



Do Farmers Need a Separate Chapter in the Bankruptcy Code?

Chapter 12, a special section in the bankruptcy code enacted in 1986 in response to the farm financial crisis, will expire on October 1, 1998. It has succeeded in keeping some farmers in business and has encouraged informal lender-farmer settlements out of court. But it has increased costs by encouraging both inefficient farmers who would otherwise liquidate and efficient farmers who would otherwise continue their operations at greater expense to reorganize their businesses and charge off part of their debts under the protection of bankruptcy. Some of these costs could be mitigated by allowing lenders the option of recapturing writedowns in secured debt as asset values increase.

Family farmers periodically have had a special place in U.S. bankruptcy law beginning with the enactment of the first modern bankruptcy act in 1898. Chapter 12, the Family Farmer Bankruptcy Act of 1986 (P.L. 99-554), was enacted in response to the farm financial crisis of the early- to mid-1980's. The law became effective on November 26, 1986, and was authorized until October 1, 1993. Chapter 12 was passed to deal with a farm financial crisis and was not intended to be permanent. It allows family farms (as defined in the code) with regular income to adjust their debts, and makes available to farmers the equivalent of a Chapter 13 repayment program. Chapter 12 bankruptcy plans are for 3 years, but with court approval may be extended to 5 years.

Chapter 12 modifies the normal Chapter 11 bankruptcy procedure by permitting farmers to submit a reorganization plan directly to the bankruptcy court, with no review by creditors. Creditors cannot reject a court-approved debt repayment plan developed under Chapter 12 if they will receive at least as much as under Chapter 7 liquidation. Chapter 12 farmers, therefore, can reduce the amount they owe, extend the payment period, and lower the interest rate on existing loans to the current market rate or lower. That is, the farmer can "cram down" a plan over the objection of creditors. As a consequence, secured creditors' bargaining positions are weakened. The writedown or "discharge" of secured debt is limited to the current market value of the underlying land or other asset, which

can be less than its original loan value. In return, the farmer agrees to a repayment plan for the remaining debt.

Chapter 12 gives family farmers considerably more power to demand concessions from lenders in the bankruptcy process than Chapter 11, the other chapter of the bankruptcy code governing business reorganization. Chapter 12 originally was to expire on October 1, 1993, but it was extended for 5 years. The National Bankruptcy Review Commission, established under 1994 legislation, went on record in May 1997 in favor of making chapter 12 permanent. Legislation was introduced in Congress to that effect in July 1997.

Rationale for Chapter 12

Chapter 12 provides extraordinary relief for those eligible. It was passed because of the downturn in the farm economy and the perceived inability of farmers to obtain meaningful relief under the provisions of the Bankruptcy Reform Act of 1978. Restrictions in both Chapters 11 and 13 were viewed as making it difficult for family farmers to obtain relief. Chapter 13, sometimes referred to as "Chapter 11 for individuals," provided a fairly inexpensive and streamlined procedure for debtors to readjust their financial obligations while obtaining at least a partial discharge of their debts. However, only "individuals with regular income" were eligible for Chapter 13 relief. Those with unsecured debts in excess of \$100,000 or secured debts in excess of \$350,000 were ineligible for Chapter 13. Because most farmers

had debt that exceeded one or both of these ceilings, Chapter 13 was usually not available.

Under Chapter 12, a “family farmer” is defined as: (1) an individual engaged in farming whose debts arise primarily (80 percent) out of a farming operation owned by the individual and whose income is derived (at least 51 percent) from the farm; or (2) a corporation or partnership engaged in farming owned (at least 51 percent) by one family (including relatives) which operates the farm and where at least 80 percent of both its assets and liabilities are used in the farming operation.

In addition, a family farmer, whether an individual, corporation, or partnership, cannot have total noncontingent debt in excess of \$1.5 million to be eligible for Chapter 12. The family farmer must have regular income, defined as that which is sufficiently regular to enable the family farmer to make payments under the Chapter 12 plan.

