NOT FOR PUBLICATION

UNITED STATES BANKRUPTCY APPELLATE PANEL

OF THE NINTH CIRCUIT

In re:	BAP No. ID-05-1467-HKMa
PAUL PENLAND; LESLIE PENLAND, Debtors.	Bk. No. 05-00172
PAUL PENLAND; LESLIE PENLAND, Appellants, v. BERNIE R. RAKOZY, Chapter 13 Trustee, Appellee.	**MEMORANDUM**[1]

Argued and Submitted on June 22, 2006
at Portland, Oregon

Filed – August 17, 2006

Appeal from the United States Bankruptcy Court
for the District of Idaho

Honorable Jim D. Pappas, Bankruptcy Judge, Presiding.

Before: Hollowell,[2] Klein and Marlar, Bankruptcy Judges.

[1] This disposition is not appropriate for publication and may not be cited except when relevant under the doctrines of law of the case, issue preclusion or claim preclusion. See 9th Cir. BAP Rule 8013-1.

[2] Hon. Eileen W. Hollowell, United States Bankruptcy Judge for the District of Arizona, sitting by designation.

INTRODUCTION

Appellants Paul and Leslie Penland (the "Penlands" or "Debtors") appeal a final order of the bankruptcy court denying confirmation of their second amended chapter 13 plan ("Second Amended Plan") for failure to prove that it was proposed in good faith as required under § 1325(a)(3), and dismissing their case under § 1307(c)(1) and (5).[3] We REVERSE the order dismissing the case, AFFIRM the order denying confirmation of the Second Amended Plan and REMAND the case for further proceedings consistent with this decision.

FACTS AND PROCEDURAL HISTORY

The Penlands are professionals who filed for bankruptcy protection because they had accumulated substantial unsecured debt, primarily to credit card companies. Mr. Penland, an experienced lawyer who specializes in representing insurance companies in workers compensation cases, is the managing partner of his three-lawyer firm. Mrs. Penland works for a bank. Their combined yearly income in the two years preceding their bankruptcy exceeded $130,000.

Mrs. Penland's elderly parents moved into the Penlands' house in 2003 after her mother experienced difficulties with Parkinson's disease, but they do not pay rent or otherwise contribute to household expenses. In 2004, the Penlands borrowed

[3] Absent contrary indication, all chapter, section, and rule references are to the Bankruptcy Code, 11 U.S.C. §§ 101-1330 and to the Federal Rules of Bankruptcy Procedure, Rules 1001-9036, in effect prior to the effective date of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), Pub. L. 109-8, 119 Stat. 23 (Apr. 20, 2005).

$52,000 from her parents and secured those loans with a second deed of trust on their 3,600 square foot, five-bedroom residence. Most of the loan proceeds were used to make repairs to the house, but some of the money was used to make payments to the first mortgage holder, to outstanding credit card debt, and to make contributions to the Penlands' exempt retirement accounts.

The Penlands have their own health problems. Mr. Penland has suffered bouts of optical neuritis which have left him unable to see for up to a month. He also suffers from depression and anxiety. Mrs. Penland has high blood pressure.

The Penlands' primary assets consist of their home which they value at $300,000, two cars (one is 8 years old and one is over 20 years old), and approximately $500,000 in various retirement accounts. There is approximately $50,000 of equity in their house. That equity and the retirement accounts are the Penlands' major exempt assets.

The Penlands originally filed for relief under chapter 7. Their schedules listed $810,565.83 in assets, and $475,469.05 in liabilities of which $221,824.05 was unsecured. The court, acting on its own motion, issued an order for the Penlands to appear and show cause why their case should not be dismissed pursuant to § 707(b). The court also ordered the Penlands to submit to a Rule 2004 examination by the U.S. Trustee. Three days before that examination, the Penlands moved to convert their case to chapter 13. The case was converted on June 7, 2005.

The Penlands' first chapter 13 plan ("Plan") was for a 36-month term with payments of $300 per month. Two non-evidentiary confirmation hearings were continued so that the Chapter 13

Trustee could conduct further investigations regarding the Penlands' assets, income, expenses and pre-bankruptcy transactions. The Chapter 13 Trustee filed three different recommendations concerning the Plan, each of which opposed confirmation.

