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ABSOLUTE PRIORITY REDUX: FIRST-DAY ORDERS AND PRE-PLAN SETTLEMENTS IN CHAPTER 11 POST-*JEVIC*

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ABSTRACT

This Article considers the problem of priority-skipping distributions made by a chapter 11 debtor outside of a plan, following the Supreme Court's Jevic *decision.*[1] *The* Jevic *Court extended the absolute priority rule—which under U.S. bankruptcy enactments dictates the order of distributions to creditors under a chapter 11 cramdown plan and in a chapter 7 liquidation—to a chapter 11 case-ending settlement known as a "structured dismissal."*

The Jevic *Court limited its holding to a case-ending settlement. It did not extend the absolute priority rule to an interim or pre-plan settlement or other transaction that is not case-ending or to a "first-day" distribution made at the very beginning of a chapter 11 case.*[2] *The Court expressed no view about the legality of structured dismissals in general and did not define when a settlement*

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1 Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973 (2017).

2 The *Jevic* Court used the term "interim" to refer to settlements and other transactions that are not case-ending and are entered into outside of a chapter 11 plan. I use the terms "interim" and "pre-plan" interchangeably in this Paper to refer to such settlements and other transactions. *Czyzewski*, 137 S. Ct. at 975, 985.

other than a "structured dismissal" is case-ending. It emphasized, without much in the way of details, that the Code's priority system was a "basic underpinning of business bankruptcy law" that must be safeguarded even with respect to a pre-plan transaction.[3]

This Article considers these issues of pre-plan or "interim" settlements and first-day distributions left open by Jevic. *It asserts that* Jevic *is best characterized as a transaction among insiders and parties asserted to have colluded with them, that assertedly provided for a distribution of estate assets to the settling parties based on their control and collusion, supported by a hypothetical rather than a market valuation of ultimate distributional outcomes. This issue—the use of control and collusion supported by a hypothetical valuation to obtain an unfair distribution or "control premium"—is the precise issue that gave rise to the absolute priority rule 150 years ago and that concerned the Court in* 203 N. LaSalle*, the last case before* Jevic *in which the Court extensively considered the absolute priority rule in chapter 11.*[4] *First-day relief in chapter 11 presents a similar though not identical valuation dilemma: can a hypothetical prediction made early in the case of ultimate distributions to creditors reliably determine that some prepetition claims should be paid at the first-day hearing because such payments ultimately will benefit (or at least will not harm) the remaining creditors who are not favored?*

This Article proposes that a proper solicitude is shown for the absolute priority rule when an interim or pre-plan settlement or other transaction with an insider, secured lender or other party who exercises some control over the debtor is subjected to higher bids in a market sale process such as an auction. This approach can provide a market valuation of the transaction and proposed distributions that can enable a bankruptcy court to determine whether the transaction includes a premium based on control that is proposed to be paid at the expense of other creditors, thus addressing the precise mischief sought to be remedied by the absolute priority rule.

The Jevic *Court also left open the rule for bankruptcy court approval of first-day distributions that violate the absolute priority*

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[3] *Id.* at 983–84, 986.

[4] Bank of Am. Nat'l Tr. & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434 (1999).

rule.[5] *This Article further contends that a market test for a "first-day" distribution to an employee, a critical vendor, or other creditor that is challenged as priority-skipping will be limited to whether the debtor sought and failed to obtain in the market the same good, service, or credit from an alternative supplier on the same or better terms than those proposed to be given by the first-day motion. A bankruptcy court in most cases will not be able to obtain, at the time of a first-day hearing, a market determination of what will be distributed to creditors months or years later when the case ends. And any hypothetical valuation that the court makes at a first-day hearing of the ultimate distributions to creditors in the case will be highly unreliable. Because of these obstacles, the question of whether a first-day payment ultimately will comport with distributional priorities should be replaced with the question of whether the debtor sought and failed to obtain an alternative supply in the market, and by a rebuttable presumption that preserving the going concern value of the chapter 11 debtor is likely, ultimately, to benefit even the disfavored creditors. This approach—which essentially adopts the occasionally maligned "doctrine of necessity" and rejects the Seventh Circuit's* Kmart *rule—recognizes the disturbing weakness of a hypothetical determination made at the first day hearing of the ultimate distributions at the end of a chapter 11 case.*

I conclude that a bankruptcy court demonstrates a proper solicitude for the absolute priority rule under both Jevic *and* 203 N. LaSalle *when it relies on market exposure of pre-plan settlements and transactions to preclude control premiums to insiders or others who have some control over the debtor, and when it bases approval of first-day relief on a presumption of going concern value, rather than on speculative, hypothetical predictions of ultimate distributions to creditors at the end of the case. I suggest that these approaches to the approval of these types of interim and pre-plan transactions also can provide the certainty sought by the Court in* Jevic.

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5 *Czyzewski,* 137 S. Ct. at 985 (the Court nonetheless voiced strong support for such payments on the ground that they "enable a successful reorganization and make even the disfavored creditors better off" (quoting *In re* Kmart Corp., 359 F.3d 866, 872 (7th Cir. 2004))).

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INTRODUCTION

STRUCTURED DISMISSALS, THE ABSOLUTE PRIORITY RULE, AND THE PROBLEM IN *JEVIC*

The settlement and dismissal that the bankruptcy court approved in *Jevic* was a "structured dismissal."[6] The secured creditors, the Official Committee of Unsecured Creditors on behalf of most of the debtor's unsecured creditors, and the shareholders entered into a settlement whereby the debtor released a fraudulent transfer claim against the secured creditors in exchange for their paying $3.7 million to the bankruptcy estate for distribution to Jevic's creditors.[7] The settlement further provided that the Court would dismiss the chapter 11 case immediately thereafter.[8]

A structured dismissal is a settlement of certain claims asserted by or against the debtor, that provides for proposed distributions on account of those claims, and that the bankruptcy court approves contemporaneously with its entering its order dismissing the case.[9] The debtor in a structured dismissal does *not* seek to end the case by confirming a chapter 11 plan after a vote by impaired classes of creditors, or by converting the case to chapter 7 for liquidation by the chapter 7 trustee.[10] Instead, in a structured

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[6] *See* 11 U.S.C. §§ 349, 1112(b)(1) (2012). The term "structured dismissal" does not appear in the Code (though neither does the term "absolute priority" or "absolute priority rule"). The legal grounds for a structured dismissal are constructed from several provisions of the Code and Rules. Section 349 authorizes the bankruptcy court to dismiss a bankruptcy case, and on the dismissal, any property remaining in the bankruptcy estate revests "in the entity in which such property was vested immediately before the commencement of the case" (which may be the debtor), subject to such conditions as the court, "for cause," may order otherwise. § 349(b). The court's authority to approve the settlement, and order the distribution of property pursuant to it, is generally located in § 363(b), which provides that a chapter 11 debtor, with court approval, may use, sell, or lease estate property out of the ordinary course of business, and in Rule 9019, which provides that the bankruptcy court "may approve a compromise or settlement." FED. R. BANKR. P. 9019.

[7] *Czyzewski*, 137 S. Ct. at 981.

[8] *Id.*

[9] *American Bankruptcy Institute Commission to Study the Reform of Chapter 11, 2012–2014 Final Report and Recommendations*, 23 AM. BANKR. INST. L. REV. 1, 293 (2015) [hereinafter *ABI Report*].

[10] *Id.*

dismissal, the case ends with the court's approval of the settlement terms followed by entry of the dismissal order.[11]

The problem with the structured dismissal in *Jevic* was that the distribution of the settlement proceeds—which the secured lenders would pay to the estate for the release by the debtor of its claims against them—would skip over a group of priority unsecured creditors, truck-drivers formerly employed by the debtor who were terminated contemporaneously with the filing of the bankruptcy case.[12] The drivers had brought their own suit against the debtor and its owner, Sun Capital Partners, for wage claims under the Worker Adjustment and Retraining Notification (WARN) Act based on the termination of their employment without having been given the sixty days advance notice required by the WARN Act.[13] The drivers' wage claims were not part of the settlement.[14] Wage claims are unsecured priority claims under the Bankruptcy Code.[15] The structured dismissal thus arguably violated the absolute priority rule because the rule required payment to the drivers prior to the payment made to the lower priority general unsecured creditors who were being paid part of the settlement proceeds under the structured dismissal.[16]

The question in *Jevic* was whether the absolute priority rule—which applies under the Bankruptcy Code for confirmation of a chapter 11 cramdown plan and to distributions in a chapter 7 liquidation—also applies to a similarly case-ending structured dismissal.[17] The Bankruptcy Code says nothing of a structured

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[11] *Id.* at 294.

[12] *Czyzewski*, 137 S. Ct. at 976, 980–81.

[13] *Id.* at 980. The federal WARN Act is codified at 29 U.S.C. §§ 2101–2109. Many states have enacted state WARN statutes that are similar to the federal WARN Act. The WARN claimants in *Jevic* brought their action under both the federal and state WARN statutes.

[14] *Czyzewski*, 137 S. Ct. at 976, 980.

[15] 11 U.S.C. § 507(a)(4) (2012).

[16] *Czyzewski*, 137 S. Ct. at 980–82.

[17] *Id.* at 978. A cramdown plan in chapter 11 is a plan that at least one impaired class of creditors has voted to reject. Such a plan must comply with the absolute priority rule. 11 U.S.C. § 1129(b) (2012). Chapter 7, in contrast to chapter 11, does not allow for the reorganization of a debtor, but instead provides for the liquidation of the debtor's assets and the distribution of the proceeds to creditors. The absolute priority rule also applies to final distributions in a chapter 7 case. 11 U.S.C. § 726 (2012).

dismissal and does not expressly provide that the absolute priority rule extends to any dismissal of a chapter 11 case, structured or otherwise.[18]

The bankruptcy court in *Jevic* held that the absolute priority rule did not apply and approved the structured dismissal.[19] The district court and the Third Circuit agreed with the bankruptcy court's interpretation of the Code and affirmed.[20]

The Supreme Court reversed. The Court held that a bankruptcy court cannot order a non-consensual priority-skipping distribution "in connection with a Chapter 11 dismissal."[21]

The Court—quoting its last major decision on the absolute priority rule, *203 N. LaSalle* in 1999—emphasized that the rule developed to address a "concern with the ability of a few insiders, whether representatives of management or major creditors, to use the reorganization process to gain an unfair advantage,"[22] and to reduce the risks of "collusion" by which those parties can gain that advantage and greater value from the estate for themselves by squeezing out other creditors.[23]

The Court also expressed its skepticism of the *Jevic* bankruptcy court's hypothetical valuations of the claim and the proposed settlement—and of such hypothetical valuations generally.[24] In its view, the bankruptcy court's finding that the settlement was the only way that any unsecured creditor would receive anything had only "equivocal support" in the record, leading the Court to "readily imagine other cases that turn on comparably dubious predictions."[25]

The Court expressly declined, though, to extend the absolute priority rule to pre-plan or "interim" settlements or to "first-day" distributions in chapter 11.[26] Regarding pre-plan or "interim" settlements, the Court stressed the difficulty of applying the absolute

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[18] *Czyzewski*, 137 S. Ct. at 984.
[19] *Id.* at 982.
[20] *Id.*
[21] *Id.* at 978.
[22] *Id.* at 987 (quoting Bank of Am. Nat'l Tr. & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 444 (1999)) (internal quotations omitted).
[23] *Czyzewski*, 137 S. Ct. at 987.
[24] *Id.*
[25] *Id.*
[26] *Id.* at 983–85.

priority rule because the nature and extent of the chapter 11 estate have not yet been fully resolved.[27] The Court also stated that "one can generally find significant Code-related objectives" for priority-skipping "first-day" relief.[28] It suggested nonetheless that a bankruptcy court must demonstrate a "proper solicitude" for the absolute priority rule in substantial, pre-plan transactions.[29] But it offered little additional guidance.[30]

This Article proposes that for pre-plan or "interim" settlements and distributions in chapter 11 that appear to circumvent the Code's safeguards of distributional priority, a proper solicitude for the absolute priority rule is best achieved by market exposure. This approach, when applied to a transaction with an insider or other person who exerts control over the debtor, can be used to achieve the remedial purposes of the absolute priority rule, which are to preclude misallocations of estate value to those who exercise control or who collude with them.[31]

A corollary of this rule involves recognizing that, to the extent that market exposure is unavailable, hypothetical valuations are of little probative use in determining the propriety of a pre-plan distribution. This is especially true with respect to first-day relief, pursuant to which a bankruptcy court may approve priority-skipping payments to some creditors because their continuing to supply the debtor is considered essential to the debtor's survival.[32] The question of whether the non-essential creditors who do not receive these payments are helped or disadvantaged by this dilution of the estate involves hypothetical valuations that are so unreliable that a different, specialized rule should apply. I suggest a rule that presumes the benefit of preserving the going concern

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[27] *Id.* at 985 (citing Motorola, Inc. v. Official Comm. of Unsec'd Creditors (*In re* Iridium Operating LLC), 478 F.3d 452, 464 (2d Cir. 2007)).

[28] *Id.*

[29] *Czyzewski*, 137 S. Ct. at 986 (quoting Ind. St. Police Pens. Tr. v. Chrysler, LLC (*In re* Chrysler LLC), 576 F.3d 108, 118 (2d Cir. 2009)).

[30] *Id.* at 986–87.

[31] *See* discussion *infra* Part II.

[32] *Czyzewski*, 137 S. Ct. at 985 (recognizing that priority-skipping first-day payments enable a successful reorganization); *see also In re* Just for Feet, Inc., 242 B.R. 821, 824–25 (D.Del. 1999) (court may "authorize the payment of pre-petition claims when such payment is deemed necessary to the survival of a debtor in a chapter 11 reorganization").

value of a business and requires strict market exposure to determine whether an alternative supplier is available on the same or better terms than those proposed by the assertedly essential supplier who is insisting on the first-day payment.[33]

Part I of this Article considers the *Jevic* Court's view of the remedial purposes of the absolute priority rule, its skepticism of hypothetical valuations used in support of chapter 11 distributions, and it declining—in large part because of that skepticism—to extend the absolute priority rule to interim settlements and first-day distributions.

Part II examines the temporal and substantive factors that the *Jevic* Court used to distinguish a case-ending settlement—to which the absolute priority rule applies—from an interim settlement, the rule for approval of which the Court left open. Part II then proposes a market rather than a hypothetical valuation of a challenged interim settlement or other transaction with an insider or other person exercising control of the debtor, to achieve the remedial purposes of the absolute priority rule, i.e., to preclude the payment of a control premium to those who are asserted to be exercising control over the debtor and those alleged to have colluded with them in achieving the settlement. This approach has the additional benefit of advancing other purposes of bankruptcy law emphasized by the *Jevic* Court, especially maximizing distributions to creditors and providing certainty of outcomes.[34]

An example of this approach involves a debtor that proposes to settle the estate's claim against an insider, by releasing the insider in exchange for a settlement payment to the estate. The question of whether the insider is receiving a control premium—in the form of having to pay a lower settlement price than what the claim is worth (thus also reducing eventual distributions to other creditors)—is clearly at issue.[35] The debtor's claim against the insider, though, can be marketed for outright sale to an arm's-length third-party buyer or to an investor who will fund the costs of the litigation in return for a percentage of any recovery on the

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[33] *See* discussion *infra* Part III.

[34] *Czyzewski*, 137 S. Ct. at 985–86 (citing Toibb v. Radloff, 111 S. Ct. 2197 (1991)).

[35] Marc J. Carmel, *If* Jevic *Is Your Problem, Litigation Finance Might Be Your Solution*, 36 AM. BANKR. INST. J. 1, 2–3 (2017).

claim.[36] A higher and better bid for the claim from a third-party buyer or investor removes the issue of whether a control premium is being paid to the insider—the costs and benefits of the transaction are now with the third party.[37] If, on the other hand, the settlement was vigorously marketed and no higher bid was obtained or the insider made the highest bid at the auction, a strong case can be made that the insider's bid reflects the highest and best market price for the claim.[38] The insider did not receive a control premium in the form of a discount because if the claim was worth more, a third party would have bid more.[39]

Part III considers the problem posed by hypothetical valuations, also stressed by the *Jevic* Court, with respect to first-day relief and distributions. Part III suggests that a different rule should apply for approval of distributions proposed to be made pursuant to first-day orders, that are challenged as priority-skipping. I contend that any determination of whether such payments ultimately will benefit the other, disadvantaged, creditors is so highly speculative as to be meaningless or nearly so in most instances. Market exposure for first-day relief—though essential to the bankruptcy court's decision—will be limited to whether an alternative can be obtained on better terms. A first-day distribution challenged as priority-skipping should be approved if the debtor proves that it has sought in the market and failed to obtain an alternative to the good, service or credit proposed to be supplied by the critical vendor, and that making the critical vendor payment is necessary to preserve the debtor's operations for the sale of the business or a restructuring. The question of ultimate benefit to other creditors should be presumed, rather than hypothetically determined. As the *Jevic* Court noted, preserving the debtor's business as a going concern is a Code-related objective in a chapter 11 bankruptcy case, and is highly likely to benefit a debtor's employees, suppliers and even the creditors who are not paid on the first day.[40] A hypothetical valuation of ultimate distributions

[36] *Id.* at 2–4.
[37] *Id.*
[38] *Id.* at 4.
[39] *Id.*
[40] *Czyzewski*, 137 S. Ct. at 985–86.

to the creditors not paid on the first day is in most cases so unreliable that it adds little or nothing to the analysis.[41]

An example of this approach with respect to a first-day motion follows. A vendor supplies the debtor with component parts necessary for the debtor's manufacturing operations, which the debtor orders from the vendor by purchase order, on credit and an as-needed basis. On the petition date, the debtor owes the vendor on unpaid prepetition invoices. The vendor, who in this example is under no obligation to continue to supply the component parts to the debtor, refuses to do so unless the bankruptcy court approves the debtor's paying the vendor 100 percent of its prepetition claim. The evidence at the first-day hearing is that the debtor sought, and was unable to obtain, an immediate alternative supply of the component parts, and that without the parts the debtor will need to shut down its operations. The market exposure in this example is limited to whether the debtor could obtain an alternative supplier. But it is reasonable to presume that preserving the debtor's operating business for sale or restructuring will maximize the value of the debtor's estate and benefit creditors more than shutting down operations and liquidating the debtor's assets piecemeal.[42] This presumption, I suggest, is more reliable than a hypothetical determination made at the first-day hearing of the ultimate distributions that will be paid to creditors at the end of the case. Indeed, Congress enacted the reorganization provisions of U.S. bankruptcy law including chapter 11 based on this presumption.[43]

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[41] *Id.* This approach, more extensively discussed in Part III, essentially adopts the "doctrine of necessity," by emphasizing the debtor's proving that it has sought in the market and failed to obtain an alternative to the good, service, or credit proposed to be supplied by the critical vendor. It rejects the Seventh Circuit's *Kmart* rule, because the hypothetical predictions that the latter rule requires to be made in the first days of a chapter 11 case, of the ultimate distributions that will be made to different creditors on account of their claims at the end of the case, are so speculative as to be meaningless in most cases.

[42] *See* H.R. REP. NO. 95-595, at 220 (1977).

[43] The reorganization provisions of chapters X, XI and XII of the Chandler Act enacted in 1938 "embodie[d] the new social economic concept of reorganization and the rehabilitation of the debtor and his business as a going concern, instead of the liquidation, distribution, and stoppage of business with the consequent loss to the debtor, creditors, employees, and the public generally."

I submit in conclusion that both interim settlements and transactions with those who exercise control over a debtor, and first-day distributions in chapter 11, should be approved on market valuations and market-based evidence to the greatest extent practicable, rather than hypothetical valuations. This approach, I suggest, can in many cases address the issue of the misallocation of estate value based on control that gave rise to the absolute priority rule and that concerned the Court when it considered the structured dismissal in *Jevic* and the plan in *203 N. LaSalle*.

This approach, as discussed in Part IV, also provides the certainty sought by the Court in this area of bankruptcy law, in a manner that encourages negotiation and settlement without altering the parties' rights under the Code.

