Bankruptcy courts cannot approve structured dismissal of Chapter 11 case that violates absolute priority rule

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In Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973 (2017), the U.S. Supreme Court held that a bankruptcy court was not authorized to approve a structured dismissal of a Chapter 11 case that violated the absolute priority rule over the objection of impaired creditors.

Justice Stephen Breyer authored the March 22 opinion for the six-member majority that also included Chief Justice John Roberts and Justices Anthony Kennedy, Ruth Bader Ginsburg, Sonia Sotomayor and Elena Kagan.

A "structured dismissal" is a hybrid dismissal order that not only dismisses the bankruptcy case but also approves certain stipulated distributions to creditors. Such orders typically also approve forms of relief beyond simply returning the parties to the status quo before the bankruptcy was filed.

Although not mentioned in the Bankruptcy Code, structured dismissals have become increasingly common. A structured dismissal does not require a disclosure statement, voting, findings or other statutory procedures that would be necessary for a bankruptcy court to confirm a plan of reorganization.

WARN ACT CLAIMS

The debtor, Jevic Transportation, was a trucking company that had gone through a leveraged buyout transaction. Through the LBO, Sun Capital Partners borrowed funds from CIT Group to purchase shares of the debtor and subsequently pledged the debtor's assets to CIT Group as collateral for the loan.

Following the LBO, the debtor conducted a mass layoff of 1,800 of its drivers. The drivers sued the debtor and Sun Capital, the buyer in the LBO, for violating the federal Worker Adjustment and Retraining Notification Act, 29 U.S.C.A. § 2902, and a corresponding New Jersey law. The statutes require companies to give workers at least 60 days' notice before a mass layoff.

The drivers were awarded a $12.4 million judgment against the debtor, of which $8.3 million constituted a priority wage claim under Section 507(a)(4) of the Bankruptcy Code, 11 U.S.C.A. § 507(a)(4).

During the bankruptcy case, the committee of unsecured creditors sued the debtor's lender, CIT, and the buyer, Sun Capital, alleging fraudulent conveyance in connection with the LBO.

The parties eventually settled the fraudulent-conveyance lawsuit, but the settlement agreement required that the case be dismissed pursuant to a structured dismissal in which CIT would deposit $2 million into an account earmarked to pay for the committee's legal fees and administrative expenses and Sun would assign its lien on the debtor's remaining $1.7 million to a trust which would pay taxes and administrative expenses and distribute the remainder to general unsecured creditors.

The proposed structure did not provide for any payments to the truck drivers for their priority wage claims, even though statutorily subordinate general unsecured creditors would receive a distribution.

Sun Capital refused to have its settlement funds paid to the truck drivers who, at the time, were still suing Sun Capital in the WARN Act litigation, because Sun did not want to indirectly fund the litigation against it.

The U.S. Bankruptcy Court for the District of Delaware approved the structured dismissal, noting that the distribution scheme violated priority rules but saying that it was willing to approve the deal because the case presented "dire circumstances."

Without the structured settlement, there was no realistic prospect of a meaningful distribution for anyone other than the secured creditors, the Bankruptcy Court said.

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The U.S. District Court for the District of Delaware affirmed the Bankruptcy Court, finding that the deviation from priority rules was permissible because the structured dismissal was not a reorganization plan. *In re Jevic Holding Corp. et al.,* No. 08-cv-11006, 2014 WL 268613 (D. Del. Jan. 24, 2014).

The 3rd U.S. Circuit Court of Appeals affirmed the District Court's holding that in "rare instances," structured dismissals need not respect priority rules. *In re Jevic Holding Corp.,* 787 F.3d 173 (3d Cir. 2015).

The Supreme Court reversed the Bankruptcy Court, District Court and the 3rd Circuit, holding that bankruptcy courts may not approve structured dismissals that violate statutory distribution rules without the consent of the affected creditors.

