ISSUES IN CHAPTER 7 ASSET CASES
CONVERTED FROM CHAPTERS 11, 12 OR 13[1]

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Introduction

When a bankruptcy case converts from Chapter 11, 12 or 13 to Chapter 7, the case sometimes has assets for a trustee to administer. This kind of case may have issues not found in an asset case initially commenced under Chapter 7. This article discusses six such issues and is intended to assist trustees in successfully administering such cases.

I. Determining Assets Subject To Administration: Property Of The Estate In Converted Cases

Section 704(1) of the Bankruptcy Code requires the trustee to collect and reduce to money property of the estate. In a converted case it is sometimes more complicated to determine exactly what that property is. While property of the estate is ordinarily fixed as of the date the case is filed, that general rule is more difficult to apply and is subject to exceptions in converted cases. Further, because Chapter 11 conversions to Chapter 7 give rise to different issues than Chapter 13 conversions, each is separately addressed below.

A. Determining Assets In Converted Chapter 11 Cases

Section 541(a)(6) of the Bankruptcy Code renders "proceeds, product, offspring, rents, or profits of or from property of the estate, except such as are earnings from services performed by an individual debtor after the commencement of the case" property of the estate. The effect of this

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[1]The views expressed in this article are those of the author and do not necessarily represent the views of, and should not be attributed to, the United States Department of Justice or the United States Trustee Program.

provision in Chapter 11 cases can be dramatic because debtors under that chapter typically operate a business and acquire and dispose of property. Thus, when a Chapter 11 case converts to Chapter 7 the debtor's schedules, which give a snapshot of its assets as of the date of filing, may not be that instructive regarding what the debtor's assets are as of the date of conversion.

Fed.R.Bank.P. 1019(5) does require the debtor to file a final report and account 30 days after conversion. Among the purposes of that report is to provide the trustee with a more accurate view of what there is to administer. Unfortunately, many debtors never file the report or do not do so timely or completely. Of course, even if the report is filed timely, the trustee in a converted case does not have the luxury of waiting 30 days to take control of the assets, but must do so quickly with the assistance of the debtor and whatever other parties are familiar with the debtor's assets. The importance of early response in determining those assets cannot be too strongly emphasized in converted Chapter 11 cases.

Occasionally Chapter 11 cases convert to Chapter 7 after having first confirmed a plan of reorganization. In addition to the difficulties mentioned above, the trustee in such a scenario must then determine what effect confirmation of the plan has upon assets to administer.

Pursuant to Section 1141(b) of the Bankruptcy Code "except as otherwise provided in the plan or the order confirming the plan, the confirmation of a plan vests all of the property of the estate in the debtor." Where neither the plan nor order confirming the plan carve out such exceptions, the estate dissolves upon confirmation. *In re Harstad*, 39 F.3d 898, 904 (8th Cir. 1994). In that event there is no property for the trustee to liquidate, all assets having vested in the debtor at confirmation. *See In re T.S.P. Industries, Inc*., 120 B.R. 107 (Bankr.N.D.Ill. 1990)(declining to convert case with confirmed plan for lack of estate to administer).

Of course, it does not follow that in such cases the trustee has nothing whatever to administer. Pursuant to Section 541(a)(3) of the Code the trustee still may create a sizeable estate based on an assortment of causes of actions, including preferences and fraudulent conveyances, among others. Even with respect to such causes of action, however, the trustee in a converted Chapter 11 case with a confirmed plan must look closely to the plan and order confirming it for direction as to what, if any, rights the trustee has to prosecute those actions. *See In re NTG Industries, Inc.*, 118 B.R. 606 (Bankr.N.D.Ill. 1990)(Debtor's right to pursue preferences under confirmed plan passed to Chapter 7 trustee upon conversion).

B. Determining Assets In Converted Chapter 13 Cases: *Applying Section 348(f)*

Determining what assets a trustee may administer in a case converted from Chapter 13 involves a number of issues. Pursuant to Section 348(f)(1)(A) of the Code "property of the estate in the converted case shall consist of property of the estate, as of the date of filing of the petition, that *remains in the possession of or is under the control of the debtor on the date of conversion*"(emphasis added). So, for example, if the debtor had a vehicle when the Chapter 13 was filed, but the stay was lifted and the vehicle repossessed by the secured creditor prior to conversion, then that vehicle would not be property of the estate upon conversion because it no longer would be in the possession of or under the control of the debtor.