At a September 28, 2005 hearing, the Penlands' counsel informed the court that the Chapter 13 Trustee's concerns had all been resolved and that a confirmation order would be forthcoming. The court, however, refused to accept a stipulated confirmation order and, instead, set an evidentiary hearing to determine if the Penlands had disposable income that should be contributed to the Plan under § 1325(b); whether the Plan met the best interests of creditors test under § 1325(a)(4); and whether the Plan had been filed in good faith as required by § 1325(a)(3). There was no indication from the court that dismissal of the case would result if the Plan was not confirmed after the hearing.

Two days before the evidentiary hearing, the Penlands filed a first amended plan ("First Amended Plan") and an amended Schedule J which reduced their monthly expenses by the amount of the monthly payments to Mrs. Penland's parents, who agreed to forebear on their secured loans until after the Penlands completed their plan payments. The First Amended Plan extended the term and increased the payment amounts by requiring three payments of $300 and 52 payments of $925.

At the evidentiary hearing, both the Penlands testified and were questioned by the Chapter 13 Trustee and the court. The court asked Mr. Penland why he expected to earn $20,000 less in 2005 than he had in the previous two years which, in the court's

view, was far less than an attorney of Mr. Penland's experience would be expected to earn in Boise. In response to the court's questions, Mr. Penland acknowledged that if the Penlands' income increased over the term of the First Amended Plan, that such increases would be devoted to plan payments. The court's examination also indicated concerns about the $5,400 amount of the Penlands' monthly expenses, especially the large amount devoted to house payments. When the Penlands were asked why Mrs. Penland's parents were not contributing to household expenses and whether they had the financial ability to make such contributions or live on their own, they responded that they did not know anything about Mrs. Penland's parents' finances and believed it would be wrong to charge rent to family.

In explaining his decision to support confirmation, the Chapter 13 Trustee stated that he had extensively reviewed the facts and the Penlands' records. He found that the loan transaction with Mrs. Penland's parents had been fully disclosed and all proceeds accounted for. The Chapter 13 Trustee stated that, while he was troubled by the fact that Mrs. Penland's parents did not pay rent or contribute to household expenses, he did not feel that was a sufficient reason to oppose confirmation for lack of good faith.

At the conclusion of the hearing, the court indicated that, while the Penlands' initial filing of chapter 7 did not necessarily demonstrate a lack of good faith, it was not clear that they were making their best efforts at dealing with their debt. The court then informed the Penlands that they would be allowed only one more opportunity to amend their plan. If such

an amended plan (or the First Amended Plan) was not confirmed, their case would be dismissed without any further hearings.

On October 12, 2005, the Penlands filed a second amended plan ("Second Amended Plan") and an amended Schedule J, which decreased their monthly expenses by $100 by reducing the amounts spent on home maintenance, food and recreation. The Second Amended Plan proposed three payments of $300 and 57 months of payments of $1,025 with a total payout of almost $60,000, which was approximately a 50% return to unsecured creditors.

On November 8, 2005, the bankruptcy court issued a memorandum decision ("Memorandum Decision") denying confirmation of the Second Amended Plan, finding that it was not proposed in good faith, and dismissing the Penlands' case. The court reviewed five factors in explaining how it had arrived at the determination that the Second Amended Plan did not meet the good faith requirements of § 1325(a)(3). First, the court found that the Penlands attempted to manipulate the Bankruptcy Code by: (a) seeking to discharge all of their unsecured debt by filing for chapter 7, in probable violation of § 707(b) and, (b) failing to propose a chapter 13 plan that made any meaningful distributions to unsecured creditors until the Chapter 13 Trustee and the court itself intervened ("Factor 1"). Second, the court found that the Penlands' living arrangements were inequitable to their creditors because they were supporting Mrs. Penland's parents even though her parents could not be considered the Penlands' dependents for purposes of the chapter 13 disposable income analysis, and thus, the creditors were effectively subsidizing the parents' lifestyle. ("Factor 2"). Third, the

