In the United States Bankruptcy Court

for the Northern District of Iowa

Western Division

GERALD D. JOHNSON and
JUDITH K. JOHNSON
Debtor(s).

Bankruptcy No. 95-50511XS

Chapter 13

ORDER RE: CONFIRMATION OF PLAN

Gerald D. and Judith K. Johnson (hereinafter JOHNSONS or DEBTORS) seek confirmation of their Second Amended Chapter 13 Plan filed November 17, 1995 (docket no. 74). Objections to the plan were filed by the United States of America on behalf of the Farm Service Agency (FSA), the State Bank of Alcester (State Bank), and Farm Credit Services of the Midlands (Farm Credit). Carol Dunbar, the standing trustee, did not object. Hearing on confirmation was held December 12, 1995, in Sioux City. Confirmation proceedings are core proceedings under 28 U.S.C. § 157(b) (2) (L).

Farm Credit's only objection was its concern that the debtors' plan did not treat it as an unsecured creditor in the event that the foreclosure sale of its collateral brought insufficient proceeds to pay its claim in full. At the hearing, debtors agreed that any confirmation order on the Second Amended Plan would provide that Farm Credit is entitled to treatment as an unsecured creditor to the extent its claim is not paid by the sale of its collateral.

State Bank's objections include the following: (1) the debtors undervalue the homestead site in which State Bank claims a mortgage interest, and thus the plan violates 11 U.S.C. § 1325(a) (5) (B) (ii); (2) in paying State Bank's secured claim against the homestead, debtors impermissibly modify State Bank's rights because Bank has a claim secured only by real property that is debtors' principal residence (11 U.S.C. § 1322(b) (2)); (3) debtors propose to use 1996 rental income from non-homestead farm ground in violation of the Bank's lien rights and 11 U.S.C. § 1325(a) (5) (B); and (4) the plan is not feasible (11 U.S.C. § 1325(a) (6)).

FSA's objections are that (1) the plan does not recognize or provide retention and payment of FSA's lien against the homestead property; (2) the plan proposes to use 1996 rental income from the non-homestead property in violation of FSA's lien rights and 11 U.S.C. §1325(a) (5) (B); (3) the plan proposes to pay the secured claims against the homestead over the five-year term of the plan, but with a substantial balloon payment at the conclusion of the five years, without an adequate showing that the balloon payment can be made; and (4) the plan is not feasible.

Gerald and Judith Johnson are husband and wife, but are separated. Gerald rents an apartment in Vermillion, South Dakota and attends school at the University of South Dakota. He is studying criminal justice and expects to graduate in the spring of 1997. He earns between $125 and $150 per week working part-time as a night manager in a grocery store. He will soon begin working about 20 hours per week for the Big Brothers/Big Sisters program in Sioux City. He intends to continue some work for the grocery store, so he expects he will earn a total of about $145 to $170 per week from both jobs. Gerald Johnson has student loans for education and living expenses. He has taken $9,000 in loans thus far and expects to borrow about $6,000 more over the next three semesters. He does not know what the repayment terms will be for the $15,000 student loan debt, but he believes they are gracious and that he will not have to commence repayment until six months after graduation. Johnson hopes to obtain a job in his chosen field either in Sioux City or in Sioux Falls. He expects to earn a starting salary between $25,000 and $30,000.

Judith Johnson lives in Sioux City and also rents. She is employed full time, and according to exhibit 3 of the plan, earns annually $27,600 in gross salary and $21,600 in net salary. The plan indicates that she will pay the plan payments to Brenton Bank and Trust on her car loan. She will also presumably pay her own living expenses. The court knows little about her. She did not appear at the confirmation hearing. She did not sign the plan. Debtors' counsel mailed the plan to her in care of an attorney, not to her. No evidence was introduced on the status of the separation or on the debtor's individual intentions regarding their marriage.

The couple owns two parcels of real estate in South Dakota. One is a 2.52-acre homestead site which includes a house and a chicken house. The parties call this Johnson Tract One. It was claimed exempt by debtors to the extent of $30,000 in an unsigned amendment to Schedule C, verified not by the debtors but by their attorney (docket no. 40). No party objected. Neither debtor lives at the homestead. Gerald Johnson intends to return to it after graduation from USD. There is no evidence as to Judith Johnson's intent. At present, the house is occupied by the Johnsons' son and his wife. According to the Plan, the son and daughter-in-law will occupy the homestead and pay monthly rent of $332.13 per month plus insurance on the premises and annual real estate taxes of $1,350. There was no evidence as to whether they would continue so to occupy and pay rent after Gerald returns to the home in the spring of 1997. Although they have been living at the homestead, debtors have inexplicably collected no rent.

