In the United States Bankruptcy Court

for the Northern District of Iowa

KEVIN L. KNIEF
Debtor(s).

Bankruptcy No. 96-21301-D
Chapter 12

ORDER RE CONFIRMATION OF DEBTOR'S AMENDED AND SUBSTITUTED PLAN OF REORGANIZATION

This matter came before the undersigned on September 3, 1997 for hearing on confirmation of Debtor's Amended and Substituted Plan of Reorganization. Debtor Kevin Knief appeared, represented by Francis Henkels. The United States on behalf of the Farm Service Agency (FSA) was represented by Martin McLaughlin. Attorney Steven J. Kahler appeared for Maquoketa State Bank. Carol Dunbar appeared as Chapter 12 Trustee. After presentation of arguments of counsel, the Court took the matter under advisement. This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(L).

STATEMENT OF FACTS

Maquoketa State Bank has a claim of approximately $32,000 secured by a first mortgage lien on Debtor's real estate and a general security interest in Debtor's property. Debtor proposes to reduce the amount of the claim to $25,000 within 120 days after confirmation, in part through turnover of proceeds of the sale of machinery and equipment, including an IH tractor. The Plan provides that at the time the Bank's claim is reduced to $25,000, the Bank would release its first lien position in $4,755 in crop insurance proceeds on deposit in Debtor's account at the Bank. The Plan further states that unsecured claims in Class 8 would receive payment, in part, "[i]f Debtor receives the crop insurance proceeds of approximately $4,800." In the alternative, unsecured creditors would be paid prorata from Debtor's disposable income over 36 months.

FSA's secured claim amounts to $235,000. It has a general security interest in Debtor's real estate and personal property, subordinate to the Bank's first lien position. The Plan provides that upon confirmation FSA shall terminate its interest in all personal property and after-acquired assets and retain a security interest in only Debtor's real estate subject to the Bank's interest. The Plan states the market value of the real estate is $313,500. The parties agree that FSA's claim is oversecured. The Plan provides for full payoff of FSA's claim over time. FSA has agreed to accept approximately $1,400 of ASCS benefits currently due to Debtor as partial payment toward its claim.

FSA objects to payment of the $4,755 of crop insurance proceeds to unsecured creditors. It asserts that either the Bank or FSA should receive these proceeds which constitute collateral on which the Bank has a first lien and FSA has a second lien. Trustee objects to turnover of proceeds of collateral directly to secured creditors without payment of trustee fees.

TRUSTEE FEES

Trustee's objection is governed by In re Wagner, 36 F.3d 723 (8th Cir. 1994). The Eighth Circuit concluded in Wagner that the Code allows Chapter 12 debtors to make direct payments to creditors. Id.at 726. It further held that, pursuant to 28 U.S.C. §586(e)(2), the Chapter 12 standing trustee may collect a percentage fee only from plan payments "received by" the trustee. Id. at 728. Chapter 12 debtors owe no fees to the trustee for direct payments to their impaired secured creditors. Id. This Court followed Wagner in In re Nichols, L88-00954W (Bankr. N.D. Iowa June 5, 1995) (finding that the holding of Wagner is also applicable to Chapter 13 cases).

Debtor proposes to turn over the $1,400 in ASCS benefits to FSA. FSA also seeks turnover of the $4,755 on account at the Bank directly to the Bank or to FSA. Both FSA and the Bank are impaired secured creditors. The Code allows the Court to approve such direct payments to impaired secured creditors. Trustee may not collect a percentage fee on these direct payments.

MARSHALING

FSA's objection relates to payment of the crop insurance proceeds of approximately $4,755 to unsecured creditors. FSA asserts a security interest in the proceeds subordinate to the Bank's lien. Under the plan, FSA's claim of $235,000 is secured by real estate worth $313,500 in a second lien position subject to the Bank's first lien of $25,000. Thus, FSA is oversecured by the real estate by approximately $53,500. The Plan attempts to marshal the collateral in favor of unsecured creditors based on FSA remaining oversecured by the value of the real estate.

