

The National Agricultural  
Law Center



University of Arkansas  
System Division of Agriculture  
NatAgLaw@uark.edu • (479) 575-7646

---

An Agricultural Law Research Article

**“Reasonable Rent” and Opportunity Cost in  
the Family Farmer Bankruptcy Act**

by

Nancy Hisey Kratzke  
Thomas O. Depperschmidt

Originally published in *DRAKE LAW REVIEW*  
39 *DRAKE L. REV.* 863 (1990)

[www.NationalAgLawCenter.org](http://www.NationalAgLawCenter.org)

# "REASONABLE RENT" AND OPPORTUNITY COST IN THE FAMILY FARMER BANKRUPTCY ACT

Nancy Hisey Kratzke\*  
Thomas O. Depperschmidt\*\*

## TABLE OF CONTENTS

I. Introduction	863
II. Chapter 12 and Adequate Protection	866
A. Adequate Protection in <i>American Mariner</i>	867
B. <i>In re Timbers</i> : Prohibition of Opportunity Costs	868
III. Opportunity Costs Versus Reasonable Rent	870
A. Opportunity Costs Defined	870
B. Prohibition of Opportunity Costs in Chapter 12	871
C. Problems Opportunity Costs Cause	871
IV. Issues in Court Treatment of Reasonable Rent	873
A. Showing Necessity of Adequate Protection	873
B. Automatic Application of Rent Provision in Farmland Use	874
C. Recovery of Rent or Decreased Land Value?	875
V. Conclusion	876

## I. INTRODUCTION

During the early 1980s American agriculture suffered serious economic declines.<sup>1</sup> Congress addressed the financial plight of the farmer by enacting the Bankruptcy Judges, United States Trustees and Family Farmer Bankruptcy Act of 1986,<sup>2</sup> which was signed into law by President Ronald Reagan on October 27, 1986. The portion of the Act that is directly applicable to

---

\* Nancy Hisey Kratzke is Assistant Professor of Business Law at Memphis State University. She holds B.A. and M.A. degrees from the University of Oklahoma and a J.D. from Memphis State. She was law clerk to the late Hon. William B. Leffler, Bankruptcy Judge for the Western District of Tennessee. She is a member of the Memphis Bar Association, Bankruptcy Section.

\*\* Thomas O. Depperschmidt is Professor of Economics at Memphis State University. He holds an A.B. degree from Fort Hays Kansas State University and a Ph.D. degree from the University of Texas. He serves as an economic consultant and expert witness, and is Vice-President, Southern Region of the National Association of Forensic Economists.

1. Ryan, *The Changing Standards of Adequate Protection in Farm Bankruptcy Reorganizations*, 37 *DRAKE L. REV.* 323, 323 (1987-88).

2. United States Trustees and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, 100 Stat. 3088 (1986).

farmers is Chapter 12,<sup>3</sup> a temporary addition to the Bankruptcy Code.<sup>4</sup>

The family farmer provision was added in an effort "to give family farmers facing bankruptcy a fighting chance to reorganize their debts and keep their land."<sup>5</sup> Prior to the enactment of Chapter 12, farmers who desired to reorganize rather than liquidate under Chapter 7 could elect one of two operative chapters: Chapter 13, Adjustment of Debts of Individual with Regular Income; or Chapter 11, Reorganization. Because farm obligations often exceeded the debt ceilings mandated by Chapter 13,<sup>6</sup> and because the Chapter 11 route often proved to be too complicated and costly,<sup>7</sup> an alternative was needed for the farmer. Chapter 12, with its relaxed eligibility requirements and modified adequate protection measures, was designed to remedy the existing deficiencies.<sup>8</sup>

When a bankruptcy petition is filed, under all of the operative chapters including Chapter 12, an automatic stay goes into effect. The stay precludes creditors from proceeding against the debtor in any way to create, perfect, or enforce a lien against property of the estate.<sup>9</sup>

Creditors seeking these remedies include both unsecured creditors and

3. 11 U.S.C. §§ 1201-31 (1988).

4. Pub. L. No. 99-554, tit. III, § 302(f), 100 Stat. 3124 (1986). Chapter 12 contains a seven-year sunset provision that gives Congress an opportunity to reevaluate the legislation to determine whether it has accomplished its goals and whether it should be extended beyond 1993. H. CONF. REP. No. 958, 99th Cong., 2d Sess. 48, *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS 5246, 5249 [hereinafter H. CONF. REP.].

