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by

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FARMERS' RELIEF UNDER THE BANKRUPTCY CODE: PRESERVING THE FARMERS' PROPERTY

PHILLIP L. KUNKEL*

Inflation, high interest rates, bumper crops, unstable foreign markets, expansion predicated on rising land values and inconsistent government policies have all combined to put the American farmer in a financial vise. Record numbers of farmers are seeking protection under the Bankruptcy Code. This article discusses the concept of "farmer" status contained in the Code, tax considerations in filing the farm bankruptcy and the application of certain provisions of the Code to obtain relief for the financially troubled farmer.

FARMERS AND THE BANKRUPTCY CODE[1]

Under the former Bankruptcy Act, a "farmer" was defined as:

> [A]n individual personally engaged in farming or tillage of the soil, and shall include an individual personally engaged in dairy farming or the production of poultry, livestock, or poultry or livestock products in their unmanufactured state, if the principal part of his income is derived from any one or more of such operations.[2]

Thus, under the Bankruptcy Act, there were two requirements: (1) the individual must have been personally engaged in farming or tillage of the soil; and (2) the principal part of his income must have been derived from farming. These requirements led to a great deal of uncertainty as to who was a "farmer" under the Act.[3]

Under the Bankruptcy Code, some of the uncertainty as to who qualifies as a farmer has been removed. According to the Code a "farmer" means a

> person that received more than 80 percent of such person's gross income during the taxable year of such person immediately preceding the taxable year of such person during which the case under this title concerning such person was commenced from a farming operation owned or operated by such person.[4]

A "farming operation" includes "farming, tillage of the soil, dairy farming, ranching, production or raising of crops, poultry, or livestock, and produc-

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1. All references to the "Code" contained herein are to the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978) (codified as 11 U.S.C. §§ 101-151, 326 (1982)).
2. 11 U.S.C. § 101(17) (1976).
3. *See, e.g.*, Jenkins v. Petitioning Creditor-Ray E. Friedman & Co., 664 F.2d 184 (8th Cir. 1981); *In re* Beery, 680 F.2d 705 (10th Cir. 1982). *See also* W. COLLIER, 2 COLLIER ON BANKRUPTCY § 101.17 (15th ed. 1983).
4. 11 U.S.C. § 101(17) (1982).

tion of poultry or livestock products in an unmanufactured state."[5]

The Bankruptcy Code therefore extends and clarifies the law with respect to the definition of a farmer in several respects. First, it is now clear that a partnership or corporation may be a farmer.[6] Second, the gross income-percentage test, which should be easy for a court to calculate, should lend more certainty to the definitional problems presented by the former Act.[7] Finally, by including the phrase "owned or operated by such person" in the definition, the definition should apply to some persons who would not have qualified as a "farmer" under the Act.[8]

Thus far, the courts have appeared willing to give a broad construction to the definition under the Code. In *In re Pommerer*,[9] the court determined that the debtors were farmers even though they were not engaged in farming at the time they filed their joint Chapter 7 petition:

> There is ample evidence that Pommerer has been engaged in farming in one way or another for many years. Part time employment as a truck driver to augment family income does not destroy his primary occupational pursuit. . . . That they do not, in fact cannot, farm at the present time, does not necessarily destroy this status. The testimony indicates that defendants intend to resume farming just as soon as circumstances permit. Their intention must be afforded great weight. Abandonment of a trade requires an intentional abandonment. . . . It is not for this Court to judge the wisdom, or even the feasability, of defendants attempting to resume farming. This Court finds nothing in the law which conditions the exemption for tools of a trade upon the debtor successfully pursuing that trade. If debtors intend to be farmers, so be it.[10]

Notwithstanding such a broad construction, the income-percentage test contained in the Code may limit the definition in such a way so as to exclude those farmers with significant off-farm income.[11]

A farmer may voluntarily seek the protection available under the Bankruptcy Code. He may not, however, be the subject of an involuntary petition.[12] The rationale for this provision is clearly set forth in the legislative history:

> Farmers are excepted because of the cyclical nature of their business. One drought year or one year of low prices, as a result of which a farmer is temporarily unable to pay his creditors, should not subject

5. *Id.* § 101(18).

6. "Person" is defined to include such entities. 11 U.S.C. § 101(30) (1982).

7. However, "gross income" is not defined by the Code. *But see* 26 U.S.C. § 61 (1976 & Supp. V 1981).

8. *See In re* Blanton Smith Corp., 7 B. R. 410, 414 (Bankr. M.D. Tenn. 1980).

9. 10 B. R. 935 (Bankr. D. Minn. 1981).

10. *Id.* at 942. *See also In re* Blanton Smith Corp., 7 B. R. 410 (Bankr. M.D. Tenn. 1980).

11. *See* Marsh, *Farmers' Exemption From Involuntary Bankruptcy*, 15 U.C.C. L.J. 162 (1982-83); Looney, *The Bankruptcy Reform Act of 1978 and the Farmer: A Survey of Applicable Provisions*, 25 S.D.L. REV. 509 (1980).

12. 11 U.S.C. § 303(a) (1982).

him to involuntary bankruptcy.[13]

The exemption from involuntary bankruptcy also prohibits a farmer who has voluntarily commenced a Chapter 11 or Chapter 13 proceeding from being converted to a Chapter 7 liquidation proceeding.[14] However, at least one court has held that the debtor's status as a farmer is an affirmative defense which must be pled and proven. It is not a jurisdictional fact.[15]

The status of the debtor as a "farmer" does not necessarily entitle the debtor to farm related exemptions. The debtor must be engaged in the trade on the date of the petition in order to claim the tools of that trade as exempt. However, when the debtor has only temporarily ceased his trade at the time of the petition, the tools of the trade may still be claimed as exempt. Exemption rights in tools of the trade are thus determined as of the date the petition is filed. They are not based upon the source of gross income in the preceding taxable year.[16]

The status of a debtor as a farmer under the Code thus merely prevents either an involuntary proceeding from being brought successfully or involuntarily converting a voluntary proceeding to a liquidation proceeding. It does not, however, prohibit a farmer's voluntary case from being dismissed.[17] The effect of a dismissal may well be substantially the same as a conversion to a Chapter 7 liquidation, and may, in fact, be worse from the farmer's point of view if there are significant unsecured claims.

TAX CONSEQUENCES OF FILING

In the event the farmer determines to seek protection from his creditors by commencing a bankruptcy proceeding, the tax consequences of such action must not be overlooked. The Bankruptcy Tax Act of 1980[18] addresses several issues which may arise following the filing of a bankruptcy petition. The entire Tax Act is beyond the scope of this article. However, there are at least two issues which must be considered.

The commencement of a Chapter 7 or Chapter 11 case by an individual creates a separate taxable entity that succeeds to the tax attributes of the debtor as well as the assets of the debtor.[19] However, no separate taxable

13. H.R. No. 95-595, 95th Cong., 1st Sess. 322, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5963, 6278.

14. 11 U.S.C. §§ 1112(c), 1307(e) (1982).

15. *In re* Johnson, 13 B. R. 342 (Bankr. D. Minn. 1981). "The law is not that a farmer cannot have an order for relief entered. He may file voluntarily. In an involuntary case whether (the) debtor is a farmer is a factual question to be pled and proven under 11 U.S.C. § 101(17) that more than 80% of his prior year's gross income was so derived. If he fails to plead and prove that he is a farmer, he has in effect consented to the entry of the order for relief." *Id.* at 346-347.

16. *In re* Johnson, 19 B. R. 371 (Bankr. D. Kan. 1982). *But see In re* Pommerer, 10 B.R. 935 (Bankr. D. Minn. 1981) where, in evaluating the issue of whether a debtor could avoid a lien on certain equipment under § 522(f)(2)(B), the court declared that the "threshold issue which must be determined . . . is whether or not debtors are farmers." *Id.* at 942.

17. 11 U.S.C. §§ 1112(b), 1307(c) (1982).

18. Pub. L. No. 96-589, 94 Stat. 3389 (1980).

19. 26 U.S.C. § 1398 (1976 & Supp. V 1981).

entity is created by the filing of a partnership or corporation.[20] Upon the termination of a bankruptcy case, the individual debtor succeeds to the tax attributes and assets of the estate.[21]

In addition to having his assets transferred to a new taxable entity, an individual debtor is granted an election to terminate his tax year on the day before the filing of a petition.[22] If the individual debtor makes such an election, any income tax liability for the short tax year prior to filing is an allowable priority claim against the estate.[23] However, since the tax liability for the first short tax year is not dischargeable,[24] the debtor is liable for any amount not collected from the bankruptcy estate. In computing the tax for the two short years, the debtor must annualize income for each short tax year as if the debtor's annual accounting period had been changed.[25] If the debtor does not make the election, none of the tax liability for the year the bankruptcy case is begun can be collected from the bankruptcy estate.

Before deciding to make a short year election, the debtor should consider that annualizing his or her income for the two short tax years could increase the total tax liability for the year. If such is the result, the debtor should weigh the increased tax against the benefit of having all or part of the tax liability for the first short tax year collected from the bankruptcy estate.

Notwithstanding this potential for increased tax liability, it is particularly important in the farm setting to consider the possibility of making the election provided by section 1398(d)(2) in the event that significant tax liabilities have been triggered by the prepetition liquidation of investment credit property or other property subject to recapture. If this has occurred, the election may result in savings for the debtor.

In contrast with a prepetition liquidation, the mere filing of the bankruptcy petition with the concomitant transfer of assets from the individual debtor to the estate is not a "disposition" within the meaning of the Internal Revenue Code.[26] Thus, no recapture, gain or loss, or acceleration of income will result from the commencement of a Chapter 7 or Chapter 11 case.

Less clear is the effect, if any, of the filing of a Chapter 7 or Chapter 11 bankruptcy petition upon the recapture tax imposed by section 2032A(c).[27] Section 2032A(c) provides that the federal estate tax benefits previously obtained under section 2032A will be recaptured if the specially valued land is disposed of outside the family or if the land ceases to be used in a "qualified use." As noted above, the commencement of a Chapter 7 or Chapter 11 case should not result in a disposition within the meaning of section 2032A(c).[28]

20. *Id.* § 1399.
21. *Id.* § 1398(i).
22. *Id.* § 1398(d)(2).
23. 11 U.S.C. § 507(a)(6)(A) (1982).
24. *Id.* § 523(a)(1)(A).
25. 26 U.S.C. § 1398(d)(2)(F) (1976 & Supp. V 1981).
26. *Id.* § 1398(f)(1).
27. *Id.* § 2032A(c).
28. *Id.* § 1398(f)(1).

