Up the Chute, Down the Ladder: Shifting Priorities Through Structured Dismissals in Bankruptcy

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UP THE CHUTE, DOWN THE LADDER: SHIFTING PRIORITIES THROUGH STRUCTURED DISMISSALS IN BANKRUPTCY

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In a structured dismissal of a Chapter 11 bankruptcy case, a bankruptcy court approves case dismissal alongside a stakeholder agreement as to the manner in which the estate is to be dealt with once the case has been dismissed. Such orders are controversial in that they are not explicitly authorized through the U.S. Bankruptcy Code ("the Code") and are especially controversial where the accompanying agreement seeks to distribute estate property in contravention of the priority scheme laid out in § 507 of the Code. Where the agreement violates this so-called waterfall payment method, bankruptcy courts are faced with difficult questions: Should structured dismissals be strictly governed by the Code's priority regime? Should they ever be approved where they deviate from priorities? If so, what standard should a bankruptcy court apply in deciding whether deviation is proper?

This Note explores a recent decision by the Third Circuit, In re Jevic Holding Corp.*, where the court affirmed a bankruptcy court's approval of a structured dismissal that cut against priorities, relying heavily on principles of economic efficiency and stakeholder compromise in reaching its holding. This Note argues that, while priority deviation is sometimes proper, the standard applied by the Third Circuit for approval of priority-noncompliant structured dismissals does not go far enough to ensure that the procedural safeguards of Chapter 11 are upheld. This Note therefore proposes a multifactor analysis that would provide a more transparent system for approval of structured dismissals that do not comply with priorities.*

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INTRODUCTION

A structured dismissal is likely the most controversial Chapter 11 bankruptcy exit strategy.[1] A recent Third Circuit decision, *In re Jevic Holding Corp.*[2] (*Jevic*), appears to have propelled that controversy further still. Last year, the Third Circuit held that a settlement and structured dismissal of a Chapter 11 case might, in rare circumstances, deviate from the priority regime laid out in the U.S. Bankruptcy Code ("the Code"), meaning assets may be distributed to creditors of lower priority before more senior creditors are paid in full.[3] In coming to this conclusion, the court extended a ruling on preplan settlements by the Second Circuit and rejected a contrary Fifth Circuit ruling.[4]

The result has been a medley of both praise and criticism: praise for the development of a more flexible mechanism by which debtors and creditors can work together to restructure or at least minimize economic harm,[5] and criticism for the court's failure to observe the important procedural

1. *See infra* Parts I.C., III.B.
2. 787 F.3d 173 (3d Cir. 2015).
3. *Id.* at 182–84.
4. *See infra* Part II.B–D.
5. *See infra* Part III.A.

safeguards of Chapter 11 reorganization.[6] This Note suggests that, while priority deviation should be permitted under certain circumstances, the standard laid out by the Third Circuit for approval of priority-noncompliant structured dismissals is a far cry from what is required to ensure evenhanded treatment of stakeholders.[7]

Part I of this Note gives an overview of Chapter 11 bankruptcy, along with its procedural steppingstones and its payment priority regime.[8] It then describes the growing use of structured dismissals in Chapter 11 bankruptcy and explicates the approval process for bankruptcy settlements.[9] Part II discusses the recent Third Circuit decision in which priority deviation was allowed in a structured dismissal context, explaining briefly the Second and Fifth Circuit decisions referenced in the Third Circuit's ruling.[10] Part III then discusses whether the Third Circuit's application of the Second Circuit's standard to structured dismissals was proper, noting first the potential for economic benefit and the importance of stakeholder compromise, but then pointing out the need for creditor protection through Chapter 11 safeguards.[11] Finally, Part IV proposes a multifactor analysis that would allow bankruptcy courts to assess, on a case-by-case basis, whether approval of a priority-noncompliant structured dismissal would be appropriate in a given situation.[12]

I. THE CHAPTER 11 PROCESS: PLAN CONFIRMATION, SETTLEMENT APPROVAL, AND OTHER REORGANIZATION MECHANISMS

This part first provides a brief overview of Chapter 11 bankruptcy, initially explaining the basic steps that a Chapter 11 debtor is expected to take throughout the course of his or her bankruptcy case[13] and then addressing the importance of the Code's priority regime for payment of unsecured creditors.[14] It next addresses the use of structured dismissals in Chapter 11 bankruptcy, including the typical circumstances in which they arise, the reasons they may be favored, and why they are often criticized.[15] Finally, since structured dismissals are deemed to be bankruptcy settlements,[16] this part of the Note also discusses the procedures bankruptcy courts must follow before approving such compromises among parties.[17] Part I.A first lays out the Chapter 11 process, explaining in particular the

6. *See infra* Part III.B.
7. *See infra* Part IV.
8. *See infra* Part I.A–B.
9. *See infra* Part I.C–D.
10. *See infra* Part II.
11. *See infra* Part III.
12. *See infra* Part IV.
13. *See infra* Part I.A.
14. *See infra* Part I.B.
15. *See infra* Part I.C.
16. The question of whether a structured dismissal agreement in fact amounts to a settlement is not disputed in this Note, but one could argue that the settlement approval process should not govern them at all.
17. *See infra* Part I.D.

stringent requirements that Chapter 11 debtors must fulfill to rehabilitate their businesses successfully.[18]

A. A Brief Overview of Chapter 11 Bankruptcy

Although individuals can file for Chapter 11 bankruptcy protection,[19] Chapter 11 of the Code is most commonly used for the reorganization of businesses, allowing business debtors to continue to operate as going concerns and thus emerge from bankruptcy viable entities.[20] Once a debtor files a Chapter 11 petition, an automatic stay prohibits debt collection efforts by the debtor's various creditors.[21] With this added layer of protection, debtors have an opportunity to construct a proposed plan of reorganization, which, if successful, will be confirmed by the bankruptcy court and then implemented according to its terms.[22] Section 1129 of the Code lays out a number of requirements that must be met before a bankruptcy court can confirm a Chapter 11 plan of reorganization.[23] Specifically, § 1129(a) governs confirmation requirements for consensual plans,[24] and § 1129(b) governs confirmation requirements for nonconsensual plans.[25]

In the context of consensual plan confirmation, § 1129(a)(9) dictates the terms on which stakeholder claims are to be paid, referring to the various kinds of claims specified in § 507 of the Code, which lays out the priority scheme for payment of unsecured creditors.[26] In the context of nonconsensual plan confirmation, § 1129(b)(2), which unpacks the "fair and equitable" standard that must be satisfied before a bankruptcy court can confirm a plan over and above the objections of an impaired class of

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18. *See infra* Part I.A.

19. JOAN N. FEENEY ET AL., BANKRUPTCY LAW MANUAL § 11:41, Westlaw (database updated Dec. 2015) ("Chapter 11 is available to individuals, as they are included in the definition of persons eligible for such relief.").

20. CHRISTOPHER S. STRICKLAND & W. HOMER DRAKE JR., CHAPTER 11 REORGANIZATIONS § 12:1 (2d ed.), Westlaw (database updated Oct. 2015).

21. *See* 11 U.S.C. § 362 (2012).

22. *See id.* § 1129.

23. *See id.*

24. A consensual plan requires every class to agree by a supermajority, meaning more than one-half of the number of claims and two-thirds in value. *See id.* § 1126(c)–(d). Among other factors, the court may only confirm a consensual plan if it complies with all other applicable provisions of Title 11; the plan proponent complies with such provisions; the plan was proposed in good faith; payments made in connection with the plan have been approved or are subject to the approval of the court as reasonable; each holder of an impaired claim or interest has accepted the plan or will receive no less than they would otherwise receive through Chapter 7 liquidation; and each class of claims or interests has either accepted the plan or is not impaired under the plan. *See id.* § 1129(a)(1)–(4), (7)–(8).

25. Where the requirements of § 1129(a)(8) are not satisfied, meaning a class of impaired claims or interests has not accepted the plan, but all other provisions of § 1129(a) are satisfied, the court can confirm the plan only under the rubric of an additional requirement: that "the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan." *Id.* § 1129(b)(1). Section 1129(b) then goes on to unpack the requirements of the "fair and equitable" standard for both secured and unsecured creditors. *See id.* § 1129(b)(2).

