

UNITED STATES BANKRUPTCY COURT
For the Southern District of Iowa

In the Matter of

WILLIAM W. OWENS,
SHIRLEY A. OWENS,

Case No. 87-681-D

Chapter 12

Debtors.

ORDER ON OBJECTIONS TO CONFIRMATION OF PLAN

On November 12, 1987 a hearing on confirmation of plan was held before this court in Davenport, Iowa. Randy E. Trca appeared on behalf of the debtors and Timothy K. Wink appeared on behalf of the Columbus Junction State Bank (Bank). Anita L. Shodeen, the Chapter 12 trustee, was also present. At the time of the hearing, the debtors stated that they had recently filed a third amended Chapter 12 plan. In response to the court's expressed concern over whether all creditors had been properly served with the amended plan, the appearing parties indicated that they had had an opportunity to review the most recent plan and were ready to proceed on their previously filed objections. The court therefore heard testimony and arguments. The matter was considered fully submitted on December 8, 1987.

Background

The debtors filed a petition for relief under Chapter 12 of the Bankruptcy Code on March 16, 1987. The Bank filed

a proof of claim in the amount of \$381,185.40. The Bank holds mortgages on the debtors' real estate and has a security interest in, among other things, the debtors' equipment, crops and livestock. The debtors' plan filed on November 12, 1987 treats the Bank's claims in Class 2. The allowed claim secured by real estate is fixed at \$151,250.00 and the allowed claim secured by livestock is fixed at \$25,860.00. The plan proposes payments on the claim for real estate over a period of 30 years at 8½ percent interest. The payments proposed on the claim for livestock are over a period of 10 years and also at 8½ percent interest. The plan further provides that:

(d) The liens and encumbrances upon the property securing this claim (real estate and livestock) shall remain as valid liens and encumbrances to the full extent of the unpaid balance of the allowed secured claim until such time as said allowed secured claims are paid in full except that Columbus Junction State Bank shall NOT have any lien on Debtors' crops or offspring.

(e) In the event the property securing the claims is sold by the Debtor, the proceeds of such sale shall be applied to the remaining balance of the allowed secured claims or shall be used by the Debtor in the ordinary course of his business. The Debtor shall, however, at all times maintain property subject to liens and encumbrances securing this claim of a kind and number equal to Columbus Junction State Bank's collateral on the date of the filing of the petition herein. If the proceeds are used in the ordinary course of business, Columbus Junction State Bank will be granted a replacement lien in all assets acquired with the use of said proceeds.

The debtors' cash flow projections for the years 1988 and 1989 indicate income in the amount of \$57,150.00, business expenses in the amount \$16,280.00 and personal expenses in the amount of \$6,720.00. After deducting proposed plan payments, the debtors' cash flows reveal a reserve in excess of \$6,000.00 or approximately 10 percent of their projected income.

With the filing of the third amended plan, several of the Bank's objections to the first and second amended plans have been satisfied. At the time of the hearing, however, the Bank indicated that four objections remained for consideration. First the Bank disputes the debtors' calculation of the amount of its claim secured by livestock by subtracting the proceeds received for the sale of livestock prior to the filing of the case. At the hearing the debtors questioned the Bank's continuing security interest in offspring. The Bank's second objection is that the interest rate provided in the plan is not calculated in accordance with the formula established by this court. The Bank's third objection concerns the allowed claim secured by real estate. The Bank seeks compensation for the reasonable value of rent which could have been earned during the pendency of the bankruptcy proceeding. Finally, the Bank objects to the plan on feasibility grounds. It asserts that projected expenses are understated.

Discussion

To confirm the Chapter 12 plan over the objection of a

secured creditor the debtors' plan must meet the requirements of 11 U.S.C. section 1225(a)(5)(B) or (C) which provides:

(B)(i) the plan provides that the holder of such claim retain the lien securing such claim; and

(ii) the value, as of the effective date of the plan, of property to be distributed by the trustee or the debtor under the plan on account of such claim is not less than the allowed amount of such claim; or

(C) the debtor surrenders the property securing such claim to such holder;

....

A. Allowed Secured Claim on Livestock

The parties have presented little evidence as to how the allowed secured claim of the Bank was calculated. The debtors' plan values the Bank's allowed secured claim in livestock at \$31,175.00. The plan indicates that this figure was arrived at by appraisal and agreement. The debtors assert that there was a prepetition sale of offspring that generated \$5,316.11 in proceeds. The debtors wish to release the proceeds held in escrow to the Bank and reduce the allowed secured claim to \$25,860.00.

