Up and Down the Hill

The following is excerpted from testimony presented by Jeff Plagge to the Senate Judiciary Committee, Subcommittee on Courts and Administrative Practices on March 31, 1993.

Mr. Chairman and Members of the Subcommittee, I am Jeff Plagge, Executive Vice President, First State Bank, Webster City, Iowa, and I am currently Vice Chairman of the American Bankers Association (ABA) Agricultural Bankers Executive Committee. ABA members represent about 90% of the industry's total assets. Approximately 75% of our members are community banks with assets of less than $100 million. I appreciate this opportunity to present ABA's views on family farm bankruptcy law provisions, more commonly referred to as Chapter 12 of the Bankruptcy Code. We believe this chapter of the bankruptcy code has not served rural communities well, and has adversely affected the availability of credit in rural communities.

Because it is important for rural communities that this relatively new bankruptcy title be carefully examined, the ABA wishes to commend this committee for holding a hearing on provisions of S. 540 which modify and extend Chapter 12 for five additional years. We particularly appreciate the hearing because ABA cannot support a simple extension of Chapter 12. At the same time, the ABA also wishes to commend the sponsors of S. 540 for addressing the procedural delay problems faced by bankers under the current Chapter 12 structure. These changes are reflected not only in S. 540, but also in S. 283, sponsored by Senator Grassley. The banking community believes this is an important first step towards correcting the current inequities under Chapter 12.

In 1986, Chapter 12 of the Bankruptcy Code was established to provide a simplified and expedited form of reorganization for debtors that qualified as family farmers. At the height of the "Ag Crisis," when both farmers and bankers were concerned about the future viability of farm operations, Chapter 12 was billed as a means to provide both temporary relief and an expedited procedure under which prompt reorganization would alleviate further distress. By establishing statutory deadlines, Congress sought to assure that Chapter 12 cases would proceed expeditiously for the benefit of both debtors and creditors. While the procedures were supposed to be expedited, many of the creditors' rights provided under traditional Chapter 11 reorganizations were removed.

Unfortunately, the expedited procedure process has not worked well in rural America. Farmers choosing bankruptcy under Chapter 12 have frequently delayed the process for filing suitable reorganization plans. Because creditors are precluded from filing their own proposed plan when such delays occur, as they can under a Chapter 11 proceeding, Chapter 12 cases are often delayed years before an approved plan is in place. Further, because such a plan is approved without the participatory vote of the creditors, the debtors maintain total leverage throughout the entire Chapter 12 proceeding, often manipulating the process while the creditors watch helplessly from the sidelines. In fact, the helpless frustration that is felt by bankers in this situation often is reflected in their reluctance to extend credit to "marginal" borrowers for fear of a future Chapter 12 filing.

For this reason, the ABA is encouraged by Section 103 of S. 540 which seeks to

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clarify the extent to which Chapter 12 filings can be extended. Specifically, Section 103 of S. 540 amends the current Chapter 12 statute by allowing for an extension only if the need is attributable to circumstances for which the debtor should not be held accountable. The ABA believes that such a change will help to reinstate the original intent of the law – that is to expedite the filing of an appropriate bankruptcy plan.

Currently under Chapter 12, bankers and individual creditors are forced (again without the participatory vote provided under Chapter 11) to "cramdown" to current market levels the value of secured loans. While cramdowns exist under Chapter 11, the option for creditors to elect "shared appreciation" also exists, allowing bankers to recover some of their losses. Conversely, under Chapter 12, the banker can recoup nothing. As the market value for agricultural land tumbled during the mid-1980s, bankers, other creditors, and individuals who had extended credit to those who filed for bankruptcy suffered large, irrevocable losses. While the value of this land has rebounded in recent years, and while farms and ranches have returned to profitability, these creditors have been precluded from sharing in the appreciation of these assets.

Bankers are not the only people adversely affected by the loss of shared appreciation under Chapter 12; individual creditors often face similar, if not more devastating, fates. A colleague of mine related to me a tragic Chapter 12 case involving a husband and wife who sold their Nebraska farm to support their retirement. Upon selling their farm, this couple took back a note from the borrower on contract, structured with a 10-year balloon payment. During this 10-year period, the husband died, leaving his wife with minimal social security and the annual farm payments as her sole source of income. In the last year of the contract, the contract holder filed for protection under Chapter 12. For three years, this widow's banker advanced monies for legal fees for Chapter 12 and for general living expenses. The proceeding took more than three years to complete, and when completed, instead of receiving the approximately $80,000 to which she was originally entitled, she was "crammed down" approximately $20,000. In addition, the contract was rewritten for another 20 years at the same rate of interest that was negotiated 10 years prior to bankruptcy.