court found that the Penlands' monthly expenses were excessive, especially the amounts spent for housing, food and life insurance ("Factor 3"). Fourth, the court found that the Penlands had understated their earning capacity and attempted to "lock in" the amount of their plan payments when Mr. Penland's earnings were below market level ("Factor 4").[4] Fifth, the court found that the failure of the Penlands to submit any evidence that they had considered accessing their exempt retirement accounts to pay their debt demonstrated a lack of good faith ("Factor 5"). The court concluded that because the Penlands were unwilling to engage in any kind of "meaningful belt tightening," the Second Amended Plan did not satisfy the good faith requirements of § 1325(a)(3).

The court then dismissed the case pursuant to § 1307(c)(1) and (5) because of the Penlands' "lack of diligence in performing their statutory responsibilities." An order was entered denying confirmation and dismissing the case on November 8, 2005.

The Penlands timely filed a notice of appeal. On March 15, 2006, the Chapter 13 Trustee filed a notice stating he would not file an opposition to the appeal because he did not object to confirmation of the Penlands' First or Second Amended Plans.

[4] The court also expressed concern that a zero value was placed on Mr. Penland's interest in his law firm in the Penlands' schedules. Apparently, no business valuation was provided to the court to support the accuracy of that contention. The court's skepticism as to that proposed value was therefore justified.

ISSUES

1. Did the bankruptcy court abuse its discretion when it dismissed the case, sua sponte, without affording the Penlands an opportunity to further amend their Second Amended Plan or otherwise address the court's concerns after it denied confirmation for the first time?

2. Did the bankruptcy court abuse its discretion by applying an incorrect legal standard in its determination that the Penlands' Second Amended Plan had not been filed in good faith, or did it clearly err in determining that it was not filed in good faith?

STANDARD OF REVIEW

The decision to dismiss a bankruptcy case is reviewed for abuse of discretion. Ho v. Dowell (In re Ho), 274 B.R. 867, 871 (9th Cir. BAP 2002). Generally, the determination regarding whether a chapter 13 plan has been proposed in good faith is a factual finding reviewed for clear error. Smyrnos v. Padilla (In re Padilla), 213 B.R. 349, 352 (9th Cir. BAP 1997). Discretion is abused when the court applies an incorrect legal standard, rests a decision on a clearly erroneous view of the facts, or reaches a result with respect to which the reviewing court has the definite and firm conviction that there has been a clear error in judgment. Reynoso v. Neary (In re Reynoso), 315 B.R. 544, 550 (9th Cir. BAP 2004).

STATEMENT OF JURISDICTION

The bankruptcy court had jurisdiction under 28 U.S.C. §§ 1334, and 157(b)(1) and (b)(2)(L). We have jurisdiction under 28 U.S.C. § 158(c)(1).

DISCUSSION

A. Dismissal of case under § 1307(c)(1) and (5)

First, we examine the bankruptcy court's dismissal under § 1307(c)(1). To support cause for dismissal, § 1307(c)(1) requires the bankruptcy court to find that a debtor was a proponent of unreasonable delay that resulted in prejudice to creditors. Leavitt v. Soto (In re Leavitt), 171 F.3d 1219, 1224 (9th Cir. 1999). Here, the court did not make any findings of unreasonable delay on the part of the Penlands. Although there had been a series of negotiations between the Chapter 13 Trustee and the Penlands to develop a confirmable plan, there was no evidence presented that the process included a lack of cooperation by the Penlands with the Chapter 13 Trustee. The court did not make any findings that the Penlands did not regularly make plan payments, or any other evidence of prejudice to creditors. Because it is unclear from the record what formed the basis for the court's determination that there had been a lack of diligence by the Penlands in prosecuting the case, that finding cannot be sustained on appeal.

