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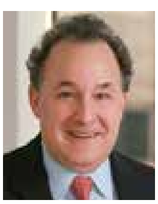
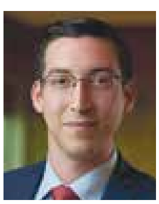
Bankruptcy Court Chooses Dismissal Over Conversion Based on the Support of the Debtor and All Key Creditors

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Financially distressed debtors frequently use Chapter 11 to sell their businesses and assets in one or more transactions, primarily in order to pay down secured debt obligations owed to one or more lenders. In the best case, the debtor will generate sufficient sale proceeds to satisfy all of their secured debt, pay administrative and other priority claims against the bankruptcy estate, and confirm a Chapter 11 plan that provides distributions to unsecured creditors. Unfortunately, in many cases, the debtor is left with insufficient sale proceeds, after paying its secured claims, to pay administrative and priority claims—which must be paid in full as a condition for obtaining court approval of a Chapter 11 plan. Under these circumstances, the Chapter 11 plan process is simply untenable and provides no benefit to many unsecured creditors, such as trade creditors.

Worse yet for unsecured creditors is the risk of conversion of the debtor's Chapter 11 case to a Chapter 7 case. Conversion exposes trade creditors to the possibility that the Chapter 7 trustee appointed to administer the debtor's bankruptcy case will seek to reel in value for the debtor's estate by commencing lawsuits against creditors to recover preference claims.

Trade creditors should find comfort in a recent decision by the United States Bankruptcy Court for the Western District of Michigan (the "Bankruptcy Court"). In *In re Goodrich Quality Theaters, Inc.*, the Bankruptcy Court denied a motion to convert the Chapter 11 case to a Chapter 7 case by the Office of the United States Trustee ("UST") where the debtor, its Chapter 11 and prepetition secured lenders, and the creditors' committee opposed conversion and instead sought to dismiss the case. The Bankruptcy Court ultimately granted the debtor's motion to dismiss, finding that dismissal, rather than conversion, was in the best interests of the debtor's estate and its creditors. The primary factors that the Bankruptcy Court considered were that all of the key parties to the case (other than the UST) supported dismissal, and the debtor's motion to dismiss did not seek to ignore the Bankruptcy Code's priority rules.

Trade creditors benefit from the *Goodrich* decision to the extent that dismissal of a Chapter 11 case eliminates preference risk while conversion of the case creates a risk that a trustee will assert preference claims against the trade. Dismissal in lieu of conversion eliminates the double loss that trade creditors would incur from not receiving any recovery on their unsecured claims and then having to pay in response to a trustee's assertion of preference claims against them.

Chapter 11 Debtor's Post-Sale Exit Strategy

Following a Chapter 11 debtor's sale of its business, the debtor can take one of three actions to exit from a Chapter 11 case. First, a debtor can propose and seek court approval of a Chapter 11 plan of liquidation that provides for cash distributions to creditors. However, one of the requirements for confirming a plan is that the debtor's estate must have sufficient cash to pay all administrative expenses and other priority claims in full. That is no easy task where the debtor has one or more secured lenders with large claims that the debtor is unable to fully pay from sale proceeds and other estate assets, or the debtor is otherwise left with insufficient cash to fully pay administrative expense claims, leaving the debtor administratively insolvent.

A Chapter 11 debtor left with insufficient available cash to confirm a plan then has two remaining options to exit from Chapter 11: (i) conversion of the case to a Chapter 7 liquidation, or (ii) dismissal of the Chapter 11 case. Bankruptcy Code section 1112(b) provides the statutory basis for conversion or dismissal of a Chapter 11 case—the bankruptcy court must find that "cause" to dismiss or convert exists based on the best interests of creditors and the estate. Courts will find that cause exists where the debtor is administratively insolvent and lacks sufficient cash to satisfy the requirements for court approval of a Chapter 11 plan.

Following conversion of a debtor's Chapter 11 case to a Chapter 7 case, a trustee is appointed and takes control of the debtor's assets and administers the debtor's estate. A Chapter 7 trustee has the power to sell estate assets, pursue estate causes of action (such as preference claims), reconcile claims asserted against the debtor's estate, and make distributions to creditors.

On the other hand, dismissal of a bankruptcy case revests estate property to the debtor entity that owned the property prior to the bankruptcy filing. In essence, dismissal returns the parties to essentially the same position in which they found themselves prior to the bankruptcy. As a result, causes of action arising under the Bankruptcy Code, such as preference claims, are extinguished and cannot be pursued against creditors.

