

UNITED STATES BANKRUPTCY COURT  
FOR THE DISTRICT OF NEBRASKA

IN THE MATTER OF

JANE E. CEDAR,

DEBTOR

)  
)  
)  
)  
)

CASE NO. BK93-81887

CH. 13

MEMORANDUM

Hearing was held on March 28, 1994, on the Chapter 13 Plan filed by the debtor. Appearing on behalf of debtor was Ray Aranza 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, Jane E. Cedar, filed a petition for Chapter 13 bankruptcy relief on November 15, 1993. Filing No. 1. The debtor's Chapter 13 Plan was filed on December 15, 1993. Filing No. 8.

The debtor is forty-four years old, separated from her husband, and may be named as the guardian of two young grandchildren. She is currently employed as a buyer for the Half Price Stores and earns approximately \$27,000 per year. Through her place of employment, the debtor participates in an ERISA-qualified retirement plan. The debtor contributes to her plan by having \$103.33 deducted from her paycheck each month through pre-tax payroll deductions. The balance of the debtors plan as of December 31, 1993 was \$3,869.59. However, the vested value of the debtor's retirement account is lower due to an outstanding loan balance.

On August 20, 1993, the debtor borrowed \$1,000 from her retirement plan. The current balance of the loan is approximately \$776.34. The loan document states that the balance of the loan is to be paid back at six per cent interest through payroll deductions of \$20.43 biweekly for fifty-two weeks. In addition, the note states that the loan is secured by the debtor's retirement account balance.

The debtor has continued to make contributions into her retirement plan and to authorize deductions from her paycheck to repay the loan during the pendency of her bankruptcy case.

The debtor's Chapter 13 bankruptcy plan proposes to pay \$270.00 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 in full and distribute the remaining proceeds to unsecured creditors under the plan. The unsecured creditors will most likely receive little or no dividend.

The debtor scheduled her retirement plan contribution and loan repayment as a payroll deduction before computing her disposable income for the bankruptcy plan. The debtor has offered to discontinue making contributions into her retirement plan during the execution of her bankruptcy plan, but the debtor desires to repay the loan in full by continuing with payroll deductions during the bankruptcy plan.

The trustee has 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 contribute \$103.33 to her retirement plan and authorize a payroll deduction of \$44.26 to repay the plan loan. The trustee suggests that these payments continue to fund the retirement plan since both payments 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 little or no dividend for 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 discontinue making retirement plan contributions and to properly account for the plan loans. In addition, if the debtor is permitted to continue paying the plan loans, the trustee requests that all payments on the plan loans be made through the trustee and not by payroll deduction.

#### Discussion

The retirement plan 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. This debtor's retirement plan is distinguishable from Miranda Soto because the debtor's loan is limited to the vested value of her own individual retirement plan account.

The debtor argues that if this debt is not a debt, it should be regarded as a social security or federal withholding deduction, which implies that the loan repayment should be permitted 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."))). Therefore, if the debtor may not use her earnings to make contributions into her account, it stands to reason that earnings used for loan repayments, which have the same effect as contributions by increasing the vested value of the debtor's retirement plan, should also be treated as disposable income.

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. In fact, the timing of the loan and the relatively low loan amount suggests that the money was borrowed as a last attempt to avoid bankruptcy. 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, no unsecured creditors have 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 increased tax liability will impact the pro rata distribution to the unsecured creditors. Not only would the loan proceeds be taxable income, but there is also a 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 must discontinue making contributions to her retirement plan. 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 13, 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	)	
	)	
JANE E. CEDAR,	)	CASE NO. BK93-81887
	)	A
<u>DEBTOR(S)</u>	)	
	)	CH. 13
	)	Filing No.
Plaintiff(s)	)	
vs.	)	<u>JOURNAL ENTRY</u>
	)	
	)	
	)	DATE: May 13, 1994
<u>Defendant(s)</u>	)	HEARING DATE: March 28,
	)	1994

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

Ray Aranza, 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.