I. THE *JEVIC* DECISION AND THE REACH OF THE ABSOLUTE PRIORITY RULE UNDER THE BANKRUPTCY CODE

A. The Structured Dismissal in Jevic

The structured dismissal in *Jevic* was obtained following negotiations over the two remaining major unresolved claims in the case. The first—an action commenced on a derivative basis by the Official Committee of Unsecured Creditors against the secured lenders, Sun Capital and CIT Group, seeking to avoid alleged fraudulent transfers made in connection with Sun Capital's prepetition leveraged buyout (LBO) of Jevic—was settled, and the defendants were released, pursuant to the structured dismissal. The second—a class action commenced by Jevic's former truck-drivers against the debtor and Sun Capital for violation of state and federal WARN Acts, for Jevic's alleged failure

Herman M. Knoeller, *Reorganization Procedure Under the New Chandler Act*, 24 MARQ. L. REV. 12, 14 (1939). Congress made the same presumption when it passed the Bankruptcy Code in 1978. *See* H.R. REP. NO. 95-595, at 220 (1977) ("The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders. The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap .... It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets.").

to provide proper notice of its closing and the termination of their employment—was not settled.[44]

Negotiations originally included all these parties—the debtor, the secured lenders, the Committee, the drivers, and the holder of the equity in the debt.[45] The debtor, the secured lenders, the Committee, and the debtor's equity holders reached a settlement.[46] Under the settlement agreement: (1) the bankruptcy court would dismiss, with prejudice, the estate's fraudulent transfer claim that the Committee had commenced against Sun Capital and CIT; (2) CIT would pay $2.0 million to the estate, for payment of administrative expenses including the Committee's legal fees; (3) Sun Capital would transfer to the estate its interest in the remaining $1.7 million of the proceeds from the liquidation of its collateral; and (4) the court would dismiss *Jevic*'s chapter 11 case.[47]

The drivers, though, were not parties to the settlement.[48] The reason was that the drivers and Sun Capital (which was both a secured creditor and owned the equity interests in the debtor) could not reach an agreement that provided for the dismissal of the drivers' WARN claims against Sun Capital. Without the drivers' release, Sun Capital would not agree to a distribution to the drivers of any of the $1.7 million that Sun Capital was contributing to the settlement because it did not want to help finance litigation against itself.[49]

The bankruptcy court found that a chapter 11 plan could not be confirmed in the case, and if the case was converted to chapter 7, the chapter 7 trustee would have no funds with which

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[44] *Czyzewski*, 137 S. Ct. at 976. The Committee alleged that Sun Capital and CIT had "hastened Jevic's bankruptcy by saddling it with debts that it couldn't service."

[45] *In re Jevic Holding Corp.,* 787 F.3d at 177.

[46] *Czyzewski*, 137 S. Ct. at 981.

[47] *Id.*

[48] *Id.* The drivers, because they were not part of the settlement, retained their claims against both the debtor and Sun Capital. Because the LBO claim was the debtor's only remaining asset, the settlement of that claim and the distribution of the settlement proceeds to parties other than the drivers effectively deprived the drivers of any recovery on their WARN claim against the debtor. The structured dismissal, though, did not affect the drivers' WARN claim against Sun Capital, which the drivers could continue to prosecute.

[49] *Id.*

to litigate the estate's LBO claims against Sun Capital and CIT.[50] Considering these "dire circumstances" facing the estate and its creditors, the bankruptcy court approved the settlement. "[T]he court predicted that without the settlement and dismissal, there was 'no realistic prospect' of a meaningful distribution for anyone other than the secured creditors."[51]

B. The Problem with the Structured Dismissal in Jevic

The problem with the structured dismissal in *Jevic* was that the distribution of the $3.7 million of settlement proceeds paid by the secured lenders to the estate for the release by the debtor of its claims against them skipped over a group of priority unsecured creditors—the drivers who had brought claims against the debtor under the WARN Act.[52] The structured dismissal thus arguably violated the absolute priority rule because the rule, if it applied to a structured dismissal, required payment to the drivers prior to the payment made to the junior, non-priority general unsecured creditors.[53]

Under the absolute priority rule, a senior creditor who has distributional priority under the Code must be paid in full on account of its claim, prior to any payment to a junior creditor or equity.[54] The rule, where it applies, requires the distribution of estate assets to the following four tranches of debt and equity, in descending order of seniority: (1) first, to each secured creditor, up to the lesser of the amount of its claim or the value of its collateral;[55] (2) next, to priority unsecured claims (which are listed in section 507(a) of the Bankruptcy Code), in descending order of priority; (3) then, to general, non-priority unsecured claims; and (4) finally, to the holders of equity interests, such as shares or membership interests, in the company.[56] Under this rule, the

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[50] *Id.* at 981–82.

[51] *Id.* at 982 (quoting App. to Pet. for Cert. 57a, 58a).

[52] *Id.* at 981.

[53] *Id.* at 980–82.

[54] *ABI Report*, *supra* note 9, at 229–30.

[55] 11 U.S.C. § 506(a) (2012) (providing that if the secured creditor's claim against the debtor exceeds the value of the secured creditor's collateral, then the amount by which the claim exceeds the collateral value is an unsecured claim; such a creditor is commonly called "undersecured").

[56] *ABI Report*, *supra* note 9, at 229–30.

creditors in the tranche at which the estate's funds available for distribution run out are paid pro rata, and all remaining creditors and equity holders who are junior in distributional priority to that tranche receive nothing.[57]

If the absolute priority rule applied to the settlement, then the drivers were entitled to payment on their priority unsecured WARN claims prior to any distribution to the non-priority general unsecured claims proposed to be paid under the terms of the settlement.[58] But Sun Capital and the drivers could not reach agreement on the payment to be made to the drivers in exchange for their release, and Sun Capital was unwilling to fund litigation against itself.[59] So, the settlement required distributions to skip over the WARN claims.[60] The bankruptcy court approved the priority-skipping distributions, reasoning that the absolute priority rule did not apply—because nothing in the Bankruptcy Code expressly required application of the rule to a pre-plan settlement—and the settlement maximized distributions to unsecured creditors.[61] If it was not approved "there was 'no realistic prospect' of a meaningful distribution for anyone other than the secured creditors."[62] The district court, and then the Third Circuit, affirmed.[63]

C. The Supreme Court's Opinion in Jevic

The question before the Court in *Jevic* was whether a bankruptcy court has the legal power to order a "priority-skipping kind of distribution scheme in connection with a chapter 11 dismissal."[64] The Court held that the bankruptcy court does not have such power.[65] Rather, a "distribution scheme ordered in connection with the dismissal of a chapter 11 case cannot, without the

[57] *Id.* at 230.
[58] *Id.* at 229–30.
[59] *Id.*
[60] *Czyzewski*, 137 S. Ct. at 981.
[61] *Id.* at 981–82.
[62] *Id.* at 982 (quoting App. to Pet. For Cert. 58a).
[63] Czyzewski v. Jevic Holding Corp. (*In re* Jevic Holding Corp.), 2014 WL 268613 (D. Del. 2014), *aff'd*, Official Comm. of Unsec'd Creditors *ex rel.* Jevic Holding Corp. v. CIT Grp./Bus. Credit Inc. (*In re* Jevic Holding Corp.)*,* 787 F.3d 173 (3d Cir. 2015).
[64] *Czyzewski*, 137 S. Ct. at 978 (emphasis in original).
[65] *Id.*

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."[66] That "primary mechanism," in the Court's view, is the "absolute priority rule."[67]

The *Jevic* Court, in disapproving the structured dismissal, raised again the specters—which have haunted U.S. insolvency proceedings since the railroad reorganizations of the late nineteenth century—of collusion among controlling secured creditors and insiders such as managers and/or shareholders that misallocate estate value to those in on the deal on the basis of hypothetical valuations or contrived "sales" of estate assets.[68] The most common situation sought to be remedied by the absolute priority rule was one in which the secured creditors, who were senior because they were entitled to the value of their collateral, entered into a reorganization plan with the railroad's managers and shareholders, who were not creditors at all and had the most deeply subordinated stake in the railroad.[69] Under that plan, those parties—each of whom exercised a degree of control over the enterprise—received all or most of the value of the reorganized

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[66] *Id.*

[67] *Id.* at 983, 984.

[68] *See, e.g.*, Louisville Tr. Co. v. Louisville, New Albany & Chi. Ry. Co., 174 U.S. 674, 684 (1899) (In which the Supreme Court asked whether the mortgagor railroad and its mortgagee could enter into an agreement "by which[,] through the form of equitable proceedings[,] all the right [of an] unsecured creditor may be wiped out, and the interest of both mortgagor and mortgagee in the property preserved and continued? The question carries its own answer. Nothing of the kind can be tolerated."). *See also* Kan. City Terminal Ry. Co. v. Cent. Union Tr. Co. of N.Y., 271 U.S. 445, 455 (1926) ("Unsecured creditors of insolvent corporations are entitled to the benefit of the values which remain after lienholders are satisfied, whether this is present or prospective, for dividends or only for purposes of control."); R.R. Co. v. Howard, 74 U.S. 392, 410 (1868). The early twentieth century case of N. Pac. Ry. Co. v. Boyd, 228 U.S. 482 (1913), provides an example of the kind of contrived "sale" that concerned the critics of the equity receiverships by which railroads were reorganized. The railroad's assets in *Boyd* were purchased on a going concern basis for $61 million at a sale "where there was no competition," even though the enterprise value of the railroad was stated at $345 million in the reorganization agreement, and the purchaser, a mere month after its purchase, issued $190 million of new bonds and $155 million of stock on the property. *Id.* at 492, 508.

[69] *See Boyd*, 228 U.S. at 492, 508; Knoeller, *supra* note 43, at 15–16.

railroad, and the unsecured creditors in the middle, who were powerless by comparison, received little or nothing.[70] Such a transaction entered into between senior stakeholders and insiders often resulted in a distribution to those in control that was attributable to that control, and that deprived the creditors who were in the middle and not in on the deal of their due.[71]

The rule at present extends to all tranches of debt and equity.[72] But the remedial purposes of the rule remain same. The *Jevic* Court, quoting its last major decision on the rule, *203 N. LaSalle* in 1999, emphasized that "the absolute priority rule was developed in response to the 'concern with the ability of a few insiders, whether representatives of management or major creditors, to use the reorganization process to gain an unfair advantage.'"[73] The Court in *203 N. LaSalle* was considering a somewhat different aspect of the same problem—the "new value corollary" or exception to the absolute priority rule.[74] Under that exception to the rule, a cramdown chapter 11 plan can be confirmed—even if a senior creditor objects because it is not being paid in full—if the property distributed to the junior creditors or equity holders under the plan is on account of their contribution of "new capital in money or money's worth, reasonably equivalent to the property's value, and necessary for successful reorganization of the restructured enterprise."[75]

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[70] *Id.*

[71] 11 U.S.C. §§ 726, 1129(b) (2012); *Czyzewski*, 137 S. Ct. at 987 (explaining that the absolute priority rule addresses "risks of collusion, i.e., senior secured creditors and general unsecured creditors teaming up to squeeze out priority unsecured creditors."); *ABI Report*, *supra* note 9, at 229–30.

[72] 11 U.S.C. §§ 726, 1129(b) (2012).

[73] *Czyzewski*, 137 S. Ct. at 987 (quoting Bank of Am. Nat'l Tr. & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 444 (1999)).

[74] *203 N. LaSalle*, 526 U.S. at 435.

[75] *Id.* at 442. Justice Douglas in 1939, in *Case v. L.A. Lumber Products Co.*, embedded the absolute priority rule into the corporate reorganization plan confirmation provisions of the Bankruptcy Act that preceded the Code, when he interpreted the textual requirement that a confirmable plan be "fair and equitable" to require compliance with a rule of "full or absolute priority." Case v. L.A. Lumber Prods. Co., 308 U.S. 106, 114, 117 (1939). Douglas enunciated the new value exception to the rule in the same case. Under the reorganization plan in *L.A. Lumber*, as in *203 N. LaSalle*, the owners of the debtor were receiving a control premium consisting of some of the shares in the new, reorganized debtor—for free—even though the creditors in the case were not being

The owners of the debtor in *203 N. LaSalle* had proposed and obtained confirmation of a plan under which they—whose interests were junior to those of creditors—would receive all of the equity in the reorganized debtor, even though the creditors were not being paid in full.[76] The owners paid for their new equity under the plan by a contribution of capital to the reorganized debtor.[77]

The problem in *203 N. LaSalle,* though, was that, under the plan, only the existing equity holders in the old debtor were given the opportunity to buy the equity in the new, reorganized entity that would emerge from chapter 11.[78] No one else was given that opportunity, and the equity in the new, reorganized debtor had not been exposed to the market for higher and better bids.[79] It was "the exclusiveness of the opportunity, with its protection against the market's scrutiny of the purchase price by

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paid in full under the plan. Douglas wrote, relying on equity receivership case law for the rule: "It is, of course, clear that there are circumstances under which stockholders may participate in a plan of reorganization of an insolvent debtor." *Id.* at 121. Douglas stressed "the necessity, at times, of seeking new money 'essential to the success of the undertaking' from the old stockholders. Where that necessity exists and the old stockholders make a fresh contribution and receive in return a participation reasonably equivalent to their contribution, no objection can be made." *Id.* at 122. A strange aspect of the *203 N. LaSalle* decision is the Court's reluctance—sixty years later—to decide whether the new value exception even exists under the Code, given that Congress said nothing of it when it replaced the Bankruptcy Act of 1898 with the Code in 1978. Justice Souter, who wrote the *203 N. LaSalle* opinion, spent much of that opinion considering but never deciding the issue. *203 N. LaSalle*, 526 U.S. at 444–49. In the end Souter wrote: "It is enough to say, assuming a new value corollary, that plans providing junior interest holders with exclusive opportunities free from competition and without benefit of market valuation fall within the prohibition of § 1129(b)(2)(B)(ii)," which sets forth the absolute priority that is applicable to a chapter 11 cramdown plan. *Id.* at 458. Justice Stevens in dissent wrote, "enough already" (to paraphrase generously), reasoning that the Court had twice previously granted certiorari on the issue of whether the new value exception to the absolute priority rule existed under the Code. *Id.* Justice Stevens "believe[d] the Court should now definitively resolve the question and state that a holder of a junior claim or interest does not receive property 'on account of' such a claim"—and thus the rule is not violated—"when its participation in the plan is based on adequate new value." *Id.* at 464.

[76] *See 203 N. LaSalle*, 526 U.S. at 436.

[77] *See id.* at 440.

[78] *See id.*

[79] *See id.* at 457.

means of competing bids or even competing plan proposals," that lead the Court to conclude that the opportunity of old equity to own the reorganized entity arose from and was "extended 'on account of' the old equity position."[80] Because the owners of the company had set aside for themselves the equity in the reorganized company, under a priority-skipping plan and supported by a hypothetical valuation of that equity that lacked market exposure, the Court reversed the bankruptcy court's confirmation of the plan.[81]

While the Court in *203 N. LaSalle* needed to consider whether the new value exception could be found in the Code, the Court in *Jevic* found it necessary to acknowledge that the absolute priority rule has a somewhat limited reach under the express provisions of the Code.[82] The rule expressly applies to a liquidation under chapter 7.[83] But "Chapter 11 plans provide somewhat more flexibility." Though the rule applies to a "cram-down" plan in chapter 11 (i.e., a plan that one or more classes of creditors has voted against) the rule does not apply to a consensual plan which all impaired classes of creditors have voted to accept.[84] The Court conceded, moreover, a "statutory silence" with respect to whether the absolute priority rule applies to a non-consensual chapter 11 structured dismissal, such as the one in *Jevic*.[85]

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[80] *Id.* at 456.

[81] *See id.* at 458.

[82] *See Czyzewski*, 137 S. Ct. at 987.

[83] *See* 11 U.S.C. § 103(b) (2012) (limiting the absolute priority rule of § 726 to chapter 7); § 726 (setting forth the absolute priority rule applicable in chapter 7).

[84] 11 U.S.C. § 1129(b)(2) (2012) (setting forth the absolute priority rule applicable to a chapter 11 cramdown plan); §§ 1129(a)(8), (10)(b)(1) (limiting the absolute priority rule of § 1129(b)(2) to a chapter 11 cramdown plan). Creditors vote on a chapter 11 plan by classes. A class of claims accepts, i.e., votes in favor of a chapter 11 plan if more than one-half of the voting creditors in class, who hold at least two-thirds of the dollar amount of the claims voted in that class, have voted to accept the plan. § 1126(c). Thus, even a chapter 11 "consensual plan" does not require unanimity of creditors, because many creditors within each accepting class may nonetheless have voted against confirmation of the plan.

[85] *Czyzewski*, 137 S. Ct. at 984. (The absolute priority rule is far from pervasive or immutable under U.S. bankruptcy law.); *see, e.g.*, John D. Ayer, *Rethinking Absolute Priority after* Ahlers, 87 MICH. L. REV. 963, 974–76 (1989); Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the*

The Court nonetheless extended the absolute priority rule to the structured dismissal before it.[86] It emphasized that the "Code's priority system constitutes a basic underpinning of business bankruptcy law" and "has long been considered fundamental to the Bankruptcy Code's operation."[87] The Court would expect that, "if Congress actually meant to make structured dismissals a backdoor means" to achieve a non-consensual priority-skipping final distribution, such as in *Jevic*, it would "see some affirmative indication of intent."[88]

The Court expressed a number of concerns with the priority-skipping structured dismissal in *Jevic*, two of which were those which gave rise to the absolute priority rule in U.S. bankruptcy law.[89] These concerns had also informed the Court in *203 N. LaSalle*, the last case before *Jevic* in which it considered the absolute priority rule.[90] First, the settled claims against the secured lenders, Sun Capital and CIT, which were estate assets, were not exposed to the market and were instead valued hypothetically by the bankruptcy court.[91] The Court took issue with the validity of that hypothetical valuation.[92] Second, the parties on one side of the settlement—the debtor's secured parties and owners—exercised

Conceptual Foundations of Corporate Reorganizations, 87 VA. L. REV. 921, 928 (2001) ("The existing priority system is an uneasy compromise between absolute and relative priority."); James C. Bonbright & Milton M. Bergerman, *Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization*, 28 COLUM. L. REV. 127 (1928); David A. Skeel, Jr., *The Empty Idea of "Equality of Creditors,"* 166 U. PA. L. REV. 699 (2017) ("In current practice, the most notable feature of the equality of creditors norm is how easily a debtor can evade it. Although there may not be fifty ways to sidestep the norm, the modes of escape are quite numerous," citing PAUL SIMON, 50 WAYS TO LEAVE YOUR LOVER (Columbia Records 1975)). Congress, moreover, has consistently and materially circumscribed the rule since the Supreme Court's decision in *L.A. Lumber*. *See* Bruce Grohsgal, *How Absolute is the Absolute Priority Rule in Bankruptcy? The Case for Structured Dismissals*, 8 WM. & MARY. BUS. L. REV. 439 (2017).

[86] *See Czyzewski*, 137 S. Ct. at 983.

[87] *Id.* at 983–84.

[88] *Id.* at 984.

[89] *Id.* at 980.

[90] *203 N. LaSalle*, 526 U.S. at 434.

[91] *See Czyzewski*, 137 S. Ct. at 980.

[92] *See id.* at 983, 986.

some control over the debtor.[93] And the distributions under the settlement skipped over the priority unsecured claims asserted by the drivers to get to the more junior, non-priority general unsecured creditors represented by the creditors committee that was on the other side of the settlement.[94] Affirming the bankruptcy court's approval of the settlement thus would increase the "risks of collusion, i.e., senior secured creditors and general unsecured creditors teaming up to squeeze out priority unsecured creditors."[95]

The Court then considered whether there should be a rare case exception to the rule.[96] The bankruptcy court in *Jevic* had found that without the priority-skipping distribution, there would be no settlement, and without the settlement, the debtor's claim would have no value.[97] Faced with "a meaningful return or zero," the bankruptcy court held that the paramount interest of the creditors mandated its approval of the settlement and nothing in the Code dictated otherwise.[98]

The Third Circuit embraced the bankruptcy court's reasoning and affirmed, holding that the bankruptcy court could approve a settlement that deviated from absolute distributional priorities in the rare case in which there are "specific and credible grounds" to justify the deviation, citing the Second Circuit's decision in *Iridium*.[99] In the Third Circuit's view, the bankruptcy court in *Jevic*, "in Solomonic fashion," had "reluctantly approved the only course that resulted in some payment" to unsecured creditors.[100]

The Supreme Court, in reversing, expressly rejected this "rare case" exception to a case-ending, priority-skipping settlement that lacked the consent of all parties.[101] The Court emphasized again that the hypothetical basis on which the bankruptcy court

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[93] *Id.* at 978.

[94] *See id.* at 978.

[95] *Id.* at 987.

[96] *See Czyzewski*, 137 S. Ct. at 986.

[97] *See id.* at 976.

[98] Official Comm. of Unsec'd Creditors *ex rel.* Jevic Holding Corp. v. CIT Grp./Bus. Credit Inc. (*In re* Jevic Holding Corp.), 787 F.3d 173, 178–79 (3d Cir. 2015).

[99] *Id.* at 183–84 (citing Motorola, Inc. v. Official Comm. of Unsec'd Creditors (*In re* Iridium Operating LLC), 478 F.3d 452, 466 (2d Cir. 2007)).

[100] *Id.* at 185.

