

# THE CHANGING STANDARDS OF ADEQUATE PROTECTION IN FARM BANKRUPTCY REORGANIZATIONS\*

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## I. INTRODUCTION

Low commodity prices, high interest rates, rising costs of production, declining land values, natural disasters, unstable foreign markets and inconsistent government policies have all combined to drive American farmers to the edge of a financial cliff.<sup>1</sup> Until recently, many farmers were able to generate sufficient income from their farming operations to provide their annual operating capital.<sup>2</sup> They managed this through renewable short-term loans, which were given at the beginning of the year and were to be paid off at harvest time or shortly thereafter.<sup>3</sup> In the late 1970s and early 1980s, however, farmers found themselves unable to repay these loans because falling commodity prices were not offsetting increasing interest rates and the costs of production.<sup>4</sup> Their only recourse was to borrow more cash each successive year to repay the last operating loan as well as to provide new operating capital.

This cycle resulted in farmers becoming dependent upon debt financ-

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1. See generally, *Farm Bankruptcy: Hearings Before the Subcomm. on Administrative Practice and Procedure, and Courts, of the Senate Committee on the Judiciary, on the Question of the Remedies Available to Debtors and Creditors Under Bankruptcy, How They Relate to the Great Plight of the American Farm and the Farm Family*, 99th Cong., 1st Sess. (1985) [hereinafter *Farm Bankruptcy Hearings*]; *Agricultural Credit Conditions: Hearings Before the Subcomm. on Conservation, Credit Amendments Act of 1985*, 99th Cong., 1st Sess., (1985), [hereinafter *Hearings on Agricultural Credit Conditions*]; *The Problems of Farm Credit: Hearings Before the Subcomm. on Economic Stabilization of House Committee on Banking, Finance and Urban Affairs*, 99th Cong., 1st Sess. (1985), [hereinafter *The Problems of Farm Credit*].

2. Anderson & Rainach, *Farmer Reorganization Under the New Bankruptcy Code*, 28 *LOV. L. REV.* 439, 441 (1982) [hereinafter Anderson & Rainach].

3. *Farm Bankruptcy Hearings*, *supra* note 1, at 242 (statement of Terry Anderson, Professor of Law, Creighton University).

4. *The Ripples of a Farm Recession*, *BUSINESS WEEK*, Sept. 28, 1981, at 27. "Crushed between plummeting commodity prices and record interest rates, the U.S. farm economy is staggering toward one of its worst performances since the Depression." *Id.*

ing.<sup>5</sup> Lending institutions took additional mortgages in inflationary farmland to secure these rollover short-term operating loans. Due to the high interest rates that accompanied inflation, however, it was soon all a farmer could do to make the yearly interest payments on his loans.<sup>6</sup> It was at this point that land values started to decrease, putting many secured creditors in a vulnerable position of not having enough collateral to insure repayment of the loan.

During the past five years, land values have declined tremendously. One farm in Minnesota which was valued at \$900,000 in 1980 is worth only roughly \$400,000 today.<sup>7</sup> Nebraska and Iowa land values have decreased fifty percent since 1981.<sup>8</sup> North Dakota farmland has dropped twenty percent in the past two years alone.<sup>9</sup> United States Senator Tom Harkin of Iowa conducted a study on farms in four Iowa counties. The land value losses in that study ranged from fifty-four percent to eighty-five percent.<sup>10</sup>

In addition to the drop in fair market value of land, the United States' export markets have shrunk.<sup>11</sup> Countries which were once major export markets for American farmers, such as China, India and Brazil have become more self-sufficient and are now major exporters themselves.<sup>12</sup> Third World nations are not wealthy enough to purchase any significant amount of United States farm products.<sup>13</sup>

The declining export markets result in an increasing surplus of agricultural products in the United States.<sup>14</sup> American farmers and the Department of Agriculture are buried under more excess wheat, corn, rice and other products than ever before in history, sending commodity prices plunging to the lowest levels in twelve years.<sup>15</sup>

This combination of decreasing land values, shrinking export markets and increasing supplies of commodities causes today's highly leveraged farmer to be simultaneously confronted with a cash flow shortage and an erosion of equity. The only remnant of the 1970s is the huge debt load.

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5. Anderson & Rainach, *supra* note 2, at 441.

6. *Farm Bankruptcy Hearings*, *supra* note 1, at 242.

7. Magnuson, *Clinging to the Land*, *TIME*, Feb. 18, 1985, at 34 [hereinafter Magnuson].

8. See *The Problems of Farm Credit* and *Hearings on Agricultural Credit Conditions*, *supra* note 1 (statements of Iowa Representatives Berkley Bedell, James Leach, James Lightfoot, and Cooper Evans, and Iowa Senators Charles Grassley and Tom Harkin; statements of Nebraska Representatives Doug Beruter and Virginia Smith).

9. *Hearings on Agricultural Credit Conditions*, *supra* note 1, at 173 (prepared statement of North Dakota Congressman Byron L. Dorgan).

10. *Id.* at 148.

11. See Hoppe, *Why Washington Should Stop Killing Agriculture with Kindness*, *BUSINESS WEEK*, Aug. 11, 1986, at 25; Koepp, *Amber Waves of Strain*, *TIME*, July 21, 1986, at 46 [hereinafter Koepp].

12. See Koepp, *supra* note 11, at 46.

13. *Id.*

14. *Id.*

15. *Id.*

These factors are forcing many farmers to think about ways in which they might be able to save their farming operations from foreclosure.

## II. THE FARM DEBTOR'S OPTIONS

The typical debt-burdened farmer has a variety of alternatives he can use to rebuild his farming operation. Often, the initial response of the farmer is to try to informally negotiate with his major creditors to restructure the debt. If this is unsuccessful, federal bankruptcy can be used by the farmer to rebuild his farm. There are four different types of bankruptcy that the farmer can choose from. Chapter 7 provides for a plan to liquidate the debtor's assets. Chapter 13 is known as the individual wage earner's reorganization plan. Chapter 11 is for business reorganizations. And finally, Chapter 12 is the newly enacted chapter for family farmers. Each bankruptcy chapter has unique advantages and disadvantages. Thus, the type of bankruptcy petition that an individual farmer will file will depend on the individual circumstances of the particular case.

