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When courts can approve structured dismissals

By David Kupetz

In *Czyzewski v. Jevic Holding Corp.*, 2017 DJDAR 2805 (March 22, 2017), the U.S. Supreme Court considered whether bankruptcy courts have the legal power to approve the structured dismissal of a Chapter 11 bankruptcy case "that provides for distributions that do not follow ordinary priority rules without the affected creditors' consent?" The court held that "[o]ur simple answer to this complicated question is 'no'." The question involves the interplay between the priority rules of the Bankruptcy Code and dismissal of a Chapter 11 case.

There are three conventional ways for exiting a Chapter 11 bankruptcy case: (1) confirmation of a plan of reorganization, (2) dismissal of the case, resulting in the parties returning to their pre-bankruptcy positions, and (3) conversion of the case to a Chapter 7 case where a trustee takes over and liquidates assets. A fourth alternative, however, known as a "structured dismissal," is increasingly common. In a structured dismissal, the Chapter 11 case is wound up with certain conditions attached, rather than simply dismissing the case. In *Jevic*, the structure of the dismissal provided for payments skipping a class of objecting creditors in favor of more junior creditors.

Ordinarily, under Section 349 of the Bankruptcy Code, dismissal reinstates the pre-bankruptcy state of affairs, revesting property in the debtor and vacating orders of the bankruptcy court, unless "for cause" the court orders otherwise. In *Jevic*, the Supreme Court viewed the court's discretion under Section 349 to be limited, finding that it only "appears designed to give courts the flexibility to make the appropriate orders to protect rights acquired in reliance on the bankruptcy case."

There is a basic system of priority under the Bankruptcy Code. Secured creditors hold the highest priority and, in a liquidation, are entitled to receive the proceeds of the collateral that secures their debt. Special classes of creditors, such as wage and tax claimants, come next in the priority waterfall. Below them are general unsecured creditors. Equity holders are at the bottom of the priority list.

The Supreme Court emphasized that the Bankruptcy Code's priority system is "a fundamental underpinning of business bankruptcy law." The court explained: "Distributions of estate assets at the termination of a business bankruptcy normally take place through a Chapter 7 liquidation or a Chapter 11 plan, and both are governed by priority. In Chapter 7 liquidations, priority is an absolute command — lower priority creditors cannot receive anything until higher priority creditors have been paid in full.… Chapter 11 plans provide somewhat more flexibility, but a priority-violating plan still cannot be confirmed over the objection of an impaired class of creditors."

Jevic was a trucking company. Prior to its bankruptcy case, Jevic was acquired by a private equity firm (Sun) in a leveraged buyout financed by secured lenders (CIT). The debtor owed more than $53 million to its first-priority senior secured creditors and over $20 million to its tax and general unsecured claimants. Moreover, two significant lawsuits were brought in Jevic's bankruptcy case.

One lawsuit was brought by a group of Jevic's terminated truck drivers based on alleged violations of federal and state Worker Adjustment and Retraining Notification (WARN) Acts. The second lawsuit, a fraudulent transfer action, was brought by the official unsecured creditors committee. It alleged that Sun, facilitated by CIT, "acquired Jevic with virtually none of its own money based on baseless projections of almost immediate growth and increasing profitability." The committee alleged that the leveraged buyout had saddled Jevic with debt and led to Jevic's bankruptcy as "the foreseeable end of a reckless course of action in which Sun and CIT bore no risk but all other constituents did."

Three years after the fraudulent transfer lawsuit was brought, all the major players in the case met to attempt to negotiate a settlement. By then, the only remaining assets in the bankruptcy estate were $1.7 million in cash (subject to Sun's lien) and the fraudulent transfer lawsuit. Jevic's tangible assets had been liquidated. The lack of estate funds to finance litigation, and the risks, uncertainty and anticipated length of the litigation, led the committee to conclude that a settlement resulting in a modest distribution to unsecured creditors would be desirable.