Chapter 12 had an immediate impact in slowing the pace of farm liquidations, with a large number of farms taking advantage of it in the first few months after its introduction; the number of filings subsequently declined and generally leveled off (fig. 1). Through December 1987 under Chapter 12 (the first 13+ months of its implementation), 6,664 bankruptcies were filed; by comparison, over the next 9-1/2 years, 12,552 cases were filed (through June 30, 1997).

Chapter 12's Successes

There are arguments for and against farmers' special provisions under the bankruptcy code. A key issue is whether maintenance of a special chapter for family farmers is warranted (Harl). Some arguments in favor are based on the belief that farms are small businesses subject to considerable risks stemming from weather, pests, markets, and other considerations because of a long biological process necessary to produce most agricul-

tural commodities. This view includes the belief that farms operate under unique business circumstances. Unique factors include a high level of capital intensity and export sensitivity plus the fact that much of agriculture deals with perishable products. Thus, delays and uncertainties commonly linked with Chapter 11 bankruptcy generate substantial problems (Harl).

Moreover, the number of farmer bankruptcies is likely to be small compared with the bankruptcies filed by large urban firms and likely to be modest by comparison. Support of special considerations also stems from the belief that the Nation is best served by having a comparatively large number of farm firms as opposed to a comparatively few large “corporate farms.” A special bankruptcy provision is one policy tool that can help maintain farm numbers. Others believe that farmers need protection from the relatively greater economic power of lenders and farm supply firms.

Most farmer bankruptcy reorganizations are now filed under Chapter 12's provisions, with the remainder split between Chapter 11 (the large farm bankruptcies) and Chapter 13. In addition, some farmers file under Chapter 7 (liquidation). The farmer bankruptcy rate in the 1990's, based on Chapter 12 data alone, has stabilized at a level above that experienced

for all farmer bankruptcies prior to the latest farm financial crisis of the early to mid-1980's (fig. 2).

Proponents argue that Chapter 12 is successful in both providing the family farmer with access to bankruptcy reorganization and reforming the process to accommodate the distinctive nature of farming. Although Chapter 12 meets its expected goal of providing bankruptcy protection to family farmers, perhaps its greatest impact is felt outside of bankruptcy court. The act shifted the balance of power in certain bankruptcy proceedings in favor of the family farmer, encouraging lenders to settle repayment problems out of court. The existence of Chapter 12 encourages informal settlement between agricultural lenders and family farmers because it redefines property rights in favor of debtors and lowers transaction costs. Chapter 12 reduces transaction costs by reducing the voting rights of creditors and other impediments to plan approval.

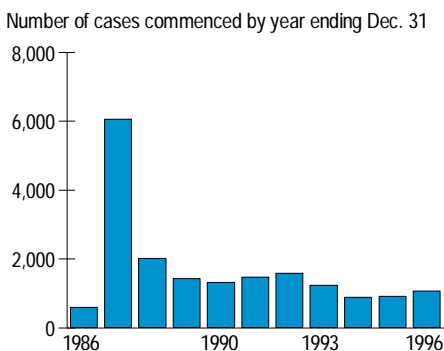
Chapter 12's largest impact likely is the setting of the bounds of negotiated workouts. It also promotes more responsible lending because farm lenders tend to be more cautious with this special provision in force. The impact of such prudence may reduce farm sector failures. Based on the evidence, proponents conclude that Congress should enact Chapter 12 as a permanent part of the Bankruptcy Code with several modifications, such as changes in trustees' fees, calculation of the discount rate, abandonment rules, and a separate Chapter 12 tax entity (Harl).

