

COPY

UNITED STATES BANKRUPTCY COURT  
MIDDLE DISTRICT OF NORTH CAROLINA

IN RE: )

Phillip Michael Messer )

Case No. 96-550617 C-7 )

**ORDER FINDING BAD FAITH CONVERSION**

This matter came on for hearing after due and proper notice before the undersigned Bankruptcy Judge on September 20, 2000 in Winston-Salem, North Carolina upon Debtor's Motion to determine disposition of funds held by Chapter 13 Trustee and the Chapter 13 Trustee's Motion for authority to disburse funds to the Chapter 7 Trustee. Appearing before the court were John Boddie on behalf of the Debtor, Kathryn L. Bringle on behalf of the Chapter 13 Trustee, Edwin H. Ferguson, Jr. on behalf of the Chapter 7 Trustee, Max R. Rodden on behalf of creditor Wilson, Biesecker, Tripp & Sink, and Gail C. Arneke on behalf of creditor Paul C. Westmoreland. Having reviewed the record and the file in this proceeding, the court makes the following:

**FINDINGS OF FACT**

1. The above captioned Debtor filed a petition for relief under Chapter 13 on May 10, 1996.
2. The Debtor's plan was confirmed by order of the Court on July 30, 1996. The confirmed plan provided that it would remain in effect until the debtor paid a base amount of \$10,150.00 or the amount needed to ensure that unsecured creditors received a minimum dividend of 25%, whichever was greater.
3. The Chapter 13 Trustee filed a Report of Filed Claims on February 12, 1997
4. During the first three years of the plan, on February 4, 1999, the Debtor's mother died, leaving real estate to the Debtor. The real estate was sold in May, 1999, and the closing attorney sent the net proceeds totaling \$39,207.97 to the Chapter 13 Trustee.
5. On June 2, 1999, due to the receipt of unanticipated, disposable income, the Trustee filed a Motion recommending that the plan be modified to pay all filed, allowed claims in full and that the balance of the monies be remitted to the Debtor. Notice was given to all creditors including Paul C. Westmoreland, a creditor who had not been listed on the Debtor's original schedules, but who had received notice of the bankruptcy in the Spring of 1998. Mr. Westmoreland elected not to file a proof of claim with the Chapter 13 office despite receiving information from the Chapter 13 office that the failure to file a proof of claim would result in no monies being paid to him by the Chapter 13 office and could result in the debt (\$6,500.00) being discharged upon the completion of the Debtor's plan. All parties were advised that unless an

objection to the Trustee's motion was filed within forty (40) days, the relief requested would be granted. No objections were filed and the modified plan became effective on July 18, 1999.

6. On June 3, 1999, Paul C. Westmoreland filed an unsecured proof of claim in the Chapter 13 proceeding in the amount of \$6,500.00. As a result of the filing of Paul C. Westmoreland's claim, the funds held by the Chapter 13 Trustee were no longer sufficient to pay the creditors in full pursuant to the Modified Plan. The Chapter 13 Trustee postponed further disbursements to the creditors until the issues concerning the claim were resolved. The Chapter 13 Trustee had already remitted the sum of \$17,577.97 to the Debtor.

7. On August 19, 1999, the Debtor filed an objection to the claim filed by Paul C. Westmoreland on the basis that it was not timely filed. The court entered an order disallowing the claim as untimely and found that the claim would be discharged upon the Debtor's successful completion of the plan. Westmoreland appealed this ruling.

8. The Chapter 13 Trustee delayed making additional disbursements to creditors while the appeal was pending.

9. During the pendency of the appeal, on March 22, 2000, the Debtor filed a motion to convert to Chapter 7 and an order of conversion was entered on March 30, 2000. At that time, the Chapter 13 Trustee still retained funds sufficient to pay all allowed claims in full and the excess proceeds had been remitted to the Debtor.

10. On March 22, 2000, the Debtor filed a claim for property exemptions which included "refund of money held by chapter 13 to extent exempt."

11. Edwin H. Ferguson, Jr. was appointed trustee in the Chapter 7 case.

12. The Debtor received his discharge by order of the court on July 12, 2000.

13. On July 14, 2000, the Debtor filed a Motion to Determine Disposition of Funds Held by Chapter 13 Trustee, requesting that the inheritance proceeds in the possession of the Chapter 13 Trustee be returned to the Debtor.

14. On July 17, 2000, the Chapter 13 Trustee filed a request for authorization to turn over funds to the Chapter 7 Trustee.

15. On October 11, 2000, the court entered an Order directing the Chapter 13 Trustee to disburse funds on hand to the Chapter 7 Trustee and continuing the matter for such other and further Orders as the court may deem just and proper.

