Private Credit Lenders: What's a "Structured Dismissal" and Why Should You Care?

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Despite the Supreme Court's rejection of a structured dismissal in 2017,[1] there is a growing trend of bankruptcy courts approving structured dismissals of chapter 11 cases following a successful sale of a debtor's assets under Section 363 of the Bankruptcy Code. A structured dismissal is a cost-effective way for a company to exit chapter 11 and is an alternative to (a) confirming a post-sale liquidating plan, which is expensive and not always viable, or (b) converting the case to chapter 7, which introduces significant uncertainty and unpredictability with the appointment of a trustee to replace management. Private credit lenders should take note of this approach because structured dismissals slash significant costs from an already expensive chapter 11 process. This article explains when structured dismissals are ripe for consideration, the alternatives on the table after a successful Section 363 sale, and the reasons why structured dismissals are gaining popularity.

Context

Private credit lenders have a simple investment thesis — get repaid in full at maturity. That game plan doesn't work when the borrower's business deteriorates to the point where there is no realistic prospect of loan repayment either through refinancing, merger or sale or an "amend & extend" to allow for performance and profitability to rebound. In this downside scenario, lenders pivot to "Plan B," which sometimes involves – as the option of last resort – acquiring or selling to a third party the borrower's business through a Section 363 sale in Chapter 11 free and clear of all or most all its debt. In this scenario, a lender may feel like an "ATM machine" routinely disbursing cash to preserve and protect its investment, including through: (a) agent advances and rescue loans in the period leading up to bankruptcy as the parties develop and document a sale strategy, (b) new money DIP loans to pay for the costs of the bankruptcy case from the filing date through consummation of the sale, and (c) post-closing working capital for the new business in those situations where the lender's credit bid is the successful bid.

In these situations, the final expense on the lender's tab is the funding needed for post-closing "wind-down" expenses (or "burial expenses") of the estate for the period *after* the Section 363 sale is consummated. Bankruptcy courts generally refuse to allow themselves to be used to sell businesses if the interested parties will not allocate funds to a soft landing as opposed to a situation where administrative expenses are left unpaid and the debtor's shell is left in shambles. Wind-down expenses, which vary by business and industry, typically include (a) costs to sell, dispose of or otherwise monetize non-core assets (if any) that were excluded in the 363 sale, (b) costs to terminate employee benefit plans, to prepare final tax returns and to dissolve corporate entities in accordance with state law, (c) costs to reconcile claims and distribute excess cash to administrative claimants and, in some instances, unsecured creditors, and (d) other miscellaneous costs, including continued payment of U.S. Trustee fees, final fee applications for estate professionals and other ministerial matters. These expenses are customarily funded by the exclusion of cash collateral (equal to the wind-down amount) from the assets acquired by the credit bidding lender/purchaser.

Post-Sale/Wind-Down Paths

Anyone who has been through the scenario described above knows that wind-down negotiation inevitably turns to the ***means*** of implementing a wind-down. There are three options: (1) confirmation of a liquidating chapter 11 plan, (2) conversion of the chapter 11 case to a case under chapter 7, or (3) a "structured dismissal" of the bankruptcy case. The negotiation occurs among the secured creditors who are providing funding for the wind-down, the debtor and its professionals who are guiding the company through its bankruptcy case, and, sometimes, a statutory creditors' committee.

1. The Plan Path

Most debtors, boards and private equity sponsors strongly prefer (and often insist on) a path that allows the company to confirm a liquidating chapter 11 plan. This path is the conventional exit path from chapter 11 and it achieves finality in an "official" sense with the entry of a plan confirmation order. The company, the board, the sponsor and their respective advisors also prefer the plan path because it customarily includes broad releases (at least on a consensual basis) and exculpation provisions providing immunity from suits by disgruntled creditors.

The plan path, however, is expensive. The expense is driven, in large part, by professional fees to prepare and prosecute a disclosure statement and plan of liquidation, the solicitation of votes from creditors and a reconciliation of claims. In addition to expense, the plan path might also be uncertain. A plan may not be viable because approval requires, among other things, acceptance by an impaired accepting class of creditors (excluding insiders) and payment in full of all administrative claims in cash, including "Section 503(b)(9) claims," which affords administrative priority status to the claims of pre-petition vendors who shipped goods that were received by the debtors within 20 days before the filing. While the plan path might be the "gold standard," there are many cases where that path is not feasible or is simply too expensive relative to other options.

2. The Conversion Path

Conversion is another option. Converting the chapter 11 case to a case under chapter 7 is the least expensive path. The debtor files the case and the board of directors walks away. A chapter 7 trustee is appointed and disposition of the business and ancillary assets is the trustee's headache. Despite the cost savings, this option is universally recognized by debtors, boards, sponsors and credit bidding buyers as the least desirable because it creates uncertainty stemming from the chapter 7 trustee. Chapter 7 trustees are compensated only when they create a pool of unencumbered assets to be distributed to creditors. This fee structure often creates situations where trustees take overzealous legal positions in an effort to extract value from stakeholders, including lenders, suppliers and owners, directors and officers. Bankruptcy works best when it is carefully planned and there is consensus on the best path to maximize value. By adding a new player into the mix, the conversion path introduces uncertainty and with uncertainty comes risk. For this reason, cases are rarely converted from chapter 11 to chapter 7 on a consensual basis.

