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How Absolute Is the Absolute Priority Rule in Bankruptcy? The Case for Structured Dismissals

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HOW ABSOLUTE IS THE ABSOLUTE PRIORITY RULE IN BANKRUPTCY? THE CASE FOR STRUCTURED DISMISSALS

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ABSTRACT

This Article challenges the view that the absolute priority rule applies to a "structured dismissal" in a chapter 11 bankruptcy case, namely a court-approved settlement of certain claims by or against the debtor followed by the dismissal of the case. Under that view, the bankruptcy court cannot approve a settlement that makes a distribution to holders of junior claims unless it also provides for payment of all senior claims in full. The Supreme Court considered the question in the fall of 2016 in Czyzewski v. Jevic Holding Corp. (In re Jevic Holding Corp.). *The question before the Court is: "Whether a bankruptcy court may authorize the distribution of settlement proceeds in a manner that violates the statutory priority scheme."*

The argument that a structured dismissal always must follow the absolute priority rule, even when a chapter 11 plan is not confirmable, overstates the current statutory reach of the rule. In 1939, the rule reached its zenith by judicial launch in Case v. Los Angeles Lumber Co., *when the Court construed the statutory term "fair and equitable" as synonymous with "absolute priority." Congress has circumscribed the rule repeatedly since: in 1952 by amending the Bankruptcy Act, in 1978 with enactment of the Code, and in 1986 and 2005 by amending the Code.*

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As a result of these statutes, the absolute priority rule is a special, limited rule that does not pervade the current Code. Indeed, the very reorganization plan—a consensual chapter 11 plan—that the Court held was not confirmable in Los Angeles Lumber Co. *would be confirmable under the current Code.*

This Article concludes that Congress has authorized a bankruptcy court to approve a structured dismissal in chapter 11 when it is in the best interest of creditors—such as when a plan is not confirmable—even if distributions do not follow the absolute priority rule. Accordingly, the Court should resolve the current circuit split by affirming Jevic.

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INTRODUCTION: STRUCTURED DISMISSALS AND THE ABSOLUTE PRIORITY RULE UNDER THE BANKRUPTCY CODE

The Supreme Court will soon decide whether the absolute priority rule applies to the "structured dismissal" of a chapter 11 case.[1] The bankruptcy court in *Czyzewski v. Jevic Holding Corp.* (*In re Jevic Holding Corp.*) approved a structured dismissal that was not in accordance with the absolute priority rule because it provided for payments to holders of junior claims without full payment of senior claims. The district court and the court of appeals affirmed.[2]

The losing creditors in *Jevic* sought certiorari based on a circuit court split on the issue.[3] The Second Circuit in *In re Iridium Operating LLC* held that a court could authorize a structured dismissal that does not make distributions to unsecured creditors in accordance with the absolute priority rule if there are specific and credible grounds to justify the deviation.[4] The Fifth Circuit in *In re AWECO, Inc.*, by contrast, stated a per se rule under which all settlements outside of a plan, reached at any time in the case, must comply with the absolute priority rule.[5] The Supreme Court granted certiorari in *Jevic* and will resolve the issue.[6]

A structured dismissal of a chapter 11 case is a settlement of certain claims asserted by or against the debtor that the bankruptcy court approves contemporaneously with its dismissal of the case pursuant to the applicable sections of the Bankruptcy Code.[7] Unlike an "old-fashioned," one sentence dismissal order, an order approving a structured dismissal typically contains or incorporates

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[1] The Supreme Court heard arguments for this case on Dec. 7, 2016. *See Czyzewski v. Jevic Holding Corporation*, SCOTUSBLOG, http://www.scotusblog.com/case-files/cases/czyzewski-v-jevic-holding-corporation/ [https://perma.cc/VU5M-LP9Z].

[2] *In re* Jevic Holding Corp., 787 F.3d 173, 175 (3d Cir. 2015), *aff'g*, Bank. No. 08-11006, 2014 WL 268613 (D. Del. 2014).

[3] *See id.* at 186.

[4] *In re* Iridium Operating LLC, 478 F.3d 452, 466 (2d Cir. 2007).

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

[6] *See* Czyzewski v. Jevic Holding Corp. 136 S. Ct. 2541 (2016).

[7] *See* 11 U.S.C. § 1112(b)(1) (2012); *id.* § 349. The term the "Bankruptcy Code," or the "Code" when used in this Article, refers to the Bankruptcy Reform Act of 1978, as amended, which is the current bankruptcy law in the United States and is codified at 11 U.S.C. §§ 101–1532.

the substantive settlement terms agreed to by the parties.[8] Those terms may include releases of the claims settled, an agreed "gifting" of the funding for the settlement by one or more secured creditors from the proceeds of their collateral, and procedures for reconciling and paying certain claims.[9] A structured dismissal resolves a chapter 11 case, typically one in which a plan is not confirmable.[10]

At the heart of a structured dismissal is the court's approval of the settlement that will not always adhere to the absolute priority rule. Parties settle numerous claims and disputes over the course of a chapter 11 bankruptcy case. Bankruptcy Rule 9019 authorizes the bankruptcy court to approve settlements and compromises in chapter 11 and in cases filed under other chapters of the Code.[11] The Rule provides no standard by which a court should grant or deny its approval of a settlement. Rather, Rule 9019(a) provides simply: "On motion by the trustee and after notice and a hearing, the court may approve a compromise or settlement."[12]

The Supreme Court requires a bankruptcy court to take a multifaceted approach when deciding whether to approve a compromise or settlement.[13] This method focuses on the complexity, expense, and likely duration of the litigation as well as the probability of success and collection—weighing the terms of the settlement

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[8] The grounds for dismissal of a chapter 11 case are set forth in section 1112. *See* 11 U.S.C. § 1112. The ordinary effects of the dismissal and the court's authority to alter those effects "for cause" are set forth in section 349. *See* § 349.

[9] *In re* Jevic Holding Corp., 787 F.3d 173, 177 (citing *In re* Strategic Labor, Inc., 467 B.R. 11, 17, n.10 (Bankr. D. Mass. 2012)).

[10] *See id.*

[11] *See* FED. R. BANKR. P. 9019. Bankruptcy Rule 9019 is one of the Federal Rules of Bankruptcy Procedure, which are the procedural rules applicable in bankruptcy cases (the "Rules" or the "Bankruptcy Rules"). The Supreme Court prescribes the Bankruptcy Rules, pursuant to the power given to it under 28 U.S.C. § 2075. The Rules are regularly revised even if there have been no intervening amendments to the Bankruptcy Code. The current Rules became effective on December 1, 2016.

[12] *Id.* 9019(a).

[13] *Id.* 9019. In addition, the Code contains provisions for settlements made as part of a plan of reorganization or liquidation. Code section 1123(b) ("Contents of plan") states that a proposed plan may provide for "the settlement or adjustment of any claim or interest belonging to the debtor or to the estate." 11 U.S.C. § 1123(b)(3) (2012).

against the risks and the possible rewards of the litigation.[14] The Supreme Court set forth this doctrine in the *TMT* case in 1968,[15] prior to enactment of the Code and the adoption of the current Rule 9019.[16] The courts continue to apply this rule today.[17]

The absolute priority rule in present parlance requires that the holders of junior claims and interests receive no payment until all senior claims and interests receive payment in full—in those circumstances to which the rule applies.[18] Thus, for example, if a class of unsecured creditors has voted to reject a chapter 11 plan, the shareholders cannot retain or receive shares in the reorganized entity or receive other value on account of their shares, unless the plan pays the creditors in the rejecting class in full.[19]

The question before the Supreme Court in *Jevic* is: "Whether a bankruptcy court may authorize the distribution of settlement proceeds in a manner that violates the statutory priority scheme."[20] The petitioners in *Jevic* and the detractors of structured dismissals say "no," and they make several arguments in support of their position.

Critics of structured dismissals assert that the absolute priority rule is "considered sacrosanct,"[21] and that any reordering of the

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[14] Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson (*TMT*), 390 U.S. 414, 424 (1968).

[15] *Id.* at 424–25 (discussing the 1898 Bankruptcy Act, as amended, setting forth the multifactor test for evaluating settlements).

[16] FED. R. BANKR. P. 9019.

[17] *See, e.g.*, *In re* Martin, 91 F.3d 389, 393 (3d Cir. 1996) (setting forth the multifactor test for evaluating settlements under Bankruptcy Rule 9019 following *TMT*).

[18] *See, e.g.*, § 1129(b) (applying this rule to a chapter 11 "cramdown" plan). A cramdown plan is a plan in which one or more impaired classes have voted to reject, and at least one impaired class has voted to accept. *See* George W. Kuney, *Cram Down: An Impaired Class of Claims Says "No" but the Plan is Confirmed Anyway*, COM. BANKR. LITIG. (Mar. 12, 2014), https://www.dailydac.com/commercialbankruptcy/litigation/articles/cram-down-an-impaired-class-of-claims-says-no-but-the-plan-is-confirmed-anyway [https://perma.cc/5N7G-D4FW]. A cramdown plan is confirmable if it complies with the absolute priority rule. § 1129(b).

[19] § 1129(b).

[20] Brief for Petitioner at i, *In re* Jevic Holding Corp., 787 F.3d 173 (3d Cir. 2015) (No. 15-649).

[21] JAYNA PARTAIN LAMAR, THE CONTINUING EVOLUTION OF CHAPTER 11 IN CHAPTER 11 BANKRUPTCY AND RESTRUCTURING STRATEGIES, 87 (Thomas Reuters ed. 2016).

priorities listed in section 507 through "the alchemy of a 'structured dismissal'" lacks textual support in the Code.[22] These detractors argue that "Congress has set out a detailed framework of dispute resolution in bankruptcy, coupled with substantive rules—principally the absolute priority rule and the best interest test—that govern decision making in cases in which consent cannot be obtained."[23] Under this view, a settlement in a chapter 11 case must adhere to the absolute priority rule, as the court held in *In re AWECO*. These commentators contend that the resolution reached in *Jevic* "provides yet one more way to circumvent the Code's priority structure, upon justifications that do not stand under close scrutiny."[24] The American Bankruptcy Institute Commission on Bankruptcy Reform appears to have leaned toward this position without completely embracing it. The Commission recently recommended, in its carefully drafted section on structured dismissals, that bankruptcy courts require "strict compliance with the Bankruptcy Code in terms of orders ending the chapter 11 case," and that a "requested dismissal and the dismissal order satisfy the applicable provisions of, and do not permit the parties to work around, the Bankruptcy Code."[25]

Detractors make several arguments closely related to this core issue. Chapter 11, they assert, "does not specifically provide for dismissals that include orders that conclude a case."[26] A structured dismissal, they continue, is not a "traditional" exit strategy. Instead, it "seem[s] to fall outside the three paths for concluding a chapter 11 case under the Bankruptcy Code—confirming a plan, converting to chapter 7 or dismissing without 'bells and whistles.'"[27]

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[22] Frederick F. Rudzik, *A Priority is a Priority—Except When It Isn't*, 34 AM. BANKR. INST. J. 16, 16 (2015).

[23] Christopher W. Frost, *Structured Dismissals: Smooth Off-Ramp or Artful Dodge?*, 35 BANKR. L. LETTER 1 (2015).

[24] *Id*.

[25] *American Bankruptcy Institute Commission to Study the Reform of Chapter 11: 2012–2014 Final Report and Recommendations*, 23 AM. BANKR. L. REV. 1, 296 (2015). This Article argues that a structured dismissal of a chapter 11 case that is in the best interest of creditors, in which a plan is not confirmable, *does* strictly comply with and is not a "work around" the applicable provisions of the Bankruptcy Code, including the absolute priority rule, the reach of which Congress purposively contracted since *Case v. Los Angeles Lumber Co.* 308 U.S. 106, 117, 123 (1939).

[26] Frost, *supra* note 23.

[27] Nan Roberts Eitel et al., *Structured Dismissals, or Cases Dismissed Outside of Code's Structure?*, 30 AM. BANKR. INST. J. 20, 20 (2011).

These critics further argue that Congress intended a bankruptcy court to dismiss a case by a plain vanilla court order that would "undo" the bankruptcy and restore all property rights to the positions of the parties found at the commencement of the case, including by unwinding settlements and other postpetition transactions.[28] Finally, they demand a narrow construction of the Code provision that authorizes a court to alter ordinary revesting of property of the estate on dismissal "for cause" under Code section 349(b)—one that precludes a deviation from the absolute priority rule that they assert is foundational to the structure of the Code.[29]

Supporters of structured dismissals begin from the premise that—in a chapter 11 case in which the estate has minimal or no cash remaining—the debtor cannot confirm a plan or the costs of obtaining confirmation will use up any funds that might be available for distribution to creditors.[30] They urge that a structured dismissal in that case may be in the best interest of creditors.[31]

Does the absolute priority rule preclude a structured dismissal in chapter 11 that provides for payments to unsecured creditors other than in accordance with the rule yet is in the best interest of creditors? This Article concludes it does not, for several reasons.

First, the rule was never absolute.[32] The rule was not absolute in the equity receiverships used for corporate reorganizations prior to the extensive amendments made to the Bankruptcy Act in the 1930s.[33] Congress did not make the rule generally or absolutely applicable in the 1930s amendments to the Bankruptcy Act either. The Chandler Act and other 1930s amendments comprehensively authorized confirmation of bankruptcy plans under chapters

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[28] Frost, *supra* note 23; *see also* Eitel et al., *supra* note 27, at 21 (citing H.R. Rep. No. 95-595, at 338 (1977); S. Rep. 95-989, at 48–49 (1978)).

[29] *See* 11 U.S.C. § 349(b) (2012); *see also* Eitel et al., *supra* note 27, at 59; Christopher H. Frost, *Settlements, Absolute Priority, and Another Look at Inter-Class Give-Ups*, 27 BANKR. L. LETTER 1 (2007) ("[A]ll settlements should be subject to the absolute priority rule .... 'Gifts' to junior claimants while more senior classes remain unpaid violates the basic principles of priority and should be prohibited.").

[30] *See, e.g.*, Brent Weisenberg, *Expediting Chapter 11 Liquidating Debtor's Distribution to Creditors*, 31 AM. BANKR. INST. J. 36, 106–07 (2012); Norman L. Pernick & G. David Dean, *Structured Chapter 11 Dismissals: A Viable and Growing Alternative After Asset Sales*, 29 AM. BANKR. INST. J. 1, 56 (2010).

[31] *See* Pernick & Dean, *supra* note 30, at 57.

[32] *See infra* Part II.

[33] *See infra* Part II.

X (corporate reorganizations), XI (arrangements), XII (real property arrangements for persons other than corporations), and XIII (wage earners' plans), in addition to chapter IX (for municipalities) and section 77 of the Railroad Reorganization Act of 1935.[34] The term "absolute priority rule" appears nowhere in the Chandler Act or the 1930s amendments.[35] Rather, the Supreme Court in *Case v. Los Angeles Lumber Co.* and other judicial opinions in the dozen years that followed the effective date of the Chandler Act established the rule and gave the rule its greatest reach.[36] The Supreme Court accomplished this by construing "fair and equitable," which was one requirement for confirmation of a corporate reorganization plan, as synonymous with a doctrine of "absolute or full priority."[37]

Since the Court's *Los Angeles Lumber* decision, Congress repeatedly has dialed back those decisional extensions and has restricted applications of the rule that led to undesirable outcomes.[38] In 1952, Congress amended the Bankruptcy Act to expressly excise the "fair and equitable" requirement—and thus the absolute priority rule—from chapters XI and XII, to which chapters the Supreme

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[34] *See generally* 1934 Amendments to Bankruptcy Act, ch. 424, Pub. L. No. 73-486, 48 Stat. 911 (1934) (enacting corporate reorganization provisions including § 77B for plan confirmation) (referred to in text as "1934 Amendments"); Chandler Act of 1938, ch. 575, Pub. L. No. 75-696, 52 Stat. 840 (1938) (incorporating the 1934 Amendments and comprehensively enacting reorganization and plan provisions for business entities and individuals) (referred to in text as "Chandler Act"); Municipal Reorganizations, ch. 657, 50 Stat. 653 (1937); Railroad Reorganization Act of 1935, ch. 774, 49 Stat. 911 (1935).

[35] 1934 Amendments to Bankruptcy Act, ch. 424, Pub. L. No. 73-486, 48 Stat. 911 (1934); Chandler Act of 1938, ch. 575, Pub. L. No. 75-696, 52 Stat. 840 (1938).

[36] *See* Case v. Los Angeles Lumber Co., 308 U.S. 106, 117, 123 (1939); *see also* Consol. Rock Prods. Co. v. Du Bois, 312 U.S. 510, 520–21, 525 (1941); Ecker v. W. Pac. R.R. Corp., 318 U.S. 448, 484, 515 (1943).

[37] *Los Angeles Lumber*, 308 U.S. at 122–24. Unlike the present Code, the Bankruptcy Act, as amended by the Chandler Act and other 1930s amendments, did not define "fair and equitable" to mean "absolute priority," even though prior to 1952 one requirement for plan confirmation under chapters IX, X, XI, XII, and XIII and under section 77 of the Railroad Reorganization Act was that the plan was "fair and equitable." *See id.* The present Code provides that a cramdown plan must be "fair and equitable," and defining that term to mean the absolute priority rule in that limited context but in no broader context. *Id.*

[38] Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 31, 31 nn.221–22 (1995).

Court had extended it, and from chapter XIII to preclude its application in that chapter, thereby keeping the rule to chapter X of the Act.[39] The Code that Congress enacted in 1978 combined the old chapters X, XI, and XII into a new chapter 11.[40] The 1978 Code removed the requirement of absolute priority from consensual plans in chapter 11.[41] The Code also confined the rule's application to the holders of claims or interests in a voting class that rejected the plan, and thus deprived dissenters within any accepting class of the treatment afforded by the rule.[42] In 1986, Congress enacted chapter 12 to permit family farmers to confirm a plan without complying with the rule,[43] which chapter Congress expanded to include family fishermen in 2005.[44]

Second, the absolute priority rule does not pervade the current Code's structure or even chapter 11 of the Code, as is often suggested.[45] In light of the history of congressional enactments summarized above, this is not a legislative accident or a drafting glitch. The absolute priority rule does *not* apply at all to a consensual chapter 11 plan, i.e., a plan that all voting classes have accepted by the requisite majorities in each class. It does not apply to the dissenting creditors in an accepting class of a cramdown plan, i.e., a plan that at least one voting class has accepted and at least one voting class has rejected.[46] It does not apply in chapter 9

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[39] 1952 Amendments to the Bankruptcy Act, ch. 579, Pub. L. No. 82-456, §§ 35, 43, 50, 66 Stat. 420, 433, 435, 437 (1952).

[40] *See* Tabb, *supra* note 38, at 35.

[41] 11 U.S.C. § 1129(b) (2012); Tabb, *supra* note 38, at 35.

[42] *See* § 1129(a)(1)–(9), (11)–(16) (2012) (consensual plan); § 1129(a)(10)–(b) (cramdown plan).

[43] Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, § 255, 100 Stat. 3088, 3105 (1986) (the chapter 12 confirmation requirements are codified at 11 U.S.C. § 1225).

[44] Chapter 12 was made permanent and was amended to apply to family fishermen by the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA), Pub. L. No. 109-8, 119 Stat. 23.

[45] *See infra* Part III.

[46] 11 U.S.C. § 1129(a)–(b). Both a consensual plan and a cramdown plan must provide for full payment of priority unsecured claims ultimately. *Id.* However, even dissenters within an accepting class of a higher priority unsecured claims can be required to accept deferred payments made after full payment to lower priority unsecured claims if the higher priority class has accepted by the requisite majorities. § 1129(a)(9)(B)(i).

(for municipalities),[47] chapter 12 (for family farmers and family fishermen),[48] chapter 13 (for individuals with regular income),[49] or chapter 15 (for cross-border cases).[50]

Rather, the Code requires application of the absolute priority rule in only two places. The rule applies to a chapter 7 liquidation pursuant to section 726 (which by express provision of the Code does *not* apply in chapter 11)[51] and to a chapter 11 cramdown plan, and then it applies only to the members of the rejecting class.[52] The Code does not require that distributions follow the absolute priority rule in any other situation. The absolute priority rule under the current Code is a special, limited rule. It is not a rule that operates substantively throughout the Code.

Third, Congress has given the bankruptcy courts wide discretion in approving compromises and settlements.[53] The Code does not require the court to determine that a compromise or settlement comports with the absolute priority rule.[54] Indeed, the Code does not list the criteria for court approval of a settlement in a chapter 11 case outside of a plan. In the absence of congressional direction, the Supreme Court has required a settlement to be fair and equitable based on the court's determination of the value of the compromise as compared with the likely risks and rewards of pursuing the litigation.[55]

Fourth, Congress has directed the bankruptcy courts to resolve a chapter 11 case in which a plan is not confirmable on consideration of the best interest of debtor's creditors—and not to resolve the case by adhering to the absolute priority rule. Section 1112 provides that a bankruptcy court shall dismiss the case or convert it to chapter 7, "whichever is in the best interests of creditors and

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[47] §§ 901–46.

[48] §§ 1201–31.

[49] §§ 1301–30.

[50] §§ 1501–32.

[51] § 726(a)(1). Section 507 says nothing of distribution, and only section 726 requires distributions in accordance with the absolute priority rule in chapter 7. Section 726 does not apply in chapter 11. Section 103(b) expressly provides that subchapter II, in which section 726 is found, applies only in chapter 7. §103(b).

[52] § 1129(b).

[53] *See infra* Part IV.

[54] *See* FED. R. BANKR. P. 9019.

[55] *See id.*; *see, e.g.*, Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 424–26 (1968).

the estate, for cause ....”[56] “Cause” under section 1112 expressly includes the inability to confirm or consummate a chapter 11 plan.[57]

Congress has underscored this directive and policy in Code section 349, which governs the effects of dismissal.[58] Section 349 does not require adherence to the absolute priority rule or refer to distributional priorities.[59] It does not direct a court to unwind settlements approved or other transactions authorized prior to the dismissal.[60] Section 349 provides that on dismissal, estate property revests in the debtor or other entity in which the property vested immediately prior to the commencement of the case, unless the court orders otherwise.[61] The property that revests on dismissal is that remaining in the estate at the time of the dismissal, both pursuant to the better reading of the text of section 349 and by well-reasoned precedent.[62] The revesting provision of section 349 does not require a court, expressly or by implication, to reverse a settlement approved by the court or any of the numerous other transactions that the debtor and other parties entered into, whether on the first day of the case or the last day prior to the dismissal.[63]

Congress, moreover, has given bankruptcy courts additional, wide discretion in Code section 349 to order “for cause” that the property of the estate vest in different parties on dismissal.[64] This authority underscores the congressional policy favoring a resolution of a chapter 11 case in which a plan is not possible based on what is in the best interest of creditors.

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[56] § 1112(b)(1). The court also may make the intermediate decision, if it is in the best interest of creditors, to appoint a chapter 11 trustee to administer the estate, and the trustee may later propose a chapter 11 plan or move to convert to chapter 7. *See id.*

[57] § 1112(b)(1). “Cause” under section 1112(b) includes that there exists a “substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation,” or that the debtor is unable to substantially consummate a plan. § 1112(b)(4).

[58] § 349.

[59] *Id.*

[60] *Id.*

[61] § 349(b)(3).

[62] *See infra* Part VI.B.

[63] § 349(b)(3).

[64] § 349(b). The Code does not provide illustrative examples of what might constitute “cause” in section 349(b), underscoring the congressional grant of broad discretion to the bankruptcy courts in this section.

The dismissal provisions of the Code highlight a more foundational principle of the Code than absolute priority—the best interest of creditors and the estate.[65] Bankruptcy is not always a pretty or predictable place. Congress has recognized this feature of failure in the numerous sections of the Code that expressly authorize a bankruptcy court to make its decision and grant relief based on the best interest of creditors[66] and to exercise its discretion for cause when determining the relief that it will grant.[67] This Article does not suggest that Congress has given the bankruptcy court unbridled discretion to resolve a chapter 11 case in which a plan is *confirmable* by a structured dismissal that does not follow the absolute priority rule. To the contrary, the Code's design points to confirmation of a plan of reorganization or liquidation, if that is

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[65] *See, e.g.*, § 349(b)(3); § 1307(c) ("[W]hichever is in the best interests of creditors and the estate ....").

[66] *See, e.g.*, § 327(d) (establishing that trustee or debtor in possession may employ lawyers, accountants, and other professionals if in the best interest of the estate); § 521(i)(4) (stating court may decline to dismiss individual case in which debtor failed to make required filings, if the best interest of creditors would be served by the continued administration of the estate); § 521(j)(2) (providing that if the debtor fails to file a tax return that becomes due after the commencement of the case, the court may convert or dismiss the case, whichever is in the best interest of creditors and the estate); § 546(h) (noting that trustee or debtor in possession may return goods, if in the best interests of the estate); § 726(a)(1) (providing that the trustee shall close the estate as expeditiously as is compatible with the best interest of parties in interest); § 721 (stating that the court may authorize chapter 7 trustee to operate the debtor's business if in the best interest of the estate and consistent with the orderly liquidation of the estate); § 943(b)(7) (requiring that chapter 9 plan must be found to be in the best interests of creditors for the court to confirm it); § 1170(a)(1) (allowing a court to authorize abandonment of a railroad line if abandonment is in the best interest of the estate and essential to formulation of a plan); § 1307(c), (e) (establishing that court may convert a chapter 13 case to chapter 7, or may dismiss the case, whichever is in the best interest of creditors); § 1324 (allowing a court to hold a chapter 13 confirmation hearing less than 20 days after the meeting of creditors, if in the best interests of the creditors). The Code, in section 1129(a)(7), also requires that any chapter 11 plan satisfy the "best interest of creditors test." Under the test, all holders of claims and interests who vote against a plan, even those in an accepting class, must do no worse under the plan than they would in a chapter 7 liquidation. The absolute priority rule by comparison protects only those in a class that votes against the plan. § 1129(a)(7).

[67] *See infra* notes 458–66 for Code provisions in which "for cause" is the statutory standard under which the bankruptcy court is authorized to grant relief.

possible, as a primary goal of chapter 11.[68] However, in a chapter 11 case in which a plan is *not* confirmable, a structured dismissal that benefits creditors is not an end run around the plan process or the absolute priority rule to which Congress has given limited application in the current Code. Rather, the best interest of creditors (which is a more pervasive policy and goal under the current Code than the absolute priority rule that Congress has persistently circumscribed) specifically and expressly governs the court's decision whether to dismiss or convert. The Code, moreover, specifically and expressly empowers the court to exercise its discretion "for cause" by ordering dismissal on terms that best achieve that end.[69]

This Article concludes that a bankruptcy court has authority under the Code to approve a settlement and structured dismissal in a chapter 11 case when it is in the best interest of creditors, even if distributions among unsecured creditors are not in accordance with the absolute priority rule.

I. WHY STRUCTURED DISMISSALS?

A structured dismissal remains the exception rather than the rule in chapter 11. Chapter 11 cases more often conclude by the confirmation of a chapter 11 plan of reorganization or liquidation,[70] or, if no party is able to confirm a plan, by a conversion of the chapter 11 case to chapter 7.[71] Still, the use of structured dismissals to resolve chapter 11 cases likely has increased as of late[72] and has drawn mostly negative views.

Bankruptcy court approval of a structured dismissal is most often sought by parties in a case in which the prepetition secured creditor has a blanket lien against nearly all of the debtor's property, but the value of the debtor's collateral is less than the

[68] *See* § 1129.

[69] *See In re* Jevic Holding Corp., 787 F.3d 173, 182 (3d Cir. 2015); *see also* Pernick & Dean, *supra* note 30, at 56.

[70] The provisions for obtaining confirmation of a chapter 11 plan are set forth in Code §§ 1121–29. Though chapter 11 is titled "Reorganization," a chapter 11 plan may be a liquidating plan. *See* § 1129(a)(11).

[71] The provisions for converting a chapter 11 case to chapter 7 are set forth in section 1112. Chapter 7 is titled "Liquidation" and contemplates only the liquidation of the debtor's property for distribution to creditors. § 1112.