## ISSUE

Was the Debtor's conversion from Chapter 13 to Chapter 7 in bad faith thereby providing that property of the Chapter 7 estate will include property of the estate as of the date of conversion pursuant to 11 U.S.C. § 348 (f)(2).

## DISCUSSION

When a Chapter 13 case is converted to a Chapter 7, the Chapter 7 case is deemed to have commenced as of the date of the Chapter 13 petition. 11 U.S.C. § 348 (a). Pursuant to 11 U.S.C. § 348 (f)(1)(A), as amended in 1994, "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 the conversion[.]" Thus, a converted Chapter 7 case includes "all legal or equitable interests of the debtor in property," (1) that the debtor had when the Chapter 13 petition was filed, and (2) that the debtor still possessed or controlled on the date the case was converted. 11 U.S.C. § 541; 11 U.S.C. § 348 (f)(1)(A). Ordinarily, wages earned or property acquired by a debtor after a Chapter 13 filing will not become part of the Chapter 7 estate in the converted case and may be retained by the debtor.<sup>1</sup>

However, when a case is converted from Chapter 13 to Chapter 7 in bad faith, the property of the Chapter 7 case is extended to include all property of the estate as of the date of the conversion. 11 U.S.C. § 348 (f)(2). Section 348 (f)(2) provides as follows:

If the debtor converts a case under chapter 13 of this title to a case under another chapter under this title in bad faith, the property in the converted case shall consist of the property of the estate as of the date of conversion.

11 U.S.C. § 348 (f)(2).<sup>2</sup> Thus, with a bad faith conversion, the Chapter 7 estate will include

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<sup>1</sup>Wages and property acquired by a debtor after a Chapter 13 filing that are turned over to a Chapter 13 Trustee for disbursement to creditors pursuant to a confirmed plan should not be returned to the debtor upon conversion to a Chapter 7. Rather, funds in possession of the Chapter 13 Trustee should be distributed to creditors in accordance with the terms of the confirmed plan and the Trustee's obligations under 11 U.S.C. § 1326. See, Memorandum Opinion of William L. Stocks, In re Salisbury, No. 99-10431 C-7G (Bankr. M.D.N.C. November 21, 2000); In re Verdunn, 210 B.R. 621 (Bankr. W.D. Mo. 1997) (payment made to Chapter 13 Trustee vests in creditors per confirmed plan); In re Hardin, 200 B.R. 312 (Bankr. E.D. Ky. 1996); In re Galloway, 134 B.R. 602 (Bankr. W.D. Ky. 1991).

<sup>2</sup>Subsection (f) was added by the Bankruptcy Reform Act of 1994 to clarify the Code and resolve a split in the case law as to what property is included in the estate when a debtor converts from Chapter 13 to Chapter 7. 140 Cong. Rec. H 10,770 (October 4, 1994). The amendment overruled the holding in cases such as Matter of Lybrook, 951 F.2d 136 (7<sup>th</sup> Cir. 1991)(property acquired post-petition by Chapter 13 debtor remains property of the estate upon conversion to

property in possession of the Chapter 13 trustee as well as property acquired by the debtor during the Chapter 13 case. In re Siegfried, 219 B.R. 581 (Bankr. D. Colo. 1998).

Since the Bankruptcy Code does not define what constitutes "bad faith" for purposes of section 348 (f)(2), courts apply "broad standards and general definitions of bad faith to specific facts of the case to determine if there is fraud, deception, dishonesty, lack of disclosure of financial acts or an abuse of the provisions, purpose or spirit of the Bankruptcy Code." Id. at 585. An inquiry into a debtor's bad faith must focus on the specific facts of the case using the totality of the circumstances approach. Id.

Based on a review of the facts in this case, it is evident to the court that the Debtor manipulated the bankruptcy system (1) to avoid having to return a portion of the inheritance proceeds to the Chapter 13 Trustee that would have been required to pay the claim of Mr. Westmoreland if Mr. Westmoreland was successful in his appeal, and (2) to recover the funds in the possession of the Chapter 13 Trustee and prevent distribution of those funds to creditors.

In May of 1999, the Chapter 13 Trustee received the sum of \$39,207.97 which represented proceeds from the sale of real property the Debtor inherited from his mother. There is no question that the inheritance was property of the Chapter 13 estate pursuant to sections 541 and 1306 of the Bankruptcy Code. Pursuant to section 541(a), property of the estate consists of "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. §541. Furthermore, pursuant to section 1306 (a)(1), property of the estate includes all property specified in 11 U.S.C. § 541 and in addition:

(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 to a case under chapter 7, 11, or 12 of this title, whichever occurs first[.]

