

In the United States Bankruptcy Court

for the Northern District of Iowa

Western Division

HAROLD V. JOHNSTON and
CLAUDINE B. JOHNSTON
Debtor(s).

Bankruptcy No. X88-00898S

Chapter 13

ORDER RE: DENIAL OF CONFIRMATION

Debtors seek confirmation of their most recent substituted and amended plan. Objections to the plan were filed by the case trustee Carol Dunbar, the Small Business Administration (SBA) and Onawa State Bank (BANK).

The confirmation hearing took place on April 20, 1989 in Sioux City, Iowa.

This is a core proceeding under 28 U.S.C. § 157(b)(2)(L). The court now issues its decision which includes findings of fact and conclusions of law as required by Bankr. R. 7052.

FINDINGS OF FACT

1. Debtors filed their chapter 13 bankruptcy case on June 3, 1988.
2. Harold Johnston, as an independent contractor, operates a landfill for Monona County, Iowa. Mrs. Johnston is a school teacher. Johnstons' son David lived with them during 1988.
3. Mrs. Johnston's teaching salary for 1988 was \$18,308.00. For 1989, it is expected to be \$22,107.00.
4. During 1988, Mr. Johnston's net profit from the operation of the landfill was \$48,630.00. His net profit was based on gross receipts for 1988 of \$76,708.00 and total deductions of \$28,078.00. These deductions included:

Car and truck expenses	\$ 4,182
Depreciation	10,076
Insurance	571
Mortgage interest	612
Other interest	1,247
Legal and professional services	823
Office expense	423
Repairs	2,021
Supplies	772
Taxes	618

Utilities and telephone	1,880
Wages	790
Miscellaneous	289
Licenses	58
Fuel	3,716

5. The 1988 adjusted gross income for both debtors as taken from their tax return (form 1040) was \$67,211. Federal income taxes were \$11,851 plus self-employment tax of \$5,859 for a total federal tax liability of \$17,710.
6. Tax liability to the State of Iowa for 1988 was \$3,807.
7. Mrs. Johnston's income for 1988 and the tax liability for 1988 would be somewhat different for 1989 because of this court's prior ruling that Mrs. Johnston would not be able under a plan to continue to make \$425 per month contributions to a tax deferred annuity with Horace Mann Co. The court indicated it would permit under a plan \$50 per month contributions by Mrs. Johnston to the tax deferred annuity. Mrs. Johnston has apparently already made arrangements to change the deduction. Therefore, her gross income, because of this lowered contribution and because of any other increases in salary will be higher. Also, because of the increase in non-tax deferred income, her taxes may be higher during the life of the plan.
8. Debtors filed their third substituted and amended plan of reorganization on February 24, 1989. The trustee, Carol Dunbar, filed her objections to the plan on February 27, 1989.
9. The debtors filed a "Immaterial Modification" to the third substituted and amended plan on February 27, 1989. On March 17, 1989, SBA filed its objections to the third amended plan and on March 27, 1989, Bank filed its objections.
10. On the date of confirmation hearing, debtors filed a "Fourth Substituted and Amended Plan of Reorganization" which would resolve the trustee's objections to the plan. None of the changes in the plan resolved the previous objections of Bank and SBA. The fourth amended plan represented no significant change from the third plan as to these or other creditors. It was agreed among the parties that the court's consideration for confirmation would be directed to the fourth substituted and amended plan.
11. Treatment by the debtors of two secured claims are relevant and are set out as follows:

"8. State Savings Bank - State Savings Bank has a secured interest in a Dodge pickup and debtor proposes to make payments to State Savings Bank for \$120.00 per month which includes interest; until the balance of the principal and interest is paid in full. These payments are to be made to the Trustee."

* * *

"11. Henry Van Iperen Henry Van Iperen has a secured claim on 16.5 acres owned by the debtors. Debtors proposes to make regular scheduled payments to the creditor outside the terms of the Plan; to that extent the creditor is unimpaired by the Plan."