However, the "qualified use" test may cause a more difficult problem.

Under the applicable Treasury regulations, it appears that each qualified heir who has obtained an interest in the specially valued property must maintain an "equity interest" in the specially valued property during the recapture period imposed by section 2032A.[29] Because a new taxable entity is created by the filing of a Chapter 7 or Chapter 11 petition, this test is probably not met since the qualified heir (the debtor) would no longer have an equity interest in the property. The equity interest would appear to be held by the estate as a result of section 1398(g).[30] If a farm debtor is a qualified heir who is operating a farm on real property which has previously been valued under section 2032A, the filing of a bankruptcy petition should be approached with extreme caution. The mere filing of the petition could trigger disastrous results.

Postpetition Issues

Several provisions of the Bankruptcy Code operate to restrain creditors from continuing or initiating collection activities against the debtor, to preserve property of the debtor to enable him to obtain a fresh start, to make operating capital available to a debtor who is attempting to rearrange his business, to avoid certain prepetition liens or transfers and to assume or reject certain prepetition contracts. The availability of one or more of these provisions may well, in some cases, be reason enough to seek protection under the Bankruptcy Code even if the debtor is not insolvent at the time the petition is filed. It is therefore crucial, in determining whether the farm debtor should seek such protection, to carefully consider these provisions. Imaginative use of these provisions may give more property to the farmer-debtor for a fresh start or preserve such property for the reorganized farming operation.

Automatic Stay: Section 362

The commencement of a case under the Bankruptcy Code operates as a stay against any action to collect a prepetition claim or debt against the debtor.[31] The legislative history clearly sets forth the purpose of the automatic stay:

> The automatic stay is one of the fundamental debtor protections provided by the bankruptcy laws. It gives the debtor a breathing spell from his creditors. It stops all collection efforts, all harassment, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganization plan, or simply to be relieved of the financial pressures

29. Treas. Reg. § 20.2032A-3(b)(1) (1983).

30. The debtor may also be subject to the rules of § 108 relating to income from the discharge of indebtedness following the filing of a bankruptcy petition. The tax treatment of such income is beyond the scope of this article. However, *see* Noffke, *Discharge of Indebtedness Under The Bankruptcy Tax Act of 1980*, 60 TAXES 635 (1982).

31. 11 U.S.C. § 362(a) (1982).

that drove him into bankruptcy.[32]

Thus, it would seem clear that the automatic stay contained in section 362 is very broad in scope. It would seem that it is intended to prohibit creditors from taking any action against a debtor which is reasonably calculated to further disorganize the debtor's efforts to deal with his financial problems and to interfere with the debtor's attempt to rehabilitate. This broad purpose should be kept in mind when analyzing any potential violation of the automatic stay.

Such violations may be found in cases where there may, in fact, have been no intent to collect a prepetition debt. For example, in *In re Haffner*,[33] the refusal of the Commodity Credit Corporation to accept grain from the debtor for deposit in the grain storage program unless the debtor agreed to allow the Commodity Credit Corporation to retain or setoff from the amount that otherwise would be paid to the debtor those amounts which were due from prepetition transactions constituted a violation of section 362(a)(6). The Commodity Credit Corporation argued that it was required by Federal regulations to set off such delinquent amounts against any payments for the current year. Further, it argued that such regulations applied to all farmers whether they were involved in bankruptcy or not. The court held that, notwithstanding such regulations, the setoff requirement was an attempt to collect a prepetition debt:

> The government admitted that the debtors meet the requirements necessary to participate in the price support program for the 1982 crops, except for the debtors' refusal to pay the past due, prepetition debt. The government, in effect, uses the regulation as leverage in forcing a debtor in bankruptcy to reaffirm a prepetition debt. It makes no difference that CCC would apply the same requirement to a farmer who is not involved in a bankruptcy proceeding, since it is the Bankruptcy Code which provides a debtor special protections from creditors not available to those who are not proceeding under a bankruptcy petition.[34]

Section 362 clearly halts foreclosure or repossession actions. However, it is not so clear as to whether section 362 operates to stay the expiration of a statutory redemption period which is granted the debtor by state law. Beginning with *In re Johnson*,[35] one line of cases has held that the automatic stay provisions of section 362(a) should be liberally construed to suspend the running of a statutory period of redemption.[36] Other decisions, holding to the contrary with respect to section 362(a), have instead found that section

32. H. REP. NO. 95-598, 95th Cong., 1st Sess. 340, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5963, 6296. The automatic stay also provides creditor protection, since, without it, certain creditors could pursue their remedies against the debtor's property. Those who acted first could benefit to the detriment of other creditors.

33. 25 B.R. 882 (Bankr. N.D. Ind. 1982).

34. *Id.* at 886. *See also In re* Hill, 19 B. R. 375 (Bankr. N.D. Tex. 1982).

35. 8 B. R. 371 (Bankr. D. Minn. 1981).

36. *Id.* at 374-75. *See also*, *In re* Jenkins, 19 B. R. 105 (D. Colo. 1982); Eaton Land & Cattle Co. II v. Rocky Mountain Inv., 28 B. R. 890 (Bankr. D. Colo. 1983); *In re* Shea Realty, Inc., 21 B. R. 790 (Bankr. D. Vt. 1982); *In re* H & W Enter., Inc., 19 B. R. 582 (Bankr. N.D. Ia. 1982); *In re*

108(b) is the sole applicable statute and that its automatic extension of a redemption period provides the only relief available.[37]

In *Johnson v. First National Bank of Montevideo*,[38] the Eighth Circuit Court of Appeals held that section 362(a) does not stay indefinitely the expiration of the statutory period of redemption. However, the sixty-day extension of time available to the debtors by section 108(b) does extend the expiration of the statutory redemption period. Under the facts of the case, the debtors, who failed to redeem from the property during the extended statutory redemption period, forfeited their rights to the property.[39] The effect of the *Johnson* case should be clear to counsel for debtors: If a repossession or foreclosure is imminent, the petition *must* be filed prior to the conduct of any sale.

Although the provisions of section 362(a) are very broad and evidence a congressional intent to protect the debtor from collection efforts, harassment and foreclosure actions, they are not absolute. Section 362(b) contains several actions to which the automatic stay does not apply.[40] In addition, section 362(d) provides that a creditor may obtain relief from the stay under certain circumstances.[41] In seeking relief from the stay, the party requesting such relief has the burden of proof on the issue of the debtor's equity in the

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Dohm, 14 B. R. 701 (Bankr. N.D. Ill. 1981); *In re* Sapphire Inv., 19 B. R. 492 (Bankr. D. Ariz. 1982).

37. 11 U.S.C. § 108(b) (1982). *See In re* Martinson, 26 B. R. 648 (D. N.D. 1983); *In re* Ecklund & Swedlund Dev. Corp., 17 B. R. 451 (Bankr. D. Minn. 1981); *In re* Owens, 27 B. R. 946 (Bankr. E.D. Mich. 1983).

38. No. 82-1622 slip op., (8th Cir. October 11, 1983).

39. The *Johnson* court also held that, under the facts of the case, the Bankruptcy Court had erred in applying section 105(a) of the Bankruptcy Code so as to stay the running of the statutory redemption period. Section 105(a) provides as follows: "The bankruptcy court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." The court declared:

> Despite the broad equitable powers bestowed by § 105(a), we . . . find ourselves in agreement with those courts which have held that § 105(a) may not be invoked to toll or suspend the running of a statutory period of redemption absent fraud, mistake, accident, or erroneous conduct on the part of the foreclosing officer. Johnson v. First National Bank of Montevideo, No. 82-1622, slip op. (8th Cir. October 11, 1983).

40. Section 362(a) does not apply to criminal actions or proceedings against the debtor; the collection of alimony, maintenance or support from property that is not property of the estate; any act to perfect an interest in property to the extent that the trustee's rights and powers are subject to such perfection; actions or proceedings by a governmental unit to enforce police or regulatory powers; the enforcement of a judgment, other than a money judgment, obtained in a proceeding by a governmental unit to enforce police or regulatory powers; the setoff of any mutual debt and claims that are commodity contracts, options, warrants or rights to purchase or sell commodity contracts; actions by the Secretary of Housing and Urban Development to foreclose a mortgage in cases in which the mortgage is insured by H.U.D. and covers property consisting of five or more living units; and the issuance to the debtor of a notice of tax deficiency. 11 U.S.C. § 362(b)(1)-(8) (1982).

41. Section 362(d) provides as follows:

> On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such that—
>
> (1) for cause, including the lack of adequate protection of an interest in property of such party in interest; or
>
> (2) with respect to a stay of an act against property, if—
>
> (A) the debtor does not have an equity in such property; and

property.[42] The party opposing such relief has the burden of proof on all other issues.[43]

"Adequate protection" which is at the heart of obtaining relief from the stay, is illustrated in section 361, which specifies three means of providing such protection.[44] To illustrate the concept of adequate protection, it is useful to examine each of the three methods in the context of a farm bankruptcy.

The first method of adequate protection outlined in section 361 is the making of periodic cash payments. In *In re Sewanee Land, Coal & Cattle, Inc.*,[45] the debtors purchased a tract of land and gave the seller of the land a promissory note secured by a deed of trust upon the land for consideration. The land was subject to a prior lien, created by a deed of trust from the seller to a bank, which deed of trust secured a debt to the bank from the seller. The debtor did not assume this debt. Rather, it was to be paid by the sellers. The debtor commenced a case under Chapter 11. Following the commencement of the case, the sellers of the land asked the court to lift the automatic stay so as to allow them to foreclose their lien upon the land. At the time of the hearing, the sellers were in default in the payments due to the bank and the bank was threatening foreclosure of its deed of trust upon the land. The court permitted the stay to remain in effect, provided that the debtor make monthly payments to the sellers of the land so as to permit the sellers to make their payments to the bank according to the terms of their debt.[46]

The second method of providing adequate protection is the provision of an additional or replacement lien on other property to the extent of the decreasing value of the property involved. The purpose of this method is to provide the protected entity with a means of realizing the value of the original property if it should decline during the case, by granting an interest in additional property from whose value the entity may realize its loss. In *In re Besler*[47] the court held that the offer by the debtors, through their sons, to grant a lender a mortgage on certain farm land owned by the debtors' sons would provide the lender with adequate protection. In so holding, the court observed:

Adequate protection is not defined in the Bankruptcy Code and must

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(B) such property is not necessary to an effective reorganization.