11 U.S.C. § 1306(a)(1). The Chapter 13 Trustee and the Debtor reached an agreement that the plan would be modified to pay all allowed claims in full and the excess funds would be released to the Debtor. The Trustee released the sum of \$17,577.97 to the Debtor and the Debtor did not object to the modified plan. The Chapter 13 Trustee was ready, willing and able to pay all allowed claims in full when Westmoreland appealed the ruling disallowing his claim. The Trustee held the monies pending resolution of the appeal and the Debtor continued to enjoy the benefits and protections of Chapter 13 but was not required to make additional plan payments.

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Chapter 7) and adopted the reasoning of In re Bobroff, 766 F.2d 797 (3d Cir. 1985)(property of Chapter 7 estate consists of property of Chapter 13 estate as of date of petition that remains in debtor's possession or under debtor's control on date of conversion). However, the legislative history states that the amendment "gives the court discretion, in a case in which the debtor has abused the right to convert and converted in bad faith, to order that all property held at the time of conversion shall constitute property of the estate in the converted case." 140 Cong. Rec. H 10,770 (October 4, 1994). Thus, under section 348(f)(2), Congress appears to have adopted Lybrook in the event of a bad faith conversion. Baker v. Rank (Matter of Baker), 154 F.3d 534 at 536 n.2 (5<sup>th</sup> Cir. 1998).

Rather than wait to see the outcome of the appeal of the disallowance of the Westmoreland claim, the Debtor converted to Chapter 7 by order of March 30, 2000. He did not make demand on the Trustee to remit the monies at the time of conversion and did not raise the issue of whether the postpetition inheritance was property of the estate in his Chapter 7 proceeding. The Debtor appeared to acknowledge that the funds should be treated as property of this Chapter 7 estate and filed a claim for property exemptions under the \$3,500.00 wild card election of N.C. Gen.Stat. § 1C-1601 requesting "refund of money held by Chapter 13 to extent exempt."<sup>3</sup> Again, the Debtor made no claim that the monies held by the Chapter 13 Trustee should be remitted to him as they were not part of the Chapter 7 estate.

Creditors of the Debtor continued to wait for payment. No objections were filed to the Debtor's discharge or to the dischargeability of a particular debt. The Debtor received an order of discharge on July 12, 2000. It is unknown, but possible, that creditors might have objected to the Debtor's discharge under 11 U.S.C. § 727 or the dischargeability of certain debts under 11 U.S.C. § 523 but refrained from doing so based upon the understanding that their claims would be paid in full or alternatively reduced only by the Debtor's \$3,500.0 wild card exemption.

On July 14, 2000, two days after the entry of the order of discharge and more than three months after the conversion of this case from Chapter 13 to Chapter 7, the Debtor asserted for the first time that the inheritance was not property of the estate and should be returned to the Debtor.

The court finds that the Debtor acted in bad faith and that the conversion to Chapter 7 was an "unfair manipulation of the bankruptcy system to the substantial detriment or disadvantage of creditors."<sup>4</sup> In re Siegfried, 219 B.R. 585. It is deceptive, abusive and manipulative for the Debtor to wait until his discharge has been entered to change his position and now demand that funds held for the payment of his creditors be remitted to him such that the Debtor would receive \$39,000.00 and the creditors would only receive a diminimus dividend in the Chapter 13 with no dividend in the Chapter 7.

## CONCLUSION

Since the Debtor's case was converted in bad faith, the Chapter 7 estate includes all funds in the possession of the Chapter 13 Trustee and all funds or property acquired by the Debtor during the pendency of the Chapter 13 case. By Order dated October 11, 2000, the court directed the Chapter 13 Trustee to disburse funds on hand to the Chapter 7 Trustee. The court concludes that any additional property acquired by the Debtor during the Chapter 13 case is also property of the Chapter 7 estate.

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<sup>3</sup>The Chapter 7 Trustee filed a motion to extend time to object to property exemptions up to and including July 27, 2000.

<sup>4</sup>Not all conversions from Chapter 13 to Chapter 7 with an intervening inheritance will constitute a bad faith conversion. The facts of each case must be examined.

Based on the foregoing it is hereby, **ORDERED, ADJUDGED AND DECREED** that due to the Debtor's bad faith conversion from Chapter 7 to Chapter 13, the Chapter 7 estate includes all property of the Chapter 13 estate as of the date of conversion, including property acquired by the Debtor during the pendency of the Chapter 13 case.

This the 22 day of November, 2000.

CATHARINE R. CARRUTHERS  
Catharine R. Carruthers  
United States Bankruptcy Judge