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Bankruptcy—Eighth Circuit's Analysis of the Chapter 13 Good Faith Requirement

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BANKRUPTCY—EIGHTH CIRCUIT'S ANALYSIS OF THE CHAPTER 13 GOOD FAITH REQUIREMENT—*In re Estus*, 695 F.2d 311 (8th Cir. 1982).

Ronald and Doris Estus filed a Chapter 13 petition in the Bankruptcy Court for the Eastern District of Arkansas on July 9, 1980. The petition listed unsecured claims totaling $10,993.20, one-quarter of which was a student loan from the appellant, the Veterans Administration. The petition also listed three secured claims, one of which was a mortgage secured by income-producing rental property on which the payments were five months in arrears.

The Estus' plan listed a total monthly income of $745.00 and monthly expenses of $492.00. The debtors proposed a payout plan to the trustee of $250.00 per month for fifteen months with a three dollar surplus. The plan provided for payment of the secured claims, so that after fifteen months the mortgage payments would be current and the other secured claims fully paid. The holders of unsecured claims were not to receive any payments.

Appellant objected on the ground that the plan was not proposed in good faith, as required by the Bankruptcy Code,[1] because it proposed no payments toward unsecured claims. The bankruptcy

1. 11 U.S.C. § 1325(a)(Supp. V 1981). The statute reads in part:

The court shall confirm a plan if—

(1) the plan complies with the provisions of this title;

(2) any fee, charge, or amount required under chapter 123 of title 28, or by the plan, to be paid before confirmation, has been paid;

(3) the plan has been proposed in good faith and not by any means forbidden by law;

(4) 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;

(5) with respect to each allowed secured claim provided for by the plan—

(A) the holder of such claim has accepted the plan;

(B) (i) the plan provides that the holder of such claim retain the lien securing such claim; and

(ii) the value, as of the effective date of the plan, of property to be distributed under the plan on account of such claim is not less than the allowed amount of such claim; or

(C) the debtor surrenders the property securing such claim to such holder; and

(6) the debtor will be able to make all payments under the plan and to comply with the plan.

court denied the objection, reasoning that the statute required "[t]hat the plan provide for distribution of properties at least equal to what the creditor would receive had there been a Chapter 7 liquidation,"[2] and that in this situation creditors with unsecured claims would have received nothing had a Chapter 7 liquidation occurred.[3] The court found that specific payment of unsecured claims is not mandatory to meet the good faith requirement.[4] The district court affirmed the decision.[5]

The Eighth Circuit Court of Appeals reversed and remanded, holding that, although the Chapter 13 good faith requirement did not impose a rigid and unyielding requirement of substantial payment of unsecured claims, the lower courts had failed to adequately inquire into several aspects of the plan which might reveal a lack of good faith, such as the short duration of the plan, the nature of the debt sought to be discharged and the failure to consider future increases in the debtors' income. *In re Estus*, 695 F.2d 311 (8th Cir. 1982).

The forerunners of the American bankruptcy system were the English bankruptcy and insolvency acts.[6] The English bankruptcy acts had the primary purpose of enabling multiple creditors to obtain an equitable distribution of the assets of a debtor.[7] These acts established jurisdictional requirements[8] and limited the use of bankruptcy proceedings against debtors to creditors who were merchants and traders.[9]

The insolvency acts were designed to enable a debtor to avoid debtors' prison.[10] Honest debtors whose entire assets had already been consumed in an earlier bankruptcy proceeding were able to obtain their release[11] and other debtors could avoid prison completely.[12] If bankruptcy was not taken, the debtor had to assign his assets to a receiver who would distribute the assets among the credi-

2. *In re* Estus, No. 80-694, slip op. at 2 (Bankr. E.D. Ark. April 20, 1981), quoting 11 U.S.C. § 1325(a)(4).

3. *Id.*

4. *Id.*.

5. *In re* Estus, No. 81-263 (Bankr. E.D. Ark. Nov. 17, 1981).

6. For a discussion of the evolution of bankruptcy see *In re* Morris, 12 B.R. 321 (Bankr. N.D. Ill. 1981).

7. *Id.* at 330-31.

