



**UNITED STATES BANKRUPTCY COURT
CENTRAL DISTRICT OF CALIFORNIA
SAN FERNANDO VALLEY DIVISION**

In re:

Robert Vilas Johnson
Linda Joyce Johnson

Debtor(s).

Case No.: 1:11-bk-18629-GM

CHAPTER 11

**MEMORANDUM OF DECISION
CONVERTING CASE TO CHAPTER 7 UPON
TRUSTEE'S MOTION FOR CONDITIONAL
DISMISSAL OF CASE (Dkt. #556)**

Date: March 1, 2017
Time: 1:00 p.m.
Courtroom: 302

Jeffrey Golden (the "Trustee"), as trustee of the chapter 11 estate of Robert Vilas Johnson and Linda Joyce Johnson (the "Debtors"), moves for entry of an order conditionally dismissing this chapter 11 case and allowing professional fees and expenses. (For ease of reference, most numbers below are approximate.)

1 Service: appears to be in order. 21-days' notice given to all creditors and parties on the
2 Court's NEF list.

3
4 Background:

5 Mr. Johnson owned and operated (in part) IS West, an internet service provider.
6
7 In February 2011, the California Superior Court entered a substantial judgment against
8 Mr. Johnson and IS West in favor of Kenneth Cleveland and William Bickley (the
9 "Judgment Creditors") relating to, among other things, a breach of contract. Shortly
10 thereafter, Drew Kaplan (Mr. Johnson's business partner) commenced an arbitration
11 proceeding against Mr. Johnson seeking damages arising out of Mr. Johnson's
12 purported misconduct in his dealings with the Judgment Creditors.
13

14 On July 18, 2011, the Debtors filed for chapter 11 relief. After two failed attempts
15 by the Debtors to confirm a plan of reorganization, the court *sua sponte* ordered the
16 appointment of a chapter 11 trustee. Mr. Golden was appointed as chapter 11 trustee
17 on November 14, 2012. The Trustee has employed (each with court approval) Mirman,
18 Bubman & Nahmias, LLP and then Baker & Hostetler, LLP ("Baker"), as counsel, and
19 Crowe Horwath LLP ("Crowe"), as accountants.
20

21 Among other actions, the Trustee prevented a below-market sale of IS West (by
22 a receiver appointed by the Superior Court for the benefit of the Judgment Creditors),
23 sold IS West for approximately \$3 million more, commenced a chapter 11 case for IS
24 West, and confirmed a plan of reorganization for IS West – ultimately resulting in a
25 distribution of nearly \$1 million to this estate. The Trustee also commenced an
26 adversary proceeding against Mr. Kaplan (the "Kaplan Adversary") and objected to Mr.
27 Kaplan's \$8.6 million claim, resulting in the subordination of that claim. The Trustee has
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1 also proposed three plans of reorganization. The most recent, the Fourth Amended Plan
2 of Reorganization and Disclosure Statement, were filed on October 24, 2016. The
3 Fourth Amended Disclosure Statement was not approved at a December 6, 2016
4 hearing (on grounds of both disclosure and feasibility) and the hearing on this disclosure
5 statement has been continued until March 21, 2017.
6

7 The principal remaining assets of the estate are: (i) claims and causes of action
8 asserted against Mr. Kaplan in the Kaplan Adversary and (ii) \$245,000 in cash.

9 The unsecured claims against the estate are:

- 10 • Professional administrative claims (including projected fees through the closure
11 of the case) of \$290,000, consisting of \$5,000 for the Trustee, \$190,000 for
12 Baker, and \$95,000 for Crowe
- 13 • Other administrative claims (held by the IRS, the FTB, and the US Trustee) of
14 \$4,000
- 15 • Priority tax claims (held by the IRS and the FTB) of \$210,000
- 16 • General unsecured claims of \$657,000
- 17 • Mr. Kaplan's subordinated claim of \$8.6 million and subordinated tax claims of
18 \$11,000
- 19 •
- 20

21 All secured claims relate to (i) the Debtors' residence, which the Trustee has
22 abandoned, or (ii) the Debtors' automobiles and have been satisfied.
23

24 The following interim fees and expenses have been court approved and paid to
25 date:

- 26 • Mirman, Bubman & Nahmias - \$36,000
- 27 • Baker - \$309,000
- 28 • Jeffrey Golden, Trustee - \$68,000 (\$60,000 in fees and \$8,000 in expenses)

1 Motion

2 After repeated attempts to confirm a plan of reorganization and two rounds of
3 mediation with Judge Meredith Jury, the Trustee has concluded that dismissal of this
4 chapter 11 case, subject to certain conditions, is in the best interests of the estate.

