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Cramdown under the New Chapter 12 of the Bankruptcy Code: A Boon to the Farmer, a Bust to the Lender

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Cramdown Under The New Chapter 12 Of The Bankruptcy Code: A Boon To The Farmer, A Bust To The Lender?

The economic plight of the farm sector has created massive credit problems. In 1985, it was estimated that over 15 percent of all farmers could not survive without financial reorganization.[1] This estimate included more than 229,000 farmers who owed more than one hundred billion dollars.[2]

Congress, recognizing the size of the problem and the role that the federal government played in contributing to the problem,[3] proposed legislation to assist the farmer in reorganizing under the Bankruptcy Code.[4] Congressional proposals, hearings, and debates culminated with the enactment of Chapter 12 of the Bankruptcy Code in the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986.[5]

This comment will review some of the issues Congress considered before enacting Chapter 12 for the "family farmer."[6] First, it will review Congress' general evaluation of existing reorganization chapters in the Bankruptcy Code, Chapters 11[7] and 13.[8] Next, it will thoroughly discuss two specific protections available to a creditor in Chapter 11 and one available in Chapter 13. Chapter 11 includes secured creditor protection through the section 1111(b)[9] election of the claim amount and unsecured creditor protection through the Absolute Priority Rule.[10] Chapter 13 protects mortgage lenders by precluding any modification of residential loans.[11] These protections are unavailable in Chapter 12. This comment

1. *Farm Bankruptcy, Hearings before the Subcomm. on Administrative Practice and Procedure, and Courts of the Comm. on the Judiciary, United States Senate,* 99th Cong., 1st Sess. 27 (Nov. 6 and 12, 1985) [hereinafter referred to as *Hearings before the Subcomm. on Administrative Practice and Procedure*] (statement of Rep. Synar).

2. *Farm Bankruptcy Amendments, Hearings on H.R. 1397 and H.R. 1399 before the Subcomm. on Monopolies and Commercial Law of the Comm. on the Judiciary, House of Representatives,* 99th Cong., 1st Sess. 61 (March 27, 1985) [hereinafter referred to as *Hearings on H.R. 1397 and 1399*] (statement of Rep. Synar).

3. *See* Anderson, *An Analysis of Pending Bills to Provide Family Farm Debtor Relief Under the Bankruptcy Code,* 132 CONG. REC. S15,076, S15,076-77 (daily ed. Oct. 3, 1986) (discussing the necessity for government-sponsored loan programs which encouraged borrowing because of their lenient terms); *see also* 131 CONG. REC. H4771 (daily ed. June 24, 1985) (discussing the effect on farm economics of governmental policies to boost the dollar's value, fight inflation, and target commodity prices).

4. H.R. 1397 and H.R. 1399, 99th Cong., 1st Sess. (1985); S. 705, 99th Cong., 1st Sess. (1985).

5. Pub. L. No. 99-554, § 255, 100 Stat. 3088, 3105-14 (to be codified at 11 U.S.C. §§ 1201-1231).

6. Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, § 251, 100 Stat. 3088, 3104 (to be codified as amending 11 U.S.C. § 101(17)) (A "family farmer" is a farm operator with no more than $1,500,000 in total debt with at least 80 percent of that debt arising out of the farming operation. Total debt excludes debt on a personal residence not part of the farming operation. Also, more than 50 percent of the operator's gross income in the year prior to filing for bankruptcy must have come from farming.).

7. Bankruptcy Reform Act of 1978, 11 U.S.C. §§ 1101-1146 (1982 & Supp. III 1985).

8. Bankruptcy Reform Act of 1978, 11 U.S.C. §§ 1301-1330 (1982 & Supp. III 1985).

9. 11 U.S.C. § 1111(b)(2) (1982).

10. 11 U.S.C. § 1129(b)(2)(B)(ii) (1982 & Supp. III 1985).

11. 11 U.S.C. § 1322(b)(2) (1982 & Supp. III 1985).

will then analyze the effect of Chapter 12 on a secured lender. The analysis will focus on a lender secured by farmland. The lender is "undersecured"[12] because the farmland that once totally secured the debt has declined in value to a point where the debt now exceeds that value. Further, the lender is an "objecting"[13] creditor, one who opposes confirming the debtor's plan of reorganization. The lender's status, thus, requires the bankruptcy court to "cramdown"[14] the debtor's plan. The lender's remaining protections under Chapter 12 will be discussed in depth. Finally, some of Chapter 12's effects outside of bankruptcy proceedings will be forecast.

