

Let's Make A Deal

The Third Circuit Approves Structured Dismissals of Chapter 11 Bankruptcy Cases

By: William L. Hallam

In a May 2015 opinion, the United States Court of Appeals for the Third Circuit approved the “structured dismissal” of the Chapter 11 bankruptcy case of Jevic Holding Corporation. The *Jevic* case is important because: (1) it is the first reported Circuit Court case approving a structured dismissal; and (2) Delaware, the jurisdiction in which many of the largest Chapter 11 cases are filed, is in the Third Circuit. *Jevic* affords debtors and secured creditors options for liquidating assets under bankruptcy court authority without the time and expense of confirming a Chapter 11 plan or the risk of turning the assets over to a Chapter 7 trustee for forced sale.

Chapter 11 of the Bankruptcy Code is entitled “Reorganization.” The title suggests that Congress envisioned Chapter 11 as a mechanism by which a financially troubled business may restructure its affairs through a plan of reorganization. Indeed, much of Chapter 11 is devoted to prescribing what may and may not be included in a proposed plan and the factors bankruptcy courts must consider in determining whether to confirm a plan.

However, the Code does permit a Chapter 11 plan to provide for the sale of all or substantially all of the debtor’s assets. Increasingly, debtors have resorted to Chapter 11, not to restructure and continue their businesses, but to sell their assets under court supervision. Historically, following the sale, the debtor either files a plan providing for the distribution of the proceeds of sale or converts its case to a Chapter 7 liquidation case, with a trustee then distributing of the proceeds of sale in accordance with the Bankruptcy Code.

For over-leveraged debtors, Chapter 11 often has not been a viable option. Unless the affected creditors otherwise agree, a plan cannot be confirmed unless it provides for payment in full of “administrative expenses,” (i.e., the expenses incurred while the debtor is operating as a debtor-in-possession, including its attorneys’ and consultants’ fees and the fees incurred by any professionals representing committees of creditors and equity security holders) and types of claims given priority by the Code (e.g., taxes and amounts owed to employees for pre-bankruptcy wages and benefits). Unless all impaired classes of claims accept a proposed plan, the plan also may not be confirmed unless it adheres to the “absolute priority rule.” Under that rule, unsecured creditors are paid only if funds remain after secured claims, administrative expenses, and priority claims have been paid in full. Chapter 7 trustees must follow that same order of priorities in distributing a debtor’s assets. If all of the debtor’s assets are encumbered and there is not enough to pay the debtor’s secured creditors in full, no one else, including the debtor’s lawyer and the trustee liquidating the assets, is paid anything.

Debtors, wishing to avoid a forced liquidation of their assets by secured creditors, and secured creditors, wishing to avoid both a forced liquidation of collateral and the potential liability that may result from operating debtors’ businesses to try to preserve going concern value, have devised the “structured dismissal” as a means of using bankruptcy as a vehicle for selling assets in an orderly way without a confirmed plan or conversion to Chapter 7. In a structured dismissal, the court does not simply dismiss a Chapter 11 case, leaving creditors to their state law rights and remedies, but includes in the dismissal order provisions for the disposition of the debtor’s assets, releases of claims, and injunctions against creditor actions. In return for the benefits of an orderly sale of collateral, secured creditors agree to reallocate or “gift” some of the proceeds to which they would otherwise be entitled to the professionals conducting the sale and to creditor constituencies deemed important to the sale process. Often, these constituencies would receive nothing if the normal priority scheme was followed.

Structured settlements have met with mixed success in the lower courts. Until *Jevic*, no Circuit Court had ever upheld one in a reported decision. The Fifth Circuit had held that bankruptcy courts had no authority to approve any settlement that contemplated distribution of the debtor’s assets in a manner inconsistent with the Code’s priority scheme. The Second Circuit had rejected the Fifth Circuit’s rigid rule, but reversed the structured dismissal presented to it for review on the grounds that the lower courts had not been presented with evidence sufficient to overcome the strong presumption that the normal priority scheme should be followed.

