Structured Dismissals, or Cases Dismissed Outside the Code's Structure?

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A recent article, "*Structured Chapter 11 Dismissals: a Viable and Growing Alternative After Asset Sales*," discussed structured dismissals as an option for debtors who sell substantially all of their assets pre-confirmation, leaving them "with no unsecured assets to administer or with insufficient unsecured assets to fund a confirmable plan."[1] The authors describe a structured dismissal as follows:

> a dismissal coupled with some or all of the following additional provisions in the dismissal order: releases (some more limited than others), protocols for reconciling and paying claims, "gifting" of funds to unsecured creditors and provisions providing for the bankruptcy court's continued retention of jurisdiction over certain post-dismissal matters.[2]

They conclude that structured dismissals could be "the quickest and most cost-effective way to conclude your chapter 11 case."[3]

No one disputes that dismissal is appropriate in the right circumstances, including cases where insufficient assets exist to justify continued administration.[4] But the structured dismissals

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1 Norman L. Pernick & G. David Dean, *Structured Chapter 11 Dismissals: a Viable and Growing Alternative After Asset Sales*, 29 AM. BANKR INST. J., June 2010, at 1, 58-59 (2010) [hereinafter *Structured Chapter 11 Dismissals* or "the article"].

2 *Id.* at 58.

3 *Id.*

4 11 U.S.C. § 1112(b).

described in the article seem to fall outside the three paths for concluding a chapter 11 case under the Bankruptcy Code—confirming a plan, converting to chapter 7 or dismissing without "bells and whistles"—and may sacrifice critical bankruptcy safeguards included in the traditional statutory options.[5] Thus, properly evaluating structured dismissals requires comparison and contrast with the statutory options.

First, compared to plan confirmation, structured dismissals "end run . . . the protection granted creditors in chapter 11" and strongly resemble impermissible *sub rosa* plans.[6] Second, unlike chapter 7 liquidation, structured dismissals distribute assets without enforcing priorities, addressing litigation or ensuring accountability for distributing assets. Third, unlike traditional dismissals, structured dismissals fail to reinstate state law creditor remedies.

Plan Confirmation

***Updated Sub Rosa Plan*?**

Structured dismissals are typically sought after court approval of asset sales or settlements.[7] Courts treat a *proper* asset sale or settlement as "a step towards possible confirmation of a plan of reorganization and not an evasion of the plan confirmation process."[8] But courts generally disapprove asset sales or settlements that "short circuit . . . the Code's carefully crafted scheme for creditor enfranchisement,"[9] including "the safeguards of disclosure,

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5 *Id.* at 58 (three options are "traditionally chosen").

6 *See Institutional Creditors of Continental Air Lines, Inc. v. Continental Air Lines, Inc. (In re Continental Air Lines, Inc.*, 780 F.2d 1223, 1224 (5th Cir. 1986).

7 *E.g., Committee of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.)*, 722 F.2d 1063, 1071 (2d Cir. 1983); *Trailer Ferry Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson,* 390 U.S. 414 (1968).

8 *See Motorola, Inc. v. Official Comm. of Unsecured Creditors (In re Iridium Operating, LLC)*, 478 F.3d 452, 467 (2d Cir. 2007).

9 *PBGC v. Braniff Airways, Inc. (In re Braniff Airways, Inc.)*, 700 F.2d 935, 940 (5th Cir. 1983) [hereinafter *Braniff*].

voting, acceptance and confirmation."[10] *Braniff* is the seminal case rejecting an asset sale that predetermined future plan terms, calling it a "*sub rosa* plan."[11] Since *Braniff*, courts have widely adopted the *sub rosa* plan language and analysis, but many now require objecting parties to identify the specific rights or protections denied by the sale or settlement.[12]

Structured dismissals are a new permutation of the *sub rosa* plan. Because structured dismissals are sought separately from the earlier sale or settlement, the sale or settlement itself does not present *sub rosa* plan issues because nothing therein limits disclosure or voting or predetermines plan terms. It is the subsequent structured dismissal that defines or restricts what would otherwise have been in a plan, such as distribution of sale or settlement proceeds, or disenfranchises other creditor rights normally attendant to plan confirmation. This process effectively bifurcates a single *sub rosa* plan. Structured dismissals, therefore, should be similarly evaluated and disapproved where confirmation safeguards are circumvented.

