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by

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THE SEARCH FOR THE PROPER INTEREST RATE UNDER CHAPTER 12 (FAMILY FARMER BANKRUPTCY ACT)

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Congressional policy to raise the debt limits for farmer eligibility under Chapter 12¹ of the Bankruptcy Code and to streamline reorganization procedures was designed to overcome farmers' reluctance to pursue debt relief under the other code chapters. Farm debtors reorganize under Chapter 12, however, in essentially the same way debtors reorganize under other chapters. After filing the bankruptcy petition, debtors work out a plan to repay creditors. A Chapter 12 plan usually covers a three-year period, but long-term debt may be repaid over an extended period, perhaps fifteen to thirty years.

Repayment of long-term debt involves two crucial and connected financial judgments: asset evaluation and interest rate determination. The debtor seeks to reduce asset values just as the creditor seeks higher values. While much of this value adjustment is negotiated between the parties, the plan that emerges is subject to court confirmation. The court is permitted, as necessary, to "cram down" a plan of reorganization over the objection of creditors.² However that asset evaluation is made, the farm debtor must pay interest to the creditor as compensation for deferred repayment of money borrowed.³ That interest is at a rate equal to the present value discount rate.⁴ The present value of a stream of

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1. Bankruptcy Judges, United States Trustees and Family Farmer Bankruptcy Act of 1986. H.R. CONF. REP. NO. 958, 99th Cong., 2d Sess. 45, *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS 5246, 5249.

2. McPhail, *Bankruptcy: Determination of an Appropriate Cram-down Interest Rate for the Family Farmer*, 41 OKLA. L. REV. 489, 490 (1988). McPhail defines "cramdown" as "the court's ability to force creditors to accept a debtor's reorganization plan if certain prerequisites are met" (when the plan is not acceptable to the creditor and the plan is confirmed over the dissent of the creditor). *Id.* One essential condition of the cramdown is that the creditor is "given the 'present value' of its claim against the debtor as consideration for accepting deferred payments." *Id.*

3. See 11 U.S.C. § 1129(a)(9)(c) (1988). The need for interest payments to compensate the creditor for the debtor's delayed payment is implicit in federal law, which provides that the "holder of such claim will receive on account of such claim deferred cash payments . . . of a value, as of the effective date of the plan, equal to the allowed amount of such claim." 11 U.S.C. § 1129(a)(9)(C) (1988).

4. The essential rationale for present value payments in bankruptcy proceedings is found in the obvious fact that the debtor cannot now pay the full current value of an outstanding debt or make the periodic payments agreed to in an original contract with a

future payments is equated thereby with the value of the creditor's allowed secured claim.⁵

There is continuing debate over which interest rate is appropriate to determine present value in the reorganization plan. That debate has focused on nine commonly known interest rates as representing the "market rate" for bankruptcy plan purposes. Effectively, of course, the debate is over the *size* of the rate. In addition to the fundamental question of equity in rate choice, the feasibility of a bankruptcy reorganization plan is determined by the size of the rate and the deferred periodic payment of which it is an integral part.

The purpose of this article is to review the interest rate issue as it has developed in farm bankruptcy litigation since 1986. The analysis and critique of several interest rates reveals that once bankruptcy courts decide that the original contract rate is not appropriate for the farmer's reorganization plan, they profess adherence to the "prevailing market rate" as the standard. The courts are divided, however, on which rate best represents the market rate. Courts differ also on whether the search should be for a rate with announced attributes ("inherent merit") or whether the focus should be on the *method* of choosing the rate.

The first search is for a rate with features pertinent to the bankruptcy plan being developed. Those rate features are *simplicity* in determination, *certainty* as to value, and *currency*. This kind of rate, also called a "formula" rate, is known *a priori* to a court, since its value has already been set, as by legislation.

creditor. An agreement instead to pay the full value periodically on a deferred basis necessarily introduces consideration of the time value of money. The essential idea of present value is the same, however stated:

[A] dollar in hand today is worth more than a dollar to be received a day, a month or a year hence. Part of the 'present value' concept may be expressed by a corollary proposition: a dollar in hand today is worth exactly the same as (1) a dollar to be received a day, a month or a year hence plus (2) the rate of interest which the dollar would earn if invested at an appropriate interest rate.

