

## EXPERT ANALYSIS

### High Court Rules Final, Nonconsensual Structured Dismissals Invalid

By Cathleen C. Moore, Esq., and James W. Thurman, Esq.  
*Bradley Arant Boult Cummings LLP*

The Bankruptcy Code contemplates that a Chapter 11 bankruptcy case will be concluded in one of three ways: a confirmed Chapter 11 plan, a conversion to Chapter 7 for liquidation of remaining estate assets, or a dismissal of the case and reversion to the pre-petition status quo.

As Chapter 11 bankruptcy practice evolved over the past 20 years, however, a newer option for resolving Chapter 11 cases emerged — the so-called structured dismissal, defined by the American Bankruptcy Institute 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.” *Czyzewski v. Jevic Holding Corp.*, 137 S. Ct. 973, 979 (2017) (citing American Bankruptcy Institute Commission to Study the Reform of Chapter 11, 2012-2014 Final Report and Recommendations 270 (2014)).

Structured dismissals, while not defined or otherwise mentioned in the code, have become increasingly common in recent years, sometimes providing for a final distribution of estate assets to creditors that does not adhere to the Bankruptcy Code’s priority scheme (and consequently, would not be permissible in the context of either a Chapter 11 plan confirmation or a liquidation under Chapter 7).

The structured dismissal before the Supreme Court in *Jevic* provided for just such final, priority-altering distributions, proposing to, among other things, pay remaining estate assets to both high-priority secured creditors and lower-priority general unsecured creditors, while skipping entirely over certain intermediate-priority creditors who did not consent to the proposed settlement and structured dismissal.

The Supreme Court concluded that parties cannot use structured dismissals to circumvent the Bankruptcy Code’s priority rules, 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 code establishes for final distributions of estate value in business bankruptcies.”

The decision reversed the 3rd U.S. Circuit Court of Appeals’ holding that such dismissals may be allowed in rare cases. In doing so, the Supreme Court provided clarity in an emerging area of bankruptcy law.

While holding unequivocally that parties cannot accomplish through structured dismissals the kind of nonconsensual, priority-altering final distributions of estate assets that are plainly prohibited under both Chapter 11 plans and in Chapter 7 liquidations, the Supreme Court was careful to narrowly tailor its opinion so as to not impair the ability of parties to provide for interim distributions of estate assets that may violate the code’s priority rules, but nonetheless serve “significant Code-related objectives.”



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Accordingly, certain orders relied on heavily by reorganizing debtors in modern-day Chapter 11 practice, including critical-vendor orders and first-day wages orders, are unaffected by *Jevic*.

### THE FACTS

The dispute before the Supreme Court arose from two lawsuits filed in a bankruptcy case resulting from the unsuccessful acquisition of the trucking company Jevic Transportation Corp. by Sun Capital Partners through a leveraged buyout financed chiefly by the lender, CIT Group.

After struggling for two years, and facing the expiration of an agreement preventing CIT from foreclosing on Jevic's assets, Jevic halted operations and sent termination notices to its employees. The trucking company filed for Chapter 11 protection in Delaware the next day.

In the first lawsuit, the unsecured creditors committee brought a fraudulent-transfer action against Sun Capital and CIT, arguing that the leveraged buyout had hastened Jevic's bankruptcy by burdening the company with unserviceable debts.

A class of truck drivers terminated by Jevic brought the second lawsuit, alleging state and federal Worker Adjustment and Retraining Notification Act violations as a result of their termination.

The truck drivers prevailed on their state law claims, and \$8.3 million of their claim qualified as wages under Section 507(a)(4)(1) of the Bankruptcy Code, 11 U.S.C.A. § 507(a)(4)(1), entitling them to priority over lower-ranked priority claims and general unsecured claims.

### THE SETTLEMENT AND STRUCTURED DISMISSAL

In June 2012, Sun Capital, CIT Bank and the unsecured creditors committee sought court approval of a settlement of the fraudulent-conveyance lawsuit and a structured dismissal, which proposed to wind up Jevic's bankruptcy case on certain specified terms.

While typically a dismissal of a bankruptcy case under Section 349 of the code, 11 U.S.C.A. § 349, simply restores the pre-bankruptcy status quo and leaves parties to whatever remedies they may have under state law, the structured dismissal sought by the movants in *Jevic* proposed to do far more: Settle the fraudulent-transfer claims against Sun Capital and CIT, dismiss the fraudulent-conveyance action with prejudice, distribute settlement proceeds among various claimants, approve mutual releases among the settling parties, and then dismiss the bankruptcy case upon satisfaction of these terms.

