In the United States Bankruptcy Court

for the Northern District of Iowa

Western Division

BYRON D. SMEBY and
LINDA J. SMEBY
Debtor(s).

Bankruptcy No. X88-00159M

Chapter 11

FINDINGS OF FACT CONCLUSIONS OF LAW AND ORDER RE: DEBTORS' PLAN OF REORGANIZATION

The matter before the court is confirmation of the debtors' amended and substituted chapter 11 plan filed on November 4, 1988 and amended on November 9, 1989. The only party objecting to the plan is the Farm Credit Bank of Omaha (formerly the Federal Land Bank of Omaha). The court now issues its findings of fact and conclusions of law as required by Bankr. R. 7052. This is a core proceeding under 28 U.S.C. § 157(b)(2)(L).

I.

The debtors, Byron and Linda Smeby (SMEBY), have farmed since 1969. They have three sons, the oldest of whom is married and lives on his own. The other two, ages 21 and 14, still live on the farm. All three sons assist in the operation of the Smeby farm. The Smebys grow corn and soybeans and raise cattle and hogs.

The Smebys farm approximately 800 acres of land, 320 acres of which is owned by them. The remainder is farmed on a cash-rent basis. The land owned by the Smebys includes two parcels. One parcel, containing 160 acres, is mortgaged to Farm Credit Bank of Omaha (FCBO) and has a value of $250,400.00. The second parcel also contains 160 acres and is being purchased from Alan and Dean Dungan. It has a value of $230,000.00. There is no equity in either parcel.

Unable to keep up with mortgage payments and faced with foreclosure proceedings instituted by FCBO, the Smebys filed their voluntary chapter 11 petition on February 1, 1988.

FCBO holds a $511,089.22 claim against the Smebys. The claim is secured by the farm real estate having a value of $250,400.00 and by monies being held by Hertz Farm Management, the receiver in FCBO's foreclosure proceeding. The receiver holds $13,900.00, but has a statutory obligation to pay unpaid real estate taxes in the amount of $5,500.00. The debtors apparently do not dispute FCBO's security interest in the remaining $8,900.00. FCBO claims also that it is entitled, as part of its secured claim, to the equivalent of the cash rental value of the mortgaged real estate for 1989. The land's fair rental value for the 1989 crop year was $110.00 per acre, or $17,600.00. Debtors contest FCBO's claim to the rental value. There was no evidence introduced at trial to substantiate the creditor's claim. Therefore, I find that for purposes of confirmation, FCBO has a secured claim in the amount of $259,300.00. Debtors paid FCBO $16,000.00 as adequate protection during the chapter 11. That amount should be applied to the unsecured claim. The FCBO unsecured claim is determined by subtracting $259,300.00 and $16,000.00 from the total claim of $511,089.22. The FCBO unsecured claim is $235,789.22.

Debtors propose to pay FCBO 5% of its unsecured claim per year for ten years, or a total of 50% of the unsecured claim. Both parties calculate the present value of the creditor's claim payments to the unsecured class under the plan is $72,439.16.(Fn.1)

1. This figure is determined by multiplying the present value of $1.00 for each of the ten years payments are to be made by 5% in order to determine

the actual present percentages that would be paid today for each of the next ten years. The total of these ten present percentage values is .30722. Therefore, the present value of proposed payments on FLB's unsecured claim is .30722 x $235,789.22 (FLB's unsecured claim) = $72,439.16. See present value chart in D. Thorndike, Thorndike Encyclopedia of Banking and Financial Tables 7-33 (1980).

II.

FCBO objects to Smebys' plan on the grounds that it fails to meet the "best interest test" of 11 U.S.C. § 1129(a)(7)(A)(ii), it violates the "absolute priority rule" of § 1129(b)(2)(B)(ii) and it was not proposed in good faith.

III.

In order to satisfy the best interest test, the plan must pay unsecured creditors, as of the effective date of the plan, at least as much as they would receive if the debtor were liquidated in a chapter 7 on such date. The present value of the proposed reorganization payments is $72,439.16. Debtors argue that payments to FCBO under the plan will exceed the amount available to unsecured creditors in a hypothetical chapter 7 liquidation.

FCBO contends that the debtors' liquidation analysis is flawed because liquidation costs and taxes are overestimated, and that the true figures result in a much larger chapter 7 payment than debtors claim.

Upon consideration of the evidence, the court agrees that the plan may not be confirmed because it violates the best interest test.

A.

