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The Third Circuit Court of Appeals Affirms Structured Dismissal of Chapter 11 Case, Holding That a Structured Dismissal Can Deviate From the Bankruptcy Code's Priority Scheme in Rare Circumstances

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On May 21, 2015, the United States Court of Appeals for the Third Circuit affirmed a decision of the United States Bankruptcy Court for the District of Delaware, which had approved the structured dismissal of the Chapter 11 cases of *Jevic Holding Corp., et al.* The Court of Appeals first held that structured dismissals are not prohibited by the Bankruptcy Code, and then upheld the structured dismissal in the *Jevic* case, despite the fact that the settlement embodied in the structured dismissal order deviated from the Bankruptcy Code's priority scheme.

Background

Jevic Transportation, Inc. was acquired by a subsidiary of Sun Capital Partners in a leveraged buyout financed by a group of lenders led by CIT Group. Jevic eventually had to reach a forbearance agreement with CIT, which agreement provided for a \$2 million guarantee by Sun Capital, in order to prevent CIT from foreclosing on the assets securing the loans. When Jevic filed for Chapter 11 bankruptcy protection, it owed \$53 million to CIT and Sun Capital, and over \$20 million to its tax and general unsecured creditors.

The official committee of unsecured creditors brought an action against CIT and Sun Capital, alleging that the leveraged buyout saddled Jevic with debts that it could not service. Three years later, the bankruptcy court granted in part CIT's motion to dismiss the case without prejudice to the creditors' committee's various claims for, among other things, fraudulent transfer and equitable subordination.

When representatives of the Committee, CIT, Sun Capital, Jevic, and Jevic's terminated drivers (the "Drivers") met to negotiate a settlement of the Committee's action, Jevic's only remaining assets were \$1.7 million in cash (which was subject to Sun Capital's lien) and the

action against CIT and Sun Capital. All parties except for the Drivers¹ reached a settlement which provided, among other things, that: the Committee action would be dismissed; Sun Capital would assign its lien to a trust for payment first to priority tax claims and certain creditors with administrative expense claims, and then general unsecured creditors on a pro rata basis; and the Chapter 11 cases would be dismissed.

The United States Trustee and the Drivers objected to the proposed settlement and dismissal order because it distributed property of the estate to creditors of lower priority than the Drivers. The United States Trustee also argued that the Bankruptcy Code does not permit structured dismissals, and the Drivers also argued that the Committee breached its fiduciary duty by agreeing to a settlement that did not include the Drivers. The bankruptcy court found that there was no realistic prospect of a meaningful distribution to anyone but the secured creditors unless the settlement was approved. The bankruptcy court also found that the proposed settlement was fair and equitable, thereby satisfying the requirements for approval of a settlement under Rule 9019 of the Federal Rules of Bankruptcy Procedure. The bankruptcy court approved the structured dismissal, holding that the settlement embodied therein need not comply with the Bankruptcy Code's priority scheme under the circumstances. The district court affirmed, holding in the alternative that the appeal was equitably moot, as the settlement had been substantially consummated.

Structured Dismissals Are Permissible Under the Bankruptcy Code

Although the Bankruptcy Code does not expressly authorize structured dismissals, the Third Circuit Court of Appeals stated that structured dismissals are “simply orders of the bankruptcy court . . . that remain in effect after dismissal.” Although dismissal typically reinstates the prepetition state of affairs, the Bankruptcy Code explicitly authorizes bankruptcy courts to alter the effect of dismissal for cause. Even accepting the Drivers' argument that structured dismissals could potentially render plan confirmation superfluous and pave the way for illegitimate sub rosa plans,² the Drivers were unable to challenge the bankruptcy court's findings that there was no prospect of a confirmable plan in this case, nor would conversion to Chapter 7 result in a better alternative, as the secured creditors would have collected what remained of the estate. Therefore, the Court of Appeals found that “absent a showing that a 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 a structured dismissal of a Chapter 11 case.