42. 11 U.S.C. § 362(g)(1) (1982).

43. *Id.* § 362(g)(2). *But see*, *In re* Kane, 27 B. R. 902 (Bankr. M.D. Pa. 1983), where the court held that a party seeking relief from the stay under § 362(d)(1) must first establish a prima facie case for relief since relief may only be granted under § 362(d)(1) "for cause." Furthermore, if the claim under § 362(d)(1) is that the lack of equity in property is the reason that the creditor is not adequately protected, the creditor must bear the burden of proof on the issue of that equity due to § 362(g). To the extent that the "cause" requirement of § 362(d)(1) is inconsistent with § 362(g), the substantive requirement of § 362(d)(1) should control.

44. 11 U.S.C. § 361 (1982).

45. 21 B. R. 813 (Bankr. N.D. Ala. 1982).

46. *Id.* at 816. *See also In re* Lambert Enter., Inc., 21 B. R. 529 (Bankr. W.D. Va. 1982); First Fed. Sav. & Loan Ass'n of Minneapolis v. Whitebread, 18 B. R. 192 (Bankr. D. Minn. 1982).

47. 19 B. R. 879 (Bankr. D. S.D. 1982).

> be determined on a case-by-case basis. Congress was aware of the turbulent rivalry of interests in reorganization. It needed a concept which would mediate polarities. But a carefully calibrated concept, subject to brittle construction, could not accomodate the "infinite number of variations possible in dealings between debtors and creditors." . . . Adequate protection was requisitioned to meet the "varying circumstances and changing modes of financing." . . . It is understood through analysis of the reorganization context and the language of 11 U.S.C. § 362(d).
>
> Adequate protection is interim protection; reorganization, dismissal or liquidation will provide the final relief. During this interim, the policies favoring rehabilitation should not be lightly discarded.[48]

The third method of providing adequate protection gives the parties and the court flexibility by allowing such other relief as will result in the realization by the protected entity of the value of its interest in the property involved. *In re Holt County Grain Storage, Inc.*,[49] the court held that a first mortgage holder was adequately protected where, although the debtor failed to pay $10,000 in real estate taxes, the value of the property was in excess of the mortgage, there was escrowed $83,000 in cash and there was a potential accrual of up to $55,000 in proceeds from the 1982 crop which could be used to pay the taxes. If there is an "equity cushion" in the property, such a cushion may be enough, by itself, to guarantee that a creditor will receive the indubitable equivalent of its interest in the property.[50]

In addressing the issue of adequate protection, the value of the property involved will nearly always be relevant. Section 361 does not specify how value is to be determined, nor does it specify when it is to be determined. The legislative history indicates that the ambiguities with respect to value was intentional:

> These matters are left to case-by-case interpretation and development. It is expected that the Courts will apply the concept in light of facts of each case and general equitable principles. It is not intended that the Courts will develop a hard and fast rule that will apply in every case. The time and method of valuation is not specified precisely in order to avoid that result. There are an infinite number of variations possible in dealing between debtors and creditors, the law is continually developing, and new ideas are continually being implemented in this field. The flexibility is important to permit the Courts to adapt to varying circumstances and changing modes of financing.
>
> Neither is it expected that the Courts will construe the term value to mean, in every case, forced sale liquidation value or full going concern value. There is wide latitude between those two extremes. In any particular case, especially a reorganization case, the determination of which entity should be entitled to the difference between the going

48. *Id.* at 383. *See also In re* Mickler, 13 B. R. 631 (Bankr., M.D. Fla. 1981); *In re* Karl A. Neise, Inc., 16 B. R. 600 (Bankr. S.D. Fla. 1981).

49. 25 B. R. 271 (Bankr. D. Neb. 1982).

50. *In re* Schaller, 27 B. R. 959 (Bankr. W.D. Wis. 1983); *In re* Reinhardt, 27 B. R. 2 (Bankr. M.D. Pa. 1982); *In re* Monroe Park, 17 B. R. 934 (D. Del. 1982).

> concern value and the liquidation value must be based on equitable considerations based on the facts of the case. It will frequently be based on negotiation between the parties. Only if they cannot agree will the Court become involved.[51]

It would thus appear that the standard of valuation to be applied in a particular case is within the discretion of the bankruptcy judge.[52]

Often, creditors of a farmer will seek relief from the stay to proceed with foreclosure proceedings, alleging, simply, that the debtor has no equity in the property. It is imperative that counsel for the debtor in such a case recognize and emphasize that a lack of equity in and of itself is not sufficient under section 362(d)(2) to obtain relief from the stay. Not only must the debtor not have an equity in the property, in order for the creditor to obtain relief from the stay, but such property must not be necessary to an effective reorganization. In the context of a farming operation, it is difficult to conceive of any significant item or items of property, whether real or personal, which would not be necessary to a reorganization.[53] However, one must bear in mind, as the *Besler* court pointed out, that adequate protection is a temporary protection.[54] It cannot be relied upon to provide a permanent solution to the debtors difficulties. Likewise, if the debtor cannot provide the creditor with adequate protection, the automatic stay will no longer afford protection to the debtor.[55]

Exemptions: Section 522

In the event that a Chapter 7 liquidation is determined to be the appropriate course of action, critical issues arise with respect to the exemptions which may be claimed by an individual debtor.[56] Such exemptions are generally intended to provide the minimum essentials to natural persons and are therefore denied to corporations and partnerships.[57]

In the event an individual files a Chapter 7 petition, he has the option under the Code of electing either the exemptions allowed by the state of his domicile or special Code exemptions.[58] However, states may prohibit the selection of the Code exemptions.[59] At least two states, Minnesota and Washington, have prohibited one spouse from electing the Code exemptions

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51. *In re* Kane, 27 B.R. 902, 906 (Bankr. M.D. Pa. 1983) *quoting* H. REP. NO. 95-598, 95th Cong., 1st Sess. 338-339 (1978).
52. *See In re* Kane, 27 B. R. 902, 906 (Bankr. M.D. Pa. 1983).
53. *See In re* Besler, 19 B. R. 879 (Bankr. D. S.D. 1982). "The Court . . . concludes that a farming and ranching operation irrefutably requires livestock, machinery, equipment, and vehicles, and also cropland, grazing land, and alfalfa land in order to effectively reorganize." *Id.* at 884.
54. *See* text accompanying note 47 *supra*.
55. *See, e.g.*, *In re* Scott Segal Farms, Inc., 31 B. R. 377 (Bankr. S.D. Fla. 1983), where the lack of equity, lack of insurance, state of poor repair and lack of use in the debtor's business were all cited by the court in finding that the secured creditor did not have adequate protection.
56. 11 U.S.C. § 522(b) (1982).
57. *See In re* Johnson, 19 B. R. 371 (Bankr. D. Kan. 1982).
58. 11 U.S.C. § 522(b) (1982).
59. *Id.*

and the other the exemptions under state law.[60]

The limitations on value contained in the Code exemptions may significantly limit their usefulness in the farm setting. For example, the Minnesota homestead exemption contains no limit as to value. The only limitation is an acreage limitation of 80 acres if located in a rural area.[61] In contrast, the Code exemption for the debtor's residence is limited, for each debtor, to $7500 in value.[62] Thus, it is necessary to carefully review both the Code exemptions and the applicable state law exemptions which may be available to the debtor in a Chapter 7 proceeding. And if the Code exemptions are available, the legislative history of section 522 gives support to the conversion of nonexempt assets into exempt property before filing a petition.[63]

If property is claimed by the debtor as exempt, it will generally remain subject to any voluntary liens which the debtor has granted. However section 522(f) grants the debtor the power to avoid judicial liens and nonpossessory, nonpurchase-money security interests that impair exemptions in certain types of personal property to the extent that the debtor would have been entitled to such exemptions under section 522(b).[64] However, section 522(f)(2) may not be applied to avoid liens acquired before the enactment of the Bankruptcy Reform Act of 1978.[65]

The Code does not define "implements" or "tools of the trade," which may be released from a security interest under section 522(f). Some courts have held that the avoidance power contained in section 522(f)(2)(B) applies only to hand tools and small implements with only nominal commercial resale value:

> There is no indication that Congress intended that, when a farmer who had pledged large items of equipment . . . for collateral defaulted and filed bankruptcy, the financing agency would make him a gift of the amount of the claimed exemption. The consequences of such a ruling to the financing institution should not be lightly brushed aside. From what appears here, a rather full loan was made to (the debtor) in order to permit him to commence his farming operation. If (the debtor) were to be successful now in holding this property exempt, PCA would have to advance the funds for the exemption and decrease its security on the collateral. . . . To permit the claim would be to inhibit financing for such equipment as well. If liens are to be avoided upon such property, it is obvious that such property will soon have no use as col-

60. *See* MINN. STAT. § 550.371 (1947 & Supp. 1983), WASH. REV. CODE §§ 6.12.100, 6.12.080 (1963 & Supp. 1983). A bankruptcy court in Washington has found that the Washington statutes are unconstitutional under the Supremacy Clause since 11 U.S.C. § 522(m) specifically allows "stacking" of state and federal exemptions. *In re* Jones, 31 B.R. 20 (Bankr. W.D. Wash. 1983).

61. MINN. STAT. § 510.01 (1947).

62. 11 U.S.C. § 522(d)(1) (1982).

63. *See* H. REP. NO. 95-595, 95th Cong., 1st Sess. 360-361 *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5963, 6316-17. *But see, In re* Schwingle, 15 B. R. 291 (W.D. Wis. 1981), where it was held that a transfer of nonexempt property for exempt property of approximately equal value was fraudulent under the former Bankruptcy Act.

64. 11 U.S.C. § 522(f) (1982).