26. *See infra* Part I.B.

creditors,[27] lays out payment distribution terms for both secured and unsecured creditors.[28]

Ultimately though, whether a plan is consensual or nonconsensual, the Code's payment priority scheme must be respected if a debtor is to achieve plan confirmation.[29] Thus, Part I.B discusses the "waterfall" payment method laid out in § 507 of the Code and discusses the "absolute priority rule," which applies only in the context of nonconsensual plan confirmation, but operates to ensure that an objecting class of unsecured creditors is not compelled to accept a plan that would subvert the priorities set out in § 507.[30]

B. Me First: The Bankruptcy Code's Payment Priority Regime

Although the Code does not impose upon Chapter 11 debtors an insolvency eligibility requirement,[31] as a practical matter most debtors cannot pay their creditors in full. As a result, § 507 of the Code sets forth a "waterfall" payment method, which "controls the allocation of the debtor's scarce resources by establishing a hierarchy of payments to creditors. Creditors with a higher priority must be paid in full before creditors having a lower priority are paid anything."[32] For the most part, § 507 governs payment to unsecured—as opposed to secured creditors—because "[s]ecured creditors are entitled to the benefit of their security."[33]

For nonconsensual plans, an additional layer of creditor protection exists in § 1129(b)(2)(B)(ii) of the Code, which sets out the "absolute priority rule."[34] The rule essentially provides:

> To be fair and equitable with respect to a class of unsecured claims, a Chapter 11 plan may provide, as an alternative to meeting the requirement that each unsecured creditor receive or retain equivalent property, that the holder of any junior claim or interest will not receive or retain any property under the plan on account of the junior claim or interest.[35]

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27. *See supra* note 25.

28. *See* 11 U.S.C. § 1129(b)(2)(A)–(B). With respect to a class of unsecured claims, § 1129(b)(2)(B)(ii) importantly provides that "the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property." *Id.* § 1129(b)(2)(B)(ii); *see also infra* Part I.B. (discussing this "absolute priority rule").

29. *See* 11 U.S.C. § 507.

30. *See infra* Part I.B.

31. *See, e.g.*, Howard Seife, *Solvent Debtors May Be Unable to Enter Bankruptcy in Absence of "Financial Distress"*, 122 BANKING L.J. 52, 52 (2005) ("Under federal bankruptcy law, a debtor need not be insolvent before filing for bankruptcy protection.").

32. James H. Barnhill, *The Conundrum of an Inadequately Protected Secured Creditor*, 97 COM. L.J. 367, 369 (1992).

33. *Id.* at 369–70 (noting that, subject to the possibility of a secured creditor obtaining a superpriority under § 507(b) as a result of inadequate protection, administrative claims are to be paid first).

34. *See* 9 AM. JUR. 2D *Bankruptcy* § 2978, Westlaw (database updated Feb. 2016) ("A plan that fails to comply with the absolute priority rule may not be confirmed without the approval of creditors."); *supra* note 28.

35. 9 AM. JUR. 2D *Bankruptcy* § 2978, Westlaw.

A plan cannot be confirmed without compliance with the absolute priority rule unless all classes of creditors approve it.[36] This requirement enforces § 507 by ensuring that a nonconsenting class of creditors is not forced, through a plan, to accept less than full compensation while junior creditors receive a payout or retain some interest in the debtor's property.[37]

Inevitably, however, not all Chapter 11 cases result in a successful reorganization; a number of them, in fact, end with case dismissal.[38] Part I.C lays out the Code's process for dismissal of a debtor's Chapter 11 case and discusses the growing tendency among bankruptcy courts to dismiss a case while also approving an accompanying agreement among stakeholders as to the administration of the debtor's estate, an order referred to as a "structured dismissal."[39]

C. Chapter 11 Case Dismissal and Its "Structured" Counterpart

Where, for instance, the particular circumstances of the debtor's case demonstrate an absence of reasonable likelihood of rehabilitation,[40] the bankruptcy court must either dismiss the Chapter 11 case or convert the case to Chapter 7 of the Code, which provides for liquidation of the bankruptcy estate.[41] Chapter 11 dismissal ordinarily returns stakeholders to their prepetition state law rights and remedies.[42] Dismissal can occur not only where plan confirmation has failed, but also in the context of § 363 of the Code. In recent years, Chapter 11 debtors increasingly have used § 363 to effectuate a sale of all or substantially all of their assets (a "363 sale"),[43] and in fact, debtors are more frequently opting out of traditional Chapter 11 reorganizations in favor of 363 sales.[44] After a 363 sale, Chapter 11 debtors usually would follow one of three routes: confirmation of a liquidating

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36. *See supra* notes 25, 28.

37. Gary L. Kaplan, *Understanding the Rules of Bankruptcy Cramdown*, LAW360 (Sept. 4, 2013, 3:31 PM), http://www.law360.com/articles/468678/understanding-the-rules-of-bankruptcy-cramdown [https://perma.cc/5HMY-2PTD].

38. The Code does not guarantee a successful reorganization, but rather provides the Chapter 11 debtor with a "breathing spell" to facilitate the desired end. *See* STRICKLAND & DRAKE, *supra* note 20.

39. *See infra* Part I.C.

40. *See* 11 U.S.C. § 1112(b)(4)(A) (2012).

41. Under § 1112(a) of the Code, a debtor has an absolute right to convert a Chapter 11 case to a Chapter 7 case. *See id.* § 1112(a).

42. *See* Nan Roberts Eitel et al., *Structured Dismissals, or Cases Dismissed Outside the Code's Structure?*, AM. BANKR. INST. J., Mar. 2011, at 20 (noting that structured dismissals, unlike traditional dismissals, do not reinstate state law creditor remedies).

43. *See id.* at 21. Section 363 of the Code allows debtors to sell estate assets outside of the ordinary course of business. *See* 11 U.S.C. § 363(f) (allowing a trustee or debtor in possession to sell estate property "free and clear" of third party interests, such as liens, claims, and other encumbrances). Section 363(f) lists conditions for 363 sales, at least one of which must be met for such a sale to be authorized. *See id.*

44. This is because 363 sales "can be accomplished quickly and without complying with Chapter 11's disclosure and voting requirements . . . [they] reduce considerably the costs of administering the debtor's estate . . . [and] will preserve the firm's going concern value." Jacob A. Kling, *Rethinking 363 Sales*, 17 STAN. J. L. BUS. & FIN. 258, 260 (2012).

Chapter 11 plan;[45] a Chapter 7 conversion; or a typical dismissal of the kind discussed above.[46]

In both contexts, but particularly with regard to 363 sales, "structured dismissals" are increasingly being viewed as an acceptable and even a beneficial means by which a debtor can exit Chapter 11.[47] Unlike typical dismissals, structured dismissals do not reinstate the prepetition status quo, but rather are conditioned upon certain elements agreed to ahead of time by stakeholders and approved by the bankruptcy court.[48] Through a structured dismissal, stakeholders may find themselves in a more advantageous position than they would have been in were the bankruptcy court to follow the archetypal case dismissal process,[49] and, because of this potential benefit to stakeholders, a number of bankruptcy courts have authorized structured dismissals upon the request of Chapter 11 debtors.[50]

This Chapter 11 exit strategy is not one that is provided for explicitly in the Code[51] and has therefore become the source of much judicial and academic debate. One of the central concerns is that structured dismissals strongly resemble *sub rosa* plans of reorganization because of the possibility that debtors could use them to circumvent Chapter 11 requirements and protections.[52] A *sub rosa* plan arises where a debtor enters into a transaction outside of a Chapter 11 reorganization plan that

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45. Although Chapter 11 is traditionally used for reorganization purposes, it also can be used to enable liquidation of the debtor's assets. Section 1123(b)(4) of the Code states that a plan may "provide for the sale of all or substantially all of the property of the estate, and the distribution of the proceeds of such sale among the holders of claims or interests." 11 U.S.C. § 1123(b)(4).

46. *See* Eitel et al., *supra* note 42.

47. *See* ERIC E. SAGERMAN, PATRICK A. MURPHY & DAVID NEIER, CREDITORS' RIGHTS IN BANKRUPTCY § 16:11 (2d ed.), Westlaw (database updated Oct. 2015) (A structured dismissal "may be particularly attractive after a debtor sells the majority of its assets under a § 363 sale . . . and the costs of implementing a liquidating plan would be prohibitive").

48. *See id.* ("As an alternative to a simple dismissal order and restoration of the status quo, parties may seek to wind up a [C]hapter 11 case through a 'structured' dismissal in which the bankruptcy court's dismissal order includes additional provisions such as court-approved releases or protocols for the reconciliation and payment of certain claims.").

49. *See, e.g.*, *In re* Jevic Holding Corp., 787 F.3d 173, 178 (3d Cir. 2015) ("[T]here was 'no realistic prospect' of a meaningful distribution to anyone but the secured creditors unless the settlement were approved because the traditional routes out of Chapter 11 bankruptcy were impracticable.").

