

Chapter 12 and farm bankruptcy in California

Robert Innes □ Edward Keller □ Hoy Carman

A study of bankruptcy plans confirmed in California suggests the new Chapter 12 provisions of the Bankruptcy Code have increased the bargaining power of financially distressed farmers relative to their lenders. But Chapter 12 may lead to higher interest rates on new agricultural loans.

The Family Farmer Bankruptcy Act, which was designed to help financially troubled farmers weather the 1980s agricultural financial crisis, became law in November 1986. The Act permits farmers to reorganize their debts and keep their land under the new Chapter 12 section of the Bankruptcy Code. This report discusses the Chapter 12 bankruptcy law, its implementation, and likely effects in both the short and long run and presents evidence on recent Chapter 12 experience in California.

Previous farm bankruptcy rules

Before November 1986, farmers could obtain relief from creditors under Chapters 7, 11, and 13 of the U.S. Bankruptcy Code (Title 11). Under Chapter 7, relief could be obtained in the course of a farm's liquidation. Chapter 11 made it possible for a farmer to obtain the court's protection while attempting to develop a reorganization plan acceptable to creditors. Under Chapter 13, small farms could write down (i.e., reduce the amount owed on) their secured debts (i.e., loans that have land or buildings as collateral) to the current value of the farm. All remaining debts could then be retired over 3 to 5 years with the farmer making only those payments he or she could afford.

In Chapter 11 and Chapter 13 cases, the goal of the reorganization plan is to revise payment schedules and payment amounts on outstanding obligations so that the debtor (individual or firm) can meet the revised obligations and not go out of business. If confirmed, the plan discharges the debtor from previous debts, obliging the debtor to meet only the revised payment schedule. Given this goal, any confirmed plan must meet a feasibility standard, implying that the debtor can actually deliver what is promised.

Unfortunately, provisions included in both Chapters 11 and 13 make them difficult

for farmers to use. Chapter 13 is available only to individuals (not partnerships or corporations) with secured debts below \$350,000 and unsecured debts below \$100,000. Chapter 13 also requires that the debtor file a reorganization plan within only 15 days after the court's order for bankruptcy relief and that payments to creditors begin within 30 days after this plan is filed. These time limits are unworkable for most farmers.

Although Chapter 11 gives a farmer 120 days in which to develop a reorganization plan, the court's "automatic stay" of creditors' foreclosure actions during this interval requires "adequate protection" for the creditors' claim on the farm. Until January 1988, the courts interpreted "adequate protection" to mean cash compensation for "lost opportunity costs" of creditors' implicit investment in the enterprise. For many financially distressed farmers, liquidity problems prevented their providing cash compensation, nipping in the bud any attempt at Chapter 11 reorganization.

Perhaps more importantly, Chapter 11 reorganization plans require "acceptance" by every class of impaired creditors—those who receive less under the plan than they are owed. "Acceptance" is defined as the support of at least one-half of the claimants and at least two-thirds of the value of claims in the class ("class" of claimants is the set of creditors with the same priority in payment). Thus, to stay in business under Chapter 11, a farmer must obtain most of his creditors' approval for the plan of reorganization.

A final disadvantage of Chapter 11 is that it is cumbersome to administer.

Chapter 12 provisions

Congress therefore enacted new Chapter 12 regulations "to give family farmers facing bankruptcy a fighting chance to reorganize their debts and keep their land" (U.S. Congress, Congressional Record, October 2, 1986, H8991). Chapter 12 meets this objective by offering farmers Chapter 13-type bankruptcy rules.

To qualify for bankruptcy relief under Chapter 12, a debtor must meet the following eligibility requirements:

- (1) Total indebtedness must not exceed \$1.5 million.
- (2) Except for a mortgage on a principal residence, 80% or more of the debt must

arise from farming operations owned or operated by the debtor.

(3) If the debtor is a corporation or partnership, more than 50% of the outstanding equity must be held by a single family (including relatives) that runs the farming operation. The firm's stock cannot be publicly traded, and 80% of the company's assets must be related to the operation of the farm.

(4) The debtor's annual income must be "sufficiently stable and regular" to permit making payments under the reorganization plan.

