Recent Developments in Chapter 12 Bankruptcy

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INTRODUCTION

This Article addresses some of the year's most important case law developments in the area of Chapter 12 bankruptcy.[1] These decisions document the continuing debate surrounding several fundamental aspects of farm reorganization under Chapter 12.

Enacted in October of 1986, Chapter 12 has existed for over four years.[2] Although this time period is sufficient to allow for substantial judicial interpretation, as this Article discusses, the circuits have failed to agree on several major issues. Even when there is agreement, a less than clear standard exists for the lower courts to follow. Thus, the controversy continues.

This Article highlights four issues that remain in dispute as evidenced by appellate cases[3] published in 1990. The first involves the fundamental issue of eligibility for Chapter 12 relief. The next three involve the powers afforded to the Chapter 12 debtor once eligibility is established. The issues discussed were chosen because of their overall significance in terms of their controversial nature and the level of judicial review afforded.[4]

I. ELIGIBILITY FOR CHAPTER 12

Only a "family farmer with regular annual income" is eligible for Chapter 12 relief.[5] The term "family farmer" is defined in section 101(17)

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1. Chapter 12 is a special chapter of the United States Bankruptcy Code that establishes rules and procedures for debt reorganization of certain family farmers. 11 U.S.C. §§ 1201-1231 (1988).

2. Bankruptcy Judges, United States Trustees and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, tit. II, § 255, 100 Stat. 3105-3113 (1986).

3. Each of the primary cases discussed involves the review of a lower court decision. Four are circuit court opinions and one is a bankruptcy appellate panel decision.

4. This discussion is by no means intended, however, to indicate that the cases discussed were the only important decisions of the year. Many bankruptcy court decisions of significant impact were published and not appealed. Among other sources, THE FARMERS LEGAL ACTION REPORT contains a quarterly review and brief summary of all of the published bankruptcy decisions involving agriculture. This newsletter can be obtained from Farmers Legal Action Group, Inc., 1301 Minnesota Bldg., 46 E. 4th St., St. Paul, MN 55101.

5. 11 U.S.C. § 109(f) provides that "[o]nly a family farmer with regular annual income may be a debtor under chapter 12 of this title." 11 U.S.C § 109(f) (1988).

of the Bankruptcy Code, with specific requirements for individuals[6] and similar, but distinct, requirements for partnerships and corporations.[7]

In general terms, section 101 requires that to qualify as a "family farmer," the debtor must be: engaged in farming; have debts below the maximum amount of total debt; have the requisite percentage of debt stem from the farming operation; have the requisite percentage of income arise from the farming operation; and if a partnership or corporation, meet the ownership and organization requirements.[8] These requirements address the issue of what constitutes farming from several different perspectives: the percentage of farm income; the percentage of farm debt; and the basic condition that the debtor be "engaged in farming." The "regular annual income" requirement is defined as annual income that is "sufficiently stable and regular to enable such family farmer to make payments" under a Chapter 12 plan.[9]

Because Chapter 12 offers significant powers to the debtor that may not be available under other bankruptcy chapters,[10] the issue of whether

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6. For individuals, § 101(17)(A) provides that a "family farmer" is

> (an) individual or individual and spouse engaged in a farming operation whose aggregate debts do not exceed $1,500,000 and not less than 80 percent of whose aggregate noncontingent, liquidated debts (excluding a debt for the principal residence of such individual or such individual and spouse unless such debt arises out of a farming operation), on the date the case is filed, arise out of a farming operation owned or operated by such individual or such individual and spouse, and such individual or such individual and spouse receive from such farming operation more than 50 percent of such individual's or such individual and spouse's gross income for the taxable year preceding the taxable year in which the case concerning such individual or such individual and spouse was filed.

11 U.S.C. § 101(17)(A) (1988).

7. For corporations and partnerships, § 101(17)(B) provides that a "family farmer" is

> (a) corporation or partnership in which more than 50 percent of the outstanding stock or equity is held by one family, or by one family and the relatives of the members of such family, and such family or such relatives conduct the farming operation, and (i) more than 80 percent of the value of its assets consists of assets related to the farming operation; (ii) its aggregate debts do not exceed $1,500,000 and not less than 80 percent of its aggregate noncontingent, liquidated debts (excluding a debt for one dwelling which is owned by such corporation or partnership and which a shareholder or partner maintains as a principal residence, unless such debt arises out of a farming operation), on the date the case is filed, arise out of the farming operation owned or operated by such corporation or such partnership; and (iii) if such corporation issues stock, such stock is not publicly traded.

11 U.S.C. § 101(17)(B) (1988).

8. *See supra* notes 6-7 and accompanying text.

9. 11 U.S.C. § 101(18) (1988).

10. For example, under Chapter 12 there is no "absolute priority rule" as exists

a debtor meets the specific eligibility requirements is frequently litigated.[11] Although the statute lists the specific amounts and percentages for debt and income requirements, the full range of activities that are to be considered "farming" remains uncertain. Because the definition of an activity as "farming" is determinative to the "engaged in farming" requirement and to several of the other eligibility requirements, the courts continue to struggle with the limits of what can be termed "farming." These struggles tend to focus on the concept of either farm income, farm debt, or the engaged in farming requirement itself.

There is no agreement on the test to be applied in addressing the areas noted above. Although admittedly there is a wide variety of types of family farms, this continuing controversy is somewhat surprising. The drafters of the Chapter 12 statutory language imposed specific guidelines. Moreover, "farming" is defined in the Bankruptcy Code. Section 101(18) provides that a "farming operation includes farming, tillage of the soil, dairy farming, ranching, production or raising of crops, poultry, or livestock, and production of poultry or livestock products in an unmanufactured state."[12] However, litigation in this area continues to be prolific and highly contested.[13]

Admittedly, it would be impractical, if not impossible, to present a definition of farming that would precisely address each individual fact

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under Chapter 11. 11 U.S.C. § 1129(b)(2)(B)(ii) (1988). The "absolute priority rule," which prohibits the retention of any equity interest by the debtor over the interest of objecting creditors, has made Chapter 11 plans for family farm operations extremely difficult to confirm. *See* Norwest Bank of Worthington v. Ahlers, 485 U.S. 197 (1988) (defining the absolute priority rule as applied to farming operations). Similarly, creditors involved in a Chapter 12 bankruptcy do not have the § 1111(b) election that is available to creditors of Chapter 11 debtors. 11 U.S.C. § 1111(b) (1988).

11. In eligibility litigation, the debtor bears the burden of proof of establishing eligibility. *See, e.g.*, *In re* Tim Wargo & Sons, Inc., 869 F.2d 1128 (8th Cir. 1989).

12. 11 U.S.C. § 101(20) (1988).

13. In 1990, the following reported cases addressed eligibility for Chapter 12 relief and the definition of "farming": *In re* Watford, 898 F.2d 1525 (11th Cir. 1990) (stone crabbing is not a "farming operation," but storing soybeans and the intent to establish catfish ponds may be; *infra* note 19 and accompanying text); *In re* Smith, 109 Bankr. 241 (W.D. Ky. 1989) (insurance proceeds from the destruction of a combine by fire do not constitute income from a "farming operation"); *In re* Way, 120 Bankr. 81 (Bankr. S.D. Tex. 1990) (nontaxable government agricultural subsidy payments qualify as "farm income" but director's fees from farming corporation do not); *In re* Easton, 118 Bankr. 676 (Bankr. N.D. Iowa 1990) (on remand from 8th Circuit, cash rental income found to be income from farming operation because debtors had a "significant degree of engagement in" and a "significant operational role in" the production of crops on the rented land; same test is used to qualify debt on hog facility as debt arising from the debtors' farming operation); *In re* Marlatt, 116 Bankr. 703 (Bankr. D. Neb. 1990) (debt owed to former spouse arising out of property settlement that awarded farming operation to debtor constitutes debt arising out of the farming operation); *In re* Richardson, 113 Bankr. 28 (Bankr. D. Colo. 1990) (contract crop spraying income is not farm income).

situation. The listing of farming activities contained in section 101 is not all inclusive.[14] Thus, the issue is what test a court should apply in determining whether an activity is a "farming" activity.