65. United States v. Security Industrial Bank, — U.S. —, 103 S. Ct. 407 (1983).

lateral for any loan.[66]

While this view may be reasonable, the Code section's express language implies no such limitation. Thus, other courts have held that any such implements and tools, including tractors and other large farm implements, are subject to the avoiding power of section 522(f)(2)(B).[67]

In considering the use of the avoidance power contained in section 522(f), one should carefully review the state exemptions available to the debtor to determine if they are more advantageous to the debtor. It is clear that one can elect state exemptions and still avoid liens against the exempt property under section 522(f).[68]

It may not be necessary for the debtor to have any equity in the exempt property to avoid a lien under section 522(f).[69] The ability to "create" equity by use of section 522(f) should not be overlooked in the farm bankruptcy, particularly in those states that have liberal exemptions available for farm implements, equipment or tools of the trade.

If the Code exemptions are claimed, the value limitations contained in section 522(d) may become applicable if the debtor avoids a lien under section 522(f). However, in *Augustine v. United States*,[70] the debtors claimed as exempt farm tools and implements, including a tractor valued at $11,800. Each debtor claimed exemptions under section 522(d)(1) of $1400 in residential property, a house trailer. They also each claimed the difference between $7500 (the maximum amount allowed by section 522(d)(1)) and that sum plus $400 (as provided for in section 522(d)(5), the "wild card" exemption) and the $750 provided for in section 522(d)(6), all of which they sought to have applied to the farm implements. They then sought to avoid the lien of the Farmers Home Administration on those farm implements. The Third Circuit Court of Appeals held that the debtors were entitled to avoid the lien to the extent of the claimed exemptions, declaring, "Nothing in Section 522 suggests a distinction that will prohibit aggregation for purposes of lien avoidance while permitting it for exemption purposes."[71] Thus, even though the Code exemption for implements and tools of the trade is limited to $750, it is possible to avoid liens in excess of that amount by using the section 522(d)(5) "wild card" exemption.

Issues with regard to exemptions will be most prevalent in Chapter 7

66. *In re* Yparrea, 16 B. R. 33, 35 (Bankr. D. N.M. 1981). *See also*, *In re* O'Neal, 20 B. R. 13 (Bankr. E.D. Mo. 1982); *In re* Sweeney, 7 B. R. 814 (Bankr. E.D. Wis. 1980).

67. *In re* Liming, 22 B. R. 740 (Bankr. W.D. Okla. 1982); *In re* Seacord, 7 B. R. 121 (Bankr. W.D. Mo. 1980); Augustine v. United States, 675 F.2d 582 (3rd Cir. 1982); *In re* Zweibahmer, 25 B. 453 (Bankr. N.D. Ia. 1982).

68. *In re* Yparrea, 16 B.R. 33 (Bankr. D. N.M. 1981); *In re* O'Neal, 20 B. R. 13 (Bankr. E.D. Mo. 1982); *In re* Zweibahmer, 25 B.R. 453 (Bankr. N.D. Ia. 1982). It may also be advantageous if there is case law that establishes that large farm machinery is a "tool of the trade" under the state exemption statutes. *See In re* Liming, 22 B. R. 740 (Bankr. N.D. Okla. 1982).

69. *In re* Mitchell, 25 B. R. 406 (Bankr. N.D. Ga. 1982); Pine v. Creditthrift of America, Inc., 18 B. R. 711 (E.D. Tenn. 1982). *But see*, *In re* Barone, 31 B. R. 540 (Bankr. E.D. Pa. 1983).

70. 675 F.2d 582 (3rd Cir. 1982).

71. *Id.* at 586. *Accord*, *In re* Pommerer, 10 B. R. 935 (Bankr. D. Minn. 1981); *In re* Dubrock, 5 B. R. 353 (Bankr. W.D. Ky. 1980); *In re* Boozer, 4 B. R. 524 (Bankr. N.D. Ga. 1980).

cases. However, it may be possible to avoid liens under section 522(f) when a Chapter 13 petition has been filed, despite the provisions of section 1325(a)(5)(B) which provides for the retention of the lien of a holder of a secured claim who does not accept a Chapter 13 plan.[72] Several cases hold that section 522(f) is applicable in Chapter 13 cases, citing section 103(a) of the Code which provides that Chapters 1, 3 and 5 of the Code apply in a case under Chapters 7, 11 or 13.[73]

There are thus several significant opportunities for the debtor in a Chapter 7 case involving the debtor's exemptions. Such issues should be considered by counsel for the debtor prior to the filing of any bankruptcy petition. One must always attempt to preserve as many exempt assets as possible.

Use, Sale or Lease of Property: Section 363

Generally, a debtor in possession in a Chapter 11 case or a debtor in a Chapter 13 case may continue to operate the debtor's business following the commencement of the case.[74] While operating the business, the debtor in possession or debtor may enter into transactions including the sale or lease of property of the estate, in the ordinary course of business and may use property of the estate in the ordinary course of business without notice or a hearing.[75] However, this power to use the property of the estate is subject to certain limitations.

With respect to "cash collateral," the debtor in possession may not use, sell or lease such collateral except upon court authorization after notice and a hearing, or with the consent of each entity that has an interest in such cash collateral.[76] "Cash collateral" is cash, negotiable instruments, documents of title, securities, deposit accounts or other cash equivalents in which the estate and another entity have an interest.[77]

In the case of a farming operation, there will frequently be an urgent need for cash to meet operating expenses for such things as feed for livestock, fuel or utilities. It will often be necessary to sell collateral such as livestock, milk or stored grain to raise such cash on a recurring basis. It is often therefore advisable, in such a case, to file a motion to use cash collateral at the same time as the petition. The court is directed to act promptly on any request for authorization to use cash collateral.[78]

If a creditor has failed to perfect a security interest in the cash

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72. 11 U.S.C. § 1325(a)(5)(B) (1982).

73. Section 103(a) provides as follows: "Except as provided in section 1161 of this title, chapters 1, 3, and 5 of this title apply in a case under chapter 7, 11, or 13 of this title." *See* Baldwin v. Avco Fin. Serv., 22 B. R. 507 (D. Del. 1982); *In re* Drummond, 17 B. R. 494 (Bankr. E.D. Ark. 1981); *In re* Mitchell, 25 B. R. 406 (Bankr. N.D. Ga. 1982). *See also In re* Mattson, 20 B. R. 382 (Bankr. W.D. Wis. 1982).

74. 11 U.S.C. §§ 1107, 1108, 1304 (1982).

75. *Id.* § 363(c)(1).

76. *Id.* § 363(c)(2).

77. *Id.* § 363(a).

78. *Id.* § 363(c)(3).

equivalent which the debtor in possession must sell, the property is not "cash collateral." In *In re Bindl*,[79] several creditors had obtained milk assignments from the debtor, a dairy farmer whose only regular income was from the sale of milk. Only one of the creditors properly perfected its interest in the debtor's milk check by filing a proper financing statement. The court held that absent a properly perfected security interest in the assigned accounts, those creditors had no interest in the cash paid on the accounts. That cash could thus be used in the operation of the debtor's business since it was not cash collateral in the hands of the debtor.[80]

If the debtor seeks authorization to use cash collateral in the operation of his business, the court may prohibit the use of such collateral or condition its use upon the debtor providing the secured creditor with adequate protection.[81] This is the same concept as is raised in the case of a creditor seeking relief from the automatic stay.[82] However, a court may not be as willing to find that the creditor has been provided adequate protection solely on the basis of an equity cushion:

> [T]his Court is satisfied that the Debtor should not be permitted to use cash collateral without making some payments to the secured party just because it has, at the commencement of the case, a meaningful equity cushion in the collateral. To accept this proposition would mean that a debtor may freely use cash collateral until the collateral is reduced to the amount of indebtedness during which time the secured party is deprived of income, for which it bargained when the loan was granted.[83]

The burden of proof with regard to adequate protection in the context of section 363 is also slightly different. The burden is placed exclusively upon the debtor to establish adequate protection.[84] In contrast, the burden of proof with respect to the debtor's equity in property is placed upon the party seeking relief from the stay in the context of section 362.[85]

However, in dealing with the secured creditor's right to adequate protection, one can point to the strong policy in favor of reorganization found in the Code:

> In an ongoing business, where the creditor's security is in accounts receivable and inventory, the value of the security will diminish through use, although it should be replenished as the business continues. The Court is not obligated to protect the creditor better than it did itself when making the loan and obtaining security. At the same time, the Court cannot allow the security to be diminished. The policy of the Code, as was that of the predecessor statutes, is to encourage reorgani-

79. 13 B. R. 148 (Bankr. W.D. Wis. 1981).
80. *Id.* at 151. *See also In re* Liles & Raymond, 24 B. R. 627 (Bankr. M.D. Tenn. 1982).
81. 11 U.S.C. § 363(e) (1982).
82. *See* text accompanying note 44, *supra*.
83. *In re* Earth Lite, Inc., 9 B. R. 440, 444 (Bankr. M.D. Fal. 1981). *See also In re* Epstein, 26 B. R. 354 (Bankr. E.D. Tenn. 1982).
84. 11 U.S.C. § 363(e) (1983).
85. *See* note 42, *surpa*.

zation if there is a reasonable possibility of success.[86]

In *In re Stein*,[87] the farm debtors applied to the court for authorization to use cash collateral consisting of the debtor's monthly milk check. The debtors had previously given the Farmers Home Administration an assignment of $4500 per month which was deducted from their monthly check. The Farmers Home Administration was undersecured by approximately $58,000. The court concluded that the Farmers Home Administration was not adequately protected previous to the filing of the Chapter 11 petition. It further found that the creditors secured position could only be enhanced by the continued operation of the farm since the liens on the livestock and crops were increasing in value as the daily herd continued to reproduce and the crops were harvested. Thus, the court set aside the prepetition milk assignment and authorized its use by the debtors in the operation of the farming business.[88]

In addressing applications for the use of cash collateral one must bear in mind that:

> [T]he Court must balance two irreconcilable and conflicting interests. The holder of a lien on cash collateral must not be left unprotected by unrestricted use of the collateral by the debtor. However, the purpose of Chapter 11 is to rehabilitate debtors and generally, access to cash collateral is necessary in order to operate a business. The equities in each case must be weighed in striking a balance. . . . The authority to grant the use of cash collateral carries with it a concomitant responsibility to insure that the value of the creditor's security is not impaired.[89]

Obtaining Credit: Section 364

Upon filing of the petition a debtor who seeks to continue his farming operation is faced with the need to obtain continued financing in order to sustain the business. This will be particularly true if the business consists of a cash grain farming operation. Section 364(a) provides that a debtor may obtain unsecured credit and incur unsecured debt in the ordinary course of business without court approval. The debts so incurred are allowable as administrative expenses under section 503(b)(1).[90]

A debtor will probably find it difficult to obtain unsecured credit when in a Chapter 11 or Chapter 13 proceeding. Thus, the Code provides that, after notice and a hearing, the debtor may obtain secured credit with a "special" priority.[91] While unsecured creditors may well object to the use of unencumbered assets as a means of obtaining postpetition operating loans to finance the future operations of the debtor, there is no requirement that

86. *In re* Heatron, Inc., 6 B. R. 493, 496 (Bankr., W.D. Mo. 1980).
87. 19 B. R. 458 (Bankr. E.D. Pa. 1982).
88. *See also In re* Besler, 19 B. R. 879 (Bankr. D. S.D. 1982).
89. *In re* Stein, 19 B. R. 458, 459 (Bankr. E.D. Pa. 1982).
90. 11 U.S.C. § 364(a) (1982).
91. *Id.* § 364(c).

holders of unsecured claims be provided adequate protection. Likewise, it would appear that there are no constitutional constraints from extinguishing the recovery rights of holders of unsecured claims because an unsecured claim confers no right in specific property of the obligor.[92] Thus, even though the use of "free" assets as collateral in order to obtain credit may impair the ability of unsecured creditors to obtain payment, such assets may be used as collateral by the debtor.

