IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re Constellation Enterprises LLC, *et al*., Debtors.	Chapter 11 Case No. 16-11213 (CSS) Jointly Administered

UNITED STATES TRUSTEE'S SUPPLEMENTAL OBJECTION TO (1) JOINT MOTION OF DEBTORS AND CREDITORS' COMMITTEE FOR AN ORDER APPROVING SETTLEMENT BY AND AMONG THE DEBTORS, THE CREDITORS' COMMITTEE, THE PURCHASER AND THE AD HOC NOTEHOLDER GROUP AND (2) DEBTORS' MOTION FOR ENTRY OF AN ORDER PURSUANT TO SECTIONS 105(a), 305(a) AND 1112(b) OF THE BANKRUPTCY CODE AND BANKRUPTCY RULE 1017 AUTHORIZING DISMISSAL OF THE DEBTORS' CASES UNDER CERTIFICATION OF COUNSEL

Andrew R. Vara, the Acting United States Trustee for Region 3 (the "U.S. Trustee"), files this supplemental objection to (1) the *Joint Motion Of Debtors And Creditors' Committee For an Order Approving Settlement by and Among the Debtors, the Creditors' Committee, the Purchaser and the Ad Hoc Noteholder Group* (D.I. 560; the "Settlement Motion") and (2) the *Debtors' Motion for Entry of an Order Pursuant to Sections 105(a), 305(a) and 1112(b) of the Bankruptcy Code And Bankruptcy Rule 1017 Authorizing Dismissal of the Debtors' Cases Under Certification of Counsel* (D.I. 685; the "Dismissal Motion") (collectively, the "Motions").

I. SUMMARY OF ARGUMENT

Bankruptcy courts may not approve structured dismissals or other final distributions of property that violate the Code's priority rules without the affected creditors' consent. *Czyzewski v. Jevic Holding Corp.*, 137 S. Ct. 973 (2017). In *Jevic*, the United States Supreme Court reaffirmed the Code's bedrock priority rules by holding that they must be respected and applied when estate property is finally distributed even absent a confirmed plan.[1] In doing so, the Court roundly rejected the Third Circuit's relaxation of the priority rules in allegedly "rare" cases where the proposed "distributions would make some creditors (high- and low-priority creditors) better off without making other (midpriority) creditors worse off (for they would receive nothing regardless)." 137 S. Ct. at 986. This Court should, therefore, deny the Motions because the settlement would result in an end-of-case distribution to some creditors that violates the Code's priority rules—the very result foreclosed by *Jevic*.

Moreover, the fiction of "gifting" by high- and low-priority creditors to evade the Code's priority rules does not and cannot square with the Supreme Court's unequivocal support for "the protections Congress granted particular classes of creditors." *See Jevic*, 137 S. Ct. at 986. The Supreme Court recognized that "gifting" undermines the rights of creditors by, among other harms, depriving them of the prospect of a settlement that respects their priority. Similarly, "gifting" here unleashes the very harms that the Court sought to avoid, namely seeming collusion between debtors and favored creditors to squeeze out disfavored creditors and the increased difficulty of reaching global settlements. For all of these reasons, the Motions violate the Code's priority rules and present this Court with the same question that the Supreme Court just answered. This Court should apply *Jevic* and deny the Motions.

[1] The Court left unresolved whether structured dismissals that do not violate priority are permissible. *Jevic*, 137 S. Ct. at 985 ("We express no view about the legality of structured dismissals in general."). But it did acknowledge that final distributions of estate assets "normally take place through a Chapter 7 liquidation or a Chapter 11 plan . . . ." *Id*. at 983.

The parties' newly-raised contention[2] in the wake of *Jevic*—that the settlement consideration does not belong to the estate and therefore *In re ICL Holdings Co., Inc.*, 802 F.3d 547 (3d Cir. 2015) applies—does not alter the result even if this Court does not reconsider the continued viability of *ICL*, post-*Jevic*. The property to be transferred, particularly the professional fee payments resulting from the increased carve-out from the secured lenders' collateral, is property of the estate. But even if not, the payments here bear little resemblance to those at issue in *ICL* even under *ICL*'s most generous reading.

