IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF NEBRASKA

IN THE MATTER OF:	)	CASE NO. BK04-42490
	)	
JEROLD STEVEN McCARTY and	)	
NELLIE IONE McCARTY,	)	CH. 13
	)	
Debtor(s).	)	

MEMORANDUM

Hearing was held in Lincoln, Nebraska, on January 26, 2005, regarding Filing No. 2, Chapter 13 Plan, filed by the debtors, and Filing No. 9, Objection to Confirmation of Plan, filed by Trustee Kathleen Laughlin. Bert Blackwell appeared for the debtors and Marilyn Abbott appeared for the Chapter 13 Trustee. This memorandum contains findings of fact and conclusions of law required by Federal Rule of Bankruptcy Procedure 7052 and Federal Rule of Civil Procedure 52. This is a core proceeding as defined by 28 U.S.C. § 157(b)(2)(L).

The Chapter 13 Trustee has objected to the confirmation of debtors' plan because, within a month prior to bankruptcy, the debtors borrowed a little more than $10,000 from relatives, granted the relatives a mortgage on the unencumbered equity in their residence, executed a note payable on a monthly basis over a three-year period, and used the proceeds for the purchase of an exempt annuity. The debtors then filed a Chapter 13 case which proposed to pay the obligation to the relatives over a three-year period, without modification of the mortgage note.

The Trustee argues that the actions of the debtors prior to bankruptcy, combined with the three-year plan, are detrimental to the rights of the unsecured creditors. Had the debtors not taken such action, they would have been required to pay the value of the unencumbered equity of approximately $10,000 to the unsecured creditors through the Chapter 13 plan. Instead, the unsecured creditors will get nothing from the equity, and the disposable income which would have been available to the debtors to make the payments to unsecured creditors will now go to the relatives holding the secured debt. The Trustee suggests such action on behalf of the debtors is bad faith and that the plan should be denied confirmation because of such bad faith.

The debtors are within a few years of retirement and the wife has health problems. The evidence is that they had financial difficulties and they knew they would be unable to pay all of their creditors. They had equity in their home and felt a legitimate need to protect the equity to enable them to have something for their retirement. By taking the action they did, they will have an annuity which will pay a little over $100 per month at retirement and they will still have the equity in the house, after payment of the mortgage.

Nebraska law does not put a time limitation on the purchase of an annuity for exemption purposes. It simply limits the amount of the exemption to $10,000. The Bankruptcy Code does not prohibit converting non-exempt property to exempt property, even shortly before filing bankruptcy.

The Trustee initially suggested that the mortgage should not be paid over a period of three

years. However, terms of the mortgage require it and modification of the mortgage is not permitted under Section 1322.

Now, the Trustee suggests that the debtors should be required to extend the life of the plan at least eight months to allow the unsecured creditors to recover the amount they would have recovered had the debtors not engaged in "pre-bankruptcy planning."

The debtors argue that "pre-bankruptcy planning" in which the debtors take action to convert non-exempt property to exempt property should not result in a fact finding that the debtors have acted in bad faith.

What the debtors have done here is perfectly legal. They have converted non-exempt property to exempt property shortly before bankruptcy. There is no evidence of intrinsic fraud in the transaction which would, if this were in the context of an objection to exemption, cause the court to deny the exemption. Abbott Bank v. Armstrong (In re Armstrong), 931 F.2d 1233, 1236 (8th Cir. 1991). Armstrong was a Chapter 7 case. However, its discussion of the right of a debtor to convert non-exempt property to exempt property shortly before bankruptcy is enlightening. In Armstrong, although the debtors were permitted their exemption, they were denied a discharge because the trial court and the appellate courts found, after viewing all elements of the transaction, that the Armstrongs had intended to hinder or delay their creditors by encumbering all of their assets and converting some to exempt status.

In this Chapter 13 case, the question of denial of a discharge is not before the court. However, the court is permitted to consider the motivation of the debtors concerning the transaction and the end result of the transaction in an attempt to determine whether the transaction, as a whole, was performed in good faith and whether the plan that the debtors have now filed deals fairly with their creditors.

Here, the stated motivation of the debtors was to make certain that some assets would be available to provide for them in their retirement. There is nothing illegitimate about such motivation. The timing of the transaction, less than one month prior to the filing of a Chapter 13 case, allows the court to infer that the transaction was entered into not only to provide for some retirement income, but to preserve the residential equity from the claims of unsecured creditors. As mentioned above, the result of the transaction, including its timing, is that the debtors not only have a new asset – the annuity contract which will pay them approximately $100 per month upon retirement – but they also retain the benefit of the equity in the residence. The mortgage loan that they will pay off over a period of three years will be released and they will once again own $10,000 of equity free and clear of the claims of creditors. The flip side of the transaction is that the unsecured creditors receive nothing from the residential equity.

