No. 15-649

IN THE

Supreme Court of the United States

CASIMIR CZYZEWSKI, *et al.*,
Petitioners,

v.

JEVIC HOLDING CORP., *et al.*,
Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

REPLY BRIEF FOR PETITIONERS

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INTRODUCTION

There is a clear and acknowledged conflict among the courts of appeals on the question whether bankruptcy courts may distribute settlement proceeds to creditors, outside a confirmed chapter 11 plan, in a manner that violates the Bankruptcy Code's priority scheme. Pet. 15-18. Indeed, the Third Circuit below expressly noted that its decision broke with the Fifth Circuit. Respondents' effort to dismiss the circuit split as "illusory" (Opp. 11-16) simply blinks reality.

Moreover, the question is one of exceptional importance—it is perhaps the most important unresolved question of bankruptcy law today. The question whether creditors' priority may be evaded in the way the Third Circuit approved here not only implicates the fundamental structure and purpose of chapter 11, but also has an obvious practical effect on day-to-day restructuring practice. The amicus filings in this Court by nineteen States, thirteen bankruptcy scholars, and two employee and consumer rights organizations, along with the presence of this issue at the top of the agenda at every bankruptcy conference and seminar, testify to the significance of this case and the pressing need for review.

Respondents' defense of the decision below only confirms that need. Respondents insist that no provision of the Code specifically forbids the parties to a chapter 11 case from colluding to distribute the property of the estate to favored creditors in a manner that would be unlawful in a chapter 11 plan or a chapter 7 liquidation. Opp. 16-23. That result cannot be squared with the text or structure of the Code. Congress made categorical judgments about the priority of distribution of estate assets to unsecured creditors in all bankruptcy

cases. 11 U.S.C. §§103(a), 507, 1129(b)(2). No provision of the Code permits a court to circumvent those judgments via settlement, "structured dismissal," or any other mechanism outside a confirmed plan. Pet. 19-26.

The decision below sets a dangerous precedent for future, similar efforts to circumvent mandatory features of the Code that parties find inconvenient. Respondents' confident assurance that this case will be "the exception that proves the rule" (Opp. 22) is baseless. The decision below has sparked substantial controversy in the bankruptcy community precisely because of what it portends as a practical matter for all priority creditors in chapter 11 proceedings. An essential function of the absolute priority rule is to provide a stable foundation for consensual negotiations toward a plan. But after the decision below and the widespread attention it has generated, negotiations over every chapter 11 plan are colored by the threat that disfavored creditors may be skipped over in a structured settlement. That these cases are rarely litigated to judgment, let alone the subject of appeals, counsels in favor of, not against, granting certiorari here. Pet. 29-31.

Finally, the question whether the Code's priority scheme may be circumvented by settlement or structured dismissal is a pure question of law that is neither "fact-" nor "case-specific" (Opp. 2), although it is exceptionally well presented by the facts of this case. The bankruptcy court here approved a distribution of settlement proceeds to general unsecured creditors, while deliberately skipping over petitioners' higher priority wage claims. Respondents' suggestion that petitioners somehow invited the error below is unfounded. Opp. 24-25. Petitioners repeatedly argued that the settlement approved in this case violated the Code's priority scheme and that it could not be justified even under the

Second Circuit's approach. The court of appeals recognized and rejected petitioners' argument on that point. Pet. App. 15a-16a. Respondents identify no other supposed vehicle problems, and there are none.

I. THE COURTS OF APPEALS ARE OPENLY DIVIDED

Respondents' principal submission is that the division of authority among the courts of appeals is "illusory" because the Fifth Circuit's per se rule, forbidding the distribution of settlement proceeds in a manner that violates the Code's priority scheme, is "*dicta*." Opp. 1. But as even a "cursory examination" (*id.*) of the relevant decision, *In re AWECO, Inc.*, 725 F.2d 293 (5th Cir. 1984), demonstrates, that is simply false.

In *AWECO* the Fifth Circuit framed the issue as follows: "[I]n the period prior to confirmation of a reorganization plan, must the bankruptcy court apply the fair and equitable standard in considering a priority creditor's objections to a settlement?" 725 F.2d at 298. As the court explained, "'fair and equitable'" is a term of art in bankruptcy, meaning "that 'senior interests are entitled to full priority over junior ones.'" *Id.*; *see* Pet. 15-16, 24-25. After extended discussion far longer than "a single sentence" (Opp. 13), the Fifth Circuit held that "a bankruptcy court abuses its discretion in approving a settlement with a junior creditor unless the court concludes that priority of payment will be respected as to objecting senior creditors," regardless of when the settlement occurs. 725 F.2d at 298.

