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Bankruptcy Settlements Post-Jevic: Potential New Requirements for Priority-Altering Settlements

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As noted in a recent Distressing Matters **post,** the United States Supreme Court in *In re Jevic Holding Corp.* held that debtors cannot use structured dismissals to make payments to creditors in violation of ordinary bankruptcy distribution priority rules. The *Jevic* dissent complained that the majority avoided the more general question presented—whether a bankruptcy settlement can violate the statutory priority scheme. The bankruptcy court for the Eastern District of Tennessee has addressed that complaint, holding that priority-altering settlements must be "fair and equitable" and promote a significant Code-related objective.

In *In re Fryar*, the bankruptcy court reviewed a settlement involving the sale of the debtor's equity interests in two private ventures. The IRS had a lien on the debtor's equity interests. The settlement proposed using the sale proceeds to pay off a bank lien on certain real estate, rather than using the proceeds to satisfy the IRS. In exchange for the sale proceeds, the bank would release its lien on the real estate and retain a subordinated deficiency claim. The IRS would then receive a lien on the now unencumbered real estate. The bank acknowledged that if the sale proceeds were distributed according to the statutory priorities and the bank merely foreclosed on the real estate, its recovery would be less than half of what it stood to receive under the settlement.

Three unsecured creditors and the United States Trustee objected to the settlement on the basis that it reordered distribution priorities for the benefit of the bank. The bankruptcy court agreed, noting that the settlement allowed the bank to jump "to the head of the line." Absent the settlement, the proceeds would have gone first to the IRS to satisfy its lien on the equity, then to the estate for distribution to priority unsecured creditors (e.g., other unpaid tax claims) and finally to general unsecured creditors on a *pro rata* basis.

The bankruptcy court cited *dicta* from *Jevic* while considering the merits of the proposed settlement:

> **We recognize that *Iridium* is not the only case in which a court has approved interim distributions that violate ordinary priority rules. But in such instances one can generally find significant Code-related objectives that the priority-violating distributions serve. . . . In doing so, these courts have usually found that the distributions at issue would "enable a successful reorganization and make even the disfavored creditors better off." [Citations omitted].**

Applying such guidance, the bankruptcy court determined that the settlement was more of a preamble to a conversion or structured dismissal than an anticipated reorganization and that the debtor did not prove that the settlement promoted a significant Code-related objective. Accordingly, the bankruptcy court sustained the objections to the settlement.

The bankruptcy court's holding essentially establishes a new requirement for acceptance of any priority-altering settlement—post-*Jevic*, debtors wishing to consummate such settlements must now prove not only that the settlements are "fair and equitable" but also that the settlements promote a significant Code-related objective. It remains to be seen whether other courts will demand that debtors meet similar standards for priority-altering settlements.

Authors