Bankruptcy Bar Assesses Supreme Court Nixing of Structured Dismissal

Bankruptcy attorneys see the U.S. Supreme Court's recent decision rejecting a "structured dismissal" in a trucking company's Chapter 11 case as potentially having a greater impact than the narrow holding might suggest.

In *Czyzewski v. Jevic Holding Corp.*, a Delaware bankruptcy judge approved a proposed structured dismissal that would have violated the Bankruptcy Code's priority rules by allowing the payment of general unsecured claims ahead of former employees who held an $8.3 million mid-level-priority wage claim against the estate.

But the Supreme Court in a 6-2 decision held that such an order exceeded a bankruptcy court's authority.

"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," Justice Stephen G. Breyer wrote for the court.

Practitioners are parsing *Czyzewski* to anticipate the fallout from the decision in the lower courts.

"Frequently, when the Supreme Court decides a bankruptcy case, it has effects on the practice beyond the strict ruling in the case," observed Boston attorney D. Ethan Jeffery, who co-chairs the Boston Bar Association's Bankruptcy Law Section.

While Jeffery reads the opinion as permitting structured dismissals as long as money is distributed in accordance with the code, he expressed concern that some bankruptcy judges may interpret the court's decision as disfavoring structured dismissals in general.

"How this gets applied by bankruptcy courts is really going to be the rub," he said.

The ruling is an important benchmark in the ongoing debate over how far bankruptcy courts can go in exercising their inherent equitable powers, according to Providence lawyer Paul M. Kessimian.

"Bankruptcy courts are courts of equity, but they're also constrained by the acts of Congress and the Bankruptcy Code itself," Kessimian said. "The struggle that has been going on for years is how far courts can go under principles of fundamental fairness to achieve the ends of the code."

Structured dismissal

In 2006, debtor Jevic Transportation was acquired by Sun Capital Partners, a private equity firm. Sun Capital accomplished the leveraged buyout with money borrowed from CIT Group.

Two years later, the debtor filed for Chapter 11 protection in Delaware. At the time of filing, the debtor owed $53 million to senior secured creditors Sun Capital and CIT. The debtor also owed more than $20 million to tax and general unsecured creditors.

A group of former Jevic truck drivers later sued the debtor and Sun Capital in Bankruptcy Court. The drivers claimed the debtor violated the federal Worker Adjustment and Retraining Notification Act — or WARN — by shutting down its operations and not telling them they would be fired until just before filing for bankruptcy.

The Bankruptcy Court granted the drivers summary judgment against the debtor.

While the drivers contend the judgment is worth $12.4 million, only $8.3 million counts as a priority wage claim under the code. Sun Capital avoided judgment on the ground that it was not the drivers' employer at the relevant time.

In 2011, a committee of unsecured creditors brought a fraudulent-conveyance claim against Sun Capital and CIT to recover assets for the bankruptcy estate. The creditors' committee alleged that the defendants' leveraged buyout had accelerated Jevic's bankruptcy by saddling it with debts the company could not service.

The parties entered into negotiations to settle the fraudulent-conveyance suit, but by that time the bankruptcy estate's only remaining assets included the fraudulent-conveyance claim and $1.7 million in cash subject to a lien by Sun Capital. The parties negotiated a proposed settlement that called for a structured dismissal of the Chapter 11 case.

Under the terms of the proposed settlement, CIT would deposit $2 million into an account to pay the committee's legal fees, and Sun Capital would assign its lien on the debtor's remaining $1.7 million to a trust used to pay taxes and administrative expenses, with the remainder distributed to low-priority general unsecured creditors.

The drivers objected, arguing that the settlement's distribution plan violated the code's priority scheme by skipping their mid-level-priority claims against estate assets, which they held by virtue of their WARN judgment, while allowing the distribution of estate assets to low-priority general unsecured creditors.

The Bankruptcy Court granted the motion, concluding that without the structured dismissal there was "no realistic prospect" of a meaningful distribution for anyone other than the secured creditors, a confirmable Chapter 11 plan was unattainable, and there would be no funds to pay the cost of converting the case to Chapter 7 liquidation.

The Bankruptcy Court's judgment was affirmed by a U.S. District Court judge and, later, by the 3rd U.S. Circuit Court of Appeals.

In the appeal to the Supreme Court, Massachusetts and Rhode Island joined in an amicus brief filed by the Illinois attorney general in support of the drivers.