Second, we examine the bankruptcy court's dismissal under § 1307(c)(5). This Panel previously has closely examined the statutory construction of § 1307(c)(5) and stressed the importance of the conjunction "and" - that the requirements of § 1307(c)(5) are cumulative and mandatory, and both elements -

denial of confirmation of a plan and denial of a request made for additional time for filing another plan, must exist to constitute "cause" to dismiss a chapter 13 case. See Nelson v. Meyer (In re Nelson), 343 B.R. 671 (9th Cir. BAP 2006). This Panel concluded in Nelson that "[t]he Bankruptcy Code contemplates in § 1307(c)(5) that chapter 13 debtors be afforded more than one opportunity to confirm a chapter 13 plan before the case is dismissed...following denial of plan confirmation." Id. at 678.

Here, at the end of the only evidentiary confirmation hearing, the court gave the Penlands an opportunity to submit a second amended plan, and they did so three days later. But the Penlands were not given any opportunity to address the court's concerns after it ruled on the Second Amended Plan and denied confirmation for the first time. The Debtors had only one confirmation hearing and that was not on the Second Amended Plan. This case is similar to Nelson where we found that the bankruptcy court "preempted the debtor's chance to try again and dismissed the case after the first denial of plan confirmation." Id. at 676.

Because the Penlands were not afforded an opportunity to respond to the court's only ruling on confirmation, they were not afforded the opportunity to make further amendments or otherwise address the court's concerns. Accordingly, the Penlands' case should not have been dismissed under § 1307(c)(5).

B. Denial of Confirmation for Lack of Good Faith Under § 1325(a)(3)

Because we have reversed the dismissal of the Penlands' chapter 13 case and remanded it for further proceedings to give

the Penlands an opportunity to address the concerns raised by the court in its Memorandum Decision, we address the requirements of § 1325(a)(3).[5]

C. Legal Standard for Establishing Good Faith

The test for assessing lack of good faith, in the chapter 13 context, is the "totality of the circumstances." Goeb v. Heid (In re Goeb), 675 F.2d 1386, 1391 (9th Cir. 1982). In Leavitt, the Ninth Circuit Court of Appeals set out a four-factor analysis for bankruptcy courts to consider in deciding whether chapter 13 debtors have exhibited a lack of good faith. 171 F.3d at 1224. Those factors are:

1. whether the debtor misrepresented facts in his petition or plan, unfairly manipulated the Bankruptcy Code, or otherwise filed his chapter 13 petition or plan in an inequitable manner; (citing Goeb, 675 F.2d at 1391);

2. the debtor's history of filings and dismissals;

3. whether the debtor only intended to defeat state court litigation; and

4. whether egregious behavior is present.

In considering the question of good faith, the court must consider all the factors that relate to the equities in a particular case. Street v. Lawson (In re Street), 55 B.R. 763, 764 (9th Cir. BAP 1985); Goeb, 675 F.2d at 1390 (a "court must

[5] On remand, the Penlands may seek permission to file a third amended plan or request a further hearing on the Second Amended Plan. In either event, they bear the burden of demonstrating that their Plan has been filed in good faith.

make its good faith determination in the light of all militating factors").

In its Memorandum Decision, the bankruptcy court cited Goeb and In re Warren, 89 B.R. 87 (9th Cir. BAP 1988) as the legal standards for the court to use in evaluating good faith. Warren includes an eleven item "laundry list" of factors for courts to consider on a case-by-case basis, as part of the good faith analysis.[6] 89 B.R. at 93. The Appellants rely almost exclusively on the Warren factors in support of their appeal.

The narrow holding of Warren was that the § 1325(a)(3) "good faith" requirement is independent of the best efforts requirement of § 1325(b) and remains good law. But the Warren guidelines for evaluating good faith have never been expressly adopted by the Ninth Circuit, and must be considered in light of subsequent

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[6] The list of factors used by the Warren court are:

1) The amount of the proposed payments and the amounts of the debtor's surplus;
2) The debtor's employment history, ability to earn, and likelihood of future increases in income;
3) The probable or expected duration of the plan;
4) The accuracy of the plan's statements of the debts, expenses and percentage of repayment of unsecured debt, and whether any inaccuracies are an attempt to mislead the court;
5) The extent of preferential treatment between classes of creditors;
6) The extent to which secured claims are modified;
7) The type of debt sought to be discharged, and whether any such debt is nondischargeable in Chapter 7;
8) The existence of special circumstances such as inordinate medical expenses;
9) The frequency with which the debtor has sought relief under the Bankruptcy Reform Act;
10) The motivation and sincerity of the debtor in seeking Chapter 13 relief; and
11) The burden which the plan's administration would place upon the trustee.

amendments to the Bankruptcy Code and later decided case law. Nelson, 343 B.R. at 677 n.10.

