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District of New Mexico

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UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF NEW MEXICO

In re:
Michael Roy Leon-Guerrero and
Evelyn Dolores Facio,
Debtors.

No. 13-99-12568 SA

MEMORANDUM OPINION ON
CONFIRMATION OF DEBTORS' CHAPTER 13 PLAN

This matter came before the Court to consider confirmation of the Debtors' Chapter 13 plan. The Debtors appeared with their counsel William P. Gordon (Bonnie Gandarilla). The Chapter 13 Trustee appeared through her attorney Annette DeBois. Having considered the file, the testimony, the arguments of counsel, and being otherwise sufficiently advised, the Court issues this Memorandum Opinion. This is a core proceeding. 28 U.S.C. § 157(b)(2)(L).

The parties agreed that there are three main issues before the Court, which the Court addresses in the following order: 1) whether tax refunds in excess of a fixed dollar amount must be devoted to the plan, 2) whether the Debtors should retain two rental properties, and 3) whether the Debtors should be allowed to repay an employer's claim directly outside of the plan. The Court also addresses the disposable income requirement.

The plan proposes to pay $170 per month for 48 months to the trustee for payment of claims. To date, there are unsecured claims totaling approximately $52,000. Debtors filed amended

Schedules I and J[1] on May 11, 2000. Schedule I lists $1,475 monthly income from real property[2]. Schedule J lists the mortgage payments on the rental properties ($1,500 per month) and a water bill for one rental ($25 per month). Schedule J does not list any other expenses related to the rental properties.

The Debtors' Schedule A lists two rental properties, 64th Street and Robin Meadows NW. The schedules indicate that Debtors believe they have no equity in either rental property.

TAX REFUNDS AND CONTINGENCY FUNDS

The Trustee claims that the plan should treat future tax refunds as projected disposable income but that it does not. The Trustee based this claim on the fact that Debtors have received refunds in the past, and that their percentage of withholding has gone up in the most recent payroll periods. The Court finds that the Debtors have included future refunds: Amended Schedule I lists a line item of $3.00 based on an annualized estimated $36.00 refund. There is no evidence that this $36 is not a good faith estimate of future refunds. It appears this figure is based on the actual 1999 results: $88 federal refund and $45

[1]Amended J states the plan payment will be $195 per month. The Trustee's brief states that the Debtors have been paying this increased amount.

[2]Ms. Facio testified at the confirmation hearing that the current rental income had increased by $20 to $1,495.

state amount due. See Debtors' amended Schedule I, filed May 11, 2000 (Doc. 30).

The Trustee and the Debtors have used this opportunity to argue whether the Debtors should be required routinely to commit to the plan any future tax refunds. That argument in turn has led to the submission of arguments by Debtors and amici curiae of additional issues, such as budgeting, what items are appropriately contained in the expense portion of the budget (Schedule J) and in what amount, Chapter 13 policy, etc. The Trustee has objected to much of those submissions on the grounds that, among other things, the submissions are not supported by evidence and are not specifically relevant to the Debtors' circumstances in this case. In the preceding paragraph, the Court ruled on the specific issue of the Debtors' treatment of their future tax refunds in this case. Nevertheless, because of the cost of preparing briefs, an expense which is particularly large relative to debtors' budgets and to the fees paid to counsel in Chapter 13 cases, it is appropriate for the Court to address the arguments raised by counsel, but within what the Court believes are the appropriate evidentiary limitations.

To begin with, tax refunds are income, as the parties concede. See In re Cochran, 141 B.R. 270, 272 (M.D. Ga. 1992):

> The Court believes that a tax refund does qualify as income, even though the Bankruptcy Code does not define that term. A tax refund is, by definition, a repayment

> of overpaid taxes on income, i.e. money that should have been classified originally as net income rather than paid as taxes.