In *Jevic*, the Third Circuit affirmed bankruptcy court and district court approval of a structured dismissal in which the secured creditors paid \$2 million into an account to be used to pay the attorneys' fees of Jevic and the Official Committee of Unsecured Creditors and certain administrative expenses and assigned its lien on a \$1.7 million deposit account to a trust for the benefit of the remaining administrative expense creditors and the holders of priority tax claims and general unsecured claims in return for a release of claims of Jevic and the Committee that the Committee had asserted in a lawsuit against the secured creditors. The dismissal left nothing for Jevic's former drivers who had priority wage claims that would have had to have been paid in full before the holders of general unsecured claims would have been paid anything if the Code priority scheme had been followed.

The former drivers appealed the approval of the structured dismissal. They presented two arguments. First, they argued that structured dismissals, regardless of the terms, are not provided for in the Bankruptcy Code. According to the drivers, "Chapter 11 provides debtors only three exits from bankruptcy: confirmation of a plan of reorganization, conversion to Chapter 7 liquidation, or plain dismissal with no strings attached." Second, based upon the Fifth Circuit's decision, the drivers argued that even if some structured dismissals were allowed, "they cannot be approved if they distribute estate assets in derogation of the priority scheme of §507 of the Code."

On the first argument, the Third Circuit noted that while the usual effect of dismissal of a bankruptcy case is to restore everyone to the status quo that existed immediately prior to the bankruptcy filing, the Bankruptcy Code section governing dismissal of cases authorizes the bankruptcy court to otherwise order "for cause." Consequently, the Third Circuit concluded that the bankruptcy court did have authority to attach strings to dismissal. Although the Third Circuit recognized the potential for abuse, it noted that the drivers did not dispute the bankruptcy court's findings that confirmation of a Chapter 11 plan for Jevic was impossible and that conversion to Chapter 7 was "a bridge to nowhere" because nobody but the secured creditors would receive anything. The Third Circuit said:

[T]his appeal does not require us to decide whether structured dismissals are permissible when a confirmable plan is in the offing or conversion to Chapter 7 might be worthwhile. For present purposes, it suffices to say that absent a showing that a structured dismissal has been contrived to evade the procedural protections and safeguards of the plan confirmation or conversion processes, a bankruptcy court has discretion to order such a disposition

On the second argument, that Third Circuit said that it agreed with the Second Circuit "that compliance with the Code priorities will usually be dispositive of whether a proposed settlement is fair and equitable." The Third Circuit continued:

If the "fair and equitable" standard is to have any teeth, it must mean that bankruptcy courts cannot approve settlements and structured dismissals devised by certain creditors in order to increase their shares of the estate at the expense of other creditors. We therefore hold that bankruptcy courts may approve settlements that deviate from the priority scheme of §507 of the Bankruptcy Code only if they have specific and credible grounds to justify [the] deviation.

The Third Circuit said that the bankruptcy court had such specific and credible grounds for deviating from the normal priority scheme based on: (1) its findings that there was no prospect of confirmation of a plan and that only the secured creditors would be paid anything in a Chapter 7 liquidation; and (2) the fact that the structured settlement resulted in creditors other than the secured creditors receiving some distribution that they would not have received if the case had been converted. In light of these circumstances, as the Third Circuit put it, "The Bankruptcy Court, in Solomonic fashion, reluctantly approved the only course that resulted in some payment to creditors other than [the secured creditors]."

Structured dismissals like the one approved in *Jevic* are likely to become the norm. Although the Third Circuit said that deviation from the usual priority scheme "is likely to be justified only rarely," the facts found sufficient in *Jevic* are present whenever all of the debtor's assets are encumbered and the debtor owes secured creditors more than its assets are worth. Once the proposition that certain classes of creditors would receive nothing through a confirmed

plan or a Chapter 7 liquidation is accepted, it is impossible for the creditors who would receive nothing to prove that a settlement increases the shares of other creditors at their expense.

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