Much of the current litigation on this subject references the 1987 Seventh Circuit decision in *In re Armstrong*.[15] The *Armstrong* decision required an interpretation of the definition of farm income under the general Bankruptcy Code requirements. *Armstrong* involved the issue of protection afforded farmers from involuntary bankruptcy. However, because both this protection and Chapter 12 eligibility rely in part on a determination of what constitutes farm income, Chapter 12 cases generally have either relied upon or dissented from *Armstrong* on a variety of eligibility issues.

Armstrong is a particularly well-suited example of the disagreement that marks the interpretation of Chapter 12 requirements. Although *Armstrong* touches on many areas, and is discussed by other courts in a variety of contexts, the primary issue in *Armstrong* was the categorization of cash rental income paid to the lessor of farmland. The majority held that for income to be categorized as farm income, it must meet what is termed the "risk test."[16] Its receipt must be dependent upon the risk inherent in traditional farming operations. If it is not, as in the case of cash rent for leased farmland, it is not farm income. The dissent rejected this mechanical approach and proposed a totality of the circumstances test.[17] Under the dissent's approach, the debtor's overall situation could be examined and an equitable result reached. After *Armstrong*, many lower courts have lined up on one side or the other, with the majority of courts appearing to reject the *Armstrong* risk test.[18]

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14. The Rules of Construction section of the Bankruptcy Code, § 102, confirms that the term "includes" as used in the § 101 listing is not to be read as a limitation. 11 U.S.C. § 102(3) (1988).

15. 812 F.2d 1024 (7th Cir.), *cert. denied*, 484 U.S. 925 (1987).

16. *Id.* at 1027.

17. *Id.* at 1030.

18. Cases following the majority's approach in *Armstrong* include *In re* Krueger, 104 Bankr. 223 (Bankr. D. Neb. 1988); *In re* Maschhoff, 89 Bankr. 768 (Bankr. S.D. Ill. 1988); *In re* Seabloom, 78 Bankr. 543 (Bankr. C.D. Ill. 1987); *In re* Haschke, 77 Bankr. 223 (Bankr. D. Neb. 1987). Cases that have rejected the *Armstrong* majority include *In re* Vernon, 101 Bankr. 87 (Bankr. E.D. Mo. 1989); *In re* Coulston, 98 Bankr. 280 (Bankr. E.D. Mich. 1989); *In re* Hettinger, 95 Bankr. 110 (Bankr. E.D. Mo. 1989); *In re* Jessen, 82 Bankr. 490 (Bankr. S.D. Iowa 1988); *In re* Burke, 81 Bankr. 971 (Bankr. S.D. Iowa 1987); *In re* Rott, 73 Bankr. 366 (Bankr. D.N.D. 1987). Note that subsequent to the opinions referenced above, the Eighth Circuit rejected both the majority and the minority *Armstrong* opinions, declaring a new test for the farm income determination. *In re* Easton, 883 F.2d 630 (8th Cir. 1989). For a discussion of *Easton* and the Eighth

The debate continued this year with the Eleventh Circuit decision on Chapter 12 eligibility in the case of *In re Watford*.[19] Three activities were presented as potential farming activities: stone crabbing, the storing of soybeans, and the debtor's future plans to establish catfish ponds. The debtors, who previously raised soybeans in a more traditional farming operation, had stored their last soybean crop and had let the land lay idle while they conducted a stone crabbing business in the Gulf of Mexico. However, the debtors testified that they intended to build commercial fishponds on the farm. The court was asked to determine whether the debtors were engaged in a farming operation for purposes of Chapter 12 eligibility.

Before evaluating the debtors' activities, the court acknowledged that a debtor must be "engaged in farming" at the time that the Chapter 12 petition is filed.[20] Two separate issues were presented — whether the activities in question could be considered farming activities and whether the debtors' future intentions were sufficient to meet the requirement that the debtor be engaged in farming at the time of filing.

On the first issue, the court held that the debtors' stone crabbing business did not constitute a farming operation. The court found it "too remote from Congress' statutory purpose."[21]

Similarly, the court held that the storage of soybeans alone did not indicate a "farming operation."[22] However, the court stated that this storage, if part of a "continuing farm effort," would be sufficient to render the debtor eligible for Chapter 12 relief.[23]

The distinction is based on the debtor's intentions. According to *Watford*, if at the time of filing, the debtor has abandoned farming, the continued storage is immaterial. The Chapter 12 petition must be dismissed. If, on the other hand, the debtor has an ongoing farming operation or "plans the reorganization of the farming operation," the farmer is "engaged in farming" for purposes of Chapter 12 eligibility.[24]

Circuit's treatment of Chapter 12 eligibility issues, see Note, *Get Down and Dirty: The Eighth Circuit's Admonition to Farmers Seeking the Protection of Chapter 12*, 43 Ark. L. Rev. 701 (1990).

19. 898 F.2d 1525 (11th Cir. 1990).

20. *Id.* at 1527 (citing *In re* Paul, 83 Bankr. 709, 712 (Bankr. D.N.D. 1988); *In re* Haschke, 77 Bankr. 223, 225 (Bankr. D. Neb. 1987); *In re* Mikkelson, 74 Bankr. 280, 284 (Bankr. D. Or. 1987); *In re* Tart, 73 Bankr. 78, 81 (Bankr. E.D.N.C. 1987); 2 Collier on Bankruptcy 101-55 (L. King 15th ed. 1989)).

21. *Watford*, 898 F.2d at 1527. Although the court does not explain what its interpretation of "Congress's statutory purpose" is, it appears to be referring to the protection of the traditional family farmer that is engaged in crop or livestock farming.

22. *Id.* (citing *In re* Haschke, 77 Bankr. 223, 225 (Bankr. D. Neb. 1987)).

23. *Id.*

24. *Id.* at 1528.

Applying this reasoning to the debtors' plans to construct commercial fish ponds on the farm, the *Watford* court held that it is the debtor's intentions at the time of filing that controls. The debtor need not be engaged in the activity as of filing, so long as the intention to farm exists. Because the lower courts found the Watfords' intention to catfish farm irrelevant, the case was remanded on this point.[25]

In so holding, the court relied upon the reasoning set forth in the *Armstrong* dissent, and cited similar lower court holdings.[26] It explicitly rejected what it termed the "contrary implication" in footnote 2 of the majority opinion in *Armstrong*.[27] Addressing the *Armstrong* court's concern that focusing on the debtor's intentions would encourage deceit, the *Watford* court noted that "distinguishing truths and untruths is an inherent function of the courts."[28]

Citing the intention of Congress in enacting Chapter 12, the court adopted a totality of the circumstances test. Again rejecting the majority opinion in *Armstrong*, the *Watford* court stated that on remand the proper question for the bankruptcy court must be "whether under the totality of the circumstances the Watfords had abandoned all farming operations, but rather were planning to continue farming operations in the form of commercial fish ponds or otherwise."[29]

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25. *Id.* at 1528-29.