A settlement agreement was reached, between the committee, Jevic, Sun and CIT, providing: (1) for the dismissal of the fraudulent transfer action and the release of claims between the parties; (2) CIT's payment of $2 million into an account earmarked for payment of Jevic's and the committee's legal fees and other administrative expenses; (3) Sun's assignment of its lien on Jevic's remaining cash to a trust, which would pay tax and administrative creditors first and then general unsecured creditors on a pro rata basis; and (4) the dismissal of the Chapter 11 case in accordance with this structure.

But there was a problem: The settlement left out the drivers. Further, the drivers' claim was estimated at $12.4 million, with $8.3 million entitled to treatment as a priority wage claim. The drivers and the U.S. Trustee (an agency within the Department of Justice that monitors bankruptcy cases) objected to the settlement and dismissal primarily on the basis that it distributed property of the estate to creditors of lower priority than the drivers in violation of the statutory priority scheme set forth in the Bankruptcy Code. The trustee also contended that the code does not permit structured dismissals.

In approving the structured dismissal, the bankruptcy court found (i) that there was no prospect of a confirmable Chapter 11 plan in the case, and (ii) that conversion to Chapter 7 was not a feasible alternative since the Chapter 7 trustee would not have sufficient funds to operate and since the secured creditors had credibly said they would not do the deal in Chapter 7. As such, the 3rd U.S. Circuit Court of Appeals said "it suffices to say that absent a showing that a structured dismissal has been contrived to evade the procedural protections and safeguards of the plan confirmation or conversion processes, a bankruptcy court has discretion to order such a disposition."

On appeal, the 3rd Circuit concluded that bankruptcy courts have the power to approve structured dismissals and next considered whether the structure can skip a class of objecting creditors in favor of more junior creditors. It held that the structure of the dismissal must be fair and equitable and stated that compliance with the priorities of the Bankruptcy Code will usually be dispositive of whether a proposed settlement is fair and equitable. The 3rd Circuit found the case to be a "close call" and a structured dismissal to be "the least bad alternative." While regrettable that the drivers were left out, the 3rd Circuit explained that if settlements were required to be perfect, they would seldom be approved.

Reversing the 3rd Circuit, the Supreme Court declined to express any view regarding the legality of structured dismissals in general. Implicitly, the court acknowledged them to be appropriate where creditors consent. Further, it is standard practice to violate ordinary priority rules during the course of Chapter 11 cases with, for example, "first-day" wage orders, "critical vendor" orders, and "roll-ups" in debtor in possession financing. The court recognized that such out-of-priority distributions, however, are found necessary to enable successful reorganization and benefit even disfavored creditors. In contrast, the priority-violating distribution under the *Jevic* structured dismissal is a final disposition that did not make the drivers better off.

The Supreme Court rejected the findings of the bankruptcy court that (1) without the driver-skipping settlement, there would be no settlement, (2) the settlement was the only means for any recovery by any unsecured creditors, and accordingly (3) the drivers weren't harmed since they would receive nothing under any scenario. Moreover, the court found the consequences of allowing priority-skipping structured dismissals to stand would include departing from protections Congress granted particular classes of creditors (e.g., employee wage priority), risks of collusion, and uncertainty making settlements more difficult to accomplish. As a result, the Supreme Court struck down the 3rd Circuit's limited approval of nonconsensual priority-violating structured dismissals in "rare cases."

Focusing on the importance of the Bankruptcy Code's priority system and perceived silence regarding structured dismissals, the Supreme Court stated "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." Finding no such indication and the lack of "any significant offsetting bankruptcy-related justification," the court rejected the violation of ordinary priority rules through a structured dismissal.

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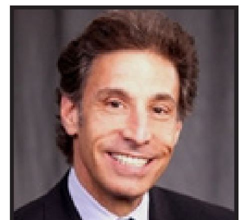
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