50. *See, e.g.*, *In re* Naartjie Custom Kids, Inc., 534 B.R. 416, 426 (Bankr. D. Utah 2015) (finding that a dismissal under § 305(a) of the Code was appropriate only if the court dismissed the Chapter 11 case through a structured dismissal); *In re* Buffet Partners, L.P., No. 14-30699-HDH-11, 2014 WL 3735804, at *3 (Bankr. N.D. Tex. July 28, 2014) ("[T]his sort of structured dismissal is well within the parameters established by the Fifth Circuit and the Bankruptcy Code.").

51. *See* SAGERMAN, MURPHY & NEIER, *supra* note 47 (noting that structured dismissals are not expressly provided for in either § 1112 of the Code, the provision dictating the requirements for conversion and dismissal of Chapter 11 cases, or § 305 of the Code, which also provides for case dismissal, although less explicitly and with no right to appeal).

52. *See generally* Christopher W. Frost, *Structured Dismissals: Smooth Off-Ramp or Artful Dodge?*, 35 BANKR. L. LETTER 1 (2015) (citing *In re* Biolitec, Inc., 528 B.R. 261 (Bankr. D. N.J. 2014), in which the court directly invoked the *sub rosa* plan doctrine in rejecting a structured dismissal that subordinated claims of an objecting creditor).

significantly affects the bankruptcy estate.[53] This often, although not always, involves a situation in which a buyer and debtor are seeking bankruptcy court approval of a sale order that not only dictates the terms of the sale but also sets out the terms on which proceeds will be distributed.[54] Agreements such as this may exist where the buyer is also a creditor of the debtor and is unlikely to go through with the purchase unless his or her claim is dealt with in a particular way. Further, a bankruptcy court may determine that a sale order amounts to a *sub rosa* plan where the transaction lays out the terms of the ensuing reorganization plan, or impedes the rights afforded to parties through the plan confirmation process, such as creditors' voting rights.[55] Although no Code provision outwardly prohibits or even mentions *sub rosa* plans, courts have long viewed them as improper.[56] The policy reason underlying this view rests on the notion that "the debtor and the Bankruptcy Court should not be able to short circuit the requirements of Chapter 11 for confirmation of a reorganization plan by establishing the terms of the plan *sub rosa* in connection with a sale of assets."[57]

Setting aside whether structured dismissals should be characterized in the same manner as *sub rosa* plans,[58] the dismissals nonetheless contain an agreement among stakeholders requiring bankruptcy court approval, and thus courts tend to afford them the same treatment as settlements arising in the course of a Chapter 11 case.[59] Part I.D provides an overview of settlement approval in bankruptcy, with particular reference to the requirements of Rule 9019 of the Federal Rules of Bankruptcy Procedure ("the Rules").

D. Rule 9019 and Settlement Approval in Bankruptcy

There are a number of different types of settlements that can arise throughout the course of a Chapter 11 case, such as a standalone settlement of a prepetition cause of action[60] or an agreement in the form of a

53. *See* Craig A. Sloane, *The Sub Rosa Plan of Reorganization: Side-Stepping Creditor Protections in Chapter 11*, 16 BANKR. DEV. J. 37, 37 (1999).

54. The parties usually seek approval for such orders before a plan of reorganization has been confirmed.

55. *See* 3 BAXTER DUNAWAY, LAW OF DISTRESSED REAL ESTATE § 28B:7, Westlaw (database updated Nov. 2015).

56. *See id.*

57. *Id.* (quoting Pension Benefit Guar. Corp. v. Braniff Airways, Inc. (*In re* Braniff Airways, Inc.), 700 F.2d 935, 940 (5th Cir. 1983)); *see also* Sloane, *supra* note 53.

58. This Note will discuss this issue later. *See infra* Part III.B.

59. *See, e.g.*, *In re* Jevic Holding Corp., 787 F.3d 173, 180 (3d Cir. 2015) (discussing the settlement approval requirements of Rule 9019).

60. A Chapter 11 debtor may have prepetition causes of action that, post-filing, belong to the bankruptcy estate. This gives either the trustee or the debtor in possession the authority to pursue such prepetition actions on the estate's behalf, many of which result in settlement. Alternatively, there may be outstanding claims existing against the debtor, which can be brought, post-filing, against the Chapter 11 estate. Again, a vast majority of these cases result in settlement. *See* 3A BANKRUPTCY SERVICE, LAWYERS EDITION § 29:695, Westlaw (database updated Apr. 2016).

disclosure statement.[61] Rule 9019 governs the procedural requirements for approval of these various kinds of settlements and compromises where the debtor's bankruptcy estate is implicated.[62] Rule 9019(a) provides that "[o]n motion by the trustee and after notice and hearing, the court may approve a compromise or settlement."[63] The purpose behind this provision is "to prevent the making of concealed agreements which are unknown to the creditors and unevaluated by the court."[64] Given this broad purpose, the provision applies not only to settlements reached in the context of contested matters but also to settlements reached in the context of adversary proceedings.[65]

Rule 9019, however, is silent on the precise standard bankruptcy courts should apply when deciding whether to approve a given settlement.[66] The leading case on this issue is *Protective Committee for Independent Stockholders of TMT Trailer Ferry, Inc. v. Anderson*[67] (*TMT Trailer Ferry*), a landmark Supreme Court ruling in which the Court laid out a multifactor test for settlement approval.[68] The factors are intended to ensure that all settlements are "fair and equitable" and are in the best interests of the Chapter 11 debtor's estate.[69] This "fair and equitable" standard for settlements generally is deemed to mean something different than the "fair and equitable" standard contained in the Code for nonconsensual plan confirmation.[70] Courts have therefore debated whether the absolute priority

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61. Unlike a settlement of a prepetition cause of action, this type of agreement takes place in the context of a plan of reorganization. *See* BANKRUPTCY LAW MANUAL § 11:59 (5th ed.), Westlaw (database updated Dec. 2015). Creditors vote on the disclosure statement, and a confirmation hearing takes place in which the substantive requirements of § 1129 are assessed by the bankruptcy court. *See id.*

62. *See* 8 NORTON BANKRUPTCY LAW & PRACTICE 3D § 167:1, Westlaw (database updated Jan. 2016) [hereinafter NORTON].

63. FED. R. BANKR. P. 9019. Because Rule 9019's language does not explicitly *require* bankruptcy court approval of settlements, courts are split as to whether the approval process is mandatory or discretionary. *See, e.g.*, Northview Motors, Inc. v. Chrysler Motors Corp., 186 F.3d 346, 351 n.4 (3d Cir. 1999) (finding that Rule 9019 does not, by itself, create a substantive requirement of bankruptcy court settlement approval). *Contra In re* Signet Indus., Inc., No. 96-2534, 1998 WL 639168, at *3 (6th Cir. Sept. 10, 1998) ("[A] trustee (or debtor-in-possession) may not enter into a compromise agreement . . . without the approval of the bankruptcy court."). It is worth noting that the weight of authority leans in favor of a mandatory standard. *See* Reynaldo Anaya Valencia, *The Sanctity of Settlements and the Significance of Court Approval: Discerning Clarity from Bankruptcy Rule 9019*, 78 OR. L. REV. 425, 437 (1999). A more detailed analysis of the arguments on either side is beyond the scope of this Note.

64. *In re* Masters, Inc., 141 B.R. 13, 16 (Bankr. E.D.N.Y. 1992), *aff'd*, 149 B.R. 289 (E.D.N.Y. 1992).

65. 8 NORTON, *supra* note 62, § 167:1.

66. *See* Mark G. Douglas, *Application of the Absolute Priority Rule to Pre-Chapter 11 Plan Settlements: In Search of the Meaning of "Fair and Equitable"*, 3 PRATT'S J. BANKR. L. 17, 25–26 (2007).

67. 390 U.S. 414 (1968).

68. *Id.* at 424 ("[T]he judge should form an educated estimate of the complexity, expense, and likely duration of . . . litigation, the possible difficulties of collecting on any judgment which might be obtained, and all other factors relevant to a full and fair assessment of the wisdom of the proposed compromise.").

69. *See* Douglas, *supra* note 66, at 26.

