Cooperative Extension College of Agriculture Washington State University Pullman, Washington 99164

AGRIBUSINESS MANAGEMENT

CHAPTER 12 BANKRUPTCY IN RETROSPECT; ITS IMPACT ON AGRIBUSINESS FIRMS[1]

Ken D. Duft[2]

"Neither a borrower, nor a lender be; for loan oft loses itself and friend, and borrowing dulls the edge of husbandry," was the sage advice of Polonius in Shakespeare's Hamlet. By the mid-1980's, many farmers, lenders, and agribusinessmen wished they had followed more closely this axiom. Indeed, by 1986, the U.S. agricultural economy was in the midst of its worst financial crisis since the 1930's. Land values were plummeting, commodity prices had earlier reached depressingly low levels, and high rates of interest on large debt amounts had forced farmers, farm lenders, and farm suppliers into a state of financial distress.[3] As farm incomes declined, so did the security positions of farm lenders. Unpaid receivables held by agribusiness firms supplying products or services grew rapidly and the entire agricultural infrastructure began to deteriorate. Farm foreclosures and agribusiness bankruptcies reached levels not seen since the Great Depression.[4]

While the term "bankruptcy" continues to send chills throughout the hearts of most farmers, lenders, and suppliers, their exposure to, and familiarity with, this legal condition has risen dramatically in recent years. In a state of wisdom or perhaps benevolence, Congress reacted in late 1986 to provide a mechanism for the restructuring of our nation's burdensome family farm debt.[5] Farmers, of course, always had access to the prior provisions of the federal bankruptcy codes. However, Congress believed that new legislation would make it, "easier for a family farmer to confirm a Plan of Reorganization," thereby removing some of the time-consuming, expensive, and perhaps unworkable provisions of the prior code.[6] The resulting act of Congress became known as Chapter 12.[7]

LEGISLATIVE INTENT

The public purpose of the new provisions can perhaps best be characterized as follows:

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[1] This paper should not be judged by the reader to comprise legal advice. It is not so designed or written. Those seeking assistance on the matter of bankruptcy should consult a qualified attorney.

[2] The author is indebted to John Albert, Attorney, *Churchill, Leonard, Brown & Donaldson*, Salem, Oregon, for his critical review and helpful suggestions.

[3] "Management Report: Land, "*Successful Farming*." February 1987, p. 8.

[4] Aiken, J. David. "Chapter 12 Family Farmer Bankruptcy." *Nebraska Law Review*, Vol. 66:632, 1987.

[5] Hahn, David H. "Chapter 12 – The Long Road Back." *Nebraska Law Review,* Vol. 66:726, 1987.

[6] H.R. Rep. No. 958, 99th Congress, 2nd Session at 48 (1986).

[7] 11 U.S.C.A. #1201-31 (Western Supplement, 1987).

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> "Under prior codes, family farmers requiring financial rehabilitation could have proceeded under Chapters 11 or 13 of the Bankruptcy Code. Most farmers, however, were judged to have too much debt to qualify under Chapter 13. Furthermore, many family farmers had found Chapter 11 to be complicated, time-consuming, expensive, or otherwise unsuitable. Chapter 12, therefore, was specifically designed for farmers, to provide for them a fighting chance to reorganize their debts and keep their land."[8]

It is interesting to note from the above that neither the welfare of, nor the impact on, agribusiness lenders and suppliers was mentioned or even alluded to. By intent, or perhaps by default, it was the concern for the current and future welfare of the family farmer that provided the primary stimulant for the enactment of Chapter 12. When judging the success or failure of Chapter 12 therefore, it is reasonable to measure results against legislative intent. Measuring its impact on agribusiness suppliers of loans, products, or services, while separate and apart from such a judgment, is still relevant. Assessing such an impact is the focus of this discussion. To accomplish this objective, we shall first review the background and content of Chapter 12, emphasizing important differences with the previous code. Second, we shall review the major issues to be decided within an approved reorganization under Chapter 12. Finally, we shall address the potential effects of the new code on: 1) lender-borrower relations; 2) the status of unsecured providers of services and products (on credit); and 3) the "balance-of-influence" between farmers and those who provide a credit service to the farmers.