5. H. CONF. REP., *supra* note 4, at 48, 1986 U.S. CODE CONG. & ADMIN. NEWS at 5249.

6. 11 U.S.C. § 109(e) (1988). "Only an individual with regular income that owes, on the date of the filing of the petition, noncontingent, liquidated, unsecured debts of less than \$100,000 and noncontingent, liquidated, secured debts of less than \$350,000, or an individual with regular income and such individual's spouse, except a stockbroker or a commodity broker, that owe, on the date of the filing of the petition, noncontingent, liquidated, unsecured debts that aggregate less than \$100,000 and noncontingent, liquidated, secured debts of less than \$350,000 may be a debtor under chapter 13 of this title." *Id.*

7. See H. CONF. REP., *supra* note 4, at 48, 1986 U.S. CODE CONG. & ADMIN. NEWS at 5249.

8. In order to seek reorganization under Chapter 12, a family farmer's total aggregate debts cannot exceed \$1.5 million. Eighty percent of an individual family farmer's debts must have been incurred because of farming, or 50% of his gross income must come from farming. 11 U.S.C. § 101(17)(A) (1988). A corporation or partnership may file if 50% of the outstanding stock or equity is held by one family, or by one family and the relative of the members of that family and if the family or relatives conduct the business. At least 50% of the outstanding stock or partnership equity must be held by a single family and its relations, and that family must actually conduct the farming business. More than 80% of the value of the assets of the partnership or corporation must come from assets related to the farming operation. At least 80% of a partnership's or corporation's debts must stem from the farming business, but partnerships and corporations may not use the alternate 50% gross income test. Corporations have the further requirement that their stock may not be publicly traded. *Id.* § 101(17)(i)-(iii).

Family farmers must have a "regular annual income" to file a Chapter 12 proceeding. *Id.* § 109(f). "Regular annual income" means that a family farmer's income is "sufficiently stable and regular to enable such family to make payments under a plan under chapter 12." *Id.* § 101(18).

9. 11 U.S.C. § 362 (1988).

undersecured creditors, who are unprotected to the extent they are unsecured.<sup>10</sup> The undersecured creditors will try to realize as much as possible on their collateral if it becomes apparent the bankrupt will not be able to pay all creditors in full. In the case of the family farmer, the undersecured creditor has become increasingly present in bankruptcies since the value of farm property has dropped so precipitously in recent years. The same collateral that was once adequate security for a loan is no longer adequate because of its lessened value.<sup>11</sup>

Section 362(d) provides the mechanism by which a creditor can petition the court to lift the automatic stay and allow the creditor to proceed against the debtor.<sup>12</sup> Lack of adequate protection is one of the principal grounds for relief from the stay.<sup>13</sup>

Section 361 establishes three methods of providing adequate protection: (1) cash payment to the creditor; (2) an additional or replacement lien; or (3) other relief that gives the creditor an "indubitable equivalent"<sup>14</sup> of its

10. See 11 U.S.C. § 506(a) (1988).

11. The court in the Chapter 12 case, *In re Shouse*, 95 Bankr. 470 (W.D. Ky. 1988), noted that "it is indeed mindful of the position an undersecured creditor is in as a result of the automatic stay if his collateral is not depreciating in value." *Id.* at 472. The court in *Shouse* tempered its concern for the creditor's dilemma by stating that "the goal of the automatic stay is to 'give the business a breathing spell and time to work constructively with its creditors' to propose a plan of reorganization." *Id.* In considering the creditor's equities, the court opined:

The continuation of the stay contemplates a debtor that is reorganizable and that is actively pursuing that goal. If there is no reasonable likelihood of reorganization or the debtor unreasonably delays in its efforts to reorganize, then the court may enforce several important provisions of the Code which are designed to protect the creditor. For instance, the time limitations in Chapter 12 cases are set forth in the Code and are significantly shorter than those in a Chapter 11 case. A debtor is required to file its plan within ninety days of the filing and a hearing on confirmation of such a plan shall be conducted within forty-five days of the filing of the plan, except as extended for cause. See § 1221 and § 1224. If the debtor unreasonably delays in the filing of the plan, a creditor may move the court to dismiss the case under Section 1208, for cause, including unreasonable delay or gross mismanagement by the debtor that is prejudicial to creditors or failure to file a timely plan.

*Id.*

12. 11 U.S.C. § 362(d)(1) (1988).

13. *Id.*

14. Judge Learned Hand coined the term "indubitable equivalence" in the Second Circuit decision, *In re Murel Holding Corp.*, 75 F.2d 941 (2d Cir. 1935). The renowned jurist, in analyzing the term "adequate protection," stated:

[i]t is plain that "adequate protection" must be completely compensatory; and that payment ten years hence is not generally the equivalent of payment now. Interest is indeed the common measure of the difference, but a creditor who fears the safety of his principal will scarcely be content with that; he wishes to get his money or at least the property. We see no reason to suppose that the statute was intended to deprive him of that in the interest of junior holders, unless by a substitute of the most *indubitable equivalence*.

*Id.* at 942 (emphasis added).

interest in the property.<sup>15</sup> Notably, section 1205(a) of the Act eliminates section 361 and the payment of opportunity costs with regard to Chapter 12 debtors while section 1205(b) sets forth how adequate protection called for under sections 362, 363, or 364 is provided.<sup>16</sup> Section 1205 does not provide for an "indubitable equivalent" as a means of providing adequate protection. However, it adds payment of a "reasonable rent" as a means of providing adequate protection.

This Article examines this form of adequate protection: the payment of reasonable rent as compensation for losses sustained by creditors due to a Chapter 12 petition. By reference to case law, journal materials, and the Bankruptcy Code and its legislative history, this Article provides answers to three questions raised implicitly in bankruptcy policy, specifically by section 1205 of Chapter 12: (1) Why was the reasonable rent provision enacted to replace opportunity costs under Chapters 11 and 13? (2) How has the concept of reasonable rent been handled in the courts? and (3) What accounts for the volume of its use? That is, why has it not been used more than it has to date?