Under Chapter 12, the farmer's secured debts are written down to the present value of the underlying collateral. The remaining secured claims (i.e., loan obligations over and above the value of the underlying collateral) are then added to other unsecured debts, the sum of which is paid off with a pro-rata share of the farm's disposable income over the 3- to 5-year period of the reorganization plan. At the end of this period, the farmer is discharged from any further obligation to the unsecured creditors, as with Chapter 13. However, the farmer must still pay off the written-down portion of the secured debt in full, although not within any statutorily specified period of time.

As with Chapter 13, creditors need not approve of a Chapter 12 reorganization plan. Under the plan, however, all creditors must obtain property with a value at least as great as that which would be available to them under a Chapter 7 liquidation. As in Chapter 13, Chapter 12 does not require a creditors' committee and has similar regulations concerning the appointment and duties of a Trustee, who oversees the development and implementation of the Chapter 12 reorganization.

Farmers have 90 days to develop a reorganization plan under Chapter 12 (versus 15 days under Chapter 13). This period can be extended with the court's permission. The plan is supposed to be confirmed by the Bankruptcy Court within 45 days after it is filed. In practice, however, crowded court calendars and lack of agreement on details of the plan have led to somewhat longer delays.

To ensure that "adequate protection" requirements not hamstring farmers' efforts to develop Chapter 12 reorganizations, Congress explicitly defined these requirements in the new chapter. Under the new

statutory guidelines, farmers can provide creditors with "adequate protection" for their collateral by "paying ... for the use of farmland the reasonable rent customary in the community where the property is located, based upon the rental value, net income, and earning capacity of the property." Significantly, there is no requirement that the rent be paid in cash. This implicitly permits the farmer to pay the creditors with a share of the crops to satisfy the interim protection requirements.

Implicit in the construction of Chapter 12 is elimination of the "absolute priority rule," which governs Chapter 11 proceedings. Under this rule in a Chapter 11 case, all senior classes of claims must accept the plan or be paid in full before a junior class of claim, such as the debtor, receives a cent. Among other things, this rule implies that all of a secured creditor's claim must be paid before an unsecured creditor receives anything. Under Chapter 12, in contrast, the portion of the secured creditor's claim that exceeds the value of the underlying collateral receives the same treatment as other unsecured claims.

Overall, Chapter 12 removes roadblocks to farmers' use of the bankruptcy statutes to gain a new financial lease on life. It thereby gives financially distressed farmers a chance to get out of the red without losing the farm, provided they can operate at a profit in the coming years. Because Chapter 12 was intended to respond to what was viewed as a temporary farm financial crisis, Congress included a "sunset" provision. In 1993, they will review the effectiveness of the chapter as well as the need for continued special protection for family farmers. After this review, the chapter may be dropped or made a permanent part of the Bankruptcy Code.

Experience with Chapter 12

To help understand the impact and implementation of Chapter 12, we have reviewed available data on case filings and have surveyed Chapter 12 filings in the Sacramento and Fresno Bankruptcy Courts. These two California Eastern District Bankruptcy Courts handle most of the farm bankruptcies in the state. In the survey, we reviewed 60 Chapter 12 plans confirmed before December 31, 1988, representing roughly 65% of all Chapter 12 plans confirmed in California through 1988.

In summarizing our results, we will first discuss the history of case filings to date, focusing on the costs of proceeding with a court case and the implications of these costs for Chapter 12 filings. Next, we will turn to the major issues in a Chapter 12 proceeding and to the ways in which these issues have been resolved by the two California courts.

California Chapter 12 bankruptcy filings from December 1986 through December 1988 peaked at 64 during the first quarter of 1987, dropped to 49 in the second quarter, and then ranged from 15 to 26 (average=23) per quarter. This pattern is very similar to that observed nationally.

California accounted for only 1.7% of total U.S. Chapter 12 filings during the fourth quarter of 1986, but this increased to an average of 2.8% in each quarter of 1987, and then to an average of 4.4% during 1988. During the entire period through 1988, California had a total of 258 Chapter 12 filings out of the U.S. total of 8,732. While California's Chapter 12 filings remained fairly steady after the second quarter of 1987, total U.S. filings decreased. The most filings were in the Eighth Circuit, which includes Arizona, Iowa, Minnesota, Missouri, Nebraska, North Dakota, and South Dakota. During the first quarter of 1987, the Eighth Circuit had 904 Chapter 12 filings (39%) out of the U.S. total of 2,319. For the period through 1988, the Eighth Circuit had 2,854 Chapter 12 filings, almost a third of the U.S. total.

