“*Sub Rosa* Plans”: Their Impact in, and Provision of a Potential Alternate Exit Strategy from, Chapter 11

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The Validity of Plan Support Agreements: Walking the Sub-Rosa Plan Line?

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I. Introduction

Plan support agreements ("PSAs"), also referred to as "lockup" agreements or restructuring support agreements, have become increasingly common in Chapter 11 bankruptcies. Proponents of the agreements contend that they promote a consensual Chapter 11 process, carrying forward a concrete proposal that the key constituents will abide to in seeking plan confirmation. Proponents argue that PSAs reduce the overall cost of the Chapter 11 case and provide certainty to the parties moving forward. But with the more frequent use of PSAs, additional scrutiny of the practice has followed. Opponents of PSAs argue that there is no better example of an impermissible *sub rosa* plan. Ultimately, the challengers contend, the Chapter 11 plan process is circumvented by these hastily- conceived agreements with little input and limited notice to the creditor body.

These materials provide a basic primer on the contents and workings of plan support agreements ("PSAs"), discuss policy concerns with respect to their use in modern restructurings, and provide a brief summary of important recent case law regarding their proper use.

II. Plan Support Agreement Basics

a. Purpose

A PSA is a contract entered into between a debtor and creditors wherein the parties agree to support a plan for confirmation in a chapter 11 proceeding. Kurt A. Mayr, *Unlocking the Lockup: The Revival of Plan Support Agreements Under New §1125(g) of the Bankruptcy Code*, 15 NORTON J. BANKR. L. & PRAC. 729, 730 (2006). PSAs allow the debtor and involved creditors to more precisely negotiate the contents of the eventual plan and to agree on its support, which can benefit the debtor and creditors in various ways and make the postpetition process considerably quicker and less expensive.

b. Timing

A PSA may be entered into prepetition or postpetition, with different statutes, rules, and standards applying in each scenario.

i. Prepetition

PSAs are often used as part of an attempt to negotiate and "lock up" a plan before the debtor even files for bankruptcy. If the debtor and important creditors negotiate a plan and hold votes in favor of the plan prepetition, the process is called a prepackaged plan of reorganization, also known as a "prepack." *See, e.g.*, Andrew M. Troop et al., *CONCURRENT SESSION: The Mechanics of Prepacks: What Happens Pre-Petition, and How to Make it Stick Post-Petition*, 071714 ABI-CLE 123, (2014). Otherwise, a prepetition PSA is usually an agreement for the signatories to support (or at least not oppose) the agreed upon plan when it comes to the plan confirmation stage. A prepetition PSA is a pre-bankruptcy contract that the parties typically will seek to have approved as an executory contract postpetition through Section 365 of the

Bankruptcy Code. Isaac Sasson, *Judicial Review of Plan Support Agreements: A Review and Analysis*, 9 N.Y.U. J.L. & LIBERTY 850, 851-52 (2015).

ii. Postpetition

Parties to a Chapter 11 bankruptcy may also negotiate and enter into PSAs postpetition. Under this approach, the debtor must seek the court's approval to enter into such a PSA pursuant to Section 363 if the PSA is outside of the usual course of business and uses the estate's property. Sasson, *supra*, at 852.

The central issue for postpetition PSAs is whether the PSA complies with Section 1125(b) of the Bankruptcy Code. Section 1125(b) prohibits postpetition solicitation in favor of a plan unless transmission of (1) the proposed plan (or plan summary) and (2) a court approved disclosure statement has already occurred. Because the Bankruptcy Code does not define "solicitation," it is up to courts to determine what is permissible under Section 1125(b). As discussed in further detail in the case-law section below, the majority of courts now define "solicitation" narrowly to permit a wide range of negotiation in furtherance of successful Chapter 11 resolution. *See, e.g.*, Troop et al., *supra*, at C.; Bruce R. Zirinsky et al., *Recent Issues in Plan Confirmation: Post Petition Lock-Up Agreements in Chapter 11 Plans*, 051613 ABI-CLE 307 (2013).

c. Contents

Although PSAs may differ significantly in terms of their specific contents, the following features are common: (1) details regarding the plan's core components; (2) an agreement to support (or at least not block) the eventual plan; (3) various predicate conditions upon which the agreement is based (*e.g.*, no material differences exist between the plan described in the PSA and the plan subject to confirmation vote; the drafting and court approval of the disclosure statement); (4) provisions allowing for signatories to escape the agreement if necessary (*i.e.*, a "fiduciary out"); and (5) remedies for breach, including specific performance. *See, e.g.*, 16-CM21 COLLIER ON BANKRUPTCY §21.14; Clement J. Farley et al., *Validity of Post-Petition Restructuring Support Agreements in Bankruptcy*, 241 N.Y.L.J. 71 (2013); Mayr, *supra*, at 730; Sasson, *supra*, at 856-858.

III. Policy Concerns For and Against Plan Support Agreements

Although PSAs can have significant benefits for certain debtors, some worry about their impact on the Chapter 11 process.

a. Arguments in Favor of PSAs

Plan support agreements, and prepacks in particular, can considerably shorten the Chapter 11 process, saving the debtor significant amounts of postpetition spending in the process. Sasson, *supra*, at 858; Stephen D. Zide et al, *In This Issue: Building Blocks, Prepackaged Bankruptcy: Is it Right for your Company?*, 34-10 ABIJ 30, 30-31, 69. The shorter administrative period also reduces the damage to the debtor in terms of reputation, employee confidence, and other business considerations. *See* Farley, *supra*; Troop, *supra*. In the same vein, by conducting negotiations prepetition, the debtor may save considerably on the various administrative costs inherent in a Chapter 11 proceeding.

