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Supreme Court Reverses *Jevic* Structured Dismissal That Deviated from Bankruptcy Code's Priority Scheme

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In light of the U.S. Supreme Court's holding in Czyzewski v. Jevic Holding Corp., *a structured dismissal can no longer include distributions of estate property that deviate from the priority system established under the Bankruptcy Code. The author of this article discusses the decision and its implications.*

In a 6-2 decision, the U.S. Supreme Court reversed the holding of the U.S. Court of Appeals for the Third Circuit which had permitted the structured dismissal of a Chapter 11 case despite the fact that it provided for distributions to creditors that deviated from the priority scheme established under the Bankruptcy Code.[1] The Third Circuit had held that a structured dismissal could deviate from the Bankruptcy Code's priority scheme "in a rare case."[2] The Supreme Court observed that: "The skipped creditors would have been entitled to payment ahead of the general unsecured creditors in a Chapter 11 *plan* (or in a Chapter 7 liquidation)," and the Bankruptcy "Code does not explicitly state what priority rules—if any—apply to a distribution" under a structured dismissal. Nevertheless, the Court held that "a bankruptcy court [does not have] the legal power to order this priority-skipping kind of distribution scheme in connection with a Chapter 11 *dismissal*."

Under Section 349(b) of the Bankruptcy Code, unless the court orders otherwise for cause, dismissal of a case vacates any orders entered by the bankruptcy court and restores the parties to their positions prior to the bankruptcy filing. In a structured dismissal, rather than simply restoring the parties to their prior positions upon dismissal, the court imposes certain terms and conditions which have been agreed to by the parties when the case is dismissed. Such terms can include approvals of settlements and releases and how monies are to be distributed to creditors. In light of the Supreme Court's holding in *Czyzewski v. Jevic Holding Corp.*, a structured dismissal can no longer

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1 *Czyzewski v. Jevic Holding Corp.*, 580 U. S. ____, 137 S. Ct. 973, 197 L. Ed. 2d 398 (2017).

2 *In re Jevic Holding Corp.*, 787 F.3d 173 (3rd Cir. 2015).

include distributions of estate property that deviate from the priority system established under the Bankruptcy Code.

BACKGROUND

Jevic was a trucking company headquartered in New Jersey that in 2006, after its business had already begun to decline, was acquired in a leveraged buyout ("LBO") by a subsidiary of the private equity firm Sun Capital Partners. The LBO was financed by a group of lenders led by CIT Group, which extended an $85 million revolving credit facility to Jevic. After struggling for another two years, Jevic ceased substantially all of its operations and provided its employees with notice of their impending terminations on May 19, 2008. The next day, Jevic filed a voluntary Chapter 11 petition in the U.S. Bankruptcy Court for the District of Delaware. As of the petition date, Jevic owed about $53 million to its first-priority senior secured creditors (CIT and Sun) and over $20 million to its priority tax and general unsecured creditors.

Thereafter, two lawsuits were filed in the bankruptcy court which were germane to the issues before the Supreme Court. A group of Jevic's terminated truck drivers filed a class action against Jevic and Sun alleging violations of federal and state Worker Adjustment and Retraining Notification ("WARN") Acts, under which Jevic was required to provide 60-days' written notice to its employees before laying them off. Ultimately, the WARN Act claim was upheld against Jevic, but not Sun. The drivers never had the opportunity to establish damages, but they estimated that their claim was worth $12.4 million, of which $8.3 million was a priority wage claim under Section 507(a)(4), which is entitled to higher priority than priority tax claims.[3]

The Creditors' Committee brought a fraudulent conveyance action on the estate's behalf against CIT and Sun, alleging that Sun, with CIT's assistance, hastened Jevic's bankruptcy by saddling it with debts that it could not service. Several years later, the bankruptcy court granted in part and denied in part CIT's motion to dismiss the fraudulent conveyance lawsuit.

