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CLERK

UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF SOUTH DAKOTA

CENTRAL DIVISION

In re: WILBUR JOHN SMITH and BETTY JEAN SMITH, Debtors,	Case No. 87-30162-INH Adversary No. 94-3010 (Chapter 12)
WILBUR JOHN SMITH and BETTY JEAN SMITH, Appellants, vs. UNITED STATES OF AMERICA, acting through the Farm Service Agency, Agriculture Credit Division, Appellee.	Civ. No. 96-3008 JUDGMENT

Pursuant to the Memorandum Opinion and Order entered this day, it is hereby

ORDERED that appellants Smiths shall have judgment against appellee United States of America and that the bankruptcy court's grant of appellee's motion for summary judgment is reversed and this case is remanded to the bankruptcy court for further proceedings relative to appellant's declaratory judgment action.

Dated this 3rd day of January, 1997.

BY THE COURT

Andrew W. Bogue

ANDREW W. BOGUE
SENIOR DISTRICT JUDGE

ATTEST:
JOSEPH HAAS

by: Katheen S Jaggers
Deputy Clerk

(SEAL)

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U.S. BANKRUPTCY COURT
DIST. SOUTH DAKOTA

UNITED STATES OF AMERICA }
DISTRICT OF SOUTH DAKOTA } ss

I, JOSEPH HAAS, Clerk of the United States District Court for the District of South Dakota, do hereby certify that the above and foregoing is a true and correct copy of the original now on file in my office.

Dated: Jan 6, 1997

By Katheen S Jaggers

68.

FILED

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UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF SOUTH DAKOTA

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In re: WILBUR JOHN SMITH and BETTY JEAN SMITH, Debtors,	Case No. 87-30162-INH Adversary No. 94-3010 (Chapter 12)
WILBUR JOHN SMITH and BETTY JEAN SMITH, Appellants, vs. UNITED STATES OF AMERICA, acting through the Farm Service Agency, Agriculture Credit Division, Appellee.	Civ. No. 96-3008 MEMORANDUM OPINION & ORDER

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U.S. BANKRUPTCY COURT
CENTRAL DIV. SOUTH DAKOTA

This matter is before the Court on appellants Betty and Wilbur Smith's appeal from a decision of the bankruptcy court entered July 24, 1995 granting appellee Farm Service Agency's [FSA, a/k/a Rural Economic and Community Development, a/k/a Farmers Home Administration] motion for summary judgment and dismissing Smiths' complaint. After the bankruptcy court's denial of their motion to reconsider and motion to amend its decision and order, Smith's timely filed their notice of appeal on January 2, 1996. FSA resists Smiths' appeal and urges this Court to affirm the bankruptcy court. Both sides have filed briefs outlining their arguments. Although appellants assert several errors on appeal, their appeal can be condensed down to two determinative issues. First, Smiths argue that the bankruptcy court lacked continuing

jurisdiction to determine matters in their Chapter 12 case because a discharge was entered and their case was closed. Second, Smiths argue the bankruptcy court erroneously determined that by virtue of FSA's 1111(b) election in a related Chapter 13 case, FSA retained "in rem" rights in Smiths' real estate despite Smiths' relief from personal liability on the debt via their Chapter 12 discharge. The Court reverses the bankruptcy court's grant of appellee's summary judgment motion for the following reasons.

FACTS

In the mid 1970's to early 1980's Wilbur Smith served as an officer of Katcon, Inc.(Katcon), a family farm corporation. From 1977 through 1981 Katcon gave FSA a security agreement and several mortgages on its real estate to secure several promissory notes for loans given to Katcon by FSA during those years. In his capacity as either president or vice-president of Katcon, Smith signed all of the Katcon promissory notes. In his individual capacity, Smith also signed two notes and one mortgage given by Katcon. On the same dates that the Katcon mortgages were given, the Smiths gave FSA mortgages on their personal real estate to secure the loans to Katcon, Inc. Katcon, Inc. filed a chapter 11 bankruptcy on December 9, 1987. At the time of its filing, Katcon's 100% shareholders were Terrance Smith and Richard Smith. Wilbur and Betty Smith were neither shareholders nor officers. Also, at the time of its filing, Katcon's debt to FSA, secured by the mortgages, was approximately $1.6 million. FSA filed a claim in Katcon's Chapter 11 case for the amount of the indebtedness. The Smiths

