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IN FUTURE ISSUES

- Oral contract with cooperative upheld
- Security interests in "growing crops" vs. "farm products"
- "Jewell" lender liability case reversed

Jewell v. Bank of America *overturned*

On May 18, 1988, a California Court of Appeals overturned a trial court's award of $22 million to a family of apple growers from Sebastopol, California. The trial court's award, which is discussed at 3 *Agricultural Law Update* 4 (June 1986), was against the Bank of America.

The plaintiff growers had claimed at trial that the fraud and illegal conduct of the Bank of America had destroyed their business and ultimately driven them into bankruptcy. After a three month trial in Santa Rosa during the summer of 1985, the jury returned a verdict in the Jewells' favor, awarding them $37.25 million in damages. The trial court reduced the award of the punitive damages and then entered a judgment of $22 million.

A request for a rehearing is being presented to the Court of Appeals. If denied, plaintiffs' attorneys have announced that they will appeal to the California Supreme Court.

A detailed discussion of the decision by the Court of Appeals will appear in a future issue of *Agricultural Law Update*.

– Donald B. Pedersen

Court rules farmers have unconditional right to reacquire farmland at appraised fair market value

A recent Federal District Court decision analyzed the right of first refusal to reacquire foreclosure farmland under the Agricultural Credit Act of 1987. In the case of *Leckband v. Naylor,* Civ. 3-88-167 (D. Minn. May 17, 1988), the Federal District Court for Minnesota held that under 12 USC § 2219a, a farmer has an unconditional right to reacquire foreclosed farmland if the farmer offers to purchase the property at its appraised fair market value.

The plaintiffs, a farming couple from Worthington, Minnesota, brought an action for a declaratory judgment and an injunction, declaring that they had an absolute right to purchase their former farmland which was foreclosed by the Federal Land Bank, at its appraised fair market value, and enjoining the Land Bank from selling the land by public auction without first offering it to the plaintiffs.

A borrower of the Farm Credit System has a right to reacquire farmland acquired by foreclosure or voluntary conveyance in lieu thereof. 12 USC § 2219a. Under 12 USC § 2219a(b), once an election to sell acquired real estate has occurred, the former owner has a right to purchase the land at its appraised fair market value. If the former owner offers the appraised fair market value for the farmland, the Farm Credit System institution is obligated to accept the offer and sell the property.

The defendant, Federal Land Bank, argued the public sale procedure of section 2219a(d) is excepted from the right of first refusal requirement. It also argued that the court should refrain from deciding the issue until the Farm Credit Administration completed its rule-making procedures, which, in the defendant's opinion, would resolve the issue.

The court rejected the Land Bank's arguments, stating that the plain language of the statute and the legislative history of the Agricultural Credit Act of 1987 made it abundantly clear that the plaintiffs have an unconditional right to purchase their former farmland at its appraised fair market value. The court also rejected the defendant's argument that the court should withhold judgment on this issue until the Farm Credit Administration completed its rule-making procedure, noting "... this court is fully competent to construe Congress' intent from the language and the legislative history of a given statute despite the absence of such interpretive regulations."

The court also analyzed the Land Bank's argument that the plaintiffs' action for injunctive and declaratory relief should be dismissed because section 2219a con-

(Continued on next page)

tains no implied cause of action. The court applied the four-factor test of *Cort v. Ash*, 422 U.S. 66, 95 S.Ct. 2080 (1975) to find that an implied cause of action does exist for violation of the right of first refusal.

Finally, the court addressed the issue of whether section 2219a applied to the plaintiffs' farmland because the Land Bank foreclosed prior to the effective date of the statute. The court reviewed Minnesota law on this question and determined that the defendant acquired the farmland at the expiration of the twelve month period of redemption, which occurred after the effective date of the statute. Consequently, the right of first refusal contained in the Agricultural Credit Act of 1987 did apply.

– Peter J. Fuchsteiner

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Classification, perfection of security interests

A California appellate decision, *Bank of Stockton v. Diamond Walnut Growers*, Case No. C000159, Cal. App. 3rd Dist. March 2, 1988, highlights difficulties in the classification and perfection of agricultural products and subsequent interests in products.

Diamond Walnut Growers (Diamond), an agricultural cooperative, made loans to a member, the loans being secured by "member proceeds . . . now or hereafter payable." Diamond filed a financing statement pertaining to the loans with the secretary of state.

Subsequently, the member and the Bank of Stockton entered into a contract whereby the member granted the Bank a lien on its 1983 walnut crop and first assignment of all proceeds from the sale of the crop. The Bank filed a financing statement in the county where the crop was being grown and with the secretary of state.

Neither the Bank nor Diamond had actual notice of the other's claim at the time their financing statements were filed.

After learning of each other's financing statements, the Bank and Diamond entered into a written agreement providing that the member would deliver the 1983 walnut crop to Diamond, but that each party reserved all rights and claims with respect to the 1983 walnut crop and its proceeds. The agreement also specifically stated that the "transfer of physical possession of the crop to Diamond [would] not change the rights of the parties."