BACKGROUND AND PRIOR CODE DEFICIENCIES

One can trace the origins of Chapter 12 to the Frazier-Lemke Act of 1934.[9] When found to be unconstitutional as violating a lender's right of due process, the 1934 Act was revised to be more protective of the lender and its validity was then upheld by the Supreme Court.[10][11] As revised, Frazier-Lemke afforded mortgager's five substantive rights, reduced the court's stay (an order of relief which stays money debt collection) from 5 to 3 years and required the debtor to pay a "reasonable rent" during the moratorium. Because this act was designed to address problems arising from the Depression Era, it was allowed to expire in 1944.[12] While Frazier-Lemke was all but forgotten by the mid-1980's, its lingering memory became the philosophical base upon which Chapter 12 rested.[13] Chapter 11 was judged unsuitable because it was designed primarily for large corporations. For example, the proceedings were subject to veto by

[8] Joint Explanatory Statement of the Committee of Conference, H.R. Conference Rep. No. 958, 99th Cong., 2nd Session, 45, 48 reprinted in the 1986 U.S. Code, Cong. and Admin. News 5227, 5246, 5249.

[9] Ch. 869, 48 Stat. 1289 (1934).

[10] Louisville Joint Stock Land Bank vs. Rodford, 295 O.S. 555, 602 (1935).

[11] 49 Stat. 943 (1935), Wright vs. Vinton Branch of the Mountain Trust Bank, 30 U.S. 440, 470 (1935).

[12] Ch. 39, 54 Stat 40 (1940).

[13] "New Hopes for Hard-Pressed Farmers." *Farm Journal*, Vol. 110, December 1986, pp. 22, 23.

creditors, the absolute priority rule rendered plans unworkable, and large legal fees often resulted.[14] Chapter 13, a possible alternative, was also found by farmers to be wanting because of its maximum allowable debt limit. Using Chapter 13 as the guide, Congress wrote into Chapter 12 an extension of the debt limit to $1,500,000, extended to 90 days the time allowed to file a plan, revised the adequate protection provision, and enhanced the authority of the debtor to sell farmland while in bankruptcy.[15][16] Finally, there was no absolute priority rule written into Chapter 12, a committee of creditors was not required, and the right of creditors to vote on the plan was eliminated.

The Basic Premise

The basic premise of Chapter 12 is that it permits a family farmer (judged eligible under the code) to reduce the amount of all indebtedness to the value of non-exempt assets owned by the farmer. Stated differently, with respect to unsecured claims, the value of the property to be distributed under the repayment provisions cannot be less than the amount, which would be paid if the debtor were liquidated under Chapter 7, save some minor exemptions. As a result, the farmer can never be more than 100% leveraged; i.e., property value payments to secured creditors are written down to that which would have been paid under liquidation. Any secured claim for an excess of this amount is converted into unsecured status and treated as such.

Chapter 12 changed three primary notions of pre-Chapter 12 bankruptcy law: adequate protection, lost opportunity costs,[17] and indubitable equivalence.

Under Chapter 11 provisions, the notion of adequate protection resulted in the required periodic payment of interest on the value of the creditor's claim (or granting of additional liens). In addition, creditors commonly asked for "lost opportunity costs" where the value of the collateral had diminished below the amount of the debt secured by the collateral. This payment of lost opportunity cost often appeared in the form of interest paid to under-collateralized secured creditors. Given the cyclical nature of annual cash proceeds in agriculture, and the fact that family farmers facing bankruptcy rarely had an adequate cash flow, the Chapter 11 provisions noted above were judged burdensome and both were modified under Chapter 12. Under Section 1205 of Chapter 12, the necessity for paying lost opportunity costs was eliminated and adequate protection (for farmland debt) was provided for by allowing the farmer to pay the creditor "the reasonable rent customary in the community where the property is located, based upon rental value, net income, and earning capacity of the

[14] Absolute priority rule states that if an impaired class of creditor rejects the plan, the class must be paid in full before any junior class can receive any payment or retain an interest under the plan.

