The Not-So-Settled Absolute Priority Rule: The Continued Threat of Priority-Deviation Through Interim Distributions of Assets in Chapter 11 Bankruptcy

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I. INTRODUCTION

It has been said that creditors have better memories than debtors.[1] That saying rings true yet again. In Chapter 11 bankruptcy, there is a norm that all senior creditors must be paid back in full before any junior interests are satisfied at all.[2] This is known as the absolute priority rule.[3] In 2017, the United States Supreme Court decided *Czyzewski v. Jevic Holding Corp.* (*Jevic*).[4] The *Jevic* Court overruled a Third Circuit case,[5] which held that a structured dismissal[6] could deviate from the absolute priority rule in order to meet a better and quicker result in the settlement context for certain creditors in Chapter 11 bankruptcy.[7] The Supreme Court held, in relevant part, that structured dismissals that deviate from priority rules as part of a final distribution of assets may not be approved over the objection of creditors.[8]

While the Court's decision remedied the priority-deviation found in the Third Circuit case, it limited its decision to the specific structured dismissal at issue because it was a *final distribution* of assets.[9] By limiting its decision to final dispositions in a bankruptcy proceeding, the Court left the door open for priority-deviation in *interim* distributions of assets.[10] In fact, the Court noted the benefits of interim priority-deviations and expressly included an example of such a deviation in the context of an

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[1] Benjamin Franklin, *Poor Richard's Almanac*, (1736).

[2] *See* Amy Timm, Note, *The Gift That Gives Too Much: Invalidating a Gifting Exception to the Absolute Priority Rule*, 2013 U. ILL. L. REV. 1649 (2013).

[3] *See* 11 U.S.C.S. § 1129(b)(2)(B)(ii) (in order to be fair and equitable concerning classes of unsecured claims during plan confirmation: "the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property . . . ."); *see also* discussion *infra* Part II.A.

[4] Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973 (2017).

[5] Official Comm. of Unsecured Creditors v. CIT Grp./Bus. Credit Inc. (*In re* Jevic Holding Corp.), 787 F.3d 173 (3d Cir. 2015).

[6] *See id.* at 181 (defining structured dismissals as "simply dismissals that are preceded by other orders of the bankruptcy court (*e.g.,* orders approving settlements, granting releases, and so forth) that remain in effect after dismissal."); *see also Jevic*, 137 S. Ct. at 979 (relying on the American Bankruptcy Institute in defining structured dismissals as a: "hybrid dismissal and confirmation order . . . that . . . typically dismisses the case while, among other things, approving certain distributions to creditors, granting certain third-party releases, enjoining certain conduct by creditors, and not necessarily vacating orders or unwinding transactions undertaken during the case.") (internal quotations omitted).

[7] *In re Jevic Holding Corp.*, 787 F.3d at 184–85.

[8] *See Jevic*, 137 S. Ct. at 976–77.

[9] *See 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.") (emphasis added).

[10] *See id.* at 985 (suggesting that interim distributions of assets are permissible in Chapter 11 cases due to the difficulty of applying priority rules to unresolved claims).

interim settlement.[11] Due to *Jevic*'s express approval of interim priority-deviation, this Comment suggests that the interim settlement context could be the avenue of choice going forward for creditors seeking to deviate from priority rules in Chapter 11.[12]

Moreover, the Court's holding could open the floodgates for an increase of future priority-deviation, despite the fact that priority must be followed at the final resolution of a Chapter 11 bankruptcy case.[13] Chapter 11 debtors are still allowed to settle claims with creditors outside of the priority scheme before the case is made final, especially if there are Bankruptcy Code related justifications for priority-deviation.[14] While the Supreme Court's *Jevic* decision implied a more strict application of the absolute priority rule, an increase in deviation may nonetheless result because creditors will now know the parameters of the rule and how to work around it. As will be discussed further in this Comment, a lack of priority can create unjust results in Chapter 11 bankruptcy.[15]

Before the Supreme Court decided *Jevic*, there existed a circuit split concerning application of the absolute priority rule vis-à-vis the settlement context.[16] The Third Circuit decision that was overruled by the Supreme Court in *Jevic* held that a structured dismissal as part of a final settlement may deviate from priority.[17] Conversely, a Fifth Circuit decision,[18] held that in order to be fair and equitable, priority must be respected in Chapter 11 cases even in the analysis of a settlement agreement.[19] This Comment

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[11] *See id.* (distinguishing the Second Circuit decision of *In re Iridium Operating LLC*, as a case that involved an interim distribution of settlement proceeds, from the Third Circuit case of *In re Jevic* that involved a final disposition of a settlement and structured dismissal); *see also* Motorola, Inc. v. Official Comm. of Unsecured Creditors (*In re Iridium Operating LLC*), 478 F.3d 452 (2d Cir. 2007) (upholding an interim distribution of settlement proceeds that deviated from priority).

[12] *See* discussion *infra* Part III.A.

[13] *See supra* note 9 and accompanying text.

[14] *See, e.g.*, *Jevic*, 137 S. Ct. at 985 (noting the justifications for interim priority-deviation in a Chapter 11 proceeding, the Court stated: "[b]ut in [interim distributions] one can generally find significant Code-related objectives that the priority-violating distributions serve."); *In re Iridium*, 478 F.3d at 467 ("Here, the bankruptcy court identified a proper [Code] justification for the [interim] Settlement."); In re Fryar, 1:16-bk-13559-SDR, 2017 Bankr. LEXIS 1123, at *14 (E.D. Tenn. April 25, 2017) (noting that the priority-deviating-settlement at issue must be justified by Code-related objectives in order to be upheld over creditor objections).

[15] *See* discussion *infra* Part III.B.

[16] *Compare* Official Comm. of Unsecured Creditors v. CIT Grp./Bus. Credit Inc. (*In re* Jevic Holding Corp.), 787 F.3d 173 (3d Cir. 2015) (holding that a structured dismissal as part of a settlement agreement, may, in rare instances, deviate from priority rules), *with* In re AWECO Inc., 725 F.2d 293 (5th Cir. 1984) (holding that priority must be followed in order for a settlement to be approved as fair and equitable).

[17] *In re Jevic Holding Corp.*, 787 F.3d at 184–85.

[18] In re AWECO Inc., 725 F.2d 293 (5th Cir. 1984).

[19] *See id.* at 300.

will discuss the facts of each Circuit in order to show the impact and procedural history of the Supreme Court case.[20] This Comment will then argue that the Supreme Court did not fully resolve the issue of absolute priority,[21] and absolving this issue can be accomplished by applying the Fifth Circuit's fair and equitable standard to all phases of a Chapter 11 bankruptcy proceeding.[22]

As a precursor to the background section of this Comment, it is important to note that Chapter 11 bankruptcy law is founded upon principles of priority.[23] Statutory provisions assign creditors to a certain pecking order for purposes of repayment by the debtor.[24] For example, Section 507 of the Chapter 11 Bankruptcy Code contains a general priority scheme, which favors certain creditors over others in regards to the order in which proceeds from the debtor's assets are distributed.[25] Priority rules such as Section 507 should be well known by Chapter 11 parties due to the prospect of future asset reorganization. Priority for creditors could mean the difference between getting paid in full and not getting paid at all.

Alternatively, the absolute priority rule, found at 11 U.S.C. § 1129(b)(2)(B)(ii), only applies to confirmed plans of reorganization.[26] Before *Jevic*, there was confusion amongst the courts as to whether or not the absolute priority rule applied to the settlement context of a Chapter 11 proceeding.[27] The *Jevic* Court, in *dicta,* ultimately stated the rule *does* apply to the settlement context, but *only if* the settlement at issue is a *final* disposition.[28] Therefore, the absolute priority rule currently remains confined to the final disposition stage of a Chapter 11 case, leaving open the option to deviate at all other stages. While the rule itself is arguably *sui generis* by virtue of the limited context in which it is applied,[29] the objective of this Comment is to expand the absolute priority rule to apply to all phases of Chapter 11.[30]

Since the settlement context can be the avenue of choice for future priority-deviation, it is important to consider the power a judge has in

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[20] *See* discussions *infra* Part II.B–D.

[21] *See* discussion *infra* Part III.A.

[22] *See* discussion *infra* Part III.D.

[23] *See* Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973, 983 (2017) ("The Code's priority system constitutes a basic underpinning of business bankruptcy law.").

[24] *See supra* note 3 and accompanying text.

[25] *See* 11 U.S.C.S. § 507 (2016).

[26] *See* 11 U.S.C.S. § 1129(b)(2)(B)(ii); *see also supra* note 3 and accompanying text.

[27] *See supra* note 16 and accompanying text.

[28] *See Jevic*, 137 S. Ct. at 985 (the Court stated that interim distributions of assets that deviate from priority are usually justified, therefore suggesting priority-deviation in the pre-plan context is permissible).

[29] *See* 11 U.S.C.S. § 1129(b)(2)(B)(ii).