Pursuant to a cooperative membership agreement, the crop was delivered to Diamond and sold. The litigation concerned the parties' competing claims to the "member proceeds." Since both parties had perfected financing statements covering member proceeds, the dispute involved priorities of perfect security interests.

The court noted that Diamond's interest in the member proceeds was an "account" as defined by the California Commercial Code. Priority of Diamond's perfected security interest in the account depending upon the date of "attachment."

The lower court found that attachment of member proceeds could only occur after they were earned because this completed the acts necessary to render the account payable.

The appellate court disagreed. The court noted the 1974 amendment of the definition of "account" altered former law so that a security interest can attach to a right to an account receivable whose creation is contingent upon future performance. Thus, the court found that attachment occurred when the member and Diamond signed the security agreement.

Diamond thereby perfected its security interest in the "member proceeds" when it correctly filed the financing statement.

The financing statements filed by the Bank created a perfected security interest in both the crop and proceeds, which included the "member proceeds." The Bank's perfected security interest in the "member proceeds" related back to the filed financing statement covering the crop.

Under Article 9 priority rules, the first to file generally has priority. Since Diamond had filed a financing statement covering "member proceeds" prior to any filings by the Bank, it had a superior interest in the "member proceeds."

The court noted that prior to sale of the walnut crop by Diamond, the Bank had a superior interest in the crop by virtue of its perfected security interest in the crop. If the Bank had employed a remedy available under California law, such as taking possession and liquidating the crop, it could have extinguished the existence of "member proceeds."

However, the Bank chose to market the walnuts through Diamond. When Diamond sold the walnuts, Diamond had a superior security interest in the resulting "member proceeds."

The court also considered the written agreement between the Bank and Diamond. Although the agreement protected the Bank's security interests in the walnuts and their proceeds, it did not modify the rules for the priority for the proceeds. Therefore, the agreement did not affect the superiority of Diamond's security interest in "member proceeds."

– Terence J. Centner

AG LAW CONFERENCE CALENDAR

Ninth Annual American Agricultural Law Association Conference and Annual Meeting. See enclosed flier.

1988 Summer Agricultural Law Institutes.
Drake University, Des Moines, IA.
June 6-9: Federal income tax issues – agricultural.
June 13-16: Water law and agriculture.
June 20-23: Agricultural bankruptcy and secured transactions.
June 27-30: Federal farm legislation – selected subjects
July 5-8: Iowa agriculture finance law.
July 11-14: Agricultural lender liability.
For more information, call 515-271-2065

Sixth Annual Western Mountains Bankruptcy Law Institute.
July 2-6, 1988. Jackson Lake Lodge, Jackson Hole, Wyoming.
Topics include: lender liability, agricultural issues, and recent developments.
Sponsored by Institutes on Bankruptcy Law
For more information, call 404-535-7722.

Eighteenth Annual Advanced Bankruptcy Procedures Seminar.
July 28-30, 1988. Holiday Motor Lodge, Clear Lake, Iowa.
Topics include: confirming Chapter 11's after *Ahlers*, discharge and dischargeability issues, current issues in appeals, and bankruptcy rules today.
Sponsored by Bankruptcy Seminars of Iowa, Inc
For more information, call 319-362-6063.

Federal Register *in brief*

The following is a selection of matters that have been published in the *Federal Register* in the past few weeks.

1. INS; IRCA of 1986; adjustment of status for certain aliens; notice of availability of working draft of proposed regulations for the adjustment of status of a temporary resident alien to that of an alien lawfully admitted for permanent residence. 53 Fed. Reg. 18096.

2. FmHA; certain provisions of the Agricultural Credit Act of 1987 and additional amendments of portions of Farmer Program regulations; proposed rule. 53 Fed. Reg. 18392.

3. FmHA; account servicing policies; final rule; effective date 5/4/88. "Eliminates the necessity for borrowers to attempt voluntary debt adjustment prior to being considered for deferral." 53 Fed. Reg. 15797.

4. FmHA; servicing and collections; final rule; effective date 5/4/88. Establishes Form 1951-56, Loan Deferral, as an official FmHA form. 53 Fed. Reg. 15799.

5. FmHA; Guaranteed Loan program; proposed rule. "Proposal to amend FmHA regulations to permit the payment of estimated loss claims while a borrower is engaged in a reorganization bankruptcy at the time the plan is confirmed by the bankruptcy court, and at the completion of the bankruptcy plan." 53 Fed. Reg. 16416.

6. FmHA; Agricultural Loan Mediation Program; proposed rule. 53 Fed. Reg. 17198.

7. PSA; antibiotic and sulfa residues in slaughter animals; economic responsibility for violative residues from packer to producer; notice of intent to institute proposed rulemaking; comments due 7/25/88. "Provides a 'bill back' mechanism designed to shift economic responsibility for violative residues from the packer to the producer." 53 Fed. Reg. 18572.

8. PSA; amendment to certification of central filing system; Idaho. 53 Fed. Reg. 15722.

9. PSA; amendment to certification of central filing system; Louisiana. 53 Fed. Reg. 15722.

10. FCS; organization; receiverships; interim rule; effective date 5/20/85. 53 Fed. Reg. 18810.

11. FCS; organization; personnel administration; general provisions; disclosure to shareholders; proposed rule; written comments due 7/6/88. 53 Fed. Reg. 20637.

