Obtaining Operating Capital in a Chapter 12 Farm Reorganization

by

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Originally published in MISSOURI LAW REVIEW
54 MO. L. REV. 75 (1989)

OBTAINING OPERATING CAPITAL IN A CHAPTER 12 FARM REORGANIZATION

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I. INTRODUCTION

The current financial crisis in American agriculture has forced many farmers to seek relief under the federal bankruptcy laws.[1] Due to the unique nature of agriculture, existing provisions of the Bankruptcy Code were deemed unworkable for most farmers who desired to continue farming and reorganize their debts.[2] In response, Congress enacted Chapter 12, a new, separate chapter for family farmers.[3]

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1. For a discussion of the financial crisis in agriculture, *see* Harl, *The Architecture of Public Policy: The Crisis in Agriculture*, 34 U. KAN. L. REV. 425 (1986).

2. H.R. Rep. No. 958, 99th Cong., 2d Sess. 45, *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS 5246, 5249:

> Under current law, family farmers in need of financial rehabilitation may proceed under either Chapter 11 or Chapter 13 of the Bankruptcy Code. Most family farmers have too much debt to qualify as debtors under Chapter 13 and are thus limited to relief under Chapter 11. Unfortunately, many family farmers have found Chapter 11 needlessly complicated, unduly time-consuming, inordinately expensive and, in too many cases, unworkable.

3. 11 U.S.C.A. §§ 1201-31 (West Supp. 1987) (codifying Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, §§ 251-57, 100 Stat. 3088, 3104-16 (1986)). For a general discussion of Chapter 12, see Aiken, *Chapter 12 Family Farmer Bankruptcy*, 66 NEB. L. REV. 632 (1987); Armstrong, *The Family Farmer Bankruptcy Act of 1986: An Analysis for Farm Lenders*, 104 BANKING L.J. 189 (1987); Hahn, *Chapter 12 - The Long Road Back*, 66 NEB. L. REV. 726 (1987); Matson, *Understanding the New Family Farmer Bankruptcy Act*, 21 U. RICH. L. REV. 521 (1987); Wilson, *Chapter 12: Family Farm Reorganization*, 8 J. AGRIC. TAX'N & L. 299 (1987); Note, *Bankruptcy Chapter 12: How Many Family Farms Can It Salvage?*, 55 UMKC L. REV. 639 (1987).

The legislative history of Chapter 12 indicates that the new chapter was designed to give family farmers facing bankruptcy a fighting chance to reorganize their debts and keep their land.[4] To effectuate the legislative purpose of Chapter 12, a family farmer will need to continue farming, generating revenue to make plan payments and rehabilitate his debt.

Once the Chapter 12 petition is filed, most farmer-debtors will need to obtain operational financing to continue farming. A farmer needs large amounts of capital for feed, fuel, fertilizer, seed, labor, and other expenses. If the debtor is unable to obtain operational financing, he will likely be forced to quit farming and liquidate his operation.

If a Chapter 12 debtor is unable to use cash collateral pursuant to section 363[5] of the Code or if no unencumbered assets are available, he will need to find a new or existing lender willing to advance operational credit. The debtor and creditor will need to follow the provisions of section 364 of the Code in order to effectuate a valid post-petition financing arrangement.[6]

Since there is no provision in the Bankruptcy Code which requires a creditor to extend credit to the Chapter 12 debtor, the debtor will need to convince a lender that it is protected under the provisions of the Code and that lending will prove beneficial. The drafters of Chapter 12 did not add any new incentives that would encourage lenders to grant post-petition credit. Rather, many opponents of Chapter 12 argue that it will dry up the availability of agricultural credit and make such credit more expensive for farmers.[7]

A recent American Banker's Association survey indicates that the enactment of Chapter 12 has decreased the availability of agricultural credit.[8] The survey, which ran from June 1986 to June 1987, indicated that 77% of the banks surveyed believed Chapter 12 had decreased farm credit.[9] Sixty-four percent of the surveyed banks said they increased their collateral requirements and 41.8% said Chapter 12 had increased costs for borrowers.[10] Fifty-one percent stated they specifically had denied credit on 10% or more

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4. H.R. Rep. No. 958, 99th Cong., 2d Sess. 45, *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS 5246, 5249.

5. *See* 11 U.S.C. § 363 (1982 & Supp. IV 1986).

6. *See* 11 U.S.C. § 364 (1982 & Supp. IV 1986).

7. *See* Armstrong, *supra* note 3, at 212-14; Matson, *supra* note 3, at 539; White, *Taking From Farm Lenders and Farm Debtors: Chapter 12 of the Bankruptcy Code*, 13 J. CORP. L. 1, 27-29 (1987); Note, *supra* note 3, at 662-64.

8. *Chapter 12 Bankruptcy Statutes Decrease Farm Credit Availability, Ag Survey Reveals*, ABA BANKERS WEEKLY, May 10, 1988, at 4. This article reports the results of the American Bankers Association's Mid-Year Farm Credit Survey, which covered the period of June 1986 to June 1987.

9. *Id.*

10. *Id.*

of their loan applications due to the threat of a Chapter 12 filing.[11]

This lender reluctance to deal with Chapter 12 farmers stems from the powers Chapter 12 gives to farmers. One of the most significant features of Chapter 12 is the writedown of secured debt to the fair market value.[12] Pursuant to section 1225(a)(5)(B)(ii)[13] of the Code, a farmer can scale down undersecured claims to the value of the collateral. The remaining indebtedness is treated as an unsecured claim.[14] There is no absolute priority rule in Chapter 12, as the creditor has no right to vote on acceptance or rejection of the plan of reorganization.[15] The debtor can retain farm assets and pay the secured creditor the present value of the collateral. The secured creditor will probably receive very little or none of the undersecured portion of the debt.[16]

Since a large amount of debts of Chapter 12 debtors are undersecured, secured lenders will be required to write off large amounts of debt, particularly loans secured by real estate.[17] This is certain to have at least a short term effect on a lender's willingness to look for additional exposure in agricultural lending.[18] Current farm lenders who have been hit hard by large debt write-offs may decide to withdraw from the farm market. The banks may choose to loan funds to other businesses or to simply invest their excess capital in investments such as treasury bonds.[19]

If the debtor is unable to obtain operating capital from traditional lending sources such as the Farm Credit System, Farmers Home Admin-

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11. *Id.*

12. *See* 11 U.S.C. § 1225(a)(5)(B)(ii) (Supp. IV 1986).

13. *Id.* § 1225(a)(5)(B)(ii) states that

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—

. . . .

(B)(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. . . .

14. White, *supra* note 7, at 13.

15. *Id.* at 11; *see also* Comment, *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, 232-34 (1988).

16. 11 U.S.C. § 1225(b)(1) (Supp. IV 1986) provides that a Chapter 12 plan may be confirmed if the holder of an allowed unsecured claim is paid at least what he would receive in a Chapter 7 liquidation and the Chapter 12 plan provides that all disposable income is applied to make payments under the plan.

17. For example, in Iowa, the average unsecured debt for each Chapter 12 debtor was $136,567. Faiferlick & Harl, *The Chapter 12 Bankruptcy Experience in Iowa*, 9 J. AGRIC. TAX'N & L. 302, 308 (1988).

18. *See* Harl, *Analyzing Chapter 12*, AGRIC. FINANCE, Mar. 1987, at 14, 15 [hereinafter Harl, *Analyzing Chapter 12*].

19. White, *supra* note 7, at 28-29. *But see* Bauer, *Where You Stand Depends on Where You Sit: A Response to Professor White's Sortie Against Chapter 12*, 13 J. CORP. L. 33 (1987).

istration, life insurance companies, and commercial banks, he may have to look for non-traditional alternative sources. Often family members or landlords may be willing to extend credit to meet operating expenses. They may be particularly interested if they can obtain a first priority security interest under section 364(d) of the Code.[20]

Several agribusiness firms recently have entered the agricultural lending market. One of the new credit suppliers is Farmland Industries, Inc., a large supply cooperative. Farmland recently has begun extending operating capital to farmers in a nineteen state service area through Farmland Services Company.[21] The input supply industry may become an increasingly important supplier of agricultural credit for the "high risk" farm borrower such as a Chapter 12 debtor. To increase sales of fertilizer, seed, and other inputs, such suppliers would probably be more willing to take on additional credit risks.[22]

In some states, state financial assistance may be available. Because of the severe farm financial problems, a number of agricultural states have developed government programs directed towards making credit available for their farmers.[23] The programs, which include loan participations, interest rate buydowns, loans to lenders, guarantees and linked deposits vary between states.

North Dakota has enacted legislation which provides for loan participations and interest buydowns to make farm operating loans more attractive to private lenders.[24] The Bank of North Dakota is to make available an appropriate amount of funds to purchase participation interests in operating loans to farmers and agribusinesses.[25] The Bank may not charge greater than 8% per annum interest on a participation interest it purchases.[26] In addition, the Bank is to establish an interest rate buydown fund with which the industrial commission may buydown or reduce the interest which a farmer pays on the Bank's portion of the participation operating loans by up to an additional five percentage points a year below the 8% figure.[27]

The North Dakota statute defines "operating loan" as a loan or extension of credit with a term of one year or less made by a non-governmental financial institution to a farmer for the operation of an existing farm.[28] There do not appear to be any restrictions regarding loans

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20. *See* 11 U.S.C. § 364(d) (1982).
21. Thompson, *New Capital Sources for Ag Credit*, AGRIC. FINANCE, Dec. 1987, at 33.
22. *Id.*
23. Gardner, *The State Role in Addressing Farm Financial Problems*, prepared for 1986 AM. AGRIC. ECON. MEETING SYMPOSIUM.
24. N.D. CENT. CODE §§ 6-09.9-03, 6-09.9-05 (1987).
25. *Id.* 6-09.9-0.3(1).
26. *Id.*
27. *Id.* § 6.09.9-05.
28. *Id.* § 6.09.9-02(3).

to farmers who are operating under a bankruptcy reorganization. Therefore, the Chapter 12 debtor may be able to convince a new lender to grant operational credit if the Bank of North Dakota is willing to participate in the loan.

Wyoming[29] and Ohio[30] have both enacted statutes providing for linked deposits. The State Treasurer of Wyoming may enter into agreements with financial institutions in Wyoming under which the financial institution makes agricultural loans to create and maintain jobs in Wyoming and the State Treasurer agrees to deposit state funds with the financial institution in the amount of the loan principal.[31] The funds deposited in the financial institution earn interest at a rate that is reduced by the number of interest percentage points the preferred rate of interest is below the existing market lending rate.[32] The purpose of this program is to encourage agricultural lenders to loan money to farmers at lower interest rates. This type of program may be of particular interest to a Chapter 12 debtor who is having difficulty making his reorganization plan cash flow because of high cost operating funds.

To reduce the costs of agricultural production credit the Kansas legislature has provided for a tax credit if a state or national banking association agrees to extend or renew an agricultural production loan at a rate of at least 1% below the bank's prime interest rate.[33] Although this statute does provide for lower credit costs, it does not encourage lenders to grant any new credit. The state does not provide any guarantees.

Recent legislation enacted in Wisconsin actually guarantees some loans made to farmers. An agricultural production loan, which is a loan to finance the purchase of fertilizer, seed, fuel, pesticides, tillage services, or crop insurance, can be eligible for a governmental authority guarantee.[34] The loan is eligible for a 90% guarantee if it does not exceed $20,000 and the interest rate is 9% or less.[35] Additionally, the participating lender must obtain a security interest in the agricultural commodity and the borrower must obtain crop insurance.[36]

A farmer is only eligible for a guaranteed loan if it is reasonably likely that the farmer's cash flow and managerial ability are sufficient to preclude voluntary or involuntary liquidation.[37] The statute does not state that reorganizing farm debtors are forbidden from participating in this guar-

29. WYO. STAT. § 9-4-832 (1977).
30. OHIO REV. CODE ANN. §§ 135.71-135.76 (Supp. 1987).
31. WYO. STAT. § 9-4-832(a) (1977).
32. *Id.*
33. KAN. STAT. ANN. § 79-1126 (1984).
34. WISC. STAT. ANN. § 234.90 (West 1987).
35. *Id.* § 234.90(2).
36. *Id.*
37. *Id.* § 234.90(4).

anteed loan program.[38] Thus, the program may be very valuable to the Chapter 12 debtor who is having difficulty convincing a new lender to grant operational credit, insofar as most of the risks are eliminated.

State programs such as interest rate buydowns, linked deposits, and tax credits for interest rate reduction will probably be of little value in convincing a lender to grant additional credit for farm operational needs. These programs do not provide any guarantee for non-payment. However, state programs which provide for loan participation or guarantees by the state or an agency will likely induce lenders to grant new credit to struggling farmers.

The programs discussed above are examples of some states' lending programs. Several other states have enacted similar programs.[39] The Chapter 12 debtor or his attorney should determine whether his state has a program that may provide assistance in obtaining operational financing or lower cost credit.

Farmers in states that do not encourage lenders to make loans to Chapter 12 debtors will have to fall back on the Bankruptcy Code. Such situations are the focus of this Article. It will discuss some of the procedures and problems the Chapter 12 debtor will encounter in obtaining operational financing under current provisions of the Bankruptcy Code. The beginning sections of this Article discuss some of the aspects of operational financing that need to be considered before a Chapter 12 petition is filed, including the impact of Chapter 12 on the availability of agricultural credit. The remaining sections focus upon potential sources of operational financing. These sources include new credit obtained under section 364 of the Bankruptcy Code and use of cash collateral and unencumbered assets.[40]

II. PRE-FILING CONSIDERATIONS

Before a Chapter 12 petition is filed, the debtor should determine how much operational financing he needs and where it can be obtained.[41] If the debtor is unable to obtain adequate amounts of operating capital, the

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38. *See id.*

39. *See* ILL. ANN. STAT. ch. 5, paras. 1201-58 (Smith-Hurd Supp. 1988); IOWA CODE ANN. §§ 175.1-175.36 (West Supp. 1988); MINN. STAT. ANN. §§ 41.51-41.61 (West Supp. 1989); MINN. STAT. ANN. §§ 41A.01-41A.09 (West Supp. 1989).