5 COLLIER ON BANKRUPTCY § 1129.03(i) (L. King 15th ed. 1991).

5. Ruskamp, *In the Interest of Fairness: Interest Payments in Bankruptcy*, 67 NEB. L. REV. 646, 648 (1988). This article is quite instructive in distinguishing the security status of claims. "A creditor has a secured claim to the extent of the value of its interest in the collateral securing its claim and an unsecured claim for the balance of the allowed claim." *Id.* (citing *In re Hall*, 752 F.2d 582, 589 (11th Cir. 1985)).

For example, if a creditor has an Article 9 security interest in a combine valued at \$10,000 securing an allowed claim of \$15,000, the creditor will have a secured claim of \$10,000 and an unsecured claim of \$5,000. Such a creditor would be recognized as being undersecured. If the combine was worth \$15,000 and the creditor's allowed claim was \$10,000, the creditor would have a secured claim for \$10,000 and would be oversecured."

Id.

The second search is for an appropriate method by which the interest rate is constructed. Emphasis on method is considered critical, because courts wish for the rate chosen to be consistent with the "market rate" (a rate set on loans of similar risk and duration).⁶

Significant contributions to resolution of the interest rate issue have been made in North Dakota Bankruptcy Court decisions, especially in *In re Edwardson*,⁷ *In re Claeys*,⁸ *In re Konzak*,⁹ and *In re Rott*.¹⁰ Moreover, a major position on determination of the *method* by which a representative market rate can be constructed was developed in courts of the Eighth Circuit (a position in which *Edwardson*, *Claeys*, and *Konzak* were also instrumental), culminating in *United States v. Doud*.¹¹

The following rate review summarizes analyses of alternative interest rates by appellate courts and bankruptcy courts. For each rate, a description of the rate or method is provided, its strengths are identified, and a critique of its use is offered.

INTEREST RATE OPTIONS

At least nine interest rates have been applied to an allowed secured creditor claim in farm bankruptcy reorganization proceedings since the passage of Chapter 12 in late 1986: (1) the rate charged by the Federal Land Bank, (2) the "cost of funds" to the creditors, (3) an average of several rates, (4) the testimonial rate, (5) the variable or floating rate, (6) the prime rate, (7) the treasury rate (bills or bonds), (8) the contract rate, and (9) the "market rate."

1. *The Rate Charged by the Federal Land Bank*

In *In re O'Farrell*,¹² the court approved the interest rate charged by the Federal Land Bank. That rate, the court stated, represented the prevailing market rate for a loan term equal to the payout period, with due consideration of the security's quality

6. *In re Camino Real Landscape Maintenance Contractors, Inc.*, 818 F.2d 1503, 1505 (9th Cir. 1987). The focus on method involves the construction of a rate by the court (a) within the concept of a "prevailing market rate," and (b) within the guidelines of a match-up with the loan repayment period, quality of collateral, and risk of loan default. Emphasis on method is exemplified by courts' employment of a professed "individualized" or "case-by-case" analysis. *Id.* at 1505-08.

7. 74 Bankr. 831 (Bankr. D.N.D. 1987).

8. 81 Bankr. 985 (Bankr. D.N.D. 1987).

9. 78 Bankr. 990 (Bankr. D.N.D. 1987).

10. 94 Bankr. 163 (Bankr. D.N.D. 1988).

11. 869 F.2d 1144 (8th Cir. 1989).

12. 74 Bankr. 421 (Bankr. N.D. Fla. 1987).

and risk of default.¹³ The court justified its choice by stating that the Federal Land Bank is "solely a farm lender, and traditionally has the most favorable rates available."¹⁴

Although exclusive use of either a lender or borrower rate typically is not appropriate as a bankruptcy interest rate, a lender's rate has merit in this instance. The Federal Land Bank rate reflects the features of an agricultural rate, especially the risk factor and regional character. At best, it has limited application in Chapter 12 bankruptcy proceedings, however, because it is pertinent only to those situations in which farm debtors borrow from the Federal Land Bank.