12. FCS; credit-related forms of insurance; authority to sell to member borrowers; proposed rule; comments due 7/6/88. 53 Fed. Reg. 20647.

13. FCS; merger and reorganization proposals; interim rule with request for comments; effective date 5/11/88. 53 Fed. Reg. 16695.

14. FCS; disclosure to shareholders; final rule. 53 Fed. Reg. 16696.

15. FCS; organization; conservatorships and receiverships; proposed rule. 53 Fed. Reg. 16934.

16. FCS; organization; examinations and investigations; proposed rule. 53 Fed. Reg. 16936.

17. FCS; loan policies and operations; funding and fiscal affairs, loan policies and operations, and funding operations; general provisions; proposed rule. 53 Fed. Reg. 16937.

18. FCS; funding and fiscal affairs, loan policies and operations, and funding operations; general provisions; proposed rule. 53 Fed. Reg. 16948.

19. FCS; funding and fiscal affairs; loan policies and operations, and funding operations; proposed rule. 53 Fed. Reg. 16963.

20. FCS; rules of practice and procedure; practice before the Farm Credit Administration; proposed rule. 53 Fed. Reg. 16966.

21. FCS; Regulatory Accounting Practices; proposed rule. 53 Fed. Reg. 16968.

22. IRS; estate and gift taxes; effective date; rules and return requirements; relating to the generation-skipping tax; corrections to temporary regulations. 53 Fed. Reg. 18839.

23. IRS; income taxes; election of taxable year other than required year by partnerships, S corporations, and personal service corporations; temporary regulations. 53 Fed. Reg. 19688.

24. CCC; Targeted Export Assistance Program; fiscal year 1989; notice. 53 Fed. Reg. 19317.

25. CCC; loan and purchase programs; cooperative marketing associations; final rule; effective date 5/31/88. 53 Fed. Reg. 19882.

26. Agricultural Marketing Service; changes in rules of practice and procedure governing proceedings to formulate marketing agreements and marketing orders and information collection; final rule; effective date 5/3/88. 53 Fed. Reg. 15658.

27. FCIC; General Crop Insurance regulations; interim rule with request for comments. Comments due 7/1/88. "Clarifies the intent of FCIC with respect to not insuring any acreage upon which a second crop is harvested within the same crop year." 53 Fed. Reg. 16539.

28. ASCS and CCC; appeal regulations; proposed rule. 53 Fed. Reg. 17054.

– Linda Grim McCormick

Damages for improperly graded soybeans

A Louisiana court has found in the case of *Moore v. Thornwell Warehouse Association*, 524 So. 2nd 828 (La. Ct. App., Feb. 3, 1988) that a cooperative marketing association is liable to farmers for damages resulting from using an improper standard in grading soybeans.

The plaintiff farmers had delivered beans to the cooperative, and a sample was taken to determine "field damage," which included a damage factor for molded or mildewed beans. Higher damage factors resulted in reductions in the price paid to farmers. The controversy centered around the proper standard for grading molded or mildewed beans.

After plaintiff Moore complained about the high damage factor applied to the beans he had delivered to the cooperative, the cooperative called in a state grader. Both the cooperative and state graders proceeded to grade eleven samples of beans, nine of which belonged to plaintiff Moore.

Large discrepancies were found between the cooperative's and the state's grades for the eleven samples. Testimony supported the conclusion that the discrepancies were based on the use of different standards for grading molded or mildewed beans.

The cooperative's graders had considered a bean to be damaged if there was any damage from mold or mildew on the seed coat. The state's grader considered a bean to be damaged only if the seed coat was seventy-five to eighty percent covered by mold or mildew.

While there was conflicting evidence concerning the applicable standard, the court found that the greater evidence showed that the cooperative used an improper standard for grading plaintiffs' beans. Thus, the cooperative was liable to plaintiffs for damages.

An additional issue concerned the establishment of damages with reasonable certainty. The cooperative argued that damages were purely conjectural or speculative and should not be allowed.

The court disagreed. Plaintiffs' legal rights to damages meant that the court had reasonable discretion to assess damages based upon all the facts and circumstances. Using a formula based upon the damage factor found by the state grader for plaintiff Moore's nine samples, the court calculated damages for each plaintiff.

– Terence J. Centner

Chapter 12 and debts arising from a farming operation

by Drew L. Kershen

To qualify for Chapter 12 bankruptcy, a person seeking relief must be either an individual (and spouse) or entity (corporate or partnership) family farmer. To be a family farmer, the person must meet the eligibility criteria set forth in 11 USC § 101(17), listing three criteria for individual family farmers and six criteria for entity family farmers. Of these criteria, only two are common to both: (1) the aggregate debt must not exceed $1,500,000; and (2) not less than 80% of the debt must arise out of a farming operation owned or operated by the family farmer.[1] This article focuses on the 80% debt criterion.