40. For a general discussion of operational financing in Chapter 11 cases, *see* Dodd, *Obtaining Operating Capital in a Chapter 11 Reorganization Proceeding Under* §§ 363(c) and 364(d) of the Bankruptcy Code, 1983 ANN. SURV. BANKR. L. 217; Hershner & Boyer, *The Financing of Crops in Chapter 11 Cases*, NORTON BANKR. L. ADVISER, Dec. 1984, at 13: Lodoen, *Chapter 11 Farm Reorganizations: Farmers Beware!*, 9 J. AGRIC. TAX'N & L. 99 (1987); Note, *Section 364(d) Superpriority Financing: Has a Secured Creditor Met His Match?*, 5 BANKR. DEV. J. 109 (1988).

41. *See* Lodoen, *supra* note 40, at 105.

filing of the Chapter 12 petition would be futile and a waste of money. The debtor will save attorney fees, court costs, and time if he and his attorney adequately investigate the operational financing issue prior to filing a petition in a bankruptcy court.[42]

Proper timing of the commencement of the Chapter 12 proceeding may also be crucial to a successful reorganization. If possible, the debtor should plan the filing of the petition at a time when operating capital is available. Unless the debtor is able to obtain new financing or has unencumbered assets on hand, he will probably need to use the cash proceeds of encumbered grain or livestock to finance the continued operation of the farm. Therefore, if he plans to use the proceeds of grain or livestock, he should start the case when he has large levels of inventory on hand. With court approval, the debtor can use the cash collateral which the grain or livestock sale creates to pay expenses of planting a new crop or feeding livestock.[43] If there is no inventory of grain or livestock on hand, the debtor may have no source of financing he can rely on to continue operating the farm.

If there are no unencumbered assets or cash collateral available, the debtor should seek a commitment from a new lender to finance the farming operation.[44] The debtor should not begin bankruptcy with the hope of

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42. The average cost of confirming Chapter 12 plans in Iowa included attorney's fees and expenses of $9,937 and trustee's fees of $3,441. Faiferlick & Harl, *supra* note 17, at 331.

43. 11 U.S.C. § 363(c)(2) (1982) provides that the trustee may not use cash collateral unless each interested entity consents or the court authorizes such use after notice and a hearing.

44. 11 U.S.C. § 364 (1982 & Supp. IV 1986) provides as follows:

(a) If the trustee is authorized to operate the business of the debtor under section 721, 1108, 1304, 1203, or 1204, of this title, unless the court orders otherwise, the trustee may obtain unsecured credit and incur unsecured debt in the ordinary course of business allowable under section 503(b)(1) of this title as an administrative expense.

(b) The court, after notice and a hearing, may authorize the trustee to obtain unsecured credit or to incur unsecured debt other than under subsection (a) of this section, allowable under section 503(b)(1) of this title as an administrative expense.

(c) If the trustee is unable to obtain unsecured credit allowable under section 503(b)(1) of this title as an administrative expense, the court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt-

(1) with priority over any or all administrative expenses of the kind specified in section 503(b) or 507(b) of this title;

(2) secured by a lien or property of the estate that is not otherwise subject to a lien; or

(3) secured by a junior lien on property of the estate that is subject to a lien.

(d) (1) The court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on

finding a new lender post-filing. As indicated in the previous section, most agricultural lenders are reluctant to finance a bankrupt debtor.[45]

III. Obtaining Credit Under Section 364

If the Chapter 12 debtor cannot use cash collateral and has no unencumbered funds, he will probably need to obtain new credit to continue farming. Because of the need for post-petition financing, the Code contains provisions in section 364 specifically dealing with the rights and procedures for obtaining such credit.[46]

The farmer-debtor may be able to obtain credit from a relative, friend, supplier, private lender, the Farm Credit System or a government lender. Every lender should become familiar with section 364 before extending credit to a Chapter 12 debtor.[47] The court must approve the extension of any credit, other than unsecured credit or unsecured debt "in the ordinary course of business."[48]

A. *Obtaining Unsecured Credit*

A trustee or debtor-in-possession may obtain unsecured credit in the ordinary course of business,[49] unless the court orders otherwise.[50] This

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property of the estate that is subject
to a lien only if -
(A) the trustee is unable to obtain such credit otherwise; and
(B) there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted.
(2) In any hearing under this subsection, the trustee has the burden of proof on the issue of adequate protection.

45. Banks appear to be requiring more collateral, stronger financial conditions and cash flow projections in reaction to Chapter 12. Welsh, *Chapter 12 is Our Only Hope*, Farm J., April, 1987, at 18, 19.

46. *See* 11 U.S.C. § 364 (1982 & Supp. IV 1986).

47. For a discussion of obtaining credit under section 364, *see* Dodd, *supra* note 40; Grossman, *Troubled Times: The Farm Debtor Under the Amended Bankruptcy Code*, 38 Okla. L. Rev. 579 (1985); Note, *Section 364(d) Superpriority Financing: Has a Secured Creditor Met His Match?*, 5 Bankr. Dev. J. 109 (1988).

48. 11 U.S.C. § 364 (1982 & Supp. IV 1986).

49. It is extremely important for both the debtor and the new creditor to determine if the credit is being obtained in the ordinary course of business. However, the Bankruptcy Code fails to provide any definition or guidelines for an "ordinary course" transaction. In Creditors v. Johns-Manville Corp. (*In re* Johns-Manville Corp.), 60 Bankr. 612 (Bankr. S.D.N.Y.), *rev'd on other grounds*, 801 F.2d 60 (2d Cir. 1986), the court set out an analysis to use when determining if a post-petition transaction is in the ordinary course of business. The court considered whether a certain post-petition transaction was entered into in the ordinary course of business through the use of two different tests: the "creditor's expectation test"

unsecured credit will be allowed under section 503(b)(1) as an administrative expense payable before other prioritized and unprioritized unsecured debts.[51] The Chapter 12 debtor can incur ordinary debts, such as seed, fertilizer, and feed bills and assure the supply creditors that their debts will receive priority.

In addition, the court can authorize the debtor in possession to obtain unsecured credit other than in the ordinary course of business.[52] This new creditor will also be given an administrative expense priority.[53]

The creditor should be aware of the risks involved in extending credit under section 364(a) or (b). The priority afforded by the grant of an administrative expense priority may not be enough protection for the new creditor. Many of the Chapter 12 reorganizations will probably fail and be converted into Chapter 7 liquidations. The administrative expenses of a superseding Chapter 7 case will have a priority over administrative expenses of a superseded Chapter 12 case.[54] Therefore, all administrative expenses in the Chapter 7 proceeding will be paid first, which may result in payments of little or nothing to the section 364(a) or (b) creditor.

Additionally, a secured creditor who is afforded adequate protection that later proves to be inadequate will be entitled to a priority claim under section 507(b). This claim will have priority over general administrative expenses, including the unsecured debt incurred under section 364(a) or (b).[55] The court in *In re Callister* held that a creditor was entitled to a

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and the "horizontal dimension test". The creditor's expectation test examines the debtor's transaction from the view of a hypothetical creditor and inquires whether the transaction subjects a creditor to economic risks of a nature different from those he accepted when he decided to extend credit. *Id.* at 616. The second analysis used in *Johns-Manville* was the horizontal dimension or industry-wide test. This test compares the business of this debtor to other similiar businesses. The court must decide whether a type of transaction is in the course of that debtor's business or in the course of some other business. *Id.* at 618.

50. 11 U.S.C. § 364(a) (Supp. IV 1986).

51. *Id.*

52. *Id.* § 364(b).

53. *Id.*

54. 11 U.S.C. § 726(b) (Supp. IV 1986) provides as follows:

Payment on claims of a kind specified in paragraph (1), (2), (3), (4), (5), (6) or (7) of section 507(1a) of this title, or in paragraph (2), (3), (4) or (5) of subsection (a) of this section, shall be made pro rata among claims of the kind specified in each such particular paragraph, except that in a case that has been converted to this chapter under section 1112, 1208, or 1307 of this title, a claim allowed under section 503(b) of this title incurred under this chapter after such conversion has priority over a claim allowed under section 503(b) of this title incurred under any other chapter of this title or under this chapter before such conversion and over any expenses of a custodian superseded under section 543 of this title.

55. 11 U.S.C. § 507(b) (1982) provides as follows:

If the trustee, under section 362, 363, or 364 of this title, provides adequate

superpriority status because the adequate protection which the debtor provided was inadequate.[56] The collateral the debtor used was diminishing in value due to unforeseeable market forces, destruction, and depreciation. Because of the superpriority status, the creditor was entitled to be paid before the payment of general administrative expenses.[57] The creditor who extends credit under section 364(a) or (b) must be aware that the secured creditor who is inadequately protected will receive payment before the new creditor. The new creditor under section 364(a) or (b) extends unsecured credit which is entitled only to payment as a general administrative expense.[58]

The issuance of a financing order under section 364(c)(1) also creates a superpriority lien that has priority over any or all administrative expenses including credit extended under sections 364(a) and (b).[59] In *In re Flagstaff Food Service Corp.*, the court held that the administrative expenses of attorney and accountant fees could not be paid from the estate until the section 364(c) lien was fully satisfied.[60] In this case the fees of the attorneys and accountants were not paid.[61] The court stated that "knowledgeable bankruptcy attorneys must be aware that the priority ordinarily given to administrative expenses may prove illusive in light of the various provisions in the Code for competing or super-priorities."[62]

B. *Obtaining Credit with Superpriority Administrative Expense*

Because a new creditor will not have any special priority under either section 364(a) or (b), it is doubtful the Chapter 12 debtor will be able to induce a new lender to extend operational financing under either of the provisions. If the trustee is unable to obtain unsecured credit allowable under section 503(b)(1) as an administrative expense, the court, after notice and a hearing, may authorize obtaining of credit or incurring of debt with: (1) priority over all administrative expenses; (2) security in the form of a lien on unencumbered assets; or (3) security in the nature of a junior lien

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protection of the interest of a holder of a claim secured by a lien on property of the debtor and if, notwithstanding such protection, such creditor has a claim allowable under subsection (a)(1) of this section arising from the stay of action against such property under section 362 of this title, from the use, sale, or lease of such property under section 363 of this title, or from the granting of a lien under section 364(d) of this title, then such creditor's claim under such subsection shall have priority over every other claim allowable under such subsection.

56. *In re* Callister, 15 Bankr. 521 (Bankr. D. Utah 1981).

57. *Id.*

58. 11 U.S.C. § 364(a), (b) (1982 & Supp. IV 1986).

59. *Id.* § 364(c)(1).

60. General Electric Credit Corp. v. Levin & Weintraub (*In re* Flagstaff Food Serv. Corp.), 739 F.2d 73 (2d Cir. 1984).

61. *Id.*

62. *Id.* at 75.

on property that is subject to a lien pursuant to section 364(c).[63]

The farm debtor will probably not have any unencumbered assets that can be offered as security, unless a security interest in after-acquired property is nullified under section 552.[64] Additionally, it is doubtful that he will be able to find a new creditor willing to accept a junior lien. Therefore, the debtor's best chance of obtaining credit under section 364(c) will be through the use of a superpriority administrative expense.[65] Since section 364(c) only applies to situations where the status of existing liens and property rights remain unchanged by the new borrowing, there is no requirement of adequate protection to existing secured creditors.[66] However, once a new creditor is given a lien status he should be entitled to adequate protection if subsequent credit extensions are made under section 364(c) or section 364(d).[67]

This superpriority afforded the farm supplier or lender gives them a superior administrative claim that must be satisfied prior to any other administrative expenses.[68] While this is a valuable method of protection to the new creditor, the creditor must be aware that often times administrative expenses remain totally unpaid, especially if the farm reorganization fails and results in liquidation. If the case is converted to a Chapter 7 proceeding, there may be no assets available for payment of administrative expenses after secured claims are satisfied.[69]

C. *Obtaining Credit Through Senior Lien*

Since creditors may be unwilling to extend credit on the basis of a junior lien or superpriority administrative expense, the Code authorizes obtaining credit secured by a senior or equal lien on property of the estate that is already subject to a lien.[70] Credit extended under sections 364(a), (b), or (c) is not secured by any particular assets of the estate. Therefore, there is a risk of nonpayment. Any credit extended under section 364(d) will be secured by particular assets of the estate. Therefore, the new creditor would be assured of recovering at least the value of the secured property.[71]

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63. 11 U.S.C. § 364(c) (1982).
64. *See id.* § 552.
65. Many farm lenders accepted junior liens as security for loans in the past. However, due to declining land values, many of these junior liens were unsecured and of no value to the creditor. Therefore, most farm lenders will probably be reluctant to grant new credit secured by a junior lien.
66. J. ANDERSON & J. MORRIS, CHAPTER 12 FARM REORGANIZATIONS § 5.10, at 5-48 (1987-88).
67. 2 COLLIER ON BANKRUPTCY para. 364.04, at 364-10 (15th ed. 1979).
68. 11 U.S.C. § 364(c)(1) (1982).
69. Administrative expenses are payable from unsecured estate property only.
70. 11 U.S.C. § 364(d) (1982).
71. *See id.* § 506(a).