Chapter 12's Limitations

The arguments against special bankruptcy treatment for farmers focus largely on efficiencies and costs. Some question why farmers should receive bankruptcy treatment different from other small businesses or what is so special about the modern farm firm. Regarding protecting the number of farms and, hence, slowing change in farm sector structure,

Figure 1

Chapter 12 bankruptcy cases decreased after 1987 because farm income has generally been higher and more lender-farmer disputes are now settled through mediation



Source: Economic Research Service compiled from

one would have to show that farm businesses receiving special bankruptcy treatment recover and survive, and would not have done so otherwise. Of the farms that filed under Chapter 12 and whose cases were concluded by yearend 1993, 43 percent successfully completed bankruptcy proceedings. Some of these might have succeeded without Chapter 12. There also is the question of the cost to lenders and to society in general stemming from the money lost or written off in farmer bankruptcy procedures. Lastly, there is some concern that prospects of dealing with a farmer under Chapter 12 may discourage lenders from making credit available to farmers who are poorer credit risks.

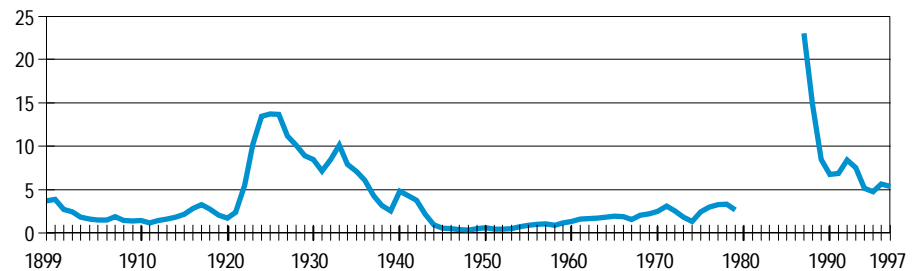
Chapter 12 imposes certain economic costs, referred to as bankruptcy costs and considered deadweight losses to the economy. The magnitude of these costs is an important element in the debate to renew Chapter 12. Deadweight loss is a measure of waste from inefficient resource allocation. By calculating deadweight loss, economists can estimate the benefits and costs of various government policies and programs.

Bankruptcy costs can be both direct and indirect. Direct bankruptcy costs specifically include the legal and administrative costs of liquidation or reorganization under bankruptcy protection. These costs are borne directly by participants in bankruptcy proceedings. Indirect bankruptcy costs result from economic distortions associated with bankruptcy or the threat of bankruptcy. Resource allocation is distorted because both creditors and farmers change business decisions in anticipation of bankruptcy. Creditors attempt to reduce their losses in the event of a filing, and farmers attempt to raise their expected return to equity by increasing the firm's risk because their loss exposure is limited. Such distortions may include the loss of sales due to weakened assurance of delivery, the inability to make otherwise profitable investments, and, in the case of a firm that should be liquidated, the value lost from not real-

Figure 2

The farmer bankruptcy rate was high in the mid-1980's, but has since stabilized at higher rates than experienced since the mid-1930's

Bankruptcies commenced/10,000 farmers (excluding sharecroppers)



Note: Bankruptcy data for year ending June 30. Data include farm bankruptcies filed under all applicable chapters for 1899-1979 and those filed under Chapter 12 (which only applies to farms) for 1987-96. No farm bankruptcy data are available for 1980-86 because after 1979 U.S. Bankruptcy Courts were no longer required to report bankruptcies by occupation.

Sources: Economic Research Service compiled from Office of the U.S. Courts and U.S. Bureau of the Census data.

locating resources to their most profitable use. Indirect bankruptcy costs equal the difference in the value of the most profitable use of the firm's resources and the value of the firm given distortions associated with bankruptcy (Collender).

Chapter 12 may have substantially increased bankruptcy costs for farm businesses. Although direct bankruptcy costs are found to be on the order of 3 percent, considerably less than the 20-30 percent of estate value found in early studies of small business and personal bankruptcy, the estimate of the upper bound of indirect costs is surprisingly large: between 73.3 and 99.1 percent of farm asset value at the time of bankruptcy filing. A conservative estimate of the incremental impact of Chapter 12 over Chapter 11 is that it raises indirect bankruptcy costs by about a fourth. To offset the costs Chapter 12 imposes on creditors, interest rates to farm borrowers will rise 0.25-1.0 percent 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 (Collender).

