LJN LAW JOURNAL NEWSLETTERS

The Bankruptcy Strategist®

An ALM Publication

Volume 33, Number 5 • March 2016

Structured Dismissals and Application Of Non-Estate Proceeds

Third Circuit Sheds Some Light on Evoloving Practices

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Corporate restructuring practice has dramatically evolved in the nearly 40 years since enactment of the 1978 Bankruptcy Code. Since *In re Lionel Corp.*, 722 F.2d 1063 (2d Cir. 1983), one of the more significant changes to Chapter 11 practice has been the use of section 363 to sell the assets of a debtor, prior to confirmation of a plan, as a means to restructure and maximize value. This transactional use of the Bankruptcy Code has, by necessity, changed how cases are administered. With more frequent under-water balance sheets and ever evolving, more complex capital structures, many modern cases have required flexible approaches. Practitioners and bankruptcy courts have been forced to adapt. Two recent precedential decisions from the U.S. Court of Appeals for the Third Circuit provided a much-needed stamp of approval on these flexible and pragmatic approaches to modern restructuring practice.

Structured Dismissal As 'The Least Bad Alternative'

In *Official Committee of Unsecured Creditors v. CIT Group/Business Credit Inc.* (*In re Jevic Holding Corp.*), 787 F.3d 173 (3d Cir. 2015), prepetition, Sun purchased Jevic, a trucking company, through a leverage buy-out funded by CIT. On the eve of filing for Chapter 11, Jevic ceased its operations and gave termination notices to its employees. As of the petition date in 2008, Jevic owed $53 million to CIT and SUN as secured creditors, and over $20 million to taxing authorities and general unsecured creditors. Two lawsuits were filed during the bankruptcy case. One was from a group of truck drivers against Jevic and Sun. alleging violations of the Worker Adjustment and Retraining Notification Act (WARN) for failure to provide adequate termination notice. The truck drivers wanted $12.4 million in damages, $8.3 million of which they asserted was entitled to priority under section 507(a)(4) of the Bankruptcy Code (for wages, subject to a cap per employee, earned within 180 days prior to the petition date). The other was from the official creditors' committee, on behalf of Jevic's estate, against Sun and CIT seeking to avoid the leverage buyout transactions.

In March 2012, Jevic, CIT, Sun and the creditors' committee negotiated and sought court approval of a settlement under Bankruptcy Rule 9019. Critically, at that time the only assets remaining in Jevic's estate was $1.7 million in cash subject to Sun's lien and the creditors' committee's avoidance action. The settlement provided:

- For a full exchange of releases among the settlement parties.
- That CIT would pay $2 million into an account to pay Jevic's and the Committee's legal fees and other expenses.
- That Sun would assign its $1.7 million lien to a trust that would pay tax and administrative creditors and then general unsecured creditors (who would receive a 4% recovery) on a priority basis.
- For dismissal of the case, which was structured insofar as it implemented the settlement.

The drivers objected on two primary grounds. They argued that the settlement constituted a "structured" dismissal ("structured" as it provided for the distribution of assets and resolution of certain issues), which were not authorized by the Bankruptcy Code. Moreover, the dismissal distributed assets to junior general unsecured creditors, even though the drivers' senior priority claims would go unpaid.

The bankruptcy court approved the settlement and structured dismissal and the district court affirmed on appeal. The drivers appealed again to the Third Circuit. The court affirmed (on a 2-1 vote) and issued a detailed opinion.

The Third Circuit noted that there was no dispute that a court could dismiss a Chapter 11 case for cause under section 1112(b)(1) of the Bankruptcy Code. Rather, the issue was whether dismissals could be "structured," "at least to the extent that they deviate from the priority system of the Bankruptcy Code in distributing estate assets." *Jevic*, 787 F.3d at 180. The court held that "bankruptcy courts may, in rare instances like this one, approve structured dismissals that do not strictly adhere to the Bankruptcy Code's priority scheme." *Id.* In upholding the dismissal of the case, the Third Circuit observed that the Bankruptcy Code prohibited a structured dismissal when there is a "showing that a structured dismissal has been contrived to evade the procedural protections and safeguards of the plan confirmation or conversion [to Chapter 7] process." *Id.* at 181.