By March 2012, when the parties met to try to settle, all of Jevic's tangible assets had been liquidated to repay the lender group led by CIT and all that remained in the estate was $1.7 million in cash (which was subject to Sun's lien) and the fraudulent conveyance action. The Committee, Jevic, CIT and Sun reached a settlement to be implemented under a structured dismissal that contained four elements. First, those parties would exchange releases of their

[3] Damages under the WARN Act qualify for priority wage claim status under Section 507(a)(4) to the extent of the monetary limits specified therein.

claims against each other and the fraudulent conveyance action would be dismissed with prejudice. Second, CIT would pay $2 million into an account earmarked to pay legal fees of Jevic and the Committee and other administrative expenses. Third, Sun would assign its lien on Jevic's remaining $1.7 million cash to a trust, which would pay tax and administrative creditors first and then the general unsecured creditors on a *pro rata* basis. Fourth, the Chapter 11 case would be dismissed. Notably, the drivers' priority wage claim, which enjoyed higher priority than the priority tax claims and the general unsecured claims, would not receive any distribution under the structured dismissal.

The drivers and the U.S. Trustee objected to the proposed settlement and structured dismissal primarily because it distributed property of the estate to creditors of lower priority. The bankruptcy court approved the settlement, and the U.S. District Court for the District of Delaware and the Third Circuit both upheld such approval on appeal.

THE SUPREME COURT'S ANALYSIS

In his majority opinion, Justice Breyer first dealt with respondents' contention that the drivers lacked standing because they suffered no injury, which rested on the argument that there would be no settlement without a violation of the priority rules and without a settlement the litigation had no value. The Supreme Court observed that there was a reasonable possibility for settlement that respects ordinary priorities and that Sun had insisted upon a settlement that gave the drivers nothing only because it did not want to help fund the drivers' Warn Act lawsuit, which issue was now moot in light of Sun's victory. Moreover, in light of the fact that CIT and Sun had been willing to settle for $3.7 million, it was clear that the lawsuit had value. Thus, approval of the priority-skipping deal cost the drivers the opportunity to participate in a settlement of a lawsuit that respected their priority.[4]

The Supreme Court then turned its attention to the substantive issue—whether a bankruptcy court can approve a structured dismissal that violates the priority scheme established under the Bankruptcy Code, which expressly applies to Chapter 11 plans and Chapter 7 liquidations, but is silent on dismissals. The majority observed that because the priority system applicable to distributions has long been considered fundamental to the Bankruptcy Code's operation, they were led "to expect more than simple statutory silence if, and when, Congress were to intend a major departure."[5]

[4] Slip Op. at 10–11.

[5] Slip Op. at 12.

In fact, the dismissal sections of Chapter 11 seek a restoration of the pre-petition financial status quo. While the majority conceded that Section 349(b) provides that a bankruptcy judge may order otherwise for cause, after analyzing the legislative history, it opined that "this provision appears designed to give courts the flexibility to 'make the appropriate orders to protect rights acquired in reliance on the bankruptcy case.'"[6] Because no provision of the Bankruptcy Code expressly authorizes a bankruptcy court to do something in a dismissal order that was explicitly impermissible under Chapters 7 and 11, "the word 'cause' [in Section 349] is too weak a reed upon which to rest so weighty a power."[7]

The Third Circuit had relied on the U.S. Court of Appeals for the Second Circuit's opinion in *In re Iridium Operating LLC*,[8] which the Supreme Court distinguished, noting that *Iridium* did not involve a structured dismissal. Rather *Iridium* dealt with an *interim* distribution of settlement proceeds to fund a litigation trust that would press claims on the estate's behalf, and that the *Iridium* court had observed that, "when evaluating this type of preplan settlement, '[i]t is difficult to employ the rule of priorities' because 'the nature and extent of the Estate and the claims against it are *not yet fully resolved*.'"[9]

