UNITED STATES BANKRUPTCY COURT

IN AND FOR THE DISTRICT OF ARIZONA

KENNETH and JESSICA ELLSWORTH **Debtors.**	**Chapter 13 proceedings** **Case No. 2-07-bk-986-CGC** **UNDER ADVISEMENT DECISION RE: MOTION TO DISMISS**

I. Introduction

For one day in January 2005, Dr. Jessica Ellsworth worked 4.1 miles from her former employer Lifescape Medical Association, P.C. in violation of a non-compete clause. In response, Lifescape filed an injunction to enforce the non-compete agreement. Dr. and Mr. Ellsworth have tirelessly fought the injunction and the subsequent award of attorneys' fees to Lifescape. That fight began at the state court; traveled through the state appellate and supreme courts; and now resides here in the US Bankruptcy Court. It is time for the Ellsworths to stop the fight. They have lost.

II. Facts

A. January Under Advisement Decision

Much of the background between the parties and the basis for the dispute are discussed in the Court's January 12, 2009 Under Advisement Decision ("January Decision") and is incorporated by reference. In the January Decision, the Court denied confirmation of the Debtors' Chapter 13 plan. The Court denied the proposed plan, in part, because the Debtors did not properly complete Form 22C. Accordingly, the Court ordered the Debtors to file an amended Form 22C and an amended Chapter 13 plan by February 11, 2009. The main thrust of the January Decision was that the Court did not trust the numbers provided by the Debtors; a point made clear during an April 14, 2009 hearing when it advised Debtors' counsel that if the Debtors could not bring the Court to trust the numbers, the Court would grant a motion to dismiss the case.

In compliance with the January Decision, the Debtors filed an Amended Form 22C on

February 11, 2009 ("February Form 22C"). However, the Debtors did not timely file an amended plan as ordered by the Court. When asked why the amended plan was not filed the Debtors' counsel explained that no new plan was necessary because under February Form 22C nothing in the existing plan would change. Lifescape, still not trusting the Debtors' numbers in the February Form 22C, filed a motion to dismiss in April 2009.

B. Creditors

The Debtors have few creditors. There a three unsecured creditors listed on the Debtors' schedules:

Creditor	Description	Amount Owed
Great Lakes Educational Loan Service	Medical School Loan	$142,732
Wells Fargo	Medical School Loan	$51,974
Lifescape	[blank]	$58,000[1]

The debt to Great Lakes and Wells Fargo are student loans that are presumptively non-dischargeable in any event. The Debtors list two secured creditors on their schedules:

Creditor	Description	Amount Owed	Value
Chase	2007 Mercedes Benz ML 360	$46,798	$42,000
Citi Mortgage	Residence	$648,991	$900,000

With the exception of Lifescape, the Debtors have remained current on payments to their creditors both pre- and post-petition. In short, there is little point to this case other than to discharge the claim of Lifescape.

The Debtors purchased their residence in July 2005 for $855,000 of which they financed $650,000. On their home loan documents, the Debtors indicated that there were no pending lawsuits against them. This was not true; in July 2005, the lawsuit between Dr. Ellsworth and Lifescape was pending. Dr. Ellsworth testified that she simply did not read this provision of the loan documents. The Debtors presented no evidence that they attempted to borrow against the equity of the residence to pay their debt to Lifescape.

The Debtors purchased the Mercedes Benz in December 2006, just three months before filing

[1]The debt to Lifescape is now in excess of $133,000.

for bankruptcy. At this point, judgment had been entered against the Debtors at the appellate level. When questioned concerning the timing of the purchase, Dr. Ellsworth testified that it was to take advantage of depreciation under the Tax Code. This testimony was buttressed by the testimony of Jonathan Moser, the Debtors' accountant. Further, Dr. Ellsworth testified that at the time of purchase she and her husband were confident that they would prevail at the Arizona Supreme Court and that they were not contemplating bankruptcy. According to Dr. Ellsworth, they never even considered bankruptcy as an option until suggested by Mr. Moser after the Supreme Court ruled against them in March 2007.

