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CREDITOR'S RIGHTS TOOLKIT

What Is a Structured Dismissal of a Bankruptcy Case and How Does It Affect Creditors?

More often than not, Chapter 11 debtors seek to exit bankruptcy by confirming a Chapter 11 plan of reorganization or liquidation. However, not only is this approach expensive, but it requires that the debtors have sufficient funds to pay administrative and priority claims in full in order to confirm the plan.

While a company can simply convert its case to Chapter 7 where the estate is administratively insolvent, conversion creates uncertainty as management is replaced with the Chapter 7 trustee and results in additional costs while the Chapter 7 trustee and their professionals get up to speed. Another option is dismissal of the case. However, a straight dismissal may fail to adequately protect the debtor or other interested parties who return to their positions before the bankruptcy with their state law rights and remedies intact. Because of these issues, there has been a rise in the use of structured dismissals.

Key Issues

- **WHEN ARE STRUCTURED DISMISSALS USED?**

  A structured dismissal is most often used when substantially all of the debtor's assets have been sold, most of the sale proceeds have been paid over to secured creditors but there remains some funds to still distribute, a plan process is either not practicable or not cost-effective, and creditors would not benefit materially from a conversion to Chapter 7 or dismissal of the case. The structured dismissal results in dismissal of the Chapter 11 bankruptcy case but in a structured way that may provide important additional relief for the debtor, creditors, and third parties.

- **HOW ARE STRUCTURED DISMISSALS STRUCTURED?**

  A court order approving a structured dismissal may include certain relief and features that may be found in a Chapter 11 plan. For example, a structured dismissal order may contain (i) a process for claims reconciliation and contemplate potential distributions to creditors, (ii) releases or exculpation to the debtor and certain third parties and (iii) language ensuring the continued effectiveness of the bankruptcy court's prior orders including any sale orders. Additionally, a structured dismissal order often includes conditions subsequent to entry of the order that must be satisfied before the case can be dismissed, such as making distributions to creditors. Creditors should review the scope of these provisions and conditions to understand not only how the structured dismissal will work, but also how these particular features may affect their rights and interests.

- **HOW DO PAYMENTS TO CREDITOR WORK IN A STRUCTURED DISMISSAL?**

  The Supreme Court has ruled that creditor distributions made pursuant to a structured dismissal of a Chapter 11 case may not violate the priority scheme outlined in the Bankruptcy Code. In other words, the structured dismissal cannot be structured so that unsecured creditors leapfrog over more senior creditors. As such, as in a Chapter 11 plan, unsecured creditors cannot receive a recovery before all creditors of a senior priority receive a recovery in full. Even if they are not receiving any distributions in a structured dismissal, some unsecured creditors still may perceive a benefit in the structured dismissal from rather than conversion to Chapter 7, since, for example, the dismissal eliminates potential liability on preferential transfers the creditor may have received in the 90 days before bankruptcy (which might otherwise be pursued by a trustee if the case were converted to Chapter 7). At the same time, holders of administrative or priority claims may view the structured dismissal as the best way to get paid something promptly on their claims, even if it is less than payment in full, and rather than the limited funds being spent on Chapter 7 trustee fees.

Takeaway

Under the right circumstances, a structured dismissal can be an effective tool for a debtor to exit Chapter 11 bankruptcy and may provide additional protections and benefits to creditors. In fact, a structured dismissal may represent the "best of all worlds" by copying certain beneficial characteristics of the other three exit options, such as providing distributions according to the Bankruptcy Code's priority scheme and ensuring that orders entered in the bankruptcy case remain in effect, while escaping some pitfalls plaguing the other options, such as a Chapter 11 plan's price tag or the cost and delay of a Chapter 7. Regardless, creditors should retain competent legal counsel to help them analyze and maneuver through the particular features of a proposed structured dismissal to ensure their rights are sufficiently protected.