5 These conditions are:

- 6
- 7 • approval of professional administrative claims,
 - 8 • distribution of cash on hand to holders of administrative and priority claims,
 - 9 • dismissal of the chapter 11 case and related adversary proceedings,
 - 10 • affirmation of all orders issued in the chapter 11 case, and
 - 11 • retention of jurisdiction by the Court to resolve certain disputes related to the
 - 12 chapter 11 case.
- 13

14 Such a dismissal will provide the greatest distributions to creditors in the circumstances.

15 Abandoning pending matters and dismissing the case will avoid the incurrence of
16 additional administrative expenses. Even if successful in the Kaplan Adversary, the
17 Trustee has concerns about recovering from Mr. Kaplan. The Debtors do not appear to
18 be willing to make the contributions required to fund the proposed plan.

19 Conversion to chapter 7 would add administrative expenses without any
20 corresponding benefit and merely delay conclusion of this case.

21 Bankruptcy Code §§105(a), 305(a), and 1112(b) provide the Court with the
22 authority to achieve the goals of bankruptcy in a conditional dismissal. Dismissal is
23 warranted under §§1112(b) and 305(a), as serving the best interests of creditors and
24 the Debtors. It maximizes the amounts available to satisfy the claims of creditors and in
25 doing so reduces the Debtors' overall debt.

26 Under §349(b) dismissal vacates any orders of this court, "[u]nless the court, for
27
28

1 cause, orders otherwise” As the purposes of the Bankruptcy Code and interests of
2 creditors are best served by a structured dismissal, an order mooted by §§349(b) is
3 warranted under §§105(a) and 349(b).

4 The Court should retain jurisdiction to resolve disputes concerning its orders in
5 this bankruptcy case, as it is in the best position to interpret and enforce its orders.
6 Seeking the guidance of other courts or reopening this case would entail substantial and
7 unnecessary expense and diminish the finality of the dismissal order.

8 The Court should approve the professional fees. Payment of administrative
9 claims of estate professional is warranted upon dismissal where, as here, the trustee
10 has rendered services that will unjustly enrich the debtor upon dismissal. The work of
11 the Trustee and his professionals resulted in the distribution of \$1 million to this estate
12 from the estate of IS West. The Trustee has also addressed and reduced substantial
13 tax liabilities. Finally, the Trustee and his professionals have substantially furthered the
14 potential claims against Mr. Kaplan, which the Trustee is abandoning to the Debtors. If
15 the administrative professional claims are not paid, the Debtors will receive these
16 benefits without bearing any of the costs.

17 The Trustee is also in negotiations with his professionals to reduce the amount of
18 their fees. Furthermore, although the Trustee has billed at his regular hourly rate in
19 excess of \$400,000, he is recovering solely his statutory fee to which he is entitled
20 under §326.

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26 United States Trustee’s Objection

27 Bankruptcy Code §330(a)(1) authorizes the bankruptcy court to award to
28 professionals employed under §327(a) “reasonable compensation for actual, necessary

1 services” and “reimbursement for actual, necessary expense. This authority includes
2 the discretion, upon motion or *sua sponte*, to award less than has been requested.
3 [This objection then lists “all relevant factors” (from §330(a) and case law) to be
4 considered by the bankruptcy court in assessing “the nature, extent, and value of
5 services rendered.”]
6

7 A significant percentage of Crowe’s compensation request includes entries for
8 duplicative services, time lumping and objectionable overhead charges in violation of
9 LBRs and other authority.

10 50% of the time Baker billed for the disclosure statement should be disallowed as
11 not necessary or beneficial to the estate. Further, Baker is seeking \$15,000 of
12 additional compensation incurred after filing the motion until dismissal of the case,
13 without specifying the services to be rendered.
14

15 The US Trustee understands that the Trustee may have further objections to fees
16 and is negotiating with the professionals. Crowe and Baker have given the US Trustee
17 additional time to supplement this objection if the US Trustee’s concerns are not
18 addressed.
19

20 21 Franchise Tax Board’s Opposition

22 Section 330 allows professionals reasonable compensation for actual, necessary
23 services that are reasonably likely to benefit the estate or are necessary to
24 administration of the estate. The applicant bears the burden of establishing entitlement
25 to the compensation and reimbursement.
26

27 The Court cannot conclude that any structured dismissal is in the best interests
28 of the estate, because the professional fees and expenses, and thus distributions to

creditors, are uncertain.