A core additional benefit to the parties to a PSA is the increased certainty the parties can have in the process's outcome. Sasson, *supra*, at 857. The debtor can wait to file its petition until the PSA negotiations are complete, or can better negotiate postpetition to ensure a speedy resolution. Negotiation between debtors and creditors is a key goal of the Chapter 11 process, and it is helped significantly by the powers presented by PSAs. Farley, *supra; In re Indianapolis Downs, LLC*, 486 B.R. 286, 297 (Bankr. D. Del. 2013) ("the filing of a Chapter 11 petition is an invitation to negotiate"). Because courts have been very willing to approve PSAs as a whole, debtors may have some confidence that their PSA will be approved absent bad faith behavior by the debtor or major creditors. Sasson, *supra*, at IV.

b. <u>Arguments Against PSAs</u>

PSAs arguably subvert significant portions of the Chapter 11 process, and in turn may harm the goal of creating a plan that is beneficial to all parties. While negotiations between significant interested parties is essential to a successful Chapter 11 case, PSAs limit or altogether remove the usual procedural safeguards built into the Chapter 11 process. *See, e.g.*, Zide, *supra*, at 30-31. The agreements are called "lock ups" for a reason – they bind parties to courses of action before all of the information is known, creating a risk of missing out on a later deal that creates more value for the estate. *See, e.g.*, Sasson, *supra*, at 872-874 (citations omitted); *Id.* at V.A. While the obvious losers are the creditors left out of unfavorable PSAs, PSAs may also harm debtors by causing their estate to be undervalued or by forcing them to sacrifice too much in the process of negotiating with creditors for their agreement to a PSA. *Id.* at V. The debtor may also be functionally giving away what would otherwise be an exclusivity period in which only the debtor could propose plans. *Id.* at V.C. These problems may be exacerbated by the negotiations taking place outside of the open Chapter 11 forum and judicial review. *See id.* at IV. Additionally, PSAs and prepacks are not effective for all debtor types, and could instead risk votes being designated instead under 11 U.S.C. §1126(e). *See* Zide, *supra*; Zirinsky, *supra*.

IV. <u>The Case Law</u>

a. <u>Innkeepers</u>

In *Innkeepers*, the Bankruptcy Court of the Southern District of New York was faced with the debtors' motion to assume a PSA that was executed in the days prior to the Chapter 11 filing. *In re Innkeepers USA Trust*, 442 B.R. 227 (Bankr. S.D.N.Y. 2010). The court declined to approve the prepetition PSA under either the business judgment review or the heightened scrutiny standard applied to insider transactions.

The court thoroughly rejected the PSA. First, the PSA was never a disinterested business transaction because the debtors' parent company was always intended to receive equity as part of the deal. *Id.* at 231. Nor was the decision entered into in "due care" because they never "shopped" around the market with the deal and because the PSA prevented the debtors from negotiating meaningfully with other creditors. *Id.* at 231-233. Second, there was no significant benefit to rushing into the PSA, locking the debtor into a path so early on in the case, especially since the PSA did not resolve $1.2 billion of the outstanding debt. *Id.* at 233. The debtor did not act in good faith in deciding to enter into the PSA or provide transparency to the creditors. *Id.* Finally, the "fiduciary out" was seriously flawed, presenting a major issue to the PSA's approval because of its limiting effect on the debtor's ability to act pursuant to their fiduciary duties. *Id.* at 235.

In rejecting the PSA, the court provided a helpful series of data points and analysis for actions violative of the requirements for a successful PSA. The court did not announce a prohibition on PSAs, but commented that the one proposed by the debtors was ill-conceived. Tellingly, the court found that the case and arguments by the opponents were not made by "out-of-the-money" constituents intended to extract hold-up value from "in-the-money" players. *Id.* at 236. Instead, the PSA failed to satisfy the impartiality required in a complex case and left the debtors paralyzed and unable to conduct a fair plan process to maximize value for all of the estates and treat all creditors with greater neutrality. *Id.*

b. <u>Genco</u>

The recent *Genco* case demonstrates the economic and business benefits of a prepack plan. Zide, *supra*, at 69- 70 (*citing In re Genco Shipping & Trading Limited*, 513 B.R. 233 (Bankr. S.D.N.Y. 2014)). The debtor in *Genco* entered into a PSA with its financial creditors as part of a prepack reorganization. *Id.* at 70. The debtor began soliciting support for its prepack plan, filed its chapter 11 petition, and sought the court's approval of the plan during a first day hearing. *Id.* The court overruled some creditors' objections and approved the PSA. *Id.* "[D]espite the appointment of an equity committee and a contested confirmation hearing," "Genco emerged from bankruptcy after only 79 days with approximately $1.2 billion less debt and largely unaffected trade creditors." *Id.*

