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Third Circuit Approves Use of Structured Dismissal, but Rarely

On May 21, 2015, the United States Court of Appeals for the Third Circuit (the "Third Circuit") held that in rare instances a bankruptcy court may approve a "structured dismissal"— that is, a dismissal "that winds up the bankruptcy with certain conditions attached instead of simply dismissing the case and restoring the status quo ante" — that deviates from the Bankruptcy Code's priority scheme. *See Official Committee of Unsecured Creditors* v. *CIT Group/Business Credit Inc. (In re Jevic Holding Corp.)*, Case No. 14-1465, -- F.3d --, 2015 WL 2403443, at *2 (3d Cir. May 21, 2015).

Background

In 2006, a subsidiary of Sun Capital Partners ("Sun") acquired Jevic Transportation, Inc. ("Jevic"), a New Jersey trucking company in a leveraged buyout. A group led by CIT Group ("CIT") financed the purchase. Two years later, Jevic was struggling and on May 19, 2008, it stopped operating and notified its employees that they were being terminated. The next day, Jevic filed a voluntary chapter 11 case in Delaware.

Two adversary proceedings were filed during the pendency of the chapter 11 case. First, a group of former Jevic truck drivers (the "Drivers") filed a class action complaint against Jevic and Sun alleging violations of federal and state Worker Adjustment and Retraining Notifications (WARN) Acts, which require 60 days' written notice before termination. Second, the official committee of unsecured creditors (the "Committee") brought a fraudulent conveyance action against Sun and CIT on behalf of the bankruptcy estate.

In March 2012, Jevic, the Committee, Sun, CIT, and the Drivers met to discuss a settlement of the fraudulent conveyance action. By then, Jevic's assets had been depleted, with only $1.7 million in cash (subject to Sun's priority lien) and the fraudulent conveyance action remaining. Jevic, the Committee, Sun and CIT negotiated a settlement in which: (i) the settling parties would provide mutual releases and the Committee's action against Sun and CIT would be dismissed; (ii) CIT would pay $2 million to cover Jevic and the Committee's legal fees and administrative expenses; (iii) Sun's priority lien on Jevic's remaining cash would be assigned to a trust to pay tax and administrative claimants first and general unsecured creditors second on a *pro rata* basis; and (iv) the chapter 11 case would be dismissed. The proposed settlement thus provided for a "structured dismissal."

The Drivers—who asserted a claim of $12.4 million, with $8.3 million allegedly entitled to priority wage claim status under the Bankruptcy Code—were not part of the settlement.[1]

The United States Trustee and the Drivers objected to the settlement agreement, maintaining that by making distributions to creditors junior to the Drivers, it violated the Bankruptcy Code's priority scheme. The Bankruptcy Code grants priority to certain categories of unsecured claims, including certain employee wage claims, and requires a debtor to pay these claims in full before making distributions to holders of general (that is, non-priority) unsecured claims.[2] The United States Trustee also argued that structured dismissals are not permitted under the Bankruptcy Code.

The Bankruptcy Court overruled the objections and approved the settlement. It acknowledged that the Bankruptcy Code does not expressly authorize structured dismissals but concluded that the relief was justified given the "dire circumstances" present in the case: (i) there was "no prospect of a confirmable Chapter 11 plan," and (ii) conversion to chapter 7 would be impracticable because the chapter 7 trustee would have no resources to fund the case. *Jevic* at *6. The Bankruptcy Court rejected the contention that it could not approve the settlement agreement because the arrangement violated the absolute priority rule, explaining that the Bankruptcy Code's priority scheme does not extend to settlements. Finding that the settlement provided the best option under the circumstances, the Bankruptcy Court approved the settlement agreement.

The Drivers appealed to the District Court, which affirmed the Bankruptcy Court's decision. An appeal to the Third Circuit followed.

The Majority Decision

In affirming, the Third Circuit focused on two issues: (i) whether a structured dismissal is permissible under the Bankruptcy Code; and (ii) if so, whether a settlement in the context of a structured dismissal must adhere to the priority scheme of section 507 of the Bankruptcy Code.[3]

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1 While the record is unclear as to why the Drivers were left out of the settlement, it seems that Sun was not willing to pay the Drivers while the WARN Act class action lawsuit was still pending. Essentially, Sun "did not want to fund litigation against itself." *Jevic* at *2.

