Post-'Jevic,' Expansive Interpretation by Bankruptcy Courts Possible

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In our last column we reported on the U.S. Supreme Court's decision in Czyzewski v. Jevic Holding , 137 S. Ct. 973 (2017). In that decision, the court ruled a bankruptcy court may not order a structured dismissal of a Chapter 11 case that provides for estate assets to be distributed in violation of the Bankruptcy Code's distribution scheme. The decision was widely discussed by bankruptcy practitioners, in part because there are a number of common practices in Chapter 11 that also distribute estate assets in violation of the bankruptcy code's distribution scheme. The Supreme Court's opinion, in dicta, distinguished those practices because they often serve an appropriate bankruptcy purpose. Today we review two recent opinions that consider the *Jevic* decision's impact on two of these common practices.

The 'Jevic' Ruling

In *Jevic*, the debtor, its secured creditor, equity holder, and the creditors' committee entered into a settlement agreement that provided, among other things, that estate funds would be distributed to general unsecured creditors while certain priority claimants would receive nothing, and the chapter 11 case would be dismissed. The priority claimants and U.S. Trustee objected, arguing that the distribution scheme of the bankruptcy code prohibited distribution of estate assets to general unsecured creditors unless priority creditors were paid in full. The Bankruptcy Court overruled their objection, observing that in the absence of the settlement and dismissal, no creditor would receive anything. After the Bankruptcy Court's decision was affirmed by the District Court, the U.S. Court of Appeals for the Third Circuit again affirmed, noting that while Congress codified the distribution scheme in plan or liquidation contexts, courts could " ... in rare instances like this one, approve structured dismissals that do not strictly adhere to the Bankruptcy Code's priority scheme."

The Supreme Court's *Jevic* decision reversed the Third Circuit's decision, rejected the "rare case" exception, and ruled that structured dismissals cannot distribute assets in violation of the Bankruptcy Code's distribution scheme. This ruling was most recently applied by Bankruptcy Judge Christopher Sontchi of the U.S. Bankruptcy Court for the District of Delaware in *In re Constellation Enterprises*, Case No. 16-11213 (CSS). In a bench ruling on May 16, 2017, Judge Sontchi denied the debtors and committee's joint motion for approval of a settlement agreement and structured dismissal, reasoning that it was prohibited in light of the Supreme Court's decision in *Jevic*.

The question remains, however, how will *Jevic* impact areas other than structured dismissals?

Distribution Issues Outside of Structured Dismissals

In *Jevic*, the Supreme Court acknowledged certain Chapter 11 practices that provide for interim distribution of estate funds in violation of the bankruptcy code's waterfall provisions. The court distinguished such practices by writing: 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. 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." By way of contrast, in a structured dismissal like the one ordered below, the priority-violating distribution is attached to a final disposition; it 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. In short, we cannot find in the violation of ordinary priority rules that occurred here any significant offsetting bankruptcy-related justification.

In *In re Fryar*, 2017 Bankr. LEXIS 1123 (Apr. 25, 2017), the Bankruptcy Court for the Eastern District of Tennessee considered a settlement agreement and 363 sale that provided for a sale of the debtor's 50 percent stock in two corporations to the individual that owned the other 50 percent. In exchange, the buyer would pay $350,000, plus one of the corporations would convey certain real property to the estate. The cash proceeds would be distributed to the debtor's secured lender, who held mortgages on two other properties owned by the debtor. Three creditors who held general unsecured claims and the U.S. Trustee objected, arguing that estate assets should not be distributed to the secured lender who had no security interest in the assets being sold.

The court agreed. The court noted that circuit courts of appeal are split on the issue of whether a settlement agreement can provide for an interim distribution of estate assets in violation of the bankruptcy code's distribution scheme. The opinion describes that the Second Circuit, in *Motorola v. Official Committee of Unsecured Creditors (In re Iridium Operating)*, 478 F.3d 452, 464 (2nd Cir. 2007), ruled that such interim distributions " ... are sometimes 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." The Supreme Court in *Jevic* distinguished *Iridium*, noting it was an interim (as opposed to final) distribution.

Despite the similarity between *Iridium* and the case at hand, which also involved an interim distribution pursuant to a settlement agreement, the court denied the sale and settlement motion. The court began its analysis by noting that the proceeds of the sale were being distributed in violation of the Bankruptcy Code. The opinion specifically referred to *Jevic*, and stated the question under *Jevic* was "whether there are code-related objectives being served that are so significant that deviation is justified." The court concluded there were not. The court reasoned that the motion at hand was not a "first day" motion. There was no business to reorganize. In light of that, the court found the sale and settlement were not interim distributions en route to a plan, but more likely a distribution in advance of a liquidation or dismissal, as in *Jevic*.

In *In re Pioneer Health Services*, 2017 Bankr. LEXIS 939 (April 4), the Bankruptcy Court for the Southern District of Mississippi considered whether to permit a hospital debtor to pay three physicians as "critical vendors." As is typical with critical vendor motions, the debtor argued that the physicians' continued performance was absolutely necessary for the business to continue and the particular vendors at hand were irreplaceable. The Creditors' Committee objected, arguing that the motion was not filed in the early days of the case (the petition date was 10 months earlier) and payment to these physicians of their prepetition claims could open the floodgates for the other approximately 240 employees.

The court began its analysis by noting that debtors are generally prohibited from making payments or other distributions on account of prepetition claims except through a confirmed plan of reorganization or court-authorized liquidation. However, the opinion notes that some courts have permitted debtors to pay prepetition claims of certain "critical" vendors in the early days of a Chapter 11 case after a showing that the vendors are necessary to the continuing of the debtor's business. After reviewing opinions by the Fifth and Seventh circuits discouraging such critical vendor programs, the court turned to *Jevic* and noted that the Supreme Court distinguished critical vendor orders from structured dismissals on the ground that, unlike the former, the latter served no significant offsetting bankruptcy-related justification. Despite the fact that *Jevic* distinguished critical vendor payments and structured dismissals, the *Pioneer* court concluded *Jevic* suggests that a more restrictive view with increased scrutiny of proposed critical vendor payments is the correct approach.

With that in mind, the court rejected the motion to pay the physicians. First, there was no evidence of the physicians' education, skills, training, or licensing to demonstrate their irreplaceability, or evidence that the hospital had attempted to replace them. Second, there was no evidence the physicians would actually leave the hospital if they were not paid. Third, by threatening to leave, the physicians may have been in violation of the automatic stay, which prohibits post-petition actions to collect on prepetition claims. Fourth, the motion did not provide any means to ensure the physicians would continue to provide services after their prepetition claims were paid. Finally, the court shared the committee's concern that paying the physicians could lead to a flood of other employees seeking similar payments. The Court concluded its analysis by noting, "The Supreme Court recently rejected nonconsensual structured dismissals as violating priority rules. Here, the courts finds no 'significant offsetting bankruptcy-related justification' for classifying the Affected Physicians as critical vendors."

Conclusion

If the two decisions reported on today serve as an indication of how bankruptcy courts will interpret *Jevic* going forward on matters other than structured dismissals, it appears that *Jevic* will stand for the proposition that any matter that results in altering the priority distribution provision of the Bankruptcy Code, while permissible, will require increased scrutiny. It is unclear if that was the intent of the Supreme Court in its dicta statements, but the passage of time will tell.

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