By Norman N. Kinel

# Conversion Equals Death for a Creditors' Committee and Its Appeal

If asked what happens to a creditors' committee appointed in a chapter 11 case if the case is converted to chapter 7, most bankruptcy practitioners would likely opine that the committee is dissolved. However, what if the committee is a party to one or more appeals at the time of the conversion? In addition, what if one of those appeals is of the conversion order itself?

These questions were recently examined and answered by the U.S. District Court for the District of Delaware in the *Constellation Enterprises* cases. The court ruled, in an appeal from the bankruptcy court's decision, that immediately upon conversion of a chapter 11 case to one under chapter 7, a creditors committee is automatically dissolved, and any pending appeal to which such committee is the only appellant must automatically be dismissed because, upon conversion, the committee ceases to exist.[1]

In *Constellation*, the unsecured creditors' committee (the "committee") appointed in the chapter 11 cases of Constellation Enterprises LLC and its affiliates (the "debtors") had appealed the bankruptcy court's denial of a motion seeking approval of a settlement (the "Settlement Motion"). The Settlement Motion sought approval of a settlement agreement entered into by the debtors, the committee and an *ad hoc* group of noteholders, which provided for an affiliate of the noteholders to contribute to a trust, to be established for the benefit of the debtors' general unsecured creditors (the "GUC Trust"), the following: (1) $1.25 million, for a direct, *pro rata* cash recovery to unsecured creditors; (2) certain potentially valuable causes of action; and (3) $1 million in funding to administer the GUC Trust and pursue such causes of action. A subset of the noteholders were both the lenders who provided debtor-in-possession (DIP) financing and the successful bidders in the bankruptcy court-approved sale of substantially all of the assets of certain of the debtors' subsidiaries (the "sale"); the settlement agreement resolved the committee's objections to both the DIP financing and the sale.

Following a hearing, the bankruptcy court issued an oral ruling that the settlement agreement could not be approved because the distributions to be made to the GUC Trust would skip certain priority claimants and treat the deficiency claim of a group of delayed-draw term loan lenders and their agent (the "DDTL Parties") less favorably than the claims of other unsecured creditors and was therefore impermissible under the U.S. Supreme Court's decision in *Czyzewski v. Jevic Holding Corp*.[2] The committee sought to distinguish *Jevic* as only being applicable to distributions of property of a debtor's estate and argued that the contributions to the GUC Trust from the noteholders were either assets they had purchased from the debtors in the noteholder sale, or assets that had always belonged exclusively to the noteholders.

The committee primarily relied on the Third Circuit's decision in *In re ICL Holding Co. Inc.*, which held that the Bankruptcy Code's "distribution rules don't apply to nonestate property."[3] However, the bankruptcy court disagreed and refused to approve the settlement agreement, finding that (1) *Jevic* did not necessarily focus on whether estate assets were involved; (2) *ICL Holding*, which otherwise might have allowed the settlement agreement to be approved, was overruled or narrowed by *Jevic*; and (3) in any event, *ICL Holding* did not apply because some of the assets to be contributed by the noteholders were "at one time" property of the debtors' estates.

The committee appealed the bankruptcy court's denial of the settlement agreement (the "Settlement Appeal"). However, while the Settlement Appeal was pending, the debtors moved to convert their chapter 11 cases to chapter 7 pursuant to § 1112(a) of the Bankruptcy Code (the "Conversion Motion"), citing, *inter alia*, the administrative insolvency of the chapter 11 cases. The Conversion Motion was supported by the DDTL Parties and U.S. Trustee, but the committee objected and asked the bankruptcy court to deny the conversion motion based on an "equitable analysis of the facts,"[4] including that (1) the debtors did not have the absolute right to convert their cases to chapter 7, (2) the debtors had agreed to support the Settlement Motion, (3) conversion would jeopardize the Settlement Appeal, and (4) absent success in the Settlement Appeal, the debtors' unsecured creditors stood no chance of recovery on their claims, and the noteholders would receive a multi-million-dollar windfall.