Respondents contend that the Fifth Circuit's rule is nevertheless "*dicta*" because the court remanded for additional fact-finding. Opp. 12-13. That has it backward. The remand was necessary only *because* the court held that a per se rule applied: "Having ascer-

tained the standard which governs approval of the settlement in this case," *i.e.*, that the settlement must respect priority of payment, the court of appeals then concluded that the record did not contain "a sufficient factual foundation" to determine whether the settlement in fact respected priority. *AWECO*, 725 F.2d at 299. Specifically, there were open questions regarding the assets that would remain in the estate after distribution of the settlement proceeds, leaving it unclear whether the IRS's priority tax claims would be paid in full. *Id.* Subsequent decisions leave no doubt that *AWECO*'s per se rule is the "well-settled" law of the circuit. *In re Buffet Partners, L.P.*, 2014 WL 3735804, at *3 (Bankr. N.D. Tex. July 28, 2014); *see also, e.g.*, *In re Mirant Corp.*, 348 B.R. 725, 738 & n.27 (Bankr. N.D. Tex. 2006); *In re CoServ, LLC*, 273 B.R. 487, 495 (Bankr. N.D. Tex. 2002).

Respondents also assert that the Second and Third Circuits "recognized" *AWECO* as *dicta* and "qualified" it. Opp. 15. But that is doubly wrong. First, neither court shared respondents' flawed reading of *AWECO*. *See In re Iridium Operating LLC*, 478 F.3d 452, 463-464 (2d Cir. 2007) ("[T]he Fifth Circuit *held* that the absolute priority rule should also apply to pre-plan settlements[.]" (emphasis added)); Pet. App. 17a (the Fifth Circuit "*held* that the 'fair and equitable' standard applies to settlements, and 'fair and equitable' means compliant with the priority system" (emphasis added)). Second, after correctly perceiving the Fifth Circuit's "per se rule," both other courts expressly rejected it, adopting instead a rule with, as the Third Circuit described it, "more flexibility" to approve priority-skipping distributions. Pet. App. 20a; *see also Iridium*, 478 F.3d at 464 (rejecting "a *per se* rule" as "too rigid").

This division among the circuits is clear to all observers, save respondents. *See, e.g.*, Illinois Br. 8-10 ("distinct split between the circuit courts on this important issue"); NELP Br. 4-5 ("clear, ripe split among the circuit courts"); Law Professors' Br. 1 ("explicit split … over the role [of] priority"); Rudzik, *A Priority Is a Priority Is a Priority—Except When It Isn't*, 34 Am. Bankr. Inst. J. 16, 16-17, 79 (Sept. 2015) (contrasting Fifth Circuit's "bright-line test" with Second and Third Circuit approaches). Had the Fifth Circuit's rule applied here, the bankruptcy court would have been compelled to reject this settlement for failure to respect petitioners' priority wage claims. Pet. 18.

Respondents identify no reason to think this disagreement will resolve itself absent the Court's intervention, nor any other reason to delay. The fact that the settling parties in this case persuaded the bankruptcy court to approve a priority-skipping distribution of settlement proceeds as a precursor to dismissing the case, rather than as "a prelude to … a reorganization plan" (Opp. 15), makes the departure from the Code's priority scheme more egregious, not less. *Infra* pp. 7-8. And the split is hardly "shallow[]." Opp. 15. The question presented has now been answered—in conflicting ways—by the three circuits in which most large chapter 11 bankruptcies are filed. Pet. 29; NELP Br. 5; Law Professors' Br. 22.

II. THE DECISION BELOW IS INCORRECT

The rule adopted in the Second and Third Circuits has no basis in the text, structure, or purpose of the Code and cannot be squared with this Court's precedent addressing priority. Pet. 19-26. Respondents fail to show otherwise. Indeed, respondents' efforts to defend the decision below in fact illustrate its flaws.

Respondents first argue that §1129(b)(2)(B)(ii) applies by its terms only to plans, not settlements outside of plans. Opp. 16-17. That is true, but no help to respondents. Section 1129 codifies a particular application of the absolute priority rule to chapter 11 plans. If a plan cannot be confirmed, the case may be converted to chapter 7, where again compliance with the §507 priorities is mandatory. 11 U.S.C. §726(a). Allowing debtors and select creditors to collude on a private deal to dispose of estate property outside this framework, in violation of the priority scheme, undermines those provisions and is incompatible with the Code's structure. Pet. 5-7, 20. Respondents do not dispute that the priority-skipping distribution approved here would be flatly unlawful were it embodied in a proposed plan.

