

Marrama v. Citizens Bank
Denial of conversion to chapter 11
Bad Faith
11 USC § 706(c)

10 Bears at Chiloquin, Inc., Case No. 06-62079-fra7

6/6/2007

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Unpublished

Code § 706 provides that a debtor may convert a chapter 7 case to one under chapters 11, 12, or 13 at any time, if the case has not been previously converted. However, the case may not be converted unless the debtor is eligible to file a case under such chapter. § 706(d).

In Marrama v. Citizens Bank of Massachusetts, 127 S.Ct. 1105 (2007), the Supreme Court ruled that a debtor may not convert to chapter 13 if sufficient cause exists under § 1307(c) to warrant dismissal or conversion of the case from chapter 13 to chapter 7. In effect, facts warranting dismissal or conversion to chapter 7 would make the debtor ineligible for chapter 13. The court found in that case that the debtor had engaged in acts constituting bad faith and denied conversion of the case to chapter 13.

In the present case, a creditor filed an objection to the Debtor's motion to convert to chapter 11. The bankruptcy court ruled that the holding of Marrama is equally applicable to a conversion to chapter 11. The court found sufficient evidence that cause existed to deny conversion to chapter 11 and, pursuant to § 1112(b)(1) and (2), that there was not a reasonable expectation that a plan of reorganization could be confirmed and that the Debtor had not acted towards its creditors in good faith. Accordingly, Debtor's motion to convert to chapter 11 was denied.

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8 UNITED STATES BANKRUPTCY COURT
9 FOR THE DISTRICT OF OREGON

10 In Re:) Bankruptcy Case
11 10 BEARS AT CHILOQUIN, INC.,) No. 06-62079-fra7
12 _____) MEMORANDUM OPINION
Debtor.)

13 The Debtor ("10 Bears") in this Chapter 7 case seeks to convert the
14 case to one under Chapter 11. 11 U.S.C. § 706. The Debtor's principal
15 creditor objects. The Court finds that the case should not be converted,
16 and it should remain in Chapter 7.

17 I. BACKGROUND

18 1. Procedural Posture

19 This case was commenced under Chapter 7 of the Bankruptcy Code¹ on
20 October 13, 2006. After actions in State Court seeking to recover
21 alleged fraudulent transfers were removed to this Court, Debtor moved, on
22 March 27, 2007, to convert the case to one under Chapter 11 of the Code,
23 pursuant to Code § 706. Pete Hansen & Sons, a partnership ("Hansens"),
24 objected, relying on a recent decision of the United States Supreme
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¹ 11 U.S.C. §§ 101-1532.

1 Court, Marrama v. Citizens Bank of Massachusetts, 127 S.Ct. 1105, 75 USLW
2 4113 (2007). The motion and objections were considered in a three-day
3 hearing ending on May 18, 2007.

4 2. History

5 10 Bears entered into an agreement with Hansens whereby Hansens
6 would loan money, which it had itself borrowed, to 10 Bears. 10 Bears
7 would in turn use the funds to acquire property, including acreage, a
8 small motel and a restaurant, on Highway 97 near Chiloquin. Hansens'
9 borrowings were secured by timber wholly owned by Hansens. While Hansens
10 may have expected to acquire an interest in the Chiloquin property to
11 secure repayment, that, as will be seen, never occurred.

12 Efforts to acquire the Chiloquin property from Lisa and Taylor Day
13 ("Days") floundered, and litigation ensued. The Days and 10 Bears
14 settled prior to trial with an agreement providing for the sale by Days
15 to 10 Bears. Payment to the Days was secured by a deed of trust.

16 As noted, 10 Bears had borrowed a substantial amount of money - at
17 least \$2 million, according to the Debtor's schedules - to finance
18 acquisition of the property and "operations." While some of the funds
19 may have been used to make the down payment to Days, 10 Bears ultimately
20 failed to pay the balance to Days when it came due, and the Days have
21 initiated proceedings to reclaim the property. This does not mean that
22 the remaining borrowed funds were idle: 10 Bears had made unsecured
23 loans of over \$500,000 to insiders. When advised by the Internal Revenue
24 Service that the practice was inappropriate, 10 Bears' directors
25 promulgated resolutions purporting to employ the insider borrowers,

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1 committing the corporation to pay compensation in amounts equal to or
2 slightly exceeding the amounts borrowed.