70. *See id.* at 27.

rule must be upheld in the preplan settlement context, with the Second and Fifth Circuits taking vastly different approaches.[71]

II. A "RARE INSTANCE": THE THIRD CIRCUIT ALLOWS PRIORITY DEVIATION IN A STRUCTURED DISMISSAL CONTEXT

This part of the Note describes the Third Circuit's decision in *Jevic* to allow priority deviation in a structured dismissal context and explores two cases the *Jevic* Court referenced to justify its decision. Part II.A first lays out the facts of *Jevic* and briefly runs through the Third Circuit's reasons for approving the structured dismissal in question.[72] Part II.B then discusses the Second Circuit's ruling in *In re Iridium Operating LLC*[73] (*Iridium*), upon which the Third Circuit relied, which allowed deviation from priorities in a preplan settlement. Part II.C lays out the Fifth Circuit's decision in *United States v. AWECO, Inc. (In re AWECO, Inc.)*[74] (*Matter of AWECO*), which was rejected by the Third Circuit; in that case, the court ruled against priority deviation, requiring strict application of § 507 in the preplan settlement at issue. Finally, Part II.D describes the Third Circuit's application of the Second Circuit's flexible *Iridium* standard.[75]

A. The Third Circuit's Jevic *Decision*

Courts and academics have afforded a fair amount of attention to the question of whether bankruptcy courts must respect priorities in the preplan settlement context.[76] Whether structured dismissals must comply with the Code's priority regime, however, has been touched on only lightly, most likely because of structured dismissal's recent recognition and use. This part of the Note addresses a recent ruling by the Third Circuit, *In re Jevic Holding Corp.*, which held that bankruptcy courts, in certain situations, may approve structured dismissals that deviate from the Code's priorities.[77] After first laying out the facts of *Jevic*, this section then discusses two conflicting courts of appeals' decisions referenced by the *Jevic* Court,[78] one of which was ultimately relied upon in reaching the *Jevic* holding.[79]

Recently, the Third Circuit confronted the question of whether a bankruptcy court can approve a structured dismissal that undercuts the Code's priority scheme. In *Jevic*, a struggling trucking company, Jevic Transportation, Inc. ("Jevic"), was purchased by Sun Capital Partners ("Sun") through a leveraged buyout financed by CIT Group/Business Credit

71. *See infra* Part II.B–C.
72. *See infra* Part II.A.
73. 478 F.3d 452 (2d Cir. 2007).
74. 725 F.2d 293 (5th Cir. 1984).
75. *See infra* Part II.D.
76. *See, e.g.*, *Iridium*, 478 F.3d at 455; *AWECO*, 725 F.2d at 298; Douglas, *supra* note 66, at 17.
77. *In re* Jevic Holding Corp., 787 F.3d 173, 184 (3d Cir. 2015).
78. *See infra* Part II.B–C.
79. *See infra* Part II.D.

Inc. ("CIT").[80] Despite the infusion of cash from the leveraged buyout, Jevic continued to struggle and eventually ceased operations. In 2008, Jevic filed a voluntary Chapter 11 petition in the U.S. Bankruptcy Court for the District of Delaware.[81] It owed around $53 million to its first priority senior secured creditors (Sun and CIT) and around $20 million to tax and general unsecured creditors.[82] Two groups filed suit during the bankruptcy case: a group of recently terminated truck drivers ("the Drivers"), alleging violations of state and federal labor laws mandating sixty days written notice before layoffs,[83] and the official committee of unsecured creditors ("the Committee"), alleging fraudulent conveyance and preferential transfer claims against Sun and CIT.[84]

In 2012, the key players—the Committee, Jevic, CIT, Sun, and the Drivers—began negotiating a settlement to resolve the Committee's fraudulent conveyance suit.[85] At that point, the Jevic estate had only $1.7 million in cash (which was subject to a lien belonging to Sun) and the claim against Sun and CIT; its remaining assets had been liquidated to repay the CIT lender group.[86] Ultimately, the Committee, Jevic, CIT, and Sun reached an agreement setting out four conditions[87]: first, they agreed to release their claims against one another and agreed that the fraudulent conveyance action would be dismissed with prejudice; second, CIT agreed to pay $2 million to cover Jevic and the Committee's legal fees and administrative expenses; third, Sun agreed to assign its lien on the $1.7 million to a trust to pay tax and administrative creditors and then general unsecured creditors on a pro rata basis; and finally, the parties agreed that Jevic's Chapter 11 case would be dismissed.[88]

With these various agreements in play, the parties contemplated a structured dismissal. There was one major problem, though—the Drivers were left uncompensated, despite having an uncontested federal law claim against Jevic on account of the insufficient notice Jevic gave before their termination (a WARN Act claim).[89] Thus, the Drivers and the U.S. Trustee filed objections to the proposed agreement, in part on the ground that it violated the Code's priority regime by distributing estate property to creditors of lower priority than the Drivers, leaving the Drivers with no

80. *Jevic*, 787 F.3d at 175.

81. *Id.* at 176.

82. *Id.*

83. *See* 29 U.S.C. § 2102(a) (2012); N.J. STAT. ANN. § 34:21-2 (West 2011).

84. *Jevic*, 787 F.3d at 176.

85. *Id.*

86. *Id.*

87. A settlement ensuring some minor distribution to unsecured creditors was seen as the best possible outcome given "'the risk . . . of litigation, including the prospect of waiting for perhaps many years before a litigation against Sun and CIT could be resolved' and the lack of estate funds sufficient to finance that litigation." *Id.*

88. *Id.* at 177.

89. *Id.* It is not clear from the record why the agreement left out the Drivers, but "[i]t seems that the Drivers and the other parties were unable to agree on a settlement . . . and Sun was unwilling to pay the Drivers as long as the WARN Act lawsuit continued because Sun was a defendant in those proceedings." *Id.*

payment at all.[90] The bankruptcy court rejected the priorities argument (and others relating to the structured dismissal),[91] approving the dismissal of the Chapter 11 case along with the accompanying agreement.[92] The district court affirmed the bankruptcy court's ruling.[93] The Drivers appealed, with the U.S. Trustee participating as amicus curiae.[94] On appeal, the Third Circuit addressed whether structured dismissals are at all permissible under the Code and then whether settlements in the context of structured dismissals may skip over objecting creditors in favor of a class of creditors junior to those objecting.[95]

In answering the first question, the court noted that although the Code does not expressly authorize structured dismissals, it does explicitly authorize bankruptcy courts to change the effect of dismissal for cause—essentially, "the Code does not strictly require dismissal of a Chapter 11 case to be a hard reset."[96] The Drivers raised concerns that bankruptcy courts' broadening settlement-approval power paves the way for illegitimate *sub rosa* plans to take hold,[97] arguing that, had Congress intended to leave open a means by which debtors could sidestep Chapter 11 plan confirmation and Chapter 7 conversion procedures, it would have explicitly included such a provision in the Code.[98] In response to this, the Third Circuit noted the possibility that the Code may forbid structured dismissals where they are intended to circumvent the plan confirmation or Chapter 7 conversion processes.[99] However, it found that in this case the Drivers had mounted no real challenge to the bankruptcy court's finding that there was no prospect of achieving a confirmable plan and that Chapter 7 conversion was futile.[100] Thus, the court deemed the Drivers' concern

90. *Id.* at 178. WARN Act claims consistently have been held to be within "the nature of wages" under § 507(a)(4). *Id.* at 177 (quoting *In re* Powermate Holding Corp., 394 B.R. 765, 773 (Bankr. D. Del. 2008)). Therefore, the Drivers' WARN Act claims were of higher priority than the tax and trade creditors' claims.

91. *See id.* at 178 ("The Trustee also objected on the ground that the Code does not permit structured dismissals, while the Drivers further argued that the Committee breached its fiduciary duty to the estate by 'agreeing to a settlement that, effectively, freezes out the [Drivers].'").

92. *See id.* at 179.

93. *See* Czyzewski v. Jevic Holding Corp. (*In re* Jevic Holding Corp.), Bank. No. 08-11006(BLS), 2014 WL 268613, at *3–4 (D. Del. Jan. 24, 2014) (finding that the bankruptcy court correctly applied the *Martin* factors in determining that the proposed settlement was "fair and equitable"). The *Martin* test derives from the Supreme Court's decision in *TMT Trailer Ferry*, *see* Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 424 (1968), and contains four criteria to be considered in settlement approval: "(1) the probability of success in litigation; (2) the likely difficulties in collection; (3) the complexity of the litigation involved, and the expense, inconvenience and delay necessarily attending it; and (4) the paramount interest of the creditors," *In re* Martin, 91 F.3d 389, 393 (3d Cir. 1996).

94. *See Jevic*, 787 F.3d at 179.

95. *See id.* at 180–86.

96. *Id.* at 181; *see also* 11 U.S.C § 349(b) (2012).

97. *Jevic*, 787 F.3d at 181; *see also infra* Part III.B.

98. *Jevic*, 787 F.3d at 181.