With only four cases directly addressing the issue, the debt criterion has not, thus far, generated much litigation. By contrast, the income criterion applicable to individual family farmers, but not entity family farmers, (requiring individual family farmers to receive more than 50% of gross income from an owned or operated farming operation) has generated a considerable amount of litigation. Moreover, the income criterion litigation came first chronologically because it was in the Bankruptcy Code, prior to Chapter 12, in the protection provided farmers from being brought involuntarily into bankruptcy.[2]

In resolving Chapter 12 issues raised by the income criteria, the courts have considered a number of factors:

1) whether the income was generated from the person's own farming efforts in her own farming operations as opposed to unrelated others putting forth the farming efforts or the farming efforts being put forth for unrelated others;[3]

2) whether the income generated was subject to the inherent risks of farming (weather, insects and disease, market instability) as opposed to income that is fixed or subject to non-farm business risks;[4]

3) whether the income was generated in an attempt to protect the family farm by scaling down or restructuring the farming organization as opposed to income created when leaving farming permanently or from non-farm businesses even if the non-farm income was sought for the purpose of saving the family farm;[5]

4) whether the income was generated from activities that are integral to the farming operation as opposed to income from a collateral business even if it is within the broad definition of the farming industry by providing farm-related services;[6] and

5) whether the income was generated by a small farmer who is meant to be protected by Chapter 12 as opposed to a larger corporation or a tax-shelter investor not meant to be given Chapter 12 protection.[7]

When the cases are carefully read, the courts do not apply any predefined test to determine whether income is received from a farming operation. Rather, the courts consider many factors specific to each factual pattern to evaluate whether the income more directly relates to farming operations than to non-farm sources. Consequently, the courts resolve issues of income criterion by evaluating the totality of the circumstances as distinguished from a black-letter test.[8]

Similarly, the courts discussing the debt criterion for Chapter 12 eligibility have also adopted a totality-of-the- circumstances evaluation of factors specific to each case in deciding what debts arise from a farming operation.

In *In re Rinker*, 75 Bankr. 65 (Bankr. S.D. Iowa 1987), the court ruled that a debt incurred to settle a lawsuit between antagonistic siblings, relating to a contract to purchase farmland by the debtor from his now deceased mother, was a debt arising out of a farming operation. The court stressed that the farmland was both the "heart of the lawsuit" and the *"sina qua non"* of the farming operation of the debtor. The court thus perceived a "direct link" between the settlement debt and the debtor's purpose in reaching a settlement to preserve the debtor's farming operation. Moreover, the court emphasized that if the debtor had not reached the settlement, the debtor would have had an option under the mother's will to purchase the farmland. Consequently, the court considered the settlement debt analogous to a debt incurred in purchasing farmland, which is incontrovertibly a debt arising from a farming operation.

In the same vein, the court in *In re Roberts*, 78 Bankr. 536 (Bankr. C.D. Ill. 1987) held that debts owed for federal estate taxes and Illinois inheritance taxes were debts arising from a farming operation. The court adopted a "pragmatic viewpoint" that the death tax debts had to be paid if the debtor were to keep the farmland that was the "heart" of the debtor's farming operation. Further, the court decreed that these death-tax debts were like mortgage payments or current property taxes, both of which are indisputably farm-related. Relying on the *Rinker* decision, the court determined that a direct link existed between the death-tax debts and the farming activity, which, therefore, meant that the death-tax debts arose from a farming operation.

Somewhat in contrast, the court in *In re Douglass*, 77 Bankr. 714 (Bankr. W.D. Mo. 1987) classified a debt as a debt arising from a farming operation even though the debt was secured by real estate developed with a gasoline station that admittedly was a non-farm business. Over the creditor's objection, the court decided that because the disbursed funds had been used by the debtor in the debtor's farming operation and the debt had been incurred for the purpose of permitting the debtor to remain in farming, the debt was a farm-related debt. In the mind of the judge, the fact that the deb was backed by a deed of trust on non-farm real estate was not sufficient to override the use and purpose factors.

To understand *Rinker*, *Roberts*, and *Douglass*, let us apply their totality-of-the-circumstances approach to several hypothetical fact patterns.

Hypothetical One. Assume that a rancher had always done well in cattle and had had sufficient ranch-generated profits in the past that she did not rely on commercial financing for operating funds. Assume further that she went to the race track and, in a gambling hinge, squandered her reserves. She was thus forced to seek operating capital from a commercial farm lender in order to remain in ranching. The lender provided the funds backed by a first mortgage on her ranch. Unfortunately, her ranching success now plummeted and within two years she sought Chapter 12 protection. Did the debt to the commercial farm lender arise from a farming operation?

The debt between the rancher and the lender looks like an ordinary farm loan in every respect except that no loan would have been needed if the rancher had not squandered her reserves by gambling. The debt facially appears to be a debt arising from a farming operation unless the court allows the lender to trace the debt to the reason (gambling) that led the debtor to request the

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Professor of Law, University of Oklahoma, Professor Kershen served as Attorney-of-Record to a Chapter 12 debtor on the topic of this article.

loan and then rules that the debt was a gambling debt that did not arise from a farming operation.