Importantly, the *Jevic* Court took pains to distinguish its holding from certain other *interim* deviations from the priority scheme such as first-day wage orders, critical vendor orders and roll-ups of pre-petition secured debt in connection with DIP financing, which are designed to enhance the prospects for a successful reorganization thereby improving the positions of even disfavored creditors.[10] Instead, the majority likened the *Jevic* settlement to instances where parties had tried to circumvent the Bankruptcy Code's procedural safeguards such as a *sub rosa* plan.[11]

Finally, the majority opinion rejected the Third Circuit's "rare case" limitation because it could open the floodgates and lead to uncertainty with potentially serious consequences including changes in the bargaining power of different classes, risks of collusion and making settlement more difficult to

[6] Slip Op. at 13 (citations omitted).

[7] Slip Op. at 13–14.

[8] 478 F. 3d 452 (2d Cir. 2007).

[9] Slip Op. at 14–15, *quoting* Iridium, 478 F. 3d at 464 (emphasis added).

[10] Slip Op. at 15.

[11] Slip Op. at 16, *citing In re Braniff Airways, Inc.*, 700 F.2d 935, 940 (5th Cir. 1983) (rejecting an asset sale that "had the practical effect of dictating some of the terms of any future reorganization plan").

achieve.[12] The dissenting opinion noted that, after *certiorari* had been granted, appellants had recast the issue on appeal in a manner that the dissent viewed as narrower. Therefore, the dissent would have dismissed the writ of *certiorari* and awaited the views of additional courts of appeals on the question presented.

IMPLICATIONS

In recent years, many companies that have landed in Chapter 11 have been burdened with secured debts that exceed the value of the company's assets. This has created tremendous tension among creditor constituencies, with senior lenders seeking a prompt resolution to preserve scarce value and creditors who are ostensibly out of the money pursuing alternate forms of recovery. If in fact all assets are encumbered and the senior lenders are underwater, then technically a plan of reorganization cannot be confirmed because, unless senior lenders waive their rights to some assets, there are no free funds to pay administrative and priority claims (although sometimes courts have waived this requirement).

Section 363 can be utilized to sell the business as a going concern and then convert the case to a Chapter 7 liquidation. However, that approach is often disfavored by senior lenders and managers because it will entail the appointment of a bankruptcy trustee who may assert litigation claims against the senior lenders and insiders who are necessary for a prompt disposition of the assets. Therefore, in over-levered cases, parties often seek alternative resolutions to maximize going concern value, avoid protracted litigation, spare expense and tie up loose ends.

Parties have availed themselves of a number of tools to resolve roadblocks that may arise in over-levered Chapter 11 cases, including prepacks, pre-negotiated cases, restructuring support agreements, quick Section 363 sales followed by a liquidating plan, "gifting" plans or other mechanisms to garner enough consensus to achieve confirmation or a sale of assets before scarce estate assets are squandered. In light of the *Jevic* decision, structured dismissals may still be utilized to resolve over-levered Chapter 11 cases, but only if the Bankruptcy Code's priority scheme is respected.

The *Jevic* decision may put another nail in the coffin of so-called "gifting" plans which are already prohibited in the Second Circuit, but until now, still viable in the Third Circuit.[13] Under a "gifting" plan, a senior lender gives its

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[12] Slip Op. at 16–18.

[13] *Dish Network Corp. v. DBSD North America, Inc.*, 634 F.3d 79 (2d Cir. 2011) (gifting plan violates the absolute priority rule); *In re LCI Holding Co.*, 802 F.3d 547 (3d Cir. 2015) (upholding gifting plan).

own property to a junior class while skipping an intermediate class. Parties who support "gifting" plans usually argue that the money paid to the junior creditors belonged to the senior lenders and thus would not have been available for distribution to any skipped priority classes. However, where the debtor's estate has a cause of action that is settled in exchange for releases, as in *Jevic*, this rationale is suspect.