2. *The "Cost of Funds" to the Creditor*

Presumably the cost of funds rate provides equitable treatment to both parties. The debtor stands to gain if the cost of funds currently is lower than the original contract rate. The creditor, moreover, receives enough interest to obtain replacement funds for doing business with other borrowers. In *In re Hardzog*,¹⁵ the court justified the cost of funds approach in these words:

Where the rate paid for funds is less than the contract rate the debtor is afforded some relief and the creditor receives its cost to obtain replacement funds. It can then reinvest the funds, providing it the opportunity to receive profit from another borrower while suffering no continuing loss due to the bankruptcy of the debtor.¹⁶

The court in *In re Caudill*¹⁷ observed, however, that "this methodology is unfair and inequitable to all parties, debtors and creditors alike, in that by using this approach, a poorly run organization would be benefited to the detriment of an efficient creditor organization."¹⁸

The cost of funds rate places the debtor at the mercy of business conditions not directly related to the interest rate negotiated. The theory of the rate also duplicates the analysis of the creditor's return on investment, a concept specific to the lender's condition,

13. *In re O'Farrell*, 74 Bankr. 421, 424 (Bankr. N.D. Fla. 1987) (citing *In re Southern States Motor Inns, Inc.*, 709 F.2d 647 (11th Cir. 1983)).

14. *Id.*

15. 74 Bankr. 701 (Bankr. W.D. Okla. 1987).

16. *In re Hardzog*, 74 Bankr. 701, 703-04 (Bankr. W.D. Okla. 1987).

17. 82 Bankr. 969 (Bankr. S.D. Ind. 1988).

18. *In re Caudill*, 82 Bankr. 969, 979 (Bankr. S.D. Ind. 1988).

not to the general market for bankruptcy lenders and borrowers jointly.

3. *Averages of Several Rates*

Bankruptcy courts' use of rate averaging is an attempt to reduce the likelihood of inaccuracy in choice of a single rate. For example, the court in *In re Bar L O Farms, West*¹⁹ permitted an average of the prime rate (9% at the time), the thirty-year treasury bond market rate (8.81%), and the thirty-year mortgage rate of the Federal Home Loan Mortgage Corporation as of the effective date of the Chapter 12 plan (9.97%), and came up with a 10% discount rate plus 1% for risk.²⁰

Rate averaging ostensibly incorporates the strengths of the several rates included and, therefore, yields a rate more representative of the bankruptcy loan market than any single rate. The difficulty in its use is that the weaknesses of individual rates are borrowed as well. An average of rates is no more representative of current economic conditions than its least responsive component. Nor is an average rate necessarily more representative of the specific bankruptcy plan being offered than a single rate is.

4. *The Testimonial Rate*

The testimonial rate has come to mean an interest rate introduced in bankruptcy testimony by an expert using surveys of rates negotiated between lenders and debtors. The rate offered by an expert in *In re Paddock*²¹ illustrates the controversy that can arise over survey data.²²

The proceedings in the North Dakota Bankruptcy Court decision in *In re Rott*²³, however, provide a better case study of the resolution of a testimonial rate controversy. Although both creditor and debtor experts agreed on the use of a market rate, they disagreed on the nature and extent of risk and time factors in determining that rate, and proposed rates differing from 1% to 1

19. 87 Bankr. 125 (Bankr. D. Idaho 1988).

20. *In re Bar L O Farms, West*, 87 Bankr. 125, 126-27 (Bankr. D. Idaho 1988).

21. 81 Bankr. 51 (Bankr. D. Mont. 1987).

22. *In re Paddock*, 81 Bankr. 51 (Bankr. D. Mont. 1987). The court observed evidence that showed "a market rate of interest between 9% and 13%." *Id.* at 53. The creditor's expert testified to a more precise rate, effectively 12 3/4%, based on a survey of commercial lending to agricultural borrowers with high risk and poor credit history. *Id.* The court was critical of the survey method, noting especially that the survey was not sufficiently representative of the agricultural borrowers. *Id.*

23. 94 Bankr. 163 (Bankr. D.N.D. 1988).

1/2%.²⁴ The creditor's expert emphasized the higher interest rate associated with a longer payout term.²⁵ The debtors' expert testified that although the firm had been managed inefficiently in the past, the reorganization plan showed definite promise.²⁶ The court ruled that the past poor management record and the fact that this was the debtors' third bankruptcy filing justified the higher rate proposed by the creditor.²⁷

Expert testimony on the appropriate rate takes additional time and energy.²⁸ Use of a testimonial rate also complicates bankruptcy proceedings because the court must judge the accuracy of the testimony or the credibility of witnesses or both. The merit of the procedure, therefore, rests on the court's ability to obtain the kinds of information it needs for a rate decision which it could not otherwise obtain. Pertinence of the rate to the current economic condition is limited by the specificity of the survey conducted. Relevance of the rate may be limited to the individual bankruptcy case being litigated.²⁹

5. *The Variable or Floating Rate*

Analysis of a variable or floating interest rate differs from that of other rates, since this "rate" is a *method* of paying any of the other rates chosen. A variable rate theoretically adjusts future plan payments to the levels of market interest rates then in effect. The court in *In re Patterson*³⁰ stated that a variable rate more accurately reflects market conditions, especially "the volatility of the agricultural economy"³¹ However, the court's view in *Patterson*, that a variable rate is workable in plan payments, is not shared by other courts.³²

The key problem with use of a variable rate is how to determine present value accurately. How can a periodic future payment be determined now, since any present value payment is a composite of principal and interest calculated at the present time for application over a given period of future years during which the rate may change?