II. <u>ARGUMENT</u>

A. <u>*Jevic* Supports the Denial of the Motions</u>

1. *Jevic* Restores Priority Rights Fundamental to the Code's Operation.

In *Jevic*, the Supreme Court ruled that 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."[3] 137 S. Ct. at 978. In doing so, the

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[2] The settling parties previously embraced *Jevic* when the Third Circuit's (now reversed) decision supported them. *See* Dismissal Motion, ¶ 47 (relying on the Third Circuit's *Jevic* decision). By contrast, the Settlement Motion did not once cite *In re ICL Holding Co., Inc.*, 802 F.3d 547 (3d Cir. 2015) or otherwise claim that the settlement consideration was not subject to the Code's priority rules based on *ICL*. The parties were uninterested in any alleged distinctions between estate and non-estate property before the Supreme Court began opining at oral argument in *Jevic*.

[3] *Jevic* is entirely consistent with the Court's long history of protecting the substantive and procedural rights of creditors, not courts, to determine whether to accept a proposal that does not follow the priorities of distribution: "the Code provides that it is up to the creditors—and not the courts—to accept or reject a reorganization plan which fails to . . . honor the absolute priority rule." *Norwest Bank Worthnigton v. Ahlers*, 485 U.S. 197, 207 (1988). Even if a "Court . . . believe[s] that petitioners or other unsecured creditors would be better off . . . " with the proposed deal, that "determination is for the creditors to make in the manner specified by the Code." *Id.* And if this is true when a plan is proposed and creditors are afforded the procedural

Court reversed an order approving a settlement of a fraudulent conveyance lawsuit that gave money to high-priority secured creditors and to low-priority general unsecured creditors but which skipped certain dissenting mid-priority creditors. *Id*. The Supreme Court considered several justifications offered in support of the priority-skipping deal. It rejected all of them.

First, the settling parties disputed that the skipped creditors had standing to challenge the structured dismissal at all. They argued that the skipped creditors would have received nothing even if the bankruptcy court had never approved the structured dismissal and would still get nothing if the structured dismissal were unwound on appeal. The Supreme Court was not persuaded. It reasoned that the structured dismissal and related fraudulent conveyance settlement harmed the skipped creditors because they "lost a chance to obtain a settlement that respected their priority [or] the power to bring their own lawsuit on a claim that had a settlement value of $3.7 million." 137 S. Ct. at 983. In reaching this conclusion, the Supreme Court questioned and ultimately rejected assertions that settlement could only occur through a priority violation and that the fraudulent conveyance claims had no value. *Id*. Overturning the structured dismissal would redress the skipped creditors' loss because it would reinstate the fraudulent conveyance claims. Consequently, the skipped creditors had standing. *Id*.

Second, the settling parties argued (and the lower courts agreed) that the Code's priority rules only apply to chapter 11 plans (and chapter 7 liquidations). The Supreme Court disagreed. Because the priority rules have "long been considered fundamental to the Bankruptcy Code's operation," limiting their scope requires more than mere legislative silence. *See* 137 S. Ct. at 984 (citations omitted). The Supreme Court saw no indication that Congress intended a "major"

safeguards attendant to plan confirmation and voting, it must be "doubly" true when creditors are denied them. Not only did the Court in *Jevic* cite *Ahlers* with approval, *Jevic*, 137 S. Ct. at 987, it reiterated the importance of the Code's procedural safeguards. *Id.* at 986 (explaining distributions looked like transactions disallowed by lower courts because they "circumvent the Code's procedural safeguards").

departure from the priority system through a structured dismissal. 137 S. Ct. at 984 ("we would expect to see some affirmative indication of intent if Congress actually meant to make structured dismissals a backdoor means to achieve the exact kind of nonconsensual priority-violating final distributions that the Code prohibits in Chapter 7 liquidations and Chapter 11 plans.").[4]