One might expect that, as more information becomes available on the courts' interpretation and implementation of Chapter 12 regulations, farmers and lenders will increasingly turn to privately negotiated reorganizations to avoid the administrative costs of a formal bankruptcy proceeding. The pattern of filings lends some support to this hypothesis.

Some casual evidence on the incentive for farmers to negotiate a reorganization privately is provided by the average administrative costs incurred by farmers filing under Chapter 12. In the Sacramento Bankruptcy Court, average costs have been \$2,776 for the services of the Trustee and \$8,131 for attorney fees. Since the Trustee's fee is typically a percentage of plan payments, these charges in any given case will depend on the scale of the reorganized farm. In addition, a recent Iowa State University study, reported in the Winter 1988 issue of the *Journal of Agricultural Taxation and Law*, suggests that the attorney fees are likely to be much higher with a Chapter 12 filing than with a private renegotiation of loan terms. Attorneys surveyed in the Iowa study indicated that out-of-court reorganizations required an average of 15.5 hours of their time to negotiate, whereas Chapter 12 cases occupied an average of 58.9 hours. Even allowing for greater complexity of the cases ending up in court, the incentive to avoid a formal proceeding is evident.

In weighing the relative merits of a Chapter 12 filing versus private negotiation, time lags in a court proceeding are also relevant. Recent experience reveals that the development and confirmation of Chapter 12 reor-

ganization plans took more time than envisioned in the legislation. In California's Eastern District, for example, farmers took an average of 2.2 months to develop their Chapter 12 plans (compared with a statutory maximum of 3 months), while the court took an average of 8 months to confirm them (compared with a statutory maximum of 4.5 months). These time lags are likely to decline eventually, as all parties become more familiar with the new law. Still, they indicate a sympathetic court attitude toward farmers' requests to extend statutory deadlines.

Major issues

Among the most important issues that must be resolved in the development and confirmation of a Chapter 12 reorganization plan are the following: What is the value of the farm assets to which the secured portion of farm debt must be written down? What interest rate should the written-down secured debt bear and over what period should this debt be paid off? What reasonable living expenses should the farmer be allowed?

Asset valuation. In valuing property, courts typically adhere to the concept of "comparable sale value" or "fair market value" of the assets, considering relevant attributes of the soil, improvements on the property, condition and type of buildings, location of the property, terrain, and so forth. Significantly, recent experience in land sales may sometimes be discounted by a bankruptcy court in arriving at the fair market value, because these may have been "forced or stress sales." The lack of reliable market prices from actual property sales often leads courts to rely on the opinions of appraisers and/or on a "capitalization value" method for estimating a property's worth.

If taking a "capitalization value" approach, the court first estimates the periodic income that would accrue to a landlord-owner of the property today (rent less the sum of property taxes and maintenance expenses). It then calculates a present value for the landlord's income stream from the property, assuming that this periodic income grows at a constant rate over time and that there is a constant opportunity cost of funds. For example, suppose the net rental income were R per acre per year, the interest rate (opportunity cost of funds) were i per year, and the estimated income growth rate were g (which is less than i); then the "capitalization value" of an acre of land would be $R(1+g)/(i-g)$.

In California's Eastern District, only three Chapter 12 rulings have explicitly stated an annual "capitalization rate" ($i-g$). In these cases, the rates used were 2% (land only), 3% (land and buildings), and 5.25% (land

and buildings). To illustrate the use of these rates, suppose a 2% discount factor is applied to California farmland. With current long-term Treasury Bond rates of roughly 10%, this 2% discount factor implicitly reflects an annual income growth estimate of 8%. If the landlord discount rate were appropriately adjusted for risk, this estimate would be even higher. If this estimate of income growth were considered too large, the "capitalization value method" would lead to an overestimate of the land value, to the disadvantage of the filing farmer.

Debt write-downs. Our review of 60 confirmed Chapter 12 plans showed that these 60 borrowers had 118 loans with the Farm Credit System (FCS), the Farmers Home Administration (FmHA), and private lenders (banks, savings and loans, insurance companies, and individuals). The secured debt obligations of all the borrowers at the filing date averaged \$485,613, with a range of \$40,103 to \$1,487,632. Thirty-eight of the borrowers received write-downs on 51 loans, with the write-downs per borrower ranging from \$3,000 to \$798,284 and averaging \$231,527. In percentage terms, these 38 borrowers obtained write-downs averaging 34.6% of their original secured debt obligations. The distribution and amount of write-downs varied by lender with FmHA having the largest percentage of loans with write-downs as well as the largest average write-downs (table 1). Overall, the borrowers with write-downs had write-downs equal to an average of 55% of their secured debt obligations.