The Trustee's final fee application does not conform to the Federal Rules of Bankruptcy Procedure and the US Trustee Guidelines, by failing to submit contemporaneous time records and a narrative of the services performed. The Trustee computes the requested compensation based on a percentage calculation under §326(a), but the Trustee is not automatically entitled to the statutory cap.

Baker has been paid fees and expenses under four interim fee applications. Baker's final fee application only covers services for the last period for which fees were sought, instead of all services performed in this case (contrary to the LBRs). Baker also fails to arrange its fees and expenses by project category, which would enable creditors and the Court to evaluate the necessity and benefit of its services. Among other things, the FTB is concerned about the amount of time spent on chapter 11 plans, even though some plans were patently non-confirmable, the cost-benefit of pursuing claims against Kaplan, and duplicative work

Crowe's final fee application includes services not reasonably likely to benefit the estate and not necessary to the administration of the estate. For instance, 39.6 hours for "research and analysis" on cash disbursements, cash receipts, and the petition, schedules and case docket was unnecessary and not likely to benefit the estate in a case with only major asset. Further, 24.8 hours for "research and analysis" supporting the Trustee's plan, including projected tax liability, was neither necessary nor beneficial where the plans did not contain any significant tax information.

The Court should deny this motion or continue it for six months to allow the FTB to conduct discovery. Any structured dismissal should state that the FTB may move all payments the FTB has received on estate tax liabilities to the Debtors' FTB individual

1 account so that such payments can be applied to the tax obligations that the debtor will
2 incur upon dismissal.

3
4 Debtors' Response

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6 The Debtors were in possession of this estate for only sixteen months, while it
7 has been four years and three months since the Trustee's appointment. The Trustee is
8 responsible for the progress of this bankruptcy case.

9 The Trustee received a deposit of \$846,000 from the sale of the estate's largest
10 asset – 50% of IS West. The professional administrative claims of \$290,000 exceed the
11 \$249,000 of remaining funds on hand by \$45,000. The Trustee and the Trustee's
12 attorneys have already received a substantial portion of this estate: Mirman, Bubman &
13 Nahmias - \$36,000; Baker - \$309,000; and the Trustee - \$68,000.

14
15 The fees sought by Crowe are for duplicative and unnecessary work.

16 The US Trustee and the FTB's oppositions sufficiently address the issues
17 regarding the professionals' claims, although the Debtors believe denying the motion or
18 continuing this hearing for discovery will only lead to further cost and delay.

19
20 This Court has discretion in approving conditions to dismissal. The Debtors ask
21 the Court to use the discretion to apportion the remaining \$249,000 among non-
22 professional administrative claims, priority unsecured claims, and nonpriority unsecured
23 claims, or convert this case to a chapter 7.

24
25
26 Omnibus Reply by the Trustee

27 The Trustee has worked diligently throughout this case. Despite numerous
28 successes, Mr. Johnson's announcement that he intended to retire has left the Trustee

1 with few options: conversion or the proposed conditional dismissal. The conditional
2 dismissal best serves the interests of the estate and creditors because it avoids the
3 additional administrative expenses that would be created by conversion.

4 The US Trustee's objection has been resolved by stipulation: Baker has agreed
5 to reduce fees and expenses by \$20,000 and Crowe has agreed to accept \$50,000 on
6 account of services rendered to the estate. Baker has also agreed to file billing
7 statements for all fees and expenses for the period between January 28, 2017 and the
8 hearing. As a result, the US Trustee has agreed to withdraw the US Trustee Objection.

9
10 In addition to this reduction in professional fees, the estate is presently amending
11 its tax returns, which the Trustee understands will result in a tax refund to the estate of
12 \$40,000-\$60,000.

13
14 The FTB Opposition lacks merit:

- 15 • The amount of distributions is not unknown. Due to the reductions agreed to by
16 Baker and Crowe, priority creditors will receive approximately \$15,000. The
17 Trustee anticipates making a second, larger distribution to priority creditors after
18 receiving the tax refund.
- 19 • **Trustee Fees:** The Trustee's compensation under §326 is not based on hours
20 worked, but is a commission based on distributions. The US Trustee Guidelines
21 are not applicable to commissions and, in any event, are internal guidelines not
22 binding on the Court.
- 23 • **Baker Fees:** The Trustee incorporated by reference Baker's interim fee
24 applications, to avoid the expenditure of further fees and expenses in this case.
25 There is no need for a final fee application. The billing invoices comply with the
26 US Trustee Guidelines, which is the reason why the US Trustee has not objected
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1 to the form of the invoices. As to the reasonableness of the fees and expenses
2 incurred, the Court should be careful to avoid using hindsight to second guess
3 actions of counsel. Fees are not unreasonable simply due to the length of time
4 the Trustee has been involved or the changes in approach necessitated by
5 changes in facts (like Mr. Johnson's retirement decision) and/or law (like the
6 Ninth Circuit decision in *Zachary v. California Bank & Trust*, 811 F.3d 1191 (9th
7 Cir. 2016), that the absolute priority rule applies to individual debtors) or the
8 failure of negotiations. Fees incurred in objecting the Kaplan's claim were
9 reasonable: they led to the subordination of the claim. The FTB argues that
10 Baker's work was duplicative of that of the Trustee or Crowe, without offering any
11 substantiation.
12