12. The monthly plan payments by the debtors under the provisions of the plan are set out in the plan's Exhibit "A" which is reproduced in full as follows:

PLAN PAYMENTS	
Internal Revenue Service	\$344.77

Iowa Department of Revenue	25.82
Onawa State Bank	128.97
Blencoe State Bank	397.64
SBA	202.33
State Savings	120.00
Unsecured Creditors	250.00
Attorney Fees	150.00
Total	\$1,619.53
Trustee Fee	179.95
Minimum Monthly Payment to the Trustee	\$1,799.48

13. The debtors' projected income and expenses for the 36- month period of payments to the trustee were set out on debtors' Exhibit "B":

INCOME	
Contract payment for Land Fill	\$6,200.00
Wages	1,268.00
TOTAL:	7,468.00
EXPENSES	
State and Federal Income Tax	1,313.33
Car and Truck	348.00
Fuel	310.00
Insurance	350.00
Depreciation & repairs	750.00
Real Estate Taxes	51.00
Utilities and part-time help	222.00
Misc., supplies license, office supplies	128.00
House payment	404.00
Pickup Payment	301.00
Van Iperen Payment	150.00
Utilities	280.00
Food	400.00
Clothing	100.00
Laundry & Cleaning	20.00
Newspaper & periodicals	20.00
Doctor and Medical	100.00
Transportation	100.00
Recreation & Entertainment	100.00
Insurance - auto, life, medical	183.00

TOTAL:	\$5,630.33
DISPOSABLE INCOME	\$1,837.67
Less Trustee Payments	1,799.48
Net	\$38.19

14. Debtors also provided as part of the plan the following "liquidation analysis."

LIQUIDATION ANALYSIS

ASSETS	VALUE	SECURED DEBT	EXEMPT	AVAILABLE TO UNSECURED CREDITORS
Cash on Hand	\$ 1,000		\$ 200.00	\$ 800.00
Deposit in Bank	12,970.56	\$12,970.56		
Household Goods	2,000.00		2,000.00	
Wearing Apparel & Shotgun	2,000.00		2,000.00	
1984 Dodge	4,000.00		4,000.00	
1972 Dodge	750.00	750.00		
1988 Dodge	15,000.00	15,000.00	15,000.00	
1959 Chevy Pickup	2,500.00	2,500.00		
1969 Sturey 15 ft boat	800.00			800.00
Adding Machine & Typewriter	100.00			100.00
Shop Equipment	7,541.00		7,541.00	
760-A Paddle Scraper	12,000.00	18,500.00	2,459.00	
17 D7	11,000.00	2,541.00		
8 Dozer	1,300.00	1,300.00		
8 Dozer	1,500.00	1,500.00		
Young Isaascon Scraper	3,500.00	3,500.00		
Bucyrus Erie	500.00	500.00		
Crane	0.00			
Tract 1 (real estate)	6,500.00	6,100.00		400.00
Tract 2	10,000.00	10,000.00		
Tract 3	45,000.00		45,000.00	
Tract 4	4,000.00	3,400.00		600.00
Tract 5	3,000.00			3,000.00
IPER	23,000.00		23,000.00	
Pension	25,000.00			25,000.00
Bar Equipment	500.00			500.00
		\$78,561.56	\$101,200.00	\$31,200.00
Total Amount Available for Unsecured Creditors				31,200.00

Minus Priority Claim of Internal Revenue	- 10,734.73
Minus Priority Claim of Iowa State Dept. of Revenue	- 800.00
Minus Administrative Claim of Debtor's Attorney fees (app)	- 2,500.00
Minus Tax Consequence of Sale (Federal) Chapter 7 (15% of the First \$14,875.00; 28% over + \$2,500.00 early withdrawal)	- 8,966.00
Minus Tax Consequence of Sale (Iowa) Chapter 7 (\$1,084 of the first \$20,000.00; 7.55% over \$20,000.00)	- 1,839.00
Minus Trustee Fees Chapter 7 and expenses	- 1,367.00
Total Chapter 7 expenses	26,206.73
Total to Unsecured in liquidation	4,993.27

