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U.S. Supreme Court to Rule on "Structured Dismissals"

By Stuart I. Gordon and Matthew V. Spero*

The U.S. Supreme Court has agreed to rule on a novel question of bankruptcy law: May a case arising under Chapter 11 be resolved in a "structured dismissal" that deviates from the Bankruptcy Code's priority system?

Under the Bankruptcy Code, a case arising under Chapter 11 can result in a confirmed plan, a conversion to a case under Chapter 7 for liquidation, or a dismissal and restoration of the *status quo ante*.

Recently, however, more and more Chapter 11 cases have concluded in what has come to be known as a "structured dismissal."[1] Unlike a typical one sentence dismissal order—"this case is hereby dismissed"—a structured dismissal is a dismissal preceded by other orders of the bankruptcy court, *e.g.*, orders approving settlements, granting releases (some more limited than others), and establishing protocols for reconciling and paying claims, among other things.[2]

Currently, the various circuit courts of appeals that have ruled on the issue are divided on the power of bankruptcy courts to approve structured dismissals of Chapter 11 cases that provide for payment of claims but do not follow the priority scheme set forth in Section 507 of the Bankruptcy Code.

In *Matter of AWECO, Inc.*,[3] the U.S. Court of Appeals for the Fifth Circuit rejected a settlement of a lawsuit against a Chapter 11 debtor that would have transferred $5.3 million in estate assets to an unsecured creditor despite the

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[1] *See, e.g., In re Kainos Partners Holding Co.*, No. 10-560-LPS (D. Del. Nov. 30, 2012); *In re World Health Alternatives*, 344 B.R. 291 (Bankr. D. Del. 2006). *But cf. In re Biolitec, Inc.*, 528 B.R. 261 (Bankr. D.N.J. 2014) (rejecting a proposed structured dismissal as invalid under the Bankruptcy Code).

[2] *See, In re Strategic Labor, Inc.*, 467 B.R. 11 (Bankr. D. Mass. 2012).

[3] *Matter of AWECO, Inc.*, 725 F.2d 293 (5th Cir. 1984).

existence of outstanding senior claims. The Fifth Circuit held that the "fair and equitable" standard applied to settlements, and that "fair and equitable" meant compliance with the Bankruptcy Code's priority system.

The U.S. Court of Appeals for the Second Circuit adopted a more flexible approach in *In re Iridium Operating LLC*.[4] There, the unsecured creditors' committee sought to settle a lawsuit it had brought on the estate's behalf against a group of secured lenders; the proposed settlement split the estate's cash between the lenders and a litigation trust set up to fund a different estate action against a priority administrative creditor. That administrative creditor objected to the settlement on the ground that the distribution violated the Bankruptcy Code's priority system because it failed to provide for payments to the administrative creditor and, instead, provided for distribution of funds to lower-priority creditors.

Rejecting the approach taken by the Fifth Circuit in *AWECO* as "too rigid," the Second Circuit held that the absolute priority rule was "not necessarily implicated" when a settlement was "presented for court approval apart from a reorganization plan[.]" The Second Circuit held that "whether a particular settlement's distribution scheme complies with the Code's priority scheme must be the most important factor for the bankruptcy court to consider when determining whether a settlement is 'fair and equitable'" under Rule 9019 of the Federal Rules of Bankruptcy Procedure,[5] but that a noncompliant settlement could be approved when "the remaining factors weigh heavily in favor of approving a settlement[.]"

Applying its holding to the facts of the case, the Second Circuit noted that the settlement at issue deviated from the Bankruptcy Code priorities in two respects: first, by skipping the objecting administrative creditor in distributing estate assets to the litigation fund created to finance the unsecured creditors committee's suit against that creditor and, second, by skipping that creditor again in providing that any money remaining in the fund after the litigation concluded would go directly to the unsecured creditors.