If the debtor cannot obtain either unsecured credit or a special priority loan under section 364(c), 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 property of the estate that is already subject to a lien if the existing lienholder is provided adequate protection. To obtain this "superpriority" lien, the debtor must prove that the lender is adequately protected.[93] In *In re Stratbucker*,[94] the farm debtor sought to obtain credit for working capital to plant his spring crops. The holder of the first real estate mortgage and the first lien on crops objected to the granting of a superpriority lien. However, the court held that the lienholder was adequately protected due to the debtor's equity in the real estate. In addition, the court found that there was also adequate protection "in that, unless the crops are planted, the lienholders will have no interest (in crops) requiring protection."[95] Thus, even if the proceeds from the crops were sufficient only to cover the costs of planting, the mortgage holder would be in as good a position as it would have been if the crops were not planted at all.[96] The court did not allow the debtor, however, to grant a superpriority lien with respect to crops already growing or in other assets of the estate.[97]

In summary, section 364 offers the debtor several alternatives means of obtaining necessary financing. Such alternatives may be useful if a lender is reluctant to provide funds to a business which is already in bankruptcy. However, because of section 364, it may well be possible to offer a lender better security because of the bankruptcy filing.

Executory Contracts: Section 365

A farmer will typically be a party to executory contracts that involve substantial future performance by both parties to the contract. A typical example is an installment sales contract. Often, the farmer will not be current in making any periodic payments under such contracts and the farmer's rights under the contract may be in jeopardy. In general, such executory

92. Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 588, (1935). *See also In re* Garland Corp., 6 B. R. 456 (Bankr. App. Panel, D. Mass. 1980).
93. 11 U.S.C. § 364(d) (1982).
94. 4 B. R. 251 (Bankr. D. Neb. 1980).
95. *Id.* at 253.
96. *Id.*
97. If the petition has been filed prior to the planting of crops, it will be possible to offer a security interest in the postpetition crops under § 364(c) because of § 552(a) which terminates any after-acquired property clause contained in a prepetition security agreement.

contracts are treated as assets of the estate by the Code, even though "executory contract" is not defined by the Code. The definition most often referred to, and the definition referred to in the legislative history, is a definition propounded by Professor Countryman. "[A] contract under which the obligations of both the Bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other."[98]

Under the Code a trustee in a Chapter 7 case must assume an executory contract or unexpired lease within sixty days after the petition is filed, unless the court, for cause, fixes an additional period of time. If the contract is not assumed, it is deemed rejected.[99] In a case under Chapter 11 or 13, the debtor may assume or reject an executory contract or unexpired lease of the debtor at any time before the confirmation of a plan. However, the other party to the contract may ask the court to require the debtor to assume or reject such a contract prior to confirmation.[100] If there has been a default in an executory contract, the debtor or trustee must cure or provide adequate assurance that he will promptly cure such defaults at the time of assumption. In addition, the debtor must provide adequate assurance that he will promptly compensate the other party for any actual loss to such party resulting from such default and provide adequate assurance of future performance under the contract.[101]

With respect to executory contracts, a careful evaluation must be made of all equipment, building and machinery leases in the case of a farm debtor. If the balance due under the contract or lease is significantly greater than the value of the property, the debtor should understandably be reluctant to assume the contract, provided it is a true lease. If, however, the transaction is a disguised sale transaction, the "lessor's" claim will be secured only to the extent of the value of the collateral.[102] Whether a "lease" is a true or bona fide lease or, in the alternative, a financing lease intended as security depends upon the circumstances of each case. The distinction between a true lease and a financing transaction is based upon the economic substance of the transaction and not upon the holding of title, the form of transaction or the fact that the transaction is denominated as a "lease." The fact that the lessee, upon compliance with the terms of the lease, becomes or has the option to become the owner of the leased property for no additional consideration, or for nominal consideration, should tend to indicate that the transaction is a financing lease or a lease intended as security. In such cases, the lessor has no substantial interest in the leased property at the expiration

98. Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1972-73). *See* H. REP. NO. 95-598, 95th Cong., 1st Sess. 347, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5963, 6203-04.

99. 11 U.S.C. § 365(d)(1) (1982).

100. *Id.* § 365(d)(2).

101. *Id.* § 365(b)(1).

102. *Id.* § 506(a). *See also*, *In re* Scrap Disposal, Inc., 15 B. R. 296 (Bankr. 9th Cir. 1981); *In re* Rojas, 10 B. R. 353 (Bankr. 9th Cir. 1981).

of the lease term. In addition, the fact that the lessee assumes and discharges substantially all the risks and obligations ordinarily attributed to the outright ownership of the property is more indicative of a financing transaction than a true lease.[103]

A second type of "executory contract" which may be very important to the reorganization or rehabilitation of a farming operation is the contract for deed, or installment land contract. Such contracts would fall within the Countryman definition set forth above, since the failure of either party to the contract to complete performance would constitute a material breach excusing the performance of the other.[104] Several cases have held, at least where the debtor is the vendor under such a contract, that a contract for deed is an executory contract.[105] If treated as such, it must be assumed or rejected as written, with its benefits and burdens.[106] In contrast, if the contract for deed is viewed as a lien, it may be modified by the debtor's plan as could a purchase money mortgage.

In a lengthy and persuasive opinion, Judge Mabey in *In re Booth*,[107] held that where the debtor was the vendee under a contract for deed, such a contract was not an executory contract which need be assumed under section 365.[108] In so holding, Judge Mabey determined that treating a contract for deed as a lien, rather than an executory contract, was of greater benefit to the estate. There were several reasons for this decision. First, treating the contract like a lien held by a secured party enabled the debtor to retain whatever equity had been built up in the property. Second, treating the contract for deed as a lien furthers the rehabilitation of the debtor by enabling him to sell it free and clear of the lien or dealing with it in a plan by scaling down the debt, reducing the interest rate or extending the maturity. Third, treating the contract for deed as a lien avoided unfairly encumbering the debtor with the costs of assuming an executory contract under section 365(b)(1).

While it may be argued that section 365(i) and (j) mandate that such contracts for deed are executory contracts, such sections treat the non-debtor vendee as a mortgagor and give him the option of either remaining in possession or treating the contract as terminated.[109] If the purchaser remains in possession, he is required to continue to make the payments due, but may

103. *See generally*, J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE 880-883 (2d ed. 1980).

104. *In re* Middleton, 3 B. R. 610 (Bankr. E.D. Pa. 1980); *In re* Mercury Home Dev. Co., 4 B.C.D. 837 (N.D. Cal. 1978); *In re* Cleve, 3 B.C.D. 1217 (S.D. Cal. 1977); *In re* Williams, 1 B.C.D. 171 (W.D. Okla. 1974).

105. *See In re* Booth, 19 B. R. 53, 58 (Bankr. D. Utah 1982).

106. "The installment land contract and the purchase money mortgage fulfill the identical economic function—the financing by the seller of the unpaid portion of the real estate purchase price." G. OSBORNE, G. NELSON & D. WHITMAN, REAL ESTATE FINANCE LAW 79 (3rd ed. 1979). With regard to the modification of a mortgage in a plan, *see In re* Hollanger, 15 B. R. 35 (Bankr. W.D. La. 1981).

107. 19 B. R. 53 (Bankr. D. Utah 1982).

108. *Id.* at 64.

109. 11 U.S.C. § 365(i), (j) (1982).

offset damages that occur after rejection. If the purchaser treats the contract as terminated, he is granted a lien on the property to the extent of the purchase price paid.

Booth has been followed by at least two courts who have, in addition to relying upon Judge Mabey's analysis, advanced other reasons for treating the contract for deed as a lien. In *In re Cox*,[110] the court cited the doctrine of equitable conversion in support of its holding:

> The doctrine of equitable conversion, when applied to a contract for the sale of the kind herein discussed, considers the vendor as a trustee holding title in trust for the purchaser and as security for the purchase price. He is considered owner of the purchase money with an equitable lien on the property for any unpaid balance of the purchase price. . . . In practical fact, the vendor in transactions of the kind in issue performs no duties after the execution and deposit of title documents with the escrow holder. He cannot terminate the agreement and recover possession of the property unless there has been a material breach by the buyer and termination does not result in the penalty to the vendee.[111]

In *In re Adolphsen*,[112] the court compared the contract for deed with a promissory note:

> In my opinion a contract for deed is not an executory contract for the same reasons a promissory note is not executory. In the case of a note, a lender is only awaiting repayment. Likewise, in the contract for deed situation the vendor also awaits payment. . . . The fact that (the vendor) holds legal title and must at some point convey it to the debtors does not render the contract executory anymore than the duty of the holder of the promissory note to return the note when the debt is satisfied makes it executory. Clearly it does not. (The vendor) merely holds title as security for payment just as a lender holds a note.[113]

In addition *Booth* has been applied to an installment sales contract dealing with personal property.[114]

The *Booth* line of cases does not necessarily render all contracts for the sale of real estate nonexecutory, however. For example, a purchase agreement in which the vendor promises to sell and the vendee promises to buy certain real property would remain an executory contract. Both obligations under such a contract remain substantially unperformed and therefore are executory.[115] It is only those contracts for deed under which the vendee has all the incidences of ownership except legal title, including the right to pos-

110. 28 B.R. 589 (Bankr. D. Idaho 1983).

