

UNITED STATES BANKRUPTCY COURT
For the Southern District of Iowa

In the Matter of
LARRY A. WILKIN and
SHARON E. WILKIN,
Debtors.

DAVID A. ERICKSON, TRUSTEE,
Plaintiff,
v.
UNITED STATES OF AMERICA,
Defendant.

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: Case No. 87-808-C H
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: Chapter 7
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: Adv. No. 88-0150
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ORDER--COMPLAINT TO DETERMINE
TRUSTEE'S INTEREST IN PROPERTY

On July 14, 1988, David A. Erickson, Chapter 7 Trustee (hereinafter "Trustee") filed a complaint under 11 U.S.C. §544(a)(1) to declare Trustee's interest as a judgment lien creditor superior to that of the United States through Farmers Home Administration (hereinafter "FmHA"). On February 14, 1989, Trustee and FmHA's attorney, Kevin R. Query, Assistant United States Attorney, filed a stipulation of facts. On February 23, 1989, the Court entered a minute order taking the matter under advisement.

This is a core proceeding pursuant to 28 U.S.C. §157(b)(2)(k). The Court, upon review of the stipulated facts and briefs submitted, now enters its findings and conclusions pursuant to F.R.Bankr.P. 7052.

FINDINGS OF FACT

The parties stipulate to the following facts:

1. Larry A. Wilkin and Sharon E. Wilkin (hereinafter "Debtors") filed for relief under Chapter 7 of the Bankruptcy Code on March 26, 1987.

2. Debtors listed FmHA in their bankruptcy schedules as the holder of a secured claim.

3. At the time of filing, Debtors were entitled to receive deficiency payments to be disbursed by check or PIK certificate on account of their participation in the 1986 Feed Grain Program administered by the Department of Agriculture through its agency, Agricultural Stabilization and Conservation Service (hereinafter ("ASCS")).

4. Debtors enrolled in the 1986 Feed Grain Program on April 25, 1986. Prior to bankruptcy, Debtors received the following program payments which are not in issue:

April 25, 1986	A PIK Certificate in the amount of \$323.27 and a check in the sum of \$759.86.
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March 19, 1987	A PIK Certificate in the amount of \$161.11 and a check in the amount of \$122.81.
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5. In their statement of financial affairs or schedules filed commensurate with this case, Debtors failed to identify the pending receipt of future 1986 program payments.

6. Trustee did not request either informally or formally from the United States Attorney a turnover of estate property held by the United States of America.

7. FmHA filed a proof of claim with the Court on July 23, 1987, evidencing an outstanding, principal claim in the sum of \$195,277.50. Said claim identified \$90,750.00 as the amount of FmHA's secured claim. Aside from the payments which are the subject of this dispute, FmHA has liquidated all non-exempt real and personal property pledged as security for its claim and realized the sum of \$83,576.24.

8. Trustee initially filed a Report of Trustee in No Asset Case on July 28, 1987, which was withdrawn by a Notice filed with the Court on November 25, 1987.

9. The County ASCS Office was directed during a phone conversation with the Trustee's office on October 20, 1987, to send pending program payments directly to Trustee. ASCS mailed on that date a check in the sum of \$578.06 and a PIK Certificate with a face value of \$604.04 on account of Debtors' participation in the 1986 Feed Grain Programs. Trustee has realized the sum of \$622.16 from negotiation of the PIK Certificate.

10. FmHA's proof of claim did not specifically assert a claim for a setoff.

11. The financing statement, G574008, filed in the Iowa Secretary of State's office by FmHA on April 24, 1980, as amended on April 3, 1984, and continued on December 17, 1984, does not contain

the language "contract rights or general intangibles."

12. Debtors were not given any notification of a setoff pursuant to 7 C.F.R. §13.4.

13. FmHA did not mail and deliver to the County ASCS office a request for setoff and notice of levy pursuant to 7 C.F.R. §13.6.

14. FmHA did not require Debtors to sign an assignment form providing for the assignment of Debtors' program payments.

15. Trustee filed a final report and final account before distribution on January 8, 1988, under which he sought to distribute the sums obtained through negotiation of the deficiency check and PIK Certificate.

16. On May 17, 1988, the United States of America filed a written objection to Trustee's final report and final account before distribution, under which the government asserted a secured interest in the funds. On June 30, 1988, the Court issued an Order regarding the objection to final report that provided a date by which Trustee was to initiate an adversary proceeding.

17. Trustee initiated by complaint an adversary proceeding on July 14, 1988, wherein he seeks to avoid pursuant to 11 U.S.C. §544 the interest claimed by the United States of America in the program benefits he seeks to distribute as unsecured assets of the estate.

