

Whether Undistributed Chapter 13 Payment Plan Funds Held By a Chapter 13 Trustee Should Be Distributed to the Debtor or the Debtor's Creditors After Conversion from Chapter 13 to Chapter 7

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Introduction

Qualified individuals seeking to reorganize their debts may file under Chapter 13 of the Bankruptcy Code. Under chapter 13, a debtor makes payments according to a court approved payment plan, which is administered by a chapter 13 trustee, and remains in possession of all the property of the estate.¹ Once a debtor makes all his payments under the chapter 13 payment plan, he has a right to seek a discharge, provided that he meets certain requirements.² These requirements include that the debtor: (1) certifying that he paid all domestic support obligations prior to the certification being made; (2) received no discharge in any case previously filed within a statutorily prescribed amount of time³; and (3) completed a course in financial management.⁴

¹ The chapter 13 estate includes all property acquired and wages earned after the case is filed but before the case is closed, dismissed, or converted under chapter 7, 11, or 12, unless the confirmed plan or order states otherwise. *See* 11 U.S.C. § 1306(a).

² *See* 11 U.S.C. §1328(a).

³ *See* 11 U.S.C. §1328(f). In chapter 7, 11, or 12, this time frame is four years, and in chapter 13, this is a two year period. *Id.*

⁴ *See* 11 U.S.C. §1328(g).

Despite the advantages of filing under chapter 13, these plans often fail when debtors can no longer make payments under the chapter 13 plan. In these situations, debtors may ask the court to dismiss their case, or they may convert their case from chapter 13 to chapter 7.⁵ A dismissal of a chapter 13 case essentially voids the bankruptcy filing, and therefore, creditors may proceed with any collection activities against the debtors. Upon conversion to a chapter 7 case, however, a chapter 7 trustee is assigned to administer the chapter 7 case⁶ and liquidate a debtor's nonexempt assets to pay the creditors.⁷ At the same time, the chapter 13 trustee winds up.⁸ Notably, undistributed post-petition funds paid by the debtor to the chapter 13 trustee are not included in the chapter 7 estate,⁹ but the Bankruptcy Code does not expressly state, and courts have not agreed on, how those funds should be treated.

The issue of how to dispose of undistributed funds in a chapter 13 trustee's possession pursuant to a debtor's confirmed plan at the time that the debtor converts his case to chapter 7 "has divided courts for thirty years."¹⁰ The only two circuit courts that have addressed this question have disagreed as to how to dispose of the undistributed funds. On one hand, the Third Circuit in *In re Michael* held that these funds must be returned to the debtor absent a finding that

⁵ See 11 U.S.C. § 1307.

⁶ See 11 U.S.C. § 704.

⁷ See 11 U.S.C. § 704.

⁸ See 11 U.S.C. § 348.

⁹ See 11 U.S.C. § 541(a). The chapter 7 estate consists of all the debtor's property at the commencement of the case, but generally, not property acquired after a chapter 7 case is filed. Creditors, therefore, are paid from the chapter 7 debtor's pre-petition property, and the chapter 7 debtor usually retains all property acquired after the start of the case. *Id.*

¹⁰ *Viegelahn v. Harris (In re Harris)*, 757 F.3d 468, 470 (5th Cir. 2014). For examples of courts which have held that funds should be dispersed according to the chapter 13 plan, see *In re Pegues*, 266 B.R. 328, 336–37 (Bankr. D. Md. 2001); *In re Bell*, 248 B.R. 236 (Bankr. W.D.N.Y. 2000); *In re Hardin*, 200 B.R. 312 (Bankr. E.D. Ky. 1996); *In re O'Quinn*, 143 B.R. 408 (Bankr. S.D. Miss. 1992); *In re Galloway*, 134 B.R. 602 (Bankr. W.D. Ky. 1991); *In re Halpenny*, 125 B.R. 814 (Bankr. D. Haw. 1991); *In re Milledge*, 94 B.R. 218 (Bankr. M.D. Ga. 1988); *Matter of Burns*, 90 B.R. 301 (Bankr. S.D. Ohio 1988); *In re Waugh*, 82 B.R. 394 (Bankr. W.D. Pa. 1988); *In re Redick*, 81 B.R. 881 (Bankr. E.D. Mich. 1987); *In re Rutenbeck*, 78 B.R. 912 (Bankr. E.D. Wis. 1987). For examples of courts which have held that funds should be returned to the debtor, see *In re Michael*, 436 B.R. 323 (Bankr.M.D.Pa.2010); *In re Boggs*, 137 B.R. 408 (Bankr.W.D.Wash.1992); *In re de Vos*, 76 B.R. 157 (N.D.Cal. 1987); *In re Luna*, 73 B.R. 999 (N.D.Ill.1987); *In re Peters*, 44 B.R. 68 (Bankr.M.D.Tenn.1984); *In re Bullock*, 41 B.R. 637 (Bankr. E.D.Pa. 1984); *In re McFadden*, 37 B.R. 520 (Bankr.M.D.Pa.1984); and *In re Hannan*, 24 B.R. 691 (Bankr. E.D.N.Y. 1982).