The senior lien granted under section 364(d) is a very valuable protection for the new creditor. All creditors would be well advised to seek a senior lien when extending credit to a Chapter 12 debtor. However, the court can only authorize credit under section 364(d) if the debtor in possession establishes that he was unable to obtain credit otherwise and that there is adequate protection of the lienholder's interest in the property upon which the senior lien will be granted.[72]

1. Inability to Obtain other Credit

A recent Chapter 12 case discussed the requirement that the debtor establish his inability to obtain other credit.[73] In *In re Stacy Farms*,[74] the debtor requested authorization to incur debt under section 364(d) and grant a superpriority senior lien to Dime Bank, a post-petition lender. The court concluded that the debtor failed to establish its inability to obtain other, more favorable credit. The debtor's only evidence of inability to obtain credit was the Farmers Home Administration's (FmHA) refusal to provide working capital for 1987 and the debtor's counsel's statement that lenders required a superpriority lien in this type of situation. There was no evidence that debtor had sought loans from institutions other than Dime Bank or FmHA, or that Dime Bank's commitment was the most favorable credit available. Therefore, the court concluded that the debtor failed to carry its burden under section 364(d)(1)(A).[75] Other cases have refined this conclusion. *In re Crouse Group*, a Chapter 11 proceeding, held that the debtor failed to establish his inability to obtain credit in accordance with section 364(d) since he had only approached one lender and never even asked any of his existing creditors if they would extend credit.[76] *In re Snowshoe Co.* held that the Code imposes no duty to seek credit from every possible lender before concluding that credit is unavailable without senior lien status.[77] The court concluded that the debtor had met the requirement by contacting several financial institutions in the immediate geographic area.[78]

It does not appear the debtor has to make an exhaustive search for credit. However, he should approach more than one lender in seeking credit in accordance with section 364(a) or (b). For example, a Chapter 12 debtor living in a small, rural county should probably try to seek operating capital from several local banks in the county, the Farm Credit

72. *Id.* § 364(d)(1)(A), (B).
73. *In re* Stacy Farms, 78 Bankr. 494 (Bankr. S.D. Ohio 1987).
74. *Id.* at 498.
75. *Id.* at 498-99.
76. *In re* Crouse Group, Inc., 71 Bankr. 544, 550 (Bankr. E.D. Pa. 1987).
77. Bray v. Shenandoah Fed. Sav. & Loan Ass'n (*In re* Snowshoe Co., Inc.), 789 F.2d 1085, 1088 (4th Cir. 1986).
78. *Id.*

System, and government entities such as FmHA before seeking an order to obtain secured credit.

2. Adequate Protection

Since the debtor under section 364(a) grants a new lien on property already subject to a security interest, the pre-petition lienholder must be provided with adequate protection.[79] The provision of adequate protection had been a major stumbling block for many farmers attempting to reorganize under the Bankruptcy Code.[80] The drafters of the new Chapter 12 provisions noted that lost opportunity costs payments present serious barriers to farm reorganization because farmland values had dropped dramatically. Family farmers are normally unable to pay lost opportunity costs. Because of this stringent requirement, many family farm reorganizations were "throttled in their infancy" when a secured creditor filed a motion for relief from automatic stay.[81] Section 361 of the Code provides that adequate protection may be provided by granting such relief that will result in the realization by the secured party of the indubitable equivalent of such entity's interest in such property.[82] Because of the harshness of section 361 to the successful family farm reorganization, the drafters of the Chapter 12 provisions developed a new adequate protection standard to be used exclusively in Chapter 12 cases.[83]

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79. 11 U.S.C. § 364(d)(1)(B) (1982).

80. Wilson, *supra* note 3, at 303. The elimination of the need to pay lost opportunity costs is no longer exclusive to Chapter 12 cases, as the Supreme Court has recently decided an undersecured creditor is not entitled to interest on its collateral while the automatic stay is in effect. The Supreme Court's decision in United States Savings Ass'n v. Timbers of Inwood Forest Assoc., 108 S. Ct. 626 (1988), resolves a conflict between circuits. The Fourth Circuit in Grundy Nat'l Bank v. Tandem Mining Corp., 754 F.2d 1436 (4th Cir. 1985) and the Ninth Circuit in Crocker Nat'l Bank v. American Mariner Indus., Inc. (*In re* American Mariner Indus., Inc.), 734 F.2d 426 (9th Cir. 1984) had held that an undersecured creditor is entitled as a matter of law to periodic interest payments during the proceeding. The Eighth Circuit determined in *In re* Briggs Transp. Co., 780 F.2d 1339 (8th Cir. 1986) that an undersecured creditor is not entitled to such payment as a matter of law, but may be so entitled under certain circumstances. The Fifth Circuit held in 1985 that a creditor is not entitled to such payments as a matter of law. This is the case the Supreme Court affirmed.

81. H.R. Rep. No. 958, 99th Cong., 2d Sess. 49, *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS 5246, 5250.

82. 11 U.S.C. § 361(3) (1982).

83. *Id.* § 1205 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

Section 1205 eliminates the need to pay lost opportunity costs.[84] There is no indubitable equivalent language contained in section 1205. It is clear that what needs to be protected is the value of property, not the creditor's interest in property.[85] In addition, section 1205 includes a new means for providing adequate protection.[86] A Chapter 12 debtor can provide adequate protection for farmland by paying the "reasonable rent customary in the community where the property is located."[87] In addition to reasonable rent, the debtor can provide adequate protection by cash payments or replacement liens.[88] Section 1205 also contains a "catch all" provision, which allows adequate protection through such other relief as will adequately protect the secured creditor's value, other than entitling such creditors to compensation allowable under section 503 (b) (1) as an administrative expense.[89] The focus of at least three of these types of adequate protection is protecting the creditor's value in the collateral.[90]

a. Rental Payments

The concept of paying reasonable rent may be a valuable method of providing adequate protection for the Chapter 12 debtor.[91] The payment of customary rental value would probably be the cheapest method of providing adequate protection to farm lenders with liens on agricultural land.[92] An Ohio bankruptcy court recently discussed this new method.[93] In

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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 the 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 property.

84. *Id.*

85. H.R. Rep. No. 958, 99th Cong., 2d Sess. 49-50, *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS 5246, 5250-51.

86. H.R. Rep. No. 958, 99th Cong., 2d Sess. 49, *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS, 5246, 5250.

87. 11 U.S.C. § 1205(b)(3) (Supp. IV 1986).

88. *Id.* § 1205(b)(1),(2).

89. *Id.* § 1205(b)(4).

90. *See id.* § 1205(b)(1),(2),(4).

91. Armstrong, *supra* note 3, at 192-93.

92. *Id.*

93. *In re* Kocher, 78 Bankr. 844 (Bankr. S.D. Ohio 1987).

In re Kocher, the Federal Land Bank, a secured farmland creditor, sought relief from the automatic stay because the debtor failed to provide adequate protection.[94] The debtor's offer of adequate protection was to pay reasonable market rent to the Federal Land Bank, which the debtor argued was no more than $40 per tillable acre. Federal Land Bank objected on the grounds that $40 per tillable acre was not a reasonable rent. Further, the Bank argued that $40 per acre would be far less than the projected decline in the value of the land over the next year.[95] The court, noting that the Federal Land Bank had introduced no persuasive evidence as to the land's value, held the Federal Land Bank was entitled only to $40 per tillable acre.[96] Moreover, in dicta, the court suggested that section 1205(b)(3) provides that the debtor's payment of a fair rental value constitutes adequate protection "per se."[97] The debtor does not need to provide the creditor with any more than the fair rental value of the land.

In its analysis, the court considered the legislative intent of Chapter 12, which was to give family farmers a fighting chance to reorganize their debts and keep their land.[98] It stated that to require the reasonable rental payments to completely offset the decrease in the secured creditor's collateral would "subvert the purpose of Chapter 12 and would stand the legislative history of section 1205 on its head."[99]

Senator Charles Grassley, the author of section 1205(b)(3), explained the rationale for allowing the Chapter 12 debtor to use this alternative form of adequate protection:

> Allowing the farmer-debtor to provide adequate protection by paying rent recognizes the economic realities of foreclosure. During a time of depressed farm values, the lender will usually be the high bidder at a foreclosure sale. If the lender cannot resell the property, it typically will rent the property at the market rate. If the debtor pays market rent while he reorganizes, the lender will be getting only what it would realistically get as a result of foreclosure. Paying a reasonable rent as a method of protecting secured creditors was permitted during the Depression by the second Frazier-Lemke Act, which survived constitutional challenge in the Supreme Court.[100]

This legislative history suggests that courts may follow the dicta in *Kocher*[101] and limit secured parties to reasonable rent even when doing so will not compensate the secured creditor for the decline in the farmland's value.[102]

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94. *Id.*
95. *Id.* at 848.
96. *Id.* at 850.
97. *Id.*
98. *Id.*
99. *Id.*
100. 132 CONG. REC. S3529 (daily ed. Mar. 26, 1986) (statement of Sen. Grassley).
101. *See In re* Kocher, 78 Bankr. 844, 850 (Bankr. S.D. Ohio 1987).
102. 132 CONG. REC. S3529 (daily ed. Mar. 26, 1986) (statement of Sen. Grassley).

The rental value form of adequate protection has given rise to other issues as well. Courts have addressed whether a farmland lender is entitled to rental payments even if the farmland's value is stable. The Code does not indicate whether debtors must pay reasonable rent to all farmland creditors or just those where there is a decrease in the value of property.[103] The legislative history indicates that reasonable rent is all that a creditor could expect if the automatic stay were not in effect and the creditor were allowed to foreclose.[104] This language appears to indicate that the farmland secured creditor should be entitled to reasonable rental payments regardless of whether there is a decline in value during the stay period.[105] Additionally, unlike the three other subsections in section 1205, the statutory language is not limited to the situation where farmland is declining in value.[106] But allowing the secured creditor to receive rental payments when there is no decline in value of the land would in effect give them lost opportunity cost payments.[107] As previously indicated, lost opportunity cost payments were intended to be eliminated from Chapter 12.[108]

In re Turner held that the provision in Chapter 12 for adequate protection through the payment of reasonable customary rent did not mandate that secured claims in land with stable value were entitled to rental payments.[109] In *Turner*, Travelers Insurance Company held a first lien on real estate. The creditor offered no proof as to whether the land was declining in value. The court held that the secured creditor is required to show a necessity for adequate protection, which includes at least a showing that the farm property securing the debt was likely to decrease in value between the time of the filing of the petition and confirmation of the plan.[110] The court noted that if Travelers, the secured creditor, was attempting to obtain rental payments as compensation for use of its collateral, the request would in reality be a request for lost opportunity costs, which are not recoverable in Chapter 12.[111] It held that section 1205(b)(3) did not authorize the granting of rental payments to a farmland lender when the land value was stable.[112]

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103. *See* 11 U.S.C. § 1205(b)(3) (Supp. IV 1986); *see also* 6 COLLIER BANKRUPTCY PRACTICE GUIDE para. 100.11, at 100-53, 54 (1988).

104. 132 CONG. REC. S3529 (daily ed. Mar. 26, 1986) (statement of Sen. Grassley).

105. 6 COLLIER BANKRUPTCY PRACTICE GUIDE para. 100.11, at 100-53, 54 (1988).

106. *See* 11 U.S.C. § 1205(b) (Supp. IV 1986); *see also* 6 COLLIER BANKRUPTCY PRACTICE GUIDE para. 100.11, at 100-53, 54 (1988).

107. *In re* Turner, 82 Bankr. 465, 468-69 (Bankr. W.D. Tenn. 1988).

108. H.R. Rep. No. 958, 99th Cong., 2d Sess. 48, *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS 5246, 5250.

109. *In re* Turner, 82 Bankr. 465 (Bankr. W.D. Tenn. 1988).

110. *Id.* at 468-69.

111. *Id.*

112. *Id.*

The *Turner* court also noted in dicta its agreement with the *Kocher* court.[113] The *Turner* court stated that if Travelers showed a decrease in value, the rental payments would be all that it was entitled to receive even though this failed to compensate Travelers for the decrease in value of the land.[114]

It appears clear that a secured creditor can obtain rental payments during the automatic stay if the value of the land is declining.[115] The issue of whether rental payments can be a basis for adequate protection in a section 364 situation, however, is not as clear. Section 1205(b) states that when sections 362, 363, or 364 require adequate protection of an entity's interest in such property, the debtor may provide that protection by paying reasonable customary rent for the farmland's use.[116] However, if section 364(d) allowed this sort of adequate protection, serious consequences would result for the secured farmland lender.

An example of a section 364 transaction may help clarify the problem. Suppose a Chapter 12 debtor obtains an operating loan for $500,000 from Hometown Bank and the court approves a financing order which grants Hometown Bank a senior lien on 1,000 acres of farmland, which is worth $500,000. This farmland is already subject to a security interest in the amount of $800,000, held by Federal Land Bank. The court can only grant a new post-petition lender senior lien status if the pre-petition secured creditor is adequately protected.[117] If the adequate protection payments are based on the reasonable, customary rent, it is possible that a lienholder could suffer a loss for which it is not compensated and still be adequately protected under the definition set forth in section 1205.

The payment of reasonable customary rent will not always provide protection in the amount of new credit extended. If the Chapter 12 plan fails and is converted to a Chapter 7 proceeding, the land will be sold and Hometown Bank will receive the amount of new credit extended before Federal Land Bank receives anything from the liquidation proceeds.[118] Since the market value of the property is less than Hometown's and Federal Land Bank's liens, Federal Land Bank will suffer a loss to the extent that the new credit extended exceeds the reasonable rental payments. For example, suppose the customary rent is $40.00 per tillable acre, which was the fair rental value proposed in *Kocher*.[119] The Federal Land Bank would receive adequate protection payments of $40,000 during the first year. If the Chapter 12 case is converted to Chapter 7 within the first year of the

113. *Id.* at 468.
114. *Id.*
115. *See In re* Turner, 82 Bankr. 465 (Bankr. W.D. Tenn. 1988).
116. 11 U.S.C. § 1205(b)(3) (Supp. IV 1986).
117. *Id.* § 364(d)(1)(B).
118. *See id.* § 364(d).
119. *See In re* Kocher, 78 Bankr. 844, 850 (Bankr. S.D. Ohio 1987).

plan it is possible that Federal Land Bank may receive nothing from the Chapter 7 liquidation proceeds, even though it had a first lien prior to the filing of the Chapter 12 petition. The Federal Land Bank will be entitled to compensation for inadequate protection payments under section 507(b).[120] However, if there are no unsecured assets in the estate, the creditor will not receive any payment.

If the court determined that reasonable rental payments would not constitute adequate protection in a section 364(d) situation, the Federal Land Bank would not suffer this large loss. The court would not allow the debtor to obtain credit from Hometown Bank with senior lien status unless Federal Land Bank was adequately protected from a decrease in the value of its lien.[121] If the case was converted to Chapter 7, the Federal Land Bank would receive at least the value of the land, even if there was no payout on unsecured debt.

