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When a Priority is Not a Priority: Structured Dismissals and the Priority Rules

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Introduction

The culmination of a chapter 11 case is typically a plan that provides for payment to creditors in accordance with the priority rules of the title 11 of the United States Code (the “Bankruptcy Code”). In *In re Jevic Holding Corp.*, the Third Circuit held that in certain rare circumstances, bankruptcy courts have the discretion to approve structured dismissals which do not comply with section 507 and section 1129 - the priority rules - of the Bankruptcy Code.¹ This holding highlights several issues with which courts have been grappling. The initial issue is whether structured dismissals themselves are even permissible under the Bankruptcy Code.² The next issue raised is why structured dismissals are objectionable and whether all the requirements of the Bankruptcy Code for plan confirmations, like the priority rules, apply. Then, if structured dismissals are not required to conform to requirements outlined in the Bankruptcy Code for other types of case resolutions, it must be determined what requirements do apply to structured dismissals. Finally, the requirements that do apply to structured dismissals must be defined and understood.

¹ *Official Comm. of Unsecured Creditors ex rel. the bankr. estate of Jevic Holding Corp. v. CIT Group/Business Credit Inc (In re Jevic Holding Corp.)*, 787 F.3d 173, 185—86 (3d Cir. 2015).

² *Id.* at 180.

The courts have established that structured dismissals are permissible under the Bankruptcy Code.³ Opponents to structured dismissals argue they provide fewer protections for creditors because they frequently deviate from the priority scheme of section 507 or violate the absolute priority rule of section 1129.⁴ While some courts have held the protections of section 507 and section 1129⁵ do not apply to structured dismissals, there is a clear need for some standard of review to ensure that structured dismissals do not result in inequitable treatment of creditors. To ensure protection, courts have established that structured dismissals must be fair and equitable.⁶ However, this leaves a lingering issue – courts must decide what fair and equitable means in the context of structured dismissals. This issue remains unclear as only one court has found a deviation from the priority scheme and absolute priority rule to be fair and equitable.⁷

Structured dismissals are simply an agreement among parties to a case to resolve that case, but with lingering requirements.⁸ The result of a structured dismissal is that when the judge approves the dismissal, the case is actually not completely over until all the lingering requirements are met.⁹ Opponents' biggest issue with structured dismissals is that they are not required to conform with the priority scheme and the absolute priority rule because neither apply

³ *Id.* at 181.

⁴ *Id.* at 182-83.

⁵ See generally *United States v. AWECO, Inc. (In re AWECO)*, 725 F.2d 293, 298 (5th. Cir. 1984) (“Our understanding of bankruptcy law’s underlying policies leads us to make a limited extension of the fair and equitable standard: a bankruptcy court abuses its discretion in approving a settlement with a junior creditor unless the court concludes that priority payment will be respected as to objecting senior creditors.”); *contra Motorola, Inc. v. Official Comm. of Unsecured Creditors (In re Iridium Operating, LLC)*, 478 F.3d 452, 446 (2nd Cir. 2007); see also *In re Jevic Holding*, 787 F.3d at 179.

⁶ *In re Jevic Holding*, 787 F.3d at 184.

⁷ *In re Jevic Holding*, 787 F.3d at 183.

⁸ See generally 15 COLLIER ON BANKRUPTCY, §18.95 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2009).

⁹ See generally *id.*

to settlements of a case, which is what a structured dismissal is classified as.¹⁰ However, this issue is not completely resolved.