the debtor converted the case in bad faith.¹¹ On the other hand, the Fifth Circuit in *In re Harris*, held that undistributed post-petition funds held by a chapter 13 trustee must be paid to creditors in accordance with the terms of the chapter 13 payment plan.¹² The United States Supreme Court granted certiorari on December 12, 2014 in *In re Harris* to resolve this issue.

This Article examines whether a debtor or his creditors have a superior claim to undistributed funds following the conversion of the debtor's case from chapter 13 to chapter 7. Part I analyzes the relevant provisions of the Bankruptcy Code that govern the conversion of a debtor's case from chapter 13 to chapter 7. Part II discusses: (i) cases that hold that the undistributed funds should be returned to the debtor; and (ii) cases that hold that the funds should be paid to the debtor's creditors pursuant to the terms of the chapter 13 payment plan. Finally, Part III discusses the implications of the split.

I. Conversion from Chapter 13 to Chapter 7 Under the Bankruptcy Code

Generally, a debtor may convert his bankruptcy case from chapter 13 to chapter 7 at any time, even after a chapter 13 payment plan is confirmed.¹³ However, a debtor may not convert to chapter 7 if in the preceding 180 days, the case was dismissed because of the debtor's intentional failure to appear before or comply with the court.¹⁴ A debtor also may not convert if he voluntarily dismissed the case after his creditors filed a request for relief from the automatic stay.¹⁵ Conversion from chapter 13 terminates the chapter 13 payment plan and the chapter 13 estate, as well as the chapter 13 trustee's duties.¹⁶ Conversion does not change the filing date of the original petition so the converted chapter 7 case is considered to have commenced on the date

¹¹ See *In re Michael*, 699 F.3d 305, 307 (3rd Cir. 2012).

¹² See *In re Harris* at 471.

¹³ See 11 U.S.C. § 1307(a).

¹⁴ See 11 U.S.C. §109(g).

¹⁵ See *id.*

¹⁶ See 11 U.S.C. § 348(e).

the bankruptcy case originally was filed.¹⁷ A chapter 7 trustee also is appointed to administer the chapter 7 estate.¹⁸

Section 348(f) governs whether the post-petition property of the chapter 13 estate is included in the post-confirmation chapter 7 estate.¹⁹ Specifically, section 348(f)(1)(A) provides that the “property of the estate in the converted case shall consist of property of the estate, as of the date of filing of the petition, that remains in the possession of or is under the control of the debtor on the date of conversion.”²⁰ This means that the chapter 7 estate consists of all the debtor’s property at the start of the case²¹ but generally not the property acquired thereafter.²²

In addition, upon conversion, section 348(e) terminates a chapter 13 trustee’s service. Federal Rule of Bankruptcy Procedure 1019(4) requires a chapter 13 trustee to give all the property in his possession to the chapter 7 trustee since the chapter 13 trustee’s duties terminate at conversion.²³ The Bankruptcy Code also requires the chapter 13 trustee to wind up his trusteeship.²⁴ Specifically, under 348(e) and the Federal Rule of Bankruptcy Procedure 1019(5), the chapter 13 trustee is required to do an accounting and file a report regarding all the funds that he administered.²⁵ The chapter 13 trustee must pay administrative expenses, taxes, and himself.²⁶ Finally, if the case is converted to chapter 7 prior to plan confirmation, the chapter 13 trustee must return to the debtor any accumulated funds in his possession, less the amounts for administrative expense claims.²⁷

¹⁷ See 11 U.S.C. § 348(a).