This Court recently considered whether to allow such marshaling in a Chapter 13 case. In re Dolezal, Adv. No. 96-6211-W (Bankr. N.D. Iowa June 16, 1997). In that case, the debtors wished to sell $10,000 of farm equipment free and clear of FSA's oversecured senior lien and pay the proceeds to a junior lienholder. Id., slip op. at 1. Dolezal noted that the Eighth Circuit recently considered the applicability of the equitable doctrine of marshaling of assets in bankruptcy in In re Oxford Dev., Ltd., 67 F.3d 683, 686 (8th Cir. 1995). It stated that two separate doctrines of marshaling are potentially applicable -- the state law doctrine and the doctrine of marshaling under federal bankruptcy law. Id. Under either versions, the doctrine may only be applied only if it does not result in injustice. Id.; Mead v. City Nat'l Bank, 8 N.W.2d 417, 420 (Iowa 1943). It is not intended to deprive any secured creditor of the benefit of its security so far as it is necessary for the creditor's protection. Mead, 8 N.W.2d at 420.

In Dolezal, this Court concluded:

> The Iowa and federal doctrines of marshaling of assets compel the conclusion that Debtors' request to pay proceeds of the sale of equipment to [the junior lienholder] is inappropriate. FSA has a senior security interest in these proceeds. It would be prejudiced by losing a portion of its collateral. The Court, in its equitable discretion, concludes that Debtor may not invoke the doctrine of marshaling because it deprives FSA of the full benefit of its security interest.

Slip op. at 4.

The Dolezal ruling arose in the context of an adversary proceeding filed by the debtors to request authority to sell the property free of liens. The issue arises in this case in the context of confirmation of Debtor's Chapter 12 plan. Under §1225(a)(5), if a secured creditor does not accept the plan, the debtor must either surrender the collateral or provide that the creditor "retain the lien securing such

claim" and receive the allowed amount of such claim. In this context, the issue is whether paying unsecured creditors with FSA's collateral violates the requirement that FSA retain its lien.

"The lien" to be retained under §1225(a)(5)(B)(i) need not invariably be the exact lien on the exact collateral as it existed prebankruptcy. Harmon v. United States, 101 F.3d 574, 583 (8th Cir. 1996). At times, such a literal application of the lien retention confirmation requirement is inappropriate. In re Hanna, 912 F.2d 945, 950 (8th Cir. 1990) (noting that creditor's lien on certain livestock may be replaced by a lien on the herd as a whole, allowing the livestock to be sold and replaced by other livestock). A debtor may not, however, deny a secured creditor the benefit of the lien for which it bargained. In re Graham, 123 B.R. 330, 332 (Bankr. W.D. Mo. 1990) (construing identical confirmation requirement in Chapter 13, §1325(a)(5)(B)). A plan cannot be confirmed where it proposes to take from a secured creditor all or a portion of its collateral. Id.

In Hanna, the court acknowledged that an oversecured creditor has a security interest in its equity cushion. 912 F.2d at 951. The plan in Hanna proposed to replace the creditor's equity cushion in a herd of livestock with a second mortgage on ranch real estate. Id. The court found that this failed to satisfy the lien retention requirement as it creates different risks than those for which the creditor had bargained. Id.at 952. The Tenth Circuit likewise found a Chapter 12 plan failed to satisfy §1225(a)(5)(B) where it substituted a second mortgage interest in real estate for a bank's lien on livestock and equipment. In re Ames, 973 F.2d 849, 851 (10th Cir. 1992), cert. denied 507 U.S. 912 (1993).