26. *Id.* (citing *Armstrong*, 812 F.2d at 1031 (Cudahy, J., dissenting); *In re* Coulston, 98 Bankr. 280, 281, 284 (Bankr. E. D. Mich. 1989); *In re* Hettinger, 95 Bankr. 110, 112 (Bankr. E.D. Mo. 1989); *In re* Paul, 83 Bankr. 709, 713 (Bankr. D.N.D. 1988); *In re* Burke, 81 Bankr. 971, 976-977 (Bankr. S.D. Iowa 1987); *In re* Sugar Pine Ranch, 100 Bankr. 28 (Bankr. D. Or. 1989); *In re* Maike, 77 Bankr. 832, 835 (Bankr. D. Kan. 1987); *In re* Mikkelsen Farms, 74 Bankr. 280, 284 (Bankr. D. Or. 1987)). *But see In re* Cluck, 101 Bankr. 691 (Bankr. E.D. Okla. 1989).

27. Footnote 2 from the *Armstrong* opinion includes the majority's criticism of the dissent's consideration of the debtors' future intentions. It provides in relevant part,

> [T]he dissent would have a court try to grapple with the issue of a farmer's future intent. The results of such fact-finding would be haphazard and unfocused. Most farmers would say that their intention would be to farm the rented acreage in the future. After all, what would there be to lose? Indeed, a farmer could be sincere in saying this but be unrealistic in his estimation of his chances. Conceivably, a farmer could rent the land for a few years — each year telling the court (at yet another hearing) he was closer to solvency, closer to tilling. Of course, some farmers would inevitably be bluffing — deceiving the court while playing landlord. The dissent suggests courts look for, the first year of [a] lease, that the farm was financially troubled, . . . participat[ion] in actually operating the farm. This criteria is more vague than it sounds. It arguably would issue a blank check for one year to any farmer who wants to lease instead of till — as long as he demonstrates he operated at a loss the year before and indicates an "intent" to let the lease expire.

Armstrong, 812 F.2d at 1028 n.2.

28. *Watford*, 898 F.2d at 1529 (citing *Coulston*, 98 Bankr. at 281 n.1).

29. *Id.*

II. Powers Available to Chapter 12 Debtors

A. Contract for Deed

Another ongoing controversy involves the classification of a contract for deed or land sale contract. Although in many instances both vendor and vendee will think of this contract as a simplified mortgage transaction, in the context of bankruptcy it may be treated very differently. The controversy is whether this type of contract should be treated as a mortgage transaction, characterizing the vendor as a lienholder, or whether the contract should be treated as an executory contract under section 365 of the Bankruptcy Code. If it is treated as an executory contract, the debtor's rights to modify that contract are severely limited, generally allowing only the opportunity to affirm or reject the contract as written.[30]

The Sixth Circuit recently addressed this issue in the context of a Chapter 12 reorganization in *In re Terrell.*[31] At issue in *Terrell* was whether the debtors' obligations under a land sale contract could be altered pursuant to section 1225, the "cram down" provision of Chapter 12 reorganization.[32] The "cram down" provision allows a debtor to adjust an obligation owed to a secured creditor without the consent of that creditor, provided that certain guidelines are met.[33] Although this provision is clearly applicable to mortgages and other secured transactions, in *Terrell* the vendor challenged its application to the land sale contract at issue.

In reaching its decision, the court confronted the somewhat confusing interaction of federal and state law with regard to executory contract determination. Accepting the Ninth Circuit's characterization of this interaction, *Terrell* found a combined role for federal and state law in determining whether the contract was executory for purposes of section 365.[34] Federal law provides the definition of the term "executory con-

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30. 11 U.S.C. § 365 (1988).

31. 892 F.2d 469 (6th Cir. 1989).

32. 11 U.S.C. § 1225 (1990).

33. *Id.* § 1225(a)(5). The plan confirmation standards set forth in § 1225(a)(5) require that the secured creditor either consent to the plan, retain its lien and receive value not less than the amount of its secured claim, or that the debtor surrender the security property to the claim holder. Under § 506, the value of the secured claim can be reduced to the value of the collateral. As such, a debtor is allowed to reduce a secured obligation to the amount of the secured claim, *i.e.*, the value of the collateral. Applying this to the facts in *Terrell*, the debtors hoped to reduce the amount owed on their land sale contract by confirmation of a reorganization plan that paid only the market value of the property, the amount of the creditor's secured claim.

34. *Terrell*, 892 F.2d at 471-72 (citing *In re* Cochise College Park, Inc., 703 F.2d 1339, 1348 n.4 (9th Cir. 1983)). *See also In re* Streets and Beard Farm Partnership, 882 F.2d 233, 235 (7th Cir. 1989).

tract."[35] State law provides the standard for evaluating the parties' legal obligations under the contract. These state law obligations are then analyzed to see if the contract meets the federal definition.[36]

Referring first to the federal definition of executory contract, *Terrell* acknowledged that the Bankruptcy Code itself provides little assistance.[37] The term "executory contract" is not defined in the Bankruptcy Code. The legislative history, however, refers to an executory contract as one "on which performance remains due to some extent on both sides."[38] Moreover, there is general acceptance of the definition provided by Professor Countryman in the article entitled *Executory Contracts in Bankruptcy: Part I.*[39] Countryman defined an executory contract as "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other."[40] Accepting this definition as the federal standard, *Terrell* focused on the concept of obligations that, if unperformed, would give rise to a material breach excusing the other party from performance.[41]

From this definition of executory contract, the *Terrell* court turned its focus to Michigan state law and the obligations of the parties to the land sale contract at issue. Specifically, the court examined whether one party's failure to perform under the contract would constitute a material breach that would excuse the other parties' performance.[42]

This approach to the application of state law is the most controversial aspect of the *Terrell* opinion. The court did not defer to state law decisions characterizing a land sale contract as akin to a purchase money mortgage. In previous cases involving land sale contracts, both the Michigan Court of Appeals and the Michigan Supreme Court have held

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35. *Terrell* at 471-72.

36. *Id.*

37. *Id.*

38. *Terrell*, 892 F.2d at 471 (citing S. Rep. No. 95-989, 95th Cong. 2d Sess. 58, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5787, 5844; H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 347, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5787, 5963, 6303).

39. Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 460 (1973). *Terrell* states that this article provides the definition that Congress "apparently had in mind" with regard to § 365 and cites to Ninth and Eighth Circuit opinions referencing it. *Terrell*, 892 F.2d at 471 (citing *In re* Select-A-Seat Corp., 625 F.2d 290, 292 (9th Cir. 1980) (per curium) (quoting Jenson v. Continental Fin. Corp., 591 F.2d 477, 481 (8th Cir. 1979)).

40. Countryman at 460.

41. *Terrell*, 892 F.2d at 471-72.