While secured loan write-downs under Chapter 12 have attracted much attention, 34% of cases in our survey had no write-down. For these filers, Chapter 12 can provide three kinds of relief: (1) interest rate reductions, (2) increased loan duration that permits farmers to meet their secured debt obligations, and (3) relief from unsecured debts after the 3- to 5-year plan period.

Interest rates and duration. In establishing an interest rate for written-down debt amounts, bankruptcy courts have sought, in principle, to apply a "market rate" rule, requiring debtors to pay the prevailing interest rate on loans similar to theirs. However, the actual California experience parallels that in other parts of the country and is not consistent with a "market rate" doctrine.

In our survey, interest rates allowed on reorganized Chapter 12 loans from private lenders and the FCS averaged 2.14 percentage points below the going rate on new FCS real estate loans and only 0.65 percentage point above the prime lending rate (fig. 1). FmHA loan interest rates were even lower, averaging 1.49 percentage points less than those allowed on private loans. The lower FmHA rates are consistent with a ruling in the Chapter 12 case of Dennis E. Doud (Iowa

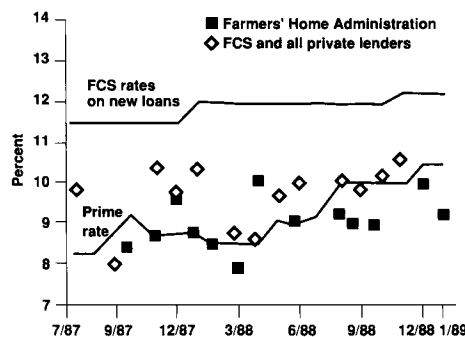


Fig. 1. Interest rates allowed in California Chapter 12 cases. (Farm Credit System [FCS] rates given here do not include the implied interest cost of required FCS stock purchase, which adds roughly 3/4% to the farmer's interest cost of FCS debt.)

Southern District Bankruptcy Court, June 10, 1987), which states that loans bearing government-subsidized interest rates should continue to bear subsidized rates in a Chapter 12 reorganization.

Overall, this evidence suggests 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.

As for the duration of secured debt obligations, a bankruptcy court can increase the amount of disposable income available to pay unsecured claims if it increases the length of time in which secured debt is scheduled to be paid off. In essence, lower payments on the secured claims translate into higher payments on the unsecured claims during the 3- to 5-year plan period. At the same time, an increased duration will raise the secured creditors' exposure to risk of loss on the loan. For both reasons, the secured creditors should favor shorter terms on their reorganized contracts, whereas unsecured creditors should favor longer terms.

Again, recent Chapter 12 experience suggests that plan feasibility concerns have been guiding the courts' specification of secured debt terms, to the likely detriment of the secured claimants. In our survey, for example, the average term on reorganized real estate debt was 22.33 years, but this varied by lender, ranging from a high average of 26.3 years for FmHA loans to a low average of 20.5 years for private lenders. The length of reorganized loans ranged from 3 to 40 years.

Farmer living expenses. Another important part of any reorganization plan, although one that has not yet been a source of controversy, is the provision for the farm family's living expenses. In our survey, allowed living expenses ranged from \$500 to \$3,250 per month with an average of \$1,735 per month. Approximately two-thirds of the observations were in the range of \$988 to \$2,482 per month.

To calculate these allowances, the court asks farmers to provide a budget for food, clothing, transport, medical, and miscellaneous expenses based on their past experience. Utilities and housing costs may also be included with living expenses, although if the family lives on the farm, these costs are typically included in business expenses. A Trustee we interviewed said that a common problem with the specification of farmers' living costs has been that they underestimate their minimum requirements.

Economic implications

In the short run, Chapter 12 will almost certainly reduce farm failure rates. Some casual evidence in support of this conclusion is provided by the recent Iowa State survey of bankruptcy attorneys: 80% of the attorneys surveyed indicated that Chapter 12 has had a notable influence on farmer/lender negotiations. They also concluded that the farmer's bargaining power (relative to lenders) has increased from 3.9 to 6 (on a scale of 1 to 10 with 5 corresponding to "equal power").

