

# In the United States Bankruptcy Court

## for the Northern District of Iowa

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DAVID R. HEGG  
ELAINE A. HEGG

Bankruptcy No. 95-62467-W

*Debtor(s).*

Chapter 7

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### ORDER RE: MOTION FOR TURNOVER AND MOTION TO AVOID LIENS

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The matters before the Court are Debtors' Motion for Turnover and Motion to Avoid Liens. A telephonic hearing was held on July 3, 1997. Present, by phone, were attorney Brian Peters representing Debtors, attorney Robert J. Cowie for creditor Postville Veterinary Clinic, and Trustee Habbo Fokkena. The parties prepared Stipulation of Facts for Hearing on Motion to Avoid Liens and Turnover and faxed it to the Court during the telephonic hearing. The parties agree that the Court may decide the case on the basis of the Motions and the stipulated facts. This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(A), (B), (K).

#### STATEMENT OF THE CASE

Debtors filed a joint Chapter 13 petition on December 18, 1995. They began making payments of \$40 per month to Trustee in January, 1996. Trustee filed an objection to Debtors' plan in February, 1996, indicating that Debtors' proposed sale of real property would leave them with no apparent source of income with which to fund their plan, as their Schedule I listed "income from real property" as their main source of income. The Court, at a February 14 hearing, gave Debtors 14 days within which to file an amended plan. On February 29, 1996, Debtors filed an explanation of how the plan was confirmable as originally proposed in lieu of an amended plan.

A series of collateral matters between Debtors and one creditor delayed confirmation of the plan. The primary item in dispute was ownership of land which Debtors planned to sell. These matters were finally resolved in favor of the creditor on October 15, 1996, with the determination that the land in question was not the property of Debtors. On that date the creditor in question filed a Motion to Dismiss the Chapter 13 case, asserting that Debtors' situation had changed pursuant to the resolution of these other matters such that the plan as originally filed was no longer feasible. This Motion to Dismiss was subsequently joined by Trustee on November 25, 1996, indicating Debtors were four monthly payments behind on their plan and had not made a payment since August 21, 1996.

Debtors filed a voluntary conversion to Chapter 7 on November 27, 1996. Chapter 13 Trustee disbursed \$280.12 to Chapter 7 Trustee on December 2, 1996, representing total payments received plus interest. The § 341 meeting of creditors was held on January 6, 1997. The only creditor present was the Postville Veterinary Clinic (Clinic), represented by attorney Robert Cowie. On February 27, 1997, Trustee filed a Report of Abandonment of Property, indicating that the following property would be abandoned:

All property listed by Debtors in Schedule A as per attached legal description and in Schedule B which has not otherwise been declared exempt or otherwise administered by Trustee EXCEPT proceeds from sale of various farm machinery and equipment.

Discharge of Debtors was issued on March 13, 1997, and May 27, 1997 was fixed for the filing of claims.

Debtors filed a Motion for Turnover and a Motion to Avoid Liens on May 19, 1997 seeking the turnover to Debtors of approximately \$2,700 held by Trustee as proceeds of the sale of certain farm equipment at auction. This sale was held on November 17, 1996, ten days before the Debtors converted from Chapter 13 to Chapter 7. The auctioneers turned the funds over to Chapter 7 Trustee. Debtors claim to be entitled to these funds as proceeds of the sale of exempt property. The equipment in question was listed as exempt as tools of the trade in Debtors' original Chapter 13 petition filed in December, 1995. Debtors state, inter alia, in their Motion that:

Creditor Postville Veterinary Clinic may claim an interest in these funds and in remaining farm machinery by reason of a filed security interest. Assuming that interest is valid, it is a non-purchase money security interest and should be avoided pursuant to 11 USC § 522 (f). This creditor also has possession of a tractor owned by Debtors. There is no basis for this creditor to retain that property, and Debtors request an order for turnover of that equipment and the avoidance of any lien claimed.

Debtors' Motion relies on their characterization of all of the property in question as exempt and subject to the lien avoidance provisions of § 522(f).

Clinic filed its Resistance to Debtors' Motion on May 21, 1997, claiming the equipment to be secured under its UCC filing, and claiming that the proceeds of sale are not exempt. Clinic requests turnover of the proceeds, and states the following concerning the tractor in its possession:

As to the tractor in possession of the Creditor, the Debtors voluntarily transferred the tractor to the Creditor in partial satisfaction of indebtedness owed by the Debtors to the Creditor more than 90 days preceding the filing of the bankruptcy. . . . The Creditor, Postville Veterinary Clinic is in rightful possession of such tractor and should not be required to return the same to the trustee or the Debtors.