42. *Id.* at 472.

that under such contracts, the vendor holds legal title only as security for payment of the contract obligations. Thus, the contract was found to be analogous to a mortgage.[43]

Instead, *Terrell* discounted the state courts' characterization, and chose to be guided by its own interpretation of the parties' obligations under the contract. It maintained that the state courts' characterizations of the nature of the vendor and vendee's interests were not determinative because they did not specifically focus on the nature of the unperformed obligations.[44] The court found that according to the terms of the land sale contract, the Terrells were obligated to make payments for several years while the vendor remained obligated to surrender legal title. Because of the presence of these mutual, unperformed obligations, the court found that "[u]nder a land sale contract, unlike most mortgages, 'performance remains due to some extent on both sides' and the failure of either party to fulfill his or her obligations would excuse the other from continued performance."[45] Based on this finding, the court held that section 365 controlled and that the Terrells were thus precluded from reorganizing the contract terms under the section 1225 powers.[46]

The *Terrell* opinion acknowledged that the Seventh Circuit adopted a contrary position in *In re Streets & Beard Farm Partnership*.[47] *Streets & Beard* also applied the Countryman definition of an executory contract.[48] However, the court found that the land contract at issue was not an executory contract. It held that the vendor's obligation to deliver legal title to the vendee was a "mere formality" and that it did not "represent the kind of significant legal obligation that would render the contract executory."[49] The court then concluded that the arrangement between the vendor and the vendee was "a security agreement where the vendor holds legal title in trust solely as security for the payment of the purchase price."[50] The court held that because security agreements

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43. Barker v. Klingler, 302 Mich. 282, 4 N.W.2d 596 (1942)(vendor holds legal title only as security for the payment of the purchase price); Rothenberg v. Follman, 19 Mich. App. 383, 387 n.4, 172 N.W.2d 845, 847 n.4 (1969)(no functional difference exists between a purchase money mortgage and a land contract). Similarly, the bankruptcy court from the Eastern District of Michigan held that a land contract was not an executory contract under § 365. *In re* Britton, 43 Bankr. 605 (Bankr. E.D. Mich. 1984). The *Britton* decision was expressly overruled by *Terrell*. *Terrell*, 892 F.2d at 472.

44. *Terrell*, 892 F.2d at 472.

45. *Id.* at 473.

46. *Id.*

47. 882 F.2d 233 (7th Cir. 1989).

48. *See supra* note 39 and accompanying text.

49. *Streets & Beard*, 882 F.2d at 235.

50. *Id.*

are not executory contracts under the Bankruptcy Code, neither was the contract at issue.[51]

In commenting on *Streets & Beard*, the *Terrell* court noted that it could not "pass judgment" on the significance of a vendor's obligations under Illinois law, but that under Michigan law, a vendor's failure to deliver title would "excuse the vendee's performance and give rise to an action for recision or specific performance."[52] It is likely that the Seventh Circuit would respond that this broad interpretation of executory contract is contrary to the intent of Congress. The Seventh Circuit stated in *Streets & Beard* that it believed that "Congress intended section 365 to apply to contracts where *significant* unperformed obligations remain on both sides."[53] It appears that the two courts differ as to the significance of delivery of legal title, and the split in the circuits remains.[54]

B. Bankruptcy and the Agricultural Credit Act of 1987

A special category of bankruptcy cases involves the interaction of bankruptcy law and the Agricultural Credit Act of 1987 (hereafter the Act).[55] The Act established debt restructuring programs for Farm Credit System (hereafter FCS) and Farmers Home Administration (hereafter FmHA) borrowers. The bankruptcy cases thereunder generally involve the debtors' attempts to use the protections promised them under the Act while in bankruptcy. With regard to FCS borrowers, numerous cases have held that the FCS lender must comply with the requirements set forth in the Act prior either to obtaining relief from the automatic stay

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51. *Id.* (citing *In re* Pacific Exp., Inc., 780 F.2d 1482, 1487 (9th Cir. 1986) for the proposition that security agreements are not executory contracts under § 365 of the Bankruptcy Code).

52. *Terrell*, 892 F.2d at 472-473 n.6.

53. *Streets & Beard*, 882 F.2d at 235 (emphasis added).

54. Although not cited in *Terrell*, the Eighth Circuit has also held that a contract for deed is executory, applying Iowa and South Dakota law. *In re* Speck, 798 F.2d 279 (8th Cir. 1986) (applying South Dakota law); Brown v. First National Bank in Lenox, 844 F.2d 580 (8th Cir. 1988) (applying Iowa law). In circuits where there has not been an appellate level decision, the bankruptcy courts are split. *Compare In re* Anderson, 36 Bankr. 120 (Bankr. D. Haw. 1983); Shaw v. Dawson, 48 Bankr. 857 (Bankr. D.N.M. 1985); *In re* Aslan, 65 Bankr. 826 (Bankr. C.D. Cal. 1986) (viewing land contracts as executory) *with In re* Booth, 19 Bankr. 53 (Bankr. D. Utah 1982); *In re* Kratz, 96 Bankr. 127 (Bankr. S.D. Ohio 1988); *In re* Sennhenn, 80 Bankr. 89 (Bankr. N.D. Ohio 1987) (treating the contract as a security device). As noted, *supra* note 40, before the *Terrell* decision, a bankruptcy court within the Sixth Circuit held that a land contract was not executory. *In re* Britton, 43 Bankr. 605 (Bankr. E.D. Mich. 1984). *Terrell* overruled this decision. *Terrell*, 892 F.2d at 472.

55. Agricultural Credit Act of 1987, Pub. L. No. 100-233, 101 Stat. 568 (1988) (codified in scattered sections of 7 & 12 U.S.C.).

or taking adverse action against the debtor.[56] Note that these cases do not mandate restructuring, only consideration for restructuring.[57]

FCS debtors have been less successful in attempting to use the Act to reduce the value of secured debt in bankruptcy. In some cases they argued that the valuation of the collateral should be based upon its liquidation value under the FCS cost of restructuring/cost of foreclosure analysis.[58] However, FCS borrowers failed to obtain this reduction in several bankruptcy reorganizations. In those instances, the bankruptcy courts held that valuation should be the fair market value of the collateral, based only upon the bankruptcy standards set forth in section 506 of the Bankruptcy Code and the case law interpreting it.[59]

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56. Hill v. Farm Credit Bank of St. Louis, 726 F. Supp. 1201, 1205 (E.D. Mo. 1989) (Congress did not intend to exclude debtors in bankruptcy from the protections of the Act); *In re* Jarrett Ranches, Inc., 107 Bankr. 969 (Bankr. D.S.D. 1989) (FCS lender required to sell property according to borrower protections set forth in the Act); *In re* Kramer, 107 Bankr. 668, 670 (Bankr. D. Neb. 1989) (order for sequestration of rents and profits cannot be obtained prior to compliance with the Act); *In re* Rudloff, 107 Bankr. 663, 665 (Bankr. D. Neb. 1989) (determination of distressed loan status required prior to sending restructuring notice; relief from stay not granted prior to compliance with Act); *In re* Wagner, 107 Bankr. 662, 663 (Bankr. D. Neb. 1989) (determination of distressed loan status required prior to offering restructuring opportunity; relief from stay denied due to failure to comply with Act); *In re* Dilsaver, 86 Bankr. 1010, 1015 (Bankr. D. Neb. 1988), *aff'd sub nom. In re* Hilton Land & Cattle Co., 101 Bankr. 604, 606 (D. Neb. 1989) (compliance with Act required prior to sequestration of rents and profits); Stainback v. Federal Land Bank of Jackson, No. GC880 (N.D. Miss. Feb. 8, 1988) (temporary restraining order issued to enjoin foreclosure sale; borrower and FCS lender directed to engage in restructuring discussions under the Act). Note that these cases do not deal with the issue of whether an implied cause of action exists under the Act. Three circuit courts have found that an implied cause of action does not exist. Zajac v. Federal Land Bank of St. Paul, 909 F.2d 1181 (8th Cir. 1990) (en banc); Griffin v. Federal Land Bank of Wichita, 902 F.2d 22 (10th Cir. 1990); Harper v. Federal Land Bank of Spokane, 878 F.2d 1172 (9th Cir. 1989), *cert. denied,* 110 S. Ct. 867 (1990). *But cf.* Payne v. Federal Land Bank of Columbia, 916 F.2d 179 (4th Cir. 1990) (granting relief to the borrower to remedy violations of the Act without addressing implied cause of action issue). For an excellent discussion of Farm Credit System borrowers' rights, including an analysis of the implied cause of action issue, see Kelley & Hoekstra, *A Guide to Borrower Litigation Against the Farm Credit System and the Rights of Farm Credit System Borrowers,* 66 N.D.L. REV. 129 (1990).

