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## Solicitor General Sides With Priority Creditors In Recent Amicus Brief

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**June 2, 2016** - Last summer, the [HHR Bankruptcy Report analyzed](#) the Third Circuit's ruling in *Official Committee of Unsecured Creditors v. CIT Group/Business Credit Inc. (In re Jevic Holding Corp.)*,<sup>[1]</sup> which approved, as part of the structured dismissal of a chapter 11 proceeding, a settlement agreement that allowed distributions that violated the absolute priority rule. Following the Third Circuit's ruling, the aggrieved priority creditors filed a *writ of certiorari* in the hope that the Supreme Court would address the split between the Courts of Appeals as to whether settlements must follow the absolute priority rule.<sup>[2]</sup> Now, in response to an invitation from the Supreme Court, the Solicitor General has submitted an amicus brief on behalf of the United States encouraging the Court to grant certiorari and to overturn the Third Circuit's ruling.

The United State government has a particular and somewhat unique interest in having the Supreme Court review the Third Circuit's decision. Federal taxing authorities (e.g. the IRS) are granted either second priority or eighth priority claims by the Bankruptcy Code depending on whether the tax obligation arose pre or post-petition. Accordingly, the government recognizes a real danger that, as a result of the Third Circuit's ruling, debtors could collude with junior creditors to "squeeze out" government tax claims with a higher priority.

At issue in *Jevic* was the approval of a settlement agreement between the debtor, the Unsecured Creditors' Committee and defendants to fraudulent transfer actions, that provided, in part, for (i) distributions to certain administrative and unsecured creditors as part of a structured dismissal of the chapter 11 proceeding, but did not provide for (ii) distributions to the debtor's former employees who held higher priority claims arising from WARN Act liability. The former employees objected to the approval of the settlement on the ground that a bankruptcy court cannot approve a settlement and related structured dismissal of the case that does not comply with the order of priorities set out in section 507 of the Bankruptcy Code. Relying on the fact that it was highly unlikely that the debtor would confirm a plan of reorganization or that the employees would receive any distribution in a chapter 7 liquidation, the Third Circuit rejected the employees' argument and held that a chapter 11 proceeding

may be resolved, in rare circumstances such as those presented in the *Jevic* proceeding, through a structured dismissal that deviates from the Bankruptcy Code's priority scheme.

The Solicitor General argued in his amicus brief that the Third Circuit had erred in reaching its holding for a number of reasons. First, the order of priorities established by the bankruptcy code reflects Congress's detailed balancing of the rights and expectations of various creditor groups, and that by approving a settlement that deviated from this order of priorities, the bankruptcy court was upending "that carefully balanced system." The Solicitor General noted that this outcome was particularly incongruous when compared to the requirements for chapter 11 plan confirmations and chapter 7 liquidations where priority creditors must be paid first (unless they consent to impairment). Second, the Solicitor General disagreed with the Third Circuit's reasoning that a deviation from the Bankruptcy Code's priority scheme was justified by the fact that the employees would not be prejudiced by the settlement because there was no prospect of a chapter 11 plan being confirmed or of a distribution to priority creditors if the case was converted to a chapter 7 liquidation (*i.e.* the employee creditors would be in the same position whether or not the settlement was approved). The Solicitor General noted that if the case had "simply been dismissed" pursuant to section 1112 of the Code, the employees could have pursued a fraudulent – conveyance action against the settling defendants on a derivative basis as creditors of *Jevic*. So rather than being outcome neutral, the employee creditors were being directly deprived of a potential source of recovery. The Solicitor General also argued that granting certiorari was appropriate in this case because of the existing split between the Circuits on this issue, as well as the real and significant impact the ruling could have on the rights of creditors in future proceedings.

The Solicitor General's amicus brief highlights the potentially wide impact of the Third Circuit's ruling, despite the court's attempt to limit its holding to cases where "specific and equitable grounds" justify deviation from the priority scheme. It is conceivable that in nearly every case where a debtor is administratively insolvent, a justification could be found for deviating from the absolute priority rule under the Third Circuit's ruling. In those circumstances, debtors will be able to apply strong bargaining pressure on priority creditors to accept reduced claim amounts, less the debtor strike a settlement with other junior creditors of the case that cuts out the recalcitrant priority creditor entirely. Additionally, in light of the Circuit split on the issue, the Third Circuit's ruling raises forum shopping concerns, as debtors (many of whom are organized under the laws of Delaware) will be more likely to commence proceedings in the Delaware bankruptcy court, if only to ensure themselves the benefit of the debtor-friendly rule adopted by the Third Circuit.

## Footnotes

[1] 787 F.3d 173 (3rd Cir. .2015).

[2] Compare *In re AWECO, Inc* 725 F.2d 293 (5th Cir 1984)(finding that a bankruptcy court abuses its discretion in approving a settlement agreement that does not comply with the absolute priority rule); with *In re Iridium Operating LIC*, 478 F.3d 452 (2d Cir. 2007) (holding that a settlement may deviate from the absolute priority rule in certain circumstances).

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