[30] *See* discussion *infra* Part III.D.

approving a settlement. The decision of whether to uphold an agreement between parties "lies within the discretion of the trial judge;" and for an appellate court to reverse, it must be shown that the trial court abused its discretion.[31] Therefore, most decisions concerning settlements at the trial court level will be upheld, absent a showing that the decision was handed down arbitrarily or willfully.[32] It should be noted, however, that bankruptcy courts may uphold settlements only if they are found to be fair and equitable.[33] Due to the Supreme Court decision in *Jevic*, the allowance of priority-deviations in interim distributions of assets as opposed to final dispositions can create a vague line for bankruptcy courts to interpret;[34] which may cause confusion as to what distributions will be upheld as fair and equitable.

As mentioned above, the crux of this Comment aims to show that the issue of absolute priority enveloping interim Chapter 11 distributions can be resolved by following the Fifth Circuit's fair and equitable standard at all stages of a bankruptcy proceeding.[35] The Fifth Circuit noted that, "[t]he words 'fair and equitable' are terms of art [in bankruptcy law] – they mean that 'senior interests are entitled to full priority over junior ones.'"[36] While this may make settlements harder to achieve,[37] a rigid application of the absolute priority rule lets creditors know where they stand from the onset

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[31] In re AWECO Inc., 725 F.2d 293, 297 (5th Cir. 1984) (citing Matter of Jackson Brewing Co. (In re Jackson Brewing Co.), 624 F.2d 599, 602–03 (5th Cir. 1980)); *see* Matter of Walsh Const. Inc., 669 F.2d 1325, 1328 (9th Cir. 1982); *see also* Matter of Ocobock, 608 F.2d 1358, 1360 (10th Cir. 1979); In re Albert-Harris Inc., 313 F.2d 447, 449 (6th Cir. 1963).

[32] *In re AWECO, Inc.*, 725 F.2d at 298 (quoting Langnes v. Green, 282 U.S. 531, 541 (1931)).

[33] *Id.* (quoting Protective Committee v. Anderson, 390 U.S. 414, 424 (1968)) (citing *In re Jackson Brewing Co.*, 624 F.2d at 602).

[34] *See* Stephen J. Lubben, *Supreme Court Ruling Draws a Vague Line in Bankruptcy Cases*, N.Y. TIMES. (April 14, 2017), *available at* https://www.nytimes.com/2017/04/14/business/dealbook/supreme-court-ruling-draws-a-vague-line-in-bankruptcy-cases.html?rref=collection%2Fcolumn%2Fdealbook-indebt&action=click&contentCollection=dealbook&region=stream&module=streamunit&version=latest&contentPlacement=1&pgtype=collection (discussing the Court's noted contrast between interim and final distributions of assets as well as the vagueness that can correspond between the terms "interim" and "final" distributions, author Stephen J. Lubben noted, "[o]f course, this line is not always obvious. In the automotive cases, for example, the assets of General Motors and Chrysler were sold to newly formed buyers. The sale process itself was interim . . . but the outcome of that process was largely set once the sale closed. Nonetheless, Justice Breyer suggest these two sales were an example of permissible interim distributions.").

[35] *See* discussion *infra* Part III.D.

[36] *In re AWECO, Inc.*, 725 F.2d at 298 (quoting SEC v. American Trailer Rentals Co., 379 U.S. 594, 611 (1965)) (citing *Anderson*, 390 U.S. at 441).

[37] *See* Official Comm. of Unsecured Creditors v. CIT Grp./Bus. Credit Inc. (*In re* Jevic Holding Corp.), 787 F.3d 173, 185 (3d Cir. 2015) ("If courts required settlements to be perfect, they would seldom be approved . . . .").

of any possible litigation. It also lets debtors know their specific obligations and could eventually facilitate quicker negotiations. Thus, adhering to the absolute priority rule outside of the final disposition context could lead to more efficient negotiations.

Ultimately, if the absolute priority rule is to have any teeth, it must be implemented in all aspects of Chapter 11 bankruptcy proceedings and not just in final dispositions. Specifically, the absolute priority rule must apply to interim settlements in order to avoid the potential increase of priority-deviation through this medium. Most importantly, adhering to a rigid application of priority at all stages of a Chapter 11 case would dovetail more completely with the fair and equitable standard found throughout bankruptcy law. By applying the Fifth Circuit's reasoning, in the event that an interim settlement is approved and a senior creditor is skipped in favor of a more junior creditor, the deciding court should be deemed to have abused its discretion.[38]

It has been noted that, "[e]quitable considerations should be preeminent in the exercise of bankruptcy jurisdiction."[39] There is no fairness or equity to be found when senior creditors are skipped over by more junior creditors in order to facilitate quicker and more efficient Chapter 11 reorganizations.[40] While in practice a lenient priority mechanism appears to create a more seamless transition for reorganization, it nonetheless burdens creditors who are left completely out of the equation after junior interests' skip over them in priority. By allowing interim devices to deviate from priority, the senior creditors in a Chapter 11 case are at a greater risk of leaving the bankruptcy proceeding empty handed.

Part II of this Comment will outline the general background terms and functions of bankruptcy law. It will also outline the facts and reasoning of the Fifth Circuit decision, the Third Circuit decision, and the Supreme Court's reasoning in overruling the Third Circuit. Part III of this Comment will analyze the Supreme Court's decision, the dangers of priority-deviation, alternative viewpoints supporting lenient application of priority, and the Fifth Circuit's fair and equitable standard and why it needs to apply to all stages in a Chapter 11 proceeding. Finally, Part IV of this Comment will conclude the issue.

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

[39] *Id.* at 300. *See* Bank of Marin v. England, 385 U.S. 99, 103 (1966); *see also* Demet v. Harralson, 399 F.2d 35, 39 (5th Cir. 1968).

[40] *See* discussion *infra* Part III.C.

II. BACKGROUND

A. Chapter 11 Bankruptcy

It is easy to fall into the false dichotomy that describes Chapter 11 as only a device for reorganization and Chapter 7 as the only means of liquidation.[41] Conversely, Chapter 11 bankruptcy expressly envisions liquidation through a plan, "[a]nd the debtor (and thus its management) has an absolute right to one conversion between the two chapters."[42] While this is true, many financially stressed businesses seek protection through the instruments of Chapter 11 bankruptcy as a means of reorganizing their debt in an effort to continue on with their business.[43] Conventional wisdom explains why the debtor's management prefers Chapter 11 rather than Chapter 7—it is because the Bankruptcy Code orders a trustee in every Chapter 7 case.[44] Alternatively, in Chapter 11, the custom is that the debtor and its administration remain "in possession," with the rights and duties of a trustee.[45] This gives the Chapter 11 debtor much more breathing room to operate its business and ward off the demands of its creditors.[46]

Once a bankruptcy petition is filed, an automatic stay is issued to thwart creditors from entering into further debt collection processes.[47] The stay "enjoins creditors from enforcing pre-petition obligations" or pursuing the debtor's property.[48] After the stay is issued and creditors are halted from debt collection, the goal becomes the debtor's exit from bankruptcy while maximizing repayment.[49] The debtor offers a "plan of reorganization," which entails an agreement "to repay a portion of the debt [owed] over a specified period of time."[50] While the reorganization plan is discussed "between the debtor and a committee appointed by the United States Trustee on behalf of the creditors[,]" as mentioned above, the

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[41] Stephen J. Lubben, Article, *Business Liquidation*, 81 AM. BANKR. L.J. 65 (2007).

[42] *Id.* at 66.

[43] Elizabeth Blakely, Comment, *Dewey Ranch and the Role of the Bankruptcy Court in Decisions Relating to the Permissible Control of National Sports Leagues Over Individual Franchise Owners*, 21 SETON HALL J. SPORTS & ENT. L. 105, 108 (2011).

[44] Lubben, *supra* note 41, at 66 (citing 11 U.S.C. §§ 701-02).

[45] *Id.* (citing 11 U.S.C. § 1107).

[46] *See* Diane Lourdes Dick, Article, *Bankruptcy's Corporate Tax Loophole*, 82 FORDHAM L. REV. 2273, 2282 (2014); *see also* Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934) ("[Bankruptcy] gives to the honest but unfortunate debtor . . . a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt.").

[47] *See* Blakely, *supra* note 43.

[48] *See* Dick, *supra* note 46.

