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Asset Sales and Structured Dismissals in Chapter 11

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This article focuses on assets sales and structured dismissals. The author concludes that courts are more frequently inclined to consider entering structured dismissal orders rather than require a debtor to file a liquidating plan after a sale of assets.

Chapter 11 of the Bankruptcy Code was established to provide companies with breathing room while they reorganize. However, in the past several years, while some companies have sold assets in the context of a reorganization plan, many Chapter 11 cases have evolved into a sale of substantially all of a debtor's assets followed by a liquidating plan, a conversion to Chapter 7 or most recently through a structured dismissal. Typically, the selection of a "stalking horse" bidder[1] is followed by approval of bid procedures, an auction and finally a hearing seeking entry of an order approving the sale. After the sale has concluded, rather than spend resources on a liquidating plan, some debtors have sought a structured dismissal in which the dismissal order identifies how proceeds are to be distributed, while the bankruptcy court retains jurisdiction to approve fees and to resolve claim objections.

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SALE IN A REORGANIZATION PLAN

One option for a debtor is to sell substantially all of its assets by incorporating the sale in a reorganization plan. Some courts have held that sales should typically occur within the context of a plan. For example, in the seminal case on this issue, the United States Court of Appeals for the Seventh Circuit held that there must be a business justification, other than the agreement of major creditors, for selling property under § 363 outside of a plan.[2] One of the benefits of selling real estate assets in a plan is the avoidance of recordation taxes under 11 U.S.C. § 1146(a).[3] The downside of selling assets within a plan is the length of time and the expense of the disclosure statement and confirmation process. However, the sale of assets within a plan also eliminates the auction process thereby limiting any potential price increase that often results when an auction is held.

SALE OUTSIDE OF A PLAN

In considering sales outside of a plan, courts evaluate what have come to be known as the *Lionel* factors:

- the proportionate value of the asset to the estate as a whole;
- the amount of elapsed time since the filing;
- the likelihood that a plan of reorganization will be proposed and confirmed in the near future;
- the effect of the proposed disposition on future plans of reorganization;

the proceeds to be obtained from the disposition vis-à-vis any appraisals of the property;

- which of the alternatives of use, sale or lease the proposal envisions; and
- whether the asset is increasing or decreasing in value.[4]

In *In re General Motors Corp.*,[5] the debtor sought to sell substantially all of its assets in a § 363 sale outside of a plan. The bankruptcy court approved the sale, determined it was not a sub rosa plan, and held that the purchaser would have no successor liability.[6] The court also commented that neither the Bankruptcy Code nor case law requires waiting for plan confirmation to sell assets when liquidation is inevitable.[7] "After *Lionel*, *LTV, FNN, Gucci, Iridium*, and of course, *Chrysler*, it is now well established that a chapter 11 debtor may sell all or substantially all of its assets pursuant to § 363(b) prior to confirmation of a chapter 11 plan, when the court finds a good business reason for doing so."[8] Similarly, in *In re Chrysler, LLC*,[9] the Debtors sought to sell substantially all of their operating assets outside of a plan. After reviewing *Lionel* and subsequent decisions, the court concluded that the proposed sale was not a sub rosa plan and that the debtors had established a good business reason for the sale.[10]

In re Summit Global Logistics, Inc.,[11] the court held that for a sale outside a plan, a debtor must prove: a sound business purpose; fair sales price; adequate and reasonable notice given; and buyer's good faith. In *In re Iridium Operating, LLC,*[12] the court approved a settlement agreement which was not deemed to a sub rosa plan of reorganization. The court confirmed the concern that sub rosa plans would be used to circumvent the Chapter 11 confirmation process.[13] However, in this case, the bankruptcy court identified a proper business justification for approving the settlement.[14]

MOTION TO SELL ASSETS

A sale of substantially all of the debtor's assets outside of a plan has become a more frequent way of resolving Chapter 11 proceedings. Section 363(b) of the Bankruptcy Code provides that a debtor "after notice and a hearing, may use, sell or lease, other than in the ordinary course of business, property of the estate."[15] To obtain court approval to use property under § 363(b) of the Bankruptcy Code, the Debtor need only show a legitimate business justification for the proposed action.[16]

Usually, the purchaser's offer is explicitly subject to both approval of the court and to any higher and/or better offer(s) that may be made in accordance with bidding and auction procedures approved by the court. Typical bidding and auction procedures include the following:

- Approval of an expense reimbursement to be paid to the purchaser in the event that it is not the successful bidder for the asset sale (a break-up fee);[17]

- Approval of an initial overbid amount (in excess of the initial offer, plus the break-up fee);
- A deposit; and
- Form of bid (usually based on stalking horse's asset purchase agreement).

