

FINDINGS OF FACT

1. On March 14, 1988, Debtor filed a Chapter 11 petition.
2. Debtor is a partnership owned by Victor Vashi and his wife, Surekha Vasha. Debtor owns a Ramada Inn motel in Des Moines, Iowa. Previously, Debtor also owned a Best Western motel in Des Moines.
3. Since the commencement of this proceeding, Debtor has remained in possession of the Ramada Inn premises as a debtor-in-possession pursuant to 11 U.S.C. §1107(a). Debtor continued to operate its motel and restaurant business until October 10, 1988, at which time Debtor voluntarily closed.
4. During the pendency of this proceeding, Debtor has operated its business and engaged in "retail sales" as defined by Iowa Code §422.42(3)(1987) without the benefit of a state sales tax permit as required by Iowa Code §422.53.
5. During the seven-month pendency of this proceeding Debtor has consistently experienced net operating losses. The aggregate net operating loss incurred as of August 31, 1988, as reflected by Debtor's operating report for the month of August, is \$81,139.01. Debtor anticipates an additional loss of \$20,000.00 for September of 1988.
6. On July 7, 1988, Debtor filed an application for preliminary injunction enjoining IDR from denying its appli

cation for a sales tax permit. On September 12, 1988, the Court entered an Order denying Debtor's motion for preliminary injunction. Debtor continued to operate without a sales tax permit in violation of Iowa Code §422.53 until October 10, 1988, when it voluntarily closed. Debtor has been closed since that time.

7. On September 23, 1988, IDR filed a motion to convert to Chapter 7. In said motion, IDR requested conversion because: 1) Debtor is unlawfully operating without a retail sales tax permit; 2) without a sales tax permit, Debtor will be unable to effectuate a plan and there is no reasonable likelihood that Debtor can be rehabilitated; 3) since the filing of Debtor's case, it has incurred substantial losses which have caused a diminution of the estate; and 4) the closure of Debtor's restaurant after a highly publicized incident of food poisoning further diminishes the likelihood that Debtor can rehabilitate itself and effectuate a plan.

7. On October 4, 1988, Trustee filed a motion to convert and requested therein joinder with IDR's motion to convert. In said motion, Trustee sought conversion because of: 1) Debtor's apparent intent to liquidate; 2) Debtor's failure to procure a sales tax permit by posting a requisite bond as required by IDR; 3) substantial operating losses in excess of \$80,000.00 that have been incurred by Debtor

during this proceeding; and 4) the apparent infeasibility of Debtor's proposed plan of reorganization.

9. Debtor is in violation of Local Bankruptcy Rule 6003 concerning the withholding and payment of taxes by a debtor-in-possession under a Chapter 11 case. Debtor failed to deposit withholding taxes into a tax escrow account, and there is a current shortfall in the account totaling approximately \$11,000.00. In addition, Debtor has failed to pay employment taxes, and at least \$7,000.00 is due to the Job Service Division of the Iowa Department of Employment Services for unpaid employment taxes.

DISCUSSION

Bankruptcy section 1112(b) lists ten "for cause" grounds for the conversion or dismissal of a debtor's case. The specific items listed in §1112(b) as cause for dismissal or conversion are not exclusive and other grounds may be considered. In re C.J. Corp., 78 B.R. 273, 275 (Bankr. D.Hawaii 1987); Matter of Young, 76 B.R. 376, 378 (Bankr. D.Del. 1987). The burden of proof for conversion or dismissal lies with the moving party. Matter of Santiago Vela, 87 B.R. 229, 231 (Bankr. D. P.R. 1988). The decision on whether the movant has shown "cause" under §1112(b) lies within the court's discretion. Id.; In re Vallejo, 77 B.R. 365, 367 (Bankr. D.P.R. 1987). Said decision is made on a

case by case basis. Vallejo, 77 B.R. at 367; Young, 76 B.R. at 378.

One ground for conversion is found in §1112(b)(1) which provides that cause includes "continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation." Section 1112(b)(1) has two separate elements:

1) continuing loss and 2) absence of reasonable likelihood of rehabilitation. The first element can be met by showing negative cash flow. In re Zahniser, 58 B.R. 530, 536 (Bankr. D. Colo. 1986); C.J. Corp., 78 B.R. at 276. It can also be met by showing actual depreciation in the value of the property of the estate. Zahniser, 58 B.R. at 536. An additional showing is a failure to pay post-petition taxes. Santiago Vela, 87 B.R. at 231.