- 14 • **Crowe Fees:** Crowe has agreed to reduce its requested fees by approximately
15 \$45,000 (almost 50%), which addresses any potential deficiencies in its fee
16 request.
- 17 • There is no cause to continue the hearing on this motion for six months, which
18 would only increase administrative expenses and benefit no one.
19

20 The Debtors' request that the Court alter the distribution scheme to apportion the
21 remaining \$249,000 in the estate among the non-professional creditors violates the
22 priority scheme of §507, and is thus impermissible. It is also unfairly prejudicial to the
23 Trustee and his professionals who have worked diligently in an effort to realize a
24 tangible benefit for creditors. While the Trustee had envisioned a different result for this
25 chapter 11, the Trustee's failure to confirm a plan was due to circumstances beyond the
26 Trustee's ability to control.
27
28

Tax Issue Supplements

At the initial February 21, 2017 hearing on this motion, counsel for the Debtors and counsel for the FTB argued that dismissal of this case would have negative tax implications for the Debtors. In order to better understand this tax issue prior to ruling on this motion, the Court issued a request for succinct statements regarding this tax issue [dkt. 568].

The Debtors submitted a declaration of their accountant stating, among other things, that

8. The individual Debtors deductions allowed under IRS regulations are vastly different, and far more limited, than those allowed administratively on Estate returns. The Debtors will be required to assume substantial additional taxes totaling as much as several hundred thousand dollars if the case is dismissed.

9. In addition to the significant increased tax liability, the Debtors will also be required to pay the expense of preparing and filing 5 years of amended tax returns, which will be very expensive.

10. There is no way to determine the total impact of these changes without further costly analysis and comparison of existing Federal and State Estate returns with amended Estate returns to those of the Debtors individually.

11. However, it is apparent to me that if this case is dismissed, the Estate tax returns will no longer be controlling by operation of law, the refunds claimed by the Estate will no longer be available, and instead the Debtors will have significant taxable income from over the past five years, including the sale of the assets of IS West, and far more limited deductions, than those deductions allowed administratively on the Estate amended returns.

12. As such, it is unlikely that a dismissal will better serve the interests of either Creditors or the Debtors, and dismissal will saddle the Debtors with substantial tax liabilities, which will remain unsecured priority debts.

13. If this case is converted to Chapter 7, the Estate will continue to exist for tax purposes, and the amended Federal and State returns already filed by the Chapter 11 Trustee, will remain controlling, with all of the deductions claimed administratively on Estate amended tax returns, and including the refunds claimed by the Estate.

[Dkt. 573] The FTB's supplement concludes that

First, if this Court grants the Motion and dismissal, for tax purposes, the Estate and Debtors will be treated as if no bankruptcy had ever been filed and Debtors' post-petition tax liabilities will be higher. In 2014, the Trustee paid FTB \$52,457 for administrative expenses on account of the Estate's post-petition tax

1 liabilities and in response to Internal Revenue Service's ("IRS") pending motion
2 to dismiss. Upon dismissal, the income of the Estate will become income of the
3 Debtors (26 U.S.C. § 1398(b)(1)) but Debtors will not be able to deduct
4 administrative expenses that were incurred by the Estate (26 U.S.C. §
5 1398(h)(2)(D)). Based upon FTB's preliminary analysis of Debtors' 2014 tax
6 return, a dismissal will result in tax liabilities for Debtors in the amount of
7 \$90,970.2 Thus, the tax implications of a dismissal do not better serve Debtors.
8 This also may not better serve FTB. More specifically, the tax liabilities owed to
9 the FTB would be changed from a situation in which the Estate's tax liabilities are
10 paid in full to a situation in which Debtors have liabilities but no assets to pay
11 those liabilities.