### A. Informal Negotiations

Most farmers are honest, hardworking men and women. Bankruptcy is viewed as a disgraceful affair by them.<sup>16</sup> That is why most farmers go to their lenders and try to make a deal when they start having trouble making their payments. While this is often the most desirable course of action for the lender, it may not produce the best or fairest result for the farm debtor. The lending institution will often condition extensions of the loan or work-out periods upon the receipt of more collateral. In this manner, all of the farming assets become encumbered. By the time the farmer realizes he might have been better off filing for bankruptcy, it is often too late. It is fair to say that most farmers simply wait too long before they file for bankruptcy.<sup>17</sup> They use it as a last resort when they are desperate. This works to their disadvantage in a reorganization plan.<sup>18</sup>

Another disadvantage of informally negotiating with creditors is that the farmer only works with one creditor at a time.<sup>19</sup> Each creditor is out to protect its own interests. This can create problems when there just isn't enough money to pay off all of the debts. In most cases, a more comprehensive treatment of the debt situation is necessary.<sup>20</sup>

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16. See Magnuson, *supra* note 7, at 32-34, 39; *One Family's Bankruptcy*, TIME, Sept. 8, 1986, at 20-21.

17. Interview with Jon Van Patten, Bankruptcy and Debtor/Creditor Rights Professor at the University of South Dakota School of Law (April 1987).

18. *Id.*

19. Center for Rural Affairs, Walthill, Neb., *Rebuilding Family Farms Through Bankruptcy: A Guide to Chapter 12 Bankruptcy 4-5* (Jan. 1987) [hereinafter *Rebuilding Family Farms*].

20. *Id.*

Some states mandate that farmers and their creditors attend farm mediations to try to solve their problems outside of bankruptcy. In 1986, Minnesota enacted the Farm Lender Mediation Act in response to the thousands of farmers who were unable to meet their current payments of interest and principal on mortgages and other loans and land contracts.<sup>21</sup> These farmers are threatened with the loss of their land, equipment, crops and livestock through mortgage and lien foreclosures, cancellation of contracts for deed and other collective actions.<sup>22</sup> The Minnesota legislature decided that this "agricultural economic emergency requires an orderly process with state assistance to adjust agricultural indebtedness to prevent civil unrest and to preserve the general welfare and fiscal integrity of the state."<sup>23</sup>

Mandatory mediation does not mean that the parties must reach any final resolutions regarding the debt restructuring; only that they make a good faith attempt to do so.<sup>24</sup> The program is only on a temporary, trial basis, as it is repealed as of July 1, 1989.<sup>25</sup> Under this new law, a creditor may not begin any proceeding to enforce a debt against agricultural property until the creditor and the debtor have completed the mediation process, as defined by the act.<sup>26</sup>

Iowa has enacted much less comprehensive farm mediation legislation.<sup>27</sup> The 1986 legislature simply provided for an appropriation of \$50,000 to the Department of Justice for farm mediation services.<sup>28</sup> No other guidelines were provided, other than to state that the farm mediation service shall be administered by the farm crisis program coordinator. This program ended as of June 30, 1986.<sup>29</sup>

### B. Chapter 7 Liquidation

A Chapter 7 liquidation is usually the last thing that the farm debtor wants. In a liquidation proceeding, the farmer gets to keep a small portion of his or her exempt personal property.<sup>30</sup> The remaining assets are then sold in satisfaction of the debt and distributed to the creditors.<sup>31</sup> One advantage of a Chapter 7 liquidation is that it is completed in a relatively short period of time. After the debtor's assets are sold and he receives his discharge, he has a chance to start picking up the pieces of his life again. The "fresh

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21. MINN. STAT. ANN. §§ 583.20-.32 (West Supp. 1988).

22. *Id.* at § 583.21.

23. *Id.*

24. *Id.* at § 583.27.

25. See note following *id.* at § 583.01 (giving legislative history).

26. *Id.* at § 583.26.

27. 1986 Iowa Acts 789.

28. *Id.*

29. *Id.*

30. See Pub. L. No. 95-598, 92 Stat. 2609 (1978); Pub. L. No. 98-353, 98 Stat. 353, 375 (1984) (amendments to Title 11 of the United States Code).

31. See 11 U.S.C. § 726 (1982).

start" concept is at the heart of this chapter.<sup>33</sup>

There is no discharge for a corporation or a partnership in Chapter 7.<sup>33</sup> Therefore, businesses only use this chapter as a last resort. A corporation may always dissolve, leaving behind the question of liability of the owners. Comparatively, it is the individual partners who need the discharge of indebtedness, not the partnership entity.

Usually the courts are eager to grant debtors a Chapter 7 discharge. There are certain precautions, however, that must be taken with any debtor that may be even more worthy of consideration with the farm debtor. Consider the type of records the farm debtor has been keeping. This is important because the court may deny a discharge of all of the farmer's debts if no records were kept to determine the debtor's financial condition.<sup>34</sup> The debtor must also be able to satisfactorily explain any loss of assets.<sup>35</sup> If these are impossible to verify, the farmer should choose a different form of bankruptcy.

### C. Chapter 13 Individual Wage Earner Plan

Individual farm debtors may qualify for reorganization under Chapter 13 if they have less than \$100,000 unsecured debt and \$350,000 secured debt.<sup>36</sup> Farm corporations and partnerships may not elect to file under this chapter.<sup>37</sup> A farmer who has an annual income can qualify for this chapter.<sup>38</sup> Chapter 13 reorganizations are simpler, speedier, and less expensive than the reorganizations under other chapters.<sup>39</sup> The focus is on using the debtor's future earnings, rather than accumulated assets, to pay creditors.<sup>40</sup>

The concept of using the debtor's "disposable income" for a period of time to pay unsecured creditors originated in Chapter 13 and is incorporated in Chapter 12.<sup>41</sup> Disposable income is the money left at the end of the month after all living expenses and farming expenses have been paid.<sup>42</sup> Whatever amounts remain unpaid at the end of the plan are simply discharged.<sup>43</sup>

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32. See S. REP. No. 989, 95th Cong., 2d Sess. (1978) (legislative history to 11 U.S.C. § 727).