[101] *Czyzewski*, 137 S. Ct. at 986.

had made its "reasonable return or zero" finding had only "equivocal support" in the record, leading the Court to "readily imagine other cases that turn on comparably dubious predictions."[102] The Court also stressed that a rare case exception would depart from the protections given by Congress to different kinds of creditors in the form of distributional priorities, would alter the bargaining power that arises from those priorities, would increase uncertainty of outcomes and risks of collusion, and in the end would make settlements more difficult to achieve.[103]

D. Circuit Splits Left Unresolved by Jevic*—To What Extent Does the Absolute Priority Rule Apply to Interim Settlements or "First-Day" Distributions in Chapter 11?*

The *Jevic* Court limited its ruling to a priority-skipping structured dismissal with respect to which the skipped over creditors had not consented.[104] It also cited with approval a bankruptcy court's approval of a priority-skipping structured dismissal that the skipped-over creditors had tacitly approved by their declining to object.[105] It "express[ed] no view about the legality of structured dismissals in general."[106]

The Court viewed interim settlements in chapter 11 that are not case-ending differently.[107] The Court, though, did not resolve the circuit split on this issue between the Fifth Circuit's *AWECO* holding that extended the absolute priority rule to all pre-plan settlements and the longstanding *TMT Trailer* rule, followed by most circuits, that does not require adherence to the rule for interim settlements.[108]

The Court also did not resolve the rule for approving priority-skipping "first-day wage orders," "critical vendor" payments, and "roll-ups" that allow a prepetition secured lender who provides

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[102] *Id.*

[103] *Id.* at 986–87.

[104] *See id.* at 983.

[105] *Id.* (citing *In re* Buffet Partners, L.P., No. 14-30699-HDH-11, 2014 WL 3735804 (Bankr. N.D. Tex. 2014)).

[106] *Id.* at 985.

[107] *See id.* at 983, 985.

[108] *Compare* United States v. AWECO, Inc. (*In re* AWECO, Inc.), 725 F.2d 293, 298 (5th Cir. 1984), *with* Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 441 (1968).

new financing after the chapter 11 commences to be paid first on its prepetition claim.[109] The Court emphasized that "one can generally find significant Code-related objectives that the priority-violating distributions serve."[110] But it did not resolve the circuit split on this issue, between the "doctrine of necessity," under which a court pursuant to a first-day order can authorize a priority-skipping payment of a claim to a creditor who will not supply services or material essential to the continued operation of the debtor's business, and the Seventh Circuit's *Kmart* rule, which requires proof that the first-day payment proposed to be made to the advantaged creditor will result, eventually, in the same or higher distributions to the disadvantaged creditors.[111]

The circuit split on interim settlements is further considered in Part II below, in the context of a proposed use of market exposure rather than a mechanical application of the absolute priority rule, to preclude misallocations of estate value to insiders and other parties who have control over the debtor. The circuit split on first-day relief is further considered in Part III below, in the context of the court's inability to obtain full market exposure of proposed first-day distributions and the unreliability of the hypothetical valuations required by *Kmart* to be made at the first-day hearing in a chapter 11 case, of the distributions that will be made at the end of the case.

II. INTERIM SETTLEMENTS DISTINGUISHED FROM CASE-ENDING TRANSACTIONS UNDER *JEVIC* AND MARKET EXPOSURE FOR CHALLENGED INTERIM SETTLEMENTS POST-*JEVIC*

Parties settle numerous claims and disputes over the course of a chapter 11 bankruptcy case. The Supreme Court in *Jevic* recognized the difficulty of applying the absolute priority rule to an *interim* settlement, made prior to the end of the case, because "the nature and extent of the Estate, and the claims against it are not yet fully resolved."[112] The Court held though, that a case-ending

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[109] *Czyzewski*, 137 S. Ct. at 985.

[110] *Id.*

[111] *Compare In re* Penn Cent. Transp. Co., 467 F.2d 100, 102 n.1 (3d Cir. 1972) (doctrine of necessity), *with In re* Kmart Corp., 359 F.3d 866, 872 (7th Cir. 2004).

[112] *Czyzewski*, 137 S. Ct. at 985 (quoting Motorola, Inc. v. Official Comm. of Unsec'd Creditors (*In re* Iridium Operating LLC), 478 F.3d 452, 464 (2d Cir. 2007)).

settlement—that makes "end-of-case distributions of estate assets to creditors of the kind that normally take place in a chapter 7 liquidation or chapter 11 plan" and to which some affected creditors object—must comply with the absolute priority rule.[113]

The Court did not define what kind of a settlement, other than a structured dismissal, it considered to be case-ending.[114] Nor did it state a rule for a bankruptcy court's approving an interim settlement or resolve the circuit split on that issue.[115]

This Part suggests, first, that the Court recognized in its *Jevic* opinion that there are both temporal and substantive aspects to the question of whether a settlement and the distributions under it are interim rather than end-of-case. Second, this Section proposes that, for an interim settlement that is challenged as priority-skipping and/or case-ending, the estate claims and other assets that are included in the proposed settlement can, in many cases, be exposed to the market in a manner that deprives controlling and colluding parties of any premium, thus addressing the problem sought to be remedied by the absolute priority rule.

A. What Is an Interim as Opposed to an End-of-Case Settlement and Distribution?

The *Jevic* Court did not define what makes a settlement interim, to which the absolute priority rule does not apply, as opposed to case-ending, such as the structured dismissal in *Jevic* to which the rule does apply.[116] The Court suggested, though, two factors: one temporal and the other substantive.[117]

1. The Temporal Component and the Circuit Split on the Extension of the Absolute Priority Rule to Interim Settlements

Temporally, a settlement approved contemporaneously with the dismissal of the case, as in *Jevic*, clearly is case-ending.[118] At

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[113] *Id.* at 984.
[114] *See id.* at 985.
[115] *See id.*
[116] *See id.* at 985–86.
[117] *See id.* at 985.
[118] *Czyzewski*, 137 S. Ct. at 985–86.

what time though, in the vast temporal middle of a typical chapter 11 bankruptcy case, might a proposed settlement be found case-ending and thus trigger compliance with the absolute priority rule under *Jevic*?[119] If the court approves the settlement prior to the debtor's filing a motion to dismiss the case, for example, and the debtor moves for dismissal on the next day, or the next week, or the next month, or even the next year, is the settlement case-ending?

The Court did not elaborate on how near in time a settlement must be to the expected closing of the bankruptcy case for it to be potentially case-ending.[120] But a definition of "end-of-case" based solely on the temporal proximity of the settlement to the closing of the case would in many cases elevate form over substance, encourage parties to game the rule, and accomplish little by way of preventing control premiums and asserted misallocations of estate value based on control and collusion.[121]

The Court could have resolved the temporal problem of what is case-ending by adopting a *per se* rule.[122] Under a *per se* rule, any interim settlement outside of a plan, reached at any time in the chapter 11 case, must comply with the absolute priority rule.[123]

One circuit court, the Fifth Circuit in *In re* AWECO, Inc., had so held.[124] The Court in *Jevic* did not.[125] While it applied the absolute priority rule to an end-of-case settlement, it expressly declined to extend the rule's reach to an interim settlement, or to resolve the circuit split on this issue.[126]

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[119] *See id.* at 985–87.

[120] *Id.* at 987.

[121] *Id.* at 977.

[122] *Id.* (explaining how the Court did not adopt a bright line rule to determine when a settlement is case-ending).

[123] *See id.*

[124] *See In re* AWECO, Inc., 725 F.2d at 293, 298.

[125] *See Czyzewski*, 137 S. Ct. at 977.

[126] *See id.* at 985–86; *see also* 11 U.S.C. § 363(b) (2012) (The Bankruptcy Code and Rules are silent on the issue of whether the absolute priority rule applies to an interim settlement. Code section 363(b) authorizes the debtor's sale or use of estate property "out of the ordinary course of business," such as in a settlement, so long as the bankruptcy court approves.). Settlements outside of a plan are authorized pursuant to Bankruptcy Rule 9019. That Rule provides

It might have been otherwise. The question originally presented to the Court in *Jevic*, on which it granted certiorari, was: "[w]hether a bankruptcy court may authorize the distribution of settlement proceeds in a manner that violates the statutory priority scheme."[127] The petitioners had argued in their application for certiorari that the Third Circuit's decision in *Jevic* "'deepened an existing ... split among the Courts of Appeals on this question."[128]

On one side of this split was the Fifth Circuit's decision establishing the *per se* rule in *AWECO*.[129] Under *AWECO*, a proposed settlement or other use of estate property must comply with the absolute priority rule from the first day of the chapter 11 case.[130] The court observed that the terms "fair and equitable," which apply to confirmation of a chapter 11 cramdown plan, are "terms of art—they mean that 'senior interests are entitled to full priority over junior ones.'"[131] It held that the rule arises "as

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that, "after notice and a hearing, the court may approve a compromise or settlement." FED. R. BANKR. P. 9019(a). Neither Code section 363 nor Rule 9019 refer to distributional priorities or the absolute priority. Since the Code became effective in 1978, most lower courts have applied variations of the risk-benefit standard set forth in the Supreme Court's decision in *TMT Trailer* (a chapter X corporate reorganization case under the Bankruptcy Act) to decide whether to approve a chapter 11 settlement. *TMT Trailer* does not require a pre-plan settlement to adhere to the absolute priority rule. *TMT Trailer*, 390 U.S. at 414, 418. Rather, a court considering a proposed pre-plan settlement must consider the potential benefits and risks of the debtor's continuing to litigate, as compared with what the debtor gains and gives up by the settlement. Specifically, the court must evaluate the probability that the debtor will succeed in the litigation, the difficulties that the debtor might have in collecting a judgment, the complexity of the litigation, the expense, inconvenience and delay in pursuing it, and the interests of creditors and their reasonable views regarding whether the settlement is advisable. 10 COLLIER ON BANKRUPTCY ¶ 9019.02 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2009).

[127] *See Czyzewski*, 137 S. Ct. at 987 (Thomas, J., joined by Alito, J. dissenting).

[128] *Id.*

[129] *See In re AWECO, Inc.*, 725 F.2d at 298.

[130] *See id.*

[131] *Id.* (quoting SEC v. Am. Trailer Rentals Co., 379 U.S. 594 (1965) (Act case)). The AWECO court extended to a pre-plan settlement the meaning of "fair and equitable" that applies to a chapter 11 cramdown plan—i.e., a plan which some impaired classes voted to accept and some voted to reject, and to which the absolute priority rule applies. Section 1129(b)(1) requires a cramdown plan to be "fair and equitable" for the bankruptcy court to confirm it. Section 1129(b)(2) provides that, for such purpose, "the condition that a plan be fair and equitable"

soon as a debtor files a petition for relief," and "does not suddenly appear during the process of approv[al] a plan of compromise."[132] Moreover, if the standard had no application before confirmation of a reorganization plan, then bankruptcy courts would have the discretion to favor junior classes of creditors so long as the approval of the settlement came before the plan."[133] The *AWECO* court's understanding of "bankruptcy law's underlying policies" led it to extend the rule, and it held that "a bankruptcy court abuses its discretion in approving a settlement with a junior creditor unless the court concludes that priority of payment will be respected as to objecting senior creditors."[134]

On the other side of the split was the Second Circuit's decision in *Iridium* and the Third Circuit's decision in *Jevic*.[135] The *Iridium* court emphasized the need for flexibility in pre-plan settlements, while conceding that such flexibility "has its costs."[136] It held that if a party (the unsecured creditors' committee in that case) "reaches a settlement that in some way impairs the rule of priorities, it must come before the bankruptcy court with specific and credible grounds to justify the deviation and the court must carefully articulate its reasons for approval of the agreement."[137]

The Third Circuit in *Jevic* agreed with the Second Circuit's standard for approval of an interim settlement in chapter 11, and rejected the Fifth Circuit's *per se* application of the absolute priority rule to all interim settlements.[138] The Third Circuit emphasized its view that the Code and the Bankruptcy Rules "leave bankruptcy courts more flexibility in approving settlements than in confirming plans of reorganization."[139] Conceding that it

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includes the distributional requirements of the absolute priority rule. 11 U.S.C. §§ 1129(b)(1)–(2) (2012).

[132] *In re AWECO, Inc.*, 725 F.2d at 298.

[133] *Id.*

[134] *Id.*

[135] Motorola, Inc. v. Official Comm. of Unsec'd Creditors (*In re* Iridium Operating LLC), 478 F.3d 452, x (2d Cir. 2007); Official Comm. of Unsec'd Creditors *ex rel.* Jevic Holding Corp. v. CIT Grp./Bus. Credit Inc. (*In re* Jevic Holding Corp.), 787 F.3d 173, x (3d Cir. 2003).

[136] *In re Iridium Operating LLC*, 478 F.3d at 452, 466.

[137] *Id.*

[138] *In re Jevic Holding Corp.,* 787 F.3d at 173, 184.

[139] *Id.*

was "a close call," the court concluded that the bankruptcy court had sufficient reason to approve the settlement and structured dismissal of *Jevic*'s chapter 11 case, even though it was priority-skipping, because doing so was the "least bad alternative."[140]

The Supreme Court in *Jevic* might have resolved this issue, but it did not.[141] In one of the more peculiar procedural paths taken in the Court's history, the petitioners—after the Court granted certiorari—recast the question presented to ask instead: "[w]hether a Chapter 11 case may be terminated by a 'structured dismissal' that distributes estate property in violation of the Bankruptcy Code's priority scheme."[142]

Both the original question and the reformulated question stated by the appellants involved priority-skipping.[143] But, as Justice Thomas protested in his dissent, "the recast question" was "narrower—and different"—than the one on which the Court had "granted certiorari."[144] It was "also not the subject of a circuit conflict."[145] The majority opinion in the *Jevic* opinion did not so much as mention the circuit split or *AWECO* or its *per se* rule.[146]

In any event, the Court declined to draw the bright temporal line that it might have, had it decided either that the rule of distributional priorities arises on the filing of the bankruptcy petition and thus applies to all interim or other pre-plan settlements and transactions or that it does not apply to those settlements and transactions at all.[147] The facts instead hit the prism of the reformulated question that limited the Court's holding to

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[140] *Id.* at 184–85.

[141] *Id.* at 987.

[142] *Id.*

[143] *See id.* at 978.

[144] *Id.* at 987–88.

[145] *Id.* The split was not quite as sharp as stated because the Fifth Circuit itself was not completely consistent in following *In re* AWECO, Inc. *See, e.g.*, Sandoz v. Bennett (*In re* Emerald Oil Co.), 807 F.2d 1234, 1239 (5th Cir. 1987) (affirming settlement with no mention of whether it complied with the absolute priority rule); Texas Extrusion Corp. v. Lockheed Corp. (*In re* Texas Extrusion Corp.), 844 F.2d 1142, 1158–59 (5th Cir. 1988) (affirming settlement contained in plan because it was not an "abuse of discretion" without mention of whether the settlement complied with the absolute priority rule), *aff'g* 68 B.R. 712 (N.D. Tex. 1986).

[146] *See Czyzewski*, 137 S. Ct. at 977–87.

[147] *See id.*

an end-of-case structured dismissal.[148] Yet the Court cast some light on another, substantive aspect of whether an interim settlement or transaction should be considered case-ending and thus require compliance with the absolute priority rule.[149] This aspect of the question is discussed below.

2. The Substantive Component—Settlements Lacking Market Exposure That Predetermine Final Distributions to Creditors

A proposed settlement or other transaction may be substantively case-ending, even though it is temporally interim, if the proposed transaction predetermines final distributions to creditors or equity holders absent a process that enables a court to determine that the transaction shows a proper solicitude for the absolute priority rule.[150]

I suggest in this Section that the procedural safeguards identified by the Court in its recent jurisprudence—specifically *Jevic* in 2017 and *203 N. LaSalle* in 1999—are procedures that expose the estate assets at issue to the market rather than those for confirmation of a chapter 11 plan.[151] The starting point is the *Jevic* Court's contrasting characterization of the pre-plan transactions in *Braniff* and *Chrysler*.[152]

The *Jevic* Court analogized to—and cited with disfavor—the proposed settlement and sale transaction in *In re* Braniff Airways, Inc. among the debtor and certain of its secured and unsecured creditors.[153] It characterized the *Braniff* transaction as "an attempt to 'short circuit the requirements of Chapter 11 for confirmation of a reorganization plan by establishing the terms of the plan *sub rosa* in connection with a sale of assets.'"[154] The Court, citing *Braniff*, stressed that the structured dismissal resembled "proposed transactions that lower courts have refused

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[148] *Id.* at 983.

[149] *Id.* at 983–87.

[150] *See id.* at 978.

[151] These procedures are similar to those by which operating business enterprises commonly are sold in bankruptcy proceedings, pursuant to section 363(b) of the Code, and prior to a chapter 11 plan. 11 U.S.C. § 363(b).

[152] *Czyzewski*, 137 S. Ct. at 977–87.

[153] *Id.* at 978.

[154] *Id.* (quoting *In re* Braniff Airways, Inc., 700 F.2d 935, 940 (5th Cir. 1989).

to allow on the ground that they circumvent the Code's procedural safeguards."[155]

Yet, the *Jevic* Court regarded *Chrysler* differently, though it too was a pre-plan sale case.[156] The Court quoted favorably the Second Circuit's determination that the bankruptcy court that approved the *Chrysler* sale had "demonstrated 'proper solicitude for the priority between creditors and deemed it essential that the [s]ale in no way upset that priority.'"[157]

The *Jevic* Court framed the issue in terms of whether a proposed interim settlement or other pre-plan transaction satisfies the "Code's procedural safeguards."[158] But the issue was hardly procedural. The debtor in each of *Braniff* and *Chrysler* had equally circumvented the procedures for plan confirmation that safeguard creditors and other parties in interest in chapter 11.[159] Those procedures include filing a chapter 11 disclosure statement and plan; giving creditors and other parties notice and an opportunity to object to court approval of the disclosure statement and confirmation of the plan; obtaining court approval of the disclosure statement on a finding that it contains adequate information about the plan; transmitting the court-approved disclosure statement to the parties

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[155] *Id.*

[156] *Id.*

[157] *Czyzewski*, 137 S. Ct. at 978 (quoting Ind. St. Police Pens. Tr. v. Chrysler, LLC (*In re* Chrysler LLC), 576 F.3d 108, 118 (2d Cir. 2009)).

[158] *Id.* at 986.

[159] Structured dismissals and pre-plan sales both have been criticized as a means by which debtors and creditors can evade the statutory procedures required for confirmation of a chapter 11 plan. *See* Nan Roberts Eital et al., *Structured Dismissals, or Cases Dismissed Outside of Code's Structure?*, 30 AM. BANKR. INST. J. 20, 20 (2011) ("Structured chapter 11 dismissals ignore important chapter 11 safeguards that structured dismissals omit, including voting, acceptance, disclosure and the 'fair and equitable' standards, including the absolute-priority rule."); Jonathan C. Lipson, *The Secret Life of Priority: Corporate Reorganization After* Jevic, 90 WASH. L. REV. 631, 634 (2018) (emphasizing disclosure and voting as the two key participatory features of the chapter 11 plan process); Mark J. Roe & David Skeel, *Assessing the Chrysler Bankruptcy*, 108 MICH. L. REV. 728, 735–36 (2010) (Terms of a pre-plan bankruptcy sale "determine core aspects that would normally be handled under § 1129, with disclosure, voting under § 1129(a)(8), and if voting fails, via a judicial cramdown under § 1129(b)," which requires compliance with the absolute priority rule. "If the restructuring is done via § 363, courts need to resolve how to reconcile such sales with § 1129. ... But fast sales with some priority determinations can be reconciled. The court can identify the offending feature of the § 363 sale and ascertain whether it's small and whether priority determination would have passed muster under § 1129.").

entitled to vote on the plan; soliciting the vote and acceptance of the plan by one or more impaired classes of creditors who are entitled to vote and, in some cases, from the holders of equity; and obtaining the bankruptcy court's confirmation of the plan following a confirmation hearing at which the bankruptcy judge considers the vote, hears the objections, and then determines whether the plan has met all of the requirements for confirmation.[160]

Put bluntly, the debtor in *Braniff* and *Chrysler* equally flaunted the procedural safeguards of chapter 11.[161] The debtor in neither *Braniff* nor *Chrysler* had proposed a chapter 11 plan at the time it sought the bankruptcy court approval of the sale.[162] Each debtor instead sought court approval of a sale, upon consummation of which the company would have new owners and new, restructured debt, and would for practical purposes have reorganized without following any of the procedures required for confirmation of a chapter 11 plan.[163]

Why then did the *Jevic* Court suggest that the *Braniff* sale had circumvented—while the *Chrysler* sale had satisfied—"the Code's procedural safeguards?"[164] Stated another way, what are the required "procedural safeguards" for approval of an interim settlement or other pre-plan transaction in a chapter 11 bankruptcy case?

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[160] The Fifth Circuit in *Braniff*, in reversing the lower court's approval of the section 363(b) sale in that case, admonished: "In any future attempts to specify the terms whereby a reorganization plan is to be adopted, the parties and the district court must scale the hurdles erected in Chapter 11. *See, e.g.*, 11 U.S.C. § 1125 (disclosure requirements); § 1126 (voting); § 1129(a)(7) (best interest of creditors test); § 1129(b)(2)(B) (absolute priority rule)." *In re* Braniff Airways, Inc., 700 F.2d 935, 940 (1989).

