Creditors' Rights in Bankruptcy § 16:11 (2d ed.)

Creditors' Rights in Bankruptcy
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Chapter 16. Chapter 11 Reorganizations—Administrative Matters

§ 16:11. Conversion or dismissal

Under Code § 1112(b) as amended by the 2005 Act, [1] at the request of a party in interest a case shall be either converted by the court to one under Chapter 7 or dismissed, whichever is in the best interests of creditors, for cause after notice and a hearing. [2] In light of § 1123(b)(4), which provides that a plan may provide for a liquidation, [3] it is open to doubt whether conversion to Chapter 7 will often be necessary. In addition, a Chapter 11 trustee may file a plan at any time, and where no trustee has been appointed, a creditor can file a plan after the exclusivity period of § 1121 has expired or been terminated. Section 1112 was extensively revised by the 2005 Act, and the result was unfortunate in several respects. To begin with, the language is now mandatory rather than discretionary, notwithstanding the fact that dismissal is a difficult topic and one where the interests of creditors and the estate should be controlling and where flexibility is often appropriate. Section 1112(b)(4) provides a long list of what will constitute cause for conversion or dismissal of the case. Section 112(b)(4) provides a long list of what will constitute cause for conversion or dismissal of the case. [4] Cases where the 2005 Act does not apply (i.e., cases commenced before October 17, 2005) will remain subject to the general standards of § 1112(b) such as loss to the estate, inability to effectuate a plan, or unreasonable delay. Where the 2005 Act applies, the list of 16 subparagraphs ranges from the general, such as gross mismanagement of the estate, to the trivial, such as failure to attend meetings. Adding to the confusion is the use of "and" rather than "or" at the end of the list. Most courts faced with the issue have concluded that it is simply a drafting error, and Congress did not intend an absurd result. The court is required to commence a hearing on the motion with 30 days after the filing of the motion and to decide the matter within 15 days after the commencement of the hearing absent the consent of the movant or compelling circumstances.

Perhaps in recognition that the items constituting cause and the mandatory language of subsection 1112(b) could otherwise lead to unfortunate, or even absurd, results, paragraphs (1) and (2) of § 1112(b) provide for relief in "unusual circumstances" where the debtor or another party in interest opposing the relief sought establishes that there is a reasonable likelihood that a plan will be confirmed within the timeframes established in §§ 1121(e) and 1129(e) (both of which apply only in small business cases) or within a reasonable period of time, and the act or omission of the debtor is one for which there exists a "reasonable justification" and will be cured within a reasonable period of time fixed by the court. Alternatively, it appears that, under paragraph (1), if the court finds that there are unusual circumstances that are specifically identified by the court, dismissal or conversion may be denied. Even if the court is unable to make the findings required by paragraphs (1) and (2) of § 1112(b), there is one more way to avoid dismissal, which is the exception at the outset of paragraph (1) in the form of a reference to § 1104(a)(3) which would permit the appointment of a trustee or examiner in lieu of a dismissal or conversion. While hardly a model of drafting clarity, the problems with § 1112 are likely to flow from its mandatory language and the precise findings that are required. These are unlikely to produce the desired effect but are very likely to permit appeals to be taken on technical grounds which may result in unexpected reversals at inopportune times. The ability to reduce the dismissal process to an absurdity illustrates the problem. A debtor in extremis, in a case where a plan is far from clear, can make one of the technical examples of cause in paragraph (4) lethal, unless care has been taken to specifically identify unusual circumstances justifying a decision not to dismiss under paragraph (1).

To summarize, a request to convert or dismiss a pending Chapter 11 case may involve some or all of the following steps:

(1) Movant must show cause under § 1112(b)(2) and (4).

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(2) The hearing must be commenced on the motion (i.e., request) within 30 days of filing unless time is extended.

(3) The motion must be decided within 15 days thereafter unless time is extended.

(4) An objection to the relief sought may be filed by the debtor or another party interest under paragraph (2).

(5) If grounds are found to exist for dismissal, the court may order the appointment of a trustee if requested and if the court determines that the appointment of a trustee or examiner is in the best interest of creditors.

(6) Even if the appointment of a trustee or examiner is not ordered and grounds for conversion or dismissal are found to exist, the court may nonetheless find that specific unusual circumstances exist and decline to grant the request.

All in all, this is a very long and roundabout way of saying that, in the exercise of its discretion, the court is required to make specific findings.

The language of § 1112(a) suggests that the court is not permitted to act sua sponte, consistent with its role as a decider of disputes.[5] Reference should be made, however, to § 105(a), which permits the court to act sua sponte to enforce orders and rules and to prevent an abuse of process, and to § 105(d), which permits the court to set various deadlines in connection with the confirmation process.