From an economic perspective, bankruptcy should facilitate only those reorganizations that increase the combined value of debt plus equity. Efficiency costs arise when uneconomic

reorganizations are pursued. However, a fairness issue must also be addressed. Bigger farms and businesses receive considerable protection under Chapter 11, but the process is costly because of negotiating requirements implicit in the absolute priority rule. The Bankruptcy Code should ideally provide equal access while minimizing efficiency costs. Chapter 12 may have improved fairness at the price of an apparently sizable increase in efficiency costs.

It also is important to note that for Chapter 13 reorganizations, the Bankruptcy Reform Act of 1994 (P.L. 103-394) increased the maximum limits to \$250,000 of unsecured debt and \$750,000 of secured debt. Chapter 12 bankruptcy was in part patterned after Chapter 13. One of the reasons for developing Chapter 12 was that the debt limits in Chapter 13 prevented many farmers from using it. These increases in the Chapter 13 debt limit make it easier for more farmers to qualify for a section of the Code more familiar to most lawyers and diminish the relative importance of Chapter 12 for the farm sector.

Moreover, although Chapter 12 is often portrayed as a small farm provision, it appears to apply to nearly all farms. It allegedly was designed to protect family farmers, not large farm operations. When passed in 1986, farmers

with \$1.5 million or less in aggregate farm debts were eligible. Yet in 1995, despite a 39.6-percent increase in prices as measured by the gross domestic product (GDP) deflator from 1986, some 99.8 percent of all farms were still eligible, according to USDA's Farm Costs and Returns Survey data.

The concern is that Chapter 12 increases total lending costs to all farmers and restricts credit availability to some degree, depending on the current economic vitality of the farm sector. Because of the threat of Chapter 12, creditors may be wary of granting credit to young producers, as well as marginal borrowers. Lenders have adopted tiered interest rate structures and increased the interest rate spread to riskier borrowers partially in response to Chapter 12.

The major efficiency effect of Chapter 12 arises from its cram-down provision which gives farmers who do not earn market rates of return from their farm assets a means to remain in business. By preventing assets from moving to farmers who can use them more productively, Chapter 12 can impose efficiency losses on the economy. These losses may be substantial during periods of dramatic price declines. This distortion could be mitigated, as it is in Chapter 11, by allowing creditors the ability to capture appreciation in secured assets and to recover writedowns in secured debt. (Under Chapter 11, creditors can do so by making a section 1111(b) election.)

Conclusions

Chapter 12 presents policymakers with a dilemma. If one believes that

good social policy strives to keep farmers on the farm, regardless of their profitability, then Chapter 12 has sometimes succeeded. Chapter 12 provides family farmers facing bankruptcy a streamlined means to reorganize their debts and keep their farms. Chapter 12 eliminated many of the Chapters 11 and 13 restrictions faced by farmers who previously declared bankruptcy and gave more power to the debtor over the lender. The impact of Chapter 12 goes much beyond the 19,216 farmers who have filed under its provisions through June 30, 1997, because it encourages lender-borrower negotiations outside of bankruptcy and encourages a more prudent use of farm credit.

But do the benefits of Chapter 12 outweigh its costs? And how are the costs distributed? If one believes that marginal economic operations should not survive, it has not worked. The major marginal effect of Chapter 12 is to encourage both inefficient farmers who would otherwise liquidate and efficient farmers who would otherwise continue their operations at greater expense to reorganize their businesses under the protection of bankruptcy. These provisions increase direct bankruptcy costs by encouraging bankruptcy filings by some farmers who would not otherwise have done so. They also increase indirect costs by increasing the number of farmers who choose to reorganize inefficient farms. This impact could be mitigated by allowing lenders the option of recapturing writedowns in secured debt if asset values recover. Such an option exists under Chapter 11.

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Further Readings

Collender, Robert N. "An Estimate of the Efficiency Effects of Chapter 12 Bankruptcy," *Agricultural Finance Review*. Vol. 53, 1993, pp. 65-81.

Harl, Neil E.. "Chapter 12 Bankruptcy: A Review and Evaluation," *Agricultural Finance Review*. Vol. 52, 1992, pp. 1-11.

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