In terms of notice, Fed. R. Bankr. P. 6004 governs sales of property. Detailed sale information is required to be included in the notice. To be safe, and to minimize "sub rosa plan" objections, it is the better practice to have a notice that mirrors the kind of information contained in a disclosure statement. That practice eliminates an objection that creditors have insufficient information to make an informed decision whether or not to object.

STRUCTURED DISMISSALS

A relatively recent bankruptcy court phenomenon is to have a dismissal conditioned upon certain agreed upon elements, as opposed to a court unconditionally dismissing the bankruptcy proceedings. Structured dismissals after a sale of assets are typically seen in two situations. The first is where a debtor has sold substantially all of its assets outside of a plan, but is either administratively insolvent or may be administratively insolvent and does not have sufficient liquidity to fund the plan confirmation process.

In the second scenario, the debtor has sold substantially all of its assets in a sale under § 363 and could confirm a liquidation plan, but the plan confirmation process likely would eliminate or significantly reduce the funds available to pay creditors. For debtors in either of these scenarios, a structured dismissal could provide an efficient and cost-effective means to conclude a Chapter 11 case, while avoiding the delay and expense associated with the conversion to Chapter 7 or plan confirmation.

Parties seeking bankruptcy court approval of a structured dismissal generally rely on § 1112(b) and/or § 305(a)(1) of the Bankruptcy Code, in conjunction with § 105(a) of the Bankruptcy Code, which permits a bankruptcy court to enter orders that are "necessary or appropriate to carry out the provisions of" the Bankruptcy Code.

Section 1112(b) authorizes the bankruptcy court to dismiss a Chapter

11 case for "cause." Cause includes: "a substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation." Once the bankruptcy court finds "cause," the court must then determine whether dismissal is in the best interests of creditors of the estate.[18] The bankruptcy court ordered dismissal because it believed that consensus of the majority of creditors favored dismissal.[19] However, the Fourth Circuit reversed, concluding that the bankruptcy court had failed to consider the interests of all creditors, including the largest creditor.[20] The Fourth Circuit expressed a concern that dismissal would result in unequal access to the debtor's assets which is precisely that bankruptcy is designed to avoid.[21] The Fourth Circuit concluded that, had the bankruptcy court taken into account all creditors' interests, the court would likely have concluded that conversion to Chapter 7 made more sense than dismissal.[22]

Section 305(a) of the Bankruptcy Code also may provide additional statutory support for structured dismissals, providing that a bankruptcy court can dismiss a case under any Chapter of the Bankruptcy Code if "the interests of creditors and the debtor would be better served by such dismissal."[23]

Historically, § 305(a) has been used to dismiss involuntary cases. However, more recently, the statute has been applied to dismiss voluntary cases as well. Because dismissals granted under § 305(a) are non-appealable, § 305(a) dismissals are acknowledged as an "extraordinary remedy," and accordingly, § 305(a)(1) "requires more than a simple balancing of harm to the debtor and its creditors.[24]

Most structured dismissal orders that have been approved were entered consensually. There are few reported or unreported decisions regarding structured dismissals. Accordingly, it is difficult to predict how a bankruptcy court would rule on structured dismissals if contested. However, more bankruptcy courts have been willing to entertain structured dismissals as a means to close a Chapter 11 case. Accordingly, debtors should consider whether a structured dismissal would be the most appropriate exit strategy to pursue.

Several courts have signed structured-dismissal orders that arguably go well beyond earlier plain-vanilla dismissal orders, although most have been entered consensually.

Here are some examples of provisions[25] that have been approved:

- Release and exculpation provisions which range from more traditional plan releases to specific releases described in the structured-dismissal motion.
- There is usually an expedited claims-reconciliation process to resolve claim objections.
- Carveouts and "gift" trusts. As a quid pro quo for a consensual structured dismissal, a senior secured lender often agrees to carve out a portion of its collateral from the sale proceeds and "gift" it to a trust[26] for the unsecured creditors.
- Enforceability of prior orders and retention of jurisdiction. Structured dismissal orders often provide that, notwithstanding § 349 of the Bankruptcy Code (vacating bankruptcy court orders when a case is dismissed), prior bankruptcy court orders of the court survive dismissal.[27]
- Another common provision requires a bankruptcy court's retention of jurisdiction, at least over fee applications and implementation of the structured-dismissal order.[28]

Three attorneys in the U.S. Trustee's Office[29] have written a piece highlighting their perception of the problems with structured dismissals. They believe a structured dismissal allows for "an end-run" around the protection Chapter 11 provides creditors just like a "sub rosa plan."[30] Also, in a structured dismissal, distributions can be made without enforcing priorities or assuming accountability as envisioned by the Code.[31] Finally, structured dismissals do not reinstate state law creditor remedies.[32]