99. *Id.*

100. *Id.*

immaterial "absent a showing that [the] structured dismissal [was] contrived to evade the procedural protections and safeguards of the plan confirmation or conversion processes."[101]

In dealing with the second issue, whether structured dismissals can be approved notwithstanding deviation from the Code's priorities, the court referred to two conflicting rulings by its sister circuits—a Fifth Circuit decision, *Matter of AWECO*,[102] and a Second Circuit decision, *Iridium*.[103] In those rulings, structured dismissals were not contemplated; rather, the Fifth and Second Circuits considered whether bankruptcy courts can approve preplan settlements that undermine the Code's contemplated order of priorities.[104] Ultimately, the *Jevic* Court adopted, in the context of structured dismissals, the standard applied by the Second Circuit to preplan settlements in *Iridium*, namely that priority deviation is acceptable under rare circumstances.[105]

B. *The Second Circuit's Flexible* Iridium *Standard*

In *Iridium*, the debtor's former parent company objected to a preplan settlement that would distribute estate property to lower priority creditors before the parent received any payment.[106] Under the Rule 9019 factors of *TMT Trailer Ferry*,[107] the Second Circuit found that "[t]he 'fair and equitable' analysis . . . does not assess whether a plan conforms to the absolute priority rule."[108] Although compliance with priorities

> must be the most important factor for the bankruptcy court to consider when determining whether a settlement is "fair and equitable" under Rule 9019 . . . where the remaining factors weigh heavily in favor of approving the settlement, the bankruptcy court . . . could endorse a settlement that does not comply in some minor respects with the priority rule.[109]

The court qualified this standard by mandating that a reviewing court adequately explain its reasons for approving a settlement containing deviations from the priority scheme.[110] In adopting the Second Circuit's approach, the Third Circuit in *Jevic* held that bankruptcy courts may, only upon "specific and credible grounds,"[111] approve a structured dismissal that

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101. *Id.* at 182.
102. United States v. AWECO, Inc. (*In re* AWECO, Inc.), 725 F.2d 293 (5th Cir. 1984).
103. *In re* Iridium Operating LLC, 478 F.3d 452 (2d Cir. 2007).
104. *See id.* at 455; *AWECO*, 725 F.2d at 298.
105. *Jevic*, 787 F.3d at 180–84.
106. *Iridium*, 478 F.3d at 456 ("Motorola[,] . . . [a] priority-creditor, objects to the Settlement on the grounds that it takes a portion of estate property and distributes it to lower priority creditors . . . before any payments are made to Motorola.").
107. *See* Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 424 (1968).
108. *Iridium*, 478 F.3d at 463 n.18.
109. *Id.* at 464–65.
110. *See id.* at 465.
111. *In re* Jevic Holding Corp., 787 F.3d 173, 184 (3d Cir. 2015) (quoting *Iridium*, 478 F.3d at 466).

impairs the rule of priorities.[112] In so doing, the court rejected the Fifth Circuit's strict ruling against preplan settlement priority deviation.[113]

C. The Fifth Circuit's Strict Matter of AWECO *Standard*

In *Matter of AWECO*, the Fifth Circuit rejected the contention that the Code's priority scheme is limited to agreements occurring within the confines of reorganization plans.[114] In that case, the Internal Revenue Service (IRS), a priority creditor, objected to the debtor's settlement of an unsecured claim with a more junior creditor, arguing a violation of priorities.[115] On appeal from the bankruptcy court's approval of the settlement, the Fifth Circuit found that the bankruptcy court had abused its discretion because the facts were insufficient to show that the IRS had been treated fairly.[116] In so finding, the court found that the "fair and equitable" standard of Rule 9019 and *TMT Trailer Ferry* means that "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."[117]

D. The Third Circuit Applies the Flexible Iridium *Standard*

As noted, however, the Third Circuit refused to extend the Fifth Circuit's reasoning to the structured dismissal in *Jevic*. Instead, it held that the *Jevic* Court had acted within the realm of its authority in approving the structured dismissal agreement, notwithstanding the Drivers' exclusion from the proposed distribution.[118] The court pointed to the fact that a structured dismissal violating priorities was 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.'"[119] According to the court, a structured dismissal was the only viable means by which creditors other than CIT and Sun could receive any payment in this case.[120] Had the court faced a slightly different

112. The court recognized implicit support for the Drivers' argument that structured dismissals cannot be approved where they distribute estate assets in violation of § 507 priorities. *Id.* at 182; *see, e.g.*, *TMT Trailer Ferry*, 390 U.S. at 424 ("The requirement[] . . . that plans of reorganization be both 'fair and equitable,' appl[ies] to compromises just as to other aspects of reorganizations."). However, the court noted that the cases cited by the Drivers spoke in the context of plans of reorganization and not settlements and are therefore not dispositive. *Jevic*, 787 F.3d at 183.

113. *Jevic*, 787 F.3d at 184.

114. United States v. AWECO, Inc. (*In re* AWECO, Inc.), 725 F.2d 293, 298 (5th Cir. 1984).

115. *Id.* at 295.

116. *Id.* at 299.

117. *Id.* at 298.

118. *See Jevic*, 787 F.3d at 185.

119. *Id.*

120. *See id.* The facts of this case may therefore limit the Third Circuit's holding—the Drivers were unable to agree on a settlement with the other parties, but the court determined that this obstacle alone did not provide an adequate reason to entirely upend the proposed settlement arrangement.

situation, perhaps one in which there existed some viable alternative to a structured dismissal, or one in which the settlement agreement could reasonably have been altered to conform with priorities,[121] it may have decided differently.[122]

As a counter to the flexibility of its ruling, the *Jevic* Court pointed out that "[a]lthough . . . the Code and the Rules do not extend the absolute priority rule to settlements in bankruptcy . . . the policy underlying that rule—ensuring the evenhanded and predictable treatment of creditors—applies in the settlement context."[123] Thus, the court imposed a requirement that bankruptcy courts find "specific and credible" grounds upon which to justify deviation, which arguably gives body to the "fair and equitable" standard of Rule 9019 by warding off approval of structured dismissals devised by certain creditors only to improve their own estate shares at the expense of others.[124]

III. THE *JEVIC* HOLDING: A PROPER OR IMPROPER EXTENSION?

Part III considers whether the Third Circuit's application of the *Iridium* standard to structured dismissals was proper. It refers both to the practical and policy justifications provided by the *Jevic* Court and to the Code's plan confirmation and preplan settlement requirements as important points of comparison. Part III.A first commends the Third Circuit's focus on the importance of compromise and the prevention of economically obscure outcomes.[125] Then, Part III.B criticizes the lack of procedural safeguards present in the Third Circuit's proffered standard, along with its reliance on Second and Fifth Circuit cases that arguably are not analogous with the structured dismissal at issue in *Jevic*.[126]

A. A Proper Extension: Promoting Economic Efficiency and Encouraging Stakeholder Compromise

In adopting the Second Circuit's approach from *Iridium*, the *Jevic* Court touched on Congress's intent when it enacted §§ 507 and 1129(b)(2)(B)(ii) of the Code.[127] It noted the absence of evidence that Congress considered settlements when legislating on this[128] and pointed out that in fact bankruptcy courts' authority to approve settlements between parties stems

121. The dissenting judge, while agreeing with the majority's adoption of the Second Circuit's rule from *Iridium*, did not believe *Jevic* presented the kind of extraordinary circumstance that justifies departure from § 507 priorities. *See id.* at 186 (Scirica, J., concurring in part and dissenting in part) ("An alternative settlement might have been reached in Chapter 11, and might have included the WARN Plaintiffs.").

122. The court pointed out that this case was a "rare instance[]." *Id.* at 180. Further, it pointed out that "compliance with the Code priorities will usually be dispositive of whether a proposed settlement is fair and equitable." *Id.* at 184.

123. *Id.*

124. *Id.*

125. *See infra* Part III.A.

126. *See infra* Part III.B.

127. *See supra* Part I.A–B.

128. *Jevic*, 787 F.3d at 182 n.7.

from Rule 9019, which was promulgated by the Supreme Court, not from congressional action.[129] Pursuant to that point, the court also noted that neither Congress nor the Supreme Court has ever explicitly stated that the absolute priority rule of § 1129(b)(2)(B)(ii) should apply to settlements in bankruptcy.[130] Thus, there is very little to indicate that the strict rules governing plan confirmation, particularly those governing nonconsensual plan confirmation, should apply to negotiated agreements of the kind at issue in *Jevic*, even where, like nonconsensual plans, there is an objecting class of creditors.

