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A DEBTOR'S RIGHT TO CONVERT: ABSOLUTE OR DISCRETIONARY?

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A CLE Presentation

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ISSUE

Traditionally the right of a debtor to convert under section 706(a) from a Chapter 7 to a Chapter 11, 12, or 13 was absolute. But a new line of cases is challenging this despite the language in section 706(a). So, is a debtor's right to convert under section 706(a) absolute or discretionary?

RULE

Section 706(a) of the Bankruptcy Code

The debtor may convert under this chapter to a case under chapter 11, 12, or 13 of this title at any time, if the case has not been converted under section 1112, 1208, or 1307 of this title. Any waiver of the right to convert a case under this subsection is unenforceable.

Section 105(a) of the Bankruptcy Code

The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, **or to prevent an abuse of process.** [emphasis added]

DISCUSSION

Scenario

Debtor chooses to exercise her right to convert from a chapter 7 bankruptcy to a chapter 13 bankruptcy. However, the court refuses to allow the conversion on the grounds that the debtor has acted in "bad faith." Can the court prohibit the debtor from converting despite the language of section 706(a)?

Traditional Line of Case Law

The traditional line of cases would find that the court could not prohibit debtor's right to convert from a chapter 7 under section 706(a). So long as the debtor meets the requirements for filing under chapter 13 and the debtor has not undergone prior conversion, reorganization, or individual repayment plan case, the debtor has an absolute right to convert. *In re Kilker*, 155 B.R. 201 (Bankr. W.D. Ark. 1993).

The traditional line of cases takes the plain language approach to interpreting the statute and looks to legislative history. The language of section 706(a) is clear; a debtor has an absolute right to convert where the case has not undergone prior conversion, reorganization, or individual repayment plan case. *9A Am. Jur. 2d Bankruptcy § 1001*. The plain meaning rule also requires that the words in section 706(a) be given their "proper effect." *In re Porras*, 188 B.R. 375 (Bankr. W.D. Tex. 1995). There is also a policy consideration for allowing an absolute right to convert; if a debtor wishes to repay her debts, the courts should never prevent her from doing so. *9A Am. Jur. 2d Bankruptcy § 1001; In re Kuntz*, 233 B.R. 580 (B.A.P. 1st Cir. 2003); *In re Little*, 245 B.R. 351 (Bankr. E.D. Mo. 2000).

Legislative history also clearly indicates an intent that the right to convert under section 706(a) be interpreted as an absolute right of the debtor. The legislative history provides that:

Subsection (a) of this section gives the debtor the one-time absolute right of conversion of a liquidation case to a reorganization of individual repayment plan case. If the case has already once been converted from Chapter 11 or 13 to Chapter 7, then the debtor does not have that right. The policy of the provisions is that the debtor should always be given the opportunity to repay his debts...."

In re Wampler, 302 B.R. 607 (Bankr. S.D. Ind. 2003) (citing H.R. Rep. No. 595, 95th Cong., 1st Sess. 380 (1977); S.Rep. No. 989, 9th Cong., 2d Sess. 94 (1978), U.S. Code Cong. & Admin. News 1978, 5787, 5880, 6336).

New Trend in Interpreting Section 706(a)

There is recent case law however, interpreting section 706(a) as not being absolute, but being at the discretion of the court. If the court determines that the debtor exercised her right under section 706(a) in bad faith, the court can disallow the conversion.