At this point, it is crucial to recognize that the debt to be characterized for Chapter 12 purposes is *the debt* between the rancher and the commercial farm lender. When attention is focused on the relevant debt, the factors that the debt was incurred so that the debtor could remain in ranching, that the funds were used in the ranching operation, and that the debt was secured by the ranch land that was the major capital asset of the farming operation should lead the court to decide that the debt is a debt arising from a farming operation. Whatever circumstances made the rancher come to the lender for assistance should be outweighed by the factors directly linking the debt to the rancher's operation. The gambling debts, paid by the ranch-generated reserves, are not the relevant debts for purposes of Chapter 12.

Hypothetical Two. Assume that a farmer had done sufficiently well in farming that the farmer had invested surplus funds in a non-farm business. From the beginning, the non-farm business lost money. To keep the non-farm business going, the farmer used her farmland as collateral for additional commercial loans to the non-farm business. Eventually, the non-farm business lost so much money that the non-farm loans were about to be foreclosed against the farmland. To remain in farming, the farmer negotiated a debt with a commercial farm lender who knew the funds would be used to pay the loans on the non-farm business. The farmer used the debt funds to terminate the non-farm business, to retain the farmland, and to remain in farming as her sole business. Several years later, after economic conditions in farming deteriorated, the farmer sought Chapter 12 protection. Did the debt to the commercial farm lender arise from a farming operation?

Hypothetical Two differs from Hypothetical One in that the debt funds were not used directly in the farming operation. Rather, the debt funds were used to satisfy non-farm loans. But again, the relevant debt to be characterized under Chapter 12 is the debt between the farmer and the commercial farm lender. With respect to that debt, the debtor incurred it so that she could retain her farmland and remain in farming as her sole business thereafter. At the same time, the commercial farm lender knew how the funds would be used, knowingly made a farm investment collateralizing the debt with the farmland, and expected to be repaid solely from funds generated by the refinanced farm operation.

If the court focuses on the relevant debt, the refinancing of the farm created a debt analogous to a purchase mortgage debt, which undeniably arises from a farming operation. Moreover, adopting a factor from the cases discussing the income criterion of Chapter 12,[9] the commercial lender knowingly made a farm investment while fully expecting that repayment of the debt would be contingent upon the inherent risks of farming. Just as the reason (gambling) the rancher in Hypothetical One had to seek commercial financing was irrelevant, so in Hypothetical Two the reason (prior non-farm loans) the farmer needed to refinance should be irrelevant to the characterization of the relevant debt. From the perspective of both the farmer and the commercial farm lender, the factors directly linking the relevant debt to the farming operation outweigh the lender's argument that the debt should be traced to its originating reason.

The author's arguments about the proper treatment of the relevant debts in Hypotheticals One and Two are strengthened by comparing the debts of the hypotheticals to debts that courts have classified as *not* arising from a farming operation.

In *In re Van Foosan*, 82 Bankr. 77 (W.D. Ark. 1987), the court ruled that a debt previously incurred as part of a divorce property settlement between the Chapter 12 petitioner and his wife was not a debt arising from a farming operation. Likewise, the court in *dicta* in the *Rinker* case stated that a debt incurred by a farmer because of a wrongful death action stemming from a hunting accident on the farmer's land or from a car accident in which the farmer was at fault would not be a debt arising from a farming operation. The *Van Fossan* and *Rinker* judges stated that these debts would not be farm-related debts even if the farmland were used to secure the debts. In both cases, the judges indicated that the "underlying nature of the debts" had to be examined to determine whether the debts arose from a farming operation.

Contrast a divorce property-settlement debt and wrongful death debt with the financing debts incurred in Hypotheticals One and Two. The farmer entered the divorce or wrongful death settlement to protect the farmland from immediate execution and to protect the capital asset of the farming operation. From the farmer's perspective, the debts seem similar to the financing debts of Hypotheticals One and Two. But from the creditor's perspective, the divorce and wrongful death debts are completely unlike the financing debts in Hypotheticals One and Two. In the divorce and wrongful death situations, the person who is the creditor became a creditor by happenstance and accepted the farmland as collateral because it was the only available asset from which the farmer could eventually make the chance creditor whole. The commercial farm lender, however, knowingly and purposefully entered the debt as a farm investment with the expectation of being repaid from farm proceeds whose future availability was dependent upon the inherent risks of farming. Finally, the type of debt discussed in *Van Fossan* and in the *Rinker dicta* are not the type of debts that Chapter 12 was meant to address and restructure. By comparison, financing debts between a farmer and a commercial farm lender are precisely the type of debts that Chapter 12 was meant to address and restructure. When the underlying nature of the debts in *Van Fossan* and the *Rinker dicta* are compared to the underlying nature of the relevant debts in Hypotheticals One and Two, the author agrees that the former are debts *not* arising from a farming operation, but concludes that the latter are debts arising from a farming operation.

The author's conclusion that the debts described in Hypotheticals One and Two are debt arising from a farming operation is subject to two limitations: 1) treatment of the debts from the loan's inception to the filing of Chapter 12, and 2) fraud on the farm debtor's part.