24. *In re Rott*, 94 Bankr. 163, 169 (Bankr. D.N.D. 1988).

25. *Id.*

26. *Id.*

27. *Id.*

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

29. Harl, *Determining 'Present Value' in Bankruptcy*, 10 J. AGRIC. TAX'N & L. 170, 173 (1988).

30. 86 Bankr. 226 (Bankr. 9th Cir. 1988).

31. *In re Patterson*, 86 Bankr. 226, 229 (Bankr. 9th Cir. 1988).

32. See *In re Caudill*, 82 Bankr. 969, 976-77 (Bankr. S.D. Ind. 1988).

6. *The Prime Rate*

The prime rate is the "interest rate banks charge their most creditworthy customers," which "tends to become standard across the banking industry when a major bank moves its prime rate up or down."³³ The prime rate has been used as a standard in bankruptcy proceedings, especially in the Ninth Circuit, serving as the base rate to which is added a percentage for risk specific to the borrower's industry or region.³⁴ That is, a risk factor found on an individual basis is added to the prime rate to represent the "market" rate.³⁵

The prime rate, as defined, applies to creditworthy, low risk borrowers, not to bankrupt borrowers with one or more defaults on past loans. Without a risk factor adjustment, therefore, the rate is definitionally inappropriate to bankruptcy proceedings. However, since there typically is no objective determination of a value for bankruptcy risk, adding a risk factor introduces inexactness and complexity into an otherwise exact and easily found prime rate. The rate does respond reasonably well, though not perfectly, to changing economic conditions.

7. *The Treasury Bill or Bond Rate*

A United States Treasury Bill or Bond rate is the interest rate at which the federal government borrows in the money markets.³⁶ Default risk is virtually absent from Treasury debt instruments, so interest rates are routinely lower than rates on investment instruments that carry some risk. There is some market value risk, however, as with any publicly traded instruments. An Eighth Circuit court, in *In re Wichmann*,³⁷ noted that the principal merits of a Treasury debt instrument are its relatively risk free nature, its ability to be matched to differing bankruptcy plan maturities, the easy determination of the rate (because it is publicly reported regularly in a number of sources), and the currency of the rate.³⁸

33. J. DOWNES & J. GOODMAN, MONEY'S COMPLETE GUIDE TO PERSONAL FINANCE AND INVESTMENT TERMS 307 (Barron's Educ. Series 1985).

34. See *In re Patterson*, 86 Bankr. 226, 228 (Bankr. 9th Cir. 1988); *In re Chaney*, 87 Bankr. 131, 134 (Bankr. D. Mont. 1988).

35. *Patterson*, 86 Bankr. at 228.

36. The three "Treasures" or negotiable debt obligations of the U.S. Government of particular interest in this article are: (1) "*Treasury Bills*—short term securities with maturities of one year or less issued at a discount from face value," (2) "*Treasury Notes*—intermediate securities with maturities of 1 to 10 years," (3) "*Treasury Bonds*—long-term debt instruments with maturities of 10 years or longer . . ." J. DOWNES & J. GOODMAN, *supra* note 33, at 443.

37. 77 Bankr. 718 (Bankr. D. Neb. 1987).

38. *In re Wichmann*, 77 Bankr. 718, 720-21 (Bankr. D. Neb. 1987).

Because a new market for Treasury instruments is "made" regularly, the rate is quite responsive to current money market conditions. As analyzed in *In re Snider Farms*,³⁹ however, the problem with the use of a Treasury rate as a bankruptcy rate arises from the market perspective of lender and borrower. Government is itself a borrower, not a lender, in the Treasury Bill or Bond market.⁴⁰ To the extent that government is involved in bankruptcy *lending*, it is, through one of its agencies, lending to debtors. The yield rate on Treasury instruments is, therefore, incorrect as a bankruptcy financing rate, since government, as a debtor, pays a lower rate than the typical private debtor.⁴¹

However, a Treasury rate has been used by Eighth Circuit courts as a base on which to "build" a market rate. These courts illustrate the use of a proper *method* (a "case by case," individualized approach) in determining a market interest rate.⁴² There are problems with that procedure. "[A]doption of this procedure requires the judiciary to ascribe rate increments for future risks to debtors and collateral and to forecast other events with a precision which this Court doubts its ability to accurately assess."⁴³ That is, the addition to the base rate for risk is essentially arbitrary.

