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# Bankruptcy Court Frowns on SmileDirect's Dismissal Request

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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 debtor 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 chapter 7 trustee to replace management. While the trend towards structured dismissal may continue to grow, we write to highlight a recent decision in which a bankruptcy court denied a request by debtors to approve a sale of their assets to insiders, which was coupled with a request for a structured dismissal.

*What is a structured dismissal?*

Readers are encouraged to review our January 2022 alert (Private Credit Lenders: What's a "Structured Dismissal" and Why Should You Care? - Insights - Proskauer Rose LLP), where we covered the basics of the structured dismissal and where it might be the right tool for the most optimal outcome. By way of review, the "structured" dismissal of a chapter 11 case may occur when a debtor exits bankruptcy without confirming a chapter 11 plan but retains many of the beneficial rulings obtained from the court during the pendency of the case. For example, the debtor may have conducted one or more successful asset sales, but still finds itself without the financial wherewithal to propose a confirmable chapter 11 plan. Often this is the case after a credit bid sale where the debtor lacks sufficient cash to pay priority unsecured claims (which must be paid in full in cash under a plan) or, less common, administrative expenses (which also must be paid in full in cash under a plan). In these circumstances, rather than converting the case to chapter 7, the debtor may ask the court to order the structured dismissal of the case. In the order approving the dismissal, the debtor may obtain a finding that all prior orders of the bankruptcy court remain in effect.

In a structured dismissal, a 363-sale buyer can still retain the benefits of their "free and clear" sale order, and the estate retains whatever benefit may have resulted from the sale. Such benefits may include liquidating assets that might otherwise cause a continued drain on the estate's limited resources. Similarly, a debtor's post-petition lenders may support entry of a dismissal order that ratifies the court's prior orders, including any release provided to the post-petition lender in connection with the court's approval of DIP financing. The key takeaway is that the order approving a structured dismissal typically allows parties to retain certain of the benefits of chapter 11, including releases, even if confirmation of a chapter 11 plan cannot be obtained.

*SmileDirect*

On January 24, 2024, Judge Christopher Lopez of the United States Bankruptcy Court for the Southern District of Texas denied the debtors' motions in SmileDirectClub, Inc., Case No. 23-90786 (Bankr. SD. Tex.) ("SmileDirect") seeking approval of a sale of their remaining assets to their DIP lenders followed by a structured dismissal. The Court denied both motions and the cases were converted to chapter 7.

In SmileDirect, the debtors had engaged in a marketing process to sell their assets. When they could not find a third-party buyer, the debtors pivoted and sought approval of a sale to their DIP lenders/founders. The proposed sale would provide (i) a credit bid of the insiders' approximately $25 million in DIP claims, (ii) $4 million in cash for distribution to administrative expense claimants, and (iii) up to $3 million of additional cash for distribution to administrative expense claimants from a subsequent liquidation of additional "hard" assets (inventory, equipment) and "select" assets (cash and a promissory note).

In addition, the debtors proposed to establish a "Creditor Trust" to investigate and potentially pursue breach of fiduciary duties claims against the CEO, the current CFO, the former CFO, and the Chief Clinical Officer. However, these claims would be limited in scope and recovery would be capped at the policy limits under the debtors' D&O insurance policies. The proposed sale order would release all other estate claims against the debtors' insiders, including chapter 5 causes of action.

Significantly, the debtors proposed the sale and the structured dismissal as a combined "package" deal in a "global" settlement.

Despite the debtors' efforts to promote the sale as part of a global settlement, cracks in the debtors' plan to sell their assets to insiders, and release claims against them, began to show immediately. Several creditors objected to the sale and dismissal on the grounds that the sale would greatly benefit the debtors' insiders, while providing little or no benefit to creditors. The objectors argued that, if approved, the debtors' insiders would have their personal assets shielded from potentially valuable estate claims. Moreover, while the debtors did establish a "special committee" to evaluate the sale, the objectors argued that the debtors failed to provide the court or creditors with any analysis as to the value the claims being released. Further, the objectors believed the equity value in certain non-debtor subsidiaries, which held up to $41 million in receivables, coupled with the potential value of the debtors' hard and select assets, as well as the potential value of other assets, could yield greater recoveries for creditors.

*Objectors urge conversion to chapter 7*

The objectors argued that the proposed sale and dismissal had many of the hallmarks of a chapter 11 plan (releases, carve-out of causes of action against insiders, establishment of a creditor trust), without a plan process. Moreover, the objectors argued that, to be approved, any sale transaction with insiders must be evaluated by the court under the "heighted scrutiny" standard, and this transaction could not withstand such scrutiny.

The objectors argued for the conversion of the cases to chapter 7 and the appointment of a chapter 7 trustee. A chapter 7 trustee, according to the objectors, would "preserve optionality" because the chapter 7 trustee, as an independent fiduciary, would have the opportunity to evaluate the proposed sale transaction, and if the transaction made sense, the chapter 7 trustee could pursue the sale. On the other hand, the chapter 7 trustee would also have the ability to investigate potential causes of action against all insiders and could pursue such actions for the benefit of creditors. It should be noted that the Statutory Committee of Unsecured Creditors (the "Committee") supported the sale and structured dismissal, but as pointed out by the court, the Committee did not explain its rationale for such support.

Following a two-day hearing on the sale and dismissal, the court determined to deny the debtors' motions and issued an order converting the cases to chapter 7.

In his ruling, Judge Lopez acknowledged that the debtors and their professionals had commenced the cases in good faith and sought a sale to the highest bidder. Further, the court recognized that, while the sale and dismissal were sought by two separate motions, the proposed sale was inextricably connected with the required structured dismissal, which contained a broad release of the DIP lenders/founders. The court was focused on the fact that it was presented as a package deal - if the structured dismissal was not approved, the DIP lender could walk away from the sale.

In siding with the creditors, the court noted that appropriate legal standard to review the sale and dismissal was the "best interests" of creditors, and that the debtors failed to establish how the proposed sale was in the best interests of creditors, especially in light of the creditor opposition. It followed, then, that the dismissal could not be approved. Further, in analyzing the proposed settlement, the court found that the estate was clearly administratively insolvent, which meant that creditor recoveries would be compromised, and this "weighed heavily" on the court's determination as to whether to approve the transaction.

In weighing all these factors, Judge Lopez found that the proposed sale, followed by a dismissal, went "too far" for the court to find that it was in the best interest of creditors. As noted by the court, "no creditor is going to receive a dollar" from the sale and there was not a single creditor that said they supported the proposal. Other than the Committee (who did not articulate a reason for their support), every other creditor who spoke was opposed to the settlement. In the final analysis, the court agreed with the objectors that the transaction "incorporates too many elements of a chapter 11 plan without a plan process." If there had been creditor support, according to Judge Lopez, the result would have been different.

At the conclusion of the SmileDirect hearing, Judge Lopez noted that he would convert the cases to chapter 7, but he indicated a willingness to wait a few days before entering the order. Presumably, this slight delay would give the parties time to reconsider whether there was some other path forward, such as proposing a sale to the DIP lenders without the objectionable releases. However, after two days, no alternative path was proposed and the court entered the order converting the cases to chapter 7.

*Conclusion*

SmileDirect is an outlier, but it is significant insofar as it highlights an approach that may not succeed when developing an exit strategy.  Despite the inability to obtain the dismissal in this case, the trend in favor of dismissals will likely continue on a positive trajectory and we anticipate debtors will continue to utilize dismissal as a viable, efficient, and cost-effective means to exit chapter 11.

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