The Second Circuit indicated that the first deviation was acceptable even though it skipped the objecting administrative creditor:

> It is clear from the record why the Settlement distributes money from the Estate to the [litigation vehicle]. The alternative to settling with the

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[4] *In re Iridium Operating LLC*, 478 F.3d 452 (2d Cir. 2007).

[5] Federal Rule of Bankruptcy Procedure 9019 authorizes settlements as long as they are "fair and equitable." *Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson*, 390 U.S. 414, 424, 88 S. Ct. 1157, 20 L. Ed. 2d 1 (1968).

> Lenders—pursuing the challenge to the Lenders' liens—presented too much risk for the Estate, including the administrative creditors. If the Estate lost against the Lenders (after years of litigation and paying legal fees), the Estate would be devastated, all its cash and remaining assets liquidated, and the Lenders would still possess a lien over the [action against the objecting administrative creditor]. Similarly, administrative creditors would not be paid if the Estate was unsuccessful against the Lenders. Further, as noted at the Settlement hearing, having a well-funded litigation trust was preferable to attempting to procure contingent fee-based representation.[6]

The U.S. Court of Appeals for the Third Circuit entered the fray last year, in *In re Jevic Holding Corp*.[7] In *Jevic Holding*, the Third Circuit held that bankruptcy courts may, in "rare" instances, approve structured dismissals that do not strictly adhere to the Bankruptcy Code's priority scheme.

The circuit split is about to be settled by the U.S. Supreme Court.

On June 28, 2016 the Court granted the petition for certiorari in *Jevic Holding*, which posited the issue as: "Whether a bankruptcy court may authorize the distribution of settlement proceeds in a manner that violates the statutory priority scheme."

The Supreme Court's decision on the availability of structured dismissals in Chapter 11 cases where the priority rules are violated will be another landmark decision by the Court, which last year alone issued two important bankruptcy rulings.[8] It undoubtedly will have a significant practical impact on many future Chapter 11 cases and will help guide counsel, bankruptcy advisers, executives, secured creditors, unsecured creditors, potential acquirers of a debtor's assets or claims, and other parties in interest in future business reorganization cases.

THE *JEVIC TRANSPORTATION* BANKRUPTCY

The *Jevic Holding* case involved Jevic Transportation, Inc., a trucking company headquartered in New Jersey. In 2006, after Jevic's business began to

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[6] Because the record did not adequately explain the second deviation, the Second Circuit remanded the case to allow the bankruptcy court to consider that issue, declaring that, "no reason has been offered to explain why any balance left in the litigation trust could not or should not be distributed pursuant to the rule of priorities."

[7] *In re Jevic Holding Corp.*, 787 F.3d 173 (3d Cir. 2015), *cert. granted by Czyzewski v. Jevic Holding Corp.*, 2016 U.S. LEXIS 4293 (U.S. June 28, 2016).

[8] *See, e.g., Baker Botts L.L.P. v. ASARCO LLC*, 135 S. Ct. 2158, 192 L. Ed. 2d 208 (2015); *Wellness Int'l Network, Ltd. v. Sharif*, 135 S. Ct. 1932, 191 L. Ed. 2d 911 (2015).

decline, a subsidiary of the private equity firm Sun Capital Partners acquired the company in a leveraged buyout financed by a group of lenders led by CIT Group. The buyout entailed the extension of an $85 million revolving credit facility by CIT to Jevic, which Jevic could access as long as it maintained at least $5 million in assets and collateral.

The company continued to struggle in the two years that followed, however, and had to reach a forbearance agreement with CIT—which included a $2 million guarantee by Sun—to prevent CIT from foreclosing on the assets securing the loans.

By May 2008, with the company's performance stagnant and the expiration of the forbearance agreement looming, Jevic's board of directors authorized a bankruptcy filing. The company ceased substantially all of its operations, and its employees received notice of their impending terminations on May 19, 2008.