[15] Adequate protection guaranteed that the creditor's security would not decline in value based on protection of property rights guaranteed by the fifth amendment.

[16] Id. #1222 (b)(8)(Supp 1986).

[17] Lost opportunity costs comprise the form of adequate protection in under-secured claims.

property."[18] Finally, under prior codes, the periodic payment of interest was judged to be the "indubitable equivalent" of the payment of lost opportunity cost. However, Chapter 12 does not contain language relating to indubitable equivalent and one must assume that Congress intended to remove it.[19]

Eligibility/Timing

Because Chapter 12 was written specifically for farmers, Congress did have the foresight to define "family farmer."[20] Only a family farmer with regular annual income can be eligible. To gain eligibility, an individual or other entity must be engaged in a farming operation and have a regular annual income sufficient to generate payments as described in the reorganization plan.[21] Further, at least 50% of the gross income for the tax year preceding the date of filing must have arisen from that farming operation, the aggregate debts of the farmer must not exceed $1.5 million, and at least 80% of the aggregate, non-contingent, liquidated debt must have arisen from the farming operation (but can exclude debt on the farmer's principal residence). Upon filing a Chapter 12 petition, the family farmer is afforded the protection of an automatic stay which can, however, be lifted: i. due to cause (failure to pay adequate protection); and/or ii. the debtor lacks equity in the property and the property is not necessary for reorganization. The family farmer/debtor is afforded the status of a debtor-in-possession and has the right to operate the farm. This right may be removed as a result of fraud, dishonesty, incompetence, or gross mismanagement by the debtor, when proven to have occurred either before, or, after the commencement of the case.

The reorganization plan, of course, is the centerpiece of the proceedings and must be filed within 90 days of the order for relief. It must allow for payments of allowed administrative claims and any net disposable income to be received in a 3-year period must be applied to make payments only to unsecured creditors under the plan.[22] The debtor may receive a discharge under Chapter 12 after all payments are made under the plan (except for those debts identified as non-dischargeable).[23]

Finally, it should be noted that Congress imposed an October 1, 1993 sunset provision on Chapter 12, for the purpose of evaluating the effectiveness of the Chapter and deciding whether the legislation should be continued.[24]

[18] 11 U.S.C.A., #1205 (b)(3)(West. Supp. 1987). It should also be noted that in many cases creditors do not ask for lost opportunity costs.

[19] H.R. Rep. supra note 2, at 50; although at least one court has allowed a debtor to surrender property other than a creditor's collateral in satisfaction of this claim.

[20] 11 U.S.C. #109 (f)(Supp III 1985).

[21] Partnership and corporations also qualify if more than 50% of the outstanding stock or equity is held by one family, or by one family and the relatives of the members of such family, which conduct the farming operations.

[22] Disposable income is defined as income, which is not reasonably necessary to be expended for the maintenance and support of the family farmer and the farm family, or for payments under the plan and other operating costs necessary for the continuation, presentation, and operation of the family farm.

[23] 11 U.S.C.A. #1228 (West Supp 1987).

[24] 132 Cong. Rec. #15076 (daily edition October 3, 1986) (statement by Sen. Grassley).

MAJOR ISSUES

Based on three years of judicial debate and a review of court proceedings, the four major issues which must be decided in the development and confirmation of a Chapter 12 reorganization plan are: 1) determining the value of the farm assets to which the secured portion of farm debt must be written-down; 2) what interest rate (discount rate) should the written-down secured debt accrue and over what period of time will the deferred payments be made; 3) what reasonable living expenses should the farmer be allowed by the court; and 4) judgment regarding the economic feasibility of the plan.

Asset Valuation: Courts commonly rely on the concept of comparable value or fair market value to determine asset valuation. Expert testimony by qualified appraisers or agronomists regarding the agronomic characteristics of the farm is relied on heavily. However, problems arise if it can be shown that recent sales used to estimate fair market value were "coerced or stress sales." In such cases the capitalization value approach may be used to estimate the value of the property.