33. 11 U.S.C. § 727(a)(1) (1982).

34. *Id.* at § 727(a)(3).

35. *Id.* at § 727(a)(5).

36. *Id.* at § 109(e).

37. 11 U.S.C. § 109(f) (Supp. IV 1986).

38. *Id.*

39. See Legislative History to § 1304, reprinted in Notes of the Committee on the Judiciary, S. REP. No. 989, 95th Cong., 2 Sess. (1978).

40. See generally 11 U.S.C. § 1306 (Supp. IV 1986).

41. Compare 11 U.S.C. §§ 1325, 1325(a)(5), 1325(a)(6), 1325(b) (1987) with §§ 1222(c), 1225(b) (Supp. IV 1986).

42. *Id.* at § 1225(b)(2) (Supp. IV 1986).

43. 11 U.S.C. § 1328 (1982).

If a farmer can meet the debt limitations, one advantage of utilizing Chapter 13 is that it gives the debtor an opportunity to "deaccelerate" or "cure" a mortgage in default.<sup>44</sup> Another benefit is that the debtor's cosigners are protected from creditor harassment.<sup>45</sup> These factors may motivate some farm debtors to choose Chapter 13 as a method of reorganizing their farming operation. However, the debt limit restrictions and the prohibition against corporations filing under this chapter eliminate many financially distressed farmers from filing under this chapter.

#### D. Chapter 11 Business Reorganization

Chapter 11 was designed to enable a large business with many debts to reorganize. It provides satisfactory relief to the mercantile debtor who is beset by a specific event or a series of unfortunate events which are generally nonrecurring.<sup>46</sup> As noted above, the financial stress troubling farmers today is not tied to a specific event or a series of generally nonrecurring events. As such, Chapter 11 impedes, rather than facilitates, the reorganization of a farming operation. Many farmers find this chapter to be unduly complicated, time-consuming, expensive and often unworkable.<sup>47</sup>

The entire range of these difficulties is beyond the scope of this paper. One of the main obstacles to the financial restructuring of farmers under Chapter 11, however, was the controversy that existed over the various standards of "adequate protection" afforded to farm creditors. Chapter 12 has taken a stand on this issue contrary to that of Chapter 11. This paper will examine the standards of adequate protection in Chapter 11, as they were defined by the courts and apply these standards to the farm debtor's predicament. The Chapter 12 methods of providing adequate protection will then be explored, emphasizing their benefit to the farm debtor who seeks to reorganize, and the problems that could arise for farm lenders as a result of this new law.

### III. THE BANKRUPTCY PROCESS

As soon as a bankruptcy petition is filed, all creditors must stop any attempts to continue collection from the debtor.<sup>48</sup> This protection is known as the "automatic stay."<sup>49</sup> It is one of the fundamental debtor protections. "It gives the debtor a breathing spell from his creditors. It stops all collec-

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44. *Id.* at § 1322(b)(5).

45. *Id.* at § 1301.

46. *Farm Bankruptcy Hearings*, *supra* note 1, at 47 (statement of Hon. Richard Stageman, Bankruptcy Judge for the Southern District of Iowa) (now retired).

47. See generally *Farm Bankruptcy Hearings*, *supra* note 1; H.R. CONF. REP. No. 598, 99th Cong., 2d Sess., reprinted in 1986 U.S. CODE CONG. & ADMIN. NEWS 5246, 5249 (legislative history to Chapter 12).

48. 11 U.S.C. § 362(a) (1982).

49. *Id.*

tion efforts, all harassment, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganization plan, or simply to be relieved of the financial pressures that drove him into bankruptcy."<sup>50</sup> The automatic stay also benefits creditors. It ensures that there will be an equitable distribution of the debtor's nonexempt or unencumbered assets. Outside of bankruptcy, the creditor who proceeds first against the debtor's property benefits to the detriment of other creditors.<sup>51</sup> Bankruptcy ensures an orderly and just payment.

The automatic stay remains in effect until the debtor's case is closed or dismissed, or a discharge of indebtedness is granted.<sup>52</sup> During this entire time, the creditor is prevented from enforcing state statutory rights of foreclosure against the property. As a result, the secured creditor must bear the risk that the property will decline in value, or that it may be lost, damaged or converted by the debtor for his own use during this time.<sup>53</sup>

While the automatic stay evidences a congressional intent to protect the debtor, a creditor may obtain relief from the stay under certain circumstances. One of these circumstances is the failure of the debtor to provide adequate protection of a creditor's interest.<sup>54</sup> Section 362(d) provides that a creditor may obtain relief from the automatic stay "for cause, including lack of adequate protection."<sup>55</sup> This means that if the debtor wants to use, sell or lease property that is collateral for a loan, he must protect the creditor's interest in that collateral.<sup>56</sup> If the value of the collateral threatens to diminish in value during the period that the automatic stay is in effect, the debtor must adequately protect that value.<sup>57</sup> Likewise, adequate protection requirements must be met if the debtor wants to incur a second lien on property that is already subject to one creditor's interest.<sup>58</sup>

#### IV. DEFINING ADEQUATE PROTECTION

The term "adequate protection" is not explicitly defined in the Bankruptcy Code. Section 361 provides three nonexclusive methods of adequately protecting a creditor's interest in collateral. Adequate protection may be provided by: (1) making periodic cash payments to the creditor to the extent that the automatic stay results in a decrease in the value of such entity's

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50. H.R. REP. No. 595, 95th Cong., 1st Sess., 340, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6296-97.

51. *Id.* at 6297.

52. 11 U.S.C. § 362(c) (1982).

53. Anderson, *Adequate Protection of Opportunity Cost After In re Briggs*, 19 CREIGHTON L. REV. 765, 766 (1985-86) [hereinafter Anderson].

54. 11 U.S.C. § 362(d)(1) (1982).

55. *Id.*

56. *Id.* at § 363(e).

57. *Id.* at § 361(1).

