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The Debtor's Conduct at the Time of Filing Controls in Determining Whether a Debtor is Eligible to Convert Their Existing Case to a Case under Subchapter V of the Bankruptcy Code

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Introduction

Congress passed the Small Business Reorganization Act of 2019 (the "SBRA") to give small businesses a better chance to successfully reorganize under Chapter 11 of Title 11 of the United States Code (the "Bankruptcy Code").¹ One of the SBRA's most important amendments was the addition of Subchapter V to Chapter 11 of the Bankruptcy Code, which was designed to reduce the cost and complexity of a small business reorganization.² Because the statute's express terms do not address its application to existing debtors, courts have been forced to address issues of conversion and eligibility.³ Generally, conversion of a case is permissive under Rule 1009 of the Federal Rules of Bankruptcy Procedure, and a debtor may amend a voluntary petition "as a matter of course at any time before the case is closed," so long as the trustee and any other entities affected by the amendment are given proper notice.⁴ A party opposing the amendment of

¹ See *In re Ventura*, No. 18-7719, 615 B.R. 1, 6 (Bankr. E.D.N.Y. 2020).

² See *id.*

³ See *id.* at 24.

⁴ Fed. R. Bankr. P. 1009.

a voluntary petition may object “on a timely basis, and the Court may undertake eligibility considerations.”⁵

Chapter 11 debtors that seek to convert their case and proceed in Subchapter V will have their eligibility evaluated based on several criteria: (1) whether their initial petition was filed before or after the enactment of the SBRA; (2) whether conversion will prejudice creditors; and (3) whether the debtor has engaged in bad faith conduct.⁶ This memorandum discusses these eligibility requirements. Part I discusses the procedural issues that arise when a debtor seeks to convert their existing Chapter 11 case to one under Subchapter V. Part II examines debtor conduct and other considerations that may cause a court to deny a debtor’s motion to convert.

I. Procedural Considerations Related to Conversion

A. Statutory Silence Concerning the SBRA’s Application to Existing Debtors

The SBRA is retroactively applicable to debtors that commenced their cases before its enactment.⁷ Traditionally, retroactive statutory interpretation “is not favored in the law,” and “congressional enactments and administrative rules will not be construed to have retroactive effect unless their language requires this result.”⁸ “Accordingly, the presumption against retroactivity particularly applies to ‘new provisions affecting contractual or property rights, matters in which predictability and stability are of prime importance.’”⁹

⁵ *In re Progressive Sols., Inc.*, 615 B.R. 894, 901 (Bankr. C.D. Cal. 2020).

⁶ *See generally In re Bonert*, 619 B.R. 248, 253 (Bankr. C.D. Cal. 2020).

⁷ *See In re Ventura*, 615 B.R. at 15–16.

⁸ *Landgraf v. USI Film Products*, 511 U.S. 244, 264 (1994) (quoting *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 208 (1988)).

⁹ *In re Moore Props. of Pers. Cty., LLC*, No. 20-80081, 2020 WL 995544, at *3 (Bankr. M.D.N.C. Feb. 28, 2020) (quoting *Landgraf*, 511 U.S. at 271).

In the context of Subchapter V conversion, creditors have claimed that their “vested property interests” justify a presumption against retroactivity.¹⁰ Because Subchapter V’s provisions largely track those of Chapter 11, courts have found that conversion generally “do[es] not impair the vested property interests of creditors and, therefore, . . . it is appropriate to apply” the SBRA to existing debtors.¹¹ In particular, conversion of a debtor’s Chapter 11 case that has not proceeded for a substantial period of time is unlikely to impair a creditor’s vested rights.¹² But even a debtor that proceeded in Chapter 11 for a significant period of time and is on the verge of filing a plan of reorganization, may be permitted to amend without impairing a creditor’s “vested rights.”¹³

Some courts have noted that “an impermissible taking” of vested property rights could be found if a case is “sufficiently advanced” that conversion would unfairly affect a creditor’s “post-petition expectations.”¹⁴ Sufficiently vested rights may be found in advanced cases if creditor investment in the case, or a court order, has affected a creditor’s expectations.¹⁵ But a creditor’s expectations are determined, and limited, by the rights they are granted under their agreement with the debtor.¹⁶ A secured creditor’s expectations typically include the ability to “proceed against the [d]ebtor to collect the amount due and owing,” as well as the right to compel the sale of collateral and apply the proceeds from the sale to the amount due.¹⁷ Because

¹⁰ *See In re Ventura*, 615 B.R. at 15–16.

