Did *Jevic* Doom Future Chapter 11 Recovery Efforts by Unsecured Creditors?

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A majority of today's large Chapter 11 cases are structured as quick Section 363 sales of all the debtor's assets followed by confirmation of a plan of liquidation, dismissal of the case, or a conversion to a Chapter 7. The purchaser in the sale is often one of the debtor's prepetition secured or undersecured lenders, which may also act as the debtor-in-possession (DIP) lender and purchase the debtor's assets through a credit bid, with no cash consideration.

In these cases, general unsecured creditors have little chance of a

meaningful recovery absent a viable and recoverable claim against the prepetition lenders, the DIP lender, or some other third party, assuming that such claim has not already been encumbered by the liens of more senior creditors or released in connection with the DIP financing.

To obtain a recovery for their constituency in these types of cases, official unsecured creditors' committees vigorously assert all of their rights under the U.S. Bankruptcy Code to seek to leverage their position. For example, the committee may raise good faith objections to, among other things, (i) the DIP financing (especially if it is being provided by the lender/credit bid purchaser), (ii) the sale procedures—including what is often a highly expedited sale timeline—which the committee may believe were not designed to maximize value for unsecured creditors, and/or (iii) whether the credit bid itself should be allowed under the particular circumstances of the case.

The committee may then negotiate a settlement of these objections, which may include the lender/credit bid purchaser agreeing to "gift" certain non-estate assets to a liquidating or litigation trust established for the benefit of general unsecured creditors. In many of these cases, confirmation of a plan is not possible due to the estate being close to, or in fact, administratively insolvent. As such, claims with a higher priority than those of general unsecured creditors may not be included in the settlement for a variety of reasons, such as (a) because such creditors are unwilling to agree to a settlement that will not pay them in full or are seeking a higher percentage recovery on their claims than the recovery provided to general unsecured creditors, or (b) because the "gift" would be severely diluted by what are often the vastly larger deficiency claims of undersecured creditors.

Although these types of settlements have been successfully implemented in many cases over the years, a recent decision by the U.S. Bankruptcy Court for the District of Delaware—if it is followed by other courts—may preclude this strategy from being used and significantly limit the leverage that a committee may have against a lender/credit bid purchaser in circumstances similar to those described.

Constellation Settlement Agreement

In the Chapter 11 cases of *Constellation Enterprises LLC, et al.*,[1] the official committee of unsecured creditors and the debtors jointly filed a motion with the Bankruptcy Court seeking approval of a settlement agreement, which was entered into by the debtors, the committee, and an *ad hoc* group of noteholders.[2] A subset of those noteholders were both the lenders that provided the DIP financing to the debtors and the successful credit bidders in a sale of substantially all of the assets of certain of the debtors' subsidiaries.

The settlement agreement resolved the committee's pending objections to both the DIP financing and the sale, in return for which the noteholders agreed (through an affiliate) to contribute to a trust to be established for the benefit of the debtors' unsecured creditors (the GUC trust) the following assets: (1) $1.25 million, for a direct *pro rata* cash recovery to unsecured creditors; (2) certain potentially valuable causes of action, which the noteholders either acquired through the sale or which

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were strictly their own; and (3) $1 million in funding to administer the GUC trust and pursue the causes of action.

However, under the settlement agreement, the distributions to the GUC trust would skip certain priority claimants, such as the Internal Revenue Service (IRS)—which held a large claim against the debtors—and treat the deficiency claim of a group of "delayed-draw term loan lenders" (DDTL) and their agent less favorably than the claims of the other unsecured creditors. Objections to the settlement motion were filed by the DDTL parties, the United States Trustee, the IRS, and certain WARN Act claimants.

