UNITED STATES BANKRUPTCY COURT
For the Southern District of Iowa

In the Matter of

RICHARD W. SOWERS, Case No. 85-1124-C
JUDITH L. SOWERS,
Debtors.

RICHARD W. SOWERS, Adv.Pro.No. 85-0374
JUDITH L. SOWERS,

Plaintiffs, Chapter 7
v.

FEDERAL DEPOSIT INSURANCE
COMPANY,

Defendant.

MEMORANDUM OF DECISION

This is a core proceeding pursuant to 28 U.S.C. section 157(b)(2)(K). Having reviewed the stipulated facts and briefs submitted by the parties and being fully advised in the premises, the court makes the following findings of fact and conclusions of law pursuant to Bankruptcy Rule 7052.

This adversary proceeding arises out of the failure of the Storv County State Bank. The issues before the court are: (1) whether real estate encumbered by a mortgage containing a dragnet clause serves as security for certain notes; and (2) what interest the debtors have in a corn crop

planted before the bankruptcy was filed. The Federal Deposit Insurance Corporation (FDIC) has indicated to the court it no longer disputes ownership of certain certificates of deposit.

FACTS

In August of 1978 the debtors purchased a house in Story City, Iowa. The Story County State Bank financed the purchase in the amount of $25,000.00. The debtors executed and delivered a mortgage on the house to the bank to secure the loan. Paragraph #1 of the mortgage contains the following language:

> This mortgage shall stand as security for said note and for any and all future and additional advances made to the mortgagors by the holder of said note in such amount or amounts so that the total of such future additional advances outstanding and unpaid at any one time shall not exceed $42,000.00 ....

The debtors are current on this note. There is a balance owing in the sum of $10,998.47.

The bank also financed the debtors' farming operation. The debtors took out a loan on November 28, 1984 in the amount of $121,000.00. Security agreements dated the same day list certain farm land, all equipment, all farm products and proceeds and products of collateral as security for the loan. The farm land securing this note has been liquidated and proceeds have been turned over to the FDIC. The balance remaining on the note is $64,407.86 in principal plus $23,404.07 in accrued interest to May 15, 1987.

On December 28, 1984 and May 6, 1985 debtor Richard Sowers borrowed $1,500.00 and $2,800.00 respectively for operating expenses. The parties executed a blanket security agreement to secure the notes. The outstanding balance on the December 28, 1984 note is $1,500.00 in principal and $499.41 in accrued interest to May 15, 1987. With respect to the May 6, 1985 note, $1,343.08 in principal and $529.74 in accrued interest to May 15, 1987 remains unpaid.

The debtors state that an official from the bank, Robert Sweet, explained to them, at the time of the closing on the house loan, that the open ended feature of the mortgage (the dragnet clause) would allow the debtors to borrow up to $42,000.00 for home improvements without incurring the costs of rewriting a new mortgage and note for every advance. Borrowing for any other purpose was neither discussed nor considered at the meeting. Representatives from the bank stated to the debtors that the dragnet clause would be limited to home improvement loans. The deposition testimony of Roger Auestad, a former bank vice-president, revealed that note forms for residential real estate loans differed from those used for commercial and farm loans. He thought that the debtors' farm notes were not secured by the mortgage on the house. FDIC, in its corporate capacity, acquired from FDIC, as receiver for the bank, all notes, security agreements, and mortgages signed by the debtors in favor of the bank.

With respect to the second issue, the debtors planted 197 acres of corn in the spring of 1985 prior to filing bankruptcy on May 28, 1985. The debtors incurred the following expenses with respect to the 1985 corn crop:

Item	Amount	Pre or Post Petition Expense
Fuel	$ 1,484.50	pre and post
Drying	1,579.22	post
Checkoff	9.19	post
Combine	4,732.80	post
Set-aside measure	22.00	pre
Seed corn	1,771.50	pre
Interest on corn expense	484.06	pre
Fertilizer	2,536.03	pre
Chemicals	1,920.05	pre
Repairs	796.23	pre
Insurance	85.80	post
Crop transport	812.61	post
Plowing and disking (debtors' labor)	1,802.00	pre
Fertilizer to Gary Johnson	1,671.30	pre
Total	$19,707.29	

Except for the drying and checkoff, the debtors paid the other expenses. A local co-op withheld corn proceeds to defray the drying

and checkoff costs. After amounts were deducted for the landlord's share, the debtors received

$17,179.03 in corn proceeds. Of that amount, $2,112.15 was delivered to the trustee and the remaining sum of $15,066.88 was deposited in the trust account of debtors' counsel. The FDIC never consented to the payment of any of the crop expenses from 1985 corn crop proceeds.

