

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
Appellate No. 08-6322-HO

4/8/2009 Judge Hogan aff'g FRA Unpublished

A creditor filed an objection to the Debtor's motion to convert to chapter 11. The bankruptcy court ruled that the holding of Marrama v. Citizens Bank of Massachusetts, which held that conversion to chapter 13 may be denied on grounds of lack of good faith, 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. Debtor appealed.

The District Court affirmed the bankruptcy court on the question of whether a debtor in chapter 7 has an absolute right to convert to chapter 11, ruling that Marrama is applicable. It also affirmed the bankruptcy court's holding that the circumstances of the case justified a finding of lack of good faith sufficient to deny conversion to chapter 11.

The bankruptcy court's underlying opinion was entered June 6, 2007 and is numbered E07-6.

E09-4

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF OREGON

In Re: Civ. No. 08-6322-HO
10 BEARS AT CHILOQUIN, INC., ORDER
Debtor.

Appellant-debtor 10 Bears at Chiloquin, Inc. (10 Bears) appeals the order of the bankruptcy court denying its motion to convert its chapter 7 liquidation case to one for reorganization under chapter 11. The bankruptcy court's factual determinations and legal conclusions are free of material error. The bankruptcy court properly found cause to deny 10 Bears's motion to convert to chapter 11. The order of the bankruptcy court is affirmed.

Jurisdiction

The court has jurisdiction over 10 Bears's appeal. 28 U.S.C. § 158(a)(1); see In re Marrama, 313 B.R. 525, 529 (1st Cir. BAP 2004), aff'd by 430 F.3d 474 (1st Cir. 2005), cert. granted by Marrama v. Citizens Bank of Massachusetts, 547 U.S.

1191 (2006), and judgment aff'd by 549 U.S. 365 (2007).

Standards of Review

"Findings of fact, whether based on oral or documentary evidence, shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the bankruptcy court to judge the credibility of the witnesses." Fed. R. Bank. P. 8013. The bankruptcy court's legal conclusions are reviewed de novo. In re Daniels-Head & Assocs., 819 F.2d 914, 918 (9th Cir. 1987).

Bankruptcy Court's Findings of Fact

The following facts are gleaned from the memorandum opinion of the bankruptcy court. Creditor-Appellee Pete Hansen & Sons (Hansen) concurs with the bankruptcy court's factual determinations.

Hansen loaned at least \$2 million to 10 Bears. Hansen and 10 Bears intended the loans to enable 10 Bears to purchase an acreage with a small motel and restaurant, to develop the property and to fund operations. Lisa and Taylor Day owned the property located near Chiloquin, Oregon. Hansen incurred debt secured by its timber holdings in order to provide financing to 10 Bears. A deed of trust secured 10 Bears's obligation to the Days. The Days initiated proceedings to reclaim the property after 10 Bears failed to timely pay a balance owed to the Days.

10 Bears made unsecured loans of over \$500,000 to insiders.

When the Internal Revenue Service advised 10 Bears that the loans were inappropriate, 10 Bears's directors promulgated resolutions purporting to employ the insiders for compensation in amounts equal to, or slightly exceeding, the amounts of the loans.

10 Bears initiated legal procedures required for a public stock offering, ostensibly to finance development of the property. To facilitate the stock offering, 10 Bears's shareholders created a new corporation, Rapids Properties, Inc. On or about January 2, 2006, 10 Bears conveyed the Chiloquin property to Rapids Properties for \$3,800,000. The transfer resulted in a significant gain to 10 Bears. Rapids agreed to assume 10 Bears's obligation to the Days and provided 10 Bears with a promissory note for \$2.7 million. The note is unsecured "except for a security agreement for all real and personal property that binds [10 Bears] resulting from its purchase of the property from Taylor and Lisa Day."

After learning of the transfer from 10 Bears to Rapids Properties, Hansen commenced a state court action to avoid the transfer as fraudulent. On October 13, 2006, before trial in Hansen's state court action, 10 Bears filed its voluntary chapter 7 petition. After the state case was removed to the bankruptcy court, 10 Bears filed its motion to convert the chapter 7 case to chapter 11. 10 Bears's schedules show assets of \$6,029,720, consisting of the promissory note from Rapids Properties, notes

from insiders Kendall and Maynard, and unliquidated legal claims against Hansen and the attorney who undertook to prepare the public stock offering.