57. The Act requires Farm Credit System lenders to consider borrowers with distressed loans for restructuring, and prescribes a basic format for this consideration, but does not mandate that a given loan be restructured. *See In re* Bellman Farms, Inc., 86 Bankr. 1016 (Bankr. D.S.D. 1988). *See also* Kelley & Hoekstra, *supra* note 56, at 191-213 (providing a detailed analysis of the restructuring procedure under the Act).

58. *See, e.g., In re* Bellman Farms Inc., 86 Bankr. 1016, 1022 (Bankr. D.S.D. 1988).

59. *See In re* Felton, 95 Bankr. 629 (Bankr. N.D. Iowa 1988) (provisions of the Act are not to be incorporated into the Bankruptcy Code and are inapplicable to valuation

The Ninth Circuit Bankruptcy Appellate Panel addressed this valuation issue with regard to FmHA borrowers in bankruptcy in the recent case of *In re Case*.[60] In *Case*, the court held that in determining the value of FmHA's secured claim and the proper rate of interest to be paid on FmHA debt,[61] the provisions of the Act did not apply.[62] The court held that the collateral should be valued according to its fair market value.[63] Several inexplicable flaws in the court's analysis, however, may well affect the precedential value of its decision.

Throughout the *Case* opinion, the court erroneously cited to the statutory provisions of the Act that apply to FCS. These are completely different from the applicable provisions of the Act that apply to the lender at issue, FmHA. Indeed, although the FCS and FmHA restructuring programs may be similar in the underlying congressional intent, different requirements apply to each lender, and these requirements are now codified in different titles of the U.S Code.[64]

With regard to FCS, restructuring determinations are based upon what the Act terms "cost of restructuring"[65] and "cost of foreclosure."[66] As has been noted, these terms, defined in the Act, have generated a certain amount of confusion as to what FCS lenders are required to consider, causing system lenders to devise different formulas to compute these costs and evaluate restructuring applications.[67]

In contrast, a separate section of the Act sets up different procedures for FmHA to follow in reviewing its troubled loans. The FmHA procedure relies upon what the Act terms "net recovery value"[68] instead of cost

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of FCS lender's secured claim); *In re* Bellman Farms, Inc., 86 Bankr. 1016 (Bankr. D.S.D. 1988) (Act does not affect § 506(a) valuation of FCS lender's secured claim); *In re* Kraus, No. BK 86-2677, slip op. at 2 (Bankr. D. Neb. May 20, 1988) (Act does not affect confirmed Chapter 11 plan); *In re* Pennington, No. 87-01485-BKC-DTW, slip op. at 2 (Bankr. N.D. Miss. March 22, 1988) (Act does not affect § 506(a) valuation). *See also* Kelley & Hoekstra, *supra* note 56 at 191-92, n.365 (discussing FCS borrowers' rights in bankruptcy).

60. 115 Bankr. 666 (Bankr. 9th Cir. 1990).

61. The portions of *Case* that deal with interest rate considerations are discussed *infra* at notes 82, 98-101 and accompanying text.

62. *Case*, 115 Bankr. at 669.

63. *Id.* at 669-70.

64. Provisions of the Act that apply to FCS are codified in scattered sections of title 12 U.S.C. and those applicable to FmHA are codified at title 7 U.S.C.

65. 12 U.S.C. § 2202a(e)(2) (1988); 12 C.F.R. § 614.4517(a) (1990).

66. 12 U.S.C. § 2202a(a)(2)(1988); 12 C.F.R. § 614.4512(c) (1990).

67. *See* Kelley & Hoekstra, *supra* note 56, at 191-99.

68. 7 U.S.C. §2001(c)(2) (1988). For a complete analysis of FmHA's loan servicing programs, including the debt restructuring provisions mandated by the Agricultural Credit Act, see Roth, Farmers Guide to FmHA (4th ed. 1990) (available through Farmers Legal Action Group, Inc., 1301 Minnesota Bldg, 46 E. 4th St., St. Paul, MN 55101.).

of restructuring and cost of foreclosure. The precise procedure to be followed in computing this amount and in applying it to a borrower's individual situation is set forth with far more specificity than is found in the FCS portion of the Act. Although the amounts inserted may vary, the statute requires that specific deductions from the fair market value of the collateral be made in computing FmHA's net recovery value.[69]

In reviewing *Case*, it is apparent that the court was not just careless in its citation; it was also careless in its analysis. The court discussed the restructuring process, clearly describing the FCS process instead of the FmHA process. After this discussion, the court concluded, "[a]s is defined by the Act 'cost of foreclosure' is intended to be nothing more than a threshold upon which to determine whether a particular restructuring proposal is economically feasible."[70] In support of its conclusion, the court then cited *In re Bellman Farms*, a case involving an FCS borrower. The court added, "The Act does not mandate the restructuring of a debt at the liquidation value of the collateral, and in fact does not set forth a calculation for the amount of the restructured debt."[71] Although this statement would be accurate if applied to FCS, it is erroneous when applied to FmHA, the lender at issue.

The court, however, does provide support for its decision that is not marred by its confusion about the applicable federal statutes. It asserted that the bankruptcy courts are not bound by the Act and that the remedies available thereunder are "separate and distinct remedies from the remedial protection afforded to farm debtors under Chapter 12."[72] On this basis, the court turned exclusively to an analysis of bankruptcy law in determining the amount of FmHA's secured claim. Under section 1225, absent creditor consent, the debtor's plan must offer the holder of each secured claim value "not less than the allowed amount of such claim."[73] In order to determine whether this "value" has been provided, the amount of the allowed secured claim must be established.[74] Section 506 of the Bankruptcy Code provides the guidelines for setting

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69. 7 U.S.C. § 1981 (1981); 7 C.F.R. § 1951.909(f) (1990).

70. *Case*, 115 Bankr. at 669.

71. *Id.*

72. *Id.* (citing *In re* Felton, 95 Bankr. 629, 630 (Bankr. N.D. Iowa 1988) (involving FCS restructuring provisions under the Act)). In one of the few bankruptcy cases involving FmHA provisions under the Act, *In re* Kvamme held that restructuring under the Act was not the only remedy available to FmHA and that it was entitled to exercise its § 1111(b) election in Chapter 11. *In re* Kvamme, 91 Bankr. 77 (Bankr. D.N.D. 1988). *Kvamme* is not cited in *Case*.

73. 11 U.S.C. § 1225(a)(5)(B)(ii) (1988) *discussed in Case*, 115 Bankr. at 669.

74. *Case*, 115 Bankr. at 669.

this amount.[75] It provides in part that an allowed claim is a secured claim "to the extent of the value of such creditor's interest . . . in such property" and that "such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property."[76] Interpreting these provisions and the purpose for which valuation is sought, *Case* states that because the debtor seeks to retain the property, deductions from fair market value are inappropriate.[77]

The court noted that if the purpose for the evaluation was different, such as if adequate protection were at issue, the deduction of liquidation expenses might be appropriate. For section 1225 purposes, however, the court held that the fair market value of the property was the amount that FmHA must receive as value under the terms of the plan.[78]

In light of the court's explanation of valuation under the Bankruptcy Code, it is unfortunate that the court did not follow the proper restructuring provisions applicable to FmHA. It can be argued that these provisions, far more specific than those applicable to FCS, which define in detail the recovery rights of FmHA, restrict the "value" of FmHA's claim under section 506. If under the statutes that govern FmHA, the property is not entitled to receive full fair market value, arguably the "value of such creditor's interest . . . in such property" under section 506 should be similarly limited. Unfortunately, *Case* does not address this important issue.