The homestead is fully encumbered by unpaid real estate taxes and by security interests of FSA and State Bank. Debtors propose to pay the value of the homestead site to the trustee over the five years of the plan. The plan does not recognize the lien of FSA, but at the hearing, neither Gerald Johnson nor his counsel disputed it. The debtors would be willing to pay the value of the homestead to the lienholders in the order of their priority.

The debtors and State Bank dispute the value of the homestead. Debtors contend that the value is $38,772 and that there are unpaid taxes of $1,857. Bank argues that the value of the site is $47,682. Debtors and Bank arrive at their estimates from the court's prior determination that a larger building site of which Johnson Tract One is part has a value of $50,000. Both sides rely on the appraisal introduced in a prior valuation hearing. The court has examined the appraisal and reviewed its prior ruling. Neither debtors' argument nor Bank's argument is very satisfactory. Both presume that one can extrapolate the value of a 2.52-acre building site containing two buildings and the only water supply from the appraisal of a 5.5-acre site containing at least 12 buildings. I am doubtful as to the reliability of the methods, but the appraisal is all I have to work with. For the purposes of this matter, I find that the fair market value of Johnson Tract One, the homestead site, is $38,772. Debtors, therefore, do not undervalue the homestead.

The debtors own 113.6 acres of farm ground in South Dakota. FCBO, FSA and State Bank all claim security interests in it. The plan proposes that the creditors be able to foreclose on the property in state court in satisfaction of the secured claims. To the extent that the foreclosure sale would not satisfy all claims secured by the property, the claimants would, absent other security, be unsecured. There may be a dispute over lien priorities, or as to the order of satisfaction, but those issues are not before the court.

The farm ground was rented to Gerald Johnson's brother in 1995. Gerald is holding $8,000 in rent. He proposes to use this money to make certain Plan payments which must be made on confirmation. Johnsons' plan contemplates the rental of the ground to the brother in 1996 and the use of that money under the plan. The rental agreement has not been finalized, but Gerald Johnson expects he will be promised sufficient bushels of the crop raised there to provide the equivalent of $85 to $90 per acre or $9,656 to $10,224.

Johnsons propose to use the rent to fund the plan. They would pay $3,000 of the rent to the trustee on April 1, 1996 as principal reduction on the homestead for payment to the secured creditors and another $3,000 on November 1, 1996 for the same purpose. After each of such payments, the plan proposes the reduction of the monthly payments to the trustee on account of the secured claims against the homestead. The plan does not propose that the rental from the son and daughter-in-law would be reduced. Under the plan, the balloon payment due to the trustee and thus to the secured creditors at the conclusion of the five-year plan would be approximately $27,000. Gerald believes that the payments on the homestead during the plan would provide with with at least a 30 per cent equity in the home at the time they would need to refinance to pay the balloon payment. That equity estimate is approximately correct. Gerald says he has a representation from a relative of his son's wife that she would consider co-signing a note to refinance if that were necessary to obtain the loan. The court places no reliance on such a representation.

Both State Bank and FSA object to debtors' use of the 1996 farm ground rentals to finance the 1996 principal reduction payments on the homestead. Both claim security interests in rents from the real estate as part of their mortgages. Both contend that under South Dakota law they have a right to the rentals, and the use of them by the debtors for another purpose violates their rights and 11 U.S.C. §1325(a) (5) (B). The court's examination of South Dakota law supports the creditors on this point. Debtors cite SDCL 15-19-17.1 to the contrary. It states that "[w]henever crops have been sown on the debtor's premises, before the issuance of a sheriff's deed, the debtor shall be entitled to the crops grown thereon and the right to enter on the premises to harvest the crops after the issuance of the deed." However, that statute appears to deal with crops planted by the debtor. Moreover, it does not appear to prohibit the enforcement of a valid security interest in crops. In this case, we are not dealing with debtors' crops. We are dealing with crops raised by one other than the debtors which would be used to pay rent to the debtors. A mortgagor can contract away his right to rents. Aetna Life Insurance Co. v. McElvain, 363 N.W.2d 186, 191 (S.D. 1985). The problem in this case is that neither FSA nor State Bank has introduced their mortgages to prove a security interest in rents. Therefore, I cannot hold that the use of the rentals by the debtors violates their lien rights in violation of 11 U.S.C. §1325(a) (5) (B).

