Second-Guessing a Chapter 11 Debtor's "Absolute" Right to Convert

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Mark G. Douglas

Although federal bankruptcy law and policy strongly encourage both business and individual debtors to pay at least a portion of their debts by means of either a plan of reorganization or a wage earner repayment plan, the general rule is that a debtor cannot be forced to do so — a debtor always has the option to liquidate its assets in chapter 7 so long as it is eligible to be a debtor under that chapter of the Bankruptcy Code. Even so, a trend appears to be developing in the bankruptcy courts whereby what is generally understood to be a debtor's unfettered prerogative to convert its case from one of the "reorganization chapters" (chapters 11, 12 and 13) to a chapter 7 liquidation may be restricted under certain circumstances. A ruling recently handed down by a Michigan district court is emblematic of this restrictive approach. In *Monroe Bank & Trust v. Pinnock*, the court held that lawmakers' use of the word "may" in section 1112(a) of the Bankruptcy Code means that a bankruptcy court is not obligated to honor a chapter 11 debtor's request to convert its case to chapter 7 without considering what course of action is in the best interests of all stakeholders involved.

Conversion and Dismissal of a Chapter 11 Case

Not every chapter 11 case culminates in the confirmation of a plan of reorganization or liquidation — some cases are dismissed outright, while others are converted to cases under other chapters of the Bankruptcy Code. Section 1112 of the Bankruptcy Code establishes the mechanism and standards for conversion and dismissal. Section 1112(a) provides that "[t]he

debtor may convert a case under this chapter to a case under chapter 7 of this title unless" (i) the debtor is not a debtor-in-possession; (ii) the case originally was commenced as an involuntary chapter 11 case; or (iii) the case was converted to a case under chapter 11 other than on the debtor's request.

Section 1112(b) governs requests for conversion or dismissal by anyone other than the debtor. It provides that upon the request of a party-in-interest, "absent unusual circumstances specifically identified by the court that establish that the requested conversion or dismissal is not in the best interests of creditors and the estate, 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, if the movant establishes cause." "Cause" is defined in section 1112(b)(4) to include the following:

- substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation;
- gross mismanagement of the estate;
- failure to maintain appropriate insurance that poses a risk to the estate or to the public;
- unauthorized use of cash collateral substantially harmful to one or more creditors;
- failure to comply with an order of the court;
- unexcused failure to satisfy timely any applicable filing or reporting requirements;
- failure to attend the initial meeting of creditors or any examination ordered by the court without good cause shown by the debtor;
- failure timely to provide information or attend meetings reasonably requested by the United States trustee or any bankruptcy administrator;

- failure timely to pay post-petition taxes or to file post-petition tax returns;
- failure to file a disclosure statement, or to file or confirm a plan, within the time fixed by the Bankruptcy Code or the court;
- failure to pay certain statutory fees or charges;
- revocation of an order confirming a chapter 11 plan;
- inability to effectuate substantial consummation of a confirmed plan;
- material default by the debtor with respect to a confirmed plan;
- termination of a confirmed plan by reason of the occurrence of a condition specified in the plan; and
- failure of the debtor to pay any post-petition domestic support obligation.

Even upon a showing of "cause" to convert or dismiss, the debtor or any other party opposing the request can defeat it by demonstrating that (i) there is a reasonable likelihood that a chapter 11 plan will be timely confirmed, and (ii) "cause" consists of something other than diminution of the estate and the absence of any reasonable likelihood of rehabilitation, a reasonable justification exists for the act or omission in question, and such act or omission will be rectified within a reasonable period of time. The ability to ward off conversion or dismissal by remedying conduct amounting to "cause" was added to section 1112 as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

Based upon the express language of the statute and its accompanying legislative history, section 1112(a) has been almost universally interpreted to confer a chapter 11 debtor with the "absolute" right to convert to chapter 7 absent the existence of one of the disqualifying circumstances specified in the statute. That is not to say, however, that the debtor has the right to keep the case

in chapter 7 — it can be converted back to chapter 11 if the court determines that reconversion best serves the interests of all stakeholders, or it can be dismissed altogether under the circumstances set forth in section 707 of the Bankruptcy Code (*e.g.*, unreasonable delay, failure to pay required fees or make required filings or conduct amounting to "substantial abuse" if the debtor is an individual with primarily consumer debts).