The issue of adequate protection is different in a section 362 motion to lift the automatic stay than when a debtor wishes to obtain credit under section 364(d).[122] In the automatic stay situation, the debtor still has a security interest in the bargained for collateral. However, if a senior lien is granted to a new creditor under section 364(d), the secured creditor's security interest is diluted by the amount of new credit.[123] The payment of reasonable rent should provide adequate protection in a section 362 relief from stay motion.[124] However, if the rental payments are less than the amount of new credit extended under section 364(d), the court should hold that the subordinated creditor is not adequately protected.

b. Constitutionality of Rental Payments as Adequate Protection

If section 1205(b)(3) is construed to allow Chapter 12 debtors to provide adequate protection by only paying reasonable rent, when the grant of a senior lien under section 364 reduces the creditor's ownership position,[125] constitutional problems may arise. In situations where the reasonable rental payments are less than the amount of the new senior lien, there would likely be an unconstitutional taking under the fifth amendment of the Constitution.[126] As indicated in the previous section, rental payments will probably be much less than the amount of the new senior lien.

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120. 11 U.S.C. § 507(b) (1982).
121. *See id.* § 364(d)(1)(B).
122. *In re* Berens, 41 Bankr. 524, 527 (Bankr. D. Minn. 1984).
123. 11 U.S.C. § 364(d) (1982).
124. *Id.* § 362(d)(1) provides that the court shall grant a creditor relief from the automatic stay for cause, including the lack of adequate protection.
125. *See* 11 U.S.C. § 364(d)(3) (1982).
126. *See generally* Dodd, *supra* note 40.

The concept of adequate protection is derived from the fifth amendment,[127] which provides that no person shall be deprived of life, liberty or property, without due process of law, nor shall private property be taken for public use without just compensation.[128] A recent Chapter 12 case discussed this fifth amendment issue.[129] In *In re Bullington*, the debtors proposed a plan of reorganization in which the secured claim of Travelers Insurance Company would be reduced from the loan balance of $645,929.77 to $475,000, the fair market value of the farm. Travelers objected to the plan proposal on the grounds that it made the loan a year before Chapter 12 was enacted. The insurance company argued it relied on the fact that the only relief that would be available to debtors was a Chapter 11 reorganization.[130]

The bankruptcy court held that allowing the debtor to propose a plan which only pays the secured creditor the fair market value of the property is not a violation of the fifth amendment.[131] The court stated that "[a] mortgage may be voided to the extent it is unsecured without being an unconstitutional deprivation of property, since the result is the same as in foreclosure . . . ."[132]

Since a security interest has been held to be a property interest within the meaning of the fifth amendment, its diminution in value is considered a taking if no compensation is provided.[133] Through the enactment of Chapter 12, Congress has certainly indicated that it favors successful reorganization of family farms.[134] However, the failure to provide adequate protection cannot be rendered constitutional simply because Congress has decided to favor reorganization.

The court in *In re Saypol* held that the legislative history of the adequate protection provisions of section 361[135] centers on protecting a secured

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127. H.R. Rep. No. 595, 95th Cong., 1st Sess. 339 (1977).

128. Amendment V of the United States Constitution provides as follows: No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any person be subject to jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.

129. *In re* Bullington, 80 Bankr. 590 (Bankr. M.D. Ga. 1987).

130. *Id.* at 591.

131. *Id.* at 593-94.

132. *Id.*

133. *See* Wright v. United Cent. Life Ins. Co., 311 U.S. 273 (1940); Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555 (1935).

134. *See* H.R. Rep. No. 958, 99th Cong., 2d Sess. 48, *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS 5249.

135. *See* S. Rep. No. 989, 95th Cong., 2d Sess. 53, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5839; H.R. Rep. No. 575, 95th Cong., 1st Sess. 338-39, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6295-96.

creditor from suffering a decline in the value of the collateral during the bankruptcy proceeding.[136] Although section 361 is inapplicable to Chapter 12 cases,[137] it appears that the secured creditor must be protected from a decline in value of his security interest to meet constitutional requirements.[138]

In considering whether an offer of adequate protection is appropriate in a particular case, a bankruptcy court should: 1) determine the value of the secured creditor's interest; 2) determine the risks to that value that will result from the debtor's use of the property; and 3) determine whether the adequate protection proposal protects that value of the secured claim from the risks to which it is exposed.[139] It is important to note that the issue as to adequate protection is different in a section 362 motion to lift the automatic stay than when a debtor wishes to use cash collateral or obtain credit under section 363 or 364.[140] If the automatic stay is not lifted, the creditor still has a security interest in the bargained for existing collateral.[141] If a debtor is allowed to use cash collateral under section 363, the creditor's security is gone. The secured party no longer has the asset it originally bargained for as collateral.[142] Likewise, if a debtor is allowed to obtain credit by granting a senior lien on already encumbered property, the subordinated creditors's security interest is diluted by the amount of new credit.[143]

Since a creditor actually loses his collateral under sections 363 and 364, the standard of adequate protection must be very high.[144] The court must, in spite of a provision that favors reorganization, be aware that bankruptcy power is subject to the fifth amendment, which prohibits the taking of private property without compensation and due process of law.[145] The offering of reasonable, customary rental payments as adequate protection[146] to a secured creditor whose lien is being subordinated pursuant to section 364(d) would probably not meet constitutional requirements. If the rental payments were less than the amount of the new senior lien, there would likely be an unconstitutional taking under the fifth amendment.

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136. Barclays Bank of N.Y. v. Saypol (*In re* Saypol), 31 Bankr. 796, 800 (Bankr. S.D.N.Y. 1983).

137. *See* 11 U.S.C. § 1205(a) (Supp. IV 1986).

138. *See* Dodd, *supra* note 38, at 217-20.

139. *See In re* Feather River Orchards, 56 Bankr. 972, 974 (Bankr. E.D. Cal. 1986).

140. *See In re* Berens, 41 Bankr. 524, 527 (Bankr. D. Minn. 1984).

141. *Id.* at 527-28.

142. *Id.*; *see also* 11 U.S.C. § 363(e) (Supp. IV 1986).

143. *See* 11 U.S.C. § 364(d) (1982).

144. *See In re* Polzin, 49 Bankr. 370, 371-72 (Bankr. D. Minn. 1985); *In re* Berens, 41 Bankr. 524, 527-28 (Bankr. D. Minn. 1984).

145. Dodd, *supra* note 38, at 219.

146. 11 U.S.C. § 1205(b)(3) (Supp. IV 1986).

c. *Replacement Lien*

The issuance of a replacement or rollover lien to a secured creditor has been a popular form of adequate protection in Chapter 11 farm reorganizations.[147] Since section 1205 also provides that replacement liens are a permissible form of adequate protection,[148] Chapter 12 debtors will certainly attempt to use cash collateral or obtain credit by granting the secured creditor a replacement lien in the next season's crop.

In a recent Chapter 12 case, however, the court held that a replacement lien did not constitute adequate protection because it was too speculative.[149] The Chapter 12 debtor attempted to obtain credit under section 364(d) by granting the secured creditor a replacement lien in the next season's harvest proceeds.[150] The court agreed with the reasoning of other courts in Chapter 11 proceedings, stating that "[s]atisfaction of a lien from future crop proceeds is insufficient to constitute adequate protection against the loss of a lien on existing collateral due to the uncertainty and speculation necessarily attendant to the farming business."[151]

The court noted that a replacement lien was not adequate protection despite the elimination of the "indubitable equivalent" language and the requirement in some circuits to pay lost opportunity costs.[152] While the court realized that without new credit the farm would go out of business, it felt that the offer of adequate protection must be weighed against the express provision of law. The court was unwilling to eradicate the collateral positions of the secured creditors without determining that they had received adequate protection for their loss, as doing so would not comport with the Congressional intent behind the enactment of section 364(d).[153]

The issue of whether a replacement lien constitutes adequate protection has been extensively litigated in Chapter 11 cases involving the use of cash collateral.[154] As the replacement lien will certainly be an issue in determining whether a Chapter 12 debtor can use cash collateral, it is fully discussed later in the cash collateral section of this Article.

Although section 1205 specifically allows that the provision of a replacement lien or paying cash or reasonable rental payments may constitute adequate protection, these are only examples of adequate protection in Chapter 12 cases.[155] The only means which section 1205 prohibits is the

147. ANDERSON & MORRIS, *supra* note 66, § 1.17, at 1-74.
148. 11 U.S.C. § 1205(b)(2) (Supp. IV 1986).
149. *In re* Stacy Farms, 78 Bankr. 494 (Bankr. S.D. Ohio 1987).
150. *Id.* at 497.
151. *Id.* at 498.
152. *Id.*
153. *Id.*
154. ANDERSON & MORRIS, *supra* note 66, § 1.17, at 1-74.
155. 2 COLLIER ON BANKRUPTCY para. 361.01, at 361-14 (15th ed. 1988).

offering of an administrative expense priority under section 503(b)(1).[156] Other forms of adequate protection include a third party guarantee;[157] limiting or conditioning the conduct of business operations; providing insurance coverage; allowing inspection of collateral; providing accounting information; and segregation and accounting for cash collateral.[158]

As previously indicated, the Code specifically provides that the debtor must demonstrate the inability to obtain credit under sections 364(a) or (b) and provide adequate protection before the court will approve a section 364(d) financing agreement.[159] In addition to these requirements, the court may require that some restrictions be placed in a financing order before granting a superpriority or senior lien status.[160] *In re Stratbucker* held that credit could only be granted under section 364(c) or (d) if certain restrictions were met.[161] The court stated that the priority would be limited to those contracts in which the interest rate did not exceed 18% per year.[162] Additionally, the court stated the priority shall not be granted to any debt unless it is evidenced by a written contract specifying the nature and amount of goods purchased, the price, the rate of interest, and the term of repayment.[163]

The court may also require the debtor to establish that the proposed lending agreement is fair, reasonable, and adequate under the circumstances. *In re Reading Tubing Industries* held that the debtor has the burden to demonstrate that less onerous post-petition financing was unavailable.[164] The Chapter 12 debtor will probably need to show that the terms of a section 364 financing agreement are reasonable before the court will approve such an agreement. The fact that the agreement calls for a higher than average interest rate or stringent reporting requirements will probably not render such an agreement unreasonable.

D. *Cross-collateralization Clauses*

The provisions of section 364 were designed to encourage lenders to lend money to reorganizing debtors and thereby effectuate the rehabilitative

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156. 11 U.S.C. § 1205(b)(4) (Supp. IV 1986).

157. *See In re* Reading Tubing Indus., 72 Bankr. 329, 333 (Bankr. E.D. Pa. 1987); LaSalle Nat'l Bank v. Harrow Leasing Corp. (*In re* Harrow Leasing Corp.), 35 Bankr. 916, 921-22 (Bankr. E.D. Pa. 1983).

158. 3 COLLIER BANKRUPTCY PRACTICE GUIDE para. 41.06, at 41-22, 23 (1988).

159. 11 U.S.C. § 364(d)(1)(A), (B) (1982).

160. 5 COLLIER BANKRUPTCY PRACTICE GUIDE para. 89.08, at 89-14, 15 (1988).

161. *In re* Stratbucker, 4 Bankr. 251, 252 (Bankr. D. Neb. 1980).

162. *Id.* at 253.

163. *Id.*

164. *In re* Reading Tubing Indus., 72 Bankr. 329, 332 (Bankr. E.D. Pa. 1987).

theme of bankruptcy.[165] However, the providing of administrative expense priority, superpriority status, or senior lien status[166] alone may not be enough to entice new lenders. Many agricultural lenders have absorbed huge losses because of bankrupt debtors.[167] Accordingly, they have been reluctant to provide new financing to Chapter 12 debtors; choosing instead to lend to non-farm businesses or invest in treasury bills.[168]

To encourage new creditors to make operational loans to Chapter 12 debtors, the court may need to allow the inclusion of a cross-collateralization clause in a loan secured under a section 364(c) or (d) financing order.[169] Such a provision would be in addition to the superpriority or senior lien status. Cross-collateralization is an arrangement in which the creditor post-petition lends money secured by a section 364(c) or (d) court order. The new lien however, secures not only the post-petition loan but also the prepetition unsecured indebtedness.[170]

Cross-collateralization may be particularly adaptable to the Chapter 12 situation because of the enormous amount of unsecured credit which farm creditors hold.[171] Cross-collateralization is only helpful to a potential lender who has an unsecured pre-petition claim. If the lender were fully secured he would not need to rely on a cross-collateralization clause to provide security.[172]

A cross-collateralization clause enables a creditor to improve its pre-petition status through post-filing actions. Blocking improvements in position by action pre or post bankruptcy is in the heart of the Bankruptcy Code.[173] Since cross-collateralization clauses are not mentioned in section 364, it is not surprising that the courts are hostile toward them.

The issue of whether cross-collateralization clauses are valid first arose in *Otte v. Mfr. Hanover Commercial Corp. (In re Texlon).*[174] *Texlon* did

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165. Grossman, *Troubled Times: The Farm Debtor Under the Amended Bankruptcy Code*, 38 OKLA. L. REV. 579, 639 (1985).

166. *See* 11 U.S.C. § 364 (1982 & Supp. IV 1986).

167. *See* Harl, *Analyzing Chapter 12*, *supra* note 18, at 14, 15.

168. White, *supra* note 7, at 28-29. *But see* Bauer, *Response to Professor White's Sortie Against Chapter 12*, 13 J. CORP. L. 33 (1987).

169. For a discussion of cross-collateralization arrangements, see Bohm, *The Legal Justification for the Proper Use of Cross-Collateralization Clauses in Chapter 11 Bankruptcy Cases*, 59 AM. BANKR. L.J. 289 (1985); Tabb, *A Critical Reappraisal of Cross Collateralization in Bankruptcy*, 60 S. CAL. L. REV. 109 (1986); Weintraub & Resnick, *Cross-Collateralization of Prepetition Indebtedness As An Inducement for Postpetition Financing: An Euphemism Comes of Age*, 14 U.C.C. L.J. 86 (1981).

170. *In re* Monach Circuit Indus., 41 Bankr. 859, 861 (Bankr. E.D. Pa. 1984).