58. *Id.* at § 361(2).

interest in such property; (2) providing an additional or replacement lien; or (3) granting such other relief as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property.<sup>59</sup>

While section 361 sets forth examples of how the value of the creditor's interest is to be adequately protected, it does not specify when or how that value is to be determined. In cases involving questions of adequate protection, determining the value of the property will always be important. The legislative history reveals that this ambiguity was intentional:

These matters are left to case-by-case interpretations and development. It is expected that the courts will apply the concept in light of the facts of each case and general equitable principles. It is not intended that the courts will develop a hard and fast rule that will apply in every case. The time and method of valuation is not specified precisely, in order to avoid that result. There are an infinite number of variations possible in dealing between debtors and creditors, the law is continually developing, and new ideas are continually being implemented in this field. The flexibility is important to permit the courts to adapt to varying circumstances and changing modes of financing.<sup>60</sup>

Thus, the purpose of the Code is to promote flexibility with regard to the changing economy and the wide variety of transactions entered into between debtors and creditors.

Defining the requirements of adequate protection has led to the emergence of three separate theories regarding how much protection a creditor should be entitled. One line of cases holds that the creditor is only entitled to protection against a decline in the recoverable value of the collateral during the period in which the right to foreclose is prevented by the automatic stay.<sup>61</sup> A second line of cases holds that the creditor must also be compensated for "lost opportunity costs."<sup>62</sup> Lost opportunity costs stem from the loss of interest that the creditor could have gained if he had received the value of the collateral and reinvested it in a profitable venture.<sup>63</sup> A compromise between these two propositions has been reached in the Eighth Circuit, acknowledging that creditors may be compensated for these lost opportunity costs, if the facts of the case indicate that to be the equitable result, but holding that such compensation is not required as a matter of law.<sup>64</sup>

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59. *Id.* at § 361.

60. H.R. REP. NO. 595, 95th Cong., 1st Sess., 339 (1978), reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6295.

61. See *infra* text accompanying notes 65-73.

62. See *infra* text accompanying notes 74-85.

63. See *In re American Mariner Indus., Inc.*, 734 F.2d 426, 427-28 (9th Cir. 1984).

64. See *infra* text accompanying notes 86-99.



### A. Adequate Protection for Decline in Value

Several courts have refused to award creditors lost opportunity costs.<sup>65</sup> They base their holdings on the legislative history involving adequate protection.<sup>66</sup> The Commission on Bankruptcy Laws described adequate protection as protection "to the extent of the anticipated decrease in the value of the collateral as a result of use."<sup>67</sup> The court in *In re South Village*<sup>68</sup> observed that when adequate protection standards were being debated by Congress prior to the enactment of the revised 1978 Bankruptcy Code, creditors proposed a provision to adequately protect the use value of money.<sup>69</sup> Despite this strong appeal by creditors, Congress did not include any reference to lost opportunity costs in the Code. Instead, adequate protection is only mentioned as it applies to the diminishing value of collateral.<sup>70</sup>

Allowing recovery for lost reinvestment opportunities seems inconsistent with other Bankruptcy Code sections.<sup>71</sup> For example, section 502(b)(2) halts the accrual of interest on all claims once the bankruptcy petition is filed. An exception to this rule comes into play where the creditor is oversecured. Section 506(b) allows an oversecured creditor to keep charging interest until the collateral equals the amount of the debt. If a creditor who is undersecured were to receive payments for the lost reinvestment opportunity, it would be like allowing them an interest benefit contrary to these other code sections.<sup>72</sup> The court in *South Village* recognized that Congress approved rewriting the creditor's bargain without offering any protection for lost opportunity costs.<sup>73</sup>

### B. Adequate Protection for Lost Opportunity Costs

Other courts have reached the opposite conclusion. The Ninth Circuit, in *In re American Mariner Industries, Inc.*,<sup>74</sup> held that undersecured creditors were entitled to interest payments under section 362(d)(1) to compensate them for the delay in enforcing their foreclosure rights as a matter of

65. See, e.g., *In re Shriver*, 33 Bankr. 176 (Bankr. N.D. Ohio 1983); *In re Cantrup*, 32 Bankr. 1004 (Bankr. D. Colo. 1983); *In re South Village, Inc.*, 25 Bankr. 987 (Bankr. D. Utah 1982); *In re Pine Lake Village Apartment Co.*, 19 Bankr. 819 (Bankr. S.D.N.Y. 1982); *In re Alyucan Interstate Corp.*, 12 Bankr. 803 (Bankr. D. Utah 1981).

66. Anderson, *supra* note 53, at 770.

67. *Id.* at 770, n.23 (quoting THE REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. 137, 237, 93d Cong., 1st Sess. pts. I & II (1973)).

68. 25 Bankr. 987 (Bankr. D. Utah 1982).

69. *Id.* at 994. For a detailed discussion of the legislative history behind adequate protection, see Anderson, *supra* note 53 at 776 n.75.

70. *In re South Village, Inc.*, 25 Bankr. at 997.

71. *Id.*

72. *Id.*

73. *Id.*

74. 734 F.2d 426 (9th Cir. 1984).

law.<sup>75</sup> The rationale behind this decision focused on the fact that when a debtor stops making payments, the creditor's investment yields no return.<sup>76</sup> The automatic stay prevents the creditor from getting the value of his investment out of the debtor's possession and into a more profitable one. Thus, to the extent that the creditor loses these reinvestment profits, it wants the debtor to provide it with adequate protection payments.<sup>77</sup>

The *American Mariner* court cited legislative history to support its interpretation of adequate protection.<sup>78</sup> After noting that a secured creditor's legal rights to take possession of and sell the collateral and reinvest the proceeds are entitled to protection, the court emphasized that secured creditors should not be deprived of the benefit of this bargain<sup>79</sup> "[t]hough the creditor might not receive his bargain in kind, the purpose of the section is to ensure that the secured creditor receives in value essentially what he bargained for."<sup>80</sup>

The *American Mariner* court also focused on the "indubitable equivalent" language in section 361(3) to support its compensatory interpretation of the adequate protection requirement for lost opportunity costs.<sup>81</sup> Section 361(3) authorizes a debtor to meet adequate protection standards by "such other relief . . . as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property."<sup>82</sup>

