CLIENT MEMORANDUM

Third Circuit Authorizes Structured Dismissal of Chapter 11 Case

May 27, 2015

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Decision is the first by a Circuit Court to allow a "structured dismissal" granting the parties a settlement and dismissal to resolve a bankruptcy case.

On May 21, 2015, the U.S. Court of Appeals for the Third Circuit in *Official Committee of Unsecured Creditors v. CIT Group/Business Credit Inc. (In re Jevic Holding Corp.)*[1] (the "Decision") approved the settlement and dismissal of a chapter 11 case, in what is known as a "structured dismissal." While the Third Circuit stressed that such a disposition was justified only in "rare" circumstances, it nonetheless found that the circumstances at issue justified a departure from the typical bankruptcy process. The Decision makes the Third Circuit the first of the courts of appeals to approve a structured dismissal, and provides additional flexibility to parties and judges in resolving future bankruptcy cases.

A. Background

The debtor, Jevic Transportation, Inc. (together with its parent holding company, Jevic Holding, Inc., "Jevic" or the "Company"), was a New Jersey-based trucking company purchased by the private equity firm Sun Capital Partners ("Sun") in 2006 through a leveraged buyout. Sun financed the purchase with a group of lenders led by CIT Group/Business Credit Inc. ("CIT"). Jevic, however, was unsuccessful under new ownership, eventually having to cease operations and lay off all of its employees on May 19, 2008. The next day Jevic filed a voluntary petition under chapter 11 of title 11 of the United States Code (the “Bankruptcy Code”) in the United States Bankruptcy Court for the District of Delaware (the “Bankruptcy Court”). At the time of the filing, Jevic owed approximately $53 million to Sun and CIT, both of whom held a first-priority lien on almost all of Jevic’s assets. Other creditors, who held tax and general unsecured claims, were owed approximately $20 million, and their interests were represented by the official committee of unsecured creditors (the “Committee”).

Two groups filed lawsuits during the bankruptcy case. First, Jevic’s recently terminated truck drivers (the “Drivers”) filed a class action complaint against the Company and Sun, alleging violations of federal and New Jersey labor laws[2] requiring 60 days’ written notice before lay offs. While Sun was ultimately deemed not an employer of the Drivers and thus not liable, the Bankruptcy Court eventually found that Jevic had undisputedly violated the New Jersey labor laws, giving rise to a claim estimated to be worth $12.4 million, of which $8.3 million was most likely entitled to the special priority status given to certain employee wage claims under the Bankruptcy Code.

Concurrently, the Committee also brought a suit against Sun and CIT on behalf of the estate on a number of legal theories, including allegations of fraudulent conveyance and preferential transfer, both of which survived a motion to dismiss in 2012.[3] Before the establishment of liability of Jevic for the Drivers’ claim, however, the Committee, Jevic, CIT and Sun negotiated a settlement agreement (the “Settlement”). Under the terms of the Settlement, the parties would execute mutual releases; the fraudulent conveyance and preference actions would be dismissed; CIT would contribute $2 million to an account to pay Jevic, and the Committee’s legal fees and administrative expenses; Sun would transfer its lien on Jevic’s only remaining assets ($1.7 million in cash) to a trust set up to first pay administrative and tax creditors, followed by unsecured creditors on a pro rata basis; and then the entire bankruptcy case would be dismissed. The Settlement would in effect be what is known as a “structured dismissal,” in which settlements reached during the bankruptcy case survive notwithstanding the dismissal of the case, instead of restoring the parties to their status before the filing.

The Drivers’ claim (most of which likely was entitled as employee wages to be paid before tax and general unsecured creditors under the normal priority rules of section 507) was not included in the Settlement, for reasons not immediately clear from the record. It appears that while the Drivers participated in the discussions leading up to the Settlement, they were unable to reach an agreement with Sun, their opponent in the then still pending labor class action. Sun eventually conceded that it was unwilling to fund a litigation against itself, and thus insisted that the Drivers not receive a portion of the Settlement.

The Drivers and the U.S. Trustee objected to the Settlement. Both argued that the Settlement denied the Drivers their statutory protections as priority wage claimants. The Drivers also argued that they had been betrayed by the Committee, which had breached its fiduciary duty to the Drivers by agreeing to a settlement that froze them out. The U.S. Trustee opposed the Settlement on the additional ground that structured dismissals were not authorized under the Bankruptcy Code.