The next day, Jevic filed a voluntary Chapter 11 petition in the U.S. Bankruptcy Court for the District of Delaware. At that point, Jevic owed about $53 million to its first-priority senior secured creditors (CIT and Sun) and over $20 million to its tax and general unsecured creditors.

In June 2008, an Official Committee of Unsecured Creditors (the "Committee") was appointed to represent the unsecured creditors.

During the Chapter 11 case, two lawsuits were filed in the bankruptcy court.

First, a group of Jevic's terminated truck drivers (the "Drivers") filed a class action against Jevic and Sun alleging violations of federal and state worker adjustment and retraining notification ("WARN") laws, under which Jevic was required to provide 60 days' written notice to its employees before laying them off.[9]

Second, the Committee brought a fraudulent conveyance action against CIT and Sun on the estate's behalf, alleging that Sun, with CIT's assistance, had "acquired Jevic with virtually none of its own money based on baseless projections of almost immediate growth and increasing profitability." The Committee claimed that the ill-advised leveraged buyout had hastened Jevic's bankruptcy by saddling it with debts that it could not service and described Jevic's demise as "the foreseeable end of a reckless course of action in which Sun and CIT bore no risk but all other constituents did."

Almost three years after the Committee sued CIT and Sun, the bankruptcy court granted in part and denied in part CIT's motion to dismiss the case. The

[9] *See*, 29 U.S.C. § 2102; N.J. Stat. Ann. § 34:21-2.

bankruptcy court held that the Committee had adequately pleaded claims of fraudulent transfer and preferential transfer under Bankruptcy Code Sections 548 and 547. Noting what it characterized as the "great potential for abuse" in leveraged buyouts, the bankruptcy court concluded that the Committee had sufficiently alleged that CIT had played a critical role in facilitating a series of transactions that had recklessly reduced Jevic's equity, increased its debt, and shifted the risk of loss to its other creditors.

The bankruptcy court dismissed without prejudice the Committee's claims for fraudulent transfer under Bankruptcy Code Section 544, equitable subordination of CIT's claims against the estate, and aiding and abetting Jevic's officers and directors in breaching their fiduciary duties, deciding that the Committee's allegations in support of these claims were too sparse and vague.

In March 2012, representatives of the Committee, CIT, Sun, the Drivers, and Jevic convened to negotiate a settlement of the Committee's fraudulent conveyance suit. By that time, Jevic's only remaining assets were $1.7 million in cash (which was subject to Sun's lien) and the action against CIT and Sun. All of Jevic's tangible assets had been liquidated to repay the lender group led by CIT.

According to testimony in the bankruptcy court, the Committee determined that a settlement ensuring "a modest distribution to unsecured creditors" was desirable in light of "the risk and the [re]wards of litigation, including the prospect of waiting for perhaps many years before a litigation against Sun and CIT could be resolved" and the lack of estate funds sufficient to finance that litigation.

Ultimately, the Committee, Jevic, CIT, and Sun reached a settlement agreement that accomplished four things:

- First, those parties agreed to exchange releases of their claims against each other and agreed that the fraudulent conveyance action would be dismissed with prejudice;
- Second, CIT agreed to pay $2 million into an account earmarked to pay Jevic's and the Committee's legal fees and other administrative expenses;
- Third, Sun agreed that it would assign its lien on Jevic's remaining $1.7 million to a trust, which would pay tax and administrative creditors first and then the general unsecured creditors on a pro rata basis; and
- Fourth, Jevic's Chapter 11 case would be dismissed.

In other words, the parties' settlement contemplated a "structured dismissal."

The settlement left out the Drivers in that it did not provide for either direct payment to the Drivers or the assignment of Sun's lien on Jevic's remaining cash to the estate. Rather, the settlement was payable to a liquidating trust earmarked for all parties but the Drivers. This occurred even though the Drivers had an uncontested WARN Act claim against Jevic. The Drivers estimated their claim was worth $12,400,000, of which $8,300,000 was a priority wage claim under Bankruptcy Code Section 507(a)(4).