LIQUIDATION COSTS

The evidence as to the cost to liquidate non-exempt property of the debtors was weak. Roy Budlong, an FCBO employee, testified for his employer as to liquidation costs. Although he has a farm background and experience with liquidation, his testimony with regard to such costs was based almost totally on hearsay. Byron Smeby's testimony was perhaps even weaker. He used an across-the-board figure of 10% stating that some such costs would be higher, others lower. However, he gave no testimony as to any liquidation costs which would be higher, and little substantiation of those he considered lower. Budlong's hearsay testimony was at least more thorough. He did, however, omit consideration of the cost of labor for loading crops and livestock. On the whole, the court considers Budlong's testimony a slightly more reliable indicator of liquidation costs. Added to it will be an amount to compensate for labor for loading livestock and grain, based upon 1% of the asset's value. I understand this is somewhat arbitrary, but the expense should not be ignored. Yet, Budlong's failure to adequately deal with it is not sufficient reason to rely on Smeby's estimate.

The court's finding as to the reasonable cost of liquidating the estate's personal property in chapter 7 is as follows:

HYPOTHETICAL CHAPTER 7 LIQUIDATION COSTS

1. LIVESTOCK:

(a) Hauling:	3 loads X $75.00	=	$ 225.00
(b) Commission:	$74,100 X .03	=	2,223.00
(c) Labor:	$74,100 X .01	=	741.00
		TOTAL	$3,189.00

2. 1988 GRAIN:

(a) Beans:	$21,480 ÷ $5.37 = 4,000 bu., 4,000 bu X .12 loading & hauling	480.00
	labor - loading: $21,480 x .01	214.80
(b) Hay		150.00
	TOTAL	$ 844.80

3. MACHINERY & EQUIPMENT: TOTAL $3,000.00

4. 1989 CROP:

(a) Hauling & Loading 60,200 bu. X .12 =	$7,224.00
(b) Labor $149,964 X .01 =	1,499.64
TOTAL	$8,723.64

SUMMARY OF TOTALS,

TOTAL LIQUIDATION COSTS $15,757.44

B.

TAXES

FCBO argues that the debtors have overestimated taxes on their liquidation analysis. Two reasons are given. First, FCBO contends that debtors' analysis provides for the abandonment of the estate's real property thereby foregoing a tax loss beneficial to the estate and the unsecured creditor. Second, FCBO submits that the CPA who calculated the liquidation taxes omitted deductible amounts.

Linda Brunscheen, debtors' CPA, calculated that taxes payable by a trustee on liquidation of the estate amounted to $104,213.00. She presumed that both 160-acre parcels of real estate would be abandoned by the trustee. Debtors' basis in the land mortgaged to FCBO is high and if sold for a fair market value of $250,400.00, there would be a taxable loss. Ms. Brunscheen admits that, based upon her calculations, if the estate sold the property at a loss, the taxes to the estate would be reduced to $58,303.00. No similar calculation was made regarding an estate sale of the 160-acre Dungan land. Based solely on the unaltered calculations of Ms. Brunscheen, the tax loss to the estate would result in a tax savings of $45,910.00.

In order to sell the land, the hypothetical trustee would have to expend estate money for sale expenses. The expenses, however, would be only a small fraction of the tax savings. Debtors argue that the trustee would be in the untenable position of having an obligation to obtain the highest price possible for the land, although the lowest price would most benefit the estate. A case trustee in the Northern District, called by debtors as a witness, testified that he would, in such a position, abandon unless ordered to sell by the court. FCBO says it would consent to sale under 11 U.S.C. § 363(f).

The court could find no authority for the proposition that the trustee in such a situation would sell or abandon or be forced to do either. The parties have cited no authority for their positions. A trustee's main duty has been said to be "to close the estate as quickly and expeditiously as is compatible with the best interests of the parties in interest. . . ." In re Riverside-Linden Inv. Co., 85 B.R. 107, 111 (Bankr. S.D. Cal. 1988), aff'd. 99 B.R. 439 (9th Cir. B.A.P. 1989), 11 U.S.C. § 704(l). The sale of overencumbered property with the consent of the secured party in order to obtain a tax loss is not incompatible with such a duty if the trustee's actions yield a benefit to the estate by reducing the estate's overall taxes, thereby increasing the dividend to unsecured creditors. A trustee arguably prevents a forced abandonment where he can show the asset has a "benefit to the estate." 11 U.S.C. § 554(a). And although a successful resistance to abandonment does not., in and of itself, permit a sale free and clear of liens under Code § 363(f), such a sale is possible where the secured party, as here, consents.

I conclude, therefore, that under the circumstances here, the trustee would sell the 160 acres mortgaged to FCBO to obtain the tax advantage. Debtors' liquidation analysis, therefore, overstates the amount of taxes by omitting the sale. Although debtors' CPA witness testified that such a sale would result in a tax savings of about $45,900.00, it is not clear to the court that that figure would be the same if considered in conjunction with other adjustments to the estate's taxable income. Therefore, the court in its findings on "best interest" will not consider the loss from the sale of the land in determining taxes on liquidation. Suffice it to say that quantifying the reduction in taxes would put debtors in a worse position as to the "best interest test."

