

CLIENT MEMORANDUM

Supreme Court Narrows Use of Structured Dismissals in Chapter 11 Cases, Reverses Third Circuit's *Jevic* Decision

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Supreme Court's ruling requires "structured dismissals" to abide by the priority system for distributions under chapter 11 plans.

On March 22, 2017, the Supreme Court of the United States (the "Supreme Court") issued an opinion in *Czyzewski v. Jevic Holding Corp.*¹ (the "Decision") narrowing the use of "structured dismissals" as a resolution of a chapter 11 bankruptcy case. The opinion of the 6-2 majority, authored by Justice Breyer, makes clear that structured dismissals must respect the priority system for chapter 11 plans and chapter 7 liquidations. The Decision struck down the terms of the settlement and structured dismissal of the chapter 11 cases of Jevic Transportation, Inc. and its parent holding company (collectively, "Jevic") and will have significant implications for parties negotiating structured dismissals of chapter 11 cases.

Background

Jevic was a trucking company purchased in 2006 by Sun Capital Partners ("Sun") through a leveraged buyout that was financed by a group of lenders led by CIT Group/Business Credit Inc. ("CIT"). Following the leveraged buyout, Jevic's business was unsuccessful and in May 2008, Jevic ceased all operations, laid off all of its employees, and filed for protection 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").

Supreme Court Narrows Use of Structured Dismissals in Chapter 11 Cases, Reverses Third Circuit's *Jevic* Decision

Continued

As discussed in greater detail in our 2015 Client Memorandum describing the approval of the U.S. Court of Appeals for the Third Circuit (the "Third Circuit") of the structured dismissal of Jevic's chapter 11 cases,² Jevic's bankruptcy cases involved a class action lawsuit by Jevic's former truck drivers (the "Drivers") for violations of New Jersey labor laws.³ The Bankruptcy Court ruled that Jevic had violated these labor laws and that the Drivers were entitled to an estimated \$12.4 million claim against Jevic, of which \$8.3 million was likely entitled to priority status afforded to certain employee wage claims under the Bankruptcy Code. Additionally, the official committee of unsecured creditors (the "Committee") brought a lawsuit against Sun and CIT (on behalf of Jevic's estates) alleging, among other claims, fraudulent transfers and preferential transfers in connection with the original leveraged buyout. After these claims survived a motion to dismiss in 2012, the Committee negotiated a settlement with Jevic, CIT and Sun (the "Settlement"), whereby (i) the Committee's claims would be dismissed with prejudice, (ii) CIT would contribute \$2 million to pay the Committee's legal fees and expenses, and (iii) Sun would transfer its lien on Jevic's sole remaining assets (\$1.7 million in cash) to a new trust which would first pay Jevic's administrative and tax creditors, and then pay unsecured creditors. The new trust made no provision for payment on account of the Drivers' claims, which would ordinarily be paid before unsecured creditors. In connection with the proceedings, Sun admitted that the Drivers were not paid pursuant to the Settlement because the Drivers were suing Sun on the WARN claims—simply put, Sun did not want to help the Drivers finance that litigation against itself. After the effectuation of the settlement, Jevic's bankruptcy cases were to be dismissed pursuant to a "structured dismissal," which allows settlements reached during the bankruptcy case to survive notwithstanding the dismissal, instead of returning all parties to their status before the bankruptcy cases were commenced.

The Drivers and the U.S. Trustee objected to the Settlement, arguing, among other things, that (i) pursuant to the priority provisions set forth by the Bankruptcy Code, the Drivers were entitled to be paid their administrative priority claims before any distributions were made on account of general unsecured claims, and (ii) the Bankruptcy Code did not authorize structured dismissals.

The Bankruptcy Court overruled these objections and approved the Settlement and the structured dismissal. The Bankruptcy Court ruled that there was no chance for Jevic to successfully reorganize, and if Jevic's cases were converted to chapter 7 liquidations, unsecured creditors would likely not receive any recoveries, since the estates only consisted of \$1.7 million in cash, which was subject to Sun's lien (absent the Settlement). Accordingly, the Bankruptcy Court approved the Settlement, as under any other alternative, general unsecured creditors (including the Drivers) would receive no recovery.

