Stuart I. Gordon and Matthew V. Spero on

Supreme Court Rejects "Structured Dismissals." Now What?

2017 Emerging Issues 7578

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The U.S. Supreme Court has ruled that a bankruptcy court cannot approve a structured dismissal that provides for distributions that do not follow statutory priorities without the affected creditors' consent.

The Supreme Court's decision in Czyzewski v. Jevic Holding Corp.[1] promises significant practical changes to the way more and more debtors over the years have sought to resolve their financial problems and their creditors' claims—with implications for all parties involved in a bankruptcy case. Indeed, Jevic is one of the most important bankruptcy-related decisions by the Court in many, many years.

BACKGROUND

Chapter 11 foresees three possible outcomes.

The first is a Chapter 11 plan confirmed by the bankruptcy court. A confirmed plan may or may not provide for a debtor's continued operations but, importantly, it also can provide for payment to creditors—perhaps over time.[2]

The Bankruptcy Code sets forth a basic system of priority of creditors' claims that ordinarily determines the order by which assets of a bankruptcy estate are distributed under a plan. Although there is some flexibility for distributions under a plan, a bankruptcy court cannot confirm a plan that contains priority-violating distributions over the objection of an impaired creditor class (i.e. creditors receiving less than 100 percent and/or that will not be paid in full upon confirmation of the plan).[3]

The second possible outcome of a Chapter 11 case is conversion of the case to a case under Chapter 7, resulting in the debtor's liquidation and the distribution of its remaining assets by a bankruptcy trustee.[4] A conversion to a case under Chapter 7 occurs when the parties are unable to reach agreement on a Chapter 11 plan or a debtor does not have the wherewithal to reorganize its business. Distributions of assets in a Chapter 7 liquidation must follow the order prescribed in the Bankruptcy Code.[5]

1 Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973, 197 L. Ed. 2d 398 (2017).
2 See 11 U.S.C. §§ 1123, 1129, 1141.
3 See 11 U.S.C. §§ 1129(a)(7), 1129(b)(2).
4 See 11 U.S.C. §§ 1112(a), (b), 726.
5 See 11 U.S.C. §§ 725, 726.

The third possible outcome is dismissal of the Chapter 11 case.[6] A dismissal typically revests the property of the bankruptcy estate in the entity in which the property was vested immediately before the commencement of the Chapter 11 case—in other words, it aims to return to the prepetition financial status quo.[7]

The Bankruptcy Code recognizes, however, that conditions may have changed after a debtor has entered Chapter 11 in ways that make a perfect restoration of the status quo difficult or impossible. Therefore, the Bankruptcy Code permits a bankruptcy court, "for cause," to alter a Chapter 11 dismissal's ordinary restorative consequences.[8] Certain of these dismissals have become known as "structured dismissals." The American Bankruptcy Institute defines a structured dismissal as a:

> hybrid dismissal and confirmation order . . . that . . . typically dismisses the case while, among other things, approving certain distributions to creditors, granting certain third-party releases, enjoining certain conduct by creditors, and not necessarily vacating orders or unwinding transactions undertaken during the case.[9]

Suppose that a bankruptcy court dismisses a Chapter 11 case in a way that does not simply restore the prepetition status quo. Rather, the bankruptcy court orders a distribution of estate assets that provides payments to (highest priority) secured creditors and to (low priority) general unsecured creditors, but that does not provide payments to certain dissenting mid-priority creditors. Suppose that the dissenting mid-priority creditors would have been entitled to payment ahead of the general unsecured creditors in a Chapter 11 plan, or in a Chapter 7 liquidation. Does a bankruptcy court have the power to order this kind of distribution scheme—that is, a structured dismissal—in connection with its dismissal of a Chapter 11 case?

That issue was at the heart of Jevic.

JEVIC

The Jevic case[10] arose in 2006, when Sun Capital Partners, a private equity firm, acquired Jevic Transportation Corporation with money borrowed from CIT Group in a leveraged buyout. Two years after Sun's buyout, Jevic sought protection under Chapter 11. At the time of its bankruptcy filing, Jevic owed $53 million to senior secured creditors Sun and CIT, and over $20 million to tax and general unsecured creditors.

The circumstances surrounding Jevic's bankruptcy filing led to two lawsuits.

