ALERTS

First Circuit Affirms Conversion of Reorganization Case to Liquidation

July 13, 2016

An individual Chapter 11 debtor's "estate was diminishing" with no "reasonable likelihood of rehabilitation," held the U.S. Court of Appeals for the First Circuit on July 5, 2016. *In re Hoover*, 2016 WL 3606918, *2 (1st Cir. July 5, 2016), affirming the bankruptcy court's conversion of the case to a Chapter 7 liquidation. In a rare appellate decision on the conversion issue, the First Circuit affirmed the finding that the debtor had sold "inventory without replacing it with new inventory or retaining cash sufficient to offset the diminution." *Id.* at *3. As for the debtor's plan to "generat[e] more income," the court dismissed it as "speculation" based on the debtor's "internet search" and a third party's renting of a competitor store's premises. *Id.* at *3n. 4. In short, reasoned the court, aside from prior losses and his failure to pay "anything to secured creditors," the debtor had insufficient "business prospects." *Id.* at *3.

Facts

The bankruptcy court granted the conversion motion of the U.S. Trustee ("Trustee") under Bankruptcy Code ("Code") §1112(b)(4) ("substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation"). Given these findings, the court did not have to consider the Trustee's alternative grounds for the motion ("unauthorized use of cash collateral"; and unexcused failure to file timely reports).

Cause for Conversion. The debtor had "conceded that he was selling inventory without replacing it, and his monthly operating reports ... showed

insufficient profit to account for or replace the sold inventory." In addition, the debtor's monthly operating reports showed insufficient cash to pay "costs and debts." *Id.* at *2.

The court rejected the debtor's argument that he was continuing "to conduct business." *Id.* at *3. Operating a business at a loss and not paying ongoing creditors was hardly persuasive.

The court also rejected the debtor's argument that state tax authorities would "hopefully … write off much" of their claims. The debtor's profits during the ongoing Chapter 11 case were "only minimal" and he had insufficient "funds and income to pay monthly expenses under" any Chapter 11 reorganization plan. His proposals for "generating more income" were "speculative and optimistic." Although the debtor "need not have a confirmed reorganization plan in place to avoid conversion … , the debtor still must have 'sufficient business prospects' … to 'justify continuance of [a] reorganization effort.'" *Id.*

Interests of Creditors. Because of the bankruptcy court's detailed findings of losses and inability to reorganize, the court found "conversion [to be] in the interest of creditors … ." *Id.* at *4. The court rejected the debtor's argument that "even a long shot at making a go of it under Chapter 11 is worth it for the creditors" when they would "mostly get nothing on liquidation … ." Aside from the debtor's failure to make this argument in the court below, the lower courts had ample grounds to find "that a prompt conversion rather than further diminution was in the best interest of creditors, especially [when] no creditor opposed conversion as hostile to its interests." *Id.*

Comments

1. *Hoover*'s indisputable facts support the validity of the court's opinion. The court did not have to mention another important obstacle for every individual Chapter 11 debtor: the absolute priority rule, which makes it practically impossible for most individuals to prosecute a Chapter 11 reorganization plan. *In re Cardin*, 751 F. 3d 734, 740 (6th Cir. 2014) ("… an individual Chapter 11 [debtor] is hit by a double whammy: he must dedicate at least five years' disposable income to the payment of unsecured creditors and … is also subject to the absolute-priority rule (and thus cannot retain any pre-petition property) if he does not pay those creditors in full."); *Accord*, *In re Lively*, 717 F. 3d 406, 410 (5th Cir.

2013); *In re Stephens*, 704 F. 3d 1279, 1287 (10th Cir. 2013); and *In re Maharaj*, 681 F. 3d. 558, 565 (4th Cir. 2012).

2. Some courts, however, give Chapter 11 debtors every opportunity to propose a reorganization plan. *See*, e.g., *In re Brown*, 951 F. 2d 564, 566, 572, 573 (3d Cir. 1991) (reversing district court's dismissal of individual's Chapter 11 petition, court remanded "case [for bankruptcy court] to determine if a reorganization is possible"; debtor had no "existing business," no "assets other than ... mortgaged properties"; "record lack[ed] the certainty needed ... "; no proof of "continuing loss or diminution of the estate."); *In re New Rochelle Tel. Corp.*, 397 B.R. 633, 641-42 (Bankr. E.D.N.Y. 2008) (delayed conversion so long as debtor paid utility creditor, other post-bankruptcy creditors, utility security deposits and obtained good faith offer from buyer for customer base); *In re Daniels*, 362 B.R. 428, 435-36 (Bankr. S.D. Iowa 2007) (delayed conversion so that debtor could establish debtor-in-possession bank account, obtain malpractice insurance, file delinquent monthly financial reports and amend schedules of assets).

Authored by Michael L. Cook.

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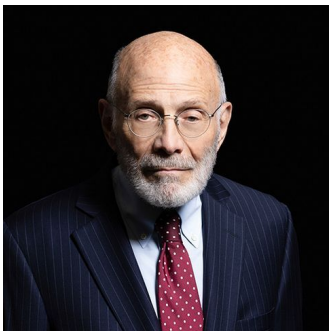

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