The term "indubitable equivalent" originated from the opinion of Judge Learned Hand in *In re Murel Holding Corp.*<sup>83</sup> Here, while explaining the concept of adequate protection, Judge Hand stated: "It is plain that 'adequate protection' must be completely compensatory; and that payment ten years hence is not generally the equivalent of payment now."<sup>84</sup> The court would not deprive the creditor in that case of his interest in the collateral "unless by a substitute of the most indubitable equivalence."<sup>85</sup> Thus,

75. *Id.* at 435. See also, *Grundy Nat'l Bank v. Tandem Mining Corp.*, 754 F.2d 1436, 1441 (4th Cir. 1985); *In re Pulliam*, 54 Bankr. 624, 625 (Bankr. W.D. Mo. 1985); *In re Wolsky*, 53 Bankr. 751, 755 (Bankr. D.N.D. 1985); *In re Deeter*, 53 Bankr. 623, 627 (Bankr. N.D. Ind. 1985); *In re Cash Currency Exch., Inc.*, 52 Bankr. 577, 580 (Bankr. N.D. Ill. 1985); *In re Bear Creek Ministorage, Inc.*, 49 Bankr. 454, 456-57 (Bankr. S.D. Tex. 1985); *In re Lilyerd*, 49 Bankr. 109, 117 (Bankr. D. Minn. 1985); *In re Cassavaugh*, 44 Bankr. 726, 729 (Bankr. W.D. Mo. 1984); *In re Nordyke*, 43 Bankr. 856, 861 (Bankr. D. Ore. 1984); *In re Mary Harpley Builder, Inc.*, 44 Bankr. 151, 155-56 (Bankr. N.D. Ohio 1984).

76. *In re American Mariner Indus., Inc.*, 734 F.2d at 435.

77. *Id.*

78. *Id.* at 429-32.

79. *Id.* at 430-31.

80. *Id.* at 431 (quoting H.R. REP. No. 595, 95th Cong., 1st Sess. 339, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS at 6295).

81. *Id.* at 432-34.

82. *Id.* at 432.

83. 75 F.2d 941 (2d Cir. 1935).

84. *Id.* at 942.

85. *Id.*

indubitable equivalence connotes the concept of a present value interest.

Under a present value interpretation of adequate protection, in order to avoid a lifting of the automatic stay, the farm debtor would have to provide his creditors with additional collateral or cash payments to compensate the creditors for any delay in the enforcement of their foreclosure rights caused by the Chapter 11 automatic stay. This value in most cases would require an interest payment at the going rate based on the liquidation value of the collateral. Even if a farmer's land was not depreciating in value, he would be required to make interest payments equal to the lost opportunity costs. If the farmer could afford to make these payments, he would not need to declare bankruptcy.

### C. *The Eighth Circuit's Compromise*

The Eighth Circuit Court of Appeals has taken a compromise approach in defining what constitutes adequate protection in *In re Briggs Transportation Co.*<sup>86</sup> This case involved two creditors who held perfected security interests in the debtor's tractors and trailers.<sup>87</sup> Both creditors were undersecured and were prevented from foreclosing on their security interests by the automatic stay.<sup>88</sup> The creditors claimed that they were entitled to adequate protection payments for their inability to foreclose, liquidate the collateral, and reinvest the proceeds.<sup>89</sup>

The court determined that while adequate protection is intended to encompass a broad range of creditor interests, it does not mandate an interpretation of the creditors' interest as the whole of the economic bargain.<sup>90</sup> The court went on to state that creditors did not have an absolute right to be placed in the same position economically as they would be in, if the debtor had not filed for bankruptcy.<sup>91</sup> Flexibility is the key to determining the standards of adequate protection which are appropriate for a given case. Therefore, an undersecured creditor will not be entitled to compensation for delay in enforcing its foreclosure rights in every instance.<sup>92</sup>

The *Briggs* court determined that adequate protection must be analyzed on a case-by-case basis.<sup>93</sup> The court set forth the following guidelines which future courts could consider in evaluating a debtor's offer of adequate protection: (1) the existence of an equity cushion; (2) valuation (which, for purposes of lifting the automatic stay, is not necessarily the same as valuation for confirming a plan); (3) the reasonable expectations of both the

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86. 780 F.2d 1339 (8th Cir. 1985).

87. *Id.* at 1341.

88. *Id.*

89. *Id.*

90. *Id.* at 1346.

91. *Id.* at 1346-47.

92. *Id.* at 1348-49.

93. *Id.*

debtor and the creditor in determining what their agreement was; (4) the quality of the collateral; (5) the length of time the automatic stay has been in force; (6) whether the collateral is appreciating, depreciating or remaining stable in value; (7) the conduct of the debtor; (8) whether the taxes and other payments are being paid to keep the collateral free of statutory liens; (9) the liquidation value of the collateral; and (10) the feasibility of the debtor's reorganization.<sup>94</sup>

While the Eighth Circuit has determined that creditors should generally receive adequate protection payments equal to their essential bargain, the creditors should not be put in a better position than they would have been in, absent the bankruptcy filing. The court held in *In re Ahlers*,<sup>95</sup> that secured creditors are entitled to adequate protection payments at the time when that creditor could realistically have sold the farmer's property through the foreclosure process.<sup>96</sup> Applying the state foreclosure law of Minnesota, the court determined that adequate protection payments would not begin until one year and six weeks from the date of foreclosure or, if no foreclosure proceedings had been commenced before the debtor filed for bankruptcy, payments would begin one year and six weeks after the adequate protection motion is filed.<sup>97</sup>

In addition, the *Ahlers* court recognized that the seasonal nature of farming makes monthly adequate protection payments a hardship on farm debtors.<sup>98</sup> Because a farmer's income is not dependent upon a monthly paycheck, but rather upon the harvest of his crops at the end of the growing season, adequate protection payments may accumulate and should not be due until the farmer has harvested his crops or sold his livestock.<sup>99</sup>

#### D. Valuation of Adequate Protection

Adequate protection payments, then, are to be made in accordance with the creditor's bargain. One writer, Professor Raymond Nimmer, suggested looking at the characteristics of the loan transaction to help define the meaning of the term "bargain."<sup>100</sup> According to Professor Nimmer, creditors structure their bargains differently when they take a security interest in equipment, as opposed to taking a security interest in a debtor's inventory or accounts receivable.<sup>101</sup> The significant feature evident when the collateral is equipment, is that the creditor's protection against depreciation or other

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94. *Id.* at 1349-50.

