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Feature

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Chapter 11 Conversion Conundrum

Should Post-Petition, Pre-Conversion Property Remain Property of the Chapter 7 Estate in a Converted Individual Chapter 11 Case?

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Editor's Note: *With a deep sense of loss, ABI acknowledges the sudden passing of Mark Stingley on July 9, 2017. Please see the more detailed notice on p. 45 of this issue.*

As the National Study of Individual Chapter 11 Bankruptcies recently found, "Individuals account for more than a quarter of chapter 11 bankruptcy filings, and this share has grown over time."[1] As part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), individual chapter 11 cases were made to operate more like chapter 13. One such amendment was the addition of § 1115, which is substantially identical to § 1306. Both §§ 1115 and 1306 expand the definition of "property of the estate" to include property acquired by the debtor after the commencement of the case. By way of contrast, in a chapter 7 case, with certain exceptions, property acquired by the debtor after the commencement of the case is generally the debtor's property.

Like a chapter 13 case, an individual chapter 11 case can be converted to chapter 7.[2] If converted, an issue arises as to whether the § 1115 expansion is reversed. In other words, is property acquired after the petition date, but prior to the conversion, still property of the bankruptcy estate, or does it revert to the debtor? On this issue, the courts are divided.

Past Is Prologue

Long before the enactment of § 1115, this conversion issue existed in the context of chapter 13. Prior to 1994, courts disagreed on the impact of § 348 (which governs the effect of conversion) on § 1306 and whether property acquired post-petition remained property of the estate upon conversion or whether it reverted back to the debtor. Eventually, a circuit split arose and two approaches emerged.

The "once in, always in" approach, adopted by the Fifth, Seventh, Eighth and Tenth Circuits found that once an asset became property of the chapter 13 estate, it would remain property of the chapter 7 estate — even upon conversion.[3] The seminal case adopting this approach was *In re Lybrook*, where the Seventh Circuit reasoned "that a rule of once in, always in is necessary to discourage strategic, opportunistic behavior that hurts creditors without advancing any legitimate interest of debtors."[4]

The First and Third Circuits reached the opposite conclusion and found that post-petition property reverts back to the debtor upon conversion.[5] The seminal case adopting this approach was *In re Bobroff*, where the Third Circuit reasoned that chapter 13 debtors should not be punished for attempting a chapter 13 case even if it fails. The Third Circuit found that its approach is "consonant with the Bankruptcy Code's goal of encouraging the use of debt repayment plans rather than liquidation."[6]

1 Richard Hynes, Anne Lawson and Margaret Howard, "Nat'l Study of Individual Chapter 11 Bankruptcies," 25 *ABI Law Review* 61 (2017), *available at* abi.org/member-resources/law-review.
2 *See* 11 U.S.C. § 1112.
3 *In re Lybrook*, 951 F.2d 136, 137 (7th Cir. 1991). *See also Baker v. Rank (In re Baker)*, 154 F.3d 534, 537 (5th Cir. 1998); *In re Calder*, 937 F.2d 862, 864-66 (10th Cir. 1992); *In re Lindberg*, 735 F.2d 1087, 1090 (8th Cir. 1984).
4 *Lybrook*, 951 F.2d at 137.
5 *In re Bobroff*, 766 F.2d 797, 803 (3d Cir. 1985); *Young v. Key Bank (In re Young)*, 66 F.3d 376 (1st Cir. 1995).
6 *Bobroff*, 766 F.2d at 803.

Congress essentially agreed with the Third Circuit by enacting § 348(f) in 1994. Section 348(f) rejects the "once in, always in" approach except in cases where the debtor converts a case in bad faith.[7] The conversion conundrum, at least in the chapter 13 context, had been solved.

Fast forward to 2005 and the addition of § 1115 to the Bankruptcy Code. Even though § 1115 is substantially identical to § 1306, Congress failed to amend § 348(f) to also include individual chapter 11 cases. As a result, the issue that § 348(f) was meant to resolve in chapter 13 is alive and well in individual chapter 11 cases. Once again, the courts are divided on the issue and basically two approaches have emerged.

The Fairness Approach: Why Penalize Chapter 11 Debtors but Not Chapter 13 Debtors?

While some courts have determined that post-petition property is part of the bankruptcy estate even after conversion from chapter 11 to chapter 7, certain courts have come to the opposite conclusion. These decisions have also been grounded in a "plain-language reading"[8] of the statutes and application of the policy rationale behind the enactment of § 348(f). In *In re Markosian*,[9] the Ninth Circuit Bankruptcy Appellate Panel (BAP) determined that post-petition earnings are property of the debtor after the case is converted to chapter 7. In coming to this conclusion, the court emphasized that silence by the legislature regarding a chapter 11 conversion is not conclusive. The BAP also looked to the policy reasons behind the addition of § 348(f) to further support its decision.