[49] *See id.*

[50] Blakely, *supra* note 43; *see* 11 U.S.C. §§ 1121-29.

debtor's management assumes a role as the debtor in possession[51] and keeps control of the business and its assets.[52] With the permission of the bankruptcy court, financing is often approved for the debtor in possession to allow the bankrupt business to carry on its operations during the stay period.[53]

In general, the Chapter 11 plan is an amalgam of distribution; it lays out the procedure for dividing assets to various constituents.[54] Due to the significance of the plan, the Bankruptcy Code gives the debtor the right to file a Chapter 11 plan within 120 days.[55] Once the plan of reorganization is set in stone, "Chapter 11 rules require the creditors to either accept or reject the plan."[56] The reorganization plan is approved if the following two conditions are met: "(1) the plan is accepted by more than half of the total number of claimants in each class; and (2) the amount claimed by those accepting claimants is at least two-thirds of the total amount claimed against the debtor by that class."[57] If all classes of creditors do not meet these conditions and the plan for reorganization is rejected, "the bankruptcy judge still has the discretion to approve the plan over an objection by the creditors."[58]

A major condition is that the reorganization plan must be "fair and equitable" in regard to the dissenting classes.[59] A plan is deemed "fair and equitable" when dissenting class members are given property equal in value to their allowed claims, or to the extent less than that amount is received, "no creditor of lesser priority (or any equity security holder) receives any distribution under the plan."[60] This requirement, which is paramount in bankruptcy law, is normally referred to as the "absolute priority rule."[61] This rule serves as an important protection for creditors by ensuring that, "unless their claims are paid in full or they agree otherwise, the Chapter 11 plan will – with limited exceptions – respect the

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[51] *See* 11 U.S.C. § 1107 (1979).

[52] Blakely, *supra* note 43, at 108–09.

[53] *Id*. at 109. (citing Robert R. Bliss & George G. Kaufman, *U.S. Corporate and Bank Insolvency Regimes: A Comparison and Evaluation*, 2 VA. L. & BUS. REV. 143, 162 (2007)).

[54] Dick, *supra* note 46, at 2283.

[55] *Id.*

[56] Blakely, *supra* note 43, at 109 (citing 11 U.S.C. § 1126).

[57] *Id.* (citing 11 U.S.C. § 1126(c)) (internal quotations omitted).

[58] *Id.* (citing 11 U.S.C. 1129(b)); *see* Jeffery M. Sharp, *Bankruptcy Reorganization Section 1129, and the New Capital Quagmire: A Call for Congressional Response*, 28 AM. BUS. L.J. 525, 550 (1991); *see also* Jeffrey I. Werbalowsky, *Reforming Chapter 11: Building an International Restructuring Model*, 8 J. BANKR. L. & PRAC. 561, 574 n.40 (1999).

[59] Dick, *supra* note 46, at 2284 (citing 11 U.S.C. § 1129(b)).

[60] *Id.*

[61] *Id.*

relative collection rights of creditors under state law."[62] Future sections of this work discuss how the absolute priority rule ought to apply without exceptions throughout a Chapter 11 case and not just in confirmed plans of reorganization.[63]

B. The Fifth Circuit's View: Adherence to the Absolute Priority Rule

In 1984, the Fifth Circuit decided the case of *In re AWECO, Inc*. (*AWECO*),[64] which ruled that the fair and equitable standard applies to settlements and that "fair and equitable" means compliant with the priority scheme, even outside the context of a Chapter 11 plan.[65] There were three parties involved in this case: AWECO, Inc. ("AWECO"), United American Car Co. ("United"), and the United States.[66] The debtor, AWECO, engaged in various business endeavors, but was mostly concerned with its oil and gas business.[67] AWECO voluntarily filed a Chapter 11 petition in early 1981, and filed a plan of reorganization several months later.[68] The plan was never offered to the court for confirmation or presented to creditors for authorization.[69]

One of AWECO's creditors, United, had an unliquidated and unsecured claim for roughly $27 million, which produced the appeal to the Fifth Circuit.[70] The claim stemmed from two contracts between AWECO and United wherein "AWECO agreed to purchase approximately $40 million worth of railroad cars from United."[71] AWECO declined to fulfill its end of the bargain and United sued for fraud and breach of contract, asserting $27 million in damages.[72] After two years of litigation and while AWECO's Chapter 11 petition was pending, AWECO and United reached a settlement.[73] The settlement's terms called for AWECO to transfer some $5.3 million worth of property and cash to United.[74] Part of the assets to be transferred from AWECO to United included property that secured Sutton Investments, Inc.'s (Sutton) claim, which is another one of AWECO's creditors.[75]

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62 *Id.*
63 *See* discussion *infra* Part III.B.
64 In re AWECO, Inc., 725 F.2d 293 (5th Cir. 1984).
65 *Id.* at 298.
66 *Id.* at 295.
67 *Id.*
68 *Id.*
69 *Id.*
70 *In re AWECO, Inc.*, 725 F.2d at 295.
71 *Id.*
72 *Id.*
73 *Id.*
74 *Id.* at 295–96.
75 *Id.* at 296.

AWECO filed notice with the bankruptcy court in early November of 1981, noting its aim to settle the litigation.[76] AWECO's four creditors: "[t]he Department of Energy, the IRS, Sutton, and the Creditors' Committee all filed objections to the proposed settlement."[77] On December 30, 1981, the bankruptcy court held a hearing to consider the objection from the Department of Energy, the IRS, and Sutton, which heard testimony from: "AWECO's president, the court-appointed examiner, the debtor's comptroller and accountant, and an attorney representing United in the Georgia litigation with AWECO."[78] A portion of the testimony focused on the fairness of the agreement between United and AWECO.[79] United provided its reasoning for accepting $5.3 million on its claim of $27 million, stating that United had been able to recoup enough of its losses to reduce the claim; they wished to avoid the delay, risk, and expense involved in more litigation; and United wanted to settle so it could count the proceeds in its 1981 taxable year.[80]

Further testimony showed the benefits to AWECO stemming from the settlement agreement.[81] Moreover, a rather large amount of testimony also concerned AWECO's interest in a non-operational oil refinery located in Lake Charles, Louisiana.[82] While previous managers of the refinery had been unable to operate it for a profit, AWECO's president declared that it would function under its control.[83] He also said that the refinery formed the basis for a successful reorganization plan, and a court-appointed examiner testified as to the liquidation value, estimating it at $13 million without the knowledge of any prior liens.[84] Counting the refinery, the examiner estimated that the proposed settlement would leave $30 million in the estate, while his testimony on specific assets listed properties that totaled only $17.5 million in value (including the refinery).[85]

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[76] *In re AWECO, Inc.*, 725 F.2d at 296.
[77] *Id.*
[78] *Id.*
[79] *Id.*
[80] *Id.*
[81] *Id.* (concerning the benefits conferred to AWECO stemming from the settlement agreement, the court noted: "The AWECO attorney involved in the Georgia litigation stated that terminating the litigation would save an estimated $200,000 – 250,000 in legal expenses of trying the suit; the two previous litigation had cost AWECO over $700,000. He also testified as to the weakness of AWECO's primary defense to the suit. AWECO's comptroller declared that the settlement would generate a loss for the company that would carry back to offset $2-2.5 million of tax liability.").
[82] *In re AWECO, Inc.*, 725 F.2d at 296.
[83] *Id.*
[84] *Id.*
[85] *Id.*

At the end of the hearing, the court declared it would approve the settlement and the next day it issued a written order, saying the settlement was "fair and equitable" and "in the best interest of the Debtor, its estate, and its creditors."[86] The bankruptcy court allowed a payment of $1 million to United after ten days and ordered that the completion of the settlement occur within one month.[87] The IRS and Department of Energy sought a rehearing, which was granted and contained contrary testimony from AWECO's president stating that the company had no intention to operate the refinery and wanted to sell it.[88] The government moved for a continuance to develop evidence concerning the value of the refinery, but the court denied the motion.[89] The court was only willing to allow a government request to submit an appraisal of the facility if United would extend its time limit on confirmation of the settlement, but because counsel for United noted the stay would jeopardize the deal, the court denied the stay.[90]

The IRS and Department of Energy then appealed to the district court, arguing the settlement's fairness to other creditors, rather than the fairness between AWECO and United.[91] The district court rejected the arguments and upheld the lower court's decision by relying on the fact that the bankruptcy court had taken testimony on the settlement's fairness to creditors and that the bankruptcy judge had extensive knowledge of the case due to months of presiding over the reorganization proceedings.[92] The district judge concluded that, because it was shown through testimony that a settlement with United would give AWECO its only chance at reorganization, the settlement benefitted all creditors.[93] The government then brought the appeal to the Fifth Circuit claiming that the bankruptcy court abused its discretion in approving the settlement without sufficient information and that fairness and equity fell victim to an apparent need for speed in approving the agreement.[94]

In sum, the key issue in *AWECO* was whether the "holder of an outstanding senior claim can validly object to a proposed settlement with a junior claimant on the basis that the settlement would keep the senior claimant from being paid in full."[95] The court reasoned that, "[a]s soon as

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[86] *Id.* at 297.
[87] *Id.*
[88] *In re AWECO, Inc.*, 725 F.2d at 297.
[89] *Id.*
[90] *Id.*
[91] *Id.*
[92] *Id.*
[93] *Id.*
[94] *In re AWECO, Inc.*, 725 F.2d at 297.
[95] *Id.* at 298.

the debtor files a petition for relief, [the] fair and equitable settlement of creditors' claims becomes a goal of the proceedings."[96] The court deemed the settlement in question to fail the fair and equitable standard because it put the junior creditor's interest before the senior creditor's interest.[97] The court noted that when courts approve settlements that deviate from the fair and equitable standard, the approving court abuses its discretion.[98]