Treatment. The totality-of-the-circumstances evaluation of the factors surrounding the inception of the relevant debts in Hypotheticals One and Two resulted in those debts being classified as debts arising out of farming operations. Yet, debts properly labeled at their inception as farm debts might not be so characterized at the time the Chapter 12 petition is filed if the debts have not been treated by the parties as farm debts during the life of the debt.[10] If the debtor in Hypotheticals One and Two treated the debt as a farm-related debt

on tax returns and other public documents and made payments against the debt with funds generated solely from farming operations, then the debt from the debtor's perspective remained a farming debt. At the same time, if the lender accepted payments generated by farming and continued to rely upon repayment solely from proceeds created through farming, then the debt from the creditor's perspective persisted in being a farming debt. However, if the source of the repayment funds changed to a non-farm business and the treatment of the debt on tax returns and other public documents showed a non-farm characterization, then on the date of filing a Chapter 12 petition, the debts properly should be characterized as non-farm debts even though the debts are still backed by the principal capital asset of the farming operation – the farmland.

Fraud. If the farm debtor in Hypotheticals One and Two engaged in fraud, a court should properly refuse to characterize the debt as one arising from a farming operation. The word "fraud" has several connotations, which should be differentiated. First, fraud (in a strong sense) exists when the farm debtor obtained the debt from the commercial farm lender on the promise to use the funds specifically and solely in the farm operation and then intentionally used the funds in a different manner, such as for non-farm investment or for gambling. Non-farm business debts and gambling debts are clearly not debts arising from a farming operation. Even though the debt was obtained as a farm debt, the fraudulent conduct of the debtor negated its characterization as a debt arising from a farming operation.[11]

Second, fraud (in a weaker sense) exists when the farmer entered a farm debt in good faith but before the entire proceeds could be used in farming, the farmer, on her own volition, put the funds, wholly or partially to a purpose not contemplated at the time of the debt's creation. For example, assume that the farmer entered a debt with a commercial farm lender and received the funds. Shortly thereafter, the farmer's family was injured in a single car accident, which required payment of substantial medical bills. Even though the farmer must pay these bills or run the risk of having them become a lien against the farmland, the farmer ought not be able to count these medical debts as farm-related. Furthermore, the farmer should not be allowed to pay these medical bills with the funds obtained from the commercial farm lender and still claim those expended funds as debts arising from a farming operation. The commercial farm lender did not knowingly consent to the use of its funds for medical bills, nor the subordination such use entails. Unless the lender knowingly agreed to the use of those funds for medical bills, so that the debtor could continue farming unimpeded, and further agreed to accept the risk of being repaid for these medical bills from farm-generated proceeds, the debt in the amount expended for medical bills is not a debt arising from farming operations.

Finally, fraud can mean abuse of the bankruptcy process. Fraud in this sense is best illustrated by *In re S Farms One, Inc.*, 73 Bankr. 103 (Bankr. D. Colo. 1987) where the Chapter 12 debtor acquired the farmland and attached debt only thirty minutes prior to filing the petition. The court correctly held that debts acquired in this manner were not debts arising from a farming operation.

In the *S Farms One* case, the creditor did not consent to the transfer of the land and accompanying debt from one corporate entity to another. Moreover, even if the creditor had consented, the creditor would have done so only on the belief that the debtor would make a good faith effort to earn adequate money from farming to repay the debt. If a debtor could use Chapter 12 to shed recently acquired debt, the debtor would be in effect taking the money for farming, but not giving the creditor a reasonable opportunity to be repaid from farming. On such fact patterns, the courts must take a careful look at the good faith of the debtor. If the debtor has unfairly taken advantage of the creditor, courts should rule that the debt, even though the funds were used in farming and the farmer was desperately trying to continue in farming, was not a debt arising from a farming operation.

Absent fraud in circumstances such as Hypotheticals One and Two, however, courts should rule that the totality-of-the- circumstances evaluation of the factors relating to the inception and treatment of the debt leads to the conclusion that the debt is a debt arising from a farming operation.

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1. The criteria differences between an individual family farmer and an entity family farmer have given rise to one constitutional challenge, which was rejected by the Bankruptcy Court. *In re Lawless*, 74 Bankr. 54 (Bankr. W.D. Mo. 1987).

2. *In re Armstrong*, 812 F.2d 1024 (7th Cir. 1987).

3. *Compare In re Schafroth*, 81 Bankr. 509 (Bankr. S.D. Iowa 1987) *with In re Tim Wargo & Sons, Inc.*, 74 Bankr. 469 (Bankr. E.D. Ark. 1987).

4. *Compare In re Wolline*, 74 Bankr. 208 (Bankr. E.D. Wisc. 1987) (Debtor earned income from riding stable, using horses bred by debtor and fed with crops raised by debtor. On these facts, the riding stable income is subject to the inherent risks of farming.) *with In re Mary Freese Farms, Inc.*, 73 Bankr. 508 (Bankr. N.D. Iowa) (Cash rent is not income subject to inherent risks of farming when debtor does not farm, has no farm equipment or livestock, and has not farmed in several years.) *In D Ill. 1987 and In re McKillips*, 72 Bankr. 565.