15. By previous order of January 24, 1989, this court ruled that Mrs. Johnston's tax deferred annuity (TDA) plan with Horace Mann Co. was not exempt. This pension plan is shown as having a value of \$25,000.00 on the debtors' liquidation analysis. Because the program was tax deferred, the debtors have introduced their estimate of 1989 taxes as if the trustee would be liquidating the exempt annuity and therefore it would be subject to early withdrawal penalties and 1989 income taxes. This is reflected in the liquidation analysis provided by the debtors. The uncontradicted estimate of the debtors is that the state and federal taxes with regard to the liquidation of this tax deferred annuity by the trustee would total \$10,805.00.
16. The debtors' incomes are regular with expenses varying by season. The monthly gross income for Mr. Johnston from the landfill operation is \$6,208.00. Mrs. Johnston's net income as a school teacher provides her with \$1,268.00 per month. Debtors' payments to Henry Van Iperen under the plan will be completed as of the March 1, 1990 payment. Further, debtors will complete the \$120.00 per month payments to State Savings Bank on the pickup in approximately two years. The property being purchased from Henry Van Iperen is bare ground which was originally purchased by the debtors for the construction of a home. No home has ever been built, but the debtors wish to retain the property.
17. Mr. Johnston explained the monthly expense for depreciation and repairs in the amount of \$750.00 indicating that depreciation allowance would be needed for replacement of business equipment if necessary. He testified that his bulldozer was a 1958 model and his scraper was a 1962 model. He further testified that generally his equipment has lasted three to five years before it was necessary to junk it out. He had to purchase a scraper tire during the course of the chapter 13 and it cost him \$1,000.00.
18. During the chapter 13, Mr. Johnston rejected an executory contract with the landfill and entered into a new contract with the landfill at a gross increase of \$500.00 per month.
19. In testifying as to his expenses on exhibit "B" to his plan, Mr. Johnston had difficulty in distinguishing between car and truck expense in the amount of \$348.00 per month versus fuel expense in the amount of \$310.00. He also listed additional transportation expense in exhibit "B" of \$100.00 per month.
20. Debtor did not know his depreciation method but based on the testimony at trial, the court concludes it must be accelerated depreciation. He further testified that most of the equipment had been fully depreciated with the exception of a CAT and a 768 scraper. The original cost of those items was \$21,500.00.

DISCUSSION

The case trustee's objections to the plan were resolved by the substitution of the fourth amended plan; therefore, the trustee at the time of the confirmation hearing, no longer objected to confirmation.

SBA and Onawa State Bank continued to press their objections. Their objections were not based upon their treatment by the debtors of their secured claims but rather related to other necessary elements of confirmation.

Certain objections were partially resolved by the agreement by the debtors in open court that they would continue to pay to the trustee, for the benefit of the unsecured creditors, the \$120.00 per month necessary to pay off the secured claim of State Savings Bank after that loan was paid. Debtors agreed also that under the plan they would pay \$150.00 per month to the trustee for the benefit of unsecured creditors after the Van Iperen loan was paid in full for the balance of the 36-month plan period.

SBA objects to confirmation on the following grounds which are echoed by Onawa State Bank:

1. Debtors' annual living expenses of \$43,124.04 are excessive particularly food in the amount of \$400 per month and clothing in the amount of \$100 per month.
2. SBA objects to the debtors' pre-bankruptcy purchase of a new pickup truck which SBA says would be paid out of disposable income if the plan is confirmed reducing disposable income distributions for unsecured creditors.
3. SBA objects also to the retention of the foregoing pickup truck and the retention of the Van Iperen land being purchased on contract. SBA argues it is in bad faith for the debtors to propose a plan which retains assets which are not essential either for living or business but which must be paid for out of future disposable income to the detriment of the unsecured creditors.
4. SBA also objects to the 13% dividend to unsecured creditors which SBA says could be increased by liquidation of the Van Iperen land, the new pickup truck and by the reduction of living expenses.
5. SBA argues that unsecured creditors are not receiving what they would receive in a chapter 7 case because of the deduction of various priority claims and administrative expenses from the liquidation value of debtors' non-exempt property. SBA essentially argues that \$31,200.00 should be distributed to unsecured creditors over the life of the plan rather than the net amount of \$4,993.27.
6. Finally, SBA argues that Mr. Johnston's motive in filing a chapter 13 was to rid himself of an assignment to the SBA of contract benefits under the rejected contract with Monona County landfill. This, SBA argues, is an element of bad faith.

In order to be confirmed, the debtors' plan must comply with 11 U.S.C. § 1325 and its subsections. Creditors' objections to the plan go to 11 U.S.C. § 1325(a)(3), good faith; § 1325(a)(4), the best interest test; and § 1325(b)(1)(B), that debtors, upon objection by unsecured creditors, must commit their projected disposable income to plan payments.