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1 *Official Comm. of Unsecured Creditors v. Constellation Enters. LLC (In re Constellation Enters. LLC)*, No. 17-757-RGA, 2018 U.S. Dist. LEXIS 47153; 2018 WL 1419886 (D. Del. March 22, 2018). The author served as lead counsel for the unsecured creditors' committee in the *Constellation* bankruptcy cases.

2 137 S. Ct. 973 (2017).

3 802 F.3d 547, 555 (3d Cir. 2015).

4 *Constellation*, 2018 U.S. Dist. LEXIS 47153, at *5.

Following a hearing on the Conversion Motion, the bankruptcy court concluded *that a debtor has the absolute right to convert its chapter 11 case to chapter 7*. The court also held that no evidentiary showing was required in order to convert the cases, even though the debtors were prepared to present evidence at the hearing. The court found that it was undisputed that the debtors were eligible to be debtors under chapter 7 and that "the 'record [had] been established over months of this case' regarding [the] administrative insolvency of the cases."[5]

Accordingly, the bankruptcy court entered an order converting the cases from chapter 11 to chapter 7 (the "Conversion Order"), which became effective several days after the hearing. However, just prior to the Conversion Order becoming effective, the committee amended its bylaws in order to purportedly continue to exist as an "*ad hoc*" committee for purposes of the Settlement Appeal in the event the district court determined that the committee was dissolved upon conversion.[6]

After the Conversion Order became effective, the DDTL Parties and U.S. Trustee filed motions to dismiss the Settlement Appeal (collectively, the "Settlement Appeal Dismissal Motions"), arguing that the Conversion Order had triggered the immediate dissolution of the committee. The committee then appealed the Conversion Order (the "Conversion Appeal," and, together with the Settlement Appeal, the "appeals") and moved for a stay pending appeal in the district court (the "stay motion"). The DDTL Parties and U.S. Trustee then moved to dismiss the Conversion Appeal (collectively, the "Conversion Appeal Dismissal Motions" and, together with the Settlement Appeal Dismissal Motions, the "motions to dismiss").

The committee filed objections to the motions to dismiss, contending that the Conversion Order was entered in error, as a matter of law, because the bankruptcy court granted the conversion based on its determination that a chapter 11 debtor has an absolute right to convert its case to chapter 7 and need not present any evidence in order to do so. The committee argued that case law holds to the contrary, including a case decided by the Supreme Court, *Marrama v. Citizens Bank of Mass*.[7] Therefore, the committee maintained that the motions to dismiss must be denied because they were solely premised upon the Conversion Order. In addition, the committee argued that even if a debtor ordinarily has a right to convert, such a right is not without limits, and it is improper for a bankruptcy court to order the conversion of a chapter case if it would interfere with, or require dismissal of, a pending appeal.

The committee also contended that even if the conversion caused its dissolution, the consequences of dissolution are not the same as "extinction" and did not result in the loss of all "vested rights of the Committee." The committee relied on *In re SPM Mfg. Corp*.[8] in support of its position, wherein the First Circuit resolved an appeal pursued by a chapter 11 committee post-conversion. Finally, the committee argued that even if it was found to have been dissolved, the motions to dismiss should still be denied because the committee granted its individual members the collective right to pursue the appeals as an *ad hoc* committee, as successor or assignee to the committee.

The district court in *Constellation* rejected each of these arguments. First, the court agreed with the DDTL Parties and U.S. Trustee (collectively, the "appellees") that "the legal entity that was the Committee automatically dissolved and ceased to exist as of the conversion of the chapter 11 cases to chapter 7."[9] According to the court:

> An official committee of unsecured creditors is created when appointed by the Trustee under § 1102 of the Bankruptcy Code, and it exists only under the framework of chapter 11. Section 103(g) of the Bankruptcy Code provides that, subject to an exception not applicable here, §§ 1101 through 1146 — which include the creditors' committee formation provision in § 1102 and the creditors' committee's powers and duties in § 1103 — "apply only in a case under such chapter" — *i.e.*, chapter 11. Section 1102 does not apply to a case under chapter 7.[10]