The Drivers appealed to the United States District Court for the District of Delaware, which affirmed the Bankruptcy Court's decision.⁴ The Drivers then appealed the case to the Third Circuit, which also affirmed (by a 2-1 decision). The Third Circuit explained that the priority provisions are only with respect to plan confirmation, and that courts could, "in rare instances," approve structured dismissals that do not "strictly adhere to the Bankruptcy Code's priority scheme."⁵

Supreme Court Narrows Use of Structured Dismissals in Chapter 11 Cases, Reverses Third Circuit's *Jevic* Decision

Continued

The Supreme Court's Majority Opinion

1. Standing

The Decision first dealt with the standing argument made by Jevic, Sun and CIT. Those parties argued that the Drivers lacked standing because if the Settlement was rejected, Sun and CIT would not provide any contribution to Jevic's estates, and the Drivers (and other unsecured creditors) would receive no recovery. Stated differently, Jevic, Sun and CIT argued that because the Drivers would receive no recovery whether the Settlement was approved or not, the Drivers have no standing to challenge the Settlement.

The majority rejected that argument, explaining that the record reflected a possibility of a recovery to the Drivers if the Settlement was not approved. First, the Supreme Court ruled that a revised settlement which provided for a distribution to the Drivers "remains a reasonable possibility."⁶ The Supreme Court noted that the reason Sun gave for not wanting to pay the Drivers is that Sun did not want to fund the Drivers' lawsuit against itself. However, Sun has since succeeded in that litigation, and so the majority reasoned that Sun would now be willing to have some of the settlement funds be distributed to the Drivers. Secondly, the majority explained that the fraudulent transfer lawsuit had some value, since CIT and Sun settled the lawsuit for \$3.7 million, and the Drivers might receive a recovery if such claim were pursued by a chapter 7 trustee (or the Drivers might bring the claim themselves if the bankruptcy cases were dismissed). Accordingly, the majority ruled that the Drivers had standing because, as a result of the Settlement's approval, the Drivers lost a "chance to obtain a settlement that respected their priorities" or the ability to "bring their own lawsuit on a claim that had a settlement value of \$3.7 million."⁷

2. Merits

Turning to the merits of the case, the Decision overviewed the priority scheme for chapter 11 plans and chapter 7 liquidations. The majority first noted that in chapter 7 liquidations, "priority is an absolute command," and lower-priority creditors cannot receive any distributions until higher-priority creditors are paid first, and chapter 11 plans which violate the priority scheme may not be confirmed over the objection of an impaired class of creditors that voted to reject the plan.⁸ The majority explained that the priority system is "fundamental to the Bankruptcy Code's operation," and ruled that if Congress had intended a departure from the priority system for structured dismissals, the Supreme Court would have "expect[ed] to see some affirmative indication of intent" if Congress intended to allow structured dismissals as a "backdoor means" to violate the priority scheme without the consent of the affected creditors.⁹

The Supreme Court examined the applicable provisions of the Bankruptcy Code regarding dismissal of chapter 11 cases and explained that they are silent on the priority scheme to be used. Specifically, the default rule regarding dismissal of a chapter 11 case is that all parties are restored to their status before the bankruptcy case was filed, although section 349(b) of the Bankruptcy Code provides that a bankruptcy court may "for cause, order[] otherwise."¹⁰ The majority interpreted the meaning of "cause" as granting bankruptcy courts the "flexibility" to issue orders to protect the rights of parties "acquired in reliance on the bankruptcy case." However, the majority ruled that such flexibility was not

Supreme Court Narrows Use of Structured Dismissals in Chapter 11 Cases, Reverses Third Circuit's *Jevic* Decision