In *Markosian*, the debtors' chapter 11 case was later converted to chapter 7 after Ara Markosian lost her job and the debtors were unable to confirm a repayment plan. Anait Markosian received a bonus from his employer for personal services rendered during the time that their chapter 11 case was pending. The debtors turned the money over to the estate, but later (after the conversion to chapter 7) sought to have the money returned. The bankruptcy court concluded that after the conversion to chapter 7, the money ceased to be property of the estate and returned the money to the debtors. The trustee appealed, and the BAP was left to decide, as a matter of first impression, whether § 348 applied to conversions from chapter 11 to chapter 7, as it does with chapter 13 conversions.

The BAP agreed with the bankruptcy court that under § 1115(a)(2), the post-petition bonus received by Mr. Markosian was property of the chapter 11 estate. However, once the case was converted to chapter 7, § 348 governs the effects of the conversion. The BAP looked to the language and plain meaning of § 348(a), which does not differentiate among the various chapters of bankruptcy. Instead, it speaks of a "conversion ... from a case under one chapter of this title to a case under another chapter of this title."[10] The court explained that this all-inclusive language clearly included both chapter 13 and chapter 11 conversions, making § 348 applicable to both.

The BAP further explained that § 348(a) provides that the petition date remains the same as the original commencement of the case and is not thereafter affected by a conversion. Section 541(a)(6) excludes all personal service earnings of the debtor that were acquired after the commencement of the chapter 7 estate. The fact that the bonus was earned prior to the conversion was irrelevant since § 348 states that the original petition date is controlling.

The court recognized that other courts have decided the issue differently, but respectfully disagreed with their conclusions. At the time that Congress amended the statute to add § 348(f), it did so to fix a split of authority. Yet, at that time, there was no split of authority in regards to chapter 11 conversions, and § 1115 did not exist. The legislature's silence is evidence only of the fact that at that time there was no need to add a similar section regarding chapter 11 conversions. "Attempting to divine congressional intent from congressional silence is an enterprise of limited utility that offers a fragile foundation for statutory interpretation."[11]

The BAP also looked to the legislative intent behind the enactment of § 348(f). Congress, during its debate on the amendment, explained that a debtor with a chapter 13 case converted to a chapter 7 case should be treated as being equal to a debtor who originally filed a case under chapter 7.[12] The BAP looked to the *Evans* decision, which stated that debtors should not be penalized for first attempting to repay their debts.[13] The BAP held that the legislature "clearly conveyed its purpose to avoid penalizing debtors who first attempt a repayment plan.... There is no policy reason as to why the creditors should not be put back in precisely the same position as they would have been had the debtor never sought to repay his debts."[14]

Strict Constructionist Approach: Individual Chapter 11 Debtors Are to Be Treated Differently from Chapter 13 Debtors

Several courts have relied on the maxims of statutory interpretation to conclude that property acquired post-petition but before conversion from an individual chapter 11 to chapter 7 is property of the estate. One of the most recent cases reaching this conclusion is *In re Lincoln*.[15] In *Lincoln*, the debtor filed a chapter 11 case that was converted to chapter 7 less than two months later. On the conversion date, there was money held in the debtor's bank account, and the chapter 7 trustee sought turnover of those funds under § 542.

The bankruptcy court granted the trustee's motion and noted that § 348(f)(1)(A) only refers to chapter 13 cases, not chapter 11. The general rule of statutory interpretation is that "[w]here Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in this disparate inclusion or exclusion."[16] Accordingly, the court found that the chapter 11 exclusion

7 11 U.S.C. § 348(f)(1)(A) and (2).
8 *In re Evans*, 464 B.R. 429, 439 (D. Colo. 2011).
9 *In re Markosian*, 506 B.R. 273, 277 (B.A.P. 9th Cir. 2014).
10 11 U.S.C. § 348(a).
11 *Markosian*, 506 B.R. at 277 (internal citations omitted).
12 *Evans*, 464 B.R at 440.
13 *Id.* at 441.
14 *Markosian*, 506 B.R. at 277 (internal citation omitted).
15 *In re Lincoln*, No. 16-12650, 2017 Bankr. LEXIS 360 (Bankr. E.D. La. Feb. 8, 2017).
16 *Id.* at *5.

from § 348(f)(1)(A) was intentional, and that post-petition, pre-conversion funds are therefore property of the estate.