5. *Compare In re Rott*, 73 Bankr. 366 (Bankr. D.N.D. 1987) (Income from partial liquidation, temporary rental, and debt restructuring is farm income.) and *In re Shepherd*, 75 Bankr. 501 (Bankr. N.D. Ohio 1987) *with In re Pratt*, 78 Bankr. 277 (Bankr. D. Mont. 1987) (Bankruptcy schedule showed non-farm income greater than farm income, but debtor apparently argued that the non-farm income was used to save the family farm. Chapter 12 petition was dismissed.)

6. *Compare In re Guinnane*, 73 Bankr. 129 (Bankr. D Mont. 1987) (Income from hauling cattle integrated with debtor's ranch business is farm income.) *with Federal Land Bank v. McNeal*, 77 Bankr. 315 (S.D. Ga. 1987) (Income from chicken house cleaning service is from a farm-service business, not a farming operation.) *and In re McKillips, supra* note 4.

7. *See, In re Burke*, 81 Bankr. 971 (Bankr. S.D. Iowa 1987).

8. *See especially, Federal Land Bank v. McNeal, supra* note 6 and *In re Burke, supra* note 7. *See also*, Wilder, *Some Observations on the Chapter 12 "Family Farmer" Concept*, 5 Ag. L. Up. #5 at 4 (Feb. 1988).

9. Citations to relevant cases are in note 4 *supra*.

10. Several bankruptcy courts, when characterizing income, have considered the treatment of the income on tax returns as a relevant factor in determining whether the income was received from a farming operation. *Compare In re Shepherd*, 75 Bankr. 501 (Bankr. N.D. Ohio 1987) (Schedule F accepted for designating ordinary income as "farm" or "non-farm.") and *In re Nelson*, 73 Bankr. 363 (Bankr. D. Kan. 1987) (Income tax treatment presumptively provides the proper characterization.) *with In re Guinnane*, 73 Bankr. 129 (Bankr. D. Mont. 1987) And *In re Rott*, 73 Bankr. 366 (Bankr. D.N.D. 1987) (Income tax treatment was not determinative.) Whether or not treatment of income or debt on tax returns is determinative of the proper characterization, consistency in treatment strengthens and inconsistency weakens a characterization.

11. Fraud in this strong sense is closely related to the discussion of whether the debt, after its inception, was treated by both parties as a farming debt.

STATE ROUNDUP

KANSAS. *Family Farm Rehabilitation Act unconstitutional.* The Kansas Supreme Court consolidated the appeals of two cases from the lower courts in *Federal Land Bank of Wichita v. Bott*, 732 P.2d 710 (1987). The Botts and the Nelsons had both been engaged in farming and had suffered financial difficulties. In the late fall of 1985, the appellee, Federal Land Bank of Wichita, filed actions to foreclose on agricultural land mortgages. The district courts then entered judgments for the Land Bank for the amount of the notes plus interest and costs and for the foreclosure of the mortgages.

Both families then filed motions for protection under the Family Farm Rehabilitation Act. Kan. Stat. Ann. § 2-3401 (Supp. 1986). Both lower courts ruled that the Act was unconstitutional and ordered execution on the judgments. The Botts and Nelsons appealed.

The 1986 Kansas legislature passed the Family Farm Rehabilitation Act in recognition of the increasing rate of farm foreclosures, the declining value of land, high interest rates, and low commodity prices. The stated purpose of the Act is "to assist in stabilizing the economic conditions of this state." Kan. Stat. Ann. § 2-3401 (Supp. 1986). The Act authorizes the stay of enforcement of certain judgments relating to land and property used in farming operations and further provides additional redemption right.

The Act is limited to farmers who are engaged in farming operations deriving eighty percent of gross income from the farm and who are insolvent. Further, it applies only to actions on mortgages commencing on or after October 1, 1985, which have been rendered to final judgment without appeal. The Act automatically expires on July 1, 1991.

The primary issue was whether the Act impaired the Land Bank's rights as mortgagee, in violation of Article 1, Section 10 of the U.S. Constitution (the contract clause). These rights included:

1. The right to retain the mortgage lien until the indebtedness secured thereby is fully paid;
2. The right to realize upon the security by a judicial sale;
3. The right to determine when such sale shall be held; and
4. The right to control the property after the normal redemption period.

Additional alleged impairments included the reduction of interest rates from that provided in the note and allowing the mortgagor to retain possession for up to three years without paying real estate taxes or accounting for rents or profits.

Because of these impairments, the Kansas Supreme Court found that Act facially unconstitutional The court went further in its review to see if it could restore the Act's constitutionality by finding a significant and legitimate public purpose behind the legislation. The court held that such a legitimate public purpose existed to justify the legislature in exercising its police power. However, when the court looked at the impairment of contracting parties' rights in light of the remedy's reasonableness and appropriateness to accomplish the desired result, the court found that the Act did not satisfy the test and held the Act unconstitutional in violation of the contract clause of the United States Constitution. Finally, the court held that the lack of "reasonable conditions" was so pervasive throughout the Act that it was unable to apply the severability clause of the Act. Thus the entire Act was held unconstitutional.

