

# SmileDirectClub Converted to Chapter 7 After Package Deal for Sale and Structured Dismissal Denied

*By: Alexander Perez*

On January 24, 2024, Judge Christopher Lopez of the United States Bankruptcy Court for the Southern District of Texas made a notable ruling in the Smile Direct Club bankruptcy case in which he denied both the Debtors' motion to sell assets to the Debtors' DIP lenders/insiders, which included releases for the same, and the Debtors' motion for a structured dismissal of the bankruptcy case. *In re SmileDirectClub, Inc.*, Case No. 23-90786 (Bankr. S.D. Tex.) (“SDC”).<sup>1</sup> Following a brief pause to allow for any new proposals to be presented by parties in interest, on January 26, 2024, Judge Lopez converted the cases to chapter 7.

## Basics of a Structured Dismissal

First, a brief discussion of some of the most common circumstances and features of a structured dismissal is warranted. A court ordering a dismissal generally tries to restore the prepetition status quo;<sup>2</sup> however, a structured dismissal may allow the debtors and other parties in interest to retain the benefits of either rulings or results achieved during the bankruptcy case. Sections 305(a)(1)<sup>3</sup> and 1112(b)<sup>4</sup> of the Bankruptcy Code taken together address dismissal of a chapter 11 case and allow the court to determine whether “cause” exists to dismiss the case and whether such dismissal is in the best interest of the creditors and the estates. Practically, structured dismissals are often sought after a bankruptcy court has approved a 363 sale of a debtor's assets as a means to exit bankruptcy in the alternative to either confirming a chapter 11 plan, which may be prohibitively expensive or otherwise financially unfeasible, or converting the case to one under chapter 7 of the Bankruptcy Code, which may not be preferred due to

management's displacement by a chapter 7 trustee. An order for a structured dismissal will typically be negotiated amongst the various stakeholders and may contain provisions that all prior orders, including, for example, those providing protections to a good faith asset purchaser or releases to a DIP lender, remain effective. A structured dismissal may not contain a “gifting” distribution or other such provisions that violate the absolute priority rule contained in the Bankruptcy Code.<sup>5</sup>

## Debtors' Motions

The Debtors were an industry leader in telehealth-driven clear orthodontic aligner therapy with a vertically integrated business model and direct-to-consumer approach. During their chapter 11 cases, the Debtors conducted a marketing process for the sale of their assets. The Debtors were unable to find an outside buyer and, ultimately, sought approval of a sale of their assets to their DIP lenders/insiders. The proposed purchase included an approximate \$25 million credit bid of the insiders' DIP claims, \$4 million in cash for payment of administrative expense claims, and up to an additional \$3 million for distribution on administrative expense claims from future liquidations of assets. Additionally, the Debtors proposed to establish a creditor trust to investigate and potentially pursue claims against Debtors' insiders, such as breach of fiduciary duty; however, such claims would be capped at D&O insurance policy limits. All other potential estate claims against the insiders, including those under chapter 5 of the Bankruptcy Code, would be released pursuant to the proposed sale order. The Debtors advocated for the proposed sale and

structured dismissal as a package deal and part of a global settlement.

## **Opposition to the Motions**

Despite the UCC's support of the Debtors' motions, a number of individual creditors objected to the Debtors' motions on the grounds that the proposed sale would primarily benefit the Debtors' insiders with no material benefit accruing to creditors. The objections noted that the proposed sale and dismissal contained many typical elements of a chapter 11 plan, *e.g.*, releases, carve-out of claims against insiders, and establishment of a creditor trust, without a formal plan process. Further, objecting creditors argued that any insider sale transaction be subject to a "heighted scrutiny" standard, which could not be met despite the Debtors' establishment of a special committee to evaluate the sale. Finally, objecting creditors argued for conversion to chapter 7. Conversion was preferable to the objectors, because the trustee could independently evaluate the proposed sale transaction and investigate the potential causes of action against the insiders and other monetizable assets.

## **Judge Lopez's Ruling**

In delivering his ruling from the bench, Judge Lopez found that the Debtors' cases were filed in good faith and that Debtors indeed sought a sale to the highest bidder. The Court emphasized that, while presented as two separate motions, the proposed sale was inseparably linked to the structured dismissal. The Court focused on the fact that it was a package deal, since, if the structured dismissal was not approved, the DIP lender/insiders could abandon the sale. Weighing the many factors, Judge Lopez found that the Debtors failed to establish that the proposed sale was in the best interests of creditors, especially, given

both the creditor opposition and the administrative insolvency of the estates. Judge Lopez also agreed with the objecting creditors that the Debtors' proposals incorporated too many elements of a chapter 11 plan without the attendant plan process. Judge Lopez noted that the result would have been different if there had indeed been any actual creditor support.

Ultimately, Judge Lopez concluded the hearing by announcing that he would convert the cases to chapter 7, but only after waiting a few days to enter such an order. The brief delay gave the parties in interest time to consider and propose other potential pathways forward in light of Judge Lopez's ruling and comments. Two days later, with no alternative pathway materializing or being proposed, the Court entered the order converting the cases to chapter 7.

## **Final Takeaways**

Given there has been an overall increasing trend in structured dismissals in the wake of *Jevic*, SDC may be viewed in some respects as an outlier. However, SDC provides an important cautionary tale regarding the development of an exit strategy during a chapter 11 case. The coupling of a sale (especially a sale to insiders) to a structured dismissal providing for extensive and potentially valuable releases to insiders it appears must draw at least a modicum of creditor support in order to meet the "best interests of creditors" test.

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<sup>1</sup> On September 29, 2023, SmileDirectClub, Inc. and eight affiliated debtors (collectively, the “Debtors”) each filed a voluntary petition for relief under chapter 11 of title 11 of the United States Code, 11 U.S.C. §§ 101-1532 (as amended, the “Bankruptcy Code”).

<sup>2</sup> See 11 U.S.C. § 349(b).

<sup>3</sup> 11 U.S.C. § 305(a)(1) (“The court, after notice and a hearing, may dismiss a case under this title ... at any time if—

(1) the interests of creditors and the debtor would be better served by such dismissal or suspension[.]”).

<sup>4</sup> 11 U.S.C. § 1112(b) (“[O]n request of a party in interest, and after notice and a hearing, the court shall convert a case under this chapter to a case under chapter 7 or dismiss a case under this chapter, whichever is in the best interests of creditors and the estate, for cause unless the court determines that the appointment under section 1104(a) of a trustee or an examiner is in the best interests of creditors and the estate.”).

<sup>5</sup> See *Czyzewski v. Jevic Holding Corp.*, 580 U.S. 451 (2017).