In reversing the lower courts, the Supreme Court recognized that the Bankruptcy Code's priority system constitutes a "basic underpinning" of business bankruptcy law. The court found it significant that there was no evidence of congressional intent to make structured dismissals a "backdoor means" to achieving priority-violating final distributions that the code prohibits in Chapter 7 liquidations and Chapter 11 plans.

The Supreme Court acknowledged that, under 11 U.S.C. §1112(b), a bankruptcy court has the power to "dismiss" a Chapter 11 case.

"But the word 'dismiss' itself says nothing about the power to make nonconsensual priority-violating distributions of estate value," Breyer wrote. "Neither the word 'structured,' nor the word 'conditions,' nor anything else about distributing estate value to creditors pursuant to a dismissal appears in any relevant part of the Code."

Reading the tea leaves

The decision underscores that the absolute priority rule is a bedrock bankruptcy principle, according to attorney George W. Tetler III of Worcester, Massachusetts.

"So any deviation from it is going to be looked upon carefully and narrowly in any Chapter 11 context," he said.

Joseph B. Collins, who practices in Springfield, Massachusetts, likewise agreed with the decision, which he viewed as a fairly narrow ruling. According to Collins, the decision protects the "integrity" of the bankruptcy

system.

“The folks who tried to do the structured dismissal really were trying to take an asset away from a certain class of creditors,” Collins said. “Without the structured dismissal, the fraudulent transfer rights that were in the bankruptcy case would have been lost to a priority set of creditors.”

Collins recognized the concern that lower courts will interpret a decision from the Supreme Court too broadly. But he did not see that as a problem with *Czyzewski*.

“It seems pretty clear to me that this is a case [that was] decided based upon what the circumstances were in this particular structured dismissal,” he said. “I don’t think that this case says that you can’t have a structured dismissal, and I don’t think the bankruptcy courts would read it that broadly.”

Jeffery said he could see bankruptcy courts expanding *Czyzewski* beyond structured dismissals, looking at the propriety of other priority-skipping mechanisms.

Tetler, meanwhile, speculated that *Czyzewski* could impact settlements of litigation inside a Chapter 11 case, sometimes done to fund a litigation trust for the benefit of victims, like those exposed to asbestos.

“Technically, the proceeds of those settlements, if the absolute priority rule were to be deployed, would go to creditors in order of priority,” Tetler said. “I could see somebody citing [the dicta in *Czyzewski*] for the proposition that the court would not look with favor upon a litigation settlement inside Chapter 11 that bends or breaks the absolute priority rule.”

Czyzewski could wind up increasing the cost of administering a bankruptcy estate in terms of obtaining the consent of creditors to the waiver of priority status, Kessimian suggested.

Indeed, *Czyzewski* raises practical questions as to how a party goes about obtaining the consent of a class of creditors in a structured dismissal, Tetler said.

“For confirming a Chapter 11 plan, there’s a process for balloting creditors,” he said. “I’m not sure practically speaking how one could ballot a class of creditors in a structured dismissal.”

Interim orders OK?

Jeffery said a key to understanding *Czyzewski* is that the case involved a deviation from priority rules in the context of a final order, a structured dismissal.

He found it important that the Supreme Court in dicta appeared to approve of the more common practice of allowing deviation from priority rules within the context of so-called “interim orders.”

For example, Breyer noted that courts have approved wage orders that allow payment of employees’ pre-petition wages and essential suppliers’ pre-petition invoices. Courts also have permitted so-called “roll-ups” that allow lenders who continue financing the debtor to be paid first on their pre-petition claims.

Breyer observed that courts justified such interim orders on the ground that the payments benefitted even disfavored creditors because a debtor’s continued operations increased the chances of a successful reorganization.

“By way of contrast, in a structured dismissal like the one ordered below, the priority-violating distribution is attached to a final disposition; it 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,” Breyer wrote.

It was important that the court gave a nod to so-called “first-day” or “critical vendor” orders, Tetler said, which are not explicitly addressed in the Bankruptcy Code.

“A reasonable read of [*Czyzewski*] is that early in a Chapter 11 case these sorts of practical deviations from the priority rules in bankruptcy are acceptable in furtherance of a reorganization,” he said. “But toward the end of a case or at the time when the reorganization is being resolved, whether it’s through a structured dismissal or a plan, those sorts of deviation are not going to be looked upon with favor.”

Kessimian said this dicta should reassure attorneys who might have wondered whether the absolute priority rule applied by the Supreme Court in *Czyzewski* raised doubt as to the continued viability of priority-offending interim orders.

“The court indicated we’re still going to theoretically allow departures from absolute priority as long as they are interim,” Kessimian said.

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