In the United States Bankruptcy Court

for the Northern District of Iowa

ROBERT C HAYES
ANDREA HAYES
Debtor(s).

Bankruptcy No. 96-21384KD

Chapter 13

ORDER RE: CONFIRMATION OF PLAN

This matter came before the undersigned on November 3, 1998 for final hearing on confirmation of Debtors' Amended Plan. Debtors Robert and Andrea Hayes appeared, represented by attorney Brian Peters. Carol Dunbar appeared as Chapter 13 Trustee. Martin McLaughlin represented the IRS. Maquoketa State Bank was represented by attorney Eric Lam. After the presentation of evidence and argument, the Court took the matter under advisement. This is a core proceeding pursuant to 28 U.S.C. §157(b)(2)(L).

STATEMENT OF THE CASE

The Bank, the IRS and Chapter 13 Trustee object to confirmation of Debtors' Amended Plan on various grounds. They object to the lack of a liquidation analysis and a disposable income provision in the plan and raise issues of good faith and feasibility. The parties also point out that Debtors have been involved in postpetition transactions without approval of the Court.

FINDINGS OF FACT

Debtors filed their Chapter 13 petition on June 3, 1996. The Bank appealed the Court's December 10, 1996 ruling on its Objection to Exemptions and Motion to Convert. The District Court filed its ruling on appeal on March 12, 1998. Debtors filed their Amended Plan June 15, 1998. Debtors have been making monthly payments under their proposed Plan for two years and five months while awaiting the decision on appeal and final plan confirmation.

During this time, Debtors have entered into post-petition transactions without seeking approval from the Court. They sold their homestead property in Baldwin, Iowa, including the portion of the property determined to be nonexempt in the Court's December 10, 1996 order. With the proceeds of the sale, after payment of a mortgage, Debtors purchased a bar and restaurant in Springbrook, Iowa for $35,000. The purchase included real estate and equipment, now valued at $15,000 and $10,000, respectively. Debtors have recently become aware that a cloud exists on the title to the real estate arising from a failure to procure a quit claim deed many years, and several purchasers, ago.

Debtors received a loan from Mrs. Hayes' parents to facilitate the purchase. They purchased the bar before the sale of their homestead was finalized. Debtors borrowed money from Mrs. Hayes' parents, without interest, to pay for the bar, and subsequently repaid them in full with the proceeds from the

sale of the homestead property. Debtors did not inform their bankruptcy counsel nor seek court approval of this transaction.

Other changes in Debtors' circumstances have occurred. Mrs. Hayes lost the job she had prepetition and is now operating the bar and restaurant in Springbrook. Mr. Hayes is employed as a mechanic 40 hours a week and works at the bar in the evenings and on weekends.

Debtors have now filed a liquidation analysis. They explain the 60-month term of their Amended Plan includes the time which has passed since they filed their petition. The Plan will be completed by June, 2001. Debtors agree to apply all projected disposable income to plan payments. They have filed amended schedules showing their change in income and other changes related to the purchase of the bar and restaurant. The Amended Plan proposes to pay a minimum of $300 per month for a total of sixty months. This will provide a minimum of $3,100 to unsecured creditors. The liquidation analysis provides that under Chapter 7, there would be no payment to unsecured creditors.

Debtors assert they did not realize they needed Court approval to sell their homestead. They point out the loan from Mrs. Hayes' parents was very short-term and was repaid out of proceeds from their exempt property. The mortgage on Debtors' homestead attached first to the non-exempt portion of the property. Debtors assert, therefore, that selling the non-exempt portion along with the exempt portion merely resulted in paying off a mortgage with no detriment to the bankruptcy estate.