C. Notable Pre-Trial Filings

After several continuances, the Court set September 2, 2009 as the date for an evidentiary hearing on the matter. The Court continued the hearing for one week based on the request of Lifescape's counsel to September 11, 2009. On the eve of both these trial dates the Debtors made several filings. On August 31, 2009, the Debtors filed their May 2008, June 2008, July 2008, August 2008, September 2008, October 2008, November 2008, December 2008, January 2009, February 2009, March 2009, April 2009, and June 2009 Operating Reports. On September 9, 2009, the Debtors filed an Amended Form 22C ("September Form 22C") and on September 10, 2009, the Debtors filed an Amended Chapter 13 Plan ("September Plan")

As part of the September Form 22C the Debtors increased their charitable giving expense from $650 to $1,199. Over the course of various documents, the Debtors have claimed the following charitable giving expense:

1. Schedule J = $650
2. March 21, 2007 Form 22C = $650
3. July 3, 2008 From 22C = $650
4. February 11, 2009 Form 22C = $650
5. September 9, 2009 Form 22C = $1,199
6. 2006 Tax Return = $15,132 (monthly = $1261)
7. 2007 Tax Return = $12,730 (monthly = $1061)
8. 2008 Tax Return = $16,055 (monthly = $1338)

Additionally, on the September Form 22C the Debtors changed: Lines 27 - Local Standards: transportation; 28 - transportation: transportation ownership/lease expense; 30 - Other necessary

expenses: taxes; 44 - Additional food and clothing expenses; 45 - charitable contributions; 47 - future payments on secured claims; 50 - Chapter 13 administrative expenses; and 57, 59 - Average Business Expenses on their September Form 22C.

The Court held the evidentiary hearing on September 11, 2009. The matter was deemed under advisement after completion of post-trial briefing on November 16, 2009.

III. Analysis

A. §1307(c) Dismissal

The Court may convert or dismiss under §1307(c) for:

> (1) unreasonable delay by the debtor that is prejudicial to creditors;
> ...
> (3) failure to file a plan timely under section 1321 of this title; [or]
> ...
> (5) denial of confirmation of a plan under section 1325 of this title and denial of a request made for additional time for filing another plan or a modification of a plan;

The Debtors actions warrant dismissal under each of these subsections.

The Debtors did not file their operating reports for most of May 2008 through June 2009 until the eve of trial. The Debtors knew that the Lifescape had several questions about their business expenses. Yet, the Debtors chose to delay the entry of over a year's worth of operating reports until just before trial. Thus, they provided Lifescape no true opportunity to review the operating reports in anticipation of trial. The delay was both unreasonable and prejudicial to the Lifescape as contemplated under §1307(c)(1).

More troubling to the Court is that the Debtors filed an amended Form 22C and plan just days before the eventual hearing date. Despite the Court's order, the Debtors failed to file an amended plan by February 11, 2009 as instructed in the January Decision. The Debtors' excuse for the September Plan and September Form 22C is twofold: 1) they filed the plan and Form 22C in September due to the ruling regarding the deduction of vehicle expenses in *In re Ransom*, 577 F.3d. 1026 (9th Cir. 2009) ("*Ransom II*")[2]; and 2) the February Form 22C still indicated negative

[2]The Ninth Circuit issued *Ransom II* on August 14, 2009.

disposable income, thus there would be no change from the plan filed in July 2008 and therefore, despite the Court's order, there was no need to file a new plan. Both excuses are unpersuasive.