filed a Chapter 12 bankruptcy on December 21, 1987. FSA filed a claim in the Smiths' Chapter 12 case in the amount of approximately $1.6 million. FSA's claims in both the Katcon and Smith cases are claims for the exact same indebtedness. That is, the FSA claim filed in Smiths' case is based upon Smiths' pledge (mortgage) of their personal real estate as security for the FSA loans to Katcon, Inc.

Smiths' chapter 12 plan was confirmed by order on July 28, 1988. According to Smiths' plan, FSA had a secured claim of $192,000 which was to survive their discharge and be paid in annual installments over fifteen years. Their plan also provided that the balance of the FSA debt was unsecured for which FSA was to receive disposable income for three years and a *pro rata* share of a one-time $10,000.00 payment. A clause in Smiths' plan provided that "[FSA] is secured to the extent of $192,000.00. . . . All [FSA] mortgages will be satisfied after these amounts are paid in full. [FSA] will have an unsecured claim of $1,190,419.00." Smiths' plan also stated that "[d]ebtors shall be entitled to prepay any and all creditors." Read together these provisions appear to entitle Smiths, at any time during the fifteen years within which they must pay the $192,000 secured claim, to prepay any unpaid portion of the claim and obtain satisfaction of the mortgages encumbering their land.

The order confirming Katcon, Inc.'s Chapter 11 reorganization plan was entered on March 8, 1989. Under Katcon's plan, FSA had a secured claim in the amount of $132,700 and an undersecured claim

in the amount of $1,263,854.73[1] FSA filed an election in the Katcon case pursuant to 11 U.S.C. § 1111(b)(2). The election was a "modified 1111(b)(2) election" made in a "stipulation for plan treatment" entered into by FSA and the principals of Katcon, Inc. By virtue of the modified election, FSA is permitted to maintain a lien on the collateral securing the full amount of its allowed claim, irrespective of the valuation of such collateral. If the land is later sold at an appreciated value, FSA can satisfy its lien out of the proceeds. Also, another provision of Katcon's confirmed plan states that the "undersecured claim will be allowed in the unsecured class of claims [in the Katcon case] and also [the] Richard Smith, Wilbur and Betty Smith, and Terrance Smith Chapter 12 cases."

Smiths' completed the trustee portion of their plan and, except for the secured portion of the debt which survived, received a discharge pursuant to 11 U.S.C. § 1228(a) on August 24, 1993. In the fall of 1994, Smiths sought to refinance their land. In order to do so, the lender required that it have a priority security interest over all other secured creditors with an interest in Smiths' land. Pursuant to the prepayment option in their plan, Smiths claim they asked FSA to determine the unpaid portion of Smiths' $192,000 Chapter 12 secured debt to FSA. Smiths intended to pay off the debt, obtain mortgage satisfactions and lien releases from FSA, and refinance by giving the new lender a first

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[1] FSA's undersecured claim was calculated by subtracting Katcon's land equity ($132,700) and Smiths' land equity ($192,000) from the total allowed claim ($1,588,554.73).

lien on their property. However, FSA indicated that prepayment of the secured balance would not entitle Smiths to a mortgage and lien satisfaction. FSA maintained that its modified election in the Katcon case applied to all the collateral securing its claim against Katcon, Inc. This would include the Smiths' personal real estate pledged as security for the 1977 through 1981 loans from FSA to Katcon. FSA maintained that while Smiths' Chapter 12 discharge relieved them of any personal liability on the debt, FSA nonetheless retained *in rem* rights against Smiths' personal real estate by virtue of the modified election in the Katcon case. FSA argued it could not be stripped of its *in rem* rights by the operation of Smiths' discharge. FSA refused to give Smiths the mortgage satisfactions they requested.