Ultimately, the court stated that, "[e]quitable considerations should be preeminent in the exercise of bankruptcy jurisdiction."[99] The decision in *AWECO* stands for the notion that as soon as the debtor files a petition for relief, fair and equitable settlements of the creditors' claims become the goal of the proceedings.[100] Unlike the *Jevic* decision discussed further *infra*, the *AWECO* Court concluded that the absolute priority rule is a firm pillar of priority, even in the settlement context.[101] The Third Circuit disagreed with the decision of *AWECO* and sought to bring leniency to the application of priority rules in the settlement context of a Chapter 11 case, much to the dismay of unpaid senior creditors.[102]

C. The Third Circuit's View: Deviation from the Absolute Priority Rule

In 2015, the Third Circuit decided a case filed in Delaware concerning a corporation operating in New Jersey entitled *Official Comm. of Unsecured Creditors v. CIT Grp./Bus. Credit Inc.* (*In re Jevic*).[103] The case featured a class of objecting creditors that were skipped over in favor of more junior creditors in a Chapter 11 proceeding, after a "structured dismissal" was approved as conditioned by a settlement agreement.[104] The Third Circuit held that in rare cases a structured dismissal may be approved even if it contains a deviation from the Bankruptcy Code's absolute priority rule.[105] The court reasoned that the settlement remained the "least bad" option and thus deviation from the priority scheme norm was permissible.[106] While overruled, in order to glean a better understanding of the unpaid creditors' claim and the subsequent Supreme

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[96] *Id.*
[97] *See id.*
[98] *See id.*
[99] *Id.*; *see* Bank of Marin v. England, 385 U.S. 99, 103 (1966); *see also* Demet v. Harralson, 399 F.2d 35, 39 (5th Cir. 1968).
[100] *In re AWECO, Inc.*, 725 F.2d at 298.
[101] *See id.*
[102] *See* discussion *infra* Part II.D.
[103] Official Comm. of Unsecured Creditors v. CIT Grp./Bus. Credit Inc. (*In re* Jevic Holding Corp.), 787 F.3d 173 (3d Cir. 2015).
[104] *See id.* at 185–86.
[105] *Id.* at 184–85.
[106] *Id.* at 185.

Court decision discussed more thoroughly *infra*,[107] a full discussion of *In re Jevic* is necessary.

Jevic Transportation, Inc. ("Jevic") was a trucking company with its headquarters located in New Jersey.[108] In 2006, after a steep decline in Jevic's business, a subsidiary of the private equity firm Sun Capital Partners ("Sun") obtained Jevic in a leveraged buyout made possible by various lenders led by CIT Group ("CIT").[109] The buyout included an $85 million revolving credit facility by CIT to Jevic, which Jevic could use as long as it held at least $5 million in assets and collateral.[110] Unfortunately for Jevic, "[t]he company continued to struggle in the two years that followed, however, and had to reach a forbearance agreement with CIT—which included a $2 million guarantee by Sun—to prevent CIT from foreclosing on the assets securing the loans."[111] By May of 2008, Jevic's board of directors authorized a bankruptcy filing due to the company's stagnant performance and the expiration of the forbearance agreement on the horizon.[112]

On May 19, 2008, Jevic ceased substantially all of its operations, and its employees received notice of their imminent terminations.[113] "The next day, Jevic filed a voluntary Chapter 11 petition in the United States Bankruptcy Court for the District of Delaware."[114] At the point of filing the Chapter 11 petition, Jevic owed approximately: "$53 million to its first-priority senior secured creditors (CIT and Sun) and over $20 million to its tax and general unsecured creditors."[115] An Official Committee of Unsecured Creditors ("Committee") was assigned to represent Jevic's unsecured creditors by June of 2008.[116]

Most notably for the purposes of the following Supreme Court decision: some of the terminated truck drivers ("Drivers") of Jevic filed a class action against Jevic and Sun claiming various federal and state abuses of the Worker Adjustment and Retraining Notification Acts (WARN);[117] "under which Jevic was required to provide sixty days written notice to its employees before laying them off."[118] While the Drivers filed their WARN claim, "the Committee brought a fraudulent conveyance

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[107] *See* discussion *infra* Part II.D.
[108] *In re Jevic Holding Corp.*, 787 F.3d at 175.
[109] *Id.*
[110] *Id.*
[111] *Id.*
[112] *Id.*
[113] *Id.* at 175–76.
[114] *In re Jevic Holding Corp.*, 787 F.3d at 176.
[115] *Id.*
[116] *Id.*
[117] *Id.*
[118] *Id.*; *see* 29 U.S.C. § 2102 (1988); *see also* N.J. Stat. Ann. § 34:21-2 (2007).

action against CIT and Sun on the estate's behalf, alleging that Sun, with CIT's assistance, 'acquired Jevic with virtually none of its own money based on baseless projections of almost immediate growth and increasing profitability.'"[119] The Committee asserted that Jevic's bankruptcy had escalated because of the poorly advised leverage buyout and by adding debts it could not service.[120] The Committee described Jevic's demise as: "the foreseeable end of a reckless course of action in which Sun and CIT bore no risk but all other constituents did."[121]

The bankruptcy court granted in part and denied in part CIT's motion to dismiss the case almost three years after the Committee filed its fraudulent conveyance action against CIT and Sun.[122] The court held that the fraudulent transfer[123] and preferential transfer[124] claims by the Committee were adequate.[125] The court noted the great possibility for abuse in leveraged buyouts and determined that the Committee had adequately alleged that: "CIT had played a critical role in facilitating a series of transactions that recklessly reduced Jevic's equity, increased its debt, and shifted the risk of loss to its other creditors."[126] Alternatively, due to the Committee's vague and sparse allegations for (1) fraudulent transfer under 11 U.S.C. § 544; (2) equitable subordination of CIT's claims against the estate; and (3) aiding and abetting Jevic's officers and directors in breaching their fiduciary duties, the Court dismissed all three state law claims without prejudice.[127]

In March 2012, representatives from the Committee, CIT, Sun, the Drivers, and what remained of Jevic, came together to discuss a settlement of the Committee's fraudulent conveyance action.[128] At the time of the settlement negotiation, Jevic's only remaining assets were the action against CIT and Sun and $1.7 million in cash (which was subject to Sun's lien).[129] In order to repay the lender group led by CIT, all of Jevic's tangible assets had been liquidated.[130] When the dust settled, the

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[119] *In re Jevic Holding Corp.*, 787 F.3d at 176 (internal quotations omitted).
[120] *Id.*
[121] *Id*. (internal quotations omitted).
[122] *Id.* at 176.
[123] *See generally* 11 U.S.C. § 548 (1979) (defining fraudulent transfers and obligations).
[124] *See generally* 11 U.S.C. § 547 (1979) (defining preferences).
[125] *In re Jevic Holding Corp.*, 787 F.3d at 176.
[126] *Id.* (citing *In re Jevic Holding Corp.*, 2011 Bankr. LEXIS 3553, at *10 (Bankr. D. Del. Sept. 15, 2011)) (quoting Moody v. Sec. Pac. Bus. Credit, Inc., 971 F.2d 1056, 1073 (3d Cir. 1992)).
[127] *Id.*
[128] *Id.*
[129] *Id.*
[130] *Id.*

Committee, Jevic, CIT, and Sun constructed a settlement agreement that contained four major provisions, i.e.:[131]

> (1) The parties would exchange releases for their claims against each other and the fraudulent conveyance action would be dismissed with prejudice.[132]
>
> (2) CIT would pay $2 million into an account earmarked to pay Jevic's and the Committee's legal fees and other administrative costs.[133]
>
> (3) Sun would assign its lien on Jevic's remaining $1.7 million to a trust, which would pay tax and administrative creditors first and then the general unsecured creditors on a pro rata basis.[134]
>
> (4) Jevic's Chapter 11 case would be dismissed.[135]

Thus, the settlement was comprised of a structured dismissal, i.e.: "a disposition that winds up the bankruptcy with certain conditions attached instead of simply dismissing the case and restoring the status quo ante."[136]

The major issue of the settlement agreement was that it left out the Drivers, completely disregarding their uncontested WARN Act claim against Jevic.[137] The Drivers estimated their claim to have been valued at $12.4 million, "of which $8.3 million was a priority wage claim[.]"[138] While it may be true that Jevic was able to quickly structure a settlement with one fell swoop of the pen, ultimately the settlement skipped an entire class of creditors, i.e., the Drivers.[139] Jevic's assets were distributed to all other creditors but the Drivers.[140]

The Third Circuit ultimately upheld this structured dismissal.[141] The structured dismissal essentially picked whom Jevic was going to pay back in order for their case to be dismissed with prejudice, while the Drivers'