¹⁸ See 11 U.S.C. § 704.

¹⁹ See 11 U.S.C. § 348(f).

²⁰ 11 U.S.C. § 348(f)(1)(A).

²¹ See 11 U.S.C. § 541(a)(1).

²² See 11 U.S.C. § 541(a).

²³ Fed. R. Bankr. P. 1019(4).

²⁴ See 11 U.S.C. § 348.

²⁵ See *id.*; see also Fed. R. Bankr. P. 1019(5).

²⁶ See 1326(a)(2).

²⁷ See *id.*

Therefore, only property in the debtor's possession at the time of filing the petition is included in the chapter 7 estate.²⁸ Undistributed post-petition funds paid by the debtor and held by the chapter 13 trustee at the time of conversion are not included in the chapter 7 estate. But, a chapter 13 trustee also has post-conversion duties to the extent that he must wind up and dispose of those undistributed post-petition funds in his possession. Although these funds, which were paid in accordance with the chapter 13 payment plan, must be returned to the debtor or distributed to the debtor's creditors in accordance with the payment plan, the Bankruptcy Code fails to directly address whether a debtor or his creditors have a superior right to these post-petition funds. How the chapter 13 trustee should dispose of these funds has divided the courts.

II. Divided Courts: Post-Conversion Disposal of Undistributed Post-Petition Funds Paid By Debtors Pursuant to a Chapter 13 Payment Plan.

Because the Bankruptcy Code fails to expressly state how a chapter 13 trustee should dispose of post-petition plan funds paid by a debtor prior to conversion but undistributed by the trustee at the time of conversion, courts across the country have disagreed on the interpretation and application of the Code in these situations.²⁹ Two opposing sides have emerged: courts which hold that the undistributed funds should be returned to the debtor, and courts which hold that the funds should be paid to the debtor's creditors pursuant to the terms of the chapter 13 payment plan.³⁰

(i) View One: The Debtor Has a Superior Claim to Post-Petition Funds Held By the Chapter 13 Trustee at Conversion.

²⁸ See 11 U.S.C. § 348(f).

²⁹ See *supra*, note 10.

³⁰ *Id.*

Presently, the Third Circuit is the only circuit court that has held that the chapter 13 trustee must return accumulated post-petition funds to the debtor upon conversion.³¹ There also have been at least ten lower courts that have decided similar to the Third Circuit.³²

For example, in *In re Michael*, the Third Circuit held that the undistributed funds must be returned to the debtor once his case converted.³³ In reaching this conclusion, the *Michael* court first turned to the plain language of the Code. The *Michael* court noted that, “no provision in the Bankruptcy Code classifies any property, including post-petition wages, as belonging to creditors.”³⁴ Moreover, turning to section 1326(a)(2) and (c), the court pointed out that these provisions only require the chapter 13 trustee to distribute the funds according to the payment plan, but they do not vest creditors with property rights.³⁵ Instead, the *Michael* court noted that section 1327(b) vests all property of a chapter 13 estate in the debtor when a payment plan is confirmed with “the implication is that property held by the Chapter 13 trustee after plan confirmation is ‘under the control of the debtor as of the date of [a later] conversion’ for purposes of § 348(f)(1).”³⁶ In this regard, since conversion does not change the date of the case filing, post-petition property does not become part of chapter 7 estate, and the debtor retains a vested interest in the property.³⁷ Therefore, the *Michael* court concluded that “[t]hough creditors

³¹ See *In re Michael*, 699 F.3d at 307.

³² See, e.g., *In re Murphy*, Nos. 09-81861, 12-30813, 2014 WL 2600168, at *2–*3 (Bankr. M.D. Ala. Feb. 11, 2014); *Gallagher v. Dockery (In re Gallagher)*, No. CC-13-1368-TaKuPa, 2014 WL 998411, at *6 (B.A.P. 9th Cir. Mar. 17, 2014); *In re Krahenbuhl*, No. 09-29618-svk, 2013 WL 3793405, at *2 (Bank. E.D. Wisc. July 19, 2013); *In re Harris*, App.; *In re Horne*, No. 97-20171, 2002 WL 33939743, at *4 (Bankr. D. Idaho Jan. 10, 2002); *DeHart v. Michael (In re Michael)*, 446 B.R. 665, 667 (M.D. Pa. 2011); *In re Michael*, 436 B.R. 323, 331 (Bankr. M.D. Pa. 2010); *In re Boggs*, 137 B.R. 408, 410–11 (Bankr. W.D. Wash. 1992); *In re Bullock*, 41 B.R. 637, 638–41 (Bankr. E.D. Pa 1984).