Smiths brought this action in U.S. bankruptcy court seeking a declaratory judgment and determination of the remaining amount of indebtedness (as reduced by any government program payments) they are required to pay in order to be entitled to a satisfaction of the mortgages they gave to FSA. They also sought an order requiring FSA to satisfy the mortgages upon payment of the remaining secured debt. The bankruptcy court, however, granted FSA's motion for summary judgment. In so doing, that Court found:

> The modified § 1111(b) election by [FSA] in Katcon covers both Katcon's and [Smiths'] real property. That election is not abated by [Smiths'] Chapter 12 discharge . . . . Katcon and its principals agreed to the modified election that covered all mortgages given to secure Katcon's debt. Therefore, the parties are bound by the terms of Katcon's plan . . . . [T]he clear intent of the [Katcon] plan provision is that both the [Smiths'] and Katcon's real property are included in the § 1111(b) election.

The court concluded that Smiths' are not entitled to have the real property mortgages satisfied and the liens removed as the mortgages and liens relate to Katcon's debt. The court stated "the mortgages given to [FSA] as part of Katcon's plan can only be satisfied if the terms of the modified § 1111(b) provision in Katcon's plan are met." The court declined to determine the remaining balance of the secured debt. Similarly, the court did not address the issue of whether Smiths' discharge "stripped" FSA of any liens it may have had against Smiths' personal real estate.

Subsequent to these events, FSA brought a foreclosure proceeding against Katcon, Inc. and named Smiths as parties in order to foreclose their interest in Katcon Inc.'s property. In state court, FCS (formerly Federal Land Bank) brought a separate foreclosure proceeding against Smiths' personal real estate (which is separate from the Katcon property being foreclosed). That matter is now in the redemptive period and an extension of the redemptive period.

On appeal, Smiths argue they took no part in the Katcon Chapter 11 case and that the 1111(b) election in that case has no bearing in their Chapter 12 case. They maintain they have fulfilled all of their obligations under their Chapter 12 plan, and therefore, are entitled to pay off the remaining debt to FSA and obtain satisfaction and release of all plan mortgages and liens on their personal real estate. FSA concedes that Smiths' plan allows them to prepay and relieve themselves of any <u>personal</u> liability for their mortgages securing the loans from FSA to Katcon. However,

FSA claims that its modified 1111(b)(2) election imposed a lien not only on the property of the Katcon Chapter 11 estate, but also on the property of Smiths' Chapter 12 estate, and that, FSA retains *in rem* rights against the Smiths' personal real estate and thus can seek satisfaction of its 1111(b)(2) lien if the "Katcon collateral" is ever foreclosed upon or sold. Further, FSA claims that since it retains *in rem* rights against Smiths' property by virtue of Katcon's Chapter 11 bankruptcy proceeding, it cannot be stripped of its § 1111(b)(2) lien on Smiths' personal real estate by operation of Smiths' Chapter 12 discharge[2]. FSA additionally argues the bankruptcy court properly found that the modified election in the Katcon case further modified FSA's relationship with Smiths' Chapter 12 estate property and that the mortgages given to FSA as part of Katcon's plan can only be satisfied if the terms of the modified election are met.

STANDARD OF REVIEW

On a motion for summary judgment, the bankruptcy court views the evidence, and inferences from the evidence, in the light most favorable to the non-moving party. Matsushita Electric Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 587, 106 S.Ct. 1348, 1356, 89

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[2] Alternatively, FSA argues that the discharge provisions of § 524 and § 1228 of the bankruptcy code relieve Smiths of their personal liability only. FSA argues it has *in rem* rights against Smiths' land independent of the 1111(b) election in that the mortgage liens given to FSA by Smiths survived their bankruptcy despite that FSA can not proceed against Smiths personally for the debt.