The Bankruptcy Court, in an oral opinion, overruled all of the objections and approved both the Settlement and the dismissal. The Bankruptcy Court noted the "dire circumstances" of the debtor meant there was essentially no chance for a reorganization. Any recovery for the unsecured creditors by other means was unlikely: If the case were converted to chapter 7, the estate's assets would consist of only the $1.7 million in cash, upon which Sun held a lien, and the claims against Sun and CIT. The court determined that a chapter 7 trustee would most likely lack the funds to further litigate the claims, and would likely simply turn over the cash and close the case. Essentially concluding that the Settlement was better than any likely alternative (where all unsecured creditors, including the Drivers, would receive nothing), the Bankruptcy Court approved the settlement.

The Drivers then appealed to the United States District Court for the District of Delaware (the "District Court").[4] The District Court affirmed[5] and the case was appealed again to the Third Circuit.

B. The Decision

By the time the case reached the Third Circuit, the Drivers and the U.S. Trustee had refined their arguments. They did not contest the factual findings of the Bankruptcy Court, or even its exercise of discretion, but instead argued that structured dismissals were either banned entirely by the Bankruptcy Code, or had at least to comply with the priority distribution scheme provided by the Bankruptcy Code.

Judge Hardman, writing for the majority, acknowledged a lack of specific statutory authorization for structured dismissals in the Bankruptcy Code, but also noted that the code allows a bankruptcy judge to modify the typical return to the prepetition status quo provisions of a dismissal for "cause." The majority stressed that the Drivers themselves had admitted that no plan could be confirmed, and that a conversion to chapter 7 would benefit no one. Therefore, the majority did not address the possibility that a structured dismissal would be used to create a *sub rosa*, or secret, plan that circumvented the procedural and substantive requirements of the chapter 11 plan process. The court thus held that, "absent a showing that the structured dismissal has been contrived to evade the procedural protections and safeguards of the plan confirmation or conversion process, a bankruptcy court has discretion to order such a disposition."[6]

The majority then addressed the Drivers' argument that even if a structured dismissal is allowed under the code, that such a dismissal must respect the standard priority scheme of section 507. Here the majority noted a disagreement between the Fifth and Second Circuits as to whether a court could approve a settlement that did not respect the standard priority scheme —though neither case addressed this question in the context of a structured dismissal.

The Fifth Circuit, in *Matter of AWECO*, *Inc.*,[7] adopted a per se rule prohibiting settlements that did not respect the standard priority scheme, and rejected a settlement of a lawsuit against the debtor that would have transferred $5.3 million of estate assets to an unsecured creditor, before payment had been made to the secured creditor.

The Second Circuit, however, in *In re Iridium Operating LLC*,[8] criticized the earlier *AWECO* holding and instead adopted a more flexible rule. The Second Circuit panel in *Iridium* (that included then Judge, now Justice Sotomayor) was asked to approve a settlement in which half of the settlement funds would be provided to the secured lenders, while half would be provided to a trust set up to fund a litigation against Motorola, who happened also to be an administrative creditor of the debtor. The remaining creditors (except for Motorola) would then receive the proceeds of the liquidation (if any) and/or any leftover funds. Motorola had objected to the settlement on the grounds that it violated the normal priority scheme. The Second Circuit held that while compliance with the normal priority rules for distribution was "the most important factor" to consider when approving a settlement, a settlement can nonetheless be approved when the normal priority distribution scheme was not followed provided "the remaining factors weigh heavily in favor of approving a settlement."[9] The Second Circuit then found that while the litigation trust structure was justified in this instance, the rules for how the trust assets were to be distributed after the end of the litigation (namely to the exclusion of Motorola) was not justified.

The Third Circuit was persuaded by the reasoning of *Iridium*, and adopted what it determined was a more flexible standard that would aid parties in crafting settlements. Like the Second Circuit in *Iridium*, the majority held that courts could approve settlements that deviate from the standard priority scheme only when they have "specific and credible grounds to justify the deviation."[10]

The majority then went on to find that the Bankruptcy Court had sufficiently justified the deviation (providing for the payment of certain administrative and unsecured creditors while not providing for any distribution to the Drivers on account of their priority wage claim) from the standard priority scheme in approving the Settlement. Alluding to the fact that it does not review findings of fact *de novo*, the majority found that, on the record provided, the Bankruptcy Court was in a situation where there was no alternative that would have provided some recovery to any creditors other than CIT and Sun. Thus, while "a close call," the majority found that the Bankruptcy Court was correct to approve the Settlement and structured dismissal.

