

GOODSILL ALERT

Creditors' Rights and Bankruptcy Practice Group

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Supreme Court Rules That Structured Dismissals Must Follow Ordinary Priority Rules

Today, in the case of *Czyzewski v. Jevic Holding Corp.*, 15-649 (March 22, 2017), the U.S. Supreme Court ruled that a bankruptcy court cannot approve a structured dismissal that provides for distributions that do not follow ordinary priority rules without the affected creditors' consent.

BACKGROUND FACTS

In *Jevic*, a Bankruptcy Court dismissed a Chapter 11 bankruptcy case and, in doing so, ordered a distribution of estate assets that gave money to high-priority secured creditors and to low-priority general unsecured creditors but which skipped certain dissenting mid-priority creditors. *Id.* at 1. The skipped creditors opposed the structured dismissal claiming it was impermissible on the grounds that, among other things, they would have been entitled to payment ahead of the general unsecured creditors in a Chapter 11 plan (or in a Chapter 7 liquidation). *Id.* (citing 11 U.S.C. §§507, 725, 726, 1129).

The Bankruptcy Court recognized that the settlement's distribution scheme failed to follow ordinary priority rules, but held that this alone did not bar approval. *Id.* at 8. The Bankruptcy Court reasoned that, because the proposed payouts would occur pursuant to a structured dismissal rather than in an approval of a Chapter 11 plan, the proposed distribution scheme was permissible, particularly in light of the "dire circumstances" facing the estate and its creditors. *Id.* The Bankruptcy Court predicted that without the settlement and 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 operate, investigate, or litigate were the case converted to a proceeding in Chapter 7. *Id.*

The District Court affirmed the decision of the Bankruptcy Court. *Id.*

The Third Circuit affirmed the District Court by a vote of 2 to 1. *Id.* at 9. The majority held that structured dismissals need not always respect priority, finding that Congress had only "codified the absolute priority rule . . . in the specific context of plan confirmation." *Id.* As a result, the Third Circuit determined that bankruptcy courts could, "in rare instances like this one, approve structured dismissals that do not strictly adhere to the Bankruptcy Code's priority scheme." *Id.*

The affected creditors appealed to the U.S. Supreme Court.

THE DECISION

The Supreme Court explained that the Bankruptcy Code's priority system constitutes a basic underpinning of business bankruptcy law. *Id.* at 11. It recognized that the distributions of estate assets at the termination of a business bankruptcy normally take place through a Chapter 7 liquidation or a Chapter 11 plan, and both are governed by priority. *Id.*¹

The Court explained that the priority system applicable to bankruptcy distributions has long been considered fundamental to the Bankruptcy Code's operation. *Id.* at 12 (citing H. R. Rep. No. 103-835, p. 33 (1994) (explaining that the Code is "designed to enforce a distribution of the debtor's assets in an orderly manner . . . in accordance with established principles rather than on the basis of the inside influence or economic leverage of a particular creditor")). The Court explained that, "[t]he importance of the priority system leads us to expect more than simple statutory silence if, and when, Congress were to intend a major departure." *Id.*

The Court also explained that dismissal of a case typically "revests the property of the estate in the entity in which such property was vested immediately before the commencement of the case"—i.e., a return to the prepetition financial status quo. *Id.* at 16. However, the Court recognized that Bankruptcy Code *does* permit the bankruptcy court, "for cause," to alter a Chapter 11 dismissal's ordinary restorative consequences. *Id.* at 3. (citing 11 U.S.C. § 349 (b)).² However, the Court found that such permission does not include a full-scale alteration of the priority scheme in the context of a dismissal as was done in this case. The Court explained:

The Code gives a bankruptcy court the power to "dismiss" a Chapter 11 case. §1112(b). But the word "dismiss" itself says nothing about the power to make nonconsensual priority-violating distributions of estate value. 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.

¹ The Court explained that, in Chapter 7 liquidations, priority is an absolute command— lower priority creditors cannot receive anything until higher priority creditors have been paid in full. *Id.* at 12 (citing 11 U. S. C. §§725, 726). The Court recognized that Chapter 11 plans provide somewhat more flexibility, but a priority-violating plan still cannot be confirmed over the objection of an impaired class of creditors. *Id.* (citing §1129(b)).

² The Court recognized that Section 349(b) allows the bankruptcy courts some flexibility in structuring dismissals, however, the Court determined that the cases in which a court has approved interim distributions that violate ordinary priority rules are usually in "such instances one can generally find significant Code-related objectives that the priority-violating distributions serve." *Id.* at 15. The Court found that, in doing so, these courts have usually found that the distributions at issue would "enable a successful reorganization and make even the disfavored creditors better off." *Id.*

Id. at 13. In finding that the structured dismissal at issue in *Jevic* differed from the relief ordered in similar cases, the Court explained:

[B]y 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. In short, we cannot find in the violation of ordinary priority rules that occurred here any significant offsetting bankruptcy-related justification.

Id. at 16.

CONCLUSION

The Supreme Court's decision today in *Jevic* clarifies that the priority rules of the Bankruptcy Code cannot be altered in the context of a dismissal. Although this is good news for mezzanine debt holders and trade creditors, who normally do not benefit from these types of structured dismissals, it deals a blow to debtors and creditors who use structured dismissals as an option for debt restructuring.

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