The Drivers and the U.S. Trustee objected to the proposed settlement and dismissal primarily because it distributed property of the estate to creditors of lower priority than the Drivers under Bankruptcy Code Section 507. The U.S. Trustee also objected on the ground that structured dismissals were not permitted under the Bankruptcy Code, while the Drivers further argued that the Committee had breached its fiduciary duty to the estate by "agreeing to a settlement that, effectively, freezes out the [Drivers]."

THE BANKRUPTCY COURT'S DECISION

The bankruptcy court rejected the objections and approved the proposed settlement and dismissal.

It recognized the absence of any provision in the Bankruptcy Code for "distribution and dismissal contemplated by the settlement motion," but it noted that similar relief had been granted by other courts. Summarizing its assessment, the bankruptcy court found that "the dire circumstances" presented in the case warranted the relief requested by the debtor, the Committee, and the secured lenders.

The bankruptcy court found that there was "no realistic prospect" of a meaningful distribution to anyone but the secured creditors unless the settlement was approved because the traditional routes out of Chapter 11 bankruptcy were impracticable. First, it declared that there was "no prospect" of a confirmable Chapter 11 plan of reorganization or liquidation being filed. Second, it stated that conversion to liquidation under Chapter 7 of the Bankruptcy Code would have been unavailing for any party because a Chapter 7 trustee would not have had sufficient funds "to operate, investigate or litigate" (because all the cash left in the estate was encumbered), and the secured creditors had "stated unequivocally and credibly that they would not do this deal in a Chapter 7."

The bankruptcy court next rejected the objectors' argument that the settlement could not be approved because it distributed estate assets in violation of the Bankruptcy Code's "absolute priority rule." After noting that Chapter 11 plans must comply with the Bankruptcy Code's priority scheme, the bankruptcy court held that settlements need not do so. The bankruptcy court also disagreed with the Drivers' fiduciary duty argument, dismissing the notion that the Committee's fiduciary duty to the estate gave each creditor veto power over any proposed settlement. The Drivers had never been barred from participating in the settlement negotiations, the bankruptcy court observed, and their omission from the settlement distribution would not prejudice them because their claims against the Jevic estate were "effectively worthless" given that the estate lacked any unencumbered funds.

Finally, the bankruptcy court applied the multifactor test of *In re Martin*[10] for evaluating settlements under Federal Rule of Bankruptcy Procedure 9019.[11] It found that the Committee's likelihood of success in the fraudulent conveyance action was "uncertain at best," given the legal hurdles to recovery, the substantial resources of CIT and Sun, and the scarcity of funds in the estate to finance further litigation. The bankruptcy court highlighted the complexity of the litigation and expressed its skepticism that new counsel or a Chapter 7 trustee could be retained to continue the fraudulent conveyance suit on a contingent fee basis. Faced with, in its view, either "a meaningful return or zero," the bankruptcy court decided that "[t]he paramount interest of the creditors" mandated approval of the settlement and that nothing in the Bankruptcy Code dictated otherwise.

The bankruptcy court, therefore, approved the settlement and dismissed Jevic's Chapter 11 case.

THE DISTRICT COURT'S DECISION

The Drivers appealed to the U.S. District Court for the District of Delaware, which affirmed the bankruptcy court's approval of the settlement and dismissal of the case.

The district court began its analysis by noting that the Drivers essentially were not contesting the bankruptcy court's factual findings. In analyzing those factual findings, the district court held that the bankruptcy court had correctly applied the *Martin* factors and had determined that the proposed settlement was "fair and equitable."

The district court also rejected the Drivers' fiduciary duty and absolute priority rule arguments for the same reasons explained by the bankruptcy judge.

[10] *In re Martin*, 91 F.3d 389 (3d Cir. 1996).

[11] The four factors cited by the Third Circuit in *Martin* to guide bankruptcy courts were: "(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 the creditors."