CONCLUSIONS OF LAW

The Bankruptcy Code requires that the Court consider the confirmation requirements set forth in 11 U.S.C. § 1325(a). A debtor's plan must be confirmed if all six factors are satisfied. In re Johnson, 708 F.2d 865, 867 (2d Cir. 1983). The Court has "an independent obligation to be sure that the proposed plan complie[s] with the Bankruptcy Code." In re Northrup, 141 B.R. 171, 172 (Bankr. N.D. Iowa 1991). The debtor who proposes a Chapter 13 plan bears the burden of proving that all requirements for confirmation of the plan are satisfied. In re Humphrey, 165 B.R. 508, 510 (Bankr. M.D. Fla. 1994).

BEST INTERESTS

In order to be confirmed, a Chapter 13 plan must satisfy the "best interests of creditors" test under § 1325(a)(4). This section provides that a court shall confirm a plan if,

> the value, as of the effective date of the plan, of property to be distributed under the plan on account of each allowed unsecured claim is not less than the amount that would be paid on such claim if the estate of the debtor were liquidated under Chapter 7 of this title on such date.

11 U.S.C. §1325(a)(4). The "best interests test" is satisfied if payments under the proposed plan, discounted to present value, provide a larger payment to unsecured creditors than would a hypothetical distribution to unsecured creditors under Chapter 7.

Maquoketa State Bank, the IRS, and Trustee ("Objectors") argue that Debtors' plan fails this "best interests test" because the post-petition sale of the homestead property yielded income in excess of the mortgage obligation ($35,000) and the allowed homestead exemption ($54,000). According to the Bank, this excess income, which is purportedly greater than the proposed payout to unsecured

creditors under the proposed plan, would be available to satisfy unsecured creditors in a Chapter 7 liquidation. The Objectors ask the Court to deny confirmation on the basis that the proposed plan fails the "best interests test".

In the Eighth Circuit, two lines of cases exist concerning the point in time referenced in the phrase "effective date of the plan". In re Forbes, 215 B.R. 183, 189 (B.A.P. 8th Cir. 1997). The majority position originates with Education Assistance Corp. v. Zellner, 827 F.2d 1222, 1225 (8th Cir. 1987), and holds that the language refers to the date on which the plan is confirmed. See also In re Hopwood, 124 B.R. 82, 85 (E.D. Mo. 1991); In re Lupfer Bros., 120 B.R. 1002, 1004 (Bankr. W.D. Mo. 1990); In re Bremer, 104 B.R. 999, 1003 (Bankr. W.D. Mo. 1989). Another line of cases, beginning with Hollytex Carpet Mills v. Tedford, 691 F.2d 392, 393 (8th Cir. 1982), hold that "effective date of the plan" refers to the date the bankruptcy petition was filed. See In re Nielsen, 86 B.R. 177, 178-79 (Bankr. E.D. Mo. 1988); In re Stratmore, 22 B.R. 37, 38 (Bankr. D. Neb. 1982). This issue is particularly important in this case due to the time that has passed since Debtors filed their Chapter 13 petition.

The Court holds that the cases interpreting the §1325(a)(4) "effective date of the plan" language leave open the possibility that the language refers to another point in time. This case is distinct because over two and one-half years have elapsed since the Chapter 13 petition was filed. During this time it is fair to conclude that there could be fluctuations in the value of the property owned by Debtors since the time of the filing of the petition. Where the delay between the filing of the petition and the hearing for confirmation is not attributable to Debtors, it is inequitable to perform the "best-interests test" as of the actual date of confirmation.

The Federal Rules of Bankruptcy Procedure specify that "[t]he debtor may file a Chapter 13 plan with the petition. If a plan is not filed with the petition, it shall be filed within 15 days thereafter, and such time may not be further extended except for cause shown..." FRBP 3015(b). Under 11 U.S.C. §1326 (a)(1), a "...debtor shall commence making payments proposed by a plan within 30 days after plan is filed." Thus, a debtor must begin making payments under the plan within 45 days of filing the petition. Failure to begin payments within this 45 day period is grounds for dismissal under §1307(c) (4).