See also In re Rhein, 73 B.R. 285, 288 (Bankr. E.D. Mi. 1987)(Overwithholding of income taxes is a "virtual savings account" of disposable income.) Therefore, they must be included in the Debtors' Schedule I (or at least accounted for in the plan), to the extent they can be "projected" or reasonably anticipated. 11 U.S.C. §1325(b)(2). Whether they are "disposable income" as the Trustee argues[3] is another question, since the determination of disposable income is the result of the calculation required by 11 U.S.C. §1325(b)(2).[4] See Freeman v. Schulman (In re Freeman), 86 F.3d 478, 481 (6th Cir. 1996) (Whether tax refund is "projected disposable income" is a fact-based inquiry.)[5] On the other hand, the conclusion of payments

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[3] Chapter 13 Trustee's Memorandum Brief in Support of Her Objection to Confirmation (Doc. 21), at 3. However, the Trustee also characterizes tax refunds as part of "gross income." Chapter 13 Trustee's Reply Brief (Doc. 25), at 2, n.1.

[4] Indeed, characterizing any specific item of income as "disposable income" is something of a misnomer unless the expenses of a debtor's budget have already been covered by other items of income.

[5] In their briefs, both sides argue the same conclusion – that projected disposable income must be committed to the plan – and both assert that the other side argues the opposite. Compare Chapter 13 Trustee's Memorandum Brief in Support of Her Objection to Confirmation, at 8, n.2, with Debtor's Brief Regarding Disposable Income Under 1325(b)(1)(B) (Doc. 22), at 1-3. But the parties disagree on the interpretation of the conclusion such that their respective applications to the facts of this case

due to a secured creditor during the life of a plan, while not comprising "income" as such, does constitute a reduction in the debtors' expenses which can be reasonably anticipated, and therefore would figure into the calculation of "projected disposable income".[6] But whether the entire amount of the reduction in expenses needs to be paid to unsecured creditors is another question. In this jurisdiction, where there is no formulaic list of allowed budget items and values and instead the budget and plan in each case are determined on a case by case basis, that issue is resolved by negotiations among the parties and ultimately a court decision if needed.

The parties have also argued about what disposable income the Debtors must commit to the plan over a period of time, and which party has the obligation, if any, of monitoring the potential changes in the Debtors' income and expenses.[7] The

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differ markedly, thus requiring the Court's consideration and disposition of the issue.

[6] At the same time, it would not be inappropriate for debtors to incorporate into the expense side of the budget an inflation factor. Practically speaking, while increases in income are questionable, increases in the cost of living are not. "[I]t is hardly unusual for debtors' incomes to rise more slowly than the rate of inflation." 8 Collier on Bankruptcy (Rev. Ed. 2000), ¶1325.08[4][a][i] at 1325-51.

[7] At the outset of this discussion, the Court concedes that the formulation of concrete rules and policies about "projected disposable income" is all based on assumptions and predictions which may turn out to have no basis in reality.

As with projected income, the court, in theory, is argument has centered on Anderson v. Satterlee (In re Anderson), 21 F.3d 355 (9th Cir. 1994). In that case, the trustee argued that the debtors, as a condition of confirmation, should be required to promise to pay into the plan all actual disposable income during the life of the plan. Id., at 357. The Ninth Circuit ruled that the clear language of Section 1325(b)(1)(B) – "all of the debtor's projected[8] disposable income [as of the effective date of the plan]" – mandated rejection of the Trustee's argument for actual disposable income.[9]

> required to project what will happen to the debtor's expenses over three years. Such a projection would require the court to guess whether the debtor would have additional children, unexpected marital separations, medical bills, home repairs, or a wide variety of other future expenses. Obviously, this is impossible. As with the income side of the budget, the court must simply use the debtor's current expenses, unless a change in them is virtually certain.

8 Collier on Bankruptcy (Rev. Ed. 2000), ¶1325.08[4][b] at 1325-52; see also id., ¶1325.08[4][a] at 1325-50.

[8] The court cited a definition of "project" as "to plan, figure or estimate for the future" from Webster's Ninth New Collegiate Dictionary 940 (1984). Id., at 357, n. 5. The purpose of the statute suggests that an additional gloss on the term "projected" would be "anticipate[d]", defined in part as "to give advance thought, discussion, or treatment to", Webster's Ninth New Collegiate Dictionary 991 (1991) or "predict[ed]", "to declare in advance, esp: foretell on the basis of observation, experience or scientific reason." Id., at 926.

[9] The court found it unnecessary to rely on legislative history because the statute was so clear. Id., at 358, n. 6.