Clinic requests turnover of the sale proceeds and denial of Debtors' Motions.

Trustee's Resistance to Turnover Order was filed on May 23, 1997, objecting to turnover of the proceeds of sale of equipment to Debtors based primarily on the following reasoning:

Prior to conversion to a Chapter 7, Debtors voluntarily converted "tools of the trade" assets into cash. Therefore, as of November 27, 1996, the date of conversion, Debtors no longer owned "tools of the trade". Instead, they owned cash proceeds.

Trustee asks the Court to deny Debtors' Motion for Turnover.

### 11 U.S.C. § 522(f)

Congress enacted § 522(f) with the broad purpose of protecting debtor's exempt property. Farrey v. Sanderfoot, 500 U.S. 291, 297 (1991). "Section 522(f) allows the debtor to avoid certain types of liens

on property that has been liberated from the bankruptcy estate." In re Morgan, 149 B.R. 147, 152 (9th Cir. BAP 1993). Certain liens which would otherwise survive bankruptcy are avoided under § 522(f), which reads in relevant part as follows:

(f)(1) [D]ebtor may avoid the fixing of a lien on an interest of the debtor in property to the extent that such lien impairs an exemption to which the debtor [is] entitled . . . , if such lien is . . . (B) a nonpossessory, nonpurchase-money security interest in any . . . (ii) tools of the trade of the debtor.

The statutory language of § 522(f) yields a four-part test for avoidance of a lien:

- (1) There must be an exemption to which the debtor "would have been entitled" under subsection (b) of § 522;
- (2) The property must be listed on the debtor's schedules and claimed as exempt;
- (3) The lien at issue must impair the claimed exemption; and
- (4) The lien must be either a judicial lien or another type of lien specified by the statute.

Morgan, 149 B.R. at 151; In re Mohring, 142 B.R. 389, 392 (Bankr. E.D. Cal. 1992). Tools of the trade are exempt property under Iowa Code sec. 627.6 up to a limit of \$10,000.

### EXEMPTION AS TOOLS OF THE TRADE

Debtors' Chapter 13 petition filed in December, 1995, listed on Schedule B - Personal Property, "Various farm machinery and equipment" as assets of the estate with a current market value of \$5,500. Debtors also list on Schedule C - Property Claimed as Exempt, the same machinery and equipment and claim the entire \$5,500 value as exempt under Iowa Code § 627.6, as "tools of the trade." Certain items of this machinery and equipment were sold by Debtors while under Chapter 13, just prior to conversion to Chapter 7. The sale was held on November 17, 1996, and Debtors' conversion to Chapter 7 was filed November 27, 1996. Trustee objects to treatment of the proceeds of this sale as exempt under Chapter 7. The sale was held prior to the conversion date and as of the commencement of the Chapter 7 case the exempt assets were no longer in the Debtors' possession. Trustee contends that prior to conversion to Chapter 7 Debtors voluntarily switched exempt assets for non-exempt cash. Trustee objects to the turnover to Debtor of this cash, which is now held by Trustee.

The issue presented is whether the proceeds from the sale of Debtors' farm equipment and machinery are exempt. The Court must decide whether to continue to give effect to exemptions as claimed in Debtors' Chapter 13 schedule 11 months prior to conversion, or to determine exemptions based on Debtors' actual assets as of the date of conversion to Chapter 7. This question was answered in In re Lindberg, 735 F.2d 1087 (8th Cir. 1984), as follows:

[A]n examination of what constitutes the property of the estate in a converted case leads us to conclude that the date of conversion controls what exemptions may be claimed from that property. . . . [I]n a case converted from Chapter 13 to Chapter 7, the property of the estate consists of all property in which the debtor has an interest on the date of conversion. . . . [T]he same date must control in determining what exemptions the debtor may claim from the estate.

Id. at 1090 (citations omitted). In Lindberg, debtors changed homesteads between their Chapter 13 filing and conversion. Id. at 1088. The court in In re Tracy, 28 B.R. 189 (Bankr. D.Me. 1983), explained that it was logical that the property of the estate be determined as of the date of conversion because all claims arising before the date of conversion are treated as if debtor commenced the bankruptcy action by filing a Chapter 7 petition on the date of conversion. Id. at 190, n. 1.