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131 *In re Jevic Holding Corp.*, 787 F.3d at 177.
132 *Id.*
133 *Id*.
134 *Id.*
135 *Id.*
136 *Id.*
137 *In re Jevic Holding Corp.*, 787 F.3d at 177 ("There was just one problem with the settlement: it left out the Drivers, even though they had an uncontested WARN Act claim against Jevic . . . [and] held claims of higher priority than the tax and trade creditors' claims.").
138 *Id.* (citing 11 U.S.C. § 507(a)(4)); *see In re* Powermate Holding Corp., 394 B.R. 765, 773 (Bankr. D. Del. 2008) ("Courts have consistently held that WARN Act damages are within 'the nature of wages' for which § 507(a)(4) provides.").
139 *In re Jevic Holding Corp.*, 787 F.3d at 177.
140 *Id.* at 185.
141 *Id.* at 186.

priority claim became an afterthought.[142] The Third Circuit noted that settlements are favored in bankruptcy (as in other areas of law) and reasoned that it makes sense that courts would have more flexibility in evaluating settlements than in confirming plans, given the "dynamic status of some pre-plan bankruptcy settlements."[143] Although the Third Circuit took this approach, it cautioned that compliance with the Bankruptcy Code's priority scheme would usually dictate whether a settlement satisfies the fair and equitable standard.[144] The court noted that settlement agreements that skip a dissenting class of creditors in distributing the estate's assets raise concerns regarding potential collusion.[145]

The Third Circuit concluded that the Bankruptcy Court had a sufficient reason to approve the settlement and structured dismissal of Jevic's bankruptcy case, as it was the "least bad alternative."[146] The court reasoned that, "there was no prospect of a plan being confirmed" and conversion to Chapter 7[147] would have simply resulted in all of the estate assets going to the secured creditors.[148] The court noted that it was regrettable that the Drivers were left out of the settlement; and that there was no support in the record for the proposition that a viable alternative existed that would have better served the estate and the creditors as a whole.[149] The court recognized that the bankruptcy court, "in Solomonic fashion, reluctantly approved the only course that resulted in some payment to creditors other than CIT and Sun."[150]

D. Third Circuit Overruled: The Supreme Court Decision of Jevic

On March 22, 2017, the Supreme Court of the United States addressed the Drivers' unpaid priority claim in *Czyzewski v. Jevic Holding*

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[142] *See id.*

[143] *Id.* (quoting Motorola, Inc. v. Official Comm. of Unsecured Creditors (*In re* Iridium Operating LLC), 478 F.3d 452, 464 (2d Cir. 2007)).

[144] *Id.* (citing *In re Iridium Operating LLC*, 478 F.3d at 455) ("[W]e agree with the Second Circuit's statement that compliance with the Code priorities will usually be dispositive of whether a proposed settlement if fair and equitable.").

[145] *In re Jevic Holding Corp.*, 787 F.3d at 186 (citing *In re Iridium Operating LLC*, 478 F.3d at 464) ("Settlements that skip objecting creditors in distributing estate assets raise justifiable concerns about collusion among debtors, creditors, and their attorneys and other professionals.").

[146] *Id.* at 185.

[147] *See* Diane Lourdes Dick, Article, *Bankruptcy's Corporate Tax Loophole*, 82 FORDHAM L. REV. 2273, 2276 (2014) ("For one thing, Chapter 11 allows a debtor's incumbent management team to command the liquidation process, whereas Chapter 7 requires management to relinquish control to a trustee.").

[148] *In re Jevic Holding Corp.*, 787 F.3d at 185 (internal quotations omitted).

[149] *Id.*

[150] *Id.*

Corp. (*Jevic*).[151] The main question presented to the Supreme Court was whether a bankruptcy court could approve a structured dismissal that deviated from priority rules, to which the Court responded with a simple "no."[152] The Court held that, when creditors object in a Chapter 11 bankruptcy proceeding, a structured dismissal attached to a final distribution must follow priority.[153] This decision ultimately overruled the Third Circuit decision of *In re Jevic*,[154] discussed *supra*.[155]

Elaborating on its decision, the Court opined that the Bankruptcy Code's priority scheme constituted the basic foundation of bankruptcy law.[156] Observing the importance of priority, the Court reasoned that Congress would not be silent if they intended a departure from the rules.[157] Instead, the Court noted that if Congress intended to make structured dismissals a backdoor means to violate priority in final distributions, Congress would have expressly indicated that intent in the Bankruptcy Code.[158] The Court explained that neither the words "structured" nor "conditions," nor any other language relating to distributions of estate value as part of a dismissal were present in any relevant part of the Code.[159]

Most notably for the purposes of this Comment, the Court noted that the Third Circuit relied upon *Motorola, Inc. v. Official Comm. of Unsecured Creditors* (*Iridium*),[160] but distinguished the holding from that case because *Iridium* did not address a structured dismissal.[161] Rather, *Iridium* concerned "an *interim* distribution of settlement proceeds to fund a litigation trust that would press claims on the estate's behalf."[162] The Court opined that *Iridium* did not state that the Bankruptcy Code authorized deviations from priority while there were objecting parties

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[151] *See* Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973, 978 (2017).

[152] *Id.* at 983.

[153] *See 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 distribution of estate value in business bankruptcies.").

[154] *See* Official Comm. of Unsecured Creditors v. CIT Grp./Bus. Credit Inc. (*In re* Jevic Holding Corp.), 787 F.3d 173, 184 (3d Cir. 2015) (holding that structured dismissals that deviate from priority rules, may, in rare instances, be upheld).

[155] *See* discussion *supra* Part II.C.

[156] *Jevic*, 137 S. Ct. at 983.

[157] *See id.* at 984.

[158] *See id.* ("We find nothing in the statute that evinces this intent. The Code gives a bankruptcy court the power to 'dismiss' a Chapter 11 case. But the word 'dismiss' itself says nothing about the power to make nonconsensual priority-violating distributions of estate value.") (internal citations omitted).

[159] *See id.*

[160] Motorola, Inc. v. Official Comm. of Unsecured Creditors (*In re* Iridium Operating LLC), 478 F.3d 452 (2d Cir. 2007).

[161] *Jevic*, 137 S. Ct. at 985.

[162] *Id.*

within the context of a dismissal, which would be a *final* distribution.[163] The Court ultimately held that the structured dismissal at issue was a final distribution of estate value where priority must be followed.[164] Alternatively, the Court mentioned, in *dicta*, that the Bankruptcy Code usually contains justifications for interim distributions that deviate from priority.[165]

The Court contrasted the Second Circuit case of *Iridium*, which concerned an interim distribution that violated priority, with the Third Circuit case of *In re Jevic*, which concerned a structured dismissal that violated priority but attached to a final disposition.[166] The Court noted that the structured dismissal found in *In re Jevic* had a resemblance to the transactions lower courts generally refused to allow for purposes that they "circumvent the Code's procedural safeguards."[167] Moreover, the Court stated that the "rare case" limitation of *In re Jevic* would not save the Third Circuit's decision.[168] The "rare case" exception, the Court reasoned, would cause potentially serious consequences of uncertainty and departure from protections Congress has granted.[169]

III. ANALYSIS

A. The Supreme Court Leaves Door Open: Future Priority-Deviations in Interim Settlements

Chapter 11 parties and courts around the country may have difficulty discerning the *Jevic* decision.[170] While instruments such as structured dismissals will be barred from priority-deviation if they are of a final

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[163] *See id.*

[164] *See id.*

[165] *See id.* ("We recognize that *Iridium* is not the only case in which a court has approved interim distributions that violate ordinary priority rules. But in such instances one can generally find significant Code-related objectives that the priority-violating distributions serve.").

[166] *See id.* at 985–86 (Noting that the aspect of priority-violation in a final disposition contains no justification, the Court noted: "By way of contrast, in a structured dismissal like the one ordered below, the priority-violating distribution is attached to a final disposition; it does not preserve the debtor as a going concern; it does not make the disfavored creditors better off; it does not promote the possibility of a confirmable plan; it does not help to restore the *status quo ante*; and it does not protect reliance interests. In short, we cannot find in the violation of ordinary priority rules that occurred here any significant offsetting bankruptcy-related justification.").

[167] *Jevic*, 137 S. Ct. at 986.

[168] *See id.* ("We recognize that the Third Circuit did not approve nonconsensual priority-violating structured dismissals in general. To the contrary, the court held that they were permissible in those 'rare case[s]' in which courts could find 'sufficient reasons' to disregard priority. Despite the 'rare case' limitation, we still cannot agree.").

[169] *See id.*

[170] *See* Lubben, *supra* note 41 and accompanying text.

dispositional nature, an interim distribution of assets can deviate from priority rules.[171] The *Jevic* Court failed to clarify when a distribution of assets is considered interim.[172] Due to this uncertainty, it is foreseeable that parties in search of options to avoid the absolute priority rule will choose the settlement context to do so, mainly due to the Supreme Court's express approval of *Iridium*, where a priority-deviating interim-settlement was approved. Therefore, even though there may be other interim routes available, the settlement context can soon become the avenue of choice for Chapter 11 parties seeking priority-deviation.