In order to be confirmed, a chapter 13 plan must be proposed "in good faith and not by any means forbidden by law." 11 U.S.C. § 1325(a)(3). The seminal Eighth Circuit law on good faith in the context of Chapter 13 is the standard recited in United States v. Estus (In re Estus), 695 F.2d 311 (8th Cir. 1982), as modified in Education Assistance Corp. v. Zellner, 827 F.2d 1222 (8th Cir. 1987), to account for the 1984 amendment to the Bankruptcy Code to add § 1325(b). All subsequent cases within the Eighth Circuit to deal with the issue of good faith consider the Estus factors. In weighing the facts of a particular case, the Eighth Circuit's Bankruptcy Appellate Panel said:

> The relevant inquiry regarding good faith is "whether the debtor has stated his debts and expenses accurately; whether he has made any fraudulent misrepresentation to mislead the bankruptcy court; or whether he has unfairly manipulated the Bankruptcy Code." Education Assistance Corp. v. Zellner, 827 F.2d 1222, 1227 (8th Cir. 1987). However, the foregoing inquiry is governed by a "totality of the circumstances" test. Noreen, 974 F.2d at 76; LeMaire, 898 F.2d at 1349; In re Estus, 695 F.2d 311, 316 (8th Cir. 1982). Factors which are particularly relevant to determining good faith under the totality of the circumstances include: (1) the nature of the debt sought to be discharged; (2) whether the debt would be dischargeable in a chapter 7 bankruptcy case; and (3) the debtor's motivation and sincerity in seeking chapter 13 relief. LeMaire, 898 F.2d at 1349 (citing Estus, 695 F.2d at 317). See also In re Kurtz, 238 B.R. 826, 830 (Bankr. D.N.D. 1999) ("Further consideration must be given to the sincerity of the Debtor in putting forth his Chapter 13 plan of repayment and whether that plan demonstrates real sincerity on the part of [the Debtor] to repay his creditors as best he can in exchange for the liberal Chapter 13 discharge."). Another relevant factor in determining good faith is the Debtor's pre-filing conduct. LeMaire, 898 F.2d at 1352 (citations omitted). However, even in light of egregious pre-filing conduct by the Debtor, a chapter 13 plan may be confirmed if other factors "suggest that the plan nevertheless represents a good faith effort by the debtor to satisfy his creditors' claims." Id. (citation omitted).

Banks v. Vandiver (In re Banks), 248 B.R. 799, 803 (B.A.P. 8th Cir. 2000), aff'd per curiam, 267 F.3d 875 (8th Cir. 2001).

In finding a plan to not have been proposed in good faith, a Minnesota bankruptcy court considered the following:

> The broader inquiry is "whether the Bankruptcy Code is being unfairly manipulated" by the debtor, Education Assistance Corp. v. Zellner, 827 F.2d at 1227, or put another way, "whether the plan constitutes an abuse of the provisions, purpose, or spirit of Chapter 13," In re Estus, 695 F.2d at 317. Though the words "good faith" suggest a subjective state of mind, the courts can consider objectively-manifested circumstances to make an inference on the existence or non-existence of this element. The relevant factors include the debtor's candor and honesty with the court in the bankruptcy case; the conformity of the plan with the policy goals of the bankruptcy laws; the debtor's expressed attitude, past and present, toward the legal process and its values; the extent to which the debtor's past conduct conformed with the substantive law that governed his relationship(s) with creditor(s); and the debtor's past conduct in relation to the integrity of the legal system. The court may consider the fundamental fairness of the debtor's proposed treatments of creditors' claims. Id. See also In re LeMaire, 898 F.2d at 1349; In re Estus, 695 F.2d at 315; In re Banks, 248 B.R. at 803 n.2; In re Barger, 233 B.R. 80, 83 (8th Cir. B.A.P. 1999) (applying identical language of 11 U.S.C. § 1225(a)(3)).

In re Soost, 290 B.R. 116, 122 (Bankr. D. Minn. 2003).

Under the facts of this case, I find that the plan, limited to thirty-six months, the exact time frame for paying off the encumbrance on the residential equity, is not filed in good faith. There is

nothing wrong with pre-bankruptcy planning. There is nothing wrong with converting non-exempt assets to exempt assets. However, the result of this particular transaction inherently harms the interest of unsecured creditors and gives the debtors a significant financial bonus. I find that result to be unfair to the creditors, which results in my finding that the plan is not being prosecuted in good faith.

The suggestion by the Trustee is that good faith would actually be shown by an extension of the plan for a minimal amount of time, such as eight and one-half months, which would permit the debtors to have their annuity, reclaim their equity, and permit the unsecured creditors to receive what they would have received had the transaction not taken place. I think such a suggestion is a reasonable one. The bankruptcy court is not authorized to require debtors to file a plan that exceeds thirty-six months. On the other hand, the bankruptcy court is not required to confirm a thirty-six month plan that the court finds is not filed in good faith.

A separate order will be entered giving the debtors until April 1, 2005, to file an amended plan which conforms with the discussion above. Failure to do so shall result in a dismissal of this case.

DATED this 14th day of March, 2005.

BY THE COURT:

/s/ Timothy J. Mahoney
Chief Judge

Notice given by the Court to:
*Bert Blackwell
Marilyn Abbott
U.S. Trustee

*Movant is responsible for giving notice of this memorandum to all other parties not listed above if required by rule or statute.

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ORDER

Hearing was held in Lincoln, Nebraska, on January 26, 2005, regarding Filing No. 2, Chapter 13 Plan, filed by the debtors, and Filing No. 9, Objection to Confirmation of Plan, filed by Trustee Kathleen Laughlin. Bert Blackwell appeared for the debtors and Marilyn Abbott appeared for the Chapter 13 Trustee.

IT IS ORDERED: The debtors are granted until April 1, 2005, to file an amended plan which conforms with the discussion in the Memorandum filed today. Failure to do so shall result in a dismissal of this case.

DATED this 14th day of March, 2005.

BY THE COURT:

/s/ Timothy J. Mahoney
Chief Judge

Notice given by the Court to:
*Bert Blackwell
Marilyn Abbott
U.S. Trustee

*Movant is responsible for giving notice of this order to all other parties not listed above if required by rule or statute.