Ms. Brunscheen testified that in calculating the taxes on a hypothetical liquidation she did not deduct certain costs of administration:

(a) Chapter 7 trustee's fees	$ 8,469.26
(b) Debtors' wages and labor	15,090.81
(c) Professional fees	15,000.00
(d) 1988 advance deficiency repayment	1,636.00

She did deduct for tax purposes $24,694.00 in expenses, $10,500.00 of which were expended by the debtors prior to the hearing. The balance was an estimate of post-confirmation, yearend expenses.

Other tax deductible expenses were omitted by the CPA: 1989 land rent in the amount of $20,000.00 and the chapter 7 liquidation costs. These will be included in the court's findings on taxes. Based on the accountant's testimony, the total of omitted deductible expenses would be multiplied by .30 to determine the reduction in taxes.

FCBO argues that any payments to it in a liquidation case would be first applied to the unpaid interest at the time of filing. This amount is $146,439.22. Debtors' accountant testified that in a chapter 7, the trustee would normally work with creditors to learn how the creditors would treat any dividend. If the dividend is applied to interest, then the trustee would take the interest deduction in calculating estate income tax. FCBO argues that payments to it would first be applied to taxes, reducing taxes to zero, and creating an even greater hurdle for debtors in meeting the "best interest test." Debtors' counsel did not address this in his brief. The court is somewhat skeptical about this assertion, and considers the evidence insufficient on this point to require a finding that there would be no taxes to the estate in liquidating the Smeby estate because of the dividend being applied to FCBO interest.

The court finds that the taxes payable by the estate in a hypothetical liquidation are $84,975.95. The calculation is as follows:

1. DEBTORS' TAX ESTIMATE	$104,213.00
2. ADJUSTMENTS TO TAXABLE INCOME NOT CONSIDERED BY DEBTORS' CPA:	
(a) Trustee's fee	$ 8,469.26
(b) Debtors' wages	15,090.81
(c) Professional fees	15,000.00
(d) Deficiency program repayment	4,000.00
(e) 1989 rent	20,000.00
(f) Liquidation costs (exhibit A)	15,757.44
(g) Unpaid operating costs	10,500.00
	$88,817.51
Less amount considered as expenses by CPA	(24,694.00)
3. NET ADJUSTMENT	$64,123.51
4. ADJUSTMENT TO TAX:	$64,123.51 X .30 = 19,237.05
5. ESTIMATED TAXES PAYABLE BY CHAPTER 7 TRUSTEE ON HYPOTHETICAL LIQUIDATION WITHOUT CONSIDERATION OF TAX LOSS ON LAND	$ 84,975.95

C.

THE LOAN

In their liquidation analysis, debtors show as an administrative obligation of the chapter 7 trustee the repayment to them of a $56,220.44 "loan." This money was used in the operation of the farm by the debtors-in-possession. The source of the money was a loan against the cash value of an exempt life insurance policy. Debtors argue that if the estate were

liquidated in a chapter 7, they would be entitled to repayment of this amount as chapter 11 administrative claimants. Neither of the parties have touched upon this issue in argument or brief. It need not be decided now. Without deciding whether such administrative repayment is permissible, the court includes the repayment in the chapter 7 liquidation analysis for purposes of this hearing.

The court makes the following findings as to the payment to the unsecured class in a hypothetical chapter 7 liquidation.

1. SUMMARY OF NON-EXEMPT ASSET VALUES FROM DEBTORS' EXHIBIT 1, BEFORE DEDUCTION OF LIQUIDATION COSTS:	
Cash	$ 100.00
Bank deposits	2,000.00
Livestock	74,100.00
1988 grain	22,980.00
Machinery & equipment	30,000.00
1989 crop	149,964.00
1989 deficiency payment	24,869.18
	$304,013.18
2. TRUSTEE'S LIQUIDATION COSTS	(15,757.44)
	$288,255.74
3. TAXES TO ESTATE WITHOUT CONSIDERATION OF SALE OF REAL ESTATE MORTGAGED TO FLB:	(84,975.95)
	$203,279.79
4. TRUSTEE'S FEES:	$ 8,469.38
	$194,810.41
5. LESS OTHER COSTS OF ADMINISTRATION:	
Debtors' wages	$15,090.81
Professional fees	15,000.00
Repay 1988 deficiency	4,000.00
Unpaid operating expense	5,250.00
Unpaid rent	20,000.00
Repayment of loan	56,220.41
	(115,561.25)
	$ 79,249.16
6. LESS PRIORITY CLAIMS	(5,500.01)
AVAILABLE TO UNSECURED CREDITORS IN HYPOTHETICAL CHAPTER 7 LIQUIDATION:	**$ 73,749.16**

The critical amounts seem close. The amount available for the unsecured class is $73,749.16. The present value of the payments to the unsecured creditor is $72,139.16. But this slight difference is without numerical consideration of the tax benefit available to the estate through the sale of the real estate mortgaged to FCBO. This savings could be up to $46,000.00. Also, as previously stated, it is calculated without reaching a decision on the effect on taxes of the treatment of the dividend by FCBO. Based on the findings, the debtors have failed to meet their burden of proof that the plan satisfies the Code's "best interest test."

