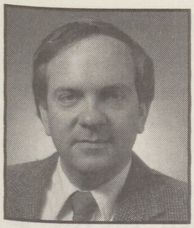

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Chapter 12 Farm Bankruptcies: A National and Missouri Perspective

by Stephen Matthews

ABA continues to have concerns about the presence of Chapter 12, particularly since it does not allow for "shared appreciation" of asset values between lenders and the bankrupted debtor. Loan losses have also had an economic ripple effect throughout rural communities. Reports from farmers about being outbid at auctions by a "former" Chapter 12 filer are disturbing. ABA supports the sunsetting of Chapter 12 as the law presently requires.

The Family Farm Bankruptcy Act (Chapter 12) was received with much anxiety by both farm debtors and ag lenders when it was signed into law on October 27, 1986. Filings began at a fast clip after the Act went into effect on November 26, 1986, with 6,664 Chapter 12s by December 31, 1987. But that pace has slackened considerably, as both farm debtors and lenders learn benchmarks for workouts from existing Chapter 12s. As of June 30, 1989, there have been 9,575 Chapter 12 petitions filed across the United States.

Chapter 12 was enacted in the midst of the "Farm Debt Crisis of the 1980s." Not a moratorium on debt collection, Chapter 12 helps farmers stay in business by scaling debts down to the collateral's current value. Basically, it relieves farmers of most of their unsecured debts, usually feed, fertilizer, and fuel bills, and writes down undersecured debts (mostly farmland) to their current values.

Most bankruptcy commentators size up Chapter 12 as pro-farmer and anti-ag lender. This assessment stems largely from the fact that normal default remedies, such as foreclosure and repossession are halted, leaving the defaulting debtor in possession of liened collateral. Lenders can not vote on the reorganization plan, nor can they reclaim written-down secured loans if the collateral (usually land) increases in value after the plan is confirmed.

But there are checks and balances in Chapter 12 that protect lenders' interests. These include a 90-day filing period for the debtor's reorganization plan, adequate protection provisions for secured creditors, and the appointment of a trustee.

After three years of experience with Chapter 12, farm debtors are still reluctant to formally file bankruptcy. The reasons are varied, but include the high cost of attorney and trustee fees, the stigma of bankruptcy, and the increasing willingness of ag lenders to write down existing debts on a par with what the farm debtors would receive by filing a Chapter 12. In effect, Chapter 12 established guideposts for compromise in renegotiating farm debts.

Missouri: Farm Bankruptcy Trends, 1981-87

One-third of Missouri farm bankruptcies during 1981-1987 were reorganization filings (Chapter 11s, 12s, and 13s). The great majority (65%) were Chapter 7 (liquidations). The advent of Chapter 12 did increase the share of "reorganization" filings in 1987 to 45% (from 27% in 1986).

Figure 1
Missouri Farm Bankruptcy Filings, 1981-1987

	Chapter				
	7s	11s	12s	13s	Totals
1987	279	21	247	8	555
1986	398	110	21[1]	19	548
1985	338	136	--	14	488
1984	278	170	--	16	464
1983	199	110	--	11	320
1982	184	46	--	17	247
1981	96	11	--	8	115
TOTALS	1,772	604	268	93	2,737

[1]Only for the month of December since the law became effective on November 26, 1986.

The number of farm bankruptcies in Missouri increased dramatically during 1981-1987, as shown by Figure 1. The peak and leveling off were in 1986 and 1987, with 548 and 555 bankruptcy filings, respectively (1988 data are unavailable).

The 1,772 Chapter 7 filings represent roughly 1.5% of Missouri's 115,000 farms. (The 1982 Census defines "farm" as one with annual ag sales of $1,000 or more). But in terms of farms with $40,000 or more in yearly ag sales, the 1,772 farms represent 7.7% of Missouri farms over the seven-year period. To what extent these 1,772 farm liquidations were replaced by new farms, absorbed by existing ones, or converted to non-ag uses is unknown.

From 1981 through 1986, the average aggregated *deficiency* (excess of debts over assets) for the bankruptcy chapters was Chapter 7s--$142,500; Chapter 11s--$7,800; Chapter 13s--$28,500 and Chapter 12s--$76,800 (only December 1986).

One would expect Chapter 7 liquidations to be more insolvent, since many assets have already been sold or repossessed by bankruptcy time. Chapter 7 debtors are seeking a discharge of excess indebtedness, not proposing a reorganization plan. Secured creditor claims exceeded debtor-declared asset values by 1.3:1, meaning 75% of such claims might be covered by asset liquidation. In this aggregated view of the 1,492 Chapter 7's, there were no funds left for the unsecured creditors (representing $151 million).

The major reorganization chapter used by farmers during 1981-1986 was Chapter 11, with 583 filings. Chapter 13 was relatively unused (85 filings) primarily because of its low debt limits ($350,000 secured; $100,000 unsecured). Again using the aggregate approach for the six-year period, the debt-to-asset ratio of 1.01 for Chapter 11s would suggest all creditors would have been repaid almost in full if liquidation had been chosen. But these are debtor asset valuations. Most certainly not all creditors favored leaving the debtor, often in default, in possession of the farm assets. Secured creditor claims represented 87% of asset value. But farmland values dropped dramatically during 1981-1986.