³³ See *In re Michael*, 699 F.3d at 307.

³⁴ See *id.* at 312–13.

³⁵ See *id.* at 313.

³⁶ *Id.* at 310.

³⁷ See *id.* at 313.

have a right to those payments based on the confirmed plan, the debtor does not lose his vested interest until the trustee affirmatively transfers the funds to creditors.”³⁸

In addition, looking at section 348, the *Michael* court noted that conversion ends the chapter 13 case and terminates the services of the chapter 13 trustee.³⁹ But, the court also acknowledged that the chapter 13 trustee continues to have limited post conversion duties, including filing a report on the funds that came in his possession, and if a case is converted prior to confirmation, returning funds in his possession to the debtor.⁴⁰ However, the court explained that this duty does not extend to distributing payments under a plan that is no longer in affect.⁴¹

Finally, the *Michael* court concluded its analysis by looking at the legislative history behind the passage of 348(f). The court determined that returning these funds to the debtor better aligned with the legislative intent.⁴² The court opined that the legislative history of section 348(f) revealed that Congress intended for accumulated payments in the chapter 13 trustee’s possession to go back to the debtor upon conversion.⁴³ When it adopted the *Bobroff* decision and passed section 348(f), Congress wanted to eliminate disincentives to filing under chapter 13.⁴⁴ The *Michael* court reasoned that distributing the accumulated funds to creditors rather than having them revert back to the debtor would discourage debtors from filing under chapter 13.⁴⁵ In addition, Congress added 348(f) to account for debtors who act in bad faith.⁴⁶ Under section 348(f), if a debtor converts in bad faith, property that normally would go to the debtor would go

³⁸ *Id.* at 310.

³⁹ *See id.* at 313.

⁴⁰ *See id.* at 310.

⁴¹ *See id.*

⁴² *See id.* at 314-15.

⁴³ *See id.*

⁴⁴ *See id.* For a discussion of *In re Bobroff*, *see infra*, note 61.

⁴⁵ *See id.* at 314-15.

⁴⁶ *Id.*

instead to the chapter 7 estate for distribution to the creditors.⁴⁷ Therefore, the *Michael* court reasoned that if property were to be distributed to creditors absent bad faith, the bad faith penalty that Congress sought would be diminished.⁴⁸

(ii) View Two: Creditors Have a Superior Claim to Post-Petition Funds Held By the Chapter 13 Trustee at Conversion.

Other courts, however, have held that post-petition funds paid by the debtor in accordance to a chapter 13 plan but held by a chapter 13 trustee at the time of conversion to chapter 7 must be distributed to the debtor's creditors. The Fifth Circuit has been the only circuit court to decide in favor of creditors,⁴⁹ and at least fifteen lower courts have decided similarly.⁵⁰

For example, in *Viegelahn v. Harris (In re Harris)*, the Fifth Circuit held that funds held by the chapter 13 trustee at conversion must be paid to the debtor's creditors. In reaching its conclusion, the *Harris* court first looked at the language of the Code. The court reasoned that while conversion terminates the chapter 13 trustee, it does not deprive the trustee of authority to distribute funds since the trustee continues to have post-conversion obligations, such as turning over records to the chapter 7 trustee, reporting, and paying expenses.⁵¹ Furthermore, the *Harris* court noted that conversion does not retroactively undo the plan.⁵²

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ See *Viegelahn v. Harris (In re Harris)*, 757 F.3d 468, 481 (5th Cir. 2014).