8. An Act Against Such Persons As Do Make Bankrupts, 1542-43, 34 & 35 Hen. 8, ch. 4.

9. An Act Touching Orders for Bankrupts, 1570, 13 Eliz., ch. 7.

10. 12 B.R. at 331.

11. *Id.* at 333.

12. *Id.* at 331.

tors.[13] The discharge granted in insolvency was only for the liability of imprisonment, not for the debt as in bankruptcy, and an unsatisfied debt was subject to satisfaction by other means.[14]

The bankruptcy laws and insolvency laws moved in parallel paths in the American Colonies and in England until the adoption of the United States Constitution.[15] The Constitution provides that: "The Congress shall have Power . . . [t]o establish . . . uniform Laws on the subject of Bankruptcies throughout the United States."[16]

Congress has enacted five major bankruptcy laws pursuant to its constitutional authority. The first was enacted in 1800 and provided only for involuntary bankruptcy proceedings against merchants.[17] This law was repealed after only three years. Its successor[18] was enacted in 1841 and extended the scope of the first law to include voluntary or involuntary proceedings against any individual. The 1841 legislation permitted a discharge of an individual's debts if the requisite percentage of his creditors consented.[19] The third major bankruptcy law, The Bankruptcy Act of 1867,[20] extended bankruptcy relief to corporations for the first time.

The fourth congressional enactment and the predecessor of modern bankruptcy law was The Bankruptcy Act of 1898[21] as amended by the Chandler Act in 1938.[22] The Bankruptcy Act permitted an individual debtor[23] to file for voluntary bankruptcy and allowed three or more creditors to join together to force a debtor into involuntary bankruptcy.[24]

The Chandler Act included the first wage earner plan to permit debtors to repay creditors from their future income. The plan was limited to individuals whose principal income came from wages, salary or commissions. Further discharge of debt was barred within six years of the confirmation of the Chapter XIII plan, and un-

13. *Id.* at 333.
14. *Id.*
15. *Id.*
16. U.S. CONST. art. I, § 8, cl. 4.
17. The Bankruptcy Act of 1800, 2 Stat. 19 (1800) (repealed 1803).
18. The Bankruptcy Act of 1841, 5 Stat. 440 (1841) (repealed 1843).
19. *Id.*
20. The Bankruptcy Act of 1867, 14 Stat. 517 (1867) (repealed 1878).
21. The Bankruptcy Act of 1898, ch. 541, 30 Stat. 544 (1898) (repealed 1978).
22. Chandler Act, ch. 575, 52 Stat. 930 (1938).
23. Voluntary bankruptcy under the Act was not available to corporations. § 4, ch. 541, 30 Stat. 544 (1898).
24. *Id.* at § 59(b), 30 Stat. 561. The creditors had to have aggregate claims of $500 or more.

secured creditors were required to approve the plan.[25] This resulted in most plans proposing almost full repayment. This substantial repayment requirement caused many debtors to be unable to complete their plans or not to undertake Chapter XIII bankruptcy at all.[26]

The current Bankruptcy Code[27] was enacted on November 6, 1978 as part of a comprehensive overhaul of The Bankruptcy Act of 1898. Congress liberalized Chapter 13 to encourage more debtors to repay their debts instead of taking straight Chapter 7 liquidation.[28]

The new Bankruptcy Code no longer restricts Chapter 13 to "wage earners." Any individual with an income stable enough to permit regular payments may file under Chapter 13.[29] Additionally, nearly all collection actions against the debtor are automatically stayed[30] and unsecured creditors are no longer required to approve a plan.[31]

The discharge provisions of Chapter 13 were made much broader than similar provisions in Chapter 7. Nondischargeable obligations under Chapter 7 include alimony, child support, student loans, debts procured through false representations and claims arising from the perpetration of fraud or the infliction of willful and malicious injury.[32] Completion of a Chapter 13 plan results in a

25. Chandler Act, ch. 575, 52 Stat. 930 (1938).

26. *See* Note, *"Good Faith" and Confirmation of Chapter 13 Composition Plans: Analysis and a Proposal*, 65 MINN. L. REV. 659, 662-63 (1981).

27. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978).