[161] Ind. St. Police Pens. Tr. v. Chrysler, LLC (*In re* Chrysler LLC), 576 F.3d 108, 127 (2d Cir. 2009); *In re Braniff*, 700 F.2d at 939–40.

[162] *In re Chrysler LLC*, 576 F.3d at 127; *In re Braniff*, 700 F.2d at 939–40. The *Chrysler* sale, moreover, was consummated at lightning speed—forty-one days from the bankruptcy filing. Chrysler filed its chapter 11 petition on April 30, 2009, the date on which the debtor entered into a Master Transaction Agreement for the sale of its business and substantially all of its assets to a new entity, New Chrysler, in which the major investor was Fiat S.p.A. The court approved bidding procedures on May 5. No other bids for the business or assets were obtained. The court held hearings from May 27 to May 29 on whether to approve the proposed sale and the bankruptcy court approved the sale on June 1. The sale closed on June 10. *In re Chrysler LLC*, 576 F.3d at 111–12, 118.

[163] *In re Chrysler LLC*, 576 F.3d at 111–12; *In re Braniff*, 700 F.2d at 938, 939–40.

[164] *Czyzewski*, 137 S. Ct. at 986 (citing *In re Braniff*, 700 F.2d at 940).

I suggest that the answer depends, first, on whether a market exposure of the debtor's assets involved in the proposed transaction resulted in a reliable determination of the value of those assets. That determination, second, can provide the clarity required for the bankruptcy court to determine whether the distributions to be made pursuant to the transaction substantively distribute value in accordance with the Code's distributional priorities or misallocate estate value to parties who exercise control over the debtor or have colluded with them. Support for this conclusion can be inferred from *Braniff*, *203 N. LaSalle*, and *Chrysler*, and the Supreme Court's 1999 decision in *203 N. LaSalle*.[165]

The interim settlement and sale in *Braniff* is the iconic improper *sub rosa* plan transaction under the Code.[166] Neither the debtor's claims proposed to be settled (by cross-releases among the settling parties) nor the debtor's assets proposed to be sold had been exposed to the market.[167] No chapter 11 plan had been filed and the parties provided no evidence that the distributions to be made pursuant to the transaction complied with the priorities for a plan.[168]

Under the proposed settlement in *Braniff*, the debtor would sell and transfer the slots and its terminal leases, cash, airplanes and equipment to the new operator in return for "travel script, unsecured notes, and a profit participation[.]"[169] The travel script entitled the holder to travel on the new airline and "[could] be used only in a future ... reorganization."[170] The script would be issued

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[165] *See generally Czyzewski*, 137 S. Ct.; *In re Chrysler LLC*, 576 F.3d; *203 N. LaSalle*, 526 U.S.; *In re Braniff*, 700 F.2d.

[166] *See In re Braniff*, 700 F.2d at 937–41.

[167] *Id.*

[168] *Id.* at 938. The Braniff settlement and sale transaction arose after the Federal Aviation Administration allocated the debtor's landing slots to other carriers. The unsecured creditors committee asserted that the slots were property of the estate and sought a declaration that the allocation constituted a violation of the automatic stay and of a temporary restraining order previously entered in the case. (The automatic stay prohibits "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate" without court approval. 11 U.S.C. §§ 362(a)(3), (d) (2012)). The parties resolved the committee's motion by the FAA's agreeing to return the slots to the debtor if the debtor or its successor recommenced operations. The debtor and certain secured and unsecured creditors then entered into the proposed settlement of claims and potential litigation.

[169] *In re Braniff*, 700 F.2d at 939.

[170] *Id.*

only to the debtor's former employees, shareholders, and unsecured creditors, without any regard to the distributional priorities of their respective claims.[171] The Fifth Circuit found that the transaction "had the practical effect of dictating some of the terms of any future reorganization plan," including because any "reorganization plan would have to allocate the scrip according to the terms of the PSA agreement or forfeit a valuable asset."[172] Any future attempt to specify the terms of a chapter 11 plan, it admonished, "would have to scale the hurdles erected in Chapter 11," including the absolute priority rule.[173] The *Jevic* Court described the transaction that the Fifth Circuit disapproved in *Braniff* as one that would have "circumvent[ed] the Code's procedural safeguards."[174]

Chrysler, by comparison, found favor in the eyes of the *Jevic* Court, for the bankruptcy court's having demonstrated proper solicitude for distributional priorities.[175] First and foremost, the assets involved in the pre-plan transaction had been exposed to the market.[176] The Second Circuit, in affirming the bankruptcy court, emphasized that court's findings that the debtor had made "prolonged and well-publicized efforts to find a strategic partner or buyer."[177] Its executives had "circled the globe in search of a deal."[178] "Notwithstanding ... highly publicized and extensive efforts [made over] two years ... the Fiat transaction [was] the only option that [was] currently viable. The only other alternative was the immediate liquidation of the company."[179]

The second lien lenders in *Chrysler* challenged the distributions of the sale proceeds as priority-skipping.[180] The market exposure of the assets gave the bankruptcy court a firm ground upon which to conclude that the Code's distributional priorities were being respected.[181] Specifically, the bankruptcy court found that the sale would yield $2 billion of sale proceeds, all of which would

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171 *Id.*

172 *Id.*

173 *Id.* at 940.

174 *Czyzewski,* 137 S. Ct. at 986.

175 *In re Chrysler LLC*, 576 F.3d at 117–18.

176 *Id.* at 118.

177 *Id.*

178 *Id.*

179 *Id.* (citing *In re* Chrysler LLC, 405 B.R. 94, 96 (Bankr. S.D.N.Y. 2009)).

180 *In re Chrysler LLC*, 576 F.3d at 118.

181 *Id.*

be paid to the first lien lenders, whose secured claims clearly exceeded that amount.[182] The objecting junior, second lien lenders, equally clearly, were out of the money.[183]

Moreover, the market sale of the *Chrysler* assets formed the basis for the bankruptcy court's approval of distributions that were challenged as priority-skipping.[184] Specifically, the terms of the sale required that the equity in the reorganized Chrysler would be issued to unsecured creditors, skipping over the second lien lenders.[185] The bankruptcy court, having determined that "all the equity stakes in New Chrysler were entirely attributable to new value" (including government loans), approved the issuance of new equity to unsecured creditors, skipping over the second lien lenders.[186]

The problem with using hypothetical valuations (as in *Braniff*) rather than market valuations (as in *Chrysler*) to determine compliance with distributional priorities was at the heart of the Court's 1999 decision in *203 N. LaSalle*, just as it was in *Jevic* in 2017.[187] The issue in *203 N. LaSalle* was the debtor's proposal to make priority-skipping distributions of equity in the reorganized debtor to those in control of the debtor, without exposing the new equity to the market.[188] Specifically, the plan in *203 N. LaSalle* was challenged as priority-skipping because it left a large unsecured claim (the bank's deficiency claim) unpaid even though a junior interest, the owners of equity in the debtor, would receive a distribution in the form of the equity in the new, reorganized debtor.[189] The market exposure problem was that only those existing equity holders were given the opportunity to buy the equity in the new, reorganized debtor. The "exclusiveness of the opportunity, with its protection against the market's scrutiny of the purchase price by means of competing bids or even competing plan proposals"

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[182] *Id.* at 117, n.9.

[183] *Id.*

[184] *Id.* at 118. The "Indiana Pensioners" challenged the *Chrysler* sale as "a *sub rosa* plan chiefly because it [gave] value to unsecured creditors (*i.e.,* in the form of the ownership interest in New Chrysler provided to the union benefit funds) without paying off secured debt in full, and without complying with the procedural requirements of Chapter 11."

[185] *In re Chrysler LLC*, 576 F.3d at 118.

[186] *Id.*

[187] *See generally Czyzewski,* 137 S. Ct. at 973; *203 N. LaSalle*, 526 U.S. at 434.

[188] *203 N. LaSalle*, 526 U.S. at 439–44.

[189] *Id.*

led the Court to conclude that the right to purchase the new equity arose from and was "extended 'on account of' the old equity position."[190] Because the owners of the company had set aside for themselves the new equity in the reorganized company, under a priority-skipping plan supported by a hypothetical valuation of the new equity that lacked market exposure, the Court reversed the bankruptcy court's conversion of the plan.[191]

The "proper solicitude for the priority between creditors"[192] shown in *Chrysler*, but lacking in the *Jevic* and *Braniff* transactions and in the *203 N. LaSalle* plan, appears to have been demonstrated by the exposure to the market of the assets implicated in the challenged transaction.[193] That market exposure in *Chrysler* enabled a court to make an informed determination regarding whether estate value had been distributed in accordance with the absolute priority rule or had been misallocated in violation of it.[194] Market exposure also formed the basis for the bankruptcy court's approval of apparent priority-skipping in *Chrysler*, in the form of the distribution to unsecured over the second lien secured creditors, because the market exposure showed that the distribution to the unsecured creditors was attributable to new value by a contribution or "gift" made by a third party rather than on account of the unsecured creditors' claims.[195] No such market exposure occurred in *Jevic*,[196] *Braniff,*[197] or *203 N. LaSalle*.[198]

The Supreme Court emphasized this problem in both *Jevic* and *203 N. LaSalle*: in *Jevic* when it took issue with what it characterized as the bankruptcy court's "dubious predictions" of distributional outcomes that would follow from the settlement or the absence of it,[199] and in *203 N. LaSalle* when it wrote that the exclusiveness of the opportunity to purchase the equity in the new debtor precluded competing bids and thus shielded the transaction

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[190] *Id.* at 456.

[191] *Id.* at 458.

[192] *Czyzewski,* 137 S. Ct. at 986 (quoting *In re Chrysler LLC*, 576 F.3d at 118).

[193] *Id.* at 981; *In re Chrysler LLC*, F.3d at 118; *203 N. LaSalle*, 526 U.S. at 440, 456; *In re Braniff*, 700 F.2d at 940–41.

[194] *In re Chrysler LLC*, 576 F.3d at 118.

[195] *Id.* at 119.

[196] *Czyzewski*, 137 S. Ct. at 978, 981.

[197] *In re Braniff*, 700 F.2d at 940–41.

[198] *203 N. Lasalle*, 526 U.S. at 440, 456.

[199] *Czyzewski*, 137 S. Ct. at 984.

with the insiders from "the market's scrutiny."[200] The distributional outcome of an alternate transaction was not put to a market test in either case.[201] The bankruptcy court, as a result, could not determine whether the transaction that it approved included a control premium in the form of a discounted price paid by a controlling party, i.e., for the release given to the secured lenders in *Jevic* or for the equity given to the old shareholders in *203 N. LaSalle*.[202]

The *Jevic* Court left open the rule for approval of interim settlements in chapter 11, limiting the reach of its dicta to a suggestion that some solicitude must be shown to the absolute priority rule even when the transaction is not case-ending.[203] I assert below that market exposure of the estate claims and other assets proposed to be transferred or released can address, in many cases, the issues of control and collusion that gave rise to the absolute priority rule. Market exposure thus can constitute the basis on which a bankruptcy court approves an interim settlement challenged on the ground that it includes a priority-skipping control premium post-*Jevic*.

*B. Market Exposure for Challenged Interim Settlements Post-*Jevic *to Achieve the Remedial Purposes of the Absolute Priority Rule*

The absolute priority rule applies to end-of-case settlements post-*Jevic*.[204] More leeway was left for approval of interim settlements.[205] The Court provided no precise definition of what might be interim as opposed to end-of-case, though as discussed above, there are both temporal and substantive aspects to this question.[206]

The Court, moreover, suggested that bankruptcy court approval even of interim transactions must demonstrate some respect

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[200] *203 N. LaSalle*, 526 U.S. at 456.

[201] *Czyzewski*, 137 S. Ct. at 976; *203 N. LaSalle*, 526 U.S. at 441.

[202] *Czyzewski*, 137 S. Ct. at 976; *203 N. LaSalle*, 526 U.S. at 441.

[203] *Czyzewski*, 137 S. Ct. at 985–86.

[204] *Id.* at 978 ("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.").

[205] *Id.* at 977, 985.

[206] *Id.* at 983, 985.

for, or as the Second Circuit described it, a "proper solicitude" to the absolute priority rule.[207]

As set forth below, market exposure of a proposed settlement or other transaction with an insider or other controlling party demonstrates a strong solicitude to the absolute priority rule.[208] The absolute priority rule arose to prevent a threatened misallocation of estate value based on control and collusion, supported by a hypothetical valuation or a contrived sale rather than by a market valuation of estate assets proposed to be distributed to creditors.[209] The Supreme Court in *203 N. LaSalle* stressed the need for market scrutiny to determine whether a control premium was being distributed to existing owners, and the Court in *Jevic* took issue with the bankruptcy court's hypothetical valuation of the released claim, setting forth its counter-hypothesis that a settlement that respected ordinary priorities remained "a reasonable possibility."[210]

Markets are extensive today—more than they were in the 19th century when the absolute priority rule arose,[211] more than in the 1930s when the reorganization provisions were added to the Bankruptcy Act,[212] and more than in 1978 when the Code was enacted.[213] Businesses are commonly sold in chapter 11, pursuant to court orders that require marketing, competitive bidding processes, and public sales.[214] Claims trading is extensive in large chapter 11 cases, and secured and unsecured claims against a chapter 11 debtor freely and regularly change hands.[215]

As markets have grown for ever-increasing amounts and types of debt and other claims and property, including for the

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207 *Id.* at 986.

208 *See infra* text accompanying notes 211–25.

209 *Czyzewski*, 137 S. Ct. at 984, 987.

210 *Id.* at 983; *203 N. Lasalle*, 526 U.S. at 456.

211 Amendments to Bankruptcy Act, ch. 424, 48 Stat. 911 (1934) § 77B(f); *L.A. Lumber*, 308 U.S. at 117, 123.

212 *See generally* Chandler Act of 1938, Pub. L. No. 75-696, 52 Stat. 840 (1938) (amending the Bankruptcy Act of 1898).

213 *See, e.g.*, Douglas G. Baird, *The New Face of Chapter 11*, 12 AM. BANKR. INST. L. REV. 69 (2004).

214 *Id.*

215 *See, e.g.*, Harvey R. Miller & Shai Y. Waisman, *Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?*, 78 AM. BANKR. L.J. 153, 181 (2004) ("distressed debt trading has grown to proportions never contemplated" at the time the Code was enacted in 1978.").

assets of insolvent companies, so too has the justifiable distrust of hypothetical, judicial valuations of those assets.[216] While most of the academic literature has focused on going concern or reorganization value, the problem applies equally to a claim that the debtor has against a third party.[217] Nearly all hypothetical, judicial valuations of a claim will be based on highly speculative testimony regarding the time and expense of the debtor's prosecuting the claim, the likelihood of the debtor's success on the merits, and, ultimately, the debtor's ability to collect on any judgment, and the bankruptcy court's equally speculative determination following its hearing such testimony.[218]

A claim that a chapter 11 debtor has against a third party—whether that third party is or is not an insider—is in one sense simply an asset of the estate.[219] The claim can be marketed and sold to the highest and best buyer who believes that, at the price paid, it will make a profit from prosecuting or settling the claim.[220] The claim can be "marketed" to a lawyer, who will prosecute it under a contingency fee agreement that retains for the estate the highest and best percentage of any recovery.[221] The claim can be marketed to an investor who makes the highest and best offer to fund the litigation in exchange for a percentage of the proceeds of any recovery.[222]

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[216] *See, e.g.*, Kenneth Ayotte & Edward R. Morrison, *Valuation Disputes in Corporate Bankruptcy*, 167 U. PA. L. REV (forthcoming 2018) (citing Walter J. Blum, *The Law and Language of Corporate Reorganization*, 17 U. CHI. L. REV. 565, 572 (1950) ("[Judicial value] can never be objectively ascertained or verified but always remains in the realm of opinion or belief.")).

[217] *Id.*

[218] *See id.*

[219] 11 U.S.C. § 541(a)(1) (2012) (property of a debtor's bankruptcy estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case"); CHARLES JORDAN TABB, THE LAW OF BANKRUPTCY 397 (2d ed. 2009) ("Virtually all of the debtor's property is swept into the estate …." Legislative history explains that property of the estate includes "causes of action") (citing H.R. REP. NO. 95-595, at 367 (1977)).

[220] *See, e.g.*, 11 U.S.C. § 363(b) (a chapter 11 debtor, "after notice and a hearing, may use, sell, or lease, outside the ordinary course of business, property of the estate."); *In re* Joseph, 330 B.R. 87 (Bankr. D. Conn. 2005).

[221] *Czyzewski*, 137 S. Ct. at 983.

[222] *See, e.g.*, *In re* Charlotte Com. Group, Inc., No. B-01-52684 C-7W, 2002 WL 31055241 (Bankr. M.D.N.C. 2002); Carmel, *supra* note 35, at 16–17. This

The process by which a chapter 11 debtor obtains authority to market and sell estate assets, including the debtor's business, through a competitive bidding process is well-developed.[223] Chapter 11 debtors regularly seek bankruptcy court approval of bidding procedures that provide for competitive bidding and, ultimately, an auction of the estate assets being sold.[224] This process often involves the debtor's having obtained an initial bidder for the assets, whose offer is subject to higher and better bids.[225] Courts typically approve these procedures if they will encourage rather than chill the bidding for the assets, and thereby maximize the value that will be obtained from the sale of the assets.[226]

Can market exposure of the assets involved in a settlement that is challenged as case-ending and/or priority-skipping be used to determine whether the distributions under the settlement include a control premium, or instead properly allocate value to the debtor's creditors and shareholders? I suggest that, in many cases, it can.

Consider again the following example set forth in the Introduction to this Article. The debtor proposes to settle the debtor's claim against an insider by releasing the insider in exchange for

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approach also has been urged to address certain asserted inadequacies in large-scale, small-claim and derivative litigation. *See, e.g.*, Jay Tidmarsh, *Auctioning Class Settlements*, 56 WM. & MARY L. REV. 227 (2014); Geoffrey P. Miller, *Competing Bids in Class Action Settlements*, 31 HOFSTRA L. REV. 633 (2003); Jonathan R. Macey & Geoffrey P. Miller, *Auctioning Class Action and Derivative: A Rejoinder*, 87 NW. U. L. REV. 458 (1993); Randall S. Thomas & Robert G. Hansen, *Auctioning Class Action and Derivative Lawsuits: A Critical Analysis*, 87 NW. U. L. REV. 423 (1993); Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1 (1991).

[223] *See, e.g.*, Douglas G. Baird, The New Face of Chapter 11, 12 AM. BANKR. INST. L. REV. 69 (2004).

[224] *See, e.g.*, Harvey R. Miller & Shai Y. Waisman, *Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?*, 78 AM. BANKR. L.J. 153, 194–96 (2004).

[225] *See, e.g.*, Douglas G. Baird, *The New Face of Chapter 11*, 12 AM. BANKR. INST. L. REV. 69 (2004); *In re* O'Brien Environmental Energy, Inc., 181 F.3d 527, 537 (3rd Cir. 1999).

[226] *See, e.g.,* Del. Bankr. L.R. 6004-1 (2017) (for the disclosures required to be made to the bankruptcy court that enable the court to determine whether to approve the proposed bidding procedures because they are likely to maximize value and do not chill bidding).

a settlement payment. The question of whether the insider is receiving a control premium—in the form of having to pay a lower settlement price than what the claim is worth (thus also reducing eventual distributions to other creditors)—is clearly at issue. The debtor's claim against the insider, though, can be marketed for outright sale to an arm's-length third-party buyer, or to an investor who will fund the costs of the litigation in return for a percentage of any recovery on the claim. A higher and better bid for the claim from a third-party buyer or investor removes the issue of whether a control premium is being paid to the insider—the costs and benefits of the transaction are now with the third party who is not in control. If, on the other hand, the settlement was vigorously marketed and no higher bid was obtained, a strong case can be made that the insider's bid reflects the highest and best market price for the claim. The insider is not receiving a control premium in the form of a discount because if the claim was worth more, a third party would have bid more.

Consider, as a second example, an interim settlement similar to the case-ending settlement in *Jevic*.[227] The debtor has a claim against a secured lender who is willing to pay a settlement amount to the estate to settle the claim. But the lender will agree to do so only if distributions of the settlement amount skip over a group of creditors who the lender fears will use their distribution of the settlement proceeds as a litigation fund to sue the lender on another claim that they have against the lender. The creditors group objects to approval of the settlement, arguing that it is priority-skipping and that the lender has colluded with the debtor's management to exercise control over the debtor at the expense of the creditors group. The issue of whether the lender is receiving a control premium, in the form of a bargain settlement amount, is present.

