New Supreme Court Decision Reminds Parties to Bankruptcies to Keep their Priorities Straight

Description

In a recent decision, the U.S. Supreme Court turned aside the efforts of a debtor and a group of creditors to make an end-run around the Bankruptcy Code's priority rules by distributing assets to junior creditors ahead of objecting senior creditors via a "structured dismissal." In doing so, the Court did not just close a loop-hole that could have threatened to erode a complex, congressionally devised priority scheme intended to ensure an orderly and fair distribution of bankruptcy assets. Rather, the Court also reminded lower courts, debtor businesses, and creditors of all stripes—whether they be lenders, vendors, employees, or business partners of the debtor—that they must keep their eyes focused firmly on the priority rules when attempting to negotiate a bankruptcy workout.

The Bankruptcy Priority Scheme

It is a fundamental rule of bankruptcy that the claims of junior creditors cannot be satisfied until the claims of more senior creditors are paid in full, absent the senior creditors' consent. A Chapter 7 liquidation case, establishes a priority scheme which mandates that certain claims, such as for wages, employee benefits, consumer deposits and taxes, be paid in full prior to general unsecured creditors receiving payments. In a Chapter 11 case, a plan of reorganization can only be confirmed if these "priority" creditors are, depending on their priority, either paid in full at confirmation or paid in full over a period of time. Another rule in a Chapter 11 case essentially requires that, absent the consent of a senior class of creditors, such senior class must be paid in full before junior classes of creditors and equity holders can receive any money or property under a Chapter 11 plan. This "absolute priority rule" reflects the Bankruptcy Code's (the "Code") instruction that distributions to creditors and other stakeholders must be "fair and equitable."

Confusion, however, had emerged among federal courts as to how "absolute" the absolute priority rule really was. Absent consent, must priority or senior creditors always be paid in full before junior creditors? "Not so," some courts had said, at least when those distributions occurred as part of a settlement agreement separate from a plan of reorganization.

The Absolute Priority Rule And Settlement Agreements In Chapter 11 Bankruptcies

The assurance of the evenhanded and predictable treatment of creditors is at the heart of bankruptcy law. To that end, the Code sets forth an elaborate scheme for the payment of creditor claims, with senior claims and certain statutorily-favored priority claims (e.g., wages, employee benefits, consumer deposits and taxes) receiving priority over junior claims. Bankruptcy courts have historically enforced this priority regime to ensure that plans of reorganization under Chapter 11 of the Code are "fair and equitable" to all creditors.

Although not express in the Code, bankruptcy courts also applied the Code's priority scheme with regard to settlements of claims that became part of a plan of reorganization. Prior to the adoption of the Code, the Supreme Court held that bankruptcy courts may only approve such settlements if they are "fair and equitable," meaning compliant with the absolute priority rule. Lower courts generally followed this dictate under the Code.

But what happened when the settlement agreement was not part of a reorganization plan, but arose in the pre-plan phase or as part of a stipulated dismissal of the bankruptcy? Courts answered differently. Some continued to apply the absolute priority rule and reject settlements that provided for distributions to junior creditors before full satisfaction of objecting senior creditors. Other courts, however, took a different approach. These courts

permitted settlement agreements to favor junior creditors over objecting senior creditors, where "specific and credible grounds" justified deviation from the absolute priority rule. These courts did not attempt to list all the circumstances that would justify settlements that departed from the absolute priority rule in reorganizations and liquidations. But their decisions suggested that such compromises survived when there was no real prospect of a plan of reorganization being confirmed and conversion to Chapter 7 liquidation would result in secured creditors claiming all of the debtor's property.

The U.S. Supreme Court Steps In

Enter the U.S. Supreme Court, which granted review in *Czyzewski v. Jevic Holding Corporation* to resolve the conflict among the lower courts. *Czyzewski* involved a settlement and structured dismissal of a Chapter 11 case that paid general unsecured creditors over the objection of priority wage creditors. The Court would decide whether the bankruptcy court had erred in approving the settlement and structured dismissal despite their deviation from the absolute priority rule.

By a 6-2 decision, the Court reversed the lower court's order. "A distribution scheme ordered in connection with the dismissal of a Chapter 11 case," the Court ruled, "cannot, without the consent of the affected parties, deviate from the basic priority rules" in the Code. To the extent "the dismissal sections of Chapter 11 foresee any transfer of assets," the Court noted, they only "seek a restoration of the pre-petition financial status quo." They do not authorize distributions "that would be flatly impermissible in a Chapter 7 liquidation or a Chapter 11 plan because they violate priority without the impaired creditors' consent." Nothing in the Code, the Court ruled, suggested Congress intended such an escape hatch to the priority regime.

In concluding so, the Court rejected an exception to the priority scheme—applied by the bankruptcy court in *Czyzewski*—that would allow distributions in a settlement and structured dismissal to avoid the absolute priority rule over the objections of senior creditors in "rare cases" where "courts could find 'sufficient reasons' to disregard priority." Such an exception, the Court observed, would threaten not just a "departure from the protections Congress granted particular classes of creditors," and a change in "the bargaining power of different classes of creditors," but also collusion ("i.e., senior secured creditors and general unsecured creditors teaming up to squeeze out priority unsecured creditors."). On a practical level, moreover, the vagueness of what would constitute "sufficient reasons" (or its lack of "precise content" as the Court saw it) would only encourage debtors and favored creditors to try to make every case a "rare case" that should be excepted from the priority rules. As such, the Court concluded that no exception was warranted. Rather, the absolute priority rule controlled here as well.

Remaining Questions Post-*Czyzewski*

Czyzewski establishes that the absolute priority rule governs all orders that end a bankruptcy case, whether by Chapter 7 liquidation, Chapter 11 plan confirmation, or settlement and structured dismissal. Distributions incorporated in such orders must comply with the Code's priority scheme or fail. But questions still remain.

First, how much deviation from the absolute priority rule is permissible for pre-dismissal distributions? *Czyzewski* indicates that some deviation in this context is permissible, particularly when taken with the purpose of preserving the debtor as a going concern and ultimately creating more value for all creditors, including the disfavored ones (e.g., payment of employees' prepetition wages and essential suppliers' prepetition invoices). But *Czyzewski* does not say how far such orders could go before raising absolute priority issues.

Second, *Czyzewski* says nothing about the viability of "gifting"—a process by which priority deviations are accomplished by (1) distribution of proceeds of secured creditor collateral sold as part of Chapter 11 plans or (2) a straight gift of the secured creditor's collateral instead of a distribution of the debtor's assets in Chapter 7 liquidations. Such silence would appear to leave the practice's legality an open question, particularly where the "gifted" property is not part of the debtor's estate and/or disposed of in a dismissal order. Yet, at the same time, the Court's favorable citation to *In re Iridium Operating LLC*—which upheld an interim settlement that contravened priority rules on a gifting theory—suggests gifting, if anything, may be on sturdier ground post-*Czyzewski*

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Finally, *Czyzewski* says nothing as to circumstances where a settlement bypasses objecting senior creditors and results in payments to junior creditors, but the settlement does not result in dismissal of the bankruptcy. In this regard, *Czyzewski* may give bankruptcy courts pause in approving such settlements and, at minimum, could prompt the courts to inquire as to safeguards for the rights of objecting senior creditors.

Only time will tell how the courts will resolve these questions. In the immediate wake of *Czyzewski*, however, one thing is clear: in a settlement and structured dismissal of a bankruptcy, the absolute priority rule is, true to its name, absolute.

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