171. For example, in Iowa, the average unsecured debt for each Chapter 12 debtor was $136,567. Faiferlick & Harl, *supra* note 17, at 308.

172. Tabb, *supra* note 169, at 111.

173. *See* 11 U.S.C. §§ 547, 549 (1982 & Supp. IV 1986).

174. Otte v. Mfr. Hanover Commercial Corp. (*In re* Texlon Corp.), 596 F.2d 1092 (2d Cir. 1979).

not invalidate the concept of cross-collateralization outright. Rather, the court stated that a financing scheme so contrary to the spirit of the Bankruptcy Act should not have been granted by an ex parte order. In the case, the bankruptcy court relied solely on representations by a debtor-in-possession that credit essential to operation of the business was otherwise unobtainable. The court stated that a hearing may have determined that other sources of credit are available; that other creditors would share in financing under similar favorable terms; or that creditors did not want the business continued if another lender was preferred.[175]

Most of the cases following *Texlon* have held that cross-collateralization clauses are disfavored, but can be recognized if certain procedural and substantive factors are met.[176] *In re VanGuard Diversified, Inc.* developed a four part test to determine whether a cross-collateralization clause should be allowed.[177] The court determined that the debtor-in-possession must demonstrate the following:

> 1) Its business operations will not survive, absent the proposed financing;
> 2) It is unable to obtain alternative financing on acceptable terms;
> 3) The proposed lender will not acceed to less preferential terms; and
> 4) The proposed financing is in the best interests of the general creditor body.[178]

It applied the four part test and concluded that the cross-collateralization clause would be proper, as VanGuard would in all likelihood cease operating and be forced to liquidate absent continued financing.[179]

It seems quite likely that a Chapter 12 debtor could meet this four part test without much difficulty. Most farming operations would not be able to continue absent the infusion of additional operating capital. It probably would not be difficult to show that the debtor is unable to obtain alternative financing or that the proposed lender will not agree to less preferential terms. Agricultural creditors have absorbed huge losses in the current farm crisis and want as much protection as possible for future advances.[180]

The most difficult part of the test is to show that the proposed finding is in the best interests of the general creditor body. In the Chapter 12 context, this may indicate that the debtor needs to show that the creditors

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175. *Id.* at 1098.

176. Tabb, *supra* note 169; *see In re* Antico Mfg., Inc., 31 Bankr. 103 (Bankr. E.D.N.Y. 1983); *In re* General Oil Distrib., Inc., 20 Bankr. 873 (Bankr. E.D.N.Y. 1982); Borne Chemical Co. v. Lincoln First Commercial Corp. (*In re* Borne Chemical Co.), 9 Bankr. 263 (Bankr. D.N.J. 1981); *In re* Flagstaff Foodservice Corp., 16 Bankr. 132 (S.D.N.Y. 1981).

177. *In re* Vanguard Diversified, Inc., 31 Bankr. 364 (Bankr. E.D.N.Y. 1983).

178. *Id.* at 366.

179. *Id.* at 367.

180. Harl, *Analyzing Chapter 12*, *supra* note 18, at 15.

would be better off if the farm continued to operate rather than liquidate. In many instances creditors would prefer liquidation over reorganization. It is important to note that creditors in Chapter 12 proceedings do not vote on the acceptance or rejection of the reorganization plan, but rather the court makes the determination.[181]

The court in *In re Monarch Circuit Industries, Inc.* differed from most bankruptcy courts by holding that cross-collateralization clauses were not authorized by the Bankruptcy Code because of their preferential nature and therefore could not be approved even after notice and a hearing.[182] While the *Monarch* Court noted that several bankruptcy courts construed the holding in *Texlon* as providing that cross-collateralization provisions may not be approved ex parte, but only after notice and a hearing,[183] it concluded that the language of section 364(c) limits the extent of the priority or lien to the amount of the debt incurred after court approval. Therefore, the pre-petition indebtedness referred to in the cross-collateralization clause was not obtained under section 364(c) and no relief could be granted for that amount.[184]

Despite the decision in *Monarch*, the Ninth Circuit has stated that cross-collateralization clauses are covered by section 364.[185] In *Burchinal v. Central Washington Bank (In re Adams Apple Inc.)*, the debtor, who was engaged in apple growing and marketing, entered into a cross-collateralization arrangement to obtain funds needed to care for his crops. The debtor testified that without the loan, his 1983 crops would fail and he would lose his orchards. He also stated that the bank would only provide financing if a cross-collateralization clause were included, and that he could not obtain other financing.[186]

Although the plain language of section 364 does not indicate whether Congress approved the inclusion of a cross-collateralization clause in a post-petition loan agreement, the court in *Adams Apple* looked to the Congress' overall policy in passing section 364.[187] It noted that section 364 was designed to provide the debtor a means to obtain credit after filing bankruptcy, which could include a cross-collateralization type provision.[188]

Although some courts have disfavored the use of cross-collateralization clauses, post-petition lenders can enter into financing agreements which include cross-collateralization provisions with the relative assurance that the

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181. *See* 11 U.S.C. § 1225 (Supp. IV 1986).

182. *In re* Monach Circuit Indus., Inc., 41 Bankr. 859 (Bankr. E.D. Pa. 1984).

183. *Id.* at 861-62.

184. *Id.* at 862.

185. Burchinal v. Central Washington Bank (*In re* Adams Apple, Inc.), 829 F.2d 1484, 1488-89 (9th Cir. 1987).

186. *Id.* at 1486.

187. *Id.* at 1488.

188. *Id.*

court's authorization will not be reversed or modified on appeal.[189] Section 364(e) of the Code provides that the reversal or modification on appeal of a section 364 authorization does not effect the validity of any debt or any priority or lien granted to an entity that extended such credit in good faith.[190]

There is no statutory definition of good faith in the Bankruptcy Code. The court in *In re EDC Holding Co.* assumed that Congress intended the statute to protect not the lender who seeks to take advantage of a lapse in oversight by the bankruptcy judge but rather the lender who believes his priority is valid, but cannot be certain because of possible objections that may arise on appeal.[191] The court further stated that the policy behind section 364(e) was to overcome people's natural reluctance to deal with a bankrupt firm by assuring them that if they are acting in good faith, they can extend additional credit without worry of losing their priority on appeal.[192]

Bankruptcy courts have extensively discussed the application of section 364(e) to cross-collateralization situations.[193] In *In re Adams Apple*, the appellant contended that section 364(e) does not apply to a lien to secure a pre-petition loan.[194] The court held that section 364(e) applies since a cross-collateral lien is within the purview of section 364. The court noted that section 364 was designed to provide a debtor a means to obtain credit after filing bankruptcy and if section 364(e) was not applied to cross-collateralization situations, Congress' intent of fostering private investment in failing companies would be defeated.[195] The protections of section 364(e) could be very valuable to a new extender of credit in a Chapter 12 proceeding. This new creditor can be assured of his priority if he is acting in good faith.

The use of a cross-collateralization clause may induce a new lender to extend post-petition operational financing. Without the use of a cross-collateralization provision, the Chapter 12 debtor will probably have a difficult time finding new operational credit, in spite of the priorities and protections of section 364.

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189. 11 U.S.C. § 364(e) (1982).

190. *Id.*

191. *In re* EDC Holding Co., 676 F.2d 945, 947 (7th Cir. 1982).

192. *Id.*

193. *See* Burchinol v. Central Washington Bank (*In re* Adams Apple, Inc.), 829 F.2d 1484 (9th Cir. 1987); *In re* First South Sav. Ass'n, 820 F.2d 700 (5th Cir. 1987); Unsecured Creditors' Comm. Mobil Oil Corp. v. First Nat'l Bank & Trust of Escanaba (*In re* Ellingsen MacLean Oil Co., Inc.), 65 Bankr. 358 (Bankr. W.D. Mich. 1986), *aff'd*, 834 F.2d 599 (6th Cir. 1987); *In re* FCX, Inc., 54 Bankr. 833 (Bankr. N.C. 1985); *In re* Monach Circuit Indus., Inc., 41 Bankr. 859 (Bankr. Pa. 1984).

194. Burchinal v. Central Washington Bank (*In re* Adams Apple, Inc.), 829 F.2d 1484, 1488 (9th Cir. 1987).

195. *Id.*

IV. Post-petition Property and Proceeds

Since the Chapter 12 debtor will probably have difficulty obtaining new credit under section 364,[196] the debtor should determine whether there are any unencumbered assets that he can use to meet post-filing operating expenses. In most farm cases, a creditor's security agreement applies to all proceeds, products, offspring, rents and profits of the secured property.[197] Therefore, the debtor is normally prohibited from using these proceeds and products to finance the operation of the farm. However, there are provisions in the Bankruptcy Code that can terminate pre-petition security interests in after-acquired property and proceeds.[198]

Section 552(a) of the Bankruptcy Code nullifies certain pre-petition liens on post-petition property to the extent that such liens include after-acquired property.[199] Article 9 of the Uniform Commercial Code provides that a debtor may execute a security agreement creating a lien on after-acquired property.[200] However, this type of security interest is subject to being cut off through the bankruptcy proceeding.[201] The effect of the filing of the bankruptcy petition is to prevent the lien from floating to new post-filing collateral, which is consistent with the "fresh start" concept of the Bankruptcy Code.[202]

Section 552(a) is not as harsh on creditors as it appears, because of the extremely important exception in section 552(b). That section allows

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196. *See supra* text accompanying notes 7-19.

197. Hershner & Boyer, *The Farmer in Distress - Can Bankruptcy Help?*, 1985 Ann. Surv. Bankr. L. 177, 199.

198. 11 U.S.C. § 552 (1982 & Supp. IV 1985) provides as follows:

> (a) Except as provided in subsection (b) of this section, property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.
>
> (b) Except as provided in subsections 363, 506(c), 522, 544, 545, 547, and 548 of this title, if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, product, offspring, rents, or profits of such property, then such security interest extends to such proceeds, product, offspring, rents, or profits acquired by such security agreement and by applicable non-bankruptcy law, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.

See also Kunkel, Walter & Lander, *The Reach of Prefiling Security Interests in Postfiling Proceeds of Agricultural Collateral - An Analysis of Bankruptcy Code Section 552*, 8 J. Agric. Tax'n & L. 311 (1987).

199. 11 U.S.C. § 552(a) (1982).

200. U.C.C. § 9-204.

201. 11 U.S.C. § 552(a) (1982).

202. Kunkel, Walter & Lander, *supra* note 198, at 312.

a creditor to retain its security interest in all pre-petition collateral and in the post-petition proceeds, products, offspring, rents, or profits of pre-petition collateral.[203] However, section 552(b) further provides that the court may after notice and hearing restrict the reach of the creditor's lien, based on the equities of the case.[204]

Although it is extremely important for the debtor to determine if any pre-petition liens in property acquired post-petition are nullified by operation of section 552, it is sometimes difficult to distinguish between after-acquired property, which is clearly taken from the secured party under section 552(a), and proceeds which may be preserved to the secured party under section 552(b).[205] If the security interest is nullified, the debtor can freely use any post-petition collateral to provide financing for the continued operation of the farm. Moreover, the proceeds exception contained in section 552(b) applies only to the proceeds of pre-petition collateral.[206] For example, a secured parties' lien in cattle acquired after the petition is nullified by section 552(a). Any offspring of these cattle are also free of the lien.[207] Once the assets are free of liens, the debtor may also be able to obtain new financing by granting a new creditor a security interest in the post-petition property under section 364(c).[208]

There has been extensive litigation in Chapter 11 farm cases regarding the application of section 552(b).[209] Since no section of Chapter 12 addresses this question, Chapter 12 courts may well look to these Chapter 11 cases for a resolution of the issue.

It appears to be quite clear that section 552(b) will not allow a prepetition secured creditor to obtain a post-petition lien on crops that are planted after filing the petition.[210] Therefore, farmers normally try to file their bankruptcy petition prior to planting season. This will allow them the opportunity to grant a new security interest in the new crops so as to obtain funds for seed, fertilizer, fuel, and other planting expenses.[211] However, if the crops have been planted prior to commencement of the case,

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203. 11 U.S.C. § 552 (b) (Supp. IV 1986).

204. *Id.*

205. 4 COLLIER ON BANKRUPTCY para. 552.01, at 552-4, 5 (15th ed. 1988).

206. *See In re* Bohne, 57 Bankr. 461, 464 (Bankr. D. N.D. 1985).

207. *See In re* Big Hook Land & Cattle Co., 81 Bankr. 1001, 1003 (Bankr. D. Mont. 1988).

208. *See* 11 U.S.C. § 364(c)(2) (1982).

209. ANDERSON & MORRIS, *supra* note 66, § 2.02, at 2-14.

210. Kunkel, Walter & Lander, *supra* note 198, at 319. *See In re* Sheehan, 38 Bankr. 859, 863 (Bankr. D. S.D. 1984); *In re* Kruse, 35 Bankr. 958, 965-66 (Bankr. D. Kan. 1983); First Nat'l Bank of Colorado Springs v. Hamilton (*In re* Hamilton), 18 Bankr. 868, 871 (Bankr. D. Colo. 1982).

211. Heshner & Boyer, *The Financing of Crops in Chapter 11 Farm Cases*, NORTON BANKR. L. ADVISER, Dec. 1984, at 13.

the pre-petition security interest will continue, since the security interest attached to the crops when planted.[212]

With regard to livestock, a valid pre-petition security interest in livestock should continue to the offspring of such livestock pursuant to section 552(b).[213] However, if the debtor acquired livestock post-petition, which were not offspring of the pre-petition livestock, section 552(a) would avoid the security interest in the after-acquired livestock.[214]

In *In re Bohne*, a Chapter 11 proceeding, the creditor had a valid security interest in all livestock now or hereafter acquired together with the young and produce thereof.[215] The debtor, who filed his petition in November, 1985, took the position that the calves born in 1986 were after-acquired property and therefore not subject to the bank's pre-petition lien, pursuant to section 552(a).[216] The court held that section 552(b) "provides that a valid pre-petition security interest in pre-petition property and the offspring of such property operates to continue that security interest in offspring acquired subsequent to the bankruptcy petition."[217] Therefore, since the calves were offspring of the pre-petition property, the pre-petition security interest in livestock extends to any 1986 calves which were offspring of pre-petition livestock.[218]

Although a valid security interest in livestock will likely continue to the offspring of pre-petition livestock,[219] the farmer-debtor may be able to recover the costs and expenses incurred in preserving the calves.[220] Section 506(c) provides that the debtor may recover from the secured collateral the reasonable, necessary costs of preserving or disposing of the collateral to the extent of any benefit to the secured creditor.[221]

Unlike cases with crops or livestock, courts have split on the question of whether milk produced post-petition by cows owned pre-petition are "proceeds, products, rents or profits" covered under section 552(b).[222] Courts holding that the secured party's interest in the milk is cut off by section 552(a) because milk is not a proceed, construe section 552(b) as a

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212. Kunkel, Walter & Lander, *supra* note 198, at 319.