111. *Id.* at 590.

112. Bky. No. 3-83-80 slip op., (Bankr. June 1, 1983).

113. *Id.* at 3. "A note is not usually an executory contract if the only performance that remains is repayment. Performance on one side of the contract would have been completed and the contract is no longer executory." S. REP. No. 95-989 95th Cong., 2nd Sess. 58 *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5787, 5844.

114. *In re* Shada Truck Leasing, Inc., 31 B. R. 97 (Bankr. D. Neb. 1983). *See also In re* Gladding Corp., 22 B. R. 632 (Bankr. D. Mass. 1982).

115. *See In re* Adolphsen, Bky. No. 3-83-80, slip op. at 4 (Bankr. June 1, 1983).

session, that may be treated as a lien.[116]

Preferences: Section 547

The Code allows the trustee or the debtor in possession in a Chapter 11 or Chapter 13 proceeding to avoid certain prepetition transfers. As a practical matter, many of these transfers will often involve large secured creditors. The debtor may well be reluctant to avoid such transfers if the cooperation of these creditors is required to formulate and implement a Plan. However, the avoidance powers should not be overlooked as a negotiation point with even these creditors.

Among the most useful avoiding power granting the debtor by the Code is the power to avoid preferential transfers.[117] Section 547 authorizes the avoidance of transfers if the five conditions set forth in section 547(b) are met. It should be kept in mind, however, that "transfer" is defined very broadly by the Code. " 'Transfer' means every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest."[118] For the purposes of section 547, "the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition."[119]

The Code specifies several exceptions to the avoiding powers contained in section 547(b). The first exception is where a transfer that is intended by the parties to be a contemporaneous exchange for new value, and which is,

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116. In addition, not all executory contracts may be assumed under § 365. Personal service contracts and contracts to make a loan or to extend financing are not assumable under § 365(c).

117. Section 547(b) provides as follows:

Except as provided in subsection (c) of this section, the trustee may avoid any transfer of property of the debtor—

(1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

(3) made while the debtor was insolvent;

(4) made—

(A) on or within 90 days before the date of the filing of the petition; or

(B) between 90 days and one year before the date of the filing of the petition, if such creditor, at the time of such transfer—

(i) was an insider; and

(ii) had reasonable cause to believe the debtor was insolvent at the time of such transfer; and

(5) that enables such creditor to receive more than such creditor would receive if—

(A) the case were a case under Chapter 7 of this title;

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

118. 11 U.S.C. § 101(41) (1982); *In re* Jam Fine Furniture, Inc. 19 B. R. 578 (Bankr. S.D. Fla. 1982) (filing of a warrant with the state of Florida which created a lien constituted a transfer); *In re* Steele, 27 B. R. 474 (Bankr. W.D. Wis. 1983) (giving of a mortgage constitutes a transfer); *In re* Enlow, 20 B. R. 480 (Bankr. S.D. Ind. 1982) (perfection of a security interest in farm machinery by the assignee of a retail installment contract more than 10 days after the sale and within 90 days of the filing of the petition constitutes a preference). *See also In re* Brame, 26 B. R. 309 (Bankr. W.D. Ky. 1982).

119. 11 U.S.C. § 547(f) (1982).

in fact, substantially contemporaneous.[120] The second exception is for transfers in the ordinary course of business and made not later than forty-five days after the debt was incurred.[121] The third exception is for enabling loans in connection with which the debtor acquires the property that the loan enabled him to purchase after the loan is actually made, provided that a security interest in such newly acquired property is perfected before ten days after such security interest attaches.[122] The fourth exception relates to the situation in which the creditor and the debtor have more than one exchange during the ninety day period immediately preceding the filing of the petition. In such a case the exchanges are netted out. Any new value that the creditor advances must be unsecured in order for it to qualify under this exception.[123] The fifth exception is for a creditor who has a security interest in a floating mass, such as inventory or accounts receivable. Such a creditor will not be subject to preference attack except to the extent that he improves his position during the ninety day period before bankruptcy and does not give new value for his improved position.[124] The final exception excepts statutory liens validated under section 545.[125]

With regard to farm bankruptcies, there are two avenues of attack under section 547 which may be available in some cases and which may not be readily apparent. The first deals with the exception to preference attack provided the lender with a security interest in inventory or receivables. Inventory is defined for purposes of section 547 to include "farm products such as crops or livestock, held for sale or lease."[126] To the extent that the holder of a security interest in such inventory improves his position during the ninety day period before bankruptcy, he has realized a preferential transfer. That is such a lender can realize from the collateral only what he could have realized ninety days before the filing of the petition. If the secured creditor improves his position by acquiring a lien in additional after-acquired property during the ninety day period immediately preceding the filing of the bankruptcy petition, and makes no new advance to match its improved position, there is an avoidable preference to the extent that the security interest increases in value. In *In re Nivens*[127] the trustee alleged that a creditor with a security interest in crops was not entitled to certain federal deficiency and disaster payments because of section 547(c)(5) since the lender had made no new advance during the ninety day period immediately preceding bankruptcy. The court held that "if there is only an increase in *value* of the inventory due to market fluctuations, without an accompanying increase in volume of inventory, there is no avoidable preference."[128] The court distin-

120. 11 U.S.C. § 547(c)(1) (1982).
121. *Id.* § 547(c)(2).
122. *Id.* § 547(c)(3).
123. *Id.* § 547(c)(4).
124. *Id.* § 547(c)(5).
125. *Id.* § 547(c)(6).
126. *Id.* § 547(a) (1982).
127. 22 B. R. 287 (Bankr. N.D. Tex. 1982).
128. *Id.* at 293.

guished a crop as "inventory" from other types of inventory:

> A crop is continuously undergoing change. Its existence commences as soon as the seed is planted and starts to germinate. It undergoes daily change until it finally matures and is ready for harvest. The lien which was initially fixed against the crops in its embryonic stages continues against the crop in all stages of development. It is the same lien and the same crop. Although the crop is increasing in value the crop was in existence at all relevant times. While there might be an increase in the value of the crop between the different stages of its development, the "inventory" itself is not increased. There is nothing added within the prohibited period which would mandate avoidance of lien against increase.[129]

Presumably, the court's reasoning in *Nivens* would allow the trustee to successfully claim that a secured lender with a security interest in livestock would be subject to attack to the extent that the size of the herd increased during the ninety day period.

The second preference issue which should be closely examined is the issue of whether any transfers have been made to an "insider" during the period that begins one year before the filing of the petition and ends ninety days before the filing.[130] An "insider" is one who has a sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at arms length with the debtor.[131] One commentator has suggested that there are two primary purposes behind section 547. The first is the desire to avoid a prepetition race to the courthouse by creditors to dismember the debtor.[132] And the second is to promote equality among creditors by not allowing a debtor to favor any particular creditor in the distribution of his assets.[133] It would thus appear that the insider provisions of section 547 are designed to prevent a party with a close relationship with the debtor from exerting influence on the debtor so as to attain a preferred position.

With regard to who is an insider, the Code does not provide a precise definition. Section 101(25) provides only a detailed but nonexclusive list of persons deemed to be insiders. Thus, it would appear that the question of who may be an insider must be decided on a case-by-case basis.[134]

Significantly, the insider definition contained in section 101(25) includes a "person in control." Because the Code does not define "person in control" or "control," these will again have to be determined on a case-by-case basis. One commentator has suggested that in using the word "con-

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129. *Id.* at 293-94.

130. For text of 11 U.S.C. § 547(b)(4)(B) *see supra* note 115.

131. *See* 11 U.S.C. § 101(25) (1982) for the definition of an insider. *See also*, S. REP. No. 95-989, 95th Cong., 2d Sess. 25 *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5787, 5810-11; *In re* Montanino, 15 B. R. 307 (Bankr. D. N.J. 1981).

132. Note, *The Term Insider Within Section 547(b)(4)(B) of the Bankruptcy Code*, 57 NOTRE DAME LAW. 726, 727-28 (1981-82).

133. *Id.*

134. *See, e.g.*, *In re* Durkay, 9 B. R. 58 (Bankr. N.D. Ohio 1981). *But see*, *In re* Castillo, 7 B. R. 135 (Bankr. S.D. N.Y. 1980), where the court applied, without an analysis of the facts, § 101(25).

trol," Congress intended the same broad concept of control as is found in the securities laws.[135] Under such laws, the possession of the power to direct or cause the direction of the management and policies of a person, whether through the ownership avoiding securities, by contract or otherwise, constitutes "control."[136] If this broad definition of control is applied to the Bankruptcy Code, the agricultural lender who has provided essential financing to the farmer may well be considered to be an insider. This broad application of the insider definition may well be consistent with the policies behind section 547 set forth above:

> Courts should define "control" in the bankruptcy insider context in a similarly broad fashion, thus furthering section 547's goal of equality among creditors. The insider concept attempts to provide creditor equality by more closely scrutinizing people who are close enough to the debtor to influence his actions. Therefore it is reasonable to apply the securities laws' broad concept of control. A bank that can withhold needed financing or collateral essential to a firm's operations may be easily tempted to influence the insolvent borrower's actions in the bank's favor.[137]

This is not to say that the mere existence of a debtor-creditor relationship, without more, establishes that the creditor is an insider.[138] However, when a debtor begins to experience financial difficulty, it is not uncommon in the farm setting for certain lenders to restructure existing loan agreements or enter into new loan agreements so as to minimize potential losses. Often times, such loans will be executed with a clear view toward liquidation of the farming operation. In *In re Brame*,[139] the farm debtor entered into such a "full proceeds loan" following losses of approximately $250,000 over a four year period. The loan agreement provided for (1) the sale of the farmer's farm; (2) negotiations with the Farmers Home Administration for refinancing of the existing farm mortgages; (3) direct payment to the lender of all proceeds from all sales of livestock and commodities; (4) strict supervision of cash flow by the lender with any diversions of cash resulting in the immediate acceleration of the $595,000 loan; and (5) no capital improvements in the farm operation. Although the case did not directly deal with the issue of whether this full proceeds loan constituted a violation of section 547, the court noted:

> By its very nature, the "full proceeds loan" invites inquiry as to its preferential character. The document herein questioned, for example, not only anticipates but requires liquidation. Whether a preference existed would of course depend upon the timing of the execution of the loan and the recapture of property accomplished pursuant to its terms.