The status of certain assets of Debtors' estate changed between filing of their Chapter 13 petition and their conversion to Chapter 7. Debtors no longer retain some of those assets as of the conversion date and they can therefore no longer claim them as exempt. The conversion date controls both assets and exemptions, based on Debtors' interests in property as of the date of conversion. Lindberg, 735 F.2d at 1090. Any other treatment would be equally unfair to creditors and to debtors. When the debtor exercises the right to convert from Chapter 13 to Chapter 7 no policy reason suggests why creditors should not be put back in the same position as they would have been had the debtor never sought to repay his debts by filing under Chapter 13. Tracy, 28 B.R. at 190, n. 1.

Immediately prior to conversion, Debtors voluntarily sold some of the farm equipment claimed as exempt in their Chapter 13 petition for cash. Since the conversion date becomes the date for evaluation of assets and exemptions thereby superseding the Chapter 13 filing date, the substitution of cash in the estate where there had been exempt farm equipment adds to the estate by removing the value of that property from exempt status. As of the conversion date, the cash proceeds from the sale of some farm equipment claimed as exempt on their Chapter 13 petition were assets of the estate. Upon conversion, the estate is reevaluated and updated to reflect the current status of Debtors' interests in property. Where Debtors once owned exempt farm equipment they now possess non-exempt cash. This cash is property of the estate properly held for disbursement by Trustee. One of the elements Debtors must establish under § 522(f) is that the property in question be exempt. Since this property is not exempt, Debtors' Motion to Avoid Liens on the sale proceeds based on § 522(f) must be denied.

### **DISPOSITION OF PROCEEDS OF SALE**

The stipulated facts indicate that Clinic has a valid UCC lien on Debtors' farm equipment, including the items sold. The sale of these items gave rise to the cash proceeds now held by Trustee. This Court must determine the proper disposition of these proceeds.

Iowa Code sec. 554.9306(2), which addresses security interests on sold property, reads as follows:

[A] security interest continues in collateral notwithstanding sale, exchange or other disposition thereof unless the disposition was authorized by the secured party in the security agreement or otherwise, and also continues in any identifiable proceeds including collections received by the debtor.

The record is devoid of any indication that the sale was authorized by the secured party. The security interest upon such sale remains a continuously perfected interest through the tenth day of receipt of the proceeds by debtor, without any action on the part of the secured party. Iowa Code sec. 554.9306 (3). Debtors never received the cash proceeds as they went directly from auctioneers to Trustee, per the stipulated facts. Iowa Code sec. 554.9306(4) reads in part as follows:

In the event of insolvency proceedings instituted by or against a debtor, a secured party with a perfected security interest in proceeds has a perfected security interest only in the following proceeds:

...

b. in identifiable cash proceeds in the form of money which is neither commingled with other money nor deposited in a deposit account prior to the insolvency proceedings;

The cash proceeds in this case were not commingled with other funds and were not deposited prior to insolvency proceedings. They went directly to Trustee from the auctioneers. Clinic's perfected security interest continues, without any action on the part of Clinic, since Debtor has not yet received funds. As proceeds of an unauthorized sale of secured property, the funds held by Trustee are properly turned over to Clinic as the perfected security interest continues in the proceeds.

### **PROPERTY HELD BY CREDITOR**

The stipulated facts establish that Clinic is in possession of a tractor and a manure spreader owned by Debtors. These were voluntarily turned over by Debtors prior to the Chapter 13 filing. There was no agreement as to transfer of ownership at the time. Debtors move for turnover of the tractor and spreader. Clinic states in its motion that the equipment in question was voluntarily turned over by Debtors "in partial satisfaction of indebtedness owed by the Debtors to the Creditor." This equipment is part of the Debtors' farm equipment and machinery in which Clinic holds a security interest.

Debtors move for avoidance of this security interest pursuant to 11 U.S.C. § 522(f) and turnover of the tractor and manure spreader. An element of § 522(f)(1)(B) requires that the security interest be "a nonpossessory, nonpurchase-money security interest." This element must be satisfied if Debtors are to avoid the security interest held by Clinic. The stipulated facts establish that the security interest is a nonpurchase-money security interest.

The Court must also consider the effect of the term "nonpossessory" in the context of § 522(f). "[T] here is no overwhelming majority construction of nonpossessory security interest for purposes of § 522(f)." In re Vann, 177 B.R. 704, 709 (D.Kan. 1995). Case law is divided on whether a nonpossessory lien loses its nonpossessory character when the property is in the possession of the lien-holding creditor. In re White, 203 B.R. 613, 616 (Bankr. N.D. Tex. 1996). However, cases in this district have consistently held that the nonpossessory character is not lost when the property is in the possession of the creditor under such lien.