Before answering these questions, however, the legislative basis for adequate protection will be examined. The payment of opportunity costs is prohibited in Chapter 12, but the concept is replaced in theory by reasonable rent.

## II. CHAPTER 12 AND ADEQUATE PROTECTION

Section 1205(b) of Chapter 12 establishes when "adequate protection" is available to the creditor against farm debtors by referring to other provisions of the Bankruptcy Code in which the concept is employed.<sup>17</sup> This section of the Act provides:

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

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

---

15. 11 U.S.C. § 361 (1988). In any plan of reorganization under the Bankruptcy Code, no creditor may be treated any worse than he would be in a Chapter 7 liquidation. The options generally available to the creditor have included opposition to the plan (often on the ground that it was unfeasible), repossession of the collateral, or payment of "lost opportunity costs."

16. 11 U.S.C. § 1205 (1988).

17. *Id.* § 1205(b).

crease in the value of property securing a claim or of an entity's ownership interest in property;

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

(4) granting such other relief, other than entitling such entity to compensation allowable under section 503(b)(1) of this title of an administrative expense, as will adequately protect the value of property securing a claim or of such entity's ownership in property.<sup>18</sup>

Neither the Code nor its amendments provide a definition of "adequate protection." Courts have attempted to determine its meaning by delving into legislative history<sup>19</sup> and by analyzing statutory language. Several key cases provide the necessary background for analysis of the "reasonable rent" option discussed later in the Article.

#### A. Adequate Protection in American Mariner

In 1984 the United States Court of Appeals for the Ninth Circuit handed down a decision that had a major impact on Chapter 11 reorganizations. *In re American Mariner Industries*<sup>20</sup> dealt with the following issue: "[W]hether an undersecured creditor who is stayed by a bankruptcy petition from repossessing its collateral is entitled, under the concept of 'adequate protection,' to compensation for the delay in enforcing its rights against the collateral."<sup>21</sup> The creditor argued it was entitled to monthly payments equal to the return it could have realized had it been permitted to foreclose and then reinvest the liquidated value of the collateral.<sup>22</sup> The court held the creditor was indeed entitled to be compensated for the delay it experienced in enforcing its rights during the time between the filing of the petition and the confirmation of the case, and this compensation would take the form of monthly interest payments.<sup>23</sup>

In short, the creditor was entitled to an equivalent of the value of its interest rather than the value of the property. The value of its interest included foreclosure rights and a right to compensation for delays in realization on the collateral. According to *Mariner*, the creditor shares few of the risks to which the family farmer recently has been exposed. Because of the automatic stay, the creditor could not foreclose, but quite literally the creditor was given an "indubitable equivalent," loosely translatable as "opportu-

---

18. *Id.*

19. *See, e.g., In re American Mariner Indus.*, 734 F.2d 426, 431 (9th Cir. 1984).

20. *In re American Mariner Indus.*, 734 F.2d 426 (9th Cir. 1984).

21. *Id.* at 427.

22. *Id.*

23. *Id.* at 435.

nity cost" payments in the form of interest.

The issue was addressed again by the United States Courts of Appeals for the Fourth, Eighth, and Fifth Circuits.<sup>24</sup> The Fourth Circuit's decision in *Grundy National Bank v. Tandem Mining Corp.*<sup>25</sup> was in accord with the *Mariner* decision. The Eighth Circuit in *In re Briggs Transportation Co.*<sup>26</sup> held that such interest payments could be ordered although the creditor was not entitled by law to be compensated.

### B. *In re Timbers: Prohibition of Opportunity Costs*

The United States Court of Appeals for the Fifth Circuit ruled contrary to *Mariner* in *In re Timbers of Inwood Forest Association* ("*Timbers*").<sup>27</sup> On appeal, the United States Supreme Court affirmed the Fifth Circuit's decision ("*Timbers II*").<sup>28</sup> The Supreme Court agreed that, to guarantee adequate protection, an undersecured creditor was not entitled to interest on its collateral during the stay.<sup>29</sup>

In the *Timbers* decision, the Fifth Circuit discussed at length the development of the family farm bankruptcy legislation, including testimony of witnesses during legislative hearings.<sup>30</sup> The court concluded that the *American Mariner* requirement of postpetition interest usually proved fatal to successful reorganization efforts by farmers.<sup>31</sup> By eliminating the applicability of section 361 to farm cases, Chapter 12 attempted to eliminate a major obstacle to family farm financial rehabilitation.<sup>32</sup>

The inapplicability of section 361 to Chapter 12 cases was confirmed in *In re Rennich*.<sup>33</sup> In *Rennich*, the debtors, South Dakota dairy farmers, owed money to the Federal Deposit Insurance Corporation ("FDIC"), which sought lost opportunity costs. The court identified the issue as "simply whether lost opportunity costs in the form of interest payments are required for retention of secured equipment as part of the concept of what is adequate protection in a case filed under Chapter 12 of the Bankruptcy Code."<sup>34</sup>

24. See *infra* notes 25-27.

25. *Grundy Nat'l Bank v. Tandem Mining Corp.*, 754 F.2d 1436 (4th Cir. 1985).