Notwithstanding, under Section 348(f)(2) of the Code "if the debtor converts a case under chapter 13 . . . in bad faith, the property in the converted case shall consist of the property of the estate as of the date of conversion." Since Section 1306(a) of the Code extends property of the estate in Chapter 13 cases to property acquired after the filing of the case, the effect of this section is to enlarge

what property a Chapter 7 trustee may administer in cases converted from Chapter 13 "in bad faith."[2]

Surprisingly, Section 348(f) has spawned little litigation. In one case, *In re Siegfried*, 219 B.R. 581 (Bankr. D. Colo. 1998), the court found the debtor's conversion to be in bad faith because of his "pattern of deception and dishonesty in revealing assets and disclosing debts..." *Id*. at 586. In another case, *In re Wiczek-Spaulding*, 223 B.R. 538 (Bankr. D. Minn. 1998), the court found the debtor's conversion not to be in bad faith because she acquired and exercised rights to severance benefits after the filing of her case. The court noted that "even if the conversion was solely to secure the benefits . . . , simply taking advantage of what the statute provides does not by itself amount to bad faith." *Id*. at 540.

Although the Code does not define "bad faith," I suggest that a debtor who could easily

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[2]The legislative history is instructive regarding the meaning and effect of Section 348, as amended in 1994. As noted at 140 Cong. Rec. H. 10,770 (October 4, 1994):

"This amendment would clarify the Code to resolve a split in the case of law about what property is in the bankruptcy estate when a debtor converts from chapter 13 to chapter 7. The problem arises because in chapter 13 (and chapter 12), any property acquired after the petition becomes property of the estate, at least until confirmation of a plan. Some courts have held that if the case is converted, all of this after-acquired property becomes part of the estate in the converted chapter 7 case, even though the statutory provisions making it property of the estate does not apply to chapter 7. Other courts have held that the property of the estate in a converted case is the property the debtor had when the original chapter 13 petition was filed.

These latter courts have noted that to hold otherwise would create a serious disincentive to chapter 13 filings. For example, a debtor who had $10,000 equity in a home at the beginning of the case, in a State with a $10,000 homestead exemption, would have to be counseled concerning the risk that after he or she paid off a $10,000 second mortgage in the chapter 13 case, creating $10,000 in equity, there would be a risk that the home could be lost if the case were converted to chapter 7 (which can occur involuntarily). If all of the debtor's property at the time of conversion is property of the chapter 7 estate, the trustee would sell the home, to realize the $10,000 in equity for the unsecured creditors and the debtor would lose the home.

This amendment overrules the holding in cases such as *Matter of Lybrook*, 951 F2d 136 (7th Cir. 1991) and adopts the reasoning of *In re Bobroff*, 766 F2d 797 (3rd Cir. 1985). However, it also gives the court discretion, in a case in which the debtor has abused the right to convert and converted in bad faith, to order that all property held at the time of conversion shall constitute property of the estate in the converted case."

complete a Chapter 13 plan, but instead converts to Chapter 7 should be found to have done so in bad faith. Such a test comports with case law under Section 707(b). Under that section a Chapter 7 case may be dismissed for substantial abuse where there is a finding that the debtor could easily repay creditors under a Chapter 13 plan. *See, e.g., In re Stewart*, 175 F.3d 796, 808-10 (10th Cir. 1999)(ability to pay is a primary factor in determining substantial abuse).

Inasmuch as debtors generally convert from Chapter 13 to Chapter 7 because they lack the ability to make plan payments, it is likely that such a scenario will prove rare. Where it does occur, however, the trustee will have to consider whether it makes more sense to administer assets for the benefit of creditors or refer the case to the United States Trustee to prosecute a Section 707(b) substantial abuse dismissal motion. There is no bright line test to resolve this issue, but it seems reasonable to suggest that if the trustee is able to produce a meaningful dividend to creditors by administering the case, that serves creditors better than a dismissal which leaves them to their own devices.

Before leaving this subject it is necessary to address what effect confirmation of a Chapter 13 plan has on the assets available to the Chapter 7 trustee after conversion. In that regard there are two scenarios to consider, conversions in good faith after confirmation and conversions in bad faith after confirmation.