3 In the meantime, 10 Bears was searching for additional funding,
4 ostensibly to finance its development of the Chiloquin property. It
5 initiated the legal procedures required for a public stock offering. To
6 facilitate this process, 10 Bears' shareholders created a new
7 corporation, Rapids Properties, Inc. The rationale was, evidently, that
8 a new, "clean" company would be better situated to raise the funds from
9 new shareholders to proceed with the purchase and development of the
10 property. On or about January 2, 2006, 10 Bears conveyed the Chiloquin
11 property to Rapids Properties for \$3,800,000, a substantial gain - on
12 paper at least - over the \$1,575,000 million purchase price from Days.
13 The terms of the sale did not involve any cash: Rapids Properties was to
14 assume the obligation to Days, and provide 10 Bears with a promissory
15 note in the sum of \$2.7 million. The note is unsecured "except for a
16 security agreement for all real and personal property that binds [10
17 Bears] resulting from its purchase of the property from Taylor and Lisa
18 Day." (See Exhibit MM.)

19 Upon learning of the transfer by 10 Bears to Rapids Properties,
20 Hansens commenced an action in the Circuit Court for Lane County, Oregon,
21 seeking to avoid the transfer as fraudulent. Before the matter could
22 come on for trial, the Debtor filed its petition for relief in this
23 Court. Debtor's schedules show assets of \$6,029,720, consisting of the
24 promissory notes from Rapids Properties, notes from insiders Kendall and
25 Maynard, and unliquidated legal claims against Hansens and the attorney
26 who undertook to prepare the public offering.

1 II. ISSUES

2 1. Have the creditors shown that cause exists to deny the Debtor
3 the opportunity to reorganize under Chapter 11 of the Bankruptcy Code?

4 If so,

5 2. Has the Debtor demonstrated an ability to propose and confirm a
6 plan of reorganization, even if cause to deny reorganization might exist?

7 III. LEGAL ISSUES

8 1. Marrama

9 In Marrama v. Citizens Bank of Massachusetts, the debtor made a pre-
10 petition transfer, without consideration, to a newly created trust.

11 Seven months later he filed his petition in bankruptcy, making no mention
12 of the transfer in this schedules and scheduling his interest in the
13 trust as valueless. These circumstances were uncovered by the trustee
14 at, or perhaps before, the meeting of creditors. At the meeting, the
15 trustee advised debtor that he intended to recover the vacation property
16 as an asset of the estate. Thereafter, the debtor filed a "notice" that
17 the case was to be converted to Chapter 13. The trustee objected, and
18 the Bankruptcy Court sustained the objection, refusing to permit the
19 conversion. The Court of Appeals for the First Circuit and the Supreme
20 Court subsequently affirmed.

21 The Supreme Court held that a party is effectively ineligible to
22 reorganize under Chapter 13 if circumstances exist constituting cause
23 under Code § 1307(c) to either dismiss a pending Chapter 13 case, or
24 convert such case to one under Chapter 7.

25 In practical effect, a ruling that an individual's Chapter 13
26 case should be dismissed or converted to Chapter 7 because of
pre-petition bad faith conduct, including fraudulent acts

1 committed in an earlier Chapter 7 proceeding, is tantamount to
2 a ruling that the individual does not qualify as a debtor under
Chapter 13.

3 Marrama, 127 S.Ct. At 1111.

4 The Court went on to note that the broad power to prevent abuse
5 granted to Bankruptcy Courts by Code § 105(a) is "surely adequate to
6 authorize an immediate denial of a motion to convert filed under § 706 in
7 lieu of a conversion order that merely postpones the allowance of
8 equivalent relief. . . ." Id. at 1112.

9 In short, the central holding of Marrama is that circumstances
10 justifying conversion or dismissal of a Chapter 13 case authorize the
11 Bankruptcy Court to prohibit conversion of a liquidation proceeding to
12 one under Chapter 13. The statutory language of Code §§ 1307 and 1112,
13 the equivalent Chapter 11 provision, are substantially equivalent. It
14 follows that the Marrama rule is applicable with respect to Chapter 11
15 reorganization as well.