The court in *Wampler* made the point that if a Chapter 13 petition can be dismissed for lack of good faith, then it stands to reason that a motion to convert from a Chapter 7 to a Chapter 13 can also be denied by a showing of bad faith by the debtor. 302 B.R. 601 at 605. The court in *Wampler* also held that “section 706(a) was not intended as a way for the dishonest debtor to abuse the bankruptcy process, perpetrate a fraud or engage in bad faith behavior.” *Id.* These courts that follow the new trend have held that the court has “inherent and statutory authority” under section 105(a) to deny a debtor’s motion in order to prevent abuse of the bankruptcy process, where the court believes that the creditors are being abused, and where the debtor’s estate has the financial capacity to satisfy all creditors. *9A Am. Jur. 2d Bankruptcy § 1001.*

Therefore, when the court believes that debtor’s motion to convert under 706(a) is based on debtor’s lack of good faith, the court can deny debtor’s motion to convert under section 105(a). In *In re Johnson*, 262 B.R. 75 (Bankr. E.D. Ark. 2001), the court found that the evidence of inaccuracies and misrepresentations in debtor’s bankruptcy schedules and statement of financial affairs constituted debtor’s lack of good faith and denied debtor’s motion to convert to chapter 13.

The court in *Wampler*, 302 B.R. 601, held that a motion to convert should be granted liberally and with the presumption that they are filed in good faith. Stated that 706(a) was “intended to give only the honest debtor an opportunity to voluntarily repay his debts via conversion from Chapter 7; it was not intended as a way for the dishonest debtor to abuse the bankruptcy process, perpetrate a fraud, or engage in bad faith behavior.”

The test as to whether the debtor has demonstrated the degree of bad faith necessary to overcome the absolute right to convert granted in 607(a) is found in the case of *Wampler*, 302 B.R. 601:

In determining whether a motion to convert a Chapter 7 case was brought in bad faith, bankruptcy court will examine the totality of the circumstances, considering the timing of the motion to convert, debtor’s motive in filing the motion, and whether debtor has been forthcoming with the bankruptcy court and creditors, whether debtor can propose a confirmable Chapter 13 plan, the impact on debtor of denying conversion weighed against the prejudice to creditors caused by conversion, the effect of conversion on the efficient administration of the bankruptcy estate, and whether conversion would further an abuse of the bankruptcy process.

Id. at 605-06.

Is This Trend Continuing?

Is this trend of denying the absolute right of a debtor to convert under 706(a) continuing, or are courts returning to the traditional interpretation? Since *Wampler* was decided in 2003, two courts have followed the rule set out in that case, one criticized it, and one partially criticized and partially followed it.

In *In re Czykoski*, 320 B.R. 385 (2005), while the issue was not whether the court had the authority to deny a debtor’s motion to convert under 706(a), the court nonetheless found that the right of the debtor to convert under 706(a) was an absolute right.

The courts in *In re Manouchehri*, 320 B.R. 880 (2004), and *In re Copper*, 314 B.R. 628 (2004), followed the reasoning in *Wampler* in its entirety.

However the most recent case to deal with this issue was *In re Kuhn*, 322 B.R. 377 (Bankr. N.D. Ind. 2005) which was decided in March, 2005. The court in this case followed the *Wampler* court when it determined that a debtor does not have an absolute right to convert. However, the court in *Kuhn* disagreed with the *Wampler* court with regard to the bad faith standard applied in *Wampler*. In fact, the *Kuhn* court took the standard even further than the *Wampler* and the other courts. The *Kuhn* court adopted a new test which does not necessarily require a showing of bad faith on the part of the debtor in order for the court to deny a conversion.

The Court thus adopts a test that would preclude or condition a debtor's right to convert from a Chapter 7 case to a Chapter 13 case under 11 U.S.C. § 706(a) only under extraordinary circumstances in which conversion is sought in bad faith, or in which the totality of circumstances on the date of filing the motion for conversion give rise to significant potential prejudice to creditors regardless of any consideration of bad faith.

Kuhn, 322 B.R. 377 at 398.

In *Kuhn* we see that not only are courts continuing with this trend to construe section 706(a) as a non-absolute right to convert, but the courts are continuing to expand it, giving the court even greater discretion to deny a debtor's rights to convert.

Will the holding in *Kuhn* will become the new standard for denying conversions? Will the test in *Wampler* be the standard? Will the courts return to the traditional approach of plain meaning and absolute right?