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Unsecured Creditor Carve-outs: Chapter 11 Misery Makes Strange Bedfellows[1]

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Companies that sell goods or extend credit to customers expect to be paid. When customers become insolvent, or file for Chapter 11 protection, those expectations are no longer realistic. Yet, there are a number of "creditor remedies" that can be utilized to maximize recovery from the insolvent customer. This article addresses one such "remedy": a carve-out from the pre-petition secured lender. At its essence, a carve-out is a transfer of cash or other value from the lender to unsecured creditors in exchange for a dismissal or waiver of claims held by creditors and/or support of the lender's objectives in the Chapter 11 case (often a quick Section 363 sale).

This remedy is in question recently because a U.S. 3rd Circuit Court of Appeals ruling approved a carve-out, which contradicts a 1984 ruling by the U.S. 5th Circuit Court of Appeals that did not allow a carve-out. The U.S. Supreme Court has granted certiorari to resolve the conflict between the circuits.

The payment priority scheme in Chapter 11 (including Section 507 of the Bankruptcy Code), essentially provides that secured creditors are paid first, next administrative claims (the costs of operating in Chapter 11 including professional fees), next certain priority claims (taxes, wages, employee benefits claims, etc.), next general unsecured claims, and last equity interests. The "absolute priority rule" of Chapter 11 (Section 1129 of the Bankruptcy Code) provides that a class of junior creditors cannot receive a dividend on its claims until all senior creditor classes are paid in full. In many recent Chapter 11 cases, there is little value to distribute after satisfaction of the secured claims. As such, unsecured claims often receive a minimal distribution, and equity interests are almost always cancelled.

However, the Bankruptcy Code also provides unsecured creditors an active role and meaningful standing in a Chapter 11 proceeding through a Chapter 11 creditors' committee.

In Chapter 11 cases where the secured lender is "underwater" and the trade creditors appear to be "out of the money", unsecured creditors can nevertheless receive a dividend as a result of the creditors' committee's exercise of its powers in the Chapter 11 case. The creditors' committee may object to motions for DIP financing, motions for approval of Section 363 sales, motions for incentive compensation for executives, and motions to confirm a plan of reorganization. Moreover, the creditors' committee has the power to investigate, and possibly bring actions with respect to, pre-petition transactions between the debtor and various parties including the lender, insiders and the debtor's significant contract counter-parties.

The exercise of these remedies is often channeled into a "settlement" between the creditors' committee and other Chapter 11 stakeholders, including the secured lender, who favors a quick and uncontentious Chapter 11 process. The settlement can be in the form of a "structured dismissal" stipu-

[1]Shakespeare's "The Tempest," shipwrecked Trinculo takes shelter with a native islander stating "misery acquaints a man with strange bedfellows."

lated by the parties, where the secured lender, in essence, gifts a portion of its recovery to unsecured creditors in exchange for the creditors' committee agreement to stand down on pursuing its various rights and remedies on behalf of unsecured creditors in the Chapter 11 case.

The rub is that such settlements arguably violate the Section 507 payment priority scheme and the "absolute priority rule" because the class of unsecured creditors receives a distribution while creditor classes with higher priority receive little or no distribution, certainly not payment in full. Creditors and the lenders argue that the lender is free to gift its property to any party it wishes, in this case, to the unsecured creditors. Legally, the "absolute priority rule" should not apply to settlement agreements that are independent of a proposed plan of reorganization. By contrast, the priority creditors who receive nothing (often tax and employee claims) argue that such structured settlements are tantamount to plans that ignore the Chapter 11 priority rules.

In the Chapter 11 case of Jevic Holding Corp., in May, 2015, the Delaware Bankruptcy Court approved a settlement agreement between the debtor, the creditors' committee, Sun Capital (the private equity owner), and the pre-petition lender, under which the lender provided cash (a "carve-out") and other concessions in exchange for the committee's dismissal of certain avoidance actions against the lenders and Sun Capital, over the objection of disgruntled and unpaid employees. On appeal, the U.S. District Court, and the 3rd Circuit Court of Appeals, affirmed the Delaware Bankruptcy Court's ruling and approved the structured dismissal.

However, the 5th Circuit of Appeals, in the case of AWECO, Inc., ruled that a carve-out agreement was not "fair and equitable" to the IRS as a higher priority creditor, and violated the Chapter 11 payment priority scheme. Based on the AWECO precedent, the employees in Jevic petitioned the U.S. Supreme Court to grant certiorari, to resolve the conflict among the circuits, and reverse the Jevic case. The U.S. Supreme Court solicited from the U.S. Department of Justice (representing the IRS) its view of the issue, resulting in the U.S. Solicitor General filing an "amicus curie" brief in support of Supreme Court review, and in support of reversal of Jevic.

The U.S. Supreme Court granted certiorari on June 28, 2016, and will likely issue an opinion in the 2016 term.

The U.S. Supreme Court's ruling on this issue will have significant impact on unsecured creditors' ability to receive payment from insolvent customers. Presumably, "strict constructionists" on the high court would vote to uphold the Section 507 priority rules. A more practical approach would be to encourage consensual resolutions in Chapter 11 and allow parties to resolve disputes to avoid protracted and costly litigation, which dissipates in litigation costs the debtor's assets that could otherwise provide value for creditors. Fact is, unsecured creditors have causes of action, and settlements usually only occur with an exchange of cash. If such exchanges are not permitted, or are redirected to other parties who did not take initiative to pursue claims, the causes of action for creditors are illusory. As creditors' committees' legal fees are normally paid by the debtor's estate (other creditor's legal fees are not), creditors' committees may be the only stakeholder with sufficient incentive to "fight the good fight."

Stay tuned. We will report back to you when SCOTUS weighs in on this critical issue for unsecured creditors.

We hope you found this useful and informative. Please contact us if you have any questions about this or any other matter.

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