⁵⁰ See, e.g., *In re Smith*, 511 B.R. 612, 620–21 (Bankr. W.D. Mo. 2014); *In re Markham*, 504 B.R. 1, 8 (Bankr. D. Mass. 2013); *Spero v. Porreco (In re Porreco)*, 426 B.R. 529, 537 (Bankr. W.D. Pa. 2010) (overruled by *In re Michael*); *Chase v. Winnecour (In re Chase)*, No. 03-10092, 2008 WL 2309529, at *1 (Bankr. W.D. Pa. June 4, 2008) (overruled by *In re Michael*); *In re Pegues*, 266 B.R. 328, 334 (Bankr. D. Md. 2001); *In re Salisbury*, No. 99-10431C-7G, 2000 WL 33673758, at *2 (Bankr. M.D.N.C. Nov. 17, 2000); *In re Bell*, 248 B.R. 236, 239–40 (Bankr. W.D.N.Y. 2000); *In re Hardin*, 200 B.R. 312, 314 (Bankr. E.D. Ky. 1996); *O'Quinn v. Brewer (In re O'Quinn)*, 143 B.R. 408, 413 (Bankr. S.D. Miss. 1992); *In re Galloway*, 134 B.R. 602, 602–04 (Bankr. W.D. Ky. 1991); *In re Halpenny*, 125 B.R. 814, 815–16 (Bankr. D. Haw. 1991); *In re Milledge*, 94 B.R. 218, 219–20 (Bankr. M.D. Ga. 1988); *Ledford v. Burns (In re Burns)*, 90 B.R. 301, 305 (Bankr. S.D. Ohio 1988); *Waugh v. Saldamarco (In re Waugh)*, 82 B.R. 394, 400 (Bankr. W.D. Pa. 1988) (overruled by *In re Michael*); *In re Redick*, 81 B.R. 881, 887 (Bankr. E.D. Mich. 1987).

⁵¹ See *In re Harris*, 757 F.3d at 474.

⁵² See *id.* at 480.

The *Harris* court also rejected some of the trustee’s arguments which contended that creditors had vested rights in the property. The court refuted the idea that the language of section 1326(a)(2), which states that a trustee “shall” distribute funds under a plan, created vested rights in creditors,⁵³ and that under section 1327(a) a debtor was bound to the chapter 13 plan even after conversion.⁵⁴ Instead, the Fifth Circuit recognized that under sections 1306(b) and 1327(b) a debtor in a chapter 13 case generally retains vested interest in his property, which includes post-petition wages, unless a plan or an order confirming a plan provides otherwise, in which case, a debtor is divested of his interest in the property.⁵⁵ The *Harris* court noted that ignoring the exception to the general rule—that a debtor generally retains vested interest in his property under 1306(b) and 1327(b)—renders the language “except as otherwise provided in the plan or the order confirming the plan” superfluous.⁵⁶

The *Harris* court also found no basis for the *Michael* court to conclude that by not returning funds to debtors, the debtors would be discouraged from filing under chapter 13, or that such a holding aligned more closely with the legislative intent of section 348(f).⁵⁷ Instead, the *Harris* court stated, “it is unlikely that a debtor would be meaningfully deterred by the knowledge that payments made under a confirmed Chapter 13 plan will not be returned to him if he chooses to convert to Chapter 7.”⁵⁸ Indeed, the distribution of these funds to creditors simply would require the debtor to keep his obligations under the chapter 13 plan that the debtor filed.⁵⁹

Finally, turning to “equity and policy,” the *Harris* court acknowledged that some courts based their decisions in similar cases on the legislative goal of “encouraging debtors to attempt

⁵³ See *id.* at 475–76.

⁵⁴ See *id.* at 476–77.

⁵⁵ See *id.* at 477.

⁵⁶ See *id.*

⁵⁷ See *id.* at 479.

⁵⁸ *Id.*

⁵⁹ *Id.*

repayment through Chapter 13 and removing disincentives that would discourage this.”⁶⁰ The *Harris* court opined that distributing the accumulated funds to creditors does not discourage the use of chapter 13 proceedings.⁶¹ Instead, the *Harris* court determined that it is an equitable remedy since creditors suffer disadvantages under chapter 13, such as depreciation of property, while debtors receive benefits, such as putting off a home foreclosure, at the creditors’ expense.⁶² Therefore, the *Harris* court concluded that it is fair to distribute the funds to the creditors rather than have the debtor receive the benefits only to liquidate everything upon conversion.⁶³

Although the Fifth Circuit held in favor of the creditors, the United States Supreme Court will resolve this split among the courts since it granted certiorari in *In re Harris* on December 12, 2014.