A further difficulty is the imperfect time matchup between the loan term of the Treasury instrument and the bankruptcy loan term. Treasury principal is paid in total at the end of the loan's term. In bankruptcy payout, however, the present values of principal plus interest are paid regularly over the term of the loan, thus reducing the principal amount outstanding as each payment is made.⁴⁴

39. 83 Bankr. 977 (Bankr. N.D. Ind. 1988).

40. *In re Snider Farms, Inc.*, 83 Bankr. 977, 993 (Bankr. N.D. Ind. 1988).

41. *Id.*

42. See *In re Underwood*, 87 Bankr. 594 (Bankr. D. Neb. 1988) (summary of the Eighth Circuit debate on the point).

43. *In re Neff*, 89 Bankr. 672, 679 (Bankr. S.D. Ohio 1988).

44. One adjustment to the Treasury Bond rate to resolve that problem is recommended in C. Carbiener, *Present Value in Bankruptcy: The Search for an Appropriate Cramdown Discount Rate*, 32 S.D.L. REV. 42 (1987). Carbiener suggests calculating the percentage of the average amount outstanding in the bankruptcy plan's repayment period and then matching the percentage to a government security with an equal maturity. *Id.* at 64-65. In *Wichmann*, the court noted Carbiener's analysis and attempted to clarify it by stating:

For example, in a case where \$10,000 debt is proposed to be paid over 10 years with yearly payments, the average outstanding indebtedness . . . is \$5,500. Stated as a percentage, 55% of the claim is outstanding over the payment period. Since the debtor's plan in this example uses a ten-year repayment term, the discount rate will be based on a government security with a duration of 55% of ten years or, in other words, 5.5 years.

In re Wichmann, 77 Bankr. 718, 721 (Bankr. D. Neb. 1987).

8. *The Contract Rate*

The contract rate is well described in one court's description of its use. The court in *In re Monnier Brothers*⁴⁵ stated that "the contract rate, which was a rate agreed upon in an arms length bargain between businessmen, presumably reflected the prevailing cost of money, . . . the prospects for appreciation or depreciation of the value of the security, and the risks inherent in a long-term agricultural loan."⁴⁶

The strongest support for the contract rate is found in non-Chapter 12 cases. In *In re Loveridge Machine and Tool Co.*,⁴⁷ the court stated, "Using the lawful contract rate where there is a contract avoids such errors" which would favor one party over the other.⁴⁸ The court also criticized opposition to the contract rate, stating, "[R]ejecting the contract rate when there is a contract might mean either a windfall to the creditor when the contract rate is less than the rate selected or a windfall to the debtor when the contract rate exceeds the rate selected."⁴⁹

That argument has been adopted implicitly in some Chapter 12 cases as well. In *In re Turner*,⁵⁰ the court rejected the market rate as a "fiction" and thereupon approved use of the contract rate.⁵¹ Similarly, the Sixth Circuit Court of Appeals, in *United States v. Arnold*,⁵² approved the contract rate over the market rate in a specific fact situation.⁵³

The essential merit in use of the contract rate is that it was the rate bargained between the two parties originally, presumably as a good faith, fair rate. The contract rate is, for that reason, a rate

45. 755 F.2d 1336 (8th Cir. 1985).

46. *In re Monnier Bros.*, 755 F.2d 1336, 1339 (8th Cir. 1985).

47. 36 Bankr. 159 (Bankr. D. Utah 1983).

48. *In re Loveridge Mach. & Tool Co.*, 36 Bankr. 159, 162 (Bankr. D. Utah 1983).

49. *Id.* at 163.

50. 87 Bankr. 514 (Bankr. S.D. Ohio 1988).

51. *In re Turner*, 87 Bankr. 514, 517 (Bankr. S.D. Ohio 1988).

52. 878 F.2d 925 (6th Cir. 1989).