26. *In re Briggs Transp. Co.*, 780 F.2d 1339 (8th Cir. 1985).

27. *In re Timbers of Inwood Forest Assocs.*, 793 F.2d 1380 (5th Cir. 1986). The decision was vacated the same day in order to provide for a rehearing en banc. *In re Timbers of Inwood Forest Assocs.*, 802 F.2d 777 (5th Cir. 1986). On January 9, 1987, the court's initial decision was reinstated. *In re Timbers of Inwood Forest Assocs.*, 808 F.2d 363 (5th Cir. 1986).

28. *United Sav. Ass'n v. Timbers of Inwood Forest Assocs.*, 484 U.S. 365 (1988).

29. *Id.* at 382.

30. See *In re Timbers of Inwood Forest Assocs.*, 793 F.2d at 1393-99; see also *In re Timbers of Inwood Forest Assocs.*, 808 F.2d at 364-70.

31. *In re Timbers of Inwood Forest Assocs.*, 808 F.2d at 364-65.

32. See H. CONF. REP. *supra* note 4 at 49, 1986 U.S. CODE CONG. & ADMIN. NEWS at 5250.

33. *In re Rennich*, 70 Bankr. 69 (Bankr. S.D. 1987).

34. *Id.* at 70.

Since the *Rennich* decision predated *Timbers II* by nearly one year and the court was bound by stare decisis, the court had to examine the Ninth Circuit case of *In re American Mariner Industries*,<sup>35</sup> discussed earlier.<sup>36</sup> The court acknowledged that both the Fourth and Ninth Circuits had required debtors to compensate the secured creditors for "so-called 'lost opportunity costs' in those cases where the value of the collateral [was] less than the amount of debt secured by the collateral."<sup>37</sup> However, drawing on the legislative history of section 1205, the court in *Rennich* reiterated congressional concern that farmers often were defeated at the inception of the bankruptcy process due to their inability to pay lost opportunity costs.<sup>38</sup>

The court then noted that section 1205 provides another method for guaranteeing adequate protection for farmland--paying reasonable market rent.<sup>39</sup> While section 1205(b)(3) did not apply to the present case because FDIC's collateral consisted of farm equipment rather than farmland, the court made it clear that lost opportunity costs are not permissible in any Chapter 12 context.<sup>40</sup>

35. *In re American Mariner Indus.*, 734 F.2d 426 (9th Cir. 1984).

36. See *supra* text accompanying notes 20-23.

37. *In re Rennich*, 70 Bankr. at 71 (citations omitted in original).

38. *Id.*

39. *Id.* at 71-72.

40. *Id.* at 72. The court added that

[a]ny argument insisting that Congress only intended to preclude recovery of lost opportunity costs with respect to farmland and not equipment is without merit. The legislative history clearly reflects an intent to completely eliminate lost opportunity costs recovery. It only discusses payment of "reasonable market rent" for farmland as a plausible adequate protection alternative to that of a payment for decrease in value of that property.

*Id.* at 71 n.4.

The initial Fifth Circuit opinion and the opinion on rehearing both delved into the legislative history of applicable sections of the Code, specifically the adequate protection provisions and relevant measures dealing with allowed secured claims and interest, 11 U.S.C. §§ 502, 506. See *In re Timbers of Inwood Forest Assocs.*, 793 F.2d at 1385. The 1987 rehearing also gave considerable attention to the development and intent of the new Chapter 12 amendment to the Code. See *In re Timbers of Inwood Forest Assocs.*, 808 F.2d at 364-70.

Under section 502, a creditor may file a proof of claim against the debtor's estate in the amount he asserts is owed by the debtor. 11 U.S.C. § 502 (1988). An allowed creditor's claim secured by a lien on property of the debtor is an "allowed secured claim" to the extent of the value of the creditor's interest in the property. The balance of the claim, if any, is deemed unsecured. 11 U.S.C. § 506 (1988). If the value of the collateral is greater than the claim it secures, then section 506(b) provides that the creditor is entitled to, among other things, interest on such claim. 11 U.S.C. § 506(b) (1988). While an oversecured creditor may recover interest, undersecured creditors, as well as unsecured creditors, have traditionally not been allowed interest accruing on their debts during bankruptcy. See *In re Timbers of Inwood Forest Assocs.*, 793 F.2d at 1385.



### III. OPPORTUNITY COSTS VERSUS REASONABLE RENT

There is little doubt that opportunity cost payments are presumed to be higher than reasonable rent payments. The burden on farmers is reduced by allowing reasonable rent. However, why was opportunity cost a problem warranting congressional action? What are the differences in theory and practice between opportunity costs and reasonable rent?

#### A. Opportunity Costs Defined

In *Timbers*, the Fifth Circuit defined opportunity costs, for bankruptcy purposes, as "those amounts that an undersecured creditor would have earned if it had been permitted to foreclose on its collateral upon default, sell the collateral, and re-invest the proceeds, which the stay prevents."<sup>41</sup> The legislative history of section 1205 reveals opportunity costs as "a sum of cash equal to the interest that the undercollateralized secured creditor might earn on an amount of money equal to the value of the collateral securing the debt."<sup>42</sup>

The origin of reasonable rent is "based upon the rental value, net income, and earning capacity of the property."<sup>43</sup> The rationale behind reasonable rent was stated by the court in *In re Kocher*:<sup>44</sup>

Allowing the farm-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 a 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.<sup>45</sup>

While the *Timbers* decision and the legislative history of section 1205 conclude that allowing opportunity costs benefits creditors, the *Kocher* court paints a less optimistic picture. Either interpretation appears academic in light of section 1205.