16 IV. CODE § 1112

17 Code § 1112 governs conversion or dismissal of Chapter 11 cases, and
18 was substantially rewritten by the Bankruptcy Abuse Prevention and
19 Consumer Protection Act of 2005 (BAPCPA). Drafted in the rococoque
20 style typical of BAPCPA, the section governs conversion or dismissal of
21 Chapter 11 cases as follows:

22 1. A case may be dismissed or converted for cause. "Cause" is not
23 explicitly defined, but is said to include any of a long list of events
24 or circumstances. Most involve some form of conduct respecting the case
25 or mismanagement of the estate. While these specified acts are calm by
26 their nature, post-petition it has long been held that Courts may take

1 pre-petition conduct into account. Marrama at 1111. ("Bankruptcy courts
2 nevertheless routinely treat dismissal for pre-petition bad faith conduct
3 as implicitly authorized by the words "for cause.") It is generally
4 recognized that "good faith" is a threshold prerequisite to securing
5 Chapter 11 relief: Matter of Madison Hotel Associates, 749 F.2d 410, 426
6 (7th Cir. 1984); In re BBT, 11 B.R. 224, 235 (Bankr. D.Nev. 1981); In re
7 Victory Constr. Co., 9 B.R. 549, 558 (Bankr. C.D. Cal. 1981), and that
8 the lack of such good faith constitutes "cause," sufficient for dismissal
9 under 11 U.S.C. § 1112(b). In re Marsch, 36 F.3d 825, 828 (9th Cir.
10 1994).

11 The existence of good faith in this context depends on "an amalgam
12 of factors," as opposed to a single fact. Marsch at 828; In re Arnold,
13 806 F.2d 937, 939 (9th Cir. 1986). The test, as stated in Arnold, is
14 "whether a debtor is attempting to unreasonably deter and harass
15 creditors or attempting to effect a speedy, efficient reorganization on a
16 feasible basis."

17 2. Notwithstanding the existence of cause, the Court shall not
18 convert or dismiss a case if there are "unusual circumstances
19 specifically identified by the court" establishing that conversion or
20 dismissal would not be in the best interest of creditors and the estate.
21 In predicate of such a finding is demonstration by the debtor or another
22 party in interest that (a) there is a reasonable likelihood that a plan
23 would be confirmed and (b) that the cause for conversion or dismissal
24 included an act or omission which was reasonably justified and which
25 would be cured within "a reasonable period of time fixed by the court."
26 Code § 1112(b) (1) and (2).

1 In other words, demonstration that past faults were innocent and
2 curable and that a plan can be confirmed to the ultimate benefit of
3 creditors and the estate is an affirmative defense to a claim that the
4 case should be converted or dismissed.

5 V. DISCUSSION

6 1. Cause Exists to Deny Conversion

7 Marrama establishes that the Court may deny a motion to convert to
8 Chapter 11 if objecting creditors establish "cause" as described by
9 § 1112(b)(4). Cause includes gross mismanagement of the estate, and
10 gross mismanagement of the debtor's affairs pre-petition. The Court
11 finds that the following circumstances constitute cause to deny the
12 Debtor's late efforts to proceed under Chapter 11:

13 The Debtor made improper loans to insiders who do not appear to have
14 the means or the inclination to repay the loans. This misconduct was
15 compounded by transparent efforts to justify these transfers by creating,
16 after the fact, employment contracts between the Debtor and the
17 recipients of the so-called loans. There is nothing in the record to
18 suggest that two of the recipients, Mr. Stagg and Mr. Kendall, performed
19 any services for the Debtor to justify compensation in the amounts
20 contemplated. Whether the third recipient, Mr. Maynard, provided
21 services of equivalent value is, at best, problematic.

22 If an employment relationship did exist between the Debtor and Mr.
23 Maynard and the others, no steps were taken to provide for tax
24 withholding and other required payments. The result may be a substantial
25 liability.

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1 The Debtor has failed to file current tax returns, and account for
2 compensation paid.

