

**UNITED STATES BANKRUPTCY COURT
FOR THE SOUTHERN DISTRICT OF IOWA**

In the Matter of	:	Case No. 94-1208-CH
	:	Chapter 11
CHAPALA INTERNATIONAL, INC.,	:	
	:	
Debtor.	:	

**ORDER--OBJECTIONS TO CONFIRMATION OF PLAN
AND OBJECTION TO CLAIM**

On December 13, 1994, Creditor's Objection to Confirmation of Debtor's Chapter 11 Plan and Debtor's Objection to Claim No. 5 came before this Court. Debtor, Chapala International, Inc. ("Chapala"), was represented by its attorney, Jerrold Wanek. Creditor, Golden Circle Development Corporation ("Golden Circle") was represented by its attorney, Mark D. Walz. The U.S. Trustee was represented by attorney, John Waters. At the conclusion of the hearing, the Court took the matter under advisement under a briefing deadline. Post-trial briefs have been filed and the Court now considers the matter fully submitted.

This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(B) and (L). The Court, upon review of the pleadings, briefs, evidence and argument of counsel, now enters its findings of fact and conclusions of law pursuant to Fed.R.Bankr.P. 7052.

FINDINGS OF FACT

1. On or about January 13, 1988, Chapala borrowed \$200,000.00 from the West Des Moines State Bank ("West Bank"). A promissory note and extension

agreement evidencing the terms of repayment were executed. The loan was 100% guaranteed by Golden Circle.

2. On or about June 13, 1989, Chapala borrowed an additional \$60,000.00 from West Bank. A promissory note and extension agreements evidencing the terms of repayment were executed. This loan was 90% guaranteed by Golden Circle.

3. Both promissory notes indicated that the obligations were secured by separate security agreements, dated September 29, 1982 and January 13, 1988, respectively. These security interests were properly perfected by UCC filings.

4. The September 29, 1982 security agreement gave West Bank a security interest in “accounts, contracts, retainages, receivables, and all inventory now owned or hereafter acquired.” The January 13, 1988 agreement granted a security interest in:

All accounts receivable, contract receivables, documents of title, general intangibles, goods, inventory, including raw materials, work in process, finished goods, consumables, furniture, FIXTURES, machinery and equipment, including automotive; all chattel paper and instruments . . . all guarantees and other property securing payment or performance . . . ; whether now or hereafter existing or acquired . . . , all securities and other property held by . . . the Bank, and the proceeds and accessions thereto; and all insurance proceeds on said chattels.

5. Golden Circle made a Guarantee Agreement and entered into a Lender Agreement with respect to both guaranteed loans. The loan agreement between Debtor and West Bank with respect to the \$200,000.00 loan specifically incorporates by reference both the Lender Agreement and the Guarantee Agreement made by Golden Circle. The loan agreement between Debtor and West Bank with respect to the \$60,000.00 loan also specifically incorporates by reference both the Lender Agreement and the Guarantee Agreement made by Golden Circle, as well.

6. The Lender Agreement provides as follows:

Upon a default, the Lender agrees to promptly liquidate any and all collateral under the loan and to collect the proceeds therefrom. Lender agrees that all such proceeds, after deduction for costs of collection paid to third parties, will be promptly forwarded to GCDC up to the amount paid pursuant to the Loan Guarantee. The Lender may retain any funds collected in excess of principle to offset any unpaid accrued interest due Lender.

7. The Loan Agreements, signed by Chapala and West Bank, state that Chapala acknowledges that it did not qualify for a “traditional” loan from West Bank, and specifically refer to the guarantees of Golden Circle acknowledging that West Bank relied upon said guarantees in making the loans.

8. On June 17, 1993, West Bank declared the loans with Chapala to be in default and sent a letter to Golden Circle demanding payment under its guarantee.

9. On or about July 27, 1993, Golden Circle paid its guaranteed portion under the two notes and sent a letter to West Bank stating as follows:

The board has agreed to pay the balance of the note and the released collateral to Profile Foods provided they are able to secure \$200,000.00 in new equity capital. The board requests that West Bank assign the note and collateral to GCDC (Golden Circle) and at the time of assignment agree to liquidate the collateral on GCDC’s (Golden Circle’s) request at West Bank’s expense as provided in § VI.B of the Lender Agreement . . .