95. 794 F.2d 388 (8th Cir. 1986), *rev'd on other grounds*, 108 S. Ct. 963, 965 (1988).

96. *Id.* at 395.

97. *Id.* at 396.

98. *Id.* at 397.

99. *Id.*

100. Nimmer, *Secured Creditors and the Automatic Stay: Variable Bargain Models of Fairness*, 68 MINN. L. REV. 1, 14-49 (1983).

101. *Id.* at 20.

value loss is the only form of financial protection required to safeguard the creditor.<sup>102</sup> In comparison, the major risk when the collateral is inventory or accounts receivable is that the creditor will not participate in the income realized from the sale of the collateral.<sup>103</sup>

By noting this distinction, one can determine whether the creditor bargained for any cash-flow expectancy and should thus be awarded adequate protection to compensate for this loss. For collateral that is wholly or partially liquid, including cash collateral, the secured creditor should receive adequate protection payments for lost opportunity costs due to the high risks involved with the debtor's use of that collateral.<sup>104</sup> On the other hand, collateral which is depreciating on a regular basis, such as equipment, machinery, and real estate, should entitle the secured creditor to payments equal to the depreciation, but not to lost opportunity costs.<sup>105</sup>

If adequate protection is demanded by a creditor under section 363 because of the farm debtor's use of the collateral, one commentator concluded that any adequate protection payments should be determined by calculating the risk of loss created by that use.<sup>106</sup> Recently, some creditors have argued successfully that the farmer's use of the land during the automatic stay caused a decline in the value of the real estate.<sup>107</sup> In Nebraska, a bankruptcy judge ordered a farmer to make adequate protection payments of \$191,000 to his secured creditor holding a real estate mortgage.<sup>108</sup> The judge compared the value of the land at the time bankruptcy was filed with the value on the date the request for relief from the automatic stay was requested to determine this amount.<sup>109</sup> Because land values had declined in the interim, the farmer was held liable for the entire loss.<sup>110</sup>

The South Dakota Bankruptcy Court has refused to place the risk of declining land values solely on the debtor. The court in *In re Sheehan*<sup>111</sup> noted that the risk of declining land values is an economic risk to be shared by the debtor and the mortgagee in a real estate transaction.<sup>112</sup> The court stated:

The intent of Congress is that the debtor should be able to reorganize around the market value of real estate rather than having foreclosure by the creditor at the same market value, with the creditor taking a loss in

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102. *Id.*

103. *Id.* at 34.

104. *Id.* at 26.

105. *Id.* at 18-22.

106. Anderson, *supra* note 53, at 768.

107. *In re Dibbern*, B.K. No. 84-1202 (1985) (unreported decision cited in *Farm Bankruptcy Hearings*, *supra* note 1, at 248).

108. *Id.*

109. *Id.*

110. *Id.*

111. 58 Bankr. 296 (Bankr. D.S.D. 1986).

112. *Id.* at 304.

either event—the creditor will either bear the expense of participation in the bankruptcy reorganization or the expense of foreclosure in another forum. Any loss under these circumstances cannot be attributed to the imposition of the stay.<sup>113</sup>

The *Sheehan* approach makes more sense. The declining value of land is not caused by the debtor's use of the land. It is the result of market forces, which would have occurred regardless of the automatic stay. It is not fair to require the farmer to become an insurer of the loan officer's lending judgment.

Farmers who are attempting to reorganize under Chapter 11 will have a better chance of defeating a creditor's motion for relief from the automatic stay if they are located in the Eighth Circuit. Here, adequate protection standards will be determined on a case-by-case basis. For qualifying family farmers who have less than \$1.5 million debt, however, the new Chapter 12 Family Farm Reorganization Act provides a more attractive chapter under which to file bankruptcy.<sup>114</sup>

## V. CHAPTER 12

The Family Farm Reorganization Act, creating Chapter 12 for farmers, went into effect on November 26, 1986.<sup>115</sup> This legislation was in response to the national farm crisis. To the extent that the prior laws impeded the ability of farmers to restructure their debt, changes were made. Congressman Mike Synar, one of the main proponents of the bill, emphasized that bankruptcy legislation will not solve the family farm crisis.<sup>116</sup> It should, however, "slow down the ongoing deterioration of rural America long enough for Congress to pass a farm bill . . . and take other steps necessary to revitalize our farm economy."<sup>117</sup>

Chapter 12 is specifically designed to give family farmers facing bankruptcy a fighting chance to reorganize their debts and keep their land.<sup>118</sup> Congress recognized that one of the most devastating obstacles to many farm reorganizations was the requirement of adequate protection as it was interpreted by some courts to protect a creditor from lost opportunity

113. *Id.*

114. The term "family farmer" covers an individual or an individual and spouse whose aggregate debt does not exceed \$1,500,000, excluding the debt on a residence if such is not involved in the farming operation. Eighty percent of the farmer's debt must arise from the farming operation, and 50% of the farmer's gross income must come from farming. The term also covers corporations and partnerships, with the same debt limits, so long as the company is held 50% by a family involved in farming. 80% of the value of the company's assets must be related to the farming operation. 11 U.S.C. 101(17) (1986).

115. Pub. L. 99-554, 100 Stat. 3088 (1986).

116. 131 CONG. REC. H85 (daily ed. June 24, 1985).

117. *Id.*

118. H.R. CONF. REP. No. 958, 99th Cong., 2d Sess. 45, reprinted at 1986 U.S. CODE CONG. & ADMIN. NEWS 5246, 5249.

costs.<sup>119</sup> "Lost opportunity cost payments present serious barriers to farm reorganization because farmland values have dropped so dramatically in many sections of the country—making for many undercollateralized secured lenders. Thus, family farm reorganizations are often throttled in their infancy upon motion to lift the automatic stay."<sup>120</sup> Thus, section 1205 sets forth a new set of requirements for adequate protection in Chapter 12 cases. It provides as follows:

(a) Section 361 does not apply in a case under this chapter.