2 The Drivers also argued that the Committee breached its fiduciary duty by signing on to a settlement agreement that "effectively, freezes [them] out." *Jevic* at *3. The Bankruptcy Court rejected the argument, noting that such fiduciary duty does not give each creditor veto power over a potential settlement.

3 The Bankruptcy Court's findings of fact and discretionary exercise were not being challenged.

The Drivers maintained that there are only "three exits from bankruptcy: confirmation of a plan of reorganization, conversion to Chapter 7 liquidation, or plain dismissal with no strings attached." *Jevic* at *5. The Circuit Court recognized that the Bankruptcy Code does not expressly provide for structured dismissals, but noted that it "explicitly authorizes the bankruptcy court to alter the effect of dismissal 'for cause' – in other words, the Code does not strictly require dismissal of a Chapter 11 case to be a hard reset." *Id.* It pointed out that the Drivers did not dispute the Bankruptcy Court's finding that there was no prospect of a confirmable plan and that chapter 7 conversion was impracticable. It concluded that "absent a showing that a structured dismissal has been contrived to evade the procedural protections and safeguards of the plan confirmation or conversions processes, a bankruptcy court has discretion to order such a disposition." *Id.* at *6.[4]

The Court turned next to the Driver's argument that structured dismissals, if permissible, may not distribute estate assets in violation of the Bankruptcy Code's priority scheme. Noting that the "Drivers' argument is not without force," it held that "bankruptcy courts may approve settlements that deviate from the priority scheme of § 507 of the Bankruptcy Code ***only*** if they have 'specific and credible grounds to justify the deviation.'" *Jevic* at *7, *9 (emphasis added). In coming to this conclusion, the Third Circuit considered two decisions from other circuits addressing whether settlements must adhere to the priority scheme set forth in section 507 of the Bankruptcy Code.

In *Matter of AWECO, Inc.*, 725 F.2d 293 (5th Cir. 1984), the Fifth Circuit adopted a *per se* rule and rejected a settlement that did not comply with the Bankruptcy Code's priority scheme. However, in *In re Iridium Operating LLC*, 478 F.3d 452 (2d Cir. 2007), the Second Circuit criticized *AWECO* and adopted a more flexible standard. The Second Circuit held that while compliance with the Bankruptcy Code's priority scheme was the most important factor to consider when determining whether to approve a settlement, "a noncompliant settlement could be approved when 'the remaining factors weigh heavily in favor of approving a settlement.'" *Jevic* at *8. The Court favored the *Iridium* approach, which it viewed as facilitating settlements.

While the Court of Appeals noted that it was a "close call", it concluded that the Bankruptcy Court had sufficient reason to approve the settlement and structured dismissal, including distributions that deviated from the Bankruptcy Code's priority scheme. *Jevic* at *9. On the record before it, the "disposition, unsatisfying as it was, remained the least bad alternative since 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." *Id.*

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[4] Based on the facts of the case, the Third Circuit did not have to decide whether structured dismissals are permissible where there are prospects for a chapter 11 plan being confirmed and/or where conversion to chapter 7 is feasible.

Conclusion

Structured dismissals are a "hot topic" in the restructuring community—proponents note how cost-effective and efficient they are in certain circumstances (e.g., when all of the assets have been sold, the debtor becomes administratively insolvent, etc.) but critics have argued that the practice is not provided for in the Bankruptcy Code and permits debtors to avoid disclosure, solicitation and other Bankruptcy Code requirements. Indeed, in its 2014 report, the American Bankruptcy Institute Commission to Study the Reform of Chapter 11 recommended eliminating structured dismissals. *See Report* at 272-73 (recommending "strict compliance with the Bankruptcy Code in terms of orders ending the chapter 11 case" and explaining that dismissal orders should "satisfy the applicable provisions of, and [] not permit the parties to work around, the Bankruptcy Code"). The Third Circuit is the first Court of Appeals to fully confront the practice. While the Third Circuit suggested that the result achieved here will "likely [] be justified only rarely," the impact of the decision—and the extent to which parties invoke it to support structured dismissals in other circumstances—remains to be seen. *Jevic* at *10.

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