In addition, the district court held that even if the bankruptcy court had erred by approving the settlement and dismissing the case, the appeal was equitably moot because the settlement had been "substantially consummated," as all the funds had been distributed.

The Drivers appealed to the Third Circuit, with the U.S. Trustee supporting them as *amicus curiae*.

ARGUMENTS IN THE THIRD CIRCUIT

The Drivers and the U.S. Trustee argued to the Third Circuit that the bankruptcy court did not have the discretion it had purported to exercise. Specifically, they claimed that bankruptcy courts had no legal authority to approve structured dismissals, at least to the extent that they deviated from the priority system of the Bankruptcy Code in distributing estate assets.

The Drivers argued that Congress would have spoken more clearly if it had intended to leave open an "end run" around the procedures that governed plan confirmation and conversion to Chapter 7. According to the Drivers, the position of the district court and the bankruptcy court overestimated the breadth of bankruptcy courts' settlement-approval power under Bankruptcy Rule 9019, "render[ing] plan confirmation superfluous" and paving the way for illegitimate *sub rosa* plans engineered by creditors with overwhelming bargaining power. The Drivers contended that neither "dire circumstances" nor the bankruptcy courts' general power to carry out the provisions of the Bankruptcy Code under Bankruptcy Code Section 105(a) authorized a bankruptcy court to deviate from the Bankruptcy Code's requirements.

Additionally, the Drivers argued that even if structured dismissals were permissible, they could not be approved if they distributed estate assets in derogation of the priority scheme of Bankruptcy Code Section 507. They contended that Section 507 applied to all distributions of estate property under Chapter 11 and that, accordingly, the bankruptcy court was powerless to approve a settlement that skipped priority employee creditors (such as the Drivers) in favor of tax and general unsecured creditors.[12]

[12] Some case law tacitly supported the Drivers' position. For example, in *TMT Trailer Ferry*, *supra* note 5, the U.S. Supreme Court held that the "requirement[] . . . that plans of reorganization be both 'fair and equitable,' appl[ied] to compromises just as to other aspects of reorganizations." The Court also noted that "a bankruptcy court is not to approve or confirm a plan of reorganization unless it is found to be 'fair and equitable.' This standard incorporates the absolute priority doctrine under which creditors and stockholders may participate only in accordance with their respective priorities[.]" Other cases have described "fair and equitable" as "'words of art' which mean that senior interests are entitled to full priority over junior ones[.]"

THE THIRD CIRCUIT'S DECISION

The Third Circuit affirmed.

In its decision, the circuit court first considered whether structured dismissals were ever permissible under the Bankruptcy Code, and decided that they were.

The circuit court conceded that the Drivers were correct that, as the bankruptcy court had acknowledged, the Bankruptcy Code did not expressly authorize structured dismissals.

The Third Circuit observed that although Bankruptcy Code Section 349 contemplated that dismissal of a Chapter 11 case typically would reinstate the prepetition state of affairs by revesting property in the debtor and vacating orders and judgments of the bankruptcy court, it also explicitly authorized the bankruptcy court to alter the effect of dismissal "for cause"—in other words, the Third Circuit said, the Bankruptcy Code did "not strictly require dismissal of a Chapter 11 case to be a hard reset."[13]

The Third Circuit then narrowed the issue, reasoning that it was clear that there was "no prospect of a confirmable plan in this case and that conversion to Chapter 7 was a bridge to nowhere" and, therefore, that it did not have to decide whether structured dismissals were permissible when a confirmable plan was possible or conversion to Chapter 7 might be worthwhile. It then declared that, absent a showing that a structured dismissal had been "contrived to evade the procedural protections and safeguards of the plan confirmation or conversion processes," a bankruptcy court had discretion to order such a disposition.

Having determined that bankruptcy courts had the power in appropriate circumstances to approve structured dismissals, the Third Circuit next considered whether settlements in that context ever could skip a class of objecting creditors in favor of more junior creditors. It decided that, in "rare circumstances," they could.