First the Debtors, through counsel, knew or should have known that their position regarding the deduction of vehicle expenses on which no debt is owed was tenuous at best. At the time the Court issued its January Decision, the Bankruptcy Appellate Panel had already ruled that a debtor cannot "deduct a vehicle ownership expense for a vehicle owned free and clear of any liens and encumbrances." *In re Ransom*, 380 B.R. 799, 801 (9th Cir.BAP 2007) ("*Ransom I")*. Further, this Court has stated that though it disagreed with *Ransom I* it is bound by it and would follow it. *See In re Sawicki,* 2008 WL 410229 (Bankr.D.Ariz. February 12, 2008) (not reported). Debtors' counsel was clearly aware of *Ransom I* and *Sawicki*.[3] To now claim that the September Plan and September Form 22C were filed based on *Ransom II* is disingenuous at best.

More importantly, when the Debtors filed the September Form 22C, they changed more than just the transportation line item.[4] Two of these line items had a substantial impact on the Debtors' disposable income: Line 45 -charitable contributions and line 59 - Average Business Expenses. The September Form 22C was not filed merely to acknowledge the ruling in *Ransom II*. Filing a new Form 22C and a new plan on the eve of hearing is prejudicial to Lifescape under 1307(c)(1).

The Debtors also failed to file a plan timely. The Court denied Debtor's plan in the January Decision. The Court ordered that the Debtors file an amended plan within 30 days of the January Decision. The Debtors did not file an amended Plan until September 10, 2009 - seven months after the Court ordered them to do so. This is a "failure to file a plan timely under section 1321." *See* §1307(c)(3).

Moreover, because the Court denied confirmation of the debtor's plan in the January

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[3]During the August 13, 2008 hearing Debtors' counsel stated that he agreed with *Sawicki* in that he didn't agree with *Ransom I*, but he is stuck with it.

[4]Lines 27 and 28 are transportation expense line items. In addition to these line items the Debtors also changed lines: 30 - Other necessary expenses: taxes; 44 - Additional food and clothing expenses; 45 - charitable contributions; 47 - future payments on secured claims; 50 - Chapter 13 administrative expenses; 57, 59 - Average Business Expenses.

Decision, the Debtors' case is susceptible to dismissal under §1307(c)(5). "[T]here are two essential elements that each must be satisfied in order to constitute 'cause' to convert or dismiss a case following the denial of confirmation of a plan: (1) denial of confirmation; and (2) denial of a request for time to file a new or a modified plan. As written, the requirements of § 1307(c)(5) are cumulative and mandatory." *In re Nelson*, 343 B.R. 671, 675-76 (9th Cir.BAP 2006). "[T]he second element of § 1307(c)(5) requires, at a minimum, that the court must afford a debtor an opportunity to propose a new or modified plan following the denial of plan confirmation." *Id.* at 676. Clearly, the Court denied confirmation of the Debtor's plan. The Court also gave the Debtors an ample opportunity, 30 days, to file an amended plan; they did not take advantage of the opportunity. In the Court's view, they Debtors have run afoul of §1307(c)(5).[5]

B. Bad Faith

In addition to the provisions listed in §1307(c), a case can be dismissed for bad faith. Bad faith factors include:

> (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," [*In re Eisen*, 14 F.3d 469, 470 (9th Cir.1994)] (citing *In re Goeb*, 675 F.2d 1386, 1391 (9th Cir.1982));
> (2) "the debtor's history of filings and dismissals," [*In re Eisen* at 470] (citing *In re Nash*, 765 F.2d 1410, 1415 (9th Cir.1985));
> (3) whether "the debtor only intended to defeat state court litigation," [*In re Eisen* at 470] (citing *In re Chinichian*, 784 F.2d 1440, 1445-46 (9th Cir.1986)); and
> (4) whether egregious behavior is present, [*In re Tomlin*, 105 F.3d 933, 937 (4th Cir.1997)]; *In re Bradley*, 38 B.R. 425, 432 (Bankr.C.D.Cal.1984).

In re Leavitt, 171 F.3d 1219, 1224 (9th Cir. 1999). The "debtor bears the burden of proving that the petition was filed in good faith." *In re Leavitt*, 209 B.R. 935, 940 (9th Cir.BAP 1997).

Here, Factor two clearly does not apply to the Debtors. The Court is aware of no other bankruptcies filed by the Debtors.