10 Bears's Facts

10 Bears asserts the following facts in its brief.

Chairman of the Board Charles Staggs, Secretary Stephens Kendall and President Wayne Maynard, President formed 10 Bears on October 18, 1999. Prior to formation, Staggs brought Maynard an option to purchase the Chiloquin property from the Days and the potential for financing provided by Hansen. The purchase option assigned to 10 Bears was to close on June 30, 2000. The Days refused to meet their obligations and 10 Bears recorded its option with Klamath County Deeds and Records. The Days responded with a lawsuit to quiet title and 10 Bears asserted a counterclaim for breach of contract by the Days. Approximately four years later, 10 Bears and the Days reached a settlement agreement whereby 10 Bears would purchase 80 acres from the Days. The deal closed on May 12, 2004, with a \$300,000 down payment from 10 Bears and a \$1,275,000 balance carried by the Days.

The property is bordered by Highway 97, the Williamson River and the Klamath Tribes KLaMoYa Casino. 10 Bears attempted to negotiate a parcel sale with the Klamath Tribes to expand the Casino's land base, develop a sewage treatment facility in joint venture with the tribes, and develop an RV park and campground.

The property has a 10 unit motel, manufactured rental homes and a café. 10 Bears leased the café, managed the rentals and operated the motel on a seasonal basis.

Between June 2000 and May 2004, Hansen provided 10 Bears with financing for operations and development opportunities. Hansen pledged its timber holdings as collateral for money it borrowed to finance 10 Bears. Hansen obtained loans totaling \$1,725,000. Hansen used some of the borrowed funds to satisfy mortgage liens and family debts and paid itself origination points and other compensation. Hansen placed \$1,300,000 into 10 Bears's beneficial control. Hansen aggregated several small loans from local lenders in refinancing through Selco Credit Union. 10 Bears was required to service Hansen's loans and made interest payments totaling \$378,000. Hansen financed 10 Bears with full knowledge that 10 Bears was engaged in litigation with the Days for breach of contract, and that 10 Bears did not seek specific performance. Hansen operates an ongoing cattle operation with a net worth exceeding \$6,000,000. Hansen consulted an attorney regarding the financing it provided to 10 Bears.

10 Bears proposed to develop a recreational vehicle park and campground on the property. Between May 17, 2004, and February 2006, when 10 Bears exhausted its cash resources, 10 Bears obtained a phase II environmental study from the Days,

commissioned a cultural survey, confirmed permitted uses, obtained a Department of Environmental Quality preliminary analysis for a septic permit, became aware of locations and capacities of existing wells, obtained preliminary drawings and a topographic map from an engineer and prepared a pro forma. Before development of the proposed RV park and campground may proceed, 10 Bears must formally apply to DEQ for a septic permit, cause a transportation study to be completed and submit final engineered drawings with an application for a building permit.

Less than a year after 10 Bears acquired the property, Hansen advised 10 Bears that it no longer wished to complete its contractual obligations to obtain \$3,000,000 for 10 Bears. The parties liquidated the debt owed by 10 Bears to Hansen in an unsecured promissory note issued by 10 Bears on October 20, 2005, in the amount of \$2,065,116.81. 10 Bears looked for alternate financing.

Hansen eventually sued 10 Bears for breach of contract, unjust enrichment, misrepresentation, corporate veil, fraudulent transfer and elder abuse. 10 Bears had also defaulted on its obligations to the Days. After unsuccessfully negotiating with the Days, 10 Bears filed its chapter 7 petition. 10 Bears removed Hansen's lawsuit to the bankruptcy court.

Hansen failed to provide presentment, notice of default or demand as required by the note. Hansen tried to accelerate the

note although the note lacked a "time is of the essence" clause. Hansen breached its agreement with 10 Bears by withdrawing its collateral before lending \$3,000,000 to 10 Bears, which left 10 Bears unable to proceed.

When 10 Bears removed the state court case, the parties had only recently commenced discovery and the state court had yet to set a trial date.

Discussion

I. Limitations on Right to Convert Chapter 7 Case to Chapter 11

First, the bankruptcy court did not err in relying on Marrama v. Citizens Bank of Mass., 549 U.S. 365 (2007) as authority for the proposition that in the circumstances of this case, 10 Bears does not enjoy an absolute right to convert the chapter 7 case to chapter 11. See e.g. In re Euro-American Lodging Corp., 365 B.R. 421, 425 (Bkrtcy. S.D. N.Y. 2007), In re Broad Creek Edgewater, LP, 371 B.R. 752, 756-57 (Bkrtcy. D.S.C. 2007), In re George Love Farming, LC, 366 B.R. 170, 177-78 (Bkrtcy. D. Utah, 2007).