41. *In re Timbers of Inwood Forest Assoc.*, 793 F.2d at 1403.

42. H. CONF. REP. No. 958, 99th Cong., 2d Sess. 49-50, reprinted in NORTON ON BANKRUPTCY LAW AND PRACTICE, BANKRUPTCY CODE (1988-90 ed.).

43. 11 U.S.C. 1205(b)(3) (1988).

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

45. *Id.* at 850 (quoting 132 CONG. REC. S3529 (daily ed. Mar. 26, 1986)) (statement of Sen. Grassley). Senator Grassley's statement was made when he introduced the Senate version of Chapter 12, which contained an adequate protection provision identical to that later adopted by Congress as section 1205. *Id.* n.12.

### B. Prohibition of Opportunity Costs in Chapter 12

Opportunity costs are prohibited explicitly in section 1205(a): "Section 361 does not apply in a case under this chapter."<sup>46</sup> Courts have addressed the prohibition in other language.

First, case law indicates there cannot be "disguised" opportunity costs. For example, if the collateral (farmland) value is stable, reasonable rent payments cannot be allowed because those payments would be equivalent to opportunity costs.<sup>47</sup> Because the creditor is not compensated for the delay in receiving the foreclosure value of collateral (*i.e.*, the creditor cannot receive opportunity costs), the creditor receives no payment in the "gap period" between the filing of a petition and the reorganization plan hearing.

The court in *In re Shouse*<sup>48</sup> ruled on whether the creditor was entitled to adequate protection in the form of reasonable rental payments because it had been denied (delayed in) the use of its property. The debtors contended there had to be a showing the collateral was declining in value before the court could award adequate protection.<sup>49</sup>

The *Shouse* court reiterated the position of *Timbers II* by noting that "if it is the 'value of the collateral' that is to be protected, a secured creditor is not entitled to adequate protection for the delay caused by the stay in foreclosing on the property."<sup>50</sup> The court then concluded:

Accordingly, this Court, adopting the reasoning of the *Timbers* and *Turner* courts, holds that the creditor's request to receive rental payments for adequate protection from the loss of his right to immediate foreclosure on the property is, in effect, a request for lost opportunity costs which has been prohibited by *Timbers*. Further, by requesting lost opportunity costs, an undersecured creditor is actually seeking to recover postpetition interest and 11 U.S.C. § 502(b)(2) and § 506(b) clearly disallow such payments.<sup>51</sup>

Either a literal reading of section 1205(a) or an analysis of the caselaw on the issue irrefutably mandates that reasonable rent cannot be used to offset any delays to creditors occasioned by the Chapter 12 filing. Clearly reasonable rent is not a substitute for lost opportunity costs.

### C. Problems Opportunity Costs Cause

The legislative history of Chapter 12 pointedly addresses the problems opportunity costs cause:

Lost opportunity cost payments present serious barriers to farm reorga-

46. 11 U.S.C. § 1205(a) (1988).

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

48. *In re Shouse*, 95 Bankr. 470, 471 (Bankr. W.D. Ky. 1988).

49. *Id.* at 470-71.

50. *Id.* at 471 (citation omitted).

51. *Id.* at 473.

nizations, because farm land values have dropped so dramatically in many sections of the country—making for many undercollateralized secured lenders. Family farmers are usually unable to pay lost opportunity costs. Thus, family farm reorganizations are often throttled in their infancy upon motion to lift the automatic stay.

Accordingly, section 1205 of the conference report provides a separate test for adequate protection in Chapter 12 cases. It eliminates the need of the family farmer to pay lost opportunity costs, and adds another means for providing adequate protection for farmland—paying reasonable market rent. Section 1205 eliminates the ‘indubitable equivalent’ language of 11 U.S.C. 361(3) and makes it clear that what needs to be protected is the value of property, not the value of the creditor’s ‘interest’ in property.<sup>52</sup>

In contrast, Congress thought the provision of reasonable rent would have positive effects: “It is expected that this provision will reduce unnecessary litigation during the term of the automatic stay, and will allow the family farmer to devote proper attention to plan preparation.”<sup>53</sup>

The probability of declining collateral values is explicit in legislative pronouncements on both opportunity cost and reasonable rent. Why would opportunity cost “present serious barriers to farm reorganization?” The tentative answer follows the assertion that “because farmland values have dropped so dramatically . . . [there are] many undercollateralized secured lenders.”<sup>54</sup> However, undercollateralized secured lenders pose no barrier to reorganization per se, but only as a “triggering” factor to realizing opportunity costs.<sup>55</sup>

The second reason follows but is a non sequitur: “Family farmers are usually unable to pay lost opportunity costs,” namely, costs lost to the lender. Although inability to pay explains the “throttling” of farm reorganization feared, it does not relate directly to the fact of declining farm values. The problem is (perhaps) farmers’ diminished cash flow or increased production costs or declining commodity prices at any time.<sup>56</sup> Any payment can be difficult for the farmer in these circumstances, including the payment of reasonable rent.<sup>57</sup>

Declining farmland value might trigger a lender’s concern about his collateral during the automatic stay. However, declining land value per se does not cause the request for opportunity costs to pose a serious barrier to reorganization. Congress presumably thought rental payments would be less burdensome on the farmer than opportunity costs.<sup>58</sup> The opportunity cost

---

52. H. CONF. REP., *supra* note 4, at 49, 1986 U.S. CODE CONG. & ADMIN. NEWS at 5250.

53. *Id.* at 5251.