The second element of §1112(b)(1) involves the reasonable likelihood of rehabilitation. Rehabilitation as used in §1112(b)(1) means "to put back in good condition; reestablish on a firm, sound basis." Zahniser, 58 B.R. at 536; In re Wright Air Lines, Inc., 51 B.R. 96, 100 (Bankr. N.D. Ohio 1985); Matter of E. Paul Kovacs & Co. Inc., 16 B.R. 203, 206 (Bankr. D. Conn. 1981). It means more than liquidation under Chapter 11, even though liquidation may constitute a permissible plan of reorganization under §1123(b)(4). Paul Kovacs, 16 B.R. at 206. Thus, liquidation under Chapter 11 is not rehabilitation. Id.

As noted earlier, the specific items listed in §1112(b) as cause are not exclusive and other grounds may be considered. One cause for conversion or dismissal is a failure to comply with local rules. In re Bacon, 52 B.R. 52, 53-54 (Bankr. N.D. Iowa 1985). Another cause is a debtor's operation in violation of state law. See In re Vermont Fiberglass, Inc., 38 B.R. 151, 153-55 (Bankr. D. Vt. 1984) (Chapter 11 case converted because the debtor was no longer authorized to act as a corporation under state law except to liquidate). An additional cause is a breach of the debtor's fiduciary duties. In re Telemark Management Co., Inc., 41 B.R. 501, 507 (Bankr. W.D. Wis. 1984).

In Telemark, the debtor failed to hold withholding taxes collected in trust for the Internal Revenue Service as required under 26 U.S.C. §7501. The court stated that breach of the debtor's fiduciary duty to the Internal Revenue Service was cause for conversion. Id.

In the case at bar, the Court concludes cause exists to convert Debtor's case to Chapter 7 for the following reasons. First is the cause found in §1112(b)(1). There is a continuing loss in Debtor's estate because of negative cash flow and a failure to pay post-petition taxes. As of August 31, 1988, Debtor's net operating losses during its operation under Chapter

11 totaled \$81,139.01. In addition, Debtor anticipates additional losses of about \$20,000.00 for September. Further, Debtor has accrued property tax

liabilities of approximately \$70,000.00 (\$10,000.00 per month) and owes approximately \$7,000.00 to the Job Service Division of the Iowa Department of Employment Services. The second element of §1112(b)(1) is also met because Debtor has no reasonable likelihood of rehabilitation. Debtor doesn't have the required sales tax permit so it can't operate. Even if it could operate, Debtor has no hope of generating the necessary cash flow to fund a reorganization. Debtor has not shown a profit since 1985 or 1986, and has been closed down since October. The effect of this closure and the food poisoning incident on future sales will likely never be overcome, as customer loyalty has been adversely affected.

The second cause for conversion is Debtor's failure to comply with Local Bankruptcy Rule 6003 concerning the withholding and payment of taxes. Debtor failed to initially provide for a tax escrow account and has repeatedly failed to make timely deposits into the account and to pay the post-petition tax obligations as they accrued.

The third cause for conversion is Debtor's continued operation in violation of state law. Iowa Code §422.53(1) provides it is unlawful to transact business as a retailer in

Iowa without a sales tax permit. Debtor does not have a sales tax permit. Debtor needed a sales tax permit to operate after the Court's Order of September 21, 1988,

denying Debtor's application for preliminary injunction enjoining IDR from denying its application for a sales tax permit. Thus, Debtor's operation from September 22, 1988, until October 10, 1988, was in violation of state law.

The fourth and final cause for conversion is Debtor's breach of its fiduciary duties. Section 7501(a) of the Internal Revenue Code imposes a trust on withholding taxes which are to be paid to the United States. Debtor's failure to segregate and preserve the federal taxes withheld from employees' wages constitutes a violation of §7501(a) and is a breach of a fiduciary duty.

CONCLUSION AND ORDER

WHEREFORE, based on the foregoing analysis, the Court concludes "cause" to convert Debtor's case to Chapter 7 exists as follows: 1) §1112(b)(1) continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation; 2) failure to comply with Local Bankruptcy Rule 6003; 3) continued operation in violation of state law; and 4) Debtor's breach of its fiduciary duties.

IT IS ACCORDINGLY ORDERED as follows:

- (1) The motions to convert from Chapter 11 to Chapter 7

of the Iowa Department of Revenue and Finance and the United States Trustee are sustained;

(2) This case is converted from a Chapter 11 case to a Chapter 7 case;

(3) The United States Trustees shall proceed to implement this order; and,

(4) Debtor, as previously acting Debtor-in-Possession, shall comply with Bankruptcy Rule 1019.

Dated this 19th day of December, 1988.

RUSSELL J. HILL
U.S. BANKRUPTCY COURT