Continued

authorization to allow a distribution of assets “that normally take place in a Chapter 7 liquidation or Chapter 11 plan” through a distribution scheme that “would be flatly impermissible ... because they violate priority without the impaired creditors’ consent.”¹¹ In other words, the majority recognized that bankruptcy courts should have some flexibility when dismissing cases, but ruled that “the word ‘cause’ is too weak a reed upon which to rest so weighty a power” when it comes to structured dismissals that do not comply with the Bankruptcy Code’s priority scheme.¹²

The Supreme Court also noted that there was no lower court precedent which conflicted with this ruling, aside from this case. A 2014 case from the Bankruptcy Court for the Northern District of Texas approved a structured dismissal, but in that case, no party with an economic interest objected to the dismissal. The Third Circuit’s opinion below relied on *In re Iridium Operating LLC*, a Second Circuit decision which approved an interim distribution of settlement proceeds in a manner that did not comply with the priority scheme.¹³ However, the Supreme Court ruled that *Iridium* did not involve a structured dismissal at all, and instead was merely an interim distribution of proceeds, and explained that the *Iridium* court noted that “it is difficult to employ the rule of priorities” because the claims against the debtor “are not yet fully resolved.”¹⁴ Notably, the Second Circuit’s panel for the *Iridium* decision included then Judge, now Justice Sotomayor, who voted with the majority in this *Jevic* opinion.

Finally, the Supreme Court pointed to some other interim distributions which would otherwise violate ordinary priority rules, such as “first day” orders that allow for the payment of (i) employees’ prepetition wages, (ii) claims of “critical vendors” and (iii) DIP lenders’ prepetition claims through “roll-ups.” However, the Supreme Court recognized that in such instances, the bankruptcy courts find that such payments “enable a successful reorganization and make even the disfavored creditors better off.”¹⁵ Here, by contrast, a structured dismissal is a “final disposition” which does not benefit disfavored creditors or help to preserve the debtor as a going concern or confirm a chapter 11 plan. Instead, the type of priority-violating structured dismissal approved in *Jevic* is simply an impermissible attempt to “circumvent the Code’s procedural safeguards.”¹⁶

The Supreme Court recognized that the Third Circuit’s opinion made clear that structured dismissals that do not comply with the priority scheme are appropriate only in “rare cases” where there are “sufficient reasons” to violate the ordinary priority scheme. However, the Supreme Court explained its concern that the “rare cases” would become the general rule, resulting in a departure from the priority scheme set forth by Congress, and a change in the “bargaining power of different classes of creditors even in bankruptcies that do not end in structured dismissals.”¹⁷ Accordingly, the Supreme Court ruled that there should not be any “rare case” exception permitting a structured dismissal which includes a deviation from the priority scheme if there are “sufficient reasons.”

The Dissent

Justice Thomas wrote a short dissenting opinion (the “Dissent”) which was joined by Justice Alito. The Dissent indicated that Justices Thomas and Alito could not agree with the majority’s opinion on procedural grounds. Specifically, the Supreme Court had granted certiorari on a particular issue — “whether a bankruptcy court may authorize the distribution

Supreme Court Narrows Use of Structured Dismissals in Chapter 11 Cases, Reverses Third Circuit's *Jevic* Decision

Continued

of settlement proceeds in a manner that violates the statutory priority scheme” (without any mention of structured dismissals). However, the parties briefed and argued a more narrow question — “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.” Justice Thomas noted that the latter question was narrower and different than the initial grant of certiorari, and that structured dismissals are not yet the subject of a circuit split. Accordingly, the dissent argued that the Supreme Court should not have decided the “reformulated question” because structured dismissals are a “novel question of bankruptcy law” and the Third Circuit’s opinion in *Jevic* was the only opinion of a court of appeals dealing with the issue. Additionally, Justice Thomas did not want to permit petitioners to ask for certiorari on one broad question which had a circuit split, only to “change the question to one that seems more favorable.”