10 Bears argues that Marrama does not apply because it predates the Bankruptcy Abuse Prevention and Consumer Protection Act. The Court relied on subsections (a) and (d) of 11 U.S.C. § 706, which 10 Bears acknowledges are not materially altered by BAPCPA. 549 U.S. at 371-72. The Court held, "[Section] 706(d) . . . provides adequate authority for the denial of [a] motion to

convert." Id. at 374. Like the pre-BAPCPA version of section 1307 considered by the Court in Marrama, Section 1112 does not include the debtor's pre-petition bad faith conduct among the enumerated causes for dismissal or conversion of a chapter 11 case to chapter 7. Yet bankruptcy courts routinely treat dismissal for prepetition bad-faith conduct as implicitly authorized by the words "for cause." Id. at 373. Distinctions between pre- and post-BAPCPA versions of sections 1112 and 1307 provide little support to 10 Bears.

The Court also rejected 10 Bears's argument that legislative history of the bankruptcy code proves that debtor's have an absolute right to convert a liquidation case to reorganization. Id. at 372.

II. Bankruptcy Court's Finding of Cause to Deny Conversion

Next, 10 Bears's challenge to the bankruptcy court's finding of cause to deny conversion is rejected.

Based on Marrama, the bankruptcy court held that when circumstances would justify conversion or dismissal of a chapter 11 case, a bankruptcy court is authorized to prohibit conversion of a chapter 7 case to chapter 11. Opinion at 5. Referring to its "rococoesque style," the bankruptcy court paraphrased section 1112.

A case may be dismissed or converted [from chapter 11] for cause. "Cause" is not explicitly defined . . . * *
* Notwithstanding the existence of cause, the [c]ourt shall not convert or dismiss a case if there are

"unusual circumstances specifically identified by the court" establishing that conversion or dismissal would not be in the best interest of the creditors and the estate. In predicate of such a finding is demonstration by the debtor or another party in interest that (a) there is a reasonable likelihood that a plan would be confirmed and (b) that the cause for conversion or dismissal included an act or omission which was reasonably justified and which would be cured within "a reasonable period of time fixed by the court." In other words, demonstration that past faults were innocent and curable and that a plan can be confirmed to the ultimate benefit of creditors and the estate is an affirmative defense to a claim that the case should be converted or dismissed.

Opinion at 6-7.

The bankruptcy court held that "good faith" is a threshold prerequisite to securing chapter 11 relief, and the lack of such good faith constitutes "cause" sufficient for dismissal under section 1112(b). Opinion at 6 (citing to In re Marsch, 36 F.3d 825, 828 (9th Cir. 1994)). The court also held that cause exists so as to justify conversion from chapter 11 to chapter 7, and that reorganization is not likely. Opinion at 7, 9.

10 Bears argues that the bankruptcy court erred by considering pre-petition conduct of 10 Bears that was not egregious. 10 Bears's authority, In re Love, 957 F.2d 1350 (7th Cir. 1992), does not bar consideration of pre-petition conduct that is not egregious.

10 Bears argues that its loans to insiders were not illegal under Oregon law. Nonetheless, the bankruptcy court permissibly considered among the totality of the circumstances that the IRS

found that the loans were improper, and that 10 Bears recast the loans as compensation even though two of the loan recipients provided no services to 10 Bears.

10 Bears faults the bankruptcy court for characterizing its business practices as "sharp." The bankruptcy court properly considered that 10 Bears transferred its only asset after Hansen put its timber holdings at risk in order to provide financing to 10 Bears.

The bankruptcy court did not find that 10 Bears mismanaged the bankruptcy estate, as 10 Bears contends.

10 Bears argues that the bankruptcy court erred by characterizing the state case as ready for trial at the time 10 Bears removed the case to bankruptcy court, and by finding that 10 Bears did not seek to reorganize until after the bankruptcy court declined to remand the state court case and authorized Hansen to prosecute the matter. Any errors by the bankruptcy court in determining the precise timing of events in the state court and bankruptcy court are immaterial. Whether the state court litigation was ready for trial at the time of removal, 10 Bears removed the action prior to trial and sought remand only after the trustee filed notice of intent to seek authorization for Hansen to prosecute the avoidance action on behalf of the bankruptcy estate.

