

In the United States Bankruptcy Court

for the Northern District of Iowa

RMM INC.

Bankruptcy No. 98-02923-C

Debtor(s).

Chapter 11

SLIPPED DISC INC.

Bankruptcy No. 98-2914-C

Debtor(s).

Chapter 11

ORDER RE: MOTION TO DISMISS OR CONVERT

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This matter came before the undersigned on June 28, 2000 on U.S. Trustee's Motion to Dismiss or Convert. The following appeared at the hearing: Thomas Fiegen for Debtors Slipped Disc, Inc. and RMM, Inc.; Janet Reasoner for the U.S. Trustee; John Waters for Iowa Department of Revenue (IDOR); Martin McLaughlin for the IRS and the SBA; and Joseph Schmall for CD Warehouse, Inc. After the presentation of evidence and argument, the Court took the matter under advisement. The time for filing briefs has now passed and this matter is ready for resolution. This is a core proceeding pursuant to 28 U.S.C. §157(b)(2)(A).

STATEMENT OF THE CASE

U.S. Trustee moves to convert or dismiss based on Debtors' inability to fund plans and their failure to timely file reports and pay fees. The creditors state Debtors have failed to keep current on postpetition taxes and royalty fees. Debtors assert they have increased profitability and believe they can fund a plan. They have been delaying filing a plan because they are trying to settle a suit against CD Warehouse based on infringement of their franchise agreement.

FINDINGS OF FACT

Debtors Slipped Disc, Inc. and RMM, Inc. filed Chapter 11 petitions on September 29, 1998 and September 30, 1998, respectively. The U.S. Trustee asserts the case is not progressing. This is the second motion to convert or dismiss filed by the U.S. Trustee.

More than a year after filing its bankruptcy petition, in December 1999, Debtor Slipped Disc filed an adversary proceeding against CD Warehouse for breach of their franchise agreement. On motion of CD Warehouse, this Court concluded the arbitration agreement of the parties should be enforced. Debtor has yet to assert a demand for arbitration. Rather, the parties have been negotiating settlement. At this point, negotiations have stalled. Debtor's attorney in the adversary proceeding has withdrawn as counsel. He had recommended Debtor proceed to arbitration. The parties appear to be attempting to avoid the costs of arbitration. Debtor's bankruptcy counsel indicates that if the parties cannot settle soon, Debtor will drop its lawsuit and attempt to reorganize while maintaining the status quo.

During the course of these Chapter 11 cases, Debtors have repeatedly been delinquent in filing monthly reports and paying quarterly fees. They are now up-to-date with monthly reports through June 2000 and all quarterly fees are paid. Debtors have not submitted weekly reports or paid royalties to CD Warehouse as required under their franchise agreements. Approximately \$21,000 in royalties is due through June 2000.

Based on the monthly reports filed by Debtors, U.S. Trustee calculates Slipped Disc has a negative cash flow from the date of filing of \$454.74. RMM's positive cash flow from the date of filing is \$886.61. U.S. Trustee postulates that, based on Debtors' failure to produce a significant cash flow in the 23 months since they filed their Chapter 11 petitions, they will be unable to pay creditors through a Chapter 11 plan.

The IDOR joins in the U.S. Trustee's motion to dismiss or convert. Debtors have failed to timely file withholding tax reports or pay taxes postpetition. They have now partially remedied the situation by hiring an accountant and filing overdue reports, but payments are not yet completely current. Both Debtors failed to make Iowa payroll tax deposits for three months in 1999.

The IRS has prepetition priority tax claims totaling at least \$45,000. It also has postpetition administrative claims for payroll taxes of at least that amount. The IRS argues Debtors' difficulty in keeping current on tax payments indicates their inability to generate sufficient income to fund a plan.

The SBA's claims are fully secured. It states that, if the U.S. Trustee's motion is granted, the cases should be dismissed rather than converted. The SBA could best execute on its collateral outside of bankruptcy.

Franchisor CD Warehouse has not received royalty payments or weekly reports from Debtors since February 2000. It asserts that if Debtors are allowed to continue in bankruptcy, they should be required to become current in weekly reports and pay the approximately \$21,000 in postpetition royalty fees due and unpaid.

Debtors explain that they recently fired their staff accountant and hired a CPA. All but one of the missing tax returns have been completed. Most of the postpetition taxes have been paid. Debtors decided to hold back the royalties due to CD Warehouse under their franchise agreement pending settlement of the infringement lawsuit. They anticipate a reduction of royalties due as part of a compromise of the lawsuit.

