Shining a Light on Structured Dismissals

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This article provides a discussion of the June 9, 2021 decision 'In re KG Winddown,' where U.S. Bankruptcy Judge Martin Glenn clarified some unresolved issues about structured dismissals in Chapter 11 bankruptcy cases that stemmed from the 2017 U.S. Supreme Court decision in 'Czyewski v. Jevic Holding.'

During the past few months several New York cases involving UCC sales of equity On June 9, 2021, U.S. Bankruptcy Judge Martin Glenn for the Southern District of New York issued a decision in *In re KG Winddown*, which clarified some unresolved issues about structured dismissals in Chapter 11 bankruptcy cases that stemmed from the 2017 U.S. Supreme Court decision in *Czyewski v. Jevic Holding (Jevic)*. *Jevic* held that bankruptcy courts may not approve structured dismissals that provide for distributions that do not follow ordinary priority rules without the consent of affected creditors.

The *Jevic* court noted that although the Bankruptcy Code does not expressly mention structured dismissals, their use in bankruptcy cases appears to be increasingly common. The court, however, expressed no view about the legality of structured dismissals generally and instead chose to limit its decision to the facts presented in the case.

The bankruptcy court in *KG Winddown* granted the debtors' motion to dismiss their Chapter 11 cases, noting that while *Jevic* imposed limits on structured dismissals, the *Jevic* court left the door open where such dismissals do not violate the absolute priority rule and otherwise comply with applicable provisions of the Bankruptcy Code, or as Judge Glenn stated "[h]ere, the debtors' request for structured dismissals fits neatly through that open door."

'*Jevic*'

Jevic involved a failed leveraged buyout transaction that left the debtor at the time of filing owing $53 million to its senior secured creditors and over $20 million to tax and unsecured creditors. The bankruptcy filing also triggered a lawsuit by a group of former truck drivers against the debtors for alleged violations of state and federal Worker Adjustment and Retraining Notification (WARN) Acts that require a company to give workers at least 60-days' notice before their termination. The bankruptcy court granted the truck drivers summary judgment.

The judgment was estimated to be worth about $12.4 million, of which about $8.3 million was entitled to a wage priority under §507(a)(4) of the Bankruptcy Code and therefore entitled to payment ahead of general unsecured creditors. Another lawsuit was commenced by *Jevic*'s unsecured creditors against parties involved in the leveraged buyout, alleging fraudulent transfers.

As a result of these litigations the parties sought to negotiate a settlement that called for the structured dismissal of *Jevic*'s Chapter 11 bankruptcy cases. Under the proposed structured dismissal, the truckers would receive nothing on their WARN wage priority claims, but lower-priority general unsecured creditors would be paid. The truckers argued that the distribution scheme accordingly violated the Code's priority rules by paying general unsecured claims ahead of their own. The bankruptcy court nevertheless approved the settlement agreement and dismissed the case, reasoning that because the proposed payouts would occur pursuant to a structured dismissal rather than an approved plan, the failure to follow ordinary priority rules did not bar approval. The district court and the U.S. Court of Appeals for the Third Circuit affirmed.

The Supreme Court reversed and remanded, holding that bankruptcy courts may not approve structured dismissals that provide for distributions that do not follow priority rules without the consent of affected creditors. The *Jevic* court clarified that cases in which courts have approved deviations from ordinary priority rules generally involve interim distributions serving significant Code-related objectives, noting that is not the case in *Jevic*, where the priority-violating distribution is attached to a final disposition; does not preserve the debtor as a going concern; does not make the disfavored creditors better off; does not promote the possibility of a confirmable plan; does not help to restore the status quo ante; and does not protect reliance interests.

While the Bankruptcy Code defines the priority scheme that must be followed in Chapter 7 and Chapter 11, it does not explicitly state what priority rules—if any—apply to a distribution in a structured dismissal. In this regard, §349 of the Bankruptcy Code states that a bankruptcy court may for cause order otherwise when the prepetition financial status quo cannot be replicated.

However, the *Jevic* court explained that this "for cause" provision does not provide sufficient evidence of congressional intent to suggest that it allows bankruptcy courts wide discretion to ignore Bankruptcy Code priority rules in dismissals. In other words, the Bankruptcy Code giving a bankruptcy court the power to dismiss a Chapter 11 case says nothing about the power to make nonconsensual priority-violating distributions to creditors.

Finally, the *Jevic* court stated that Congress did not authorize a "rare case" exception that permits courts to disregard priority in structured dismissals for "sufficient reasons," noting that the fact that it is difficult to give precise content to the concept of "sufficient reasons" threatens to turn the court below's exception into a more general rule, resulting in uncertainty that has potentially serious consequences—e.g., departure from the protections granted particular classes of creditors, changes in the bargaining power of different classes of creditors even in bankruptcies that do not end in structured dismissals, risks of collusion, and increased difficulty in achieving settlements. The *Jevic* court concluded that courts cannot deviate from the strictures of the Code, even in "rare cases."

‘*KG Winddown*’

The debtors in *KG Winddown* operated a chain of luxury Italian restaurants that were sold during the bankruptcy cases. Unfortunately, the sale proceeds, together with cash on hand were insufficient to pay administrative expense claims—in other words the debtors were administratively insolvent. To resolve this dilemma, the debtors were able to have their counsel reduce their legal fees to allow other administrative claims to be paid in full. In order to implement that process the debtors proposed a structured dismissal of their bankruptcy cases.

The bankruptcy court reviewed *Jevic*, noting that whether a bankruptcy court has the authority to order a structures dismissal is the subject of some debate and determined that dismissal was warranted. Some key factors considered by the bankruptcy court was the fact the debtors have sold substantially all of their assets, have no further operations, and have insufficient resources to fund a plan.

The court noted that the other alternatives under §1112(b)(1)—conversion to Chapter 7 or appointment of a trustee or examiner—would impose costs that would only further erode the value of the already administratively insolvent estates with no apparent benefit, and are therefore not in the best interests of creditors and the estates.

Interestingly, the court found that although the distribution scheme regarding payment of administrative claims did not require court approval, this did not mean that the court cannot (or even should not) approve the distribution scheme. The court stated that while perhaps not required, approval would provide certainty to the debtors and the creditors, and promote the orderly winding up of the estates, which is precisely the purpose of the contemplated structured dismissal.

Takeaways

When *Jevic* was decided several years ago many bankruptcy professionals felt that they had lost an important restructuring tool or at a minimum that the concept of structured dismissals was clouded. Indeed, the Supreme Court’s position with respect to structured dismissals generally was left intentionally unresolved and the parties and lower courts were left to sort things out. That is precisely what Judge Glenn did in *KG Winddown* where he clarified that *Jevic* did not preclude structured dismissals per se, but provided flexibility for the courts and parties under §349 of the Bankruptcy Code to shape reasonable solutions that recognize one key principle—that a fixed priority scheme is the cornerstone of reorganization practice and theory.

Among the other non-priority claim factors to be considered in any future structured dismissals are whether the dismissal preserves the debtor as a going concern, does it make the disfavored creditors better off, does it promote the possibility of a confirmable plan, does it help to restore the status quo ante, and does it protect reliance interests.

Conclusion

KG Winddown is a perfect example of a bankruptcy court following the guidance offered by *Jevic* with respect to structured dismissals that required courts and parties to sharpen their restructuring tools and to devise creative ways to use structured dismissals without offending the fundamental claim priority scheme of the Bankruptcy Code. *KG Winddown* teaches us that the perceived limitations on structured dismissals resulting from *Jevic* are not insurmountable and that restructuring tools are still available to bankruptcy professionals to address how structured dismissals can work.

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