DRIVERS HAD STANDING

First, the court dispensed with the debtor's argument that the truck drivers had no standing because they suffered no injury, since they would still receive nothing if the structured dismissal was undone.

The court noted that the standing argument was premised on two dubious assumptions: that there would not have been a settlement without the violation of priority rules, and without a settlement, the fraudulent-conveyance lawsuit had no value.

The court did not think it was impossible to have a settlement without violating priority, reasoning that Sun's insistence that the truck drivers receive nothing may have been a bluff or negotiation tactic. In light of Sun's dismissal from the WARN Act lawsuit, the court said, Sun's desire to avoid funding litigation against itself was no longer a bar to settlement.

As to the second assumption, the court found that in light of the fact that the parties settled for $3.7 million, the fraudulent-conveyance lawsuit had significant value. Had the bankruptcy case been converted from Chapter 11 to Chapter 7, a Chapter 7 trustee could have continued to pursue the fraudulent-conveyance suit.

NO 'RARE CASE' EXCEPTION

Turning to the merits of the case, the court said the priority distribution system is a fundamental aspect of bankruptcy administration and requires that court-approved distributions be made in accordance with established statutory priorities, rather than on the basis of inside influence or the economic leverage of particular creditors.

Because of the importance of the priority system, the court said, Congress would have clearly indicated if it wanted to permit structured dismissals to be a backdoor means of achieving a nonconsensual priority violating distribution that is prohibited in Chapter 11 plans and Chapter 7 liquidations.

The court looked next to the statutes that could justify an out-of-priority structured dismissal and found that none of them permitted the priority violating structured dismissal that had been authorized in this case.

Section 1112(b) of the Bankruptcy Code, 11 U.S.C.A. § 1112(b), states that a bankruptcy court has the power to "dismiss" a case, but says nothing about the power to make nonconsensual priority-violating distributions.

The court then turned to Section 349 of the Bankruptcy Code, 11 U.S.C.A. § 349, which provides "Unless the court, for cause, orders otherwise, a dismissal of a case … reinstates … vacates … and revests the property of the estate."

The court found that the dismissal provisions of Chapter 11 seek to restore the debtor to its pre-bankruptcy financial status quo, and that the phrase "unless the court, for cause otherwise" in Section 349 only gives courts limited flexibility to protect "reliance interests acquired in bankruptcy."

It does not, however, authorize a bankruptcy court to approve an end run around the code's priority scheme for distributions. "The word 'cause' is too weak a reed upon which to rest so weighty a power," the court said.

Bankruptcy courts can approve some priority-violating distributions, such as first-day wage orders, critical vendor orders, and debtor-in-possession financing orders, but those distributions are permissible because they are interim orders that preserve the debtor as a going concern or promote the possibility of a confirmable plan for the benefit of all creditors, the court said.

In the *Jevic* case, the proposed structure of the dismissal went beyond restoring the status quo ante or protecting reliance interests.

Moreover, the court found that Congress did not authorize a rare case exception to the absolute priority rule as articulated by the 3rd Circuit. The court found that the 3rd Circuit's reasoning threatened to turn the rare case exception into a general rule.

The uncertainty surrounding a rare case exception would lead to similar claims being made in other cases and would have serious consequences.

> Although the *Jevic* ruling concerns structured dismissals, it may cast doubt on the continued viability of other common practices in bankruptcy cases.

Congress authorized priority status for wage claims to alleviate the hardships of unemployment and to encourage employees not to abandon failing businesses, the court noted. Ignoring the priority of unpaid wage claims was contrary to Congress' rationale in granting those claims priority.

Furthermore, authorizing a rare case exception might encourage collusion between different creditor groups and would make settlements more difficult to achieve because of the uncertainty over whether the statutory priority scheme would be enforced.

BAIT AND SWITCH

Justice Samuel Alito joined Justice Clarence Thomas in his dissent, which pointed out that the issue on which the Supreme Court granted certiorari was much narrower than the issue the majority actually decided.