It is not known how many of these 583 Chapter 11s achieved plan confirmation or met plan payments. Many Chapter 11s, according to anecdotal evidence from ag lawyers, farmers, and court personnel, were converted to Chapter 7s or dismissed.

The Emergence of Chapter 12

November 26, 1986 marked the effective date for Chapter 12, the Family Farm Bankruptcy Act. Its impact was immediate and phenomenal: 600 filings across the United States in the first month, and 6,664 filings at the end of its first year (December 31, 1987). In Missouri, Chapter 12 virtually eliminated Chapter 11 filings and reduced the proportion of Chapter 7s (50% in 1987, from 73% in 1986).

Nebraska leads in total Chapter 12 filings (as of December 31, 1988) with 925, followed by South Dakota (573), Louisiana (442), Illinois (413), Iowa (403), Missouri (367), Indiana (355), and Texas (336). Refer to Figure 2 for state tallies through December 31, 1988. But the initial filing pace is slackening, and the number of Chapter 12s filed in the United States continues to decline each quarter:

	1986	1987	1988
1st Quarter	--	2,307	648
2nd Quarter	--	1,905	533
3rd Quarter	--	929	401
4th Quarter	600	923	454

Figure 2
Chapter 12 Filings by State As Of December 31, 1988

Alabama	129	Louisiana	442	Ohio	317
Alaska	1	Maine	17	Oklahoma	300
Arizona	24	Maryland	14	Oregon	119
Arkansas	158	Massachusetts	0	Pennsylvania	24
California	260	Michigan	250	Rhode Island	0
Colorado	187	Minnesota	201	South Carolina	43
Connecticut	1	Mississippi	159	South Dakota	573
Delaware	1	Missouri	367	Tennessee	173
Florida	59	Montana	180	Texas	336
Georgia	256	Nebraska	925	Utah	50
Hawaii	0	Nevada	15	Vermont	6
Idaho	251	New York	78	Virginia	43
Illinois	413	New Hampshire	0	Washington	195
Indiana	355	New Jersey	5	West Virginia	10
Iowa	403	New Mexico	64	Wisconsin	243
Kansas	333	North Carolina	222	Wyoming	72
Kentucky	209	North Dakota	218		

Why Creditors Opt For Non-Chapter 12 Workouts

Ag lenders have several major reasons for renegotiating with farm debtors considering Chapter 12. These may explain much of the drop-off in Chapter 12 filings. Since farmland values no longer decline, and in many areas are gradually increasing, lenders anticipate asset appreciation. Under Chapter 12, land value increases belong to the debtor absent shared appreciation in the reorganization plan.

Another lender concern is that in Chapter 12 attorney and trustee fees diminish debt repayment. Lawyer fees of $10,000 and 10% trustee fees are standard. These costs can be compromised between farm debtors and ag lenders in nonbankruptcy workouts.

Disagreements over farm asset valuations and the appropriate interest rate have been sore points between lenders and debtors in Chapter 12. With over three years of benchmark Chapter 12 cases, both sides understand the guidelines for both appraisals and interest rates. Why add the cost, time, and effort of a formal Chapter 12 when a similar compromise can be achieved in a nonbankruptcy workout.

General Farm Economy Outlook: Impact on Chapter 12

An improving ag economy suggests there will be fewer filings of Chapter 12. However,there are a sizeable number of farms with a dangerously low income and/or high debt load. USDA's Farm Costs and Returns Surveys for 1986-1988 show a decrease in the percentage of farms considered "vulnerable" or of "marginal sol-

Figure 3
U.S. Farm Operators by Financial Position Using Net Farm Income

	% Favorable[1]	%Marginal Income[2]	%Marginal Solvency[3]	%Vulnerable[4]
1988	66.9	19.5	8.3	5.3
1987	68.1	16.9	10.1	4.9
1986	56.8	21.6	11.7	10.0

Source: Farm Costs and Returns Surveys, USDA

[1]"Favorable" is defined as positive net income and debt-to-asset (D/A) less than 0.40.

[2]"Marginal income" represents farms with negative net income and D/A less than 0.40.

[3]"Marginal solvency" farms have both positive net income and D/A greater than 0.40.

[4]"Vulnerable" farms have both negative net income and D/A greater than 0.40.

vency". See Figure 3. Correspondingly, the farms with a "favorable" financial position has increased from 56.8% in 1986 to 66.9% in 1988.

Outlook for Chapter 12: A Major Player For Four More Years

Chapter 12 has a sunset date of October 1, 1993, and there is every indication it will be left intact until then. While there have been fewer 12 filings recently, its availability is influential. Continued Chapter 12 filings probably reflect the inability of farm debtors to compromise with all key creditors.

Sizeable debt is being written off under Chapter 12's influence, by both undersecured and unsecured creditors. These write offs have immediate impacts on lenders, rippling through local economies. Creditors are understandably more cautious in lending to farmers and to agribusinesses that extend credit to farmers.

Not to be ignored are farmers' opinions about debt forgiveness for other farmers. Risks are part of farming and defaulted loan obligations should have legal remedies like foreclosure and repossession according to some farmers who feel that many farmers are in trouble (and using Chapter 12) because of imprudent investment decisions, poor management, and living "too high on the hog." These sentiments represent the social stigma of even imitating a Chapter 12 workout, let alone filing. This factor is becoming more prominent in lender reluctance to write off debt, especially as farmland values improve.