¹¹ *See In re Body Transit, Inc.*, 613 B.R. 400, 407–08 (Bankr. E.D. Pa. 2020).

¹² *See id.* (finding no impairment of “vested rights” where the debtor filed for Chapter 11 relief approximately one month prior to the effective date of the SBRA to prevent a creditor levy).

¹³ *See In re Ventura*, 615 B.R. at 14 (finding a debtor that filed for Chapter 11 relief fifteen months prior to the passage of the SBRA could convert to Subchapter V without impairing their primary creditor’s “vested rights.”).

¹⁴ *See In re Moore Props. of Pers. Cty., LLC*, 2020 WL 995544, at *5.

¹⁵ *See id.*

¹⁶ *See In re Ventura*, 615 B.R. at 17.

¹⁷ *See id.*

“Subchapter V incorporates most of existing [C]hapter 11,” conversion from Chapter 11 to Subchapter V does not impair a creditor’s ability to exercise its rights, and thus does not affect their expectations.¹⁸ Notably, courts have yet to identify a situation where a creditor’s rights were sufficiently vested to preclude a debtor from converting their case.¹⁹

B. Deadlines Imposed by the SBRA

Debtors that cannot comply with the timing considerations of Subchapter V upon conversion can overcome a creditor’s objection if their need for an extension is not “attributable to circumstances for which” they should be held accountable.²⁰ Delay resulting from conversion of a case to Subchapter V is an important consideration because Subchapter V’s purpose is to provide small business debtors with “a less costly and time-consuming path to reorganization.”²¹ Courts have allowed debtors to convert if the debtor filed their petition prior to the enactment of the SBRA, even if Subchapter V’s 60-day status conference and 90-day plan deadline have passed.²²

The law concerning conversion of cases commenced after the enactment of the SBRA is less clear, but cases considering the conversion of pre-enactment petitions are instructive. A court may extend applicable deadlines “if . . . the need for an extension is attributable to

¹⁸ See *In re Moore Props. of Pers. Cty., LLC*, 2020 WL 995544, at *4.

¹⁹ See *In re Ventura*, 615 B.R. at 16 (noting that a creditor’s “vested rights” were not impaired by conversion to Subchapter V because its rights remained unchanged even though significant progress had been made in Chapter 11).

²⁰ See *In re Ventura*, 615 B.R. at 14–15 (citations omitted).

²¹ See *id.* at 16–17.

²² See *id.* at 11, 14–15 (permitting conversion one week after the SBRA became effective); *In re Moore Props. of Pers. Cty., LLC*, 2020 WL 995544, at *1 (permitting conversion “[f]ive days after the SBRA became effective.”). *But see In re Seven Stars on the Hudson Corp.*, 618 B.R. 333, 347 (Bankr. S.D. Fla. 2020) (denying conversion four months after the SBRA became effective).

circumstances for which the debtor should not justly be held accountable.”²³ Importantly, circumstances that the debtor cannot be held accountable for are evaluated under a standard higher “than the mere ‘for cause’ standard.”²⁴ Thus, a debtor that commenced a Chapter 11 case would need to demonstrate a substantial justification to overcome an objection to a motion to convert its case to Subchapter V.²⁵ Notably, “circumstances for which the debtor should not justly be held accountable” do not include “difficulties *in seeking to reorganize . . .* [such as] inability to meet the statutory deadlines.”²⁶ Other courts have stated that the inquiry into whether conversion of a post-enactment petition is proper should be “fact-intensive” and focus on the specific case at hand.²⁷

II. Debtor Conduct and Other Considerations that may Preclude Conversion

A. Prejudice to Creditors

An existing Chapter 11 debtor will not be permitted to convert their case if doing so will result in undue prejudice to creditors.²⁸ In *In re Body Transit Inc.*, the court noted that prejudice in Subchapter V conversion would be evaluated based on typical prejudice determinations applicable in other bankruptcy amendments.²⁹ Actions by the debtor that would unnecessarily

²³ *In re Ventura*, 615 B.R. at 14 (quoting 11 U.S.C. § 1188(a) (2018)).