The court also found that "numerous courts have agreed that upon conversion to chapter 7, the chapter 11 committee of unsecured creditors is terminated"[11] and concluded that it could "see no other result under the structure of the Bankruptcy Code. Once the case is converted to a different chapter, the relevant provisions of the new chapter must govern." The court then held that case law did not support the post-conversion existence of the committee, even while an appeal is pending:

> The Court is persuaded by *Great Northern Paper*, a case [that] directly addressed the same question at issue here: "What happens to a pending appeal by the Official Committee of Unsecured Creditors when the bankruptcy court converts a chapter 11 proceeding to a chapter 7 proceeding during the appeal?"... The court held, "When the statutory basis of the case is changed, either through dismissal or, as in this case, conversion, 'the statute under which the Committee was created no longer applies and the committee is automatically dissolved.'"[12]

The court also rejected the committee's reliance upon *SPM*, noting that no party had moved to dismiss the appeal in

5 *Id.* at *6 (quoting bankruptcy court's opinion).

6 The bylaw's amendment provided as follows:

> In the event any court of competent jurisdiction determines that the Committee has ceased to exist, has dissolved or has been divested of its powers or of its ability to pursue the appeal of the decision and order issued on May 16, 2017, by the [bankruptcy court] which denied the Joint Motion of the Debtors and Creditors' Committee for an Order Approving Settlement by and among the *Ad Hoc* Noteholder Group [Doc. No. 560] (the "Appeal"), the Members hereby elect to continue to function as an "*ad hoc*" committee of unsecured creditors ("*Ad Hoc* Committee"), in order to protect the interest of the Committee and/or its Members in the Cases and the Appeal and to prosecute the Appeal.
>
> Upon entry of (a) any order converting the Cases to cases under Chapter 7 of the Bankruptcy Code (a "Conversion Order"), and (b) a binding, judicial determination that the Committee has been dissolved, terminated or otherwise rendered incapable of proceeding with (i) the prosecution of the Appeal, (ii) approval of the settlement subject to the Appeal, or (iii) any matter related thereto, the Committee shall automatically be deemed reconstituted as the *Ad Hoc* Committee, which reconstitution shall be deemed to have occurred prior to the effective date and time of entry of a Conversion Order, without further action on the part of the Committee.

*Id.* at *22-24 (quoting Article XIV.A-.B of the Committee's Amended and Restated Bylaws).

7 549 U.S. 365 (2007).

8 984 F.2d 1305 (1st Cir. 1993).

9 *Constellation*, 2018 U.S. Dist. LEXIS 47153, at *12.

10 *Id.* at *12-13 (internal citations omitted).

11 *Id.* at *15 (citing *In re World Health Alts.*, 344 B.R. 291, 295 (Bankr. D. Del. 2006); *Creditors' Comm. v. Parks Jaggers (In re Parks Jaggers Aerospace Co.)*, 129 B.R. 265, 268 (M.D. Fla. 1991); *In re Freedlander Inc., The Mortg. People*, 103 B.R. 752, 758 (Bankr. E.D. Va. 1989); *In re Kel-Wood Timber Prods. Co.*, 88 B.R. 93, 94 (Bankr. E.D. Va. 1988)).

12 *Id.* at *19 (citations omitted).

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*SPM* based on the conversion and that "the issue of whether the creditors' committee in that case had survived the conversion was not raised, argued, or discussed."[13] Therefore, "[a]s the *SPM* court never considered the issue of the committee's post-conversion existence, this drive-by ruling offers no guidance here."[14]

Next, the court refused to accept what it termed the committee's "parade of horribles" arguments as to the dangerous precedent that would be set if the appeals were dismissed. The committee had argued:

> Taken together, the Conversion Order and the relief sought in the Motions to Dismiss would mean that a bankruptcy court can grant a debtor's motion to convert without any opportunity for an opposing party — even an estate fiduciary such as an official committee of unsecured creditors — to be heard or afforded due process. Instead, debtors would have the unilateral ability to divest an official committee of its statutory rights, and all related rights and powers arising under law, including vested appeal rights. Permitting conversion to operate as a dissolution of a committee and the forfeiture of all of its vested rights runs afoul of basic due process and should not be permitted.[15]