In evaluating the motion to assume the PSA, the court found that the debtors' decision to assume the PSA clearly met the "business judgment" standard. *In re Genco Shipping & Trading Limited*, 509 B.R. 455, 463-64 (Bankr. S.D.N.Y. 2014). This conclusion was supported by evidence that the Chapter 11 proceeding was an appropriate vehicle for the debtors to restructure its business, and the mechanism chosen (*i.e.*, the "prepack") would help avoid a long, drawn out Chapter 11 process and the attendant costs. *Id*. The non-debtor parties to the PSA also made significant concessions in the Chapter 11 case and provided for a meaningful recovery for all stakeholders. *Id*. The PSA also provided a fiduciary out that gave the debtors the ability to receive, review and negotiate unsolicited proposals for any better alternative transaction. *Id*.

c. <u>Indianapolis Downs</u>

In *Indianapolis Downs* the Bankruptcy Court for the District of Delaware reviewed the appropriateness of a postpetition PSA and whether such agreement can survive the challenges posed by Section 1125(b)'s restriction on solicitation. *In re Indianapolis Downs, LLC*, 486 B.R.

286 (Bankr. D. Del. 2013). After two prior Delaware cases rejected PSAs under Section 1125(b) because of solicitation concerns, *Indianapolis Downs* signaled a potential change of direction for the court. *Id.* at 295 (*citing In re Stations Holding Co., Inc.*, 2002 WL 31947022 (Bankr. D. Del. 2002); *In re NII Holdings, Inc.*, 288 B.R. 356 (Bankr. D. Del. 2002)). In the case, the debtors and various creditors entered into a PSA after months of negotiating. *Id.* at 292. The PSA was filed with the court immediately after its execution, contemporaneously with a proposed disclosure statement and accompanying plan. *Id.* The court approved the disclosure statement and later issued a decision regarding confirmation of the plan. Included in its confirmation decision was the issue concerning the appropriateness of the PSA whether the PSA creditors' votes should be designated/not counted pursuant to Sections 1125(g) and 1126(e) of the Bankruptcy Code.

Following the reasoning of the Third Circuit's seminal decision in *In re Century Glove*, 860 F.2d 94 (3d Cir. 1988), the court adopted the majority position that solicitation under Section 1125(b) must be defined narrowly. *Indianapolis Downs*, 486 B.R. at 295 (*quoting Century Glove*, 860 F.2d at 101) ("solicitation must be read narrowly. A broad reading of §1125 can seriously inhibit free creditor negotiations."). Congress intended debtors and creditors to negotiate with one another during the Chapter 11 process, and the narrow understanding of solicitation better fits that goal. *Id.* Additionally, designating the PSA's parties' votes would be inconsistent with the bankruptcy code for two reasons. First, creditor suffrage is a bedrock of chapter 11 and a vote of the overwhelming majority of the creditors should not be ignored or discounted absent bad faith or wrongful conduct. *Id.* Second, the purpose of Section 1125 and Chapter 11's disclosure requirements are to ensure that acceptance is not solicited when the creditors and stockholders are too ill informed to act. *Id.* (citations omitted). Here, on the contrary, the parties were "sophisticated financial players" "represented by able and experienced professionals throughout [the] proceedings." *Id.* at 296. The court so held even though the PSA contained a specific performance remedy.

Put simply, *Indianapolis Grounds* stands for the idea that "courts must be chary of construing those disclosure and solicitation provisions in a way that chills or hamstrings the negotiation process that is at the heart of Chapter 11." *Id.* at 297 (citation omitted).[1]

d. <u>Residential Capital</u>

In another case addressing the postpetition assumption of a PSA, the Southern District of New York's *Residential Capital* ruling demonstrates the importance of properly constructed termination events in a PSA. *In re Residential Capital, LLC*, 2013 WL 3286198 (Bankr. S.D.N.Y. June 27, 2013). At the outset, the court remarked that the PSA was the result of many months of negotiations and mediation sessions and found support by a substantial majority of the debtors' major claimant constituencies. *Id*. at 20. As a result, the court distinguished the case from that of *Innkeepers*. *Id*. The court approved the PSA, after a finding that the postpetition PSA did not constitute a "solicitation" under Section1125 because of the "numerous termination events that allow a party to withdraw from this obligation under certain circumstances" and because "none of the Parties have agreed to vote in favor of the Plan unless and until the Court approves the disclosure statement and their votes have been properly solicited pursuant to section 1125." *Id.*

e. <u>In re Kellogg Square Partnership</u>

Cited by the Delaware court in *Indianapolis Downs*, the Bankruptcy Court of the District of Minnesota reasoned similarly in *In re Kellogg Square*, another postpetition PSA case. *In re Kellogg Square P'ship*, 160 B.R. 336 (Bankr. D. Minn. 1993). *Kellogg* is an important

[1] According to Webster's Dictionary, "chary" means "cautious or careful."

postpetition approval case because it explains that for a solicitation analysis, "the act by which the Debtor solicited [the vote] must be deemed to have taken place after the Court approved the amended disclosure statement, and only when the Debtor's plan and disclosure statement and ballot were actually presented." *Id.* at 340.