The Bank contends that it has a valid security interest in livestock and offspring. Since the cattle sold prior to filing the petition were offspring of secured cattle, the Bank asserts that the proceeds belong to the Bank and should be added to the figure used to value its allowed secured claim.

Resolution of this dispute turns upon whether the debtors and the Bank included the sold cattle in the calculation of the value of the livestock. If that is the case, then proceeds from the sale of a portion of that collateral may be released to the Bank and the allowed secured claim reduced accordingly. If, however, the livestock on hand postpetition was valued without reference to the cattle sold prepetition, then the proceeds from the sale constitute additional collateral that would have been available to satisfy the debt and must be added to the value of the existing collateral to determine the Bank's allowed secured claim. Accordingly, the parties shall clarify their valuation of the Bank's claim in light of the above and, if warranted, the debtors shall amend their plan accordingly.

The debtors' plan also provides that the Bank's liens upon the property securing the claim shall remain as valid liens except that the Bank shall not have any lien on crops OV4 or offspring. The next paragraph of the plan provides that the debtors shall maintain property subject to liens of a kind and number equal to the Bank's collateral on the date of filing and if sale proceeds are used the Bank will be granted a replacement lien in acquired assets.

The Bank's security agreement in this regard grants a security interest in "all equipment, all farm products, including, but not limited to crops, livestock, supplies used or produced in farming operations, rents, contract

rights, and accounts and all proceeds." The form further provides that "if this Agreement includes livestock, then as additional collateral Debtor grants to Bank a security interest in all increase and issue thereof and additions, replacements, and substitutions thereof."

11 U.S.C. section 552 provides that a valid prepetition security interest in prepetition property and the offspring of such property operates to continue that security interest in offspring acquired subsequent to the bankruptcy petition. The Bank's security interest in livestock and all increase and issue thereof is sufficiently clear to cause the prepetition interest to extend to any postpetition offspring. In re Bohne, 57 B.R. 461, 464 (Bankr. D. N.D. 1985).

The debtors offer no authority for extinguishing the Bank's postpetition lien on offspring. Section 552(b), however, permits the court to order, based on the equities of the case, that the security interest of the creditor does not extend to certain offspring. In Matter of Wobig, 73 B.R. 292, 294 (Bankr. D. Mich. 1987), Judge Timothy Mahoney addressed the tension between section 552(b) and section 1225(a)(5)(B)(i):

If the Court were to find that debtor with a livestock operation subject to security interests in livestock and the offspring of such livestock was unable to sell the livestock to fund an operating Chapter 12 plan because of the terms of Section 1225 (a) (5) (B) (i) no "family farmer" whose business was substantially a livestock operation would be able to obtain confirmation of a Chapter 12 plan

of reorganization.

....

Chapter 12 does not absolutely prohibit debtors from using the proceeds of sale of certain collateral. This Court believes that if the debtor can propose a plan which "adequately protects" the interest of the creditor in the collateral, debtor may use such proceeds. This is no different than the standards for relief from the automatic stay under Section 362 and the standards for use of cash collateral under Section 363. Creditor must be protected, but if the creditor is protected, the debtor is permitted to use cash collateral. The Court is aware that preconfirmation "adequate protection" analysis may not be applicable to the interest of the creditor, postconfirmation. See In re Monnier Brothers, 755 F.2d 1336, at 1340, 41 (8th Cir. 1985). However, if a plan is feasible and meets other confirmation requirements, the creditor only has a right to receive the allowed amount of its secured claim and retain a lien on collateral to the extent of the balance due on the allowed secured claim. Any other conclusion prohibits Chapter 12 reorganization of a livestock operation.

Id. at 294-95.

Although feasibility and satisfaction of other confirmation requirements are unsettled at this juncture, the plan provisions regarding lien retention protect the interest of the Bank. The plan provides that the debtors shall maintain the approximate herd levels they presently have and provides the Bank with a replacement lien in assets acquired with proceeds from the sale of secured collateral. Accordingly, the Bank retains a lien on collateral to the extent of the

balance due on the allowed secured claim and its interest is adequately protected. In re Hansen, 77 B.R. 722, 726 (Bankr. D. N.D. 1987). See Matter of Halls, No. 87-943-C, slip op. (Bankr. S.D. Iowa February 1, 1988) (claim secured by collateral consisting of used machinery, which made up 75% of the security, and livestock could not be stretched beyond 7 years); Matter of Royona Ranch, No. 87-1118-C, slip op. (Bankr. S.D. Iowa April 11, 1988) (claim secured by livestock could be paid out over 15 years if plan provided for a replacement lien and maintenance of herd levels at a value equal to or greater than the balance of the claim). Therefore, the Bank's objection to this aspect of the debtors' plan is overruled.