In contrast, in Rowley v. Yarnall, 22 F.3d 190 (8th Cir. 1994), construing precisely the same language in a Chapter 12 case[10], the Eighth Circuit concluded that the debtors must commit all actual disposable income to the plan in order to confirm it and ultimately receive a discharge. Although the court conceded that a "plain reading of the statute might appear to support the [debtors'] position", it stated that such a reading yielded an "absurd result". Id., at 192. As an example, the court stated that such a reading could result in a zero distribution to unsecured creditors. Id.[11] "Section 1225(b) would serve no

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[10] Chapter 12 was modeled on Chapter 13, and Chapter 13 jurisprudence may be taken as a guide for much of Chapter 12 jurisprudence. E.g., Arkison v. Plata (In re Plata), 958 F.2d 918, 921 n. 9 (9th Cir. 1992).

[11] The court made no reference to Section 1225(a)(4), which requires for confirmation a distribution on unsecured claims of "not less than the amount that would be paid on such claim[s] if the estate of the debtor were liquidated under chapter 7...." The wording of Section 1325(a)(4) is identical. In consequence, Chapter 13 plans are confirmed which project a zero distribution on unsecured claims. 8 Collier on Bankruptcy (Rev. Ed. 2000), ¶1325.08[1] at 1325-47. "We agree with the Eighth Circuit that '[a] per se minimum payment requirement to unsecured creditors as an element of good faith would infringe on the desired flexibility of Chapter 13 and is unwarranted.'" Flygare v. Boulden, 709 F.2d 1344, 1348 (10th Cir. 1983) (citation omitted). See also In re Edwards, 51 B.R. 792, 793 (Bankr. D.N.M. 1984) ("[I]t is clear that the percentage of dividend received by unsecured creditors will not, in and of itself, be grounds for denying the confirmation of a plan, assuming that the creditors get at least as much as they would in a liquidation proceeding." (citing Flygare v. Boulden)).

purpose other than a mechanical one." Id.[12] The court then examined the legislative history of Chapter 12, compared it with the provisions of Chapter 11 (rather than referring to Chapter 13), and concluded that "[w]hile the statute may be less than facially ambiguous", id. at 193, Congress could not have intended anything but to require the debtors to commit all their disposable income. Id., 192-93.[13]

The Court is convinced that the Ninth Circuit's reasoning and interpretation of the Code are more persuasive. Congress easily could have required the payment of actual disposable income, but it did not. And while requiring the payment of actual disposable income would in some ways make administration of the process easier, especially for the Trustee, we are bound to enforce the statute as clearly written. Contrary to the conclusion drawn by the Eighth Circuit, requiring the payment of only "projected" disposable income is not an absurd result. The

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[12] In a sense, a "mechanical" (as in "arithmetic") test is apparently what Congress intended. See Commercial Credit Corporation v. Killough (Matter of Killough), 900 F.2d 61, 64 (5^{th} Cir. 1990). Presumably the Rowley court intended to use the term in the sense of "merely going through the motions".

[13] In an earlier case, involving one of the same judges that sat on the Rowley panel, the Eighth Circuit confirmed a Chapter 13 plan because it included all the debtor's disposable income. Education Assistance Corporation v. Zellner, 827 F.2d 1222 (8^{th} cir. 1987). However, the issue addressed was whether debtor was correctly estimating his expenses and projecting his income, id. at 1226, and not the specific issue addressed by Rowley.

Court therefore holds that the Debtors' need only commit their "projected disposable income" to the plan. While it is certainly possible that in some instances, a debtor may suddenly have a substantial increase in income, for example, by winning the lottery, such an occurrence cannot ordinarily be anticipated. Rather, that eventuality is addressed by Section 1329(a), which permits, among other things, modification of the plan payments upon request of the debtor, the trustee or other parties. Anderson, 21 F.3d at 358.