Like its counterpart in Chapter 11, Section 1327 (b) of the Code provides that confirmation vests property of the estate in the debtor unless the plan or order confirming the plan provides otherwise. Based upon the statutory language and the Chapter 11 decisions cited above, it would appear that unless such exceptions to vesting were made in the plan or order confirming the plan, the

Chapter 7 trustee has nothing to administer in such cases.

It is doubtful conversion in bad faith changes this result. Section 348(f)(2) provides that "if the debtor converts a case under chapter 13 . . .in bad faith, the property in the converted case shall consist of the *property of the estate* as of the date of conversion."(emphasis added). Accordingly, it would appear that estates arising from "bad faith" conversions also will have no property, all such property having vested in the debtor by reason of the confirmation.[3] While this result may not have been what Congress intended and certainly seems questionable from an equitable standpoint, it does appear implied by the plain language of the statutes involved.[4]

II. Determining The Universe Of Claims Entitled To A Distribution In Converted Cases

A second issue which is more complicated in a converted case is determining the universe of claims arguably entitled to distribution. During the Chapter 11, 12 or 13 case the debtor may have accrued additional debt to that originally scheduled. While creditors of the debtor in possession

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[3]Of course, the result would be different had the plan or order confirming the plan excepted certain property from vesting in the debtor at confirmation. In the writer's experience that seldom happens.

[4]One may ask who receives any money held by the Chapter 13 trustee if the debtor converts to Chapter 7 after having confirmed a Chapter 13 plan. Although there is a division of authority on whether the undistributed funds held by the Chapter 13 trustee are "property of the estate," *see, In re Price*, 130 B.R. 259, 268-269 (N.D.Ill. 1991)(collecting cases), resolving that issue is unnecessary to this question. The confirmed plan binds the debtor pursuant to Section 1327(a) of the Code and nothing in the conversion changes that. Further, Sections 1326(a)(2) & (c) of the Code require the Chapter 13 trustee to make payments to creditors under the plan. Therefore, in such cases the Chapter 13 trustee should pay the money to creditors pursuant to the plan notwithstanding conversion of the case. This view is adopted by a leading treatise, *see* W. Homer Drake, Jr. and Jeffrey W. Morris, *Chapter 13 Practice and Procedure* §13.04, May, 1999 Supp. at p. 233 (West Group 1999)(citing cases). *Contra In re Boggs*, 137 B.R. 408 (Bankr.W.D.Wash. 1992)(debtor receives money on theory that conversion vacated plan).

(hereafter "DIP creditors") are entitled to share in the ultimate distribution, they cannot do so if they lack notice. Thus, Fed. R. Bank. P. 1019(5) requires the debtor to file a final report of post-petition debts. If the report is filed before the bar date notice is mailed to creditors, there generally is no problem. If, however, the report either is not filed or is filed after the bar date notice has been mailed to creditors, such DIP creditors may be divested of their right to a dividend, unless the trustee takes remedial action.

In the case of no debtor in possession report, the trustee should file a motion requesting the court to compel the filing of the report by the debtor. For non-individual debtors, the trustee should also consider requesting the court to designate an individual as the debtor pursuant to Fed. R. Bank. P. 9001(5) in order to aid compliance. If the debtor in possession report is filed after the bar date has been mailed to creditors, the trustee should request the court to set a bar date for DIP creditors. Remember, only after creditors have had their opportunity to file claims or requests for payment of administrative expenses and the trustee has reviewed and had objections to them determined by the court, is the case ripe for closing.[5]

In this connection the trustee should note the change in Fed. R. Bank. P. 1019(6) made by the amendments to the Federal Rules of Bankruptcy Procedure that became effective on December 1, 1999. Under the former practice persons who had claims arising after the filing of the petition but

[5]Trustees also should remember that the universe of claims entitled to distribution is different for cases filed before August 1, 1987. Under current rules a creditor must file a proof of claim or request for payment of administrative expense in order to receive a dividend. Although a claim filed before conversion stands in the Chapter 7, the debtor's Chapter 11 schedules cannot be used as a basis for paying claims. For cases filed before August 1, 1987, however, claims listed by the Chapter 11 debtor as not disputed, contingent or unliquidated are deemed allowed and must be paid notwithstanding that the creditor has not filed a proof of claim. *See, Matter of Fesco,* 908 F.2d 240 (7th Cir. 1990).