As a result, instead of living comfortably, this widow must contend with an installment payment that was rewritten by the courts. Furthermore, the farm has appreciated considerably since it was renegotiated during the Chapter 12 proceedings, and neither she, nor her family, is allowed to enjoy any of the appreciation. This situation is blatantly unfair and painfully unjust. We recommend that Chapter 12 be further amended to allow creditors the option to share in the appreciated value of an asset up to the original amount lost during bankruptcy. Such a provision would also greatly reduce the current reluctance of lenders to provide loans to financially marginal borrowers due to fear of losses in a potential Chapter 12 bankruptcy.

Bankers are not alone in expressing the unfairness of this situation. Last June, before the House Judiciary Subcommittee on Economic and Commercial Law, Richard Bohanon, the Chief Judge for the United States Bankruptcy Court for the Western District of Oklahoma suggested that some form of shared appreciation would improve the current Chapter 12 statute:

> The obvious pain to the banks in this procedure is that they must realize their deficiency and absorb that loss now rather than at some later time. Additionally, they normally are not in a position to benefit from some future increase in the value of the farm, should that ever occur, for the face amount of their note is "written down" to the present fair market value of the collateral. Given time for thoughtful study, I believe that a solution could be found to the predicament of the banks and allow for an effective farm reorganization.
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> A clear comparison is with section 1111(b)(2) of Chapter 11 which allows secured creditors to elect to waive their deficiency claim and retain their lien for the full amount.[1]

The ABA is in total agreement with Judge Bohanon's assertion concerning shared appreciation. A shared appreciation provision seems particularly justified because these same creditors have suffered not only from a lack of shared appreciation, but also from "lost opportunity." Under Chapter 11, the principle of adequate protection includes protection of the secured value of a creditor's interest in collateral – the lost opportunity to reinvest the secured value of an asset. This protection is not provided in Chapter 12, leaving creditors with frozen loans receiving no interest from the date the bankruptcy petition is filed until the plan goes into effect. The cumulative result of lost opportunity and foregone shared appreciation is that many bankers and Main Street creditors have become reluctant to extend credit to new, beginning farmers as well as to financially marginal farmers who otherwise might have received credit. Moreover, the inability of these creditors to share in the appreciation of these assets results directly in the loss of funds available for all borrowers in rural America.

Statistically, findings concerning the actual impact of Chapter 12 filings have not been surprising to rural lenders. According to a September 1992 study released by USDA's Economic Research Service (ERS) titled: "Bankruptcy Costs Under Chapter 12," the comparative total cost of bankruptcy between Chapter 12 and Chapter 11 historically is substantial. The ERS study concludes that conservatively the incremental impact of Chapter 12 over Chapter 11 raises indirect bankruptcy cost by about one-fourth. The study shows the impact this cost has on the borrower, not the banker:

> To offset the costs Chapter 12 imposes on creditors, interest rates to farm borrowers will have to be 0.25 and 1.0 percent higher on average. Much higher costs will be borne by financially weaker farm borrowers, either in the form of increased interest or other charges or in their inability to obtain loans at any price.[2]

Further, the ERS concludes that allowing a secured creditor to share in some form of asset appreciation under a plan similar to those currently provided under Chapter 11 should work to mitigate the "negative efficiency consequences of Chapter 12" for the lender and borrower alike.

Mr. Chairman, in an effort to assist this Committee in addressing the shared appreciation issue, I have attached suggested legislative language which would make the option of shared appreciation available to creditors facing loss under Chapter 12.

Because of the threat of Chapter 12, young farmers and ranchers, as well as marginal borrowers – those most in need of funding – often have a difficult time finding lenders who are willing to extend credit. When they do find a willing lender, they must pay an interest rate premium on their loans. This increase in interest rates is the result of "risk pricing" that lenders must utilize to protect depositors and to satisfy the regulators. In conclusion, Chapter 12 bankruptcy has had two major effects on farmers and ranchers in rural America: the availability of credit has been lessened and the cost of credit has increased because of its existence.

While the ABA appreciates the efforts made to address the problems associated with needless delays in the Chapter 12 process, we would encourage this committee to address the issue of shared appreciation which has made Chapter 12 so difficult for bankers attempting to lend to borrowers in rural America. ▲

Notes

[1]Statement of Richard L. Bohanon, Chief Judge, United States Bankruptcy Court for the Western District of Oklahoma, before the House Judiciary Subcommittee on Economic and Commercial Law, June 24, 1992.

[2]Robert N. Collender, "Bankruptcy Costs Under Chapter 12," U.S. Department of Agriculture, Economic Research Service, September 1992 (Report No. AGES 9210) p. 16.


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