213. *See In re* Bohne, 57 Bankr. 461, 464 (Bankr. D. N.D. 1985).

214. *See In re* Big Hook Land & Cattle Co., 81 Bankr. 1001, 1003 (Bankr. D. Mont. 1988).

215. *In re* Bohne, 57 Bankr. 461, 462 (Bankr. D. N.D. 1985).

216. *Id.*

217. *Id.* at 464.

218. *Id.*

219. *See In re* Bohne, 57 Bankr. 461 (Bankr. D. N.D. 1985).

220. *See In re* Hamilton, 18 Bankr. 868, 872-73 (Bankr. D. Colo. 1982). *But see In re* Bohne, 57 Bankr. 461 (Bankr. D. N.D. 1985); Brookfield Prod. Credit Ass'n v. Borron, 738 F.2d 951 (8th Cir. 1984).

221. 11 U.S.C. § 506(c) (1982).

222. Ray, *After-Acquired Property in Farm Bankruptcies - Some Practical Considerations*, 7 NORTON BANKR. L. ADVISOR, July 1986, at 1, 2.

narrow exception to section 552(a).[223] One court reasoned that milk is created totally post-petition like crops planted post-petition.[224] Another court reasoned that milk is produced using post-petition assets such as feed and labor.[225] Since the secured creditor did not contribute to these inputs the court concluded that the creditor's lien should not reach the milk.[226]

Cases holding that milk is a proceed under section 552(b) have more liberally construed the statutory language.[227] The central reasoning of these cases is that milk is a proceed under Article 9 of the U.C.C.[228] In *In re Johnson*, the debtor's milk cows were subject to security interests held by Highland State Bank and FmHA. Highland's financing statement also gave it a security interest in proceeds and products of livestock, while FmHA's financing statement covered farm products and proceeds thereof. Using an Article 9 analysis, the court determined that milk was a farm product.[229] U.C.C. section 9-109(3) provides that goods are farm products if they are products of livestock in their unmanufactured states, such as milk.[230] Additionally, the secured creditors also had a perfected security interest in proceeds from the sale of the debtor's milk since their financing statement explicitly covered proceeds of farm products. Since milk is the "proceeds, products, offspring, rents or profits" of pre-petition livestock within the meaning of section 552(b), the court held that the security interests extended to the debtor's post-petition milk.[231]

Two cases have also discussed whether the equities of the case justify termination of the secured party's lien in the milk even if the milk is a

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223. *See In re* Lawrence, 41 Bankr. 36 (Bankr. D. Minn. 1984).

224. *Id.* at 38.

225. *In re* Vanas, 50 Bankr. 988, 997 (Bankr. E.D. Mich. 1985).

226. *Id.* at 998.

227. *See In re* Potter, 46 Bankr. 536 (Bankr. E.D. Tenn. 1985); *In re* Nielson, 48 Bankr. 274 (D.N.D. 1984); United States v. Hollie (*In re* Hollie), 42 Bankr. 111 (Bankr. M.D. Ga. 1984).

228. Kunkel, Walter & Lander, *supra* note 198, at 315.

229. *In re* Johnson, 47 Bankr. 204, 206 (Bankr. W.D. Wisc. 1985).

230. U.C.C. § 9-109(3) provides that goods are "farm products" if they are crops or livestock or supplies used or produced in farming operations or if they are products of crops or livestock in their unmanufactured states (such as ginned cotton, wool-clip, maple syrup, milk and eggs), and if they are in the possession of a debtor engaged in raising, fattening, grazing or other farming operations. If goods are farm products they are neither equipment nor inventory.

231. *In re* Johnson, 47 Bankr. 204, 207 (Bankr. W.D. Wisc. 1985). U.C.C. §9-306(2) provides as follows:

> Except where this Article otherwise provides, a security interest continues in collateral notwithstanding sale, exchange or other disposition thereof unless the disposition was authorized by the secured party in the security agreement or otherwise, and also continues in any identifiable proceeds including collections received by the debtor.

proceed under section 552(b).[232] *In re Lawrence* held that the special circumstances of milk production justified termination of the lien even if milk were considered a proceed.[233]

In contrast, the *Johnson* court concluded that the equity exception to section 552(b) could not be used to cut off the secured party's lien in milk.[234] The court reasoned the equity is to act only if legal remedies are inadequate. The court stated that the equity exception was unnecessary since the debtor could obtain the use of milk proceeds by following the procedures for the use of cash collateral.[235]

The question of whether government payments are proceeds coming under section 552(b) protection is especially important to the Chapter 12 debtor. Most farmers rely heavily on government farm program benefits to help meet the expenses of operating their farms.[236] For many large farming operations, government farm benefits, such as deficiency payments, may be the largest source of operational financing. In calender year 1986, direct government subsidy payments to producers totaled $11.8 billion, with another $8.3 billion made available to eligible producers through net CCC loans.[237] Several bankruptcy courts have addressed the issue of whether a pre-petition security agreement covers federal price support payments.[238]

The major source of government payments are deficiency payments. Target prices provide for direct payments to producers of the difference between the target price and the average market price for a set period or the loan rate. The difference between the target price and average market price is referred to as a "deficiency payment".[239] *In re Nivens* addressed the issue of whether deficiency payments are proceeds of crops.[240] The court held:

> [D]eficiency payments are made, because it is determined that farmers should receive a target price for the crop. The crop lien includes a lien on the proceeds and the deficiency payments are monies from the government which make up the difference between the amount of money

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232. *In re* Johnson, 47 Bankr. 204, 207 (Bankr. W.D. Wisc. 1985); *In re* Lawrence, 41 Bankr. 36, 38 (Bankr. D. Minn. 1984).

233. *In re* Lawrence, 41 Bankr. 36, 38 (Bankr. D. Minn. 1984).

234. *In re* Johnson, 47 Bankr. 204, 207 (Bankr. W.D. Wisc. 1985).

235. *Id.*

236. For a discussion of government farm payments, see Flaccus & Dixon, *The New Bankruptcy Chapter 12: A Computer Analysis of If and When a Farmer Can Successfully Reorganize*, 41 ARK. L. REV. 263, 272-84 (1988).

237. ECON. RESEARCH SERV., U.S. DEPT. OF AGRIC., FARM FINANCE, AGRICULTURAL OUTLOOK, June 1987, at 21.

238. *See generally* Hamilton, *Securing Creditor Interests in Federal Farm Program Payments*, 33 S.D. L. REV. 1 (1988).

239. 1 J. JUERGENSMEYER & J. WADLEY, AGRICULTURAL LAW § 9.9, at 279 (1982 & Supp. 1985).

240. First State Bank of Abernathy v. Holder (*In re* Nivens), 22 Bankr. 287 (Bankr. N.D. Tex. 1982).

> actually received for the crop and that amount which the Department of Agriculture had determined, on a nationwide basis, that a producer should receive for a particular crop. It is logical to conclude that the deficiency payments are substitute for proceeds of crops.[241]

Although this decision did not discuss the implications of section 552(b), the case does provide guidance in determining whether deficiency payments can be used by the debtor, free of any security interests. Based on the court's decision, any deficiency payments received on account of crops planted prior to bankruptcy would likely be held subject to a prepetition security interest, unless the equities of the case exception is invoked.

In addition to cash payments, some government subsidies are paid to the farmer in the form of payment-in-kind (PIK) certificates. In simple terms, PIK certificates are entitlement payments made to a farmer to not plant certain acreage or to abandon a planted crop.[242] *In re Kruse* held that government entitlement payments including PIK payments are proceeds if received in exchange for an abandoned planted crop.[243] Relying on section 552(b) the court reasoned that the Production Credit Association (PCA) had a lien on any PIK entitlements which the debtor received on account of the crop that was planted before the bankruptcy petition was filed and thereafter abandoned or turned under pursuant to the PIK program.[244] However, the court stated that any proceeds of a PIK agreement entered into after filing the bankruptcy petition would be free of any pre-petition security interests pursuant to section 552(a). In contrast, post-petition payments received under the PIK program stemming from an agreement not to grow crops are not proceeds, but rather after-acquired property and therefore exempt from any pre-petition security interest.[245]

The Chapter 12 debtor should not encounter any problem using government payments to finance his farming operation if the benefits are received for crops planted after filing of the petition.[246] However, if the government payments are received for crops planted before filing the petition, the payments will probably be considered proceeds, resulting in any pre-petition liens surviving the bankruptcy filing.[247] Additionally, the debtor may be able to use government payments, which appear to be subject to

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241. *Id.* at 291-92.

242. *See* 1 J. JUERGENSMEYER & J. WADLEY, AGRICULTURAL LAW § 9.9, at 279 (1982 & Supp. 1985).

243. *In re* Kruse, 35 Bankr. 958 (Bankr. D. Kan. 1983).

244. *Id.* at 964-65.

245. *Id.*

246. The lien should be cut off pursuant to 11 U.S.C. § 552(a) (1982).

247. The lien will continue in the proceeds unless the court invokes the "equities of the case" exception. *See* 11 U.S.C. § 552(b) (1982 & Supp. IV 1986).

a security interest, based on current federal regulations.[248] Federal regulations prohibit Agricultural Stabilization & Conservation Service (ASCS) payments from being assigned to serve any pre-existing indebtedness.[249] The regulations also prohibit the encumbrance of any ASCS program payments made in PIK certificates.[250] These federal regulations may have a significant impact on the financing of farm operations. Farmers may have access to another source of unencumbered funds that can be used to finance the operation of their farms. However, farm lenders may become reluctant to extend additional credit if farmers are unable to use most federal farm program benefits as collateral to secure farm debt.

If a pre-petition lien in farm products is cut off under section 552(a) or (b), the Chapter 12 debtor will be allowed to use this freed-up property

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248. In *In re Halls*, 79 Bankr. 417 (Bankr. S.D. Iowa 1987), the court held that program payments made in the form of PIK certificates and cash were not cash collateral because of federal statutory and regulatory provisions. In that case the debtor had borrowed operating capital in 1986 from the creditor, FDIC's predecessor in interest, granting a security interest in, among other things, "entitlements and payments from all state and federal farm programs." *Id.* at 418. The debtor was enrolled in the 1986 and 1987 Federal Feed Grain Program. The debtor received both cash deficiency payments and PIK certificates. The debtor contended that the regulatory provisions governing the program precluded the FDIC from encumbering any program payments made in PIK certificates or any 1987 program payments made in cash. Based on the regulations contained in 7 C.F.R. Part 709, the court in *Halls* concluded that the FDIC could not encumber 1987 program payments made in cash since the FDIC did not finance the 1987 crop. Therefore, the farmer was allowed to use the cash payments for 1987 without meeting the requirements for use of cash collateral under § 363.

249. 7 C.F.R. § 709.3 (1988) provides that a payment which may be made to a producer under an ASCS program may be assigned only as security for cash or advances to finance making a crop for the current crop year. No assignment may be made to secure or pay any preexisting indebtedness of any nature whatsoever. The purpose behind this provision is to ensure that the intended beneficiary of government payments receive the payments. The purpose of the ASCS payments is to benefit the producing farmer and allow him to plant a new crop. ASCS payments are not intended to be used to pay a farmer's pre-existing indebtedness. *See also* 16 U.S.C. § 590h(g) (1982).

250. 7 C.F.R. § 770.6 (1988) provides that "in kind" payments may not be the subject of an assignment, except as determined and announced by CCC. Further, 7 C.F.R. § 770.4 (1988) provides that commodity certificates shall not be subject to any lien, encumbrance, or other claim or security interest, except that of an agency of the United States government arising specifically under federal statute. The court in *In re* Halls, 79 Bankr. 417 (Bankr. S.D. Iowa 1987) also addressed the issue of whether PIK certificates could be assigned. Based on 7 C.F.R. § 770.6 (1988), the court concluded that payment in kind certificates can never be subject to any encumbrances. *Id.* at 419-20. Based on the court's interpretation of the regulations, the PIK certificates were not encumbered by FDIC's security interest. The debtor was free to negotiate the PIK certificate and use the proceeds for operation of the farm. The court believed the regulations were enacted to prevent interruption of the marketability of PIK certificates. *But see In re* Arnold, 88 Bankr. 917 (Bankr. N.D. Iowa 1988).

and any proceeds of this collateral to finance the farming operation. The debtor can freely use the proceeds without obtaining court approval or providing adequate protection.[251] These proceeds may be very valuable to the reorganizing farm debtor.

V. Sale of Existing Assets to Generate Operating Funds

If the Chapter 12 debtor does not have any unencumbered assets, the farmer-debtor may need to seek court or trustee approval to sell encumbered assets to finance the continued operation of the farm.[252] As previously indicated, most agricultural lenders are reluctant to extend additional credit to Chapter 12 debtors.[253] Therefore, the cash proceeds of farmland, farm equipment or stored farm products may be the only source of operational financing for the Chapter 12 debtor.