In 2007, the Second Circuit decided *Motorola, Inc. v. Official Comm. of Unsecured Creditors* (*Iridium*).[173] The Second Circuit ultimately found that the absolute priority rule "is not necessarily implicated" when a settlement is presented for court approval apart from a reorganization plan.[174] The court reviewed the argument from the *AWECO* Court, which suggested that the absolute priority rule ought to apply in pre-plan settlements, but disagreed and, stated that the Fifth Circuit "employ[ed] too rigid a test."[175] As mentioned above, the Supreme Court specifically distinguished the case of *Iridium* as a permissible violation of priority due to its interim nature.[176]

The Second Circuit noted that, "whether a particular settlement's distribution scheme complies with the Code's priority scheme must be the most important factor for the bankruptcy court to consider when determining whether a settlement is 'fair and equitable' . . . ."[177] While this is true, the court noted that a noncompliant settlement could be approved when the remaining factors weigh heavily in favor of approving the settlement.[178] Specifically, when there are other factors that, viewed in the aggregate, compose a much more daunting challenge to fairness and equity, the absolute priority rule may be disregarded.[179] The Second Circuit posited that there are circumstances that are better served by deviating from the rigidness of the absolute priority rule.[180]

On April 25, 2017, the United States Bankruptcy Court for the Eastern District of Tennessee, Southern Division, decided the case of *In*

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171 *See supra* notes 165–66 and accompanying text.
172 *See* Lubben, *supra* note 41 and accompanying text.
173 Motorola, Inc. v. Official Comm. of Unsecured Creditors (*In re* Iridium Operating LLC), 478 F.3d 452 (2d Cir. 2007).
174 *Id.* at 463.
175 *See id.* at 463–64.
176 *See supra* note 11 and accompanying text.
177 *In re Iridium Operating LLC*, 478 F.3d at 464.
178 *See id.*
179 *Id.*
180 *Id.*

re Fryar (*Fryar*).[181] *Fryar* was the first bankruptcy case to interpret the Supreme Court decision of *Jevic*. In *Fryar*, the debtor filed, *inter alia*, a motion for settlement.[182] The settlement agreement sought to repay Pinnacle Bank, who had a lien on the debtor's property in the form of a mortgage.[183] Three unsecured creditors objected to the settlement agreement between the debtor and Pinnacle, claiming that Pinnacle was being preferred and "the priorities set for distribution under the bankruptcy code [were] being ordered to Pinnacle's benefit."[184] Thus, the three unsecured creditors argued the settlement was not fair and equitable.[185]

The court in *Fryer* analyzed the settlement under the guidance of the Supreme Court decision of *Jevic*.[186] First, the court noted that the settlement did not in fact follow ordinary priority rules.[187] Next, in light of *Jevic*, the court noted that the settlement might be upheld if all the creditors consented, but this was not the case.[188] Instead, in following the Supreme Court's *dicta*, the court stated that the next step must be to determine whether there were any significant Code-related justifications for the deviation at hand.[189] The court found that the debtor had failed to prove that the priority-deviation by virtue of the settlement agreement with Pinnacle would promote a Code-related objective.[190] Ultimately, the court held that: due to "the Supreme Court's recent ruling in *Jevic*, parties who seek approval of settlements that provide for a distribution in a manner contrary to the Code's priority scheme should be prepared to prove that the settlement . . . is justified because it serves a significant Code-related objective."[191]

The cases of *Iridium* and *Fryar* are examples of the potential interim distributions of assets that violate priority through the medium of settlement agreements. Even though the court in *Fryar* invalidated the settlement agreement at issue for lack of Code-related justifications as per the *dicta* in *Jevic*,[192] the case itself shows that the settlement context could see an increase in selection for future Chapter 11 proceedings as a means of priority-deviation. While there are new safeguards in place to prevent

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[181] In re Fryar, 1:16-bk-13559-SDR, 2017 Bankr. LEXIS 1123 (E.D. Tenn. April 25, 2017).
[182] *See id.* at *1.
[183] *See id.* at *2.
[184] *Id.*
[185] *See id.*
[186] *See id.* at *12.
[187] *Fryar*, 2017 Bankr. LEXIS 1123, at *13.
[188] *Id.* at *14.
[189] *See id.*
[190] *See id.* at *15.
[191] *Id.* at *16.
[192] *See supra* note 165 and accompanying text.

deviation,[193] the Supreme Court decision of *Jevic* still leaves open the door for priority-deviations. As subsequent sections of this Comment suggest, a *post hoc* justification for priority-deviation does not preserve justice in bankruptcy law and should not be the standard going forward.[194]

B. The Dangers of Priority-Deviation

The entire process of Chapter 11 bankruptcy without priority creates an escape hatch for more junior creditors to satisfy their claims, while senior claimants are left holding the bag. At this point the question must be proposed: what is the advantage of being a senior creditor if your priority position can be lawfully usurped before the case is resolved? Fairness and equity cannot be found in situations like *Iridium*, and other similar cases involving priority deviations through interim means.[195] The fact that courts have only looked to the substance of the settlement between the debtor and a particular creditor to determine the fairness of the overall proceeds "contravenes a basic notion of fairness."[196] A plan that deviates from the absolute priority rule sets a lawless stage of take-what-you-can-get mentality that destroys the bedrock principles of priority that bankruptcy law is founded upon.

Through the means of an interim settlement, a debtor can be wholly depleted of assets before a senior creditor has a chance to be paid back while the settlement is upheld as fair.[197] Without the rigid adherence to the absolute priority rule, assets may be freely taken in all directions at any time leading up to a plan being confirmed and create an abundance of dissatisfied creditors, e.g., the Drivers in the overruled Third Circuit decision of *In re Jevic*.[198] Although the Supreme Court remedied the

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[193] *See, e.g.*, Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973, 978 (2017) (prohibiting priority-deviations over creditor objections at the final disposition stage of a Chapter 11 bankruptcy proceeding); *Fryar*, 2017 Bankr. LEXIS 1123 (holding that interim settlements that deviate from priority must be justified by a significant Bankruptcy Code related objective).

[194] *See* discussion *infra* Part III.B.

[195] *See, e.g.*, Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973, 985 (2017) (suggesting that the priority-deviating mechanisms in interim distributions of assets in Chapter 11 cases are permissible); Toibb v. Radloff, 501 U.S. 157 (1991) (recognizing permitting business debtors to reorganize and restructure their debts in order to revive the debtors' businesses and maximizing the value of the bankruptcy estate as purposes of the Code) (internal quotations omitted); In re Kmart Corp., 359 F.3d 866, 872 (7th Cir. 2004) (discussing the justifications for critical-vendor orders); Motorola, Inc. v. Official Comm. of Unsecured Creditors (*In re* Iridium Operating LLC), 478 F.3d 452 (2d Cir. 2007) (upholding an interim distribution of assets that deviated from the priority rules of Chapter 11 bankruptcy).

[196] In re AWECO Inc., 725 F.2d 293, 298 (5th Cir. 1984).

[197] *See id.*

[198] *See supra* note 137 and accompanying text.

Drivers' issue, the Supreme Court still left open the door for future deviations of priority, which can leave future Chapter 11 parties empty-handed in a similar fashion to the Drivers.[199] This is a slippery slope that can undermine the entire construct and goals of bankruptcy law. Without the rule's protections, a reorganization plan may leave more senior creditors out of the equation entirely.

Furthermore, it is possible that any reason can be reason enough for parties to seek deviation from priority rules. For example, in the Third Circuit case of *In re Jevic*, Sun was unwilling to pay the Drivers as long as their WARN Act lawsuit continued due to their interest in the litigation.[200] The Third Circuit noted that Sun, "did not want to fund litigation against itself."[201] Yet, the structured dismissal was still approved.[202] The case of *In re Jevic*, while overruled, is still an example of how reasons such as conflicts of interest can lead to deviation from the absolute priority rule, thus leaving senior creditors unpaid.[203] Conflicts of interest can still be reason enough to deviate from priority, and in light of the recent decision of the Supreme Court, interim distributions are an avenue for deviation to continue.

It is foreseeable that future Chapter 11 settlement negotiations will, *inter alia*, involve parties who have direct interests against each other. With a relaxed interpretation of the absolute priority rule, interested parties will continue to be able to pick and choose when and how they will get paid back through interim settlements. Applying the absolute priority rule at all stages of Chapter 11 proceedings would hedge that process before litigation ensued. If it is not in the priority order, then there should be no possibility for unjust distribution of assets, regardless of the interests of certain creditors. Moreover, applying a strict priority rule could potentially benefit debtors, as a rigid application of the absolute priority rule would create a less muddied scheme in which there is a concrete order for paying back creditors. There would be less confusion and less animosity between "who" gets "what" priority.

Arguably most important, due to a relaxed priority scheme under the guise of absolute priority in Chapter 11 proceedings, it is possible that creditors will expressly contract out of Chapter 11 with debtors for fear of not being paid back. The mere possibility that a creditor who obtains a

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[199] *See* discussion *supra* Part II.D.