Next, the court analyzed settlement principles under Bankruptcy Rule 9019 in determining whether the structured dismissal could go outside the Bankruptcy Code's priority scheme. The court held that settlements must be "fair and equitable," which does not mean that the Bankruptcy Code and the Bankruptcy Rules "extend the absolute priority rule to settlements in bankruptcy." Yet, the underlying policy of the rule "ensuring the evenhanded and predictable treatment of creditors — applies in the settlement context." *Id.* at 184. The Third Circuit thus held that bankruptcy courts could deviate from the priority scheme of section 507 of the Bankruptcy Code, only with "specific and credible grounds to justify [the] deviation." *Id.* (quoting *In re Iridium Operating LLC*, 478 F.3d 452, 466 (2d Cir. 2007). *Id.* Although a "close call," the deviation was justified because there was no prospect of plan confirmation and the alternative would have been a conversion to Chapter 7 and the secured creditors taking the remaining assets in "short order." *Id.* In that situation, the drivers would have received nothing, and as found by the bankruptcy court, there was "no realistic prospect" of a meaningful distribution to unsecured creditors. Thus, the settlement and the structured dismissal "remained the least bad alternative." *Id.* at 185.

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Credit Bidder's Settlement Payment Not Property of The Estate

LifeCare Holdings, Inc.(n/k/a ICL) filed for Chapter 11 protection as a struggling operator of long-term acute care hospitals. It had roughly $484 million in debt, of which $355 million was secured and was in need of capital. In an attempt to sell its business, it received seven bids. The highest came in at approximately 80%-85% of the secured debt. Because there was no suitable buyer, the secured lender issued a credit bid of $320 million, and agreed pay LifeCare's's legal, accounting wind-down fees, and creditors' committee fees. The lenders directed cash funds totaling $1.8 million (the "Escrow Funds") into escrow accounts to cover the fees, with the excess amounts to be returned to the lender.

The creditors' committee objected on the grounds that the transaction was a "veiled foreclosure." The United States government objected because the sale would have given rise to an estimated $24 million capital gains tax liability, as an administrative expense claims that would go unpaid, even though other administrative expense claims (professional fees) would be paid.

The lender resolved the creditors' committee objection by agreeing to deposit $3.5 million in trust (the "Settlement Proceeds") for the benefit of general unsecured creditors. The settlement gave rise to an additional government objection: that creditors would receive distributions on account of general unsecured claims that were lower in priority than the government's unpaid tax claim. The bankruptcy court approved the sale and committee settlement over the government's objection.

The Third Circuit affirmed in *In re ICL Holding Company, Inc.*, 802 F.3d 547 (3d Cir. 2015). The government's primary argument was that the Escrow Funds and the Settlement Proceeds were property of the estate that were being distributed outside of the plan. The court disagreed, observing that the Settlement Proceeds were not property of the estate, proceeds of the liens, or lender collateral. The Settlement Proceeds were not given as consideration for the assets, but were paid by the secured lender to withdraw the objection as an obstacle to completing the transaction. As for the Escrow Funds, the government took the position that it constituted the cash paid to LifeCare. But the court noted that LifeCare transferred its cash to the lender under the purchase agreement, and that excess amounts would be returned to the lenders. *ICL*, 802 F.3d at 556. Because the Escrow Funds were funded by purchaser's property with its own funds, the payments were not property of the estate. In *dicta*, the Third Circuit indicated that the government may have had an argument that the Escrow Funds were estate property if they were a carve-out of collateral rather than lender property.

What This Means

Taken together, the *Jevic* and *ICL* decisions approve flexibility based on the circumstances and needs of a case. Where a Chapter 11 plan is unlikely to be confirmed or beneficial, say where the senior secured creditor is out of the money as in *ICL*, these circuit-level decisions clear paths to allow for structured dismissals and distribution of the secured lender's purchase and settlement proceeds outside of the Bankruptcy Code's priority scheme and provide room at the table to unsecured creditors who may otherwise be out of the money.