B. Interest Rate

Section 1225(a)(5)(B)(ii), identified above, requires that a secured creditor who is being paid over time receive the present value of its claim. The interest rate or discount rate used must be a rate which will insure present value and is determined "as of the effective date of the plan". Compare In re Robinson Ranch, Inc., 75 B.R. 606 (Bankr. D. Mont. 1987) (present value should be determined as of or as close to the effective date of the plan as possible) with In re Erwin, 25 B.R. 363 (Bankr. D. Minn. 1982) (earliest date for determining value under facts of case was date upon which the third amended plan was filed). This court in Matter of Doud, 74 B.R. 865 (Bankr. S.D. Iowa

1987), aff'd sub nom. United States v. Doud, No. 87-577-B (S.D. Iowa December 7, 1987) held that the treasury bond yield with a remaining maturity matched to the average amount outstanding during the repayment period of the allowed claim plus a 2 percent upward adjustment to account for risk best estimates the prevailing market discount rate to be applied in Chapter 12 cases. The decision sets forth a fairly detailed analysis of the method to be used in calculating the appropriate discount rate. Id. at 868-869.

The bank objects to the interest rate of 8.5 percent proposed in the plan as not being in conformance with the Doud analysis. The debtors' explanation of their calculation clearly indicates a misunderstanding of this court's opinion. First, the term used by the debtors is the three year term of the plan rather than the term of repayment of the allowed secured claim under the plan. Secondly, it does not appear that the debtors calculated the percentage of the average amount outstanding during the repayment term for purposes^{of} matching the percentage to a government security with an equal maturity. Finally, the debtors figured the yield on treasury bonds on the date the petition was filed, March 16, 1987, rather than "as of the effective date of the plan." Thus, the debtors must recalculate the interest rate applicable to the allowed secured claims of the Bank pursuant to the analysis contained in the Doud opinion.¹

¹ As an example to assist the debtors, the plan proposes to pay the \$151,250.00 debt on real estate over 30 years. The average outstanding indebtedness is calculated by summing (continued on p. 10)

C. Rental Payments

For its third objection the Bank contends that it should be given a secured claim in the amount of rent that would have been earned upon the real estate of the debtor prior to confirmation of the plan. The Bank has not sought adequate protection in this case and relies solely upon 11 U.S.C. 1205(b)(3) which provides:

(b) In a case under this chapter, when adequate protection is required under section 362, 363, or 364 of this title of an interest of an entity in property, such adequate protection may be provided by--

....

(3) paying to such entity for the use of farmland the reasonable rent customary in the community where the property is located, based upon the rental value, net income and earning capacity of the property;

Typically the adequate protection provisions of section 1205 govern preconfirmation proceedings. In this case section 1205 was not invoked by the Bank prior to the

¹ (continued from p. 9)

the principal amounts owed during each payment period and dividing that sum by the number of periods. ($\$151,250.00 + \$146,208.33 + \$141,166.66 + \$136,124.99 + 131,083.32 + 126,041.65 \dots = \$2,344,373.65 \div 30 = \$78,145.79$). That sum divided by the debt provides of the percentage of the claim outstanding over the payment period-- $\$78,145.75 \div \$151,250.00 = .52$ or 52 percent. Since the plan proposes a year repayment term, the discount rate will be based on a government security with a duration of 52% of 30 years or 15.6 years. On April 22, 1988 a treasury bond with a maturity date of 15 years (the year 2003) yields 9.12 percent. With the added 2 percent adjustment for risk associated with a Chapter 12 plan, the discount factor would be 11.12 percent.

hearing on confirmation. The provisions of section 1205 may extend postconfirmation only if necessary to ensure payment of the present value of the allowed claim. In re Big Hook Land & Cattle Co., 77 B.R. 793, 798 (Bankr. D. Mont. 1987). The rental concept in the adequate protection analysis, however, does not require that rental value be considered in every value determination. In re Beyer, 72 B.R. 525, 528 (Bankr. D. Colo. 1987).

In this case the plan indicates that the allowed secured claim on real estate was fixed at \$151,250.00 by appraisal and direction of the court. The Bank seeks to add to that value the amount that may have been received if it had sought adequate protection of its interest preconfirmation. The Bank does not assert that the rental analysis should be the basis for determining the value of its allowed secured claim. The court can find no authority to permit the Bank to assert its entitlement to protection now when it failed to do so previously. Accordingly, the Bank is not entitled to a separate secured claim for rent that might have been received prior to confirmation.