C. *Interest Rate*

Once the value of the secured claim is established, the next debate concerns the modification of the terms of the debtor's secured loans.

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75. 11 U.S.C. § 506(a) (1988) *discussed in Case,* 115 Bankr. at 669.

76. *Id.*

77. *Case*, 115 Bankr. at 669 (citing *In re* Felten, 95 Bankr. 629, 630 (Bankr. N.D. Iowa 1988); *In re* Anderson, 88 Bankr. 877, 885-86 (Bankr. N.D. Ind. 1988); *In re* Bellman Farms, Inc., 86 Bankr. 1016, 1019 (Bankr. D.S.D. 1988); *In re* Foster, 79 Bankr. 906, 907 (Bankr. D. Mont. 1987); *In re* Snider Farms, Inc., 79 Bankr. 801, 811 (Bankr. N.D. Ind. 1987); *In re* Danelson, 77 Bankr. 261, 263 (Bankr. D. Mont. 1987); *In re* Robinson Ranch Inc., 75 Bankr. 606, 608 (Bankr. D. Mont. 1987) (for the proposition that when a debtor retains the collateral, fair market value, without deduction for cost of sale, is the appropriate valuation). Note, however, that in the usual context, deductions for liquidation costs are not made when the debtor retains possession of the collateral because a liquidation sale will not be held. Thus, the value ascribed to the collateral reflects the debtor's continued possession of the property. Liquidation sale costs are not deducted, in part because such costs will presumably not be incurred. In contrast, under the requirements of the Act, deductions based on FmHA's hypothetical liquidation costs are required even though the property will remain in the possession of the debtor. *See Roth*, *supra* note 68.

78. *Case*, 115 Bankr. at 670.

Chapter 12 allows the debtor to alter these loan terms to provide for an extended payment period and/or an adjusted interest rate.[79] As discussed previously, however, Chapter 12 plan confirmation standards require that the secured claim holders receive the full value of the allowed amount of their secured claim.[80] Thus, if payments are stretched out over a period of time, the creditor must receive the "present value" of its claim. Payments are "discounted" to reflect the receipt of the funds in the future. The basic concept is:

> When the debtor's plan proposes to pay a secured claim in deferred cash installments, the court must find that the present value of the proposed payments is not less than the allowed amount of the secured claim. In order to make this finding, it will be necessary for the court to apply a discount factor to the proposed stream of payments to determine the present value of those payments. This is typically accomplished by ascribing an interest rate to the allowed amount of the claim and by requiring payment of the amount of the claim along with interest at the specified rate.[81]

The rate of interest to be paid is a much litigated aspect of Chapter 12 reorganization. The resulting case law generally has established that, with the exception of FmHA loans, a "market" rate of interest is appropriate.[82] However, there exists what has been termed a "bewildering array of methods for determining how a market rate of interest is to be calculated."[83] A split remains in the various circuit courts' interpretations of the proper method to be used in determining the appropriate market rate for interest on restructured loans.[84]

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79. 11 U.S.C. § 1225(a) (1988).

80. *See supra* note 68 and accompanying text.

81. 5 Collier on Bankruptcy ¶ 1225.03[4][c], at 1225-21 (15th ed. 1989).

82. R. Rodgers, Collier Farm Bankruptcy Guide ¶ 4.08[2] at 4-98 (L. King ed. 1990). With regard to FmHA loans, several courts have authorized a below-market interest rate. *In re* Doud, 74 Bankr. 865 (Bankr. S.D. Iowa 1987), *aff'd*, unrep. D.Ct. dec., *aff'd*, 869 F.2d 1144 (8th Cir. 1989); *In re* Schaal, 93 Bankr. 644 (Bankr. W.D. Ark. 1988); *In re* Kesterson, 94 Bankr. 561 (Bankr. W.D. Ark. 1987). This is justified by the fact that because of FmHa's special government subsidized role in agricultural lending, the contract rate for FmHA loans is below the market rate. *See* Roth, *supra* note 68. *But see* United States v. Arnold, 878 F.2d 925 (6th Cir. 1989). *See also Case*, 115 Bankr. 671 (holding that FmHA is entitled to the "fair market rate" of interest, without addressing the special loan rates offered by FmHA; *infra* note 99).

83. Rodgers, *supra* note 82, at 4-98.

84. Commentators have also split in their opinions on this issue. For an interesting and lively interchange see Harl, *Determining "Present Value" in Bankruptcy*, 10 J. Agric. Tax'n & L. 170 (1988) [hereinafter Harl] (supporting a rate based on the Treasury bond

Two recent circuit decisions take very different views on this subject. The Ninth Circuit, in *In re Fowler*, authorized the use of a formula based on the prime rate plus an additional percent based on an individual risk factor.[85] This method, utilized in numerous other cases, is based on the concept of either the prime rate or the treasury bond rate as providing a floor, termed the "riskless" rate of interest.[86] From zero to three percent of the interest is then added on to this rate to compensate the lender for the risk of repayment that may accompany the loan. The percentage added on is determined according to a variety of factors, including the value and type of collateral, the risks inherent in the agricultural economy, and any risks associated with the specific situation of the debtor.[87]

In *Fowler*, the bankruptcy court applied the formula approach to loans owed to the Farm Credit Bank and the Interstate Production Credit Association. It computed the base rate according to the prime rate at the time of plan confirmation, and then added a risk factor of 0.75%. This produced a total rate of 9.5%.[88]

On appeal, the district court reversed and set the rate at 10.5%.[89] On further appeal, the Ninth Circuit reversed the district court and authorized the bankruptcy court's use of the formula approach. The case was remanded, however, for findings of fact to support the court's risk factor determination. The Ninth Circuit noted that the bankruptcy court should consider "evidence in the record . . . including information on market rates" as well as all "facts in the record which reduce *and* heighten the risks associated with the debtor."[90]

In contrast, the Tenth Circuit, in *In re Hardzog*, rejected this approach.[91] In *Hardzog*, the bankruptcy court had approved a reorganization plan that provided a secured claim holder with a ten percent

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rate plus a flat percentage increase), the article criticizing Professor's Harl's analysis, Duft & Frasier, *Computing the Correct Discount Rate for Deferred Payments Under Chapter 12 of the Bankruptcy Code*, 11 J. Agric. Tax'n & L. 253 (1990) (supporting a rate based on comparable loans), and Professor Harl's rebuttal, Harl, *Professor Harl's Response*, 11 J. Agric. Tax'n & L. 266 (1990).

85. 903 F.2d 694, 698 (9th Cir. 1990).

86. *See, e.g.*, Doud, 869 F.2d 1145-46; *In re* Wichmann, 77 Bankr. 718 (Bankr. D. Neb. 1987). For a detailed discussion of this method of computing interest, see Harl, *supra* note 84, at 175-79. *See also* Rodgers *supra* note 82, at 4-100 (discussing the analysis of the bankruptcy court in *Wichmann*).

87. *In re* Underwood, 84 Bankr. 594 (Bankr. D. Neb. 1988). For a suggested listing of factors to be considered, see Harl, *supra* note 84, at 177-78.

88. *In re* Fowler, 83 Bankr. 39, 44 (Bankr. D. Mont. 1987).

89. *Fowler*, 903 F.2d at 695 (referencing unreported district court opinion).

90. *Id.* at 699.