In support of this point, the court laid out some factors that tend to indicate that Congress might have had different intentions with respect to negotiated agreements as compared with plan confirmation.[131] Specifically, the court highlighted the importance of settlements in bankruptcy, noting that settlements are as favored in bankruptcy as in other areas of the law.[132] Compromises and settlements have long played a crucial role in the bankruptcy process, as they prevent stakeholders from having to endure the time and expense of ongoing proceedings.[133] As a result, the court reasoned that the Code and the Rules ought naturally to leave bankruptcy courts additional flexibility in approving settlements as compared with confirming Chapter 11 plans of reorganization.[134] Successfully negotiated agreements are bound to become more commonplace where the approval process is less stringent, which fosters the important policy of encouraging Chapter 11 stakeholders to strike compromises in an effort to rescue what remains of the debtor corporation and to ensure fair distribution of any remaining assets.

Moreover, a flexible approach to structured dismissal approval prevents bankruptcy courts from being compelled to reach outcomes that fail to serve the majority interest and perhaps cut against economic incentives. Referring again to congressional intent, the Third Circuit noted that the

129. *Id.*

130. *Id.* at 183 (noting that the Drivers themselves conceded that the absolute priority rule does not apply in this situation, but instead argued over the applicability of its underlying legal principle). The Supreme Court has held that a settlement proposed *as part of a reorganization plan* must conform to the absolute priority rule to be considered "fair and equitable," Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 424 (1968), but "[w]hen a settlement is presented for court approval apart from a reorganization plan . . . the [absolute] priority rule . . . is not necessarily implicated," *In re* Iridium Operating LLC, 478 F.3d 452, 463 (2d Cir. 2007).

131. *See Jevic*, 787 F.3d at 184.

132. *Id.*; *see also In re* Nutraquest, 434 F.3d 639, 644 (3d Cir. 2006).

133. *See* Valencia, *supra* note 63, at 430 ("[N]egotiated outcomes save the bankruptcy estate the time and expense of protracted proceedings, perhaps even litigation, regarding the disputed issue or issues. The courts are uniform in their respect, desire, and appreciation of settlements in a bankruptcy case."); *see also In re* Martin, 91 F.3d 389, 393 (3d Cir. 1996) ("[I]t is an unusual case in which there is not some litigation that is settled between the representative of the estate and an adverse party."); 6B BANKRUPTCY SERVICE, LAWYERS EDITION, *supra* note 60, § 59:575 ("Compromises are favored in bankruptcy.").

134. *Jevic*, 787 F.3d at 184 ("[I]t would make sense for the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure to leave bankruptcy courts more flexibility in approving settlements than in confirming plans of reorganization.").

Code's drafters could not have intended § 507 to force an "economically ugly result" where a more beneficial alternative clearly exists.[135] In *Jevic*, for instance, the bankruptcy court made findings of fact that the dire circumstances of the case warranted the kind of relief requested by the debtor: there was no real possibility of a meaningful distribution to anyone except Jevic's secured creditors unless the structured dismissal was approved because the ordinary Chapter 11 exit strategies would not have proved practical.[136] Furthermore, the Drivers' WARN Act claim against Jevic was deemed "effectively worthless" because of the lack of unencumbered funds remaining in the Jevic estate; thus, the risk of prejudice to the Drivers as a result of their exclusion from the agreement was essentially nonexistent and did not provide the Third Circuit with sufficient reason to overturn a bankruptcy court ruling that clearly operated in the best interest of a majority of the debtor's creditors.[137]

The Third Circuit evidently saw reason to rely on the findings of fact of the bankruptcy court below and to trust in the bankruptcy judge's conclusion as to which outcome would best serve the majority interest. One might argue, then, that any tight restriction placed on bankruptcy judges' ability to deviate from priorities in this context must be based on some unfounded distrust in bankruptcy judges to make these important judgment calls.[138] Although an in-depth analysis of political distrust in bankruptcy courts is beyond the scope of this Note, whether bankruptcy judges are capable of determining in every instance which outcome best meets the interests of the estate and creditors is pertinent to whether they should have the authority to approve structured dismissals that undermine the Code's contemplated priorities.

Since bankruptcy courts are non-Article III tribunals, the breadth of bankruptcy judges' power has long been questioned.[139] In fact, numerous bankruptcy reform efforts arguably have sought to curb the discretion of bankruptcy judges,[140] which seems to cut against the notion that Congress would have intended the kind of flexibility provided through the *Jevic* holding. However, specifically in the context of settlement approval, bankruptcy judges historically enjoy significant discretion. They are

135. *Id.* at 185–86.

136. *Id.* at 178.

137. *Id.*

138. *See id.* at 185–86 ("We doubt that our national bankruptcy policy is quite so nihilistic and distrustful of bankruptcy judges . . . . [T]he Code permits a structured dismissal, even one that deviates from the § 507 priorities, when a bankruptcy judge makes sound findings of fact that . . . the settlement is the best feasible way of serving the interests of the estate and its creditors.").

139. *See* U.S. CONST. art. III, § 2; Troy A. McKenzie, *Judicial Independence, Autonomy, and the Bankruptcy Courts*, 62 STAN. L. REV. 747, 747 (2010) ("Bankruptcy judges enjoy neither of the twin structural protections provided by Article III of the Constitution: life tenure and compensation that cannot be diminished.").

140. *See, e.g.*, McKenzie, *supra* note 139, at 776 n.158 ("Bankruptcy judges have been critical of the 2005 amendments [to the Bankruptcy Code] in part because of the view that one motivation for the [Bankruptcy Abuse Prevention and Consumer Protection Act] was political distrust of the bankruptcy bench.").

entrusted through Rule 9019 with determining whether a particular compromise serves the estate's best interests.[141] Moreover, reviewing courts grant great deference to these decisions, looking only for a "clear abuse of discretion" in determining whether to approve a bankruptcy court's ruling on a particular settlement agreement.[142] While this breadth of power has developed through common law, Congress has not legislated to rein that power in, which perhaps speaks to the existence of greater congressional trust in bankruptcy judges where these bankruptcy-specific questions are at play.[143] Although "[t]here is no explicit command in the Code requiring such deference . . . it is taken to be implicit in the generalized, open-textured instructions the Code gives to bankruptcy judges."[144] Such analysis might speak to the appropriateness of the kind of flexibility afforded to bankruptcy judges through the *Jevic* decision.

Despite these considerations, the importance of cooperation among stakeholders and the need for economic efficiency may be outweighed by the need to instill the procedural protections of the Code and the Rules.[145] The next section discusses whether these vital safeguards, which exist in both the plan confirmation and the settlement approval context,[146] overshadow the Third Circuit's *Jevic* reasoning and should prevent approval of structured dismissals that are noncompliant with § 507 priorities.[147] The section also discusses the Third Circuit's potentially problematic assumption that an agreement in a structured dismissal is a settlement like any other and, in so doing, criticizes the court's failure to highlight the differences between a preplan settlement and a structured dismissal when adopting the *Iridium* standard.[148]

B. An Improper Extension: The Need to Enforce Procedural Safeguards

Even though structured dismissals contain negotiated agreements between parties, where a structured dismissal is disputed for violation of priorities, even if by a single class of creditors, it does not fall squarely within the bankruptcy meaning of the term "consensual." Where plan confirmation is concerned, a consensual plan requires every class to agree to the proposed plan by a supermajority, meaning it must be approved by

141. *See supra* Part I.D.
142. *See, e.g.*, Nellis v. Shugrue, 165 B.R. 115, 123 (S.D.N.Y. 1994) (limiting the review of the bankruptcy court's settlement approval to determining whether there was a clear abuse of discretion).
143. *See* McKenzie, *supra* note 139, at 778.
144. *See id.*
145. *See, e.g.*, Frost, *supra* note 52 ("[W]e could often save the time and expense of litigating questions simply by ignoring substantive rights and picking a winner, but that is not the way we generally decide disputes. Indeed the claims of the various parties may not have been worth litigating, but that is no reason to pick a winner without bothering to litigate.").
146. *See supra* Part I.A–D.
147. *See infra* Part III.B.
148. *See infra* Part III.B.

more than one-half of the number of claims and two-thirds in value.[149] Where a compromise is concerned, there is no such clear-cut consensus requirement; however, where there exists an objection to the proposed agreement, the circumstances align more with nonconsensual plan confirmation than with consensual plan confirmation. Because of this, comparison with the hurdles set up in § 1129(b) arguably sheds some light on whether the Third Circuit erred in adopting such a lenient standard for approval of priority-noncompliant structured dismissals.

