No. 15-649

IN THE

Supreme Court of the United States

CASIMIR CZYEWSKI, *et al.*,

Petitioners,

v.

JEVIC HOLDING CORP., *et al.*,

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Third Circuit

BRIEF FOR *AMICI CURIAE* LAW PROFESSORS IN SUPPORT OF RESPONDENTS

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

CASES Page(s)

TABLE OF AUTHORITIES—Continued

TABLE OF AUTHORITIES—Continued

TABLE OF AUTHORITIES—Continued

OTHER AUTHORITIES Page(s)

TABLE OF AUTHORITIES—Continued

Page(s)

INTEREST OF THE *AMICI CURIAE*[1]

The *amici curiae,* whose names are set forth below are law professors at various universities, where they teach courses on bankruptcy law, conduct research, and are frequent speakers and lecturers at seminars and conferences on bankruptcy law. Professor Carlson was recently cited by this Court in *Bank of America v. Caulkett*, 135 S.Ct. 1995 (2015). They write based solely on their concern about the effect that this Court's opinion may have more broadly on bankruptcy jurisprudence and other cases.

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Petitioners ask this Court to rule that the absolute priority rule, as now codified in 11 U.S.C. § 1129(b), is a *mandatory* requirement for approval of the bankruptcy settlement and dismissal which occurred below. The Third Circuit correctly ruled that it is an

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[1] Pursuant to this Court's Rule 37.3(a), all parties submitted letters to the Clerk granting blanket consent to *amicus curiae* briefs. Pursuant to Rule 37.6, *amici* affirm that no counsel for a party authored this brief in whole or in part, and that no person other than *amici* or their counsel contributed any money to fund its preparation or submission.

important consideration only, but is not mandated by statute. We agree.

The *amici*, as law professors, submit this brief to address the overbroad and misstated notion of the role of the absolute priority rule in bankruptcy jurisprudence, which is deeply misstated as framed by Petitioners. In so doing, they have presented a portrayal of the absolute priority rule as an overarching principle of chapter 11 that controls all dispositions. It does not. Instead, it has historically developed as a limited doctrine, as recently summarized: "[T]here is no absolute priority rule of the kind described in the literature under current law. It is not clear that there ever has been such a rule. And even if there were, adopting such a rule would be inconsistent with chapter 11, or any other sensible system of reorganization."[2]

Indeed, the U.S. Trustee has argued that the statutory absolute priority rule of section 1129(b) is *not* the proper issue here, and that in the decisions below there was a "conflation" of section 507 with section 1129(b).[3] This "conflation" in truth worked an important distortion in the arguments of Petitioners, as these two sections are profoundly different. Thus, the United States Trustee's position supports our view here that this is not a proper case to expand the role of absolute priority, either in the context

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[2] Stephen J. Lubben, *The Overstated Absolute Priority Rule*, 21 FORDHAM J. CORP. & FIN. L. 581 (2016).

[3] *See infra* for discussion on the improper "conflation" of absolute priority with the significantly different issue of the application of § 507 in this case.

presented here, nor as an overarching principle applicable in other business and individual cases.

We also write out of a concern that the arguments advanced here, which seek an expansive view of absolute priority, will have harmful consequences in other areas of bankruptcy practice. The absolute priority rule, and its "new value" corollary, controls the outcome in many business cases, such as single asset real estate cases, and is currently the subject of divided judicial decisions in individual chapter 11 cases.[4] This case, however, is not the appropriate vehicle for addressing broader concerns about the scope of the absolute priority rule. The development of the doctrine of absolute priority in those contexts should await a more proper vehicle for addressing this important issue.

Accordingly, the *amici* submit this brief in support of affirmance of the Third Circuit decision. Chapter 11 settlements should be permitted without a mandatory requirement that such settlements comply with the absolute priority rule.

SUMMARY OF THE ARGUMENT

The central issue in this case is whether the distribution of settlement proceeds in bankruptcy cases must *always* comply with the Code's priority

[4] *See e.g., Zachary v. California Bank & Trust,* 811 F.3d 1191, 1196 (9th Cir. 2016) noting, "A significant split of authorities has developed nationally among the bankruptcy courts" regarding application of the absolute priority rule to individual chapter 11 debtors.

scheme.[5] History and precedent make clear the answer is no.

First, Petitioners seek to engraft the absolute priority rule onto settlements and dismissals by constructing an argument that relies almost entirely on an overstated and historically inaccurate view of the role of absolute priority. Thus, they write, "the single most important principle of Chapter 11 is the rule of absolute priority. . ." (Cert. pet. 3.) Absolute priority is, at some points, framed as the dispositive issue: "[S]trict adherence to absolute priority when distributing settlement proceeds is critical. . ." (Cert. pet. 25.)

The absolute priority rule, however, is not the most important principle of Chapter 11, nor does it have the meaning ascribed to it by Petitioners. The development of the doctrine of absolute priority has been far more restrained and limited than urged by Petitioners, and has consistently been limited by "equitable" and "pragmatic" considerations. It was not, as urged here, an unbending and inflexible doctrine.