Mr. Robert McDonell, Debtors' President, testified that Debtors could become current in postpetition taxes owed to the IRS and the IDOR within three to four months. He also estimates Debtors could become current on royalties in three months if a reduction in royalties is negotiated or if the franchise agreement is ended. Mr. McDonell testified that comparing receipts and disbursements in the most recent quarter ending in April 2000 with the quarter ending April 1999 shows a trend for significant improvement. He attributes this to changes he made in management and other staff at Debtors' stores. Mr. McDonell testified he expects to end negotiations with CD Warehouse soon and will be able to file a plan quickly.

Debtors have not escrowed the royalties due to CD Warehouse. In reporting disbursements on their monthly reports, Debtors' figures include payments to landlords and the SBA. The disbursements do not, however, include payments for royalties, attorney fees or accountant fees. Slipped Disc has cash in the bank of approximately \$10,300 and unpaid federal and state postpetition taxes total \$15,390.

RMM has cash of \$16,900 and unpaid taxes equal \$3,020. Debtors have a total of \$217,000 secured debt and \$99,000 unsecured debt.

CONCLUSIONS OF LAW

The bankruptcy court has broad discretion in deciding whether to dismiss or convert a Chapter 11 case, In re Lumber Exch. Bldg. Ltd. Partnership, 968 F.2d 647, 648 (8th Cir. 1992). Under §1112(b), the court first determines whether "cause" exists to dismiss or convert. In re Windsor on the River Assocs., Ltd., 7 F.3d 127, 133 (8th Cir. 1993). Once cause is established, the Court considers which of the options in §1112(b), dismissal or conversion, is "in the best interest of creditors and the estate." Id.; In re Hatcher, 218 B.R. 441, 448 (B.A.P. 8th Cir. 1998), aff'd, 175 F.3d 1028 (8th Cir. 1999).

The statutory definition of "cause" includes, "continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation; inability to effectuate a plan; [and] unreasonable delay by the debtor that is prejudicial to creditors[.]" 11 U.S.C. §1112(b)(1-3). The statutory list is not exhaustive and the Court may consider other factors and equitable considerations in order to reach an appropriate result in the individual case. Hatcher, 218 B.R. at 448. The Court determines whether relief is appropriate on a case by case basis. In re Laguna Assoc. Ltd. Partnership, 30 F.3d 734, 737 (6th Cir. 1994).

"The purpose of § 1112(b) . . . is to provide relief where the debtor's efforts, however heroic, have proven inadequate to the task of reorganizing [its] affairs effectively within a reasonable amount of time." In re Tiana Queen Motel, Inc., 749 F.2d 146, 151-52 (2d Cir. 1984), cert. denied, 471 U.S. 1138 (1985). Dismissal or conversion may be appropriate where the drive, good intentions and sincere hope of reorganization are present, but the numbers are not. In re Witt, 60 B.R. 556, 561 (Bankr. N.D. Iowa 1986).

Consideration of the different criteria set forth in §§1112(b)(1), (2), or (3) "inevitably leads to an analysis of whether the debtor has, without seemingly just reason, delayed too long in attempting to formulate a plan." In re Smith, 77 B.R. 496, 501-02 (Bankr. E.D. Pa. 1987). Dismissal or conversion under §1112(b)(1) is appropriate when the moving party shows continuing losses coupled with the absence of a reasonable likelihood of rehabilitation. This section requires the Chapter 11 debtor to accomplish its purpose within a reasonable time. Id. In In re Clarkson, 767 F.2d 417, 420 (8th Cir. 1985), the court found that the absence of financial data and definite sources of income indicated the absence of a reasonable likelihood of rehabilitation under §1112(b)(1). Delay diminished creditors' positions without an increase in the likelihood of their satisfaction. Id.

Under §1112(b)(2), a bankruptcy court is free to dismiss or convert a Chapter 11 case where the debtor cannot propose a confirmable plan. Lumber Exchange, 968 F.2d at 650.

Dismissal under § 1112(b)(2) is appropriate where the debtor's failure to file an acceptable plan after a reasonable time indicates its inability to do so whether the reason for the debtor's inability to file is its poor financial condition, the structure of the claims against it, or some other reason.

In re Preferred Door Co., 990 F.2d 547, 549 (10th Cir. 1993). A long delay in formulating a plan bespeaks an inability to do so. Smith, 77 B.R. at 502.