[72] *See, e.g.*, *In re* Jevic Holding Corp., 787 F.3d at 181 (citing Pernick & Dean, *supra* note 30).

amount of the claim, i.e., the creditor is undersecured.[73] A secured creditor's lien or security interest continues in the proceeds of any sale of the collateral, both under state law and by court order as adequate protection of the creditor's interest on a free and clear sale in the bankruptcy case.[74] If the proceeds of the sale are less than the amount of the secured claim, the secured lender also remains undersecured after the sale.[75]

In such a situation, the debtor must pay the sale proceeds to the secured creditor in partial satisfaction of the claim, leaving the debtor and other creditors with nothing.[76] The debtor thus will not be able to pay the costs of preparing, proposing, soliciting votes for, and seeking and obtaining confirmation of a chapter 11 plan.[77]

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[73] The second, far less common situation is one in which the key constituencies reach agreement regarding a comprehensive settlement of the case, and there *are* sufficient funds available to pay the settling parties and any other claimants in full. In such a case, rather than seeking dismissal under Code section 1112, the parties may ask the court to abstain from hearing the bankruptcy case and to dismiss the case under Code section 305. That section provides: "The court, after notice and a hearing, may dismiss a case under this title, or may suspend all proceedings in a case under this title, at any time if— (1) the interests of creditors and the debtor would be better served by such dismissal or suspension ...." § 305(a)(1). A dismissal under section 305(a) generally is not appealable, and courts accordingly treat abstention and dismissal under section 305(a) as an "extraordinary remedy"—that is, appropriate only if both the debtor and its creditors would be better served by the court's abstention and dismissal of the case. *In re* Monitor Single Lift I, Ltd., 381 B.R. 455, 462 (Bankr. S.D.N.Y. 2008); *see also In re* Colonial Ford, Inc., 24 B.R. 1014, 1023 (Bankr. D. Utah 1982) ("Where … the workout is comprehensive, and designed to end, not perpetuate, the creditor-company relations, dismissal under section 305(a)(1) is appropriate. One 'reorganization,' under these circumstances, is enough. Section 305(a)(1) precludes an encore, thereby furthering the policies of expedition, economy, and good sense."). A motion for abstention under section 305(a) raises concerns, since in such a case a plan might be confirmable. But, because all creditors and equity holders typically will have agreed to the treatment afforded or will be paid in full, those resolutions do not implicate the absolute priority rule and are thus not considered further in this Article.

[74] *See, e.g.*, U.C.C. § 9-315(a) (AM. L. INST. & UNIF. L. COMM'N 2010) (stating that security interest in personal property attaches to proceeds on sale); § 363(e) (stating that the holder of lien against estate property that is sold in the bankruptcy case free and clear of interests is entitled to adequate protection of its interest, typically accomplished by the court's attaching the lien to the proceeds).

[75] *See* § 506.

[76] *Id.*

[77] *See generally* Pernick & Dean, *supra* note 30.

Most crucially, the debtor will have no funds with which to make the payments to priority unsecured creditors required to confirm a plan or to make any distributions to general unsecured creditors.[78]

A conversion to chapter 7 is an equally bleak prospect in such a case. The chapter 7 case will be a "no asset" case. The secured creditor's lien will continue in effect, and the chapter 7 trustee will not be able to pay anything to other creditors.[79]

It is against these unpromising alternatives that some or all of the major constituencies in the case—typically the debtor and some or all of the secured creditors and unsecured creditors—may negotiate for a structured dismissal. In a typical structured dismissal, the secured creditor will agree to fund a settlement that will result in some payment to some creditors prior to the dismissal.[80]

The secured creditor who agrees to fund the structured dismissal rarely does so purely from altruism. In exchange, the creditor will secure a release of any claims that the debtor or other settling parties have asserted or may assert against the creditor and will put an end to the costs the creditor is incurring.[81] The settlement typically will exclude a party that is unwilling to agree to a release or from whom the secured creditor determines it needs no release.[82]

As a result, a structured dismissal negotiated by willing parties in chapter 11 may provide for payment of claims, which deviate from the absolute priority rule that applies to distributions in chapter 7[83] or that applies to the holders in a rejecting class under a chapter 11 cramdown plan.[84] Critics urge that in such a case, the structured dismissal violates the absolute priority rule and thus the court cannot approve it.[85]

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[78] *See* § 507.

[79] *See* U.S. DEP'T OF JUSTICE, HANDBOOK FOR CHAPTER 7 TRUSTEES (2012), https://www.justice.gov/ust/handbook-chapter-7-trustees [https://perma.cc/L9WU-A4YC]. A case in which no assets will be available for distribution to creditors is a "no-asset" or "no-distribution" case. *See id.* ch. 8. There is no deadline for the filing of proofs of claims by creditors, and the chapter 7 trustee is not required to review or seek to disallow any claims that are filed because doing so would be a pointless exercise. Following the closing of the case, the chapter 7 trustee receives a sixty dollar fee. *Id.*

[80] *See* Frost, *supra* note 23.

[81] *See id.*

[82] Pernick & Dean, *supra* note 30, at 57–58.

[83] § 726.

[84] § 1129(b).

[85] Frost, *supra* note 23.

II. The Origins of the Absolute Priority Rule and Congressional Responses to Judicial Extensions and Undesirable Consequences of the Rule

One narrative of structured dismissals and the dynamics of reorganization practice describes a "wondrously talented" bar of bankruptcy lawyers who "manage to continually resurrect practices that are manifestly inconsistent with positive law, sometimes even in the face of outright prohibitions of said practices by Congress and the Supreme Court."[86] Bankruptcy counsel, the story goes, succeed in obtaining questionable results for their clients by asserting little more than that expediency is required.[87] For these commentators, settlements and structured dismissals are an "end run" around the absolute priority rule and are a case in point.[88]

Implicit in this critique is that bankruptcy judges, swayed by expediency arguments, make exceptions to pervasive and immutable requirements expressly set forth in the Bankruptcy Code, such as the absolute priority rule. These critics conclude that courts instead need to follow the congressional directive even when it is not convenient to do so.

This account is simply and materially inaccurate. The terms "absolute priority rule" or "absolute priority" do not appear anywhere in the Bankruptcy Code.[89] Congress likewise mentioned nothing of an absolute priority rule in the 1934 Amendments that established a regime for corporate reorganization,[90] or in the 1938 Chandler Act,[91] which are the bankruptcy statutes that preceded the Code.

Rather, section 77B of the 1934 Amendments merely required a corporate reorganization plan to be "fair and equitable" for the

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[86] Ralph Brubaker, *Taking Chapter 11's Distribution Rules Seriously: "Inter-Class Gifting Is Dead! Long Live Inter-Class Gifting!*," 31 Bankr. L. Letter 1 (2011).

[87] *Id.*

[88] Eitel et al., *supra* note 27, at 59 ("Desire to make an end run around a statute is not an adequate reason .... It is not part of the judicial office to seek out creative ways to defeat statutes."); Frost, *supra* note 23.

[89] *See generally* 11 U.S.C. § 1129 (2012); Bank of Am. Nat'l Trust Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 442 (1999) ("The latter condition [in section 1129(b)(2)(B)(ii)] is the core of what is known as the 'absolute priority rule.'").

[90] 1934 Amendments to Bankruptcy Act, ch. 424, Pub. L. No. 73-296, 48 Stat. 911 (1934).

[91] Chandler Act of 1938, ch. 575, Pub. L. No. 75-695, 52 Stat. 840 (1938).

bankruptcy court to confirm it.[92] The 1938 Chandler Act and other 1930s bankruptcy enactments that extensively amended the 1898 Bankruptcy Act also did not require bankruptcy plans to comply with an absolute priority rule. Instead, the Supreme Court in 1939, in *Case v. Los Angeles Lumber Products Co.*, embedded the rule into the corporate reorganization confirmation provisions of the Chandler Act when it interpreted the textual requirement that a confirmable plan be "fair and equitable" to require compliance with a rule of "full and absolute priority."[93]

Subsequent congressional enactments contradict any argument that Congress acquiesced in this interpretation. Congress, since *Los Angeles Lumber*, has consistently *reduced* the reach of the absolute priority rule.[94] First, in 1952, Congress severely contracted the judicial interpretation of the Bankruptcy Act by which the courts had extended the requirement of absolute priority to confirmation of all consensual and cramdown plans in chapters X, XI, and XII of the Act. By the same amendment, Congress preemptively removed the requirement from chapter XIII.[95] In 1978, Congress made absolute priority in chapter 11 applicable only to the holders in a dissenting class of cramdown plan.[96] In 1986 and 2005, Congress acted again to make the rule inapplicable to plans proposed by family farmers and family-owned commercial fishing operations.[97] Congress, by these numerous enactments, made the absolute priority rule inapplicable to chapter 9 plans, consensual chapter 11 plans, chapter 12 plans, and chapter 13 plans. The rule today has only two applications: first, to the holders of claims or equity interests in a class that has voted against a chapter 11 cramdown plan, and second, in a chapter 7 liquidation case.

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[92] 1934 Amendments to Bankruptcy Act, ch. 424, § 77B(f), 52 Stat. at 919.

[93] Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 114 (1939).

[94] *See infra* notes 95–107 and accompanying text.

[95] The House in its report explained that, first,

> the fair and equitable rule, as interpreted in *Boyd* and *Los Angeles Lumber*, "cannot realistically be applied in a chapter XI, XII, or XIII proceeding. Were it so applied, no individual debtor and, under chapter XI, no corporate debtor where the stock ownership is substantially identical with management could effectuate an arrangement except by payment of the claims of all creditors in full .... Nor is it practicable or realistic to apply the rule in a proceeding under chapter XI, XII, or XIII."

H.R. REP. NO. 2320, ¶ 43, at 21 (1952).

[96] *See* CHARLES JORDAN TABB, THE LAW OF BANKRUPTCY 1157–58 (2d ed. 2009).

[97] *See, e.g.*, Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 198 (1988).

As Congress acted on these occasions to severely constrict the reach of the absolute priority rule following expansive judicial interpretations and to address other undesirable consequences arising from those decisions, it is simply untrue that a wayward bankruptcy bench and bar ran end runs around the absolute priority rule or sidestepped congressional requirements. To the contrary, Congress consistently and on numerous occasions reined in the decisional law that raised and then extended the rule.

This section of the Article begins with a brief account of the origins and extent of the "absolute" priority rule in the equity receiverships by which most railroads reorganized prior to the enactment of reorganization legislation by Congress in the 1930s. The rule, even in those cases, more often commanded "relative" rather than "absolute" distributional priority. Next, this section summarizes the construction of the "fair and equitable" requirement for confirmation of plans under the 1930s amendments to the Act and the Supreme Court's expansive construction of the rule in *Case v. Los Angeles Lumber Products Co.* Finally, this section considers the congressional enactments that followed *Los Angeles Lumber*, in 1952, 1978, 1986, and 2005, that severely narrowed the application of the absolute priority rule.

A comprehensive analysis of the scope of the rule prior to *Los Angeles Lumber* and the arc of congressional enactments since that opinion demonstrate that the absolute priority rule does not pervade the bankruptcy law. Rather, the rule never was absolute prior to *Los Angeles Lumber*. Further, Congress has consistently restricted the scope of the rule since the Court's decision in that case.

A. The Origins of the Absolute Priority Rule

The rules of distributional priorities in reorganization cases have their origins in the equity receivership cases by which insolvent railroads reorganized across state lines in the 1800s.[98] The absolute priority rule, strictly applied, requires payment first to secured creditors and then payment to unsecured creditors of an insolvent enterprise, prior to shareholders receiving any stock in the reorganized entity or other value on account of their shares in the old

[98] Tabb, *supra* note 38, at 21–23 (discussing equity receiverships).

entity.[99] However, the rule underlying equity receiverships appears to have been one of relative or weighted distributional priorities from the start.[100] The doctrine of equity receiverships can best be characterized as one designed to prevent overreaching by the secured bondholders, managers, and shareholders acting in concert to deprive unsecured creditors of any distribution in the reorganization of the business enterprise.

The use of the equity receivership rather than a bankruptcy statute to reorganize a railroad arose out of necessity.[101] The Constitution authorizes Congress to establish uniform bankruptcy laws.[102] Though Congress enacted bankruptcy or insolvency laws pursuant to this power in 1801, 1841, and 1867,[103] it repealed each after several years without replacement; so, for most of the 19th century, no federal bankruptcy law was in effect.[104] Further, none of the 19th century Bankruptcy Acts enabled a corporation to reorganize.[105] Rather, they merely provided for the liquidation of the bankrupt's assets for distribution to creditors.[106]

The equity receivership enabled a troubled railroad to reorganize and thus preserve its business as a going concern, as opposed to

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[99] *Id.*

[100] *Id.*

[101] *Id.*

[102] Congress has the authority to "establish ... uniform laws on the subject of bankruptcies throughout the United States." U.S. CONST., art. I, § 8, cl. 4.

[103] *See infra* note 106 (discussing relevant statutes).

[104] Tabb, *supra* note 38, at 13–14.

[105] *See generally id.* at 14–29.

[106] Bankruptcy Act of 1800, ch. 19, 2 Stat. 19 (1800), *repealed by* Bankruptcy Act of 1803, ch. 6, 2 Stat. 248 (1803); Bankruptcy Act of 1841, ch. 9, 5 Stat. 440 (1841), *repealed by* Bankruptcy Act of 1843, ch. 82, 5 Stat. 614 (1843); and Bankruptcy Act of 1867, ch. 176, 14 Stat. 517 (1867), *repealed by* Bankruptcy Act of 1878, ch. 160, 20 Stat. 99 (1878). Though none of those 19th century Bankruptcy Acts enabled a corporation to reorganize or provided for the confirmation of bankruptcy plans as under current law, an 1874 amendment to the 1867 Act did briefly allow for compositions of creditors until the 1867 Act was repealed in 1878. Act of June 22, 1874, ch. 390, 18 Stat. 178, § 18 at 182–84. *See, e.g.*, DAVID A. SKEEL, DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 54–60 (2001); *see also In re* Jeppson, 66 B.R. 269, 272 (Bankr. D. Utah 1986) ("Until the enactment in 1933 and 1934 of Sections 77 and 77B of the Bankruptcy Act, there was no statutory machinery generally available to facilitate the reorganization of insolvent corporations. The Bankruptcy Act of 1898 had concerned itself almost entirely with liquidation of the debtor's assets and distribution of the proceeds among creditors ....").

a piecemeal liquidation of the enterprise's assets.[107] Maintaining the railroad as a business enterprise maximized values for stakeholders and benefitted the public and the economy.[108] The equity receiverships for most of the 1800s filled the void left by the nonexistence of a federal bankruptcy act and, until the 1930s, by the absence of reorganization provisions in the federal bankruptcy acts.

The debt and capital structures of 19th century railroads were highly developed, with secured bondholders (often holding several issues and classes of bonds), unsecured creditors, and shareholders (typically holding several classes of both preferred and common shares) each holding a stake in the enterprise.[109] The insolvent railroad's assets were extensive, consisting of real estate interests, rolling stock, and other tangible and intangible personal property located in several states.[110]

A creditor upon the railroad's default, or the railroad itself in contemplation of such default, would initiate the equity receivership by seeking and obtaining the appointment of a receiver for the railroad's assets in federal district court.[111] Usually various committees of creditors were formed, which would negotiate a restructuring of the debt and the capital structure for the new, reorganized entity.[112] Once the committees reached an agreement, they combined into a single reorganization committee authorized to credit bid up to the face value of the secured bonds at the foreclosure sale.[113] Competing bidders willing to pay more than the face amount of the secured debt were rare.[114] As a result, the reorganization committee usually purchased all or most of the railroad's assets at the foreclosure sale and transferred those assets to the new corporation in which the old holders of debt or equity were given the agreed upon debt and/or equity in the new, reorganized railroad.[115]

Sometimes, though, a creditor or other senior stakeholder would object that it was receiving nothing (or not enough) on account of

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[107] SKEEL, *supra* note 106, at 57.
[108] *See id.*
[109] *See id.* at 58.
[110] *Id.*
[111] *Id.*
[112] *Id.*
[113] SKEEL*, supra* note 106, at 59.
[114] *Id.*
[115] *Id.*

its claim against the old entity, and that a junior stakeholder, such as a shareholder, was receiving too much. The courts began to develop rules for distributional priorities—the purpose of which was to enable a court to determine the fairness of the value proposed to be given on reorganization to creditors and shareholders on account of their claims against the old entity.[116]

The aim of these distributional rules was to protect creditors from overreaching by the managers and shareholders who negotiated the restructuring with the secured bondholders.[117] The Supreme Court in 1868 in *Railroad Co. v. Howard* set down the rule that the proceeds of the sale of a business corporation are "assets of the corporation, and as such constitute a fund for the payment of its debts"; if the plan distributed proceeds to stockholders but left any debts of the corporation unpaid, then the "established rule in equity" was that the stockholders took the funds "charged with the trust in favor of creditors," which a court of equity would order paid in satisfaction of the creditors' claims.[118] The existence of a mortgage lien against the assets sold did not change this: "whatever interest remained after the lien of the mortgages was discharged belonged to the corporation, and as the property of the corporation when the bonds were discharged, it became a fund in trust for the benefit of their creditors."[119]

The Supreme Court visited the issue again in *Louisville Trust Co. v. Louisville, N.A. & C. Ry. Co.* in 1899. The Court asked whether the mortgagor and mortgagee could enter into an agreement "by which[,] through the form of equitable proceedings[,] all the right" of an "unsecured creditor may be wiped out, and the interest of both mortgagor and mortgagee in the property preserved and continued? The question carries its own answer. Nothing of the kind can be tolerated."[120]

The rule established by *Howard* and *Louisville Ry. Co.* was a safeguard against abuse of unsecured creditors by the secured creditors, managers, and shareholders who took the lead in negotiating the restructuring. In late nineteenth-century equity receiverships, the doctrine took into account the relative priorities

[116] *See id.* at 67.
[117] *Id.*
[118] Chi., R.I. & P.R. v. Howard, 74 U.S. 392, 410 (1868).
[119] *Id.* at 414.
[120] Louisville Tr. Co. v. Louisville, N.A. & C. Ry. Co., 174 U.S. 674, 684 (1899).

of the secured and unsecured debt and of the shares of preferred and common stock in the old railroad's debt and capital structure.[121] It restrained managers and shareholders from misappropriating all the residual value or control premium value in the enterprise unless the reorganization plan paid a reasonable amount to all creditors.[122]

The rule, though, did not require distributions of value in strict accordance with an absolute priority rule. Instead, the reorganization plans allocated and distributed values in the new entity in a way that gave everyone something in rough proportion to the seniority of their claims and interests in the insolvent enterprise.[123] Further, participation in the new enterprise of old equity holders, who were the most junior stakeholders in the insolvent enterprise, often was conditioned on their paying "assessments," i.e., making cash contributions to the reorganized entity.[124]

A reorganization plan would provide, for example, that senior secured bondholders would receive new bonds equal to most or all of the value of their claims against the assets (e.g., the holder of $1,000 first priority secured bonds against the assets of the old railroad would receive $1,000 first priority secured bonds against the assets of the new railroad).[125] Junior secured bondholders would receive a combination of secured debt in a reduced amount and preferred shares in the new entity.[126] Old preferred and common shareholders would receive new shares and/or bonds, provided they were willing to pay cash assessments.[127] The funds raised by assessments paid dissenting security holders and the expenses incurred by the railroad during the receivership, and funded new capital expenditures.[128]

Notably absent from this typical restructuring were general unsecured creditors—the vendors of goods and services and others

[121] *See* SKEEL, *supra* note 106, at 58–59.
[122] *See id.* at 60.
[123] *See id.* at 59.
[124] Peter Tufano, *Business Failure, Judicial Intervention, and Financial Innovation: Restructuring U.S. Railroads in the Nineteenth Century*, 71 BUS. HIST. REV. 1, 14 (1997).
[125] *See, e.g.*, SKEEL, *supra* note 106, at 58–59.
[126] *Id.*
[127] Tufano, *supra* note 124, at 14.
[128] *Id.*

who had done business with the railroad day-to-day, extending credit in the ordinary course of business. In 1913, *Northern Pacific Railroad Co. v. Boyd* "threw a monkey wrench into all of this."[129] Boyd, an unsecured creditor, objected to a reorganization under which he received nothing.[130] The railroad had sold for $61 million at a sale "where there was no competition."[131] The encumbrances against it were $157 million.[132] Yet, the reorganization agreement stated that the value of the railroad was $345 million.[133] Further, the purchaser immediately following the sale issued $190 million of new bonds and $155 million of stock on property that a month before had been bought for $61 million.[134]

The Supreme Court stated that a "transfer by stockholders from themselves to themselves" could not defeat the claim of a non-assenting creditor such as Boyd.[135] "As against him the sale is void in equity, regardless of the motive with which it was made," and the subordinate interest of the old stockholders remained "subject to his claim in the hands of the reorganized company."[136]

Boyd further complicated matters for reorganizers.[137] Even *Boyd*, though, did not establish an absolute priority rule in reorganization cases. Shareholders still could participate in the reorganization but "only if unsecured creditors were given 'a fair and timely offer of cash, or a fair and timely offer of participation in such corporation.'"[138]

The Supreme Court in *Kansas City Terminal* stated 15 years later that all parties to a reorganization, including the public, "are best served by [cooperation] between bondholders and stockholders."[139] If creditors decline a fair offer, "they are left to protect themselves. After such refusal they cannot attack the reorganization

[129] SKEEL, *supra* note 106, at 67.
[130] N. Pac. Ry. Co. v. Boyd, 228 U.S. 482, 492 (1913).
[131] *Id.* at 508.
[132] *Id.* at 507.
[133] *Id.*
[134] *Id.*
[135] *Boyd*, 228 U.S. at 502.
[136] *Id.*
[137] SKEEL, *supra* note 106, at 67.
[138] *Id.* (citing 1 ROBERT T. SWAINE, THE CRAVATH FIRM AND ITS SUCCESSORS 173 (1946)).
[139] Kan. City Terminal Ry. Co. v. Cent. Union Tr. Co., 271 U.S. 445, 455 (1926).

in a court of equity."[140] Further, if it was impossible to obtain new value from shareholders unless they were "permitted to contribute and retain an interest sufficiently valuable to move them," then "[i]n such or similar cases the chancellor may exercise an informed discretion concerning the practical adjustment of the several rights."[141]

Bonbright and Bergerman, reviewing case law in the late 1920s, concluded that the courts showed a distinct leaning toward relative priority.[142] Courts were "reluctant to upset a plan, when accepted by a substantial majority of interested bond-holders, merely on the

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[140] *Id.* (citing N. Pac. Ry. Co. v. Boyd, 228 U.S. 482, 502 (1913)) ("Unsecured creditors of insolvent corporations are entitled to the benefit of the values which remain after lienholders are satisfied, whether this is present or prospective, for dividends or only for purposes of control. But reasonable adjustments should be encouraged. Practically, it is impossible to sell the property of a great railroad for cash and, generally, the interests of all parties, including the public, are best served by co-operation between bondholders and stockholders. If creditors decline a fair offer based upon the principles above stated, they are left to protect themselves. After such refusal they cannot attack the reorganization in a court of equity."); *see also* Jameson v. Guar. Tr. Co., 20 F.2d 808, 811 (7th Cir. 1927) (quoting *N. Pac. Ry. Co. v. Boyd*, 228 U.S. at 508) ("The Boyd decision does not require that in the reorganization each interest must be accorded the same rank in every particular it formerly held. The most it holds is that the stockholder's interest in the old company may not, as against unsecured creditors, be carried into the reorganized company, and these creditors wholly disregarded. The court said: 'This conclusion does not, as claimed, make it necessary to pay an unsecured creditor in cash as a condition of stockholders retaining an interest in the reorganized company. His interest can be preserved by the issuance, on equitable terms, of income bonds or preferred stock. If he declines a fair offer, he is left to protect himself as any other creditor or a judgment debtor, and, having refused to come into a just reorganization, could not thereafter be heard in a court of equity to attack it.'"); Douglas G. Baird, *Present at the Creation: The SEC and the Origins of the Absolute Priority Rule*, 18 AM. BANKR. INST. L. REV. 591, 597 (2010) [hereinafter *Present at the Creation*] (stating that the rule in *Boyd* "merely insists that, in whatever priority regime existed, everyone participate. The question of exactly what priority rights each investor enjoyed was actively debated in the law reviews over the next twenty-five years."); *but see* Samuels v. Ne. Pub. Serv. Co., 174 A. 127, 131 (Del. Ch. 1934) (citing *N. Pac. Ry. Co. v. Boyd*, 228 U.S. at 510) ("It is inequitable for the court to appropriate to stockholders rights in assets which belong to creditors.").

[141] *Kan. City Terminal Ry. Co.*, 271 U.S. at 455.

[142] *See* James C. Bonbright & Milton M. Bergerman, *Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization*, 28 COLUM. L. REV. 127 (1928) [hereinafter *Two Rival Theories*].

ground that it violate[d] absolute priorities in favor of approximate relative priorities."[143]

In sum, though many courts and commentators have referred to the distributional doctrine in equity receiverships as an "absolute priority rule,"[144] it was not. Instead, the courts in the 1800s and early 1900s often applied a rule of "relative" (rather than absolute) priority.[145] The rule prevented the secured creditors, managers, and stockholders from freezing out the company's unsecured creditors and paying them nothing while equity retained an interest.[146] However, under the pre-1930s case law under which some of the largest business enterprises of the time were reorganized, those unsecured creditors only had a right to participate on fair terms in the reorganized company in which old equity would have an interest.[147] They were not entitled to insist that a plan conformed to an absolute priority rule.[148]

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[143] *Id.* at 154; *see also* John D. Ayer, *Rethinking Absolute Priority after Ahlers*, 87 MICH. L. REV. 963, 974–76 (1989) (citing *Two Rival Theories*) ("Fifteen years after *Boyd*, two scholars were able to argue that corporate practice recognized two priority rules—a rule of absolute priority, à la *Boyd*, and a rule of 'relative' priority, functioning in practice much like the informal 'share' scheme that obtained before *Boyd*."); Randolph J. Haines, *The Unwarranted Attack on New Value*, 72 AM. BANKR. L. J. 387, 401 (1998) ("*Boyd* did not adopt an absolute priority rule. In simplest terms, the *Boyd* rule was that equity could not receive anything for its old interests unless unsecured creditors received something too. Although *Boyd* required that a fair offer be made to unsecured creditors, it did not say how the fairness of any offer would be determined, and it certainly did not require payment in full." Even "the seminal *Howard* case ... suggested that creditors would only be entitled to the sixteen percent fund reserved for stockholders, not necessarily to be paid in full. Thus, instead of adopting the absolute priority rule, *Howard* and *Boyd* merely set the stage for the debate between two possible views of priority, one which is absolute and one which is relative. Those rules were not even given those names until fifteen years later" by Bonbright and Bergerman.); SKEEL, *supra* note 106, at 67–68 (stating that railroad reorganizers after *Boyd* "offered general unsecured creditors a continuing interest in the reorganized firm so long as they, like the stockholders, paid a cash assessment").

[144] Haines, *supra* note 143, at 387 n.3.

[145] *Id.*

[146] Ayer, *supra* note 143, at 964.

[147] *See Present at the Creation*, *supra* note 140, at 605.

[148] *See, e.g.*, *id.* at 597 ("The [*Boyd*] opinion itself, however, does not confront the question of whether receivership law could continue to accept a regime of relative priority analogous to the rule of the general average. It merely insists that, in whatever priority regime existed, everyone participate. The question

B. "Fair and Equitable" Under the Chandler Act

Congress, in the early years of the Great Depression and in response to its effects, enacted a series of amendments to the Bankruptcy Act of 1898.[149] The 1934 amendments added a new section, 77B, to the Act, entitled "Corporate Reorganizations."[150] Under Section 77B, a court could confirm a corporate reorganization plan if it determined that the plan was "fair and equitable" and fulfilled certain other requirements.[151] Widespread municipal bond defaults[152] caused Congress to enact a municipal bankruptcy chapter, chapter IX, in the same year.[153] The reorganization of insolvent railroads under the Bankruptcy Act was the subject of amendments in 1935.[154] In 1938, Congress passed the Chandler Act, which extensively overhauled U.S. bankruptcy law, making further changes to and incorporating many of those earlier Depression era amendments in the 1898 Act.[155]

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of exactly what priority rights each investor enjoyed was actively debated in the law reviews over the next twenty-five years.").