10. On July 30, 1993, Chapala delivered to West Bank a note for the remaining funds due after the guaranteed portion was paid. The note is secured by the same two security agreements dated September 29, 1982 and January 13, 1988.

11. On May 9, 1994, Chapala filed a voluntary petition for bankruptcy relief under Chapter 11 of the U.S. Bankruptcy Code.

12. Debtor filed a Plan of Reorganization and on December 7, 1994, Chapala filed a modification of Plan. The Plan proposes to pay \$40,000.00 over time to unsecured creditors.

13. In the proposed Plan, Golden Circle is identified as a Class 3 creditor. The Plan proposes to pay the proceeds of a royalty agreement as full payment of its secured claim. Any unsecured portion would receive a proportional share of the \$40,000.00 paid to unsecured creditors.

14. On September 7, 1994, West Bank formally assigned the loan documents to Golden Circle. These loans were secured by a blanket lien on all of the assets of Debtor and by an assignment of the royalty agreement by and between Debtor and Sparta Foods of Minnesota.

15. Golden Circle timely filed its proof of claim as a secured creditor claiming a security interest by virtue of the blanket security interest on all assets of Debtor as assigned by West Bank.

16. Golden Circle and the U.S. Trustee timely objected to confirmation of Debtor's Plan of reorganization.

17. Chapala has filed a Report of Ballots. The report stated that "all classes with the exception of Class 3 have accepted the Plan, including unimpaired Classes 6 and 7."

18. On November 15, 1994, Debtor objected to the Proof of Claim of Golden Circle which has been resisted by Golden Circle.

DISCUSSION

Objection to Claim

On September 14, 1994, Golden Circle filed a Proof of Claim as a secured creditor describing its collateral as “all personalty, including the Royalty & Licensing agreement with Sparta Foods.” Golden Circle stated that the amount of the secured claim included two obligations in the amount of approximately \$54,593.16 plus interest and \$164,445.70 plus interest.

Golden Circle argues that it is subrogated to the secured position of West Bank by virtue of payment of its guaranty to West Bank. West Bank held a blanket lien on all of the assets of Debtor pursuant to two security agreements dated September 29, 1982 and January 13, 1988, respectively. Golden Circle asserts that the payment of the guaranty triggered an automatic equitable subrogation wherein Golden Circle stepped into the shoes of West Bank. Alternatively, Golden Circle maintains that it received express subrogation rights in the Loan and Lender Agreements or in the formal assignment by West Bank on September 7, 1994.

Chapala objects to the claim filed by Golden Circle. Chapala argues that Golden Circle’s secured interest is limited to the Royalty and Licensing Agreement with Sparta Foods. Chapala’s position is that Golden Circle has no security interest in the remaining property and is not subrogated to the position of West Bank. Chapala argues that no equitable subrogation occurred upon payment of the guaranty because Chapala requested an express subrogation and, therefore, had no intent to be equitably subrogated. Chapala

contends that West Bank's conduct in refinancing the remainder of the obligation with Chapala using as collateral the same two security agreements further demonstrates that West Bank never intended to transfer the collateral to Golden Circle. Lastly, Chapala argues that the post-bankruptcy assignment made between West Bank and Golden Circle illustrates that the parties did not believe a subrogation had occurred and that such post-bankruptcy assignment is an improper transfer.

11 U.S.C. § 509 permits subrogation for codebtors, but is inapplicable to the facts in this case in that the payment by Golden Circle was prepetition. However, § 509 is not the exclusive source of subrogation rights in bankruptcy. In re Spirtos, 103 B.R. 240, 244 (Bankr.C.D.Cal. 1989). The doctrine of equitable subrogation is "separate and distinct from the subrogation rights afforded by § 509." Id. at 245.