The dissent stated that the issue on which certiorari was granted was "whether a bankruptcy court may authorize the distribution of settlement proceeds in a manner that violates the statutory priority scheme."

After the court granted certiorari, the petitioners recast the issue as "whether a Chapter 11 case may be terminated by a structured dismissal that distributes estate property in violation of the Bankruptcy Code's priority scheme," the dissent said.

The dissent stated that it was unwise for the court to decide the reformulated question because:

- Structured dismissals are relatively new and the law surround them is developing rapidly, so the court would have benefited from the views of additional appellate courts before taking on this issue.

- The respondents did not fully brief the recast question that the majority ended up deciding.

The dissent noted that deciding this question might encourage other petitioners to use "bait and switch" tactics.

THE DECISION'S IMPACT

Although the *Jevic* ruling concerns structured dismissals, it may cast doubt on the continued viability of other common practices in bankruptcy cases such as secured creditor "gifting" — priority deviations out of a secured creditor's collateral — or structured distributions of sale proceeds as part of court approved sales under Section 363 of the Bankruptcy Code, 11 U.S.C.A. § 363.

In *Jevic* the court expressed discomfort with certain aspects of Section 363 practice and cited the *Braniff* and *Lionel* cases as two examples where Section 363 orders were overturned as evasions of statutory Chapter 11 requirements. *In re Braniff Airways,* 700 F.2d 935 (5th Cir. 1983); *In re Lionel Corp.*, 722 F.2d 1063 (2d Cir. 1983)

However, the court was careful to distinguish the impermissible structured dismissal in this case from critical vendor and first day wage orders that may violate priority rules but promote the larger goal of reorganization.

The court also cited to an American Bankruptcy Institute report that proposed substantial reforms to sale practices under Section 363.

In general, *Jevic* can be read as a warning to bankruptcy courts that they do not have authority to approve actions that conflict with other statutory requirements of the Bankruptcy Code in the absence of promoting a reorganizational goal.

Although this does not mean the end of the use of structured dismissals as a mechanism to dispose of bankruptcy cases, this decision will undoubtedly incentivize parties to negotiate with and obtain the consent of claimholders whose priority rights may be affected by a structured dismissal or other case dispositive distribution mechanism.

As long as affected creditors consent to an out-of-priority distribution scheme, the court's ruling does not prohibit the approval of a structured dismissal.

Creditors who hold priority claims might consent to out-of-priority distributions under some circumstances, for example to obtain finality, to avoid protracted litigation and burdensome attorney fees, or to receive funds at an earlier date.

It is also worth noting that the out-of-priority distribution sought to be approved in *Jevic* resulted from a unique set of facts. Sun Capital's refusal to pay the truck drivers on their priority wage claims based on the fact that Sun was, at the time, also a defendant in the truck drivers' WARN Act lawsuit (from which it was subsequently dismissed).

In many situations, secured lenders do not have much incentive to disfavor priority claimants and violate the priority scheme.

Regardless of the circumstances, now that the court has drawn the line that structured dismissals cannot violate the priority scheme, this ruling could encourage even more creativity from those who are trying to get around the statutory priority requirements.

For example, parties who want to evade the statutory priority scheme might attempt to reframe such priority-violating distributions as interim distributions or characterize them as supporting a larger reorganizational goal, consistent with the out-of-priority distributions the court characterized as potentially permissible.

Although the Bankruptcy Code and its priority rules exist for a reason, bankruptcy judges and practitioners appreciate the bankruptcy courts' need for flexibility to serve reorganizational goals.

While structured dismissals are clearly not permissible means to make out-of-priority distributions, bankruptcy practitioners, lenders, and bankruptcy courts will continue to test the boundaries of when it is allowable to deviate from the statutory priority scheme.

The full impact of the *Jevic* decision may only be understood in the future cases that struggle to apply its teachings.

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