18. The parties agree that the Court may take judicial notice of FmHA's proof of claim and attached documents, to-wit: mortgages and security agreements. In said security agreements, Debtors granted FmHA an interest in, among other things, the "proceeds and

products" of Debtors' crops. In said mortgages, Debtors granted FmHA a mortgage on various properties together with, among other things, the "rents, issues, and profits thereof."

DISCUSSION

The issue in this case is whether Trustee has a superior interest to the alleged interest of FmHA in Debtors' 1986 farm program deficiency payments. Bankruptcy Code §544(a) provides that a trustee in bankruptcy has the rights and powers of a hypothetical lien creditor at the time the case is commenced. 11 U.S.C. §544(a).

As such, the trustee has a superior right to any unperfected security interest existing in the debtor's property. In re Armstrong, 56 B.R. 781, 785 (W.D. Tenn. 1986).

In order to decide the issue in this case, the Court must make two determinations. The first is whether the deficiency payments are property of the estate in which FmHA has an interest. The second is whether FmHA has a perfected security interest in deficiency payments.

FmHA makes a number of arguments in support of its position that it possesses an interest in Debtors' 1986 deficiency payments including: 1) not property of the estate; 2) superior perfected security interest; and 3) assignment of the interest. The Court will separately address each ground.

1. Property of the Estate

FmHA initially argues the deficiency payments are not property of the estate under §541 because of its right of offset and the

"personal services earnings" exception under §541(a)(6).

a. Offset

FmHA claims an interest in the farm program benefits under the administrative offset provisions in 7 C.F.R. Part 13. Bankruptcy Code §553(a) permits creditors to offset debts that are mutual and pre-petition. In Matter of Hunerdosse, 85 B.R. 999 (Bankr. S.D. 1988), aff'd sub nom. United States of America v. Hunerdosse, No. 88-364-B (S.D. Iowa November 28, 1988), Chief Judge Jackwig relied upon her analysis from Matter of Butz, 86 B.R. 595 (Bankr. S.D. Iowa 1988), rev'd sub nom. United States of America v. Butz, No. 88-366-A (S.D. Iowa March 21, 1989) and rejected the identical argument FmHA now makes to this Court. In Butz, Chief Judge Jackwig rejected FmHA's identical setoff argument on the ground FmHA and ASCS did not stand in the same capacity and thus the debts owed to FmHA and ASCS were not mutual. Id. at 601-02.

Subsequent appeals by FmHA of both cases has resulted in a split among the district courts concerning the mutuality issue in offsets.

In a one paragraph ruling, Chief Judge Vietor affirmed Hunerdosse which, as previously noted, relied upon Butz. Judge Wolle, in a six-page ruling four months later, reversed Butz on the mutual debt capacity ground only and held federal agencies are not separate legal entities under §553(a).

The analysis in the Butz appeal specifically analyzed the issue of whether federal agencies are the same legal entities within the meaning of §553(a) and therefore able to offset the payments another

federal agency owes to the debtor. This issue was not specifically analyzed in the Hunerdosse appeal. The analysis in the Butz appeal is more persuasive and the court finds that FmHA and ASCS do stand in the same capacity for purposes of mutuality of debts under §553(a).

Such a result, however, will not resurrect FmHA's offset claim. Federal regulations set out the requirements FmHA must follow in order to exercise its rights to setoff. 7 C.F.R. §13.4 requires FmHA to notify the debtor of setoff, and 7 C.F.R. §13.6 requires FmHA to mail or deliver to the county ASCS office a request for setoff and notice of levy. In the case *sub judice* there is no evidence in the record indicating FmHA met either of these requirements.

Moreover, the Court notes FmHA waived its right to setoff under the facts of this case. FmHA's proof of claim filed on July 23, 1987, indicated the claim was not subject to any setoff or counterclaim, and FmHA did not raise the setoff issue until well after this date. See Matter of Hotopp, No. 87-650-CJ slip op. at 4 (Bankr. S.D. Iowa July 5, 1988) (citing In re Britton, 83 B.R. 914 (Bankr. E.D.N.C. 1988)); In re Butler, 61 B.R. 790, 791-92 (Bankr. S.D. Fla. 1986) (creditor will generally be deemed to have waived right to setoff if he filed a proof of claim in bankruptcy without asserting the right). As a result, the Court concludes FmHA's setoff argument is invalid because FmHA did not meet the setoff requirements under the federal regulations and waived the right.

b. Personal Services Earning Exception--§541(a)(6)

FmHA next argues the farm program deficiency payments are not property of the estate because of the exception for personal services earnings under §541(a)(6). Section 541(a)(6) provides that "earnings from services performed by an individual debtor" post-petition are not property of the estate. In a well reasoned opinion, Chief Judge Jackwig rejected an identical argument by FmHA in Hunderdosse on the grounds that participation in the farm program does not require a producer to render personal services. Id. at 1004. This Court agrees with the Hunderdosse result and concludes Debtors' deficiency payments are property of the estate.