The Bankruptcy Court of the Southern District of Iowa has held that "Under Iowa law a guarantor required to pay the debt of his principal has an enforceable right of subrogation in the collateral securing the obligation." In re Hemphill, 18 B.R. 38, 47 (Bankr.S.D.Iowa 1982). A claimant must satisfy the following five-part test to invoke the doctrine of equitable subrogation:

- 1) the claimant must have made payment to protect his own interests;
- 2) the claimant must not have been a volunteer;
- 3) the payment must satisfy debt for which the claimant was not primarily liable;
- 4) the entire debt must have been paid; and
- 5) subrogation must not cause injustice to the rights of others.

In re Hagen, 147 B.R. 166, 167 (Bankr.N.D. Iowa 1992) (citations omitted).

In this case, the Court finds that Golden Circle made a payment to West Bank to protect its own interests. Golden Circle was not a volunteer nor was it primarily liable for

the debt. Moreover, the entire debt subject to guaranty was paid by Golden Circle on July 27, 1993. Therefore, as long as equitable subrogation does not work an injustice on other creditors, the elements of the test have been met.

Chapala argues that Golden Circle has no equitable rights of subrogation because it attempted to obtain an express assignment and then did so after the bankruptcy petition was filed. An attempt to obtain an express assignment is only a waiver of subrogation if such action “thereby deprived other creditors of an opportunity to take steps necessary to protect their interest in the event of subrogation” and thereby works an injustice to the creditors. In re Disanto & Moore Assoc., Inc., 41 B.R. 935, 940 (N.D.Cal. 1984).

The Court finds that Chapala has failed to prove that such attempts to obtain an express assignment have deprived other creditors of the opportunity to protect their interests. Therefore, the Court finds that Golden Circle did not waive its rights of equitable subrogation. Moreover, the Court finds that equitable subrogation would work no injustice on other creditors.

The fact that West Bank may have chosen to make an additional loan using the same security agreements does not change this finding. Golden Circle guaranteed the loan with West Bank and paid the guaranty as required. Golden Circle is, therefore, entitled to be equitably subrogated to West Bank’s position regardless of any subsequent express assignment of such interest. West Bank had obtained a security interest by virtue of security agreements on Chapala’s property and on the Royalty and Licensing Agreement with Sparta Foods. The Court finds that Golden Circle is entitled to assume that secured position by virtue of equitable subrogation.

In addition to the foregoing rights of subrogation, Champala specifically agreed that upon payment on the guaranty Golden Circle succeeded to the security rights in all the collateral held by West Bank. These rights of Golden Circle were fixed and binding upon Chapala when Chapala signed the loan agreements of January 13, 1988 and June 13, 1989 and the Guaranty Agreement and Authorizations on January 29, 1988 and June 13, 1989. The Court, therefore, need not reach the issue of the validity of the assignment made after the filing of the petition.

Accordingly, the Court finds that the Debtor's objection to claim of Golden Circle is overruled and denied.

Objection to Confirmation

The U.S. Trustee originally filed an Objection to Confirmation on the grounds that if the unsecured creditors failed to accept the Plan, the absolute priority rule of § 1129(b)(2)(B) prohibits confirmation. The unsecured creditors voted by ballot to accept the proposed Plan. Therefore, the Court finds such objection is moot.

Golden Circle has also filed an objection to the proposed treatment of its secured claim in the Plan. The Plan proposes that Golden Circle continue to receive the cash flow from Sparta Foods pursuant to the assignment of a licensing agent. The Plan states that such agreement is the only security for Golden Circle's debt.

This Court has found that Golden Circle's claim is secured by virtue of equitable subrogation wherein Golden Circle steps into West Bank's position as a secured creditor with a security interest in all of the assets of the Debtor. The Class 3 claim of Golden Circle is, therefore, impaired and is not subject to the cram down provisions of §

1129(b)(2)(A)(i)(II) as the proposed payments are less than the value of Golden Circle's interest in the collateral. Golden Circle objects to this treatment. Therefore, the Court finds that Golden Circle's objection to confirmation is sustained.

ORDER

IT IS THEREFORE ORDERED that Debtor's Objection to Claim No. 5 is overruled and denied.

IT IS FURTHER ORDERED that the Objection to Confirmation of Plan filed by Creditor, Golden Circle Development Corporation, is sustained.

Dated this _____ day of May, 1995.

RUSSELL J. HILL, CHIEF JUDGE
UNITED STATES BANKRUPTCY COURT