3. The Structured Dismissal Path

The final option is a structured dismissal. A structured dismissal is memorialized in a negotiated order approved by the bankruptcy court that dismisses the chapter 11 case together with other provisions and conditions that provide some sense of finality beyond merely dismissing the case. The terms of a structured dismissal order are case specific and the product of bespoke negotiations, but often include provisions (i) recognizing the continued effectiveness of the bankruptcy court's prior orders, particularly the order approving the sale; (ii) setting procedures for final payment of professional fees; (iii) authorizing the destruction or abandonment of non-core retained assets; (iv) establishing claims reconciliation procedures to provide for the distribution of cash to holders of allowed claims, which typically include administrative expense claimants and, with less frequency priority unsecured claims and general unsecured creditors; and (v) consensual releases. Structured dismissal orders usually contemplate a number of conditions precedent to effectiveness of the dismissal of the case (*e.g.*, finalizing distributions, selling non-core assets).

A structured dismissal is much faster and cheaper than the plan path. Yet there is often resistance to embrace this strategy` as the best post-sale exit option. Critics make two arguments: (1) the Bankruptcy Code does not specifically contemplate structured dismissals and (2) the Supreme Court rejected the structured dismissal in *Czyzewski v. Jevic Holding Corp*. 137 S. Ct. 973 (2017) ("Jevic"). The critics are wrong.

First, the Bankruptcy Code contemplates dismissal of a chapter 11 case in Section 305(a) and 1112(b) of the Bankruptcy Code.[2] Each statute affords the bankruptcy court wide discretion to determine whether there is "cause" to dismiss the case and whether the interests of debtor and creditors are best served by dismissal. The argument that a dismissal order must be "plain vanilla" and simply dismiss the bankruptcy case ignores the fact that many bankruptcy court orders (like DIP orders and sale orders) include conditions that go beyond the general language in the applicable authorizing statute. Bankruptcy courts enjoy discretion to craft provisions to an order beyond a simple dismissal. The key is to restrict the order's extra provisions to matters otherwise authorized under the Bankruptcy Code. Section 105(a) of the Bankruptcy Code permits the court to "issue any order … that is necessary or appropriate to carry out the provisions" of the Bankruptcy Code. Thus, the conditions in a dismissal order are authorized when they are "necessary or appropriate" to implement Sections 305(a) and/or 1112(b) of the Bankruptcy Code.

The Supreme Court did not ban all structured dismissals in *Jevic*. In *Jevic*, the Supreme Court only addressed a particular feature (a "gifting" distribution that violated the Bankruptcy Code's absolute priority rules) of a structured dismissal order. *Jevic* merely held that structured dismissals cannot be approved if distributions are made to creditors in violation of the Bankruptcy Code's priority rules and the affected creditors have not consented. *Id.* at 983–7. Jevic is not a death-knell for structured dismissal. In fact, the Supreme Court noted that structured dismissals were "increasingly common" and "express[ed] no view about the legality of structured dismissals in general." *Id.* at 979 (quoting American Bankruptcy Institute Commission To Study the Reform of Chapter 11, 2012–2014 Final Report and Recommendations 270, n. 973 (2014).

According to a recent survey, in the five years since the *Jevic* decision in 2017 there have been at least 21 bankruptcy cases involving a structured dismissal. *See* Dennis J. Connolly & Christopher K. Coleman, The Increasing Utilization (and Challenges) of Structured Dismissals as an Alternative Disposition of Bankruptcy Cases, 2021 Ann. Surv. of Bankr.Law 1 (Oct. 2021). In nearly all of those cases (17 out of 21), parties in interest objected to the motion to dismiss. A majority of these objections focused on the treatment of the objector's individual claim and not the propriety of the structured dismissal itself. In each case where the U.S. Trustee filed an objection, the trustee challenged the legitimacy of a structured dismissal as opposed to targeting specific statutory infractions. Nonetheless, in 18 of those 21 cases, the bankruptcy court entered the structured dismissal order. That is an impressive record and provides a strong and credible basis to push for structured dismissals in the right circumstances.

In sum, the trend in favor of structured dismissals is a positive development for private credit lenders and adds a practical and efficient tool to their in-court restructuring tool box.

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[1] *Czyzewski v. Jevic Holding Corp*. 137 S. Ct. 973 (2017).

[2] Section 305(a)(1) provides that the "court, after notice and a hearing, may dismiss a case under this title, or may suspend all proceedings in a case under this title, at any time if—the interests of creditors and the debtor would be better served by such dismissal or suspension"

Section 1112(b) provides that “on request of a party in interest, and after notice and a hearing, the court shall convert a case under this chapter to a case under chapter 7 or dismiss a case under this chapter, whichever is in the best interests of creditors and the estate, for cause unless the court determines that the appointment under section 1104(a) of a trustee or an examiner is in the best interests of creditors and the estate.”

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