The Warren factors were borrowed from an Eighth Circuit decision, United States v. Estus (In re Estus), 695 F.2d 311, 317 (8th Cir. 1982). However, in Educ. Assistance Corp. v. Zellner, 827 F.2d 1222, 1227 (8th Cir. 1987), the Eighth Circuit Court of Appeals recognized that the 1984 amendments to § 1325(b) subsumed most of the Estus factors, to permit confirmation of chapter 13 plans in which the debtor uses all disposable income for three years to make payments to his creditors regardless of the amount of the payments or the return to creditors. The Eighth Circuit court noted:

> [O]ur inquiry into whether the plan constitutes an abuse of the provisions, purpose or spirit of Chapter 13, has a more narrow focus. The bankruptcy court must look at factors such as 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.

Zellner, 827 F.2d at 1227. (citations omitted).

Because so many of the Warren factors have been subsumed into § 1325(b), the factors identified in Leavitt should control a § 1325(a)(3) good faith analysis.

D. Applying Leavitt to the Penlands' case

The only Leavitt factors applicable to the Penlands' case are whether they engaged in bad faith manipulation of the Bankruptcy Code or proposed their chapter 13 Plan in an inequitable manner. As noted earlier, in finding that the Second Amended Plan was not filed in good faith, the Memorandum Decision identified five factors which the court found demonstrated either

a bad faith manipulation of the Bankruptcy Code or inequitable treatment of creditors.

In Factors 2 and 3, the court considered a number of matters related to the Penlands' income and expenses which generally would be reviewed as part of a disposable income analysis under § 1325(b). On appeal, the Penlands, citing to Andrews v. Loheit (In re Andrews), 155 B.R. 769 (9th Cir. BAP 1993), argue that the court could not, sua sponte, address disposable income issues.

The holding of the BAP in Andrews was that a chapter 13 trustee was not limited to § 1325(b)(1) in objecting to a plan, but also had standing to object under § 1325(a)(5). Id. At 772. The BAP opinion does state that the ability-to-pay test may not be raised by a court sua sponte. Id. at 771. However, that statement was not essential to the holding. The BAP's decision in Andrews was affirmed by the Ninth Circuit Court of Appeals without any reference to a court's rights to review a debtor's ability to pay in the absence of objections from the Chapter 13 Trustee or unsecured creditors. Andrews v. Loheit (In re Andrews), 49 F.3d 1404 (9th Cir. 1995). Arguably, therefore, the BAP's statement regarding a bankruptcy court's ability to, sua sponte, consider a debtor's ability to pay, is dicta.

Since Andrews was decided, we have found that a bankruptcy court's § 1325(a)(3) good faith determination "necessarily requires an assessment of a debtor's overall financial condition including, without limitation, the debtor's current disposable income". Sunahara v. Burchard (In re Sunahara), 326 B.R. 768, 781-82 (9th Cir. BAP 2005). The court, therefore, could properly engage in its own independent analysis of the Penlands' income

and expenses, relying on its specific experience in deciding if the Second Amended Plan had been proposed in good faith.

Because the court's multi-factored determination that the Second Amended Plan did not meet the good faith requirement of § 1325(a)(3) does not leave us with a definite and firm conviction that a clear error was committed, we sustain the denial of confirmation of the Second Amended Plan. However, while we affirm the denial of confirmation, some of the court's findings regarding the Penlands' lack of good faith merit discussion because, by themselves, they would be insufficient to support a finding of a lack of good faith.