2. Perfected Security Interest in Deficiency Payments

FmHA maintains it has a perfected secured claim superior to Trustee's interest because the deficiency payments are "rents, issues or profits" under its mortgage interest and a "proceed" of its perfected interest in Debtors' crop.

a. Mortgage Interest

FmHA holds a valid, pre-petition mortgage interest in some of Debtors' real estate and contends the deficiency payments constitute "rents, issues and profits" within the meaning of that phrase in the mortgages. The Court disagrees.

In Butz, Chief Judge Jackwig adopted the analysis from In re Liebe, 41 B.R. 965 (Bankr. N.D. Iowa 1984) in holding that government program payments are not "rents and profits" of the land because of

the "attenuated nature of the relationship between the government contracts and the land." Id. at 597-98. Chief Judge Jackwig reached her conclusion in spite of being directed by FmHA to In re Preisser, 33 B.R. 65 (Bankr. D. Colo. 1983), the very case FmHA would have this Court rely upon. Judge Wolle affirmed this part of the Butz ruling on appeal. This Court agrees with the rulings in Butz and Liebe and concludes Debtors' farm program deficiency payments are not "rents and profits" under FmHA's mortgage.

b. Security Agreement

FmHA next argues it has a security interest in deficiency payments because the payments are "proceeds" of crops in which it has a perfected security interest. If the Court were to accept FmHA's argument, FmHA's security interest clearly would cover the payments under the Iowa Uniform Commercial Code. See Iowa Code §554.9306 (security interest continues in identifiable proceeds). The Court, however, does not agree with FmHA's argument.

In Hunerdosse, FmHA made the identical argument and cited In re Sumner, 69 B.R. 758 (Bankr. D. Or. 1986) for the proposition that deficiency payments are "proceeds" of a planted crop under the Uniform Commercial Code. Id. at 1004. Chief Judge Jackwig rejected Sumner and instead followed In re Kruger, 78 B.R. 538 (Bankr. C.D. Ill. 1987) in holding that deficiency payments made to a debtor are not "proceeds" for purposes of the Uniform Commercial Code. Id. at 1004-05. This Court agrees with the well-reasoned opinions in Kruger and Hunerdosse and concludes FmHA's security interest in the proceeds

of Debtors' crops does not cover farm program deficiency payments made to Debtors.

3. Regulations Prohibiting Assignments

Assuming arguendo FmHA does have an interest in the deficiency payments, said interest still could not be encumbered under federal statutes and regulations.

In Matter of Halls, 79 B.R. 417 (Bankr. S.D. Iowa 1987), Chief Judge Jackwig analyzed the ability of a creditor to encumber PIK certificates and government program payments made in cash. Regarding cash payments, the court ruled that under 16 U.S.C. §590h(g), assignments could not be made to secure any "preexisting indebtedness" but could be assigned as security for cash advances to finance the making of a crop. Id. at 419. Regarding PIK certificates, the court ruled the operation of 7 C.F.R. §§770.4(b)(2) and 770.6 and the Supremacy Clause of the United States Constitution precluded a creditor from encumbering commodity certificates under state law. Id. at 420-21.

This Court recently declined to follow Halls in Matter of Ferrari, No. 87-2841-CH, slip op. at 9 (Bankr. S.D. Iowa May 8, 1989). In Ferrari, the Court followed In re Arnold, 88 B.R. 917 (Bankr. N.D. Iowa 1988) in holding that 7 C.F.R. §§770.4(b)(2) and 770.6 did not preempt state law on secured transactions because the necessary authorization by Congress to CCC to preempt state law was absent. Id. As a result, the Court determined PIK certificates could be assigned as security but only to the extent the security

interest conformed with the requirements of 16 U.S.C. §590h(g)--for cash or advances to finance making a crop and not to secure any preexisting indebtedness. Id.

In the case *sub judice* the deficiency payments at issue were for Debtors' 1986 crops. FmHA's cash advances to Debtors, however, were for years prior to and not including 1986. As a result, the Court concludes that under 16 U.S.C. §590h(g), FmHA does not have a security interest in Debtors' 1986 deficiency payments made in cash and in PIK certificates.

CONCLUSION AND ORDER

WHEREFORE, based on the foregoing analysis, the Court concludes Debtors' 1986 farm program deficiency payments are property of Debtors' estate and that FmHA does not have any interest in said payments.

FURTHER, the Court concludes that because FmHA does not have any interest, Trustee's interest is superior and any determination under §544(a) is moot.

IT IS ACCORDINGLY ORDERED that Debtors' 1986 farm program deficiency payments are property of Debtors' estate; Trustee has a superior interest in said deficiency payments; and FmHA does not have any interest in said payments.

Dated this _____ day of June, 1989.

RUSSELL J. HILL
U.S. BANKRUPTCY JUDGE