53. *United States v. Arnold*, 878 F.2d 925, 929 (6th Cir. 1989). The Eighth Circuit Court of Appeals has decided recently that the market rate is preferred over the original contract rate, even when that contract rate is part of a special loan program. In *In re Fisher*, 930 F.2d 1361 (8th Cir. 1991), the court ruled that "limited resource operating loans" made to disadvantaged farmers at below market rates do not entitle those farmers declaring bankruptcy to the lower rate in determining the present value of the creditor's allowed secured claim. A cramdown reduced the allowed secured claim to less than 24% of its original value. *Id.* at 1362. The debtors proposed a weighted average rate of 5.41% for three loans based on their original contract rates. *Id.* The court ruled instead in favor of the creditor Farmers Home Administration (FmHA), stating that "secured creditors are to be treated equally," and "the 'cramdown provision' makes no exceptions." *Id.* at 1363. "It makes no distinction between the present value of claims that result from special programs such as FmHA's limited resource operating loans and those of any other secured creditors." *Id.*

most pertinent to the bankruptcy condition being litigated. The contract rate's responsiveness to current market conditions is limited, however, since it was, presumably, the market rate only at the time the contract was negotiated. Indeed, the basic problem with the contract rate is that the debtor may need relief from the contract rate itself as it applies to the current default condition.

9. *The Market Rate*

Although the term is used regularly as a desired rate objective in bankruptcy reorganization planning, "market rate" can have at least three different meanings in bankruptcy litigation. The most commonplace use of the term is to describe any rate set in a money market, therefore referring to any of the eight rates described previously.⁵⁴ Generally, those rates are easily found but have varying degrees of responsiveness to current market conditions and varying relevance to the bankruptcy condition being litigated.

Another use is indicated in the language of a "prevailing market rate." Courts employing that term typically refer to determination of the appropriate rate on a "case-by-case" or individualized case method to avoid application of "formula" rates they feel are representative of the rates discussed above. In effect, they seek to duplicate that prevailing rate by adding a percentage for risk to a base rate they approve, such as a Treasury security rate or the prime rate.⁵⁵ Courts emphasizing the method by which the "prevailing rate" is determined place the burden of relevance of the rate developed on the risk percentage that is added to the low-risk base rate chosen (the Treasury or prime rate).⁵⁶

The third meaning of "market rate" is an average or representative rate negotiated between creditors and debtors and approved by the court. It identifies the rate on loans of similar risk and duration; namely, a rate common to that kind of bankruptcy proceeding. This rate is best determined through market surveys of negotiated rates on loans made in similar circumstances.⁵⁷ The

54. See, e.g., *Travelers Ins. Co. v. Bullington*, 878 F.2d 354, 356-57 (11th Cir. 1989) (court of appeals allowed a 10.75% rate on a 30-year mortgage as "within the range of market rates"), *reh'g denied*, 889 F.2d 276 (11th Cir. 1989).

55. The capstone cases in the two circuits on the use of a base rate plus a risk factor determined by the court are *In re Doud*, 74 Bankr. 865 (Bankr. S.D. Iowa 1987), *aff'd* 869 F.2d 1144 (Bankr. 8th Cir. 1989) (Treasury Bond rate as a base), and *In re Patterson*, 86 Bankr. 226 (Bankr. 9th Cir. 1988) (prime rate as a base).

56. The mandate to use a "case-by-case" method is especially clear in *In re Camino Real Landscape Maintenance Contractors, Inc.*, 818 F.2d 1503, 1508 (9th Cir. 1987).

57. See *In re Neff*, 89 Bankr. 672 (Bankr. S.D. Ohio 1988) (Sixth Circuit court's

Bankruptcy Court in North Dakota sought to develop the guidelines for its determination in the following three decisions: *In re Edwardson*,⁵⁸ *In re Claeys*,⁵⁹ and *In re Konzak*.⁶⁰

In *Edwardson*, the court analyzed the debtor's financial condition against the market rate standard announced in earlier Eighth Circuit Court of Appeals decisions.⁶¹ The court observed that the debtor, because of the write-down of asset value in reorganization, has "an opportunity to shed several hundred thousand dollars worth of unsecured debt" ⁶² Hence, the rate chosen as a market rate should be lower, since the debtor "is not the severe credit risk that the Bank would have the court believe."⁶³