IV.

ABSOLUTE PRIORITY

Debtors contend that the present value of their retained interest is low--approximately $50,000.00. Their CPA calculates this by estimating that the retained assets will have an unencumbered value in 30 years of $800,000.00 and that the

present value of that amount based upon a 10% discount rate is $50,000.00. Based on exhibit A, the precise present value would be $45,840.00. Debtors say that under the new value exception to the absolute priority rule, they are contributing in excess of that amount to the estate. They tally their contribution as follows: a $50,000.00 loan to the estate which they would make after confirmation, the source of which is the exempt insurance of the debtors; the debtors' agreement to waive repayment of $15,090.81 contributed by them in labor and money to the estate during the chapter 11. They arrive at this latter figure by Byron's calculation of the value of his chapter 11 labors added to Linda's contribution of her salary from off-farm work; from the total, they subtract living expenses taken from the debtor-in-possession account--($32,880.00 + $6,017.40 - $23,806.59 = $15,090.81). The court finds these figures are accurate. Debtors have also contributed to the estate the use of exempt machinery and equipment, and they say they will continue to do so if the plan is confirmed. No value was placed on this contribution.

FCBO does not dispute the contributions but contends that there is no exception to the absolute priority rule, and that it must be repaid 100 cents on the dollar or the plan cannot be confirmed. FCBO argues that even if the exception exists, the debtors are retaining an interest greater in value than the "new value" contributed.

The Supreme Court has recently declined the opportunity to resolve the dispute as to whether a "new capital" exception to the "absolute priority rule" still exists. Norwest Bank, Worthington v. Ahlers, 108 S.Ct. 963, 967, n.3 (1988). That does not leave this court free to decide the issue anew. The "infusion of new capital" exception appears still valid in this circuit. In re Blankemeyer, 861 F.2d 192, 194 (8th Cir. 1988) reh'g. denied (1988). Where the junior class makes a new and necessary contribution, the members of the class may receive in return a "participation reasonably equivalent" to the contribution. Case v. Los Angeles Lumber Products Co., 308 U.S. 106, 121 (1939), rehg. denied 308 U.S. 637 (1939).

The debtors in this case have failed to prove that they meet the standards of the exception. Even if debtors' method of calculation of the present value of the retained interest is correct, there is no reason to assume that a 30-year period should be used for the calculation. Debtors' theory is to assume that all of the estate's present assets will be unencumbered at the end of 30 years when all plan payments are completed, including payments on secured debt. They discount that value to present value by the application of present value tables, utilizing a 10% discount rate. However, debtors under such a theory would have $304,013.00 in unencumbered, non-exempt personal assets at the end of 10 years when payments to the unsecured class are completed. At that point, there would theoretically be some equity in the real estate. The present value of $304,013.00 in 10 years is $117,197.00 ($304,013.00 X .3855).(Fn.2)

2. See present value chart in D. Thorndike, Thorndike Encyclopedia of Banking and Financial Tables 7-33 (1980).

The debtors' proposed contribution $50,000.00 in cash and forgiveness of a $15,090.81 administrative claim. If the administrative claim is valid, the total contribution would be $65,090.81. It is not substantially equivalent to the retained interest. Moreover, the cash contribution is speculative. It is nowhere mentioned in the plan or disclosure statement. The court questions whether it is enforceable based solely on the testimony of Mr. Smeby. Based on this evidence, the court does not believe the debtors have proven that they meet the new capital exception to the absolute priority rule. Because the plan does not propose to pay the dissenting unsecured class in full, the rule bars confirmation.

V.

GOOD FAITH

FCBO has raised the issue of whether the plan was filed in good faith. Because of the foregoing, the court need not reach that issue.

CONCLUSIONS OF LAW

The plan fails to meet the requirements of 11 U.S.C. § 1129(a)(7)(A). The plan may not be confirmed under 11 U.S.C. § 1129(b).

ORDER

Judgment shall enter that confirmation of debtors' proposed plan of reorganization is denied.

SO ORDERED ON THIS 25th DAY OF APRIL, 1990.

William L. Edmonds
Chief Bankruptcy Judge