The debtor's claim against the lender, in this example too, can be marketed for outright sale to an arm's-length third-party buyer, or to an investor who will fund the costs of the litigation in return for a percentage of any recovery on the claim. As with the prior example, a higher and better bid for the claim from a third-party buyer or investor removes the issue of whether a

[227] *Czyzewski*, 137 S. Ct. at 980–82.

control premium is being paid to the lender because, again, the costs and benefits of the transaction are now with the third party who is not in control. If, on the other hand, no higher bid was obtained after a vigorous marketing process, the market exposure would indicate that the claim has no value other than to the lender, whose bid reflects the highest and best market price for the claim, even with the priority-skipping. The lender is not receiving a control premium in the form of a discount because, if the claim was worth more, a third party would have bid more. The lender simply does not want to fund litigation against itself.

Exposing settlements to market scrutiny can, in sum, address the issue of the misallocation of estate value based on control and collusion that gave rise to the absolute priority rule. Hypothetical valuations—such as those that concerned the Court in both *Jevic* and *203 N. LaSalle*—are poor and suspect substitutes.[228]

Issues can be expected to recur in some cases, even if this approach is taken. Most turn on the market for and the marketing of such claims or other assets. Aspects of both bankruptcy and non-bankruptcy law pose other, special issues.[229]

Foremost, a rule relying on market exposure requires, to state the obvious, a robust marketing and sale process.[230] Inadequate marketing, restrictions on potential bidders' access to information, no-shop provisions, exclusionary bidder qualification rules, unnecessary or excessive break-up fees, excessive overbid

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[228] *Id.* at 983, 986; *203 N. LaSalle*, 526 U.S. at 456–58.

[229] *See infra* text accompanying notes 233–37.

[230] Such a marketing process includes establishing a sufficient marketing period, providing the necessary information to prospective bidders, contacting prospective buyers, negotiating with prospective "stalking horse" bidders one of whom will set a floor by making an initial bid, providing an incentive such as a breakup fee to the initial bidder (which initial bid will be subject to higher bids of other bidders who then bid against it), and establishing overbid minimums and other rules for an auction when more than one prospective bidder is obtained. The auction should provide an opportunity to creditors who hold liens against the asset being sold to credit bid at the auction. 11 U.S.C. § 363(k) (2012). Bankruptcy Judge Frank Santoro (Bankr. E.D. Va.) suggests that the bidding procedures approved by the court might also permit credit bidding by creditors who hold priority unsecured claims under Code section 507, though credit bidding by priority unsecured creditors is not expressly provided for in the Code. 11 U.S.C. §§ 507, 363(k) (2012).

requirements, and similar provisions that chill rather than encourage bidding will skew the market exposure and reduce the market price.[231] To the extent that these flaws favor an insider, they make a control premium more likely.[232] Bankruptcy courts have developed court rules and precedents that encourage a warm and healthy bidding process and many courts have extensive experience in ruling on these bidding procedure issues in a manner that maximizes market exposure in connection with any auction of a debtor's assets.[233] But absent a bankruptcy court's rigorous application of such rules the market exposure will be lost, the value of estate assets and distributions to creditors will diminish, and control premiums will be paid.[234]

"Gifting" by a senior stakeholder, such as by a secured creditor to a junior stakeholder, that skips over an intermediate stakeholder, poses a related bankruptcy law issue.[235] The question for the bankruptcy court is whether such distribution is a "true gift" because it is made from the secured creditor's property or is disguised priority-skipping because the distribution is made from estate assets.[236] Market exposure of the estate's assets resolves

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[231] *See, e.g.*, *In re* O'Brien Environmental Energy, Inc., 181 F.3d 527 (3d Cir. 1999) (considering whether proposed break-up fee would encourage bidding on the debtor's assets, and thus maximize value, or would instead chill that bidding by driving away prospective competing bidders to the detriment of the debtor's estate and creditors).

[232] *See, e.g.*, Bank of Am. Nat'l Tr. & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 444 (1999) (citing H.R. Doc. No. 93-137, pt. I, p. 255 (1973) (discussing concern with "the ability of a few insiders, whether management or major creditors, to use the reorganization process to gain an unfair advantage")); *In re O'Brien Environmental Energy, Inc.,* 181 F.3d at 536 (asking whether the relationship of the parties who negotiated the break-up fee was "tainted by self-dealing or manipulation").

[233] *See, e.g.*, 6004-1; *In re* Family Christian, LLC, 533 B.R. 600 (Bankr. W.D. Mich. 2015).

[234] *See, e.g.,* Roe & Skeel, *supra* note 159, at 747 (criticizing the bidding procedures in *Chrysler* for discouraging competing bids, including by requiring a competing bid to "conform substantially to the terms set out in the Treasury's proposed Purchase Agreement," prohibiting bidders from bidding on Chrysler's assets free of its liabilities, and restricting bids "on other configurations of a reorganized Chrysler.").

[235] *In re* ICL Holding Co., Inc., 802 F.3d 547, 555 (3d Cir. 2015) ("The Code's distribution rules don't apply to nonestate [sic] property.").

[236] *Id.*

this issue in many cases.[237] Once the senior secured creditor's share of the estate has been determined by a market sale and its share of the sale proceeds have been distributed (or held for ultimate distribution) to it, any payment made by it to others is a true gift.[238] By contrast, a hypothetical valuation of the secured creditor's collateral, and an allocation of part of that value to a junior stakeholder, fails to resolve the question of priority-skipping because the valuation is speculative.[239]

But while market exposure enables the court to preclude control premiums with respect to the settlement of claims that

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[237] *See, e.g.*, *Bank of Am. Nat'l Tr. & Sav. Ass'n*, 526 U.S. at 455–56 (requiring the opportunity given to insiders to acquire the equity interests in the reorganized debtor to be subjected to competing, potentially higher bids by third parties).

[238] In *In re* ICL Holding Co., Inc., decided by the Third Circuit contemporaneously with its Jevic decision, the debtor tried to sell its assets to at least seven potential "suitors." The highest third-party bid reflected a recovery to the debtor's secured lenders of only 80–85 percent of their debt. The secured lenders exercised their right to credit bid under Code section 363(k), and credit bid 90 percent of the face amount of their debt, which was the highest bid for the debtor's assets. The bidding fixed the value of the estate's assets (including the debtor's cash on hand) at 90 percent of the secured lenders' claim, which is the amount that they paid for the assets pursuant to the credit bid. But a secured creditor whose winning bid is less than the amount of its claim pays for the assets it purchased by reducing its secured claim by the amount of the credit bid, and pays no cash to the estate. So, upon the secured lenders' successful credit bid, they owned the assets of the estate without having to pay any cash for them and nothing was left of the estate. Thus, the up to $1.8 million to be paid from the cash on hand to the debtor's and the creditors committee's lawyers and accountants was not property of debtor's estate, and the secured lenders' agreement to pay such sum was a "true gift." *In re* ICL Holding Co., Inc., 802 F.3d at 550–51, 555–56.

[239] *In re* Armstrong World Indus., Inc., 432 F.3d 507, 509, 514 (3d Cir. 2005) (finding that none of the distributions of estate property had been exposed to the market). The plan in *Armstrong* provided for a distribution to a class of unsecured creditors, who would waive their distribution in favor of the owners of the common stock of the debtor. The bankruptcy court confirmed the plan. The district court reversed, distinguishing a payment by a secured creditor with a perfected lien because in such case the collateral is not estate property subject to distribution under the Code's absolute priority rule, and the payment is a "carve out" being made from "a portion of its lien proceeds." The Third Circuit affirmed the district court's reversal of plan confirmation. *In re Armstrong*, 432 F.3d at 514.

are purely within the estate, and to determine whether a priority-skipping payment is a "true gift," the problem becomes more difficult if the proposed settlement or gift includes rights that do not strictly belong to the estate.[240] Some settlements involving multiple parties may provide for distributions of assets in which both the estate and another party has an interest, and thus are outside of what some commentators have described as the "bankruptcy partition."[241] The structured dismissal in *Jevic* arguably extended beyond the partition in one aspect, because by the bankruptcy court's approving it the drivers lost the power to bring their own avoidance action against Sun Capital and CIT based on the same leveraged buyout.[242] This problem likely will involve a fairly small percentage of settlements and other transactions, though in some cases it will be very difficult to resolve.[243]

Standing issues pose special problems. Questions regarding an assignee's standing or authority to prosecute a claim may suppress the market for the outright purchase of claims from a chapter 11 debtor. The outright sale of certain kinds of claims, such as a receivable or other contract claim, normally gives standing to the purchaser.[244] Sales of avoidance actions (such as the one in *Jevic*) or tort claims, though, can present special standing issues because some courts have interpreted the Code to limit the prosecution of avoidance actions to the trustee or debtor in possession

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[240] *See* Baird et al., The Bankruptcy Partition (Univ. of Chi. Coase-Sandor Inst. for Law & Econ., Research Paper No. 848, 2018), https://ssrn.com/abstract=3110210 or http://dx.doi.org/10.2139/ssrn.3110210.

[241] *Id.*

[242] *Czyzewski*, 137 S. Ct. at 983.

[243] Baird et al., *supra* note 240, at 5. Moreover, bankruptcy jurisdiction is essentially *in rem*. Cent. Va. Cmty. Coll. v. Katz, 546 U.S. 356 (2006). Accordingly, the court's jurisdiction and authority over property that is not property of the bankruptcy estate is highly problematic.

[244] 6 Am. Jur. 2d § 134 (Aug. 2018 update) (assignee "stands in the shoes of the assignor" and has standing to prosecute claim); 6A C.J.S. Assignments §§ 88, 94 (Sept. 2018 update) ("A valid assignment generally operates to vest in the assignee the same right title, or interest that the assignor had in the thing assigned," and in "most states, in the absence of a contrary intention, an assignee acquires the same rights as the assignor to protect and enforce the assigned rights, including the right to maintain a civil action."); Uniform Commercial Code § 9-404 (receivables); 29 Williston on Contracts § 74:56 (4th ed.) (under U.C.C. section 9-404, "just as was the case under the common law and under the earlier version of the [Uniform Commercial Code], the assignee steps into the shoes of the assignor").

(excluding a purchaser of the claim),[245] or because the transfer might be champertous or "meddlesome" under state law.[246]

But courts increasingly allow the sale of such a claim in a bankruptcy proceeding when doing so is in the best interest of estate and its creditors.[247] Some courts have held that a debtor

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[245] 11 U.S.C. § 547(b), 548(1)(a) (2012); Harris Winsberg & Michele J. Kim, *Unlocking Value: Can a Trustee Sell Avoidance Claims Grounded in Section 544(B), 547 or 548 of the Bankruptcy Code?*, 22 No. 2 J. BANKR. L. & PRAC, NL 2 ART. 2 (2013).

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> "Maintenance" at common law is "an officious intermeddling in a suit that in no way belongs to the meddler, and signifies an unlawful taking in hand, or upholding of quarrels or sides, to the disturbance or hindrance of common right." "Champerty" is a species of maintenance and "is the unlawful maintenance of a suit in consideration of part of the matter in controversy." Traditionally, at common law, maintenance and champerty of personal injury tort claims has been forbidden based on a policy that protected the injured party "so that an unrelated third-party cannot reap a windfall by paying the injured party a pittance for the claim and then prosecute litigation for injuries that the party never suffered."

In re Brown, 354 B.R. 100, 105 (Bankr. N.D. W. Va. 2006).

[247] *See, e.g.*, *In re* Moore, 608 F.3d 253, 257 (5th Cir. 2010) ("As a general matter, a trustee may sell causes of action belonging to the estate."); *In re* Mickey Thompson Ent. Group, Inc., 292 B.R. 415, 421–22 (B.A.P. 9th Cir. 2003) (equating a settlement of a debtor's litigation claim with the sale of the claim to the defendant, and holding that, when confronted with a motion to approve a settlement of a claim, "a bankruptcy court is obliged to consider, as part of the 'fair and equitable' analysis" applicable to Rule 9019 settlements, whether the claim "might draw a higher price through a competitive process and be the proper subject of a section 363 sale"); William P. Weintraub & Barry Z. Bazian, *Avoiding the Avoidable: The Uncertainty of Selling Avoidance Actions*, 26 No. 6 J. BANKR. L. & PRAC. NL ART. 2 (2017) ("Several recent decisions have held that a trustee was not permitted to assign avoidance claims to a creditor that wanted to pursue the claims for the creditor's own benefit. These decisions suggest that the result may have been different had the trustee or creditor requested derivative standing to pursue the claims on behalf of the estate."); Winsberg & Kim, *supra* note 245, at 2 (courts approve such sales under two primary approaches: (1) granting derivative standing to the claims purchaser, if the suit by the purchaser is in the best interest of the estate and is necessary and beneficial to the fair and efficient resolution of the bankruptcy proceeding, or if the purchaser is pursuing interests common to all creditors, and allowing the purchaser to pursue the claim will benefit the remaining creditors; and (2) analyzing the sale under Bankruptcy Code section 363(b), and authorizing the sale if the debtor has articulated a business justification, good business judgment, or sound business reasons for the proposed sale, and the sale price is the highest and best offer).

or trustee *must* consider a higher bid from a third party for a claim that its proposes to settle with the defendant.[248] The doctrines of champerty and maintenance likely do not apply to marketing the claims to a litigation financier, or to a purchaser of a percentage of any recovery on the claim, or to a contingency fee law firm, which process can provide the market exposure necessary to prevent the payment from the estate of premiums based on control.[249]

There also are times when market exposure cannot be obtained or will be limited. Such exposure will be limited, for example, at the first-day hearing in a chapter 11 bankruptcy case. I suggest in the next Part that a different rule is preferable at that time.

III. THE TEMPORAL SWAY OF THE ABSOLUTE PRIORITY RULE—FIRST-DAY ORDERS AND THE DIFFICULTY OF MAKING A HYPOTHETICAL VALUATION OF ULTIMATE ESTATE VALUE AND PLAN DISTRIBUTIONS EARLY IN A CHAPTER 11 CASE

A crucial aspect of the Court's decision in *Jevic* is what the Court did *not* do.[250] *Jevic* does not restrict the bankruptcy courts' authority to approve priority-skipping first-day transfers on account of certain prepetition claims, including to employees, to customers, to certain suppliers who are critical to the chapter 11 debtor's

[248] *See, e.g., In re* Mickey Thompson Ent. Group, Inc., 292 B.R. at 420–22.

[249] *See, e.g.,* Charge Injection Tech. Inc. E.I. DuPont De Nemours & Co., C.A. No. N07C-12-134-JRJ, 2016 WL 937400, at *3–4 (Del. Super. Ct. 2016) (holding that a litigation financing agreement, under which the defendant alleged that the borrower had "signed away all rights to litigation proceeds," but which the court found gave the litigation funder no right to direct, control, or settle the claims, was not a champertous assignment because "there was no assignment" and the original plaintiff remained the bona fide owner of the claims;" nor was it "maintenance involv[ing] officious intermeddling … for purposes of stirring up litigation and strife"). *See also* Carmel, *supra* note 35, at 17 ("Although there has only been a limited number of litigation-finance arrangements in bankruptcy to date, nothing prevents a debtor from entering into such an arrangement with bankruptcy court approval if necessary. Simply put, a debtor's meritorious litigation claims are assets, and litigation finance is often the best way to maximize the value of those assets."); Kevin LaCroix, *Delaware Court Rejects Challenge to Litigation Funding Arrangement*, LITIG. FIN. (Mar. 23, 2016), https://www.dandodiary.com/2016/03/articles/litigation-financing-2/delaware-court-rejects-challenge-to-litigation-funding-arrangement/ [https://perma.cc/CSV3-SQN5].

[250] *See infra* text accompanying notes 258–59.

operations, or to a secured lender who, it is proved to the court's satisfaction, is willing to advance needed postpetition funds only pursuant to a "roll-up," under which the lender's prepetition claim is paid down first from the debtor's postpetition operating revenues.[251] It also did not resolve the split between jurisdictions that apply the doctrine of necessity and those that apply the *Kmart* rule in determining whether to approve first-day relief.[252]

Part III considers, first, the reasons for first-day relief, and, second, the circuit split on priority-skipping first-day relief.[253] It then parses the difficulty of determining eventual enterprise value and distributions to creditors under a hypothetical plan, as required by *Kmart*.[254]

Because, in nearly all cases, this determination will be based on conjecture, this Part concludes that the rule going forward should presume the benefit of preserving the debtor's business as a going concern. It should require, though, that the chapter 11 debtor prove (as is required by the doctrine of necessity) that it diligently has sought alternative suppliers in the market, and has failed to obtain them.

This approach addresses the excessive first-day relief of which some critics, rightfully, complain.[255] It does so without engaging in the unreliable predictions of ultimate distributions required by *Kmart*, and without sacrificing the going concern value, supplier relationships and jobs that first-day relief preserves.

A. Why First-Day Relief in Chapter 11?

First-day relief has become a common feature of chapter 11 practice.[256] Hope springs eternal, or nearly so, for many chapter 11 debtors at the beginning of a bankruptcy case. Chapter 11

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[251] *Czyzewski,* 137 S. Ct. at 986 (citing DOUGLAS G. BAIRD, ELEMENTS OF BANKRUPTCY 232–34 (6th ed. 2014); Mark J. Roe & Frederick Tung, *Breaking Bankruptcy Priority: How Rent-Seeking Upends the Creditors' Bargain*, 99 VA. L. REV. 1235, 1250–64 (2003)).

[252] *See* Roe & Tung, *supra* note 251, at 1255–57.

[253] *See infra* Section III.A & B.

[254] *See infra* text accompanying notes 335–77.

[255] *See infra* Section III.B.

[256] *See generally* DEBRA L. GRASSGREEN ET AL., FIRST DAY MOTIONS: A GUIDE TO THE CRITICAL FIRST DAYS OF A BANKRUPTCY CASE (3d ed. 2012) for a comprehensive treatment of first-day relief.

gives a struggling business the prospect of a better future, in which insurmountable debt is restructured and reduced, and the reorganized debtor returns to profitability.[257]

The chapter 11 debtor, though, is in a vulnerable position early in the case. Many of the debtor's employees, customers, suppliers, and lenders may have lost confidence in the enterprise and are intent on reducing their own losses and risk, using whatever leverage they have. Yet the debtor needs the labor, custom, and credit of certain key counterparties to persist and to reorganize. First-day relief can be essential to the debtor's maintaining its operations for long enough for it to sell its business as a going concern or otherwise reorganize in chapter 11.[258]

First-day motions typically are filed by a chapter 11 debtor with its voluntary petition.[259] Court approval is required.[260] Bankruptcy courts regularly enter first-day orders following the first hearing in the case, held within a day or two of the filing of the case.[261] Common first-day orders include those that permit

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[257] *Id.*

[258] *See, e.g.*, *In re* The Colad Group, Inc., 324 B.R. 208, 212 (Bankr. W.D.N.Y. 2005) ("In bankruptcy practice, the phrase 'first day motions' refers generally to any of a variety of requests made shortly after the filing of a chapter 11 petition, for prompt authorizations needed to facilitate the operation of the debtor's business.").

[259] John D. Ayer et al., *The Life Cycle of a Chapter 11 Debtor Through the Debtor's Eyes: Part I*, ABI J. (Sept. 2003).

[260] Court approval is required under various Code provisions. Code section 363(c) requires court approval of the chapter 11 debtor's use of cash in which another party, such as the debtor's secured lender has a lien. 11 U.S.C. § 363(c). Code section 364 requires court approval of postpetition secured financing and other extensions of credit, other than credit (such as trade credit) that is in the ordinary course of the debtor's business. *Id.* § 364. Courts restricting a chapter 11 debtor's ability to pay unsecured prepetition claims prior to the final distributions in the case have cited the Code's silence regarding authority rather than an express prohibition in the Code. *See, e.g.*, *In re Kmart Corp.*, 359 F.3d at 871.

[261] First-day hearing procedures and orders are authorized by the local bankruptcy rules of many jurisdictions. Many bankruptcy courts schedule the hearing on these first-day motions for the first or second business day after the case is filed. *See, e.g.*, Del. Bankr. L.R. 9013-1(m) (2017) (providing for consideration by the court of motions filed with, or contemporaneously with, the chapter 11 petition, on less than seven days' notice, provided that they are "confined to matters of a genuinely emergent nature required to preserve the assets of the estate and to maintain ongoing business operations and such other

the debtor to pay critical vendors on account of their prepetition claims;[262] to honor prepetition customer warranties, credits, gift cards and promotions;[263] and to pay prepetition wages to honor paid time off and other benefits earned prepetition by the debtor's employees.[264]

B. The Circuit Split on Priority-Skipping First-Day Relief—The Doctrine of Necessity and Kmart

These payments and transfers usually are priority-skipping at the time they are made.[265] A payment to a critical vendor on account of its non-priority prepetition claim, for example, skips over

matters as the Court may determine appropriate"); Bankr. S.D.N.Y. 1002-1(b) (providing that "[t]o the extent practicable, when a prospective chapter 11 debtor or chapter 15 petitioner anticipates the need to seek orders for immediate relief, counsel for the debtor or petitioner shall contact the United States Trustee and the Clerk prior to filing a voluntary petition for relief under chapter 11 or chapter 15 of the Bankruptcy Code, for the purpose of advising the United States Trustee and the Clerk of the anticipated filing of the petition (without disclosing the identity of the debtor or petitioner) and the matters on which the debtor or petitioner intends to seek immediate relief"; Bankr. S.D. Fla. 9013-1(F) (providing that first-day motions, including those for authority to use cash collateral, for approval of postpetition financing, for authority to pay postpetition wages outstanding on the petition date, for authority to maintain prepetition bank accounts, and for authority to pay prepetition claims based on the "doctrine of necessity," shall be scheduled within two business days, if reasonably possible).