Respondents' crabbed reading of §507 is also unsupportable. Opp. 17-18. That section specifies the categories of "expenses and claims [that] have priority" of payment, 11 U.S.C. §507(a), and it applies to all cases, *id.* §103(a). Other provisions of the Code contain detailed exceptions to §507 in limited circumstances. Pet. 20. Thus, where Congress intended to permit a nonconsensual departure from its priorities, it said so. No provision of the Code permits a bankruptcy court to distribute settlement proceeds to creditors in violation of the order of priority specified in §507.

Respondents' insistence that "*no* case" applies §507 to settlements (Opp. 17) is incorrect. Indeed, that is precisely what *AWECO*, *Iridium*, and the decision below all effectively do, in conflicting ways. In respondents' own telling, compliance with "the Code's priority system" should "'*usually be dispositive*'" of whether a settlement is fair and equitable to all creditors. Opp. 19. Section 507 is the very heart of the "priority system." The question is thus not whether §507 applies to

settlements, but rather whether bankruptcy courts may sometimes depart from it on what respondents themselves describe as "policy" grounds. *Id.*

In analogous contexts, this Court has repeatedly made clear that bankruptcy courts are not free to second-guess the categorical judgments Congress made in §507. Pet. 21-23. Certainly, whatever residual equitable authority bankruptcy courts possess under §105(a) does not permit them to do so, as respondents effectively concede. *See Law* v. *Siegel*, 134 S. Ct. 1188, 1195 (2014) (equitable powers "may not be exercised in contravention of the Code"); *Zachary* v. *California Bank & Trust*, ---F.3d---, 2016 WL 360519, at *6 (9th Cir. Jan. 28, 2016) ("Our task is not to balance the equities, however, but to interpret the Bankruptcy Code."). Disavowing §105(a), respondents point instead to Bankruptcy Rule 9019 as the putative source of authority to approve a priority-skipping settlement. Opp. 18 n.3. But Rule 9019 is procedural, not substantive; as the Rules Enabling Act makes clear, it cannot authorize any actions that the Code does not permit. 28 U.S.C. §2072(b) ("[R]ules shall not abridge, enlarge, or modify any substantive right."); *see* Law Professors' Br. 8-11.

As a last resort, respondents reprise their argument below that the result here is defensible as the "least bad alternative," given the estate's administrative insolvency. Opp. 10, 20-21. That assertion is flawed on a number of levels. First, Congress has already made a considered decision to afford petitioners' wage claims priority over the claims of general unsecured creditors, and "it is not for courts to alter the balance struck by the statute" even in the face of allegedly "inequitable results" or "economic harm." *Law*, 134 S. Ct. at 1197-1198; *see* Pet. 22; NELP Br. 13-14. Second, if anything, the justification for a departure

from the priority scheme is at its weakest in a case where there is no prospect of a confirmable plan. If no plan is on the horizon, and the settlement is proffered to the bankruptcy court as a final distribution of estate assets, a class-skipping feature can have no purpose other than to effect an end-run around Congress's priority scheme—as illustrated by this case. And third, an alternative arrangement that complied with the Code's priorities was "impossible" here only because Sun refused to pay any money to petitioners. Pet. 11, 27-28, 30-31; *see* Pet. App. 25a (Scirica, J., dissenting) (putative lack of alternatives was, "at least in part, a product of [respondents'] own making").[1]

Claims of necessity or hardship cannot justify approving a distribution of estate assets outside a plan in a manner that violates the priority scheme. The rule of absolute priority has been a bedrock of bankruptcy practice for a century. Pet. 23-26. It protects and effectuates the policy judgments Congress made in affording some claims priority over others. The decision below disregards those judgments and should be reversed.

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[1] It is very much *not* "undisputed" (Opp. 21) that Sun and CIT had claims on the estate that would have precluded petitioners' priority wage claims from being paid in any event. The validity of Sun and CIT's liens on Jevic's remaining assets was at issue in the fraudulent transfer action, the settlement of which gave rise to this controversy. Pet. 9-12. And, in any event, the proceeds of a fraudulent conveyance action constitute a post-petition asset that falls outside the scope of pre-petition liens. 11 U.S.C. §552(a).