[149] *See* 1933 Amendments to Bankruptcy Act, ch. 204, 47 Stat. 1467 (1933); 1934 Amendments to Bankruptcy Act, ch. 424, Pub. Law. No. 73-296, 48 Stat. 911 (1934) ("1934 Amendments"); Railroad Reorganization Act of 1935, ch. 774, 49 Stat. 911 (1935). Congress during this period also enacted the Frazier-Lemke Act for bankruptcy relief to financially distressed farmers, which the Supreme Court held unconstitutional. *See generally* Louisville Joint Stock Bank v. Radford, 295 U.S. 555 (1935).

[150] 1934 Amendments to Bankruptcy Act § 77B(f).

[151] *Id.*

[152] *See* Solicitor General Jackson's statements in United States v. Bekins, 304 U.S. 27, 34 (1938), that "[c]ities as large as Detroit and Miami and Asheville were in default" and, by 1938, "over 3,000 units of government were found to be in default."

[153] 1934 Amendments to Bankruptcy Act, ch. 345, 48 Stat. 798 (1934). The 1934 municipal bankruptcy chapter was declared unconstitutional in Ashton v. Cameron Cty. Water Improvement Dist., 298 U.S. 513 (1936). In 1937, Congress enacted a new municipal act, which the Court held as constitutional. *See* 1937 Amendments to Bankruptcy Act, ch. 657, 50 Stat. Ann. 653 (1937); *accord* United States v. Bekins, 304 U.S. 27 (1938). The 1937 municipal bankruptcy act contained sunset provisions, and Congress several times reenacted it. The municipal bankruptcy chapter was originally chapter X. The Chandler Act designated it as chapter IX, which parallels its present place as chapter 9 of the Code.

[154] Railroad Reorganization Act of 1935, ch. 774, 49 Stat. 911 (1935).

[155] Chandler Act of 1938, ch. 575, 52 Stat. 840 (1938); *see also* Tabb, *supra* note 38, at 29–30; Vincent L. Leibell, Jr., *The Chandler Act—Its Effect Upon the Law of Bankruptcy*, 9 FORDHAM L. REV. 380, 380–406 (1940); Herman M.

The Chandler Act established for the first time a comprehensive statutory regime for the restructuring of the financial affairs of a corporation or the rehabilitation of an individual debtor by a plan confirmed by the court.[156] The statutory provisions for these plans appeared in four chapters of the Chandler Act's amendments to the Bankruptcy Act: chapter X (corporate reorganizations);[157] chapter XI (arrangements);[158] chapter XII (real property arrangements for persons other than corporations);[159] and chapter XIII (wage earners' plans).[160] The acts that provided for municipal arrangements (chapter IX) and railroad reorganizations continued in effect.[161]

Each of chapters X–XIII required the court to confirm a proposed plan if it was "fair and equitable" and fulfilled the other conditions set forth in that chapter.[162] The Chandler Act, though, did not define "fair and equitable," and it remained for the Supreme Court to do so.[163]

Knoeller, *Reorganization Procedure Under the New Chandler Act*, 24 MARQ. L. REV. 12, 12 (1939).

[156] The Chandler Act amended and incorporated section 77B into chapters X–XIV of the Chandler Act. *See generally* Chandler Act of 1938, ch. 575, Pub. Law No. 75-696, 52 Stat. 840 (1938). It amended, but did not repeal or incorporate, the provisions of the Railroad Reorganization Act of 1935 or the provisions of the 1937 municipal bankruptcy law, Ch. 657, 50 Stat. Ann. 653 (1937), though it designated the municipal chapter as chapter IX. *Id.* § 3(a). For business enterprises, the reorganization provisions of the Chandler Act "embodie[d] the new social economic concept of reorganization and the rehabilitation of the debtor and his business as a going concern, instead of the liquidation, distribution, and stoppage of business with the consequent loss to the debtor, creditors, employees, and the public generally." Knoeller, *supra* note 155, at 14. For wage earning individuals, the provisions of the Act provided relief "from harassments of garnishments and attachment proceedings." *Id.*

[157] Chandler Act of 1938, ch. 575, Pub. Law No. 75-696, §§ 101–276, 52 Stat. 840, 883–905 (1938).

[158] §§ 301–99.

[159] §§ 401–526.

[160] §§ 601–86.

[161] Railroad Reorganization Act of 1935, ch. 774, 49 Stat. 911 (1935); Municipal Reorganizations, ch. 657, 50 Stat. Ann. 653 (1937).

[162] Chandler Act of 1938, § 221(2) (chapter X); § 366(3) (chapter XI); § 472(3) (chapter XII); § 656 (chapter XIII).

[163] *See generally* Chandler Act of 1938, ch. 575, Pub. Law No. 75-696, 52 Stat. 840 (1938).

C. *The Supreme Court in* Case v. Los Angeles Lumber *Defines "Fair and Equitable" to Require Absolute Distributional Priority in a Plan*

The debtor in *Los Angeles Lumber* was a holding corporation that owned six subsidiary corporations; only one of which, a dry dock company, had substantial assets.[164] In early 1938, the debtor petitioned for corporate reorganization under the 1934 Amendments.[165] The trustee proposed a plan, which the bankruptcy court, with some modifications, confirmed.[166] The plan provided for the organization of a new corporation to which the trustee would transfer all of the assets of the subsidiary dry dock company free and clear of liens.[167] Bondholders would receive preferred stock in the reorganized entity, additional preferred stock would be sold to generate additional working capital, and common stock would be issued to the holders of old equity.[168]

The plan was "properly approved in writing" by all of the following affected classes of creditors and shareholders, and by overwhelming majorities in each:

> (a) The owners and holders of 92.81 per cent face value of debtor's outstanding bonds;
> (b) 100 per cent, in amount, of other creditors;
> (c) The owners and holders of 99.75 per cent of debtor's outstanding Class A capital stock;
> (d) The owners and holders of 90 per cent of debtor's outstanding Class B capital stock.[169]

The district court sitting in bankruptcy confirmed the plan over the objection of dissenters who held $18,500 of the bonds.[170] The court determined that the plan was "fair and equitable" and that old equity could receive the new shares.[171] The dissenting bondholders

[164] *In re* Los Angeles Lumber Prods. Co., 100 F.2d 963, 964 (9th Cir. 1939).
[165] *Id.*
[166] *Id.*
[167] *Id.*
[168] *Id.*
[169] *In re* Los Angeles Lumber Prods. Co., 24 F. Supp. 501, 507 (S.D. Cal. 1938).
[170] Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 112 (1939).
[171] *In re Los Angeles Lumber Prods. Co.*, 100 F.2d at 965.

appealed to the Ninth Circuit.[172] They asserted, among other claims, that the plan was neither fair nor equitable as to them, and that "the trial court erred in allowing the present stockholders of the insolvent debtor to participate in the reorganization."[173]

The Ninth Circuit accepted the district court's findings that the present shareholders, by cooperating in the plan, had given new value that exceeded the value of their new stock under the plan.[174] The shareholders had modified a prepetition forbearance agreement, and their cooperation and participation in the new company preserved the going concern value of the dry dock company, avoided further litigation, and enhanced the value of the enterprise because of their familiarity with the business of the dry dock subsidiary and their financial standing and influence in the community.[175]

The objecting bondholders sought and obtained certiorari from the Supreme Court.[176] The Supreme Court per Justice Douglas held that the Ninth Circuit had erred in at least three material respects.[177]

First, the Supreme Court determined that "fair and equitable" in section 77B(f) were "words of art" that "had acquired a fixed meaning through judicial interpretations in the field of equity receivership reorganizations."[178] The words "fair and equitable" in Douglas's view meant that a bankruptcy plan needed to satisfy the rule of "full or absolute priority," at least insofar as it kept shareholders from receiving anything prior to full payment to creditors.[179] Douglas reasoned that the Supreme Court's equity receivership decisions had "dealt with the precedence to be accorded creditors over stockholders in reorganization plans."[180] The

[172] *Los Angeles Lumber*, 308 U.S. at 106.

[173] *In re Los Angeles Lumber Prods. Co.*, 100 F.2d at 965.

[174] *Id.*

[175] *Id.*

[176] *Los Angeles Lumber*, 308 U.S. at 106.

[177] *Id.* at 122–24.

[178] *Id.* at 115.

[179] *Id.* at 115–17.

[180] *Id.* at 115–16 (citing Chicago, R.I. & P.R. Co. v. Howard, 74 U.S. 392 (1868); *see also* Louisville Tr. Co. v. Louisville, N.A. & C. Ry. Co., 174 U.S. 674 (1899); N. Pac. Ry. Cent. v. Boyd, 228 U.S. 482 (1913); Kan. City Terminal Ry. Co. v. Cent. Union Tr. Co. of N.Y., 271 U.S. 445 (1926)).

stockholder's interest in the property "is subordinate to the rights of creditors; first, of secured and then of unsecured creditors."[181]

Second, the Court held that the requirement that the plan must be "fair and equitable" applied even to a consensual plan, such as the *Los Angeles Lumber* plan, which had been accepted by all affected classes of creditors and shareholders.[182] The court was "not merely a ministerial register of the vote of the several classes of security holders."[183] Consent of all affected classes by the majorities required by section 77B was not a substitute for the court's determination that the plan was fair and equitable,[184] and absent such determination, the court could not confirm the plan.[185]

Third, the Court held that the absolute priority rule shielded the holder of each claim or interest, without regard to how the holder or its class voted.[186] Thus, the absolute priority rule applied regardless of whether the holder was in an accepting class or was in a rejecting class.[187] "All those interested in the estate are entitled to the court's protection," and specifically to the shelter of the "absolute or full priority doctrine" that the court had established.[188]

The Court found that the debtor was insolvent on a balance sheet basis, and thus that there was no value in the enterprise beyond that available for partial payment to creditors.[189] The distributions of shares in the reorganized debtor to the old shareholders of the debtor violated the absolute or full priority doctrine.[190] Thus, the plan was not fair and equitable and could not be confirmed.[191]

It is fair to say that the Court's determination in *Los Angeles Lumber* that "fair and equitable" were words of art requiring absolute

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[181] *Id.* at 116 (quoting Louisville Tr. Co. v. Louisville, N.A. & C. Ry. Co., 174 U.S. 674 (1899)). It has not gone unnoticed that Justice Douglas, who wrote the opinion, had joined the court less than a year earlier from serving as chair of the Securities and Exchange Commission, and that his opinion adopted "much of the substance of an *amicus* brief filed by the SEC" in the case. Ayer, *supra* note 143, at 974.

[182] *Los Angeles Lumber*, 308 U.S. at 114.

[183] *Id.*

[184] *Id.*

[185] *Id.*

[186] *Id.*

[187] *See id.*

[188] *Id.* at 114, 123.

[189] *Id.* at 119–21.

[190] *Id.* at 131–32.

[191] *Id.*

priority in distributions—and from which its second and third holdings flowed—was something of a reach. The term "fair and equitable" was not defined in section 77B or elsewhere in the 1898 Act as amended, and the term "absolute or full priority doctrine" was not used in the Act at all, either before or after the 1930s amendments.[192] Further, the Chandler Act and the other Depression Era amendments to the Bankruptcy Act used the term "fair and equitable" elsewhere, in several different contexts that clearly meant much different things.[193]

Moreover, Douglas's statement that the term "fair and equitable" had acquired a fixed meaning in the equity receivership cases was, as Ayer has put it, "poppycock, and Justice Douglas knew it. None of the Supreme Court's absolute priority cases had used that particular phrase in that particular way."[194] Specifically, the Supreme Court had not used the term "fair and equitable" in any of the cases which Douglas cited.[195]

Regardless, the decision stood. Congress had enacted the Chandler Act shortly before the Supreme Court's opinion in *Los Angeles Lumber*, though section 77B of the 1934 Amendments, and not the Chandler Act, applied to the case. The Chandler Act required a plan to be "fair and equitable" under all four of its chapters enabling reorganizations or arrangements,[196] which opened the door to further extensions of the absolute priority rule to several chapters of the Act.

D. The Courts Extend the Absolute Priority Rule to Plans Under Chapters X, XI, and XII of the Chandler Act

The Chandler Act incorporated the 1930s amendments and made other changes to the Bankruptcy Act. The Chandler Act's provisions required a plan to be fair and equitable in chapter X (corporate reorganizations), chapter XI (arrangements), chapter

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[192] Bankruptcy Act of 1898, ch. 424, sec. 77B, § 1, 48 Stat. 911, 912 (1934).

[193] *See infra* notes 407–08.

[194] Ayer, *supra* note 143, at 975.

[195] *See Los Angeles Lumber*, 308 U.S. at 115–16 (citing Chi., R.I. & P.R. Co. v. Howard, 74 U.S. 392 (1868); Louisville Tr. Co. v. Louisville, N.A. & C. Ry. Co., 174 U.S. 674 (1899), N. Pac. R. Co. v. Boyd, 228 U.S. 482 (1913); Kan. City Terminal Ry. Co. v. Cent. Union Tr. Co. of N.Y., 271 U.S. 445 (1926)).

[196] Chandler Act of 1938, ch. 575, Pub. Law No. 75-696, § 221, 52 Stat. 840, 897 (1938).

XII (real property arrangements for persons other than corporations), and chapter XIII (wage earners' plans) for the court to confirm it.[197] The fair and equitable requirement also applied to plans under chapter IX (municipal arrangements)[198] and under section 77 of the Railroad Reorganization Act.[199]

It is not surprising, then, that in the several years following the decision in *Los Angeles Lumber*, the Supreme Court and lower courts applied the absolute priority rule to chapter X (corporate reorganizations),[200] chapter XI (arrangements),[201] chapter XII (real property arrangements for persons other than corporations),[202] and section 77 of the Railroad Reorganization Act.[203] The Court in *Los Angeles Lumber* held that the absolute priority rule was "firmly embedded" in the "fair and equitable" requirement for plan confirmation in section 77B.[204] It followed that the rule would apply to chapters X through XII of the Chandler Act and to the Railroad Reorganization Act of 1934, because those chapters also expressly required a plan to be "fair and equitable" for it to be confirmed.[205]

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[197] *Id.* §§ 221(2), 366(3), 472(3), 656.

[198] Bankruptcy Act of 1898, ch. 657, § 83(e), 50 Stat. Ann. 653, 655 (1937); Bankruptcy Act of 1898, ch. 438, § 83(e), 54 Stat. 667, 669 (1940); Bankruptcy Act of 1898, ch. 434, Pub. Law No. 77-622, § 84, 56 Stat. 377 (1942); Bankruptcy Act of 1898, ch. 532, § 83(e), 60 Stat. 409, 410 (1946). As noted above, the absolute priority rule was never applied in chapter 9 cases.

[199] Railroad Reorganization Act of 1935, ch. 774, § 77B(e), 49 Stat. 911 (1935).

[200] *See, e.g.*, Marine Harbor Props. v. Mft.'s Tr. Co., 317 U.S. 78, 86–87 (referring to the "full priority rule" of *Boyd* and *Los Angeles Lumber*), *aff'g* 125 F.2d 296, 298 (2nd Cir. 1942).

[201] SEC v. U.S. Realty & Improvement Co., 310 U.S. 434, 452 (1940) ("'Fair and equitable,' taken from § 77B and made the condition of confirmation under both Chapter X or Chapter XI are 'words of art' having a well understood meaning in reorganizations in equitable receiverships and under § 77B which is incorporated in the structure of both Chapters X and XI.").

[202] *See, e.g.*, *In re* Hamburger, 117 F.2d 932, 936 (6th Cir. 1941).

[203] Grp. of Institutional Inv'rs v. Chi., M., St. P. & Pac. R.R. Co., 318 U.S. 523, 541–42 (1943).

[204] Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 118–19 (1939). The Supreme Court decided *Los Angeles Lumber* after the 1938 effective date of the Chandler Act, but because the case was filed prior to that effective date, section 77B applied. *Id.* at 119–20 n.14; Bankruptcy Act of 1898, ch. 424, § 77B(f), 48 Stat. 911, 919 (1934).

[205] Chandler Act of 1938, §§ 221(2), 366(3), 472(3), 52 Stat. 840, 897, 911, 923 (1938); Bankruptcy Act of 1898, ch. 424, sec. 77B(f), § 1, 48 Stat. 911, 918–19 (1934).

In chapter XIII (wage earners' plans), the *Los Angeles Lumber* interpretation of "fair and equitable" as "words of art" requiring absolute distributional priority does not appear to have been considered in any published decision. The closest an opinion came to considering the issue was Justice Owen Roberts's dissent in a 5–3 decision in the chapter XI case of *Securities and Exchange Commission v. United States Realty & Improvement Company*.[206] Roberts suggested in dissent that the wholesale application of those words of art to a chapter XIII (wage earners' plans) case might not be an appropriate reading of the Chandler Act.[207] In chapter IX (for municipalities), the courts declined to interpret "fair" and "equitable" to mean absolute priority with respect to confirmation of the municipality's plan.[208] The Supreme Court asked not whether the plan satisfied the absolute priority rule, but whether the "plan in its practical incidence embodie[d] a fair and equitable bargain openly arrived at and devoid of overreaching, however subtle."[209]

[206] *U.S. Realty*, 310 U.S. at 461–69 (Roberts, J., dissenting).

[207] *Id.* at 467. ("The short answer is that the phrase is used not only in chapter XI and chapter X but also in chapter XII respecting real property arrangements, and in chapter XIII respecting wage earners' plans. Obviously the phrase as used in the Chandler Act must be given the connotation appropriate to the section in which it is used.").

[208] Bankruptcy Act of 1898, ch. 657, sec. 83(e), 50 Stat. 653, 658 (1937); Bankruptcy Act of 1898, ch. 438, § 83(e), 54 Stat. 667, 669 (1940); Bankruptcy Act of 1898, ch. 532, § 83(3), 60 Stat. 409, 414 (1946); *see also* Bankruptcy Act of 1898, ch. 434, § 84, 56 Stat. 377 (1942).

[209] Am. United Mut. Life Ins. Co. v. City of Avon Park, 311 U.S. 138, 146 (1940). The Court in *City of Avon Park* wasted no ink trying to reconcile its interpretation of "fair and equitable" in that case with its reading of the same words in *Los Angeles Lumber*, likely for two reasons. *See generally id.* First, a court cannot force a municipality, as a subdivision of a sovereign state, to sell its assets. Second, a municipality has no stockholders or other owners of equity whose interests are junior to creditors. Today's commentators follow this view, noting that in "a municipal debt adjustment case the strict fair and equitable rule of corporate reorganizations cannot be applied without some adjustments." 6 COLLIER ON BANKRUPTCY ¶ 943.03(1)(f)(i)(A) (Alan N. Resnick & Sommer eds., 16th ed., 1941). One adjustment is that the "fair and equitable rule" does not prevent a municipality from retaining its property and continuing to operate, even if the plan does not provide for payment in full to creditors. *Id.* But, the *City of Avon Park* opinion frustratingly said nothing of any of this. *See generally* 311 U.S. 138, 1940.

Circuit court decisions required a finding that the payments under the plan were all that the municipality was "reasonably able to pay in the circumstances."[210] The express statutory term "fair and equitable" simply did not mean absolute and full priority in chapter IX.

E. 1952—Congress Removes the Absolute Priority Rule from Chapters XI, XII, and XIII of the Bankruptcy Act

In 1952, Congress cut back the absolute priority rule, little more than a decade after *Los Angeles Lumber*.[211] Congress used a sharp knife, deleting the term "fair and equitable" from the plan confirmation requirements for chapter XI (arrangements),[212] chapter XII (real property arrangements for persons other than corporations),[213] and chapter XIII (wage earners' plans)[214] of the Act. To make matters clear, Congress further amended each chapter to state expressly that plan confirmation "shall not be refused solely because the interest of a debtor,"[215] or if "the debtor is a corporation, the interests of its stockholders or members will be preserved under the arrangement."[216]

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[210] Lorber v. Vista Irrigation Dist., 143 F.2d 282, 283 (9th Cir. 1944); *see also* Lorber v. Vista Irrigation Dist., 127 F.2d 628, 639 (9th Cir. 1942) (citing West Coast Life Ins. Co. v. Merced Irrigation Dist., 114 F.2d 654 (9th Cir. 1940), *cert. denied*, 311 U.S. 718 (1941)); Moody v. James Irrigation Dist., 114 F.2d 685, 689 (9th Cir. 1940), *cert. denied*, 312 U.S. 693 (1941); Bekins v. Lindsay-Strathmore Irrigation Dist., 114 F.2d 680, 685 (9th Cir. 1940); Jordan v. Palo Verde Irrigation Dist., 114 F.2d 691 (9th Cir. 1940), *cert. denied*, 312 U.S. 693 (1941); COLLIER, *supra* note 209, ¶ 943.03(f)(1)(A).

[211] Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 117 (1939).

[212] Bankruptcy Act of 1898, ch. 579, sec. 366, § 35, 66 Stat. 420, 433 (1952) (amending § 366 of the Chandler Act by removing the requirement that an "Arrangement" under Chapter XI be "fair and equitable") [hereinafter 1952 Amendments].

[213] 1952 Amendments, sec. 472, § 43, 66 Stat. at 435 (amending section 472 of the Chandler Act by removing the requirement that a "Real Property Arrangement" under Chapter XII be "fair and equitable").

[214] 1952 Amendments, sec. 656, § 50, 66 Stat. at 437 (amending section 656(a) of the Chandler Act by removing the requirement that a "Wage Earners' Plan" under Chapter XIII be "fair and equitable").

[215] 1952 Amendments, sec. 366, § 35, 66 Stat. at 437; *see id.* at sec. 472, § 43, 66 Stat. at 433.

[216] 1952 Amendments, sec. 366, § 35, 66 Stat. at 433 (applying only in chapter XI, because chapters XII and XIII were not applicable to corporations).

The contraction of the absolute priority rule that the 1952 amendments accomplished was no accident. Critics of the rule asserted that it was pointlessly impractical.[217] The amendment was advisable, as was noted in the Senate Report, because the "fair and equitable rule" as reaffirmed in *Los Angeles Lumber* could not be applied in a chapter XI, XII, or XIII proceeding "without impairing, if not entirely making valueless, the relief provided" by those chapters.[218] The House Report similarly stated it was not "practicable or realistic to apply the rule in a proceeding under chapter XI, XII, or XIII," and that the "proposed amendment is designed to remove the fair and equitable provision" and make "clear that the rule of the *Boyd* and *Los Angeles* cases shall not be operative under those three chapters."[219] Following the 1952 amendments, the absolute priority rule applied only to corporate reorganization plans in chapter X and to railroad reorganization plans under the Railroad Reorganization Act.[220]

F. 1978—Congress Enacts the Code and Removes the Absolute Priority Rule from the Requirements for Confirmation of a Consensual Chapter 11 Plan

The 1970s witnessed a material reevaluation of U.S. bankruptcy law. In 1970, Congress created the Commission on the Bankruptcy Laws of the United States to reconsider the law.[221] The Commission recommended a comprehensive revision of the bankruptcy

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[217] *See, e.g.*, Note, *Absolute Priority under Chapter X—A Rule of Law or a Familiar Quotation*, 52 COLUM. L. REV. 900, 921 (1952) (arguing absolute priority, as stated by the Supreme Court, left "no room for the by-play of equitable factors"). It closed the door on the "pragmatic approach," and "therein [lay] its weakness. A rule of law which fails to recognize the uniqueness of each case and the sense of justice of he who administers it, though universally reiterated, is bound to be honored in the breach rather than in the observance." *Id.*

[218] S. REP. NO. 1395, at 11 (1952).

[219] H.R. REP. NO. 2320, ¶ 43, at 21 (1952).

[220] Chandler Act, ch. 575, sec. 221, 52 Stat. 840, 897–98 (1938); Railroad Reorganization Act of 1935, ch. 774, sec. 77(e), 49 Stat. 911, 918 (1935). Junior creditors and interest holders in chapters XI, XII, and XIII were protected by the requirement, that the plan provide at least as much to creditors as they would have received in a liquidation, i.e., the "best interests of creditors" test. *See* Ralph A. Peeples, *Staying In: Chapter 11, Close Corporations and the Absolute Priority Rule,* 63 AM. BANKR. L.J. 65, 67–68 (1989).

[221] S.J. Res. 88, 91st Cong., 84 Stat. 468 (1970).

system in its 1973 report to Congress,[222] including combining chapters X, XI, and XII into a single, new business reorganization chapter and a "more flexible" absolute priority rule.[223]

The Commission spelled out in detail its view of the deficiencies of the absolute priority rule. Criticisms included that the rule did "not work well on a practical level," it often led to "a large amount of useless litigation," and served "only to prevent reasonable compromises and to wipe out the interest of shareholders."[224] Absolute priority seemed to the Commission "to leave no room for the by-play of equitable factors. It close[d] the door on the 'pragmatic approach'—therein [lay] its weakness."[225]

The decision in *Los Angeles Lumber* had rigidly required satisfaction of the absolute priority rule even for a consensual plan that all classes had approved.[226] Indeed, the Supreme Court in *Los Angeles Lumber* had reversed confirmation of a reorganization plan that 90 percent or more in each class, including 100 percent of unsecured creditors, had voted to accept.[227]

The Commission recommended a new rule by which a trustee could obtain confirmation of a consensual plan, such as the one in *Los Angeles Lumber*, even if the plan did not comply with the absolute priority rule.[228] If no publicly held securities were affected, and the court found that the plan had been "knowingly and voluntarily accepted by all the creditors and equity security holders materially and adversely affected by it after full disclosure," then no finding of valuation as a basis for applying the fairness doctrine would be required.[229] This modification would permit "the continuation of negotiated settlements by the debtor with small groups of creditors," as under chapter XI at the time.[230] By these changes,

[222] EXEC. DIR. OF THE COMM'N ON THE BANKR. LAWS OF THE U.S., REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137 (1973) (Pts. I, II) [hereinafter 1973 BANKRUPTCY COMMISSION REPORT]. *See* Note, *The Proposed Bankruptcy Act: Changes in the Absolute Priority Rule for Corporate Reorganizations*, 87 HARV. L. REV. 1786, 1786 n.1 (1974).

[223] 1973 BANKRUPTCY COMMISSION REPORT, *supra* note 222, pt. I, at 248.

[224] *Id.* pt. I, at 256.

[225] *Id.* pt. I, at 256, 258.

[226] *In re* Los Angeles Lumber Prods. Co., 24 F. Supp. 501, 511 (S.D. Cal. 1938).

[227] *Id.* at 507.

[228] 1973 BANKRUPTCY COMMISSION REPORT, *supra* note 222, pt. I, at 257.

[229] *Id.* pt. II, at 252.

[230] *Id.* pt. I, at 258; *see also id.* pt. II, at 252.

the "fairness test" would be "made more flexible and the so-called 'absolute priority' doctrine" would be "substantially modified."[231]

Congress recognized that evolution in the capital structures of companies also supported changing the *Los Angeles Lumber* rule. The House Report accompanying the Bankruptcy Reform Act of 1978 noted that when Congress enacted the Chandler Act in 1938, most public investors in bankrupt companies held unsecured claims in the form of debentures in "corporations [that] were more often privately held."[232] In that setting, "the absolute priority rule protected debenture holders from an erosion of their position in favor of equity holders."[233] By the 1970s, if there were public security holders in a bankruptcy case, they likely held either subordinated debentures or shares.[234] Thus, in chapter X, the application of the absolute priority rule had lead "to the exclusion, rather than the protection, of the public."[235] A House amendment permitted confirmation of a plan with respect to "a particular class without resort to the fair and equitable test if the class ha[d] accepted or [was] unimpaired under the plan."[236] A dissenting member of the class would be protected not by the absolute priority rule, but instead by the best interest of creditors test, by which the distribution under the plan to a dissenter in the accepting class would need to be at least as much as the dissenter would receive in a liquidation.[237]

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[231] *Id.* pt. I, at 258; *see also id.* pt. II, at 252 ("[I]f the court finds that the plan has been knowingly and voluntarily accepted by all creditors and equity security holders materially and adversely affected by it after full disclosure," then "the court need not make the findings" that the plan is fair and equitable.).