L.Ed.2d 538 (1988). Summary judgment is granted only if there is no dispute as to any issue of material fact and if the moving party is entitled to a judgment as a matter of law. Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 250, 106 S.Ct. 2502, 2511, 91 L.Ed.2d 202 (1986); Fed.R.Civ.P. 56(c); Fed.R.Bkr.P. 7056. On appeal of the bankruptcy court's judgment to the district court, the district court acts as an appellate court and reviews the bankruptcy court's legal determinations *de novo* and findings of fact for clear error. In re Lauer, 98 F.3d 378, 382 (8th Cir. 1996). "A finding is `clearly erroneous' when although there is evidence to support it, the reviewing court is left with the definite and firm conviction that a mistake has been committed." In re Hoffman Farms, 195 B.R. 80, 83 (D.S.D. 1996)(citing United States v. Gypsum Co., 333 U.S. 364, 395, 68 S.Ct. 525, 542, 92 L.Ed. 746 (1948). When reviewing a grant of summary judgment by the bankruptcy court, this court must determine *de novo* whether FSA was entitled to judgment as a matter of law. In re Lauer, 98 F.3d at 382.

DISCUSSION

I. Jurisdiction

Although Smiths originally brought this adversary proceeding, on appeal they assert that because they received a discharge and their Chapter 12 case was closed, the bankruptcy court lacked jurisdiction to determine matters in their case. Judicial proceedings in a bankruptcy case are divided into "core" proceedings and proceedings related to a bankruptcy case. 28 U.S.C. § 157(b);

In re Cook, 126 B.R. 575 (D.S.D. 1991)(citations omitted). Bankruptcy judges have jurisdiction to hear and determine all core proceedings under Title Eleven. Id. Core proceedings are those central to the adjustment of the debtor/creditor relationship in bankruptcy. Id. "Core proceedings include . . . determinations of the validity, extent, or priority of liens." 28 U.S.C. § 157(b)(2)(K); (*See* In re Cook 126 B.R. at 579(dispute between FmHA and debtors regarding extent and validity of FmHA's lien was a core proceeding)). This action is essentially one to determine whether a valid lien exists against a Chapter 12 estate either by operation of an 1111(b) election or by the provisions of Chapter 12 proper such that Smiths' can not give their potential refinance lender a first lien on their land. Thus, the bankruptcy court properly found that this adversary proceeding is a core proceeding pursuant to 28 U.S.C. 157(b)(2).

II. Validity and Extent of the 1111(b) lien on Smiths' land

Section 1111(b) converts an unsecured deficiency claim into a claim fully secured by the electing creditor's collateral. The creditor is permitted to maintain a lien on its collateral to secure the full amount of its allowed claim, irrespective of the valuation of such collateral. The purpose of the election is to provide additional protection to a partially secured creditor when he believes the collateral has been undervalued or that the treatment accorded to unsecured creditors under the plan is so unattractive that he is willing to waive his unsecured deficiency

claim. 5 Collier on Bankruptcy ¶ 1111.02[5] (15th ed. 1996). If the collateral is later sold, the creditor can apply his lien against the proceeds and realize any appreciation in the property. However, the provisions of § 1111 require that the creditor's claim be "secured by a lien on the property of the estate." 11 U.S.C. § 1111(a). Although the bankruptcy court's opinion is unclear on this point, it appears the court grounded its conclusion that the election covered Smiths' land on the assumption that the Smiths somehow participated in or consented to the application of FSA's election to their Chapter 12 bankruptcy estate. This Court believes it is clear error for the bankruptcy court to assume that the Smiths consented to or participated in the 1111(b) election. Moreover, this assumption tainted the bankruptcy court's conclusion that the election is therefore binding on the Smiths' Chapter 12 bankruptcy estate.

Property of the estate is defined in relevant part as "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1). The Smiths' personal real estate is not part of Katcon's Chapter 11 estate property. Indeed, as the bankruptcy court pointed out in his memorandum of decision, "[h]ad a straight § 1111(b) election been made by [FSA] in Katcon, the Smiths' property may not have been included since § 1111(b) applies to `property of the estate' and Debtors' real property is not part of [the] Katcon bankruptcy estate." The court determined, however, that this distinction is irrelevant in the case at bar because the modified 1111(b) election

further modified FSA's relationship with Smiths' estate property such that the election covered both Smiths' and Katcon's real property. However, there is nothing in the record on appeal from which this Court can fairly determine that the election, without the consent or active participation by Smiths, has modified FSA's relationship with Smiths' Chapter 12 estate such that their property in effect becomes property of Katcon's chapter 11 estate.