That in turn raises the issue of who bears the burden of monitoring and reporting, if necessary, changes in the Debtors' income or expenses. The Trustee argues that putting the burden on the Debtors to pay additional income into the plan unless they provide a sufficient reason not to, is the most practical solution to the problem. E.g., 2 Lundin, Chapter 13 Bankruptcy §5.35 at 5-99 (2nd ed. 1997) (requiring Chapter 13 trustee to periodically review every pending case to determine whether income and expenses have been properly adjusted would require hundreds if not thousands of hours of additional work each year). After all, the Debtors are easily in the most advantageous position to quickly and accurately determine their changing levels of expenses and income, and would have the incentive to report an increase in expenses, and can easily be required to pay excess income into the plan. But, as set out above, the Code does not require the Debtors to automatically pay excess income, disposable or otherwise, into the plan, except to the extent the excess income qualifies as “projected disposable income.” Section 1325(b)(1)(B). That leaves the Trustee with the option of requesting updates, as unsatisfactory as that may be. A reasonable reporting requirement should not unduly burden debtors in carrying out a Chapter 13 plan, and the imposition of that burden on the debtors, which will allow the Trustee the opportunity to consider modifications, seems particularly appropriate. The Court will not now rule what the extent of the burden should be, leaving that issue rather to be negotiated among the parties and decided by the Court only as necessary.

Whether the tax refunds must be committed to the plan is a different question than the “form” in which the money comes into the estate and is used by the Debtors. First, there is nothing to prevent the Debtors from accruing a refund by means of having the government withhold more than is needed from each paycheck, and then receiving that refund in the form of a lump sum payment.[14] Although such a “savings plan” generates no interest

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[14] Of course, such an accrual device has to be reflected accurately in a debtor’s schedules and plan, and is subject to a test of good faith and reasonableness, but those requirements are imposed on a Chapter 13 debtor in all aspects of the Chapter 13. Additionally, if there is an objection by the trustee or an unsecured creditor, the plan must meet the disposable income test of § 1325(b)(1)(B).

for a debtor, a taxpayer could use additional withholding as a means of providing a lump-sum fund of cash available each year for various needs.[15] There is no reason that Chapter 13 debtors should not be able to use the same device, as long as the lump sum received is accounted for on some basis in the plan.

Second, as the Trustee also concedes[16], there is nothing in the Code which precludes a debtor from developing and maintaining a contingency fund as part of the execution of a Chapter 13 plan. See In re Bottelberghe, __ B.R. __, 2000 WL 1464720 (Bankr. D. Mn. 2000)("[R]easonable reserve or contingency funds to meet unexpected or extraordinary expenses are also permissible family expenses.")(citations omitted); In re Belt, 106 B.R. 553, 562 (Bankr. N.D. In. 1989):

> The Code requires a meaningful and realistic budget accompanied by devotion of most of the debtor's surplus income to repay creditors. This is not to say, however, that the debtor must devote every penny of the disposable income to the plan in order to comply with § 1325(b)(1)(B). A reasonable reserve or contingency fund does not violate that section. Such a cushion is necessary in chapter 13 budgeting to guard against life's unexpectancies. It is not in the public's

[15] The Court can also take judicial notice that the distribution resulting from the earned income tax credit (EITC), paid out as it is in a lump sum (at least up to now), Sorenson v. Secretary of the Treasury of the United States, 477 U.S. 851, 854-55(1986), may be used by its recipients for once-a-year purchases, such as replacing the roof on a house, the purchase of a replacement vehicle, etc. In that way the EITC serves a similar role to a tax refund.

[16] Chapter 13 Trustee's Reply Brief, at 2 and 4.

> interest to squeeze the last dollar from chapter 13 debtors to fund a chapter 13 plan. To do so would cause additional time and expense to the debtor, his counsel, and the trustee in constantly amending the plan to reflect the changes to the debtor's regular income and expenses, not to mention burdening the court's calendar.

(Citations and internal punctuation omitted). Nothing about being in a Chapter 13 case insulates debtors from the same unanticipated expenses that visit themselves on non-debtors. Indeed, given the straitened circumstances in which debtors usually find themselves, the chances of an uninsured medical expense, the breakdown of an older car without the funds to get it repaired, or similar crises, are probably greater for debtors than for the rest of the population as a whole. And if one of the goals of the Chapter 13 process is to teach debtors the skills of "saving for a rainy day", then such contingency funds should be encouraged. Compare In re Newton and Johnson, 161 B.R. 207, 219 (Bankr. D. Mn. 1993)(Plan based on a frugal budget, with no reserve for "unanticipated major automobile or home repairs, uncovered medical or dental expenses, education-related expenditures, and other financial burdens" was not confirmable.) And that would mean not only would the debtors be allowed (and encouraged) to include such a fund in their budgets, but logically at the successful conclusion of the plan they would be allowed to “take it with them” as they continue their economic lives after bankruptcy.[17]

For the foregoing reasons, the Court will deny the Trustee’s objection that goes to the commitment of future tax refunds to fund the plan.