Alternatively, a well-crafted sale order can avoid *sub rosa* plan bifurcation by precluding a subsequent structured dismissal. The estate does not generally benefit from a debtor-in-possession selling over-encumbered property, and the DIP can abandon it under §554 as burdensome or of inconsequential value. Most lenders, however, prefer that the DIP liquidate the collateral in a §363 sale so the creditor can reap its attendant benefits. Thus, the DIP can and should negotiate for some benefit to the estate for selling over-encumbered property under §363, including that secured creditors set aside sale proceeds to pay administrative expenses so the case

Field Code Changed

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10 *Lionel*, 722 F.2d at 1071.

11 *Braniff*, 700 F.2d at 949.

12 *Continental Air Lines*, 780 F. 2d at 1228; *In re Gulf Coast Oil Corp*., 404 B.R. 407, 422 (S.D. Tex. 2009).

can be administered in accordance with the Code.[13] A sale order can also require the parties to either confirm a plan or convert to chapter 7.

Omitted Confirmation Safeguards

Structured Chapter 11 Dismissals ignores important chapter 11 safeguards that structured dismissals omit, including voting, acceptance, disclosure and the "fair and equitable" standards, including the absolute priority rule.[14] Three provisions discussed in the article illustrate the point.

Releases and Exculpations

The article suggests including releases and exculpations in a structured dismissal.[15] Section 1141(d)(3), however, bars "non-individual" debtor discharges in liquidating plans, just as §727(a) bars equivalent discharges in chapter 7 liquidation. Thus, any release of a debtor entity in a structured dismissal contravenes the Code.

With respect to nondebtors, even with the procedural and substantive protections afforded by the disclosure statement and plan confirmation process, courts disagree about the permissibility of nonconsensual releases.[16] Courts consider the released party's contribution to reorganization and the litigation's impact on the ability to reorganize.[17] In a structured dismissal such justifications are absent because there is no reorganization.

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13 *See* 11 U.S.C. § 506(c).

14 *See Structured Chapter 11 Dismissals*, *supra* note 1, at 57-58.

15 *Id.* at 57. The scope of the releases may be rather broad and include those "traditional releases seen in a chapter 11 plan*."* *Id.*

16 *Airadigm Commc'ns v. FCC (In re Airadigm Commc'ns)*, 519 F.3d 640, 655-56 (7th Cir. 2008); *see also In re Continental Airlines*, 228 F.3d 203, 212-13 (3d Cir. 2000); *Bank of New York v. Official Unsecured Creditors' Comm. (In re Pacific Lumber)*, 584 F.3d 229, 252-53 (5th Cir. 2009).

17 *E.g., Airadigm*, 519 F.3d at 656.

Even in jurisdictions where nonconsensual releases are permitted at confirmation, they should not be permitted in a structured dismissal. A structured dismissal forecloses a creditor's ability to assess and negotiate releases because the creditor has neither the information typically provided through the disclosure statement nor the leverage afforded by plan voting. Disclosure statements must address litigation and release issues.[18] Plan voting and acceptance requirements then provide an opportunity for creditors and shareholders to obtain improved treatment, such as additional contributions from nondebtors seeking releases or the elimination of nondebtor releases as unnecessary or excessive. The Code's protections against improper releases and indemnification are absent in a structured dismissal, and a court should generally deny nonconsensual releases as inconsistent with chapter 11.

Modified Claims Objection Procedure

The article further recommends including an "expedited, cost-effective way to reconcile claims and distribute funds."[19] The suggested approaches include debtors unilaterally defining claim amounts in the dismissal motion and requiring creditors to object, requiring creditors to pay costs if they object and filing an omnibus claims objection that binds creditors who do not object.[20] These scenarios impermissibly alter the claim objection process defined in the Code and Federal Rules of Bankruptcy Procedure. "[T]he need for expedition . . . is not a justification for abandoning proper standards."[21]

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[18] *In re U.S. Brass Corp.*, 194 B.R. 420, 429 (Bankr. E.D. Tex. 1996); *In re Metrocraft Pub. Servs., Inc.*, 39 B.R. 567, 571 (Bankr. S.D. Ga. 1984).