Second, the plain meaning of the Code demonstrates that absolute priority only applies in the context of a plan of reorganization. Both the United States Trustee, as *amicus*, and the Solicitor General, acknowledged that the absolute priority issues had been "conflated" (in the litigation below) with the

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[5] The question presented is, "Whether a bankruptcy court may authorize the distribution of settlement proceeds in a manner that violates the statutory priority scheme." (Cert. pet. (i)). While the Petitioners address other priority sections, its view of the absolute priority rule dominates much of its argument.

priority scheme in section 507.[6] This argument acknowledges that the absolute priority under section 1129(b) only applies to a plan of reorganization, and that therefore this case does not raise an issue as to the meaning of the absolute priority rule.

Third, nor is section 507 necessarily implicated here, which is the foundation for the Petitioner's "statutory scheme" argument (as distinct from "absolute priority"). However, as a leading scholar writes, the Code contemplates numerous pre-plan dispositions, such as sales and settlements, none of which are expressly or impliedly tied to section 507.[7]

Fourth, a needless expansion of the absolute priority rule would adversely affect both business cases and individual cases by hampering the ability of debtors to reorganize. The full import of the absolute priority rule has been the subject of substantial controversy, both in business cases and individual chapter 11 cases. This case should not be a stalking horse to address the full scope of absolute priority. Its full meaning should await a case which squarely addresses the doctrine.

Accordingly, we urge the Court to affirm that the legal standard for testing settlements and dismissals in Chapter 11 does not embrace the absolute priority rule.

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[6] The United States Trustee argued that, "it appears that the bankruptcy court conflated section 507 with the absolute priority rule codified in section 1129(b)(2)(B)(ii)." Resp. Sup. Br,, App. 8a.

[7] Lubben, *supra* note 2.

ARGUMENT

I. Petitioners have overstated the scope and historical role of the absolute priority rule.

A. The absolute priority rule was limited by Congress in 1978 to apply only to a plan of reorganization.

Petitioners assert that this Court need not reach the underlying issue of whether a structured dismissal can ever be permitted.[8] Instead, they initially focused this appeal on the narrow issue of whether, when permitted, a bankruptcy court *must* test the settlement by a mandatory application of the absolute priority rule, which they argue is found in 11 U.S.C. § 1129(b)(2)(B)(ii) of the Code ("1129(b)").[9] Their argument, in short, is that the protections afforded creditors in a formal plan of reorganization somehow must apply in a vastly different disposition, namely a settlement coupled with dismissal.

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[8] *Neither* party asks this Court to address the threshold question of whether structured dismissals are, or are not permitted by the Code. ("It is not necessary to reach that broader question. . ." Cert pet. 20). Accordingly, Petitioners have conceded that structured dismissals are permitted in some cases.

[9] In their principal brief, Petitioners shifted the weight of their argument from "absolute priority" to the priority scheme found in section 507. (*See* discussion below.) Neither pertain here. Yet, this important shift also underscores that the issue before this Court does not require resolution of the full meaning of the absolute priority rule.

The foundation of Petitioners' argument may be seen in two key statements. They write, "the single most important principle of Chapter 11 is the rule of absolute priority. . ." (Cert. pet. 3.) Petitioners also write, "Strict adherence to absolute priority when distributing settlement proceeds is critical to effectuate and protect the choices Congress made in affording some claims priority over others." (Cert. pet. 25.) A substantial portion of its certiorari petition is devoted to this argument. *See* cert. pet. 23 *et seq*. Thus, Petitioners seek to unmoor absolute priority from section 1129(b) and to make it a universal concept governing all dispositions of estate property.

These foundational assertions are incorrect. They vastly overstate the role of absolute priority in bankruptcy jurisprudence, and therefore wrongly attempt to engraft a limited statutory concept onto a procedural device that does not reflect nor require applying the absolute priority rule. "The academic conception of the absolute priority rule in corporate reorganization is based on a world that does not exist. . . . Reorganization in reality is fundamentally inconsistent with heartfelt fondness for a strict absolute priority rule." Lubben, *supra*, at 585.

The error in Petitioners' position may be seen in the long history of the absolute priority rule, which is a steady march against the overly rigid and broad application of the rule. A brief summary is as follows: the phrase "absolute priority" was never used in any version of the Bankruptcy Act or the Code: instead, the concept of "fair and equitable" was a judge made principle that had its origins in the railroad receivership cases of the early twentieth

century, [10] and was designed to prevent collusion between shareholders and bondholders. The "fair and equitable" concept initially prevented any agreement which did not pay senior creditors before junior creditors, even where a large majority of the class of creditors had otherwise voted for a plan. The doctrine developed over two distinct paths (later Chapter X and XI);[11] initially overstrict and unbending, absolute priority was historically an impediment to reorganization and was expressly *deleted* in 1952 from former Chapter XI. After the complete overhaul of the Bankruptcy Code in 1978 the absolute priority rule was consciously limited by Congress to apply only in certain contexts related to a formal plan of reorganization, but one which permitted a class of creditors to outvote a dissident provided it received at least what it would have received in a Chapter 7 liquidation. *See Bank of Am. Nat'l Trust & Sav. Ass'n. v. 203 N. LaSalle St. Pt'ship.,* 526 U.S. 434, 448 (1999); *see also* Douglas G. Baird, *Elements of Bankruptcy,* 240-43 (6th ed. 2014)(describing plan confirmation process). Thus, the "best interest" test of 11 U.S.C. § 1129(a)(7) is the statutory protection for a

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[10] "Federal courts entered the reorganization business with the advent of the equity receivership. Use of this device blossomed in the late nineteenth century as a means to keep the railroads running. . . Court supervised receiverships remained the predominant means of corporate reorganization for about a half century until federal reorganizations laws were enacted during the Great Depression." Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5 (1995) ("History").