Section 1112(b)(3) expressly addresses the issue of delay. Debtors need time to stabilize a business when attempting to reorganize. In re Huntington Ltd., 654 F.2d 578, 589 (9th Cir. 1981) (stating

Congress has determined that it is better to reorganize when possible, particularly when it is in creditors' best interests). In In re Sheehan, 58 B.R. 296, 300 (Bankr. D.S.D. 1986), the court held that thirteen months to file a disclosure statement and a plan was not an unreasonable delay because of the fundamental change in management, the size and complexity of the estate, no evidence of an intent to delay, and management of the estate had been "excellent." Under these circumstances, the creditors were not prejudiced. Id. However, where a case "has been pending for over two years with no confirmable plan proposed by the debtor, cause can exist to convert or dismiss the case under §1112(b)(3)." In re Sunflower Racing, Inc., 226 B.R. 665, 670 (D. Kan. 1998) (citing cases where unreasonable delay existed where debtor failed to submit confirmable plan over 15 or 16 month periods).

Section 1112(b)(10) states that nonpayment of any fees or charges required under Chapter 123 of Title 28 constitutes cause to dismiss or convert. Under 28 U.S.C. § 1930, Chapter 11 debtors are required to pay quarterly fees to the U.S. Trustee. Failure to pay the fees required, without more, provides cause to dismiss or convert the case. In re Tornheim, 181 B.R. 161, 164 (Bankr. S.D.N.Y. 1995); In re Nugelt, Inc., 142 B.R. 661, 667-68 (Bankr. D. Del. 1992).

In converting a Chapter 11 case to Chapter 7, the court in In re Moore Constr., Inc., 206 B.R. 436 (Bankr. N.D. Tex. 1997), found:

The non-payment of postpetition tax debt, combined with financial statements that show a current inability to make a profit constitutes a continuing loss to or diminution to the estate pursuant to §1112(b)(1).

Failure to pay postpetition employment taxes and file monthly reports also support a finding of unreasonable delay under §1112(b)(3). Id. The court also found the debtors' ability to effectuate a plan under §1112(b)(2) is affected by its failure to pay postpetition taxes because one requirement of confirmation is payment of such administrative claims in full on the effective date of the plan. Id.; see also Tornheim, 181 B.R. at 164 (concluding failure to file a plan after 16 months shows both unreasonable, prejudicial delay and an inability to effectuate a plan, requiring conversion or dismissal); Nugelt, Inc., 142 B.R. at 667-68 (finding failure to file monthly reports, inability to effectuate a plan and the inability to pay fees under Chapter 123 of title 28 was statutory cause to dismiss or convert under § 1112(b)(2) and (10)); In re Berryhill, 189 B.R. 463, 466 (N.D. Ind. 1995) (finding failure to pay post petition taxes evidenced a continuing loss or diminution of the estate and was a factor in determining the absence of a reasonable likelihood of rehabilitation); In re Santiago Vela, 87 B.R. 229, 231-32 (Bankr. D.P.R. 1988) (finding cause under §1112(b)(1) and (b)(3) where the debtors had failed to timely file and pay post petition self-employment taxes, and failed to have a plan confirmed after more than three years); In re Security Energy Sys., Inc., 62 B.R. 676, 677 (Bankr. W.D.N.Y. 1986) (ordering conversion where tax payments were habitually late, debtor failed to file monthly reports and postpetition business indicated a cash loss).

This Court in In re Bacon, 52 B.R. 52, 54 (Bankr. N.D. Iowa 1985), found that failure to prosecute a bankruptcy case and disregard of local rules requiring the filing of monthly reports were each cause to dismiss a Chapter 11 case. The Court noted the debtors' actions were characterized by knee-jerk reactions to motions filed by a secured creditor. Id. at 53. The debtors failed to comply with court orders and rules until forced to. Id. In In re Ver Dell Cox, No. A-86-01718S, slip op. at 12-13 (Bankr. N.D. Iowa Aug. 28, 1990), this Court ordered conversion to Chapter 7 where four years had passed since filing with almost no payments to creditors, substantial administrative expenses had accrued, significant attorney's fees were incurred, assets were not disclosed, United States Trustee's reporting

requirements were not met, receipts and disbursements were not adequately disclosed, and assets were not turned over to the trustee.