[19] *Structured Chapter 11 Dismissals, supra* note 1, at 58.

[20] *Id.* (omitting citations to unpublished case examples).

[21] *TMT Trailer Ferry*, 390 U.S. at 450.

Rule 3003(b) generally defines the schedule of liabilities as "prima facie evidence of the validity and amount" of a creditor's claim, and §502(a) presumes the validity of a filed claim absent objection. [22] If a party objects to a proof of claim, the issue becomes a contested matter for hearing.[23] *Prima facie* validity for claims and mandatory hearings on claim objections "guard against abuse of the objection process. . . ."[24] Although the article posits that modified claim procedures are "cost-effective," in reality, each imposes extra burdens and costs on the creditor and impermissibly undermines protections afforded by the Code and the Rules.

'Gifting'

The third structured dismissal provision discussed is the "carveout or 'gift' trust."[25] When a debtor files for chapter 11 with substantially all assets encumbered, the secured creditor often seeks to monetize its collateral and reap the benefits of a sale under §363. Such sales are not unusual, but the deals negotiated to secure sale or settlement approval are often problematic. Although funds allocated for distribution to junior creditors in a structured dismissal may be funded from the proceeds of a lender's collateral, they should rarely be viewed as a "gift."

To have the sale or settlement approved without objection, either the secured creditor or the purchaser sets aside funds for the *sole* benefit of a particular group, usually general unsecured creditors, from proceeds otherwise payable to the secured lender. Because there will be insufficient estate funds after the sale to pay administrative expenses or priority creditors in full,

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22 A creditor that does not comply with the requirements of Rule 3001 does not enjoy *prima facie* validity. *In re Stoecker*, 5 F.3d 1022, 1028 (7th Cir. 1993) (Posner, J.) ("the creditor cannot rest on the proof of claim" if it failed to attach the documentation required under the Rule).

23 Fed. R. Bankr. P. 3007(a); Fed. R. Bankr. P. 9014.

24 9 Alan S. Resnick & Henry J. Sommer, COLLIER ON BANKRUPTCY, ¶ 3007.01[1] (15th ed. rev. 2009).

25 *Id.*

the lender makes a class-skipping "gift" to junior creditors who otherwise would receive no distribution under the Code's priority rules.

"Gifting" in structured dismissals contravenes the Code in several ways. First, the "gift" is typically provided in exchange for consideration, such as a release of claims or settlement of an objection. Because secured creditors do not typically make charitable contributions to their borrowers' junior creditors, the "gift" may actually resolve avoidance, liability or other litigation issues. Thus, the structured dismissal should be adjudicated under the rules governing settlement or plan confirmation.

Second, funds from the sale of a lender's collateral are estate property.[26] Accordingly, whether a senior creditor can "gift" directly to junior creditors—bypassing creditors in the middle—without violating the "absolute priority rule" is unsettled.[27] When a structured dismissal alters the Code's priorities of distribution, it should be reviewed under the standards for settlement approval or plan confirmation.[28]

Third, "gifts" in structured dismissals pose disclosure problems. Without the disclosure required for plan confirmation, creditors and shareholders can neither assess whether the lender is resolving potential litigation claims nor determine whether the settlement amount is proper.

Conversion to Chapter 7

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[26] *U.S. v. Whiting Pools, Inc.*, 462 U.S. 198, 203-04 (1983).

[27] The Second and Third Circuits have each held that in chapter 11 cases, "gifting" plans violate the absolute priority rule of 11 U.S.C. §1129(b)(2), without regard to whether the bypassed class would have received a distribution absent the gift. *See In re DBSD North America, Inc.*, __ F.3d __, No. 10-1175, 2011 WL 350480 (2d Cir. Feb. 7, 2011); *In re Armstrong World Indus., Inc.*, 432 F.3d 507 (3d Cir. 2005). However, *DBSD* and *Armstrong* leave open the question of whether gifting distributions would also be impermissible in a chapter 7 liquidation. *Cf. Official Unsecured Creditor's Comm. v. Stern (In re SPM Mfg. Corp.)*, 984 F.2d 1305, 1307, 1312 (1st Cir. 1993) (upholding undisputed lienholder's "gift" to unsecured creditors in chapter 7 liquidation).