DISCUSSION

I.

The debtors contend that they and the bank never intended that their house stand as security for farm loans. If this matter involved only the debtors and the bank, there would be no controversy because the debtors and officials from the failed bank stated that it was their mutual understanding that the dragnet clause would apply just to residence-related advances. The language of the mortgage does not reflect this understanding.

The FDIC concedes that the debtors' proof would be sufficient to prevent the bank's enforcement of the dragnet clause. However, it maintains that the operation of 12 U.S.C. section 1823(e) prevents the debtors from limiting the effect of the dragnet clause as to the FDIC. This provision states:

> No agreement which tends to diminish or defeat the right, title or interest of the Corporation in any asset acquired by it under this section, either as security for a loan or by purchase, shall be valid against the Corporation unless such agreement (1) shall be in writing, (2) shall have been executed by the bank and the person or persons claiming an adverse interest thereunder, including

> the obligor, contemporaneously with the acquisition of the asset by the bank, (3) shall have been approved by the board of directors of the bank or its loan committee, and (4) shall have been, continuously, from the time of its execution, an official record of the bank.

Id. Section 1823(e) generally is considered to be a codification of the holding articulated in D'Oench, Duhme & Co. v. FDIC, 315 U.S. 447, 62 S. Ct. 676, 86 L.Ed.-956 (1942), wherein the Supreme Court ruled that a secret agreement designed to deceive creditors or one having that effect would not be a defense against the FDIC in a collection action on a note. FDIC v. Wood, 758 F.2d 156, 159 (6th Cir. 1985). The language of section 1823(e) has been characterized as all encompassing--"any agreement is subject to the statute if it tends to defeat or diminish FDIC's rights in an asset purchased under authority of S 1823." FDIC v. Hoover-Morris Enterprises, 642 F.2d 785, 787 (5th Cir. 1981) (Unit B).

Understanding the underlying purpose of section 1823(e) depends upon an awareness of the mechanics of a bank closing. An explanation of FDIC's role once a bank is closed is set out in Gunter v. Hutcheson, 674 F.2d 862, 865-6 (llth Cir. 1982), cert. denied, 459 U.S. 826, 103 S. Ct. 60, 74 L.Ed.2d 63 (1982):

> The Federal Deposit Insurance Corporation is a federal agency which insures bank deposits. As insuror one of the primary duties of the FDIC is to pay the depositors of a failed bank. The FDIC has two

methods of accomplishing this duty. The simplest method is to liquidate the assets of the bank and then pay the depositors their insured amounts, covering any shortfall with insurance funds. This option, however, has two major disadvantages. First, the sight of a closed bank, even an insured one, does not promote the utmost confidence in the banking system. Accounts are frozen, checks are returned unpaid, and a significant disruption of the intricate financial machinery results. Second, depositors may wait months to recover even the insured portion of their funds, and uninsured funds may be irrevocably lost.

To avoid the significant problems with liquidation, the FDIC whenever feasible employs a 'purchase and assumption' transaction in which the Corporation attempts to arrange for another bank to purchase the failed bank and reopen it without interrupting banking operations and with no loss to the depositors. A purchase and assumption involves three entities: the receiver of the failed bank, the purchasing bank, and the FDIC as insuror. In most cases, the FDIC is appointed receiver by the appropriate banking authority and thus acts in two separate capacities: as receiver and as corporate insuror.

As soon as the receiver is appointed, the FDIC solicits bids from other banks for the purchase of the failed bank and assumption of its liabilities. The bids represent the 'going concern' value of the failed bank. After receiving the bids, the FDIC Board of Directors determines whether the purchase and assumption is feasible according to the statutory requirements of 12 U.S.C. 1823(e). If a bid is accepted, the purchasing bank agrees with the receiver to buy the assets and assume the liabilities of the failed bank.

While the purchase of a failed bank is an attractive way for other banks to

> expand their operations, a purchase and assumption must be consummated with great speed, usually overnight, in order to preserve the going concern value of the failed bank and avoid an interruption in banking services. Because the time constraints often prohibit a purchasing bank from fully evaluating its risks, as well as to make a purchase and assumption an attractive business deal, the purchase and assumption agreement provides that the purchasing bank need purchase only those assets which are of the highest bank quality. Those assets not of the highest quality are returned to the receiver, resulting in the assumed liabilities exceeding the purchase assets. To equalize the difference, the FDIC as insuror purchases the returned assets from the receiver which in turn transfers the FDIC payments to the purchasing bank. The FDIC then attempts to collect on the returned assets to minimize the loss to the insurance fund. In an appropriate case, therefore, the purchase and assumption benefits all parties. The FDIC minimizes its loss, the purchasing bank receives a new investment and expansion opportunity at low risk, and the depositors of the failed bank are protected from the vagaries of the closing and liquidation procedure.