To date, three circuit courts have addressed the issue of whether the priority rules apply to structured dismissals. In *In re AWECO*, the Fifth Circuit held that the priority scheme and absolute priority rule must be applied to all structured dismissals.¹¹ However, in *In re Iridium*, the Second Circuit held that it is permissible for structured dismissals to deviate from the priority rules if there are specific and credible grounds, but the court there failed to find those grounds in the *Iridium* case.¹² Finally, the Third Circuit in *In re Jevic* agreed with the *Iridium* court, finding that structured dismissals not in conformance with the priority rules are permissible in some circumstances, and the court found those circumstances were present in the *Jevic* case.¹³

While the Circuits are split, causing uncertainty for the future, the *Iridium* and *Jevic* courts do agree that structured dismissals not in conformance with the priority rules are permissible in certain rare circumstances: when the dismissal is fair and equitable, in spite of its failure to conform to the priority rules.¹⁴ The *Iridium* and *Jevic* courts applied the *Martin* multi-factor test to determine when a non-conforming settlement will be fair and equitable.¹⁵ As of now, it seems a structured dismissal not in conformance with the priority rules will be permissible only when the debtor's assets are so diminished that there is virtually no chance of success for the creditors in litigation, and therefore the interests of the creditors are best served through the dismissal so as to not further diminish the debtor's assets.¹⁶

¹⁰ See *In re Jevic*, 787 F.3d at 182-83.

¹¹ *In re AWECO*, 725 F.2d at 298.

¹² *In re Iridium Operating*, 478 F.3d at 464-65.

¹³ *In re Jevic*, 787 F.3d at 184.

¹⁴ See *id.*

¹⁵ *Martin v. Martin (In re Martin)*, 91 F.3d 389, 393 (3d Cir. 1996).

¹⁶ *In re Jevic*, 787 F.3d at 182-184.

While there is uncertainty surrounding structured dismissals, they are becoming increasingly popular and it is likely more courts will be addressing this issue in the future, hopefully leading to greater certainty. As the law currently stands, if the court does allow for a structured dismissal deviating from the priority rules - which will be rare as the priority rules are usually dispositive - the dismissal must be fair and equitable.¹⁷

Structured Dismissals

A structured dismissal is a “dismissal of a chapter 11 case, but with additional provisions.”¹⁸ These additional provisions include fixing claims resolution procedures, approving gifting and “providing that certain orders entered during the case remain in effect and impose other conditions which must be met before the effectiveness of any dismissal.”¹⁹ The court in *In re Jevic* described structured dismissals as “simply dismissals that are preceded by other orders of the bankruptcy court (*e.g.*, orders approving settlements, granting releases, and so forth) that remain in effect after dismissal.”²⁰

The key difference between structured dismissals and ordinary dismissals described in the Bankruptcy Code is that ordinary dismissals “typically reinstate the pre-petition state of affairs by revesting property in the debtor and vacating orders and judgments of the bankruptcy court.”²¹ However, the Bankruptcy Code also expressly provides that the court can, for cause, grant otherwise.²² Cause simply means “an acceptable reason.”²³ Thus, while structured dismissals are not expressly permitted under the Bankruptcy Code, they are in conformance with

¹⁷ *Id.* at 184.

¹⁸ 15 COLLIER ON BANKRUPTCY, §18.95 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2009).

¹⁹ *Id.*

²⁰ *In re Jevic*, 787 F.3d at 181.

²¹ *Id.* at 181; see also 11 U.S.C. §349 (2012).

²² 11 U.S.C. §349.

²³ *In re Sadler*, 935 F.2d 918, 921 (7th Cir. 1991).

the Bankruptcy Code, as long as the court ordering the structured dismissal has an acceptable reason for doing so.

Issues with Structured Dismissals

While structured dismissals themselves are permissible under the Bankruptcy Code, opponents of structured dismissals still have grounds to challenge them, if the structured dismissals are not in compliance with other portions of the Bankruptcy Code.