[232] H.R. COMM. ON THE JUDICIARY, BANKRUPTCY LAW REVISION, H.R. REP. NO. 95-595, at 222 (1983).

[233] *Id.*, *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6468. The First Circuit in *In re Continental Mortg. Investors* noted concerns with the distinctions between chapter XI, "intended primarily to protect the rights of trade creditors," to which the absolute priority rule did not apply after the 1952 Amendments, and chapter X, "intended primarily for the protection of public investors," to which the absolute priority rule still applied after the 1952 Amendments. 578 F.2d 872, 879 (1st Cir. 1978) (citing Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 441–44; SEC v. Am. Trailer Rentals Co., 379 U.S. 594 (1965)).

[234] H.R. REP. NO. 95-595 at 261, *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6468.

[235] *Id.*

[236] *Id.* at 6436.

[237] *Id.* at 6473.

The Bankruptcy Reform Act of 1978 embraced the Commission's recommendations by requiring the court to confirm a consensual plan that did not provide for distributions in accordance with the absolute priority rule.[238] Moreover, Congress adopted the House amendment under which the absolute priority rule would no longer apply to dissenters in an accepting class.[239] Congress in 1978 thus rolled back two more aspects of the rule stated in *Los Angeles Lumber*. Thereafter: (1) a consensual plan accepted by majorities in all impaired classes was confirmable even if it did not satisfy the absolute priority rule; and (2) dissenters in an accepting class of any plan, whether consensual or cramdown, were not entitled to absolute priority.[240]

G. 1986 and 2005—Congress Rolls Back the Absolute Priority Rule with Respect to Certain Family-Owned Businesses

Congress further reduced the reach of the rule in 1986 by enacting chapter 12.[241] Prior to enactment of chapter 12, the absolute priority rule presented a formidable obstacle to bankrupt family farmers retaining their farms.[242] The problem posed was simply that the family farmers' ownership interest in the farm, or ownership of stock in the farm if the business was held and operated in corporate form, was junior to the senior interests of creditors.[243] Under the absolute priority rule, the debtors would need to pay all creditors in full if they were to continue to own their farm.[244]

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[238] Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 1129(a), (b) (1978), 92 Stat. 2549, 2635–36 (1978).

[239] *Id.* § 1129(a)(7)(A)(ii).

[240] Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 114 (1939). The 1977 House Report stated that an "important difference" from the rule in chapter X was that the new bill "permits senior classes to take less than full payment, in order to expedite or insure the success of the reorganization." H.R. REP. NO. 95-595 (1978), *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6184.

[241] Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, ch. 12, Pub. L. No. 99-554, 100 Stat. 3088.

[242] H.R. CONFERENCE REPORT, BANKRUPTCY JUDGES, UNITED STATES TRUSTEES, AND FAMILY FARMER BANKRUPTCY ACT OF 1986, H.R. REP. No. 99-958, at 48–50 (1986) (Conf. Rep.).

[243] *Id.*

[244] Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 202 (1988*), rev'g In re* Ahlers, 794 F.2d 388 (8th Cir. 1986). *Ahlers* is most often cited for the principle that sweat equity is not new value for the purpose of a new value exception to

The Supreme Court in *Norwest Bank Worthington v. Ahlers* confronted the issue in 1988, in a case filed by family farmers under chapter 11, prior to enactment of the new chapter 12.[245] The *Ahlers* court unequivocally concluded that in chapter 11 there was "little doubt that a reorganization plan in which respondents retain[ed] an equity interest in the farm [was] contrary to the absolute priority rule."[246]

Under the new chapter 12, compliance with the absolute priority rule was not required.[247] A plan was confirmable even over objections if it satisfied the best interest of creditors test, i.e., a creditor would receive at least what it would have received in a chapter 7 liquidation, if the plan provided for the payment of the debtor's disposable income to creditors over the 3-year (or longer) term of the plan.[248] The debtor farmers could keep their farm even if the plan did not pay unsecured creditors in full.[249] The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005[250] made chapter 12 applicable on the same terms to certain family-owned commercial fishing operations.[251]

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the absolute priority rule. The new value exception (though it has never been unequivocally embraced by the Supreme Court), permits confirmation of a cramdown plan under which the debtor retains its equity ownership in exchange for new value notwithstanding that creditors are not paid in full. The Eighth Circuit had held that "a farmer's efforts in operating and managing his farm," i.e., his sweat equity, was new value. *In re* Ahlers, 794 F.2d 388, 399, 402 (8th Cir. 1986). The Supreme Court disagreed and reversed, noting that Congress must also have agreed with its analysis, else Congress would not have recently passed the new chapter 12. *See Norwest Bank Worthington*, 485 U.S. at 202.

[245] *Norwest Bank Worthington*, 485 U.S. at 198.

[246] *Id.* at 202.

[247] *See* 11 U.S.C. § 1225 (2012).

[248] *See* Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. 99-554, sec. 255, § 1225, 100 Stat. 3090, 3105 (1986) (inserting the new chapter 12). See chapter 12 provisions section 1225(a)(4), the best interest of creditors requirement, and section 1225(b)(1)(B), the disposable income requirement.

[249] *Id.* § 1228(b)–(c).

[250] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. 109-8, 119 Stat. 23, 109th Cong. (2005) ("BAPCPA").

[251] *See* Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. 109-8, § 1007, 119 Stat. 23, 187–88 (2005) ("BAPCPA") (amending the Code to include 11 U.S.C. §§ 101(19A), 109(f)).

H. Summary—Congress Persistently and Severely Has Contracted the Absolute Priority Rule Since Its Judicial Expansion in Los Angeles Lumber

The Supreme Court made three material determinations construing section 77B in *Los Angeles Lumber*: first, "fair and equitable" meant "full or absolute priority" in a bankruptcy plan;[252] second, the rule applied to reorganization plans, whether consensual such as the plan before the court in *Los Angeles Lumber*, or otherwise;[253] and third, the rule applied to each creditor.[254] Subsequent decisions in the dozen years after *Los Angeles Lumber* extended the rule beyond corporate reorganizations, to several chapters of the Chandler Act which expressly required plans to be "fair and equitable."[255]

Congress over the last sixty years steadily and severely has limited the reach of the *Los Angeles Lumber* rule.[256] In 1952, it rolled back the requirement of absolute priority for plans under chapters XI (arrangements) and XII (real estate arrangements), to which the courts had extended it.[257] Congress by the same enactment also expressly made the rule inapplicable in chapter XIII (wage earners' plans).[258] By so doing, Congress sharply contracted the reach of the first determination made by the Court in *Los Angeles Lumber*, i.e., that the "absolute or full priority" doctrine extended to all bankruptcy plans by virtue of the statutory requirement that a plan be "fair and equitable."[259] The years leading to the Code's enactment in 1978 witnessed further criticisms of the rule, including from the Commission authorized by Congress to recommend changes to U.S. bankruptcy law.[260] Congress in the 1978 Code made the rule inapplicable to the confirmation of a consensual plan and to dissenting creditors in an accepting class, even in a cramdown plan,

[252] Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 118, 122 (1939).
[253] *Id.* at 106, 107, 115.
[254] *Id.*
[255] *See* Chandler Act of 1938, ch. 575, § 48, 52 Stat. 840, 863 (1938).
[256] *See* Bankruptcy Act, 1958 Amendments, Pub. L. 456, 66 Stat. 420, 421, 437–38 (1958).
[257] *Id.* § 2(c).
[258] *Id.* § 54.
[259] Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 118, 122 (1939).
[260] *See generally* 1973 BANKRUPTCY COMMISSION REPORT, *supra* note 222.

completely negating the second and third determinations made by the Court in *Los Angeles Lumber*.[261] Finally, in 1986 and then in 2005, Congress reduced the applicability of the absolute priority rule again, excluding certain family businesses from its reach.[262]

The absolute priority rule did not erode from creative lawyering against a stony legislative decree or a judiciary who side stepped the rule to achieve expedient outcomes. Rather, Congress chiseled away the rule over time to enable positive resolutions of failed businesses and individuals that did not require application of the absolute priority rule, yet were in the best interest of creditors.

III. THE RESULTING LIMITED TEXTUAL REACH OF THE ABSOLUTE PRIORITY RULE UNDER THE CODE

The absolute priority rule requires that senior claims are paid in full before junior claims receive anything, that junior claims are paid in full before equity holders receive anything, and that senior equity holders (such as preferred shareholders) are paid in full before junior equity holders (such as common shareholders) receive anything.[263]

Some commentators have called the absolute priority rule "the cornerstone of reorganization practice and theory."[264] Others have described it as "central" to chapter 11 under the Code[265] and to the "bankruptcy bargain."[266] Yet the reach of the absolute priority

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[261] *See* 11 U.S.C. § 1129 (2012). Indeed, the plan in *Los Angeles Lumber* would have been confirmed under the Code, because it was a consensual plan. *See Los Angeles Lumber*, 308 U.S. at 109–10. Other statutory requirements for consensual plan confirmation continued to apply under the Code, in particular the "best interest of creditors test" of section 1129(a)(7) pursuant to which each dissenter must receive under the plan at least what it would receive in chapter 7. *See* § 1129(a)(7).

[262] *See* Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. 99-554, sec. 255, § 1225, 100 Stat. 3090, 3110–11 (1986); Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. 109-8, sec. 101, § 1007, 119 Stat. 23, 187–88 (2005).

[263] *See* § 1129(b).

[264] Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69, 123 (1991).

[265] DOUGLAS G. BAIRD, ELEMENTS OF BANKRUPTCY 57 (6th ed. 2014).

[266] Elizabeth Warren, *A Theory of Absolute Priority*, 1991 ANN. SURV. AM. L. 9, 11 (1992).

rule under the current Code is surprisingly limited. The absolute priority rule does not pervade chapter 11 or the other chapters of the Code to the extent that many suggest.

The text of the Code does not expressly require absolute priority with respect to all distributions in, or resolutions of, a bankruptcy case. Rather, the Code expressly limits the rule to two circumstances: (1) distributions to unsecured creditors and equity holders in a chapter 7 liquidation case, and (2) distributions to the holder of claims in a voting class that has rejected a chapter 11 cramdown plan.[267]

In chapter 11, the current Code does not require absolute priority for confirmation of a consensual plan.[268] For confirmation of a cramdown plan, the rule applies only to the holders of claims or interests in a rejecting class of claims or interests.[269]

Compliance with the rule is not required for the confirmation of plans under other chapters of the Code. Specifically, the rule does not apply in chapter 9 (adjustment of debts of a municipality),[270] chapter 12 (for family farmers and family fishermen),[271] chapter 13 (for individuals with regular income)[272] or chapter 15 (for cross-border cases).[273] An analysis of the current Code's text on a chapter-by-chapter basis follows.

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[267] *See generally* §§ 701–84, 1129.

[268] *See* § 1129(a). If all classes of claims and interests have accepted the plan under § 1129(a)(8), the absolute priority rule in § 1129(b) does not apply. § 1129(a)(8). A plan must pay priority claims in full under § 1129(a), but even a dissenter in an accepting class of priority claims can be required to take deferred payments, rather than payment in full on the effective date of the plan, while the plan pays junior claims and interests in full on the effective date. § 1129(a)(9)(B)(i). "Under the 1978 Bankruptcy Code, consent can be given through a classwide vote of creditors." Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738, 738 (1988) ("A single uncompromising creditor's objection is not sufficient to prevent the participation of shareholders.").

[269] *See* § 1129(a)(9).

[270] § 943.

[271] § 1225.

[272] § 1325.

[273] *See generally* §§ 1501–32 (demonstrating that nothing in chapter 15 authorizes a United States bankruptcy court to impose the absolute priority rule on distributions).

A. Chapter 7 (Liquidation)[274]*—The Absolute Priority Rule Applies*

The absolute priority rule applies, first, in chapter 7 liquidation.[275] Both individuals and most business organizations such as corporations are eligible to be a debtor in chapter 7.[276]

Decisions and commentators often cite section 507 as the basis for the absolute priority rule, but the rule is not there. Section 507 merely defines ten priorities of unsecured claims, in descending order of seniority and subordination from "first" to "tenth."[277] Section 507 says nothing of secured claims.[278] It also does not direct distributions to the holders of the listed unsecured priority claims.[279] Section 507 does not refer at all to general unsecured claims or equity, and similarly says nothing of the place of those more substantial and numerous claims and interests in the distribution scheme applicable in chapter 7.[280]

Rather, the distributional rules for chapter 7 begin with the state law and other nonbankruptcy law that determine liens and other interests in a debtor's property and the recognition in decisional law that such liens and interests generally remain in effect after the bankruptcy case has been filed.[281] That rule is subject to

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[274] Code chapters 7, 9, 11, 12, 13, and 15, discussed below, contain the Code provisions for six different types of bankruptcy cases. *See* §§ 701–1532. The reference, "Liquidation," is the Code chapter heading for chapter 7. *See id.* The chapter headings for the other these six chapters are: "Chapter 9—Adjustment of Debts of a Municipality"; "Chapter 11—Reorganization"; "Chapter 12—Adjustment of Debts of a Family Farmer or Fisherman with a Regular Annual Income"; "Chapter 13—Adjustment of Debts of an Individual with Regular Income"; and "Chapter 15—Ancillary and Other Cross-Border Cases." *Id.*

[275] *See* § 726(a).

[276] § 109(b). Notable exceptions are railroads, which are eligible to be debtors only under chapter 11, and insurance companies, banks, and certain other financial institutions, which are subject to resolution under other federal and/or state insolvency laws. *Id.*

[277] *See* § 507.

[278] *See id.*

[279] *See id.*

[280] *Id.*

[281] "Property interests are created and defined by state law" in a bankruptcy case, under the Supreme Court's holding in *Butner v. United States*. 440 U.S. 48, 54–55 (1979) (1898 Act case). State law establishes the extent, validity, and priority of liens and other interests in a debtor's property. *Id.* State law recordation acts, and related real property and contract law (such as that applicable to subordination agreements) determine which lien or other encumbrance has priority and which is subordinate. *Id. Butner* makes clear that the holder of a

Code section 506 that provides that a secured claim is not allowed beyond the value of the collateral securing it.[282] Beyond this principle, the rules for payment to holders of unsecured claims and equity holders in chapter 7 are set forth in Code section 726.[283] The resulting distributional rules, in order of descending priority, are as follows:

- First, a secured creditor is entitled to receive the value of its collateral, up to the amount of its claim secured by that collateral. If the secured creditor is undersecured, i.e., the value of its collateral is less than the amount of its claim, then the amount of the claim in excess of the value of its collateral becomes a general unsecured claim pursuant to Code section 506(b).[284]
- Second, if value remains in the debtor's estate, priority unsecured claims in chapter 7 are paid "in the order specified in" section 507(a), such that holders of claims in each tranche are paid in full prior to any payment to the holders of claims in the next junior tranche or priority unsecured claims.[285]
- Third, if value remains in the debtor's estate, general unsecured claims are paid.[286]
- Finally, after all claims referred to in the prior paragraphs are fully paid, the remaining value is paid to the debtor.[287]

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prepetition lien should be "afforded in federal bankruptcy court the same protection he would have under state law had no bankruptcy ensued." *Id.* at 49, 54–56. The secured creditor must perfect its lien under state law, such as by filing a mortgage or financing statement or by obtaining a judgment lien. *See* Nobelman v. Am. Sav. Bank, 113 S. Ct. 2106, 2109 (1993) (1978 Code case, following *Butner*). If the lien is not perfected it will be subject to avoidance under Code section 544. *See* § 544.

[282] *See* § 506(a).

[283] *See generally* § 726.

[284] *See* § 506(a).

[285] § 726(a)(1). When the music stops and the estate has insufficient value with which to pay in full a tranche of priority claims, or to pay in full the tranche of general unsecured claims after priority claims have been paid in full, the remaining value is distributed to the holders in that tranche on a pro rata basis. § 726(b).

[286] § 726(a)(2).

[287] § 726(a)(6).

The chapter 7 distributional rules, as pure as they are, do not extend to chapter 11 or to any other chapters of the Code. Code section 103(b) makes this clear.[288] Section 726 is part of subchapter II of chapter 7 of the Code.[289] Section 103(b) unequivocally states that the provisions of subchapter II of chapter 7 apply *only* in chapter 7.[290]

B. Chapter 9 (Adjustment of Debts of a Municipality)—The Absolute Priority Rule Does Not Apply

Chapter 9 applies to an insolvent municipality that "desires to effect a plan to adjust" its debts.[291] Chapter 9 presents a peculiar situation and its text is frustratingly unclear.[292]

Though chapter 9 incorporates section 1129(b) and thus the requirement that a cramdown plan be "fair and equitable,"[293] chapter 9 does not require absolute distributional priority, for two reasons. One is textual, and the other relates to the special nature of a municipality.

First, chapter 9 does not require distributions to unsecured creditors per the priorities listed in section 507(a).[294] None of those priorities listed other than administrative expense claims, which are a second priority claim under section 507(a)(2), apply in chapter 9 cases.[295] The other priorities of section 507(a) simply do not apply to chapter 9.[296] At least two of those priorities—the fourth regarding wages and salaries payable to employees, and the

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288 § 103(b).

289 *See generally* § 726.

290 § 103(b).

291 § 109(c)(4). Specifically, § 109(c) makes §§ 1129(a)(2), 1129(a)(3), 1129(a)(6), 1129(a)(8), 1129(a)(10), 1129(b)(1), 1129(b)(2)(A), and 1129(b)(2)(B) (and a number of other sections that are not part of section 1129) applicable in a chapter 9 case. *See also In re* Stephens, 704 F.3d 1279, 1287 (10th Cir. 2013) (holding that absent clear indication, amendments to the Bankruptcy Code do not impliedly exempt debtors from absolute priority rule).

292 *See* §§ 901–46.

293 § 901(a). Code section 103(f) states that, except as provided in section 901, only the provisions of chapter 1 (general provisions) and chapter 9 (adjustment of debts of a municipality) apply in a chapter 9 municipal bankruptcy case. § 103(f).

294 § 901(a).

295 *Id.*

296 *See id.*

fifth, regarding contributions to an employee benefit plan—would have clear application in chapter 9 and to a cramdown plan proposed in the case but for the exclusionary text of section 901(a).[297]

The requirements for chapter 9 plan confirmation set forth in section 943(b) are consistent with this analysis. Under section 943(b)(5), the plan must provide only for payment of section 507(a)(2) administrative expense claims.[298] Chapter 9 imposes no obligation on the municipal debtor to adhere to the absolute priority rule with respect to any other priority unsecured claims set forth in of section 507(a).[299]

Second, a municipality has no stockholders or other owners who would be subject to the absolute priority rule. Thus, by case law in a municipal debt adjustment case, the "fair and equitable" requirement does not prevent the municipality from retaining its property and continuing to operate even if the plan does not provide for full payment to creditors.[300] A chapter 9 plan must only pay creditors "all that they 'can reasonably expect in the circumstances.'"[301]

The bankruptcy court in *In re City of Detroit* recently stated the rule: "because municipalities have no junior class of shareholders, the absolute priority rule provides unsecured creditors with no protection."[302] Instead, the plan must embody "a fair and equitable bargain openly arrived at and devoid of overreaching, however subtle."[303] The court in *City of Detroit* found that no viable alternatives to the plan would solve the City's problems and at the same time pay more to the dissenting creditors.[304] The cramdown plan thus was "fair and equitable," and the court confirmed it.[305]

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[297] *See* § 507(a)(4) (on wage claims); § 507(a)(5) (on employee benefit contribution claims); *see also* § 507(a)(8) (unsecured claims of governmental units).

[298] § 943(b)(5).

[299] *See* §§ 901(a), 943(b)(5).

[300] COLLIER, *supra* note 209, ¶ 943.03(1)(f)(i)(A).

[301] *Id.* ¶ 943.03(1)(f)(i)(B) (citing Lorber v. Vista Irrigation Dist., 127 F.2d 628, 639 (9th Cir. 1942)).

[302] *In re* City of Detroit, 524 B.R. 147, 260 (Bankr. E.D. Mich. 2014) (citing *In re* Corcoran Hosp. Dist., 233 B.R. 449, 458 (Bankr. E.D. Cal. 1999)).

[303] *Id.* at 210 (citing Am. United Mut. Life Insur. Co. v. City of Avon Park, 311 U.S. 138, 145–46 (1940)).

[304] *Id.* at 262.

[305] *Id.*

In sum, confirmation of a chapter 9 plan does not require compliance with the absolute priority rule.[306] Only the second priority listed in section 507 (for administrative expense claims) applies at all. And though the Code's text requires the plan to be "fair and equitable," decisional law construes that term in chapter 9 to mean an equitable process by which the bankruptcy court weighs the benefits of confirmation to the citizenry and the creditor body as a whole against the harm to dissenting creditors.

C. Chapter 11 (Reorganization)—The Absolute Priority Rule Applies to Holders in Dissenting Class in a Cramdown Plan; The Absolute Priority Rule Does Not Apply to Consensual Plans or to Dissenters in Any Accepting Class; The Best Interest of Creditors Test Protects Dissenters

Chapter 11 does not contain a provision corresponding to section 726.[307] No section in chapter 11 requires distributions in a chapter 11 case to accord with the priorities set forth in section 507 in all cases. Instead, the absolute priority rule applies only to a cramdown plan and then only to the holders of claims in a voting class that has rejected a plan.[308]

The proponent of the chapter 11 plan (most often the debtor in possession) designates the classes of claims and interests in the proposed plan.[309] Voting for or against the plan is by class.[310] A class of claims generally accepts the plan if "at least two-thirds in amount and more than one-half in number of the allowed claims of such class held by creditors ... have accepted or rejected such plan."[311] A class of interests, i.e., equity holders, generally accepts

[306] *See* 11 U.S.C. § 901(a) (2012); *see also* § 943(b)(5); *City of Detroit*, 524 B.R. at 260 (citing *Corcoran,* 233 B.R. at 458).

[307] §§ 1101–74.

[308] § 1129(a)–(b).

[309] § 1123(a)(1). The debtor in possession or other party in interest that proposes the plan has some leeway in classifying claims and interests under the proposed plan, subject to section 1122. That section provides generally that "a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class." § 1122(a).

[310] *See* § 1126(c)–(d).

[311] § 1126(c).

the plan if "such plan has been accepted by holders of such interests ... that hold at least two-thirds in amount of the allowed interests of such class held by holders of such interests ... that have accepted or rejected such plan."[312]

A "cramdown" plan in chapter 11 is a plan that one or more impaired classes of claims voted to reject, but that at least one impaired class of claims voted to accept.[313] A "consensual" plan is a plan that all impaired classes of claims and interests have voted to accept.[314] Both cramdown plans and consensual plans are confirmable by the bankruptcy court in a chapter 11 case.[315] The primary difference is that a cramdown plan is confirmable only if the plan follows the absolute priority rule with respect to each holder in the dissenting class or classes.[316] The absolute priority rule does not apply, though, to the holders of claims in a consensual plan, or to the dissenters in a voting class that has accepted a cramdown plan.[317]

1. The Absolute Priority Rule Applies to Holders in a Dissenting Class in a Cramdown Plan

The absolute priority rule applies in chapter 11 only to a cramdown plan. The court may confirm a cramdown plan notwithstanding the negative vote of a dissenting class, but only if the plan satisfies the absolute priority rule with respect to the holders in the dissenting class.[318]

The rule in chapter 11 applies only to the holders of claims and interests in a class that has voted against the plan, as follows:

- With respect to a class of secured claims, the plan must provide that each holder within the class will

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[312] § 1126(d).

[313] § 1129(a)(10), (b).

[314] § 1129(a)(8). A claim or interest generally is "impaired" unless it "leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest," i.e., an "impaired" class of claims or interests essentially is a class the members of which will receive less than they would be entitled to outside of the bankruptcy. § 1124(1). If, for example, each of the holders in a class of unsecured creditors will be paid 7 percent rather than 100 percent of its allowed claim, then the class is impaired.

[315] § 1129(a)(1)–(9), (11)–(16).

[316] § 1129(b)(1).

[317] § 1129(a)–(b).

[318] § 1129(b)(1).

receive the equivalent of its allowed secured claim, i.e., the value of its collateral up to the amount of its claim;[319]

- With respect to a class of unsecured claims, the plan must provide that each holder within the class will receive or retain value on the plan effective date equal to the allowed amount of such claim, or the holder of a junior claim or interest will receive nothing under the plan;[320] and
- With respect to a class of interests (i.e., shares or other equity), the plan must provide that each holder will receive the liquidation, redemption or actual value of such interest, or the holder of a junior interest will receive nothing under the plan.[321]

The gist of section 1129(b) as it applies to a cramdown plan is the essence of the absolute priority rule. Unless each holder in the senior rejecting class of, say, unsecured claims will receive the full value of its claim under the plan, then the plan may not distribute anything at all to any junior stakeholder on account of its claim or interest.[322] The rule applies to a cramdown plan even if all of the other requirements for confirmation set forth in section 1129(a) have been satisfied.[323] The simple reason is that the absolute priority rule set forth in section 1129(b) required for a cramdown plan has not been satisfied.

2. The Absolute Priority Rule Does Not Apply to Consensual Plans or to Dissenters in Any Accepting Class in a Cramdown Plan

The absolute priority rule does not apply, though, to a consensual chapter 11 plan. Section 1129(b) expressly provides that the absolute priority rule applies *only* if one or more impaired classes

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[319] § 1129(b)(2)(A) (setting forth the various ways in which this may be accomplished under the plan).

[320] § 1129(b)(2)(B).

[321] § 1129(b)(2)(C).

[322] *See* H.R. REP. NO. 95-595, at 413 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6370.

[323] § 1129(b)(1).

of claims or interests has voted against the plan, and thus the plan fails to satisfy section 1129(a)(8).[324] If all impaired classes of claims and interests designated in the plan have voted to accept under section 1129(a)(8), then the plan is a consensual plan and section 1129(b) does not apply.[325] The bankruptcy court "shall confirm" a consensual plan that complies with the other requirements of section 1129(a), notwithstanding that it does not comply with the absolute priority rule.[326]

Consider the following illustration. The Code provides that the court shall confirm a consensual plan that pays pennies on the dollar to the holders of classes of general unsecured claims and gives all of the equity in the reorganized debtor to existing shareholders on account of their interests. If each voting class of claims and interests has accepted the plan by the requisite majorities in accordance with section 1129(a)(8), then the absolute priority rule of section 1129(b) does not apply and the court shall confirm the plan if it satisfies the other conditions of section 1129(a), even over the dissenters' votes and objections.

Even in a cramdown plan, the absolute priority rule only applies to the holders in the *rejecting* class.[327] The requirement that a cramdown plan must be "fair and equitable" by satisfying the absolute priority rule applies only to "each class of claims or interests that is impaired under, and *has not accepted*, the plan."[328] The dissenters within any accepting class under a cramdown plan may not avail themselves of the rule.

Consider a cramdown plan in which two classes of unsecured claims are impaired and entitled to vote. One unsecured class has accepted and the other unsecured class has rejected the plan. The plan violates the absolute priority rule because it will pay pennies on the dollar to the holders in each class of unsecured claims and the shareholders in the old company will own the reorganized company. The absolute priority rule applies, but only to the dissenting class,

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[324] § 1129(a)(8), (b)(1).

[325] Courts have split since the 2005 BAPCPA amendments regarding whether the absolute priority rule applies to an individual's chapter 11 plan. *See In re* Maharaj, 681 F.3d 558, 563 (4th Cir. 2012). This question is beyond the scope of this Article.

[326] § 1129(a), (b)(1).

[327] § 1129(b)(1).

[328] *Id.* (emphasis added).

because it "is impaired under, and *has not accepted*, the plan."[329] Section 1129(b) does not require compliance with the rule with respect to holders in the accepting class, even if they dissented and voted against the plan.