28. "Chapter 13 of the proposed title 11, though derived in basic concept from Chapter XIII of the present Bankruptcy Act, is new in many of its essential features. It gives the debtor more flexibility in the formulation of the plan; . . . it is available to a wider class of debtors . . . ." H.R. REP. NO. 595, 95th Cong., 1st Sess. 118, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5787, 6079; Chapter 13 "satisfies many debtors' desire to avoid the stigma attached to straight bankruptcy and to retain the pride attendant on being able to meet one's obligations." *Id.*

29. 11 U.S.C. § 109(e). "Only an individual with regular income . . . may be a debtor under chapter 13 . . . ." *Id.* An individual with regular income is defined as an "individual whose income is sufficiently stable and regular to enable such individual to make payments under a plan under chapter 13 of this title . . . ." *Id.* at § 101(24).

30. 11 U.S.C. § 362 (Supp. V 1981).

31. H.R. REP. NO. 595, 95th Cong., 1st Sess. 121-229 (1977), *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5963, 6084-85:

> The standards for confirmation of the plan differ from those under current law [the Act of 1898] . . . . [T]he bill does not require consents from unsecured creditors. Under present law, the consent requirement often prevents a debtor from making a legitimate offer of less than full payment, for fear that the offer will not obtain the requisite consents. Instead, the debtor, unable to pay his debts in full within a reasonable period, will opt for liquidation. The bill requires only that creditors receive under the plan more than they would if the debtor went into straight bankruptcy.

32. 11 U.S.C. § 523(a) (Supp. V 1981).

discharge of all obligations except alimony, child support and certain long-term obligations.[33] These generous discharge provisions make a Chapter 13 bankruptcy much more desirable than its Chapter 7 counterpart.

If a debtor's plan satisfied the provisions of section 1325 of the Bankruptcy Code, the court had to confirm the plan.[34] Since the approval of unsecured creditors was no longer required, plans proposing nominal or zero payment became common.[35] Faced with this situation, creditors began to argue that such plans did not meet the good faith requirement of section 1325(a)(3).

In re Iacovoni[36] was an early judicial interpretation of the good faith issue which held that the purposes and provisions behind Chapter 13 indicate that some payment of unsecured claims is mandatory.[37] The court also held that good faith required a meaningful payment to creditors.[38] The court stated that the budget of the debtor, his future income and payment prospects, the dollar amount of outstanding debts, the proposed percentage of repayment, and the nature of the debts sought to be discharged were all factors to consider when determining if a good faith effort to make meaningful payment had been proposed.[39]

Some bankruptcy courts[40] have applied the definition of good faith often used under former Chapter XIII: "whether or not under the circumstances of the case there has been an abuse of the provisions, purpose or spirit" of the chapter.[41] In *In re Cloutier*[42] the court applied this definition to confirm a plan which proposed zero payment of unsecured claims. The court criticized[43] the *Iacovoni* decision[44] and stated that legislative history did not indicate that

33. *Id.* at § 1328(a). *See* §§ 523(a)(5) and 1322(b)(5).

34. *See* 11 U.S.C. § 1325(a)(1978).

35. *E.g., In re* Iacovoni, 2 B.R. 256 (Bankr. C.D. Utah) (a consolidation of eight zero payment plans); *In re* Terry, 3 B.R. 63 (Bankr. W.D. Ark. 1980) (a plan which proposed zero payment because the debtor's expenses exceeded his monthly income); *In re* Sadler, 3 B.R. 536 (Bankr. E.D. Ark. 1980) (another zero payment plan).

36. 2 B.R. 256 (Bankr. C.D. Utah 1980) (the court consolidated and rejected eight plans proposing zero payments on unsecured claims because they lacked meaningful repayment).

37. *Id.* at 261-67.

38. *Id.* at 268.

39. *Id.* at 267.

40. *E.g., In re* Yee, 7 B.R. 747 (Bankr. E.D. N.Y. 1980); *In re* Cloutier, 3 B.R. 584 (Bankr. D. Colo. 1980); Beaver, 2 B.R. 337 (Bankr. S.D. Cal. 1980).

41. 9 COLLIER ON BANKRUPTCY 9.20 at 319 (14th ed. 1978).