However, the court found that because the committee did not suggest any "limiting principle," were it to "adopt the Committee's position, and hold that a case may never be converted where to do so would interfere with ... a pending appeal," it would be introducing "another avenue for potential gamesmanship and abuse in the proceedings."[16] The court rejected the committee's contention that the *ad hoc* committee comprised of its former members was vested with the right of the committee to prosecute the Settlement Appeal as a result of the committee's bylaw amendment. According to the court:

> There is no provision in the Bankruptcy Code that permits the Committee to hold or transfer rights or interests, nor is there any provision that permits the Committee to transfer its statutory duties to another entity. And there could be no "transfer" here, because the nature of any interests the Committee, as a statutory body and fiduciary, asserted in the appeal of the Settlement Denial Order are of wholly different cloth than personal interests held post-conversion by individual creditors. Only Congress may determine whether there is a successor-in-interest to a dissolved federal entity. The entity may not on its own name a successor to which it transfers its interests.[17]

The court also noted that no other creditor had appealed the settlement or Conversion Orders, nor had any creditor sought to intervene, and would by then be time-barred from doing so.[18] Accordingly, the court concluded that *no "party" had appealed the conversion order*, since the committee ceased to exist upon conversion.[19] In sum, the court held as follows:

> A creditors' committee exists only under the statutory framework of the Bankruptcy Code. When these cases converted, the chapter 11 order for relief became an order for relief under chapter 7, the statutory predicate for the existence of [the] Committee no longer applied, and the Committee automatically dissolved. As the Committee has dissolved, it has no capacity or authority to appear before this Court, including filing the notice of appeal of the Conversion Order and any filings made in further prosecution of the appeal of the Settlement Denial Order. Because the Committee has no capacity to pursue these appeals, and there is no co-appellant to pursue these appeals, the appeals must be dismissed. Accordingly, the Court dismisses the Motion for Stay Pending Appeal as moot.[20]

As a result of the district court's ruling, the Settlement Appeal was never heard on the merits, leaving the important *Jevic*-related issues that it raised unanswered at the appellate level. The unfortunate net result of the *Constellation* decision was that the noteholders received a multi-million-dollar windfall, and there will almost certainly be no distribution to unsecured creditors.

Although the district court seemed to suggest that the Settlement Appeal might have been saved if an individual creditor had also appealed, it is unclear whether any such non-objecting creditor — even if it possessed the financial incentive and wherewithal to do so — would have standing to prosecute the appeal of an order denying a settlement that resolved *the committee's objections* to the DIP and noteholder sale, which was entered into between debtors who were no longer DIPs and a committee that no longer existed.[21]

The result in *Constellation* highlights how a committee's efforts to obtain recoveries for its constituents were completely thwarted once the debtors determined to convert their cases to chapter 7. Unfortunately, the decision may have broader —and perhaps unintended — consequences, since it may serve to invite "gamesmanship" by an unscrupulous chapter 11 debtor who wishes to rid itself of a committee's appeal based on its right to obtain "conversion on demand." abi

13 *Id.* at *15.
14 *Id.* at *16.
15 *Id.* at *20-21 (quoting committee's objection to motions to dismiss).
16 *Id.* at *22 (quoting U.S. Trustee's motion to dismiss).
17 *Id.* at *24-25.
18 *Id.* at *21.
19 *Id.* at *20-22.
20 *Id.* at *25-26.
21 *See In re Combustion Eng'g Inc.*, 391 F.3d 190, 214 (3d Cir. 2004) ("Standing to appeal in a bankruptcy case is limited to 'persons aggrieved' by an order of the bankruptcy court ... the 'persons aggrieved' test ... limits bankruptcy appeals to persons 'whose rights or interests are "directly and adversely affected pecuniarily" by an order or decree of the bankruptcy court....' '[P]erson[s] aggrieved' must show the order of the bankruptcy court 'diminishes their property, increases their burdens, or impairs their rights.' Whether someone is a person aggrieved is normally a question of fact.") (internal citations omitted).