Moreover, even under the requirements for confirmation of a chapter 11 plan, section 507 does not always apply. Under both a consensual plan and a cramdown plan, the majority in a consenting class of section 507 priority unsecured employee wage or benefit plan claims, agricultural supplier claims, or consumer deposit claims can bind dissenters within that class to accept deferred payments.[330] The court may confirm a plan even if it provides for the deferral of payments to holders of priority claims in those classes until after full payment of lower priority claims, and even after the debtor has received its discharge and the court has closed the case.[331]

3. The Best Interest of Creditors Test Protects Dissenters in Chapter 11

The limited reach of the absolute priority rule in chapter 11 does not mean that dissenting stakeholders are without protection. The "best interest of creditors" test, set forth in section 1129(a)(7), requires that each holder of a claim or interest that has voted against the plan will receive at least as much as it would receive if the debtor were liquidated under chapter 7.[332] If

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[329] *Id.* (emphasis added).

[330] § 507(a)(1), (4)–(7); § 1129(a)(9)(B); *see* TABB, *supra* note 96, at 733.

[331] The bankruptcy court normally closes a chapter 11 case in which a plan was confirmed by entry of a final decree under Rule 3022 once distributions under the plan have commenced. *See* FED. R. BANKR. P. 3022 advisory comm. n. ("[F]inal decree closing a chapter 11 case should not be delayed solely because the payments required by the plan have not been completed."). *Closing* a case after plan *confirmation* is not the same thing as *dismissing* the case under section 1112, grounds for which include the *failure* to confirm or consummate a plan. § 1112(b)(4)(M) (emphasis added).

[332] § 1129(a)(7)(A)–(B). The requirement of section 1129(a)(7)(A) is consistently referred to as the "best interest of creditors test," though the Code does not use that term. The designation predates the Code. *See* H.R. COMM. ON JUDICIARY, Bankruptcy Reform Act of 1978, H.R. REP. NO. 95-595, at 400 (1978), *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6356; S. REP. NO. 95-989, at 126 (1978), *as reprinted in* 1978 U.S.C.C.A.N. 5787, 5913. The House Report in its section-by-section analysis stated that section 1129(a)(7) "incorporates the former 'best interest of creditors' test found in chapter 11, but spells out precisely what is intended." H.R. REP. NO. 95-595, at 412 (1978), *as reprinted in* 1978 U.S.C.C.A.N.

a dissenting creditor will receive less under the plan, then bankruptcy court may not confirm it.

In sum, the absolute priority rule is far from absolute in chapter 11. Chapter 11 does not require that distributions in chapter 11 must be made in accordance with the priorities listed in section 507 or otherwise must adhere to the absolute priority rule with respect to all of the holders of claims or interests. The rule is limited to the holders in a class that has voted against the plan.

D. Chapter 12 (Adjustment of Debts of a Family Farmer or Fisherman with a Regular Annual Income)—The Absolute Priority Rule Does Not Apply

The absolute priority rule does not apply to chapter 12[333] or to a chapter 12 plan.[334] The Code requires a chapter 12 debtor to file a plan within ninety days.[335] The plan is subject to confirmation by the bankruptcy court, but there is no voting by holders of claims or interests.[336]

Most significantly, a farmer or family fisherman may keep the farm or fishing business even if the plan does not pay creditors in full.[337] If the debtor's corporation or limited partnership owns the farm or commercial fishing operation, then the debtor may retain her corporate shares or partnership interests even if the plan does not pay the debtor's creditors in full.[338]

5963, 6368; *see also* Markell, *supra* note 264, at 88 (explaining the legislative compromise that resulted in the requirement that a plan satisfy the best interest of creditors test rather than the absolute priority rule to safeguard the interests of dissenting creditors and shareholders in chapter 11). The directive that that the bankruptcy court act "in the best interests of creditors and the estate" in determining whether to convert or dismiss under section 1112(b) is different from the "best interest of creditors" test of section 1129(a)(7)(A) which, as set forth above, is a legal term of art.

[333] *See Chapter 12 and Family Farm Bankruptcies*, FINDLAW (Dec. 21, 2016), http://corporate.findlaw.com/finance/chapter-12-and-family-farm-bankruptcies.html [https://perma.cc/W3L9-CVVZ] (noting the absence of any reference to the absolute priority rule in chapter 12); §§ 1201–31.

[334] §§ 1222, 1225.

[335] § 1221.

[336] § 1325(a).

[337] TABB, *supra* note 96, at 113.

[338] § 1222(a)(4)–(d); *see also* TABB, *supra* note 96, at 113 ("[C]hapter 12 rules are very different from the chapter 11 requirements in a number of ways that

The chapter 12 plan also may pay unsecured priority claims "in deferred cash payments," temporally may pay priority claims out of the order set forth in section 507, and may pay priority claims prior to paying general unsecured claims.[339] Further, notwithstanding the priority given to tax claims under section 507, if a priority claim is "owed to a governmental unit that arises as a result of the sale, transfer, exchange, or other disposition of any farm asset used in the debtor's farming operation," then it is "treated as [a general] unsecured claim that is not entitled to priority."[340]

In sum, the absolute priority rule does not apply in chapter 12. First, the debtor may retain its farm or fishing business even if it does not pay the holders of claims in full. Second, chapter 12 permits the debtor to pay priority unsecured claims over time, even if it pays unsecured claims of lower priority in full on an earlier date.

E. Chapter 13 (Adjustment of Debts of an Individual with Regular Income)—The Absolute Priority Rule Does Not Apply

The absolute priority rule similarly does not apply to chapter 13,[341] or to a chapter 13 plan.[342] A chapter 13 debtor shall file a plan that provides for a three- to five-year payout to creditors.[343] The plan is subject to confirmation by the bankruptcy court but, like chapter 12, there is no plan voting.[344]

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greatly benefit the farmer or fisherman debtor. For example, the 'absolute priority' rule in chapter 11, which prohibits the debtor from retaining any property (e.g., the farm) over the objection of a class of unsecured creditors unless that class is paid in full, § 1129(b)(2)(B), is not included in chapter 12."); Ayer, *supra* note 143, at 1020 ("In each case [of chapters 12 and 13], the Code permits the debtor to retain property that might otherwise go to creditors, even where creditors are not paid in full."). A "family farmer" and a "family fisherman" with regular annual income may be a debtor under chapter 12. § 109(f). Each definition includes a family-owned corporation or limited partnership through which the family conducts the operation. § 101(18)(B), (19A)(B).

[339] §§ 507(a)(8), 1222(a)(2)(A), 1225(a)(1), (4).

[340] § 1222(a)(2)(A).

[341] *See* §§ 1301–30.

[342] *See* §§ 1322, 1325.

[343] § 1325(b)(4)(A)(i)–(ii); *see also Chapter 13—Bankruptcy Basics*, U.S. COURTS, http://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-13-bankruptcy-basics [https://perma.cc/Y7QY-Y6K9].

[344] *See* § 1325; *see also Chapter 13—Bankruptcy Basics*, *supra* note 343.

Section 1325(b) provides that the bankruptcy court shall confirm a plan if the debtor's projected disposable income "will be applied to make payments to unsecured creditors under the plan."[345] The debtor may retain his *non*-exempt property even if he does not pay unsecured creditors in full,[346] in clear contradiction of the result that would occur if the absolute priority rule applied. Though a chapter 13 plan must provide for full payment of all section 507 priority claims in deferred cash payments over the term of the three- to five-year plan,[347] chapter 13 does not require the payment of senior priority unsecured claims prior to payment of junior priority unsecured claims.[348]

F. Chapter 15 (Ancillary and Other Cross-Border Cases)—The Absolute Priority Rule Does Not Apply

Congress enacted chapter 15 in 2005 as part of BAPCPA.[349] Chapter 15 applies to international bankruptcies,[350] when a "foreign court or foreign representative in connection with a foreign [insolvency] proceeding" seeks assistance in the United States, or "assistance is sought in a foreign country in connection with a case under" the Bankruptcy Code.[351]

The absolute priority rule does not apply in chapter 15. Code section 103(a), which enumerates the Code provisions applicable to chapter 15, does not include section 507 (listing the unsecured priority claims), section 726 (providing for distributional priorities in chapter 7), or section 1129(b) (setting forth the absolute priority for purposes of confirmation of a cramdown plan).[352] Nothing

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[345] 11 U.S.C. § 1325(b)(1)(B).

[346] *Id.* § 1325(b) (emphasis added); *see* Ayer, *supra* note 143, at 1020; TABB, *supra* note 96, at 1202, 1246 ("[C]lasses of unsecured creditors in chapter 13 cannot invoke the absolute priority rule, meaning that the debtor is free to retain her property and any equity interests therein.").

[347] 11 U.S.C. § 1322(a)(2).

[348] Though the plan must pay priority unsecured claims in full over the life of the plan, there is "no additional requirement that those claims be paid temporally in the order of their priority. For example, the debtor could provide that all eighth priority tax claims be paid first." TABB, *supra* note 96, at 1227.

[349] *See id.* at 118–19.

[350] *See* 11 U.S.C. § 1501.

[351] *Id.* § 1501(b)(1)–(2).

[352] *Id.* §§ 103(a), 507(a), 726(a), 1129(b).

in chapter 15 authorizes a United States bankruptcy court to impose the absolute priority rule on distributions in chapter 15.

G. Summary—The Absolute Priority Rule and the Bankruptcy Code

The current text of the Code gives the absolute priority rule a surprisingly narrow scope. The rule applies unequivocally in chapter 7. Outside of that chapter, the rule's reach is weak.

The restriction against a debtor or its shareholders from retaining their ownership interests until all senior claims are paid in full does not apply at all in chapters 9, 12, 13 or 15. Distributions to priority unsecured claimants also have a limited application under most chapters of the Code. Payments per those priorities: (1) are not required at all in chapter 9 (except that administrative expense claims must be paid), (2) are altered with respect to some tax priorities and also may be temporally reordered in chapter 12, (3) may be temporally reordered in 13, and (4) are not required in chapter 15.[353]

In chapter 11, the absolute priority rule has no application to a consensual plan that has been accepted by the requisite majorities in each impaired class.[354] A consensual plan may permit equity to retain ownership of the reorganized debtor even if it does not pay creditors in full; under an approved plan equity may also pay priority unsecured claims on a deferred basis, after payment of lower priority claims, even following the debtor's discharge and the closing of the case. The absolute priority rule applies only to a chapter 11 cramdown plan and then, only to the holders of claims or interests in a rejecting class.[355] Dissenters in accepting classes, whether under a consensual plan or a cramdown plan, cannot invoke the rule.[356] Other, more pervasive rules—including the best interest of creditors test and the other requirements of section 1129(a)—protect those dissenters.[357]

In sum, the absolute priority rule under the text of today's Code is more a special than a general rule. Its limited scope did not result from legislative accident, clever lawyering, or creative judging.

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[353] *See supra* Part III.B.
[354] 11 U.S.C. § 1129(a)(8).
[355] *See supra* notes 51–52 and accompanying text.
[356] TABB, *supra* note 96, at 733.
[357] *See supra* Part III.C.3.

Rather, Congress consistently and deliberately has limited the reach of the rule.

IV. Settlements and Compromises Under the Code

Bankruptcy Rule 9019 authorizes a bankruptcy court to approve a settlement or compromise.[358] The Rule provides that, "after notice and a hearing, the court may approve a compromise or settlement."[359] Nothing in the text of the current Code or Rules expressly requires that settlements outside of a plan adhere to the absolute priority rule or provide other criteria for the approval of a compromise or settlement. Rather, Congress has left the development of the rules for approval of settlements to the courts.

A. Settlements and Compromises Under TMT

The bankruptcy case that set the standard for court approval of a settlement is *Protective Committee for Independent Stockholders of TMT Trailer Ferry, Inc. v. Anderson* ("*TMT*").[360] *TMT* was a chapter X corporate reorganization case under the Bankruptcy Act.[361]

The Chandler Act, unlike the Code, contained an express provision regarding settlements.[362] Section 27 of the Act authorized the receiver or trustee, with the approval of the court, to "compromise any … controversy arising in the administration of the estate upon such terms as he may deem for the best interest of the estate."[363] The Supreme Court's General Order 33 also governed approvals

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[358] Fed. R. Bankr. P. 9019 (2012).

[359] *Id.* 9019(a).

[360] Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 418, 424 (1968).

[361] *Id.* at 418. Justice White wrote for a 5–3 majority in *TMT*. The dissent said nothing of the standard for approval of a settlement outside of a plan. The dissent, instead, considered that "the only question which could be thought even remotely to justify" the grant of certiorari was "whether the trustee, by virtue of his office, was as a matter of law disqualified from being selected as president of the reorganized company," and would have dismissed the writ of certiorari on the ground that it was improvidently granted. *Id.* at 454 (Harlan, J., dissenting).

[362] Chandler Act of 1938, ch. 575, § 27, 52 Stat. 840, 855 (1938); 2 Modern Bankruptcy Manual: Law and Practice 1476 (1966).

[363] *See* Modern Bankruptcy Manual, *supra* note 362, at 1476.

of settlements when *TMT* was decided in 1968.[364] General Order 33 required the receiver, trustee, or debtor in possession who was seeking approval of the compromise to set forth the reasons why it was "proper and for the best interest of the estate that the controversy should be settled."[365] Neither section 27 nor General Order 33 expressly required a settlement to be "fair and equitable" or to comply with the absolute priority rule.

The Court in *TMT* stated that it was necessary for it to consider only two questions: whether it was error to affirm, first, "approval of compromises of substantial claims against the debtor," and, second, the "District Court's judgment that the debtor was insolvent, when that judgment was rendered without considering the future estimated earnings of the reorganized company."[366] Two settlements were at issue.

The first claim settled in *TMT* was in the face amount of $330,000, though the holders of the claim had paid $280,500 for it.[367] Preferred ship mortgages against the debtor's vessels allegedly secured the claim.[368] The trustee proposed to settle the claim for $280,500, payable in installments with interest.[369] The trustee proposed the settlement notwithstanding that the trustee's own report had concluded that the holders of the preferred ship mortgages, who were insiders, "had diverted corporate opportunities through the flagrant abuse of their control, fiduciary or inside positions, and should be made to account for the profits they had made."[370] Moreover, at the time the preferred ship mortgages were executed, the insiders "were in a position to dictate terms which TMT would be forced to accept."[371]

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[364] *Id.*

[365] Chandler Act of 1938, § 27; *see also* MODERN BANKRUPTCY MANUAL, *supra* note 362, at 1476–77. Rule 919, which replaced General Order 33 in the mid-1970s prior to enactment of the Code, said simply that "the court may approve a compromise or settlement" on notice and a hearing. MODERN BANKRUPTCY MANUAL, *supra* note 362, at 173. Rule 919 was strikingly similar to the present Rule 9019, and provided that "after hearing on notice to the creditors as provided in Rule 203(a) and to such other persons as the court may designate, the court may approve a compromise or settlement." *Id.*

[366] *TMT*, 390 U.S. at 423 (1938).

[367] *Id.* at 425.

[368] *Id.* at 419.

[369] *Id.* at 426.

[370] *Id.* at 427.

[371] *Id.*

The second claim settled was in the face amount of $1.6 million.[372] Maritime liens against the debtor's vessels allegedly secured about $600,000 of the claim, though there were material questions regarding the validity of the liens.[373] The trustee proposed to allow this $1.6 million claim in full as a general unsecured claim, and to issue common stock in the reorganized debtor to the holder of the claim.[374]

The district court approved both settlements.[375] The court of appeals affirmed, emphasizing that the "litigation must at long last be brought to an end" and that it reviewed the trial judge's determination for abuse of discretion and clearly erroneous determinations.[376] The Supreme Court granted certiorari.[377]

Compromises are "'a normal part of the process of reorganization'" wrote Justice White.[378] He continued, "In administering reorganization proceedings in an economical and practical manner it will often be wise to arrange the settlement of claims as to which there are substantial and reasonable doubts."[379]

Yet, it remained "essential that every important determination in reorganization proceedings receive the 'informed, independent judgment' of the bankruptcy court."[380] The Court noted that the requirement that a chapter X plan be "'fair and equitable'" applied to "compromises just as to other aspects of reorganizations."[381] A court could not have an "informed and independent judgment as to whether a proposed compromise [was] fair and equitable until the bankruptcy judge ha[d] apprised himself of all facts necessary for an intelligent and objective opinion of the probabilities of ultimate success should the claim be litigated."[382] This required the judge to "form an educated estimate of the complexity, expense, and

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372 *Id.* at 425.
373 *Id.*
374 *Id.* at 420.
375 *Id.* at 416.
376 *Id.*
377 *Id.* at 418.
378 *Id.* at 424 (citing Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 130 (1939)).
379 *Id.*
380 *Id.* (citing Nat'l Surety Co. v. Coriell, 289 U.S. 426, 436 (1933)).
381 *Id.*
382 *Id.*

likely duration of such litigation, the possible difficulties of collecting on any judgment which might be obtained, and all other factors relevant to a full and fair assessment of the wisdom of the proposed compromise."[383] Basic to this process was "the need to compare the terms of the compromise with the likely rewards of litigation."[384] The Court said nothing of the absolute priority rule in connection with the standard for court approval of a settlement.

The Court found the proceedings below lacking. The bankruptcy court had tagged all the bases in a statement that the Supreme Court quoted at length.[385] The bankruptcy court, though, had merely adopted the assertions of the trustee's counsel: the compromise was the best available; the prospect of material reductions of the claims did not warrant extensive litigation, and the likelihood of recoveries against the claimants beyond the amounts of their claims was too remote for serious consideration.[386] The alternative to approval of the compromises was extensive litigation at heavy expense and "unnecessary delay in reorganization contrary to the intent and purpose of chapter X of the Bankruptcy Act."[387]

The bankruptcy court's error was that it had accepted "the bald conclusions of the trustee" without referring to any of the objections filed or to the substantial facts in the record that cast doubt upon the trustee's claims.[388] The bankruptcy court had casually approved the settlements "despite the fact that the trustee had once concluded that the [ship's] mortgage was null and void and that TMT had sizeable setoffs against its holders."[389] The trustee had once sought reference of the $1.6 million ship mortgage claim to a special master for investigation, and the trustee "had never placed on the record any of the facts of his subsequent investigation and had never provided any explanation of why he had completely reversed his field on these claims."[390] Though the bankruptcy court was understandably eager to end the protracted proceedings, there was no adequate explanation for the trustee's

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[383] *Id.*
[384] *Id.* at 425.
[385] *Id.* at 432–34.
[386] *Id.*
[387] *Id.* at 432–33.
[388] *Id.* at 433.
[389] *Id.*
[390] *Id.* at 433–34.

"cursory, conclusory recommendation of these 'compromises,' or the perfunctory, almost offhand, manner in which the court accepted that recommendation."[391]

It "would without question have been justifiable" to approve the settlements if the bankruptcy court's statement

> had been the result of an adequate and intelligent consideration of the merits of the claims, the difficulties of pursuing them, the potential harm to the debtor's estate caused by delay, and the fairness of the terms of settlement .... It [was] essential, however, that a reviewing court have some basis for distinguishing between well-reasoned conclusions arrived at after a comprehensive consideration of all relevant factors, and mere boilerplate approval phrased in appropriate language but unsupported by evaluation of the facts or analysis of the law.[392]

The bankruptcy court had provided no explanation of how it had evaluated the strengths or weaknesses of the debtor's causes of action or the probable outcomes of the litigation and had not even offered an "educated estimate of the complexity, expense, and likely duration of the litigation."[393]

In the Supreme Court's view, the court of appeals had done no better, dealing with the compromises "in five sentences," focusing mostly on the fact that the committee and the SEC were the only objectors.[394] The Supreme Court held that it was error for the bankruptcy court to approve the settlements and for the court of appeals to affirm, and reversed.[395]

The *TMT* Court stated that a settlement must be "fair and equitable" for a court to approve it.[396] It used the term "fair and equitable" for settlement approval to mean that a court must engage in a sufficiently thorough analysis of the claim being settled; any counterclaim that the estate might have against the claimant; and the costs, risks, and benefits of pursuing the litigation compared with the terms of the settlement.[397] The Court answered

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[391] *Id.* at 434.
[392] *Id.*
[393] *Id.*
[394] *Id.* at 416.
[395] *Id.* at 418.
[396] *Id.* at 424–25.
[397] *Id.*

the first question—whether it was error for the district court to approve the settlements—on consideration only of the bankruptcy court's inadequate examination of the "fairness of the terms of compromise" and without any consideration of whether the settlement was at variance with the absolute priority rule.[398] The Court cited three courts of appeals cases in support of its holding regarding approval of a compromise that similarly said nothing of the absolute priority rule.[399]

Justice White, the authoring judge, referred to the absolute priority rule only when he turned to the second question that he had framed at the outset: Whether it was error to affirm the bankruptcy court's judgment that the debtor was insolvent for the purposes of plan confirmation. Justice White determined that the district court's determination of insolvency "was not made in accordance with the proper standards of valuation," and, thus, equity might still be in the money.[400] Confirmation of a plan that excluded shareholders, thus, could not stand.[401]

In sum, Congress in section 27 of the Chandler Act authorized a bankruptcy court to approve a compromise that was in the best interest of the bankruptcy estate.[402] Neither section 27 nor General Order 33 required that a settlement conform to an absolute

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[398] *Id.* at 434–35, 440.

[399] *Id.* at 424 (citing Ashbach v. Kirtley, 289 F.2d 159 (8th Cir. 1961); *In re* Chicago Rapid Transit Co., 196 F.2d 484 (7th Cir. 1952); Conway v. Silesian-American Corp., 186 F.2d 201 (2d Cir. 1950)). Other pre-Code circuit court cases, not cited by the court in *TMT*, had approved settlements or compromises without requiring compliance with the absolute priority rule and had required instead that the settlement or compromise be in the best interest of creditors per section 27 of the Bankruptcy Act. *See, e.g.*, Connecticut Ry. & Lighting Co. v. New York, N.H. & H.R. Co., 190 F.2d 305, 307–08 (2d Cir. 1951) (concerning the Railroad Reorganization Act—a court may approve a compromise if it is fair and in the best interest of the estate, and the order can be reversed only on a clear showing of an abuse of discretion); Daniel Hamm Drayage Co. v. Willson, 178 F.2d 633, 635 (8th Cir. 1949) (filing under chapter X, citing cases); Fernow v. Gubser, 136 F.2d 971, 972 (10th Cir. 1943) (involving 77B corporate reorganization, enforcing no requirement that settlement comply with the absolute priority rule; instead: "The approval of a compromise of this kind is addressed to the sound judicial discretion of the court, and its action thereon will not be disturbed on appeal except in case of abuse of such discretion.").

[400] *TMT*, 390 U.S. at 441.

[401] *Id.*

[402] Chandler Act of 1938, ch. 575, § 27, 52 Stat. 840, 855 (1938).

priority rule or even that it be "fair and equitable."[403] Though the trustee reached the settlements in *TMT* in contemplation of a plan of reorganization, the Court did not review the settlements in terms of the absolute priority rule.[404] It exhaustively considered instead whether the lower courts had rigorously examined the risks and rewards of continuing the litigation as opposed to approving the settlements.[405]

The Supreme Court in *TMT* did not extend the absolute priority rule to bankruptcy settlements—even those made in contemplation of a plan. Justice White of course used the term "fair and equitable" in the first part of his *TMT* opinion in which he stated the standard for approval of a compromise.[406] Nowhere, did he imply, though, that for such purposes the term was synonymous with absolute distributional priority. This is not surprising. The Bankruptcy Act used the term "fair and equitable" in several contexts having nothing to do with absolute priority.[407] Only for confirmation of a chapter X plan did the term mean absolute priority, and not by express statutory language, but only by Justice Douglas's holding in *Los Angeles Lumber*, the reach of which Congress already had severely limited. Post-*TMT*, pre-Code cases also did not require that compromises comply with the absolute priority rule in chapter X or under the Railroad Reorganization Act of 1935, those chapters of the Bankruptcy Act to which the absolute priority rule still pertained after 1952.[408]

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403 *Id.*; *see also* MODERN BANKRUPTCY MANUAL, *supra* note 362, at 1476–77.

404 *See TMT*, 390 U.S. at 424–41.

405 *Id.* at 433–35, 440–41.

406 *Id.* at 424.

407 *See, e.g.*, Chandler Act of 1938, ch. 575, § 48(f)–(g), 52 Stat. 840, 862–63 (1938) (noting that compensation of marshal, receiver, or trustee under a confirmed arrangement or plan of reorganization is required to be "fair and equitable"); *id.* § 863 (explaining that a court may allow a claim against the debtor that the claimant assigns to a third party in an amount that it determines to be "fair and equitable," upon consideration of the amount of the claim, the circumstances of the assignment, and the consideration paid for the assignment of the claim); *id.* § 216(12) (holding that provisions of plan shall provide for a "fair and equitable" distribution of voting powers among the shareholders of the reorganized debtor).

408 *See, e.g.*, *In re* Continental Inv. Corp., 642 F.2d 1, 4 (1st Cir. 1981) (see 586 F.2d 241, 243, 246 for the court's affirming transfer of the proceeding from chapter XI to X); *In re* Jackson Brewing Co., 624 F.2d 599, 602 (5th Cir. 1980)

B. Settlements and Compromises Under the Bankruptcy Code

The Code, unlike section 27 of the Chandler Act, said nothing of a bankruptcy court's settlement authority. Rule 9019, which contains such authority, states only that, "after notice and a hearing, the court may approve a compromise or settlement."[409]

Since the code became effective in 1978, the circuit courts have continued to apply the TMT risk-benefit standard to decide whether to approve a settlement, both in chapter 11 and chapter 7 bankruptcy cases—without any requirement settlements adhere to the absolute priority rule[410]—as well as settlement outside of

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(chapter X); *In re* Wonderbowl, Inc., 515 F.2d 18, 19 (9th Cir. 1975) (finding under chapter X with no consideration of absolute priority rule: "trustee was fully empowered, with court approval, … to compromise within or without a reorganization plan."), *cert. denied*, Fallon v. Jonas, 423 U.S. 869 (1975). Even in cases in which approval of a compromise was in connection with a plan, the courts flexibly applied the absolute priority rule to the resolution of the case or applied the *TMT* factors without even considering the rule. *See, e.g.*, *In re* Penn Cent. Transp. Co., 596 F.2d 1127, 1146–48 (3d Cir. 1979) (concerning the Railroad Reorganization Act section 77, alluding to the "relativity" inherent in the absolute priority rule and declining "to adopt a mechanical application of any of the embellishments, clarifications, extensions, derivatives or off-shoots of the rule" which were "so strenuously urged by the appellants"); *In re* Penn Cent. Transp. Co., 596 F.2d 1102, 1113–14 (3d Cir. 1979) (concerning the Railroad Reorganization Act section 77: the "proposed compromise distribution" under and "forming part of a reorganization plan" must be "fair and equitable" and the settlement "fairly equivalent to the value of the potential claim surrendered." Though the bankruptcy court must exercise its "informed, independent judgment" in reaching its determination, "the weighing of claim against compensation cannot be an exact one."); Am. Emp'rs' Ins. Co. v. King Res. Co., 556 F.2d 471, 478–79 (10th Cir. 1977) (affirming compromise based on district court's "discretionary power to approve compromises involving claims and interests in reorganization proceedings," which "judgment will not be reversed except for abuse of discretion or if clearly erroneous," and citing both *TMT* and *Los Angeles Lumber*); *In re* Equity Funding Corp. of Am., 519 F.2d 1274, 1277–78 (9th Cir. 1975) (chapter X). Further, the *TMT* rule was of sufficiently general applicability that courts applied it to many other areas, outside of bankruptcy law, in which court approval of a compromise is required. *See, e.g.*, Seigal v. Merrick, 590 F.2d 35, 38 n.2 (2d Cir. 1978); Cotton v. Hinton, 559 F.2d 1326, 1330 (5th Cir. 1977); *In re Equity Funding Corp. of Am.*, 519 F.2d at 1277; Flinn v. FMC Corp., 528 F.2d 1169, 1173 n.7 (4th Cir. 1975); Bryan v. Pittsburgh Plate Glass Co. (PPG Industries, Inc.), 494 F.2d 799, 801, 804 (3d Cir. 1974).

[409] FED. R. BANKR. P. 9019(a).