42. 3 B.R. 584 (Bankr. D. Colo. 1980).

43. *Id.* at 587.

44. 2 B.R. 256 (Bankr. C.D. Utah 1980).

good faith required any payment, meaningful or otherwise,[45] in excess of that required by section 1325(a)(4).[46] *In re Beaver*[47] used the same definition to deny a plan because it proposed only one percent repayment.[48]

Other interpretations of good faith have required seventy percent payment of unsecured claims,[49] "substantial" or "meaningful" repayment,[50] and "best efforts" of the debtor.[51] All of these definitions have been used to deny confirmation.

The first circuit court of appeals case to consider the good faith issue was *In re Terry*.[52] There, the Eighth Circuit Court of Appeals reviewed[53] a plan which proposed no payments because the debtor's expenses exceeded his income. The court held that the Bankruptcy Code contemplates the making of payments, that plans which proposed no payments were not made in good faith, and that such plans amounted to an abuse of section 1328 discharge provisions and the spirit of Chapter 13.[54]

Subsequently, the Seventh,[55] Ninth,[56] and District of Columbia[57] Courts of Appeal reviewed the good faith issue. Each court endorsed a different test for determining good faith.[58]

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45. 3 B.R. at 586.

46. *See* 11 U.S.C. § 1325(a) (Supp. V 1981).

47. 2 B.R. 337 (Bankr. S.D. Cal. 1980) (the debtor proposed a one percent payment plan which the court rejected for failing to deal fairly with creditors).

48. *Id.* at 341.

49. *In re* Burrell, 2 B.R. 650 (Bankr. N.D. Cal. 1980), *rev'd*, 6 B.R. 360 (N.D. Cal. 1980) (substantial payment still required), *rev'd*, 25 B.R. 717 (N.D. Cal. 1982) (Good faith is not quantifiable. The plain meaning of the statute is to use § 1325(a)(4) [*see supra* note 1] as a floor. There is no basis for reading a percentage requirement into the statute).

50. *In re* Hall, 4 B.R. 341 (Bankr. E.D. Va. 1980) (debtor proposed a six percent repayment plan which the court rejected); *In re* Howard, 3 B.R. 75 (Bankr. S.D. Cal. 1980) (the debtors proposed an eight percent plan which the court rejected as a Chapter 7 liquidation in the guise of a Chapter 13 proceeding).

51. *In re* Keckler, 3 B.R. 155 (Bankr. N.D. Ohio 1980) (the court accepted a five percent plan as reasonable based on the circumstances).

52. 630 F.2d 634 (8th Cir. 1980).

53. *In re* Terry, 3 B.R. 63 (Bankr. W.D. Ark. 1980).

54. 630 F.2d at 635.

55. *In re* Rimgale, 669 F.2d 426 (7th Cir. 1982).

56. *In re* Goeb, 675 F.2d 1386 (9th Cir. 1982).

57. *In re* Barnes, 689 F.2d 193 (D.C. Cir. 1982).

58. The Seventh Circuit Court of Appeals held that Congress intended for unsecured claims to receive meaningful payment. 669 F.2d at 432. The Ninth Circuit Court of Appeals held that the proper test was whether the debtor acted equitably. 675 F.2d at 1390. The District of Columbia Court of Appeals held that § 1325(a)(3) did not prohibit plans proposing only nominal payment and that no particular level of repayment is required. 689 F.2d at 198-99.

In *In re Deans*[59] the Fourth Circuit Court of Appeals reviewed a decision of the district court which found that a debtor's plan was not proposed in good faith because the plan did not provide for substantial and meaningful repayment.[60] The Fourth Circuit rejected the lower court's reasoning and stated that the plain meaning of section 1325(a)(3) precludes importation of a per se rule of substantial repayment in every case.[61] The court cautioned against permitting Chapter 13 to serve as a haven for debtors who wish to receive discharges without making an honest effort to pay their debts.[62] The court held that the proposed percentage of repayment is but one factor which the determining court must consider. To determine if the plan complies with the spirit and purposes of Chapter 13, the court must look at the circumstances on a case by case basis.[63]