[11] Chapter X of the prior [Chandler Act] and Chapter XI of the prior Act, each of which were later merged into modern Chapter XI under the Code. *See* Tabb, History*, id.*

dissenting creditor who was outvoted, and *not* the absolute priority rule. [12]

The absolute priority rule had its "genesis in the judicial construction of the undefined phrase "fair and equitable," and it is commonly traced to the equity receivership case of *Northern Pacific Railway Co. v. Boyd,* 228 U.S. 482 (1913)." The fair and equitable doctrine as initially framed in *Boyd* demonstrated the persistent problem with the doctrine, and why today it is not the overarching principle suggested by Petitioners. Its literal application would have precluded *any* agreed upon restructuring, despite overwhelming support by most creditors, where even a single creditor objected. "If purposely or unintentionally a *single creditor* was not paid, or provided for in the reorganization, he could assert his superior rights against the subordinate interests of the old stockholders in the property transferred to the new company." *Boyd,* 228 U.S. at 502. Justice Lurton dissented, noting that it was unfair for a "single creditor who comes forward many years after a judicial sale" and objects based on priority of distribution. *Id* at 511-512. This narrow view of "fair and equitable" (not yet so named) was soundly criticized by leading members of the bar as impeding reorganizations. [13]

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[12] Section 1129(a)(7) provides that with respect to an impaired class, it must either have accepted the plan or "each holder of a claim" of such class "will receive or retain under the plan. . . not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date. . ."

[13] This strict view was attacked by a leading New York reorganization lawyer, Paul Cravath, who stated that it materially reduced the opportunities for stockholders to participate in a reorganization. Kenneth N. Klee and Whitman L. Holt,

The phrase "fair and equitable" first appears in a bankruptcy statute in § 77B of the prior Bankruptcy Act, 48 Stat. 912, 11 U.S.C. § 207.[14] The stricter view of "fair and equitable" in prior section 77B(f) required both class approval of a plan *and* compliance with the fair and equitable standard. *Id*. at 8. This meant that a plan could not be approved even if accepted by the required votes of the class of creditors; a single creditor had veto power over a plan of reorganization. It was this stultifying view that was to lead to its shrinkage and challenge, continuing through today.

In the early interpretation of "fair and equitable" Justice Douglas used the phrase "absolute priority" when discussing "fair and equitable," thus creating some needless confusion between the two. The first major "fair and equitable" case in which the Court interpreted Bankruptcy Act § 77B, was *Case v. Los*

Bankruptcy and the Supreme Court: 1801-2014, p. 294-295 (West, 2015). Cravath noted that in most large reorganizations it was still the preference of bondholders' committee's to afford stockholders participation in order to avoid litigation and delay and "partly to secure new capital." *Id.* at 295.

[14] "The Bankruptcy Act of 1898 marked the beginning of the era of permanent federal bankruptcy legislation. The 1898 Act remained in effect for eighty years, until being replaced by the Bankruptcy Reform Act of 1978 (the "Code"). History, *supra* at 23.

Section 77B sub. f of the Bankruptcy Act provided in part, "After hearing such objections as may be made to the plan, the judge shall confirm the plan if satisfied that (1) it is fair and equitable and does not discriminate unfairly in favor of any class of creditors or stockholders, and is feasible; (2) it complies with the provisions of subdivision (b) of this section; (3) it has been accepted as required by the provisions of subdivision (e), clause (1) of this section . . ." Bankruptcy Act, § 77B, Act of June 7, 1934, ch. 424, § 77B, 48 Stat. 912-22, 11 U.S.C. § 207 (1934).

Angeles Lumber Products Co, 308 U.S. 106 (1939). Section 77B "nowhere states that claims must be paid by a principle of absolute priority."[15] However, Justice Douglas stated that the phrase "fair and equitable" were words of art that had acquired a meaning in the railroad receivership cases. Thus, he held that a plan was not fair and equitable, even though approved by the required class votes under section 77B if it violated the notion that "stockholders' interest in the property is subordinate to the rights of creditors. . ." *Id*. at 116.[16] Justice Douglas' statement that fair and equitable required absolute priority in payment based on prior decisions has since been questioned by some leading scholars.[17]

Even in *Case,* however, this Court did not require absolute compliance with absolute priority, and held that the doctrine must give way to practical considerations. The decision in *Case* acknowledged the power of a small group of dissenting creditors to prevent an otherwise agreed upon restructuring.[18] A

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[15] John D. Ayer, *Rethinking Absolute Priority After Ahlers*, 87 Mich. L. Rev. 963, 974 (1989).