RENTAL PROPERTIES

Exhibits 1 and 2 consist of the Debtors’ 1998 and 1999 federal income tax returns. The filing status on both returns is married filing jointly.

For 1998 Debtors had wages and business income of $55,175, a rental loss of $11,285, adjusted gross income of $43,579, and taxable income of $28,379. Total federal tax due was $4,877, and the Debtors received a $79 refund. Total state tax due was $1,029 and the Debtors received a $129 refund. The 1998 Schedule E showed three rental properties, only two are relevant to confirmation: 64th Street and Robin Meadows NW. 64th Street had rents of $9,020 and total expenses of $9,913 ($7,331 interest plus $2,582 other expenses), for a net cash outlay before taxes

[17] The question will undoubtedly arise about what amount is appropriate for such a contingency fund. That question should be answered as a separate matter, either in this case or another, since the parties have not addressed it directly. However, the Court would note the Congressional policy inherent in the Religious Liberty and Charitable Donation Protection Act of 1998, see 11 U.S.C. § 1325(b)(2)(A), by which Congress has determined that it is appropriate for debtors to direct up to 15% of the funds that would otherwise go to their unsecured creditors to religious and charitable institutions instead.

of $893. Depreciation expense on 64th Street was $3,111, giving a loss for tax purposes of $4,004. Robin Meadows had rents of $6,000 and total expenses of $7,039 ($6,739 interest plus $300 other expenses), for a net cash outlay before taxes of $1,039. Depreciation expense on Robin Meadows was $2,318, giving a loss for tax purposes of $3,357. Therefore, the tax loss for the relevant properties for 1998 was $7,361. The total cash outlay before taxes[18] for 1998 was $1,932.

For 1999 the Debtors had $56,389 from wages and "1099-Misc" income, $214 of interest, a rental loss of $7,965, adjusted gross income of $48,248, and taxable income of $30,657. Total federal tax due was $4,601 and the Debtors received a $88 refund. Total state tax due was $1,167 and Debtors owed $45. 64th Street had rents of $10,200 and total expenses of $11,489 ($6,693 interest plus $4,794 other expenses), for a net cash outlay before taxes of $1,289. Depreciation expense on 64th Street was $3,111, giving a loss for tax purposes of $4,400. Robin Meadows had rents of $7,800 and total expenses[19] of $9,047 ($6,731 interest plus $2,316 other expenses), for a net cash outlay before taxes of $1,247. Depreciation expense on Robin Meadows was $2,318,

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[18]Actually, the total cash outlay for both properties would be increased by the mortgages' principal reduction, but the Court does not have these figures, which are probably minimal.

[19]Neither the 1998 or 1999 return showed an expense for real estate taxes or insurance for Robin Meadows.

giving a loss for tax purposes of $3,565. Therefore, the tax loss for the relevant properties for 1999 was $7,965. The total cash outlay before taxes for 1999 was $2,536.

The Debtors were in the 15% marginal tax bracket for federal taxes for the past two years. 26 U.S.C. § 1(a)("There is hereby imposed on the taxable income of (1) every married individual who makes a single return jointly with his spouse... a tax determined in accordance with the following table: If taxable income is not over $36,900, the tax is 15% of taxable income").

The Debtors were in the 6.0% marginal tax bracket for state taxes for the past two years. § 7-2-7(B) N.M.S.A. 1978 (1999 Supp.)("For ... married individuals filing joint returns: if the taxable income is: Over $24,000 but not over $40,000, the tax shall be $768 plus 6.0% of excess over $24,000.)