The Eighth Circuit Court of Appeals considered the good faith issue once again in *In re Estus*.[64] The court refused to adopt substantial payment as a requirement of good faith. Reasoning that such a requirement would infringe on the desired flexibility of Chapter 13, the court held that "subsection (a)(3) good faith does not impose a rigid and unyielding requirement of substantial payment [of] unsecured [claims]."[65]

The court did not attempt to specifically define good faith. However, the court did suggest adherence to the Fourth Circuit Court of Appeals'[66] analysis of whether good faith exists. Thus, the bankruptcy court should determine whether the plan constitutes an abuse of the provisions, purpose or spirit of Chapter 13.[67]

The Eighth Circuit indicated that the good faith requirement demands a separate, independent determination.[68] The bankruptcy court must utilize its fact-finding expertise and judge each case on its facts after considering all of the circumstances.[69] If after such consideration the plan is determined to constitute an abuse of the provisions, purposes or spirit of Chapter 13, confirmation must be

59. 692 F.2d 968 (4th Cir. 1982).
60. *Id.* at 968.
61. *Id.* at 970.
62. *Id.* at 972.
63. *Id.*
64. 695 F.2d 311, 316 (8th Cir. 1982).
65. *Id.* at 316.
66. *In re* Deans, 692 F.2d 968 (4th Cir. 1982).
67. 695 F.2d at 316.
68. *Id.*
69. *Id.*

denied.[70]

The Eighth Circuit Court of Appeals stated that the proposed percentage of payment of unsecured claims was of special significance when reviewing a plan.[71] If the plan proposed a low percentage of repayment, the reviewing court should examine the plan carefully since repayment is one of the purposes behind Chapter 13.[72] The court cautioned, however, that repayment is only one of the many factors which a court must consider. Other factors or exceptional circumstances might exist which would allow a finding of good faith even though only nominal repayment was proposed.[73] The court listed[74] the following factors which, in addition to the percentage of repayment of unsecured claims, would be relevant to a determination of good faith:

(1) the amount of the proposed payments and the amount 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 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.

In reviewing the Estus' plan, the Eighth Circuit mentioned several factors which indicated an apparent lack of good faith. First, the debtors proposed a plan scheduled to run for only fifteen

70. *Id.*.
71. *Id.* at 317.
72. *Id.*
73. *Id.*
74. *Id.*

months.[75] Three years is permitted under the Bankruptcy Code.[76] Second, the student loan which the debtors sought to discharge would be nondischargeable in Chapter 7.[77] Third, the plan did not take possible future increases in income into consideration.[78] Since the lower court did not make specific findings concerning the total circumstances, the case was remanded to determine if the plan constituted an abuse of the provisions, purpose or spirit of Chapter 13.[79]

With the decision in *In re Estus*, the Eighth Circuit has followed the trend[80] by refusing to require substantial payment of unsecured claims in order to gain confirmation of a Chapter 13 plan. This reasoning is in line with current congressional thinking[81] and should help to stop the wide disparity of decisions at the bankruptcy and district court levels.

Just as importantly, *In re Estus* has provided the lower courts with guidelines for determining if a plan has been proposed in good faith. While the list of factors set forth is not exhaustive, it is an improvement over past decisions. The lower courts are no longer forced to base their decisions on an abstract definition of good faith.

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75. *Id.*

76. 11 U.S.C. § 1322(c) (Supp. V 1981) provides that a "plan may not provide for payments over a period that is longer than three years, unless the court, for cause, approves a longer period, but the court may not approve a period that is longer than five years."

77. 695 F.2d at 317.

78. *Id.*

79. *Id.* On remand, the bankruptcy court concluded that the Estus' plan had been filed in good faith. United States v. Estus, No. 80-694 (Bankr. E.D. Ark. April 20, 1983); *appeal filed*. *Id.* (May 6, 1983).

80. *See supra* notes 55 to 63 and accompanying text.

81. A technical amendment to § 1325(a)(4) has been proposed which would read as follows:

> (a) The court shall confirm a plan if . . .
>
> (4) 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, and such plan represents the debtor's bona fide effort . . . .

126 CONG. REC. H11,735 (daily ed. Dec. 3, 1980).