Accordingly, Justice Thomas and Justice Alito dissented because they would have dismissed the writ of certiorari as improvidently granted.

Implications

Recently, structured dismissals have been increasingly used as a conclusion of a chapter 11 bankruptcy case. Prior to the Decision, there were two primary questions being debated in the lower courts and by academics: (i) whether structured dismissals were permissible at all; and (ii) whether structured dismissals may deviate from the priority scheme set forth for chapter 11 plans and chapter 7 liquidations. The Supreme Court’s decision in *Jevic* is silent as to the first question (the majority expressly noted that it was not ruling on the propriety of structured dismissals as a general matter), but very clear on the second question. Structured dismissals, and presumably all other “final” dispositions of a debtor’s property, must comply with the priority scheme in the Bankruptcy Code for chapter 11 plans and chapter 7 liquidations.

The Decision is likely to be the final word on whether structured dismissals may violate the priority scheme, as lower courts will not have the opportunity to further explore under what rare circumstances a deviation from the priority scheme may be appropriate. Parties in chapter 11 cases and their professionals will need to be aware that any settlement which results in a structured dismissal will have to comply with the priority scheme for chapter 11 plans.

Notably, the American Bankruptcy Institute’s Commission to Study the Reform of Chapter 11 (the “Commission”) issued a report in 2014 on suggested changes to chapter 11. The Commission’s report included a recommendation that the Bankruptcy Code be amended to remove structured dismissals (although the Commission separately recommended that certain of the benefits from structured dismissals be incorporated in other provisions of the Bankruptcy Code). Certain commissioners noted that in their view, structured dismissals stem from a desire by debtors or purchasers to affect a sale free and clear of liabilities (potentially with the benefits of releases or other benefits of a confirmation order) without having to comply with the requirements of the confirmation process. While the Decision only prevents the use of structured dismissals that do not comply with the priority scheme in chapter 11 plans, it is clear the Supreme Court shares at least some of the Commission’s concerns about the practice.¹⁸

Supreme Court Narrows Use of Structured Dismissals in Chapter 11 Cases, Reverses Third Circuit's *Jevic* Decision

Continued

Finally, the Decision is at least some support for “interim” distributions of property which do not comply with the Bankruptcy Code’s priority scheme (such as the interim distributions in *Iridium*, or payments made pursuant to “first day” orders), although this issue was not part of the question presented to the Supreme Court.

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¹ No. 15-649 (March 22, 2017).

² See Client Memorandum titled “*Third Circuit Authorizes Structured Dismissal of Chapter 11 Case*,” dated May 27, 2015 (available [here](#)).

³ Specifically, these worker protections were the Worker Adjustment and Retraining Notification (“WARN”) Acts. See 29 U.S.C. § 2102; N.J. Stat. Ann. § 34:21-2.

⁴ *Caismir Czyzewski v. Jevic Holding Corp.* (*In re Jevic Holding Corp.*), No. 13-104-SLR, 2014 WL 268613 (D. Del. 2014).

⁵ *In re Jevic Holding Corp.*, 787 F.3d 173, 180 (3d Cir. 2015), *as amended* (Aug. 18, 2015).

⁶ Decision, page 10.

⁷ Decision, page 11.

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Supreme Court Narrows Use of Structured Dismissals in Chapter 11 Cases, Reverses Third Circuit's *Jevic* Decision

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- ⁸ Decision, page 12.
- ⁹ Decision, page 12.
- ¹⁰ Section 349(b) is the statutory authority cited to justify structured dismissals.
- ¹¹ Decision, pages 13-14.
- ¹² Decision, page 14.
- ¹³ 478 F.3d 452 (2d Cir. 2007).
- ¹⁴ Decision, pages 14-15.
- ¹⁵ Decision, page 15.
- ¹⁶ Decision, page 15.
- ¹⁷ Decision, page 17.
- ¹⁸ Notably, the Decision cited to the Commission's report for its definition of structured dismissals. Decision, page 3.