Supreme Court Gives WARN-ing To Companies In Bankruptcy: Don’t Ignore Wage Claims

Insights
3.22.17

The U.S. Supreme Court held today in a 6 to 2 decision that “structured dismissals” resolving Chapter 11 bankruptcy proceedings cannot deviate from the Bankruptcy Code’s priority scheme without the consent of the affected parties – which means that businesses must ensure workers receive their unpaid wages as part of any such resolution. Specifically, the Court rejected a structured dismissal that left a group of WARN Act plaintiffs without any compensation, telling employers, essentially, that they must squeeze blood from a stone to compensate their workers.

The court’s ruling means that a company in Chapter 11 bankruptcy must ensure that all of its creditors and potential creditors with priority under the Bankruptcy Code, which could include current or former employees, agree to settlement terms in order for a structured settlement to be approved. By expanding the requirements for reorganization or liquidation plans to apply to structured settlements, this holding will significantly change how most companies in Chapter 11 will approach settlements by reducing their flexibility and providing affected workers with more leverage at the settlement table (*Czyzewski v. Jevic Holding Corporation*).

Bankruptcy Bootcamp

There are several options available to a business struggling under the weight of financial distress. A Chapter 11 bankruptcy allows a company to reorganize with the objective of keeping the business running, paying creditors over time, and becoming profitable again. However, any company desiring this option must develop a reorganization plan and present it to the bankruptcy court, which will only confirm the plan if deemed reasonable and created in good faith. Also, the court needs to see evidence of sufficient funds available to completely pay priority claims, with some money left over to pay for the administration of the case itself, or it will not approve the plan.

A not-so-pleasant alternative to a Chapter 11 bankruptcy is a Chapter 7 bankruptcy, which shuts down the business, liquidates all assets, and distributes the liquid assets to repay creditors.

If a company elects to go through with a Chapter 11 bankruptcy but later finds itself in a position where a plan cannot be confirmed, its only other options are to either convert the bankruptcy to Chapter 7, or to dismiss the case either via a standard dismissal or a structured dismissal. Unlike a standard dismissal that would simply put the parties back in their prior respective positions, a structured dismissal allows for the bankruptcy court to exercise its discretion and approve the distribution of the assets unless there is a showing that the parties are purposely using the structured dismissal to bypass the procedural protections that would apply if they went through a Chapter 11 or Chapter 7 bankruptcy.

Background: The Death of a Company

Jevic Transportation, Inc. was a financially declining New Jersey trucking company that entered into a leveraged buyout with a group of lenders in 2006. Unfortunately for Jevic and its employees, the buyout did not save the company. In 2008, Jevic filed for Chapter 11 bankruptcy and the company ceased most of its operations, laying off its truck drivers on the same day. At the time it filed for bankruptcy, Jevic was $53 million dollars in the red to the buyout lenders, and owed another $20 million in taxes and unsecured debt.

A class of terminated truck drivers filed an action against Jevic for violations of the federal and New Jersey state Worker Adjustment and Retraining Notification (WARN) Acts, which required Jevic to give the workers 60 days' notice before laying them off. Meanwhile, a group of Jevic's unsecured creditors brought a fraudulent conveyance action against the buyout lenders on behalf of the bankruptcy estate, alleging the buyout was a reckless transaction that fast-tracked Jevic's financial demise.

The Bankruptcy Settlement

A group of interested parties – including the truck drivers, the unsecured creditors, Jevic, and the buyout lenders – gathered in March 2012 to settle the fraudulent conveyance lawsuit. By that time, Jevic had liquidated its tangible assets to repay the buyout lenders and only had $1.7 million in cash remaining. This money was owed to the buyout lenders, so Jevic did not have the necessary funds to go through the process of getting the Chapter 11 plan confirmed. For that reason, the case moved toward resolution via a structured dismissal.

Ultimately, the company believed that the former employees were driving too hard of a bargain and forged a compromise that excluded them. Without the drivers' approval, the group agreed to a settlement and structured dismissal, which they submitted to the Bankruptcy Court for confirmation. The Bankruptcy Court approved the settlement, and the funds were distributed to the buyout lenders.

Out Of A Job, And Out Of Money: No Settlement Share For The Drivers

The settlement, structured dismissal, and distribution of funds left out the truck drivers, despite the fact that their WARN class action lawsuit was pending. The bulk of the damages claimed by the truck drivers consisted of wages.