BACKGROUND

Chapter 12 is not Congress' first attempt to initiate special bankruptcy legislation to aid the failing farmer. In 1933, section 75 was added to the old Bankruptcy Act[15] to provide relief from the Great Depression.[16] That section, designed to be temporary, was extended because of World War II. It eventually expired in 1949, 16 years after enactment.[17] The Chandler Act, enacted in 1938, contained Chapter XII[18] which did not specifically aid the farmer but was available for restructuring his finances. Chapter XII saw little use due to post-World War II prosperity.[19] The Bankruptcy Reform Act of 1978 repealed all prior bankruptcy acts.[20] It contains, however, two reorganization chapters, Chapter 11[21] and Chapter 13.[22]

CHAPTER 11

Before passing Chapter 12, Congress considered the use of Chapter 11 for farm reorganization. Chapter 11, however, contains provisions for a creditor's committee. It requires preparation of and hearings on a disclosure statement. Creditors' approval and acceptance of a debtor's proposed plan must be solicited. These requirements, which are time-consuming and expensive,[23] are detrimental to the debtor and diminish farm assets.

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12. L. LOPUCKI, STRATEGIES FOR CREDITORS IN BANKRUPTCY PROCEEDINGS § 7.4.8, at 242 (1985) (defining "undersecured" as a creditor whose debt would be only partially satisfied if proceeds from the sale of collateral which was sold in a commercially reasonable manner were applied to the debt).

13. *See id.* § 9.13, at 331, n. 1 (describing an "objection" to a plan as a legal basis requiring the bankruptcy court to refuse plan confirmation. That differs from "rejecting" a plan which occurs when a creditor *votes* against a plan.).

14. *See* 3 D. COWANS, BANKRUPTCY LAW AND PRACTICE § 19.19, at 245 (1987 ed.) (stating that "cramdown" is required when a creditor does not accept a plan or rejects it outright).

15. Act of March 3, 1933, ch. 204, § 75, Pub. L. No. 420, 47 Stat. 1467, 1470 (expired 1949).

16. Anderson, *supra* note 3, at S15,077 (citing 10 H. REMINGTON, A TREATISE ON THE BANKRUPTCY LAW (1947)).

17. *Id.* at S15,077.

18. Chandler Act, ch. 575, §§ 401-526, Pub. L. No. 696, 52 Stat. 840, 916-30 (1938) (repealed 1978).

19. Anderson, *supra* note 3, at S15,080.

20. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 401, 92 Stat. 2549, 2682.

21. Bankruptcy Reform Act of 1978, 11 U.S.C. §§ 1101-1146 (1982 & Supp. III 1985).

22. Bankruptcy Reform Act of 1978, 11 U.S.C. §§ 1301-1330 (1982 & Supp. III 1985).

23. *Hearings on H.R. 1397 and 1399, supra* note 2, at 131 (reply letter from F. Kennedy, Univ. of Iowa law professor, to Rep. Rodino, chairman of the Committee on the Judiciary, House of Representatives).

Chapter 11 also contains cramdown provisions which are extensive and complex.[24] Those provisions are beyond the scope necessary to confirm a simple plan proposed by a typical farmer. Further, Chapter 11 poses a risk that a creditor might propose a plan which liquidates the farmer.[25] That prospect is untenable when considering legislation to rehabilitate the farmer.

Finally, and importantly, Congress considered the practicalities of the typical farm debtor-creditor relationship. Most of a farmer's debt will be held by a lender who loaned him money to acquire farmland or who took farmland as collateral for other loans. Because farmland values have significantly declined, a lender who was once totally secured is now unsecured for a large portion of debt. Since Chapter 11 requires an affirmative vote by certain classes of creditors to effect reorganization,[26] this creditor might dominate the vote of the unsecured class.[27] This, alone, could prevent plan confirmation and defeat the purpose of the reorganization legislation.

CHAPTER 13

Congress, at the same time, reviewed Chapter 13 for farm reorganizations. Chapter 13's debt limit presents a significant obstacle to its successful use by farmers. Chapter 13 is available only if total debts do not exceed $450,000.00.[28] That limit is too small for many insolvent farmers. Chapter 13, too, is only available to individuals.[29] That limitation excludes many farmers who have formed family partnerships or corporations.[30] Chapter 13 has several requirements that a farmer cannot practically meet. Chapter 13, designed for wage-earners, requires plan payments to be made within 30 days after the debtor files for bankruptcy protection.[31] A farmer's dependence on a seasonal harvest for income does not allow the farmer to meet this payment requirement.[32] Another significant Chapter 13 provision precludes a debtor from modifying the debt secured by his principal residence.[33] Unlike wage-earners, a farmer lives on the land from which he derives his income. The inability to modify his mortgage debt will likely preclude a successful reorganization. Because Congress disallowed home mortgage modification in Chapter 13, it required all payments to be made within the maximum three-year plan term.[34] A normal Chapter