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

(1) requiring the trustee to make a cash payment or periodic cash payments to such entity, to the extent that the stay under section 362 of this title, use, sale, or lease under section 363 of this title, or any grant of a lien under section 364 of this title results in a decrease in the value of property securing a claim or of an entity's ownership interest in property;

(2) providing to such entity an additional or replacement lien to the extent that such stay, use, sale, lease, or grant results in a decrease in the value of property securing a claim or of an entity's ownership interest in property;

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

(4) granting such other relief, other than entitling such entity to compensation allowable under section 503(b)(1) of this title as an administrative expense, as will adequately protect the value of property securing a claim or of such entity's ownership interest in the property.<sup>121</sup>

Chapter 12 explicitly rejects the creditors' argument that they should receive compensation for lost opportunity costs.<sup>122</sup> The House and Senate Conference report "makes it clear that what needs to be protected is the value of the property, not the value of the creditor's 'interest' in property."<sup>123</sup>

Farming is a unique business. Because it is seasonal in nature, there is no orderly cash flow, no accounts receivable, and often no dependable income. The lack of cash flow prior to harvest time makes it extremely unlikely that any debt-burdened farmer will have enough cash to offer as adequate protection to creditors. As discussed earlier, some courts are now requiring adequate protection payments for lost reinvestment opportunities, in addition to the adequate protection payments necessary to insure against the risks involved with the farmer's use of farm machinery and other en-

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119. *Id.* at 5250.

120. *Id.*

121. 11 U.S.C. § 1205 (Supp. IV 1986).

122. *Id.* at 1205(a).

123. H.R. CONF. REP. No. 958, *supra* note 118, at 5250.

cumbered assets necessary for the effective reorganization of the farming operation.<sup>124</sup>

The farmer's inability to make these adequate protection payments is predictable. As a result, the stay must be lifted, exposing the farmer's assets to foreclosure and replevin. Once a farmer's assets are depleted in this manner, the ability to reorganize completely disappears. Thus, the application of adequate protection payments creates an exceptional hardship and is unfair when it is applied to the farm-debtor.

In addition to eliminating lost opportunity costs, section 1205 adds another method by which a farmer may provide adequate protection. The farmer may adequately protect the interests of an unhappy creditor by paying the reasonable fair market rental value of the property.<sup>125</sup> Reasonable rent should be determined based on the rental value, net income and the earning capacity of the property.<sup>126</sup> It is important to note that this does not mean that a farmer will only have to pay the fair rental value on his farm throughout the reorganization. The adequate protection payments usually come into play only during the time period between the filing of the bankruptcy petition and the confirmation hearing.<sup>127</sup> Under Chapter 12, this time period will likely be 135 days or less.<sup>128</sup>

This additional means of providing adequate protection through the payment of a reasonable rental value was derived from section 75 of the controversial Frazier-Lemke Act enacted in the midst of the Great Depression in response to the farm crisis at that time.<sup>129</sup> The thrust of the Frazier-Lemke Act was as follows:

to permit financially distressed farmers to retain their land over a minimum of three years, to be granted a moratorium in paying creditors, to be required to pay only a reasonable rental set by the court, to be allowed to work their land in an attempt to gain refinancing or other financial help, and to be required to pay only the appraised value of their property to redeem it, rather than the full amount of any burdensome mortgage debt.<sup>130</sup>

In a report prepared for the Committee on Farmer Insolvency, pursuant to a request from the Committee on the Judiciary of the United States Senate to comment on the proposed family farmer bankruptcy bills, Professor

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124. See *supra* text accompanying notes 74-85.

125. 11 U.S.C. § 1205(b)(3) (Supp. IV 1986).

126. *Id.*

127. *Rebuilding Family Farms*, *supra* note 19, at 16.

128. After filing the petition, the debtor has only 90 days to file a plan, 11 U.S.C. § 1221 (Supp. 1986), and the confirmation hearing is to be concluded no later than 45 days after the filing of the plan. *Id.* at § 1224.

129. Anderson & Rainach, *supra* note 2, at 457. This article provides an extensive history of farm reorganizations.

130. *Id.*



John C. Anderson noted that the last factor mentioned above, the writing off of debt, is especially important since the Depression appeared to create a deflation in the fair market value of farm land.<sup>131</sup> Farmers today are experiencing the same economic and financial crisis of overburdening farm debt and declining land values.

Chapter 12 has incorporated this debt write-off treatment of undersecured debt into section 1225(a)(5) by reducing the amount of the debt to the present value of the security.<sup>132</sup> Thus, it may be possible for the debtor to cash-out the secured creditor by paying an amount equal to the appraised value of the collateral.<sup>133</sup> For example, land mortgaged for \$200,000 might be worth \$120,000 in today's market. Under Chapter 12, a farmer would have to show that he could repay \$120,000 over a "reasonable" period of time, such as twenty years. The remaining \$80,000 becomes an unsecured debt and is treated the same as other unsecured debts.<sup>134</sup>

Farmers can then repay the unsecured debts under the Chapter 12 plan from all their disposable income over a period of three to five years.<sup>135</sup> At the end of the plan, any remaining unsecured debts, including the unsecured land debt, are discharged.<sup>136</sup>

While Chapter 12 appears to be very pro-debtor on its surface, there are some serious disadvantages that may cause a debtor to think twice before reorganizing under this chapter. Throughout the three- to five-year plan, the farmer's management techniques will be under the scrutiny of a Chapter 12 trustee.<sup>137</sup> All farming decisions must be approved by the trustee to ensure

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131. 132 Cong. Rec. S15079 (daily ed. Oct. 3, 1986).

132. That subsection provides:

(a) Except as provided in subsection (b), the court shall confirm a plan if—

(5) with respect to each allowed secured claim provided for by the plan—

(A) the holder of such claim has accepted the plan;

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

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

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

11 U.S.C. § 1225(a)(5) (Supp. IV 1986).

133. Schneider, *Chapter 12 Bankruptcy—How Will It Operate*, 2 FARMERS LEGAL ACTION REPORT, No. 1, at 6 (Nov.-Dec. 1986).

134. Tevis, *Chapter 12 Offers New Option to Family Farmers*, SUCCESSFUL FARMING, Feb. 1987, at 18-W [hereinafter Tevis].