Where the parties originally enter into a nonpossessory security agreement perfected by filing, a clause giving the secured party right to possess the collateral upon default does not render the security interest possessory within the meaning of 11 U.S.C. § 522(f)(2)(B) where the secured party repossesses the equipment by self-help or by judicial action.

In re Schultz, 101 B.R. 68, 71 (Bankr. N.D. Iowa 1989).

This Court has determined in prior rulings that a nonpossessory security interest is not transformed into a possessory security interest by virtue of repossession under a writ of execution. In re Lawrey, Ch. 7, No. 86-02399F, slip op. at 8 (Bankr. N.D. Iowa April 13, 1987). See also In re Sobolik, Ch. 7, No. 86-01880W, slip op. at 9 (Bankr. N.D. Iowa February 23, 1987), aff'd No. C87-2024, slip op. (N.D. Iowa August 4, 1987). The Iowa cases do not address, however, the question of whether a voluntary surrender of collateral after default would create a possessory security interest. Schultz, 101 B.R. at 72.

Clinic's security interest allowed Debtors to retain possession of the equipment and machinery covered under the instrument from the outset. This is indicative of the nonpossessory nature of the original agreement between the parties. There is no evidence that a possessory security interest was ever intended by the two parties. If a security interest is originally intended by the parties to be nonpossessory, it does not change its character when the creditor takes possession of the collateral to enforce its lien on default. In re Kinnemore, 181 B.R. 516, 519 (Bankr. D.Idaho 1995).

However, Debtors did turn over the tractor and spreader to Clinic sometime prior to Chapter 13 petition, and the two machines have been in Clinic's possession ever since. The stipulation states that Debtors voluntarily agreed to such possession, but did not agree to transfer ownership. The Court in Kinnemore considered agreed changes in possession by stating: "It is not significant that the Debtors and Creditor agreed that the creditor could take possession of the collateral upon default. Every security interest is, by Bankruptcy Code definition, the product of agreement. 11 U.S.C. § 101(50)." 181 B.R. at 519-520. The voluntary turnover of the equipment by Debtors to Clinic does not convert Clinic's security interest to possessory.

The tractor and spreader were subject to a nonpossessory, nonpurchase-money lien, they were tools of Debtors' trade, and they were exempt except for Clinic's lien. Thus they satisfy the elements of § 522 (f)(2)(B)(ii) for lien avoidance. Debtors' Motion to Avoid Liens, as it relates to the equipment held by Clinic, is sustained. Debtors' request for turnover of that same equipment is also sustained.

#### **LIEN AVOIDANCE--REMAINING EQUIPMENT**

Clinic holds a security interest on Debtors' farm equipment. Some of that equipment was sold just prior to conversion to Chapter 7, and some of that equipment is presently in the possession of Clinic, and is to be turned over to Debtors. The Court has not been informed as to whether the equipment sold and the equipment presently held by Clinic exhaust the farm equipment in which Clinic has a security interest, or whether Debtors may be in possession of additional equipment covered by Clinic's security interest. In the event that Debtors hold additional equipment, the Court addresses lien avoidance as it relates to such equipment.

Debtors move for avoidance of the Clinic lien under 11 U.S.C. § 522(f). Any farm equipment covered by Clinic's lien and presently held by Debtors qualifies under § 522(f)(1)(B)(ii) for lien avoidance because it meets all of the elements of that code section. The total exemption amount claimed for tools of the trade on Debtors' Schedule C is \$5,500. Clinic's lien on any such property is avoided.

**WHEREFORE**, Debtors' Motion for Turnover of \$2,700 cash proceeds of sale of equipment is DENIED.

**FURTHER**, Trustee is ordered to turn over to Postville Veterinary Clinic the \$2,700 cash proceeds of sale of equipment.

**FURTHER**, Debtors' request for turnover of the tractor and manure spreader in Clinic's possession and for avoidance of lien on such equipment is SUSTAINED.

**FURTHER**, Debtors' Motion to Avoid Lien of Clinic on any farm equipment claimed as exempt and remaining in Debtors' possession is SUSTAINED.

**SO ORDERED** this 22nd day of July, 1997.

Paul J. Kilburg  
U.S. Bankruptcy Judge