[16] "Any arrangement of the parties by which the subordinate rights and interests of stockholders are attempted to be secured at the expense of the prior rights of either class of creditors comes within judicial denunciation."

[17] Professor Ayer writes that the notion that "fair and equitable" had come to reflect the absolute priority rule was "strictly speaking. . . poppycock, and Justice Douglas knew it. None of the Supreme Court's absolute priority cases used that particular phrase in that particular way." Ayer, *supra* at 975.

[18] The objecting creditors held $18,500 face amount of bonds in a class which had claims totaling $3,807,071. 80% of the bondholders and 90% of the stockholders approved the plan. *Id*. at 110-112.

minority group of dissenting creditors could veto a plan that was otherwise essential based on strict compliance with absolute priority. Thus, Justice Douglas acknowledged that there were "circumstances under which stockholders may participate in a plan of reorganization of an insolvent debtor" even where senior creditors were not paid in full (or anything). *Id*. at 121.

> In application of this rule of full or absolute priority this Court recognized certain *practical considerations* and made it clear that such rule did not 'require the impossible, and make it necessary to pay an unsecured creditor in cash . . . And it also recognized the necessity at times of permitting the inclusion of stockholders on payment of contributions. . . In such *or similar* cases the chancellor may exercise an informed discretion concerning the practical adjustment of the several rights. *Id*. at 117 (emphasis added).

This of course was the genesis of the "new value" corollary,[19] but more importantly, the recognition that

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[19] *See Bank of Am. Nat'l Trust & Sav. Ass'n. v. 203 N. LaSalle St. Pt'ship.,* 526 U.S. 434, 449 (1999):

> The upshot is that this history does nothing to disparage the possibility apparent in the statutory text, that the absolute priority rule now on the books as subsection (b)(2)(B)(ii) may carry a new value corollary. Although there is no literal reference to "new value" in the phrase "on account of such junior claim," the phrase could arguably carry such an implication in modifying the prohibition against receipt by junior claimants of any interest under a

still stands today: a Chapter 11 plan can be confirmed which does not comply with the notion that senior creditors must always be paid in full before junior creditors. It was an essential part of the development away from single creditor or minority creditor veto power. "Practical considerations," "discretion" and "practical adjustments" may be required, and are permitted.

Thus, long before this Court found a textual basis in the 1978 Code for the "new value corollary," Justice Douglas had held that absolute priority is not always mandated, and must, at times, give way to practical necessity. His ruling, in this sense, is deeply consistent with the Bankruptcy Court's ruling that absolute priority is a "consideration" but not a barrier to effective relief in all cases.

Ultimately, the fair and equitable standard was deleted from a major portion of the bankruptcy laws. Section 77B of the Bankruptcy Act was amended in 1938 by Chapter X, 52 Stat. 883, 11 U.S.C. § 501 *et seq*. (The Chandler Act).[20] Two distinct kinds of business reorganizations now emerged, with two profoundly different views of absolute priority. One was Chapter X which governed corporate reorganizations, and the other Chapter XI which governed

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plan while a senior class of unconsenting creditors goes less than fully paid.

[20] "The fury of bankruptcy legislation in the 1930's came to a head in 1938 with the passage of the comprehensive Chandler Act." History, *supra* at 29. "The Chandler Act, c.10, 52 Stat. 840, 893, § 101 *et seq*. 11 U.S.C.A. § 501 *et seq*. approved June 22, 1938 now supplants § 77B." *Boyd*, *supra* at 119, n 14.

arrangements.[21] Chapter XI deleted the fair and equitable test altogether "because its presence impaired or made valueless the relief provided by those Chapters." Klee at 304, n. 2368, citing S. Rep. No. 1995, 82d Cong., 2d Sess. 11 (1952).[22]

Absolute priority was not the most important doctrine of bankruptcy law under prior Chapter XI. *See generally* Ayer, *supra* at 976-77. "This absolute priority rule had never been a principle of composition law. Quite the contrary, the point was that a creditor might be bound to anything he agreed to in a composition. This was part and parcel of the theory of composition: if you had to pay the full going concern value of the enterprise to your creditors, even though

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[21] History, *supra* at 30. For a brief discussion of "arrangement" under former Chapter XI see *Sec. & Exch. Comm'n v. Am. Trailer Rentals Co.,* 379 U.S. 594, 605–06 (1965), stating as follows:

> Chapter XI is a statutory variation of the common-law composition of creditors and, unlike the broader scope of Chapter X, is limited to an adjustment of unsecured debts. . .
>
> [Chapter XI was] a quick and economical means of facilitating simple compositions among general creditors who have been deemed by Congress to need only the minimal disinterested protection provided by that Chapter.