– *Neil D. Hamilton*

PENNSYLVANIA. *Forfeiture of tenant's crops.* Unless expressly reserved to the landlord in a lease, the tenant who breaches a lease does not forfeit all of his or her property on the leased premises. In addition, for an express forfeiture to be enforceable, it must not lead to an unconscionable result. In the case of *Langley v. Tiberi*, 528 A.2d 207 (Pa. Super. 1987), the tenant failed to perform certain work for the landlord, which had a value of $50.00. The value of the tenant's corn, which the landlord seized and sold, was more than $5,000. Forfeiture was not expressly granted in this oral lease situation and the disparity in values would make enforcement unconscionable.

– *John C. Becker*

MONTANA. *Tort actions against PCAs.* The farmer in *Tooke v. Miles City Production Credit Association*, ___ P.2d ___, ___ Mont. ___, 45 St. Rptr. 641 (1988), applied for a Production Credit Association loan. As a result of PCA's actions on the loan application, the farmer brought a civil action in state district court alleging that the PCA's action amounted to a breach of fiduciary duty and constituted constructive and actual fraud. The PCA moved to dismiss the suit in state district court, contending that under the Federal Tort Claims Act (FTCA), subject matter jurisdiction for torts alleged against the PCA rests exclusively in federal court. The state district court dismissed for lack of subject matter jurisdiction. The farmer appealed to the Montana Supreme Court.

The Montana Supreme Court, noting that the Farm Credit enabling legislation provides instrumentality status for PCAs, held that PCAs should be treated as instrumentalities acting primarily as agents of the United States, and tort claims against a PCA must be pursued under the FTCA.

– *Donald D. MacIntyre*

OKLAHOMA. *Oklahoma Mortgage Foreclosure Moratorium Act.* Oklahoma Statutes title 62, §§ 492-493 (Supp. 1987) provided for a one-year moratorium, beginning in 1986, on foreclosures by the Federal Land Bank of Wichita against Oklahoma land. Although the one-year moratorium expired in May 1987, the Supreme Court of Oklahoma recently decided ten consolidated appeals in which the constitutionality of the moratorium was at issue.

In *Federal Land Bank of Wichita v. Story*, 59 Okla. B. J. 1212, ___ P.2d ___ (1988), the Oklahoma Supreme Court ruled that the moratorium legislation was an unconstitutional impairment of the contracts clauses of the federal and state constitutions. The court believed that the 1986 legislation was identical to 1930's legislation that was declared unconstitutional in *State ex rel. Roth v. Waterfield*, 167 Okla. 209, 29 P.2d 24 (1933). Like the 1930's legislation, the court held that the moratorium provided an absolute prohibition on foreclosure actions without providing individual judicial review or adequate protection for the Federal Land Bank loans affected by the legislation. Hence, the court ruled that *stare decisis* governed and determined that no significant policy or factual differences existed that should cause the court to reach a decision with respect to this new moratorium legislation contrary to the *Waterfield* case.

– *Drew L. Kershen*

agricultural law update
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AMERICAN AGRICULTURAL LAW ASSOCIATION NEWS

Job Fair. The American Agricultural Law Association's Fourth Annual Job Fair will be held concurrently with the 1988 Annual Meeting October 13 and 14, 1988, at the Westin Crown Center in Kansas City.

Prior to the annual meeting, known positions and information regarding scheduled on-site interviews will be circulated to ABA-approved law school placement offices by the Job Fair Coordinator. Placement offices will forward resumes to interested firms and organizations. Employers can schedule interviews any time during the conference.

To obtain further information or to arrange an interview, please contact: Gail Peshel, Director, Career Services and Alumni Relations, Valparaiso University, School of Law, Valparaiso, Indiana 46383, 219 / 465-7814

Fifth Annual Student Writing Competition. The AALA is sponsoring its fifth annual Student Writing Competition. This year, the AALA will award two cash prizes in the amount of $500 and $150.

Papers must be submitted by June 30, 1988. For complete competition rules, contact Prof. John Becker, Department of Agricultural Economics, Penn. State University, University Park, PA 16802; 814-865-7656.

1989 Oberly Award nominations. Nominations are sought for the 1989 Oberly Award for bibliographic excellence in the agricultural or related sciences. To be eligible, a bibliography must have been published in 1987 or 1988, and at least one author, editor, or compiler must be a U.S. citizen. Bibliographies will be judged on usefulness, scope, accuracy, format, explanatory features, and indexing methods. The award is administered by the Science and Technology Section of the Association of College and Research Libraries Division of the American Library Association. It will be presented at the 1989 annual meeting of the American Library Association in Dallas, Texas. Nominations in the form of a letter, including if possible a copy of the bibliography, should be sent by January 1, 1989 to Carolyn L. Warmann, Chair, Oberly Award Committee, Reference Department, Carol Newman Library, Virginia Polytechnic Institute and State University, Blacksburg, VA 24061.

Election reminder. By now all members should have received their ballots for election of the president and two directors of the American Agricultural Law Association. Ballots should be returned to Mason Wiggins, Jr., Heron, Burchette, Ruckert and Rothwell, Suite 700, 1025 Thomas Jefferson St., N.W., Washington, D.C. 20007. The deadline is July 15, 1988.