54. *Id.* at 5250.

55. *Id.*

56. *Id.*

57. *Id.*

58. *Id.*

payment by nature is an interest payment on the total secured collateral value.<sup>59</sup> Reasonable rent, however, is based on the "customary" payment for the "use of farmland" in the community. That rent is a lower payment precisely because of the declining value of farmland.<sup>60</sup>

#### IV. ISSUES IN COURT TREATMENT OF REASONABLE RENT

How has the reasonable rent concept been handled in case law? What are the key issues in case development?

##### A. *Showing Necessity of Adequate Protection*

Must the creditor first show that adequate protection is a necessity before reasonable rent may be allowed (as one adequate protection option under section 1205)?

The court in *In re Turner*<sup>61</sup> first had to determine if adequate protection was necessary at all under section 363(e).<sup>62</sup> In the *Turner* case the court emphasized section 1205(b)(3) was not automatically available; creditors such as Travelers Insurance Companies ("Travelers"), which held a first lien on approximately 1,039 acres of debtors' farmland, had to demonstrate a need for adequate protection.<sup>63</sup> This could be accomplished by proving the collateral was likely to diminish in value during the period of time when adequate protection was in fact permitted.<sup>64</sup> If Travelers could show this decline, there would be a per se right to "reasonable rent" according to the *Kocher* case.<sup>65</sup>

The court conjectured that if Travelers simply had been trying to recover lost opportunity costs via reasonable rent, its request would be denied.<sup>66</sup> After examining the legislative history of section 1205 and case law affecting its position, including *In re Rennich* and *Timbers II*,<sup>67</sup> the court turned to consideration of Travelers' situation. The court concluded that while there may be cases in which the need for adequate protection could justify the payment of reasonable rent, this was not one of them.<sup>68</sup> Travelers

---

59. *Id.*

60. *Id.*

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

62. *Id.* at 468. 11 U.S.C. § 363(e) (1988) provides:

Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest.

63. *In re Turner*, 82 Bankr. at 469.

64. *Id.*

65. *Id.* at 468.

66. *Id.* at 468-69.

67. *Id.* at 469.

68. *Id.* at 468.

had failed to establish its need for adequate protection.<sup>69</sup> The court went on to conclude that “[m]erely because the Debtors propose and intend to continue using the farm land secured to this creditor does not entitle the creditor to automatically recover rent under section 1205(b)(3). The court does not read section 1205(b)(3) to mean that rent is always required.”<sup>70</sup>

In concluding there is no per se right to adequate protection, the court in *In re Anderson*<sup>71</sup> focused on the following conditional wording in section 1205: “When adequate protection is required . . . adequate protection *may* be provided by various means including reasonable rental payments.”<sup>72</sup> The *Turner* decision was analyzed, quoted in depth, and adopted by the *Anderson* court.<sup>73</sup> The Court held: “Thus, based both on the legislative history of [section] 1205, and the holding in *Timbers [II]*, the court is restrained from ordering adequate protection for ‘lost opportunity costs,’ and is limited to awarding adequate protection to those cases [in which] the property itself is decreasing in value.”<sup>74</sup>

The *Anderson* court also stated that when adequate protection is required under sections 362, 363, or 364, such protection may be provided by several means, including payment of reasonable rent.<sup>75</sup> The court in *Turner* stated that adequate protection payments under section 1205 are justified if the creditor shows the value of property is “suffering.”<sup>76</sup>

When adequate protection is required under section 362, 363, or 364, the proposition that the protection may be provided by section 1205(b)(1), (2), (3), or (4) suggests one of these four alternatives must be used. Otherwise, the requirement of adequate protection is devoid of effect. However, that provision does not define *when* adequate protection is required, nor does it state adequate protection is *always* required during the stay.

### B. Automatic Application of the Rent Provision in Farmland Use

Does the reasonable rent provision apply automatically whenever a debtor *uses* farmland subject to a lien? Or does it apply only when the value of farmland is decreasing (due to any of the three reasons stated in the law: automatic stay; use, sale, or lease of the land; or grant of a lien)?<sup>77</sup> *Collier* states:

While at one time an argument could be made that the language of section 1205(b)(3) requires reasonable rent to be paid whenever a debtor

---

69. *Id.*

70. *Id.* at 469.

71. *In re Anderson*, 88 Bankr. 877 (Bankr. N.D. Ind. 1988).

72. *Id.* at 888 (emphasis in original).

73. *Id.* at 889-90.