[22] "Before the 1952 Amendment to Chapter XI, Bankruptcy Act of 1938 § 366(3), 11 U.S.C. § 766(3) (1940) provided that the bankruptcy court could confirm the Chapter XI plan of arrangement only if, inter alia, it is "fair and equitable." Pub. L. No. 75-696, ch. 575 (§ 366(3) 52 Stat. 840, 912 (1938). The 1952 amendment, however, deleted the fair and equitable test and moved the feasibility test into paragraph (2) of Bankruptcy Act § 366." Klee, *supra* note 13, at 304, n. 2386.

they might agree to accept less, composition was never possible." *Id*. at 978.

In 1978 Congress adopted the current Code, merging Chapter X and Chapter XI into the modern Chapter 11. The Report of the Bankruptcy Commission, acting as the "fountainhead of learning," "proposed to emasculate substantially the absolute priority rule."[23] While Congress did not accept this proposal, neither did it "codify any authoritative pre-Code version of the absolute priority rule." *Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. Pt'ship.,* 526 U.S. at 448 (1999). The 1978 Code adopted "a modified absolute priority rule." Ayer, *supra* at 978. The House Report states that "[t]he elements of the [fair and equitable] test are new[,] departing from both the absolute priority rule and the best interests of the creditors found under the Bankruptcy Act." H.R. Rep. No. 95-595 (1977).

This history is at best equivocal and uneven; it offers no basis to conclude that Congress meant to enlarge either the "fair and equitable" doctrine or the statutory absolute priority rule. Absolute priority is not an overarching application that must be applied in every form of disposition, nor without concern for pragmatic concerns. It does not support the foundational argument advanced here that the absolute priority rule is the "most important principle" of Chapter 11. Absolute priority was expressly limited to plan confirmation, and nothing else. The absolute priority rule should not be applied to this case, nor to any context outside of a plan of reorganization.

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[23] Ayer, *supra* at 978.

II. The absolute priority rule in 11 U.S.C. § 1129(b) does not pertain to this case and does not govern settlements.

A. Both the U.S. Trustee and the Solicitor General have acknowledged that this case does not involve application of the absolute priority rule of section 1129(b).

The plain meaning of the Code is straightforward: absolute priority only applies to a plan of reorganization, and nothing more. This of course was one of the core rulings by the Bankruptcy Court and District Court below and is unassailable. *In re Jevic Holding Corp,* Pet. App. 58a. ("[T]he settlement does not follow the absolute priority rule. However, this is not a bar to the approval of the settlement *as it is not a reorganization plan.*" (Pet. Cert. Br. 42a. (Emphasis added.)

That section 1129(b) and the statutory absolute priority rule is not the controlling standard for this case is consistent with arguments made below by the U.S. Trustee and later the Solicitor General before this Court. Thus, in its *amicus* brief to the Third Circuit, the U.S. Trustee wrote: "it appears that the bankruptcy court conflated section 507 with the absolute priority rule codified in section 1129(b)(2)(B)(ii). Under the absolute priority rule, general unsecured creditors may not receive any distributions *under a plan* unless objecting priority creditors have been paid in full." Resp. Sup. Br. App. 8a. (Emphasis added.)

At oral argument, the U.S. Trustee made the same argument, stating that "there was an undue focus or—or a conflation between Section 1129, which sets

out a somewhat different Absolute Priority Rule as-as *it applies to plans*." (Resp. Supp. Br., App. 30a-31a)(emphasis added).

The Solicitor General likewise made the same acknowledgment, and described this conflation as follows:

> In discussing the governing legal principles, the court below referred repeatedly to the "absolute priority rule." See Pet. App. 16a-17a. The term "absolute priority" is most accurately used to refer to the requirements in 11 U.S.C. § 1129(b) that junior classes of creditors may not be paid through a plan of reorganization unless senior classes of creditors either are paid in full or consent to an impairment of their rights.

Brief for the United States as amicus, in support of cert., p. 14, n.2.

And lastly, in its principal *amicus* brief, the United States again acknowledged this underlying confusion in terminology, noting that the "'absolute priority rule' is most accurately used to refer to the requirement in 11 U.S.C. § 1129(b)" and that for some reason this section was used to "encompass the additional rule" found in § 507. Brief for United States, at 22.

The absolute priority rule however, is more than "somewhat different" than section 507, and it is not "encompassed" within section 507 in any fashion. Nor was it merely the court below that conflated the statutory terminology. This oft repeated conflation runs throughout the Petitioners' certiorari petition. In their petition, Petitioners expressly argued that

the Second and Third Circuit's rule (approving settlements) "is also discordant with this Court's case law addressing absolute priority, a central structural feature of the Bankruptcy Code." Pet. 23. This argument concerning the dispositive role of absolute priority forms a significant portion of the petition for certiorari. *See* Pet. 25 *et. seq*.

This "conflation" is not inconsequential. It puts in focus that the true issue is *not* the absolute priority rule. In view of the briefing subsequent to the petition for certiorari, it is now unlikely that any party will contend that the statutory absolute priority rule, with its unique history (see above) is the actual issue in this case. At most, this is a case about the applicability, if any, of section 507 to settlements.