III. THE PETITION SQUARELY PRESENTS A QUESTION OF EXCEPTIONAL PRACTICAL IMPORTANCE

Whether a bankruptcy court may distribute estate assets to creditors outside a confirmed plan in a manner that violates the Code's priority scheme is a question of exceptional importance to the practical workings of chapter 11 proceedings. Pet. 26-31.

Respondents contend that it would be "inappropriate" to address that question here because petitioners supposedly invited the error below. Opp. 24-25. Not so: Petitioners consistently argued that "[t]he diversion of settlement proceeds for the benefit of general unsecured creditors," skipping petitioners' claims, "violates the Code's priority system." Appellants' C.A. Br. 35 (capitalization altered); *accord* Appellants' C.A. Reh'g Pet. 8 ("impermissible end run around the priority scheme mandated by Congress"). Both respondents and the panel majority correctly understood that position, the latter noting petitioners' "primary argument" that structured dismissals "cannot be approved if they distribute estate assets in derogation of the priority scheme." Pet. App. 15a; *see* Appellees' C.A. Br. 28-29 (petitioners "insist that … the settlement does not comport with the Code's priority system"). The court of appeals rejected the argument, and petitioners now seek review of that error.

What respondents point to as "gamesmanship" (Opp. 25) is merely petitioners' argument below that even *Iridium* would not support the result here. *E.g.*, Appellants' C.A. Reh'g Pet. 7 ("*AWECO* flatly prohibits" priority-skipping settlements, while "*Iridium* prohibits the sort of bankruptcy-exiting, class-skipping settlement authorized in this case"); Appellants' C.A. Reply Br. 13 ("more egregious than the priority skip-

ping in *Iridium*").[2] The fact the court of appeals' decision goes one step further beyond the pale than the Second Circuit did in *Iridium* is hardly a reason to *deny* review.

Respondents are also wrong to suggest that the question is unimportant because it has been addressed in "[o]nly three appellate decisions" in "more than thirty years." Opp. 15, 23.[3] Counting reported decisions in this context is misleading. The "disputed cases that reach the appellate courts are just the tip of the iceberg," NELP Br. 6, and do not accurately reflect the significance of the issue in practice. Many structural features of bankruptcy litigation—including time pressure and scarcity of resources—make pursuing an appeal to final judgment difficult, especially for "small creditors such as employees and consumers." *Id.* 7. More broadly, the threat of a priority-skipping distribution outside a confirmed plan will profoundly affect (and is already profoundly affecting) the negotiating position of all priority creditors in chapter 11, whether or not such a distribution is ultimately proposed or approved. Pet. 29-31; Law Professors' Br. 16-17; NELP

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[2] Petitioners explained, in particular, that the Second Circuit did not actually affirm the priority-skipping feature of the settlement in *Iridium*, but rather remanded for reconsideration with the caution that the bankruptcy "court must be certain that parties to a settlement have not employed a settlement as a means to avoid the priority strictures of the Bankruptcy Code," 478 F.3d at 464, as was manifestly the case here. Appellants' C.A. Reh'g Pet. 13-14; *accord* Pet. App. 29a-30a (Scirica, J., dissenting); Illinois Br. 10-11.

[3] Although respondents return to the point repeatedly (Opp. 1, 15-16, 23), they fail to explain why the fact that *AWECO* was decided thirty years ago militates against review. The Second and Third Circuits disagreed with it recently.

Br. 14-15. Respondents do not controvert that point, arguing only that priority creditors should not have the same protections "in the *settlement* context" as "in the *plan* context." Opp. 23. That, of course, begs the question whether parties may evade the Code's priority scheme by distributing the assets of the estate outside a plan; it does nothing to diminish the practical importance of the issue.

Finally, respondents' reassurance that the sort of deviation from the priority scheme permitted here will prove "rare" is based on nothing more than the panel majority's own similar assertion. Opp. 22; Pet. App. 21a-23a. As Judge Scirica explained in dissent, however, the circumstances that were held to justify this settlement are hardly "*sui generis*." Pet. App. 31a; *see* Law Professors' Br. 15 ("garden-variety failed leveraged buyout"). Many other supposedly "rare" exceptions have later proven to be common in practice. Pet. 27-28. If select parties to a bankruptcy may "agree on a distribution of the debtor's assets in a way they prefer, rather than according to the Code's priority scheme," Illinois Br. 2, there is every reason to expect that they will seek to do so routinely.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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