One issue with structured dismissals is they “typically lack the protections offered by the chapter 11 plan process” including the “absence of application of the ‘fair and equitable’ standard for the treatment of claims and of the absolute priority rule.”²⁴ According to the Supreme Court in *TMT Trailer Ferry*, “a bankruptcy court is not to approve or confirm a plan of reorganization unless it is found to be ‘fair and equitable.’”²⁵ This concept of “fair and equitable” plan conformations was codified in 11 U.S.C. §1129(b)(2)(B)(ii) and is referred to as the “absolute priority rule.”²⁶

Under section 1129(b)(2), “the condition that a plan be fair and equitable with respect to a class includes the following requirements ... (B)(ii) 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 claims or interest any property....”²⁷ In essence, in order for a plan to be fair and equitable, the claims of junior creditors cannot be paid before the claims of senior creditors.

²⁴ 15 COLLIER ON BANKRUPTCY, §18.95 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2009).

²⁵ *Protective Comm. for Independent Stockholders of TMT Trailer Ferry, Inc. v. Anderson*, 390 U.S. 414, 442 (1968).

²⁶ 11 U.S.C. §1129(b)(2)(B)(ii) (2012).

²⁷ 11 U.S.C. §1129(b) (2012).

Another issue with structured dismissals is they may “approve distribution of assets without due regard to the Bankruptcy Code’s priority scheme.”²⁸ Bankruptcy Code section 103(a) states that “chapters 1, 3, and 5 of this title apply in a case under chapter 7, 11, 12, or 13 of this title.”²⁹ Section 507 is, of course, within chapter 5 and there is an argument to be made that section 507 applies to all cases filed under chapter 7, 11, 12 or 13.³⁰ It would follow from that argument that section 507 applies to all structured dismissals filed under chapter 7, 11, 12, and 13.³¹ If this argument was the rule, no deviations from the priority scheme of section 507 would be permissible.

Permissibility of Structured Dismissals Not in Compliance with the Priority Rules

The requirements for plan confirmations have been made abundantly clear, both by the Supreme Court and Congress, through the absolute priority rule.³² Simply put, in the context of plan confirmations, no creditor with a junior claim may be paid before a creditor with a senior claim.³³ However, a structured dismissal is a settlement, not a plan confirmation and as such, the rules for structured dismissals are much less clear.

The absolute priority rule specifically applies to plan confirmations, not settlements.³⁴ As such, the term “fair and equitable” is undefined in the Bankruptcy Code in the context of settlements. In fact, the requirement that settlements be “fair and equitable” is not even expressed

²⁸ 15 COLLIER ON BANKRUPTCY, §18.95 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2009).

²⁹ 11 U.S.C. §103(a) (2012).

³⁰ See *In re Jevic Holding Corp.*, 787 F.3d at 182 (explanation of the Driver’s, appellants from a structured dismissal not in conformance with §507, argument that §507 applies to all chapter 11 cases).

³¹ *Id.* at 182.

³² See *TMT Trailer Ferry*, 390 U.S. at 442; 11 U.S.C. §1129(b).

³³ See 11 U.S.C. §1129(b).

³⁴ *In re Jevic*, 787 F.3d at 183.

in the Bankruptcy Code. However, the requirement that settlements be “fair and equitable” does exist, under Rule 9019 of the Federal Rules of Bankruptcy Procedure.³⁵

Rule 9019 is intended to “prevent the making of concealed agreements which are unknown to the creditor and unevaluated by the court.”³⁶ In order to fulfill this intention, courts have developed a set of factors used to determine whether settlements are “fair and equitable.”³⁷ In *In re Martin*, the Third Circuit looked to the following factors: “(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.”³⁸ Thus, structured dismissals not in conformance with the absolute priority rule are permissible, as long as they are in conformance with the *In re Martin* multi-factor test.

However, while it is clear that the absolute priority rule does not apply to settlements, the priority scheme of section 507 is less clear. While there is, as mentioned above, an argument to be made that section 507 applies to all structured dismissals, this argument is far from established law. As the court of *In re Jevic* notes, “[i]f § 103(a) meant that all distributions in Chapter 11 cases must comply with the priorities of Section 507, there would have been no need for Congress to codify the absolute priority rule specifically in the plan confirmation context.”³⁹ Thus, whether a settlement may be approved turns not on its conformance with the priority scheme, but only on whether it is “fair and equitable,” as that standard has been interpreted in the context of settlements through the *In re Martin* multi-factor test.⁴⁰

When is a Structured Dismissal Fair and Equitable?