The §1325(a)(4) "effective date of the plan" language refers to July 18, 1996, which was the last date to commence payments under the plan. On this date, Debtors owned the Baldwin property which was purchased for $80,750 on May 31, 1996. This property was encumbered by a lien arising from a $35,261 purchase money mortgage. The Court determined, on December 10, 1996, that Debtors were entitled to a homestead exemption in the amount of $54,000. Therefore, in a hypothetical Chapter 7 liquidation under §1325(a)(4), the liquidation of Debtors' real estate on the "effective date of the plan" would yield a 0% dividend to unsecured creditors because the aggregate of the purchase money mortgage and homestead exemption exceeded the value of the Baldwin property.

BEST EFFORTS TEST (§1325(B)(1))

The Bank, IRS and Trustee object to confirmation of the plan on the basis that it fails the "best efforts test". They also object to the omission of a "disposable income" provision in the plan provideing that Debtors agree to pay out to unsecured creditors any increases in their disposable income which occur during the length of the plan.

The "best efforts" test provides that,

> (b)(1) If the trustee or the holder of an allowed unsecured claim objects to the confirmation of the plan, then the court may not approve the plan unless, as of the effective date of the plan --
>
> > (B) the plan provides that all of the debtor's projected disposable income to be received in the three-year period beginning on the date that the first payment is due under the plan will be applied to make payments under the plan.

11 U.S.C. §1325(b)(1)(B). "Disposable income" is defined as

> ...income which is received by the debtor and which is not reasonably necessary to be expended --
>
> > (A) for the maintenance or support of the debtor or a dependent of the debtor; and
> >
> > (B) if the debtor is engaged in business, for the payment of expenditures necessary for the continuation, preservation, and operation of such business.

11 U.S.C. §1325(b)(2)(A), (B). "The creditor has, at minimum, 'the initial burden of producing satisfactory evidence to support the contention that the debtor is not applying all his disposable income' to the plan payments." Zellner, 827 F.2d at 1226 (quoting In re Fries, 68 B.R. 676, 685 (Bankr. E.D. Pa. 1986)).

The "best efforts" test is similar to the "best interests" test under §1325(a)(4), keyed to the "effective date of the plan". As previously concluded, the "effective date of Debtors" plan is July 18, 1996. The Court is satisfied that as of this date Debtors committed all their projected disposable income to the plan. The objectors have failed to specify any extra income which should be distributed to creditors under the plan.

FEASIBILITY (1325(A)(6))

Under §1325(a)(6), debtors have the burden of proving that their plan is feasible, i.e. that they "will be able to make all payments under the plan and to comply with the plan." Debtors must have a sufficiently stable income to regularly make payments under the plan. 5 William L. Norton, Jr., Norton Bankruptcy Law and Practice 2d §115:4 (1994). In addition, if debtors are unable to meet living expenses, the plan fails the feasibility test of §1325(a)(6) and cannot be confirmed. In re Wilson, 117 B.R. 714, 714 (Bankr. M.D. Fla. 1990).

Several factors affect the feasibility if a plan, including: the future earning capacity of the debtor, the future disposable income of the debtor, In re Brunson, 87 B.R. 304, 312 (Bankr. D.N.J. 1988); the debtor's perseverance and motivation to execute the plan successfully, In re Ryals, 3 B.R. 522, 524-25 (Bankr. E.D. Tenn. 1980); the type of employment the debtor is engaged in or may be engaged in, In re Goodavage, 41 B.R. 742, 746 (Bankr. E.D. Va. 1984); whether the plan includes a cushion for unexpected expenses, Id.; and whether the plan considers the possibility of inflation, In re Perskin, 9 B.R. 626, 633 (Bankr. N.D. Tex. 1981). 9B Am. Jur. 2d Bankruptcy §2642 (1991).

In this case, Debtors have made payments under the plan for two and one-half years, they are current under the plan, and have only missed one payment. Although Mrs. Hayes had difficulty maintaining

employment, Debtors purchased the restaurant/bar in order to ensure sufficient income flow to make payments under the plan. This is indicative of perseverance and motivation to successfully execute the plan. This plan is unusual because Debtors' payment capability is established by actual payments in excess of two years rather than hypothetical ability presented in most cases. This Court concludes that Debtors have established that they "will be able to make all payments under the plan and to comply with the plan." 11 U.S.C. §1325(a)(6).