First, a group of former Jevic truck drivers filed an action in the bankruptcy court against Jevic and Sun. The truck drivers pointed out that, just before entering bankruptcy, Jevic had halted almost all

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6 See 11 U.S.C. § 1112(b).
7 See 11 U.S.C. § 349(b)(3).
8 See 11 U.S.C. § 349(b).
9 American Bankruptcy Institute Commission to Study the Reform of Chapter 11, 2012–2014 Final Report and Recommendations 270 (2014).
10 For further background, see Stuart I. Gordon & Matthew V. Spero, U.S. Supreme Court to Rule on "Structured Dismissals," 12 PRATT'S JOURNAL OF BANKRUPTCY LAW 346-56 (Oct. 2016).

of its operations and had told them that they would be fired. The truck drivers claimed that Jevic and Sun had violated state and federal Worker Adjustment and Retraining Notification ("WARN") Acts, which require companies to give workers at least 60 days' notice before their termination.[11] The U.S. Bankruptcy Court for the District of Delaware granted summary judgment for the truck drivers against Jevic, leaving them with a judgment that, they said, was worth $12.4 million. Approximately $8.3 million of that judgment counted as a priority wage claim[12] and, therefore, was entitled to payment ahead of general unsecured claims from the Jevic bankruptcy estate.

Second, the bankruptcy court authorized a committee representing Jevic's unsecured creditors to sue Sun and CIT. The bankruptcy court and the parties were aware that any proceeds from such a suit would belong not to the unsecured creditors, but to the bankruptcy estate.[13] In its action, the committee alleged that Sun and CIT, in the course of their leveraged buyout, had "hastened Jevic's bankruptcy by saddling it with debts that it couldn't service."

In the committee's action, the bankruptcy court held that the committee had adequately pleaded claims of preferential transfer under Bankruptcy Code Section 547 and of fraudulent transfer under Bankruptcy Code Section 548.

Sun, CIT, Jevic, and the committee then tried to negotiate a settlement of the committee's action. By that point, the depleted Jevic estate's only remaining assets were the committee's fraudulent conveyance claim itself and $1.7 million in cash, which was subject to a lien held by Sun.

The parties reached a settlement agreement that provided that:

> (1) The bankruptcy court would dismiss the committee's fraudulent conveyance action with prejudice;
>
> (2) CIT would deposit $2 million into an account earmarked to pay the committee's legal fees and administrative expenses;
>
> (3) Sun would assign its lien on Jevic's remaining $1.7 million to a trust, which would pay taxes and administrative expenses and distribute the remainder on a pro rata basis to general unsecured creditors, but which would not distribute anything to the truck drivers with respect to their $8.3 million wage claim against the estate;[14] and
>
> (4) Jevic's Chapter 11 bankruptcy case would be dismissed.

Thus, the proposed settlement called for a structured dismissal that provided for distributions that did not follow the Bankruptcy Code's priority rules.

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11 See 29 U.S.C. § 2102; N. J. Stat. Ann. § 34:21-2.
12 See 11 U.S.C. § 507(a)(4).
13 See 11 U.S.C. § 541(a)(1), (6).
14 Apparently Sun insisted on a distribution that would skip the truck drivers because their WARN suit against Sun still was pending and Sun did not want to help finance that litigation. Eventually, Sun prevailed in the truck drivers' WARN suit on the ground that it was not the truck drivers' employer at the relevant times.

Sun, CIT, Jevic, and the committee asked the bankruptcy court to approve the settlement and dismiss the case.

The truck drivers and the U.S. Trustee objected to the proposed structured dismissal, arguing that the settlement's distribution plan violated the Bankruptcy Code's priority scheme because it skipped the truck drivers—who, by virtue of their WARN judgment, had claims against estate assets superior to the claims of general unsecured creditors—yet proposed to distribute estate property to the general unsecured creditors instead of to the truck drivers.

The bankruptcy court agreed with the truck drivers that the settlement's distribution scheme failed to follow the Bankruptcy Code's priority rules. The bankruptcy court held, however, that this failure did not bar approval of the settlement. The bankruptcy court reasoned that the settlement was not prohibited because the proposed payouts would occur pursuant to a structured dismissal of a Chapter 11 petition rather than in connection with approval of a Chapter 11 plan for Jevic.

The bankruptcy court, therefore, decided to grant the motion to approve the settlement in light of what it characterized in its opinion as the "dire circumstances" facing the estate and its creditors. Specifically, the bankruptcy court predicted that without the settlement and dismissal, there was "no realistic prospect" of a meaningful distribution for anyone other than the secured creditors. The bankruptcy court determined that a confirmable Chapter 11 plan was unattainable, and that there were no funds to operate, investigate, or litigate were the case converted to a proceeding under Chapter 7.