Structured Dismissal: The "Least Bad Alternative"

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Question Presented: *Are "structured dismissals" permissible under the Bankruptcy Code, and if so, may the bankruptcy court authorize the distribution of estate assets in a manner that violates the Bankruptcy Code's priority scheme?*

I. Introduction

Structured dismissals are not a new or particularly novel method for exiting a chapter 11 case. The rapid change of chapter 11 practice over the past several years, however, has led to an increasing use of structured dismissals as a viable exit to chapter 11. These materials provide an overview of the nature and modern use of structured dismissals, including the recent Third Circuit's controversial decision in *In re Jevic Holding Corp.* that pushed the frontier of structured dismissals to permit a distribution of estate assets contrary to the priority scheme under the Bankruptcy Code. As of the submission of these materials, the petition for writ of certiorari of the *Jevic* decision is pending before the Supreme Court. At the invitation of the Supreme Court, on May 23, 2016 the Solicitor General submitted a brief in support of granting certiorari to determine the Circuit split on the question whether estate property may be distributed under a settlement and/or dismissal order that deviates from the absolute priority rule. These materials will frame the arguments for and against structured dismissals to be debated at the 23rd ABI Northeast conference.

II. The Structured Dismissal

A "structured dismissal" has been described as "a hybrid dismissal and confirmation order."[1] The Third Circuit aptly summarized structured dismissals as "dismissals that are preceded by other orders of the bankruptcy court (*e.g.,* orders approving settlements, granting releases, and so forth) that remain in effect after dismissal." *In re Jevic Holding Corp.*, 787 F.3d 173, 185 (3d Cir. 2015), as amended (Aug. 18, 2015), petition for writ of certiorari pending, U.S. Supreme Court, Case No. 15-649.

There is no express authority under the Bankruptcy Code to authorize a structured dismissal. Yet, proponents and opponents of structured dismissals root their respective arguments under Bankruptcy Code sections §§ 105, 305, 349, and 1112. To date, only the Court of Appeals for the Third Circuit in the *Jevic* case has weighed in on the debate concerning the nature and scope of structured dismissals. Lower district courts and bankruptcy courts generally accept the authority for a structured dismissal, but depending on the facts in the particular case, there may not be sufficient "cause" to warrant the relief requested. However, the fundamental issue raised in *Jevic* concerns the extent to which estate property may be distributed through a structured dismissal and outside of a chapter 11 plan in deviation of the Bankruptcy Code's priority scheme. This issue appears to be subject to a Circuit split, with *Jevic* following the Second Circuit's decision in *Iridium Operating*, 478 F.3d 452 (2_{nd} Cir. 2007) and rejecting the Fifth Circuit's rulings in *In re AWECO, Inc.*, 725 F.2d 173 (5_{th} Cir. 1984).[2]

Structured dismissals are typically sought when the traditional routes out of chapter 11 would not maximize the interests of the estate's creditors. Often, a structured dismissal is a consensual resolution and pursued: (1) after a sale of substantially all of the debtor's assets and

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[1] *See* Norman L. Pernick & G. David Dean, *Structured Chapter 11 Dismissals: A Viable and Growing Alternative After Asset Sales*, Am. Bankr. Inst. J., June 2010, at 1.
[2] But see Section IV infra, challenging the extent of a Circuit split on the issue presented.

there is no viable plan alternative, and (2) in conjunction with a settlement of significant disputes between parties that results in a distribution of substantially all assets of the debtor. The most common factors leading to a decision to seek a structured dismissal are that the debtor's estate is administratively insolvent, or otherwise does not have sufficient liquidity to pursue an expensive plan process, and/or the undersecured creditor, as the fulcrum security, finds no value in continuing to fund the chapter 11 case where it will not realize any further benefit from continuing the chapter 11 process.

"Unlike the old-fashioned one sentence dismissal orders,"[3] the hallmarks of a structured dismissal are the "bells and whistles" that are set forth in the bankruptcy court's dismissal order or companion order authorizing a settlement that provides for a distribution of all estate assets. The following relief is most common to a structured dismissal:

a. Retention of the bankruptcy court's jurisdiction, notwithstanding Bankruptcy Code section 349;

b. Survival of bankruptcy court orders, notwithstanding Bankruptcy Code section 349;

c. Claim resolution procedures that tend to be more expedited than in chapter 11;

d. Releases and exculpation provisions that might ordinarily be approved as part of a confirmed chapter 11 plan;

e. Carve-outs, gifting, or otherwise transferring a distribution due a senior creditor to a more junior creditor, typically as an inducement to the junior creditor constituents;

f. Final determination of professional fees and other administrative claims;

g. Expedited procedures to resolve prepetition claims; and

h. Provisions specifying the manner and amount of distributions to creditors.

III. Policy Concerns For and Against Structured Dismissals.

While it is not atypical for a bankruptcy court to authorize a structured dismissal, there continues to be meaningful debate whether the practice has any support under the Bankruptcy

[3] *In re Strategic Labor, Inc*., 467 B.R. 11 (Bankr. D. Mass. 2012).

Code, and if so, whether there are any boundaries to the relief that may be contained in the order permitting the structured dismissal. The following summarizes the primary arguments for and against structured dismissals:

A. **Arguments in Favor of Structured Dismissals.**

Proponents of structured dismissals primarily look to Bankruptcy Code sections 305(a) and 1112(b) for statutory support, with limited additional support found at Bankruptcy Code sections 105(a) and 349. The approach adopted by the Third Circuit in *Jevic* and discussed herein, gives great flexibility to the bankruptcy court and settling parties to craft the terms and distribution of settlement proceeds under a structured dismissal to provide some return to parties other that a senior secured creditor where (a) no chapter 11 plan could be confirmed, and/or (b) conversion to chapter 7 would only add additional and potentially unnecessary administrative expenses without any accretive benefit to creditors.