²⁴ *See In re Seven Stars on the Hudson Corp.*, 618 B.R. at 344.

²⁵ *See id.*

²⁶ *Id.* at 346 (finding that the debtor’s inability to meet the deadlines of Subchapter V were “not due to COVID-19 or the fact that Subchapter V first became available after Seven Stars commenced th[e] case.”).

²⁷ *See In re Trepetin*, 617 B.R. 841, 850 (Bankr. D. Md. 2020) (“[I]f the Debtor . . . commenced his case after the effective date of SBRA and had missed a plan deadline prior to requesting conversion or making a Subchapter V election, then perhaps an extension would not be warranted.”).

²⁸ *See In re Body Transit, Inc.*, 613 B.R. 400, 409 (Bankr. E.D. Pa. 2020).

²⁹ *See id.* at 408.

delay the administration of the case are typically prejudicial.³⁰ While no cases have denied conversion on the grounds of prejudice to creditors, many have contemplated denial upon such a finding.³¹ Creditors are not prejudiced when a debtor seeks to convert its petition after an enacted provision qualifies them for relief, or the debtor becomes eligible throughout the course of the case.³²

B. Bad Faith Conduct

A Chapter 11 debtor's bad faith conduct is also grounds to preclude the conversion of their case to one under Subchapter V.³³ Bad faith is typically found when the debtor seeks to mislead the court, mischaracterizes debts, lies on its schedules, or conceals assets.³⁴

Courts have yet to identify conduct that would qualify as bad faith in Subchapter V conversion.³⁵ It has been held not to be bad faith for a debtor to seek “to avoid the absolute priority rule.”³⁶ Additionally, a debtor's “failure to comply with the turnover of information concerning the [c]reditors' collateral” is not bad faith if the debtor's business makes doing so inherently difficult.³⁷ In *In re Easter*, the debtor's delay in responding to information requests did “not rise to the level of bad faith” because its trucking business involved leasing and

³⁰ See *In re Cudeyro*, 213 B.R. 910, 919 (Bankr. E.D. Pa. 1997) (finding the debtor's late-stage attempt to change its exemptions after assets had already been distributed was unfairly prejudicial to creditors).

³¹ See, e.g., *In re Body Transit, Inc.*, 613 B.R. at 409; *In re Ventura*, 615 B.R. at 14.

³² See *In re Ventura*, 615 B.R. at 13-14.

³³ See *In re Bonert*, 619 B.R. at 254–256; *In re Easter*, 623 B.R. 294, 302 (Bankr. N.D. Miss. 2020).

³⁴ See *In re Ventura*, 615 B.R. at 8 (noting the debtor did not attempt “to mislead . . . or to create a false impression” to creditors or the court when characterizing her business debts as “primarily consumer debts”); see also *In re Cudeyro*, 213 B.R. at 918 (citations omitted) (“[B]ad faith on the part of the debtor . . . generally is identified as some sort of attempt to conceal an asset.”).

³⁵ See *In re Bonert*, 619 B.R. at 254–56.

³⁶ See *In re Easter*, 623 B.R. 294, 302 (Bankr. N.D. Miss. 2020).

³⁷ See *id.*

subcontracting the collateral for use by third parties, making turnover difficult.³⁸ The court will undertake a fact specific inquiry when determining if the conduct of a particular debtor rises to the level of bad faith.³⁹ Like in *In re Easter*, business considerations will play a role in the determination.⁴⁰

Conclusion

Courts have afforded debtors seeking to convert their cases from Chapter 11 to Subchapter V broad leeway.⁴¹ But the cases that have come through the courts thus far have involved debtors that did not have the opportunity to file for Subchapter V relief at the time of their initial petition.⁴² Because a plain statutory reading of conversion under Subchapter V calls for a “higher standard” than traditional conversion, future debtors will have a heavy burden to shoulder when seeking to convert their cases and will have to demonstrate that the circumstances do not prejudice creditors or amount to bad faith.⁴³

³⁸ *See id.*

³⁹ *See id.*

⁴⁰ *See id.*

⁴¹ *See In re Ventura*, 615 B.R. at 15–16.

⁴² *See In re Seven Stars on the Hudson Corp.*, 618 B.R. at 346.

⁴³ *See id.*