Therefore, for 1998 there was a tax savings of $1,546 (21% of $7,361) as compared to an outlay of $1,932; for 1999 there was a tax savings of $1,673 (21% of $7,965) as compared to an outlay of $2,536. In other words, there was a real, after tax cost to hold these properties of $386 in 1998 and $863 in 1999.

The Court finds that it should not confirm the plan. First, the Court finds that the budget represented by the amended Schedules I and J is not feasible because it omits rental property expenses[20]. The mortgage payments are listed, but the only other rental expense is the $25 monthly water bill. The income tax returns show that actual, non-mortgage, expenses were $2,882[21] in 1998 and $7,110[22] in 1999. The current level of rents, $1,495 is substantially the same as the $1,500 mortgage payment listed. There is no room in the budget to fund the other rental property expenses, which are not insignificant. The plan is not feasible. See 11 U.S.C. § 1325(a)(6)(Debtor must be able to make all payments under the plan for it to be confirmable.)

Second, the Debtors expressed their desire to keep the rental properties, and cited tax reasons as the main reason. As the above analysis shows, however, even with the tax deductions there is a negative cash flow of, conservatively, about $70 per month. This cash should be used to fund a plan, not to meet the cash flow deficit on real estate investments. See In re Lindsey, 122 B.R. 157, 158 (Bankr. M.D. Fl. 1991)("[T]he court may not and should not permit the Debtors to use a Chapter 13 plan to retain and increase their equity in investment property at the expense

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[20]The Court also notes that the Amended Schedule J does not include any proposed self-employment tax for Ms. Facio's monthly projected $1,735 "contract work". Debtors' 1998 return included a self-employment tax liability of $621 based on $4,394 of business income. The 1999 return did not calculate a self-employment tax liability.

[21]$2,582 for 64th Street plus $300 for Robin Meadows.

[22]$4,794 for 64th Street plus $2,316 for Robin Meadows.

of their unsecured creditors.”); In re Cardillo, 170 B.R. 490, 491 (Bankr. D. N.H. 1994)(“[T]o the extent that this condominium is not self sufficient, the deficiency is being paid out of what would otherwise be disposable income available for the benefit of the Debtor’s other creditors.”) The Court finds that a plan which seeks to keep investment property at the expense of unsecured creditors is not proposed in good faith. See 11 U.S.C. § 1325(a)(3)(Plan must be proposed in good faith to be confirmable.)

EMPLOYER AS CREDITOR

The Debtors’ amended Schedule I shows a proposed repayment of a loan from Mr. Leon-Guerrero’s employer of 13 years, a non-profit organization, in the amount of $207.30 per month. Mr. Leon-Guerrero testified that this loan, in the original amount of $13,300 was a seven year loan that will be paid off in 2005. He wants to pay this creditor directly. He testified that the loan was made to him when he asked for a higher salary and they were unable to give it to him. He stated that the purpose of the loan was to help him with his financial situation at the time because he was having financial difficulties. This loan is currently repaid by payroll deduction.

The Court finds that the “plan” in this case actually consists of the plan filed with the Court plus the direct payments to the employer anticipated by Schedule I. Essentially the plan creates two classes of unsecured creditors: those dealt with by the plan who will receive only a small percentage dividend, and the employer who will be paid 100% directly by payroll withholding. See In re Tatum, 1 B.R. 445, 446 (Bankr. S.D. Oh. 1979)(Plan that pays some unsecured creditors outside of plan and some inside plan classifies claims.); In re Green, 70 B.R. 164, 167 (Bankr. W.D. Ar. 1986)(Court finds unfair discrimination and refuses to confirm plan with direct payments to unsecured creditor.)

Section 1322(b) of the Bankruptcy Code provides:

> [T]he plan may–
> (1) designate a class or classes of unsecured claims, as provided in section 1122 of this title, but may not discriminate unfairly against any class so designated.

Therefore, the Bankruptcy Code permits classification, but only if the classifications do not discriminate unfairly.

