UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF NEBRASKA

IN THE MATTER OF	)	
	)	
FAY ROBIN MICHELSEN,	)	CASE NO. BK93-81233
	)	
DEBTOR	)	CH. 13

MEMORANDUM

Hearing was held on December 8, 1993, on the Amended Chapter 13 Plan filed by the debtor. Appearing on behalf of debtor was Mary Powers of Omaha, Nebraska. Kathleen Laughlin appeared as Chapter 13 Trustee. This memorandum contains findings of fact and conclusions of law required by Fed. Bankr. R. 7052 and Fed. R. Civ. P. 52. This is a core proceeding as defined by 28 U.S.C. § 157(b)(2)(L).

Background

The debtor, Fay Robin Michelsen, filed a petition for Chapter 13 bankruptcy relief on July 28, 1993. Filing No. 1. The debtor filed bankruptcy after falling behind on residence mortgage payments. The debtor's Amended Chapter 13 Plan was filed on October 13, 1993. Filing No. 13.

The debtor is single, thirty-five years old, and employed by 3M Company, where she earns $2,306.42 per month before taxes. At 3M, the debtor has participated in the Employee Voluntary Investment Plan (VIP) for approximately six years. The VIP is an ERISA-qualified retirement savings plan pursuant to which an employee may commit from two percent to sixteen percent of pre-tax earnings to the plan.

In January 1991, and again in August 1992, the debtor borrowed money from the plan in the amounts of $2,000.00 and $2,400.00 respectively. Both loan documents state that in consideration of the loans, the debtor agreed to pledge and assign to the plan the remaining funds in her VIP Savings Plus Account. Affidavit of Fay Michelsen, attached exhibits 2 & 3. To pay back these loans, the debtor authorized the plan to deduct installment payments automatically through a payroll deduction. The loan documents state that the amount deducted from each paycheck is $23.13 for the $2,000.00 loan and $35.17 for the $2,400.00 loan, which is a total of $58.30 per paycheck.

On December 31, 1993, the amount of debtor's interest in the plan was $11,367.99. However, $4,132.08 of loan principle remained

unpaid, so her actual vested value was $7,235.91. During the Chapter 13 case, the debtor has discontinued making contributions to the plan. However, throughout the pendency of her bankruptcy case, she has continued to authorize payroll deductions to repay her loan.

The debtor's Chapter 13 bankruptcy plan proposes to pay $200.00 per month to the Chapter 13 trustee for distribution to her secured and unsecured creditors for a plan period of thirty-six months. The plan will pay priority and allowed secured claims, including her plan loans, in full and distribute the remaining proceeds to unsecured creditors under the plan. The debtor estimates that the unsecured creditors will receive 66% of their claims under the plan.

The debtor proposes to pay the loans from her retirement plan in full by continuing with payroll deductions throughout the duration of the plan. The trustee filed a resistance to the treatment of the debtor's retirement plan loan. The trustee alleges that the debtor is not submitting all of her disposable income to the plan because the debtor continues to authorize a payroll deduction of $134.33 to repay the plan loan. The trustee suggests that this payment actually funds the retirement plan since all proceeds accrue to her benefit by increasing the vested value of her retirement fund.

The trustee argues that the retirement plan asset is not part of the bankruptcy estate, and since the loan from the plan is either not a debt (for bankruptcy purposes) or, at best, an unsecured obligation, the debtor is unfairly discriminating against other unsecured creditors under 11 U.S.C. § 1322(b)(1). The treatment unfairly discriminates because other unsecured creditors are receiving significantly less return on their claims in comparison to the plan loans being paid 100%. The trustee requests that the Court order the debtor to amend her Chapter 13 plan and schedules to properly account for the plan loans and, if the debtor is permitted to continue paying the plan loans, all payments on the plan loans be made through the trustee and not by payroll deduction.

Discussion

The plan loan assets, including the note, are not property of the estate. The Bankruptcy Code at 11 U.S.C. § 541(c)(2) prohibits the transfer of property of debtor to the estate if the property is subject to a restriction on the transfer enforceable under "applicable non-bankruptcy" law. Patterson v. Shumate, ___ U.S. _, 112 S. Ct. 2242 (1992) (holding that ERISA-qualified investment plans are excluded from the bankrupt estate under Section 541(c)(2) because the anti-alienation requirement contained the ERISA statute would constitute "applicable non-bankruptcy" law under the bankruptcy code). The parties do not dispute that the retirement

plan is ERISA-qualified, and therefore, contains an anti-alienation clause. The debtor's funds in the plan are, therefore, unavailable to the debtor's creditors. In re Scott, 142 B.R. 126, 130 (Bankr. E.D. Va. 1992) (citing Moore v. Raine (In re Moore), 907 F.2d 1476 (4th Cir. 1990).