In one recent case, the debtor filed a motion to dismiss after the sale of substantially all of its assets, seeking a "structured dismissal."[33] One can guess that the outcome won't be pretty when the opinion starts with: "This matter offers an object lesson in how not to run a Chapter 11 case."[34] The IRS objected to the motion to sell and, after castigating the debtor, its counsel and the US Trustee, the court denied the motion and instead granted the US Trustee's motion to convert to Chapter 7.[35] In a footnote, the court discussed some of the provisions typically included in a structured dismissal.[36] The court also referenced the objections voiced by several attorneys in the US Trustee's Office in the article mentioned previously.[37]

On the other hand, the Third Circuit has upheld a structured dismissal over the debtor's objection.[38] After the individual debtor sought an unconditional dismissal of his Chapter 7 proceeding, the trustee filed a cross-motion to dismiss with certain conditions (payment of professional fees and conditions to protect creditors).[39] The bankruptcy court granted the trustee's motion and the district court affirmed.[40] The Third Circuit agreed that the bankruptcy court did not abuse its discretion by dismissing with conditions.[41] "The trustee argued that a structured dismissal with conditions was in the best interests of the parties, particularly in light of the estate's continued expenditure of legal fees in response to *Fleurantin*'s motions and other efforts to obstruct its administration."[42] The Third Circuit noted that the bankruptcy court, which was well aware of those circumstances, evidently agreed. *Fleurantin* raised nothing suggesting that the bankruptcy court abused its discretion in doing so.[43]

Similarly, in *In re Felda Plantation, LLC,*[44] the debtor filed a motion for a structural dismissal. The court granted the motion and the dismissal order included the following:

- notwithstanding dismissal, all orders entered in the bankruptcy survived dismissal;
- the court retained jurisdiction to rule on fee applications;
- the debtor was ordered to pay outstanding U.S. trustee fees and professional fees; and
- the debtor was ordered to pay creditors as set forth in the dismissal order.

CONCLUSION

It appears that, notwithstanding the opposition from the Office of the United States Trustee, courts are more frequently inclined to consider entering structured dismissal orders rather than require a debtor to file a liquidating plan after a sale of assets. The benefit of this approach is that there will likely be more money to distribute to unsecured creditors and administrative fees and costs can be reduced considerably. To alleviate the concerns raised by opponents, courts can carefully craft structured dismissal orders such that the language provides the same kind of creditor protections identified in the Bankruptcy Code.

NOTES

1 A "stalking horse" is the first one willing to sign an asset purchase agreement which sets the bar for potential competitor bidders. The stalking horse is usually rewarded with a break-up fee if outbid at auction.
2 *In re Lionel Corp*, 722 F.2d 1063, 1070 (7th Cir. 1983).
3 This is a special tax provision that exempts a sale in a plan from taxation. 11 U.S.C. § 1146(a). A sale outside of a plan does not enjoy the same benefit.
4 *In re Lionel Corp*, 722 F.2d at 1091, *see also In re GSC, Inc.*, 453 B.R. 132, 155 (Bankr.S.D.N.Y. 2011) (sale of assets was not impermissible sub rosa plan).
5 407 B.R. 463 (Bankr. S.D.N.Y. 2009).
6 *Id.* at 496. *See also In re Naron & Wagner, Chartered,* 88 B.R. 85, 88 (Bankr. D. Md. 1988) (proposed sale was not sub rosa plan because it sought only to liquidate assets, not to restructure creditors' rights); *Severstal Sparrows Points, LLC v. EPA*, 794 F. Supp. 2d 624, 630 (D. Md. 2011) (no successor liability for pre-closing environmental problems); *but see In re Grumman Olson Indus. Inc.*, 445 B.R. 243, 245 (S.D.N.Y. 2011) (granting summary judgment to injured party against debtor's successor for post-sale injuries).
7 407 B.R. at 489. The court took guidance from general previous secured claims, including *Lionel, Financial News Network, Gucci* and *Iridium* decisions on the sale of assets outside of a plan.
8 *In re General Motors*, 407 B.R. at 491; *see also In re Boston Generating, LLC*, 440 B.R. 302, 335 (Bankr. S.D.N.Y. 2010) (approving sale of substantially all assets outside of plan based on satisfaction of *Lionel* factors); *In re Montgomery Ward Holding Corp.*, 242 B.R. 147, 154 (D. Del. 1999) (*Lionel* factors provided guideline only and did not require debtor to establish reasonable likelihood of successful reorganization).
9 405 B.R. 84, 92 (Bankr. S.D.N.Y. 2009).
10 *Id.* at 96.
11 2008 WL 819934*9 (Bankr. D. N.J. March 26, 2008).
12 478 F.3d 452, 466 (2d Cir. 2007).
13 *Id.* at 466.
14 *Id.* at 467.