The court found that the Penlands had attempted to manipulate the Bankruptcy Code by initially filing for chapter 7, in apparent violation of § 707(b).[7] However, initially filing for chapter 7 relief and then converting to a chapter 13 is not a bad faith manipulation of the Bankruptcy Code. Arguably, the Penlands' attempts to secure a discharge under chapter 7 may have been grounds for a finding of substantial abuse and dismissal, but dismissal is not mandatory. See Zolg v. Kelly (In re Kelly), 841 F.2d 908, 914 (9th Cir. 1988). Furthermore, the fact that a debtor's case could have been dismissed under § 707(b) should not result in a per se finding of a lack of good faith under § 1325(a)(3). If that were the case, debtors would be faced with

[7] In fact, the court applied, at least in part, the totality of the circumstances analysis it would have used in a § 707(b) proceeding. However, to the extent that the good faith analysis in § 707(b) proceeding requires a court to consider a "hypothetical" chapter 13 case, it is irrelevant to the good faith analysis in an actual chapter 13 case.

an impossible paradox of being refused bankruptcy relief except under chapter 13 (11 or 12) and then being refused confirmation because their case was initially commenced as a chapter 7. Such a result is inconsistent with congressional policy which prefers chapter 13 over chapter 7 as evidenced by the enactment of § 707(b), and by the amendments to the Bankruptcy Code made by the Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA")of 2005. Specifically, under BAPCPA, a debtor is permitted to request conversion to chapter 13 if there is a determination of substantial abuse. See § 707(b)(1).

The court found that the failure of the Penlands to consider borrowing from their tax exempt retirement accounts put their good faith in question. A court may properly consider the existence and use or non-use of exempt assets as part of the good faith analysis of § 1325(a)(3). Solomon v. Cosby (In re Solomon), 67 F.3d 1128, 1133 (4th Cir. 1995). However, outside of bankruptcy, creditors cannot reach exempt assets and, generally, the results should not be different in bankruptcy. As the U.S. Supreme Court noted in Patterson v. Shumate, 504 U.S. 753, 764 (1992), the mere "happenstance of bankruptcy" should not result in a windfall to creditors. Here, there was no evidence that the Penlands engaged in aggressive pre-bankruptcy asset protection planning, that they hid assets or failed to cooperate with the Chapter 13 Trustee. An exemption the legislature has provided should not be denied or impaired simply because a judge finds it to be out of proportion. In re Crater, 286 B.R. 756, 772 (Bankr. D. Ariz. 2002) (citing Norwest Bank Nebraska (In re

Tveten), 848 F.2d 871, 879 (8th Cir. 1988)). To do so is to "invade the province of the legislative branch." Id.

The record also does not support the court's determination that the Penlands had engaged in bad faith manipulation of the Code by "locking in" their plan payments at a time when Mr. Penland's income was artificially low. Mr. Penland testified that he understood that if his income increased, plan payments would increase. Furthermore, debtors cannot lock in their plan payments because § 1329(a)(1) permits a trustee or an unsecured creditor to request a plan modification to increase the amount of plan payments.

CONCLUSION

On remand, it may be that the bankruptcy court will again find that the Penlands have not satisfied the good faith requirements of § 1325(a)(3) and that their case should again be dismissed. However, the Penlands must be given an opportunity to address the concerns set forth in the Memorandum Decision. The fact that the Penlands first filed a chapter 7 petition and that Mr. Penland's income may later increase cannot be considered as negative factors in the good faith analysis. Given that the legislative branch has specifically provided for the protection of exempt assets, any determination that the failure to use exempt assets to fund a plan constitutes bad faith should be supported by a finding that the Penlands affirmatively engaged in bad faith conduct, such as aggressive and fraudulent pre-bankruptcy planning.

For these reasons we AFFIRM in part, REVERSE in part, and REMAND for further proceedings.

KLEIN, Bankruptcy Judge, CONCURRING:

With one exception, I join the decision reversing the order dismissing the case in light of Nelson v. Meyer (In re Nelson), 343 B.R. 671 (9th Cir. BAP 2006), which was decided after the entry of the order we now reverse on that account, affirming the denial of confirmation, and remanding for further proceedings.

I have reservations about part of the penultimate paragraph of part D. In my view, the implications of use or non-use of exempt assets is a fact-intensive inquiry that presents a question of degree that ultimately rests on the discretion of the trial judge in evaluating the totality of the circumstances.