March 24, 2017

Supreme Court Bars Use of Nonconsensual Priority-Violating Structured Dismissals

On March 22, 2017, the United States Supreme Court held that bankruptcy courts cannot approve a "structured dismissal"—a dismissal with special conditions or that does something other than restoring the "prepetition financial status quo"—providing for distributions that deviate from the Bankruptcy Code's priority scheme absent the consent of affected creditors. *Czyzewski* v. *Jevic Holding Corp.*, No. 15-649, 580 U.S. ____ (2017), 2017 WL 1066259, at *3 (Mar. 22, 2017). The Supreme Court's decision reversed the ruling of the United States Court of Appeals for the Third Circuit approving such dismissals, without creditor consent, in "rare instances."

Background

In 2006, a subsidiary of Sun Capital Partners acquired Jevic Transportation, Inc., a New Jersey trucking company in a leveraged buyout. A group led by CIT Group financed the purchase. Two years later, Jevic was struggling and on May 19, 2008, it stopped operating and sent termination notices to 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 chapter 11 case. First, some 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 of termination. Second, the Official Committee of Unsecured Creditors 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 exchange 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 (but not to fund a distribution to the Drivers); and (iv) the chapter 11 case would be resolved as 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 included in the settlement.

© 2017 Paul, Weiss, Rifkind, Wharton & Garrison LLP. In some jurisdictions, this publication may be considered attorney advertising. Past representations are no guarantee of future outcomes.

The United States Trustee and the Drivers objected to the settlement agreement, maintaining that distributions to creditors junior to the Drivers 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. The United States Trustee also argued that the Bankruptcy Code does not permit structured dismissals.

The Bankruptcy Court overruled the objections and approved the settlement. While acknowledging that the Bankruptcy Code does not expressly authorize structured dismissals, it justified the relief given the "dire circumstances" of 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. The Bankruptcy Court rejected the contention that it could not approve the settlement agreement because it 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 available option, 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 Third Circuit affirmed the District Court's ruling by a vote of 2 to 1. The majority explained that Congress had only "codified the absolute priority rule . . . in the specific context of plan confirmation." *Jevic*, at *8. As a result, courts could, "in rare instances like this one, approve structured dismissals that do not strictly adhere to the Bankruptcy Code's priority scheme." *Id.*

The Majority Decision[1]

In reversing the Third Circuit, the Supreme Court noted that the Bankruptcy Code provides for only three possible outcomes to a chapter 11 case: (i) confirmation of a plan, (ii) conversion to a chapter 7 liquidation or (iii) dismissal, which "typically 'revests the property of the estate in the entity in which such property was vested immediately before the commencement of the case.'" *Jevic*, at *4, quoting 11 U.S.C. § 349(b)(3).[2]

---

[1] Justices Thomas and Alito dissented from the majority's ruling on the grounds that the Drivers had reframed the question presented in their merits briefing from the question presented in their petition for certiorari. Initially, the question was "whether a bankruptcy court may authorize the distribution of settlement proceeds in a manner that violates the statutory priority scheme." The minority therefore took the position that the writ should have been dismissed as improvidently granted.

[2] The Court also addressed the argument that the Drivers lacked standing because they would not have obtained recovery if the structured dismissal had never been approved (and would not obtain one if they prevailed in their appeal) and, thus, had not suffered an injury. The Court found that the settled fraudulent conveyance claim might have litigation value, and the loss of such potential litigation value was sufficient to confer standing to creditors of the estate, such as the Drivers. *Jevic* at *9.

The Court found that under the plain language of the Bankruptcy Code only the first two possibilities—a chapter 11 plan or a chapter 7 liquidation—explicitly allow for any distribution to creditors. *Id.* at *10. A dismissal, by contrast, does not. *Id.* "Insofar as the dismissal sections of Chapter 11 foresee any transfer of assets, they seek a restoration of the pre-petition financial status quo." *Id.* at *11.

In a chapter 7 liquidation or under a chapter 11 plan, the Bankruptcy Code's priority scheme will govern any distributions: in a chapter 7 liquidation, "priority is an absolute command—lower priority creditors cannot receive anything until higher priority creditors have been paid in full." *Id.* at *10 (citing 11 U.S.C. §§ 725, 726). Similarly, a chapter 11 plan violating the Bankruptcy Code's priority scheme cannot be confirmed over the objection of an impaired class of creditors. *Id.* (citing 11 U.S.C. § 1129(b)).

The Court observed that the Bankruptcy Code's priority scheme has "long been considered fundamental to the Bankruptcy Code's operation." *Id.* at *10.