> A classification is not ipso facto unfairly discriminatory because it provides for a greater percentage of payment to some unsecured creditors than to others. A debtor, however, bears the burden of showing that the proposed classification does not unfairly discriminate. In re Wolff, 22 B.R. 510 (9th Cir. B.A.P. 1982). This is consistent with the general burden on the Chapter 13 debtor to show that the proposed plan ought to be confirmed. In re Elkind, 11 B.R. 473 (Bankr. D. Co. 1981); In re Crago, 4 B.R. 483 (Bankr. S.D. Oh. 1980).
>
> Factors to be considered by the court in determining whether a classification unfairly discriminates are: 1) whether the discrimination has a reasonable basis, 2) whether the debtor can carry out a plan without such discrimination, 3) whether such discrimination is proposed in good faith, and 4) the treatment of the class discriminated against. In re

> Dziedzic, 9 B.R. 424, 427 (Bankr. S.D. Tx. 1981); see also In re Gay, 3 B.R. 336 (Bankr. D. Co. 1980); In re Blackwell, 5 B.R. 748 (Bankr. W.D. Mi. 1980).

Worthen Bank & Trust Company, N.A. v. Cook (In re Cook), 26 B.R. 187, 190 (D. N.M. 1982).

In this case, the Court finds that the Debtors have not met their burden of showing that the plan does not discriminate unfairly. The Court also finds that the proposed classification fails the Cook test and in fact discriminates unfairly. First, the Court finds no reasonable basis to discriminate between the employer and the general unsecured creditors. All of their claims are general, unsecured, non-priority claims. Mr. Leon-Guerrero testified that the loan was to help him with his financial difficulties. There is nothing unique about this that would justify different treatment than that given to, for example, credit card claims. Second, the Court finds that the Debtors could carry out their plan without this discrimination. Mr. Leon-Guererro testified that while he would not feel right not paying back the loan, there have been no threats or indications that his employment would be in jeopardy if he failed to make direct payments on this loan. Furthermore, there is nothing that prevents the Debtors from treating this loan as not dischargeable in their chapter 13 if they so desire, and they can pay the loan eventually. Third, the Court finds that this classification was not proposed in “good faith”. Under the current classification scheme the Debtors propose to pay $207 per month directly out of their disposable income to one unsecured creditor, but less than that to all other creditors combined. This is not to say the Court is finding “bad faith”; it is understandable that a Debtor would want to pay his employer. Good faith, however, embodies a reasonably best effort approach to repaying creditors. The Court does not find this best effort in the proposed plan. Fourth, the proposed treatment of the unsecured creditors is unfair. As discussed above, it is unfair to pay one unsecured creditor more than all the others combined. See In re Tennis, 232 B.R. 403, 405 (Bankr. W.D. Mo. 1999)(“[I]t is hardly reasonable to compel certain unsecured creditors to accept payments totaling some 15% of their claims while other creditors, who happen to be friends of the Debtor, are repaid 100% of the amounts they have loaned the debtor.”) Therefore, the treatment fails the Cook test, and discriminates unfairly. Therefore, the plan is not confirmable. 11 U.S.C. § 1325(a)(1) and § 1322(b)(1)(Plan must comply with provisions of Chapter 13; Chapter 13 allows classification but may not discriminate unfairly.)

As an alternate argument, Debtors claim that repayment of the employer should be viewed as a recoupment, citing Aetna Life Insurance Company v. Bram (In re Bram), 179 B.R. 824 (Bankr. E.D. Tx. 1995) and Anthem Life Insurance Co. v. Izaguirre (In re

Izaguirre), 166 B.R. 484 (Bankr. N.D. Ga. 1994). Their argument is that the employer loan and the Debtor's continued employment are one transaction, and the employer should be allowed to recoup from postpetition wages the amount it loaned to Debtor prepetition. The Court disagrees. First, both Bram and Izaguirre involve prepetition overpayments on disability insurance contracts where there was a continuing postpetition duty of the insurer to continue to make payments to the Debtor postpetition based on a prepetition event, the disability. Bram, 179 B.R. at 826; Izaguirre, 166 B.R. at 487. The duty to make payments in the future and the prior overpayments were, in both cases, contractual matters arising from a single contract. In this case, however, the employer's duty to pay future wages will be based only on the Debtor's postpetition employment. Furthermore, the Court finds that the loan transaction was a different transaction from the employment relationship, which pre-dated the loan by at least ten years.