[410] *See, e.g.*, Ritchie Capital Mgmt., L.L.C. v. Kelley, 785 F.3d 273, 278–82 (8th Cir. 2015) (chapter 11); *In re* MQVP Inc., 477 F. App'x 310, 313 (6th Cir. 2012)

bankruptcy.[411] The present formulation of the *TMT* criteria requires the bankruptcy court to consider:

> (a) [t]he probability of success in the litigation;
> (b) the difficulties, if any, to be encountered in the matter of collection;

(chapter 7); *In re* Am. Cartage, Inc., 656 F.3d 82, 91–92 (1st Cir. 2011) (chapter 7); *In re* Moore, 608 F.3d 253, 262–63 n.20 (5th Cir. 2010) (chapter 7); Saad v. GE HFS Holdings, Inc., 366 F. App'x 593, 604 n.11 (6th Cir. 2010) (chapter 11); *In re* Bodenheimer, Jones, Szwak, & Winchell, L.L.P., 592 F.3d 664, 675 (5th Cir. 2009) (chapter 7); Tri-State Fin., LLC v. Lovald, 525 F.3d 649, 654–55 (8th Cir. 2008) (chapter 7); *In re* Iridium Operating LLC, 478 F.3d 452, 463 (2d Cir. 2007) (chapter 11, discussed *supra* Part VIII below); *In re* Doctors Hosp. of Hyde Park, Inc., 474 F.3d 421, 426–27 (7th Cir. 2007) (chapter 9); *In re* Arden, 176 F.3d 1226, 1228–31 (9th Cir. 1999) (chapter 9); *In re* Bay Area Material Handling, Inc., 111 F.3d 137, 1997 WL 173922, at *1–2 (9th Cir. Apr. 9, 1997) (chapter 7); *In re* Martin*,* 91 F.3d 389, 393 (3d Cir. 1996) (chapter 7); *In re* Foster Mortg. Corp., 68 F.3d 914, 917 (5th Cir. 1995) (chapter 11); *In re* Bond, 16 F.3d 408, 1994 WL 20107, at *3 (4th Cir. 1994) (chapter 11); *In re* Energy Coop., Inc., 886 F.2d 921, 929 (7th Cir. 1989) (chapter 11 converted to chapter 7); Reiss v. Hagmann, 881 F.2d 890, 891–93 (10th Cir. 1989) (chapter 7); *In re* Texas Extrusion Corp., 844 F.2d 1142, 1158–59 (5th Cir. 1988) (chapter 11, citing *TMT* and *AWECO*, affirmed settlement contained in plan because it was not an "abuse of discretion" without mention of whether the settlement complied with the absolute priority rule), *aff'g* 68 B.R. 712 (N.D. Tex. 1986); *In re* Emerald Oil Co., 807 F.2d 1234, 1239 (5th Cir. 1987) (chapter 11, affirming settlement, citing *TMT* and *Matter of AWECO*, also with no mention of whether the settlement complied with the absolute priority rule). *See also In re* Energy Future Holdings Corp., 648 F. App'x 277, 280–81, 2016 WL 2343322, at *2 (3d Cir. 2016) (following *Jevic* and *Iridium*, discussed in section VIII below); *In re* ICL Holding Co., Inc., 802 F.3d 547, 553–57 (3d Cir. 2015) (pursuant to settlement, the payment of some administrative claims—but not others of equal priority—and payment to unsecured creditors ahead of priority claim, by secured lenders who also had purchased the debtor's assets in the bankruptcy case, was approved because the funds used were the secured lenders' and not the estate's property).

[411] Even the Supreme Court ultimately cited *TMT*, in a case involving an employment discrimination claim settlement in a non-bankruptcy context, for the principle that courts "judge the fairness of a proposed compromise by weighing the plaintiff's likelihood of success on the merits against the amount and form of the relief offered in the settlement." Carson v. Am. Brands, Inc., 450 U.S. 79, 88 n.14 (1981). *See, e.g.*, New England Health Care Emps' Pension Fund v. Woodruff, 512 F.3d 1283, 1294–96 (10th Cir. 2008); Hanlon v. Chrysler Corp., 150 F.3d 1011, 1026 (9th Cir. 1998); DeBoer v. Mellon Mortg. Co., 64 F.3d 1171, 1176–77 (8th Cir. 1995); Handschu v. Special Servs. Div., 787 F.2d 828, 833 (2d Cir. 1986); Piambino v. Bailey, 757 F.2d 1112, 1139 n.68 (11th Cir. 1985); *In re* Corrugated Container Antitrust Litig., 643 F.2d 195, 212 (5th Cir. 1981); Greenspun v. Bogan, 492 F.2d 375, 378 (1st Cir. 1974).

> (c) the complexity of the litigation involved, and the expense, inconvenience and delay necessarily attending it; [and]
> (d) the paramount interest of the creditors and a proper deference to their reasonable views in the premises.[412]

The vast majority of courts approving settlements under the Code have emphasized the paramount or best interest of creditors—not absolute distributional priority.[413]

The exception is the Fifth Circuit's 1984 decision, *In re AWECO*.[414] The court was persuaded that the "underlying policies" of bankruptcy law regarding absolute priority justified what the court acknowledged was an "extension of the fair and equitable standard" required for a cramdown plan to a settlement in chapter 11.[415] This Article argues that *AWECO* was wrongly decided. Congressional enactments since *Los Angeles Lumber* demonstrate only a limited policy regarding the absolute priority rule. The much stronger underlying policy is the best interest of creditors.

C. Summary—Settlements Under the Bankruptcy Code Do Not Require Adherence to the Absolute Priority Rule

Congress has not called for a settlement to comply with the absolute priority rule in order for the bankruptcy court to approve it.[416] Section 27 of the Chandler Act, the pre-Code law, expressly gave the courts wide discretion, commanding only that the compromise or settlement serve the best interest of the estate.[417]

Decided under the Act, the Supreme Court in *TMT* directed the courts to determine whether a proposed settlement was fair and equitable by undertaking a rigorous risk-benefit analysis before approving it.[418] The Court did not refer at all to the absolute priority rule in the context of approval of the settlements at issue.

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[412] 10 COLLIER ON BANKRUPTCY ¶ 9019.02 (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2010).

[413] *See id.*

[414] *See generally In re* AWECO, Inc., 725 F.2d 293 (5th Cir. 1984).

[415] *Id.* at 298.

[416] Chandler Act of 1938, ch. 575, § 27, 52 Stat. 840, 855 (1938).

[417] *Id.*

[418] Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 424–25 (1968).

Congress enacted the Code in 1978 and again said nothing of the absolute priority rule in the context of settlements.[419] Courts continued to apply the *TMT* standard under the Code.[420] Nearly without exception, the opinions approving settlements in chapters 11 and 7 have made no mention of absolute distributional priority and have focused on the paramount interest of creditors.[421] *AWECO*, decided in 1984, where the Fifth Circuit explicitly acknowledged that it was extending the absolute priority rule to settlements for policy reasons, has remained an outlier.[422]

No omnipresent congressional policy for absolute distributional priority exists under the Code, whether with respect to settlements specifically or bankruptcy distributions generally.[423] As argued above, any such policy under the current Code is far weaker and more narrowly contained than *AWECO* suggests. The stronger argument is that the policy at present, shaped by congressional bankruptcy enactments from 1952 to BAPCPA in 2005, favors negotiated resolutions evaluated by the courts determining the best interest of creditors without reference to the absolute priority rule.

Critics of structured dismissals argue that courts' authority is or should be different when the settling parties are seeking dismissal of the case immediately following the approval of the settlement.[424] The next section argues that these critics misconstrue the provisions of the Code that govern dismissals.

V. Dismissal of a Chapter 11 Case and of Cases Under Other Chapters of the Code

Critics of structured dismissals claim that such a resolution of a chapter 11 case exceeds the bounds of the Bankruptcy Code.[425] This section argues that this position is weak. Rather, Congress has given bankruptcy courts express authority to act in the best interest of creditors regarding the dismissal of chapter 11 cases.

[419] 11 U.S.C. § 101 (1978).

[420] *See supra* notes 410–11 and accompanying text.

[421] *See supra* notes 410–11.

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

[423] 11 U.S.C. § 101 (2012).

[424] *See, e.g.*, Frost, *supra* note 23, at 3 (citing *In re* Jevic Holding Co., Inc., Brief of Appellants, 2014 WL 3572018, at *45–46 (3d Cir. July 8, 2014)); Eitel et al., *supra* note 27, at 20.

[425] Eitel et al., *supra* note 27, at 1.

A. The Code Does Not Limit Chapter 11 Resolution to a Confirmed Plan, a Chapter 7 Liquidation, or a Plain Vanilla Dismissal Order

The Code does not state that the only three paths to concluding a chapter 11 case are plan confirmation, conversion to chapter 7, or a one page, plain vanilla order dismissing the case. The Code does not require that, on dismissal of a chapter 11 case, distributions must follow the descending priorities listed in section 507 or must be in accordance with the rule set forth in section 726 for chapter 7. Indeed, neither section 1112 (regarding the court's dismissal of a chapter 11 case) nor section 349 (which sets forth the effects of such dismissal) refer at all to sections 507, 726, or 1129(b), or to any other rule of distributional priority.[426] The Code instead expressly authorizes the court to act in the best interest of creditors in resolving a case other than by confirmation of a plan.[427]

A debtor may obtain dismissal of its chapter 11 case under Code section 1112. Section 1112 authorizes the court to make its decision in furtherance of the "best interests of [the debtor's] creditors and the estate."[428] The court is not a passive player with respect to the best course of action, and is not limited to granting or denying the motion.[429] Section 1112 provides instead that the court may dismiss the chapter 11 case, may convert the case to chapter 7 or may appoint a chapter 11 trustee to replace the debtor in possession, whichever "is in the best interest of creditors and the estate."[430]

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[426] 11 U.S.C. §§ 349, 1112.

[427] *Id.* § 1112(b)(1).

[428] *Id.* A debtor is a "party in interest" in chapter 11, and a party in interest may request dismissal of a chapter 11 case under section 1112(b). *Id.* § 1109(b).

[429] *Id.* § 1112(b)(1).

[430] *Id.* The 1977 House Report in its section-by-section analysis stated that section 1112(b) "gives wide discretion to the court to make an appropriate disposition of the case when a party in interest requests. The court is permitted to convert a reorganization case to a liquidation case or to dismiss the case, whichever is in the best interest of creditors and the estate." H.R. REP. NO. 95-595 at 405 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6361. The 1978 Senate Report contains similar commentary regarding the "wide discretion" given to the court by section 1112(b) "to make an appropriate disposition." S. REP. 95-989, at 118 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5903. Both reports refer to the ability of the court under section 1112(b) "to use its equitable powers to reach an appropriate result in individual cases." *Id.*; H.R. Rep. No. 95-595 at 406 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6362.

Section 349 states the ordinary effects of dismissals of a case in chapter 11, as well as chapters 9, 12, and 13.[431] Section 349 expressly gives a bankruptcy court the discretion to alter those effects and to decree terms in its dismissal orders that it determines appropriate "for cause."[432]

The text and structure of the Code underscore the discretion given by Congress to the courts to decree the best outcome in a bad situation when a case must be resolved outside of a plan. The Code's text regarding plan filing is more permissive for chapter 11 than for chapters 9, 12, and 13. Chapter 11 provides that a debtor "*may* file" a plan of reorganization or liquidation.[433] Chapters 9, 12, and 13 provide that a debtor "*shall* file" a plan,[434] yet the debtor even in those chapters may move for and obtain an order dismissing the case[435] on terms that the court "for cause" deems appropriate.[436] Because chapters 9, 12, and 13 mandate the filing of a plan, one most likely would find in those chapters any congressional restrictions to courts entering something other than a plain vanilla dismissal order. Yet, no such limitations exist.

No provision of the Code or the Bankruptcy Rules blocks the path to a structured dismissal by prohibiting court approval of a settlement followed by a dismissal. Rather, both section 1112(b) and the "for cause" discretion afforded by section 349(b) authorize a court to determine the best interest of the debtor's creditors and estate in determining a motion to dismiss a chapter 11 case, whether in conjunction with a settlement or otherwise.[437] The dominant congressional directive given to the bankruptcy court is

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[431] 11 U.S.C. § 349(b).

[432] *Id.*

[433] *Id.* § 1121 (emphasis added).

[434] *See id.* § 941 (emphasis added); *see also id.* §§ 1221, 1321 (2012); ANTONIN SCALIA & BRYAN A. GARNER, READING LAW: THE INTERPRETATION OF LEGAL TEXTS 112 (2012) ("The traditional, commonly repeated rule is that *shall* is mandatory and *may* is permissive."). Scalia and Garner assert that "notoriously sloppy" drafting has resulted in a "morass of confusing decisions" on the meaning of "shall," but raise no semantical issue with the word "may." *Id.* They further claim that "[w]hen drafters use *shall* and *may* correctly, the traditional rule holds—beautifully." *Id.*

[435] 11 U.S.C. §§ 930(a), 1112(b), 1208(b), 1307(b) (2012).

[436] *Id.* § 349(b).

[437] *Id.* §§ 349(b)(3), 1112(b)(1).

to pursue the best interest of the debtor's creditors and estate, and that directive includes the court's authority to alter ordinary outcomes in its discretion "for cause."[438]

B. The Dismissal of a Chapter 11 Case Revests Only the Property in the Estate at the Time of the Dismissal

Second, critics of structured dismissals misstate the normal effects of dismissal and fail to recognize the continuing validity of a settlement post-dismissal. The normal effects of a dismissal are as follows. First, the dismissal "revests the property of the estate in the entity in which such property was vested immediately before the commencement of the case."[439] Second, receiverships and other custodianships that were superseded by the commencement of the bankruptcy case are reinstated.[440] Third, some transfers and liens previously avoided over the course of the bankruptcy case are reinstated.[441]

The first of these ordinary effects of a dismissal—the revesting—is the most significant.[442] An oft-cited statement in the legislative history of the 1978 Code suggests that Congress proposed by section 349 to "undo" the bankruptcy and return parties to the status quo that existed on the petition date.[443]

Yet the Code's text does not expressly state whether the "property of the estate" that revests is that which existed on the date on which the case commenced—by which construction the status quo on the commencement date would be restored—or that which exists in the estate on the date of the dismissal.[444] The definition

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[438] *Id.* §§ 349(b), 1112(b).

[439] *Id.* § 349(b)(3).

[440] *Id.* § 349(b)(1). Upon commencement of a bankruptcy case, a receiver or other court-appointed custodian in possession of property of the debtor case ordinarily loses authority to act on account of that property and must turn the property over to the bankruptcy trustee or debtor in possession. *See id.* § 543(a)–(b).

[441] *Id.* § 349(b)(1)–(2).

[442] *Id.* § 349(b)(3).

[443] H. COMM. ON THE JUDICIARY, Bankruptcy Reform Act of 1978, H.R. REP. NO. 95-595, at 338 (1978), *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6294; *see also* S. REP. 95-989, at 49 (1978), *as reprinted in* 1978 U.S.C.C.A.N. 5787, 5835.

[444] 11 U.S.C. § 349(b).

of "property of the estate" in chapter 11 arguably fills this statutory gap in favor of the latter interpretation.[445] Property of the estate in chapter 11 includes both the debtor's property on the commencement date and after-acquired property.[446] A debtor in possession completes numerous transactions prior to a dismissal. An interpretation of the "property of the estate" that revests under section 349(b)(3) is that existing on the dismissal date best harmonizes section 541, which provides that after-acquired property is estate property, with section 349, because an interpretation of section 349 that turns back the clock for revesting to the petition date would "orphan" all property acquired postpetition.[447] The more harmonious reading of section 349(b) is that estate property on the dismissal date revests in the party entitled to it on that date.[448]

Moreover, courts with good reason—more pragmatic than textual—have construed section 349(b)(3) to mean that only the property of the estate determined as of the date of dismissal revests.[449] They have not required time travel back to the petition

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[445] *See id.* § 541.

[446] *See id.* § 541(b).

[447] *Id.* §§ 349(b), 541(a).

[448] The canons of textual interpretation provide that the "text must be interpreted as a whole," which includes consideration of the entire language and design of the statute. SCALIA & GARNER, *supra* note 434, at 167. "The imperative of harmony among provisions is more categorical than most other canons of construction because it is invariably true that intelligent drafters do not contradict themselves (in the absence of duress)." *Id.* at 180.

[449] *See, e.g.*, United States v. Standard State Bank*,* 91 B.R. 874, 879 (W.D. Mo. 1988) ("Revesting 'includes only that property left in the estate at the time of dismissal.'"); *In re* Searles*,* 70 B.R. 266, 270 (D.R.I. 1987) ("The few cases that mention subsection 349(b)(3) refer to its applicability only in the context of property or property rights that have not passed out of the bankruptcy estate."); *In re* Day, 292 B.R. 133, 137 (Bankr. N.D. Tex. 2003); *In re* Derrick*,* 190 B.R. 346, 352 (Bankr. W.D. Wis. 1995) ("However, to equate dismissal with some form of time travel, unceremoniously dumping the parties where they were the moment before the debtor made the fateful choice to file bankruptcy, would be to say both too much and too little about the effect of § 349."); *In re* Tri-Glied, Ltd., 179 B.R. 1014, 1020–21 (Bankr. E.D.N.Y. 1995) (holding the lease held by debtor at commencement of case, which was rejected during case, does not revest in debtor on dismissal); *In re* Ethington, 150 B.R. 48, 50 (Bankr. D. Idaho 1993) ("Were the Court to hold that dismissal of the case immediately revested the property in the debtor, beyond the reach of the Court to order payment of administrative fees, all parties who rendered postpetition services

date. Rather they have held that the revesting applies to property of the estate existing on the date of the dismissal, thus leaving postpetition transactions intact.[450] Section 349(b)(3) thus "undoes" the bankruptcy only to a very limited extent.

Were it otherwise, section 349(b)(3) would result in an unraveling so extensive that the debtor's creditors and other parties in interest would suffer losses unfairly, and their justifiable reliance on the bankruptcy court's orders would be defeated. In chapter 11, for example, a revesting dating back to the commencement of the case would reverse payments made to employees, taxing authorities, bankruptcy counsel, trade creditors, and other administrative claimants over the course of the case. Liens and adequate protection given by the debtor in possession in connection with its obtaining postpetition financing or court approval of its use of cash collateral would be undone. Sales, purchases, compromises, and other transactions between the debtor in possession and third parties made during the bankruptcy proceeding, both in the ordinary course[451] and, outside the ordinary course of the debtor's business with court approval, would be nullified.[452]

A chapter 11 debtor in possession that operates its business in bankruptcy will have entered into hundreds or even thousands of such transactions between the commencement date of the bankruptcy case and a dismissal. All of these transactions and actions will involve the debtor's transferring or obtaining "property of the

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would be at the mercy of the debtor's decision to terminate the case and leave those expenses unpaid."); *In re* Kucera, 123 B.R. 852, 854–55 (Bankr. D. Neb. 1990) (determining that cash proceeds of after acquired property which was sold during the pendency of the bankruptcy case are subject to the secured creditor's lien); *In re* Depew, 115 B.R. 965, 971–72 (Bankr. N.D. Ind. 1989) ("It is noteworthy that § 349(b) does not mention or seek to reverse transfers *out* of the bankruptcy estate, such as those which might be made pursuant to § 363, § 365(f), or § 726. This would seem to indicate that § 349(b) was designed to deal only with the property that was still part of the estate on the date of dismissal."); *In re* BSL Operating Corp., 57 B.R. 945, 952 (Bankr. S.D.N.Y. 1986) (concluding that debtor's lease rejected during the case does not revest in the debtor on dismissal of the case); *see also In re* Marine Maint. Co., 169 F.2d 548, 551 (3d Cir. 1948) (finding that lease terminated by landlord pursuant to ipso facto clause upon filing of involuntary case that subsequently was dismissed cannot be reinstated notwithstanding the dismissal of the case).

[450] *In re Searles*, 70 B.R. at 270.

[451] 11 U.S.C. § 363(c).

[452] *Id.* § 363(b).

estate."[453] A complex chapter 11 case that has gone on for months or years prior to its dismissal, in which the debtor's business may have been sold and is now operating outside of bankruptcy as part of the new owner's business, makes any effort to unscramble the egg a fool's quest. The "property of the estate" that ordinarily re-vests on dismissal can only mean property of the estate at the time of the dismissal, as the courts consistently have held.[454]

C. Congress Has Expressly Authorized the Bankruptcy Court "For Cause" to Order Otherwise

Third, the critics of structured dismissals understate the broad scope given by Congress to alter the ordinary results of a dismissal "for cause" by ordering otherwise.[455] The Bankruptcy Code in many of its provisions gives the bankruptcy court little or no flexibility.[456] In other provisions though, including section 349(b), Congress has given the bankruptcy courts the discretion to decide matters on a case-by-case basis, to develop rules of law that are not specifically delineated under the Code, and to reach beneficial results, including by authorizing the courts to approve certain actions and alter ordinary outcomes "for cause."[457]

The bankruptcy court's "for cause" authority goes far beyond section 349. Congress permits a bankruptcy court "for cause" to

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[453] *Id.* § 541(a)(1)–(2).

[454] *In re Searles*, 70 B.R. 266 at 270.

[455] 11 U.S.C. § 349(b).

[456] *See, e.g.*, *id.* § 941.

[457] Section 365 of the Code provides one of many examples of Code provisions that give the court "for cause" flexibility in some clauses but not in other clauses of the same statutory section. *See, e.g.*, *id.* § 365(b) (regarding the requirements that must be satisfied for a debtor in possession or trustee to assume a lease under which it has defaulted, which does not authorize the court to alter those requirements "for cause"); *id.* § 365(c) (regarding the requirements that must be satisfied for a debtor in possession or trustee to assume and/or assign a lease whether or not it is in default, which does not authorize the court to alter those requirements "for cause"). *Compare id.* § 365(d)(1) (pursuant to which the court "for cause" may extend delay for up to 60 days the requirement that the debtor "timely perform" its postpetition obligations under a lease), *with id.* § 365(d) (which permits a debtor in possession or trustee to extend "for cause" the 120-day period within which it must assume or reject a lease, but does not permit an extension beyond 210 days even if there is cause, unless each landlord has given its written consent).

limit the public's access to papers to protect an individual or her property from injury.[458] The court "for cause" may require that petitioners in an involuntary case file a bond,[459] may grant relief from the automatic stay,[460] and may limit a secured creditor's credit bid of its allowed secured claim at a sale.[461] It may extend "for cause" both the time for a trustee or debtor in possession to assume or reject leases and executory contracts[462] and the exclusive period within which a debtor in possession may file a plan and seek acceptances of it.[463] The court may oust a debtor in possession from authority to act for the estate by appointing "for cause" a chapter 11 trustee with such authority.[464] In all, there appear to be more than forty instances in which Congress gave the bankruptcy court the power to act "for cause."[465]

Congress did not define "for cause" in the Code. In some instances, Congress has given guidance by providing non-exclusive examples of what constitutes "cause."[466] Other sections of the Code that permit entry of an order "for cause" say nothing about what might constitute cause.[467]

Section 349(b) provides no illustrative examples regarding what constitutes "cause" under that section. Courts have construed the "for cause" provision of section 349(b) to give them the express statutory authority, informed by and in furtherance of other Code provisions and the policies of the Code, to act flexibly in dismissing

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458 *Id.* § 107(c).

459 *Id.* § 303(e).

460 *Id.* § 362(d)(1).

461 *Id.* § 363(k).

462 *Id.* § 365(d)(4).

463 *Id.* § 1121(d)(1).

464 *Id.* § 1104(a)(1).

465 *Id.* §§ 107(c), 109(h)(3)(B), 303(e), 324(a), 341(e), 345(b)(2), 348(b), 349(a)–(b), 362(d)(1), 362(d)(3), 363(k), 365(d)(1), 365(d)(3), 365(d)(4)(b)(i), 502(j), 503(a), 505(b)(2)(A)(ii), 521(a)(2)(A)–(B), 524(m)(1), 557(c)(1), 707(a), 930(a), 1102(a)(3), 1104(a)(1), 1112(b)(1), 1121(d)(1), 1121(e)(1)(B), 1141(d)(5)(A), 1202(b)(2), 1204(a), 1208(c), 1222(c), 1224, 1229(c), 1307(c), 1322(d)(2), 1329(c); 28 U.S.C. §§ 157(d), 1441(d) (2012). The Rules also expressly authorize the court's granting relief and authorizing actions "for cause" in numerous instances. *See, e.g.*, FED. R. BANKR. P. 1017(e)(1), 1019(1)(B), 2002(p)(2)–(3), 2006(f), 2015(a)(6), 2015(d), 3002(c)(1), 3017(d)(4), 3018(a), 4003(b)(1), 4004(b)(1), 4007(c)–(d), 9033(c), 9037(d) (2012).

466 *See, e.g.*, 11 U.S.C. § 1104(a)(1).

467 *See, e.g.*, *id.* § 363(k).

a bankruptcy case.[468] Some courts have used the "for cause" authority of section 349(b) to protect rights acquired in reliance on the bankruptcy case.[469] Those and other courts have exercised their "for cause" authority under section 349(b) to further the Code's purpose of equitable treatment to creditors.[470]

The Seventh Circuit has defined "cause" under section 349(b) to mean "an acceptable reason,"[471] with the proviso that a "[d]esire to make an end run around a statute is not an adequate reason."[472] The same circuit in a subsequent case held that, in the absence of an effort to make an "end run," the court's varying the ordinary outcome of a dismissal "for cause" was within its discretion under section 349(b).[473]

Courts in numerous cases in chapters 12 and 13 have changed the ordinary outcomes of section 349(b) "for cause." On various grounds, those courts have altered the revesting that would ordinarily occur on a dismissal "for cause."[474]

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[468] *In re* Lewis, 346 B.R. 89, 111 (Bankr. E.D. Pa. 2006); *see also In re* Clements, 495 B.R. 74, 87, n.21 (Bankr. E.D. Pa. 2013) ("[O]n its face, the Code accords the bankruptcy court more discretion to vary the statutory default treatment of undistributed plan payments when a chapter 13 case is dismissed than upon conversion to chapter 7.").

[469] Wiese v. Cmty. Bank of Cent. Wis., 552 F.3d 584, 590 (7th Cir. 2009) (citing H.R. REP. NO. 95-595, at 338 (1977)); *see also In re* Keener*,* 268 B.R. 912, 919 (Bankr. N.D. Tex. 2001); *In re* TNT Farms*,* 226 B.R. 436, 442 (Bankr. D. Idaho 1998).

[470] *Wiese*, 552 F.3d at 590 (citing *In re* Derrick*,* 190 B.R. 346, 351 (Bankr. W.D. Wis. 1995)); *TNT Farms,* 226 B.R. at 442.

[471] *In re* Sadler, 935 F.2d 918, 921 (7th Cir. 1991).

[472] Judge Easterbrook described his reasons for cutting off the "end run" in *Sadler* as follows:

> Congress specified that Chapter 13 cases pending on the effective date of Chapter 12 may not be converted. It would defeat this express decision to treat as "cause" the debtors' wish to file a new Chapter 12 case with all dates relating back to the original Chapter 13 proceeding. That would be, as we remarked in *Sinclair,* conversion by another name. It is not part of the judicial office to seek out creative ways to defeat statutes.

Id.

[473] *Wiese*, 552 F.3d at 591–92.