The primary source of authority is Bankruptcy Code section 1112(b). Relief under section 1112(b) requires a two-step analysis, first whether "cause" exists either to dismiss (or to convert the chapter 11 case to a chapter 7 case), and second to determine which option is in "the best interest of creditors and the estate." *See In re Mechanical Maintenance, Inc.,* 128 B.R. 382, 386 (E.D.Pa.1991).

First, cause is a flexible standard, which includes but is not limited to the factors identified at Bankruptcy Code section 1112(b)(4). Often, cause for a structured dismissal is established in the following scenarios:

- Estate assets have been liquidated under a sale and there is nothing remaining to reorganize;[4]
- Inability to confirm a plan;

[4] *See, Camden Ordnance Mft. Co. of Ark., Inc. v. United States Trustee (In re Camden Ordnance Mfg. Co. of Ark., Inc.)*, 345 B.R. 794, 799 (E.D. Pa. 2000).

- Estate is administratively insolvent;
- Motive for filing was to abuse the reorganization process;
- Conversion to chapter 7 will likely result in no distribution beyond the secured creditors;
- Dissipation of assets during a case will deplete availability of funds for a liquidation trust;

Once the bankruptcy court finds "cause," the court must next determine whether dismissal is in the best interests of creditors of the estate. 11 U.S.C. § 1112(b)(1). In the Fourth Circuit case of *Superior Siding & Window*, the court denied the structured dismissal where the debtor failed to take into account the interests of all creditors, which would have concluded that conversion to a chapter 7 case was better than dismissal. *Rollex Corp. v. Associated Materials, Inc. (In re Superior Siding & Window, Inc.)*, 14 F.3d 240, 242 (4th Cir. 1994); *see also In re Mechanical Maintenance, Inc.*, 128 B.R. at 386 (require a comparison of the creditors' interests in bankruptcy with those they would have under state law).

Another source of authority for entering a structured dismissal is Bankruptcy Code section 305. While typically seen as a source of authority to dismiss involuntary cases,[5] section 305(a) is not limited to involuntary cases and authorizes a dismissal if "the interests of creditors and the debtor would be better served by such dismissal or suspension." 11 U.S.C. § 305(a)(1); *see also In re Monitor Single Lift I Ltd*., 381 B.R. 455, 463 (Bankr. S.D.N.Y. 2008) (dismissal under section 305 warranted where evidence establishes dismissal is better for the creditors and debtor). Section 305(a)(1) provides extraordinary relief because dismissal is only subject to appellate review by the district court or a bankruptcy appellate panel. *See In re Kennedy*, 504

[5] *See* Michael J. Lichtenstein, *Asset Sales and Structured Dismissals in Chapter 11*, Jnl. of Bankr. L. 2014.01-04; *see also In re Biolitiec, Inc.,* 528 B.R. 261, 267 (Bankr. N.J. 2014*), In re Monitor Single Lift I Ltd*., 381 B.R. 455, 463 (Bankr. S.D.N.Y. 2008) (relief under section 305 is considered an "extraordinary remedy").

B.R. 815, 828 (Bankr. S.D. Miss. 2014) (dismissal or suspension order under section 305(a) reviewable by bankruptcy appellate panel). Thus, courts have cautioned dismissal under section 305 only in extraordinary circumstances. *See Hartigan v. Pine Lake Village Apartment Co., (In re Pine Lake Village Apartment Co.)*, 16 B.R. 750, 754 (Bankr. S.D.N.Y. 1982) ("this section should be used sparingly and not as a substitute for a motion to dismiss under … §1112(b)).

Section 349 outlines the effect of dismissal and provides support by which the bankruptcy court may, at its discretion, alter the general effect of dismissal to return the parties to status quo ante. 11 U.S.C. § 349. Lending support for crafting creative dismissal orders, it may be necessary to read sections 349 and 105(a) together to provide the relief required to wind-down the case through a structured dismissal.[6]

B. <u>Arguments Against Structured Dismissals</u>.

There is no authority under the Bankruptcy Code to authorize a structured dismissal. Rather, the Bankruptcy Code identifies only the following three paths for a debtor to exit chapter 11: (i) confirmation of a plan of reorganization or liquidation, (ii) conversion to chapter 7 upon request of the Debtor or court, or (iii) dismissal that simply returns the debtor to its pre-filing position.

Opponents of structured dismissals assert that this exit option is problematic because it may:

a. Distribute assets in deviation of Bankruptcy Code statutory priorities;

b. Include improper and overbroad releases and exculpation clauses;

c. Violate the express requirements of Bankruptcy Code section 349(b) to return the parties status quo ante;

d. Constitute an impermissible "sub rosa" chapter 11 plans; and

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6 *See* Amir Shachmurove, *Another Way Out: Structured Dismissals in Jevic's Wake*, 2015 No. 11 Norton Bankr. L. Adviser NL 1 (2015).

e. Seek an improper retention of the bankruptcy court's jurisdiction without any statutory authority.