> "The fact that the same two parties are involved [in the claims to be offset], and that a similar subject matter gave rise to both claims ... does not mean that the two arose from the 'same transaction'" for purposes of the doctrine of recoupment. Lee v. Schweiker, 739 F.2d 870, 875 (3rd Cur, 1984). In fact, courts have generally only found this "same transaction" requirement to be satisfied when the debts to be offset arise out of a single, integrated contract or similar transaction. See In re B & L Oil Co., 782 F.2d at 157-158; Quittner v. Los Angeles Steel Casting Co., 202 F.2d 814, 816 (9th Cir. 1953).

Davidovich v. Welton (In re Davidovich), 901 F.2d 1533, 1538 (10th Cir. 1990).

In addition, the doctrine of recoupment is an exception to the general bankruptcy scheme and goal of equal distribution to claimants. Conoco, Inc. v. Styler (In re Peterson Distributing, Inc.), 82 F.3d 956, 959 (10th Cir. 1996). As such, the doctrine of recoupment should be narrowly applied. Id. See also Ashland Petroleum Company v. Appel (In re B & L Oil Company), 782 F.2d 155, 158 (10th Cir. 1986). Recoupment also constitutes an exception to the policy of not paying pre-petition debts by means of post-petition transactions. Id. "Any recoupment exception to this general principle perhaps should be narrowly construed." Id. Indeed, the Tenth Circuit, having recognized and applied the doctrine of recoupment in a bankruptcy case in B & L Oil[23], then limited the application of B & L Oil when it decided Peterson Distributing:

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[23] In that case, plaintiff Ashland Oil had overpaid B & L Oil Co., prepetition, on purchases of oil by about $90,000. Shortly after receipt of the overpayments, B & L filed a chapter 11 petition. Ashland continued to take deliveries of oil from B & L postpetition, until it had generated a postpetition "obligation" with B & L of about $81,000. Ashland then asserted that it did not owe the $81,000 to B & L because of the recoupment doctrine. The Tenth Circuit agreed with that position. The result was that a prepetition unsecured claim was repaid almost or entirely dollar-for-dollar in a post petition transaction, which transaction also resulted in the depletion of the nascent chapter 11 estate's cash resources. It is hard to imagine a result more at odds with the general goals of the bankruptcy process.

> In light of recoupment's equitable foundation, the doctrine is only applicable to claims that are so closely intertwined that allowing the debtor to escape its obligation would be inequitable notwithstanding the Bankruptcy Code's tenet that all unsecured creditors share equally in the debtor's estate.

Peterson Distributing, 82 F.3d at 960.

For the foregoing reasons, the Court concludes that recoupment is not available to the Debtors.

DISPOSABLE INCOME

The Court also finds that the treatment proposed by the plan violates the disposable income requirement. Section 1325(b)(1)(B) provides:

> If the trustee or the holder of an allowed unsecured claim objects to the confirmation of the plan, then the court may not approve the plan unless, as of the effective date of the plan–
>
> > ...
> > (B) the plan provides that all of the debtor's projected disposable income to be received in the three-year period beginning on the date that the first payment is due under the plan will be applied to make payments under the plan.

Disposable income is defined in Section 1325(b)(2) as:

> 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 a 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.

The Court finds that the negative cash flow related to the rental properties is a drain on disposable income; without the rental properties the disposable income would be higher. See Cardillo, 170 B.R. at 491. The Court also finds that the $207 payroll deduction is includable in disposable income. It is not necessary for maintenance or support, nor is it an expense necessary for the continuation of a business. See In re Grear, 163 B.R. 524, 527 (Bankr. S.D. Il. 1994)(Plan that proposes to pay certain trade creditors directly outside of plan fails disposable income test.) Because the plan does not pay all disposable income for 36 months, it violates Section 1325(b)(1)(B) and is not confirmable.

CONCLUSION

For the various reasons set forth above, the Court will enter an Order denying confirmation of the Debtors' Chapter 13 plan. The Court will also order that the Debtors have 20 days from the entry of this order to file an amended plan, convert the case, or dismiss.

Honorable James S. Starzynski
United States Bankruptcy Judge

I hereby certify that, on the date stamped above, a true and correct copy of the foregoing was either electronically transmitted, faxed, delivered or mailed to the listed counsel and parties.

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