[474] For chapter 12, see *Wiese*, 552 F.3d at 590, 592, where the terms of confirmed chapter 12 plan, including debtor's release of lender liability claims, remained binding on the parties. *In re* Fox, 140 B.R. 761, 764–65 (Bankr. D.S.D. 1992), holding estate funds would not revest in the debtor but would remain available to pay counsel fees allowed post-dismissal. For chapter 13, see *In re*

In chapter 11, courts have modified ordinary revesting "for cause" by ordering that funds not be returned to the debtor on dismissal because it would not be fair to a creditor of the debtor.[475] A court has delayed for 180 days the revesting of property, to prevent an "imaginative" serial-filing debtor from obtaining the benefit of a subsequent stay by filing another bankruptcy case after the dismissal.[476] Courts "for cause" have denied a chapter 11 debtor's request for possession of premises under a prepetition lease that

Kee, 2015 WL 5860492, at *1 n.2 (Bankr. E.D. Pa. 2015), regarding some chapter 13 trustees' practice of distributing debtor's plan payments on hand on dismissal to creditors pursuant to confirmed plan pursuant to section 349(b); *see also In re* Cusano, 431 B.R. 726, 730–31, 738 (B.A.P. 9th Cir. 2010) (ordering that royalties payable to debtor be paid instead to the clerk of the court for distribution in pursuant to pending non-bankruptcy litigation); *In re* Kirk, 537 B.R. 856, 860 (Bankr. N.D. Ohio 2015) (exercising discretion in furtherance of section 1326(a)(2) directing chapter 13 trustee to deduct administrative expenses from funds held prior to returning funds to debtor); *In re* Hufford, 460 B.R. 172, 180 (Bankr. N.D. Ohio 2011) (finding that debtor's motion to recover funds from the chapter 13 trustee, on ground that dismissal had effectively vacated confirmed plan resulting in the revesting of the funds with the debtor, denied); *In re* Shields, 431 B.R. 446, 450 (Bankr. S.D. Ind. 2010) (paying funds on hand to administrative expense claimants; only remaining balance revests in the debtor); *In re* Cox, 381 B.R. 525, 529 (Bankr. E.D. Tenn. 2008) (ordering debtor's funds held by chapter 13 trustee on dismissal to be distributed in accordance with the confirmed plan); *In re* Lewis, 346 B.R. at 111, 115 (Bankr. E.D. Pa. 2006) (exercising discretion in furtherance of section 1326(a)(2) directing chapter 13 trustee to deduct administrative expenses from funds held prior to returning funds to debtor); *In re* Witte, 279 B.R. 585, 588 (Bankr. E.D. Cal. 2002) (ordering chapter 13 trustee to hold cash proceeds of sale of the debtors' house court order determining whether lien holders were entitled to the proceeds); *In re* Prud'homme, 161 B.R. 747, 751 (Bankr. E.D.N.Y. 1993) (ordering that property would not revest in a chapter 13 debtor for eighteen months to protect against the debtor's repeated bankruptcy filings); *In re* DeLuca, 142 B.R. 687, 688, 691 (Bankr. D.N.J. 1992) (ordering chapter 13 trustee to hold funds on hand at dismissal pending the court's consideration of fee applications filed by the debtor's counsel, voiding a post-dismissal tax levy against those funds in order to enable the payment of those counsel fees); *In re* Torres, 2000 WL 1515170, at *2–3 (Bankr. D. Idaho 2000) (ordering debtor's funds held by chapter 13 trustee on dismissal to be distributed in accordance with the confirmed plan).

475 *In re* Gonic Realty Tr., 909 F.2d 624, 627 (1st Cir. 1990).

476 *In re* Halpern, 229 B.R. 67, 76–77 (Bankr. E.D.N.Y. 1999) (delaying 180 days for the purpose of restraining debtor from "betting with the other guy's money," in the hope of delaying liquidation until "the market will turn and he will be able to salvage something out of a sale after payment of his obligation to his partners").

had been rejected in its prior chapter 11 case that was dismissed.[477] Courts "for cause" under section 349(b) have ordered payments to some creditors other than in the order listed in section 507 and have approved a structured dismissal as the "least bad alternative" when compared with a "nihilistic" exercise that would result in nothing for unsecured creditors.[478]

D. Summary—Congress Has Directed Bankruptcy Courts to Pursue the Best Interest of Creditors and Not Absolute Distributional Priority in Determining to Dismiss a Chapter 11 Bankruptcy Case

In sum, if a chapter 11 plan is not confirmable or for other "cause," the Code authorizes the bankruptcy court to convert the chapter 11 case to chapter 7, to cause the appointment of a chapter 11 trustee, or to dismiss the case.[479] Congress expressly has authorized the courts to determine which of these alternatives is in the best interest of the debtor's creditors and estate.[480] Further, the strongest textual interpretation of section 349 is that the property that revests is that existing on the date of the dismissal.[481] The courts are not required to turn back the clock to the petition date and undo all of the transactions that occurred prior to dismissal.[482] The courts have so held, mostly on pragmatic rather than textual grounds.[483] On this construction, a settlement approved

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[477] *In re* BSL Operating Corp., 57 B.R. 945, 952 (Bankr. S.D.N.Y. 1986) (concluding that lease rejection in prior, dismissed chapter 11 case occurred by operation of law pursuant to section 365(d)(4), because the debtor had not timely assumed the lease; construing section 349 to revest the lease in the debtor "would utterly defeat the intent of section 365(d)(4)," which the court harmonized with § 365(d)(4) by using the "flexibility inherent" in section 349 "to prevent a lessee's bankruptcy from holding a nondebtor lessor hostage to repeated filings.").

[478] *See In re* Jevic Holding Corp., 787 F.3d 173, 185 (3d Cir. 2015). See also the list of unpublished cases in Hon. Kevin J. Carey et al., *Delaware Views from the Bench: Structured Dismissals*, AM. BANKR. INST., at 52–53 (2013), http://www.abi.org/education-events/sessions/structured-dismissals [https://perma.cc/6GXM-736Y].

[479] *See supra* notes 476–78 and accompanying text.

[480] *See* 11 U.S.C. § 1104(a)(1) (2012).

[481] *See supra* notes 445–49 and accompanying text.

[482] *See supra* notes 477–50 and accompanying text.

[483] *See supra* notes 477–50 and accompanying text.

by the court survives the dismissal of the case. Moreover, Congress has given courts broad discretion to alter normal revesting "for cause."[484] In sharp contrast to these statutory provisions, the Code says nothing of the absolute priority rule on a dismissal.

VI. THE CIRCUIT SPLIT: *JEVIC*, *IRIDIUM*, AND *AWECO*

The Supreme Court has granted certiorari in *Jevic*[485] on the question of whether a bankruptcy court may authorize the distribution of settlement proceeds in a manner that violates the statutory priority scheme.[486] Three circuit courts have considered the issue: the Third Circuit in *In re Jevic Holding Corp.* in 2015;[487] the Second Circuit in *In re Iridium Operating LLC* in 2007;[488] and the Fifth Circuit in *In re Matter of AWECO, Inc.* in 1984.[489] Both *Jevic* and *Iridium* allowed for bankruptcy court approval of a pre-plan settlement in chapter 11 if it was in the best interest of creditors, even if it was not in accord with the absolute priority rule.[490] In contrast, *AWECO* applied a *per se* rule by which any distributions pursuant to a settlement in chapter 11 must be in the order of absolute priority.[491] A summary of each of *Jevic*, *Iridium,* and *AWECO* follows.

A. In re Jevic Holding Corp.

Little was left of the *Jevic* debtors or their property more than four years after the debtor commenced its chapter 11 case.[492] The

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[484] *See* 11 U.S.C. § 1104(a)(1).

[485] Czyzewski v. Jevic Holding Corp., 787 F.3d 173 (3d Cir. 2015), *petition for cert. granted,* 136 S. Ct. 2541 (2016) (No. 15-649).

[486] *Id.*

[487] *In re* Jevic Holding Corp., 787 F.3d 173, 175 (3d Cir. 2015).

[488] *In re* Iridium Operating LLC, 478 F.3d 452, 466 (2007) (finding that settlements that result in distributions to unsecured creditors other than in accordance with the priorities of the Code section 507 may be approved in a narrow band of circumstances in which there are specific and credible grounds to justify the deviation).

[489] *In re* AWECO, Inc., 725 F.2d 293, 298 (5th Cir. 1984) (noting that settlements outside of a plan must comply with the "absolute priority rule").

[490] *In re Jevic Holding Corp.,* 787 F.3d at 183–84; *In re Iridium Operating LLC,* 478 F.3d at 466.

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

[492] *In re* Jevic Holding Corp., 2014 WL 268613, at *4 (D. Del. Jan. 24, 2014).

debtors had sold their property and used the proceeds to pay a group of secured lenders headed by CIT Group ("CIT").[493] Another secured lender, Sun Capital Partners, had a lien against the debtors' $1.7 million in cash, and a claim that exceeded that amount.[494] A subsidiary of Sun also owned the equity in the debtors, having acquired the debtors two years before the bankruptcy filing in a leveraged buyout financed by CIT.[495]

The debtors' only remaining asset was a suit that the official committee of unsecured creditors had brought against CIT and Sun on a derivative basis.[496] The committee claimed that Sun had used virtually none of its own money to acquire the debtors.[497] Instead, with CIT's assistance, it had leveraged the debtors' assets to make the acquisition, saddling the debtors with debt they could not service and hastening their demise.[498] Accordingly, the committee alleged that the transaction was an avoidable fraudulent transfer.[499] Though the committee's suit had survived a motion to dismiss, the bankruptcy court found that the action was "far from compelling, especially in view of CIT's and Sun's substantial resources" and the committee's having none.[500]

The structured dismissal in *Jevic* involved a $3.7 million settlement of the committee's action.[501] CIT would pay $2 million into an account earmarked for professional fees and other priority administrative expenses, and Sun would assign its lien in the debtors' $1.7 million of cash to a trust that would pay in full the remaining priority administrative expense claims and priority taxes, and the balance of the $3.7 million pro rata to general unsecured creditors.[502] The settling parties requested the court to approve the settlement and immediately thereafter dismiss the case.[503]

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[493] *Id.* at *1.

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

[495] *Id.* at 176–77.

[496] Code section 1102 provides that the United States Trustee shall appoint an official committee of unsecured creditors in a chapter 11 bankruptcy case. 11 U.S.C. § 1102(a)(1) (2012).

[497] *In re Jevic Holding Corp.,* 787 F.3d at 176.

[498] *Id.*

[499] *Id.*

[500] *Id.* at 180.

[501] *Id.* at 188.

[502] *Id.* at 176–77.

[503] *Id.* at 180; *see also* 11 U.S.C. § 1112(e) (2012).

Other unsecured creditors in *Jevic*, who were not parties to the settlement and who would receive nothing under it, and the United States Trustee, opposed the motion.[504] The objecting creditors were a class of truck drivers formerly employed by the debtors who were pursuing Worker Adjustment and Retraining Notification (WARN) Act claims against both the debtors and Sun.[505] Their collective claim was in the amount of $12.4 million by their own estimation, $8.3 million of which they asserted as an unsecured priority wage claim under Bankruptcy Code section 507(a)(4).[506] Though the drivers were not barred from participating in the settlement negotiations, they ultimately were not parties to the settlement because they did not reach an agreement providing for the dismissal of the WARN claims against Sun.[507] So long as the WARN litigation continued, Sun, which was contributing $1.7 million toward the settlement, was unwilling to pay the drivers without being given a release because it "did not want to fund litigation against itself."[508]

The drivers and the United States Trustee argued that the proposed settlement and dismissal violated the absolute priority rule.[509] They further asserted that the Code "does not permit structured dismissals."[510]

The bankruptcy court found that there was "no realistic prospect" of confirming a plan or of a "meaningful distribution" to any unsecured creditor unless it approved the settlement.[511] A conversion to chapter 7 would be "unavailing" because the chapter 7 trustee would have no funds with which to litigate the committee's claims and "the secured creditors had 'stated unequivocally and credibly that they would not do this deal in a Chapter 7.'"[512]

The court held that while chapter 11 plans must comply with the Code's distributional priority scheme, settlements do not.[513] The

504 *In re Jevic Holding Corp.*, 787 F.3d at 178.
505 *Id.* at 176.
506 *Id.* at 177.
507 *Id.*
508 *Id.*
509 *Id.* at 178.
510 *Id.*
511 *Id.*
512 *Id.* (citation omitted).
513 *Id.*

settlement did not prejudice the drivers because the debtor had no unencumbered assets or funds with which to pay the drivers.[514] The drivers' claims were "effectively worthless."[515]

Finally, the court determined that the settlement was fair and equitable under Bankruptcy Rule 9019,[516] given the low possibility that the committee would win on the merits, the complexity of the case, and the high costs of proceeding.[517] Faced with the "dire" outcome of either "a meaningful return or zero," the "'paramount interest of the creditors mandate[d] approval of the settlement' and nothing in the Bankruptcy Code dictated otherwise."[518]

The district court affirmed, including because the settlement "was in the best interest of the estate and of resolving the pending Chapter 11 cases."[519] The drivers and the United States Trustee appealed.[520]

The Third Circuit emphasized that none of the objectors contended that the bankruptcy court had erred in determining that the settlement was fair and equitable under the *TMT* standard.[521] Further, cause existed under section 1112(b)(1) to convert the case to chapter 7 or dismiss the case, "whichever [was] in the best interests of creditors and the estate."[522]

The objectors argued that there were only three avenues available to the debtors: convert to chapter 7, confirm a plan, or dismiss "with no strings attached."[523] The Third Circuit characterized a structured dismissal as simply a dismissal "preceded by other orders

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[514] *Id.*

[515] *Id.*

[516] FED. R. BANKR. P. 9019. *See supra* notes 11–12 and accompanying text.

[517] *In re Jevic Holding Corp.*, 787 F.3d at 178–79 (citing *In re* Martin, 91 F.3d 389 (3d Cir. 1996) (setting forth the multifactor test for evaluating settlements under Bankruptcy Rule 9019)). The Third Circuit in *Martin* followed *Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson*, 390 U.S. 414 (1968), considered at greater length above. *See supra* notes 14–15, 361 and accompanying text. *See also In re Martin*, 91 F.3d at 393; *TMT*, 390 U.S. at 424–25; *In re* Iridium Operating LLC, 478 F.3d 452, 461–62 (2d Cir. 2007).

[518] *In re Jevic Holding Corp.*, 787 F.3d at 179.

[519] *In re Jevic Holding Corp.*, 2014 WL 268613, at *3 (D. Del. Jan. 24, 2014).

[520] *In re Jevic Holding Corp.*, 787 F.3d at 179.

[521] *Id.* at 179–80.

[522] *Id.* at 180 (citing 11 U.S.C. § 1112(b)(1), (b)(4)(A) (2010)); *see also* 11 U.S.C. § 1112(b)(1) (2012).

[523] *In re Jevic Holding Corp.*, 787 F.3d at 180.

of the bankruptcy court (*e.g.*, orders approving settlements, granting releases, and so forth) that remain in effect after dismissal."[524] Further, revesting under section 349(b) did not require a "hard reset" but authorized the court "for cause" to order otherwise.[525]

The drivers urged that a bankruptcy court's broad power to approve settlements and structured dismissals that do not strictly comply with the priorities listed in section 507 could "render … superfluous" the plan confirmation process set forth in chapter 11.[526] The court reasoned that, even if that were true, the Code forbade only a structured dismissal contrived to circumvent or evade the protections of the plan confirmation or conversion process.[527] Since there was no prospect of a confirmable plan, and conversion to chapter 7 "was a bridge to nowhere," that issue was not before it.[528]

Rather, the court reasoned, settlements are favored in bankruptcy, and the Code and the Rules left bankruptcy courts "more flexibility in approving settlements than in confirming plans of reorganization."[529] Compliance with the Code's priorities "will usually be dispositive of whether a proposed settlement is fair and equitable."[530] "Settlements that skip objecting creditors in distributing estate assets raise justifiable concerns about collusion."[531] The court held nonetheless that a bankruptcy court may approve a settlement in chapter 11 that deviates from the absolute priority rule if there are "specific and credible grounds to justify [the] deviation."[532]

The Third Circuit in *Jevic* acknowledged that the case before it was "a close call," but concluded that the bankruptcy court "had sufficient reason to approve the settlement and structured dismissal."[533] "This disposition, unsatisfying as it was, remained the least bad alternative since there was 'no prospect' of a plan being confirmed

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[524] *Id.* at 181.
[525] *Id.*
[526] *Id.*
[527] *Id.*
[528] *Id.* at 181–82.
[529] *Id.* at 184.
[530] *Id.* (citing *In re* Iridium Operating LLC, 478 F.3d 452, 455 (2d Cir. 2007)).
[531] *Id.* (citing *In re Iridium Operating LLC*, 478 F.3d at 464).
[532] *Id.* (alteration in original) (citing *In re Iridium Operating LLC*, 478 F.3d at 466).
[533] *Id.* at 184–85.

and conversion to Chapter 7 would have resulted in the secured creditors taking all that remained of the estate in 'short order.'"[534]

B. In re Iridium Operating LLC

The situation in *In re Iridium Operating LLC* was equally bleak. The debtor's secured lenders "asserted liens over much of what [was] left of Iridium."[535] The official committee of unsecured creditors contested the liens.[536] The committee also sought to pursue claims against the debtor's former sole shareholder, Motorola, Inc., but lacked the funds to do so.[537] The committee "decided to seek a settlement with the [secured] [l]enders and to focus its litigation efforts on Motorola."[538]

The committee and the lenders reached a settlement one and a half years into the bankruptcy case.[539] The settlement acknowledged the lenders' security interest in the estate's remaining cash, but provided for the distribution of only part of that cash to the lenders.[540] The $37.5 million balance of the cash would fund a litigation trust and be used by the committee to sue Motorola.[541] The secured lenders and the estate would split any recoveries from the Motorola suit.[542]

Litigation recoveries would go to the estate and pay the priority administrative claims first, and then general unsecured claims under a liquidating plan "according to the Bankruptcy Code's priority scheme."[543] The trust would pay any unused portion of the $37.5 million that remained at the end of the litigation directly to general unsecured creditors.[544]

Motorola, which asserted a priority administrative expense claim against the debtor in addition to its equity ownership interest

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[534] *Id.* at 185.
[535] *In re Iridium Operating LLC*, 478 F.3d at 456.
[536] *Id.*
[537] *Id.*
[538] *Id.* at 458.
[539] *Id.* at 458–59.
[540] *Id.* at 459.
[541] *Id.*
[542] *Id.*
[543] *Id.*
[544] *Id.*

in the debtor, objected to the settlement.[545] It argued that under one outcome, estate property would be distributed to lower priority creditors (the general unsecured creditors) before any payments to Motorola on account of its priority claim.[546]

The bankruptcy court approved the settlement and the district court affirmed.[547] Motorola appealed.[548] The Second Circuit held that a settlement outside of a plan does not necessarily implicate the absolute priority rule,[549] and declined to apply the per se rule formulated by the Fifth Circuit in *AWECO*.[550] Nonetheless, the most important factor for approval of a pre-plan settlement was whether distributions under it complied with the Code's priority scheme.[551]

The Second Circuit held that, if the committee in pursuit of its duty to maximize creditor recoveries reached a settlement "that in some way impair[ed] the rule of priorities, it must come before the bankruptcy court with specific and credible grounds to justify that deviation and the court must carefully articulate its reasons for approval of the agreement."[552] Since the committee had not done so, the court remanded to the bankruptcy court for it to assess the justification.[553]

C. In re AWECO, Inc.

The debtor in *In re AWECO, Inc.* filed its chapter 11 case after commencement of a $27 million breach of contract claim against it.[554] Several months later, the debtor filed its plan of reorganization but never solicited acceptances from its creditors.[555] The debtor subsequently settled the contract claim for $5.3 million and sought bankruptcy court approval of the settlement.[556]

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[545] *Id.* at 456.
[546] *Id.*
[547] *Id.* at 460.
[548] *Id.*
[549] *Id.* at 463 (citing Protective Comm. For Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 424 (1968)).
[550] *Id.* at 464 (citing *In re* AWECO, Inc., 725 F.2d 293, 298 (5th Cir. 1984)).
[551] *Id.* at 463.
[552] *Id.* at 466.
[553] *Id.*
[554] *See In re AWECO, Inc.*, 725 F.2d at 295.
[555] *Id.*
[556] *Id.* at 295–96.

Several creditors objected, including a judgment creditor whose lien extended to certain of the debtor's assets, the IRS that asserted priority tax claims, and the Department of Energy that held an unsecured claim.[557] The bankruptcy court found that the settlement was "fair and equitable" and in the best interest of the debtor, its estate, and creditors, and approved it.[558] The IRS and the Department of Energy appealed.[559] The district court concluded that the settlement benefitted all creditors because it would give the debtor its only chance at reorganization, and affirmed.[560] The IRS appealed.[561]

The Fifth Circuit found convincing the policy arguments in support of some extension of the "fair and equitable standard" to settlements outside of a plan and reversed.[562] The court reasoned that the goal of absolute distributional priority arises when the bankruptcy case commences.[563] Based on the "bankruptcy law's underlying policies," it made "a limited extension of the fair and equitable standard: a bankruptcy court abuses its discretion in approving a settlement with a junior creditor unless the court concludes that priority of payment will be respected as to objecting senior creditors."[564]

VII. The Case for Structured Dismissals

A debtor and its stakeholders confront a bleak reality when seeking the best resolution in a chapter 11 case in which a plan is not confirmable. The bankruptcy court in *Jevic* had the unenviable task of determining whether to approve a negotiated resolution and structured dismissal that salvaged some value for creditors, but

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[557] *Id.* at 296.
[558] *Id.* at 297.
[559] *Id.*
[560] *Id.*
[561] *Id.*
[562] *Id.* at 298.
[563] *Id.*
[564] *Id.* The Fifth Circuit has not adhered to the *AWECO* rule in later bankruptcy cases in which it considered court-approved settlements. Rather, in both chapter 11 and chapter 7 bankruptcy cases decided after *AWECO*, that court continued to apply the *TMT* risk-benefit standard to settlement approval without regard to whether the settlement complied with the absolute priority rule. *See supra* note 410.

did not adhere to the absolute priority rule. The Supreme Court in *Jevic* is expected to decide whether bankruptcy courts have the authority to approve such a settlement.

The case for structured dismissals begins with the Code's text. The absence of a reasonable likelihood of rehabilitation or the failure to file or obtain confirmation of a plan by the time required by the Code or the court constitutes cause for the court to dismiss or convert the case.[565] Once the bankruptcy court finds cause to dismiss, Congress gives the court broad discretion to dismiss the case or convert it to chapter 7, "whichever is in the best interests of creditors and the estate."[566] The Code provisions that address the effects of a dismissal do not require an "undo" of settlements or any of the numerous other transactions that occurred during the proceeding prior to the dismissal. Even if they did, Congress has given the bankruptcy court broad discretion to order otherwise for cause.[567] The bankruptcy court's authority to approve a settlement similarly is broad and based on long-standing precedent that Congress has not constrained in the Code.[568]

Textual support is lacking for the requirement that all negotiated resolutions and dismissals comply with the absolute priority rule. Moreover, the role of the absolute priority rule is highly circumscribed by the text of the current Code, contrary to the assertions of the critics of structured dismissals.[569] Congressional enactments in the years since *Los Angeles Lumber* make clear that the limited reach of the absolute priority rule in chapter 11 and under the present Code is no accident.[570]

A structured dismissal, such as that approved by the court in *Jevic*, is the result of negotiations that typically conclude with a settlement that gives something to some unsecured creditors.[571] The alternative in *Jevic*, as in many such cases, was a conversion to chapter 7 in which unsecured creditors would receive nothing.[572]

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[565] 11 U.S.C. § 1112(b)(4)(A), (J) (2012).

[566] *Id.* § 1112(b)(1).

[567] *Id.* § 349(b)(3).

[568] *See In re* Jevic Holding Corp., 787 F.3d 173, 180 (3d Cir. 2015).

[569] 11 U.S.C. § 1129(b)(2)(B)(ii); *see also* H. COMM. ON JUDICIARY, Bankruptcy Reform Act of 1978, H.R. REP. NO. 95-595, at 412–18 (1978), *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6356.

[570] 11 U.S.C. § 1129(b).

[571] *See In re Jevic Holding Corp.,* 787 F.3d at 176–77.

[572] *Id.* at 185.

The structured dismissal in *Jevic* was in the best interest of the unsecured creditors and thus the court was correct in approving it.

Critics expressly or by inference raise a number of concerns with a rule that permits settlements that do not adhere to the absolute priority rule. They assert that a structured dismissal, such as was approved in *Jevic*, is nothing more than an end run around the absolute priority rule.[573] They claim that such settlements often result from and encourage collusive behavior that deprives middle priority claimants of their due.[574] They argue that higher priority claims, such as the workers' claims in *Jevic*, remain unpaid though more junior claims are paid.[575] This Article addresses these arguments in turn.

A structured dismissal is not an end run around the process for obtaining plan confirmation or the distributional priorities that apply to a rejecting class under a chapter 11 cramdown plan if, as in *Jevic*, a plan is not confirmable. Rather, in a case in which a chapter 11 plan is not confirmable, Congress has authorized the bankruptcy court to decide whether and how to dismiss or convert the case based on the court's determination of what is in the best interest of the debtor's creditors and estate.[576] The Code's provisions governing dismissal do not require adherence to distributional priorities.

Even so, the end run critique might find some traction if the absolute priority rule pervaded the Code or chapter 11, but it does not. The absolute priority rule reached its zenith by a judicial launch in *Los Angeles Lumber*. Since then, Congress has brought the rule much closer to earth, so that today it has a far smaller and very specific, if important, role in chapter 11 and the Code. The very reorganization plan, a consensual plan, that the Supreme Court held was not confirmable in *Los Angeles Lumber* would be confirmable since 1979 under the Code.[577] Other protections shield creditors in chapter 11.[578] Under the Code, acting in the best interest of creditors is a stronger, expressly stated policy.

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[573] *Id.* at 181.
[574] *See In re* Iridium Operating LLC., 478 F.3d 452, 464 (2d Cir. 2007).
[575] *See In re* AWECO, Inc., 725 F.2d 293, 298 (5th Cir. 1984).
[576] *See In re Jevic Holding Corp.*, 787 F.3d at 184.
[577] *See* 11 U.S.C. § 1129(a) (2012).
[578] *See id.* § 1129(c).

A settlement negotiated by the parties at arm's length that benefits creditors and the estate is distinguishable from a settlement that results from collusion and does not. The bankruptcy courts must regularly make such a distinction with respect to settlements, sales, and other transactions brought to the court for approval, both outside of and in connection with, a plan.[579] The court made such a determination in *Jevic*. The WARN claimants in *Jevic* participated in the negotiations that resulted in a settlement.[580] The reason that the settlement provided nothing for the WARN claimants was not collusion. Rather, they would not agree to release their claims in consideration of the settlement amount, which is the fundamental exchange in any monetary settlement.[581] Not surprisingly, the party funding the settlement was not willing to pay settlement funds to the non-releasing WARN claimants, because the latter would just use those funds to pursue their litigation against the former.

Determining whether a proposed settlement resulted from collusion among the settling parties is a fact-intensive undertaking. Requiring adherence to the absolute priority rule will not flush out or prevent such collusion. The debt and capital structures of distressed companies have evolved since the days of equity receiverships and since the enactment of the Code. In *Jevic,* the settling party asserted both a senior secured claim and a junior ownership interest.[582] In *Iridium*, the objecting party, Motorola, asserted both a high priority administrative expense claim and a junior ownership interest.[583] Even the WARN claimants in *Jevic* asserted both a priority unsecured claim and a lower priority general unsecured claim.[584] Which hat was each of these parties wearing at the time of the settlement negotiations?

Moreover, in none of *Jevic*, *Iridium,* or *AWECO*, did the debtors' managers or shareholders, in concert with the secured creditors, walk off with the residual value of the company at the expense of unsecured creditors.[585] Facts such as these have nothing in common

[579] *See In re Jevic Holding Corp.*, 787 F.3d at 184.
[580] *Id.* at 176–77.
[581] *Id.* at 177–78.
[582] *See id.* at 175–76.
[583] *See In re* Iridium Operating LLC, 478 F.3d 452, 456, 459, 465 (2d Cir. 2007).
[584] *See In re Jevic Holding Corp.*, 787 F.3d at 177.
[585] *See id.* at 176; *see also In re Iridium Operating LLC*, 478 F.3d at 459; *In re* AWECO, Inc., 725 F.2d 293, 296–97 (5th Cir. 1984).

with the practices that gave rise to the rule that shareholders could not retain the residual value of a business enterprise by colluding with the senior creditors to give other creditors nothing, as was the case in the equity receiverships which preceded the Chandler Act and the Code. The bankruptcy court in *Jevic* correctly found that the settlement was reached not by collusion, but as the result of negotiations in which the WARN claimants had a seat at the table.[586] That and other facts regarding the course of the negotiations are better indicators of whether the settlement and structured dismissal resulted from collusion or from arm's length negotiations based on the strengths and weaknesses of the parties' positions as well as their willingness to compromise.