[262] Critical vendors "are commonly defined as essential vendors or suppliers who are indispensable to the debtor's business—either because of the types of goods or services they supply, their knowledge of the debtor's business, or some other unique aspect to the business relationship—and without whom the debtor likely cannot achieve a successful reorganization." *ABI Report*, *supra* note 9, at 97. Most critical vendor claims are general unsecured claims and are junior to unsecured priority claims under Code § 507(a).

[263] Most customer claims are general unsecured claims and are junior to administrative expense claims and other unsecured claims that have priority under Code § 507(a). *See* 11 U.S.C. § 507(a) (2012).

[264] Employee claims for salary and wages are fourth priority unsecured claims pursuant to § 507(a)(4), subject to a $12,850 per employee cap, and employee benefit claims are fifth priority unsecured claims pursuant to § 507(a)(5), subject to a different cap. Both claims are junior to administrative expense claims and other unsecured claims that have a higher priority unsecured under Code § 507(a). *See* 11 U.S.C. § 507(a)–(b) (2012).

[265] *See ABI Report*, *supra* note 9, at 101.

holders of priority unsecured claims.[266] Payment to an employee on account of her lower priority claim for prepetition salary and benefits skips over administrative expense claimants (including the debtor's and the creditors committee's lawyers) who have a higher priority.[267] All of these claims paid pursuant to first-day orders also are junior to secured claims to the extent of the value of each secured party's collateral.[268]

The reasons given for priority-skipping first-day orders vary somewhat, depending on the type of payment or transfer. If a supplier or service provider who provides an essential product or service to the debtor is not paid, it will cease providing the debtor with the goods or services;[269] if credits owed to customers, or gift cards and promotions, are not honored, the debtor will lose its customers;[270] and if employees are not paid what the debtor owes them on the first payday after the commencement of the case,

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[266] *See id.* at 98, n.337.

[267] *See id.* at 98.

[268] "Property interests are created and defined by state law" in a bankruptcy case, under the Supreme Court's holdings in Butner v. United States, 440 U.S. 48, 54–55 (1979) (1898 Act case) and Nobelman v. Am. Sav. Bank, 113 S. Ct. 2106, 2109 (1993) (1978 Code case, following *Butner*). In a debtor's bankruptcy proceeding, state law establishes the extent, validity, and priority of liens and other interests in the debtor's property. Thus, under bankruptcy's distributional priorities, the secured creditor who holds a lien is entitled to payment of its claim up to the amount of the value of its collateral prior to any payment to unsecured creditors, such as the debtor's employees and customers, whose claims are unsecured.

[269] *See, e.g.*, *In re* Just for Feet, Inc., 242 B.R. 821, 826 (D.Del. 1999)

> Clearly, Just for Feet cannot survive unless it has name brand sneakers and athletic apparel to sell in its stores. The Debtors need a continuous supply of inventory from athletic footwear and apparel vendors such as Nike, New Balance, Fila, Reebok, Adidas, Asics, K-Swiss and Converse. Rockey testified that without new merchandise from these vendors, Just For Feet will not survive. Therefore, the court finds that payment of the prepetition claims of certain trade vendors—the athletic footwear and apparel vendors—is essential to the survival of the debtor during the chapter 11 reorganization.

[270] *See, e.g.*, *In re* Hawker Beechcraft, Inc., 486 B.R. 264, 272 (Bankr. S.D.N.Y. 2013) (first-day customer programs motion approved on testimony that "[a]ny interruption or discontinuation of the Customer Programs risks the permanent loss of certain customers.").

they will quit.[271] But the underlying rationale is consistent: in most cases the debtor and its creditors are better off if the court preserves the debtor's operations and going concern value by authorizing the payment.[272]

The temporal distinction between transfers made under first-day orders, the authority for which the *Jevic* Court did not disturb, and distributions made pursuant to case-ending settlements, which was the focus of the Court, is clear.[273] The ultimate outcome of the case, with respect to the debtor's creditors and equity holders and the very survival of the company, is speculative at the start of the case.[274] The value of the debtor, its assets, and the distributions that will be made to creditors at the end of the case if the debtor continues to operate its business and reorganizes under a plan are highly speculative.[275] Indeed, some commentators have described it as "axiomatic" that valuations are uncertain at the moment that a debtor files for bankruptcy.[276]

At the time of a structured dismissal or other end-of-case distribution, by contrast, the die is cast. It is clear at the end of the case whether some junior creditors or equity holders are receiving a distribution prior to payment in full to senior creditors in a manner that is inconsistent with the absolute priority rule.[277]

Moreover, end-of-case transfers normally have no effect on the debtor's survival or longer-term profitability.[278] The purpose

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[271] *ABI Report*, *supra* note 9, at 102 (recognizing that first-day employee compensation motions "are often noncontroversial and ultimately granted by the court," because "[m]any courts, debtors, and commentators recognize the value to the debtor of receiving uninterrupted service from its employees.").

[272] *See id.* at 184, 235 n.792.

[273] *See Czyzewski*, 137 S. Ct. at 985–86 (discussing priority-violating distributions and first day wage orders).

[274] *See id.* at 986 (stating that the results of the case are speculative).

[275] *See ABI Report*, *supra* note 9, at 11 n.40 (discussing the uncertainty and inefficiencies of the chapter 11 process).

[276] Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 YALE L.J. 862, 896 (2013). Others have concluded that "[n]onmarket valuations are necessarily imprecise," even at the end of the case when the plan has been formulated, "and the judge can do little more than find that any particular plan falls within a broad range of reasonable." Douglas G. Baird, *Bankruptcy's Quiet Revolution*, 91 AM. L.J. 593, 594 (2017).

[277] *See* Jacoby & Janger, *supra* note 276, at 890 (absolute priority rule).

[278] *See id.* at 880 (discussing cases such as *Lionel*, where creditors failed to illustrate the need for speedy transfers).

of preserving going concern value by priority-skipping transfers often is gone at the end of the case.[279] That upside, by then in most cases, has been captured or lost.[280]

The *Jevic* Court left undisturbed the bankruptcy courts' authority to grant priority-skipping first-day relief, recognizing that "one can generally find significant Code-related objectives" that the priority-violating first-day transfers serve.[281] The Court reasoned that the bankruptcy courts granting such relief "have usually found that the distributions at issue would 'enable a successful reorganization and make even the disfavored creditors better off.'"[282]

The *Jevic* Court shied away from going further though. In particular, the Court did not address the circuit split over the two primary rules under which bankruptcy courts grant first-day relief: the doctrine of necessity, which is applied in the Third Circuit and other courts,[283] and the *Kmart* standard, applied by

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[279] *See id.* at 881, 894 (elaborating on concern values and speed premiums in bankruptcy sales).

[280] *See id.* at 891 n.115, 894 (analyzing going-concern value and the means to preserve it).

[281] *Czyzewski*, 137 S. Ct. at 985.

[282] *Id.* (quoting *In re Kmart Corp.*, 359 F.3d at 872).

[283] *In re Penn Cent. Transp. Co.*, 467 F.2d at 102 n.1 (Act case)

> A number of cases declare a so-called 'necessity of payment' exception to the normal deferment of the payment of pre-reorganization claims until their disposition can be made part of a plan of reorganization. These cases permit immediate payment of claims of creditors where those creditors will not supply services or material essential to the conduct of the business until their pre-reorganization claims shall have been paid.

In re Just for Feet, Inc., 242 B.R. at 824 (Code case). Case law tends to use the term "doctrine of necessity" and "necessity of payment rule" interchangeably, and I have done so in this Article. Some commentators have drawn a distinction between the doctrine of necessity, which more precisely applies in chapter 11 "to authorize the postpetition payment of prepetition employee wages, benefits and services when the failure to make those payments would be catastrophic," and the necessity of payment rule, which more precisely applies in railroad reorganizations to authorize the trustee "to pay claims where such payment is exacted as the price of providing goods or services indispensably necessary to continuing the rail service." Russell A. Eisenberg & Frances F. Gecker, *The Doctrine of Necessity and Its Parameters*, 73 MARQ. L. REV. 1, 2–3 (1989) (quoting *In re* Boston & Maine Corp., 634 F.2d 1359, 1382 (1st Cir. 1980), *cert. denied*, 450 U.S. 982 (1981)). The two rules:

> share the same underlying policy rationale. Both principles are premised on the bankruptcy goal of maintaining the prospects for a viable reorganization during the early stages of a case. Both principles embody the fact that there are some prepetition creditors who must be paid immediately because if they are not paid, everyone else will suffer.

Id. at 4. Courts that have followed the "doctrine of necessity" or "necessity of payment rule" in determining whether to authorize pre-plan payments of prepetition claims include: 1st Cir. court cases: Chesapeake & Ohio Ry. Co. v. Boston & Maine Corp. (*In re* Boston & Maine Corp.), 634 F.2d 1359, 1382 (1st Cir. 1980) (Act case)

> [T]he rule is not based on considerations of equity but is a device for handling a threat to the continued operation of the railroad *during reorganization* ... it would not be a rule conferring a right of recovery on the claimant but a rule of exculpation, protecting the trustee who paid under economic duress for a supply or service indispensable to continued operation of the railroad.

J.M. Blanco, Inc. v. PMC Mktg. Corp., No. 09-1781(GAG), 2009 WL 5184458, at *5 (D.P.R. 2009) (citing *In re* CoServ, LLC, 273 B.R. 487, 498 (Bankr. N.D. Tex. 2002)) (finding necessity of payment authority in Code section 105(a), which authorizes the bankruptcy court to enter orders "necessary or appropriate to carry out the provisions of" the Bankruptcy Code; the court reasoned that the debtor in possession is a fiduciary, with a duty "to protect and preserve the estate, including an operating business's going concern value," and the bankruptcy court "is authorized to use its equitable powers under section 105(a) in aid of preservation or enhancement of the estate.")*; see also* 11 U.S.C. § 105(a) (2012); *In re* Zenus Is Jewelry, Inc., 378 B.R. 432, 434 (Bankr. D.N.H. 2007) (recognizing doctrine but denying authority to pay critical vendors because the evidence showed that they would supply the debtor on a COD basis). 3d Cir. court cases: *In re* Lehigh & New England Ry. Co., 657 F.2d 570, 581 (3d Cir. 1981) (railroad receivership case) (citing *In re* New York, New Haven & Hartford R.R. Co., 278 F. Supp. 592, 602 n.15 (D. Conn. 1967), *aff'd*, 405 F.2d 50 (2d Cir. 1968), *and cert. denied*, 349 U.S. 999 (1969)) ("[T]he 'necessity of payment' doctrine ... teaches no more than, if payment of a claim which arose prior to reorganization is essential to the continued operation of the railroad during reorganization, payment may be authorized even if it is made out of corpus."); *In re Penn Cent. Transp. Co.*, 467 F.2d at 104; *In re Just for Feet, Inc.*, 242 B.R. at 824–25 (Code case); *In re* Columbia Gas Sys., Inc., 171 B.R. 189, 191–92 (Bankr. D. Del. 1994) (Code case). 4th Cir. court cases: *In re* Synteen Tech., Inc., No. 00-02203-W, 2000 WL 33709667, at *2 (Bankr. D.S.C. 2000) (critical vendor payments); *In re* NVR L.P., 147 B.R. 126, 128 (Bankr. E.D. Va. 1992) (recognizing the necessity of payment doctrine but declining to authorize the payments because the threat posed by non-payment was "too remote and speculative to justify invoking" the doctrine). 5th Cir. court cases: *In re* CEI Roofing, Inc., 315 B.R. 50, 60 (Bankr. N.D. Tex. 2004) (authorizing first-day wage order on the ground that prepetition wage claims have the Seventh Circuit and other courts, which requires a showing that the creditors who do not receive first-day payments will be as well off in the reorganization which the first-day payments purportedly enable, as they would be in the liquidation that might result if the first-day payments were not made to the favored creditors.[284]

The difference between the two rules is fairly simple: the doctrine of necessity presumes a benefit in the debtor's continuing to operate while the *Kmart* rule requires proof of it.

The necessity of payment doctrine had its origin in the equity receiverships by which railroads were reorganized prior to the enactment of the reorganization provisions of the Bankruptcy Act in the 1930s.[285] The doctrine permits "immediate payment of

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priority under Code section 503(a) (3), without considering whether the payment might ultimately result in priority-skipping, e.g., because senior, administrative expense claims ultimately might not be fully paid); *In re* CoServ, LLC, 273 B.R. 487, 498 (Bankr. N.D. Tex. 2002) (*CoServ* is best characterized as a variant of the necessity of payment doctrine: "First, it must be critical that the debtor deal with the claimant. Second, unless it deals with the claimant, the debtor risks the probability of harm, or, alternatively, loss of economic advantage to the estate or the debtor's going concern value, which is disproportionate to the amount of the claimant's prepetition claim. Third, there is no practical or legal alternative by which the debtor can deal with the claimant other than by payment of the claim."); *see also* B & W Enter. v. Goodman Oil Co. (*In re* B & W Enter.), 713 F.2d 534, 537 (9th Cir. 2010) (declining to extend the necessity of payment doctrine beyond railroad cases to a trucking company)

> Absent compelling reasons, we deem it unwise to tamper with the statutory priority scheme devised by Congress in the 1978 Act. ... Even if we were convinced that the Necessity of Payment Rule survived the 1978 Act, appellants have not presented to this court sufficient justification for extending the Necessity of Payment Rule to trucking reorganizations.

In re EcoSmart, No. 2:15-bk-27139-RK, 2015 WL 9274245, at *9 (Bankr. C.D. Cal. 2015) (only priority prepetition claims, such as employee claims, may be paid immediately postpetition under the doctrine of necessity).

[284] *See In re Kmart Corp.*, 359 F.3d at 872 (requiring the debtor to show that "that the disfavored creditors will be as well off with reorganization as with liquidation—a demonstration never attempted" in *Kmart* (emphasis in original)); *see also In re* Tropical Sportswear Int'l Corp., 320 B.R. 15, 17–18 (Bankr. M.D. Fla. 2005); *In re* Corner Home Care, Inc., 438 B.R. 122, 126–27 (Bankr. W.D. Ky. 2010); *In re* Jeans.com, Inc., 502 B.R. 250, 253 (Bankr. D.P.R. 2013); *In re United Am.*, 327 B.R. at 781–82, 784 (Bankr. E.D. Va. 2005).

[285] *See, e.g.*, Gregg v. Metro. Tr. Co., 197 U.S. 183, 193 (1905) ("Many circumstances may exist which may make it necessary and indispensable to the

claims of creditors where those creditors will not supply services or material essential to the conduct of the business until their pre-reorganization claims have been paid."[286] Under the necessity of payment doctrine, if a prepetition creditor, by refusing to deal with the debtor during reorganization unless its prepetition claims are paid, "threatens to make continued operations impossible," then "as a matter of economic necessity" the debtor in possession "may properly be permitted to pay such claims, even out of the corpus of the estate."[287] The benefit of the debtor's continued operations is presumed.[288]

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business of the road and the preservation of the property, for the receiver to pay pre-existing debts of certain classes, out of the earnings of the receivership, or even the corpus of the property, under the order of the court, with a priority of lien. Yet the discretion to do so should be exercised with very great care."); Miltenberger v. Logansport Ry. Co., 106 U.S. 286 (1882). The Chandler Act amended the 1898 Bankruptcy Act to comprehensively provide for the confirmation of plans that enabled a reorganization pursuant to chapters X (corporate reorganizations), XI (arrangements), XII (real property arrangements for persons other than corporations), and XIII (wage earners' plans). Other 1930s amendments to the Bankruptcy Act included chapter IX (for the reorganization of municipalities) and section 77 of the Railroad Reorganization Act of 1935 (for the reorganization of railroads). *See generally* Chandler Act of 1938, Pub. L. No. 75-696, 52 Stat. 840 (1938) (incorporating the 1934 Amendments and comprehensively enacting reorganization and plan provisions for business entities and individuals) (referred to in text as "Chandler Act"); Municipal Reorganizations, ch. 657, 50 Stat. 653 (1937); Railroad Reorganization Act of 1935, ch. 774, 49 Stat. 911 (1935); 1934 Amendments to Bankruptcy Act, Pub. L. No. 73-486, 48 Stat. 1289 (1934) (enacting corporate reorganization provisions, including § 77(B) for plan confirmation).

[286] *In re Just for Feet, Inc.*, 242 B.R. at 825 (Code case) (quoting *In re Penn Cent. Transp. Co.*, 467 F.2d at 102 n. 1 (Act case)).

[287] *In re* Penn Cent. Transp. Co., 458 F. Supp. 1234, 1326 (E.D. Pa. 1978). Of course, the necessity of payment rule has special application to railroad insolvency. The purposes of railroad insolvency proceedings under the equity receiverships, which gave rise to the necessity of payment rule, went beyond paying creditors in accordance with distributional priorities. They included the public's interest in the continuation of the railroad. *See, e.g.*, Miltenberger v. Logansport Ry. Co., 106 U.S. 286, 311–12 (1882) (authorizing payment of prepetition claims to creditors who threatened not to furnish supplies on credit, unless they were paid the arrearages, because otherwise "the business of the road would suffer great detriment," and "the public interest in such a highway for public use as a railroad" would suffer). Congressional protection of the public's interest in a railroad's continued operations is reflected, even today, in several provisions of the Code. A railroad is not eligible to be a debtor under chapter 7, because under chapter 7 the debtor's operations cease (unless

The Seventh Circuit in *Kmart* rejected this presumption and required a debtor requesting court approval of priority-skipping first-day payments to prove ultimate benefit to the disfavored creditors.[289] Under the *Kmart* rule, the debtor must show not only that the suppliers of goods or services are critical to the debtor's operations and would cease deliveries if they are not paid on account of their prepetition claims, but also that "the disfavored creditors *will* be as well off with reorganization as with liquidation."[290]

The *Kmart* rule arose in a case in which the debtor had pushed the doctrine of necessity to, and arguably beyond, its limit.[291] The bankruptcy court in *Kmart* had authorized the payment in full for the prepetition claims of 2,330 of the debtor's "critical" suppliers at a total cost of $300 million.[292] Another 2,000 suppliers were not deemed "critical."[293] They and 43,000 other unsecured creditors, who also were not deemed critical, ultimately received only 10¢ on the dollar on account of their claims in the form of stock in the reorganized *Kmart*, as compared with the full payment afforded to the 2,330 "critical" vendors.[294]

The Seventh Circuit held that a bankruptcy court does not have the "discretion to set aside the Code's rules about priority and distribution" when it determines whether to grant first-day relief.[295] It rejected the doctrine of necessity as "just a fancy

continued by court order, "for a limited time," pursuant to Code § 721), and the debtor's assets are liquidated. *See* 11 U.S.C. §§ 109(b) (1), 721 (2012). A railroad *is* eligible to file and reorganize under chapter 11, but the court is required by the Code to consider the public interest—in addition to the interests of the debtor, its creditors and equity holders—in deciding whether the railroad will reorganize or liquidate, and other key matters in the case. *See* 11 U.S.C. § 1165 (2012). In particular, the abandonment of a line and the confirmation of a plan must be consistent with the public interest. *See* 11 U.S.C. § 1170(a)(2) (2012); *see also* 11. U.S.C. § 1173(a)(4) (2012).

[288] *See Czyzewski*, 137 S. Ct. at 978–79.

[289] *In re Kmart Corp.*, 359 F.3d at 873.

[290] *Id.*

[291] *See id.* at 868.

[292] *Id.* at 869.