Because the plan assets are not property of the estate, there is no property in the estate to secure the plan loan. Scott, 142 B.R. at 132. "The accepted rule is that the assignment of future wages as security for a present debt does not constitute a lien within the meaning of the Bankruptcy Code." Id. (quoting In re Miranda Soto, 667 F.2d 235, 237 (1st Cir. 1981) (citing cases)). If the plan loan is not a secured loan, it must be determined whether it is an unsecured debt or whether for bankruptcy purposes it is not a debt.

Cases discussing loans against ERISA-qualified plans conclude that a loan that pledges benefits in a retirement plan is not a debt under the Bankruptcy Code. In New York City Employees' Retirement System v. Villarie, 648 F.2d 810 (2nd Cir. 1981), the Second Circuit found that a loan against a city retirement system represented an advance of the employee's future benefits and did not constitute a "debt" or a "claim" under 11 U.S.C. §§ 101(12), 101(5)(A) because the loan did not create a liability that the retirement plan can enforce against the debtor or the debtor's estate. 648 F.2d at 811-12.

In re Jones applied the Villarie holding to a loan pledged with the benefits of an ERISA-qualified plan and concluded that no "debt" or "claim" existed because the only recourse available to the retirement plan was to offset the debtor's future benefits and to report the debtor's unpaid loan balance to the Internal Revenue Service as earned income and as subject to an early withdrawal penalty tax. 138 B.R. 536, 538-39 (Bankr. S.D. Ohio 1991). The judge in Jones concluded that, as in Villarie, any loan payments not made to the retirement plan are offset from the debtor's future benefits by the retirement plan. Id. at 538.

In re Scott found the reasoning of Villarie and Jones persuasive and held that the ERISA-qualified plan did not have a right to repayment which could be asserted against the debtor. 142 B.R. 126, 130-31 (Bankr. E.D. Va. 1992). The Scott court believed that the debtor's loan constituted taking money out of his own account and replacing that money with a note; therefore, the obligation was not a debt because the retirement plan does not have a right to sue a debtor for taking out his own funds, but may set off the unpaid portion against the debtor's future benefits. Id. at 131.

In In re Miranda Soto, the First Circuit distinguished its case from Villarie by holding that the debtor's loan, which was pledged with the assets of a pooled retirement fund, was a

dischargeable debt under the Bankruptcy Code. 667 F.2d 235, 238 (1st Cir. 1981). The First Circuit, however, noted that unlike Villarie, where the debtor took a loan pledged by the debtor's individual retirement account, the debtor in Miranda Soto took out a loan pledged by an entire pool of retirement funds, and the loan amount available to the debtor was not restricted to a percentage of the contributions to the fund. Id.

The debtor's plan loans are not debts under the Bankruptcy Code. This case is analogous to Villarie, Jones and Scott because the retirement plan is ERISA-qualified, and the retirement plan's only recourse against the debtor is the pledge of the debtor's future benefits under the plan and the right to report the loan to the IRS as earned income and as subject to an early withdrawal penalty tax of ten percent. This debtor's retirement plan is distinguishable from Miranda Soto because the debtor's loan is limited to a percentage of her own individual retirement plan account.

The debtor argues that if this debt is not a debt, she should be permitted to pay off the plan loan because saving for her retirement is necessary for her maintenance under 11 U.S.C. 1322(b)(2). This Court has previously held that contributions to a retirement account while in bankruptcy is impermissible because the money that the debtor proposes to use to pay into a retirement plan is disposable income that should be paid to creditors. In re Cavanaugh, Neb. Bkr 93:449, 450 (Bankr. D. Neb. 1993). See also Scott, 142 B.R. at 134 (stating that earnings of the debtor are property of the estate under 11 U.S.C. § 1306(a)(2), and therefore, must be committed to the plan as disposable income to pay creditors, otherwise the debtor is taking an asset of the estate out of the reach of creditors); Jones, 138 B.R. at 538 (citing In re Carpenter, 23 B.R. 318, 319-21 (quoting In re Shepard, 12 B.R. 151, 153 (E.D. Pa. 1981) (stating that debtor's estate included "earnings from services performed by the debtor after the commencement of the case.")).