91. *In re* Hardzog, 901 F.2d 858, 860 (10th Cir. 1990).

interest rate on a debt secured by a real estate mortgage. This rate was determined by the use of a base rate of 9.3% and adding a risk factor rate of 0.7%.[92] The district court affirmed the bankruptcy court's decision.[93]

On appeal, the Tenth Circuit held that absent special circumstances, the interest rate should be the "current market rate of interest used for similar loans in the region."[94] It specifically rejected the formula approach as not accurately reflecting the market rate.[95] In support of its position, the court expressed its concern that judges are not well suited to determine interest rates, and that in contrast, lenders are familiar with the assessment of risk factors in the setting of interest rates. As such, it stated that more fair results will be achieved by reference to the current rates being charged in the region.[96] On this basis, it reversed the district court's affirmance and remanded the case to the bankruptcy court.[97]

Subsequent to the *Fowler* and *Hardzog* circuit decisions, the Ninth Circuit Bankruptcy Appellate Panel decided *In re Case*.[98] Addressing the interest rate that FmHA must be paid, the court held that although a case-by-case approach was required, the proper rate was the "fair market value."[99] On this basis, it rejected the bankruptcy court's approval of a below-market rate for the FmHA loan at issue. However, the holding in *Case* is confusing because the court cites to *In re Doud* for authority; yet, *Doud* can be read as calling for a different result.[100]

The Eighth Circuit in *Doud* allowed a below-market rate for three of the debtors' FmHA loans, referencing the bankruptcy court's finding that these loans should be "viewed in light of the agency mission to provide credit to family farmers who are unable to obtain credit from conventional sources" and that such FmHA loan programs are a form of "social welfare."[101] The remaining FmHA loan was an emergency

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92. *In re* Hardzog, 77 Bankr. 840, 843 (Bankr. W.D. Okla. 1987).

93. *In re* Hardzog, 113 Bankr. 718, 722 (W.D. Okla. 1989).

94. *Hardzog*, 901 F.2d at 860. Although the court specifically reserved the right to define all of the "special circumstances" that would permit the court to deviate from this approach, it indicated that one such circumstance would be when the market rate was higher than the contract rate.

95. *Id.*

96. *Id. See also* Duft & Frasier, *supra* note 84 (advocating the use of this approach and criticizing the cost of funds formula approach as favoring debtors).

97. *Hardzog*, 901 F.2d at 860.

98. 115 Bankr. 666 (Bankr. 9th Cir. 1990) (The aspects of this case that involve the valuation of the creditor's secured claim are discussed *supra* notes 60-78 and accompanying text).

99. *Case*, 115 Bankr. at 670-71 (citing *Hardzog*, but apparently unaware of its own circuit's decision in *Fowler*).

100. *Id.* at 671 (citing *Doud*, 869 F.2d at 1145-46).

101. *In re* Doud, 74 Bankr. 865 (Bankr. S.D. Iowa 1987), *aff'd sub nom.* United

loan bearing a commercial rate of interest. For that loan, the court applied the formula approach approved in *Fowler*, adding a risk rate of two percent to the applicable treasury bond rate. *Case* followed neither approach, adding to the confusion surrounding this issue.

The controversy over the proper method of determining an appropriate interest rate for restructured loans is likely to continue to produce litigation. This result is unfortunate for both debtors and creditors because it increases the cost of bankruptcy proceedings by adding attorney hours and makes pre-bankruptcy evaluation and planning difficult. Over three years ago, the bankruptcy court in *Wichmann* rejected the current market rate in the region test, noting among other factors that it would require expert testimony in every case.[102] The court went on to indicate its preference for an easily ascertainable standard that would allow for sensible planning by both debtors and creditors and diminish litigation over interest rates.[103] Now, after years of litigation and commentary, not only is the standard in controversy, but the method of approaching it is as well.

D. Livestock Operations: Lien Retention

An area that has not previously produced reported appellate case law, but involves a fundamental issue for livestock operations, is the lien retention requirement of the section 1225 confirmation standards.[104] This issue was addressed recently in the Eighth Circuit case of *In re Hannah*.[105] Here, the court contrasted the "cramdown powers" of the Chapter 12 debtor[106] with the rights of a secured creditor having an interest in the debtor's livestock.

Again, the central issue in *Hannah* was section 1225(a)(5), which sets forth the requirements for plan confirmation. According to section 1225, a Chapter 12 plan that provides for the debtor's retaining possession of secured property cannot be confirmed without secured creditor approval unless the plan provides that the holder of a secured claim "retain the lien securing such claim."[107] The court interpreted this requirement

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States v. Doud, 869 F.2d 1144 (8th Cir. 1989). *See supra* notes 61, 82 and accompanying text.

102. *In re* Wichmann, 77 Bankr. 718, 720 (Bankr. D. Neb. 1987).

103. *Id.*

104. Bankruptcy court decisions that have addressed this issue include: *In re* Underwood, 87 Bankr. 594 (Bankr. D. Neb. 1988); *In re* Milleson, 83 Bankr. 696 (Bankr. D. Neb. 1988); *In re* Big Hook Land & Cattle Co., 77 Bankr. 793 (Bankr. D. Mont. 1987); *In re* Wobig, 73 Bankr. 292 (Bankr. D. Neb. 1987).

105. 912 F.2d 945 (8th Cir. 1990)

106. *See supra* note 32 and accompanying text.

107. 11 U.S.C. § 1225(a)(5)(B)(i) (1988).

with regard to a creditor's interest in the debtor's herd of livestock.

The objecting creditor in *Hannah* called for a literal reading of the requirements of section 1225. Thus, it argued not only that its security interest in the debtor's livestock must be retained, but that this security interest applied specifically to each animal in the livestock herd as of the time of filing.[108]

In contrast, the debtor proposed a plan that allowed the sale of a portion of the livestock, free of the creditor's interest, for use in funding the plan and paying operating expenses. The plan provided for the granting of a second mortgage to the creditor in substitution for the security interest in the livestock to be sold, and provided for the creditor's retention of its interest in the remaining livestock.[109]

At confirmation, the value of the creditor's lien was approximately 120% of its claim. Under the proposed plan, its combined liens were estimated to be valued at 165% of its claim. Finding that the bank was adequately protected by the plan, the bankruptcy court confirmed the plan. On appeal, the district court affirmed.[110]

The Eighth Circuit reversed the lower courts, holding that the debtor's plan did not meet the requirements of section 1225. It found that the replacement lien offered to the creditor was inconsistent with the requirement that the creditor "retain the lien" securing its claim. The substitution of other collateral was unacceptable because it did not meet the specific requirement that the creditor retain "the lien."[111]

The court, however, also rejected the creditor's strict interpretation of section 1225. A literal interpretation of the lien retention requirements of section 1225 would require the debtor to turn over all proceeds of annual sales to the secured creditor, making no funds available to fund the plan or pay operating expenses. The court observed that under this interpretation, a livestock operation never could obtain confirmation of its plan absent creditor acceptance. Noting that it did not believe that Congress could have intended such a result, the court softened the meaning of "retain the lien." It held that this requirement can provide for the retention of a lien on the herd, as opposed to a lien on the particular animals in existence as of filing. The court stated that "this interpretation affords family farmers in the livestock business the potential to reorganize under Chapter 12, but does not depart completely from the express terms of section 1225(a)(5)(B)(i)."[112]

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108. *Hannah*, 912 F.2d at 948.

109. *Id.* at 947.

110. *Id.*

111. *Id.* at 951-52.

112. *Id.* at 950. This result was suggested by RODGERS, *supra* note 82, at ¶ 4.08[2] 4-95 to -97.