24. *Id.* at 56 (statement of F. Kennedy).
25. *See id.* at 131 (letter from F. Kennedy to Rep. Rodino).
26. 11 U.S.C. § 1126(c) (1982); 11 U.S.C. § 1129(a)(10) (1982 & Supp. III 1985).
27. *Hearings before the Subcomm. on Administrative Practice and Procedure, supra* note 1, at 165 (statement of A.Thomas Small, Bankruptcy Judge, E.D. N.C.).
28. 11 U.S.C. § 109(e) (1982) (limits the availability of Chapter 13 to a debtor owing less than $100,000 in unsecured debts and $350,000 in secured debts as of the date of filing a bankruptcy petition).
29. 11 U.S.C. § 109(e) (1982) (limits the availability of Chapter 13 to only an "individual").
30. *Hearings on H.R. 1397 and 1399, supra* note 2, at 89-90 (written statement of H. Graves, an Oklahoma attorney and co-drafter of H.R. 1399).
31. 11 U.S.C. § 1326(a)(1) (Supp. III 1985).
32. *Hearings on H.R. 1397 and 1399, supra* note 2, at 92-93 (written statement of H. Graves).
33. 11 U.S.C. § 1322(b)(2) (1982 & Supp. III 1985).
34. *See* 11 U.S.C. § 1322(b)(5) (1982); 11 U.S.C. § 1322(c) (1982).

13 debtor has no need for a longer term since his only long-term debt is his home loan. Allowing mortgage debt modification to a farmer, though, requires a longer term to repay this mortgage debt.[35]

CHAPTER 12

After considering the deficiencies of Chapter 11 and Chapter 13, Congress enacted a separate Chapter 12. This chapter was designed to overcome the deficiencies of Chapters 11 and 13 while preserving certain creditor protections.[36]

The Chapter 12 proposal received significant criticism. It reportedly creates a legal atmosphere which encourages bankruptcy and discourages a farmer's incentive to work out arrangements with his lender.[37] Without lender participation in a plan, debtor-owned lenders will realize more losses, resulting in higher interest rates to farm borrowers.[38] Chapter 12 also imposes the entire burden of debt forgiveness on farm lenders, with no hope of recovery. Debt forgiveness may reach billions of dollars. That massive debt forgiveness may chill future agricultural loans.[39]

Despite this criticism, Congress enacted Chapter 12. While Congress readily admits that this bankruptcy chapter will not solve the farm crisis, it is designed to give the farmer a "fighting chance" to reorganize and stay on the farm. In the meantime, Congress plans to pass a farm bill while reassessing tax and trade policies, all intended to revitalize the farm economy.[40] Its benefits reportedly extend to creditors and the general public alike. Farm reorganization inhibits liquidation. Fewer farm liquidations will stabilize farm values and stop the erosion in lenders' collateral values.[41] The American public benefits from retaining farm operations. More farmers create more competition and lower food prices. Furthermore, Chapter 12 supposedly costs the taxpayer not "one red cent."[42]

SIGNIFICANT ISSUES IN THE BANKRUPTCY CODE

While working on Chapter 12, Congress considered two Chapter 11 protections that significantly affect an undersecured creditor. Those provisions govern the amount of the creditor's *secured* claim[43] and the re-

35. H.R. 1399 proposed a plan term of ten years. Even that longer term was criticized as being too short for restructuring a farmer's long-term debt. *Hearings on H.R. 1397 and 1399, supra* note 2, at 77 (written statement of G. Paine, II, Bankruptcy Judge, M.D. Tenn.).

36. *Hearings before the Subcomm. on Administrative Practice and Procedure, supra* note 1, at 183 (letter to Samuel Gerdano, counsel for the Subcommittee, from A. Thomas Small, Bankruptcy Judge, E.D. N.C., and co-drafter of a proposed bill establishing Chapter 12).

37. 132 CONG. REC. S15,092 (daily ed. Oct. 3, 1986) (statement of Sen. DeConcini).

38. *See Hearings on H.R. 1397 and 1399, supra* note 2, at 173-75 (letter from D. Banner, President of The Farm Credit Council, an association of borrower-owned farm lending institutions).

39. 132 CONG. REC. S15,092 (daily ed. Oct. 3, 1986) (statement of Sen. DeConcini).

40. 131 CONG. REC. H4769 (daily ed. June 24, 1985) (statement of Rep. Synar advocating passage of H.R. 2211 which he co-sponsored).