In response to a perceived growing trend favoring structured dismissals, attorneys for the Office of the United States Trustee published an article challenging the use of a structured dismissal as an end run around the typical creditor protections under a chapter 11 plan that "strongly resemble impermissible sub rosa plans." *See* Nan Roberts Eitel, T. Patrick Tinker & Lisa L. Lambert, *Structured Dismissals, or Cases Dismissed Outside of Code's Structure?*, 30 Am. Bankr. Inst. J. 20 (Mar. 2011) (quoting *Institutional Creditors of Continental Air Lines Inc. v. Continental Air Lines Inc. (In re Continental Air Lines Inc.),* 780 F.2d 1223, 1224 (5th Cir. 1986). The article points out that, "unlike chapter 7 liquidation, structured dismissals distribute assets without enforcing priorities, addressing litigation or ensuring accountability for distributing assets." *Id*.

The opposition's argument rests on the plain language of Bankruptcy Code. Sections 1112 and 305 do not provide authority to insert all of the "bells and whistles" contained in the orders authorizing a structured dismissal. Rather, the plain language of Bankruptcy Code section 349 prohibits structured dismissals. Section 349 speaks of "cause" for dismissal, but it should not be read more broadly. Opponents argue it should be given its ordinary meaning that, upon dismissal, all rights should be restored to their pre-bankruptcy position. The legislative history of section 349 supports this argument. It states "the basic purpose of [section 349] is to undo the bankruptcy case as far as practicable, and to restore all property rights to the position in which they were found at the commencement of the case." H.R. Rep. No. 95-595 (1977).

In December 2014, the American Bankruptcy Institute issued the Report of the Commission to Study the Reform of Chapter 11, which recommends the following:

> The Bankruptcy Code should be amended to clarify that a chapter 11 case can be resolved only in the following three ways: (i) confirmation of a plan

> under section 1129; (ii) conversion of the case under section 1112; and (iii) dismissal of the case subject to section 549.

See ABI Commission to Study the Reform of Chapter 11, VI. Proposed Recommendations: Exiting the Case, 269 (2014) (the "Commission Report"). The Commission Report raised significant concerns that structured dismissals "short-circuits or completely eliminates creditor protections under the Bankruptcy Code." *Id*. at 272. In addition, the Commission Report noted its particular disdain for structured dismissals that violate the absolute priority rule (such as under the *Jevic* decision), grant third party releases, or deviate from a traditional claims processes. *Id*.

The Commission Report, however, made certain recommendations permitting greater flexibility in cases involving sales of substantially all assets under Bankruptcy Code section 363, which may address some of the "bells and whistles" presently deemed problematic in a structured dismissal. In a sale scenario under Bankruptcy Code section 363(b), the Commission Report recommends that the Bankruptcy Code be amended to build in greater creditor protections that are typically found in the plan confirmation process. If adopted, the Commission Report stated, structured dismissals should be unnecessary, and courts could comply strictly with the Bankruptcy Code in connection with orders ending chapter 11 cases.

IV. Pushing the Envelope: *Jevic*; Class Skipping Under a Structured Dismissal

A. *Jevic*: The case for class skipping under a structured dismissal.

While many courts recognize the bankruptcy court's authority to provide for a structured dismissal, the Third Circuit recently considered and approved a structured dismissal that deviated from the priority scheme under Bankruptcy Code section 507. *In re Jevic Holding Corp.,* 787 F.3d at 185.

Jevic Transportation, Inc. (“Jevic”), a trucking company headquartered in New Jersey, experienced financial distress and was acquired by a subsidiary Sun Capital Partners, Inc. (“Sun”) through a leveraged buyout. The buyout was financed by a group of lenders led by CIT Group Business Credit Inc. (“CIT”). Jevic continued to experience liquidity problems and to avoid CIT’s anticipated foreclosure, Jevic filed for chapter 11 in May 2008. The bankruptcy case was embroiled with litigation. First, a group of Jevic’s terminated truck drivers (“Drivers”) brought a class action against Jevic and Sun, alleging violations of the Worker Adjustment and Retraining Notification (WARN) Act with damages estimated at $12.4 million, inclusive of an $8.3 million priority wage claim. Second, the official committee of unsecured creditors (“Committee”) sued CIT and Sun for, among other things, fraudulent transfer arising out of the leverage buyout.

After several years of litigation and various rulings on certain dispositive issues in the Committee litigation, in March of 2012, representatives of all the major players in the case – the Committee, CIT, Sun, the Drivers, and Jevic – engaged in settlement negotiations. By the time the parties began to discuss a global settlement, the only remaining asset in the debtor’s estate was $1.7 million in cash. At the conclusion of the settlement discussions, the Committee, Jevic, CIT and Sun reached a settlement that contemplated a structured dismissal. Under the settlement, CIT would contribute $2 million into an account to pay administrative expense claims and Jevic’s remaining $1.7 million in cash would be transferred to a trust to pay tax and administrative creditors, and then to general unsecured creditors *pro rata*. The only problem with this settlement scheme was that the Drivers were left out.

The Drivers and the United States Trustee objected to the settlement and dismissal because the settling parties proposed a distribution of the settlement proceeds that included estate property to creditors with a lower priority than the Drivers under Bankruptcy Code section 507.