135. Queenan, *The Preference Provisions of the Pending Bankruptcy Law*, 82 COM. L.J. 465, 470 (1977). *See also* Note, 57 NOTRE DAME LAW. at 731, *supra* note 130.
136. 17 C.F.R. § 240.12b-2 (1983).
137. Note, 57 NOTRE DAME LAW. at 732, *supra* note 130.
138. *In re* Jefferson Mortgage Co., 25 B. R. 963, 970 (Bankr. D. N.J. 1982). *See also In re* Yonkers Hamilton Sanitarium, Inc., 22 B. R. 427 (Bankr. S.D. N.Y. 1982).
139. 23 B. R. 196 (Bankr. W.D. Ky. 1982).

> But in any event, the full-proceeds arrangement lends credence to "suggestions that some creditors 'keep alive' a debtor beyond the period of vulnerability for the very purpose of protecting a transfer otherwise avoidable as a preference."[140]

Such a loan arrangement would also, it would appear, render the agricultural lender an insider for purposes of section 547. As a result, if the lender has obtained additional security, forced a partial liquidation of otherwise exempt assets or otherwise improved its position during the one year period prior to filing, such actions may be challenged as preferential.[141]

Once it has been determined that a transferee of property is an insider and that the transfer occurred between ninety days and one year before the filing of the bankruptcy petition, the trustee or debtor in possession must establish that the insider had reasonable cause to believe that the debtor was insolvent and that the debtor was actually insolvent on the date of the transfer.[142] This burden may well be very difficult to carry.[143] However, such transactions should be closely scrutinized by counsel for the debtor under section 547.

Fraudulent Conveyances: Section 548

A second type of transfer which may be avoided by a trustee in bankruptcy or a debtor in possession is a fraudulent conveyance. Section 548(a)(2) provides as follows:

> The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor . . . received less than a reasonably equivalent value in exchange for such transfer or obligation; and . . . was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation. . . .[144]

Such fraudulent conveyance statutes have generally been intended to prevent a debtor from taking deliberate action to hinder, delay or defraud his creditors. The debtor typically violates such statutes by making transfers to or for the benefit of his relatives or friends.[145] However, given the broad sweep of section 548(a)(2), if a debtor-mortgagor defaults on a real estate loan and the mortgagee exercises its remedies, the subsequent foreclosure

140. *Id.* at 200 n.6 (citations omitted).

141. There are two additional bases for challenge to such a lender. First, the lender may be bound to be an undisclosed principal. *See* A. Gay Jenson Farms Co. v. Cargill, Inc., 309 N.W. 2d 285 (Minn. 1981). Second, the lender may find its lien subordinated to the liens of other creditors under § 510(c). *See In re* American Lumber Co., 5 B. R. 470 (D. Minn. 1980).

142. 11 U.S.C. § 547(b)(3) and (b)(4)(B)(ii) (1982).

143. *See*, Note, 57 NOTRE DAME LAW. at 738-39, *supra* note 130.

144. 11 U.S.C. § 548(a)(2) (1982).

145. Such transfers are prohibited and may be set aside by a trustee pursuant to 11 U.S.C. § 548(a)(1).

sale of the property, if made at a bargain price, may be subject to avoidance under section 548.

In *Durrett v. Washington National Insurance Co.*,[146] a debtor in possession under the former Bankruptcy Act sought to avoid as a fraudulent conveyance under section 67(d)(1) of the Act, a transfer of property of the debtor with a value of $200,000.00 for $115,400.00 at a foreclosure sale held within one year of the date of the filing of the petition. The amount bid at the foreclosure sale by the purchaser was the exact amount due on the loan secured by the deed of trust. The successful purchaser was also the only bidder at the foreclosure sale. The Fifth Circuit Court of Appeals held that the transfer of title to the real property of the debtor in possession by the trustee on foreclosure of a deed of trust to a purchaser at the sale constituted a "transfer" by the debtor in possession within the meaning of section 67(d). In addition, the court held that the price paid at the foreclosure sale, which price amounted to 57.7% of the fair market value of the property, was not a "fair equivalent" for the property. *Durrett* has been followed in several other cases under the Bankruptcy Code which applied its reasoning to foreclosure sales.[147]

This is not to say however that *Durrett* has been followed unanimously. In *In re Alsop*,[148] the bankruptcy court held that the transfer effected by the foreclosure sale relates back to the time of the original execution of the mortgage deed. Since, in the facts presented, this transfer occurred beyond the one year reach of section 548, there was no avoidable transfer.[149] And in *In re Madrid*,[150] a Bankruptcy Appellate Panel for the Ninth Circuit held that a noncollusive and regularly conducted foreclosure sale conclusively establishes reasonably equivalent value.[151]

Durrett may be of most benefit to the farmer who is attempting to reorganize his business. If such a debtor can regain substantial equity in property previously sold by a foreclosure sale prior to his filing for bankruptcy, his chances for successfully rearranging his affairs may be increased. How-

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146. 621 F.2d 201 (5th Cir. 1980).

147. *In re* Richardson, 23 B. R. 434 (Bankr. D. Utah 1982) (holding that a foreclosure price of 21% of the value of the property was not a reasonably equivalent value); *In re* Smith, 21 B. R. 345 (Bankr. M.D. Fla. 1982) (holding that any execution sale price of approximately 6% of the value of the property was not reasonably equivalent value); *In re* Jones, 20 B. R. 988 (Bankr. E.D. Pa. 1982) (holding that a foreclosure sale price of 1/3 to 1/2 of the market value of the property was not a reasonably equivalent value, but noting some hesitancy in allowing a debtor to avoid a properly conducted sale); *In re* Thompson, 18 B. R. 67 (Bankr. E.D. Tenn. 1982) (holding that a foreclosure price of 80.8% of the fair market value of the property was a reasonably equivalent value). *See also* Abramson v. Lakewood Bank and Trust Co., 647 F.2d 547 (5th Cir. 1981), *cert. denied*, 454 U.S. 1164 (1982); *In re* Peridido Bay Country Club Estates, Inc., 23 B. 36 (Bankr. S.D. Fla. 1982); *In re* Coleman, 21 B. R. 832 (Bankr. S.D. Tex. 1982); *In re* Smith, 24 B. R. 19 (Bankr. W.D. N.C. 1982).

148. 14 B. R. 982 (Bankr. D. Alaska 1982), *aff'd*, 22 B. R. 1017 (D. Alaska 1982).

149. However, at least in mortgage "lien" states, it would seem that the *Alsop* court confuses two separate transfers: the creation of a lien by the execution of a mortgage and the subsequent transfer of the debtors' equity to a purchaser at a foreclosure sale.

150. 21 B. R. 424 (Bankr. 9th Cir. 1982), *appeal docketed*, No. CC-82-4433 (9th Cir. 1982).

151. However, giving conclusive effect to a regularly conducted foreclosure sale would seem to completely prohibit the inquiry into reasonably equivalent value which § 548(a)(2) was designed to foster.

ever, even in the case of a liquidation, a debtor may prefer to set aside a prior foreclosure sale if he would prefer to see his creditors paid rather than to allow a foreclosure sale purchaser to keep a windfall profit.[152]

In addition to providing a basis for scrutinizing real property foreclosure sales, *Durrett* would seem to be equally applicable to a sale of personal property which was sold pursuant to section 9-504 of the Uniform Commercial Code (U.C.C.).[153] Since personal property sold in a commercially reasonable manner under U.C.C. section 9-504 obtains "reasonably equivalent value" with no greater certainty than real property sold pursuant to state foreclosure procedures, such a sale should be no less subject to examination under section 548.[154]

The ability of a debtor in possession to avoid a prepetition foreclosure sale based upon section 548 has acquired increased importance as a result of the *Johnson v. First National Bank of Montevideo* case discussed above.[155] *Durrett* would appear to grant the debtor a de facto redemption period of one year in those cases in which he does not receive "reasonably equivalent value." The ability to avoid such foreclosure sales may well, in some cases, be sufficient reason alone to seek protection under the Bankruptcy Code.[156]

Postpetition Effect of Security Interests: Section 552

As a general rule, property that the estate or the debtor acquires after the commencement of a case is not subject to any lien resulting from a prepetition security agreement entered into by the debtor.[157] Thus, the filing of a bankruptcy petition cuts off any "after-acquired property" clause contained in a security agreement pursuant to section 9-204 of the Uniform Commercial Code. As a result, a debtor, debtor in possession or trustee may use, lease or sell property which would otherwise be subject to such an after-acquired property clause in a prepetition security agreement without court permission.[158] Since no other party has an interest in this property, it is not cash collateral and there is no interest which requires adequate protection.

152. Note, *Nonjudicial Foreclosure Under Deed of Trust May Be a Fraudulent Transfer of Bankrupt's Property*, 47 MO. L. REV. 345 (1982).

153. *See* Alden, Gross & Borowitz, *Real Property Foreclosure as a Fraudulent Conveyance: Proposals for Solving the* Durrett *Problem*," 38 BUS. LAW. 1605, 1623 (1983).

154. In the event that a transfer is set aside under § 548, the trustee may recover for the estate the property transferred or the value of the property. 11 U.S.C. § 550(a) (1982). The transferee is entitled to a lien on the property to the extent that he gave value to the debtor. 11 U.S.C. § 548(c) (1982).

155. *See* text accompanying note 38, *supra*.

156. Other avoiding powers of the trustee or debtor in possession should also not be overlooked. A trustee or debtor in possession may avoid an unperfected security interest pursuant to section 544(a). Given the complexities involved in dealing with the rules provided by Article 9 of the Uniform Commercial Code for obtaining a valid security interest in farm products, such unperfected interests may be relatively common. In addition, a statutory lien on property of the debtor may be avoided to the extent that it is for rent or is a lien of distress for rent. 11 U.S.C. §§ 545(3) and (4) (1982).

157. 11 U.S.C. § 552(a) (1982).

158. *See* text accompanying note 75, *supra*.