It has become common practice for a debtor to seek dismissal of a Chapter 11 case following a sale of substantially all of the debtor's assets where the debtor is left with insufficient assets to satisfy the requirements for confirmation of, and otherwise provide funding for, a Chapter 11 plan. The debtor and other stakeholders might negotiate a "structured dismissal" of the case, where they agree that the order dismissing the case will provide distributions to certain creditors, including, in some cases, unsecured creditors. Pursuing such a dismissal allows the debtor (and, in turn, its creditors) to avoid incurring the substantial administrative expenses of pursuing a futile Chapter 11 plan process.

In a landmark decision issued in 2017 in *Czyzewski v. Jevic Holding Corp.* ("Jevic"), the United States Supreme Court held that structured dismissals that violate the priority rules of the Bankruptcy Code are impermissible. The *Jevic* decision has impeded a debtor's ability to pursue a structured dismissal that provides for a distribution to unsecured creditors where administrative expense and other higher priority claims are not paid in full. However, the Bankruptcy Court's decision in the *Goodrich* case makes clear that a court can entertain a structured dismissal of a Chapter 11 case and deny conversion of the case to Chapter 7 where the relief requested as part of the structured dismissal does not violate the Bankruptcy Code's priority rules.

Background Regarding the *Goodrich* Decision

The debtor, Goodrich Quality Theaters, Inc. ("Goodrich," or, the "Debtor"), operated a chain of 30 multiplex theaters, including one drive-in theater. The Debtor was the 17th largest theater chain in the United States with 267 screens in five states.

The Debtor had borrowed approximately $20 million during the five years prior to its Chapter 11 filing to remodel and upgrade its theaters and expand its business. The Debtor's lenders had a security interest in substantially all of the Debtor's personal property that was perfected by UCC filings, and the lenders also had validly recorded mortgages in all of the Debtor's owned real property. Unfortunately for the Debtor, changes in the movie industry largely due to online screening resulted in a decrease in ticket sales, ultimately causing the Debtor to struggle to meet its obligations to its secured lenders.

Prior to the Debtor's Chapter 11 filing, the Debtor had defaulted under its agreements with its secured lenders, and the Debtor and the lenders entered into a forbearance agreement. On February 24, 2020, the agent for the secured lenders sent a notice of acceleration and default notifying the Debtor of the default and the amount owed—consisting of $29,580.339 of principal, plus $99,577.19 in accrued interest, and additional interest, fees, costs, and expenses.

On February 25, 2020, the Debtor commenced its Chapter 11 case by filing a voluntary petition in the Bankruptcy Court in the Western District of Michigan. The Debtor utilized its Chapter 11 case to reject unprofitable leases, sell substantially all of its assets to one or more potential movie industry buyers, and use the sale proceeds to pay down its substantial secured loan indebtedness. The secured debt included obligations to the Debtor's post-petition secured lender and the approximately $30 million owed to the Debtor's pre-petition secured lenders.

On June 25, 29, and 30, 2020, the Bankruptcy Court approved orders (the "Sale Orders") collectively authorizing the Debtor to assign certain contracts and sell substantially all of its assets, free and clear of all liens, claims, and encumbrances, to three separate purchasers. The assets that the Debtor had sold included substantially all Chapter 5 avoidance actions, such as preference claims against the Debtor's trade creditors. The Debtor had closed on all three sales by July 10, 2020, resulting in the Debtor's receipt of net sale proceeds totaling $18,146,883. That left the pre-petition secured lenders with a very large unsecured deficiency claim.

Following the closings on the sales, the Debtor sought to wind down its affairs and conclude its Chapter 11 case. The Debtor utilized the net sale proceeds to satisfy its obligations to its Chapter 11 secured lender, partially pay down its prepetition secured lenders' claims, and fully pay all known outstanding administrative expense claims by paying the post-petition indebtedness owing to its vendors and employees and funding professional fee and administrative expense carve out accounts and hold-backs.

Then, on July 30, 2020, the Debtor filed a motion to dismiss the Chapter 11 case (the "Motion to Dismiss") with the support of its secured lenders and the creditors' committee appointed in the Chapter 11 case. The Debtor argued that dismissing the case was in the best interests of its estate and creditors because the alternatives—pursuing a futile Chapter 11 plan process or converting the case to a Chapter 7 liquidation—would only serve to create additional expenses to the detriment of the Debtor's creditors. The Debtor no longer conducted any business, had no remaining assets to pay claims (after allocating the sale proceeds to secured, administrative, and priority claims), and had no possibility of restarting its business or earning any income. Therefore, continuing the Chapter 11 case would only result in the Debtor unnecessarily incurring substantial administrative expenses associated with pursuing a hopeless Chapter 11 plan confirmation process or creating a Chapter 7 estate simply to distribute cash to administrative and priority creditors that could be accomplished at far less expense by dismissing the Chapter 11 case.