Debt Write-Down: Research conducted in California suggests that debt write-downs are consequential in magnitude and number.[25] Of the 60 confirmed cases evaluated, 38 borrowers obtained write-downs averaging $231,527. In percentage terms, this represented a decrease by 55% of their original secured debt obligation. And what of borrowers not granted debt write-downs? They received relief in the form of: 1) interest rate reductions; 2) extended loan terms; and/or 3) relief from unsecured debts after the 3- to 5-year plan period. A similar study in Iowa[26] found that on the average petitioners' debt in real property was written-down from $489,500 to $262,000 as a result of a confirmed Chapter 12 reorganization. The California study also found that the term on reorganized real estate debt ranged from 3 to 40 years and averaged 22.33 years.

Discount Rate: One of the most litigated issues in Chapter 12 is the discount rate. The purpose of the rate, of course, is to assure creditors their "full value" for claims and to protect those claims from losing value over the duration of the plan. Because payments under the plan are deferred into the future, an interest rate (or discount rate) is required to compute a present value of those payments such that full value is realized.

Courts have utilized many different methods to determine the discount rate. In Hardzog, the court listed some of those methods as: 1) the contract rate; 2) the tax rate; 3) state or federal legal rates; 4) the legal rate plus a premium; 5) the prime rate; 6) various U.S. Treasury bill rates plus a premium; 7) the average of several rates; 8) the prevailing market rate; and 9) the rate at which the creditor could invest funds.[27] A majority of the courts have

[25] Innes, R., E. Keller, and H. Carman. "Chapter 12 and Farm Bankruptcy in California." *California Agriculture*, Vol. 43, No. 6, Nov.-Dec. 1989, pp. 28-31.

[26] Fairferlick, C. and N.E. Hari. "The Chapter 12 Bankruptcy Experience in Iowa." *Journal of Agriculture, Tax, and Law*, winter 1988, pp. 302-339.

[27] Sec in re Hardzog, 74 Bankr. 701 (Bankr. W.D. Okla. 1987).

relied on the market rate and defined it as, "the prevailing market rate for a loan of equal value of a term equal to the payment period, with due consideration for the quality of the security and the risk of subsequent default.[28]

Even though there may be some consensus as to the application of the market rate theory, there remains ample disagreement as to the elements of which the market rate is comprised. Harl has argued for the computation of a matched, risk-free U.S. Treasury rate with a risk premium added, and Missouri courts have complied.[29][30] However, in Montana the court acknowledged that the prime rate of interest is a major factor in computing market rate[31]. Finally, the Florida court has ruled that the appropriate rate is the prevailing market rate for loans of a similar nature.[32] More recent research by Duft and Frasier[33] has shown that Harl's method results in a computed rate, which is generally biased in favor of the debtor. They, in contrast, support a rebuttable presumption that the current rate charged by the affected creditor for comparable loans is the true market rate and promises expedition, economy, and accuracy. This position has been supported by a Bankruptcy Appellate Panel ruling which reversed a Montana court finding and stated, "the best evidence of what a reasonable discount rate is for a given principal, term, and risk, is the rate the debtor would pay for such a loan in the marketplace absent the event of bankruptcy.[34]"

AGRIBUSINESS IMPACT

It is doubtful that there currently exists a single provider of funds, farm supplies, and/or agricultural services which has not been directly or indirectly impacted by the advent of Chapter 12. Indeed, some major suppliers of fuel, seed, fertilizer, and chemicals, operating as large-scale holders of unsecured claims on agricultural producers, have been forced into Chapter 7 liquidation as a result of their customer's treatment under Chapter 12. In our highly integrated and interdependent agricultural economy, it would appear that the domino theory is well supported by recent experience.