[200] Official Comm. of Unsecured Creditors v. CIT Grp./Bus. Credit Inc. (*In re* Jevic Holding Corp.), 787 F.3d 173, 177 (3d Cir. 2015) ("Sun was unwilling to pay the Drivers as long as the WARN Act lawsuit continued because Sun was a defendant in those proceedings and did not want to fund litigation against itself.").

[201] *Id.*

[202] *See id.* at 184–85.

[203] *See id.*

senior claim to the debtor's assets can be overtaken by a junior creditor through an interim settlement agreement that complies with any Code related justification could cause creditors to shy away from Chapter 11 altogether. In order to be better protected, a perturbed creditor cognizant of the parameters of the lenient priority rule might attempt to preclude the debtor from choosing Chapter 11 as a reorganizational tool by express language in a loan agreement. Thus, a relaxed rule of priority in Chapter 11 can lead to a decrease in Chapter 11 filings entirely. Why would courts be willing to risk so much?

C. Counter-Analysis

Before the Supreme Court decision of *Jevic*, adhering to the absolute priority rule in Chapter 11 was far from the norm. A modified and more lenient standard had taken center stage in lieu of the more rigid rule. The results were detrimental to priority creditors.[204] So what seems to be the reason for the prior deviations? First, deviation from the absolute priority rule, especially in settlements, tends to hasten the process. With a strict following of the rule, valuation fights over the debtor's assets become inevitable.[205] When parties come to a settlement agreement, courts seldom wish to intervene and further complicate the process. Courts encourage settlement in every facet of the law and bankruptcy is no different.[206] To hasten the progression of settlements in Chapter 11 bankruptcy, as seen in the Second[207] and Third[208] Circuit decisions, the debtor is allowed some leeway in distributing its assets and courts will only intervene if there are not "specific and credible grounds to justify the deviation."[209]

An argument against the efficiency of these rulings and the avoidance of valuation fights is: if parties are already aware of the implications of a strict interpretation of the absolute priority rule at all stages of Chapter 11, then the parties will understand what they are going up against *ab initio* and plan accordingly. Giving the parties more information at the onset of the litigation will create more informed parties when settlement negotiations ultimately arise, which would therefore decrease the valuation fights at the backend of the settlement and facilitate

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[204] *See id.* at 177.

[205] Stephen J. Lubben, *The Overstated Absolute Priority Rule*, 21 FORDHAM J. CORP. & FIN. L. 581, 593 (2016) ("In particular, senior classes were unable to consent to deviations from the rule, so valuation fights were required in every case.").

[206] *See In re Jevic Holding Corp.*, 787 F.3d at 184 (citing Will v. Northwestern Univ. (*In re* Nutraquest), 434 F.3d 639, 644 (3d Cir. 2006)).

[207] Motorola, Inc. v. Official Comm. of Unsecured Creditors (*In re* Iridium Operating LLC), 478 F.3d 452 (2d Cir. 2007).

[208] *In re Jevic Holding Corp.*, 787 F.3d 173 (3d Cir. 2015).

[209] *Id.* at 184 (citing *In re Iridium*, 478 F.3d at 466).

efficiency altogether. A rigid application could cut down negotiation time because parties to a Chapter 11 case will know where the law stands and can plan around it. The process would be fair to the senior creditors who expected their priority position to be respected. There would be uniformity and reliability in the terms "fair" and "equitable" that could give Chapter 11 filings a better appeal to creditors who are dealing in this arena.

Another argument for lenient priority rules stems from the actions that lead up to the settlement itself, i.e., the debtor's assets often shift and reorganize before a plan becomes confirmed. The absolute priority rule is only implicated at the plan confirmation stage.[210] Therefore, by the time the absolute priority rule is implicated, the debtor's assets might have already gone through several substantial deviations from the rule.[211] Even the Supreme Court has acquiesced to pre-plan deviations of priority.[212] In essence, the absolute priority rule can be seen as "rigor for rigor's sake,"[213] an almost useless barrier towards the end of the case because it is not often followed leading up to the plan confirmation stage to begin with.

Since priority-deviation is lawful leading up to plan confirmation,[214] the absolute priority rule can, in essence, seem to be an odd creature of rigidity that lacks practicality. The prophylactic purpose of the absolute priority rule can be entirely frustrated through any instrument, as long as deviation does not occur during the final disposition of a case. But, if priority becomes truly absolute throughout the entire bankruptcy proceeding leading up to plan confirmation, then the rule will not be a useless barrier at the end of a Chapter 11 case. Parties would be barred from priority-deviation at all stages of a Chapter 11 case, not just at the plan confirmation phase. Therefore, strict adherence to the absolute priority rule at all stages of Chapter 11 bankruptcy would ultimately absolve the argument that the rule is rigor for rigor's sake, and instead would become rigor for justice's sake.

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[210] *See* 11 U.S.C.S. § 1129(b)(2)(B)(ii).

[211] *See* Lubben, *supra* note 205, at 598 ("The debtor-firm's assets at the end-point of the case are subject to the [absolute priority] rule, but those assets might have been significantly reshaped before that point.").

[212] *See generally* Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973 (2017) (noting that pre-plan distributions of assets that deviate from priority are usually justified).

[213] *See* Lubben, *supra* note 205, at 602 ("Strict application at confirmation seems little more than rigor for rigor's sake, at a point when the barn door has been open for too long.").

[214] *See id.* at 601 (citing Jacob A. Kling, *Rethinking 363 Sales*, 17 STAN. J.L. BUS. & FIN. 258, 308 (2012)) ("More generally, as noted earlier, the application of strict absolute priority rule at the point of plan confirmation seems somewhat odd given the well-known practices that allow deviations from priority for various practical reasons before confirmation.").

Consequently, even though rigid adherence to the absolute priority rule through all stages of a Chapter 11 proceeding may, *inter alia*, add an element of sharpened due diligence at the onset of the case, it is the best way to ensure just outcomes for creditors. There will be less power in the hands of the courts to determine when the rule will actually apply, i.e., determining the line between interim and final distributions of assets. It is inherently unjust and unfair to usurp a senior creditor's priority by striking a deal with a junior creditor at any given stage of a bankruptcy proceeding. It leaves the door open for depletion of the debtor's assets without a proper chance for the senior creditor to exact its claims in a timely fashion. Junior creditors would benefit at the detriment of senior creditors, and as such, those proceedings are not fair and equitable *per se*.

D. The Fifth Circuit Standard Should Apply

The Fifth Circuit's fair and equitable standard[215] should be applied to all aspects of Chapter 11 bankruptcy proceedings, thereby hedging the potential increase of priority-deviating settlements and precluding any other interim mechanism that seeks deviation. The Fifth Circuit noted that, "[a]s soon as a debtor filed a petition for relief, fair and equitable settlement of creditors' claims becomes a goal of the proceedings."[216] This goal does not just suddenly surface during the approval process of compromise.[217] Without the absolute priority rule before plan confirmation, bankruptcy courts would be able to "favor junior classes of creditors so long as the approval of the settlement came before the plan."[218] A lack of priority at any stage of a bankruptcy case is at odds with principles of fairness.[219]

By applying the Fifth Circuit's standard of the terms fair and equitable to all facets of a Chapter 11 proceeding, the line drawn by the Supreme Court would vanish.[220] There would not only be a rigid

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[215] *See* In re AWECO, Inc., 725 F.2d 293, 298 (5th Cir. 1984) (quoting SEC v. American Trailer Rentals Co., 379 U.S. 594, 611 (1965)) ("The words 'fair and equitable' are terms of art – they mean that 'senior interests are entitled to full priority over junior ones.'").

[216] *Id.*

[217] *Id.*

[218] *Id.*

[219] *See id.* ("Regardless of when the compromise is approved, looking only to the fairness of the settlement as between the debtor and the settling claimant contravenes a basic notion of fairness.").

[220] The line drawn by the Supreme Court refers to the Court's approval of priority-deviation in interim asset distributions as opposed to disapproval of instruments in Chapter 11 bankruptcy that are attached to a final disposition, e.g., structured dismissals. Hence, following priority at all stages of a Chapter 11 case would absolve that line and the ambiguity attached to it.

adherence to the priority rules at the final resolution of a case but during all interim stages as well. All facets of a Chapter 11 bankruptcy proceeding should be exact and create a reliable precedent for future creditors to interpret. A lenient approach to the absolute priority rule in recent case law is diluting the priority scheme of Chapter 11 bankruptcy in its entirety.[221] The interest of creditors is not considered when more junior interest usurps a senior creditor through interim instruments such as settlement agreements.

There is a difference between the inherent moral notions of what constitutes fair and equitable and the "fair and equitable" standard in bankruptcy law. The "fair and equitable" standard does not apply to interim settlements in Chapter 11, but fairness and equity are to be considered in every aspect of law. In *AWECO*, the court rightfully served fairness and equity for the senior claimant. The court noted that, even though the junior creditor reached a "fair and equitable" settlement in terms of bankruptcy law,[222] it was inherently unfair because it would have skipped over the more senior creditor.[223] In order to be truly fair and equitable, the Fifth Circuit's reasoning must be the standard at all stages of Chapter 11 proceedings going forward.