In addition to not objecting to their treatment as secured creditors, objectors do not argue that the valuations of property or secured claims are incorrect under the proposed plan. Creditors, therefore, do not object to the debtors' estimate that there is \$31,200.00 in non-exempt, unencumbered value in debtors' property. Objectors argue, however, that is the amount that should be paid out to unsecured creditors over the three-year life of the plan. SBA and Bank are objecting to debtors' subtraction from that figure of estimated chapter 7 priority and administrative claims totaling \$26,206.73.

The court agrees with the debtors' analysis for purposes of the best interest test under 11 U.S.C. § 1325(a)(4). The major asset is Mrs. Johnston's tax deferred annuity with Horace Mann Co. which had

a value of \$25,000.00 at the time of confirmation. However, if a trustee were to liquidate the TDA, that liquidation would trigger tax consequences for the estate. In re Bentley, slip op. No. 87-952-E (S.D. Iowa, Oct. 13, 1988). If the annuity were liquidated by a trustee in a chapter 7, the tax liability would be an administrative expense which would decrease the amount of distribution to unsecured creditors under a liquidation case. This would also be true of taxes payable by the estate to the Iowa Department of Revenue arising out of the liquidation of the TDA. Further, debtors' plan shows priority claims of IRS and State of Iowa for pre-petition taxes which would also decrease the amount available to unsecured creditors if this case were a liquidation case.

The court, therefore, agrees with the debtors that they may subtract the estimated tax expenses which would be administrative expenses in the chapter 7 liquidation as a result of the liquidation of the TDA and may subtract also estimated administrative and priority claims under the chapter 7 in arguing that they meet the requirements of § 1325(a)(4). There is no evidence that debtors' estimates are incorrect.

The court has reservations with the debtors' contention that debtors' attorney fees in the estimated amount of \$2,500.00 during the course of the chapter 13 may be fully paid from property of the estate if the case were one which were a liquidation case.

However, there is insufficient evidence for the court to determine that the \$2,500.00 estimated by the debtors would not be fully allowed.

SBA and Bank further object to confirmation of the plan on the grounds that it is not offered in good faith because debtors are retaining assets, liquidation of which would be of greater benefit to the creditors in the chapter 13 case. They specifically point out the potential liquidation of the 1988 Dodge truck, the Van Iperen 16-1/2 acres and the bar equipment. Creditors see no reason why these assets which are not essential for living or business purposes should be retained and paid for by the debtors using disposable income. Creditors argue that this is an indication of bad faith. It may also be an argument that it is a deviation from the requirement that debtors commit all disposable income to the payment of unsecured creditors during the life of the plan.

The court expressed concern during the final arguments at the confirmation hearing that such an argument is contrary to the purposes of chapter 13. The very case cited to the court by SBA on the meaning of "good faith" in chapter 13 supports the court's belief that debtors may retain their property in a chapter 13 case and that retention is not objectionable because it diverts future income to the payment of the retained assets. In re Estus, 695 F.2d 311 (8th Cir. 1982).

The Court of Appeals stated in Estus at 314:

[C]hapter 13, in contrast to Chapter 7, does not require the debtors to surrender all non-exempt assets for distribution to creditors.

6. The benefit to the debtor of developing a plan of repayment under chapter 13, rather than opting for liquidation under chapter 7, is that it permits the debtor to protect his assets. In a liquidation case, the debtor must surrender his non-exempt assets for liquidation and sale by the trustee. Under chapter 13, the debtor may retain his property by agreeing to pay his creditors. H.R.Rep. No. 595, 95th Cong., 2d Sess. 118, reprinted in 1978 U.S. Code Cong. & Ad. News at 6079.

In re Estus, 695 F.2d 311, 314, n.6 (8th Cir. 1982).

Creditors in a chapter 7 case would be prevented from obtaining the future income of the debtors. While debtors are able to keep their assets in a chapter 13 case, they must plan to pay creditors out of future income. The required payments are determined by the application of 11 U.S.C. § 1325.

The debtors' plan to keep the bar equipment, Van Iperen land, and pickup truck is not objectionable, so long as the non-exempt equity in those assets is paid out to unsecured creditors over the period of the plan and so long as the payment to unsecured creditors equals at least the liquidation value of the property at present value at confirmation, and is the best effort of the debtors under 11 U.S.C. § 1325 (a)(3).