As an alternative to a simple dismissal order and restoration of the status quo, parties may seek to wind up a chapter 11 case through a "structured" dismissal in which the bankruptcy court's dismissal order includes additional provisions such as court-approved releases or protocols for the reconciliation and payment of certain claims.[6] This approach may be particularly attractive after a debtor sells the majority of its assets under a § 363 sale or when workout has been achieved, and the costs of implimenting a liquidating plan would be prohibitive. Although not expressly provided for in §§ 1112 or 305 of the Code, the Third Circuit, in one of the few published decisions on point, recently upheld the use of structured dismissals at least in certain circumstances.[7]

One matter which is far from clear is the relationship between §§ 1112 and 305. Both provide for dismissal of the case, although the latter is much less explicit and precludes a right of appeal. The standards to be applied are different in the two sections, since § 305 requires consideration of the debtor's interests while § 1112 does not. It should be noted that, while there are no express time limitations in either § 305 or § 1112, the former seems most applicable in the early days of the case while the latter will apply more often after the passage of some time.

Finally, § 1112(c) and (d), which were not amended by the 2005 Act, limit the court's power to convert Chapter 11 cases to another Chapter by recognizing that certain debtors, e.g., farmers, are exempt from involuntary liquidation under Chapter 7 and that Chapters 12 and 13 are wholly voluntary. In any event, a case may not be converted to another chapter unless the debtor may be a debtor under that Chapter.[8]

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Footnotes

1 11 U.S.C.A. § 1112.

2 In re Owens, 552 F.3d 958, 61 Collier Bankr. Cas. 2d (MB) 943 (9th Cir. 2009) (consideration must be given to best interests of all creditors).

3 See 11 U.S.C.A. § 1123(b)(4).
See § 17:2 for a discussion of creditor plans.

4 A judicial doctrine has developed that a Chapter 11 reorganization case can be dismissed where there the case was filed in "bad faith," even though bad faith is not listed as one of the reasons a case should be dismissed under § 1112. The seminal case is In re Victory Const. Co., Inc., 9 B.R. 549, 7 Bankr. Ct. Dec. (CRR) 257, 3 Collier Bankr. Cas. 2d (MB) 655 (Bankr. C.D. Cal. 1981), order vacated on other grounds, 37 B.R. 222, 11 Bankr. Ct. Dec. (CRR) 749 (B.A.P. 9th Cir. 1984) and (rejected by, In re Victoria Ltd.

Partnership, 187 B.R. 54, 27 Bankr. Ct. Dec. (CRR) 1210, Bankr. L. Rep. (CCH) P 76666 (Bankr. D. Mass. 1995)). See also In re Kingston Square Associates, 214 B.R. 713, 725, 31 Bankr. Ct. Dec. (CRR) 615 (Bankr. S.D. N.Y. 1997) (dismissal appropriate where court finds both objective futility of reorganization and subjective bad faith in filing); In re General Growth Properties, Inc., 409 B.R. 43, 51 Bankr. Ct. Dec. (CRR) 280, 62 Collier Bankr. Cas. 2d (MB) 279 (Bankr. S.D. N.Y. 2009) (same, but noting dismissal for lack of good faith should only be used "sparingly and with great caution;" evidence that debtors were intended to be bankruptcy-remote entities not sufficient cause to dismiss cases); In Re Capitol Food Corp. of Fields Corner, 490 F.3d 21, 48 Bankr. Ct. Dec. (CRR) 101, 57 Collier Bankr. Cas. 2d (MB) 220, Bankr. L. Rep. (CCH) P 80959 (1st Cir. 2007) (§ 1112(b) expressly provides mechanisms for weeding out bad faith petitions; noting courts that find a good faith requirement require party to establish prima facie showing of bad faith); compare In re Integrated Telecom Express, Inc., 384 F.3d 108, 43 Bankr. Ct. Dec. (CRR) 175, Bankr. L. Rep. (CCH) P 80168 (3d Cir. 2004) (good faith filing requirement; case prior to 2005 Act).

5 The court in Matter of Nikron, Inc., 27 B.R. 773, 10 Bankr. Ct. Dec. (CRR) 335, 8 Collier Bankr. Cas. 2d (MB) 107 (Bankr. E.D. Mich. 1983) found that it did have the power to act sua sponte. See, however, In re Moog, 774 F.2d 1073, 13 Bankr. Ct. Dec. (CRR) 998, 13 Collier Bankr. Cas. 2d (MB) 910, Bankr. L. Rep. (CCH) ¶70827 (11th Cir. 1985) (court can dismiss sua sponte only where an abuse of process is present).

6 See In re Strategic Labor, Inc., 467 B.R. 11, 17 n.10, 56 Bankr. Ct. Dec. (CRR) 39, 109 A.F.T.R.2d 2012-1361 (Bankr. D. Mass. 2012). See also Pernick and Dean, Structured Chapter 11 Dismissals: a Viable and Growing Alternative After Asset Sales, 29 Am. Bankr. Inst. J. 1, 56 (June 2010).

7 See In re Jevic Holding Corp., 787 F.3d 173, 61 Bankr. Ct. Dec. (CRR) 21 (3d Cir. 2015) (upholding a settlement that resulted in a structured dismissal of the chapter 11 case where the bankruptcy judge made "sound findings of the fact that the traditional routes out of Chapter 11 are unavailable and the settlement is the best feasible way of serving the interests of the estate and its creditors").

8 See generally § 109 and §§ 1:1 et seq., §§ 3:1 et seq.

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