The same court furthered the dialogue emerging in Eighth Circuit courts over the use of the Treasury Bond rate with a risk factor added, versus the use of a market survey rate.⁶⁴ Consistent with its ruling in *Edwardson*, the *Claeys* court sided with the "market" proponents, observing that the "rates being offered in the marketplace by agricultural lenders have inherently factored into them the prevailing cost of money, prospects for appreciation or depreciation of the value of the security, and the risks inherent in long term loans."⁶⁵

Within days, the court reaffirmed its *Claeys* decision in *In re Konzak*.⁶⁶ The court stated, "Generally, the best evidence of what a reasonable discount rate is for a given principal, term and risk, is the rate the creditor involved would charge the debtor for such a loan in the marketplace absent the event of bankruptcy."⁶⁷ The Eighth Circuit Court of Appeals, in *United States v. Doud*,⁶⁸ eventually decided that the "market" approach must be used, but that using the Treasury Bond rate plus 2% for risk adjustment was an appropriate market rate method.⁶⁹

The limitation in the third definition of the market rate is data, especially a specific numerical value to represent the general

discussion of the merits of the Federal Reserve System's periodic survey of agricultural lending rates).

58. 74 Bankr. 831 (Bankr. D.N.D. 1987).

59. 81 Bankr. 985 (Bankr. D.N.D. 1987).

60. 78 Bankr. 990 (Bankr. D.N.D. 1987).

61. *In re Edwardson*, 74 Bankr. 831, 836 (Bankr. D.N.D. 1987).

62. *Id.*

63. *Id.*

64. *See, e.g., In re Underwood*, 87 Bankr. 594, 599 (Bankr. D. Neb. 1988) (good summary of this discussion).

65. *In re Claeys*, 81 Bankr. 985, 993 (Bankr. D.N.D. 1987).

66. 78 Bankr. 990, 992 (Bankr. D.N.D. 1987).

67. *In re Konzak*, 78 Bankr. 990, 992 (Bankr. D.N.D. 1987).

68. 869 F.2d 1144 (8th Cir. 1989).

69. *United States v. Doud*, 869 F.2d 1144 (8th Cir. 1989).

market rate. The court in *In re Neff*⁷⁰ noted that “[i]t is undisputed that the standard in this circuit for discount rates . . . is . . . ‘the current market rate of interest used for similar loans in the region.’ It is not clear, however, how such rate is calculated.”⁷¹

The general observation on the three definitions of “market rate” is that they all purportedly *represent* the market condition. The numerical value found for all three is theoretically the same. In practice, however, there are likely to be differences among them, given regional variations in economic, money market, and agricultural industry conditions. The strongest objective rate validation is found in the formula rates, the least in the “case-by-case” rates.⁷² The “case-by-case” method, however, is ostensibly more pertinent to the bankruptcy condition, while the formula rates are less pertinent. The survey of rates (third definition) retains much of the objective validation of the formula rates, while retaining the individualized treatment found in the “case-by-case” method. That definition emphasizes discovery of a rate on loans of similar risk and duration to be applied to the case being litigated.

CONCLUSION

The interest rate chosen to settle a bankrupt’s obligation on an allowed secured claim is essential to the feasibility of a farmer’s reorganization plan. After the appraisal value of property is set

70. 89 Bankr. 672 (Bankr. S.D. Ohio 1988).

71. *In re Neff*, 89 Bankr. 672, 677 (Bankr. S.D. Ohio 1988) (citing *Memphis Bank & Trust Co. v. Whitman*, 692 F.2d 427, 431 (6th Cir. 1982)).

72. Whichever approach is used, the concept of the market rate as the standard for determining the appropriate interest rate is widely held. There are at least three noteworthy cases in opposition to the market rate, however.

The court in *In re Caudill* rejected the market rate in opting for a Treasury rate plus risk adjustment, observing that the Family Farm Reorganization Act is a national act and should be applied impartially throughout the United States. *In re Caudill*, 82 Bankr. 969, 979-81 (Bankr. S.D. Ind. 1988). Under this market approach, “one would benefit certain creditors and debtors in certain parts of the nation to the detriment of certain farmers and creditors in other parts of the nation.” *Id.* at 979. This comment assumes that a market rate would be national in scope.