On the other hand, factor three clearly applies to the Debtors. The Debtors have only five

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[5]Additionally, the failure to file a new plan was prejudicial to Lifescape. "[A] debtor who declines to revise a plan after denial of confirmation becomes vulnerable to § 1307(c)(1) 'cause;' for unreasonable delay by the debtor that is prejudicial to creditors. 11 U.S.C. § 1307(c)(1)." *Nelson* at 676 n.9.

creditors. As Dr. Ellsworth testified, the sole reason that the Debtors filed the bankruptcy was because "we didn't have the money to pay" the judgment. For the past several years the Debtors have vigorously fought the state court litigation. This is the latest attempt to defeat the state court litigation. As noted, there is clearly no other reason for this case to have been filed.

The Court also finds that the Debtors have violated factor one. All of the Debtors' plans are based on the premise that the Debtors cannot afford to repay the judgment obtained by Lifescape. When the Debtors filed their petition and original plan, they only offered to pay Lifescape approximately $43,000 of its claim. However, as argued by Lifescape, when they filed their petition, the Debtors listed the value of the home as $900,000 with an outstanding debt of $648,991 - leaving over $250,000 in equity. While the value of the home has likely deceased with the collapse of the Phoenix housing market, the fact remains that at the time of filing their petition the Debtors had more the enough equity to pay the judgment. The Debtors counter this argument by claiming that there is no evidence before the Court that there was available credit at the time the case was filed; the argument is misplaced. The Debtors bear the burden of proof to show good faith in filing the petition. How the Debtors can claim that they filed for bankruptcy protection because the could not afford to pay a $130,000 judgment while at the same time having $250,000 in equity in their residence is a question that remains unanswered - a question that it was the Debtors' duty to answer.

The Debtors' lack of good faith is shown in their September Form 22C and September Plan. Despite their claim to the contrary, the Debtors did not file the September Form 22C in order to comply with *Ransom II* because they updated more than just their vehicle expense. First, the Debtors updated their claimed business expenses reducing the amounts from $26,407 on the February Form 22C to $23,513 on the September Form 22C. The Debtors arrived at the new calculation, according to Mr. Moser's testimony, by removing Dr. Ellsworth 's salary, legal fees paid to Mr. Hirsch, health care allowance and student loan payments. Additionally the Debtors changed their reasonable charitable contributions line item from $650, in their three previous Form 22Cs, to $1199. There is no reason that these changes should have been made on the eve of trial. Instead, they should have been part of the February Form 22C. Thus, the Court concludes that the Debtors

unfairly manipulated the Bankruptcy Code by misrepresented facts in their plan.

Finally, the change in charitable giving is particularly egregious. While advising the Court and Lifescape that they intended to spend $650 per month in charitable giving the Debtors instead spent $1061 per month in 2007 and $1338 per month in 2008 on charitable giving. When this amount is changed from $1,199 back to $650 on the September Form 22C, the Debtors disposable income more than doubles from $412 per month to $961. Accordingly, their sixty month disposable income increases from $24,720 to $57,660.

IV. Conclusion

This entire saga has been completely unnecessary. The substantial fees incurred both to their own trial counsel and in the judgment to Lifescape could, of course, have been avoided by not violating the covenant, but, more importantly, by not fighting the quixotic battle they chose to undertake, for no apparent business reason. As a result of not choosing to let the matter resolve itself but rather to litigate through multiple levels of two different court systems at enormous financial and personal expense, the Debtors face serious consequences today. They have tried to erase those consequences through this Chapter 13 case. But, for the reasons set out above, that choice has also failed.

The Debtors bankruptcy warrants dismissal under §1307(c) and for bad faith under the *Leavitt* factors. Therefore, Lifescape's motion to dismiss is granted. Counsel for Lifescape is to upload a form of order.

DATED: March 24, 2010

CHARLES G. CASE II
UNITED STATES BANKRUPTCY JUDGE

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