Nonetheless, debtors' plan permits these creditors to foreclose their mortgages in state court, and I construe that plan provision to permit the creditors to try to establish their rights to such rentals. If they are able to do so, the debtors would not be able to use the rentals as proposed. It might affect their ability to perform their plan. But even treating it as a feasibility issue, I cannot sustain the objection of the creditors on this ground as they have introduced no evidence of their claim to rentals. I rule only that they would not be barred, even if the plan were confirmed, from pursuing in state court either the rentals or the right to rent the property through a receivership.

State Bank contends that debtors impermissibly seek to modify their security interest in the homestead. Bank says it has a claim against the debtors which is secured only by a security interest in real property that is the debtors' principal residence and that 11 U.S.C. §1322(b) (2) does not permit this treatment. Debtors' treatment of the secured claim is to pay the property's value over five years at interest. State Bank says this is a new issue. However, it was raised in its objection to the pending plan (State Bank objection, docket no. 81,¶ 3(A)). Debtors' previous plan proposed no payment to State Bank on account of State Bank's interest in the homestead. Bank objected to that treatment. I do not consider the Bank's objection untimely. But Bank has not introduced any evidence of its security interest in the debtors' principal residence. It has attached documents to its objection, but that is not a substitute for the introduction of evidence at trial. The rights which may not be modified under §1322(b) (2) "are reflected in the relevant mortgage instruments." Nobelman v. American Savings Bank, 113 S.Ct. 2106, 2110 (1993). These have not been proven, and the objection on that ground, therefore, may not be sustained.

FSA objects to the plan on the ground that its lien in the homestead is not recognized--the plan does not provide for FSA lien retention or payment. Debtors' counsel responds that inasmuch as the plan provides for payment of the claims secured by liens against the homestead to the extent of the value of the homestead, and in the order of their priority, they do not care to whom the money is paid. The problem with the debtors' position is that they have proposed a plan which specifically states that "Johnson Tract One is not subject to RECD's [now know as FSA] claim" (Second Amended Plan, page 2), and "FmHA" [now known as FSA] does not Claim a mortgage lien on Johnson Tract One" (Second Amended Plan, ¶ 8). The Plan also appears to say that Farm Credit has a prior lien to State Bank on Johnson Tract One, but that Farm Credit will release it when it is paid from the foreclosure sale of the non-homestead property (Second Amended Plan, ¶ 7). The plan also proposes payment of the value of Johnson Tract One to State Bank from the trustee. The debtors' plan does not propose to pay the value of the property to whomever has value liens in the order of priority. If, as debtors say, they do not contest the FSA lien, then the plan as written cannot be confirmed on the ground that debtors really meant something else.

The last issue is whether the debtors will be able to make all payments under the plan and to comply with it. 11 U.S.C. §1325(a) (6). To show they can make the proposed payments, debtors have attached exhibit 3 to the plan. It shows income, expenses for 1996, and the difference available to fund plan payments. *Id.*

FSA and State Bank contend that the debtors will not be able to make payments under the plan. FSA is particularly concerned about debtors' ability to pay off the balloon payment on Johnson Tract One. FSA says that a plan provision for a large balloon payment is subject to abuse, presumably meaning that if debtors cannot pay the balloon at the end of five years, they will file another chapter 13 and extend the debts further.