For support of his conclusion that the election applied to Smiths' land, the bankruptcy court relied on the fact that "Katcon and its principals agreed to the modified election that covered all mortgages given to secure Katcon's debt." Yet, nothing in the record indicates that the Smiths were "principals" of Katcon during these bankruptcy proceedings. As noted above, at the time Katcon filed for bankruptcy, its 100% shareholders were Terrance and Richard Smith. Also, Smiths' assertions that at the time of the bankruptcy proceedings the Smiths were nearly 80 years old, were neither officers nor shareholders of Katcon, and did not participate in any way in the Katcon bankruptcy or confirmation, are not refuted by FSA. The bankruptcy court also concluded that because of the agreement between Katcon and its principals, the "clear intent of the [Katcon] plan is that both [Smiths'] and Katcon's real property are included in the 1111(b) election." This conclusion was made notwithstanding that all of the intent to include Smiths' property as part of the Katcon Chapter 11 estate appears to derive entirely from the unilateral actions of FSA and Katcon - without participation by Smiths.

With respect to FSA's claim, Smiths' Chapter 12 plan reads in relevant part as follows:

4. (a) Creditors' claims in Class (a) are as follows:

Name	Amount	Arrearage	Security
[FSA]	$1,584,419	all	real estate - 2d mortgage

. . . . .

(b) Creditors in this class are to be paid as follows:

	1988	1989	1990
[FSA]	($1,392,419) unsecured ($192,000) secured	$10,112 8,982	

. . . . .

[FSA]

[FSA] is secured to the extent of $192,000. [FSA] will receive annual payments of $10,112 and $8,982. Those payments are computed on the basis of loans of $86,549 amortized at 8% interest over 15 years = $10,112 annual payment, and $105,450.54 loan amortized at 3% interest over 15 years = $8,982 annual payment. All [FSA] mortgages will be satisfied after these amounts are paid in full. [FSA] will have an unsecured claim of $1,190,419.

15. Except as provided in section 1228(a) of Title Eleven United States Code, and except as provided in this Plan or the Order confirming this Plan, the property of the estate is vested in the [Smiths] free and clear of any claim or interest of any creditor provided for by this Plan pursuant to section 1227(b) of Title Eleven, United States Code.

FSA concedes that no other provision of Smiths' plan addressed FSA's 1111(b)(2) election in the Katcon, Inc. case or addressed any other treatment of FSA's claim. Similarly, nothing in the modified 1111(b) election in the Katcon plan refers to the election's

applicability to Smiths' Chapter 12 case[3]. Yet, in support of its

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[3] The modified § 1111(b) election provisions state:

> (a) [FSA] shall retain both its first and second mortgage interest in the debtor's real estate. If the debtor's real estate on which [FSA] has a mortgage interest is sold at any time before or within ten years after confirmation of a plan, [FSA's] mortgage interest shall entitle it to be paid proceeds from the sale in an amount up to its secured claim of $1,588,524.73. The amount of the sale proceeds to be paid [FSA] on the total claim will not exceed the proceeds of the sale.
>
> (b) The total proceeds of the sale to be paid to the [FSA] shall be calculated as:
>
> > The total amount of the allowed claim of $1,588,524.73, which is the face amount of the principal and interest owing to the [FSA] on the date of the filing of the petition, together with accrued interest from that date at the interest rate set out in the promissory notes with [FSA] or the interest rate as agreed upon in the plan.
>
> (c) The modified 1111(b) provisions shall apply if any sale occurs after confirmation of the plan and prior to payment in full of the allowed secured claim of [FSA], except as further provided by provision g.
>
> (d) The total sale proceeds paid to [FSA] upon a sale of any portion of the real estate in which [FSA] holds a mortgage behind any other prior mortgages may be released by the amount of any sale proceeds actually paid to such mortgagee.
>
> (e) The Chapter 11 debtor shall be given credit against the total proceeds to be paid to [FSA] for any payments made by the Chapter 11 debtor after the filing of the petition.
>
> (f) Upon payment of the proceeds to which [FSA] is entitled under this provision, [FSA] shall release its mortgages.
>
> (g) If any sale of the real estate is for only a portion of the total real estate mortgaged to [FSA], the debtor and [FSA] shall apportion the remaining debt according to the value which the real estate sold represents to the total value of the mortgaged real estate. The debtor and [FSA] may either mutually agree