12 Second, on or about February 18, 2017, the Trustee filed amended tax
13 returns with FTB and IRS for tax refunds. Dkt No. 567, Exs. 1, 2. However, this
14 Court may not determine the right of the Estate to a tax refund for 120 days after
15 the requests (June 18, 2017), unless FTB or IRS makes a determination sooner.
16 11 U.S.C. § 505(a)(2)(B). Thus, this Court cannot yet determine the right of the
17 Estate to a tax refund.

18 Given this uncertainty, if the Court orders a dismissal, in order to protect
19 FTB, FTB requests that the dismissal order state that FTB may move all
20 payments it has received for the Estate's tax liabilities to Debtors' individual FTB
21 account for the same tax year. FTB will then be able to apply such payments to
22 Debtors' tax liabilities, which will be incurred as a result of the dismissal.

23 [Dkt. 569 at 2:17-3:16]

24 The Trustee's supplement does not really address the tax effects on the Debtors
25 of a dismissal, but does argue that dismissal would better serve the interests of the
26 FTB.

27 [U]nder the proposed conditional dismissal as modified per the FTB's request,
28 the FTB would receive payment on account of the Estate's tax liabilities and then
would be authorized to credit these amounts to the Debtors' liabilities. In other
words, the FTB would receive the exact same amount. Moreover, even if the
Trustee were not agreeable to this proposal, if the concerns articulated by the
FTB are accurate, in that the Debtors may not get the benefit of certain payment
and/or deductions made by the Estate, the FTB has the potential to recover twice
on account of the same claim. In fact, the only certainty if the Bankruptcy Case
is dismissed is that a portion of the tax liability the Trustee is proposing to satisfy
by and through the Motion will be discharged, and more administration expenses
will reduce payment to the FTB on account of the liability that is not discharged.

[Dkt. 574 at 3:25-28].

In his supplement the Trustee also argues that it was the Debtors – not the
Trustee – who had wanted to move forward with a conditional dismissal (which was

1 strongly advocated by Judge Jury in mediation), so the Trustee prepared this motion.
2 He also argues that the Debtors' initial response to this motion did not oppose the
3 proposed dismissal and that the FTB has no standing to present arguments on behalf of
4 the Debtors. Further, while §305(a) involves consideration of the interests of both
5 debtors and creditors, the Trustee also moved for dismissal under §1112(b), which
6 requires only cause.
7

8 (The bulk of the FTB's supplement and the Trustee's supplement concern
9 numerous objections that the FTB has made to the fees of the Trustee's counsel.
10 These arguments will be considered when the Court reviews the fees and expenses of
11 the Trustee and his professionals under §330.)
12

13 14 **Analysis**

15 It has become clear to the Court and all active parties in this case that this
16 chapter 11 cannot continue. No plan of reorganization appears possible and
17 continuation of this case results only in increased administrative expenses. The
18 question is how this chapter 11 should end: by conversion or dismissal?
19

20 The Motion seeks a conditional dismissal (more commonly known as a structured
21 dismissal), pursuant to §§105(a), 305(a), and 1112(b). Section 1112(b) provides for
22 dismissal or conversion "for cause" with the choice of conversion or dismissal based on
23 "whichever is in the best interests of creditors and the estate." Section 305(a) allows
24 the court to dismiss a case if "the interests of creditors and the debtor would be better
25 served by such dismissal" The Court must find that a §305(a) dismissal would
26 better serve both creditors and the debtor. *In re Eastman*, 188 B.R. 621, 625 (B.A.P. 9th
27 Cir. 1995).
28

1 Rather than a typical dismissal's "hard restart" of reinstating the pre-petition state
2 of affairs pursuant to §349(b), a structured dismissal of a chapter 11 is preceded by
3 orders of the bankruptcy court that remain in effect after the dismissal. Structured
4 dismissals often follow an asset sale or major settlement and, although increasingly
5 used, they remain controversial:
6

7 Two notable opponents of structured dismissal are the United States Trustee
8 ("UST") and the American Bankruptcy Institute. In the wake of the growing
9 popularity of structured dismissals, the UST co-authored and published an article
10 that delineated several objections to such dismissals. The UST primarily argued
11 that structured dismissals fail to afford parties with the protections provided in a
12 standard confirmation process and therefore "strongly resemble impermissible
sub rosa plans." Additionally, the American Bankruptcy Institute's Commission to
Study the Reform of Chapter 11 released a lengthy report suggesting that
Congress amend the Code to clarify that structured dismissals are impermissible.

13 Kaylynn Webb, Comment, *Utilizing the Fourth Option: Examining the Permissibility of*
14 *Structured Dismissals That Do Not Deviate from the Bankruptcy Code's Priority*
15 *Scheme*, 33 Emory Bankr. Dev. J. 355, 357–58 (2016).