In the early days of the Bankruptcy Code, parties generally presumed that a reorganization through Chapter 11 plan was the "gold standard" to achieve in a case. The plan process was preferred and carried the hallmarks of a fair outcome: a priority scheme, a best interests of creditors test, and, most importantly, an opportunity to vote on the plan transaction and distributions with supermajority rules. A section 363 sale promised none of those things. Instead, a party could merely object to a proposed transaction and if that objection was overruled, the transaction moved forward and proceeds came into the estate. Because a section 363 sale resolved *the debtor's business issues* and liquidated estate proceeds outside of a plan, parties generally viewed section 363 sales as illegal *sub-rosa* plans.

The Chapter 11 plan process remains the ideal, but it simply cannot work for many situations.

Then came *In re Lionel Corp*. In *Lionel*, the U.S. Court of Appeals for the Second Circuit held that a debtor could undertake a section 363 sale, where it could demonstrate that it exercised sound "business judgment." The Second Circuit provided a non-exhaustive list of considerations, including the likelihood reorganization, the elapsed time since the filing and the effect of the proposed disposition on future plans of reorganization.

Over time, it became regular practice for getting transctions done in many cases. As the *ICL* opinion properly and succinctly observes, "[i]n modern bankruptcy practice [a section 363 sale] *is the tool of choice* to put a quick close to a bankruptcy case. It avoids the time, expense, and, some would say, the Bankruptcy Code's unbending rules." *ICL*, 802 F.3d at 549. (emphasis added).

The Chapter 11 plan process remains the ideal, but it simply cannot work for many situations. The voting process invites minority or special interest stakeholders to hold up transactions that might be beneficial for creditors of a whole. Lenders will not advance DIP financing or consent to cash collateral unless they have assurances that a process will run on a tight timeline, with a tight budget and strict milestones. The 2005 amendments to the Bankruptcy Code reduced to 210 days the time in which one can assume and assign a commercial real property lease without landlord consent. Moreover, when a secured lender is out of the money, there may not be the funds necessary to meet the Chapter 11 plan requirements, such as payment of administrative claims.

What are the options? On one hand, strict adherence to the Chapter 11 formality has the benefit of ensuring that creditors will be treated according to anticipated priorities. On the other, few are prepared to fund the plan process and more practically, many cases simply cannot confirm a plan.

Official (and even unofficial) committees have become increasingly important to the process so that there is some form of "check" on the process and so there is a party to investigate and if advisable negotiate and settle, which are hallmarks of the Chapter 11 process.

Bankruptcy judges are often faced with a decision: consider a post-section 363 sale structured dismissal, Rule 9019 settlement, or direction of purchaser proceeds to go forward — or to strictly adhere to the principles of the Code. In some jurisdictions, they have recognized that the latter can be a hollow victory. Perfection often becomes the enemy of the good: Insistence on a Chapter 11 plan can mean destroying a deal, with no value to creditors and, often, the risk of termination of employees.

Through *ICL* and *Jevic*, the Third Circuit has shown that it understands this conundrum that practitioners and bankruptcy courts often face and provides pathways for dealing with these issues. The *Jevic* decision relied significantly on the Second Circuit's *Iridium* opinion and rejected a decades-old decision from the U.S. Court of Appeals for the Fifth Circuit: *In re AWECO, Inc.*, 725 F2d 293 (5th Cir. 1984). In *AWECO*, the Fifth Circuit rejected a settlement as not "fair and equitable" that would have transferred assets outside of the Code's priority scheme. Questions remain as to what extent other circuits follow *Jevic* and whether the Fifth Circuit revisits its decision.

Questions also remain whether proposed changes to the Bankruptcy Code will allow it. The ABI Chapter 11 Commission Report envisions a so-called section 363(x) sale, which would incorporate certain creditor protections of a plan into sale process. Only time will tell how these issues continue to evolve.