The Fifth Circuit argued that if the "fair and equitable" standard had no application before the plan confirmation, then bankruptcy courts would have the discretion to favor junior creditor interests so long as the approval of the settlement came before the plan.[224] That would be neither fair nor equitable to the skipped senior creditor. The words "equity" and "fairness" are not just terms of art in bankruptcy—they are catch phrases of bankruptcy law in general.[225] Allowing bankruptcy courts the power to uphold interim distributions of assets that deviate from priority is inapposite with the goals of bankruptcy law.

The most effective way to change the trends in this area of bankruptcy law is to amend the statutory language of the Code to apply the absolute priority rule into all areas of Chapter 11 bankruptcy, instead of just confirmed plans of reorganization. Alternatively, a Supreme Court ruling that commands adherence to the absolute priority rule in all aspects of a Chapter 11 proceeding would also suffice. If parties wish to waive

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[221] *See supra* note 195 and accompanying text.

[222] *In re AWECO, Inc.*, 725 F.2d at 298 ("An estate might be wholly depleted in settlement of junior claims – depriving senior creditors of full payment – and still be fair as between the debtor and the settling creditor.").

[223] *See id.* ("Regardless of when the compromise is approved, looking only to the fairness of the settlement as between the debtor and the settling claimant contravenes a basic notion of fairness.").

[224] *Id.*

[225] *Id.* at 300.

their procedural protections then by all means they should be able to do so, but when a reorganization plan surfaces—the more senior creditors need to have a reliable pillar of stability at the forefront. That pillar was—and still needs to be—the absolute priority rule.

Amending the statutory construction of 11 U.S.C. § 1129(b)(2)(B)(ii) to encompass the Fifth Circuit's reasoning would truly create fair and equitable results. Section 105(a) of the Bankruptcy Code provides that a bankruptcy court may not override explicit mandates of other sections of the Bankruptcy Code.[226] Further, the Supreme Court noted that a bankruptcy court may not infringe upon specific statutory requirements.[227] Therefore, an amended Code equipped with the Fifth Circuit's reasoning—that the absolute priority rule must apply at all stages of a bankruptcy—would truly insulate the rule from deviation through express statutory language and added support from the Supreme Court.

Bankruptcy courts should not be able to approve interim distributions of assets that deviate from priority, regardless of any justifications. In approving settlements, a court must act "for the benefit of all creditors,"[228] not to facilitate quicker negotiations to the detriment of senior creditors who do not object in time.[229] In an analogous situation to *AWECO*, the Supreme Court in *Protective Committee v. Anderson*,[230] noted its sympathy for the desire of a court to terminate drawn-out bankruptcy proceedings.[231] Nonetheless, the Court noted, "[t]he need for expedition is not a justification for abandoning proper standards."[232] Ultimately, upholding proper standards is what gives the law its power.

If there are justified situations where creditors must be paid back outside of priority, e.g., the Code-related justifications the Supreme Court noted in *Jevic*, then those justifications should be given express priority in the Code. This way, those Code-related justifications will remain an option due to the Code's express accounting of those justifications in priority rules. The Code itself would allocate a guaranteed priority position for those justifiable circumstances. Therefore, the rule will still retain its true absolute form and account for circumstances where creditors are better served with quicker access to assets.

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[226] 11 U.S.C.S. § 105(a) (1979).

[227] Law v. Siegel, 134 S. Ct. 1188, 1194 (2014).

[228] *In re AWECO, Inc.*, 725 F.2d at 299 (quoting Matter of Boston & Providence R. Corp., 673 F.2d 11 (1st Cir. 1982)).

[229] *See id.* (internal quotations omitted) ("This obligation prevails even where the creditors are silent.").

[230] *See* Protective Committee v. Anderson, 390 U.S. 414 (1968).

[231] *See id.* at 450.

[232] *Id.*

Ultimately, having a strict interpretation of the absolute priority rule will act as a firm backbone to settlement conversations and thus facilitate a process more apt to fairness from the onset of any possible litigation. Applying the Fifth Circuit's interpretation of the absolute priority rule will ultimately change the structure of negotiations. If the parties agree to waive the rule, then that is their decision—but going into a Chapter 11 case without the assurances of a rigid absolute priority rule leaves the more senior creditors in a vulnerable position. A well-settled law encompassing absolute priority will finally put to rest the injustice of usurped creditors and the ambiguity of when the rule is to be applied.

IV. CONCLUSION

A creditor expects to count on a priority system in Chapter 11 bankruptcy the way the human body depends on the spine for support. Priority ought to be the backbone for all settlement negotiations in Chapter 11 bankruptcy, not just during final dispositions of the case. There must be a reliable system that does not reward a junior creditor with the priority right of a senior creditor simply due to time constraints,[233] which was noted in the Fifth Circuit's decision of *In re AWECO, Inc*. as a major reason the bankruptcy court upheld the initial settlement agreement.[234] A strict enforcement of the absolute priority rule at all stages of a bankruptcy case will put parties on notice at the forefront of litigation. Due to the upfront knowledge of how priority will be respected, parties will be able to bargain with more efficiency and certainty.

Admittedly, it is a worthy goal for debtors to make a deal that benefits them at an opportune time,[235] but consider the consequences when a creditor—who not only expects, but deserves to be in that priority position—is overtaken by a more junior creditor and left with nothing. Unreliability of this sort in Chapter 11 proceedings could ultimately deter Chapter 11 filings through express language in loan agreements between creditors and debtors. Potential creditors may be less likely to lend to a debtor knowing priority is not guaranteed, despite efforts to obtain

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[233] *See In re AWECO, Inc.*, 725 F.2d at 298 ("Time pressure apparently influenced the bankruptcy judge to deny the government's request for a continuance to develop evidence on the refinery's worth and to deny the government leave to submit its own appraisal of the refinery.").

[234] *Id.* at 300 ("In this case time pressure functioned as a shotgun. The bankruptcy court blessed the settlement without sufficient factual information to determine if the settlement was fair and equitable to the government.").

[235] *Id.* at 299 ("Moreover, preserving a settlement potentially advantageous to the debtor and its creditors is a worthy goal.").

priority. Bankruptcy proceedings should not be risking so much in order to encourage the mere possibility of swift settlements.[236]

Furthermore, deviation from the rule up until plan confirmation undermines the major equitable principles of bankruptcy law. Whereas some settlements that deviate from the absolute priority rule can be fair and equitable as a term of art in bankruptcy law,[237] when senior creditors are skipped over in favor of more junior creditors, the settlement becomes inherently unjust[238] and should not be approved. Any scenario where junior claimants supersede senior creditors creates an unjust environment. Priority-deviation may be a positive outcome for some parties in their individual settlements, but siphoning assets is a zero-sum game. Junior interests will continue to benefit from the non-application of the absolute priority rule at the expense of senior creditors.[239] A rule that masquerades itself as absolute, when it in fact and practice has become lenient, only undermines the basic priority constructs of bankruptcy law.

Assuming, *arguendo*, that a relaxed interpretation of the absolute priority rule in the settlement context creates a more succinct outcome blatantly ignores the possibility of efficiency through rigid application of the rule.[240] The shift to rigidity in Chapter 11 priority will lead to more informed parties and will lead to efficient negotiations. The parties to a Chapter 11 case will be more informed because the absolute priority rule will follow its explicit meaning, and not what a court interprets it to be. A rigid application of the absolute priority rule will foster a process that leads to less confusion about what the law means from the onset of litigation and will provide a firm foundation for settlement negotiations. A longer process may possibly result,[241] but that is a small price to pay for dissolving the ambiguity that has recently been enveloping Chapter 11.

A strict adherence to the absolute priority rule at all stages of a Chapter 11 case will allow parties to consider the pros and cons of litigation and use that information as a bargaining tool. Applying the Fifth Circuit's strict interpretation of the absolute priority rule will prevent the use of interim mechanisms as an escape hatch for deviation. Any justifiable scenario for priority-deviation should be given express priority in the Bankruptcy Code. Used properly, the absolute priority rule is a

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[236] *See id.* at 300.

[237] *See supra* note 222 and accompanying text.

[238] *See supra* note 223 and accompanying text.

[239] *See generally* Motorola, Inc. v. Official Comm. of Unsecured Creditors (*In re* Iridium Operating LLC), 478 F.3d 452 (2d Cir. 2007) (upholding an interim distribution of assets that deviated from the priority rules of Chapter 11 bankruptcy).

[240] *See* discussion *supra* Part III.C.

[241] *See* discussion *supra* Part III.C; *see also* Lubben, *supra* note 205 and accompanying text.

device that can lessen the amount of future contested plans and facilitate quicker and more efficient negotiations; which is the precise reasoning many courts employ today for deviating from the absolute priority rule in the first place.[242] Ensuring that parties are aware of rigid application of the absolute priority rule at the onset of a Chapter 11 proceeding will ultimately lead to truly fair and equitable results for creditors and debtors alike.

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[242] *See supra* notes 233–34 and accompanying text.