Third, the parties claimed that, under the allegedly rare circumstances of the case, the Court faced a binary choice of approving a settlement that made many creditors better off or rejecting the settlement and leaving all creditors empty-handed—an argument that the bankruptcy court had adopted. *See In re Jevic*, 08-11006, Docket No. 1519, *14 (Bankr.D.Del. Dec. 4, 2012) ("I am presented with two options, a meaningful return or zero."). The Supreme Court, however, was unmoved and reiterated that courts cannot "alter the balance struck by the statute . . . not even in rare cases." 137 S. Ct. at 987 (*quoting Law v. Siegel*, 134 S. Ct. 1188, 1198 (2014)) (further citations omitted). The Supreme Court also saw through the "rare case" justification as both dubious and dangerous. "[O]ne can readily imagine other cases that turn on comparably dubious predictions. . . . '[D]ebtors and favored creditors can be expected to make every case that 'rare case''" *Id.* at 987[citation omitted]. The Court further found the rare case exception to be dangerous because it would inflict uncertainty upon the bankruptcy system with serious consequences—consequences including collusion and changes in bargaining power even in cases not ending in a structured dismissal. *Id*. (observing that the consequences of the rare case justification "include risks of collusion, *i.e*., senior secured creditors and general unsecured creditors teaming up to squeeze out priority unsecured creditors.").

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[4] In arriving at the conclusion that the Code does not authorize general end-of-case distributions outside of a chapter 11 plan, the Court found that "the word 'cause' [in section 349(b)] is too weak a reed upon which to rest so weighty a power." 137 S. Ct. at 985 (*citing United Sav. Assn. of Tex. v. Timbers of Inwood Forest Associates, Ltd.*, 484 U.S. 365, 371 (1988) (noting that "[s]tatutory construction ... is a holistic endeavor" and that a court should select a "meanin[g that] produces a substantive effect that is compatible with the rest of the law")) (further citations omitted).

2. *Jevic* Casts Doubt on *ICL's* Continued Viability.

Before the Supreme Court's consideration of *Jevic*, the Third Circuit decided *In re ICL Holding Co., Inc.*, 802 F.3d 547 (3d Cir. 2015). There the Third Circuit affirmed an order approving a pre-plan settlement between an official creditors' committee and a secured lender group that had purchased the debtors' assets. Similar to *Jevic*, high-priority (secured) creditors and low-priority (unsecured) creditors teamed up to squeeze out a dissenting mid-priority creditor (the United States, which held a large tax claim entitled to administrative priority). But unlike *Jevic*, the settling parties in *ICL* argued that the settlement payments did not belong to the estate and were instead a "gift" of the secured lenders' own money. Under the specific facts of the case, the Third Circuit agreed that the payment scheme did not involve bankruptcy estate property and therefore did not implicate the Code's priority rules. *Id*. ("the settlement sums paid by the [secured lenders and affiliated] purchaser were not proceeds from its liens, did not at any time belong to LifeCare's estate, and will not become part of its estate even as a pass-through"). In essence, *ICL* limited the scope of the priority rules on the grounds that the Code did not expressly prohibit distributions of non-estate property in bankruptcy.

To be sure, the Supreme Court did not expressly consider whether the Code's priority rules apply to "gifts" of purportedly non-estate property. But in rejecting the *Jevic* settlement, the Supreme Court demanded strict adherence to the rules established by Congress and laid bare the true harms of so-called "gifting."[5] For at least two reasons, *Jevic* casts substantial doubt on *ICL*'s reasoning.