In *In re Hamilton*,[159] a prepetition security agreement covered crops, including crops to be grown after the execution of the security agreement. At issue was whether the lender's security interest extended to crops planted after the filing of the bankruptcy petition. Among other challenges, the lender challenged the constitutionality of the application of section 552(a) to the bank's security interest. It argued that as applied to secured creditors whose security interest in after-acquired property arose prior to the effective date of the Bankruptcy Code, the section was unconstitutional as a taking of property because the lender had a vested property right in the debtor's after-acquired property.[160] The bankruptcy court rejected the lender's argument and upheld the constitutionality of § 552(a):

> It is impossible on the face to have a vested property right in after-acquired property. This is so because, by definition, after-acquired property is a mere contingency. Since after-acquired property is not in existence at the time of the agreement the most which the Bank could have acquired by their agreement with the Debtor was a vested interest, which, had the property ever come into existence, would have become a vested property right. Before the Bank's interest became a property right, that interest was altered by § 552 of the Bankruptcy Code.[161]

An important exception to the rule set forth in section 552(a) is provided in section 552(b). Subsection (b) thus creates an exception to the rule of section 552(a) for proceeds of prepetition collateral but not for any property acquired by the estate after the filing of the petition.[162]

Thus, in *Hamilton*, the only proceeds to which the lender had any entitlement were the proceeds from those crops which were in existence at the time of the filing of the bankruptcy petition and not for any crops which were planted after that date.[163] And in *In re Texas Tri-Collar, Inc.*,[164] a prepetition general assignment of all existing and future accounts receivable to a lender was held insufficient to allow the lender to receive accounts receivable generated after the commencement of the case. The court observed that such postpetition accounts receivable were not proceeds, product, offspring, rents or profits of prepetition accounts receivable.[165]

Section 552 will be particularly relevant in the case involving a dairy operation in which the farmer has made a prepetition assignment to a credi-

159. 18 B. R. 868 (Bankr. D. Colo. 1982).

160. *See* United States v. Security Indus. Bank, — U.S. —, 103 S. Ct. 407 (1983).

161. *In re* Hamilton, 18 B. R. 868, 870 (Bankr. D. Colo. 1982).

162. 11 U.S.C. § 552(b) (1982).

163. *See also In re* Lovelady, 21 B. R. 182 (Bankr. D. Or. 1982), where a lender who had previously allowed a debtor in possession to use the proceeds of prepetition crops to plant postpetition crops without obtaining a lien on the new crops was held to have lost its lien on any such new crops. *Accord*, *In re* Kahl Iron Foundry, Inc., 21 B. R. 372 (Bankr. E.D. Mich. 1982) (decided under the Bankruptcy Act).

164. 29 B.R. 724 (Bankr. W.D. La. 1983).

165. *Id.* at 726-27. *See also In re* Miranda Soto, 667 F.2d 235 (1st Cir. 1981); *In re* All-Brite Sign Service Co., 11 B. R. 409 (Bankr. W.D. Ky. 1981).

tor of a portion of his periodic milk payment.[166] To the extent that such payments represent the sales price of milk produced after the filing of the bankruptcy petition, such prepetition assignments may no longer be valid. Such assignments create a security interest in "proceeds" of milk. If the milk is acquired after the filing of the petition, section 552(b) may not assist the lender. Section 552(b) applies only to proceeds of prepetition property, not to proceeds of postpetition property.[167]

Section 552 has also been cited by several courts in addressing the issue of whether a prepetition security agreement covers federal price support payments. In *In re Sunberg*,[168] the debtors filed a joint petition under Chapter 11 in April, 1983. Prior to filing their petition, but after giving a lender a comprehensive security agreement, the debtors applied to participate in the payment-in-kind (PIK) program and agreed to divert approximately 199 acres to non-crop use. A creditor had a perfected security interest in all crops, farm products, accounts, contract rights and general intangibles. The debtors applied to the court for permission to incur secured debt, pursuant to section 364, for purposes of planting the 1983 crop. They had obtained a commitment from the Farmers Home Administration which was to be secured by the 1983 crops, livestock and the PIK entitlements. The lender objected to the debtors' application to incur debt, alleging that the PIK entitlements were covered by its prepetition security agreement. The court held that the contract with the Commodity Credit Corporation which was entered into by the debtors in order to obtain their PIK entitlements, was a "general intangible" under the Uniform Commercial Code and was in existence prior to bankruptcy. Thus, section 552(a) did not apply to the contract. Alternatively, the court held that such entitlements were "proceeds" within the meaning of section 552(b) and that the lender's security interest in the debtors' right to PIK entitlements would survive the filing of the bankruptcy.[169]

PIK entitlements were also at issue in *In re Joyner*,[170] and *In re Preisser*.[171] In both cases, the debtors had, prior to filing their bankruptcy petitions, granted the Farmers Home Administration a deed of trust which covered the land itself and "the rents, issues and profits thereof and revenues and income therefrom." Both courts held that the PIK benefits which the debtor would receive constituted rents or profits of the land, and therefore

166. In cases involving such assignments, one should also not overlook the possibility of avoiding such assignments under § 544(a) due to the failure of the creditor to properly perfect its security interest in the "account" or "contract rights." *See, e.g.*, *In re* Bindl, 13 B. R. 148 (Bankr. W.D. Wis. 1981); *In re* Liles & Raymond, 24 B. R. 627 (Bankr. M.D. Tenn. 1982).

167. *In re* Hamilton, 18 B.R. 868 (Bankr. D. Colo. 1982); *In re* Texas Tri-Collar, 29 B.R. 724 (Bankr. W.D. La. 1983). *See also* Local Loan Co. v. Hunt, 292 U.S. 234 (1934).

168. No. 83-540-W, slip op. (Bankr. S.D. Iowa 1983).

169. Specifically, the court held that the PIK entitlements were "proceeds" of a contract, not proceeds of crops. However, the cases cited by the court, *In re* Nivens, 22 B. R. 287 (N.D. Tex. 1982) and *In re* Munger, 495 F.2d 511 (9th Cir. 1974), held that Federal disaster and deficiency payments were proceeds of crops.

170. No. 683-00063, slip op. (Bankr. S.D. Ga. 1983).

171. 33 B.R. 65 (Bankr. D. Colo. 1983).

were subject to the prepetition security agreement because of the exception provided for rents or profits by section 552(b).[172] In dictum, the *Joyner* court indicated that, because of section 552(b) a security agreement such as involved in the case would extend to PIK entitlements even if the debtor's PIK entitlement had not vested until *after* the Chapter 11 filing.[173]

However, even if a prepetition security interest extends to proceeds, product, offspring, rents or profits of prepetition property, the issue is not totally resolved. Section 552(b) provides that a prepetition security interest extends to such income "to the extent provided by such security agreement and *by applicable nonbankruptcy law*."[174] In *In re DiToro*,[175] the debtors had granted a lender a mortgage covering a multi-unit apartment complex and extending to the rents therefrom. After obtaining relief from the stay, the creditor foreclosed its mortgage. However, the trustee contested the creditor's claim that it was entitled to the postpetition rents. The court found that, under section 552(b) applicable nonbankruptcy law to be applied to the issue was to be found in Pennsylvania case law.[176] Under such law, until there is a default and subsequent possession by the mortgage, the rents received by the mortgagor are the property of the mortgagor. Since the lender did not acquire possession until it purchased the property at the foreclosure sale, it was not entitled to any of the rents acquired by the estate prior to such sale.[177] Thus, state law must be consulted with regard to the question of who is entitled to the income from property covered by a prepetition security agreement.[178]

In addition, even if a prepetition security interest extends to income from prepetition property, the trustee or debtor in possession may recover from the collateral "the reasonable, necessary costs and expenses of preserving, or disposing of, such property" to the extent of any benefit to the secured party.[179] The court in *In re Hamilton* held that, under section 506(c), the debtor was entitled to recover from the proceeds of the prepetition crops

172. The *Preisser* court, citing *In re* Nivens and *In re Munger*, noted above, found that the PIK benefits were "intended to be a substitute for what would have actually been produced on the land." *Id.* at 67. It did not address the issue of whether the deed of trust would have covered the crops for which the PIK benefits were a substitute.

173. The *Sunberg* court would apparently disagree since its decision was based, to a large extent, on § 552(a) and the fact that the PIK contracts were already in existence at the time the case was commenced.

174. 11 U.S.C. § 552(b) (1982) (emphasis added).

175. 17 B. R 836 (Bankr. E.D. Pa. 1982).

176. The court cited Butner v. United States, 440 U.S. 48 (1979), for the proposition that the question of whether a security interest in property extends to rents and profits derived from that property may only be resolved by reference to state law. *In re DiToro*, 17 B.R. 836, 838 (Bankr. E.D. Pa. 1982).

177. Similarly, if state law provided that a mortgagor was entitled to remain in possession following a foreclosure sale until the expiration of a statutory redemption period, the holdings of both the *Joyner* and *Preisser* cases should be reversed. If PIK entitlements are profits of the land, the party entitled to possession of the land should be entitled to such profits at least until the expiration of such a redemption period. Neither case involved a mortgage that had already resulted in a foreclosure sale.

178. Section 552(b) also allows the court to consider the equities in each case.

179. 11 U.S.C. § 506(c) (1982).

the reasonable, necessary costs of maintaining, harvesting and marketing these crops.[180] The debtor was not entitled however, to recover his planting costs from such proceeds. Similarly, it would seem, that in the case of PIK entitlements, any costs incurred by the estate for conservation practices required by the terms of the PIK contract or in transportation or marketing of PIK commodities should be recoverable from the proceeds of the PIK crop.

CONCLUSION

The commencement of a bankruptcy proceeding in the case of a farming operation is not a course of action which should be pursued without careful consideration. It truly represents a last chance to relieve the financially troubled farmer of some of his financial pressure.

This article has discussed basic prepetition considerations involving the issue of whether a debtor is a farmer and certain tax issues which may be relevant in many farm related cases. It has also reviewed various sections of the Bankruptcy Code as they relate to the ability of a debtor who is attempting to rearrange his business affairs so as to preserve the farming operation, to avoid certain transfers or modify other prepetition agreements. Finally, the article has discussed ways in which the Bankruptcy Code may be employed by the farm debtor so as to provide himself with the greatest opportunity for the "fresh start" contemplated by the Code. It is hoped that such a review will assist counsel for a debtor so that the farming operation may be successfully reorganized and enable the farm debtor to, once again, become the operator of a profitable enterprise.

180. 18 B. R. 868, 872-73 (Bankr. D. Colo. 1982).