[293] *Id.*

[294] *Id.*

[295] *In re Kmart Corp.*, 359 F.3d at 871. The court focused in particular on § 105(a), which "allows a bankruptcy court to 'issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of' the Code," and held that this section of the Code does not authorize priority-skipping. *Id.*

name for a power to depart from the Code."[296] In the Seventh Circuit's view, the doctrine of necessity was no longer good law because it had been supplanted by the provisions of the Code.[297]

The Seventh Circuit proceeded to formulate a rule that requires the debtor to show the benefit to the disfavored creditors of the reorganization that the first-day payment ostensibly would enable.[298] The debtor had made no such showing to the bankruptcy court, and the Seventh Circuit reversed.[299]

Several bankruptcy courts have embraced *Kmart*.[300] Some have altered the rule somewhat to require the debtor to show that the disfavored creditors eventually will be at least as well off as a result of the first-day payments having been made, regardless of whether the debtor reorganizes or is liquidated.[301]

Critics of excessive first-day relief express sound concerns.[302] *Kmart*'s payment of $300 million to 2,300 creditors designated "critical" by the debtor is their poster child.[303]

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[296] *Id.*

[297] *Id.*

[298] *See id.* at 873.

[299] *See id.* at 873–74. The court likened its test to the "best interest of creditors" rule, under which any creditor who voted against a chapter 11 plan can block confirmation of the plan if it would receive less under the plan than it would receive in a chapter 7 liquidation. *See* 11 U.S.C. § 1129(a)(7)(A) (2012).

[300] *In re Tropical Sportswear Int'l Corp.*, 320 B.R. at 20 (payment of prepetition amounts to critical vendors can be authorized only if: "(1) those critical vendors are indeed critical and have refused to do business with a debtor absent payment; and (2) only if the court finds that the disfavored creditors will be at least as well off as a result of the court's granting critical vendor status to the select vendors."); *In re Corner Home Care, Inc.*, 438 B.R. at 127, 129 (citing *Kmart* approvingly and applying *United American* rule); *In re Jeans.com, Inc.*, 502 B.R. at 257 (adopting rule of *Tropical Sportswear Int'l Corp.*); *In re United Am.*, 327 B.R. at 781–82, 784 ("If there is to be a Doctrine of Necessity, it must be narrowly construed and sparingly applied," and include a finding that "the favorable treatment of the critical vendor must not prejudice other unsecured creditors.").

[301] *Id.*

[302] Roe & Tung, *supra* note 251, at 1255; Christopher D. Hunt, Note, *Not-So-Critical Vendors: Redefining Critical Vendor Orders*, 93 KY. L.J. 915, 935 (2004–2005) ("Critical vendor orders should be eliminated. The only place in the Bankruptcy Code where their use can be justified is in railroad company petitions.").

[303] *In re Kmart Corp.*, 359 F.3d at 869.

Critical vendor practice, in the words of some commentators, has "mushroomed, with critical vendor (and roll-up) orders disposing of major portions of estate value."[304] To make matters worse, the first-day hearing in a chapter 11 case is held a day or two after the case was filed, on minimal notice to creditors and other parties in interest, without the possibility of objection from an unsecured creditors committee (which has not yet been formed), before the first meeting of creditors has been convened, and, generally, with few parties in the courtroom to advocate for the creditors who might be disfavored by the payments.[305]

The *Jevic* Court, swimming a bit against this tide of criticism, went out of its way to provide support for priority-skipping first-day relief, albeit in dicta.[306] The Court did not resolve the circuit split or draw a distinction between the doctrine of necessity and its presumption of the benefit of "preserv[ing] the debtor as a going concern," and the Seventh Circuit's *Kmart* rule which requires proof that such payments will "make even the disfavored creditors better off."[307] While the Seventh Circuit in *Kmart* laid the blame for excessive first-day relief on the doctrine of necessity, which in its view harmed disfavored creditors and had no basis in the Code,[308] the *Jevic* Court showed no sign that it shared this view.[309]

Since the Court went as far as it did to provide support for first-day relief in chapter 11, it might have gone further in its dicta to suggest a resolution of the circuit split.[310] But it did not and left the issue to the lower courts.[311]

What rule, then, should courts follow for first-day relief post-*Jevic*? I argue in the next Section that the doctrine of necessity's presumption of benefit compares more favorably than its critics acknowledge with the highly speculative hypothetical valuation of ultimate distributions that is required by *Kmart*.

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304 Roe & Tung, *supra* note 251, at 1255; Hunt, *supra* note 302, at 915, 935.
305 *See also* Hunt, *supra* note 302, at 925, 934–35.
306 *See Czyzewski*, 137 S. Ct. 973, 985–86 (2017).
307 *Id.*
308 *See In re Kmart Corp.,* 359 F.3d at 871.
309 *See Czyzewski*, 137 S. Ct. at 984.
310 *Id.*
311 *Id.*

C. Hypothetical Valuations Under the Doctrine of Necessity and Kmart

The necessity of payment doctrine and the Seventh Circuit's *Kmart* rule differ in one material respect.[312] The doctrine of necessity presumes that the debtor's continued operation ultimately will benefit the disfavored creditors.[313] *Kmart*, by comparison, requires the debtor to show that the disfavored creditors will be at least as well off, and the bankruptcy court to find, based on a series of hypothetical valuations, that the disfavored creditors ultimately will not be harmed by the debtor's continued operations.[314]

As the Court noted in *Jevic*, it is difficult in nearly all cases to make meaningful predictions of final distributional outcomes in the first days of a chapter 11 case.[315] I suggest below that the hypothetical valuations required by *Kmart* are so speculative that the presumption of ultimate creditor benefit under the doctrine of necessity is preferable.

1. Presumed Going Concern Value and Disfavored Creditors Under the Doctrine of Necessity

Is the doctrine of necessity, post-*Jevic*, up to the task of protecting the disfavored creditors against the excesses of first-day relief? Likely yes.

The determinations that a court must make with respect to requested first-day relief under the doctrine of necessity are not that speculative. The court must ask whether the debtor's operations will be severely damaged or imperiled if it cannot obtain the critical good, service or credit, and whether the debtor sought and failed to obtain an alternative in the market on the same or better terms than those proposed to be given to the prepetition creditor by the first-day motion.[316] The answers to these questions involve ordinary evidentiary findings of facts that are (or are not) in existence at a time that is contemporaneous with the

[312] *Compare id.* at 986, *with In re Kmart Corp.*, 359 F.3d at 873.
[313] *See Czyzewski*, 137 S. Ct. at 986.
[314] *See In re Kmart Corp.*, 359 F.3d at 873.
[315] *See Czyzewski*, 137 S. Ct. at 983.
[316] *See In re Kmart Corp.*, 359 F.3d at 873.

day of the first-day hearing.[317] Whether a critical vendor has a contractual obligation to continue to supply postpetition under the terms of a contract—and therefore is not legally entitled to refuse to perform—is a matter of law that the court can determine based on the evidence of the contract.[318]

Whether a critical vendor or other creditor, who is not bound by contract, will continue to supply the debtor with goods, services, or credit postpetition if it is not paid the full price that it has demanded, gives rise to a game of chicken that bankruptcy judges regularly play, often with large and well-represented institutions insisting on harsh terms.[319] Sometimes the court balks at entering the order, and the debtor's counterparty walks away for good.[320] More often, the debtor and the counterparty renegotiate and obtain court approval on new terms that are more favorable than those originally proposed by the vendor to the debtor.[321]

The doctrine of necessity presumes that disfavored creditors will benefit, or at the very least will not be harmed, by the debtor's preserving its operations.[322] Congress also made this presumption when it enacted the Chandler Act in 1938 and the Bankruptcy Code in 1978.[323] The *Kmart* rule, in contrast, requires the

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[317] *Id.*

[318] *See id.* A party to a contract with a debtor, who refuses to perform post-bankruptcy unless it is paid on account of a prepetition claim, is in violation of the automatic stay because the party seeking payment is exercising control over property of the estate (the contract). 11 U.S.C. § 362(a)(3) (2012).

[319] *See also In re Kmart Corp.*, 359 F.3d at 873–74.

[320] *See id.* at 873.

[321] The findings required under the doctrine of necessity are, to a significant degree, market-based. A supplier of goods and services who has no contract with a chapter 11 debtor or other counterparty can charge whatever price it can get. That supplier, in most cases, will not have gained the ability to increase its price by rent-seeking in the sense of manipulating public policy or economic conditions as a strategy for increasing profits any more than a wheat farmer does by charging more when wheat is scarce or an airline does when it has nearly filled the plane. The bargain sought by the supplier who is not bound by a prepetition contract, while distasteful to some and perhaps onerous to others, is market-driven.

[322] *See also Czyzewski*, 137 S. Ct. at 977.

[323] The strength of the presumption of the benefit of the preservation of going concern value was recognized by Congress when it enacted the Code, and is stressed by the Supreme Court in its bankruptcy jurisprudence. Indeed, the presumption predates the Code. It was key to the comprehensive enactment

debtor to show, and the bankruptcy court to find, that the creditors not being paid will be as well off under a hypothetical reorganization plan confirmed at the end of the case as they would be under a hypothetical liquidation of the debtor's assets.[324] But on application, the rules are remarkably similar.

First, the doctrine of necessity addresses the abuses of first-day relief in nearly every instance without resort to the hypothetical valuation of end-of-case benefit required by *Kmart*.[325] Indeed, the payments reversed by the Seventh Circuit in *Kmart* would have failed under the doctrine of necessity because the bankruptcy court had made no finding that the vendors proposed to be paid were critical to Kmart's continued operations.[326] "All the order did was authorize Kmart to pay any vendor that Kmart in its discretion deemed 'critical.'"[327] The bankruptcy court also failed to find "that any firm would have ceased doing business with Kmart if not paid for pre-petition deliveries, and the scant record would not have supported such a finding had one been made."[328] In addition, many of the allegedly critical vendors—including the recipient of the largest critical vendor payment—had long-term

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of the reorganization provisions of the Chandler Act that preceded the Code. *See, e.g.*, H.R. REP. NO. 95-595, at 6179 (1977). Regarding the 1978 Bankruptcy Code:

> The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders. The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap … It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets.

Knoeller, *supra* note 43, at 14 (for business enterprises, the reorganization provisions of the Chandler Act "embodie[d] the new social economic concept of reorganization and the rehabilitation of the debtor and his business as a going concern, instead of the liquidation, distribution, and stoppage of business with the consequent loss to the debtor, creditors, employees, and the public generally.").

[324] *See In re Kmart Corp.*, 359 F.3d at 872.

[325] *See id.* at 870–71, 874 (discussing hypothetical scenarios involving preference-recovery actions and reorganization).

[326] *See id.* at 874.

[327] *Id.* at 870.

[328] *Id.* at 874.

contracts with the debtor.[329] Such vendors were legally required to continue to supply the debtor under the contract postpetition, and "the automatic stay prevent[ed] these vendors from walking away as long as the debtor pa[id] [them] for new deliveries."[330] The critical vendor motion in *Kmart*, simply, failed under the doctrine of necessity.

Second, the rules are similar because each considers whether similarly situated creditors who do not receive a first-day distribution will benefit, nonetheless, by the preservation of the debtor's operations and going concern value.[331] The difference is that the doctrine of necessity presumes such benefit.[332] *Kmart* by comparison requires a bankruptcy court to make several highly speculative findings and hypothetical valuations at the first-day hearing, to determine whether such benefit exists.[333] The uncertainty and logistical difficulties in reaching these findings and

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[329] *See id.* at 873.

[330] *See id.* The Supreme Court also responded by issuing Bankruptcy Rule 6003 in 2007 to provide some further check on the excesses that the Seventh Circuit criticized in 2004. That Rule provides that, "[e]xcept to the extent that relief is necessary to avoid immediate and irreparable harm," a bankruptcy court cannot, within twenty-one days after the filing of the petition, issue an order authorizing the use of estate property to pay "all or any part of a claim that arose before the filing of the petition." FED. R. BANKR. P. 6003(b). *See* FED. R. BANKR. P. 6003 Notes, *archived at* Cornell Law School, https://www.law.cornell.edu/rules/frbp/rule_6003 [https://perma.cc/EHG9-HQKS]; FED. R. BANKR. P. 6003 Committee Notes on Rules—2007, *archived at* Cornell Law School, https://www.law.cornell.edu/rules/frbp/rule_6003 [https://perma.cc/EHG9 -HQKS].

[331] *See generally* FED. R. BANKR. P. 6003 (describing case-applications for employment motions); *In re Kmart Corp.*, 359 F.3d at 866.

[332] Russell A. Eisenberg & Frances F. Gecker, *The Doctrine of Necessity and Its Parameters*, 73 MARQ. L. REV. at 4 (1989) (the doctrine of necessity is "premised on the bankruptcy goal of maintaining the prospects for a viable reorganization during the early stages of a case" and "embod[ies] the fact that there are some prepetition creditors who must be paid immediately because if they are not paid, everyone else will suffer.").

[333] *Compare In re Penn Cent. Transp. Co.*, 467 F.2d at 102 n. 1 (Act case) (the necessity of payment doctrine "permit[s] immediate payment of claims of creditors where those creditors will not supply services or material essential to the conduct of the business until their pre-reorganization claims shall have been paid."), *with In re Kmart Corp.,* 359 F.3d at 873 (requiring a debtor show "that the disfavored creditors *will* be as well off with reorganization as with liquidation—a demonstration never attempted in this proceeding").

valuations are considered below and, in the end, are not that different from the presumption of benefit that is made under the doctrine of necessity.[334]

2. Hypothetical Valuations and the Kmart *Rule*

Commentators and some courts lauded *Kmart* for reigning in excessive first-day priority-skipping relief, and perhaps with good reason on the facts of that case.[335] But is the *Kmart* rule an effective solution to such excesses? Likely not.

Hypothetical, judicial valuations inherently fall far short of determining actual, market values.[336] The hypothetical valuations required by *Kmart* are wildly speculative at best.[337]

The Seventh Circuit in *Kmart* required a debtor to demonstrate, and a bankruptcy court to find, that the disfavored creditors will be as well off with the reorganization that was enabled by the first-day payments as with liquidation that will result if the first-day payments are not authorized and the debtor's operations cease.[338] The court did not consider how this valuation was to be obtained, it stated simply that the debtor never attempted such a demonstration in the bankruptcy court.[339] I consider, in the following paragraphs, the hypothetical valuation that must be made to satisfy this requirement, and conclude that it is of inconsequential probative value.

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[334] In some rare cases, a chapter 11 debtor's prospects may be so dim from the outset that preserving its operations will harm creditors. Chapter 11's presumption that the debtor's continuing to operate ultimately will benefit all creditors is rebuttable in such cases, under § 1112, which recognizes that the bankruptcy court may dismiss that debtor's chapter 11 case or convert it to a chapter 7 liquidation. 11 U.S.C. § 1112(b) (2012). A rebuttable presumption of the benefit of continuing operations for the purpose of first-day relief is, I urge, more in line with Congress's findings and purposes when it enacted the chapter 11 provisions of the Code. Shifting the burden of proof to the debtor on this issue at the first-day hearing in the case is not.

[335] Roe & Tung, *supra* note 251, at 1257.

[336] *See* Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE L.J. 1930, 1941–42 (2006) (detailing the difficulties involved in valuing a business).

[337] *Id.*

[338] *In re Kmart Corp.*, 359 F.3d at 872–73.

[339] *Id.* at 873.

The bankruptcy judge actually must make two different hypothetical valuations under *Kmart*, each of which requires a number of guesses and assumptions: for the first valuation, the judge must assume that the first-day payments are not made, and then determine the amount of distributions to creditors if the debtor's assets were liquidated at the beginning of the case;[340] for the second valuation, the judge must assume that the first-day payments are made, and then must project the ultimate resulting estate value and creditor distributions under a hypothetical reorganization plan—that the bankruptcy court predicts it could confirm as of an indefinite time that is months or years in the future.[341]

The first valuation is the simpler one. The bankruptcy judge, to satisfy the *Kmart* rule, must determine the present value of the debtor's assets and business on a liquidation, without any exposure of those assets to the market.[342] She then must quantify the claims against those assets, by amount and priority—in most cases before the debtor's schedules listing those claims have been filed, before the debtor has been examined on those schedules at the first meeting of creditors, before most creditors have filed proofs of claims, and before the claims allowance process by which claims are allowed or disallowed has even commenced.[343] These uncertainties

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[340] *See infra* Section III.C.

[341] *Id.*

[342] *See generally In re Kmart Corp.*, 359 F.3d at 868.

[343] The bankruptcy judge at a first-day hearing has very little evidence on which to base a determination of the ultimate distributional outcomes in a chapter 11 case. Almost all of the information needed to make this determination comes later. A chapter 11 debtor, for example, is not required to file the schedules or other information regarding its assets and liabilities until 14 days of the filing of a voluntary case. 11 U.S.C. § 521(a) (2012); FED. R. BANKR. P. 1007(b). That deadline can be extended by the court, for cause shown. FED. R. BANKR. P. 1007(c). And those schedules are just the debtor's side of its financial story. The United States trustee does not examine the debtor with respect to that financial information until the meeting of creditors that it convenes, within "a reasonable time" after the filing of the voluntary petition, on not less than twenty-one days' notice to all creditors who at the meeting also may question the debtor. 11 U.S.C. § 341(a) (2012); FED. R. BANKR. P. 2002(a)(1). Creditors also are entitled to file claims against the debtor, which often are in addition to or different from the claims listed by the debtor in its schedules. The deadline for filing those proofs claim in a chapter 11 case, i.e., the "bar date," comes later, and is fixed by the court, typically on the filing of the debtor's motion on twenty-one days' notice to creditors. FED. R. BANKR. P 3003(c). Creditors then are entitled to another twenty-one days' notice of the bar date, so that they have due time to prepare and file their claims. FED. R. BANKR. P 2002(a)(7). The debtor then can object to the proofs of claim.

in nearly all but a pre-packaged chapter 11 case will overwhelm the probative worth of the valuation.

The harder part for the judge comes next, though. She must hypothetically value the debtor's business on a going concern basis—as of the indeterminate time, months or years in the future, at which she predicts that the debtor's reorganization plan will be confirmed.[344] And she must then, somehow, also determine the distributions that will be made to creditors under that suppositional plan that has not yet been filed and the terms of which have not yet been proposed to or negotiated with the debtor's creditors, owners and other parties in interest.[345]

In the end, all methods for hypothetically valuing a business "are merely estimates of the present value of the business's future earning capacity."[346] The value of a non-fungible asset such as a business cannot be determined with any precision unless it is properly marketed to potential buyers and then is sold to the highest bidder for the asset.[347] This second valuation required by *Kmart* involves no exposure to the market; it begins with guesswork at best, of a projected future value of the firm.[348]

And the difficulties with this second, future hypothetical valuation do not end there. Chapter 11 plans are not predetermined or formulaic.[349] A debtor can propose a plan[350] or, after expiration of the exclusive period within which only the debtor may propose a plan, any creditor or other party in interest can propose one, including a chapter 11 trustee if one has been appointed.[351] The proponent of the plan determines the classes of creditors and holders

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FED. R. BANKR. P 3007. The court ultimately either allows the claim, in whole or in part, or disallows it. The process described above occurs over a period of months or years after the first-day hearing in a typical chapter 11 case. Determining the aggregate claims against the estate early in the case is further complicated because many claims are unliquidated (such as unresolved contract and tort claims) at the that time, and many claims have not yet arisen (such as damage claims arising from the rejection of executory contracts and leases).

344 *In re Kmart Corp.*, 359 F.3d at 873 ("it is necessary to show… that the disfavored creditors *will* be as well off with reorganization as with liquidation").

345 *Id.*

346 Baird & Bernstein, *supra* note 336, at 1941–42.

347 *Id.*

348 *See generally In re Kmart Corp.*, 359 F.3d at 868.

349 *See* 11 U.S.C. § 1121 (2012).

350 *Id.*

351 §§ 1122–23.

of equity interests, and the treatment of the claims interests within each of those classes, within the Code's somewhat flexible parameters.[352] Confirmation of a consensual plan which all voting classes have voted to accept has fewer requirements than does a cramdown plan (which at least one voting class has voted for, but which one or more classes have voted against).[353] But the plan's terms bind dissenting creditors within a class that votes for a plan that the bankruptcy court confirms regardless.[354] As a result of these factors and others, the distributions to creditors and equity on account of their claims and interests under a plan are the result of negotiations that can take months or even years to conclude, punctuated in a complex case by periodic litigation over issues that have a material bearing on the terms of the plan.[355] For all of these reasons, the ultimate terms of a reorganization plan in a typical chapter 11 case are shrouded, at the beginning of a case, in a haze of uncertainty.[356]

The *Kmart* valuation also requires the bankruptcy judge to speculate on when the plan providing for the distributions to creditors will be confirmed.[357] This finding by the judge is based on mere conjecture, unless the debtor negotiated a "pre-packaged" plan with its creditors prior to filing the case.[358]

As a result of these assumptions that the bankruptcy judge must make, which in most cases are nearly arbitrary, the quality of the hypothetical valuations under *Kmart* will be very weak. The finest crystal ball will give the judge little guidance. Moreover, if the judge has determined that not paying the allegedly critical creditors will cause immediate and irreparable harm by threatening the debtor's operations and existence, then she will need to make all of these valuations at a first-day hearing, without

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[352] *Id.*

[353] § 1129(b)(1).

[354] § 1126(c)(d).