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[5] If the payment from the secured lender to the unsecured creditor were truly a "gift," with the secured lender receiving *nothing* in return, then the Bankruptcy Court need not have approved that part of the transaction and the lender could have given the creditor a gift after the bankruptcy case concluded (subject to any legal constraints on giving, receiving, or promising money for acting or not acting in a case under title 11). Of course, the lender would not do so because lenders are not in the business of making charitable donations to their debtors' junior

First, courts cannot approve distributions that deviate from the "basic system of priority" simply because the Code does not contain an express prohibition. The Supreme Court directly repudiated this line of reasoning when it rejected arguments that the priority rules apply only to chapter 11 plans. *See* 137 S. Ct. at 984. Because the priority system is fundamental to the Code's operation, any departure from it (whether in a structured dismissal, sale, settlement or other court-approved agreement) must come from Congress. *See id.* No such authorization exists for bankruptcy courts to approve priority-skipping gifts of non-estate property. The integrity of a comprehensive bankruptcy scheme, including the painstakingly detailed priority rules governing distributions to creditors, cannot be cast aside in favor of creditor side deals. *See In re Lehman Bros. Holdings, Inc.*, 508 B.R. 283, 294 (S.D.N.Y. 2014) ("The Bankruptcy Code is meant to be a "comprehensive federal scheme . . . to govern" the bankruptcy process. Although flexibility is necessary[,] the federal scheme cannot remain comprehensive if interested parties and bankruptcy courts in each case are free to tweak the law to fit their preferences . . .") (citations omitted). Simply put, parties should not reap the benefits from the comprehensive bankruptcy process without also accepting its obligations, including the obligation to follow statutory priorities.[6]

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creditors. Moreover, one suspects more generally that the payments so freely described as "gifts" in bankruptcy court are nowhere else characterized as such, including in internal accounting records and reports to shareholders, taxing authorities, or regulators. Perhaps the donors and donees should produce such evidence before they can make those (currently unsubstantiated) claims in bankruptcy court.

[6] The Supreme Court's mention of *In re Iridium Operating LLC*, 478 F.3d 452 (2d Cir. 2007) does not alter this analysis. The Court made clear that "[*Iridium*] does not state or suggest that the Code authorizes nonconsensual departures from ordinary priority rules in the context of a dismissal—which is a *final* distribution of estate value—and in the absence of any further unresolved bankruptcy issues." 137 S. Ct. at 985 (emphasis in original). Taken together, the Motions involve final distributions here. Even if the Debtors seek conversion and not dismissal, the distribution of the settlement proceeds is the final distribution of substantially all of the Debtors' assets and none of the Debtors are seeking to reorganize. The potential conversion of

Second, the Third Circuit in *ICL* failed to consider the full consequences of priority-skipping distributions. By contrast, the Supreme Court exposed the harms that priority-skipping settlements inflict upon disfavored creditors and observed that departures from the Code's priority rules—even in supposedly "rare" cases—run counter to the protections Congress granted particular classes of creditors. 137 S. Ct. at 986. Those statutory protections take precedence over even well-intentioned payments to junior creditors, and departing from them invites "collusion, *i.e*., senior secured creditors and general unsecured creditors teaming up to squeeze out priority unsecured creditors." *Id*. at 986-987 (*citing Bank of America Nat. Trust and Sav. Assn. v. 203 North LaSalle Street Partnership*, 526 U.S. 434, 444 (1999) (discussing how the absolute priority rule was developed in response to "concern with 'the ability of a few insiders, whether representatives of management or major creditors, to use the reorganization process to gain an unfair advantage' " (*quoting* H.R. Doc. No. 93–137, pt. I, p. 255 (1973))). And by increasing uncertainty in the bankruptcy process, the failure to follow creditor priorities makes settlements more, not less, difficult to achieve. *Id*. at 987. When the Third Circuit evaluated the priority-skipping settlement on its merits in *ICL*, it did not consider the systemic harms that the Supreme Court found important when deciding *Jevic*.