As a general rule, the debtor is required to deliver all disposable income to the trustee for distribution to her creditors. Both Jones and Scott reached the conclusion that a debtor could continue to authorize direct payroll deductions to pay back a retirement plan loan only if the debtor's Chapter 13 plan paid all unsecured creditors 100% of their claims. Those courts opined that the resulting tax consequences could not be avoided if the debtor was to propose a fair plan to the creditors. Jones, 138 B.R. at 539; Scott, 142 B.R. at 134-35. Both courts were concerned that future debtors would take out huge loans against their retirement accounts to insulate those funds from the estate and to preserve those funds for the debtors' future use. Jones, 138 B.R. at 539; Scott, 142 B.R. at 134.

However, there are instances when it is not unfair nor discriminatory for a debtor to pay a loan against an ERISA-qualified plan during the pendency of the bankruptcy plan. In this case, the debtor has not engaged in any behavior that suggests that she had an improper purpose when she took out the plan loans. The second plan loan was taken out almost one year before the debtor filed bankruptcy. Except for the plan loan payroll deduction, the debtor has discontinued making contributions to the retirement plan. The debtor's bankruptcy appears to be a result of her falling behind on mortgage payments, not because the debtor was acting recklessly. The debtor's schedules indicate that the debtor lives a modest lifestyle, and there is no evidence that the debtor has attempted to use the plan loans to shield her income from the bankruptcy estate. In addition, the debtor's three unsecured creditors are types of businesses that regularly deal with bankruptcy. Not one of these unsecured creditors has filed an objection to this debtor's Chapter 13 Plan.

For these reasons, it is not necessary for the debtor to be subject to the rule in Jones and Scott that requires the debtor to pay 100% to unsecured creditors before being entitled to have the plan loans repaid. If the plan loan cannot be repaid during the case, the amount of the loans will likely be deemed taxable income with taxes and penalties due. The impact that the increased tax liability would have on the pro rata distribution to the unsecured creditors in this case is significant. Not only would the loan proceeds be taxable income, but there is also a ten percent penalty for early withdrawal of the retirement plan funds. If the debtor is ordered to discontinue her payroll deduction payments, the estate will have the additional burden of the tax claim that it otherwise would not have.

Conclusion

The debtor may continue to authorize payroll deductions to pay her plan loan if she pays the unsecured creditors 100% of their claims minus the pro rata difference the tax claim would have on the estate. Since the loans are not debts under the Bankruptcy Code, it is not necessary for the debtor to pay them through the trustee if the debtor maintains payroll deductions. If the debtor cannot propose a 100% payment to unsecured creditors class minus the additional potential tax claims, the debtor is prohibited from paying the plan loan during the case and will have to deal with the IRS obligations resulting from the loan balance being deemed taxable income.

The plan is denied confirmation. Debtor granted thirty days to amend.

Separate journal entry to be entered.

DATED: May 2, 1994.

BY THE COURT:

/s/ Timothy J. Mahoney
Timothy J. Mahoney
Chief Judge

CC: Movant, Debtor(s) Atty. and all parties appearing at hearing
[ ] Chapter 13 Trustee [ ] Chapter 12 Trustee [ ] U.S.Trustee

Movant is responsible for giving notice of this journal entry to any parties in interest not listed above.

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF NEBRASKA

IN THE MATTER OF FAY ROBIN MICHELSEN, DEBTOR(S) Plaintiff(s) vs. Defendant(s)	CASE NO. BK93-81233 A CH. 13 Filing No. 13, 18, 24 JOURNAL ENTRY DATE: May 2, 1994 HEARING DATE: December 8, 1993

Before a United States Bankruptcy Judge for the District of Nebraska regarding Amended Chapter 13 Plan by debtor; Resistance and Amended Resistance by Trustee.

APPEARANCES

Mary Powers, Attorney for debtor
Kathleen Laughlin, Trustee

IT IS ORDERED:

Plan denied confirmation. Debtor granted thirty days to amend. See memorandum this date.

BY THE COURT:

/s/ Timothy J. Mahoney
Timothy J. Mahoney
Chief Judge

CC: Movant, Objector/Resistor (if any), Debtor(s) Atty. and all parties appearing at hearing
[ ] Chapter 13 Trustee [ ] Chapter 12 Trustee [ ] U.S.Trustee

Movant is responsible for giving notice of this journal entry to all other parties if required by rule or statute.