16 Although not explicitly authorized by the Bankruptcy Code, structured dismissals
17 (under §1112(b) and/or §305(a)) have been found to be implicitly authorized under
18 §349(b) (which allows a court "for cause" to depart from the normal effects of dismissal
19 as spelled out in §349(b)) in a number of recent decisions, including one by the Third
20 Circuit:
21

22 [T]he Code does not expressly authorize structured dismissals. And as structured
23 dismissals have occurred with increased frequency, even commentators who
24 seem to favor this trend have expressed uncertainty about whether the Code
25 permits them. As we understand them, however, structured dismissals are simply
26 dismissals that are preceded by other orders of the bankruptcy court (e.g., orders
27 approving settlements, granting releases, and so forth) that remain in effect after
28 dismissal. And though § 349 of the Code contemplates that dismissal will
typically reinstate the pre-petition state of affairs by revesting property in the
debtor and vacating orders and judgments of the bankruptcy court, it also
explicitly authorizes the bankruptcy court to alter the effect of dismissal "for
cause"—in other words, the Code does not strictly require dismissal of a Chapter
11 case to be a hard reset. 11 U.S.C. § 349(b); H.R. Rep. No. 595 at 338, 1978

1 U.S.C.C.A.N. 5963 at 6294 (“The court is permitted to order a different result for
2 cause.”); *see also Matter of Sadler*, 935 F.2d 918, 921 (7th Cir.1991) (“ ‘Cause’
under § 349(b) means an acceptable reason.”).

3 *In re Jevic Holding Corp.*, 787 F.3d 173, 181 (3d Cir. 2015), as amended (Aug. 18,
4 2015)(citations to the record omitted), *cert. granted sub nom. Czyzewski v. Jevic*
5 *Holding Corp.*, 136 S. Ct. 2541 (2016))(cert. granted on the question of whether,
6 through a structured dismissal, the court can approve a distribution of the estate in
7 contravention of the Code's priority scheme).

8
9 However, it is important to note that the Third Circuit’s conclusion that structured
10 dismissals are permissible was limited to situations where the dismissal is not used to
11 circumvent the plan process or conversion to chapter 7:
12

13 For present purposes, it suffices to say that absent a showing that a structured
14 dismissal has been contrived to evade the procedural protections and safeguards
15 of the plan confirmation or conversion processes, a bankruptcy court has
discretion to order such a disposition.

16 *Jevic*, 787 F.3d at 182. In fact, a recent bankruptcy court decision refused to approve a
17 structured dismissal where, as here, a chapter 7 was possible, albeit more expensive:

18 Here, the Motion, while passing the “practicality” test, must be denied
19 because the structured dismissal seeks to alter parties' rights without their
20 consent and lacks many of the Code's most important safeguards. It is well-
21 established that § 105 may not be invoked to provide relief that contradicts the
22 express requirements of the Code. *See In re Combustion Eng'g, Inc.*, 391 F.3d
23 190, 286 (3d Cir.2004) (“The general grant of equitable power contained in §
24 105(a) cannot trump specific provisions of the Bankruptcy Code, and must be
exercised within the parameters of the Code itself.”). Even if a structured
25 dismissal would result in more assets being made available to the creditor body,
26 such relief may not be approved without assurances that creditor protections
27 provided by confirmation or liquidation pursuant to § 1129 or dismissal or
28 conversion pursuant to § 1112(b) are either present or waived by all parties. If a
chapter 11 case could be dismissed solely to avoid additional expenses
associated with liquidating the estate, parties would rarely, if ever, convert to
chapter 7 and the conversion option in section 1112(b) would essentially be
rendered superfluous. Section 105 cannot be interpreted to create the authority
for this result. *See Resorts Int'l v. Lowenschuss (In re Lowenschuss)*, 67 F.3d
1394, 1402 (9th Cir.1995) (“Section 105 does not authorize relief inconsistent
with more specific law.”); *United States Trustee v. Price Waterhouse*, 19 F.3d

1 138, 142 (3d Cir.1994) (“[B]ankruptcy courts cannot use equitable principles to
2 disregard unambiguous statutory language.”) (quoting *In re Middleton Arms L.P.*,
934 F.2d 723, 725 (6th Cir.1991)).