3 The Debtor has failed to maintain the debt service on its only
4 asset, the Chiloquin property. If there is any justification for failure
5 to pay the amounts due to the Days, particularly in light of the sums
6 borrowed from Hansens, it does not appear on this record.

7 The transfer by the Debtor to Rapids Properties was fraudulent in
8 two respects: First, it appears to have been intended to put the
9 property beyond the reach of creditors such as the Hansens. Second, it
10 appears that the Debtor's management intended to market shares in the
11 second company in a manner designed to disguise the substantial debt owed
12 to the Days and the Hansens.

13 The Debtor's schedules failed to disclose a number of unpaid loans,
14 including \$275,000 to Herb and Lenore Person.

15 The sale by 10 Bears to Rapids Properties purports to yield a very
16 substantial capital gain. However, the sale is structured in a manner
17 that yields to the Debtor no cash with which to pay the inevitable tax.
18 Assuming for the sake of argument that the sale cannot be set aside, the
19 Debtor has saddled itself with a potentially ruinous tax burden for no
20 discernable purpose. Moreover, the debt is unsecured, constituting an
21 unreasonable risk to 10 Bears' creditors.

22 Finally, it is significant that this case was filed by the Debtor
23 under chapter 7 shortly before the Hansens' state court proceeding was to
24 be tried. After the case was removed, the Debtor sought to have it
25 remanded. The Debtor did not seek to reorganize until after this court
26 declined to do so, and authorized Hansens to prosecute the matter for the

1 benefit of the estate. The effect, of course, of a conversion would be
2 to stop the avoidance action. This adds to the "amalgam" of bad faith
3 making conversion inappropriate.

4 2. Reorganization Is Not Likely

5 In support of its position, the Debtor advances only a vague
6 proposal to "substantively consolidate" 10 Bears and Rapids Properties.
7 The approach is not feasible. Rapids Properties is not a functioning
8 corporation, and presently exists without shareholders or officers. Its
9 only asset is legal title to the Chiloquin property. Moreover, it may
10 well be that Rapids Properties has its own creditors, which would render
11 consolidation impracticable, if not inequitable.

12 Assuming that the case can go forward with all the assets under one
13 roof, the Debtor's management does not present any reasonable likelihood
14 that it can successfully reorganize. While plans have been drawn up for
15 the extensive renovation and improvement of the subject property, the
16 Debtor's only proposed method of payment appears to involve either more
17 borrowing, or a stock offering. The Debtor's record to date provides no
18 reason to believe that any such efforts would succeed. Moreover, the
19 record does not reflect that the Debtor has given due consideration to
20 such issues as tax liabilities, payment for professional costs, land use
21 planning, or a host of other issues.

22 Finally, it must be observed that the Debtor has not acted with good
23 faith towards its creditors, and cannot be expected to do so in the
24 future. Debtor's dealings with the Hansens have, in particular, shown an
25 utter disregard for the Hansens' interests. While maneuvering the
26 property to ensure that it not be available to pay the debt to the

1 Hansens, the Debtor nevertheless enticed the Hansen partnership into
2 putting up its own property to secure the original borrowing. That
3 property has since been lost to the Hansens' creditors, and the Hansens
4 have nothing to show for it. While it may well be said that the Hansens
5 might have been more careful in their dealings, this does not excuse the
6 damage done to them by the Debtor's sharp practices. Any effort to
7 reorganize requires a debtor to protect the interest of creditors and the
8 estate, as well as its own. The debtor here has demonstrated that it is
9 incapable of doing so.

10 VI. CONCLUSION

11 The Debtor has engaged in a pattern of bad faith and mismanagement
12 which has caused considerable loss to its creditors. These circumstances
13 provide ample justification for refusal, under Marrama and Code § 1112,
14 to allow this case to proceed under Chapter 11 of the Bankruptcy Code.
15 For that reason, an order will be entered denying the Debtor's motion to
16 convert the case to one under Chapter 11.

17 This opinion constitutes the Court's findings of fact and
18 conclusions of law. An order consistent herewith will be entered by the
19 Court.

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22 FRANK R. ALLEY, III
Bankruptcy Judge
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