Under the proposed settlement, the truck drivers would receive nothing on their priority wage claims, while general unsecured creditors would receive distributions on their lower-priority claims.

### LOWER COURT RULINGS

The truck drivers objected to the dismissal because it would distribute estate assets to creditors over whom the truck drivers had priority.

The U.S. Bankruptcy Court for the District of Delaware held that structured dismissals were permissible even though not expressly authorized by the code, and that while Chapter 11 plans must satisfy the absolute priority rule, under which an impaired class of dissenting unsecured creditors must be paid in full before a junior class of claimants is paid, settlements outside the context of a plan need not adhere to the priority rule.

The court based its decision in part on the assumption that without the structured dismissal there was "no realistic prospect of a meaningful distribution for anyone other than the secured creditors." *In re Jevic Holding Corp.*, No. 08-11006, 2011 WL 4345204 (Bankr. D. Del. Sept. 15, 2011).

The District Court affirmed, and the truck drivers appealed to the 3rd Circuit, which declined to approve nonconsensual structured dismissals generally but held that a court could, "in rare instances like this one, approve structured dismissals that do not

strictly adhere to the Bankruptcy Code's priority scheme." *In re Jevic Holding Corp.*, 787 F.3d 173, 180 (3d Cir. 2015).

## SUPREME COURT

Before reaching the merits of the case, the majority answered the respondents' challenge to the petitioners' standing.

The respondents argued that the petitioners suffered no harm as a result of the structured dismissal because even if the court had not approved the structured dismissal, the truck drivers would still have received nothing, and they would receive nothing now if the dismissal were undone.

The court found that this argument was based on two faulty assumptions: "(1) that, without a violation of ordinary priority rules, there will be no settlement; and (2) that, without a settlement, the fraudulent-conveyance lawsuit has no value."

With respect to the first point, the court found that the record below supported the conclusion that there existed a reasonable possibility that a settlement that adhered to priority rules could have been achieved, particularly given the fact that the respondents' stated reason for excluding the truck drivers from settlement — a desire not to fund their WARN Act lawsuit against Sun — was no longer an issue after Sun won that lawsuit.

As for the second point, the court found that the record indicated that the fraudulent-conveyance claims could have litigation value, so if the Supreme Court unwound the structured dismissal, the case could be converted to Chapter 7, where a trustee could pursue the claims, or dismissed by way of a conventional dismissal, thereby restoring the pre-bankruptcy status quo and allowing the truck drivers to assert the claims themselves.

Although the court noted that the further pursuit of the fraudulent-transfer claim might prove fruitless, the approval of the structured dismissal removed all possibility for the truck drivers to recover from the suit. Accordingly, the Supreme Court found that an injury in fact had occurred in that the "bankruptcy court's approval of the structured dismissal cost petitioners something."

It is worth noting that the court's determination that the truck drivers had standing to object to the structured dismissal was based on its review of the particular factual record below, and not on any per se rule that higher-priority creditors left out of a settlement that distributes assets to lower-priority creditors automatically suffer an "injury in fact" for standing purposes, leaving open the possibility that under different facts, a standing objection might be sustained.

## MERITS OF THE CASE

Turning to the merits of the case, Justice Stephen Breyer noted the three possible outcomes for a Chapter 11 bankruptcy case:

- A court-confirmed plan designed to continue operations while providing recovery for creditors.
- A liquidation of the business and distribution of its assets.
- Dismissal of the bankruptcy case.

Dismissals under Section 349(b) generally restore the pre-petition status quo of the parties; however, Section 349 grants discretion to a bankruptcy court to deviate from the standard consequences of dismissal "for cause."

The court's decision turned on whether Congress intended the "for cause" exception to be used to effectuate nonconsensual structured dismissals that reorder statutory priorities.

In analyzing whether the "for cause" exception of Section 349 could be used to deviate from the statutory priority scheme, the court recognized the fundamental nature of the code's priority

system: “The code is ‘designed to enforce a distribution of the debtor’s assets in an orderly manner ... in accordance with established principles rather than on the basis of the inside influence or economic leverage of a particular creditor.’”

The court said these priority rules are a foundational principle of bankruptcy law; indeed, they are “the cornerstone of reorganization practice and theory.”