On August 18, 2020, the UST objected to the Motion to Dismiss and simultaneously moved to convert the case to Chapter 7. The UST acknowledged, and agreed with the Debtor, that continuing the Chapter 11 case after the Debtor has ceased all regular operations would cause a continuing loss to and diminution of the Debtor's estate with no likelihood of rehabilitation of the Debtor's business. However, the UST argued that the Debtor should not be permitted to continue its wind down activities outside of the purview of the Bankruptcy Court, and that approval of the Motion to Dismiss would set a "bad precedent" of allowing parties to use the bankruptcy sale process to skirt court-supervised distributions that should occur consistent with the Bankruptcy Code while the bankruptcy case is pending. The UST further asserted that the Debtor should not be permitted to make "end-of-case" distributions in the absence of a Chapter 11 plan. The UST argued that if a Chapter 11 plan cannot be confirmed, the case should be converted to Chapter 7 so that a trustee can be appointed to review all claims against the Debtor, administer estate assets, make distributions to creditors, and prepare and file a final accounting pursuant to the Bankruptcy Code. The UST also noted that the trustee could review the scope of the estate's sale of Chapter 5 avoidance actions in connection with the Sale Orders, leaving open the possibility that the trustee could pursue any remaining avoidance actions, including preference claims.

The Bankruptcy Court's Decision

The Bankruptcy Court denied the UST's motion to convert in a memorandum order entered on September 16, 2020. The Bankruptcy Court concluded that cause existed under section 1112(b) of the Bankruptcy Code to dismiss or convert the Debtor's Chapter 11 case following the sale of substantially all of the Debtor's assets and the distribution of sales proceeds. The court found no prospects for reorganization, or for confirmation of a Chapter 11 plan, following the conclusion of the going concern sales pursuant to the Sale Orders. This left the Bankruptcy Court with one question: which means of exiting Chapter 11 is in the best interest of the Debtor's estate and creditors—dismissal or conversion?

The Bankruptcy Court concluded that dismissal was the more appropriate route. The Bankruptcy Court relied on the fact that all parties with a financial stake in the case—including the Debtor (the estate's representative with an untainted history acting as the estate's fiduciary), the Debtor's secured lenders, and the creditors' committee—supported dismissal of the case and opposed conversion. As the Bankruptcy Court acknowledged, the creditors' committee (which speaks on behalf of all unsecured creditors) had conceded that there was absolutely no prospect for any payment to the Debtor's unsecured creditors. So, as far as the Debtor's financial stakeholders were concerned, conversion of the case would merely increase administrative expenses and engender confusion among the Debtor's creditor body without promising any meaningful recovery for unsecured creditors. The Bankruptcy Court held that the UST had offered no persuasive reason for the court to substitute the UST's view of the best interests of creditors in place of the views expressed by the Debtor's secured lenders and the creditors' committee. Therefore, the court held that conversion was not in the best interests of the estate and denied the UST's motion to convert. In reaching this decision, the court noted that the relief requested by the Debtor in connection with its Motion to Dismiss did not undermine the Bankruptcy Code's priority scheme (which would be a violation of the Supreme Court's ruling in *Jevic*). Though the court did not rule on the Debtor's Motion to Dismiss in connection with its order denying the UST's motion to convert, the Bankruptcy Court granted the Motion to Dismiss at a hearing held on October 19, 2020.

Conclusion

The *Goodrich* decision suggests that courts may consider dismissal of a Chapter 11 case to be a viable option where a debtor's estate simply lacks the resources to shoulder the administrative burden of a Chapter 11 or Chapter 7 case where there is no chance of a recovery for unsecured creditors. In this regard, the decision is a victory for trade creditors as the dismissal of a bankruptcy case eliminates the risk that a trustee may seek to augment the bankruptcy estate by pursuing avoidance actions (such as preference claims) against creditors. That said, it is important to note that the Debtor's proposed dismissal was only viable because the terms of the proposed dismissal did not seek to circumvent the Bankruptcy Code's priority scheme. Moreover, the fact that all of the Debtor's financial stakeholders (including unsecured creditors) supported dismissal certainly weighed heavily on the Bankruptcy Court's decision. The Bankruptcy Court observed that it had evaluated the interests of creditors specifically in the *Goodrich* case. It remains to be seen whether other bankruptcy courts will follow the *Goodrich* decision under the circumstances of their specific cases. Stay tuned!