A second layer of conflation throughout this case occurs when Petitioners argue that "fair and equitable" somehow *always* imports "absolute priority." It does not. As a matter of statutory interpretation, the phrase "fair and equitable' does not mean the same as the "absolute priority rule."[24] This Court said as

[24] It may be accurate that absolute priority was "incorporated" into a statutory standard for Chapter 11 plan confirmation, but the broader suggestion that "absolute priority" is *always* baked into the *judicial* "fair and equitable" standard, and that any reference, in any context to "fair and equitable" (settlement or other) must therefore mean compliance with absolute priority is required is simply incorrect. See *In re Genesis Health Ventures, Inc.*, 266 B.R. 591, 612 (Bankr. D. Del. 2001) explaining that the condition that "a plan be fair and equitable with respect to a class *includes* the following requirements." 11 U.S.C. § 1129(b)(2) (emphasis added). The statute offers illustrative ways to satisfy the fair and equitable standard for classes of secured and unsecured creditors, as well as for a class of interests."

much: "The elements of the [fair and equitable] test are new[,] departing from both the absolute priority rule and the best interests of creditors tests found under the Bankruptcy Act"). *Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. at 449.

The U.S. Trustee and the Solicitor General were correct that section 1129(b) is not the governing section in this matter, and thus we urge this Court not to frame its decision in terms of the statutory absolute priority rule. That section 507 does not control here is addressed below.

B. The Code permits distributions and dispositions outside of the "statutory priority scheme" of section 507.

Where we part ways with the U.S. Trustee and the Solicitor General is the conclusion that since section 1129(b) is not controlling in this case, that section 507 must be the governing section, which they argue prohibits distributions that do not strictly comply. This of course is the foundation of the argument by Petitioners that what was violated here was, if not the absolute priority rule, then at least the "statutory priority scheme." Section 507, however, is not violated by the approval of the settlement in this case.

As the Third Circuit below held, there is no indication that Congress legislated with settlements in mind, nor that settlements must comply with section 507. *Jevic,* Pet. App. 16a, n. 7. ("If § 103(a) meant that all distributions in Chapter 11 must comply with the priorities of § 507, there would have been no need for Congress to codify the absolute priority rule specifically in the plan confirmation context.")

Equally important, in framing its ultimate ruling, the Third Circuit referred not to section 1129(b), but rather to section 507, holding that a bankruptcy court may "approve settlements that deviate from the priority scheme of § 507 of the Bankruptcy Code only if they have 'specific and credible grounds to justify [the] deviation." 787 F.3d at 184, citing *Iridium,* 478 F.3d at 466. A key part of this ruling is that the focus is on section 507, and not on section 1129(b) and the statutory "absolute priority rule."

Pre-plan distributions, such as in a sale or settlement do not necessarily implicate section 507 nor any other "priority scheme." As Professor Lubben points out, the Code may allow the debtor to distribute assets before the confirmation of a plan, and without reference to any notion of absolute priority or the distribution scheme in section 507. He gives numerous examples of situations in which parties are exempt from the normal rules of distributions, or otherwise are permitted to opt out of "standard" priority schemes, including counter-parties to executory contracts, and critical vendors. *Id*. at 596. Holders of swaps and derivatives are largely exempt from the bankruptcy process. *Id*. at 597. Ironically, the very "priority" which the Petitioners seek in this case is one example of deviation in which one group of unsecured creditors is paid before other unsecured creditors.

Further, Professor Lubben correctly demonstrates that interim distribution, as here, before plan confirmation, which are part of a settlement are a form of distribution and value allocation that are done without any determination of absolute priority. "A debtor in litigation with a counterparty might enter

into a settlement, and that settlement might ultimately provide a greater recovery than the creditor-counterparty would have received if the debtor was liquidated." *Id*. at 597. "The debtor-firm's assets at the end-point of the case are subject to the rule, but those assets might have been significantly reshaped before that point. Moreover, that reshaping may have allowed substantial deviation from the absolute priority rule that would have governed on the day the bankruptcy case commenced." *Id*. at 598.

Thus, the notion that all distribution schemes require adherence to the "statutory priority" scheme is not accurate. Settlements and sales, by their very nature, and interim timing, are the most pertinent examples and govern here.

To a limited extent, this Court has addressed the issues of settlements, although not in the context presented here, and under an entirely different code section. Thus, in *Protective Committee for Independent Stockholders of TMT Trailer Ferry, Inc. v. Anderson,* 390 U.S. 414 (1968) ("*TMT*") the Court was asked to decide whether a bankruptcy court could approve a "proposed compromise forming part of a reorganization plan [as being] fair and equitable." *Id*. at 425. This Court did state that the "requirement . . . that plans be both "fair and equitable" appl[ies] to compromises as to other aspects of reorganizations." *Id*. at 424.

This Court's other rulings in *TMT* demonstrate that settlements may be approved without any showing of "absolute priority" and that the "fair and equitable" doctrine directs a court to consider various equitable factors. For example, in *TMT* this Court stated that if the record had shown an "adequate and intelligent

consideration of the merits of the claims, the difficulties of pursuing them . . . and the fairness of the terms of the settlement. . .” then “it would without question have been justifiable to approve the proposed compromises.” *Id.* at 434.

