judge eventual handle the reversal and remand?
  - This will be a difficult case to put the "genie back in the bottle"
  - Does the Judge get the same result with equitable mootness? (not well regarded in the 3rd Circuit)
  - With a "No Assets" Case, who would do the work to try to recover the $3.7M of money distributed years ago?
  - Do you only try to recover the distributions only to creditors lower in priority than the WARN priority claimants ($1.2M)?
  - Doesn't the distributed money if disgorged from creditors simply go back to the secured creditors anyway?
  - What happens to the settled fraudulent conveyance lawsuit?
  - Could the secured creditors CIT and Sun as a practical matter potentially get the benefit of the deal without paying the full agreed price?
  - Do the parties involved attempt to renegotiate a new deal?

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What Might Have Been Done Differently in the 9019 Settlement?

- **Who knows if any of these would have worked but some options would have been:**
  - **Do the 9019 Settlement as a stand alone settlement and let time pass before doing the Structured Settlement**
  - **Pay the WARN creditors out of the settlement instead of the lower priority creditors**
  - **Have the secured creditor take the remaining funds in the case subject to its lien, seek a Structured Dismissal and attempt to do the same settlement outside of the bankruptcy court**

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

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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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[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*.

<u>The Lower Court Decisions</u>

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.

<u>The Supreme Court Decision</u>

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.

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

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[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.

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 interest.

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.

<u>Decisions Subsequent to *Jevic*</u>

Three opinions 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*, 2017 Bankr. LEXIS 939 (Bankr. S.D. Miss., Apr. 4, 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*, 2017 Bankr. LEXIS 939 at *14-15.

"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*. at *15-17. The bankruptcy court further noted that if the debtor could establish that the doctors were leaving because the debtor would

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[5] Several other cases have cited *Jevic* for its holding regarding standing.

not pay them 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*.[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.

Finally, in *In re Fryar*, 2017 Bankr. LEXIS 1123, 64 Bankr. Ct. Dec. 8 (Bankr. E.D. Tenn., Apr. 25, 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.

[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*, 2017 Bankr. LEXIS 1123 at *8-10.

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 *11.

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 *14. 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 *16.

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. at *16-17.

<u>The Third Circuit's *LifeCare* Decision</u>

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 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*.

<u>Beyond *Jevic*</u>

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) <u>Issue</u>: 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?

<u>Analysis</u>: *Jevic* will likely have broad application. It 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). 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. Although neither is binding precedent, the decisions may augur the approach likely to be taken by many, if not most, courts post-*Jevic*. Whether, and to what extent, courts require a more robust evidentiary showing to support first day motions seeking to pay prepetition claims (ala *Kmart*) remains to be seen.

(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*, 2017 Bankr. LEXIS 1123 at *14. 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 *12-13. 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. Whether 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*, 2017 Bankr. LEXIS at *13 (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. 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*, 2017 Bankr. LEXIS 1123 at *16-17 (and at *13, quoting *In re Kmart Corp*., 359 F. 3d 866, 872 (7th Cir. 2004) discussing justifications for critical vendor motions). *Fryar*, of course, is one bankruptcy court's opinion. 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.