GOOD FAITH (1325(A)(3))

Another element in determining whether a Plan should be confirmed is whether it has been proposed in good faith and not by any means forbidden by law. 11 U.S.C. §1325(a)(3). This good faith requirement focuses on debtor's motivation for seeking relief, financial and personal goals to be accomplished through the case, and debtor's attitude toward the integrity of the bankruptcy process, as manifested on the face of statements, schedules, pleadings, and the plan. In re Cordes, 147 B.R. 498, 503 (Bankr. D. Minn. 1992).

Section 1325(b) authorizes courts to confirm a plan in which all of debtor's projected disposable income for three years is applied to make payments under the plan. 11 U.S.C. § 1325(b). In Education Assistance Corp. v. Zellner, 827 F.2d 1222, 1227 (8th Cir. 1987), the Eighth Circuit concluded that this section's "ability to pay" criteria narrowed the scope of the good faith inquiry. The court described the narrower focus as depending upon "whether the debtor has stated . . . debts and expenses accurately; whether [debtor] has made any fraudulent misrepresentations to mislead the bankruptcy court; or whether [debtor] has unfairly manipulated the Bankruptcy Code." Id.; cf. In re LeMaire, 898 F.2d 1346, 1348 (8th Cir. 1989) (court considers the totality of circumstances in determining whether a Chapter 13 plan has been proposed in good faith).

SALE OF PROPERTY OF THE ESTATE (§363)

The Objectors claim that Debtors' sale of the Baldwin property, without first obtaining the Court's approval under §363, is indicative of Debtors' bad faith. Under §363(b)(1), a "trustee after notice and a hearing, may use, sell or lease, other than in the ordinary course of business, property of the estate." By virtue of §1303, a Chapter 13 debtor has the same rights as the trustee under §363. Thus a Chapter 13 debtor who sells "property of the estate" is subject to §363.

> In Chapter 13, "property of the estate" is defined, in relevant part, as
>
> ...in addition to the property specified in section 541 of this title.
>
> (1) all property of the kind specified in such section that the debtor acquires after the commencement of the case but before the case is closed, dismissed, or converted...

11. U.S.C. §1306(a)(1). Thus, "property of the estate" under §1306 includes property not considered "property of the estate" under §541. If a debtor were to acquire property one year after filing a bankruptcy petition, this would not be considered property of the estate under §541(5)(a) but would be included as property of the estate under §1306. Nevertheless, §1306 is, by its express terms, keyed to §541 and is limited in its scope of operation by property which is removed from the §541 estate due to §522 exemptions.

Under §§ 541(a)(1), (a)(2), all of a debtor's property, as of the date of the petition, becomes property of the estate. This initially includes any property which the debtor intends to claim exempt. In re Reed, 184 B.R. 733, 737 (Bankr. W.D. Tex. 1995). When the §522 exemption is allowed, the exempt property is no longer considered property of the estate. In re Gagnard, 17 B.R. 811, 813 (Bankr. W.D. La. 1982). Any proceeds from the disposition of exempt homestead property do not revert to the estate. Reed, 184 B.R. at 738.

In Reed, the debtor sold his exempt homestead property subsequent to filing a chapter 11 petition. Reed, 184 B.R. at 735. The debtor used proceeds from the sale in order to pay a variety of expenses and to purchase real property. Id. After conversion to Chapter 7, the trustee initiated adversary proceedings seeking to avoid the postpetition transfers on the basis that these transfers were made using property of the estate. Id. at 736. The court rejected the trustee's argument and held that proceeds from the sale of properly exempted property do not become property of the estate under §§ 541(a)(6);(a)(7). Id. at 738, 740. The court emphasized that debtor, "...could have used the proceeds to buy another ranch for cash. He could have invested in penny stocks in gold mine ventures. He could have bought a Winnebago. None of those activities would have operated to restore... [the] proceeds, to the bankruptcy estate." Id. at 740.