74. *Id.* at 891.

75. *Id.* at 888.

76. *In re Turner*, 82 Bankr. at 469.

77. 11 U.S.C. § 1205(b)(1) (1988).

uses farmland subject to a lien, the Supreme Court decision in *United States Association of Texas v. Timbers of Inwood Forest Associates, Ltd.* (*In re Timbers of Inwood Forest Associates, Ltd.*) renders such an argument implausible. The *Timbers* case established that adequate protection under section 361 need only be provided to the extent of a decrease in the value of the property securing a creditor's claim. If the holder of a lien on farmland in a chapter 12 case is entitled to receive reasonable rent whenever a debtor uses the farmland, the scope of the debtor's obligation to provide adequate protection would be greater in a chapter 12 case than in cases filed under other chapters of the Code. This would be an absurd result in light of Congress' intent to make it easier for debtors in chapter 12 cases to provide adequate protection to secured creditors.<sup>78</sup>

Consequently, if farmland is either holding its value or actually appreciating, the undersecured creditor is not entitled to "reasonable rent" as adequate protection under section 1205.

The *Anderson* court ruled section 1205 did not entitle the creditor to adequate protection vis à vis rental payments because the property was appreciating rather than declining in value.<sup>79</sup> The court opined that "[u]nless waste is committed by the [d]ebtor and there was no evidence whatsoever of this fact, it is clear that the unimproved farm land has not decreased in value while this case has been pending and the stay is in effect."<sup>80</sup>

### C. Recovery of Rent or Decreased Land Value?

If land value is decreasing, is the creditor allowed only the reasonable rent payment? Or can he recover the decreased value of the land?

The statutory language "to the extent" in several parts of section 1205 suggests the creditor can recover the decreased farmland value. Section 1205(b)(1) and (2) both state adequate protection may be provided by payment to the extent the automatic stay, use of land, or grant of lien results in a decrease in the value of property securing a claim.<sup>81</sup> Was the "reasonable rent" provision designed to compensate the creditor fully for a decline in land value, meaning a complete offset to the decreased value? Conversely, were the payments only designed to provide protection of the interest of the creditor in some sense?

Other interpretations of the Code, insist the purpose of the adequate protection standard is to protect the value of the property, not the value of the creditor's interest in property. *Collier* suggests "to the extent" means

78. 5 COLLIER ON BANKRUPTCY ¶ 1205.01 - 1205-08 (15th ed. 1990) (citations omitted).

79. *In re Anderson*, 88 Bankr. at 888. Based on its secured claim and its undersecured status, the creditor would have been entitled to annual rental payments of \$24,107 if adequate protection had been deemed appropriate. *Id.*

80. *Id.*

81. 11 U.S.C. § 1205 (1988).

simply "whenever"; the reasonable rent payment is an option "whenever" the stay, use, or grant condition results in a decrease in the value of property.<sup>82</sup> Courts have been even more explicit in identifying the meaning of the provision. For example, in the *Kocher* decision the court stated section 1205(b)(3) does not require the decline in value of the collateral to be fully offset by rental payments.<sup>83</sup> "[T]he Chapter 12 debtor will in no event need to provide the creditor with more than the fair rental value of the land" in order to provide the requisite adequate protection.<sup>84</sup> The court further opined: "Section 1205(B)(3) clearly and unequivocally states that, where a creditor's claim is secured by farmland, the payment by the debtor of a fair rental value constitutes adequate protection *per se*."<sup>85</sup>

The *Kocher* court summarized its position with regard to the amount of rental payments as follows:

In sum, the rental payment form of adequate protection sanctioned by § 1205(b)(3) takes into account the economic realities of farm foreclosure. The addition of this alternative form of adequate protection; the elimination of the indubitable equivalent requirement; and, the statement by Congress that the debtor need only protect the value of the property, and not the value of the creditor's interest in the property, all are designed to achieve the avowed Congressional purpose of giving family farmers a fighting chance to reorganize their debts and keep their land. To accept the interpretation of § 1205(b)(3) which FLB urges the Court to adopt—that the reasonable rent paid by the debtors must completely offset the decrease in the value of FLB's collateral—would subvert the purpose of Chapter 12 and would stand the legislative history of § 1205 on its head.<sup>86</sup>

The statutory language is not clear as to the amount of rent that can be charged to meet adequate protection requirements. Interpretation of section 1205 benefits the debtor by limiting payments to a reasonable sum, not a figure fully compensating the creditor for any decline in land values.

## V. CONCLUSION

In order to realize compensation for the delays occasioned by the automatic stay before passage of Chapter 12, undersecured creditors looked to the adequate protection provisions in sections 361 and 362(d)(1).<sup>87</sup> Their argument was premised on the belief that their interest in the collateral included a right to foreclose, which deserved adequate protection under the

82. See *supra* text accompanying note 78.

83. *In re Kocher*, 78 Bankr. at 849-50.

84. *Id.* at 850.

85. *Id.*

86. *Id.*

87. See Note, "Adequate Protection" and the Availability of Postpetition Interest to Undersecured Creditors in Bankruptcy, 100 HARV. L. REV. 1106, 1107 (1987).