TMT is not dispositive. First, it was decided under a prior statutory scheme for former Chapter X, (*id*. at 418) and gives no recognition to the deletion of the “fair and equitable” standard in former Chapter XI. It was also ruling only on a settlement that “form[ed] part of a reorganization plan.” *Id*. at 425. The Second Circuit squarely rejected the notion that *TMT* applies to a settlement “presented for court approval apart from a reorganization plan,” stating that in such cases the priority rule of 11 U.S.C. § 1129 is not necessarily implicated. *In re Iridium Operating LLC,* 478 F.3d 452, 463 (2d Cir. 2007).

What is required, therefore, in order to pass muster with the fair and equitable test, is an adequate and informed consideration of the fairness of the settlement, among other factors.[25] We submit this pragmatic test is the core holding, and is more pertinent to this dispute. Because the bankruptcy court below did in fact, conduct such an investigation, and did make adequate and informed findings, its ruling should not be disturbed. “Here, the Drivers mount no real challenge to the Bankruptcy Court’s

[25] “We recognize four criteria that a bankruptcy court should consider in striking this balance: (1) the probability of success in litigation; (2) the likely difficulties in collection; (3) the complexity of the litigation involved, and the expense, inconvenience, and delay necessarily attending it; and (4) the paramount interest of creditors.” *In re Martin,* 91 F.3d at 393. Respondents challenge whether *Martin* is correct. Even if it does apply, the standards it announces are satisfied in this case.

findings that there was no prospect of a confirmable plan and that conversion to Chapter 7 was a bridge to nowhere." *In re Jevic Holding Corp.,* Pet. App. 14-15a.

III. Petitioners seek an unwarranted expansion of the absolute priority rule that could harm both other commercial and individual bankruptcy cases.

The unwarranted expansion of the absolute priority rule, sought here by Petitioners, would be harmful to modern bankruptcy practice, and would almost certainly injure numerous business debtors as well as individual chapter 11 cases. In short, this case has potential consequences far beyond the Drivers.

One area of potential harm from an undue expansion of absolute priority would occur in the context of commercial real estate cases. Modern bankruptcy practice currently addresses a large number of commercial real estate cases.[26] One report states that, "Since [2012] the volume of real estate restructurings has risen significantly, including the high profile chapter 11 case *In re General Growth, Inc.; In re Extended Stay Inc.; In re Innkeepers USA Trust;* and *In re MSR Resorts Golf Course LLC*.[27] Facilitation of restructuring of commercial real estate, (mostly

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[26] *See generally,* David R. Kuney, *Chapter 11 Cases Involving Real Estate Business,* in COLLIER GUIDE TO CHAPTER 11, KEY TOPICS AND SELECTED INDUSTRIES, ¶ 21.07[8].p 21.114 (Alan Resnick and Henry J. Sommer, ed., 2013).

[27] Kirkland & Ellis, LLP, *Recent Developments in Bankruptcy Law Leave Many Real Estate Finance Issues Unresolved* (March 2012), https://www.kirkland.com/siteFiles/Publications/Alert_031212.pdf.

"single asset real estate cases") has been shown to serve valid policies and macro-economic concerns. [28]

The absolute priority rule and its "new value corollary" is now a dominant consideration in the financial restructuring of commercial real estate cases, both large and small.[29] Real estate restructurings typically look to the new value corollary as the foundation for their restructurings. This is generally true because former owners frequently seek to retain their equity

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[28] Professor Ken Klee writes as follows:

> Contrary to the claim that the common pool problem is the sole or primary basis to evaluate the desirability of allowing SARE debtors access to chapter 11, three principal arguments, developed below, powerfully favor access to chapter 11 to allow SARE debtors an opportunity to reorganize: First, chapter 11 smoothes out market inefficiencies, particularly during massive real estate downturns. Second, federal public policy supports giving property owners a chance to save their investments. Third, macro-economic and social policies favor reorganization of SARE debtors.

Kenneth N. Klee, *One Size Fits Some: Single Asset Real Estate Cases,* 22 CORNELL L. REV. 1 (2002).

[29] Paul B. Lewis, *203 N. Lasalle Five Years Later: Answers to the Open Questions,* 38 J. MARSHALL L. REV. 61, 96 (2004), who writes as follows:

> In practice, the new value exception is overwhelmingly employed in single-asset real estate cases. See David Gray Carlson & Jack F. Williams, *The Truth About the New Value Exception to Bankruptcy's Absolute Priority Rule,* 21 CARDOZO L. REV. 1303, 1305 n.10 (2000) (noting that an empirical survey of post-Ahlers cases shows ninety-two percent of new value cases involve real estate); Lynn M. LoPucki & William C. Whitford, *Preemptive Cram Down*, 65 AM. BANKR. L.J. 625, 645 n.91 (1991)."

ownership through contributing the necessary capital to the debtor entity.

Just as in the railroad cases earlier, the new value corollary is now the key factor at work in commercial real estate restructurings. It permits equity holders to participate in a reorganization and to retain their equity interests, even when unsecured creditors were not paid in full, provided that they agree to provide the necessary capital to restore the debtor to an economically viable entity. On-going value is preserved and liquidation avoided.