III. Implications of Divided Courts and the United States Supreme Court Decision

The United States Supreme Court will decide the issue of whether post-petition funds paid by the debtor in accordance to a chapter 13 payment plan and held by the chapter 13 trustee at the time the debtor converts to chapter 7 should be returned to the debtor or paid to the debtor’s creditors.

Although the Supreme Court’s decision will settle this issue, in actuality, a debtor’s decision to convert from chapter 13 to chapter 7 should not be affected by the decision since

⁶⁰ *Id.*

⁶¹ *See id.* at 479–81 (“Subsequent court opinions have interpreted this legislative history as reflecting a congressional policy of encouraging debtors to attempt repayment through Chapter 13 and removing disincentives that would discourage this.”). In its analysis, the *Harris* court discussed that with the passage of 11 U.S.C. § 348(f), the Congress adopted the reasoning *In re Bobroff* and rejected the reasoning in *In re Lybrook*. *Id.* at 479. In *In re Bobroff*, that court held that tort actions which accrued during a chapter 13 case did not become part of the estate when debtor converted to chapter 7, pointing to the “Bankruptcy Code’s goal of encouraging the use debt repayment plans rather than liquidation.” *Bobroff v. Cont’l Bank (In re Bobroff)*, 766 F.2d 797, 803–04 (3rd Cir. 1985). In *In re Lybrook*, the debtors inherited property during a chapter 13 proceeding, and the Seventh Circuit held that the inherited property converted to the chapter 7 estate because, upon balance, this would “discourage strategic, opportunistic behavior that hurts creditors without advancing any legitimate interest of debtors.” 951 F.2d 136, 137–39 (7th Cir. 1991).

⁶² *See In re Harris*, 757 F.3d at 480–81.

⁶³ *See id.*

debtors generally convert from chapter 13 to chapter 7 when they can no longer make payments under a chapter 13 payment plan. In practice, a debtor will not plan around the funds that he paid under a chapter 13 payment plan since he will not know whether those funds remain in the possession of the chapter 13 trustee or have been distributed to his creditors at the time the debtor converts his case. If the funds are returned to the debtor at conversion, that money essentially would be equivalent to “found money,” and therefore, the debtor should not make decisions based on those funds. Nevertheless, if the Supreme Court decides that these funds must be paid to the debtor’s creditors, a debtor may be inclined to convert from chapter 13 to chapter 7, or to stop making payments under the chapter 13 payment plan, as soon as he realizes that he will be unable to continue under the chapter 13 payment plan since the debtor will not get back any undistributed funds in the chapter 13 trustee’s possession.

On the other hand, until the Supreme Court’s decision, creditors will continue to argue that they are entitled to the funds in the chapter 13’s possession at conversion since the debtor already made the payments under the chapter 13 plan with the expectation that those payments would be paid to the creditors. In their practice, chapter 13 trustees should adopt procedures to prevent, or at least curtail, an *In re Harris* situation from arising so that the chapter 13 trustee will have no money, or very little amount, in his possession if a debtor converts his case. But, if the Supreme Court decides that funds should be returned to debtors, the creditors may receive less money if the debtor converts than they would have received under a chapter 13 plan.

Ultimately, until the Supreme Court issues its decision, both debtors and chapter 13 trustees should be aware of where the courts in their jurisdictions stand on the issue. Chapter 13 trustees should continue to disperse of funds in accordance with those courts, and their own office procedures, and debtors should continue to consider the timing of their conversion.

Conclusion

Although the Bankruptcy Code is unclear as to who receives post-petition funds held by a chapter 13 trustee when a debtor converts from chapter 13 to chapter 7, lower courts and at least two circuit courts have attempted to interpret the provisions of the Code in order to justify the return of the funds to the debtor or disbursement of the funds to creditors. Since the Supreme Court granted certiorari *In re Harris*, it will decide this issue this year. Until then, however, trustees should remain cognizant of their local jurisdictions' position on this issue so that they may properly dispose of any accumulated post-petition funds paid under a chapter 13 plan when a case is converted to chapter 7, while debtors will likely remain unaffected as they continue to make decisions to convert from chapter 13 to chapter 7 based on their ability to make payments under a chapter 13 payment plan.