The short-run gain to financially distressed farmers comes at the expense of some creditors. In particular, secured creditors lose their ability to force a liquidation and thereby insure receipt of the secured portion of their claim. Effectively, they are forced to make a loan equal to the liquidated value of their claim, even though the farmer has no equity to contribute. As a result, the secured creditors must bear considerable downside risk on their implicit investment in the farm, giving up short-run upside gains to unsecured creditors and long-run upside gains to the farmer; the low interest rates typically allowed secured lenders only increases the cost of Chapter 12 to these claimants. Oversecured creditors (those who have collateral for their loan which is worth more than the amount owed on the loan) bear somewhat less risk of loss since, by retaining their original liens, they effec-

TABLE 1. Chapter 12 secured loan write-downs in California's Eastern District by lender, last quarter 1986 through 1988

| Lender | No. with write-downs | Percent of loans | | Average write-down | |
|---------|----------------------|------------------|---------|--------------------|---|
| | | % | \$ | % | % |
| FCS | 11 | 27.5 | 151,042 | 33.9 | |
| FmHA | 19 | 76.0 | 291,568 | 57.2 | |
| Private | 21 | 39.6 | 86,324 | 57.2 | |
| All | 51 | 43.2 | 176,747 | 55.0 | |

tively obtain some cushion against any downward movements in land prices or poor farm profit performance. Thus, it is the creditors with security that is closest in value to the amount of their claim that lose most. In contrast, any unsecured creditors who stand to receive little under a liquidation will gain from Chapter 12.

The long-run effects of Chapter 12 on farm viability will depend, to a great extent, on economic events in the agricultural sector over the next several years. Although reorganized farms will have received dramatic relief in their debt burden under Chapter 12, they will remain among the most financially vulnerable agricultural enterprises because of their exceedingly weak post-bankruptcy net worth.

By limiting lenders' ability to recover on their collateral, Chapter 12 is also likely to

have long-run effects on lender behavior. To compensate them for the possibility of Chapter 12-induced losses in the event of a farm's financial distress, lenders are likely to charge higher interest rates on new agricultural loans, particularly to farmers with little equity.

There is some evidence that similar relief legislation in the 1930s led banks to increase interest rates charged on agricultural loans as well as tighten credit. Since Chapter 12 will be in force for a much longer period than were the 1930s foreclosure limitation laws (which were on the books for only 1 to 2 years), its effects on lender behavior are likely to be even greater. Of course, the extent to which lenders are likely to increase interest rates and tighten loan eligibility standards will depend on the extent to which they view Chapter 12 as a permanent

phenomenon. It will also depend on eligibility criteria for resale of agricultural loans in the new federally underwritten secondary market. As it stands, these eligibility criteria are sufficiently stringent (including restrictions to real estate debt and a 70% loan-to-value ceiling) to suggest that Chapter 12 will have a continued influence on the loan terms that banks are willing to offer agricultural producers.

Robert Innes is Assistant Professor, and Hoy F. Carman is Professor, Department of Agricultural Economics, University of California, Davis. Edward Keller, former Research Assistant in Agricultural Economics, is now with Wells Fargo Bank. The assistance of Randy Rogers of Murphy, Weir & Butler, Stephen Sosnick, and Perry Poe is gratefully acknowledged.

1989 INDEX

Following are articles appearing in *California Agriculture*, Volume 43, Numbers 1 through 6, January through December 1989. Back issues may be purchased, while supplies last, at \$1.00 per copy (make checks payable to UC Regents).

ANIMAL AND AVIAN SCIENCES

- Attitudes of milk producers toward bovine somatotropin - Zepeda *Mar-Apr 11*
- Beef production increased by intensive grazing - George et al. *Sep-Oct 16*
- Cattle: short-duration grazing on irrigated pasture - Raguse et al. *Jul-Aug 4*
- Cattle and sheep: pistachio culls acceptable in feed - Hull et al. *May-Jun 28*
- Dairy corrals: computerized feed stations - Shultz *Sep-Oct 26*
- Lactating dairy cows: added fats in diets - DePeters et al. *Mar-Apr 20*
- Lambs grazing desert alfalfa - Guerrero, Marble, Hernandez *Mar-Apr 31*
- Pigs: heat stress and copper supplementation - Heitman, Morrison, Parker *Jan-Feb 27*
- Range heifers and cows: seasonal changes in vitamin A and carotene - Morris, Iglesias, Kang *May-Jun 30*