The U.S. District Court for the District of Delaware affirmed the bankruptcy court's decision. The district court recognized that the settlement distribution violated statutory priority rules. The district court decided that those rules, however, were "not a bar to the approval of the settlement" because the settlement was "not a reorganization plan."

The U.S. Court of Appeals for the Third Circuit affirmed the district court's decision by a vote of 2 to 1. The majority held that structured dismissals need not always respect priority. Congress, the majority explained, only had "codified the absolute priority rule . . . in the specific context of plan confirmation." As a result, the majority decided, bankruptcy courts could, "in rare instances like this one, approve structured dismissals that do not strictly adhere to the Bankruptcy Code's priority scheme."

The truck drivers sought certiorari, and the Supreme Court granted their petition.

THE SUPREME COURT'S DECISION

The Court, in a decision by Associate Justice Stephen G. Breyer, reversed the Third Circuit, holding 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 Bankruptcy Code establishes for final distributions of estate value in business bankruptcies.

The Court explained that the issue in the case concerned the interplay between the Bankruptcy Code's priority rules and a Chapter 11 dismissal. It pointed out that the bankruptcy court had neither liquidated Jevic under Chapter 7 nor confirmed a Chapter 11 plan for Jevic.

Rather, the Court noted, the bankruptcy court, instead of reverting to the pre-bankruptcy status quo, had ordered a distribution of the Jevic estate's assets to creditors by attaching conditions to the dismissal (i.e., it ordered a structured dismissal). The Court observed that the Bankruptcy Code does not explicitly state what priority rules, if any, apply to a distribution in these circumstances. The Court asked:

> May a [bankruptcy] court consequently provide for distributions that deviate from the ordinary priority rules that would apply to a Chapter 7 liquidation or a Chapter 11 plan? Can it approve conditions that give estate assets to members of a lower priority class while skipping objecting members of a higher priority class?

In deciding that a bankruptcy court could not so act, the Court reasoned that the Bankruptcy Code's priority system constitutes a "basic underpinning of business bankruptcy law." It noted that distributions of estate assets at the termination of a business bankruptcy normally take place through a Chapter 7 liquidation or a Chapter 11 plan, both of which are governed by priority rules. In Chapter 7 liquidations, the Court said, priority "is an absolute command— lower priority creditors cannot receive anything until higher priority creditors have been paid in full." The Court recognized that there was "somewhat more flexibility" in Chapter 11 plans, but noted that "a priority-violating plan still cannot be confirmed over the objection of an impaired class of creditors."

The Court then said that there was nothing in the Bankruptcy Code that indicated that Congress had intended to make structured dismissals a "back- door means to achieve the exact kind of nonconsensual priority-violating final distributions" prohibited in Chapter 7 liquidations and Chapter 11 plans. The Court found that Section 349(b)'s authorization for a bankruptcy court to alter, "for cause," a dismissal's restorative consequences—that is, to something other than the prepetition financial status quo—appeared designed only to give bankruptcy courts the flexibility to "make the appropriate orders to protect rights acquired in reliance on the bankruptcy case."

The Court found nothing else in the Bankruptcy Code that authorizes a bankruptcy court ordering a dismissal to make general end-of-case distributions of estate assets to creditors of the kind that normally take place in a Chapter 7 liquidation or Chapter 11 plan—let alone "final distributions that do not help to restore the status quo ante or protect reliance interests acquired in the bankruptcy, and that would be flatly impermissible in a Chapter 7 liquidation or a Chapter 11 plan because they violate priority without the impaired creditors' consent."

The Court was not persuaded by the argument that disregarding priority in a structured dismissal should be permitted in "rare cases," such as Jevic, where there were "sufficient reasons" to disregard priority, as the Third Circuit had suggested. In the Court's view, it was "difficult" to give precise content to the concept "sufficient reasons," which threatened to turn a "rare case" exception into "a more general rule."

EARLY APPLICATION OF JEVIC

At least one bankruptcy court already has rejected a proposed settlement based on the reasoning of Jevic.[15]

In this case, the debtor proposed to sell property free and clear of a tax lien filed by the Internal Revenue Service. In particular, the debtor proposed to sell stock interests in two corporations whose value the debtor listed as $900,000; the buyer of these interests was to be the other shareholder of the companies. The purchase price for these interests was $350,000 plus the conveyance by one of the companies of a piece of property it owned.