The bankruptcy court recognized the lack of express statutory authority for a structured dismissal, but noted that many courts acknowledged the authority for a structured dismissal under sections 1112 and 349. The bankruptcy court found that (i) there was "no realistic prospect" of a meaningful distribution to anyone other than secured creditors; (ii) there was "no prospect" of a confirmable chapter 11 plan (of either reorganization or liquidation); (iii) conversion to a chapter 7 liquidation would have been unavailing because a chapter 7 trustee would not have sufficient funds "to operate, investigate or litigate"; and (iv) the secured creditors had "stated unequivocally and credibly that they would not do this deal in a chapter 7." *Jevic*, 787 F.3d at 178.

In considering the objections to class-skipping, the bankruptcy court overruled the Drivers' opposition, holding that settlements approved under Rule 9019 do not need to conform to the absolute priority rule (as is required under a chapter 11 plan). The bankruptcy court applied the *Martin* test and approved the settlement . *See In re Martin*, 91 F.3d 389, 393 (3d Cir. 1996). Under the *Martin* test, the bankruptcy court considered: (i) the probability of success in the litigation; (ii) the likely difficulties in collecting on a judgment; (iii) the complexity of the litigation, as well as the cost, inconvenience, and delay associated with it; and (iv) the paramount interests of creditors. The bankruptcy court reasoned that the Committee's likelihood of success in the avoidance action was "uncertain at best," and that there were limited estate funds available prior to the settlement in comparison to the the consideration received under the settlement. The district court affirmed on appeal and the Drivers appealed to the Third Circuit.

The Third Circuit affirmed the district court in a 2-1 split decision. Writing for the majority, Judge Hardiman stated that "[t]his appeal raises a novel question of bankruptcy law: may a case arising under Chapter 11 ever be resolved in a 'structured dismissal' that deviates from the Bankruptcy Code's priority system?" He concluded that "in a rare case, it may." *Jevic*, 787 F.3d at 177.

At the outset, the Third Circuit swiftly determined that structured dismissals may be utilized despite the lack of any express statutory authorization. The court concluded that there was no prohibition under the Bankruptcy Code to order a structured dismissal, which may be appropriate pursuant to sections 1112(b) and 349 for cause. *Jevic*, 787 F.3d at 181. In upholding the district court, the Third Circuit's ruling provided 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." The court also held that "bankruptcy courts may approve settlements that deviate from the priority scheme of [the Bankruptcy Code]," but only if the court has "specific and credible grounds" to justify the deviation. *Jevic*, 787 F.3d at 183 (quoting *In re Iridium Operating LLC,* 478 F.3d 452 (2007)).

The court rejected the Drivers' argument that the settlement was an inappropriate application of Rule 9019, "'render[ing] plan confirmation superfluous' and paving the way for illegitimate *sub rosa* plans engineered by creditors with overwhelming bargaining power." *Jevic*, 787 F.3d at 181.

With respect to "class skipping" under a structured dismissal settlement, Jevic considered the apparent split in the authority between the Fifth Circuit in *AWECO, Inc.*, 725 F.2d at 456, 459-60, and the Second Circuit *In re Iridium Operating LLC*, 478 F.3d at 463–64. *Jevic*, 787 F.3d at 182. In the *AWECO* case, the Fifth Circuit rejected a settlement that would have transferred litigation proceeds to an unsecured creditor without paying senior creditors in full. *AWECO* held that chapter 11's "fair and equitable" standard, which requires compliance with the priority scheme, applies to settlements. *AWECO,* 725 F.2d. at 298. *Jevic* rejected the reasoning of *AWECO* and agreed with the *Iridium* court's more flexible approach. *Iridium* focused on whether the settlement is "fair and equitable" under Rule 9019, without a requirement for strict adherence to the priority scheme under the Bankruptcy Code. *Iridium*, 478 F.3d at 464. However, the *Jevic* court cautioned that "settlements that skip objecting creditors in distributing estate assets" . . . "raise justifiable concerns about collusion among debtors, creditors, and their attorneys and other professionals." *Jevic*, 787 F.3d. at 184. In recognizing the challenging issues presented by a structured dismissal that is contrary to the priority scheme under the Bankruptcy Code, the *Jevic* court stated "[t]his disposition, unsatisfying as it was, remained the least bad alternative since there was 'no prospect' of a plan being confirmed and conversion to Chapter 7 would have resulted in the secured creditors taking all that remained of the estate in 'short order.'" *Id.* at 185.

B. The Dissent: A case against non-extraordinary structured dismissals that violate the Bankruptcy Code.

The dissent in *Jevic*, submitted by Judge Scirica, opposed the settlement and the use of a structured dismissal under the facts in this case that were "at odds with the goals of the Bankruptcy Code." While Judge Scirica was not objectively offended by settlements that deviated from the Bankruptcy Code's priority rules, he was concerned that any such scenario may authorize routine class skipping. Judge Scirica cautioned that class skipping may be permissible where it "presents an extraordinary case where departure from the general rule is warranted." *Jevic*, 787 F.3d. at 186. Judge Scirica's dissent was premised on his conclusion that the facts under *Jevic* did not warrant such an extraordinary deviation.