The Bankruptcy Court initially deferred hearing the settlement motion until the U.S. Supreme Court issued its ruling in *Czyzewski v. Jevic Holding Corp.*, which was pending at the time.[3] When the Supreme Court issued its opinion and ruling in *Jevic*, it reversed a decision by the 3rd U.S. Circuit Court of Appeals, which had affirmed a Bankruptcy Court order approving the distribution of proceeds from the settlement of certain *bankruptcy estate causes of action* to general unsecured creditors in connection with a structured dismissal, which skipped distributions to certain higher priority claims. The Supreme Court framed the question before it and its ruling as follows:

> The question before us is whether a bankruptcy court has the legal power to order this priority-skipping kind of distribution scheme in connection with a Chapter 11 *dismissal.*
>
> In our view, a bankruptcy court does not have such a power. 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.[4]

The Supreme Court provided a second iteration of the question presented, and its answer, as follow:

> Can a bankruptcy court approve a structured dismissal that provides for distributions that do not follow ordinary priority rules without the affected creditors' consent? Our simple answer to this complicated question is "no."[5]

In additional briefing in *Constellation* requested by the Bankruptcy Court following the Supreme Court's ruling, the committee argued that *Jevic* was either inapplicable to the settlement motion or distinguishable because it only addressed distributions of property of a debtor's estate, whereas the contributions to be made to the GUC trust by the noteholders were either assets they had purchased from the debtors in the sale and now owned or assets that had always belonged exclusively to the noteholders.

In support of its argument, the committee relied in part on the 3rd Circuit's decision in *In re ICL Company, Inc.*,[6] for the proposition that the Bankruptcy Code's "distribution rules don't apply to non-estate property." The committee pointed out that, notably, *ICL Holding* was not addressed or even cited in the Supreme Court's *Jevic* decision.

In opposing the settlement motion, the principal argument advanced by the objectors was that approval of the settlement agreement was precluded by the ruling in *Jevic*. Specifically, the objectors argued that: (a) the prohibition against class-skipping in *Jevic* did not specifically focus on the distinction between property of the estate and non-estate property and hence, that distinction was irrelevant; (b) *Jevic* reflected a broad policy against all class-skipping; (c) *ICL Holding*, which permitted class-skipping, was either effectively overruled by *Jevic* or should be narrowly read to mean that if there was a distribution of non-estate assets that were at one time property of the estate, then a class-skipping distribution was not permitted; (d) the causes of action were "laundered" through the sale to the noteholders to make it appear that they were not estate assets; and (e) the settlement agreement included other forms of estate property or involvement, such as the payment of legal fees, releases, and assistance by the debtors in the claims reconciliation process.

Following an evidentiary hearing, the Bankruptcy Court declined to approve the settlement agreement on the basis that it was impermissible under *Jevic*. The Bankruptcy Court, in an oral ruling, held that (a) *Jevic* did not necessarily focus on whether estate assets were involved; (b) *ICL Holding*, which the committee contended supported approval of the settlement agreement, may have been overruled or significantly narrowed by *Jevic*; and (c) in any event, *ICL Holding* did not apply to the facts of the *Constellation* cases because some of the assets to be contributed by the noteholders were "at one time" property of the debtors' estates.

The committee appealed the Bankruptcy Court's denial of the settlement motion to the U.S. District Court for the District of Delaware. The DDTL parties, the U.S. Trustee, and the IRS opposed the appeal.

The Committee's Arguments on Appeal

In the settlement appeal, the committee argued that in *Jevic*, the Supreme Court specifically focused on the distinction between estate assets and non-estate assets and that its holding pertained only to a distribution of estate assets. According to the committee, the Bankruptcy Court erred by failing to recognize this important distinction, and the only material assets involved in the settlement agreement were non-estate assets.

The committee also argued that *ICL Holding* correctly held that the distribution scheme under the Bankruptcy Code does not apply to distributions of non-estate property pursuant to a settlement and that the Bankruptcy Court incorrectly disregarded that ruling, which, according to the committee, remained binding precedent in the 3rd Circuit. Further, citing to a then recent decision by the District Court in another case,[7] the committee submitted that a settlement that involves the distribution of non-estate property does not require compliance with the Bankruptcy Code's priority scheme, even if such property was "at one time" property of the estate. In addition, those causes of action that did not already belong to the noteholders were legally transferred to them pursuant to the order approving the sale, which was final in all respects before the Bankruptcy Court considered the settlement motion, such that they were non-estate assets and, therefore, not subject to the Bankruptcy Code's priority scheme. Finally, the committee maintained that the payment of legal fees, the proposed releases, and the debtors' nominal assistance in the claims reconciliation process did not constitute an impermissible distribution of estate assets.