Lincoln relied on *Rogers v. Freeman (In re Freeman)*,[17] which addressed the different canons of statutory construction that support the conclusion that post-petition, pre-conversion property is property of the estate. First, as also noted in *Lincoln*, is the canon that the express mention of one thing excludes all others. By its terms, § 348(f) only applies in chapter 13. Although § 1115 did not exist at the time that Congress enacted § 348(f)(1)(A), Congress did not amend § 348(f)(1)(A) when it added § 1115 in 2005. "Congress is presumed to know the content of existing, relevant law," and "where Congress knows how to say something but chooses not to, its silence is controlling."[18] Further, § 1207 did exist in 1994 (at least in temporary fashion)[19] and is substantially identical to § 1306, but chapter 12 is not included in § 348(f).

Freeman also addressed the canon of avoiding absurd results. Proponents of treating post-petition, pre-conversion property as the debtor's property assert that § 348(f) simply clarifies what is intended by § 348(a). However, this would make the exception in § 348(f)(2) irrational.

Under § 348(f)(2), if a debtor converts a case in bad faith, the property of the estate in the converted case shall consist of the property of the estate as of the date of conversion. Section 348(a) contains no such bad-faith exception. Thus, the proponents' interpretation leads to the absurd result where non-chapter 13 debtors could convert a case in bad faith and keep post-petition, pre-conversion property, while chapter 13 debtors could not. Rather than assuming that Congress only wanted to punish bad-faith chapter 13 debtors, "A better understanding is that Section 348(f)(1)(A) excepts Chapter 13 debtors — who are typically less affluent and less sophisticated than Chapter 11 debtors — from the correctly applied meaning of Section 348(a), but with the caveat that such relief shall not be awarded to those who attempt to take advantage of the bankruptcy system."[20]

Finally, *Freeman* addressed the statutory cannon that a statute should be construed to give effect to all of its provisions. If § 348(f)(1)(A) serves only to clarify § 348(a), then § 348(f)(1)(A) is duplicative and unnecessary. Similarly, the strict construction approach gives meaning to § 541(a)(7), which provides that any interest in property that the estate acquires post-petition is property of the estate.[21]

ABI Commission on Consumer Bankruptcy Should Take Up This Issue

Both approaches discussed herein have merit. Similar to the 1994 amendments, Congress could simply resolve this issue by amending § 348(f) to also cover individual chapter 11 cases. The question then becomes whether an individual chapter 11 case is so fundamentally different from a chapter 13 case that on this key question it should be treated differently. For example, is there something inherent about an individual chapter 11 case that makes the rationale of the "once in, always in" approach more compelling?

Recently, ABI announced the formation of its Commission on Consumer Bankruptcy.[22] Its charge is to recommend "improvements to the consumer bankruptcy system that can be implemented within its existing structure."[23] While individual chapter 11 cases occupy the space between business and consumer cases,[24] the Commission should take up and examine the tensions created by BAPCPA to individual chapter 11 cases.[25] Specifically, the Commission should consider and examine the policy implications and make recommendations as to whether § 348(f) should be expanded to include individual chapter 11 cases. Until such time as Congress acts or this issue reaches the Supreme Court, it will continue to bedevil both courts and practitioners alike. abi

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17 *Rogers v. Freeman (In re Freeman)*, 527 B.R. 780 (Bankr. N.D. Ga. 2015).
18 *Id.* at 793 (quoting *Lindley v. FDIC*, 733 F.3d 1043, 1056-57 (11th Cir. 2013)).
19 Chapter 12 became permanent in 2005. P.L. 109-08, Title X, § 1001.
20 *Freeman*, 527 B.R. at 796.
21 *See Baker*, 154 F.3d at 538 n.3.
22 Hon. William H. Brown, Hon. Elizabeth L. Perris and Prof. Robert M. Lawless, "ABI Announces Commission on Consumer Bankruptcy," XXXVI *ABI Journal* 4, 14-15, 93, April 2017, *available at* abi.org/abi-journal.
23 *Id.* For more on the Commission's activities, visit ConsumerCommission.abi.org.
24 *See* "Nat'l Study," *supra* n.1, at 65-66.
25 The ABI Commission to Study the Reform of Chapter 11 specifically refrained from making recommendations related to those provisions impacting individual chapter 11 debtors. *See Final Report and Recommendations*, 317-18 (2014), *available at* commission.abi.org/full-report.