Id. (citation and footnotes omitted).

In order to preserve the going concern value of a failed bank, decisions concerning the course of action the FDIC should take must be made with extraordinary speed. FDIC v. Gulf Life Ins., 737 F.2d 1513, 1517 (11th Cir. 1984); Gunter, 674 F.2d at 869. Section 1823(e) permits decisions to be made quickly because the statute contemplates that FDIC appraisers can limit their scrutiny to official bank records. See FDIC v. O'Neil, 809 F.2d 350,

353 (7th Cir. 1987)

The first question the court must address is whether section 1823(e) applies to this case. Section 1823(e) is not, applicable to situations where there is no secret agreement. FDIC v. Hatmaker, 756 F.2d 34, 37 (6th Cir. 1985); In re Howard, 65 B.R. 498, 503 (Bankr. W.D. Tex. 1986). The basis of Division I of the debtors' complaint is the verbal agreement between the debtors and the officials from the closed bank regarding the scope of the dragnet clause. Thus section is 1823(e) is applicable. Compare FDIC v. Gulf Life Ins., 737 at 1516 ("[b]ecause [debtor's] theories of waiver, estoppel, and unjust enrichment are not doctrines based on the parties' mutual assent, section 1823(e) is inapplicable to these defenses").

The agreement fails to qualify as an exception under the exacting standard of section 1823(e). Although the debtors and the bank came to an agreement contemporaneously with the bank's acquisition of the asset (the mortgage lien), the agreement was not reduced to writing, was not approved by the board of directors and was not an official record of the bank continuously from the time of its execution.

The debtors attempt to evade the effect of section 1823(e) by evoking the "relatedness rule" of contract construction under Iowa law. Dragnet clauses are valid but not favored and consequently are strictly construed against

a mortgagee. First Trust & Savings Bank v. Manning, 311' N.W. 285, 299 (Iowa 1981). One of the factors used to determine the vitality of a dragnet clause is an inquiry into "whether the later loan is related to or within the same class as the original debt......” Matter of Estate of Simpson, 403 N.W. 791, 793 (Iowa 1984). The operation of the "relatedness rule" is vividly illustrated in Freese Leasing v. Union Trust & Sav. Bank, 253 N.W.2d 921 (Iowa 1977), wherein a debtor borrowed money from a bank and gave the bank mortgages on certain real estate. The mortgages contained a dragnet clause. The debtor also was engaged in used car sales and relied upon the bank to finance this business. Business notes were signed by the debtor with reference to the business and the notes made no reference to the mortgages. Separate liability ledgers were kept for the business loans. In response to an inquiry from the debtors' bookkeeper as to the balance "for each mortgage," the bank responded without referring to the business loans. The debtor also testified that he did not intend that the real estate mortgages secure the business loans. In deciding that the parties did not intend that the business loans be covered by the dragnet clauses, the court noted that there was no relationship between the real estate loans and the business loans. The court stated:

> (I]n the absence of clear, supportive evidence of a contrary intention a mortgage containing a dragnet-type clause will not be extended to cover

> future advances unless the advances are of the same kind and quality or relate to the same transaction or series of transactions as the principal obligations secured or unless the document evidencing the subsequent advance refers to the mortgage as providing security therefore.

Freese Leasing, 253 N.W. at 927 quoting Emporia Bank & Trust Co. v. Mounkes, 214 Kan. 178, 184, 519 P.2d 618, 623 (1974).

The debtors' reliance upon the "relatedness rule" is misplaced. The purpose of utilizing the rule is to determine the intent of the parties. Simpson, 403 N.W. at 793. Here the bank admits that the dragnet clause was intended to secure the farm loans. Moreover, the intent of the parties has no bearing on this case to the extent the requirements of section 1823(e) are unsatisfied. As discussed earlier, the verbal agreement failed to satisfy those requirements.

Finally, to accept the debtors' argument would undermine the purpose of section 1823(e). Even where future advances do not relate to the principal transaction, dragnet clauses will be upheld under Iowa law if creditors adduce clear and supportive evidence of a contrary intention. FDIC appraisers do not have the luxury of determining whether such evidence exists. Their work must be completed with dispatch. They must rely solely on the language contained on the face of mortgages. The language contained on the face of the mortgage in question supports finding that the mortgage secures the farm loans.