Further, it is not appropriate to evaluate a structured dismissal based on whether the unpaid stakeholder is more, or less appealing than the stakeholder who is paid from the settlement that resulted from the negotiations. Congress, by directing that a dismissal accord with the best interest of creditors and by authorizing a bankruptcy court "for cause" to decree appropriate terms in the dismissal order, expressly allowed for some "play in the joints" of the Code.[587] That flexibility gives bankruptcy judges the authority and discretion to approve a settlement and structured dismissal that provides the greatest good to the greatest number.[588] In *Jevic* those who benefitted included general unsecured creditors who, but for the settlement, would have received nothing, and excluded the holders of senior WARN claims who would not agree to give a release in exchange for the terms of the settlement.[589] In the next case, those who benefit might include employees, who but for the settlement would receive nothing, and might exclude certain senior administrative expense claimants such as, estate professionals who do not agree to give a release in exchange for the settlement terms. In the case after that, both parties might agree to give releases and thus share in a settlement fund that would not be available absent such releases. The Code's text expressly enables this process when a plan is not confirmable, and in such a case authorizes the court to approve the negotiated resolution if it is in the best interest of creditors.[590]

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[586] *See In re Jevic Holding Corp.*, 787 F.3d at 176–78.
[587] 11 U.S.C. § 1112(b)(1) (2012).
[588] *Id.*
[589] *See In re Jevic Holding Corp.*, 787 F.3d at 179, 185.
[590] 11 U.S.C. § 1112(b)(1).

The elephant in the room, of course, is whether there are any limiting factors on a bankruptcy court's dismissing a case and decreeing terms of the dismissal that do not comply with the absolute priority rule. Both Congress and the courts in *Jevic* and *Iridium* addressed this reasonable concern by requiring that a structured dismissal must be in the best interest of creditors.[591]

Congress, in the Code, directs bankruptcy courts to resolve a chapter 11 case in which a plan is not confirmable based on a determination of what is in the best interest of creditors.[592] It has given the courts the discretionary authority to enter a dismissal order that contains terms that alter the ordinary effect of a dismissal for cause.[593] This express congressional grant of authority and discretion to the bankruptcy courts is not unique to the resolution of a chapter 11 case in which a plan is not confirmable, and applies to many other decisions made by the bankruptcy courts.[594] Congress could easily have limited the bankruptcy courts' authority and discretion with respect to a dismissal, and could have made the absolute priority rule applicable to a dismissal. It did not do so. The congressional direction is clear.

Moreover, the courts in their exercise of this authority have not abused it. Both *Iridium* and *Jevic* were decided on narrow grounds.[595] Each court considered both the best interest of creditors as a whole and the specific interest of creditors who were not part of the settlement.[596] The Second Circuit in *Iridium* required that settling parties "come before the bankruptcy court with specific and credible grounds to justify [a] deviation" from the priorities applicable in chapter 7 so it could carefully formulate and articulate its reasons for approving the settlement.[597] Since the creditors' committee had not established those grounds, the court remanded

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[591] *Id.* § 1112(b)(1); *see also In re Jevic Holding Corp.*, 787 F.3d at 182, 186; *In re* Iridium Operating LLC, 478 F.3d 452, 456, 466–67 (2d Cir. 2007).

[592] 11 U.S.C. § 1112(b)(1).

[593] *Id.* § 349.

[594] *See supra* notes 437–38 and accompanying text; *see also supra* note 450 and accompanying text.

[595] *See In re Jevic Holding Corp.*, 787 F.3d at 184–85; *In re Iridium Operating LLC*, 487 F.3d at 461–62, 464–66.

[596] *See In re Jevic Holding Corp.*, 787 F.3d at 177, 180, 186; *In re Iridium Operating LLC*, 487 F.3d at 461, 465.

[597] *In re Iridium Operating LLC*, 487 F.3d at 466.

to the bankruptcy court for it to assess the justification for approval.[598] The bankruptcy court in *Jevic* found that a plan was not confirmable. It found that the WARN claimants had a seat at the negotiating table.[599] They were not part of the ultimate settlement because they would not release their claims in exchange for the payment being made by the secured creditors, and the secured creditors were not willing to make the settlement payments unless they received the release from the WARN claimants.[600] Further, a conversion to chapter 7 would result in no distribution to any unsecured creditors, whether priority or otherwise.[601] Neither the Third Circuit in *Jevic* nor the Second Circuit in *Iridium* casually disregarded the distributional priorities applicable in chapter 7 or to a chapter 11 cramdown plan, or the interests of those claimants who were not part of the settlement. Each court required specific and credible grounds for a deviation from the priorities applicable in chapter 7 and under a cramdown plan. The *Jevic* court held, rightfully, that such deviation was justified because a plan was not confirmable and the settlement and structured dismissal provided the greatest distribution to the greatest number of unsecured creditors.

Conclusion

Congress has not enthroned absolute priority or a policy that favors it atop the Bankruptcy Code. Rather, it has lowered the doctrine's place, severely and consistently, since 1952.

The rule was never as absolute in application in the equity receiverships as it was in courts' pronouncements in the dozen years following the Chandler Act. The Supreme Court in *Los Angeles Lumber* nonetheless exalted the rule and the policy behind it shortly after the Chandler Act became law, by making absolute priority synonymous with the term "fair and equitable."[602] For a very few years thereafter the federal courts, following *Los Angeles Lumber*, extended the rule to plans under chapters X, XI, and XII of the Chandler Act.[603]

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598 *Id.*
599 *See In re Jevic Holding Corp.*, 787 F.3d at 177–78.
600 *See id.* at 177.
601 *Id.* at 185.
602 *See* Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 117–19 (1939).
603 *See supra* notes 200–02 and accompanying text.

Congress, beginning a dozen years after *Los Angeles Lumber* and repeatedly and unwaveringly in the six decades since, has contracted the reach of the absolute priority rule. The assertion by the *AWECO* court and certain commentators of a congressional policy favoring a pervasive rule requiring absolute distributional priority in bankruptcy generally, and in chapter 11 specifically, is simply inaccurate.

The justification for extending the reach of the absolute priority rule to a structured dismissal is especially weak if a plan is not confirmable and equity will receive nothing or will receive only a release in exchange for its contribution of cash used to make a distribution to other creditors. The primary purpose of the absolute priority rule was always to keep managers and shareholders from misappropriating the enterprise's residual value in a reorganization, unless unsecured creditors received a reasonable value for their claims.[604]

Has Congress in all bankruptcy cases required payment to priority unsecured creditors in the order listed in section 507, prior to any payment to general unsecured creditors? The answer, simply, is no. In chapter 9, a plan must provide for payment of administrative expense claims.[605] The other unsecured priorities do not apply.[606] In chapter 12, the Code does not require payment of specified priority tax claims on a priority basis at all, and transforms those claims into general unsecured claims.[607] Both chapters 12 and 13 allow a debtor to retain equity in its property though unsecured creditors are not paid in full, and allow payment to general unsecured creditors before priority unsecured claims, so long as the plan provides for the ultimate payment of those priority claims in full.[608] In both a consensual plan and a cramdown plan in chapter 11, the majority in an accepting class of employee wage and benefit plan claims, agricultural supplier claims, and consumer deposit claims, all of which are priority claims, can bind dissenters within that class to accept deferred payments that are subordinate in time of payment to lower priority claims.[609] Those

[604] *See supra* note 146 and accompanying text.
[605] 11 U.S.C. § 943(b) (2012).
[606] *See id.* § 943(b).
[607] *Id.* § 1222(a)(2).
[608] *See supra* notes 346–47 and accompanying text.
[609] *See supra* Part III.C.2.

priority claims held by dissenters may be paid even after junior unsecured claims are paid in full, equity has received interest in the reorganized debtor, the debtor has received its discharge and the court has closed the case.[610] In a consensual chapter 11 plan approved by the requisite majorities of all voting classes, the absolute priority rule does not apply at all, and shareholders can retain their interests though creditors are not paid in full.[611]

Most significantly, Congress has directed the bankruptcy courts to resolve a case in which a plan is not confirmable based on the best interest of creditors, not adherence to absolute distributional priorities.[612] The Code gives the court broad discretion to approve a settlement that will facilitate such an outcome.

A chapter 11 case in which the court finds that a plan is not confirmable and unsecured creditors will receive nothing, but in which a structured dismissal will provide some distribution to creditors, should not present a quandary. Approving a structured dismissal upon such findings is the correct result. If the structured dismissal will result in the greatest good to the greatest number and is not the result of collusion, then the court should approve it. Congress, by a consistent course of enactments over more than sixty years, has made absolute priority a special, but limited, rule. The current Code does not prescribe adherence to the absolute priority rule in a chapter 11 case in which a plan is not confirmable and a structured dismissal pays something to creditors. The Code requires instead that a bankruptcy court approve a structured dismissal that is in the best interest of creditors.

[610] *See supra* Part III.C.2.
[611] *See supra* Part III.C.2.
[612] 11 U.S.C. § 1112(b)(1).

EPILOGUE—THE SUPREME COURT'S DECISION IN *JEVIC*

The Supreme Court entered its opinion in *Czyzewski v. Jevic Holding Corp*. on March 22, 2017,[613] when the publication of the print version of this issue of the *William & Mary Business Law Review* was imminent. This epilogue by the Author briefly summarizes the opinion, its reach, and its likely effects.

The Supreme Court in *Jevic* framed the question before it as whether, "in connection with a Chapter 11 *dismissal*," a bankruptcy court has the legal power to order the "priority-skipping kind of distribution scheme" that the bankruptcy court approved in the structured dismissal in *Jevic*.[614]

The Court held that: "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,"[615] i.e., the rules that govern distributions in a chapter 7 liquidation or under a confirmed chapter 11 plan, respectively.

Chapter 11 "foresees three possible outcomes," the Court continued.[616] The first is a confirmed chapter 11 plan.[617] The second—which "in effect confesses an inability to find a plan"—is conversion of the case to a chapter 7 proceeding for the liquidation and distribution of the debtor's remaining assets.[618] The third is a dismissal of the case that "aims to return to the prepetition financial status quo."[619]

The Court briefly considered the distributional scheme in a chapter 7 case, in which rigid adherence to the absolute priority rule is required. Distributions in chapter 7 must be made: first, to

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613 Czyzewski v. Jevic Holding Corp., 787 F.3d 173 (3d Cir. 2015), *cert. granted*, 136 S. Ct. 2541 (2016) (No. 15-649, 2016 October Term), 2017 WL 1066259.

614 *Id.* at *3 (emphasis in original).

615 *Id.* at *4.

616 *Id.*

617 *Id.* (citing 11 U.S.C. §§ 1123, 1129, 1141 (2012)).

618 *Id.* (citing 11 U.S.C. §§ 1112(a)–(b), 726).

619 *Id.* (citing 11 U.S.C. §§ 1112(b), 349(b)(3)).

each secured creditor on account of its claim up to the extent of the value of its collateral;[620] second, to the holders of priority unsecured claims (such as for administrative expenses, wages, and taxes) in the order of the priorities for those claims listed in section 507;[621] next to the holders of non-priority, general unsecured claims;[622] and finally to the holders of equity in the enterprise.[623] The Court acknowledged that the Code provides somewhat more flexibility for distributions under chapter 11, but emphasized that "a bankruptcy court cannot confirm a plan that contains priority-violating distributions over the objection of an impaired creditor class."[624]

The question of whether the structured dismissal in *Jevic* was permissible concerned "the interplay between the Code's priority rules and a Chapter 11 dismissal."[625] The Court stated that the Code does not explicitly address distributions made at the time of the dismissal of a chapter 11 case, and asked: "Can a bankruptcy court approve a structured dismissal that provides for distributions that do not follow ordinary priority rules without the affected creditors' consent?"[626]

The Court's "simple answer to this complicated question" was "no."[627] In reaching its conclusion, the Court emphasized its view

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[620] *Id.* at *5 (citing 11 U.S.C. § 725). Section 725 provides only that "the trustee, after notice and a hearing, shall dispose of any property in which an entity other than the estate has an interest, such as a lien, and that has not been disposed of," and the Court's citation to this section for the proposition stated is imprecise. Nonetheless, the proposition stated—that each secured creditor is entitled to payment of its claim up to the extent of the value of its collateral—is both true and well-established, pursuant to Supreme Court opinions that generally preserve in bankruptcy a creditor's lien created under state law, and section 506(a), which limits the distribution to the secured creditor to the value of its collateral. *See supra* notes 281–82, 284 and accompanying text.

[621] *Id.* (citing 11 U.S.C. §§ 507, 726(a)(1)).

[622] *Id.* (citing 11 U.S.C. § 726(a)(2)).

[623] *Id.* (citing 11 U.S.C. § 726(a)(6)).

[624] *Id.* at *5.

[625] *Id.*

[626] *Id.* at *10.

[627] *Id.* Prior to turning to this substantive question, the Court considered the respondents' contention that the petitioning WARN claimants lacked standing. *Id.* at *8–9. The Court determined that the petitioners had standing because the bankruptcy court's "approval of the structured dismissal cost petitioners something. They lost a chance to obtain a settlement that respected their priority. Or, if not that, they lost the power to bring their own lawsuit on

that the Code's "priority system constitutes a basic underpinning of business bankruptcy law," and "has long been considered fundamental to the Bankruptcy Code's operation."[628] The importance of the priority system led the Court "to expect more than a simple statutory silence if, and when, Congress were to intend a major departure" that would authorize a structured dismissal that provided for priority-skipping distributions.[629]

The Court found nothing in the statute that evinced this intent. Section 1112(b) authorizes the bankruptcy court to dismiss a chapter 11 case. The Court noted:

> But the word, 'dismiss' itself says nothing about the power to make nonconsensual priority-violating distributions of estate value. Neither the word 'structured,' nor the word 'conditions,' nor anything else about distributing estate value to creditors pursuant to a dismissal appears in any relevant part of the Code.[630]

The Court further emphasized its view that the dismissal provisions of section 1112(b) and section 349(b), which govern the effect of the dismissal of a chapter 11 case, "seek a restoration of the prepetition financial status quo."[631] The Court considered the bankruptcy court's statutory authority to "for cause, orde[r] otherwise," to be "designed to give courts the flexibility to 'make the

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a claim that had a settlement value of $3.7 million. For standing purposes, a loss of even a small amount of money is ordinarily an 'injury.'" *Id.* at *9 (citing McGowan v. Maryland, 366 U.S. 420, 430–31 (1961)).

[628] *Id.* at *10.

[629] *Id.* ("Congress ... does not, one might say, hide elephants in mouseholes.") (quoting Whitman v. Am. Trucking Ass'ns, Inc., 531 U.S. 457, 468 (2001)). Two elephants are in the room, rather than in the mousehole, in the Author's view. The first is Congress's persistent dissatisfaction with the Court's expansive view in *Los Angeles Lumber* (and now in *Jevic*) of the absolute priority rule. Congress acted on this dissatisfaction in its 1952, 1978, 1986, and 2005 enactments, which severely restricted the reach of the rule and negated most of *Los Angeles Lumber*. The second is the text of section 1112(b), which comes into play when a chapter 11 plan cannot be confirmed. That provision expressly directs a bankruptcy court to make its determination based on the "best interest of creditors and the estate," and not on the absolute priority rule. 11 U.S.C. § 1112(e) (2012). The elephant occupying the mousehole, the Author argues, is the notion that the absolute priority rule applies to the resolution of a chapter 11 case in which a plan is not confirmable.

[630] *Id.* (citing 11 U.S.C. § 1112(b)).

[631] *Id.* at *11.

appropriate orders to protect rights acquired in reliance on the bankruptcy case.'"[632]

The Court did not extend its ruling to structured dismissals regarding which creditors did not object (and thus tacitly consented) to a priority-skipping structured dismissal. It "express[ed] no view about the legality of structured dismissals in general."[633] The Court also distinguished *Iridium*, the Second Circuit case upon which the Third Circuit had relied in part in *Jevic*.[634] The Court noted that *Iridium* "did not involve a structured dismissal. It addressed an *interim* distribution of settlement proceeds to fund a litigation trust that would press claims on the estate's behalf."[635]

The Court also recognized that many other interim distributions made in a chapter 11 case—including those made pursuant to "first-day" orders such as wage, critical vendor, and financing orders that provide for a "roll-up" of a lender's prepetition claim—also are "priority-violating."[636] The Court emphasized that these

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[632] *Id.* (citing H.R. Rep. No. 95-595, at 338 (1978)). A settlement approved by the bankruptcy court pursuant to Bankruptcy Rule 9019 clearly implicates rights acquired in reliance on the bankruptcy case. FED. R. BANKR. P. 9019. Under the Court's interpretation of the temporal scope of section 349(b), the rights acquired under a settlement reached and approved at some time prior to the dismissal of the chapter 11 case would be entitled to protection under section 349(b). Yet, those same rights acquired under a settlement reached and approved immediately prior to, and in contemplation of, such dismissal would not be entitled to protection under section 349(b). 11 U.S.C. § 349(b). The *Jevic* Court did not adopt the per se rule advanced by *AWECO*, pursuant to which a settlement reached at any time after the commencement of the bankruptcy case must comply with the absolute priority rule. Thus the question of how long before dismissal a settlement must be reached to be entitled to protection under section 349(b) remains unanswered.

[633] *Jevic,* 2017 WL 1066259 at *12 (citing *In re* Buffet Partners, L.P., 2014 WL 3735804 (Bankr. N.D. Tex., July 28, 2014)). The Third Circuit cited that same case in its decision affirming the bankruptcy court's approval of the structured dismissal in *Jevic*. *See In re* Jevic Holding Corp., 787 F.3d 173, 182 (3d Cir. 2015).

[634] *Jevic,* 2017 WL 1066259 at *12 (citing *In re* Iridium Operating LLC*,* 478 F.3d 452 (2d Cir. 2007)).

[635] *Id.* (citing *In re Iridium Operating LLC*, 478 F.3d at 459–460).

[636] *Id.* "First day" motions are those filed early in the case, typically with the chapter 11 bankruptcy petition, which request the immediate relief that the chapter 11 debtor in possession asserts that it requires to continue to operate in chapter 11. "First day" orders are those entered on those motions in the first few business days of a case, normally immediately following the court's

and other interim distributions typically are founded on the goal of making "even the disfavored creditors better off," including enabling reorganizations and thus maximizing the value of the estate.[637] It suggested that the distributions under the *Jevic* settlement "more closely resemble[d] proposed transactions that lower courts have refused to allow on the ground that they circumvent the Code's procedural safeguards."[638]

The Court acknowledged that the Third Circuit in *Jevic* "did not approve nonconsensual priority-violating structured dismissals in general," but had limited its ruling to the "rare case" in which the court found "sufficient reasons" to disregard priority.[639] The Court rejected this approach because it was "difficult to give precise content to the concept "sufficient reasons," which threatened to turn

first hearing in the case. Examples include "first day" orders that authorize a chapter 11 debtor in possession to obtain new, post-bankruptcy financing and/or use its cash that is subject to a pre-bankruptcy lien. Many "first day" orders are priority-skipping, and authorize a chapter 11 debtor in possession to pay certain pre-bankruptcy claims, which it otherwise could not pay until the effective debt of its plan or other conclusion of the case. A "first day" wage order, for example, authorizes the payment of the pre-bankruptcy portion of payroll and employee benefits, absent which payment the employees are more likely to quit. A critical vendor order authorizes the payment early in the case of the pre-bankruptcy claims of certain key suppliers of goods or services—such as a supplier that provides a component part that is critical to the debtor's manufacturing operation and cannot be reasonably obtained elsewhere—absent which payment the supplier is more likely to stop supplying such critical good or service. A "roll-up" is a new financing extended by the debtor's pre-bankruptcy lender—under which the lender's pre-bankruptcy claim is paid off with the proceeds of the new, post-bankruptcy loan, and only the amount of the new loan in excess of the lender's pre-bankruptcy loan balance is actually advanced to the debtor—absent which the lender is less likely to extend the new loan. All of these "first day" orders, and others, can result in payments that are priority-skipping and favor certain creditors over others, enabling the favored creditors to receive more than they would under a confirmed chapter 11 plan or, if the case is converted to chapter 7, on the distribution at the conclusion of the chapter 7 case.

[637] *Id.* (citing *In re* Kmart Corp., 359 F.3d 866, 872 (7th Cir. 2004); Toibb v. Radloff, 501 U.S. 157, 163–64 (1991)).

[638] *Id.* at *13 (citing *In re* Braniff Airways, Inc., 700 F.2d 935, 940 (5th Cir. 1983); *In re* Lionel Corp., 722 F.2d 1063, 1069 (2d Cir. 1983); *In re* Biolitec, Inc., 528 B.R. 261, 269 (Bankr. N.J. 2014); *In re* Chrysler LLC, 576 F.3d 108, 118 (2d Cir. 2009)).

[639] *Id.* (citing *In re* Jevic Holding Corp., 787 F.3d 173, 175, 186 (3d Cir. 2015)).

a "rare case" exception into a more general rule.[640] In the Court's view, allowing the "rare case" exception would be the opening of the floodgates—resulting in uncertainty, the loss of protections given to priority claimants, collusion among insiders and senior and junior creditors to the detriment of those in the middle, increased litigation, and fewer settlements.[641]

The Court concluded that Congress had not authorized the "rare case" exception.[642] The courts could not "alter the balance struck by the statute."[643] The Court reversed and remanded for further proceedings consistent with its opinion.[644]

The dissent was founded on one of the most peculiar aspects of the path that the *Jevic* case took from the Court's grant of certiorari through briefing and oral argument to decision.[645] The Court had granted certiorari on the following issue: "[w]hether a bankruptcy court may authorize the distribution of settlement proceeds in a manner that violates the statutory priority scheme."[646]

According to the petition, the Third Circuit's decision in *Jevic* deepened an existing split among the courts of appeals.[647] The Second Circuit had held in *Iridium* that a settlement outside of a plan does not necessarily implicate the absolute priority rule, and may be approved if it maximizes creditor recoveries and there are specific and credible grounds for any deviation from the absolute priority rule.[648] The Fifth Circuit in *AWECO* established, to the contrary, a per se rule, pursuant to which all settlements outside of a plan, reached at any time in the case, must comply with the absolute priority rule.[649]

The dissent found dispositive that, after the Court granted certiorari, the petitioners had "recast the question" to whether a chapter 11 case may be terminated by a structured dismissal that

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[640] *Id.*
[641] *Id.* at *13–14.
[642] *Id.* at *14.
[643] *Id.* (citing Law v. Siegel, 134 S. Ct. 1188, 1198 (2014)).
[644] *Id.* at *14.
[645] *Id.* at *15 (Thomas, J., joined by Alito, J.).
[646] *Id.*
[647] *Id.*
[648] *See supra* notes 4, 487–91, 535–53, 583–85, 591–601 and accompanying text.
[649] *See supra* notes 5, 414–15, 491, 555–64 and accompanying text.

distributes estate property in violation of the Bankruptcy Code's priority scheme.[650]

This question, the dissent asserted, was "narrower—and different"—than the one on which it had granted certiorari.[651] It also was *not* the subject of a circuit conflict, because neither *Iridium* nor *AWECO* involved a structured dismissal.[652] The respondents, relying on the Court's Rules prohibiting the parties from changing the substance of the question presented, declined to brief the recast question that the majority decided.[653] The Court did not have the benefit of a full, adversarial briefing. It further would have "greatly benefit[ed] from the views of additional courts of appeals" on this "'novel question of bankruptcy law' arising in the rapidly developing field of structured dismissals."[654] The dissent would not have rewarded such "bait-and-switch tactics," and would have dismissed the writ as improvidently granted.[655]

So where are the parties in *Jevic* left after the Supreme Court's decision? And where does *Jevic* leave future parties with respect to settlements and distributions in chapter 11 that are outside of a plan?

First, the petitioners in *Jevic* may or may not fair better on remand. The Court's ruling may reopen negotiations in *Jevic*, which may or may not result in a global settlement of the case. It may result in nothing more than a smaller settlement, all of which will go to administrative claimants (whose claims have distributional priority over those of the WARN claimants), or a larger settlement which will result in some distribution to the WARN claimants, or even no settlement at all and a conversion to chapter 7. In that latter case, the chapter 7 trustee may or may not decide to pursue the estate's fraudulent conveyance claims against CIT and/or Sun, and if she decides to pursue those claims, may or may not prevail. The WARN claimants may or may not decide to pursue, as creditors, their state law fraudulent conveyance claims against CIT and/or Sun, and if they decide to pursue those claims, may or may

[650] *Id.* at *15.
[651] *Id.*
[652] *Id.*
[653] *Id.* (citing SUP. CT. RS. 24.1(a), 14.1(a)).
[654] *Id.* (quoting *In re* Jevic Holding Corp., 787 F.3d 173, 175 (2d Cir. 2015)).
[655] *Id.* (quoting S.F. v. Sheehan, 575 U.S. 135 S. Ct. 1765, 1779, (2015) (Scalia, J., concurring in part and dissenting in part)).

not prevail. If they prevail, their recovery may or may not be in an amount in excess of their legal fees and costs.

One outcome, though, is clear. The WARN claimants cannot settle and by a structured dismissal obtain a distribution of their fourth priority unsecured employee claims that is prior to full payment of the second priority administrative expense claims in the case (which include the claims of the debtor's and the creditors committee's counsel and other professionals for their fees and expenses), unless those second priority claimants consent (see "Second" below).

Second, a bankruptcy court may approve a structured dismissal the distributions under which are in accordance with section 726 priorities, and a priority-skipping structured dismissal to which the adversely affected creditors have consented. The Court in *Jevic* appears to have accepted that a creditor's tacit or constructive consent, such as that arising from its failure to object to the proposed structured dismissal, is sufficient.[656]

Third, a bankruptcy court may order distributions under "first day" orders, provided that those orders further the goal of enabling reorganizations and maximizing the value of the estate, and thus might increase distributions even to the disfavored creditors.[657] The bankruptcy court is not required to engage in an absolute priority analysis in connection with "first day" motions, except to this extenuated and fairly speculative extent.

Fourth, pre-plan settlements authorized under Bankruptcy Rule 9019 remain subject to the rule established by the Court in *TMT*.[658] That rule authorizes a bankruptcy court to approve a settlement if it is in the best interest of the estate based on "an educated estimate of the complexity, expense, and likely duration of such litigation, the possible difficulties of collecting on any judgment which might be obtained, and all other factors relevant to a full and fair assessment of the wisdom of the proposed compromise."[659] The Court in *Jevic* did not adopt *AWECO*'s per se rule requiring the bankruptcy court in a chapter 11 case to approve a pre-plan settlement

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[656] *Id.* at *12.

[657] *Id.* at *12.

[658] *See supra* Part IV.

[659] Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 424 (1968).

and the distributions under it only if it complies with the absolute priority rule.[660]

Fifth, the Court did not prohibit a Rule 9019 settlement in accordance with *TMT*, followed by a "conversion of the case to a Chapter 7 proceeding for liquidation of the business and a distribution of its remaining assets," rather than by a structured dismissal of the case. Such conversion to chapter 7 is one of the three ways by which a chapter 11 case can be resolved under the Supreme Court's opinion in *Jevic*.[661]

Sixth, the *Jevic* Court did not rule out "gifting," whereby a secured creditor or other senior creditor entitled to distributional priority agrees to give some or all of its property to a junior creditor, usually to settle a claim against it or resolve the chapter 11 case, skipping over creditors having intermediate priority.[662]

Seventh, and finally, Congress may roll back—yet again—the reach of the absolute priority rule established by the Court in *Los Angeles Lumber*, as it did in 1952, 1978, 1986, and 2005. If Congress does so, it likely will be because it has determined that, if a chapter 11 plan cannot be confirmed, the debtor's creditors are best served not by a rigid rule of absolute distributional priority, but by the Code's leaving some "play in the joints" and authorizing other resolutions that are in the best interests of those creditors.

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[660] The Court also did not reject the Second Circuit's *Iridium* rule, which provides that a settlement outside of a plan does not necessarily implicate the absolute priority rule, and may be approved if it maximizes creditor recoveries and there are specific and credible grounds for any deviation from the absolute priority rule. *Jevic*, 2017 WL 1066259 at *12–13.

[661] *Id.* at *4.

[662] *See, e.g.*, Official, Unsecured Creditors' Comm. v. Stern (*In re* SPM Mfg. Corp.), 984 F.2d 1305 (1st Cir. 1993).