

How Are Stakeholders Affected When a Case Converts From Chapter 11 to Chapter 7?

Creditor's Rights Toolkit

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The Bankruptcy Code provides that a debtor may voluntarily convert its case from Chapter 11 to Chapter 7 unless a Chapter 11 trustee has been appointed, the case was commenced involuntarily, or the case had previously been converted to Chapter 11. This article will discuss the key issues of converting from Chapter 11 to Chapter 7, and how stakeholders may be affected.

The Bankruptcy Code provides that a debtor may voluntarily convert its case from Chapter 11 to Chapter 7 unless a Chapter 11 trustee has been appointed, the case was commenced involuntarily, or the case had previously been converted to Chapter 11. 11 U.S.C. § 1112(a). Alternatively, a party in interest may request the court convert a case to Chapter 7 “for cause.” 11 U.S.C. § 1112(b).[1] While the list of causes enumerated in the Bankruptcy Code is not exhaustive, the Bankruptcy Code does expressly note that “cause” can include loss or diminution of the bankruptcy estate, mismanagement of the estate, unauthorized use of estate assets, and failure to comply with a court order. *Id.* § 1112(b)(4).

KEY ISSUES

APPOINTMENT OF TRUSTEE

In a Chapter 7 bankruptcy proceeding, once a case is converted and a trustee is appointed, the trustee assumes control over the debtor’s estate, which involves managing and liquidating the debtor’s assets to pay off creditors. If there is a secured lender, the trustee must negotiate with the lender regarding the use of cash collateral. In addition to costs incurred in getting up to speed on the case, the trustee will incur administrative expenses necessary for managing the estate, such as costs related to asset liquidation, legal fees, and other professional services.

ADMINISTRATIVE INSOLVENCY

Cases often convert to Chapter 7 because the estate is administratively insolvent, meaning the debtor lacks sufficient funds to cover the administrative costs of the bankruptcy process. In this situation, conversion is seen as a last resort (rather than simply dismissing the case), with the hope that creditors receive some payment, even if it is minimal.

PAYMENT OF CLAIMS

For a creditor who has provided goods or services to the debtor prior to conversion, conversion to Chapter 7 will significantly impact their ability to recover amounts owed. Payments will be distributed in accordance with the priorities set forth in 11 U.S.C. § 507, which expressly provides that secured claims and then administrative expense claims (first those of the Chapter 7 estate, followed by those of the Chapter 11 estate) must be paid before any distribution can be made to general unsecured creditors.

STATUTORY DEADLINES

Where a Chapter 11 case has been pending for some time prior to conversion, it is likely that deadlines imposed by the Bankruptcy Code — such as filing a proof of claim, filing a complaint to object to discharge, or otherwise — will have passed. These deadlines are reset upon the conversion to Chapter 7. See FED. R. BANKR. P. 1019(b). Importantly, however, a proof of claim that has been filed in a converted Chapter 11 case will be deemed filed in the new Chapter 7 case. See FED. R. BANKR. P. 1019(c). To the extent a creditor provided post-petition services prior to the case's conversion for which no proof of claim was filed, it is imperative that an application for payment of administrative expenses be timely filed in the Chapter 7 case.

TAKEAWAY

Conversion of a case from Chapter 11 to Chapter 7 shifts the focus from reorganization to liquidation, and adds a new level of claims (Chapter 7 administrative claims) that must be paid before Chapter 11 administrative claims and unsecured claims can receive a distribution. Creditors of a converted Chapter 7 debtor should remain diligent in keeping up with deadlines set by the court or the Bankruptcy Rules in order to properly protect their interests.

[1] Section 1112(b) also permits the court to dismiss the case on request of a party in interest rather than convert, whichever is in the best interest of the creditors and the debtor's estate.

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