The dissent acknowledged that, if the settlement were vacated, Jevic's chapter 11 case would likely be converted to a chapter 7 liquidation in which secured creditors would be the only creditors to recover anything. Judge Scirica outlined the exit plan he would have preferred:

> I would not unwind the settlement entirely. Instead, I would permit the secured creditors to retain the releases for which they bargained and would not disturb any of the proceeds received by the administrative creditors either. But I would also require the bankruptcy court to determine the WARN Plaintiffs' damages under the New Jersey WARN Act, as well as the proportion of those damages that qualifies for the wage priority.[6] I would then have the court order any proceeds that were distributed to creditors with a priority lower than that of the WARN Plaintiffs disgorged, and apply those proceeds to the WARN Plaintiffs' wage priority claim. To the extent that funds are left over, I would have the court redistribute them to the remaining creditors in accordance with the Code's priority scheme.

Jevic, 787 F.3d at 190.

C. <u>Petition for Writ of Certiorari; Support and Opposition to Granting Certiorari</u>.

On November 16, 2015, the Drivers filed a petition for writ of certiorari. The petition highlights the apparent conflict in the law amongst the Circuits regarding the distribution of estate proceeds outside of a chapter 11 plan or chapter 7 liquidation. The Drivers assert that the issue is of paramount significance to bankruptcy practice. The Drivers point out that the law in the Second and Third Circuit is now in direct conflict with the Fifth Circuit "on an important and recurring question of bankruptcy law that implicates one of the fundamental features of the Code – the priority scheme." *Casimir Czyzewski v. Jevic Holding Corp*., Case No. 15-649, Petition for Writ of Certiorari, p. 18 (Nov. 16, 2015). Granting certiorari in this case, the Drivers assert, is significant given the prominence of Third Circuit case law to bankruptcy practice. "Almost half of bankruptcy cases involving at least $50 million in assets and liabilities commenced nationwide between November 2013 and March 2015 were filed in Delaware." *Id*. at 29 (citing GAO, *Corporate Bankruptcy: Report to the Senate Judiciary Committee Chairman*, app'x III, at 41-44 (Sept. 2015)).

Several amicus curiae were submitted in support of the Drivers' request for certiorari.[7] The amici assert that the *Jevic* decision may only be the tip of the iceberg with more and more problematic structured dismissals to follow under the guise of "extraordinary relief." In addition, the amici raise concerns that the uncertainty about the Bankruptcy Code's priority scheme under dismissal orders will "increase the costs, and undermine the integrity, of the Chapter 11 system by promoting gamesmanship and collusion among stakeholders powerful enough to obtain agreement to a structured dismissal."[8]

The respondents oppose the petition, asserting that there is no legitimate circuit split. The opposition acknowledges that the *Jevic* decision is in harmony with the Second Circuit's decision in *Iridium*, but that the suggestion of a conflict with the Fifth Circuit's *AWECO* decision is illusory.[9] The respondents point out that the *AWECO* decision is over 30 years old and the purported Circuit conflict is reduced to one sentence dicta where the *AWECO* court stated "a bankruptcy court abuses its discretion in approving a settlement with a junior creditor unless the court concludes that priority of payment will be respected as to objecting senior creditors." *See AWECO*, 725 F.3d at 298. The respondents note that the settlement under *AWECO* was rejected as an abuse of the bankruptcy court's discretion based on the court's insufficient factual

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[7] *See Casimir Czyzewski v. Jevic Holding Corp*., Case No. 15-649, Brief of Amici Curiae Law Professors in Support of Petitioners, dated December 16, 2015 (the "Law Professors Brief"); *Casimir Czyzewski v. Jevic Holding Corp*., Case No. 15-649, Brief of Amici Curiae National Employment Law Project and National Consumers League in Support of Petitioners, dated December 17, 2015; and *Casimir Czyzewski v. Jevic Holding Corp*., Case No. 15-649, Brief of Amici Curiae States of Illinois, Alaska, Arizona, Georgia, Hawaii, Louisiana, Main, Montana, New Hampshire, New York, Ohio, Oregon, Pennsylvania, Rhode Island, Tennessee, Texas, Utah, Washington, and West Virginia, in Support of Petition for Certiorari, dated December 17, 2015.

[8] See Law Professors Brief, p. 2.

[9] *See Casimir Czyzewski v. Jevic Holding Corp*., Case No. 15-649, Brief in Opposition, dated January 19, 2016.

foundation. In addition, the respondents assert “there is not a single reported decision from any circuit holding that any provision of the Bankruptcy Code extends the absolute priority rule to settlements” and therefore any suggestion of a Circuit split is illusory.

V. Conclusion

The changing landscape of bankruptcy law is likely to increase the use of structured dismissals as an efficient exit strategy where it is the “least bad alternative.” The arguments for and against structured dismissals remain relevant today, especially as this exit strategy may seek to distribute estate property in direct conflict with the Bankruptcy Codes’ priority scheme. This is a particularly important debate where the foundational law authorizing dismissal orders that include “bells and whistles” is unclear. It is also unclear, however, whether the issue is ripe for the Supreme Court to grant certiorari. Given the relatively week split of authority based on the Fifth Circuit decision in *AWECO*, the Supreme Court may decline the *Jevic* petition in favor of allowing the issues to continue to play itself out longer in the Circuits. However, given the influence of the Third Circuit in modern bankruptcy jurisprudence, clarity on these issues by the Supreme Court would provide the bankruptcy courts and practitioners greater certainty in crafting appropriate chapter 11 exit strategies.