135. 11 U.S.C. § 1225 (Supp. IV 1986).

136. *Id.* at § 1228.

137. Taylor, *New Hope for Hard-Pressed Farmers*, FARM JOURNAL, Dec. 1986, at 23 [hereinafter Taylor].

that the farmer is acting in accordance with the farm plan. This may require debtors to make detailed written reports to the trustee.

In addition, the trustee fees may be cost prohibitive. The trustee currently receives ten percent of all payments made under the plan.<sup>138</sup>

Tax penalties under Chapter 12 should not be ignored. In comparison with the other bankruptcy chapters, Chapter 12 does not give debtors an option to elect two short tax years when they are filing for bankruptcy.<sup>139</sup> This difference could leave the debtor with higher taxes and no money to pay them.

With these considerations in mind, declaring bankruptcy is a serious decision to make. It is not the right choice for every farmer. Chapter 12 is available to assist those farmers who have the true potential to reorganize and to give them some relief from their heavy debt burden. Congress meant to maintain the balance in farm communities between suppliers, creditors and farmers.<sup>140</sup>

The following chart<sup>141</sup> compares Chapters 11 and 12:

	Chapter 11 Reorganization	Chapter 12 Reorganization
Timetable	Within 120 days after filing, a 3- to 5-year plan is required for reorganizing assets and repaying debt. Confirmation may require a minimum of 240 days from filing.	Within 90 days after filing, a 3- to 5-year plan is required for reorganizing assets and repaying debt. Confirmation hearing is required 45 days after filing.
Maximum debt limits	No ceiling	\$1,500,000. More than 50% gross income from farming—previous tax year.
How it works	Allows reduction of the value of secured debt, and payments of unsecured debt on discounted basis.	May scale down secured debt to current value, and show relief from much unsecured debt.
Advantages	No trustee fee. Protection from tax consequences.	Plan does not require creditor approval. Rental payments for use of land overcomes "adequate protection" problem. No forced liquidation.
Disadvantages	Requires detailed projection of income and expenses. Creditors can turn down plan, block use of assets and force liquidation.	Tax penalties may be severe, since farmer absorbs brunt. Trustee will require extensive paperwork.
Cost for average farm	\$8,000 to \$15,000	\$5,000 to \$8,000. Trustee fee is 10% or less for first \$450,000 of payments; 3% for amounts above that.

138. Taylor, *supra* note 137, at 23.

139. *Id.*

140. 132 CONG. REC. S15074 (daily ed. Oct. 3, 1986) (statement of Senator Strom Thurmond).

141. Illustration from Tevis, *supra* note 133, at 18-V.

Many creditors are not happy with the treatment they will receive under Chapter 12. A spokesman for the American Bankers Association commented that "there is no question it will hurt all lenders and pressure banks to get out of agricultural lending."<sup>142</sup> Another banker stated that the reason lenders are unhappy with the debt-forgiveness features is because there is no way for a lender to recover forgiven debt if land values rebound.<sup>143</sup>

The enactment of Chapter 12 is predicted to affect the way that some lending institutions loan money.<sup>144</sup> A farmer's actual cash flow, evidencing his ability to repay a loan, will be more important than the value of collateral in future loan decisions.<sup>145</sup>

Farm groups and supporters of Chapter 12 claim that lenders are just crying wolf. "Every time something comes down the road, the lending community hollers it's going to dry up credit. In actuality, credit has been drying up anyway."<sup>146</sup>

Farm experts believe that the new law will encourage a much greater number of farm mediations and other informal debt-restructuring outside of bankruptcy.<sup>147</sup> Debtors simply have more bargaining chips on their side of the table in discussing debt workouts.

## VI. CONCLUSION

The major problem in the farm economy today is that the assets do not generate sufficient revenues to service the debt that encumbers them. The rural agricultural sectors are almost on the brink of collapse. When a farmer is foreclosed upon, the equity value of every adjoining farm decreases, with the result of causing more collateral to be called in by the lenders. This can have a devastating impact on rural communities where small businesses, such as farm implement dealers, seed companies, rural banks, and fertilizer dealers, are dependent upon the vitality of agriculture.

In order to halt this domino effect, Chapter 12 is an attempt to stem the foreclosures on those farms that have a chance of making it. Congress was seeking to achieve an equitable balance in finding relief for the farmer while not unduly burdening the farm lender.<sup>148</sup> "Indeed, to the extent that we further jeopardize the lenders' precarious position, we shall simply compound and exacerbate the problem for all participants in the farm economy."<sup>149</sup>

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142. Taylor, *supra* note 136, at 23.

143. *Id.*

144. Brown, *Farm Bankruptcy Law Halts Some Loans and Stirs Fears About Farmers' Credit*, Wall St. J., Jan. 19, 1987, at 10.

145. *Id.*

146. *Id.*

147. Tevis, *supra* note 133, at 18-W.

148. *Farm Bankruptcy Hearings*, *supra* note 1, at 2.

149. *Id.*

Chapter 12 is not the ultimate solution to the problems plaguing the agricultural sector of our economy. It is an attempt by Congress to give farmers the same right that every other United States citizen has—the right to reorganize their businesses under the protection of federal bankruptcy laws. Eliminating adequate protection payments for a creditor's lost reinvestment opportunities is a major benefit to the reorganizing farmer. Under the Chapter 12 definition of adequate protection, the feasibility of farm bankruptcy plans should dramatically increase.

The success of Chapter 12 remains to be seen. Congress will carefully monitor its use by the farm debtor. It is scheduled to expire in 1993.<sup>150</sup> If it is a success, the family farmers who are facing the loss of their farming way of life have a new ray of hope for the future.

Destroy our cities and they will spring up again as if by magic, but destroy our farms and the grass will grow in every city in the country.<sup>151</sup>

Hopefully, Chapter 12 will be the answer to stemming the tide of family farm foreclosures that is crippling the agricultural economy today.

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150. H.R. CONF. REP. No. 598, *supra* note 116, at 5249.

151. Quoting William Jennings Bryan in his famous speech "Cross of Gold." Chicago Democratic National Convention of 1896.