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In This Issue

Excessive Administrative Expense and Inability to Effectuate a Plan are Cause to Convert Chapter 11 Cases to Chapter 7.

In Loop Corp. v. United States Trustee, 379 F.3d 511 (8th. Cir. 2004). The Eighth Circuit Court of Appeals affirmed the United States District of Minnesota, holding that it did not abuse its discretion in affirming the Bankruptcy Court's order converting a jointly administered Chapter 11 reorganization into a Chapter 7 liquidation despite the assertions that the value of the debtors' net operating losses could be realized, if at all, only in Chapter 11.

The debtors filed their Chapter 11 reorganization plan in December, 2001, with the intent to liquidate rather than reorganize their business. Loop Corp., the owner of 50% of the debtors' stock, and the committee of unsecured creditors then began to negotiate for a consensual plan.

The U.S. Trustee moved to convert the cases from Chapter 11 to Chapter 7, but the debtors stated they wished to stay in Chapter 11 and use part of the $3.25 million cash assets of the estate to fund lawsuits against accountants and directors, rather than distribute the cash to unsecured creditors. The U.S. Trustee argued that failure to confirm a plan, and the accumulating administrative costs in Chapter 11, over $1.3 million during the period from September, 2001 to January, 2002 alone, were cause to convert the case to Chapter 7. The parties failed to agree on a plan, and eventually even the creditors committee agreed to conversion to Chapter 7. The Bankruptcy Court granted the motion to convert and the District Court affirmed. Loop appealed.

Section 1112 (b) of the Bankruptcy Code states that upon a proper request, "the Court may convert a case under this Chapter to a case under Chapter 7 of this title or may dismiss a case under this Chapter, whichever is in the best interest of the creditors and the estate, for cause, including – (1) continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation; (2) inability to effectuate a plan…."

The Bankruptcy Court determined that the first cause for conversion was established by the ongoing expenses of administering the estate and because the debtors were liquidating and therefore had no likelihood of rehabilitation. The Bankruptcy Court also believed it unlikely that the debtors had the ability to confirm a plan.

Loop argued on appeal that the Bankruptcy Court's reading of Section 1112 (b) would make it impossible for liquidating debtors to ever remain in Chapter 11 because a liquidating debtor will inevitably have a negative cash flow. Loop also contended that "rehabilitation" should be understood to refer to liquidation of a debtor's assets rather than only restoration of its business operations.

The Court of Appeals disagreed, finding that the negative cash flow associated with the debtor that has ceased its business operations and liquidated its assets "effectively comes straight from the pockets of the creditors." The Court of Appeals noted that Bankruptcy Courts have consistently ruled that "this negative cash flow situation alone is sufficient to establish continuing loss or diminution of the estate" for purposes of Section 1112 (b) (1) and have construed the term "rehabilitation" to refer to the restoration of a debtors business.

Loop argued that this interpretation would require conversion to Chapter 7 whenever a debtor seeks to liquidate under Chapter 11. The Court concluded that the word "may" in Section 1112 (b) gives the bankruptcy court "broad discretion" to deny dismissal or conversion of the case despite a showing of cause, if the best interest of creditors dictates a continuation of the Chapter 11 case.

District Court Holds Draw On Letter Of Credit by Lessor Proper when Debtor fails to Renew.

In Bartholomew v. General Electric Capital Corp., 2004 WL 2066817 (Case No. 04-1353-JRT), the United States District Court for the District of Minnesota held that drawing on an irrevocable letter of credit was proper even though the sole default relied upon was the expiration of the letter of credit itself. Additionally, the District Court outlined the requirements needed to establish the equitable doctrines of unjust enrichment and subrogation.

The District Court was asked to review a three party dispute arising out of a Section 363 sale of telephone equipment subject to a lease. The equipment lessor (the "Lessor") had entered into a 60-month lease (the "Lease") with the equipment lessee (the "Lessee") which subsequently filed bankruptcy. The Lease required the Lessee to keep an irrevocable (evergreen) letter of credit in place guaranteeing the Lessee's monthly payments. Under the terms of the letter of credit it was an event of default for the Lessee not to renew the letter of credit and gave the Lessor the right to draw upon the letter of credit.

During the course of the bankruptcy the Lessee procured an interested buyer (the "Buyer") for some of its assets, including the equipment subject to the Lease. Prior to closing on the asset purchase agreement, the Lessee received a notice of renewal for the irrevocable letter of credit from the bank, but failed to renew it. Subsequently, but before the closing of the asset purchase agreement, the Lessor drew on the letter of credit and was paid. The Buyer received the right to use the telephone equipment under the terms of the Lease, but did not have to make payments to the Lessor because the Lessor was fully paid by its draw on the Lessee's letter of credit.