15 *See In re Ames Dept. Stores, Inc.*, 136 B.R. 357, 359 (Bankr. S.D.N.Y. 1992).
16 *See, e.g., In re Martin,* 91 F.3d 389, 395 (3d Cir. 1996) (citing *Fulton State Bank v. Schipper (In re Schipper)*, 993 F.2d 513, 515 (7th Cir. 1991)).
17 *In re 995 Fifth Ave. Assocs., L.P.*, 96 B.R. 24, 28 (Bankr. S.D.N.Y. 1989) (bidding incentives may "'be legitimately necessary to convince a "white knight" to enter the bidding by providing some form of compensation for the risks it is undertaking'") (citation omitted); *In re Marrose Corp.*, 1992 WL 33848, at *5 (Bankr. S.D.N.Y. Feb. 15, 1992) ("agreements to provide breakup fees or reimbursement of fees and expenses are meant to compensate the potential acquirer who serves as a catalyst or 'stalking horse' which attracts more favorable offers."); *Official Committee of Subordinated Bondholders v. Integrated Res., Inc. (In re Integrated Res., Inc.),* 147 B.R. 650, 657-58 (S.D.N.Y. 1992) (establishing three basic factors for determining whether to permit breakup fees in bankruptcy: whether relationship between initial bidder and seller is tainted by self-dealing or manipulation; whether fee is designed to encourage bidding; and whether amount of the fee is reasonable in relation to purchase price).
18 *See, e.g., In re Superior Siding & Window,* 14 F.3d 240, 242 (4th Cir. 1994).
19 *Id.*; *see also In re First Connecticut Consulting Group, Inc.*, 340 B.R. 210, 221-22 (D. Vt. 2006) (dismissing Chapter 11 at creditor's request); In re *Schur Management Co., Ltd.*, 323 B.R. 123, 129, n. 5 (Bankr. S.D.N.Y. 2005) (bankruptcy dismissed as premature).
20 14 F.3d at 243.
21 *Id.*
22 *Id.*
23 11 U.S.C. 305(a)(1).
24 11 U.S.C. §305(c); *See, e.g., In re Monitor Single Lift I Ltd.*, 381 B.R. 455, 463 (Bankr. S.D.N.Y. 2008) (dismissal under Section 305 appropriate only when creditors and debtor would be better served by dismissal).
25 For a more detailed review with citations, *see* Norman L. Pernick and G. David Dean, "Structured Chapter 11 Dismissals: A Viable and Growing Alternative after Asset Sales," 29 Am. Bankr. Inst. J., June, 2010.
26 For an in depth review of "gifting" *see* Ted Gavin, "The Paradox of Dueling Trustees: The Evolving Nature of SPM 'Gifts,'" ABI Journal, June, 2011. Similar to their views of structured dismissals, some US Trustees have objected to "gifting" as violating the priority scheme in bankruptcy.
27 *See, e.g., In re Felda Plantation, LLC*, 2012 WL 1965964 (Bankr. D. Fla. May 29, 2012 (notwithstanding dismissal, all orders remain in full force and effect);

see also In re Professional Golf Management MICC, LLC, 2007 WL 1847529 *1 (Bankr. E.D.N.Y. Jan. 30, 2007) (creditors committee's objection to structured dismissal motion in part because no provision for reserves and no provision for validity of existing orders, stipulation and agreements).

[28] *Id.*

[29] "Structured Dismissals, or Cases Dismissed Outside the Code's Structure?" Nan Roberts Eitel, T. Patrick Tinker and Lisa L. Lambert, Office of the United States Trustee, ABI Journal, March, 2011.

[30] *Id.*

[31] *Id.*

[32] *Id.*

[33] *In re Strategic Labor, Inc.,* 467 B.R. 11 (Bankr. D. Mass. March 5, 2012).

[34] *Id*. at 13.

[35] *Id*. at 25-26.

[36] *Id.* at 26 Note 10.

[37] *Id*.

[38] *In re Fleurantin*, 420 Fed. Appx. 194 (3rd Cir., March 28, 2011).

[39] *Id*. at 195.

[40] *Id*.

[41] *Id*. at 197.

[42] *Id*.

[43] *Id*.

[44] WL 1965964 (Bankr. N.D. Fla. May 29, 2012).