COOPERATIVE EXTENSION

- Cooperative Extension at 75 - Beall *May-Jun 4*

ECONOMICS, FARM MANAGEMENT

- Agricultural sustainability: overview and research assessment - Carter *May-Jun 16*
- Chapter 12 and farm bankruptcy in California - Innes, Keller, Carman *Nov-Dec 28*
- Crisis in agricultural education - Thompson, Gwynn, Kawamura *Jan-Feb 25*
- Farmers who sell at farmers' markets - Vaupel *Jan-Feb 28*

- Financial information needs of California households - Varcoe, Adams *Jul-Aug 8*
- SAW employment data and the need for RAWs - Rosenberg *May-Jun 35*
- Tax reform effects on beef cattle operations - Innes, Carman *Jan-Feb 19*
- Update on procedures for prospective RAWs - Rosenberg *Sep-Oct 32*
- Wineries: growth and change in California - Cooke, Vilas *Mar-Apr 4*

ENGINEERING

- Traction research at UC Davis - Upadhyaya, Wulfsohn *Mar-Apr 15*

FIELD CROPS

- Alfalfa: dodder control - Orloff et al. *Jul-Aug 30*
- Alfalfa: Verticillium wilt in southern California - Erwin et al. *Sep-Oct 12*
- Cereals: barley yellow dwarf - Griesbach et al. *Jan-Feb 23*
- Cotton: control of potassium deficiency syndrome by soil solarization - Weir et al. *May-Jun 26*
- Field corn: Fusarium ear rot - Davis et al. *Nov-Dec 4*
- Kidney beans: effect of harvesting and handling on damage in canned product - Canevari et al. *May-Jun 32*
- Rice: field-drying by modified swath harvesting - Jenkins *Mar-Apr 25*
- Rose clover: cold-tolerant selections - Drake et al. *Nov-Dec 16*

FORESTRY

- Attitudes about oaks in Calaveras County - LeBlanc et al. *Jul-Aug 11*
- Eucalyptus: wood volume equations for central coast blue gum - Pillsbury et al. *Nov-Dec 13*
- Regenerating native oaks - McCreary *Jan-Feb 4*

- Twig blight of oaks - Hecht-Poinar, Costello, Parmeter *Jan-Feb 15*

FRUITS AND NUTS

- Almond frost protection affected by sprinkler spacing - Connell, Snyder *Jan-Feb 30*
- Almond orchards: vegetation management systems - Elmore *Jul-Aug 16*
- Plant composition of orchard floors - Elmore et al. 18
- Management of navel orangeworm and ants - Barnett et al. 21
- Water use and soil characteristics - Prichard et al. 23
- Management costs - Klonsky, Elmore 25
- Almond, prune, sweet cherry orchards: Prunus necrotic ringspot and prune dwarf viruses - Uyemoto et al. *Sep-Oct 14*
- Almonds: effects of fungicides on shot hole disease - Teviotdale *May-Jun 21*
- Apricots: lepidopterous pests in central coast orchards - Coates, Van Steenwyk, Pickel *Mar-Apr 29*
- Citrus: insecticide resistance of a California red scale parasitoid - Rosenheim et al. *Jan-Feb 17*
- French prune trees: refuge for grape leafhopper parasite - Wilson et al. *Mar-Apr 7*
- Grapes: integrated control of botrytis bunch rot - Bettiga et al. *Mar-Apr 9*
- Grapes: monitoring black vine weevil - Phillips *May-Jun 12*
- Grapevines: preventive control of powdery mildew - Bettiga *Mar-Apr 28*
- Grapevines: rootstocks resistant to fanleaf degeneration - Walker et al. *Mar-Apr 13*
- Grapes (wine): rootstock effects - Foott, Ough, Wolpert *Jul-Aug 27*
- Olive leaf spot: copper fungicides - Teviotdale, Sibbett, Harper *Sep-Oct 30*
- Olives: biological control of black scale - Daane, Caltagirone *Jan-Feb 9*
- Pistachio fruit: 'Achilles heel' (stem-end insect damage) - Michailides *Sep-Oct 10*