Still, some courts quarrel with the notion that a chapter 11 debtor's right to convert to chapter 7 is unfettered, particularly if the debtor's motivation for doing so is perceived as being suspect. For example, in *In re Adler*, a chapter 11 debtor proposed a plan of reorganization that was unconfirmable and then moved to convert his case to a chapter 7 liquidation in response to the U.S. Trustee's motion seeking dismissal of his case and an order barring any subsequent bankruptcy filings. The bankruptcy court denied the conversion motion, ruling, among other things, that even though section 1112(a) clearly states that a debtor "may" convert his case, it does not state that the court "shall" honor the request. In addition, the court explained, because procedural rules require advance notice to creditors of a motion to convert, rather than the mere filing of a notice of conversion by the debtor, the bankruptcy court must retain some discretion to rule on the propriety of a conversion motion under section 1112(a).

In considering a debtor's proposed conversion under section 1112(a), the court observed, many courts have either: (i) recognized that conversion may be improper in situations involving "extreme circumstances" (*e.g.*, bad faith, abuse of process or other gross inequity); or (ii) engaged in some kind of equitable analysis of the facts, including whether a debtor can propose a confirmable chapter 11 plan. Concluding that "the sole motive for the Debtor's conversion

motion is to avoid the possibility of dismissal with prejudice," the bankruptcy court in *Adler* denied the debtor's request under section 1112(a). Instead, the court granted the U.S. Trustee's motion to dismiss, finding that "cause" existed to dismiss the case under section 1112(b). Similar reasoning was recently employed by a Michigan district court in *Monroe Bank & Trust v. Pinnock*.

The District Court's Ruling in *Pinnock*

Lascelles Pinnock and Helen A. Byrd filed for chapter 11 protection in February 2005. After they were unable to confirm a chapter 11 plan, the debtors moved pursuant to section 1112(a) to convert their chapter 11 case to a chapter 7 liquidation. A creditor-bank opposed the motion, arguing that conversion would not be in the best interests of creditors because it would deprive them of access to significant assets acquired by the debtors during the course of their chapter 11 case. The bank moved to dismiss the case under section 1112(b).

The bankruptcy court granted the debtors' conversion motion, ruling that section 1112(a) gives a chapter 11 debtor the absolute right to convert to chapter 7 and, as a consequence, the factors set forth in section 1112(b) governing "cause" for dismissal do not figure into the calculus. The bank appealed the ruling to the district court.

Noting that the issue of whether a debtor has an absolute right to convert from chapter 11 to chapter 7 is a matter of first impression in the Sixth Circuit, the district court reversed. The court cited to *Adler* and authority construing a nearly identical provision in chapter 13 in concluding that Congress' omission of any language in section 1112(a) directing a court to convert a case upon the debtor's request means that there is no absolute right to convert. It ruled that the

bankruptcy court erroneously held to the contrary, and should have considered the bank's motion to dismiss the debtors' chapter 11 case according to the criteria set forth in section 1112(b). The district court accordingly reversed the ruling below and remanded the case to the bankruptcy court to determine whether dismissal or conversion was in the best interests of the estate and creditors.