before conversion of the case would simply file a proof of claim whether or not the claim was entitled to be treated as an administrative expense.[6] After the amendment such persons must now must file a request for payment of an administrative expense instead of a proof of claim in order to have the claim treated as an administrative priority claim.[7]

III. Determining The Proper Amount Of A Claim In Converted Cases

A third issue that is more complicated in a converted case is determining whether a claim is filed for the proper amount. This is especially nettlesome where a plan has been confirmed before conversion, (but there is an estate to administer because the plan or order confirming the plan did not vest all property in the debtor) . In making the determination a preliminary and unresolved question is whether a claim should be allowed based on the amount due when the case was filed or whether the starting point is what the confirmed plan provided.

Suppose, for example, that a creditor had a $100 claim on the date the case was filed. The plan provided for a 10% payment or $10. Suppose, further that the creditor had in fact received $5 in plan payments before the case converted to Chapter 7. Under the first alternative the creditor has a claim for $95 ($100 minus the $5 plan payment). Under the second alternative the creditor only has a claim for $5 ($10 due under the plan minus the $5 plan payment).

The first alternative appears to disregard the plan and Bankruptcy Code sections which provide

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[6]Even under the former practice professionals such as trustees, attorneys and accountants were required to file fee applications rather than proofs of claims.

[7]For an interesting case discussing the former practice see *In re Gerardo Leasing, Inc.,* 1999 Bankr. LEXIS 765 (Bankr.N.D.Ill. 1999).

that the plan binds creditors. *See* 11 U.S.C. §§ 1141(a), 1227(a) & 1327(a). Nevertheless, in the Chapter 13 context at least one court has held that the plan is no longer binding if the debtor fails to make plan payments and converts the case to Chapter 7. *In re Pearson*, 214 B. R. 156, 161 (Bankr. N.D. Ohio 1997).

The second alternative recognizes the binding effect of plans. So, for example, in a serial Chapter 11 case, *In re Sportpages Corp.*, 101 B.R. 528 (N.D. Ill. 1989), the court limited a creditor's claim to the amount remaining to be paid under the debtor's first confirmed plan, although that plan had only been partially performed. The court did not allow the creditor's claim based on the amount due at the time the debtor's first case was filed.

In the writer's view the *Sportpages* theory is more defensible than the one advocated in *Pearson*. Not only does *Sportpages* recognize the binding effect of confirmed plans, it also does no violence to the plan revocation provisions of 11 U.S.C. §§1144, 1230 & 1330. Each of those provisions is specifically designed to unwind a plan. Further, each conditions its availability upon strict time limits and proof of fraud by the debtor, whereas the *Pearson* theory unwinds a plan simply on the basis of conversion to Chapter 7. Finally, the *Sportpages* theory is entirely consistent with the principle noted above that the Chapter 13 trustee holding funds pursuant to a confirmed plan at the time of conversion should distribute those funds to creditors in accordance with the provisions of the plan. If conversion had the effect of nullifying the plan, there would be legal basis for the Chapter 13 trustee to make such payments.

Of course, irrespective of which view is adopted in the trustee's jurisdiction, before making a distribution the trustee will still have to determine how much was promised to be paid and how much in

fact was paid under the plan. Determining how much was actually paid under a plan is more difficult than determining what was promised to be paid under the plan. In addition to consulting with the plan proponent and creditors, the trustee may review the final report and account of the debtor and, if applicable, the final report and account of the Chapter 12 or 13 trustee. Only by so doing will the trustee be in a position to make applicable credits and thereby determine the proper dividend to creditors.

Finally, the trustee also should keep in mind that in cases converted from Chapter 13, Section 348(f)(1)(B) provides that allowed secured claims are reduced to the extent that they have been paid during the Chapter 13 case.[8] This result also should apply in converted Chapter 11 and 12 cases even in the absence of express authority, since there is no right, statutory or otherwise, to be paid twice on the same debt.