³⁵ Fed. R. Bankr. P. 9019.

³⁶ *In re Masters*, 141 B.R. 13, 16 (Bankr. E.D. N.Y. 1992).

³⁷ *Martin v. Martin (In re Martin)*, 91 F.3d 389, 393 (3d Cir. 1996).

³⁸ *Id.*

³⁹ *In re Jevic*, 787 F.3d at 182 n.7.

⁴⁰ *In re Martin*, 91 F.3d at 393.

The circuit courts have decided only three cases addressing when, or if, a structured dismissal is fair and equitable, in spite of deviating from the priority scheme of section 507.⁴¹ Each of these cases had different outcomes, causing continued uncertainty in the circuits as to whether a structured dismissal can be fair and equitable while noncompliant with section 507, and if so, when.⁴²

The purpose of section 507 is to ensure “the even handed and predictable treatment of creditors.”⁴³ The same underlying policy applies to settlements and courts will typically consider whether the priority scheme under section 507 is being followed in determining whether or not the settlement is fair and equitable.⁴⁴ However, because the statutes and precedents do not require strict conformance with the priority scheme, if a bankruptcy court has “specific and credible grounds to justify ... deviation” they may approve nonconforming settlements.⁴⁵

The first circuit court to address whether structured dismissals may deviate from the priority rules was the Fifth Circuit in *In re AWECO*. In *In re AWECO*, the Fifth Circuit adopted a strict approach and held that section 507 must be followed in all cases.⁴⁶ The Fifth Circuit therefore rejected a structured dismissal not in conformance with the priority rules.⁴⁷

The next circuit court to evaluate the acceptance of structured dismissals deviating from the priority rules was the Second Circuit in *In re Iridium*. While the Second Circuit took a less

⁴¹ *In re Jevic*, 787 F.3d at 183.

⁴² Compare *In re AWECO*, 725 F.2d 293 (where the court held non-complaint structured dismissals could never be fair and equitable); with *In re Iridium Operating*, 478 F.3d 452 (where the court held structured dismissals deviating are permissible in theory, but the facts in the case did not support one); and *In re Jevic*, 787 F.3d 173 (where the court approved a structured dismissal deviating from the priority scheme).

⁴³ *In re Jevic*, 787 F.3d at 184.

⁴⁴ *Id.* (citing *In re Iridium Operating*, 478 F.3d at 455).

⁴⁵ *In re Jevic*, 787 F.3d at 184 (citing *In re Iridium*, 478 F.3d at 466).

⁴⁶ See *In re AWECO*, 725 F.2d at 298.

⁴⁷ *Id.*

severe approach in deciding *In re Iridium*, the court still failed to approve a structured dismissal that did not follow section 507, holding that while it may be permissible to circumvent section 507 in rare circumstances, the priorities will usually be dispositive of whether the proposed settlement is fair and equitable.⁴⁸ In *Iridium*, the Second Circuit was denied the opportunity to evaluate whether the priority rules were dispositive in the case before it because the record provided no factual reason for the violation of the priority rule.⁴⁹

The most recent circuit court to evaluate the permissibility of structured dismissals deviating from the priority rules was the Third Circuit in *In re Jevic*. While *Jevic* closely followed the analysis of *In re Iridium*, *In re Jevic* offered the first example of “specific and credible grounds”⁵⁰ sufficient to justify the deviation,⁵¹ which were grounded in the multifactor test of *In re Martin* for evaluating settlements.⁵² Through its analysis of the *In re Martin* multifactor test, the *Jevic* bankruptcy court determined that the factors mandated the approval of the settlement.⁵³ The *Jevic* bankruptcy court decided that traditional routes out of chapter 11 were not available, and the settlement in question best served the creditors and the estate.⁵⁴ Interestingly, the Drivers (creditors protesting the structured dismissal) agreed with this contention arguing that even if the creditors and estate were best served, it was irrelevant because

⁴⁸ *In re Iridium Operating*, 478 F.3d at 464-65.