In light of the statutory and historical guidance, the Court found that Congress could not have intended that dismissal—the only outcome of a chapter 11 case that does not explicitly provide for distribution of estate property—would facilitate such distribution by violating the Bankruptcy Code's priority scheme. Specifically, the Court stated that "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." *Id.*

However, the Court found that no such affirmative intent was evident in the Bankruptcy Code. While it conceded that section 349 of the Bankruptcy Code allowed a court to deviate from the ordinary, restorative nature of dismissal "for cause," the Court was not persuaded that such language provided a basis to convert the Bankruptcy Code's dismissal provision into a distribution provision, let alone a distribution provision permitting violations of the Bankruptcy Code's priority scheme. Instead, the Court stated that the "for cause" exception to dismissal allowed courts the flexibility to fashion orders as necessary to protect the reliance interests acquired during the pendency of a chapter 11 case. *Id.* at *11.[3]

Notably, the Supreme Court distinguished the priority-violating dismissal in *Jevic* from the priority-deviating settlement approved by the United States Court of Appeals for the Second Circuit in *In re Iridium Operating LLC*, 478 F. 3d 452 (2d Cir. 2007). *Id.* at *12. *Iridium*, the Court found, did not involve a *final* distribution of estate value; instead, the settlement provided for an *interim* distribution in the chapter 11 case. *Id.* The Court emphasized that courts have consistently recognized the "Code-related objectives" served by interim, priority-violating distributions that facilitate a case's ongoing administration. *Id.* Such interim distributions include: first-day wage orders, critical-vendor orders,

[3] The Court cited as an example of such reliance interest a bank's agreement to give up its lien in exchange for a release from the debtors. *Jevic*, at *11.

"roll-ups," which allow a debtor's postpetition lender to be paid its prepetition claims, and interim settlements. *Id.* All of these priority-deviating distributions enhance the prospect of a successful reorganization that makes all creditors better off. *Id.* A priority-violating dismissal, by contrast, links a priority-violating distribution with the case's final disposition: "it does not preserve the debtor as a going concern; it does not make the disfavored creditors better off; it does not promote the possibility of a confirmable plan; it does not help to restore the status quo ante; and it does not protect reliance interests." *Id.*

Instead, the Supreme Court analogized the *Jevic* distribution arrangement to proposed 363-sale transactions struck down by courts as evading the procedural safeguards of chapter 11's disclosure and solicitation process. *Id.* at *13 (citing *In re Braniff Airways, Inc.*, 700 F.2d 935, 940 (5th Cir. 1983) and *In re Lionel Corp.*, 722 F.2d 1063, 1069 (2d Cir. 1983)).

Finally, the Court disposed of the Third Circuit's "rare case" exception, noting that the consequences of allowing such an exception, one that might quickly swallow the rule, were potentially serious and, more importantly, there was no support for such an exception in the statute. *Id.* at *14.

Conclusion

The Supreme Court noted in *Jevic* that structured dismissals "appear to be increasingly common." *Jevic*, at *5. While proponents argue that structured dismissals are efficient and cost-effective in certain circumstances (for example, when a debtor becomes administratively insolvent, has disposed of all of its assets, etc.), critics maintain that they are nowhere authorized in the Bankruptcy Code and that they circumvent disclosure, solicitation and other important Bankruptcy Code requirements. While *Jevic* answers the narrow question of whether nonconsensual priority-violating structured dismissals are permissible, it leaves a number of related questions unanswered, including:

- whether "consensual" priority-violating structured dismissals are permissible, and, if so, what sort of consent suffices (for example, would an objection by the United States Trustee invalidate the dismissal);
- whether, and in what circumstances priority-violating "interim" settlements can be approved;
- whether structured dismissals that distribute property in accordance with the Bankruptcy Code's priority scheme are permissible; and
- whether arrangements in which a secured creditor "gifts" its distribution to junior creditors, skipping over senior priority creditors, will be affected.

Although *Jevic*'s holding was narrow, the decision undoubtedly will impact consideration of these issues as lower courts grapple with the Supreme Court's ruling.

* * *

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Jacob A. Adlerstein
212-373-3142
jadlerstein@paulweiss.com

Kelley A. Cornish
212-373-3493
kcornish@paulweiss.com

Alice Belisle Eaton
212-373-3125
aeaton@paulweiss.com

Brian S. Hermann
212-373-3545
bhermann@paulweiss.com

Alan W. Kornberg
212-373-3209
akornberg@paulweiss.com

Elizabeth R. McColm
212-373-3524
emccolm@paulweiss.com

Andrew N. Rosenberg
212-373-3158
arosenberg@paulweiss.com

Jeffrey D. Saferstein
212-373-3347
jsaferstein@paulweiss.com

Stephen J. Shimshak
212-373-3133
sshimshak@paulweiss.com

Erica G. Weinberger
212-373-3422
eweinberger@paulweiss.com

Associate Michael M. Turkel contributed to this client alert.