[28] *See Iridium*, 478 F.3d at 467; *see also United States v. AWECO, Inc. (In re AWECO, Inc.)*, 725 F.2d 293, 298 (5th Cir. 1984).

Chapter 7 incorporates checks and balances that structured dismissals lack. These checks and balances make liquidation after a sale of substantially all estate assets preferable to a structured dismissal.

Because chapter 7 trustees must account for all estate assets,[29] the chapter 7 trustee makes a "final report" addressing the assets liquidated, the claims quantified and the distribution proposed.[30] The trustee then distributes funds in accordance with the "final report" and files a "final account."[31] Structured dismissals may include a post-dismissal distribution, but they lack oversight by a disinterested chapter 7 trustee and the chapter 7 safeguards against error or abuse.

Moreover, when a case converts to chapter 7 from chapter 11, chapter 7 administrative expenses have priority over chapter 11 administrative claims.[32] This chapter 7 administrative priority enables chapter 7 trustees to investigate preference, fraudulent transfer and litigation claims, as well as other possible assets. It also means that chapter 11 professionals will likely receive less and must wait for payment. A structured dismissal may avoid this result, giving the appearance that the chapter 11 professionals may be serving their own interests.

Dismissal and Section 349 Unwinding

The article also details various statutory grounds supporting dismissal of administratively insolvent cases.[33] No one disputes, however, that "cause" exists to convert or dismiss under §1112. Rather, the dispute is whether the cases should be converted, dismissed or dismissed with "bells and whistles" in a structured dismissal.

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29 11 U.S.C. § 704(a)(2).

30 11 U.S.C. § 704(a)(9).

31 *Id.*

32 *In re Rittenhouse*, 76 B.R. 610, 611 (Bankr. S.D. Ohio 1987).

33 *Structured Chapter 11 Dismissals, supra* note 1, at 56.

If a case should be terminated, it can be dismissed, returning parties to the *status quo ante* and preserving their rights under state law in accordance with §349. Section 349's purpose is "to undo the bankruptcy case, as far as practicable, and to restore all property rights to the position in which they were found at the commencement of the case."[34] Traditional dismissal, therefore, typically reinstates receiverships, avoided transfers and avoided liens, and revests property in the debtors.[35] Structured dismissals, however, distribute assets and limit or foreclose a creditor's state law property rights.

Although courts can alter the presumptive effect of §349(b) for "cause," the "power to override" §349(b)'s requirements "is used sparingly."[36] "'Cause' under §349(b) means an acceptable reason. Desire to make an end run around a statute is not an adequate reason. . . . It is not part of the judicial office to seek out creative ways to defeat statutes."[37]

Conclusion

Chapter 11 is designed to administer estates and to allocate rights and obligations through court-approved disclosure statements and plans. Alternatively, the Code provides for liquidation and distribution after conversion to chapter 7 or dismissal in accordance with §349's reinstatement of state law rights.

The purported need for a structured dismissal is often foreseeable—and thus avoidable—when estates arrive in chapter 11 over-encumbered by liens with a sale of substantially all estate assets the obvious strategy. Although parties may thereafter look for the "quickest and most cost-effective" exit from chapter 11, the supposed expediency of a structured dismissal should

34 H.R. Rep. No. 95-595, at 338 (1977); S. Rep. 95-89, at 48-49 (1978).

35 *See* 11 U.S.C. § 349(b) (referencing reinstatement of these transactions).

36 3 Alan S. Resnick & Henry J. Sommer, COLLIER ON BANKRUPTCY, ¶ 349.03[2] (16th ed. rev. 2010).

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

not trump the statutory protections it alters or ignores. Cases should be administered according to the structure set forth in the Code and not concluded in a summary manner that is "structured," but flawed.