Supreme Court Holds in *Jevic* that the Absolute Priority Rule is Absolute in Bankruptcy

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In a 6-2 opinion issued on March 22, 2017, the United States Supreme Court held in *Czyzewski v. Jevic Holding Corp.* that bankruptcy courts may not approve so-called structured dismissals that provide for distributions that do not comply with the bankruptcy priority rules without the consent of affected creditors. The opinion was penned by Justice Breyer, with Justices Thomas and Alito dissenting. The opinion has significant implications to chapter 11 practice and arguably limits the flexibility that many litigants and courts have enjoyed in crafting and approving settlements (often through a structured dismissal or a gifting arrangement). The most important question in the wake of this decision is: how will bankruptcy courts interpret *Jevic* going forward?

The debtor in *Jevic* was a trucking company that filed for chapter 11 protection in 2008, approximately two years after the company was acquired through a leveraged buyout by Sun Capital Partners ("Sun"). The leveraged buyout transaction was financed by CIT Group ("CIT"). In the bankruptcy case, a group of the company's terminated employees filed a class action against the debtor alleging violations of the WARN Act. The WARN Act claimants obtained summary judgment against the debtor, a substantial portion of which was entitled to priority in payment under section 507(a)(4) of the Bankruptcy Code.[1]

Additionally, the official committee of unsecured creditors ("Committee") filed suit against CIT and Sun alleging that the leveraged buyout transaction was a fraudulent transfer. Three years later, the Committee, CIT and Sun entered into a settlement of the litigation which contemplated: (i) dismissal of the fraudulent transfer action and releases in favor of CIT and Sun, (ii) CIT paying $2 million into the estate for payment of administrative expenses, (iii) Sun assigning its lien on the debtor's remaining cash, which cash would pay general unsecured creditors on a pro rata basis, and (iv) dismissal of the debtors' bankruptcy cases by way of a so-called structured dismissal.

The term "structured dismissal," which is not found in the Bankruptcy Code, refers to the increasingly utilized procedure of dismissing a case pursuant to a court order with certain conditions attached (such as distributions to creditors) instead of simply dismissing the case and restoring the status quo ante. Some courts have approved structured dismissals as a cost-effective alternative to a traditional dismissal of the case, conversion of the case to a chapter 7, or confirmation of a plan.

[1] 11 U.S.C. § 507(a)(4) provides a priority unsecured claim for wages, salaries and commissions, up to a statutory cap, earned by employees within 180 day before the filing of the bankruptcy petition or the cessation of the debtor's business, whichever occurs first.

The WARN Act plaintiffs objected, arguing that the settlement violated the absolute priority rule in bankruptcy, which generally contemplates that secured creditors will be paid before priority unsecured creditors, who will be paid before general unsecured creditors and equity. Nevertheless, the Delaware bankruptcy court approved the settlement, and that approval was affirmed by the district court.

On appeal, the Third Circuit Court of Appeals, in a 2-1 opinion authored by Judge Ambro, held that "bankruptcy courts may, in rare instances like this one, approve structured dismissals that do not strictly adhere to the Bankruptcy Code's priority scheme." The settlement was appropriate, the Third Circuit held, because "there was no prospect of a confirmable plan … and conversion to Chapter 7 was a bridge to nowhere." The court also noted that "settlements in bankruptcy are favored" and "where specific and creditable grounds" justify deviation from the priority scheme, bankruptcy courts may approve settlements that include such a deviation.

The Supreme Court reversed. The Court began its analysis by rejecting the debtor's standing arguments. The debtor argued that the petitioners had not "suffered an injury in fact," because the WARN Act claimants would have received nothing even if the Bankruptcy Court had denied the proposed settlement. This argument, the Court noted, was based on the assumption that without a settlement, the fraudulent transfer claims would have no value. The Court rejected this assumption, concluding that the fraudulent transfer claims might have some "litigation value" (after all, the lenders were paying $3.7 million to settle the claims) such that a trustee on conversion of the case to chapter 7 or the WARN Act claimants on dismissal could have pursued the lawsuit. As a consequence of the settlement, the WARN Act claimants lost a chance to litigate or to obtain a settlement that respected their priorities and resulted in them receiving some distribution.

Turning to the absolute priority rule issue, the Court held that, absent consent, a distribution scheme ordered in connection with the dismissal of a chapter 11 case cannot deviate from the basic priority rules that apply under the Bankruptcy Code. The Court stated:

> The Code's priority system constitutes a basic underpinning of business bankruptcy law. Distributions of estate assets at the termination of a business bankruptcy normally take place through a Chapter 7 liquidation or a Chapter 11 plan, and both are governed by priority. In Chapter 7 liquidations, priority is an absolute command – lower priority creditors cannot receive anything until higher priority creditors have been paid in full. Chapter 11 plans provide somewhat more flexibility, but a priority-violating plan still cannot be confirmed over the objection of an impaired class of creditors. The priority system to those distributions has long been considered fundamental to the Bankruptcy Code's operation.

The importance of the priority system, the Court found, led it to expect "more than simple statutory silence if, and when, Congress were to intend a major departure." The Court reviewed the Bankruptcy Code, and concluded that nothing in the statute evinced such an intent.

The Court did not take issue with structured dismissals generally; it expressly stated: "We express no view about the legality of structured dismissals in general." But the structured dismissal at issue in this case, the Court held, constituted a "final" distribution of estate assets that violated the absolute priority rule. The Court distinguished certain "non-final" distributions that are frequently authorized by bankruptcy courts (*i.e.* first day wage orders, "critical vendor" orders, and "roll-ups" that allow lenders who continue financing to be paid first on their prepetition claims), because such distributions usually "enable a successful reorganization and make even the disfavored creditors better off." Conversely, the Court found, in the structured dismissal context, the priority-violating distribution is "final" and does not make the disfavored creditors better off. The Court concluded: "we cannot find in the violation of ordinary priority rules that occurred here any significant offsetting bankruptcy-related justification."

Finally, the Court rejected the Third Circuit's suggestion that there might be a "rare cases" exception to the absolute priority rule. Such an exception, the Court found, threatens to swallow the rule. The Court reasoned that the uncertainty that would be caused by such an exception could result in potentially serious consequences such as: (i) departure from the protections Congress granted particular classes of creditors, (ii) changes in the bargaining power of different classes, (iii) collusion amongst creditors, and (iv) increased litigation.

The dissent was based on procedural, not substantive, grounds. The concern raised in the dissent was that the parties addressed a different question in their briefs than the one on which the Court granted certiorari. On the more narrow issue that was briefed and argued ("whether a chapter 11 case may be terminated by a structured dismissal that distributes estate assets in violation of the Bankruptcy Code's priority scheme"), there was no circuit court split. The dissenters stated that they "would not reward such bait-and-switch tactics" and would have dismissed the writ of certiorari as improvidently granted.