Because § 1129(b) contemplates plan approval over and above the objections of certain creditors, its requirements are rather stringent. All of the provisions of § 1129(a), aside from § 1129(a)(8), which requires plan acceptance by all classes of impaired claims or interests, must first be satisfied.[150] Moreover, the proposed plan must be "fair and equitable" with respect to each objecting impaired class of claims or interests.[151] Further still, § 1129(b)(2)(B)(ii), which codifies the absolute priority rule, requires that in order for a plan to be fair and equitable, senior creditors must be paid in full before junior creditors receive or retain any property on account of their junior claim or interest.[152] As noted, these requirements have never been explicitly declared applicable to settlements in bankruptcy.[153] The fair and equitable standard of § 1129(b) is not the same fair and equitable standard interpreted under Rule 9019, and the absolute priority rule has only ever been used where plan confirmation is concerned.[154] Despite this, where a structured dismissal is contemplated, a bankruptcy court may have good reason to pay close attention to these requirements.

Notwithstanding the potential advantages of structured dismissals, their growing approval by bankruptcy courts has not been without controversy. Specifically, stakeholders not benefited by a structured dismissal often argue that bankruptcy courts do not have the authority, either express or inherent, to approve such agreements because they offer an exit strategy not specifically provided for in the Code.[155] Whereas the plan confirmation process is safeguarded by stringent requirements for approval, the structured dismissal process provides stakeholders with no such statutory safeguards.[156] Chapter 11 debtors requesting structured dismissals often seek to rely on §§ 1112(b) and 305(a)(1), both of which provide for dismissal of Chapter 11 cases for cause, along with § 105(a),[157] which

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149. *See supra* note 24 and accompanying text.

150. *See supra* note 25 and accompanying text.

151. *See supra* note 25 and accompanying text.

152. *See supra* note 28 and accompanying text.

153. *See In re* Jevic Holding Corp., 787 F.3d 173, 183 (3d Cir. 2015); *see also supra* Part III.A.

154. *See* Douglas, *supra* note 66, at 17.

155. *See, e.g.*, Eitel et al., *supra* note 42, at 2 ("[Structured dismissals] seem to fall outside the three paths for concluding a [C]hapter 11 case under the Bankruptcy Code—confirming a plan, converting to [C]hapter 7, or dismissing without 'bells and whistles.'").

156. *See id.* ("[Structured dismissals] may sacrifice critical bankruptcy safeguards included in the traditional statutory options.").

157. *See* 11 U.S.C. §§ 1112(b), 305(a)(1), 105(a) (2012); *see also* Norman L. Pernick & G. David Dean, *Structured Chapter 11 Dismissals: A Viable and Growing Alternative After*

provides that bankruptcy courts may enter "any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Code]."[158] Parties also invoke § 349(b) of the Code, which describes the effect of dismissal but reserves a possibility that such effect may be altered for cause by a court order.[159] However, even if bankruptcy courts' authority to approve structured dismissals can be read into the Code's provisions, the absence of a specific provision governing structured dismissals highlights their unconventional nature and raises a potential need for especially close monitoring and scrutiny.

As abovementioned, structured dismissals have been compared with illegitimate *sub rosa* plans of reorganization.[160] In *In re Biolitec, Inc.*,[161] for instance, the U.S. Bankruptcy Court for the District of New Jersey rejected a proposed structured dismissal in part on the ground that it resembled a *sub rosa* plan.[162] The court noted that the scope of bankruptcy courts' ability to approve structured dismissals is limited, even where they do comply with the priorities of § 507, pointing out that courts have permitted structured dismissals only *occasionally* by adopting a broad interpretation of § 105(a).[163]

Further, the *Biolitec* Court reasoned that the particular agreement in question could not be approved because it shifted stakeholders' rights without satisfying many of the Code's most important safeguards.[164] It found that cases in which structured dismissals have been approved, such as *In re Buffet Partners, L.P.*,[165] have been based in large part upon the fact that the agreement "satisfied the most important Code requirements, including disclosure, consent or voting of creditors, and compliance with statutory priorities and the absolute priority rule."[166] In *Biolitec*, however, those who were not a party to the agreement that accompanied the dismissal did not receive an opportunity to negotiate or vote on its provisions, even though it "clearly affect[ed] parties' rights by assigning rights and interests,

Asset Sales, AM. BANKR. INST. J., June 2010 ("Parties requesting approval of structured dismissals rely on § 1112(b) and/or § 305(a)(1) of the Bankruptcy Code . . . often coupled with a request pursuant to § 105(a) of the Code.").

158. 11 U.S.C. § 105(a).

159. *See, e.g.*, *In re* Naartjie Custom Kids, Inc., 534 B.R. 416, 422 (Bankr. D. Utah 2015).

160. *See, e.g.*, Frost, *supra* note 52.

161. 528 B.R. 261 (Bankr. D.N.J. 2014).

162. *Id.* at 272 ("[T]he structured dismissal resembles an impermissible *sub rosa* plan.").

163. *Id.* ("[C]ourts have occasionally permitted structured dismissals by adopting a broad interpretation of § 105(a)."). The *Biolitec* Court also noted that even though § 105 may allow structured dismissals under certain circumstances, it "does not give courts 'free-floating discretion to redistribute rights in accordance with . . . personal views of justice and fairness, however enlightened those views may be.'" *Id.* at 269 (quoting United States v. Pepperman, 976 F.2d 123, 131 (3d Cir. 1992)).

164. *See id.* ("Here, the [m]otion, while passing the 'practicality' test, must be denied because the structured dismissal seeks to alter parties' rights without their consent and lacks many of the Code's most important safeguards.").

165. No. 14-30699-HDH-11, 2014 WL 3735804 (Bankr. N.D. Tex. July 28, 2014) (holding that the agreement was fair and equitable because it did not give any junior interests priority over any senior interests, it did not short circuit the requirements of Chapter 11, and no party objected because any alternative would reduce their dividend).

166. *Biolitec*, 528 B.R. at 269.

forcing creditors to receive distributions through the [l]iquidating [t]rust instead of the bankruptcy process, and subordinating the claims of the [n]on-[d]ebtor [a]ffiliates."[167] Thus, the bankruptcy court felt it could not approve the proposed structured dismissal without some assurance that the creditor protections of § 1129 were either present or waived by all of the parties.[168] By contrast, the Third Circuit's lack of consideration for the unique problems presented by structured dismissals, such as the potential for subversion of Chapter 11 safeguards, is evidenced by its heavy reliance on *Iridium*, which dealt not with a structured dismissal but with a preplan settlement that violated § 507 priorities.[169] The Third Circuit's failure to mention the distinction between a preplan settlement and an agreement accompanying case dismissal is particularly noteworthy.

Ultimately, the fact that Chapter 11 debtors must break through such stringent procedural barriers to achieve plan confirmation, a reorganization technique clearly contemplated by Congress and, in fact, the primary method of reorganization in Chapter 11, suggests that approval of a structured dismissal, a potentially unauthorized and certainly unclear bankruptcy exit strategy, should contain similar hurdles to ensure that the principles and goals of Chapter 11 are upheld. Allowing bankruptcy judges the flexibility to approve a structured dismissal that distorts the Code's priority regime, with a requirement only that such deviation be justified upon "specific and credible" grounds,[170] arguably undermines the otherwise transparent nature of Chapter 11 approval procedures. According to the Third Circuit in *Jevic*, the specific and credible grounds requirement is intended to enforce the fair and equitable standard of Rule 9019 as well as the underlying policy of the absolute priority rule—ensuring the "evenhanded and predictable treatment of creditors."[171] However, the court's lenient holding appears to fall short of that goal; the court essentially rules out structured dismissals only where the agreement was formed specifically to contravene Chapter 11 safeguards, expressing little concern about a situation in which a structured dismissal innocently mistreats an impaired class of claims or interests.[172]

In sum, there is plainly an argument that even where a bankruptcy court or a reviewing court offers some "least bad alternative" justification for approval of a structured dismissal that does not comply with priorities,[173] that justification is counteracted by the need to protect creditors from abuse of the Chapter 11 process. While economic efficiency is important, the answer may not be to subordinate a particular party's claim or interest for the purpose of making matters easier or accelerating conclusion of the

167. *Id.* at 271.
168. *Id.* at 269.
169. *In re* Jevic Holding Corp., 787 F.3d 173, 184–85 (3d Cir. 2015).
170. *Id.* at 184.
171. *Id.*
172. The Third Circuit's ruling seems to understand the "evenhanded and predictable treatment of creditors" to mean that no agreement should be formulated *with the intention* of benefiting one creditor to the detriment of others. *See id.*
173. *Id.* at 185.