Analysis

The approach advocated by the courts in *Adler* and *Pinnock* undeniably has visceral appeal as a means of ensuring that a chapter 11 debtor cannot abuse the bankruptcy process in at least temporarily warding off outright dismissal of its bankruptcy case by converting to chapter 7. Even so, these rulings may be based on questionable logic. By focusing solely on the absence of any express language in section 1112(a) to the effect that a bankruptcy court "shall" grant a conversion motion filed by a chapter 11 debtor, these courts have overlooked the provision's unambiguous pronouncement that "[t]he debtor may convert a case" to chapter 7 and, without a statutory mandate for doing so, have superimposed the standards set forth in subsection (b) on the debtor's conversion "request." In effect, *Adler* and *Pinnock* have rewritten the statute to provide that a chapter 11 debtor may convert to chapter 7, unless someone (including the court *sua sponte*) objects, in which case the court will only grant the request if it determines that conversion would not amount to abuse of the bankruptcy process in some way.

The Bankruptcy Code, however, already contains a mechanism to address this eventuality — the objecting party-in-interest can simply move to reconvert the case to chapter 11 or to dismiss the chapter 7 case under section 707. The courts in *Alder* and *Pinnock* had the benefit of pending motions to dismiss under section 1112(b) when confronted with the debtors' conversion requests.

Their rulings appear to indicate that a dismissal motion under section 1112(b) trumps a debtor's conversion motion under section 1112(a). Perhaps this should be the rule, but the reasoning articulated in the decisions falls short of explaining why. Moreover, consider what would have happened if the creditors involved had merely objected to conversion, but had not moved to dismiss. Without any standard of "cause" justifying dismissal to fall back upon, it would then be left to the bankruptcy court to fashion criteria by which a conversion request should be judged, an approach that is difficult at best to support based upon the Bankruptcy Code or its legislative history.

Interestingly, the predecessor to section 1112(a) under chapter X of the Bankruptcy Act of 1898 (Rule 11-42(a) of the former Rules of Bankruptcy Procedure) provided that, upon the debtor's motion to convert to a liquidating bankruptcy case, the court "shall . . . enter an order adjudicating the debtor a bankrupt." This language was construed to remove any discretion from the court to do otherwise when faced with a conversion request. The absence of a similar directive in section 1112(a) may indicate, consistent with *Adler* and *Pinnock*, that the drafters of the current statute wished to give the bankruptcy court the discretion to deny a conversion request under appropriate circumstances.

The imposition of a kind of moral calculus by bankruptcy judges in situations where the express terms of the Bankruptcy Code do not appear to require examination of a debtor's underlying motivation (or the impact on other affected parties) has been a magnet for controversy during recent times. A growing number of courts feel justified in exercising their broad discretion as instruments of equity to prevent what they perceive as conduct amounting to abuse of the

bankruptcy process. In addition to restricting a chapter 11 debtor's ability to convert to chapter 7, courts have recently exercised their discretion in assessing "cause" to dismiss non-consumer debt chapter 7 cases and in denying a debtor's request to convert its chapter 7 case to one under another chapter of the Bankruptcy Code. The latter issue is currently being considered by the U.S. Supreme Court in *Marrama v. Citizens Bank of Massachusetts*. The Court heard argument on the case on November 6, 2006.

Monroe Bank & Trust v. Pinnock, 2006 WL 2367350 (E.D. Mich. Aug. 15, 2006).

In re Adler, 329 B.R. 406 (Bankr. S.D.N.Y. 2005).

In re Texas Extrusion Corp., 844 F.2d 1142 (5th Cir. 1988).

In re Schuler, 119 B.R. 191 (Bankr. D. Mo. 1990).

In re Marill Alarm Systems, Inc., 100 B.R. 606 (Bankr. D. Fla. 1989).

In re Dieckhaus Stationers of King of Prussia, Inc., 73 B.R. 969 (Bankr. E.D. Pa. 1987).

In re Grinstead, 75 B.R. 2 (Bankr. D. Minn. 1985).

In re Midheaven Restaurant, Inc., 1980 U.S. Dist. LEXIS 13848 (D. Mass. Oct. 1, 1980).

Marrama v. Citizens Bank of Massachusetts (In re Marrama), 313 B.R. 525 (Bankr. 1st Cir. 2004), *aff'd*, 430 F.3d 474 (1st Cir. 2005), *cert. granted*, 126 S.Ct. 2859 (2006).