The court acknowledged, however, that this interpretation also presented a problem. Clearly, section 1225 does not authorize the termination of the creditor's lien on individual livestock sold under the plan in order to pay other creditors. To resolve this problem, *Hannah* asserted that section 552(b) may also be applicable to the livestock lien.[113]

Under section 552(b), the bankruptcy court may cut off a creditor's lien in certain proceeds, product, or offspring of pre-petition collateral after notice and hearing "on the equities of the case."[114] The court in *Hannah* noted that this 552(b) hearing can be incorporated into the plan confirmation hearing. A ruling on section 552(b), however, should "focus on the collateral that must be sold to implement the plan and whether cutting off the lien on that collateral would leave the creditor's claim without adequate protection under the plan."[115] Similarly, *Hannah* stated that the lien on the herd must adequately protect the creditor's secured claim over the course of the plan.[116]

Applying this standard to the facts in *Hannah*, the court reversed the lower courts' acceptance of the debtor's plan. It held that the bank's equity cushion in the livestock herd could not be replaced with a second real estate mortgage. This replacement did not meet the "retain the lien" requirement of section 1225.[117] Moreover, the court found insufficient assurance in the plan that the value of the herd would be maintained. It stated that the plan must assure the protection of the creditor's claim over the life of the plan.[118] Thus, although the plan at issue in *Hannah* was rejected, the court did use this rejection to define the ways in which a livestock operation can be reorganized despite the restrictive provisions of section 1225.

III. Conclusion

Reports indicate that the number of Chapter 12 filings have never reached the total volume of early predictions and that current filings are down.[119] Moreover, commentators report a much publicized improvement in the farm economy.[120] Some may question the continued

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113. *Hanna*, 912 F.2d at 950-51.

114. 11 U.S.C. § 552(b) (1988) *discussed in Hannah*, 912 F.2d at 950.

115. *Hannah*, 912 F.2d at 950.

116. *Id.* at 951.

117. *Id.* at 952.

118. *Id.*

119. United States, General Accounting Office, Pub. No. RCED-89-142BR, Farm Finance: Participants Views on Issues Surrounding Chapter 12 Bankruptcy (1989).

120. *See, e.g.*, Agri-News, Nov. 22, 1990, at A2, col. 2. *See also* Hanson, *Beyond the Debt Crisis*, Choices, Fourth Quarter 1990, at 33 (addressing the farm economy problems of the 1980s and providing strategies for maintaining the present improved debt to asset ratios in the 1990s).

utility of focusing on Chapter 12 developments. Several responses to this suggestion are appropriate.

First, although Chapter 12 filings may be less numerous at present, it remains an important frame of reference for rural financial workouts. Chapter 12 provides a baseline, and many farm loans have been and continue to be worked out voluntarily outside of bankruptcy because of the existence of Chapter 12.[121]

Second, although many farmers are experiencing better financial times than a few years ago, several factors point to increased volatility in the farm economy. These factors include low farm prices,[122] reduced subsidy payments and an increased tax burden as a result of deficit reduction measures,[123] dramatic farm policy changes advocated by the administration in its GATT proposals,[124] and higher than anticipated fuel and fertilizer costs as a result of the higher price of oil.[125] Although any one of these factors conceivably could be enough to make one leery of promises of a strong and stable farm economy, this combination of factors is truly unsettling.

Third, in the last few years, many farmers have restructured their debts with Farm Credit System and Farmers Home Administration under the Agricultural Credit Act of 1987.[126] For these farmers, the protections

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121. Bromley, *The Effects of the Chapter 12 Legislation on Informal Resolution of Farm Debt Problems*, 37 Drake L. Rev. 197 (1987-1988).

122. Commentators predict continued low commodity prices as a result of 1990 surpluses. St. Paul Pioneer Press, Oct. 14, 1990, at 1H, col. 1.

123. A detailed analysis of the impact of the Farm Bill resulted in the conclusion that "the combined effects of the new taxes and budget cuts in farm programs will take a disproportionate share of deficit reduction from agriculture" and that "within agriculture, a disproportionate share of deficit reduction falls upon the midsized operation." 136 Cong. Rec. S16,665 (daily ed. Oct. 25, 1990) (statement of Sen. Daschle incorporating National Farmers Union, *NFU Analysis Shows Farmers Singled Out in Budget Cuts* (1990)).

124. In this round of the GATT (General Agreement on Tariffs and Trade) negotiations, the United States has continuously advocated the elimination, over a ten-year period, of all market access restrictions and trade-distorting subsidies. While increased trade is the long-term goal of this proposal, in the short-term it is likely to mean cuts in farm income from further cuts in farm subsidy payments to U.S. farmers. United States, General Accounting Office, Pub. No. NSIAD-88-144BR, Agricultural Trade Negotiations 17-24 (1988).

125. It is estimated that farm fuel expenses may be 10% higher in 1990 than they were in 1989. Higher oil prices may also increase farm chemical costs 2-3%. Agweek, Nov. 26, 1990, at 32, col. 3.

126. For example, a study on the implementation of the Agricultural Credit Act of 1987 revealed that as of November 30, 1989, over one-third of the eligible delinquent FmHA borrowers qualified to have their debt restructured or to purchase their security property in a "net recovery buy-out." United States, General Accounting Office, Pub. No. T-RCED-90-38 (1990) (testimony of John W. Harman). While the total figures are not available to show how many of these borrowers actually restructured their loans,

of Chapter 12 were not needed. However, in the future, with FmHA attempting to move away from direct lending in favor of guaranteed loans,[127] and with the anticipated use of the new secondary loan market by FCS,[128] many of the borrower protections afforded by the Act will be unavailable.[129] Similarly, as farmland prices stabilize, statistics indicate a resurgence of private investment in agricultural loans.[130] The Agricultural Credit Act never has been applicable to private lenders. Borrowers from these sources will continue to rely on the provisions of Chapter 12 to provide the baseline for loan restructuring in times of stress.

Chapter 12 continues to be an important tool for farmers and as is presented in this Article, still produces interesting and highly contested litigation. It is this author's suggestion that it be preserved past its 1993 sunset.[131]

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presumably a significant number have obtained or will obtain restructuring relief outside of bankruptcy.

127. United States, General Accounting Office, Pub. No. RCED-89-86, Farmers Home Administration: Implications of the Shift From Direct to Guaranteed Farm Loans (1989); *see also* United States, General Accounting Office, Pub. No. T-RCED-90-31, The Farmers Home Administration's Guaranteed Farm Loan Program 1-7 (statement of John W. Harman) (discussing problems associated with the increasing FmHA emphasis on the guaranteed loan program).

128. The Agricultural Credit Act authorized the creation of a secondary market for the pooling of agricultural loans. 12 U.S.C. §§ 2279aa to 2279aa-14 (1988).

129. Although the Agricultural Credit Act of 1987 authorizes FmHA to honor guaranteed loan commitments in certain voluntary debt reduction work outs, the primary lender is not subject to the debt restructuring requirements imposed on FmHA by the Act. 7 U.S.C. §§ 2005, 1999, 1983b, and 1989. *See* Roth, *supra* note 68, at 15.1-15.55. Similarly, with regard to Farm Credit System, borrowers that consent to the pooling of their loan onto the secondary loan market waive restructuring rights available to them as Farm Credit System borrowers under the Act. 12 U.S.C. § 2279aa-9(a),(b) (1988). *See also* Kelley & Hoekstra, *supra* note 56, at 227-28 (discussing FCS borrowers' rights and the secondary loan market).

130. Nationally, there has been a "steady erosion" of the loan market share held by FCS institutions over the last several years. Commercial banks have gained in the farm loan market and in 1989 held 32% of the U.S farm debt. 1989 Farm Credit Admin. Ann. Rep. 31.

131. At the present time, Chapter 12 provisions are to be repealed by a sunset provision that takes effect on October 1, 1993. Bankruptcy Judges, United States Trustees and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, tit. III, § 302(f), 100 Stat. 3124 (1986).