Despite the broad application of this corollary to the absolute priority rule, this Court has not issued any definitive ruling on whether the corollary survived the enactment of the 1978 Code. In *203 North LaSalle*, this Court was confronted with a large scale commercial real estate case in which the principal issue was whether the absolute priority rule was subject to the "new value" exception or corollary, which had developed under pre-Code law. This, of course, was the core ruling of *Case v. Los Angeles Lumber*. Justice Douglas had declared that equity holders could participate, even without compliance with the absolute priority rule, when they made an equity contribution that was necessary and essential to the reorganization.

Most commentators agree that this Court implicitly held that the corollary continues to be valid.[30] Lower courts also continue to use it.[31]

Nevertheless, it would not be surprising, that Petitioners, and some of their *amici*, would favor using a decision here as a stepping stone to a hoped-for retreat from this Court's broader view of new value and absolute priority as a way of closing the door to otherwise worthy chapter 11 debtors.

Significantly, both in this case, and others, the United States (as Solicitor General, and as the U.S. Trustee) has challenged the existence of the new

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[30] Paul B. Lewis, *203 N. Lasalle Five Years Later: Answers to the Open Questions,* 38 J. MARSHALL L. REV. 61, 83–84 (2004). ("Courts and commentators have interpreted the Supreme Court's opinion as an implicit recognition of the ongoing viability of the new value exception.")

[31] *See e.g. In re Red Mountain Mach. Co*., 448 B.R. 1, 14–15 (Bankr. D. Ariz. 2011), aff'd, 471 B.R. 242 (D. Ariz. 2012):

> The Supreme Court has addressed the absolute priority rule at least twice since the Ninth Circuit's holding in *Bonner Mall*. First, in the *Bonner Mall* case itself the Supreme Court expressly declined to vacate the Ninth Circuit's opinion. Second, although given the opportunity to overrule the new value corollary as recognized by both the Seventh and Ninth Circuits, the Court expressly declined to do so in *203 North LaSalle*. Instead of overruling their interpretations of the new value corollary, the Supreme Court held that one or two of the five elements of the new value corollary could not be satisfied when old equity retains the exclusive right to contribute the new value . . . .[T]he Supreme Court's holding in *203 North LaSalle* leaves intact the Ninth Circuit's holding in *Bonner Mall* whenever exclusivity has terminated, as it has here.

value corollary, stating its rigid view of absolute priority. In *Ahlers*, similar to its view here, it urged this Court to "hold that codification of the absolute priority rule has eliminated any 'exception' to that rule suggested by *Los Angeles Lumber." Northwest Bank Worthington v. Ahlers*, 485 U.S. 197, n.3 (1988). A similar argument was made in *203 North LaSalle.* This Court, however, found the view of the United States, to be "starchy" and declined to adopt it.[32]

The absolute priority rule is also a matter of national dispute among the various courts as applied in individual chapter 11 cases. Here the issue is whether individual debtors can retain some of their assets [acquired after the bankruptcy case] even if creditors are not paid in full. Thus, the American Bankruptcy Institute recently concluded in its multi-year study of bankruptcy as follows:

> Finally, the issue of the applicability of the absolute priority rule in individual chapter 11 cases has been a fundamental-yet-troublesome issues addressed by the courts. Currently, there is no judicial consensus on whether (and to what extent) the BAPCPA Amendments abrogated the absolute priority rule by excepting postpetition property

[32] "We understand the Government, as *amicus curiae,* to take the starchy position not only that any degree of causation between earlier interests and retained property will activate the bar to a plan providing for later property, Brief for United States as *Amicus Curiae* 11–15, but also that whenever the holders of equity in the Debtor end up with some property there will be some causation. . ." *Bank of Am. Nat. Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 451, (1999).

> and earnings from amended 11 U.S.C. § 1129(b)(2)(B)(ii).[33]

Thus, the universe of debtors who have a major stake in this case, is large, and in particular, if the decision adopts a rigid view of absolute priority. Not only does this case not require any application of the absolute priority rule, but even if it did, it would not require the rigid and overarching doctrine that permeates the arguments of Petitioners.

This case is not the correct vehicle to address the full scope and application of the absolute priority rule. Nevertheless, because Petitioners have used the absolute priority rule as a key part of their foundational argument, they seem to have invited this Court to adopt broad based views on absolute priority which may well spill over, intended or not, into another major area of bankruptcy law without a chance to perceive its full consequences of doing so. We urge this Court not to frame its decision on the basis of "absolute priority."

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[33] American Bankruptcy Institute Commission to Study the Reform of Chapter 11, *Final Report and Recommendations* 318 (2014). *See also, In re O'Neal,* 490 B.R. 837 (Bankr. W.D. Ark., 2013) citing, Andrew G. Balbus, *Continued Disagreements Over the Application of the Absolute Priority Rule to Individuals in Chapter 11: Friedman and Maharaj*, 21 NORTON BANKR. L. & PRAC. 755, 761 (2012).

CONCLUSION

For the foregoing reasons, the decision of the Third Circuit should be affirmed.

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Respectfully submitted,

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