If the company had been in the midst of Chapter 11 or 7 proceedings, these wages would have been subject to the "absolute priority" rule. This is one of the most fundamental principles in bankruptcy law, determining who gets paid first when assets are distributed. Section 507 of the U.S. Bankruptcy Code specifically provides that certain claims for wages by employees or former employees are granted priority over other types of corporate debt and paid out first. But because the matter was resolved through a structured dismissal, the parties did not comply with that priority scheme.

resolved through a structured dismissal, the parties did not comply with that priority scheme.

The WARN Action

The WARN action survived the settlement, and a federal court ultimately ruled in favor of the drivers on this claim. The court found that Jevic had "undisputedly" violated New Jersey's WARN Act given the undeniable out-of-the-blue nature of the terminations. The drivers estimated their claim to be worth $12.4 million, and $8.3 million of would qualify as a priority wage claim under the absolute priority rule.

However, they were unable to get in line to claim any of this money, despite the priority nature of their claims, because the nature of the structured settlement left them in the cold. They sought relief from the 3rd Circuit Court of Appeals, which similarly rebuffed them (although the appeals court judges noted that it was a "close call"). They then filed an appeal to the Supreme Court, which resolved the dispute today.

SCOTUS: Don't Ignore Wage Claims, Employers

The issue before the Supreme Court was "whether a bankruptcy court has the legal power to order a priority-skipping distribution scheme in connection with a Chapter 11 *dismissal*." The Supreme Court determined that it may not.

Specifically, the Court held that, while Chapter 11 plans provide more flexibility than Chapter 7 liquidations "a priority-violating Chapter 11 plan still cannot be confirmed over the objection of an impaired class of creditors." In doing so, the Court emphasized the importance of the priority scheme, noting that Congress would have expressly indicated in the statute if it intended to allow a departure from the priority scheme such as the one exercised here.

The Court also highlighted the importance of the WARN Plaintiffs' objection to the settlement given no existing case law permits "nonconsensual departures from ordinary priority rules in the context of a dismissal . . . and in the absence of any further unresolved bankruptcy issues." The Court also hinged its decision on the fact that it did not believe that any "significant Code-related objectives" – such as a reorganization that would increase the value of the bankruptcy estate for all the creditors – were achieved by the structured dismissal.

Ultimately, the Court rejected the "rare case" exception that the 3rd Circuit proposed that would allow the courts to find "sufficient reasons" to disregard priority. In doing so, the Court expressed a concern that the exception would overtake the rule given the uncertainty of how it may apply.

In particular, the Court pointed to the respondent's argument that a settlement could not take place without a violation of the priority rule, and absent a settlement, the fraudulent-conveyance lawsuit would be worthless. Both of these arguments were summarily rejected as "dubious predictions." As the Court noted, settlement was possible, and the fraudulent conveyance claim had potential value. The Court therefore feared that allowing the exception would lead courts in future cases apply it beyond "rare" instances to "many, not just a few, cases." According to the Court, overuse of the exception could lead to innumerable unintended consequences, including collusion among creditors, problematic changes to the bargaining power of different classes of creditors, and adding further obstacles to settlement.

What This Decision Means For Employers

Unfortunately, sudden mass layoffs are often necessary for companies that file for Chapter 11 bankruptcy. However, with such a sudden mass layoff, a company is also likely to face exposure under both the federal and state WARN Acts. These claims qualify as claims for unpaid wages because the employees would have earned wages for an additional period of time had they been given proper notice of the layoff. As noted above, under the Bankruptcy Code's detailed priority scheme, wage claims – including the portion of WARN Act claims that represent wages – receive priority over many other types of debt.

Under today's Supreme Court's holding, a structured dismissal of Chapter 11 claims must still adhere to the Bankruptcy Code's priority scheme, and potential wage liability must be given the same priority it would under a Chapter 7 liquidation. While this decision may lead to reduced creativity and flexibility in settlements, creditors (such as employees or former employees) are likely to still prefer this type of settlement because it will typically maximize recovery.

This case should serve as a "WARN-ing" to companies facing the option of bankruptcy. As a result of today's decision, employers in financial distress should be wary of class action plaintiffs' attorneys, who are likely to bring whatever wage claims they can even against a company that has filed for bankruptcy. Their desire to gain even a small slice of the already diminished pie available in settlement could result in additional financial exposure, so compliance with WARN Acts is an absolute priority for troubled employers.

For more information, visit our website at www.fisherphillips.com or contact your regular Fisher Phillips attorney.

This Legal Alert provides an overview of a specific Supreme Court case. It is not intended to be, and should not be construed as, legal advice for any particular fact situation.

Service Focus

Litigation and Trials

Mergers and Acquisitions

Reductions in Force (RIFs)