3. The Court Should Apply *Jevic* Here.

Although filed separately, the Settlement Motion and the Dismissal Motion should be viewed as part and parcel of the same package. Specifically, the Dismissal Motion contemplates the approval of the Settlement Motion as a condition precedent to dismissal, and the proposed dismissal order expressly provides that "[n]otwithstanding section 349 of the Bankruptcy Code,

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these cases does not alter the analysis. The Court's discussion of critical vendors makes clear that the courts approving such requests "have usually found that the distributions at issue would enable a successful reorganization and make even the disfavored creditors better off." *Id*. (citations omitted). That does not hold true here.

prior orders of this Court, including … any orders approving (a) the Committee Settlement… shall survive dismissal of these chapter 11 cases." Dismissal Motion, Exhibit 1, ¶ 3. The Settlement Motion likewise reveals that the dismissal of the cases is an express deal term. *See* Settlement Motion, Exhibit 1, pp. 11 of 12. The Debtors further contend that "there is simply no prospect of being able to confirm a chapter 11 plan in these cases." Dismissal Motion, ¶ 4. The Motions, therefore, are effectively a two-step structured dismissal that will conclude the case with a final distribution of assets that violates the Code's priority rules. Any finding otherwise could promote gamesmanship in the structuring of structured dismissals to evade *Jevic* and its ban on non-consensual, priority-violating final distributions.[7]

Although the Debtors claim that the Motions will "maximize[e] the recovery for as many creditors as possible," as in *Jevic*, that is irrelevant when there is no dispute that lower ranking creditors will receive distributions before higher ranking priority creditors without the senior creditors' consent. Just as the Supreme Court rejected the supposed choice between "a meaningful return or zero," so, too, must this Court. The newly-raised non-estate property incentives[8] and undermine the integrity of a comprehensive bankruptcy scheme.

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[7] Even if the Debtors indicate that they will be seeking conversion, and not dismissal, that does not alter the analysis. The settlement proceeds here constitute the final distribution of substantially all of the value of the Non-CSC Debtors' estates. Characterizing these distributions as anything other than end-of-case distributions because the Debtors may elect to convert the case to prosecute avoidance actions held by the CSC Debtors would put form over substance.

[8] Taking a single example, the settlement consideration may place the Committee professionals in direct conflict with the unsecured creditors that they serve. The direct incentives for Committee professionals (*i.e.*, the increase in the Committee Fee Cap) may cause the Committee professionals to pursue a personal benefit at an untold cost to general unsecured creditors. If no priority rules apply as the parties claim, these Motions inescapably leave unsecured creditors guessing whether the consideration they receive will represent the best deal available. Such unpredictability undermines the integrity of a comprehensive bankruptcy process by creating tension between professionals and clients and by forcing all parties to scramble for scraps. The objectives of the Code's priority rules become readily apparent.

B. *ICL* Does Not Apply to This Case

Even if this Court chooses not to revisit *ICL* after *Jevic*, the Motions cannot be granted. In *ICL*, the Third Circuit examined a settlement between an official unsecured creditors' committee and a secured lender group. Under the terms of that settlement, the committee agreed to drop its objections to an asset sale where the secured lender group would acquire all of the estate's assets through a credit bid. In return, "the secured lenders agreed to deposit $3.5 million in trust for the benefit of the general unsecured creditors." 802 F.3d at 551. Under those fact-specific circumstances, the Court found that the settlement payments were not "proceeds . . . of or from property of the estate" under section 541(a)(6) and, therefore, did not implicate the Code's priority rules. *See* 802 F.3d at 556 (finding that "the settlement sums paid by the [secured creditors and] purchaser were not proceeds from its liens, did not at any time belong to LifeCare's estate, and will not become part of its estate even as a pass-through").

Here, the settling parties argued that the settlement consideration was not estate property in accordance with *ICL* only after the Supreme Court held oral arguments in *Jevic*. In any event, they are wrong. The settlement consideration differs from *ICL* in four critical ways.