The appeal to the District Court involved specific factual issues as well as some discrete legal issues. The Bankruptcy Court had held that the Lessor did not violate the automatic stay by drawing on the irrevocable letter of credit. The District Court had no trouble in affirming the Bankruptcy Court ruling that "it is well established that letters of credit are not property of a debtor's estate." The District Court then reversed the holding of the Bankruptcy Court that the draw of the letter of credit was nonetheless wrongful because there was no default under the Lease. Instead, the District Court held that the letter of credit by its terms required renewal, and failure to renew was sufficient cause to draw. The District Court remanded the remaining issue of whether any surplus amounts recovered from the letter of credit by the Lessor could constitute a breach of contract action for the Lessee.

Regarding the Buyer of the Lease, the Bankruptcy Court had found that under the theory of unjust enrichment the Buyer must pay to the Lessee (Seller) the value of the equipment. The issue on appeal was whether unjust enrichment was the appropriate doctrine or whether the Bankruptcy Court might have found for the Lessee/Seller under a theory of equitable subrogation. The Court stated that "in order to establish a claim for unjust enrichment, the claimant must show that another party knowingly received something of value to which he was not entitled and that the circumstances are such that it would be unjust for that person to retain the benefit." Additionally, the Court stated that "[u]njust enrichment, as an equitable remedy, comes into play only when the rights of the parties are not governed by a valid contract." In the present case, because the rights and obligations of the Lessee and the Buyer were governed by an asset purchase agreement, the District Court held that the Buyer had not been unjustly enriched.

The District Court defined equitable subrogation as "one who has been compelled to pay a debt which ought to have been paid by another is entitled to exercise all the remedies which the creditor possessed against that other." A party wishing to establish the elements of equitable subrogation must show that:
(1) the payment was made by the subrogee [Lessee] to protect his own interests;
(2) the subrogee did not act as a volunteer;
(3) the debt must be one for which the subrogee was not primarily liable; (4) the entire debt must have been paid; and
(5) subrogation must not work an injustice to the rights of others. The District Court found that the Lessee had satisfied the necessary elements to establish equitable subrogation, but remanded to the Bankruptcy Court to calculate damages under this theory.

Workers Compensation Lump Sum Settlement Exempt Under Minnesota Law.

In Johnson v. Iannaconne (In re Johnson), Case No. 03-CV-6202 (D. Minn. 2004.), the United States District Court for the District of Minnesota reversed the Bankruptcy Court and held that a debtor's lump sum settlement, pursuant to the Minnesota's Workers' Compensation Act was exempt under Minn. Stat. § 176.175, subd.2. The appellant, Ms. Johnson, received a lump sum settlement in 1994 for temporary and permanent partial disability. In Ms. Johnson's 2003 voluntary bankruptcy petition, she claimed that the lump sum settlement balance was exempt. The Bankruptcy Court sustained the trustee's objection to the exemption. In her appeal, Ms. Johnson claimed her workers' compensation settlement was exempt pursuant to Minn. Stat. § 176.175, which provides "any claim for compensation owned by an injured employee or dependants is exempt from seizure or sale for the payment of any debt or liability." (emphasis added)

The Bankruptcy Court defined "claim" by referencing Minn. Stat. § 550.37 and the recent cases interpreting it. Section 550.37, which addresses property that is exempt from the execution of judgments, provides a distinction between the claim itself and its proceeds. Under Minn. Stat. § 550.37, proceeds of a claim are available to creditors while the right of action or claim itself is exempt. Based upon that reasoning, the Bankruptcy Court found that the debtor's workers' compensation settlement constituted "proceeds," not a claim, and was therefore not exempt. The District Court disagreed, and held that the proper statute to be interpreted was Minn. Stat. § 176.175, which makes no distinction between a claim and its proceeds.

NEWS

News From the Chapter 13 Trustee's Office.

The Chapter 13 subcommittee of the local rules committee has finished its work on the revised local form Chapter 13 plan and has forwarded the proposed plan to the full local committee for approval (other proposed rule changes and revised forms were sent to the full committee earlier). The Chapter 13 rule and form changes will be incorporated into the entire package of local rules revisions, to be sent to the Judges for their review.

Jasmine Keller and two of her staff recently returned from a fact finding trip to Texas, where they observed the operations of two of the 15 Texas Chapter 13 trustees and had extensive meetings with the trustees and their respective staffs. The purpose of the trip was to observe the functioning of a "paperless" trustee operation and to discuss ways of implementing it in Minnesota.

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