[355] *See supra* notes 363–71 and accompanying text.

[356] *See id.*

[357] *See infra* Section III.C.2.

[358] *Id.* Under a typical prepackaged plan in current chapter 11 practice, the secured debt is consensually restructured, unsecured debt "rides through," i.e., is paid in full in the ordinary course of the debtor's business operations, and the equity in the reorganized company is issued to the secured debtholders who agreed to the restructuring. Because the unsecured creditors are not impaired, the absolute priority rule is satisfied with respect to them.

the extensive advocacy and evidentiary record that informs most complex judicial decisions.[359]

The Seventh Circuit in *Kmart* recognized that a judge, to confirm a chapter 11 plan, must conduct a similar comparison of distributions on liquidation as opposed to distributions under the plan.[360] That comparison, called the "best interest of creditors" test, requires the judge to find that any creditor who voted against the chapter 11 plan will receive a distribution under the plan that is not less than the amount that it would receive if the debtor were liquidated under chapter 7.[361]

But the "best interest of creditors" determination for plan confirmation under the Code is made by the judge after the terms of the plan have been negotiated, reduced to writing, filed, submitted to, and analyzed by the judge and by the debtor's creditors and other parties in interest.[362] The filings made in connection with the plan must include a liquidation analysis prepared by the plan proponent's accountants or financial advisors, against which the judge can compare the distributions to creditors and equity on a hypothetical chapter 7 liquidation against the distributions to creditors and equity provided for in the plan.[363] Creditors and other parties in interest may object and be heard on the issue of whether the "best interest of creditors" requirement has been met.[364] The judge has the advantage of considering all of this information and these objections in a contested proceeding prior to reaching her decision.[365] Further, the two outcomes that the judge must compare in applying the "best interest of creditors" test at confirmation are for the most part contemporaneous, requiring near-term predictions on liquidation prices compared to the distributions to creditors that are set forth in detail in the chapter 11 plan.[366]

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[359] FED. R. BANKR. PROC. 6003(b).

[360] *In re Kmart Corp.*, 359 F.3d at 872–73.

[361] 11 U.S.C. § 1129(a)(7)(A) (2012). The Seventh Circuit likened the second prong of its rule to this requirement for plan confirmation.

[362] *See* § 1123 (delineating the contents a plan must have for presentment to the judge).

[363] § 1129(a)(7)(A).

[364] FED. R. BANKR. P. 2002(b).

[365] *Id.*

[366] 11 U.S.C. § 1129(a)(7)(A) (2012).

The bankruptcy judge, in sum, has a far smaller task in determining, at plan confirmation, whether the "best interest of creditors" requirement has been satisfied than he has under the *Kmart* rule.[367] The point in time for comparison (plan confirmation) and the terms of the plan are no longer speculative, and a far greater advocacy over a lengthy period of time is associated with the court's decision.[368] Courts and commentators recognize nonetheless that the hypothetical liquidation-to-reorganization comparison that must be made to satisfy the "best interest of creditors" requirement at the chapter 11 plan confirmation hearing "is not an exact science and must in part be based on reasonable assumptions and 'best guesses.'"[369] The proof required by *Kmart* by comparison will in most cases be based on arbitrary assumptions and wild guesses.[370]

The Seventh Circuit's reversal in *Kmart* turned on the debtor's failure to offer any evidence that the creditors who were not paid on the first-day would be as well off under a hypothetical reorganization plan as they would be under a hypothetical liquidation of the debtor's assets.[371] One can view *Kmart* as doing nothing more than shifting a burden of proof.[372] The court declined to presume, as a court may under the doctrine of necessity, that a priority-skipping first-day payment that preserves the debtor's operations and going concern value is sufficiently likely to benefit even the disadvantaged creditors.[373] Instead, under *Kmart*, the debtor must prove it.[374]

Given how hypothetical any such proof of ultimate distributional outcomes will be at the first-day hearing in a chapter 11 case, it is hardly surprising that neither *Kmart* nor any case which has purported to follow it has turned on the quality of such proof.[375] Rather, the Seventh Circuit and such other courts have

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[367] CHARLES JORDAN TABB, THE LAW OF BANKRUPTCY 1138 (2d ed. 2009) (citing *In re* Crowthers McCall Pattern, Inc., 120 B.R. 279 (Bankr. S.D.N.Y. 1990)).

[368] *See supra* notes 379–84 and accompanying text.

[369] *Id.*

[370] *See id.*

[371] *In re Kmart Corp.*, 359 F.3d at 873.

[372] *Id.* at 865.

[373] *Id.*

[374] *Id.*

[375] *Id.* at 868; *see infra* note 393 and accompanying text.

based their decisions on: (1) whether the debtor proved that it could not find a market alternative (the inquiry at the heart of the doctrine of necessity); and/or (2) whether the debtor had offered *any* evidence regarding ultimate distributional outcomes for skipped-over creditors in a hypothetical reorganization as compared with a hypothetical liquidation test.[376]

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[376] *See id.* at 873 (debtor "never attempted" to show either that the critical vendors would have ceased deliveries absent the payment or that the disfavored creditors would be as well off with reorganization as with liquidation); *In re Tropical Sportswear Int'l Corp.*, 320 B.R. at 17, 19–21 (purportedly following *Kmart*, yet presuming, as does the doctrine of necessity, that if the debtor is "unable to continue in business without the continued supply" of the critical products, then, "[i]n such cases, even the disfavored creditors are better off by paying the critical vendors since the payments enable a successful reorganization;" the court also speculated that the disadvantaged creditors would benefit because the critical vendors were being paid only a percentage of their claims and were waiving the balance other than their "valid reclamation claims" which would be paid in full, so that "the exact discount" to the debtors was "yet to be determined"); *In re Jeans.com, Inc.*, 502 B.R. at 257, 259 (following *Tropical Sportswear*, yet presuming that "the disfavored creditors [were] better off by paying the critical vendors since the payments enable[d] a successful reorganization ...." There was no evidence regarding the predicted distributions to skipped-over creditors on a hypothetical reorganization.). The court in *United American* considered a critical vendor motion, filed six weeks after the chapter 11 case was commenced, in which the debtor asserted that two vendors were "essential for the debtor's continued operation and successful reorganization," and that the court should authorize payment of the vendors' prepetition claims under the doctrine of necessity. After an evidentiary hearing, the court denied the motion as to one vendor and granted it as to the other, "not on the basis of the Doctrine of Necessity, but as an assumption of an executory contract." The court nonetheless cited *Kmart* for the proposition that the doctrine of necessity was easily abused and "[i]f there is to be a Doctrine of Necessity, it must be narrowly construed and sparingly applied." Regarding the vendors at issue, the court found that the question of prejudice to creditors was resolved by the determination of whether the goods or services were essential, and whether the price paid by the debtor was too high. *In re United Am.*, 327 B.R. at 783–84. And in *In re* Corner Home Care, Inc., while the court cited *Kmart* and *United American* favorably for the proposition that "the favorable treatment of the critical vendor must not prejudice other unsecured creditors," it denied the motion because the debtor failed to show that there was no alternative supplier of the goods, or that the asserted critical supplier would not supply the goods unless it received payment of its prepetition claim. *In re Corner Home Care, Inc.*, 438 B.R. at 128. The bankruptcy court in *In re* Pioneer Health Services, Inc., decided post-Jevic, similarly denied the debtor's motion to make critical vendor payments to physicians because there was no evidence that the physicians were irreplaceable, or could or would stop working if they were not paid. It did not

There will be some extraordinary cases in which the bankruptcy court's first-day predictions required by *Kmart* of the ultimate net benefit to creditors are plausible notwithstanding these difficulties. This might be the case if the first-day payments of prepetition claims to critical creditors are so high, and the prospects for meaningful returns to the disfavored creditors that might result from the debtor's continuing to operate and reorganize are so low, that a prompt liquidation of the debtor's assets is preferable. This might be the case where the debtor is "dead on arrival," and there simply is no reasonable prospect of a reorganization. It also might be the case with respect to a prepackaged plan. But in nearly all other cases, the opposite will hold. The variables will be so numerous, the assumptions will be so arbitrary, and the ultimate outcomes will be so uncertain, that the hypothetical valuations required by *Kmart* will be nearly if not entirely meaningless.[377]

D. First-Day Relief After Jevic

The *Jevic* Court did not resolve the circuit split between the doctrine of necessity and the *Kmart* rule.[378] But, though arguably dictum, the Court's message was clear: "One can generally find significant Code-related objectives" for first-day relief "that the priority-violating distributions serve," whether preserving the debtor as a going concern, as required by the doctrine of necessity, or making "even the disfavored creditors better off," as required by *Kmart*.[379] The Court left it at that, declining to embrace the hypothetical valuations required by *Kmart*.[380]

The inadequacy of such hypothetical valuations and the efficacy of market exposure to address the problems of control premiums and collusion is an analytic theme of the Court's last two absolute priority rule cases—in *Jevic* when it second-guessed the bankruptcy court's determination, made without market exposure, that the settled claim had little value, and in *203 N. LaSalle*

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consider the likelihood of eventual benefit or detriment to the other creditors who were not receiving the first-day payments. *In re* Pioneer Health Services, Inc., 570 B.R. 228, 235–36 (Bankr. S.D. Miss. 2017).

[377] Baird & Bernstein, *supra* note 336, at 1941–42.

[378] *Czyzewski,* 137 S. Ct. at 987–88 (Thomas, J., dissenting).

[379] *Id.* at 985 (citing *In re Kmart Corp.*, 359 F.3d at 872).

[380] *See generally id.* at 973.

when it reversed because the equity in the new debtor had not been marketed.[381] The Court accepted as a given the difficulty of applying the rule of priorities to first-day relief or other interim transactions in a chapter 11 case, because the nature and extent of the estate and the claims against it are not yet fully resolved and thus, I suggest, can be valued only hypothetically.[382]

Jevic did not discard the doctrine of necessity as a relic of pre-Code law, nor did it disparage *Kmart*.[383] *Jevic* does suggest, though, that a bankruptcy court's finding that first-day relief will "make even the disfavored creditors better off" does not require hypothetical future valuations of a chapter 11 debtor's business or assets, or projections of the ultimate distributions to creditors.[384] More likely, chapter 11's presumption that continued operations and preservation of going concern value will benefit all creditors should suffice.[385]

This approach addresses the excessive first-day relief of which some critics, rightfully, complain.[386] It does this by requiring evidentiary proof that the relief is essential to the debtor's operations, and that the debtor sought and could not obtain an alternative on better terms, in the market.[387] This proof will consist, in most cases, of credible testimony that the critical vendor has refused to provide a good, service or credit essential its operations unless it is paid on account of its prepetition claims, and that the debtor diligently contacted alternative suppliers, none of whom would provide the good, service or credit on better terms than those demanded by the critical vendor.[388]

It dispenses, though, with the wildly speculative hypothetical predictions of future value and distributions, based on facts largely

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[381] *Id.* at 983; *203 N. LaSalle*, 526 U.S. at 466–69.

[382] *Czyzewski*, 137 S. Ct. at 985.

[383] *Id.* at 985, 986.

[384] *Id.* at 985 (quoting *In re Kmart Corp.*, 359 F.3d at 872).

[385] *Id.* at 977.

[386] *See* Roe & Tung, *supra* note 251.

[387] This evidentiary requirement is not very different from the evidentiary requirement for approval of postpetition borrowing under Code section 364. Under that section, for example, a debtor in possession cannot obtain approval of a loan secured by a lien in its assets unless it proves that it could not obtain the loan on an unsecured basis. 11 U.S.C. § 364(c) (2012).

[388] *Id.*

undeveloped at a first-day hearing, that the Seventh Circuit required.[389] It replaces these hypothetical valuations with the Congressional presumption of going concern value that, for nearly a century, has been at the core of reorganization law in the U.S.[390]

IV. VALUATION UNCERTAINTY, LEGAL CERTAINTY, AND THE ABSOLUTE PRIORITY RULE

"The result is uncertainty," the *Jevic* Court emphasized when it declined to create a "rare case" exception to the absolute priority rule for case-ending settlements in chapter 11.[391] This uncertainty, the Court continued, alters the parties' leverage and makes settlements more difficult to achieve.[392]

Market exposure can in many cases provide that certainty, which hypothetical predictions and valuations cannot, with respect to both first-day relief and interim and other pre-plan settlements and transactions in chapter 11.[393] Such market certainty enables a court to determine to a greater legal certainty the value of the good, service, or credit being offered by an allegedly critical vendor in exchange for a proposed first-day distribution, the value of a claim or other estate asset that is the subject of such settlement or transaction, and whether a control premium is being paid from estate assets.

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[389] *In re Kmart Corp.*, 369 F.3d at 872–73.

[390] Knoeller, *supra* note 43, at 14; H.R. REP. NO. 95-595, at 120 (1977).

[391] *Czyzewski*, 137 S. Ct. at 986.

[392] *Id.* at 987 (citing RadLAX Gateway Hotel, LLC v. Amalgamated Bank, 566 U.S. 639, 649 (2012); William M. Landes & Richard A. Posner, *Legal Precedent: A Theoretical and Empirical Analysis*, 19 J. LAW & ECON. 249, 271 (1976)).

[393] The transition from hypothetical to market valuations of a debtor's business already has occurred to a great extent in U.S. bankruptcy law and practice with the rise and development of the court-approved going concern sale under Code section 363(b). The business in larger chapter 11 cases most often is valued, not by plan negotiations over hypothetical values, but by court-approved auction procedures. The business, once sold, has new owners, new secured financing (often enabling both the business' acquisition by the new owners and its post-sale operations), and new unsecured creditors with respect to goods and services obtained by the business on credit post-sale. Because it is no longer in the debtor's estate, bankruptcy court supervision ends, and the reorganization and restructuring of the business is done. The fund arising from the acquirer's paying the purchase price is then distributed to creditors of the debtor's estate, either pursuant to a liquidating plan, or if a plan cannot be confirmed, by a trustee following conversion to chapter 7.

This certainty is obtained, for requested first-day relief, by requiring a debtor to seek a market alternative for the good, service or credit at issue, coupled with a rebuttable presumption that creditors will benefit if the debtor's business is preserved as a going concern. This certainty is lost if first-day decisions are based on hypothetical projections of the distributions that will be made to creditors under an imaginary plan postulated to be confirmed months or perhaps years later.

Certainty also is obtained for a proposed interim or pre-plan settlement or other transaction once it is exposed to the market. The value of estate property becomes certain, as the Court recognized in both *Jevic* and *203 N. LaSalle*, when the assets are exposed to the market.[394] A properly marketed sale ends the uncertainty about what something is worth. The battle of experts in a hypothetical valuation proceeding does not. Determining value by exposing a settlement or other transaction with an insider or other controlling entity to competing bids also enables a court to determine whether a control premium is being paid in violation of a fundamental policy behind the absolute priority rule.

This ultimate certainty also is likely to encourage negotiations, over the terms of first-day relief, and over an interim or other pre-plan settlement or other disposition of a claim or asset, and the distribution of estate property among parties who have different priority positions. Parties in chapter 11 often bargain in the midst of valuation uncertainty, knowing that the values at issue must at some time become certain. A party can be expected to bargain more efficiently—cognizant of its weaknesses as well as its strengths—if it knows that marketing is imminent or ongoing, and that this market exposure will preclude with certainty both a below-market sale and the payment of a control premium.

CONCLUSION

The *Jevic* Court mapped the sea from the dry land to a great extent. The firm ground is clearly defined—at the end of a chapter 11 case, strict compliance with distributional priorities generally *is required* for non-consensual distributions made outside of a plan (such as pursuant to a structured dismissal).[395]

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[394] *Czyzewski*, 137 S. Ct. at 978–79; *203 N. LaSalle*, 526 U.S. at 455.
[395] *Czyzewski,* 137 S. Ct. at 986.

The Court, though, left mostly uncharted the vast sea in which one finds transactions that are not case-ending, such as interim and other pre-plan settlements and transactions, first-day orders, and the distributions made under them.[396] The Court plotted, instead, a wide course around two shoals created by circuit splits on the issue of distributions that are not case-ending, leaving them mostly unmarked.[397]

The first circuit split that the Court did not resolve was whether there is a per se rule that requires absolute distributional priority for interim and other pre-plan settlements and transactions in chapter 11. The Court on this issue emphasized the difficulty of hypothetically assessing such a settlement or other transaction that is not case-ending, because the "extent of the Estate and the claims against it are *not yet fully resolved*."[398] Still, it suggested, bankruptcy courts approving even these settlements and transactions must show a proper solicitude—or at least not show an outright disregard—for the absolute priority rule.[399]

The other unresolved split was the ground for approving first-day distributions in chapter 11 that may be priority-skipping. The doctrine of necessity presumes the benefit of preserving the debtor's operations, while the Seventh Circuit's *Kmart* decision requires a bankruptcy court to make a finding that such payments ultimately will benefit (or at least will not harm) the remaining creditors who do not receive a first-day payment.[400] The Court on this issue indicated that priority-skipping first-day relief and distributions often serve some significant Code-related purpose, such as preserving the debtor's operations in order to maximize value and enable a reorganization.[401] It said nothing, though, of whether a bankruptcy court can presume, or instead must require proof of, such benefit.

The Court in both *Jevic* and *203 N. LaSalle* more firmly expressed unease with transactions approved on a record devoid of evidence of market exposure and based instead on a hypothetical

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[396] *See id.* at 973.
[397] *Id.* at 987–88 (Thomas, J., dissenting).
[398] *Id.* at 985.
[399] *Id.* at 986.
[400] *Id.* at 985.
[401] *Id.*

valuation.[402] A bankruptcy court assessing a transaction hypothetically, without market exposure, cannot determine with a reasonable degree of certainty whether the value of the estate is being misallocated to parties who exercise control over a debtor and to those who colluded with them.[403]

The course toward the rules for approval of pre-plan settlements and transactions and first-day distributions becomes more certain, I suggest, with these markers left by the Court in *Jevic* and *203 N. LaSalle* kept in view.

Exposing to market scrutiny the estate claims and other assets proposed to be released or transferred pursuant to a transaction challenged as benefiting an insider or other party exercising control can throw into strong relief whether a control premium is being paid at the expense of the estate and the parties who are not in on the deal, and can thus cast light on the shadows in which collusion may have occurred.[404] This sale process in most cases will provide reliable evidence that no part of the estate is going to those exercising control or those who colluded with them, and will result, in many cases, in a higher and better bid for the claim or other asset at issue.[405]

This approach, especially with respect to first-day relief, also entails acknowledging both that market exposure is not always possible, and the extent to which the hypothetical valuations that might be used in its stead are unreliable.[406] This recognition does not leave the question of first-day relief at sea. Rather, a bankruptcy court can determine whether a chapter 11 debtor sought and failed to obtain a market alternative to what is being provided by the party who would receive the priority-skipping distribution under the requested first-day order.[407] The issue of whether the parties not receiving such first-day distributions will benefit is best addressed, I suggest, not by the highly speculative determination of the ultimate distributions that the bankruptcy court hypothesizes will be made at the end of the case, but by a

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402 *See Czyzewski*, 137 S. Ct. at 978–79; *203 N. LaSalle*, 526 U.S. at 455–57.

403 *Czyzewski*, 137 S. Ct. at 985; *203 N. LaSalle*, 526 U.S. at 436, 457–58.

404 *Czyzewski*, 137 S. Ct. at 985.

405 Baird & Bernstein, *supra* note 336, at 1943.

406 *Id.* at 1941–42.

407 *See In re Kmart Corp.*, 359 F.3d at 872–74; *In re Corner Home Care, Inc.*, 438 B.R. at 127.

rebuttable presumption that preserving a chapter 11 debtor's operations in order to maximize value and enable a reorganization ultimately will benefit those creditors more than if the first-day payments had not been made and the debtor's operations had ceased.

Distributional priorities and the problem of control premiums that deviate from them have been at the epicenter of U.S. bankruptcy law for 150 years.[408] Still, the extent to which the absolute priority rule applies to interim and pre-plan settlements and transactions and to first-day relief is not mapped by the Code. It has been sketched but lightly by the *Jevic* Court.[409] I suggest that the approaches outlined in this Paper can address in many cases the issues that the absolute priority rule was created to remedy. Market exposure of the claims and other assets that are the subject of such interim settlements and transactions can preclude to a great extent misallocations of estate value to those in control. Market exposure of the good, service or credit proposed to be provided by an asserted critical provider pursuant to first-day relief can preclude misallocations of estate value to providers who are not critical. Maximizing the use of these approaches, and reducing speculative, hypothetical determinations of asset values and creditor distributions, also can provide the certainty sought by the *Jevic* Court in this area of U.S. bankruptcy law.

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[408] R.R. Co. v. Howard, 74 U.S. 392, 410 (1868).

[409] 11 U.S.C. §§ 1122, 1123(a)(4) (2012); *Czyzewski*, 137 S. Ct. at 985–88.