IV. Determining The Priority Of United States Trustee Quarterly Fees In Converted Cases

A fourth issue, one that arises only in cases converted from Chapter 11, is the status of unpaid United States Trustee quarterly fees. When a Chapter 11 case converts to Chapter 7 there are often unpaid fees owed to the United States Trustee pursuant to 28 U.S.C. §1930. These fees have the same priority as Chapter 7 costs of administration and Clerk's fees. Because the unpaid fees may be substantial, sometimes there is little or no other money available to pay other claims, even Chapter 11 administrative ones. This has resulted in challenges to the priority of these fees, notwithstanding the

[8]Opinion is divided on whether the creditor's lien can be completely eliminated based upon payments made before conversion. *Compare Pierson* (no) with *In re Archie*, 240 B.R. 425 (Bankr.S.D.Ala. 1999)(yes, if secured claim paid in full before conversion)

apparently clear language of Section 507(a)(1) of the Code.

To date no appellate court has sustained such a challenge to the United States Trustee's position on this matter. *See In re Endy,* 104 F.3d 1154 (9th Cir. 1997); *In re Juhl Enterprises, Inc.*, 921 F.2d 800 (8th Cir. 1990). Further, while the United States Trustee generally files a proof of claim or request for administrative expense for the unpaid fees, such filing is for informational purposes only and is no more required than for Clerk's fees. Therefore, trustees should be advised to check with the United States Trustee's Office prior to preparing a proposed distribution to determine whether there are any outstanding United States Trustee fees owed. Remember that under Section 726(a)(1) of the Code this claim may be filed at any time prior to the trustee's distribution and still retain its priority status.

V. Determining Trustee Fees In Converted Cases

The fifth issue which is more complicated in a converted case is determining trustee and professional fees. Section 326 imposes a cap on trustee compensation. The formula has changed over the years, most recently with the Bankruptcy Reform Act of 1994. The applicable percentage fee cap is determined by the statutory language of Section 326 in *effect on the date the case was filed,* not the date the case was converted or any other date. Therefore, the case trustee must be cognizant of the applicable fee schedule for the case in question and not assume it is the one currently in effect. Obviously, if a trustee seeks compensation in excess of the applicable statutory formula, an objection may be filed. *See In re H & S Motor Freight, Inc.*, 23 F.3d 1431 (8th Cir. 1994).

In converted cases trustees sometimes work more closely with secured creditors than in other

cases. Due to the delay engendered by the debtor in possession period secured creditors may find it more expeditious to request the trustee to conduct a sale under Section 363 of the Code than to enforce their rights in state court. Where there is some benefit for the estate trustees may do so and seek to surcharge the creditor's collateral pursuant to Section 506(c) of the Code. The interplay of Sections 326 and 506(c) may become an issue because "in any instance in which a trustee has expended estate funds to preserve or dispose of a secured creditor's collateral, the trustee's recovery under section 506(c) is to reimburse the estate for the trustee's expenditure; it is not compensation to the trustee." 4 Collier on Bankruptcy ¶506.05 **[**1**]** (15th ed.rev. 1999). Accordingly, while there is no statutory limitation on the amount a trustee may recover under Section 506(c), the trustee's compensation continues to be limited by Section 326.

Occasionally, a trustee may attempt to circumvent the limitation of Section 326 through the use of Section 506(c) or attempts to treat Section 506(c) as a compensation statute, thereby enlarging the fee. This is inappropriate and likely will cause an objection by the United States Trustee. *See In re Pink Cadillac Associates,* 1997 WL 164282, 37 Collier Bankr. Cas.2d 1213 (1997).

VI. Determining Professional Fees In Converted Cases

The sixth and last issue which is more complicated in a converted case is how to deal with fees of professionals from the debtor in possession period. In converted cases there are frequently professionals who have received retainers or interim compensation prior to conversion. In order to close a case all compensation issues must be finally determined. Thus, the trustee may have to request the court to compel professionals to file final fee applications or conduct a review of fees under Section

329 of the Code.

Furthermore, once all professional fees are allowed as final, there may be insufficient funds to pay them. If professionals have received interim allowances, the trustee should consider whether it is appropriate to request the court to order disgorgement so that all claims of the same priority receive the same percentage distribution. *See In re Unitcast, Inc.*, 219 B.R. 741, 752-54 (6th Cir. BAP 1998)(collecting cases and discussing standards for ordering disgorgement). While some trustees may be reluctant to do so, the integrity of the bankruptcy system requires trustees to consider this issue and reach a principled decision on how best to close a case with this problem.

Conclusion

As the discussion above illustrates there are a number of daunting issues in cases converted to Chapter 7. It is hoped that by providing a better understanding of those issues this article will increase the likelihood that such cases will be successfully administered.