debtor's case. As an alternative to the structured dismissal in *Jevic*, for instance, "the case could have been settled with the proceeds held pending the outcome of the WARN Act litigation."[174] And, even if this alternative would not have been feasible, perhaps because of the negotiation deadlock caused by Sun being the subject of the Drivers' WARN Act claims,[175] the threat that the estate would be consumed by litigation may not be enough to end the case simply by excluding the WARN Act claimants from distribution altogether.[176]

IV. TREAD CAREFULLY: HITTING THE STEPS OF THE CHAPTER 11 PROCESS

Part IV of this Note suggests that, because of the questions surrounding the legitimacy of the use of structured dismissals in Chapter 11 bankruptcy,[177] the Third Circuit's adoption of the Second Circuit's flexible approach to priority deviation was improper. It notes that the benefits of the Third Circuit's ruling, namely the promotion of compromise and the prevention of obscure or unwanted monetary outcomes, are outweighed by the need to protect creditors from the risk that their rights will be undermined.[178] While this Note does not suggest that priority deviation should never be permitted through a structured dismissal, it puts forward a standard for reviewing priority-noncompliant structured dismissals that would better allow bankruptcy courts to determine, on a subjective, case-by-case basis, whether the safeguards of plan confirmation would be subverted if the dismissal and its accompanying agreement were to be approved.[179]

A. A Slip and Fall: The Third Circuit's Lack of Respect for Procedural Safeguards

A bulk of the reasoning behind the Third Circuit's affirmation of the structured dismissal in *Jevic* is based upon the notion of economic efficiency.[180] The court refers to the agreement between the parties as the "least bad alternative" given the circumstances of Jevic's bankruptcy estate.[181] However, not only did a potentially reasonable alternative to the structured dismissal exist,[182] but even if there were no such alternative, that does not provide a sufficient basis upon which to subordinate an entire class of claims. Although the court approved the structured dismissal with the caveat that approval will only be deemed appropriate in a "rare case,"[183]—a

174. *See* Frost, *supra* note 52.
175. *See id.*
176. *See id.*
177. *See supra* Parts I.C., III.B.
178. *See infra* Part IV.A.
179. *See infra* Part IV.B.
180. *See supra* Part III.A.
181. *In re* Jevic Holding Corp., 787 F.3d 173, 185 (3d Cir. 2015).
182. *See id.* at 186 (Scirica, J., concurring in part and dissenting in part).
183. *Id.* at 175.

holding that this Note does not criticize–the court then fails to provide any kind of breakdown as to the kinds of "rare cases" that might warrant a similar ruling in the future. While this Note recognizes that the court could not have predicted with particularity the various factual scenarios that might give rise to an acceptable priority-noncompliant structured dismissal, its requirement that bankruptcy courts simply provide "specific and credible grounds" upon which to justify a priority deviation is a poor effort to police the use of structured dismissals going forward.[184]

Further, another of the Third Circuit's chief rationales for approving the structured dismissal in *Jevic*, namely the promotion of compromise among parties,[185] is not well supported. As noted, the court fails to point out, when applying the *Iridium* holding, that structured dismissals differ from other bankruptcy settlements in that they deal specifically with distributing the remainder of the estate's assets upon the close of the case after the asset pool has already been substantially depleted.[186] As a result of the court's failure to pay regard to this distinction in its discussion of the need to promote compromise, it cites no authority that speaks specifically to the structured dismissal context.[187] In fact, due to their fairly recent development and use, where structured dismissals are concerned there is no longstanding history of compromise among stakeholders as there may be at other points in the Chapter 11 process.[188]

Moreover, not only does the Third Circuit inappropriately emphasize economic efficiency and compromise at the expense of the Drivers' rights to see their WARN Act claims through, it then fails to put any emphasis where the emphasis in fact belongs—the preservation of Chapter 11 procedural safeguards. The majority fails entirely to address structured dismissals' similarity to *sub rosa* plans of reorganization. Judge Scirica's partial dissent is the only opinion to deal with this concern.[189] He notes that

> [a]lthough the . . . structured dismissal here does not, strictly speaking, constitute a *sub rosa* plan—the hallmark of such a plan is that it dictates the terms of a reorganization plan, and the settlement here does not do so—the broader concerns underlying the *sub rosa* doctrine are at play.[190]

Judge Scirica goes on to note that the proposed structured dismissal sought to reallocate assets in a manner that would not have been possible were it

184. *Id.* at 184.
185. *Id.*
186. Structured dismissals typically occur after a 363 sale, *see supra* Part I.C., and therefore seek to distribute what little remains of the estate's assets among existing creditors. This Note does not disagree with the court's reference to Rule 9019 and its "fair and equitable" standard for settlement approval; instead, it argues that bankruptcy courts should be warier of safeguarding concerns when deciding what is "fair and equitable" in a structured dismissal context.
187. *See supra* Part III.B.
188. The court, in its discussion of the importance of settlements in bankruptcy, cites *In re Nutraquest*, 434 F.3d 639, 644 (3d Cir. 2006), which dealt with a proposed settlement of a claim against the debtor's estate, and *In re Iridium Operating LLC*, 478 F.3d 452, 464 (2d Cir. 2007), which dealt with a preplan settlement proposal.
189. *See Jevic*, 787 F.3d at 187–88 (Scirica, J., concurring in part and dissenting in part).
190. *Id.* at 188.

not for the authority conferred by Chapter 11 upon the creditors' committee, yet the reallocation fails to implement the "safeguards of disclosure, voting, acceptance, and confirmation."[191]

B. Striking the Balance: A Multifactor Analysis for Approval of Priority-Noncompliant Structured Dismissals

To ward off the possibility that these important Chapter 11 creditor protections will be undermined, this Note suggests an analysis that would require bankruptcy judges to assess a priority-noncompliant structured dismissal with § 1129(b) in mind, notwithstanding that its requirements are not strictly applicable.[192] A bankruptcy court, in deciding whether a structured dismissal that violates § 507 is "fair and equitable" under Rule 9019,[193] should pay particular attention to: whether and when stakeholders whose rights would be affected by the structured dismissal were informed of the negotiations leading up to the proposed agreement; whether such stakeholders received sufficient opportunity to participate in the negotiations; whether such stakeholders received adequate opportunity to be heard on their objections; the nature of the claims or interests that would be subordinated by the proposed agreement; the nature of the claims or interests that would be protected or advanced through such subordination; whether there exists a viable alternative to the proposed agreement; and the relative difference in payout that would result to each class of creditors through the alternative course of conduct.

While this is not intended to be a closed list of factors, a bankruptcy court's reference to these issues would provide greater transparency in the structured dismissal approval process. This Note proposes that a bankruptcy court should consider each of these factors (and others it deems necessary) and conduct a balancing test to decide whether, given the particular circumstances of the case, a structured dismissal that deviates from the Code's priority scheme is appropriate. The way in which these factors intertwine surely would vary according to context. For instance, where a proposed structured dismissal follows a 363 sale, viable alternatives to the agreement may be few and far between (because the debtor's estate already has been depleted through a sale of all or substantially all of its assets); thus, that particular factor may weigh heavily into the court's decision in a 363 sale context. Where, however, there has been no 363 sale, or where a bankruptcy court is concerned that a particular class of creditors is seeking to improperly advance its own interests at the expense of other creditors, its analysis may place greater emphasis on the importance of mirroring § 1129(b)'s procedural safeguards.

191. *Id.* (quoting *In re* Lionel Corp., 722 F.2d 1063, 1071 (2d Cir. 1983)).
192. *See id.* at 183.
193. *See supra* Part I.D.

CONCLUSION

Because of the extreme controversy surrounding the use of structured dismissals in bankruptcy, the Third Circuit's recent decision to extend bankruptcy judges such flexibility in approving these agreements creates a platform for debate. The problem of priority deviation is of the utmost importance, as payment distribution in bankruptcy raises not only economic concerns but also moral concerns, particularly where bankruptcy courts are presented with a situation like that of the Drivers in *Jevic*. Ultimately, it is an issue that is ripe for review by the U.S. Supreme Court; accordingly, a petition for a writ of certiorari has been filed with the Supreme Court and is currently pending response.[194] This Note proposes that, moving forward, a multifactor analysis governing the use of structured dismissals that violate priorities would be most helpful in achieving equitable outcomes, while also preserving Chapter 11 procedural safeguards.

194. *See* Petition for Writ of Certiorari, Czyzewski v. Jevic Holding Corp., No. 15-649, 2015 WL 7252903 (U.S. Nov. 16, 2015).