The plan is proposed for a five-year period beginning January 1996. Debtors have submitted a cash flow for 1996 only. There is evidence that the factors on which that cash flow is based will change substantially after 1996. Debtors have $8,000 from 1995 farm ground rentals. They may or may not have $9,656 to $10,224 for 1996. There will be no farm income in 1997 or after. They propose to have lease income on Johnson Tract One for 1996 which includes $3,985.56 plus insurance and real estate taxes of $1,350. Gerald Johnson says he will move back to the homestead after finishing school in May 1997. There is no evidence of it, but presumably the rental will terminate. But his present Vermillion lease payments will terminate also. He will begin a full-time job in about June 1997, and he expects to earn $25,000 to $30,000. Presumably, the two part-time jobs will end. There will be no farm income in 1998, but there will be one full year of income for both debtors from full-time jobs. There will be no student loan income after early 1997, and Gerald's student loans for his present degree will require repayment beginning at the beginning of 1998. There is no evidence of the amount of monthly payments. There is no evidence as to whether debtors plan or hope to continue to be married or what effect their martial situation will have on the performance of the Plan.

Nonetheless, based on the testimony of Gerald Johnson, I do not find any of the expectations unreasonable, only uncertain. I have estimated cash flows beyond 1996 based on debtor's testimony, and it appears the debtors would have sufficient funds to pay plan payments whether or not they have access to 1996 farm rental income. There may be sufficient income after payment of all expenses and proposed plan payments to increase the monthly payments on account of the Johnson Tract One claims as well as pay a respectable dividend to unsecured creditors. How those payments should be balanced, I will not now decide. I calculate that even if debtors do not have access to 1996 farm rentals, that over the life of the plan, they would have approximately $30,000 for such division. The fairness of the division will be left for another day. Suffice it to say that based on the testimony of Gerald Johnson, there would be sufficient income over five years to fund a plan. I also find that the present payment plan for creditors holding secured claims against Johnson Tract One is insufficient to assure them that the balloon payment will be made at the end of the plan period. I give no credence to the debtors' evidence that they will obtain co-signors or that the equity in the property will be sufficient in five years to assure a refinancing. Debtors need to increase the monthly payments at some point. It would help also if the debtors could prove that the $6,000 in principal reduction could be made in light of the resistance of FSA and State Bank.

There are other problems with the plan which have not been raised by creditors but which should be mentioned. Debtors have not signed their plan. I can find nowhere in the plan where it provides for the submission of all or such portion of debtors' future incomes to the supervision and control of the trustee as is necessary for the execution of the plan.

The plan proposes to make initial payments out of 1995 farm rentals. This money would pay approximately $4,000 in professional compensation, real estate taxes in the amount of $1,350, and $1,000 to the Internal Revenue Service plus approximately $635 in trustee's fees on those amounts. The $8,000 payment should have already been made to the trustee. Debtors would also begin transferring rental income from their son to the trustee and the trustee's fee annually on that amount would be $399. The latter could also come from the $8,000. If so, all but $616 of the $8,000 would be used in 1996. The court will assume no principal reduction payments of $6,000 in 1996, and that the payments will be made at the level of $332 throughout. The Plan proposes that the payments on the two liquidated student loans and the car payments will be made directly. The trustee is to pay the annual IRS payment of $1,592, and she will receive approximately $159 in fees for the distribution. No where in the plan can I find any provision for monthly payments or other payments to the trustee to permit her to make the IRS payment or to pay unsecured creditors. This is so despite regular income by the debtors.

The plan proposes to pay the debtors' attorney directly, which I will not permit. The debtors propose to pay $36,915 to the trustee for payment of liens against the homestead, but it reaches that figure by subtracting $1,857 in "pro-rated" taxes from a value of $38,772. There is no evidence of $1,857 in taxes against the homestead. The evidence and other portions of the plan show the figure to be $1,350. Therefore, the calculation of the payment to the trustee is in error.

Having concluded that the Plan does not meet the confirmation requirements of chapter 13 of the Code,

IT IS ORDERED that confirmation of the debtors' Second Amended 13 Plan filed November 17, 1995 is DENIED.

IT IS FURTHER ORDERED that debtors shall have one opportunity to file an amended plan. Any amended plan must

be filed by January 17, 1996. Failure to file will result in dismissal of the case. The debtors shall give notice of filing and shall serve a copy of the amended plan on all parties with notice of a bar date for objections. The bar date shall be January 29, 1996. The court will hold an informal phone conference with debtors' counsel and with counsel for objectors to select a trial date. The notice shall state that final confirmation hearing will be set by separate notice. If the amended plan is not confirmed, the case will be dismissed.

So ORDERED THIS 28th DAY OF DECEMBER 1995.

William L. Edmonds
Bankruptcy Judge