Final distributions of assets made through Chapter 11 plans and in Chapter 7 liquidations are expressly governed by these priority rules, but, as noted by the court, the code is silent on the question of what (if any) priority rules govern distributions made in connection with a dismissal under Section 349.

Ultimately, the court declined to read this silence as evidence of congressional intent to do an end run around the priority rules.

Given that Congress crafted a comprehensive system for the orderly distribution of estate assets, with the priority scheme as its central and fundamental tenet, the court said, “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.”

The court found no evidence of such intent in the text of the Bankruptcy Code. Section 1112(b), which grants courts the power to dismiss a Chapter 11 case, does not mention structured dismissals or provide for distributions in contravention of the priority scheme.

To the extent that the code’s dismissal provisions contemplate a transfer of assets, “they seek a restoration of the pre-petition financial status quo.”

As for whether the “for cause” language in Section 349 authorizes an alternative outcome from the two primary paths for distribution of assets through bankruptcy — a Chapter 11 plan that substantially limits deviation from the priority scheme, and a Chapter 7 liquidation that flatly forbids it — the court was not persuaded, noting that “the word ‘cause’ is too weak a reed upon which to rest so weighty a power.”

Finally, the court was not persuaded by the 3rd Circuit’s “rare-case exception,” under which priority-violating structured dismissals were not permissible generally, but only in those “rare case[s] in which courts could find ‘sufficient reasons’ to disregard priority.”

The court noted the difficulty of formulating workable criteria for evaluating “sufficient reasons” for priority-violating distributions on a case-by-case basis, which “threaten[s] to turn a ‘rare case’ exception into a more general rule.”

In addition to generating uncertainty, such a rule risks collusion between classes of high-priority creditors and low-priority creditors to squeeze out those in the middle.

Furthermore, departing from the code’s priority scheme without intelligible limitations could cause “changes in the bargaining power of different classes of creditors even in bankruptcies that do not end in structured dismissals.”

Accordingly, the court held that Congress did not authorize a “rare case” exception for deviating from the statutory priority scheme when making final distributions of estate assets.

### **SCOPE OF SUPREME COURT’S HOLDING**

*Jevic* holds that “bankruptcy courts may not approve structured dismissals that provide for distributions that do not follow ordinary priority rules without the consent of affected creditors.”

The court expressly noted, however, that “we express no view about the legality of structured dismissals in general” and declined to pass judgment on the unopposed structured dismissal approved by the bankruptcy court in *In re Buffet Partners LP*, No. 14–30699, 2014 WL 3735804 (Bankr. N.D. Tex. July 28, 2014), suggesting that consensual structured dismissals, or structured dismissals that adhere to the code’s priority scheme, may still be permissible.

In addition, the court drew a clear distinction between *final* distributions of estate assets that violate the priority rules, and *interim* distributions of assets that deviate from the priority rules but further important code-related objectives.

The court noted several kinds of interim Chapter 11 distributions that violate the priority rules — but may be permissible if done in furtherance of code-related goals such as increasing the chances of a successful reorganization, preserving the debtor as a going concern, or maximizing the value of the estate for all creditors — such as first-day wage orders paying employees' pre-petition wages; critical-vendor orders paying suppliers whose products are critical to the continued operation of the business; and roll-ups, which pay claims of lenders who agree to finance the debtor's operations during bankruptcy.

In contrast, the court said, a nonconsensual structured dismissal that orders a final, priority-violating distribution "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."

As no important code-related objectives are served in such cases, the court found no justification for deviating from the code's priority rules.

## CONCLUSION

*Jevic* makes it clear that bankruptcy courts may not order structured dismissals that provide for a final distribution of estate assets in violation of the Bankruptcy Code's priority scheme.

In so holding, the court recognized that the priority rules are a foundational principle of the Bankruptcy Code and expressed concerns that permitting deviation from these rules could invite collusion between parties, disruption of bargaining dynamics and general uncertainty that could undermine the goals of Chapter 11.

These concerns may very well drive the development of structured dismissals in bankruptcy going forward. But for now, interim priority-violating distributions that serve important Chapter 11 objectives and consensual structured dismissals appear safe.



**Cathleen C. Moore** (L), counsel with **Bradley Arant Boult Cummings LLP** in Birmingham Alabama, represents creditors and debtors in state, federal and bankruptcy courts. **James W. Thurman** (R), is an associate at the firm who advises clients in a variety of bankruptcy-related matters.

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