3 If, as the Trustee asserts, the estate lacks the funds needed to confirm or
4 liquidate under chapter 11, section 1112(b) provides that the case may be
5 dismissed outright or converted to chapter 7 and liquidated under the supervision
6 of a chapter 7 trustee. If the case is dismissed, all parties' pre-petition rights and
7 interests are restored. If the case is converted, the chapter 7 trustee protects
8 creditors' rights by accounting for estate assets, issuing a final report that
addresses liquidated assets, claims quantified, and distributions proposed, and
distributing assets pursuant to the final report. Thus, under conversion or
dismissal under § 1112(b), all parties to the bankruptcy proceeding are assured
that their interests are accounted for and preserved.

9 *In re Biolitec, Inc.*, 528 B.R. 261, 269 (Bankr. D.N.J. 2014); *see also In re Petersburg*
10 *Regency LLC*, 540 B.R. 508, 532 (Bankr. D.N.J. 2015)(allows structured dismissal, but
11 notes “there is no possibility for a distribution to unsecured creditors without a
12 settlement, and no realistic possibility of a reorganization or conversion to Chapter 7”).
13 *But see In re Buffet Partners, L.P.*, 2014 WL 3735804, at *3 (Bankr. N.D. Tex. July 28,
14 2014)(“the economic value of the Debtor in this case will be served by dismissing the
15 case, rather than converting it. Converting this case to chapter 7 would interfere with
16 prompt and efficient payment to creditors”). Thus, the Court is reluctant to grant the non-
17 statutory remedy of a structured dismissal when conversion to chapter 7 remains
18 possible (albeit more expensive) – for the reasons set forth by the New Jersey
19 Bankruptcy Court in *Biolitec*.

22 That general reluctance is magnified in this case, which involves individual
23 debtors. The Court is not aware of any cases approving a structured dismissal for an
24 individual debtor: a Westlaw search for bankruptcy cases containing the phrases
25 “conditional dismissal” or “structured dismissal” found structured dismissals only being
26 proposed in *corporate* bankruptcies. Dismissal – as opposed to conversion to chapter 7
27 - means that the debtor will not receive a discharge. The lack of a discharge is not
28

relevant in the bankruptcy of a corporation, which cannot receive one in chapter 7. In contrast, the failure to obtain a bankruptcy discharge places a burden – often a very heavy burden – on individual debtor[s].

In this case, in a dismissal the Debtors would remain liable for the unpaid portion of the \$210,000 of priority tax claims, the full amount of general unsecured claims (\$656,643 according to this motion, which presumably includes the Judgment Creditors' remaining \$350,000 claim), and the full \$8.6 million of subordinated unsecured claims (comprised primarily of Mr. Kaplan's claim). In a chapter 7, by contrast, while the unpaid portion of \$210,000 of priority tax claims would most likely be both larger - due to chapter 7 administrative expenses - and non-dischargeable under §523(a)(1), the Debtors would be discharged from over \$9 million of general and subordinated debt. Thus, the proposed dismissal would deny the Debtors with the "fresh start" that is one of the major policy goals of the Bankruptcy Code.

A dismissal will also leave the Debtors with a heavy tax burden. Upon dismissal, the income of the estate will become the Debtors' income, but the Debtors, unlike the Trustee, will not be able to deduct the estate's administrative expenses:

INDIVIDUALS IN CHAPTER 7 OR 11

During the chapter 7 or 11 bankruptcy, the debtor continues to file an individual tax return on Form 1040. The bankruptcy trustee files a Form 1041 for the bankruptcy estate.

PUBLICATION 908 BANKRUPTCY TAX GUIDE, 2012 WL 6553969, at *5.

CONVERSION OR DISMISSAL OF CHAPTER 11 CASES.

If the chapter 11 case is converted to a chapter 7 case, [t]he property of the chapter 11 estate will become property of the chapter 7 estate. Any income on this property will be taxed to the estate even if the income is realized after the conversion to chapter 7. If a chapter 11 case is dismissed, the debtor is treated as if the bankruptcy case had never been filed and as if no bankruptcy estate had been created.

Id. at *9–10; see 26 U.S.C. §1398. Aside from the taxes themselves, the expense of

1 preparing five years of tax returns would be another substantial cost to the Debtors from
2 dismissal. The Trustee has not attempted to refute this conclusion by the FTB and the
3 Debtors' accountant that the proposed conditional dismissal would leave the Debtors
4 with a substantial increased tax liability. Even the risk of this outcome is an
5 unacceptable burden on the Debtors.
6

