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Connecticut District Court Affirms the Bankruptcy Court's Dismissal of an Individual Chapter 11 Case For The Debtor's Failure to Satisfy Section 1112(b)(2)'s Strict Standards

*Posted by Jessica Grossarth
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Countless individual debtors file for bankruptcy to save their homes from foreclosure, but some of them abuse the bankruptcy court system in the process. Vega v. United States Trustee, 2014 WL 4843698 (D. Conn. 2014) highlights this type of abusive debtor. Cecilio Vega filed three (3) bankruptcy cases between 2010 and 2012. In April 2010, Mr. Vega filed a Chapter 13 case, which was eventually converted to Chapter 7 resulting in a discharge of all his unsecured debts. Another Chapter 13 case followed in September 2011, but that case was dismissed in January 2012. Mr. Vega filed a third bankruptcy, a Chapter 13, in July 2012. Each time Mr. Vega filed, it was on the eve of losing title to the properties at issue in the foreclosure actions.

In April 2013, Mr. Vega converted his Chapter 13 case to one under Chapter 11. Two administrative requirements for debtors in Chapter 11 are filing monthly operating reports and paying quarterly fees. Mr. Vega failed to satisfy either requirement between April 2013 and August 2013.

As a result, the United States Trustee ("UST") filed a motion to compel Mr. Vega to pay the fees and file the reports, and also asked the Court to dismiss the case or set a deadline to file a plan of reorganization. In connection with the request for dismissal, the UST relied on §1112(b)(1), which states that "the court shall convert a case under this chapter to a case under Chapter 7 or dismiss a case under this chapter, whichever is in the best interest of creditors, for cause." The UST argued that Mr. Vega's failure to pay the fees and file the reports constituted "cause" under §1112(b) and warranted dismissal.

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Although Mr. Vega submitted monthly reports prior to the hearing on the motion, they were incomplete and the quarterly fees were never paid. Nevertheless, Mr. Vega argued that these failures should be excused, and that the court should confirm a plan of reorganization, which had been filed. Having little faith in the debtor's ability to complete a plan of reorganization, and observing that the debtor had been "playing the system," the Court dismissed the case and barred Mr. Vega from filing another petition for one year. Mr. Vega appealed the dismissal, and argued that the bankruptcy court erred because it failed to consider lesser sanctions than dismissal with a filing bar. Also, Mr. Vega argued that the court failed to properly consider whether the newly submitted plan of reorganization could be confirmed.

To support his argument concerning lesser sanctions, Mr. Vega relied on In re Sagecrest, LLC, 444 B.R. 20 (D. Conn. 2011), which case construes and applies Federal Rule of Civil Procedure 37, not section 1112(b). The District Court found Sagecrest to be distinguishable because unlike Fed. R. Civ. P. 37, section 1112 provides that when the bankruptcy court finds cause, it "shall" convert or dismiss unless the debtor meets the standard in section 1112(b)(2).

The District Court then held that Mr. Vega failed to meet his burden under section 1112(b)(2). Section 1112(b)(2) provides that a bankruptcy court must not dismiss or convert even if it finds "cause" when: (1) a court finds unusual circumstances establishing that converting or dismissing the case is not in the best interests of creditors and the estate; (2) a plan is likely to be confirmed in short order; and (3) the debtor shows that the cause for the conversion or dismissal is not continuing loss to the estate, there was a reasonable justification for the failure constituting cause, and the failure will be cured within a reasonable period of time. Mr. Vega failed to address any of the elements of the section 1112(b)(2) test, and as such, there was no basis for the District Court to conclude that the bankruptcy court abused its discretion. The District Court affirmed the bankruptcy court's order dismissing the case.

Interestingly, the one-year bar for the Debtor to re-file any bankruptcy imposed by the bankruptcy court ceased at the end of August 2014. Unfortunately, this case demonstrates how debtors wrongfully utilize the bankruptcy process to delay, which is not and should not be the purpose of bankruptcy. The case also demonstrates, however, that debtors eventually run out of luck with the bankruptcy process if they abuse it, as Mr. Vega did.

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