First, the Debtors are parties to this Settlement Motion and are themselves providing consideration to counterparties. Unlike *ICL*, where the debtors were not parties to the settlement or the motion to approve it, the Debtors here are providing "full mutual releases and exculpations" to the secured lenders (as well as the lenders' "past and current respective directors, officers, employees, partners, insurers, co-insurers, reinsurers, agents, attorneys, accountants, auditors, advisors, investment advisors, or legal representatives"). Settlement Motion, Exhibit 1, pp. 5 of 12. Because those causes of action are estate property under section 541(a)(1), the consideration paid by the secured lenders for the release of those claims are proceeds from estate property and therefore estate property under section 541(a)(6). By contrast, the Third Circuit in *ICL* did not confront the release of any debtor claims, and its decision did not require the *ICL* debtors to do anything.

Second, this Settlement Motion effectively releases the committee's ability to challenge the validity, perfection, priority, extent, or enforceability of the secured lenders' claims by allowing the DIP Order to become final. *See* Settlement Motion, Exhibit 1, pp. 6-7 of 12; *see also* Final DIP Order, Docket No. 566, ¶ 15. The committee could only mount such a challenge if it obtained derivative standing on behalf of and "for the benefit of the estate." *See Official Comm. of Unsecured Creditors of Cybergenics Corp. ex rel. Cybergenics Corp. v. Chinery*, 330 F.3d 548, 580 (3d Cir. 2003). Consequently, any consideration that the committee receives for the settlement of such claims belongs to the estate. By contrast, the settlement in *ICL* solely covered objections relating to an asset sale and did not necessarily implicate the same derivative claim analysis.

Third, this Settlement Motion involves an ordinary carve-out where the secured lenders are permitting the use of a portion of their collateral. Beyond the initial carve-out from the secured lenders' collateral to pay the fees of committee professionals in this case, the Settlement Motion removes previously-imposed monthly caps and instead sets an overall cap of $2,050,000 (the "Committee Fee Cap"). Paragraph 10 of the Final DIP Order expressly provides that the Committee Fee Cap derives from the secured lenders' collateral subject to the DIP Liens. Final DIP Order, Docket No. 566, ¶ 10. In *ICL*, the Third Circuit strongly suggested that a gift through a carve-out from a secured lenders' collateral for the benefit of a junior class involves estate property. *See* 802 F.3d at 557 ("if we were [dealing with a carve-out], this would suggest it was LifeCare's property"). Here, the Settlement Motion transfers value to committee professionals through a carve-out. *ICL* counsels that these carve-out payments involve estate property, and therefore, the Code's priority rules expressly apply.

Fourth, this Settlement Motion involves the transfer of avoidance claims that belong to the estate. In *ICL*, the Third Circuit expressly considered whether specific cash transfers represented proceeds from the secured creditors' liens. *See* 802 F.3d at 556. Unlike cash transfers that may not have been traceable in *ICL*, the settlement in this case transfers non-cash litigation assets from the estate (whether directly or indirectly) to a litigation trust. Such claims must be traceable to the estate or else the party holding them has no ability to prosecute them. Separate from the tracing issues, the Code created many of the underlying rights for the estate in the first instance. *See* 11 U.S.C. §§ 544-551. Permitting the sale of these claims and their subsequent assignment to unsecured creditors outside of priority undermines the Code's purpose and structure. In other words, this Settlement distributes Code-created rights in violation of Code-specified priority.

For all of these reasons, the Motions distribute estate property even under *ICL's* most generous reading. Because *Jevic* directly forbids these distributions, this Court should deny the Motions.

III. CONCLUSION

For the reasons stated above, the Court should deny the Motions and grant any other such relief as may be just and proper.

Andrew R. Vara,
Acting United States Trustee, Region Three

Dated: May 5, 2017

BY: ___/s/_________________

Linda J. Casey, Esquire
Trial Attorney
J. Caleb Boggs Federal Building
844 King Street, Suite 2207, Lockbox 35
Wilmington, DE 19801
(302) 573-6491
(302) 573-6497 (Fax)