The debtors next contend that they should either be paid for the expenses they incurred in producing the 1985 corn crop or retain corn proceeds in an amount equal to the proportional length of the growing season that remained after the bankruptcy was filed. The debtors assert that the corn had a growing life of 122 days and was planted 15 days prior to filing. Thus 12.3% of growing life is prepetition. Of the $17,173.03 in corn proceeds, the debtors maintain that 12.3% of this amount is the FDIC's and the remainder belongs to the debtors. In the alternative, the debtors maintain they should be reimbursed $19,707.29 for corn expenses that they paid. The FDIC maintains that the debtor should be reimbursed only for expenses paid postpetition.

The debtors concede that the FDIC's security interest in 1985 corn attached at the time the crops were planted. Pursuant to 11 U.S.C. section 552(b), the FDIC's security interest continues in identifiable proceeds of the 1985 corn because the debtors planted the crop prior to filing bankruptcy.

11 U.S.C. section 552(b) provides:

> Except as provided in section 363, 506(c), 522, 544, 545, 547, and 548 of this title, if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, product, offspring, rents, or profits of such property, then such security interest extends to such

> proceeds, product, offspring, rents, or profits acquired by the estate after the commencement of the case to the extent provided by such security agreement and by applicable nonbankruptcy law, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise. (Emphasis added.)

According to the legislative history, the above "provision allows the court to consider the equities in each case. In the course of such consideration the court may evaluate any expenditures by the estate relating to proceeds and any related improvement in position of the secured party." 124 Cong. Rec. H 11,097-11,098 (Sept. 28, 1978); S 17,414 (Oct. 6, 1978).[1]

Former Bankruptcy Judge Richard Stageman utilized the equitable theme of section 552(b) in Matter of Rieber, No. 82-1174-W, Adv. Pro. No. 84-0147, slip op. (Bankr. S.D. Iowa, February 28, 1985), the only case cited by the parties in support of their respective positions on the crop issue. Debtors suggest that Rieber allowed both pre and post petition expenses for caring for the crop; the FDIC contends that Rieber allowed only post petition expenses. Upon reviewing Judge Stageman's decision, it is clear to the undersigned that her predecessor's ruling is consistent with

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[1]Comparing Schedule B-1 and B-4 with the trustee's September 11, 1985 application to abandon suggests that the land upon which the crops were grown and presumably the crops are no longer property of the estate. Noticeably, the trustee has not intervened in the adversary action seeking any recovery under 11 U.S.C. section 506(c).

the overall statutory scheme of the Code. That is, only post petition expenditures were awarded the debtors against the creditor's claim in the value of the crop. To approve prepetition costs and expenses would favor some prepetition unsecured creditors over others similarly situated.

Accordingly, the debtors are entitled to reimbursement for combining ($4,732.80), insurance ($85.80) and crop transportation ($812.61). Expenses for drying ($1,579.22) and checkoff ($9.19) were satisfied prior to the debtors receipt of $17,179.03 in net proceeds. Debtors failed to prove which portion of the fuel cost ($1,484.50) was postpetition. That expense will not be allowed. Finally, the debtors use of the combine to harvest one-half acre of corn does not justify awarding the repair costs ($796.23).

CONCLUSION

WHEREFORE, based on the foregoing analysis, the court hereby finds:

1. The mortgage in issue secures the farm loans;

2. The debtors are not entitled to prepetition crop production expenses; and

3. The debtors are entitled to $5,631.21 reimbursement for combining, insurance and transportation expenses.

An appropriate order will be entered.

Signed and dated this 7th day of April, 1988.

LEE M. JACKWIG
CHIEF U.S. BANKRUPTCY JUDGE

Place behind Dec. #104
in Dec. Book

IN THE UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF IOWA
CENTRAL DIVISION

RICHARD W. SOWERS and
JUDITH L. SOWERS
Debtors and
Plaintiffs-Appellants,
v.

CIVIL NO. 88-293-B

FEDERAL DEPOSIT INS. CORP.,

Defendant-Appellee.

MEMORANDUM AND.DECISION
ON APPEAL FROM
BANKRUPTCY COURT

This is a bankruptcy appeal.

In 1978 the debtors, plaintiffs-appellants, purchased a house in Story, City, Iowa. The Story Cour State Bank financed the purchase and the debtors executed and delivered to the bank a mortgage on the house to secure the loan. The mortgage contains the following "dragnet" clause:

> This mortgage shall stand as security for said note, and for any and all future and additional advances made to the. Mortgagors by the holder of said note in such amount or amounts so that the total of such future additional advances
> outstanding and unpaid at any one time shall not
> exceed $42 000.00

The debtors' payments on the home loan are current, but a balance remains to be paid.