A Structured Dismissal May Deviate From the Priority Scheme Set Forth in the Bankruptcy Code in Rare Circumstances

The Drivers argued that even if structured dismissals are permissible, they cannot be approved if they distribute assets in violation of the priority scheme set forth in section 507 of the Bankruptcy Code, because all distributions of estate

¹ The Drivers had filed a class action lawsuit against Jevic and Sun Capital alleging violations of the federal and state Worker Adjustment and Retraining Notification Acts (“WARN Act”), which required that Jevic provide 60 days' written notice to its employees prior to terminating their employment. Sun Capital was unwilling to pay the Drivers as long as the WARN Act lawsuit continued, because Sun Capital was a defendant in those proceedings and did not want to fund litigation against itself. The Drivers estimated their uncontested WARN Act claim to have been worth \$12,400,000, of which \$8,300,000 was a priority wage claim under 11 U.S.C. §507(a)(4). As a result, any settlement that paid the Drivers' priority claim would have left unsecured creditors with nothing.

² A *sub rosa* plan essentially dictates the terms of a plan of reorganization, but avoids the Chapter 11 requirements for plan confirmation including, among other things, voting by creditors.

property under Chapter 11—including distributions made pursuant to a settlement—must comply with section 507. While finding some merit to the Drivers’ argument, the Court of Appeals ultimately held that structured dismissals need not comply with the Bankruptcy Code’s priority scheme. The Court of Appeals noted that the cases cited by the Drivers in support of their position were decided in the context of plans of reorganization, not settlements. The Court of Appeals also pointed out that if all distributions in a Chapter 11 case had to comply with the priority scheme, it would have been superfluous for Congress to codify the absolute priority rule in the plan confirmation context,³ and neither Congress nor the United States Supreme Court has said that the priority scheme set out in the Bankruptcy Code is applicable to settlements.

The Third Circuit Court of Appeals agreed with the approach taken by the United States Court of Appeals for the Second Circuit in *Iridium*,⁴ which held that strict adherence to the absolute priority rule is not necessarily required when considering approval of a settlement outside of a plan of reorganization, pointing out that settlements are favored in bankruptcy. The Court of Appeals also agreed with the holding of the *Iridium* court that while compliance with the Bankruptcy Code priorities usually is dispositive in determining whether a settlement is fair and equitable, settlements that skip objecting creditors in distributing estate assets do raise concerns about collusion. As a result, although the absolute priority rule does not extend to settlements in bankruptcy, “...the policy underlying that rule—ensuring the evenhanded and predictable treatment of creditors—applies in the settlement context.” Therefore, the Court of Appeals held that a settlement that deviates from the priority scheme set forth in the Bankruptcy Code may be approved only if there are specific and credible grounds to justify the deviation. Under the facts of *Jevic*, because the bankruptcy court’s determination that there was no realistic prospect of a meaningful distribution to unsecured creditors outside of the settlement was not disputed by the evidence, the Court of Appeals found that the bankruptcy court was justified in approving the settlement and structured dismissal.

³ See 11 U.S.C. § 1129(b)(2)(B)(ii).

⁴ *In re Iridium Operating LLC*, 478 F.3d 452 (2d Cir. 2007).

Conclusion

The Court of Appeals specifically stated that the result reached in this case, where the settlement embodied in the structured dismissal violated the Bankruptcy Code's priority scheme, is likely to be justified only in rare cases. Thus, court approval of a structured dismissal providing for distributions to creditors (especially distributions that skip over senior classes or are made only to some creditors within a class) and releases will be highly dependent on the facts and circumstances of a given case. This decision gives parties the potential, depending on the facts of a given case, to craft settlements around structured dismissals that may provide greater flexibility than a Chapter 11 plan process or a conversion to Chapter 7 after the sale of substantially all of a debtor's assets. For example, structured dismissals could, under the right circumstances, be utilized in cases involving large legacy liabilities where assets are insufficient to pay all priority claims in full, potentially after or in tandem with a sale of substantially all of a debtor's assets under section 363 of the Bankruptcy Code. This decision also may pave the way for parties to argue that in the absence of collusion, a settlement embodied in a structured dismissal which provides for a distribution to unsecured creditors is always a better alternative to conversion to Chapter 7 with no such distribution, even if all priority claims are not paid in full.

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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