⁴⁹ *Id.* at 466.

⁵⁰ *Id.* at 466.

⁵¹ *In re Jevic*, 787 F.3d at 184–85 (“we concluded that the Bankruptcy Court had sufficient reason to approve the settlement and structured dismissal of *Jevic*’s Chapter 11 case.”).

⁵² *Id.* at 180 (“we gleaned from *TMT Trailer Ferry* four factors to guide bankruptcy courts in this regard: ‘(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.’”) (citing *In re Martin*, 91 F.3d at 393).

⁵³ See generally *In re Jevic*, 787 F.3d at 179.

⁵⁴ *Id.* at 186.

the Bankruptcy Code did not permit the settlement's approval.⁵⁵ However, the court found that if the way to best serve the creditors and the estate is a settlement not in conformance with section 507, then that settlement may be approved.⁵⁶

While the *In re Jevic* court allowed a deviation from section 507, it also warned these were rare circumstances in which a court would approve a settlement plan not conforming with section 507.⁵⁷ However, the criteria to meet these rare circumstances does not seem as strenuous as the Third Circuit implies.⁵⁸ The *In re Jevic* court allowed a deviation because it was best for the estate and the creditors;⁵⁹ in essence, because the *In re Martin* multifactor test favored settlement, the deviation was permissible.⁶⁰

There is still disagreement among the circuits with some enforcing a *per se* rule that section 507 applies to settlements.⁶¹ Until more decisions involving structured dismissals not in conformance with section 507 are handed down, there is no clear answer as to whether or not structured dismissals must comply with section 507.

Conclusion

While not expressly allowed in the Bankruptcy Code, structured dismissals have been approved by courts as in conformance with the Bankruptcy Code. Structured dismissals become more complicated when they are used as a means to avoid protections or requirements that other forms of case resolution, such as plan confirmations, have. The increasingly popular structured dismissals are therefore becoming increasingly contentious as they are used to skirt the

⁵⁵ *See id.* at 180.

⁵⁶ *Id.* at 186.

⁵⁷ *Id.* at 186.

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *See Id.*

⁶¹ *In re AWECO*, 725 F.2d at 298.

requirements of the priority rules of section 507 and section 1129. However, while the Second and Third Circuits have held that structured dismissals do not have to comply with the priority rules, the Fifth Circuit held that any structured dismissals not in conformance with the priority rules are *per se* invalid.⁶² Further, although the Second and Third Circuits have held that structured dismissals may deviate from the priority rules in theory, in reality they have only upheld one such deviating structured dismissal.⁶³ Further, the Second and Third Circuits make clear that structured dismissals are still required to be fair and equitable and that the priority rules will usually be dispositive as to whether or not a structured dismissal is fair and equitable.⁶⁴ Because only one Circuit case upholding a structured dismissal not in conformance with the Bankruptcy Code's priority rules has been decided, there is still ambiguity as to how rare these deviations will be and exactly what is required for the courts to allow them. In November, 2015, the losing creditors in *Jevic* filed a *writ for certiorari* with the United States Supreme Court.⁶⁵ If certiorari is granted, hopefully the ambiguity about the application of the priority rules to structured dismissals will be resolved.

⁶² *See id.*

⁶³ *See In re Jevic*, 787 F.3d at 179-184.

⁶⁴ *See In re Jevic*, 787 F.3d at 184.

⁶⁵ *Czyzewski v. Jevic Holding Corp.*, (3d Cir. 2015), *petition of cert. filed*, 84 U.S.L.W. 3475 (U.S. Nov. 17, 2015) (No. 15-649).