EFFECT OF ONGOING LITIGATION

Debtors argue they will be better able to reorganize and formulate a plan when their franchise agreement dispute with CD Warehouse is resolved. Chapter 11 cases cannot be permitted to remain motionless in the Bankruptcy Court while issues are litigated in other courts. In re Petit, 189 B.R. 227, 228 (Bankr. D. Me. 1995). "[L]ike any principle, the viability of the contention that the pendency of litigation tolls the filing of a plan depends upon the circumstances." Smith, 77 B.R. at 502. In In re Minnesota Alpha Found., 122 B.R. 89, 94 (Bankr. D. Minn. 1990), the court found cause to dismiss a case where the U.S. Trustee had pointed out the nascent status and uncertain merits of the debtor's proposed litigation. The debtor had proposed to fund a plan through the fruits of pending adversary proceedings. Id. at 92.

DISMISS OR CONVERT

The U.S. Trustee's motion as filed requests conversion of the case to Chapter 7. At the hearing, the U.S. Trustee amended the motion, without objection, by also requesting dismissal under §1112(b). A court may in its discretion dismiss a Chapter 11 case where a party in interest has moved only for conversion to a liquidation case under Chapter 7. In re Continental Holdings, Inc., 170 B.R. 919, 933 (Bankr. N.D. Ohio 1994) (ordering conversion where motion requested dismissal); In re The Ledges Apartments, 58 B.R. 84, 88 (Bankr. D. Vt. 1986). Under the plain language of §1112(b), a court exercises discretion in determining whether to convert or dismiss depending on the best interests of creditors and the estate. The court has broad discretion to make an appropriate disposition of the case when a party in interest requests. Lumber Exch. Bldg. Ltd. Partnership, 968 F.2d at 648. The determining factor is not whether the motion requests conversion or dismissal, but rather whether dismissal or conversion will be in the best interest of creditors and the estate. In re Klenosky, 130 B.R. 132, 135 (E.D.N.Y. 1991).

In deciding whether to convert or dismiss, the court must determine the impact on creditors and on the estate of each of the options. In re Superior Siding & Window, Inc., 14 F.3d 240, 243 (4th Cir. 1994). The court compares the creditors' status in bankruptcy and their status outside of bankruptcy and takes into account the interests of all of the creditors. Id. The court gives deference to creditors' opinions as to which remedy is in their best interests. In re Johnson, No. 93-40123XM, slip op. at 2 (Bankr. N.D. Iowa Dec. 17, 1993). In In re Whitehurst, 198 B.R. 981, 985-86 (Bankr. N.D. Ala. 1996), the court found dismissal appropriate where the debts were mainly unpaid taxes, and the IRS could effectuate an orderly liquidation outside of bankruptcy.

CONCLUSIONS

Based on the foregoing, the Court concludes cause exists under the several sections of §1112(b) for conversion or dismissal of this case. Further, it is in the best interests of creditors and the estate to dismiss the case. As asserted by the U.S. Trustee, bankruptcy is a safe harbor, not a dry dock. Debtors' cases have been pending for 23 months. Debtors have failed to pay postpetition payroll taxes, royalties and quarterly fees. They lack sufficient net income to fund a plan. They have been dilatory in providing the U.S. Trustee with monthly reports, CD Warehouse with weekly reports, and the IRS and IDOR with postpetition payroll tax reports.

The viability of any plans Debtors may propose is dependent on the uncertain results of their action against CD Warehouse. Debtors will not be able to fund plans unless the royalties due under the franchise agreement are reduced. Debtors have yet to request arbitration and no end to the dispute is in sight.

Although Debtors have some cash in the bank and show a slight increase in business over the previous fiscal year, they remain unable, or unwilling, to remain current in their postpetition obligations. Their financial reports indicate there is little likelihood they will be able to pay administrative claims and other postpetition obligations, let alone fund a Chapter 11 plan.

All the parties recommend dismissal rather than conversion, including Debtors. The SBA and the taxing entities can easily enforce their rights outside of bankruptcy court. Debtors' arbitration or settlement negotiations with CD Warehouse can continue without this Court's oversight. The Court concludes dismissal, rather than conversion, is in the best interests of creditors and the estate.

WHEREFORE, the U.S. Trustee's Motion to Convert, amended to include a request for dismissal of the case, is GRANTED.

FURTHER, cause exists under §1112(b) to dismiss the Chapter 11 bankruptcy cases of Debtors Slipped Disc, Inc. and RMM, Inc.

FURTHER, the cases are hereby DISMISSED.

SO ORDERED this 23rd day of August, 2000.

Paul J. Kilburg
Chief Bankruptcy Judge