Debtors' plan should, therefore, not be denied confirmation because they propose to retain assets which would be liquidated in a chapter 7. The creditors have failed to refute the liquidation analysis of the debtors with regard to the present value which must be paid to creditors under 11 U.S.C. § 1325(a) (4).

SBA argues that the plan is proposed in bad faith because debtors filed chapter 13 bankruptcy in order to reject the old landfill contract, payments under which had been assigned to SBA, so they could enter into a new contract absent the security interest of SBA in the new contract payments.

This court does not believe it is per se bad faith for a debtor to file bankruptcy because of financial difficulties resulting from the encumbrance of critical or essential assets. The division of claims into secured and unsecured elements is often crucial to the filing of a bankruptcy case; the avoiding of liens may be what makes a reorganization or wage earner's plan feasible. If this court were to find that a debtor could not file bankruptcy where it was necessary for that debtor to remove burdensome liens from property, the court would be hindering legitimate effects to reorganize. The court, therefore, finds that the debtors' plan was not in bad faith because the debtors during the course of the bankruptcy case defeated SBA's interest in a contract right.

IV.

SBA also argues that the plan is not in good faith because it is not the debtors' best effort in committing disposable income. The court has already disposed of the argument with regard to the cost to unsecured creditors of the debtors' retention of nonessential assets. However, that is not the SBA's whole argument. SBA points out that expenses and particularly living expenses of the debtors are excessive and therefore reduce the payments to unsecured creditors.

Debtors' monthly income (gross from the landfill operation and net from the school teaching salary) is \$7,468.00. Debtors, in their plan exhibit "B", show monthly expenses of \$5,630.33 not including plan payments.

SBA calculates that of the \$67,563.96 in annualized expenses, the sum of \$25,896.00 is devoted to personal living expenses which SBA says is excessive.

The court will not quibble with the addition of the SBA. By eliminating all expenses on exhibit "B" prior to house payment, and adding house payment and the following payments on the list, it does appear that \$2,158.00 per month is being spent by the debtors for living expenses. SBA points particularly to food in the amount of \$400.00 per month and clothing in the amount of \$100.00 per month as being excessive.

It does appear that the food allowance may be somewhat inflated for a family of three. However, as stated at the close of the case, this court believes the evidence is insufficient to find that the monthly food allotment is excessive. This is true also with regard to the clothing estimate.

With regard to business expenses, SBA points to the depreciation and repairs listed as \$750.00 per month. The court believes that based on the evidence, the debtors' allowance for depreciation and repairs is excessive. Debtors' actual repairs for the 1988 business year were \$2,021.00. Recently \$1,000.00 has been spent.

Debtor projects \$9,000.00 per annum for repairs and depreciation or \$27,000.00 during the 36 months of payments to the trustee. The depreciation allowance would presumably permit the debtor to lay away funds for the purchase of new machinery and equipment. The court does not believe that such a provision should be to the detriment of the unsecured creditors especially where such a large amount is not supported by the historical experience of the debtors and may not be necessary in fact. This depreciation provision in debtors' plan based on the 1988 year would be nearly \$7,000.00. There has been insufficient justification by the debtors that the ages of two pieces of equipment and the cost of one tire should justify the exclusion for depreciation of nearly \$7,000.00 from debtors' income.

It is this aspect of the debtors' proposal which indicates that the \$250.00 per month payments to the unsecured creditors is not the best effort of the debtors. Because of this failure to distribute through the trustee a significant portion of income because of depreciation and repair allowances, the plan does not meet the requirements of 11 U.S.C. § 1325(b)(1)(B). That section requires that upon the objection of unsecured creditors the plan must commit the projected disposal income for the three-year period. For purposes of that Code section, "disposal income" means:

"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 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).

This court finds that the use of \$750.00 per month for repairs and depreciation is excessive and therefore improperly reduces the disposal income of the debtors which should be directed toward the payment of unsecured creditors.

In light of the foregoing, the court need not reach the issue of good faith.

CONCLUSIONS OF LAW

The wage earners plan of the debtors should not be confirmed because it fails to comply with 11 U.S.C. § 1325(b)(1)(B).

ORDER

IT IS THEREFORE ORDERED that the confirmation of the debtors' wage earners plan is denied. Debtors shall have twenty-one days to amend their plan.

SO ORDERED ON THIS 3rd DAY OF MAY, 1989.

William L. Edmonds
Chief Bankruptcy Judge