The settlement, however, did not propose to have the IRS lien attach to the proceeds of the sale. Rather, the debtor proposed to have the lien attach to two other properties that the debtor owned in Chattanooga, Tennessee, encumbered by a $531,000 mortgage in favor of Pinnacle Bank. The debtor also proposed that Pinnacle Bank's lien would be satisfied by the payment to Pinnacle Bank of the $350,000 in sales proceeds—even though the debtor contended that the property subject to Pinnacle Bank's lien was worth only $200,000.

The U.S. Trustee and various creditors opposed the proposed settlement. They argued that Pinnacle Bank was being preferred and that the priorities set for distribution under the Bankruptcy Code were being reordered to Pinnacle Bank's benefit.

The bankruptcy court rejected the proposed settlement, finding that it provided for a distribution that did "not follow the ordinary priority rules."

In its decision, it explained that, based on the filed claims, the proceeds from the sale of the stock should go first to the lien of the IRS. Then, the proceeds should be paid into the estate for distribution to priority creditors and to unsecured creditors on a pro rata basis. However, the bankruptcy court pointed out, the proposed settlement would have Pinnacle Bank move "to the head of the line."

The bankruptcy court observed that this might be acceptable if all of the creditors were consenting, but it pointed out that they were not. The bankruptcy court concluded that the proposed settlement was "a preamble to a conversion or structured dismissal" without serving any significant Bankruptcy Code-related objective and, therefore, that it could not be approved.

CONCLUSION

The Supreme Court made it clear in its opinion in Jevic that it was not ruling that interim distributions were not permitted. Thus, it did not reject the decision by the U.S. Court of Appeals for the Second Circuit in In re Iridium Operating LLC,[16] which involved an interim distribution of settlement proceeds to fund a litigation trust that would press claims on the estate's behalf.

15 In re Fryar, 2017 Bankr. LEXIS 1123 (Bankr. E.D. Tenn. Apr. 25, 2017).
16 In re Iridium Operating LLC, 478 F.3d 452 (2d Cir. 2007).

The Court also seemed to tacitly approve "first day" wage orders that allow payment of employees' prepetition wages, "critical vendor" orders that allow payment of essential suppliers' prepetition invoices, and "roll ups" that allow lenders that continue financing a debtor to be paid first on their prepetition claims—at least when these distributions are intended to "enable a successful reorganization and make even the disfavored creditors better off." Of course, it remains to be seen how bankruptcy courts—and, perhaps, ultimately even the Supreme Court—will decide the permissible parameters of these kinds of orders when they are directly faced with them in the future.

Notwithstanding these kinds of limited exceptions, Jevic will significantly alter existing bankruptcy practice. With non-consensual structured dismissals no longer permissible, many business cases will have to be filed under Chapter 7 rather than Chapter 11, or will have to be converted from Chapter 11 to Chapter 7 soon after they are commenced when it becomes clear that they do not belong in Chapter 11 because there is no realistic chance of proposing a plan that either complies with the priority scheme of the Bankruptcy Code or that would be acceptable to the creditor body and capable of confirmation.

Many debtors that would prefer to operate in Chapter 11, with hopes (no matter how slim) of reorganizing and of continuing to operate post-bankruptcy now will find that they may not do so because they will have to comply with the Bankruptcy Code priorities or otherwise obtain creditor support. Some companies that would prefer a Chapter 11 filing rather than a Chapter 7 case with the appointment of a trustee with full investigative powers are likely to be disappointed as a result of Jevic.

Moreover, many creditors that would prefer to resolve their claims under the supervision of a bankruptcy judge will find that they are unable to do so without fully complying with the Bankruptcy Code's priority rules. Secured creditors interested in maximizing the value of their collateral also may find it more difficult to do so in a way that insulates them from potential litigation.

Further, professionals who serve in Chapter 11 cases as trustees or as counsel to committees or other parties in interest will likely find that there will be fewer Chapter 11 cases being filed (especially if there is no exit strategy and no creditor support in place on the filing date) because they cannot survive the stricter scrutiny post-Jevic. Moreover, many of the cases that are filed will be subject to dismissal or conversion to Chapter 7.

Simply put, the days of trying to formulate an "exit strategy" on the fly that contemplates a plan that is not consistent with the priority rules of the Bankruptcy Code as a way of avoiding Chapter 7 are over absent the consent of all parties. Welcome to the post-Jevic world!

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