Since most of the debtor's assets probably will be subject to liens, the debtor must follow the procedures set forth in section 363 of the Code before he can use any sale proceeds to meet operational expenses.[254] Although section 363(c)(1) allows the Chapter 12 debtor in possession to use or sell estate property in the ordinary course of business, the sale will not be free and clear of liens unless one of the provisions in section 363(f) is met.[255] Section 363(f) provides that the trustee may sell free and clear of any liens only if: (1) applicable non-bankruptcy law would permit a sale of such property free of the interest, (2) the other entity consents, (3) the interest is a lien and the sales price is greater than the aggregate value of all liens on such property, (4) the interest is in bona fide dispute, or (5) the entity could be compelled in a legal or equitable proceeding to accept a money satisfaction of such interest.[256]

Since the secured creditor often objects to the sale of encumbered property, the court must rely on a provision of section 363(f) other than (2) above to allow property to be sold free and clear of liens.[257] Although the language of section 363(f) is not clear, several courts have concluded that farm products can be sold free and clear of liens as long as the secured creditor is granted a lien in the proceeds.[258]

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251. The proceeds could be used without meeting the requirements for use of cash collateral set forth in 11 U.S.C. § 363 (1982 & Supp. IV 1986).

252. 11 U.S.C. § 363(c) (1982 & Supp. IV 1986).

253. *See supra* text accompanying notes 7-19.

254. *See* 11 U.S.C. § 363 (1982 & Supp. IV 1986).

255. *Id.* § 363(c)(1), (f).

256. *Id.* § 363(f).

257. 2 Collier on Bankruptcy para. 363.07, at 364-31, 32 (15th ed. 1979).

258. *See In re* Nikolaisen, 38 Bankr. 267 (Bankr. D.N.D. 1984); *In re* Frank, 27 Bankr. 748 (Bankr. S.D. Ohio 1983).

Section 1206[259] has modified the restrictive terms of section 363(f) to allow Chapter 12 debtors to sell farmland and farm equipment free and clear of liens without the consent of secured creditors.[260] However, since section 1206 only applies to the sale of farmland and farm equipment, the debtor will still need to follow section 363(f) to sell farm products, such as crops and livestock.[261]

Once the farm products, farmland, or farm equipment are sold, the proceeds will become cash collateral. Cash collateral is defined as cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents in which the estate and another entity each have an interest. Cash collateral may include the proceeds, products, offspring, rents, or other profits of any property subject to security interests.[262]

The debtor will not be allowed to use the cash collateral unless the court authorizes the use under section 363(c)(2).[263] If most of the debtor's assets are cash collateral, conflicts will often arise immediately after filing. The debtor has operating expenses that must be paid immediately to continue the farming operation. Since creditors are often unwilling to consent to the use of cash collateral, the farmer may need to seek an emergency order authorizing its use. The Rules of Bankruptcy Procedure provide that the debtor may move for such an order,[264] realizing that the prohibition of its use can result in emergency situations. The debtor may need to use the cash to buy feed for livestock or seed to plant crops. In these situations, the debtor can hardly afford to wait until a final hearing.

The Code does not provide clearcut standards for determining when a debtor should be allowed to use cash collateral.[265] One court concluded that it must balance two irreconcilable and conflicting interests in reviewing

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259. 11 U.S.C. § 1206 (Supp. IV 1986) provides as follows:
After notice and a hearing, in addition to the authorization contained in section 363 (f), the trustee in a case under this chapter may sell property under section 363(b) and (c) free and clear of any interest in such property of an entity other than the estate if the property is farmland or farm equipment, except that the proceeds of such sale shall be subject to such interest.

260. ANDERSON & MORRIS, *supra* note 66, § 5.04, at 5-21.

261. *See* 11 U.S.C. § 1206 (Supp. IV 1986).

262. *Id.* § 363(a).

263. *Id.* § 363(c) (2).

264. FED. R. BANKR. P. 9014 provides that in a contested matter in a case under the Code not otherwise governed by these rules, relief shall be requested by motion, and reasonable notice and opportunity for hearing shall be afforded the party against whom relief is sought. In *In re* Sheehan, 38 Bankr. 859 (Bankr. D. S.D. 1984), the court noted that "Local Rule of Bankruptcy Procedure 15(c) provides for expedited hearings on 48 hours' notice to parties in interest for the proposed use, sale, or lease of property". *Id.* at 861.

265. Note, *Standards and Sanctions for the Use of Cash Collateral Under the Bankruptcy Code*, 63 TEX. L. REV. 341, 343 (1984).

an application for the use of cash collateral.[266] It noted that the holder of a lien must not be left unprotected by unrestricted use. On the other hand, the purpose of the reorganization chapters of the Code is to rehabilitate debtors, which normally means access to cash collateral is necessary to operate a business.[267]

The drafters of Chapter 12 did not include any special standards to guide courts' consideration of whether it should allow the use of cash collateral.[268] The legislative history to the Family Farmer Bankruptcy Act indicates that no Chapter 12 debtor may use cash collateral unless the secured creditor consents, or unless the court, after notice and hearing, authorizes such use.[269] The drafters of the new Chapter 12 provision intended to have courts apply existing legal precedents consistent with this legislation when considering whether to allow the use of cash collateral.[270] Based on the conferees' statement it appears that Congress intended courts to follow the same procedures as they did in Chapter 11 farm reorganizations in determining the use of cash collateral.

The general test for authorization to use cash collateral is whether the secured party who has an interest in the collateral will receive adequate protection in exchange for the use of the cash collateral.[271] Secured creditors will nearly always object to the use of cash collateral since cash is always more attractive than any form of adequate protection.[272]

As noted above, because of section 361 obstacles to the successful family farm reorganization, Congress developed a new adequate protection standard exclusively for Chapter 12 cases.[273] Section 1205 eliminates the need to pay lost opportunity costs. There is no indubitable equivalent language contained in section 1205. It is clear that what needs to be protected is the value of property, not the creditor's interest in property.[274] Adequate protection may be provided by periodic cash payments, a replacement lien for the decrease in value of the collateral, reasonable rental payments or such other relief that will adequately protect the secured creditor's value.[275] Numerous cases in Chapter 11 have discussed adequate protection for the farm crop lender.[276]

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266. Stein v. United States (*In re* Stein), 19 Bankr. 458, 459 (Bankr. E.D. Pa. 1982).

267. *Id.*

268. H.R. Rep. No. 958, 99th Cong., 2d Sess. 49, *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS 5246, 5250.

269. *Id.*

270. *Id.*

271. Dodd, *supra* note 40, at 221.

272. *See In re* Berens, 41 Bankr. 524, 527-28 (Bankr. D. Minn. 1984).

273. *See* U.S.C. § 1205 (Supp. IV 1986).

274. H.R. Rep. No. 958, 99th Cong., 2d Sess. 45, *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS 5246, 5250-51.

275. 11 U.S.C. § 1205(b)(1), (2), (3), (4) (Supp. IV 1986).

276. *See In re* Weiser, Inc., 74 Bankr. 111 (Bankr. S.D. Iowa 1986); *In re*

A. *Sale of Farmland or Farm Equipment*

If the Chapter 12 debtor has a larger farming operation than he actually needs, he may want to consider selling an unneeded tractor or section of land. The Act allows the Chapter 12 trustee, after court authorization, to sell farmland or farm equipment free and clear of any interest in such property. The proceeds of the sale will be subject to any security interest in the property.[277] As noted above, the debtor does not need to seek the consent of the secured creditor prior to selling the assets.[278]

Once the assets are sold and converted to cash collateral, the Chapter 12 debtor could seek permission to use the proceeds, pursuant to section 363(c)(2).[279] The debtor would be required to provide adequate protection to the secured farmland or equipment lender.[280]

The Joint Explanatory Statement of the Committee of Conference for the Family Farm Bankruptcy Act gives the following explanation for the enactment of section 1206: "Most family farm reorganizations, to be successful, will involve the sale of unnecessary property. This section of the Conference Report allows Chapter 12 debtors to scale down the size of the farming operations by selling unnecessary property."

> This section modifies 11 U.S.C. 363(f) to allow family farmers to sell assets not needed for the reorganization prior to confirmation without the consent of the secured creditors, subject to approval of the court.
>
> This section also explicitly makes clear that the creditor's interest (which includes a lien) would attach to the proceeds of the sale. Of course, the holders of secured claims would have the right to bid at the sale to the extent permitted under 11 U.S.C. 363(k).[281]

The Nebraska Bankruptcy Court held that a plan can be confirmed which provides for the sale of a severable portion of farmland which is subject to a mortgage.[282] Relying on section 1206, the court concluded that the sale of severable portions of land is proper if fair market value is offered and the secured creditor retains a lien in the proceeds of the sale.[283] Although the proceeds would be subject to any liens, they could become

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276. *See In re* Weiser, Inc., 74 Bankr. 111 (Bankr. S.D. Iowa 1986); *In re* Berens, 41 Bankr. 524 (Bankr. D. Minn. 1984); *In re* Sheehan, 38 Bankr. 859 (Bankr. D. N.D. 1984); *In re* Nickolaisen, 38 Bankr. 267 (Bankr. D. N.D. 1984).

277. 11 U.S.C. § 1206 (Supp. IV 1986).

278. *Id.*

279. 11 U.S.C. § 363(c)(2) (1982) provides that a trustee may use cash collateral only with creditor consent or court approval.

280. *See* 11 U.S.C. § 363(e) (Supp. IV 1986); 11 U.S.C. § 1205 (Supp. IV 1986).

281. H.R. Rep. No. 958, 99th Cong., 2d Sess. 50, *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS 5246, 5251.

282. *In re* Lauck, 76 Bankr. 717 (Bankr. D. Neb. 1987).

283. *Id.* at 718-19.

a valuable source of funds to meet current operational financing needs if the debtor is able to provide adequate protection.

B. *Sale of Farm Products Through Granting of Replacement Liens*

If the Chapter 12 debtor does not have any unnecessary farmland or farm equipment to sell, he will probably need to use the cash proceeds of crops or livestock to finance the continued operation of the farm.[284]

Farmers who have granted crop liens will find most of their current working capital subject to the restrictions against use of cash collateral.[285] Therefore, unless they can either obtain the creditor's consent or court approval, the chances of beginning the reorganization process may be hopeless. As stated above, the debtor must provide adequate protection before the court will approve the use of cash collateral.[286] In most Chapter 11 farm reorganizations, the debtor attempts to provide the adequate protection to the secured creditor by granting a replacement or rollover lien on future farm products.[287] The debtor will argue that allowing him to use the cash proceeds from the sale of cows will benefit the creditor holding the security interest in the cows in that the cash will be used to feed and maintain the remaining cows, which are subject to the security interest.[288] The debtor will give the creditor an additional lien in any livestock which he purchases or are born after filing.[289]

The issue of granting a replacement or rollover lien as adequate protection has been extensively litigated in Chapter 11 farm reorganizations.[290] Because section 1205 also provides that a debtor can use a replacement lien to satisfy the adequate protection standard, this issue is certain to give rise to frequent litigation.[291] At least one bankruptcy court has determined that a replacement lien will constitute adequate protection in a Chapter 12 case.[292] In *In re Westcamp*, the debtor provided a replacement lien on yet-to-be-grown crops to adequately protect the creditor's cash collateral which the debtor was to use. The court concluded that the debtor had eliminated

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284. *See* Flaccus & Dixon, *The New Bankruptcy Chapter 12: A Computer Analysis of If and When a Farmer Can Successfully Reorganize*, 41 ARK. L. REV. 263, 319 (1988).

285. U.C.C § 9-306(2) provides that a security interest continues in any identifiable proceeds.

286. 11 U.S.C. § 363(e) (Supp. IV 1986).

287. ANDERSON & MORRIS, *supra* note 66, § 1.17, at 1-73.

288. *Id.* § 2.02, at 2-10, 11.

289. *Id.* at 2-11.

290. *Id.*

291. 11 U.S.C. § 1205(b)(2) (Supp. IV 1986).

292. *In re* Westcamp, 78 Bankr. 834 (Bankr. S.D. Ohio 1987). *But see In re* Stacy Farms, 78 Bankr. 494 (Bankr. S.D. Ohio 1987).

normal risks associated with farming operations and therefore a replacement lien would adequately protect the creditor's interest.[293]

The court noted that normally the value to a creditor of a lien on an existing crop or its proceeds is greater than the promise of a lien on a crop to be grown. However, in this case the court determined that the debtor had introduced evidence that the granting of a replacement lien together with the assignment of federal crop insurance and ASCS deficiency payments would result in the elimination of the risks of farming.[294]

The *Westcamp* decision is in line with the reasoning of several Chapter 11 cases in which the farmer was allowed to use cash collateral as long as crop insurance is provided and a rollover lien is given to the creditor.[295] In *In re Sheehan* the Chapter 11 debtors sought court approval to use $4.7 million of cash collateral to finance the continued operation of his farm.[296] The debtors offered an 11 point adequate protection plan which included detailed budgets, a replacement lien in the future crop, a replacement lien in new equipment, all risk crop insurance, the services of an experienced accountant and a new professional management team.[297] The court concluded that the 1984 crop would be more than an expectancy in light of this adequate protection offer and therefore would provide the creditors with the values of their bargains. Since the creditors would be adequately protected, the court held that the debtor could use the cash collateral to provide financing for the new crop.[298]

In another case, *In re Nikolaisen*, the debtors sought court approval to use cash collateral to finance the planting of their 1984 crops.[299] The debtors proposed to use stored grain from the previous year's crop, which was subject to a security interest held by the Commodity Credit Corporation (CCC). The debtor proposed to grant the CCC a first lien in all 1984 crops and assign any federal crop insurance proceeds.[300] The creditor objected to the use of the stored crop on the basis that it was not adequately protected, in that the offer of a future interest is too speculative and is not the equivalent of their present interest in the certified, stored grain.[301] The court held that the granting of a first lien in 1984 crops and assignment of crop insurance proceeds virtually insures the creditor of its interest and therefore the creditor was adequately protected.[302]

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293. *In re* Westcamp, 78 Bankr. at 839.
294. *Id.* at 838.
295. *See In re* Weiser, Inc., 74 Bankr. 111 (Bankr. S.D. Iowa 1986); *In re* Sheehan, 38 Bankr. 859 (Bankr. D. S.D. 1986); *In re* Berens, 41 Bankr. 524 (Bankr. D. Minn. 1984).
296. *In re* Sheehan, 38 Bankr. 859, 863 (Bankr. D. S.D. 1984).
297. *Id.* at 865.
298. *Id.* at 869.
299. *In re* Nikolaisen, 38 Bankr. 267 (Bankr. D. N.D. 1984).
300. *Id.* at 268.
301. *Id.* at 269.
302. *Id.* at 270.