The court in *In re Wichmann* stated serious reservations that the market rate is not the same as the coerced loan rate in bankruptcy:

[The] Court believes that the appropriate ‘market rate’ for a loan of a term equal to the payout period, with due consideration for the quality of the security and the risk of subsequent default, is not necessarily, nor even usually, the rate at which some lender would, if coerced, loan money to a debtor in bankruptcy. If that were the standard, the Court would probably be required to find that no lender would make a loan of this type to any debtor in bankruptcy

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

Reservations on use of the market rate are also based on the unavailability of data. In *In re Foster*, the court stated that there is no commercial interest rate in some instances, due to the absence of lending activity between sellers and buyers of agricultural property. *In re Foster*, 79 Bankr. 906, 912 (Bankr. D. Mont. 1987).

through debtor-creditor negotiation or "cramdown," the interest payable on debt over the life of the plan ordinarily is the largest monetary factor addressed in bankruptcy proceedings.⁷³

The creditor is guaranteed by statute the present value of allowed future claims in order to insure that he is as well-off financially as he would have been had the debt been paid when due. Present value to the creditor is provided by the debtor's interest payments on those claims. The selection of an interest rate that best represents the market earning potential of invested funds, effectively a rate with an appropriate value or size is, therefore, the pivotal issue specifically addressed in these proceedings. The fact that there is substantial diversity among bankruptcy courts as to choice of a proper interest rate to discount those future values prompts this analysis and recommendation.

These authors' brief analysis of the suitability of nine interest rates in bankruptcy proceedings leads to the conclusion that the courts' search is really for an *ideal* bankruptcy rate. There are two main groups of ideal rate characteristics for a Chapter 12 proceeding. First, the rate should represent the actual, negotiated loan market agreements in agriculture in the same region for loans of the same maturity and equivalent principal amount, security status, and risk of default. The broader the loan market being represented, the greater the statistical reliability the rate is likely to have. Second, the rate should respond well to changing market conditions and should be quickly and easily known to observers.

While no existing rate has all these characteristics, a properly structured and conducted survey of privately negotiated rates would come closest to the ideal. That approach is consistent with the *Neff* court's approval of the use of properly conducted surveys to establish a representative market rate.⁷⁴ The court noted a Federal Reserve Bank survey of rates of "Agricultural Credit Conditions at Commercial Banks" as especially appropriate to a farm bankruptcy proceeding: "Of the various approaches used, the averages set forth in the Survey best comported with the Court's independent perception of market rates generally."⁷⁵ In commending the Federal Reserve System rate,⁷⁶ the court in *Neff* sug-

73. One simple calculation is presented to demonstrate that difference: Total payments on a \$500,000 loan, payable over 30 years, differ by \$129,450 for an interest rate of 9 1/2% versus 8 1/2%. J. Belcher, *Cramdown Under the New Chapter 12 of the Bankruptcy Code: A Boon to the Farmer, A Bust to the Lender*, 23 LAND & WATER L. REV. 227, 239 (1988).

74. *Neff*, 89 Bankr. at 679.

75. *Id.*

76. Survey data referred to by the court in *In re Neff* is from N. WALRAVEN & J.

gested that the survey might be complemented with evidence on "unusual more recent trends in interest rates, relevant subsidies for the lender, or compelling characteristics of the particular debtor or security."⁷⁷ That information clearly would be better than what is now available in the several bankruptcy jurisdictions. In a best case scenario, the result would be a rate specific to the farm economy in a region and, therefore, one attuned specifically to farm bankruptcy proceedings.

ROSINE, AGRICULTURAL FINANCE DATABOOK (Board of Governors of the Federal Reserve System, 1989) (quarterly publication which reports data from regular surveys by the Federal Reserve Board staff of (primarily) commercial banks involved in agricultural lending). The specific table referred to in *In re Neff* is Table IV "Federal Reserve Bank Quarterly Surveys of Agricultural Credit Conditions at Commercial Banks," part IV.D., dealing with interest rates charged for farm loans. The July, 1989 edition reveals the following data from five Federal Reserve Bank Districts: Richmond (5th), Chicago (7th), Minneapolis (9th), Kansas City (10th), and Dallas (11th).

District Bank	No. of Banks	Kinds of Bank Survey Data
Richmond	43	Banks of all sizes, with sampling heavier for banks with a heavier volume of farm loans.
Chicago	about 900	Banks whose farm loans comprise 25% or more of the banks' total loans.
Minneapolis	325	Banks whose farm loans comprise 25% or more of the banks' total loans.
Kansas City	max. of 188	Banks whose farm loans comprise 50% or more of the banks' total loans.
Dallas	about 300	Banks in which farm loans "are relatively important."

N. WALRAVEN & J. ROSINE, *supra*, at 25-26.

77. *Neff*, 89 Bankr. at 679.