Code.<sup>88</sup> Central to the creditors' argument was their compensation for "lost opportunity costs" whenever a delay in foreclosure occurred.

The congressional reason for reasonable rent—to lessen the financial burden on the farmer—is realized by elimination of opportunity costs in the formal (statutory) sense. It is also realized in an informal sense: when there is no decline in the value of land, no rental payment is required. That is, to the extent reasonable rent "replaces" opportunity cost in the adequate protection scenario, rent can be ordered by the court: only when the value of collateral is declining.

Given the seemingly favorable treatment extended to debtors by Congress in allowing for reasonable rent to replace opportunity cost, the intriguing question remains why section 1205(b)(3) has not been used more extensively. Research on the subject has yielded only a handful of decisions involving reasonable rent, all at the bankruptcy court level.

The dearth of "reasonable rent" cases may have several explanations. As pointed out in the *Kocher*, *Turner*, and *Anderson*, there is no per se right to reasonable rent. In order to trigger section 1205, the creditor must show he needs adequate protection. The case law shows he must do this by demonstrating the collateral (farmland) is declining in value.

Whether such a decline is statutorily mandated is examined in *Collier on Bankruptcy*.<sup>89</sup> The author points out that in the other three provisions under section 1205, specifically (b)(1), (2), and (4), reference is specifically made to a decrease in the collateral. This qualification is missing from section 1205(b)(3), thus raising "the question of whether reasonable rent is required to be paid in every instance where the debtor is using farmland or only, as in the three other alternatives, where the farmland is decreasing in value."<sup>90</sup>

*Collier* goes on to conclude the last option, declining value of collateral, is the only option that makes sense. Consequently, if farmland is either holding its value or appreciating, the undersecured creditor is not entitled to "reasonable rent" as adequate protection under section 1205. Recent stabilization of farmland values and increases in some regions accounts for nonuse of the reasonable rent option.

In order to find the farmland is declining in value, there must be either agreement by the parties as to its value, or a valuation hearing in which expert testimony helps the court establish the collateral value. This must be done in order to determine the fair market rental value. Failure to show a decline results in rejection of a bid for adequate protection. Often this evaluation occurs at the time of or just before the confirmation hearing, leaving little time for another court determination on reasonable rent.

In denying the creditor's motion for adequate protection, the *Turner*

---

88. *Id.* at 1108.

89. 5 COLLIER ON BANKRUPTCY ¶ 1205.01-1205.08 (15th ed. 1990).

90. *Id.*



court stated that "Travelers is not barred from refileing its motion . . . and asserting proof to show a diminution in farm value prior to confirmation."<sup>91</sup> The court had earlier noted that neither the debtor nor the creditor had introduced proof as to the value of the farmland or the likelihood of a decline in value between the filing of the Chapter 12 petition and confirmation of the plan.<sup>92</sup> The question of valuation, especially the timing of valuation, is a most important factor in assessing why "reasonable rent" has not been selected as the most viable of the Chapter 12 adequate protection alternatives.

Scant use of the reasonable rent provision is a by-product of congressional intent present in Chapter 12 as well as other agricultural legislation. The policy is to avoid formal or procedural resolution of disputes and instead to favor negotiated settlements. There is evidence such informal resolution has occurred often, leading to nonuse of some or all Chapter 12 machinery, including the reasonable rent provision.<sup>93</sup>

The simplest answer may be the most correct. In contrast to Chapter 11 and 13 proceedings, a Chapter 12 petition is on a "fast track." The debtor is allowed only ninety days from the date the order for relief is granted in which to file a plan.<sup>94</sup> Similarly, the plan must be confirmed by the court not later than forty-five days after it is filed.<sup>95</sup> If the 135-day time limit is extended, as is happening more often in Chapter 12 proceedings, the extension is usually by mutual consent of the parties, and the creditor, therefore, is not disposed to challenge the quality of adequate protection, if any, being provided.<sup>96</sup>

The reasonable rent provision is best viewed as one example of social policy aimed at assisting debtors, specifically farm debtors, out of financial straits. If the forces that made farm property values plummet do not disappear, serious questions arise whether any measures will save the family farm. If such forces do disappear, the question also arises whether special legislation for family farmers is even necessary. This country has a long-standing tradition of social policy to help the perceived underdog and to respect the political power wielded by farm bloc states. Many instances of special farm price support, farm credit, and farm debt legislation can be cited to demonstrate that tradition. It seems appropriate to carry out congressional policy, Chapter 12 was enacted. It established a particular allocation of losses during the seven year life of the Act. The sentiment of Con-

---

91. *In re Turner*, 82 Bankr. at 469.

92. *Id.* at 467.

93. Interview with the Hon. David S. Kennedy, Chief Bankruptcy Judge, Western District of Tennessee, in Memphis, Tennessee (Jan. 10, 1990).

94. 11 U.S.C. § 1221 (1988). The court may extend the time period only if the extension is substantially justified.

95. 11 U.S.C. § 1224 (1988). The time may be extended by the court for cause.

96. *See supra* note 77.

gress is if farm creditors share the losses caused by the decrease in farm values, then the family farm might survive. Traditional social policy and assistance to a favored group coalesced in Chapter 12. The irony in the reasonable rent provision may be that special attention was not needed.