D. Feasibility

The concept of feasibility in Chapter 12 cases is set forth in section 1225(a)(6) which requires that the debtor be able to make all payments under the plan and to comply with the plan. With respect to feasibility determinations, the Eighth Circuit Court of Appeals has declared that the

"feasibility test is firmly rooted in predictions based on objective fact." In re Clarkson, 767 F.2d 417, 420 (8th Cir. 1985). A feasibility finding does not hinge upon a showing that a successful farm reorganization is guaranteed. In re Hanson, 77 B.R. 722, 726 (Bankr. D. N.D. 1987). Projecting income and expenses in the farm context is not an exact science. In re Monnier Bros., 755 F.2d 1336, 1341 (8th Cir. 1985). Labile markets, unpredictable weather, and changes in government programs preclude precise forecasting. In re Fursman Ranch, 38 B.R. 907, 912 (Bankr. W.D. Mo. 1984).

The Bank asserts that the plan is not feasible because the projection for both personal and business expenses are understated. Specifically the Bank disputes the debtors' food and utility expenses and livestock feed expenses. At the hearing the Bank introduced two exhibits bearing on the debtors' 1985 and 1986 farming expenses and asked the court to take notice of the debtors' monthly reports filed during the bankruptcy proceeding.

The debtors contend that the expense projections contained in their cash flows are accurate. Moreover, they assert that the cash flows contain a yearly reserve amount that could be carried forward to offset expenses not covered. They offered the testimony of William W. Owens and Richard Duane Owens.

After consideration of the record in light of the feasibility standards, the court concludes that the plan

fails to satisfy 11 U.S.C. section 1225(a)(6). The plan projects annual personal expenses in 1988 and 1989 at \$6,720.00. The monthly utility expense of \$35.00 and monthly food expense of \$100.00 are questionable despite the testimony regarding the debtors' lifestyle. Although the Bank's exhibit reflecting the debtors' 1986 personal expenses sheds light on these projections, the debtors' monthly reports clearly show a variance between actual and projected income and expense when compared to the cash flow for 1987. The projected personal expenses for 1987 are stated as \$5,000.00. The monthly reports for 1987 (nine months reported) show that personal expenses totaled approximately \$7,000.00. The cash flow projections for 1988 and 1989 use the same estimates for personal expenses but include two additional months.

The plan projects annual business expenses in 1988 and 1989 at \$16,280.00. The projected feed expense is stated at \$850.00 per year. The Bank introduced exhibits reflecting the debtors' feed expenses in 1985 as \$4,683.00 and in 1986 as \$3,105.35. The accuracy of these figures is questionable, however, given testimony that the debtors also raised hogs in those years. Again the debtors' monthly reports are most indicative of actual expenses. The debtors' 1987 business expenses total \$17,103.00. The plan projected expenses for the same period at \$12,650.00. While the debtors' actual feed expenses were indeed low, expenses for insurance and

taxes are higher than projected. Moreover, the monthly reports indicate a yearly machine hire expense of \$1,621.00 that is not contemplated in the cash flow.

The income received in 1987 as reflected in the debtors' monthly reports likewise does not meet the projected 1987 income of \$40,000.00. Actual income in 1987 is reported as \$32,597.00. Deducting actual business and personal expenses leaves \$8,583.00 for debt service and reserve. While the plan projects additional income in 1988 and 1989 from the sale of livestock, the assumptions used to arrive at a \$25,000.00 income figure are not set forth in the plan. Assuming that the income projected in 1988 and 1989 is accurate, reducing that income by the business and personal expenses incurred in the 9 months of 1987 would leave approximately \$33,047.00 for debt service. The plan at this juncture provides payments of \$28,131.00 in 1988 and \$27,418.00 in 1989. As noted earlier, those payments are subject to change after re-evaluation of the interest rate and the allowed secured claim on livestock. Even without those changes, the plan would allow less than \$5,000.00 for reserve after debt service.

Given that the debtors must make various amendments to their plan to satisfy the other objections of the Bank, they shall be given an opportunity to recalculate their cash flows and to make adjustments to their projected expenses to reflect more accurately their actual expenses.

CONCLUSION AND ORDER

WHEREFORE, based on the foregoing discussion, the court finds that the debtors' plan fails to satisfy the requirements of 11 U.S.C. section 1225.

THEREFORE, the debtors are directed to amend their Chapter 12 plan in accordance with this opinion within 20 days.

IT IS FURTHER ORDERED that the amended plan shall be served on all creditors and shall establish a 15 day bar date for objections. Any objections filed shall be set for hearing during this court's next Davenport assignment.

Signed and filed this 26th day of April, 1988.

LEE M. JACKWIG

CHIEF U.S. BANKRUPTCY JUDGE