Hanna also recognized that the requirements for confirmation in §1225(a) implicitly embody the concept of adequate protection for a secured creditor's claim. 912 F.2d at 951. The Bankruptcy Court in Nebraska has held that an oversecured creditor may not be deprived of a lien in an equity cushion in Chapter 12 unless the Plan provides adequate protection of the creditor's interest as set out in §363(e). In re Underwood, 87 B.R. 594, 597 (Bankr. D. Neb. 1988); In re Milleson, 83 B.R. 696, 701 (Bankr. D. Neb. 1988). In both cases, the debtors proposed to keep the creditor's equity cushion at 110% of their secured claims but wished to sell collateral and use the proceeds or use cash collateral. The court found the creditors' interests were not adequately protected. Underwood, 87 B.R. at 597; Milleson, 83 B.R. at 701. It stated that the oversecured creditors are entitled to maintain their economic status quo. Underwood, 87 B.R. at 598. The extent the creditors are entitled to protection depends on the stability of the value of their collateral. Id.

Prebankruptcy, FSA was oversecured by a general lien in Debtor's real estate, crops, cattle, equipment, proceeds, etc., second in priority to the Bank's general lien in the same collateral. According to Debtor's schedules and proofs of claims, the amount of the Bank's lien was approximately $72,000, the amount of FSA's lien was $235,000 and the value of all the property was $603,000. The Plan removes FSA's lien from all Debtor's property except the real estate valued at $313,000, subject to the Bank's prior lien of $32,000 (soon to be reduced to $25,000).

The Plan reduces the amount of FSA's equity cushion from almost 200% of its claim to less than 125% of its claim. It converts FSA's lien from a lien on real estate and all personal property, to a lien on only real estate. Only by removing FSA's lien on the crop insurance proceeds of $4,755 may those funds be paid to unsecured creditors as proposed in the Plan.

The Court concludes that this treatment of FSA's claim does not meet the lien retention requirement of §1225(a)(5)(B)(i). FSA is entitled to retain a lien at least similar to the one it bargained for. It objects to use of its insurance proceeds collateral to pay other creditors. FSA cannot be coerced into giving up its collateral under §1225(a)(5)(B).

Reducing FSA's equity cushion from 200% to 125% does not comport with the concept of adequate protection. Payments on FSA's claim are amortized over a 30-year period under the Plan. Considering the length of the payment period and the reduction of FSA's equity cushion, the Court cannot say with certainty that FSA's interest in its collateral will be protected at all times during the repayment period.

Payment of the insurance proceeds collateral to unsecured creditors does not comport with the lien retention requirements of §1225(a)(5)(B). This type of marshaling of assets is not acceptable. The Plan's treatment of FSA's oversecured claim does not provide adequate protection. Therefore, the provision of the Plan calling for payment of the insurance proceeds to unsecured creditors is inappropriate.

CONCLUSION

Applying these principles and conclusions, the Amended and Substituted Plan of Reorganization filed May 28, 1997 can be confirmed. Maquoketa State Bank has agreed to its treatment under the Plan. It has agreed to release its claim to the $4,755 in insurance proceeds when its claim is paid down to $25,000. This amount should then be paid by Debtor directly to FSA which has refused to release its lien on the funds. No Trustee fee is due on this direct payment. The Plan also provides for direct payment to FSA of the ASCS benefits of approximately $1,400. No Trustee fee is due on this direct payment.

Unsecured creditors are provided for in the Plan in Class 8 on pages 6 and 7. Because option "A" on page 6, payment of the $4,755 insurance proceeds, is not feasible in light of this ruling, option "(B)" on page 7 shall be applicable. That paragraph provides for payment to unsecured creditors prorata from disposable income paid to the Trustee over 36 months.

WHEREFORE, Debtor's Amended and Substituted Plan of Reorganization filed May 28, 1997 is CONFIRMED.

FURTHER, Debtor may not pay the $4,755 in crop insurance proceeds to unsecured creditors.

FURTHER, upon the fulfilment of the conditions regarding Maquoketa State Bank, Debtor shall pay the crop insurance proceeds in the account at the Bank directly to FSA.

FURTHER, no Trustee fees shall be paid on the direct payments to FSA of the insurance proceeds and the ASCS benefits.

SO ORDERED this 19th day of September, 1997.

Paul J. Kilburg
U.S. Bankruptcy Judge