C. The Dissent

Judge Scirica dissented from the majority's opinion, finding that while the majority was correct to adopt the flexible standard from *Iridium*, the special circumstances required by *Iridium* were not present in *Jevic*. Judge Scirica first noted that the prospect of a chapter 7 liquidation was mostly a result of Sun's unwillingness to allow estate funds to be used in the litigation by the Drivers. Judge Scirica was more concerned, however, that while the deviation from the priority scheme did increase the recovery of some creditors, it did not increase the value of the estate overall. *Iridium*, in Judge Scirica's view, was an example in which a more minor deviation[11] was justified by the goal of maximizing the total recovery of the estate. For Judge Scirica, the Bankruptcy Court in *Jevic* had not made it sufficiently clear how deviating from the standard priority scheme increased the recovery of the estate. Judge Scirica would have remanded, with instructions to redistribute the proceeds of the Settlement in accordance with the standard priority scheme, but otherwise leaving the Settlement in place.

D. Observations

The Decision follows an extensive debate over a bankruptcy court's authority to approve structured dismissals[12] and is the first by a Circuit Court of Appeals that approves the use of a structured dismissal as an alternative to conversion of a case to chapter 7 or the dismissal of a case that returns all parties to their status quo. While many have raised concerns over the practice, the Decision unquestionably grants additional flexibility to courts and parties in interest in crafting settlements and resolving chapter 11 cases, at least in the Third Circuit and in other circuits and courts that following the reasoning of *Jevic* and *Iridium*. Future cases likely will provide additional guidance regarding the substantive limits of structured dismissals and whether the practice is able to expand beyond the "rare" circumstances described by the majority in *Jevic*.

If you have any questions concerning the foregoing or would like additional information, please contact Marc Abrams (212-728-8200, mabrams@willkie.com), Paul V. Shalhoub (212-728-8764, pshalhoub@willkie.com), Gabriel Brunswick (212-728-8163, gbrunswick@willkie.com) or the Willkie attorney with whom you regularly work.

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1 No. 14-1465 (3d Cir. May 21, 2015).

2 These worker protections are called the Worker Adjustment and Retraining Notification ("WARN") Acts. *See* 29 U.S.C. § 2102; N.J. Stat. Ann. § 34:21-2.

3 The Committee also made claims for state law fraudulent conveyance, equitable subordination, and aiding and abetting breach of fiduciary duty, which the Bankruptcy Court dismissed without prejudice.

4 The Drivers simultaneously moved before the Bankruptcy Court to have the implementation of the settlement stayed pending appeal before the District Court, which the Bankruptcy Court denied. The Drivers did not appeal the stay motion, and the settlement closed several months later.

5 *Caismir Czyzewski v. Jevic Holding Corp. (In re Jevic Holding Corp.)*, No. 13-104-SLR, 2014 WL 268613 (D. Del. 2014).

6 Decision, page 18.

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[7] 725 F.2d 293, 295-96 (1984).

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

[9] *Id.* at 464.

[10] Decision, page 24, citing *Iridium*, 748 F.3d at 466.

[11] Recall that in *Iridium*, the Second Circuit only approved denying Motorola its share of the settlement while the litigation against it was pending, and remanded back to the lower court for further findings on how the funds should be distributed after the litigation against Motorola was complete.

[12] *See, e.g.*, Michael J. Lichtenstein, *Assets Sales and Structured Dismissals in Chapter 11*, PRATT'S JOURNAL OF BANKRUPTCY LAW, Jan. 2014; Norman L. Pernick, *Structured Chapter 11 Dismissals: A Viable and Growing Alternative after Asset Sales*, 29-5 ABIJ 1, June 2010; Nan Roberts Eitel, *Structured Dismissals, or Cases Dismissed Outside of Code's Structure*, 30-2 ABIJ 20, March 2011; Brent Weisenberg, *Expediting Chapter 11 Liquidation Debtor's Distributions to Creditors*, 31-3 ABIJ 36, April 2012.