Some courts have been more reluctant to hold that a replacement lien is adequate protection in Chapter 11 farm reorganizations.[303] *In re Berens* held that a replacement lien will not provide adequate protection when it is shown the debtor will lose money on the crops during a year of average yield.[304] The court reasoned that the possibility of poor weather, disease, lower crop prices and other risks were too high to allow the debtors to use cash collateral on rented land.[305] It is important to note that the debtors were unable to provide all risk insurance as a form of adequate protection. The court stated that a replacement lien in crops to be grown is not sufficient adequate protection unless there is an expectation of a significant profit margin or a minimal guarantee of payment through crop insurance.[306]

The farmer-debtor may run into a problem if he wishes to use proceeds in order to allow him to enter a new type of farming.[307] The farmer in *In re Frank* proposed to sell soybeans, which were subject to the creditor's security interest, to purchase cattle.[308] The court refused to authorize the use of the proceeds since the proposal encompassed the removal of significant assets from the ready reach of creditors and into a less "liquid" form, which involved more than typical business risk.[309]

In *In re Martin*, the Eighth Circuit Court of Appeals held that when determining whether to allow the use of cash collateral, the court must establish the value of the secured creditor's interest, identify the risks to the secured creditor's value resulting from the debtor's request for use of cash collateral, and determine whether the debtor's adequate protection proposal protects value as nearly as possible against risks to that value consistent with the concept of indubitable equivalence.[310] The debtors sought to use cash collateral in March of 1984 to plant and harvest their 1984 crop by offering the secured creditor a substitute lien in the 1984 crop along with an assignment of federal crop insurance proceeds.[311]

The Eighth Circuit Court of Appeals held that the bankruptcy court failed to establish that the value of the lien offered on the 1984 crop was equal to the amount of cash collateral being requested.[312] The court noted that the debtor did not present any evidence regarding proven yields or expected market prices of the 1984 crops. Additionally, the bankruptcy court failed to adequately identify the risks to the secured creditors value

303. *See In re* Berens, 41 Bankr. 524 (Bankr. D. Minn. 1984); *In re* Berg, 42 Bankr. 335 (D. N.D. 1984); *In re* Serbus, 48 Bankr. 5 (Bankr. D. Minn. 1984).
304. *In re* Berens, 41 Bankr. 524, 527 (Bankr. D. Minn. 1984).
305. *Id.* at 528.
306. *Id.*
307. *See In re* Frank, 27 Bankr. 748 (Bankr. S.D. Ohio 1983).
308. *Id.* at 749.
309. *Id.* at 750.
310. *In re* Martin, 761 F.2d 472, 476-77 (8th Cir. 1985).
311. *Id.* at 475.
312. *Id.* at 477.

associated with the planting and harvesting of a crop not yet in existence.[313] The court suggested that the bankruptcy court consider the following factors in determining whether the value of the secured party's lien in the stored crops was sufficiently protected:

> the anticipated yield in light of the productivity of the land; the husbandry practices of the farmer, including his proven crop yields from previous years; the health and reliability of the farmer; the condition of the farmer's machinery; whether there are encumbrances on the machinery which may subject it to being repossessed before the crop is harvested; the potential encumbrances on the present or future crop by other secured creditors; the availability of crop insurance and the risk of crop failure not covered by the crop insurance; and the anticipated fluctuation in market price of the farmer's crop.[314]

It is important to note that *Martin* was a Chapter 11 proceeding and the court relied on an adequate protection scheme that differs from the adequate protection provision of Chapter 12.[315] The *Martin* court analyzed the case based on the indubitable equivalent language of section 361(3). The drafters of Chapter 12 specifically noted that the indubitable equivalent requirement does not apply to family farmers.[316]

Since the indubitable equivalent requirement does not apply in Chapter 12, it is possible that some courts may conclude *Martin* is inconsistent with Chapter 12.[317] If the *Martin* test is held inapplicable, the court may determine that a replacement lien is adequate protection without requiring the Chapter 12 debtor to show that the future crop will be profitable or that the replacement lien will protect against the risks involved in planting and harvesting a new crop.

In spite of the removal of the indubitable equivalence language, the *Martin* decision should provide guidance to bankruptcy courts in determining the value of the creditor's security interest and the risks resulting from the use of cash collateral in a Chapter 12 case. The replacement lien must adequately protect the creditor's secured value before cash collateral can be used.

If the Chapter 12 debtor is unable to use the cash proceeds of farm products, farmland, or farm equipment, he will have a difficult time reorganizing the farming operation. In many cases, cash collateral will be

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313. *Id.*

314. *Id.*

315. 11 U.S.C. § 361 (1982 & Supp. IV 1986) is the adequate protection provision which must be followed in Chapter 11 proceedings. Section 361 does not apply in Chapter 12 since the drafters included a new adequate protection provision for reorganizing family farmers. *See* 11 U.S.C. § 1205 (Supp. IV 1986).

316. H.R. Rep. No. 958, 99th Cong., 2d Sess. 45, *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS 526, 5250-51.

317. Armstrong, *supra* note 3, at 195-96.

the only available source of operational financing in that most agricultural lenders are reluctant to extend new credit to Chapter 12 debtors.[318]

V. Post-Confirmation Financing

This Article has focused primarily on the problems a Chapter 12 debtor may encounter in obtaining operational financing during the pre-confirmation stage of the bankruptcy proceeding. However, a Chapter 12 debtor may have an equally difficult problem obtaining the post-confirmation financing needed to fund the plan. The legislative history to Chapter 12 indicates that the drafters recognized the problem of obtaining post-confirmation credit. The explanatory statement provides:

> The Conferees are concerned that farmers be able to obtain post-confirmation credit. The Conferees are in agreement that current law allows Chapter 13 debtors to do so. Because section 1227 is modeled after section 1327, family farmers may provide in their plans for post confirmation financing secured by assets that have revested in the debtor. The debtor may also use revested property to the extent it is not encumbered by the plan or order of confirmation to secure post-confirmation credit.[319]

Section 1227 sets forth the effect of the court's confirmation of a Chapter 12 plan.[320] The confirmed plan binds the debtor, each creditor, each equity and security holder, and each general partner in the debtor whether such person has been provided for in the plan and regardless of whether such person has objected to, accepted, or rejected the plan.[321] In addition, the plan vests all of the property of the estate in the debtor, unless it is otherwise provided in the plan or order confirming the plan. The property vested in the debtor will be free and clear of any claim or

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318. *See supra* text accompanying notes 7-19.

319. H.R. Rep. No. 958, 99th Cong., 2d Sess. 45, *reprinted in* 1986 U.S. Code Cong. & Admin. News 5246, 5251-52.

320. 11 U.S.C. § 1227 (Supp. IV 1986) provides as follows:

> (a) Except as provided in section 1228(a) of this title, the provisions of a confirmed plan bind the debtor, each creditor, each equity security holder, and each general partner in the debtor, whether or not the claim of such creditor, such equity security holder, or such general partner in the debtor is provided for by the plan, and whether or not such creditor, such equity security holder, or such general partner in the debtor has objected to, has accepted, or has rejected the plan.
>
> (b) Except as otherwise provided in the plan or the order confirming the plan, the confirmation of a plan vests all of the property of the estate of the debtor.
>
> (c) Except as provided in section 1228(a) of this title and except as otherwise provided in the plan or in the order confirming the plan, the property vesting in the debtor under subsection (b) of this section is free and clear of any claim or interest of any creditor provided for by the plan.

321. 11 U.S.C. § 1227(a) (Supp. IV 1986).

interest of any creditor provided for by the plan, unless otherwise provided.[322]

Although section 1227(c) provides that property will vest in the debtor free and clear of any creditor's claims, in many cases the plan will not meet confirmation criteria unless the creditor retains its lien.[323] To meet the confirmation requirements the plan must provide for each allowed secured claim in one of the three following alternatives:

1. the holder of such claim has accepted the plan;
2. the plan provides that the holder of the claim retains the lien securing the claim and the value of the property distributed under the plan is not less than the allowed secured claim; or
3. the debtor surrenders the property securing such claim to the holder.[324]

If the secured creditor is satisfied with his treatment under the plan and thereby accepts it, the confirmation standard is met.[325] However, if the holder of the allowed secured claim does not accept the plan, the debtor will be required to either surrender the property to the secured creditor or allow the secured creditor to retain his lien.[326] Since many secured creditors in Chapter 12 cases will be reluctant to accept it, the plan will have to provide for retention of the secured creditor's lien. If the plan provides for retention of the lien, the property of the estate will not revest in the debtor free of liens and the debtor will not be able to use this property as security for post-confirmation loans, unless the debtor complies with the provisions of section 364.[327]

Since the provisions of section 1227 are virtually identical to section 1327,[328] which discusses the effect of Chapter 13 confirmation, it is important to look at the issues that have evolved in Chapter 13 proceedings. There have been some problems with the interpretation of section 1327(c), which

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322. *Id.* § 1227 (b), (c).

323. *See id.* § 1225(a)(5) which 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.

324. *Id.*

325. 11 U.S.C. § 1225(a)(5)(A) (Supp. IV 1986).

326. *Id.* § 1225(a)(5)(B), (C).

327. Small, *Family Farmer Bankruptcy Act of 1986*, 1987 ANN. SURV. BANKR. L. at 75.

328. *See* 11 U.S.C. § 1327 (1982).

provides that all property vesting in the debtor at confirmation is free and clear of any claim or interest, unless the plan provides otherwise.[329] The litigated cases involve the effect of section 1327(c) on claims when the secured creditor fails to object to the plan. The major controversy has been whether section 1327(c) includes liens.[330] The legislative history to section 1327(c) provides no guidance.[331] Collier on Bankruptcy notes "there appears to be no sound reason for lifting liens by operation of law at confirmation under Chapter 13."[332]

The weight of authority indicates that the terms "claim" or "interest" includes liens and therefore section 1327(c) directly affects the status of a holder of a secured claim in a confirmed Chapter 13 plan if that creditor accepts the plan.[333] The court in *In re Brock* stated:

> Congress was wise to provide in Section 1327 that after confirmation the property vests in the debtor free and clear of any claim or interest of any creditor provided for in the Plan. A debtor may carry out his duties under a Confirmed Plan without fear of having a creditor pull out from under him the very equipment needed to accomplish the Plan. Section 1327, therefore, virtually renders a secured creditor provided for in a Confirmed Plan impotent. It would appear that such a creditor's remedies are limited to a motion to convert or dismiss in the event the debtor defaults in the payments required to be made to the trustee.[334]

However, there is some indication that the terms claim or interest may not include liens.[335] If so, even failing to object to the plan will not lead to invalidation of the secured party's lien. The court in *In re Honaker* reasoned that a "claim" is distinct from a lien and therefore held that section 1327(c) does not vest property in the debtor free and clear of liens. It determined that by operation of section 541(a)(1) the estate was vested with the same interest in the collateral that the debtor had, which is an interest subject to a valid security interest or mortgage.[336]

If the court determines that a lien is covered under section 1227(c) and the creditor accepts the plan,[337] property which was subject to a lien will vest in the debtor free and clear of all liens.[338] The debtor can use

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329. 5 COLLIER ON BANKRUPTCY para. 1327.01, at 1327-5 (15th ed. 1988).
330. *Id.*
331. *See* H.R. Rep. No. 595, 95th Cong., 1st Sess. 430 (1977).
332. 5 COLLIER ON BANKRUPTCY para. 1327.01, at 1327-5 (15th ed. 1988).
333. *See In re* Pettit, 18 Bankr. 832 (Bankr. S.D. Ohio 1982); Ford Motor Credit Co. v. Lewis (*In re* Lewis), 8 Bankr. 132 (Bankr. D. Idaho 1981); Associates Commercial Corp. v. Brock (*In re* Brock), 6 Bankr. 105 (Bankr. N.D. Ill. 1980).
334. Associates Commercial Corp. v. Brock (*In re* Brock), 6 Bankr. 105, 108 (Bankr. N.D. Ill. 1980).
335. Second Nat'l Bank of Saginaw v. Honaker (*In re* Honaker), 4 Bankr. 415 (Bankr. E.D. Mich. 1980).
336. *Id.*
337. 11 U.S.C. § 1225(a)(5)(A) (Supp. IV 1986).
338. *Id.* § 1227(c).

this property to provide collateral to post-confirmation creditors.[339] The offer of property which is free and clear of liens should induce a new lender to extend the operational financing needed to fund the plan. This is clearly what the drafters of Chapter 12 intended.[340]

VII. CONCLUSION

If the Chapter 12 debtor wishes to continue farming and successfully reorganize his debts, he must have access to operational financing funds. There are basically three sources of operational financing for the Chapter 12 debtor: obtaining post-petition financing under section 364 of the Code; use of unencumbered assets; or use of cash collateral.

If the farmer cannot convince the bankruptcy court to authorize the use of cash collateral or if no unencumbered assets or cash collateral are available, the farmer's chances of remaining in farming are remote. Current agricultural lenders appear reluctant to extend operating credit to the Chapter 12 debtor even though they may be able to obtain a superpriority status or senior liens on estate property under section 364 of the Code.

If the farmer has a high debt/asset ratio, obtaining financing will be extremely difficult. Additionally, the farmer-debtor who is unable to make his reorganization plan cash flow will have an equally difficult problem in obtaining new credit after confirmation. The drafters of Chapter 12 did not add any new incentives that would encourage lenders to grant post-petition credit.

The federal government or state governments in farming states may need to pursue the possibility of injecting capital into the agricultural market, either through direct or guaranteed lending, to allow family farmers to stay on the land and thereby effectuate the legislative intent of Chapter 12. Without this injection of new operating capital, many Chapter 12 reorganizations will fail at a very early stage.

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339. H.R. Rep. No. 958, 99th Cong., 2d Sess. 45, *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS 5246, 5251-52.

340. *Id.*