Even before its passage, Chapter 12 was opposed by many. Some members of Congress argued that Chapter 12 would create a legal atmosphere, which encouraged bankruptcy and discouraged a farmer's incentive to work out arrangements with his or her lender.[35] Lenders argued that since Chapter 12 provided for no lender participation in the development of the plan, debtor-owned lenders would realize more

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[28] 5 Collier on Bankruptcy 1129, 1129-65 (1988).
[29] Hari, N.E. "Chapter 12 Issues to be Resolved." *Agriculture Finance*, September 1988, pp. 12-13.
[30] In re Bartlesmeyer, 87 Bankr. 975, 976-77 (Bankr. W. D. Mo. 1987).
[31] In re Janssen Charolais Ranch, Inc., 73 (Bankr. 125, 128 Bankr. D. Mont. 1987).
[32] In re O'Farrel, 74, Bankr. 421, 424 (Bankr., N.D. Fla. 1987).
[33] Duft, K.D. and G.E. Frasier. "Computing the Correct Discount Rate for Deferred Payments Under Chapter 12 of the Bankruptcy Code." *Journal of Agriculture, Tax, and Law*, Spring 1990.
[34] Big Hook Land & Cattle Co. vs. Federal Land Bank of Spokane, BAP No. MT-88-1039 VJP, BK No. 86-040635, September 27, 1989.
[35] 132 Cong. Rec. S15,092 (daily edition October 3, 1986 x statement by Sen. DeConcini).

losses, resulting in higher interest rates to all their farm borrowers.[36]

While Chapter 11 contained provisions for protecting an under-secured creditor, wherein that creditor could opt for potential appreciation in collateral value rather than receiving payments on its under-secured claim, Congress chose to exclude such provisions from Chapter 12, thus conveying to farmers the entire windfall associated with future increases in the value of farmland. As a result, the once-secured creditor is left with only the collateral value of the secured claim amount, without an opportunity to recover any losses from future appreciation.[37]

A review of the nationwide farmland value recovery now under way suggests that while gains from appreciation may be significant, farm lenders will gain no direct benefit from the trend insofar as recovering prior loan losses are concerned.[38] The write-down, or cram-down, provision forced a downside risk on real estate lenders under Chapter 12, while it conveyed all upside benefits to the farmer.

[36] See Hearings on H.R. 1397 and 1399 supra note 2, at 173-75 (letter from D. Bannes, President of the Farm Credit Council, an association of borrower-owned lending institution; i.e., Land Banks and Production Credit Association).

[37] Belcher, James R. "Cram-down Under the New Chapter 12 of the Bankruptcy Code: A Boom to the Farmer, A Bust to the Lender." *Land and Water Law Review*, University of Wyoming, College of Law, Vol. 23, No. 1, 1988, p. 232.

[38] "U.S. Farmland Values." *Agrifinance*, February 1990. p. 48.

The interest rate issue raises another impact-related question. In establishing an interest rate for written-down debt amounts, bankruptcy courts have sought, in principle at least, to apply a market rate rule requiring debtors to pay the prevailing rate on loans similar to these. However, the actual California experience parallels that uncovered in Iowa and elsewhere, which shows that rates applied by the courts are not consistent with the market rate doctrine.[39] Indeed, rates allowed for private lenders and the Farm Credit system averaged 2.14% below the going rate on new real estate loans. Overall, the California authors concluded that, "the Bankruptcy Courts have been setting interest rates with a primary concern for ensuring the feasibility of the reorganization plan and the continued viability of the farm." While that viability might be an admirable public policy goal, it appears that lenders will bear the burden of its achievement.

The allowed duration or term of secured debt obligations raises yet another impact question. Quite obviously a court can increase the amount of disposable income available to pay unsecured claims by increasing the length of time over which secured debt is to be paid off. As such, there exists a trade-off wherein lower payments on the secured claims translate into higher payments on the unsecured claims during the 3- to 5-year reorganization period. Also, any lengthening of the duration will raise the secured creditors' exposure to continued downside risk on the loan. Again, recent Chapter 12 experience, as reported in Iowa and California, suggests that plan feasibility concerns have preempted a concern for secured creditor welfare as the average secured debt term for

[39] Innes, Keller, Carman, op. cit., p. 24.

reorganized real estate debt exceeded 22 years and ranged up to 40 years.