Appeal Thwarted

While the settlement appeal was pending, the *Constellation* debtors moved to convert their Chapter 11 cases to Chapter 7 on the basis that their estates were administratively insolvent. The

committee objected to the conversion motion on the basis that, among other things, conversion would jeopardize the viability of the settlement appeal. The Bankruptcy Court nevertheless approved the motion, a ruling the committee also appealed to the District Court.

The appellees then moved to dismiss both the settlement and conversion appeals, arguing that, immediately upon conversion of the debtors' Chapter 11 cases to Chapter 7, the committee was automatically dissolved. Because the committee was the only appellant, both appeals had to be dismissed, they contended. In a reported decision, the District Court agreed and dismissed both appeals.[8]

As a result, the settlement appeal was never heard or decided on the merits. Thus, the Bankruptcy Court's ruling in *Constellation* was never subject to appellate review. All of the consideration they were to contribute to the GUC trust remained with the noteholders, who thereby received a multimillion-dollar windfall, since they were under no obligation to, nor did they ever, contribute those assets to the debtors' estates.

Conclusion

The Bankruptcy Court's ruling in *Constellation*, if followed by other courts, may serve to significantly impair a creditors' committee's options and leverage when seeking to obtain a recovery from the debtor's secured or undersecured lenders. Secured and/or undersecured creditors generally already dominate these types of cases and, just like in *Constellation*, often acquire all of the estate's assets by credit-bidding their debt and leave the estate either close to or, in fact, administratively insolvent. In these cases, the only hope for unsecured creditors is for a committee to use whatever leverage it can muster to try to obtain some recovery for its constituency from the only available source—the debtor's senior secured (or undersecured) creditors.

Committees will undoubtedly continue to advocate for the position advanced by the committee in *Constellation*, such that when a secured creditor has obtained title to former estate assets free and clear of liens and encumbrances, it should be permissible for that creditor to contribute what are now its own assets—or its own funds or causes of action that were never estate assets—to unsecured creditors, even if doing so involves class-skipping. Committees will continue to argue that, where there is no transfer of estate assets but rather a gift of non-estate assets to unsecured creditors, there is no requirement that such gifting must comply with the priority scheme imposed by the Bankruptcy Code.

It remains to be seen whether other courts will follow the ruling in *Constellation* or distinguish it from the ruling in *Jevic*. Like the committee argued in *Constellation*, courts may conclude that *Jevic* does not prohibit the gifting of non-estate property from a secured lender and/or purchaser of estate assets to unsecured creditors, even if in doing so, certain creditors who would be entitled to a higher priority in the context of a plan of reorganization or liquidation will not be similarly treated.

If, on the other hand, courts decide to follow the *Constellation* ruling and prohibit priority-skipping settlements and gifting in all circumstances, Chapter 11 may largely become nothing more than a federal foreclosure statute, for the sole benefit of secured creditors. J

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[1] *In re Constellation Enterprises LLC*, Case Number 1:16-bk-11213.

[2] Squire Patton Boggs (US) LLP was lead counsel for the committee in the *Constellation* bankruptcy cases.

[3] 137 S. Ct. 973 (2017).

[4] *Id.* at 978 (emphasis in original).

[5] *Id.* at 983.

[6] 802 F.3d 547, 555 (3d Cir. 2015).

[7] See *Hargreaves v. Nuverra Environmental Solutions, Inc. (In re Nuverra Environmental Solutions, Inc.)*, No. 17-1024, 2017 U.S. Dist. LEXIS 122317 (D. Del. Aug. 3, 2017).

[8] *Official Comm. of Unsecured Creditors v. Constellation Enters. LLC (In re Constellation Enters. LLC)*, No. 17-757-RGA, 2018 U.S. Dist. LEXIS 47153 (D. Del. March 22, 2018). The District Court summarized its ruling as follows:

> A creditors' committee exists only under the statutory framework of the Bankruptcy Code. When these cases converted, the Chapter 11 order for relief became an order for relief under Chapter 7, the statutory predicate for the existence of Committee no longer applied, and the Committee automatically dissolved. As the Committee has dissolved, it has no capacity or authority to appear before this Court, including filing the notice of appeal of the Conversion Order and any filings made in further prosecution of the appeal of the Settlement Denial Order. Because the Committee has no capacity to pursue these appeals, and there is no co-appellant to pursue these appeals, the appeals must be dismissed.

Id. at *286-87.