SEC v. Am. Trailer Rentals Co., 379 U.S. 594, 611, 85 S. Ct. 513, 13 L. Ed. 2d 510 (1965); *accord Otis & Co. v. SEC*, 323 U.S. 624, 634, 65 S. Ct. 483, 89 L. Ed. 511 (1945); *Case v. L.A. Lumber Prods. Co.*, 308 U.S. 106, 115–16, 60 S. Ct. 1, 84 L. Ed. 110 (1939); *see also* 11 U.S.C. § 1129(b)(2)(B)(ii) (codifying the absolute priority rule by requiring that a plan of reorganization pay senior creditors before junior creditors in order to be "fair and equitable" and confirmable).

It nonetheless is worth noting that nothing in the Bankruptcy Code indicates that Congress legislated with settlements in mind—in fact, the power of bankruptcy courts to approve settlements comes from a Federal Rule of Bankruptcy Procedure promulgated by the U.S. Supreme Court, not Congress. *See* Rules Enabling Act, 28 U.S.C. § 2075.

[13] For support, the Third Circuit pointed to this statement in the legislative history of the Bankruptcy Code: "The court is permitted to order a different result for cause." H.R. Rep. No. 595, 95th Cong., 1st Sess. at 338 (1977).

The Third Circuit observed that when Congress codified the absolute priority rule, it had done so in the "specific context of plan confirmation" under Bankruptcy Code Section 1129(b)(2)(B)(ii) and that neither Congress nor the Supreme Court had ever said that the rule applied to settlements in bankruptcy.

The Third Circuit pointed out that settlements were "favored in bankruptcy." Given the "dynamic status of some pre-plan bankruptcy settlements," it agreed with the Second Circuit in *Iridium* that it made sense for the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure to leave bankruptcy courts "more flexibility" in approving settlements than in confirming plans of reorganization.

The Third Circuit acknowledged that settlements that skipped objecting creditors in distributing estate assets raised "justifiable concerns about collusion among debtors, creditors, and their attorneys and other professionals," and it stated that the policy underlying the absolute priority rule—ensuring the evenhanded and predictable treatment of creditors—applied in the settlement context. Accordingly, the Third Circuit held that bankruptcy courts could approve settlements that deviated from the priority scheme of Bankruptcy Code Section 507 only if they had "specific and credible grounds to justify [the] deviation."

Finally, the Third Circuit concluded that the bankruptcy court in this case had sufficient reason to approve the settlement and structured dismissal of Jevic's Chapter 11 case. This disposition, it said, remained the "least bad alternative" given that there was "no prospect" of a plan being confirmed and conversion to Chapter 7 would have resulted in the secured creditors taking all that remained of the estate. The Third Circuit stated:

> If courts required settlements to be perfect, they would seldom be approved; though it's regrettable that the Drivers were left out of this one, the question [was] whether the settlement serves the interests of the estate, not one particular group of creditors. There is no support in the record for the proposition that a viable alternative existed that would have better served the estate and the creditors as a whole.

The Third Circuit stated that the bankruptcy court, "in Solomonic fashion, reluctantly approved the only course that resulted in some payment to creditors other than CIT and Sun." Simply put, the Third Circuit concluded, the Bankruptcy Code permitted a structured dismissal, even one that deviated from the priorities in Bankruptcy Code Section 507, in the "rare" situation when a bankruptcy court made "sound findings of fact that the traditional routes out of Chapter 11" were unavailable and the settlement was "the best feasible way of serving the interests of the estate and its creditors."

CONCLUSION

Clearly, there are arguments for and against allowing bankruptcy courts to authorize the distribution of settlement proceeds in a structured dismissal in a manner that violates the Bankruptcy Code's priority scheme. The answer that the Supreme Court provides will determine whether future Chapter 11 cases will be able to be resolved through a structured dismissal, or whether parties will be required to resolve their disputes through the more limited methods set forth under the Bankruptcy Code. Stay tuned.