10 Bears argues that the bankruptcy court erred in finding

that conversion to chapter 11 would stop Hansen's avoidance action. 10 Bears's authority, Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery, 330 F.3d 548 (3rd Cir. 2003), is not contrary to the bankruptcy court's finding. The case holds that a bankruptcy court can authorize an unsecured creditors committee to sue on behalf of the estate to avoid a fraudulent transfer where the debtor in possession refuses to prosecute such a claim. Id. at 568-69.

10 Bears provides no reasonable justification for the following additional factual findings of the bankruptcy court regarding the conduct of 10 Bears: 10 Bears took no steps to provide for tax withholding and other required payments; 10 Bears failed to file 2005 tax returns and account for compensation paid; 10 Bears failed to maintain the debt service on the property and the record discloses no justification for 10 Bears's failure to meet its obligations to the Days; the transfer of the property from 10 Bears to Rapids Properties appears to have been intended to put the property beyond reach of creditors, such as Hansen, and to market shares in the second company in a manner designed to disguise the substantial debt owed to the Days and Hansen; 10 Bears's debtor schedules do not disclose a number of unpaid loans, including \$275,000 to Herb and Lenore Person; the transfer of the property to Rapids Properties purports to yield a substantial capital gain, but no cash to 10 Bears to pay

resulting taxes; and Rapids Properties's debt to 10 Bears is unsecured, constituting an unreasonable risk to 10 Bears's creditors. Opinion at 8-9.

III. Bankruptcy Court's Application of 11 U.S.C. 1112(b)(2)

10 Bears challenges the bankruptcy court's failure to find reasonable justification for 10 Bears's acts, or reasonable likelihood that a plan could be confirmed. See 11 U.S.C. § 1112(b)(2).

10 Bears argues that the bankruptcy court required that it prove its conduct was innocent, which it contends is a higher standard than the reasonable justification required by section 1112(b)(2)(B)(i). 10 Bears relies on the Black's Law Dictionary definition of "innocent." "Free from guilt; acting in good faith and without knowledge of incriminating circumstances[.]" 10 Bears contends that the bankruptcy court equated innocence with good faith, and deprived it of the possibility of being found to have acted in bad faith, but with reasonable justification. As an example, 10 Bears argues that the bankruptcy court erred in faulting it for not filing 2005 and 2006 tax returns post-petition, because it could not speak for itself and only the standing trustee could file 10 Bears's tax returns.

This argument is unpersuasive. The bankruptcy court recited the statutory language and used the word "innocent" in explanation of the language. The dictionary definition advanced

by 10 Bears includes the good faith standard. The bankruptcy court did not hold that 10 Bears may not provide reasonable justification for its conduct, as 10 Bears's contends. While 10 Bears argues that its 2006 return was not due until after it filed the chapter 7 petition, 10 Bears provides no reasonable justification for failing to file its 2005 tax return prior to filing the petition. Nor does 10 Bears provide reasonable justification for other prepetition conduct noted by the bankruptcy court in support of its determination that cause exists to deny 10 Bears's motion to convert.

10 Bears next argues that the bankruptcy court erred by requiring that it prove a reasonable likelihood that it can reorganize, rather than a reasonable likelihood that a plan can be confirmed, as required by section 1112(b)(2)(A). 10 Bears contends that the former burden is significantly higher than the latter. 10 Bears argues that reasons cited by the bankruptcy court to deny conversion to chapter 11 are issues for plan confirmation, and are not appropriate for consideration in determining the threshold question of whether there is a reasonable likelihood that a plan can be confirmed.

Specifically, 10 Bears argues that its plan to consolidate with Rapids Properties proposal was workable, the bankruptcy court erred by speculating that Rapids Properties was non-functional under Nevada corporations law, and plans may be implemented and

capital raised by asset transfers, merger or consolidation, issuance of securities and borrowing. 10 Bears contends that the bankruptcy court gave no weight to its proposal to potentially sell excess acreage to raise capital.

Any error by the bankruptcy court in substituting a reasonable likelihood of reorganization standard in place of a reasonable likelihood of plan confirmation standard is harmless, because 10 Bears failed to provide reasonable justification for nearly all of the conduct relied upon by the bankruptcy court for the determination that cause existed to deny 10 Bears's motion to convert. As discussed above, the bankruptcy court permissibly considered prepetition conduct and 10 Bears provided no reasonable justification for its conduct other than to point out that it had no authority to file its 2006 tax returns.

Conclusion

Based on the foregoing, the order of the bankruptcy court denying 10 Bears's motion to convert its chapter 7 liquidation case to chapter 11 is affirmed.

SO ORDERED.

DATED this 7th day of April, 2009.

s/ Michael R. Hogan
United States District Judge