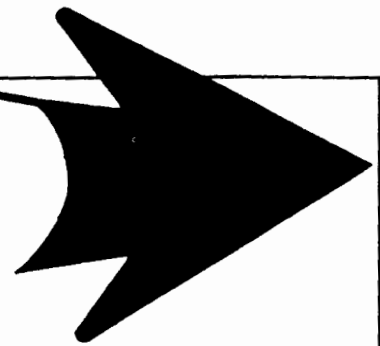


# THE ARROW

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## CHAPTER 7 DISMISSAL VERSUS CONVERSION: CREDITORS' INTERESTS DECIDE

When a bankruptcy court determines whether to dismiss a case or convert it to a Chapter 7 proceeding under 11 U.S.C. 1112(b), the Court cannot dismiss the case merely because a majority of the creditors favor dismissal.

In a recent Fourth Circuit Court of Appeals decision, the Court held that after finding "cause" existed to either dismiss or convert the Chapter 11 proceeding to Chapter 7, the bankruptcy court should have made its decision to dismiss or convert according to "the best interest of creditors and the estate." Rollex Corp. v. Associated Materials, Inc., et al. (In re Superior Siding & Window, Inc.) 25 Bankr. Ct. Dec. (CRR)

186 (4th Cir. 1994). Had the bankruptcy court made a comparison between all of the creditors' interests in bankruptcy and those they would have outside of bankruptcy under state law, the bankruptcy court would have likely concluded that the interest of the creditors was best served by conversion to Chapter 7.

In the Superior Siding case, the debtor bought supplies on credit from eight suppliers. None of the debts was secured. When the debtor failed to pay these creditors, seven of the eight obtained judgments in state court. Some began to levy on the debtor's assets. Less than 90 days after the creditors started to levy on their judgments, the debtor filed a Chapter 11 proceeding to reorganize its affairs.

The seven creditors that obtained judgments filed a Motion to Dismiss the Chapter 11 proceeding pursuant to Section 1112(b). They argued that the debtor filed its Chapter 11 petition in bad faith solely to frustrate the creditors' efforts to collect and that no reorganization plan could succeed.

The largest creditor, the only one that did not obtain a judgment, objected to dismissal and urged the court to convert the case to Chapter 7 or to appoint a trustee. The largest creditor argued that,

if the case was converted, the amounts that the seven creditors had obtained from their judgments would be subject to preference actions. Accordingly, all eight unsecured creditors would thereafter share in the assets of the estate on a pro rata basis.

The largest creditor contended that the best interest of the creditors would be served by pro rata distribution. On the other hand, under dismissal, the assets of the debtor would be seized under state law by the other creditors pursuant to their judgments. The largest creditor had not obtained a judgment and thus would be at the end of the line in terms of priority under state law.

The bankruptcy court dismissed the Chapter 11 proceeding, finding that the filing was in bad faith and that reorganization was futile. The bankruptcy court refused to convert the case to Chapter 7 because a majority of the creditors favored dismissal. The District Court affirmed. The largest creditor appealed.

The Fourth Circuit held that the bankruptcy court's reason for refusing to convert the case to a Chapter 7 proceeding was legally insufficient. Under Section 1112(b), after finding "cause," the bankruptcy court should have made its decision to dismiss or convert according to "the best interest of its creditors and the estate." The policy of giving equal treatment to creditors in the same classification is central to the Bankruptcy Code and is one of the factors to be considered in determining "the best interest of the creditors" under Section 1112(b). This policy is not served by merely tallying the votes of the creditors and yielding to the majority. Had the bankruptcy court made a comparison between all of the creditors' status in bankruptcy, where there would be a pro rata distribution, and their status outside of bankruptcy, where one of the larger creditors that had obtained a judgment would probably receive all of the debtor's assets, the bankruptcy court would likely have concluded that the interest of the creditors was best served by conversion to a Chapter 7 proceeding. □

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