While Chapter 12 appears to have provided some short-run benefit to those family farmers in crisis, it has obviously become a burden to secured creditors. In large part, they have lost their ability to force a liquidation and thereby ensure themselves receipt of the secured portion of their claims. As stated by Innes, Keller, and Carman, "they are forced to make a loan equal to the liquidated value of their claim, even though the farmer has no equity to contribute himself."[40]

This creates a unique financial scenario wherein the secured creditors must bear the risk for any future downside risk on their farm investment, while unsecured creditors gain from any short-run upside trends and farmers, themselves, are the primary recipients of any long-run upside improvements. Below market rates of interest allowed by the courts only serve to accelerate the costs of the secured claimants. Ironically, unsecured creditors (largely providers of farm production supplies) who would normally stand to receive little under a Chapter 7 liquidation, may, in fact, stand to benefit from a Chapter 12 proceeding.

The balance-of-influence between lender and borrower is a very nebulous concept and one that is difficult to measure. However, Faiferlick and Harl attempted to gain some evidence on this matter by surveying bankruptcy attorneys in Iowa.[41] They found that 80% of the attorneys surveyed felt that Chapter 12 had had a notable influence on farmer/ lender negotiations. Moreover, they concluded that the farmer's bargaining power (influence), relative to that previously held by the lender, had increased from 3.9 to 6.0 on a scale of 10 (where 5.0 was judged to describe a point of equal influence by the two parties).

SUMMARY

By 1987, our nation's agricultural economy was in the midst of a serious financial crisis. That some form of financial relief was required is not arguable. Indeed, the role of the family farm remains so critical that its continued financial and operational viability is justifiably a matter of public policy. Family farmers required assistance, and sound public policy demanded that some form of relief be provided. Chapter 12 was written within this context and seems to have contributed to at least the short-run survival of many family farming units.

Yet one can now begin to assess this legislation and attempt to ascertain who sustained the major impact or cost of this endeavor. In my opinion, the cost of this meritorious public policy was not uniformly distributed amongst the U.S. general public. The financial burden was primarily born by institutional agricultural lenders -particularly those, which historically funded farm real estate purchases.

FmHA, the Farm Credit System, insurance companies, and commercial banks have all been adversely impacted by Chapter 12. This burden would have likely existed with or without Chapter 12 as declining land values largely generated it. However, it must now be recognized that Chapter 12 has rigidly

[40] Innes, Keller, Carman, op. cit., p. 25.
[41] Fairferlick & Hari, op. cit., p. 32.

institutionalized those losses with those lenders, as gains from improved land values are accruing solely to the farmer. In brief, suppliers of agricultural funds, supplies, and services were asked to bear the downside burden and denied access to any upside gains. Therefore the true impact of Chapter 12 on our nation's agribusiness firms is very real, quite large, and potentially long lasting.

And what about the farmers receiving such assistance? No doubt, some will recover and survive as viable enterprises. But others who received dramatic relief may remain for years as financially vulnerable operations with continued low levels of equity.

The activities of lenders and suppliers will change as they reduce their credit offerings and/or charge higher interest to compensate for the low equity position of their borrowers and to compensate for prior losses. Gradually the true burden of this legislation will be shifted to a new set of individuals -- the future generation of our nation's farmers and ranchers.

Ken D. Duft

Ken D. Duft
Extension Marketing Economist

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13. 11 U.S.C.A., #1205 (b)(3)(West. Supp. 1987). It should also be noted that in many cases creditors do not ask for lost opportunity costs.

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18. 11 U.S.C.A. #1228 (West Supp 1987).

19. 132 Cong. Rec. #15076 (daily edition October 3, 1986) (statement by Sen. Grassley).

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32. Belcher, James R. "Cram-down Under the New Chapter 12 of the Bankruptcy Code: A Boom to the Farmer, A Bust to the Lender." *Land and Water Law Review*, University of Wyoming, College of Law, Vol. 23, No. 1, 1988, p. 232.

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