Later the bank financed the debtors' farming operation. Security agreements on the farm loans liste as security farmland, equipment and other security, but did not list the house in Story City as part of the security.

At the time the debtors obtained the house loan a bank official explained to them that the dragnet clause quoted above would allow the debtors to borrow up to $42,000.00 for home improvements without incurrin the costs of rewriting a new mortgage and note for every advance. Borrowing for any other purpose was neither discussed nor considered. It was the mutual understanding of the bank and the debtors that the dragnet clause wou

be limited to future home improvement loans and neither of the parties ever understood or believed that the later far operation loans were covered by the mortgage on the house.

Later the bank was closed and the Federal Deposit Insurance Corporation (FDIC), defendant-appellee, in its corporate capacity, acquired from FDIC, as receiver of the bank, all notes, security agreements and mortgages siqned by the debtors in favor of the bank.

On April 7, 1988, the bankruptcy court entered the order from which debtors appeal. That order holds that the dragnet clause in plaintiffs' home mortgage operates to grant the FDIC a security interest in the home for the subsequent farm operation loans. The bankruptcy court reached this conclusion based on 12 U.S.C. § 1823(e), which provides:

> No agreement which tends to diminish or defeat the right, title or interest of the Corporation [FDIC] in any asset acquired by it under this section, either as a security for a loan or by purchase, shall be valid against the Corporation unless such agreement (1) shall be in writing, (2) shall have been executed by the bank, and the person or persons claiming an adverse interest thereunder, including the obligor, contemporaneously with the acquisition of the asset by the bank, (3) shall have been approved by the board of directors of the bank or its loan committee, which approval shall. be reflected in the minutes of said board or committee, and (4) shall have been, continuously, from the time of its execution, an official record of the bank.

Debtors argue that as a matter of Iowa law the dragnet clause does not extend the mortgage security in the house to the later farm loans and that therefore the FDIC's interest in the farm loans never included a security interest in the house. The FDIC argues that the dragnet clause applies by its terms to the farm loans and that any understanding to the contrary between the bank and the debtors cannot defeat FDIC's security interest in the house because the four conditions enumerated in section 1823(e) are not met.

The Iowa Supreme Court has construed dragnet clauses in mortgages as follows:

> [I]n the absence of clear, supportive evidence of a contrary intention a mortgage containing a dragnet-type clause will not be extended to cover future advances unless the advances are of the same transaction or series of transactions as the principal obligations secured or unless the document evidencing the subsequent advance refers to the mortgage as providing security therefore.

In re Simpson,, 403 N.W. 2d 791, 793 (Iowa 1987) (quotinq Freese Leasing, 253 N.W. 2d 921, 927 (Iowa 1977) quoting Emporia Bank and Trust Co. v. Mounkes, 519 P.2d 618,623 (Kan. 1974).

It is undisputed that the farm loans do not refer to the house as security and are not of the same kind and quality and do not relate to the same transactions or series of transactions as the house mortgage loan. Also, there is no evidence whatsoever of an intention on the part of the debtors or the bank that the farm loans be secured by the house mortgage. [1]

It is clear, therefore, that under Iowa law the farm loans never were secured by the house mortgage. Section 1823(e) does not expand coverage of a mortgage interest acquired by the FDIC; it merely provides that the reach of any mortgage interest acquired by FDIC cannot be diminished or defeated by some side agreement unless the four enumerated conditions are met. Stated another way, the statute does not operate to create an agreement that never was (i.e., an agreement to secure the farm loans with the house mortgage).

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[1] The bankruptcy judge stated at page 11 of her memorandum of decision that "the bank admits that the dragnet clause was intended to secure the farm loans." The bankruptcy court's

> [f]indings of fact, whether based on oral or documentary evidence, shall not be set aside unless clearly erroneous, and due regard shall be given to the bankruptcy court to judge the credibility of witness.

Bankruptcy R. 8013. This finding is unsupported by the evidence and clearly erroneous, which the FDIC concedes. The quoted finding of the bankruptcy court is set aside as clearly erroneous.

The underlying purpose of section 1823(e) is not frustrated by this court's decision because the FDIC was on notice of the Iowa law governing the limited reach of mortgage dragnet clauses and was on notice that there were no facts brining the farm loans within the reach of the dragnet clause as construed by the Iowa Supreme court.

The bankruptcy court erred in concluding that the farm loans were secured by the house mortgage, and therefore the decision of the bankruptcy court is reversed and the case is remanded for proceedings consistent with this opinion.

Dated this 9th day of February, 1989.

Harold D. Vietor, Chief Judge

Southern District of lowa

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