7 Furthermore, this result is completely inequitable. To date, the administrative
8 creditors (the professionals) have been the beneficiary of all income of the estate.
9 Under the proposed conditional dismissal, the professionals (and possibly a small
10 amount of priority tax claims) will receive the remaining cash in the estate. The Debtor,
11 however, will be left with a substantial tax burden that arose from that income. For
12 example, the Trustee has recently filed tax returns showing entitlement to refunds,
13 which he plans to distribute pursuant to the structured dismissal. When the Debtors file
14 tax returns for the same period, they will probably be obligated to pay taxes rather than
15 entitled to receive a refund, due to their more restricted deductions. In essence, the
16 Trustee proposes that he, his professionals, and possibly some priority tax claims be
17 paid from the tax refund that the Debtor will, at least in part, subsequently need to repay
18 to the taxing authorities.
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21 On the other hand, the only real advantage of a structured settlement over
22 conversion to a chapter 7 is avoiding the cost and delay of a chapter 7. However,
23 administrative creditors and possibly tax priority creditors would be the only parties to
24 benefit from the net savings realized from dismissal instead of conversion. The
25 unsecured creditors are completely out of the money and will not receive any
26 distribution from this estate under either scenario.
27

28 The Motion argues that these unsecured creditors – who could pursue their

1 remedies after dismissal - would be benefited by the reduction in the overall debt.
2 However, given the prospects of recovering from a couple of individuals who are without
3 any substantial assets that are clearly non-exempt and who are on the verge of
4 retirement, a small reduction in claims would have little effect on unsecured creditor
5 recoveries.
6

7 The Trustee has also argued that the unsecured creditors would benefit from
8 retaining their remedies against the Debtors, but this is merely the “flip side” of the
9 Debtors’ failure to obtain a discharge. The Trustee and Mr. Bickley argue that Mr.
10 Johnson is not a “good guy” and should remain liable on his obligations. But being a
11 good person is not the standard for receiving a discharge. The Bankruptcy Code has a
12 presumption in favor of discharge: Debtors are entitled to receive a discharge unless
13 one of the exceptions of §523(a) or §727(a) is shown to apply. (So, while it will be an
14 additional cost to the Judgment Creditors to refile their action and establish that the
15 Debtors’ \$350,000 obligation to them is nondischargeable under §523(a), that is how
16 the Code is meant to work.) The Court will not grant this motion, essentially rendering
17 all of the Debtors’ obligations nondischargeable, based on the general notion that Mr.
18 Johnson is not a good guy.
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21 Furthermore, the creditors would not likely keep this advantage of
22 nondischargeability for any length of time. Dismissal would not bar the Debtors from re-
23 filing in chapter 7 and the Debtors’ continued liability on millions of dollars of debt
24 without realistic prospects of repayment make a new chapter 7 almost inevitable. The
25 creditors (including the Judgment Creditors) would then have to bring a
26 nondischargeability action anyway. The only differences between a conversion to
27 chapter 7 now and a dismissal plus a new chapter 7 are: the dismissal plus new chapter
28

1 7 will result in additional, substantial tax liability for the Debtors and will allow the
2 professionals to avoid being subordinated to the administrative expenses of the chapter
3 7.
4

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6 Conclusion

7 The only real advantage of dismissal - the savings of chapter 7 administrative
8 expenses - is outweighed by the heavy burden on the Debtors – heavy undischarged
9 debt and inequitable tax liability of an unknown, but substantial, amount. Further,
10 despite the Trustee’s invocation of benefit to the creditors, the only creditors to realize
11 any benefit from the savings of avoiding chapter 7 are the professionals themselves and
12 possibly the FTB and the IRS.
13

14 The Debtors may have favored dismissal prior to understanding its implications
15 for them, but that does not justify a dismissal in these circumstances. Whether or not
16 these issues were raised by the Debtors or the FTB, the Court has a mandate to
17 consider the Debtors’ interests under §305(a). Under §1112(b), the heavy and
18 inequitable burdens facing the Debtors in a dismissal cannot be ignored by this court of
19 equity.
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21 This conclusion is buttressed by the uncertain state of the law on structured
22 dismissals, which do not have an explicit statutory basis and are disfavored by the ABI
23 Commission on chapter 11 reform. A circuit court of appeals has recently approved a
24 structured dismissal, but the court pointedly left this very situation – where chapter 7
25 remains a viable option – out of its approval. In sum, this case does not present the
26 compelling facts that might induce the Court to approve the controversial remedy of a
27 structured dismissal, much less to extend it to a case involving individual debtors,
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1 thereby effectively denying the Debtors a discharge.

2 This chapter 11 case shall be converted to chapter 7, for cause shown under
3 §1112(b)(4)(a), pursuant to an order entered in conjunction with this Memorandum of
4 Decision.
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24 Date: March 3, 2017



Geraldine Mund
United States Bankruptcy Judge