position that the election is binding on the Smiths in their case, FSA proffers: (1) that the above treatment of the FSA debt in Smiths' plan acknowledges the relationship between the claim and the collateral; (2) that the Smiths' plan treatment of FSA's claim represented by the value of the Smiths' individual property was credited in the same amount on the claim in the Katcon plan to arrive at FSA's Chapter 11 plan treatment; and (3) that a clause in the Katcon plan indicates that the undersecured portion of FSA's claim in the Katcon case will be allowed in the unsecured class of claims in the Wilbur and Betty Smith Chapter 12 case. This argument is too attenuated to allow this Court to agree that Smiths' personal real estate is therefore, in effect, made property of the Katcon Chapter 11 estate and subject to the 1111(b) election without Smiths' consent or active participation in the Katcon case.

CONCLUSION

The Court finds that the bankruptcy court committed clear

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on these values with or without appraisals or may have a court determine these values in any appropriate proceeding in any state or federal court of general jurisdiction or in the bankruptcy court.

(h) Regardless of debtor's prepayment of any plan payments to [FSA] that fully satisfy Katcon's initial obligation to pay $132,700.00 under its confirmed plan, [FSA] shall be entitled to receive the above amounts if the debtor takes any action within the ten year period to sell its real estate mortgaged to [FSA], even if the sale proceeds are received by debtor beyond the ten year period.

(i) Upon payment in full of [FSA's] secured claim of $132,700.00 after the twenty years, and provided debtor retains the real estate, [FSA] agrees to release the mortgages against the property although the string of payments will not equal $1,558,554.73.

error when, it asumed that the Smiths consented to or participated in the application of FSA's 1111(b) election to their personal real estate. Moreover, the bankruptcy court erroneously relied on this assumption for its conclusion that Smiths' real property was included in the election and that therefore Smiths are not entitled to have the real property mortgages satisfied and the liens released as the mortgages and liens relate to Katcon's debt. In this Court's opinion, there is a genuine issue of material fact regarding whether Smiths' participated in or consented to the 1111(b) election as it relates to their personal real estate. In the absence of a showing that Smiths participated in or consented to an 1111(b) election against their property, and that such participation or consent legally binds them to the provisions of the Katcon plan[4], summary judgment is improper. For the foregoing reasons it is hereby

ORDERED that the bankruptcy court's grant of appellee's motion for summary judgment is reversed and this case is remanded to the bankruptcy court for further proceedings relative to appellant's declaratory judgment action[5].

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[4]Assuming, arguendo, that the Smiths had consented to application of the 1111(b) election to their property, it should be noted that the Bankruptcy Court cited no authority in his opinion for the legal conclusion that such election was therefore binding upon their personal real estate which was not the property of the Katcon Chapter 11 estate.

[5] This Court is aware of the uncertainty of the state of the law regarding whether § 506 of the bankruptcy code provides a "stripping" mechanism for these types of liens in a Chapter 12 case. However, it is unnecessary at this juncture to decide whether an 1111(b) lien can be stripped in a Chapter 12 case because, as this Court finds, the bankruptcy court improperly

Dated this 3rd day of January, 1997.

BY THE COURT

ANDREW W. BOGUE
SENIOR DISTRICT JUDGE

ATTEST:
JOSEPH HAAS

by: _____
Deputy Clerk

(SEAL)

Jan 6, 1997

held that such lien existed upon Smiths' land. Similarly, the Court makes no disposition of FSA's argument that an unsecured or undersecured mortgage lien on real estate in a Chapter 12 bankruptcy retains *in rem* viability after discharge despite the debtors' relief from personal liability on the debt. However, these issues may become salient as the declaratory judgment action proceeds.