POSTPETITION FINANCING (§364)

Objectors claim that Debtors' use of borrowed funds in order to purchase the Springbrook real estate constitutes "obtaining of credit" governed by §364. 11 U.S.C. §364(b), (c). Under §364(b) "the court, after notice and a hearing, may authorize the trustee to obtain unsecured credit or to incur unsecured debt..." If a trustee is unable to obtain unsecured credit the court may approve certain types of secured credit. 11 U.S.C. §364(c). As with § 363, §364 applies to Chapter 13 debtors under §1303.

A line of cases beginning with In re American Cooler Co., 125 F.2d 496, 497 (2d Cir. 1942), establishes the possibility of a court using its equitable powers to grant post facto approval for post-petition financing. See In re National Reserve Corp., 199 B.R. 241, 244 (Bankr. D. Mass. 1996) (adopting American Cooler test in deciding whether to grant approval of §364 postpetition loan); In re Braniff Int'l Airlines Inc., 164 B.R. 820, 828 (Bankr. E.D.N.Y. 1994)(holding that the "American Cooler factors continue, at minimum, to dictate the propriety of retroactive approval for unauthorized postpetition financing"), aff'd 101 F.3d 686 (2d Cir. 1996). The court in National Reserve Corp. identified the American Cooler factors necessary for post facto approval of a postpetition loan as,

> First, the court must be confident it would have authorized the postpetition financing if a timely application had been made. Second, the court must be reasonably persuaded that no creditor has been harmed by the continuation of the business made possible by the loan. Third, the lender must have honestly believed it had authority to enter into the loan transaction.

National Reserve Corp., 199 B.R. at 245.

The Bank alleges that Debtors' plan should not be confirmed because it was proposed in bad faith as evidenced by Debtors' failure to obtain this Court's permission prior to engaging in several transactions. First, Debtors sold the Baldwin property, which was partly non-exempt. Second, in anticipation of the proceeds from the sale of the Baldwin property, Debtors borrowed money from their parents in order to close on the Springbrook property. Third, Debtors executed a one-year note to

the owner of the Springbrook property. Finally, Debtors settled a personal injury claim. The bank alleges generally that §§363 and 364 govern these transactions.

Assuming that the Bank is correct and that each of these transactions is governed by §§ 363 or 364, this Court nevertheless declines to hold that the plan has been proposed in bad faith. Debtors purchased the Springbrook property prior to closing the sale on the Baldwin property. In order to finance this purchase, Debtors executed a one-year note to the owner of the Springbrook property. Debtors also borrowed $12,000 from Mrs. Hayes' parents in order to facilitate the purchase of the bar and to pay for start-up costs and supplies. Debtors borrowed these moneys in contemplation of the proceeds they would receive, upon closing, from the sale of the Baldwin property. Upon receiving the proceeds from the Baldwin property, Debtors repaid the interest-free loan to their parents and paid off the note on the Springbrook mortgage.

Creditors were not harmed by the loan or the note because they were both short-term and no "property of the estate" was used to pay back the creditors. Furthermore, there is no indication in the record that Debtors, their parents, or the owner of the Springbrook property believed that the transaction was improper. Though not in compliance with the Code, the Court is satisfied that it would have approved this interest-free, short-term loan from Debtors' parents if timely application had been made. Likewise, the Court is satisfied that it would have approved the note on the Springbrook property since it was also paid off using exempt proceeds from the sale of the Baldwin property.

WHEREFORE, for the reasons set forth herein, the Court concludes that Debtors' Amended Plan is confirmable.

FURTHER, the Chapter 13 Trustee is to prepare an appropriate order of confirmation which shall include a disposable income provision.

SO ORDERED this 30th day of December, 1998.

PAUL J. KILBURG

U.S. BANKRUPTCY COURT