

Got A Priority Bankruptcy Claim? Nothing To Worry About Then, Right? Wrong.

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. In a chapter 7 liquidation case, 11 U.S.C. § 507 establishes a priority scheme which mandates that certain claims, such as for wages, employee benefits, consumer deposits and taxes, must 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 instruction that distributions to creditors and other stakeholders must be "fair and equitable."

Confusion, however, has begun to emerge among federal courts as to how "absolute" the absolute priority rule really is. Absent consent, must priority or senior creditors always be paid in full before junior creditors? "Not so," some courts have said, at least when those distributions occur as part of a settlement agreement separate from a plan of reorganization. This term, the U.S. Supreme Court will review whether these courts are right.

The decision could have great significance for all creditors to a bankruptcy, whether they are lenders, employees, vendors, or business partners of the debtor.

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 Bankruptcy Code (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 expressed in the Code, bankruptcy courts have also applied the Code's priority scheme with regard to settlements of claims that become 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 have generally followed this dictate under the Code.

But what happens when the settlement agreement is not part of a reorganization plan, but arises in the pre-plan phase or as part of a stipulated dismissal of the bankruptcy? Courts have answered differently. Some continue to apply the absolute priority rule and reject settlements that provide for distributions to junior creditors before full satisfaction of objecting senior creditors. Other courts, however, have taken a different approach. These courts permit settlement agreements to favor junior creditors over objecting senior creditors, where "specific and credible grounds" justify deviation from the absolute priority rule. These courts have not attempted to list all circumstances where settlements that break from the absolute priority rule are proper. But their decisions suggest that such compromises survive when there is 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. Whether these courts might approve settlements in additional circumstances is unclear.

U.S. Supreme Court To Review Settlement Exception To The Absolute Priority Rule

On June 28, 2016, the U.S. Supreme Court granted review in *Czyzewski v. Jevic Holding Corporation*.

Although it is impossible to determine how narrow or broad the Court's decision will be (*Jevic* 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 might render an opinion as to whether pre-plan settlement agreements can ever deviate from the absolute priority rule and favor junior creditors over objecting senior creditors. The implications of the Court's review are significant. A decision to eliminate any settlement exception to the absolute priority rule would work to preserve the Code's priority scheme and tie judges' hands in situations where a departure from that rule might be of greater benefit to the debtor and a larger group of junior creditors. Conversely, a decision to allow pre-plan settlements to deviate from the absolute priority rule in certain circumstances has potentially serious consequences as well. Such a ruling could encourage collusion between debtor businesses and favored creditors to increase such creditors' share of the debtors' assets at the expense of other creditors, an outcome arguably contrary to one of the major purposes of bankruptcy law. At the same time, workarounds to established priority rules make returns on investment harder to predict and may cause creditors to raise prices or forgo what would otherwise be value-increasing transactions. The Supreme Court's resolution of the issue is therefore likely to have strong ramifications either way.

The Supreme Court is set to hear oral arguments in *Czyzewski* on November 28, 2016, with a decision to be rendered in the first half of 2017. Stay tuned.

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