41. *Hearings before the Subcomm. on Administrative Practice and Procedure, supra* note 1, at 184 (letter to S. Gerdano, counsel for the Subcommittee, from A. Thomas Small, Bankruptcy Judge, E.D. N.C.).

42. 131 CONG. REC. H4770 (daily ed. June 24, 1985) (statement of Rep. Synar).

43. 11 U.S.C. § 1111(b)(2) (1982).

quirement to pay *unsecured* debts in full before a debtor retains a property interest in the reorganized business.[44]

AMOUNT OF SECURED CLAIM

Section 506(a) defines a "secured claim" as the amount of the debt, up to the value of the property securing the debt.[45] In the case of an undersecured debt, the balance becomes an unsecured debt.[46] The secured claim amount is important in cramdown because secured creditors are given certain protections. Chapter 11 contains a special provision giving an undersecured creditor the option to elect a higher secured claim amount than that contained in section 506(a). Section 1111(b)(2) allows an undersecured creditor to claim the entire amount of the debt as its secured claim, not limit it to the collateral value.[47] Its purpose was to overrule the result of *In re Pine Gate Associates.*[48] That case allowed a debtor to "cash out" the objecting secured creditor's loan for merely the value of the collateral during a temporary period of depressed prices.[49]

Section 1111(b)(2) protects an undersecured creditor in two different ways. If the undersecured creditor thinks the collateral is undervalued, or if it dislikes the plan's treatment of its unsecured portion, it can make this election.[50] This election treats the creditor's entire claim as a secured claim.[51] In a long-term plan, this election will not change the amount which would be paid on the secured portion of the debt.[52] It will, however, alter payments on the unsecured portion because the creditor's election waives all payments on the unsecured portion of the debt.[53] The creditor, however, retains a lien on the property for the full debt amount rather than for the smaller collateral value.[54] If the property's appreciation is greater than the plan payments the creditor would have received on its unsecured claim, the lender will benefit from the election. Its lien assures that it will realize

44. 11 U.S.C. § 1129(b)(2)(B)(ii) (1982 & Supp. III 1985).
45. 11 U.S.C. § 506(a) (1982).
46. *See id.*
47. 11 U.S.C. § 1111(b)(2) (1982). The election can only be made if the property has more than inconsequential value and the property is not to be sold by the debtor. 11 U.S.C. § 1111(b)(1)(B)(i)-(ii) (1982).
48. 2 Bankr. Ct. Dec. (CRR) 1478 (1976) (cited by *In re* South Village, Inc., 25 B.R. 987, 999 (Bankr. D. Utah 1982), also citing *Hearings on S. 2266 and H.R. 8200 before the Subcomm. on Improvements in the Judicial Machinery of the Senate Comm. on the Judiciary,* 95th Cong., 1st Sess. 704, 720-21 (1977)).
49. *In re* South Village, Inc., 25 B.R. 987, 999 (Bankr. D. Utah 1982).
50. *See* 5 COLLIER ON BANKRUPTCY ¶ 1111.02[5] (15th ed. 1979).
51. 124 CONG. REC. H11,103 (daily ed. Sept. 28, 1978); 124 CONG. REC. S17,420 (daily ed. Oct. 6, 1978).
52. 11 U.S.C. § 1129(b)(2)(A)(i)(II) (1982). This section requires that payments under the plan aggregate at least the amount of the secured claim. The *total* payments, in the case of election of § 1111(b)(2), must be at least as much as the unpaid debt as of the date of the bankruptcy petition. Also, the present value of the plan payments must be at least as great as the value of the *collateral* as of the effective date of the plan. If farmland declined to a value of $500,000 but total debt was $1,000,000, this standard can still be met. Total payments during a plan term of 30 years , at 6%, on the $500,000 collateral value, exceed the $1,000,000 unpaid debt amount.
53. *In re South Village,* 25 B.R. at 998-99.
54. 5 COLLIER ON BANKRUPTCY ¶ 1111.02[5] (15th ed. 1979).

that appreciation. In essence, the creditor opts for potential appreciation in collateral value rather than receiving payments on its unsecured claim. This insures that the bankruptcy laws will be used only as a shield to protect debtors, not as a sword to enrich debtors at the secured creditors' expense.[55]

Section 1111(b)(2) was discussed frequently in Chapter 12 legislative hearings. Those in favor of excluding section 1111(b)(2) from Chapter 12 argued that farmland appreciation might be due to a farmer's personal efforts.[56] A co-drafter of the original House bill, Herbert Graves, testified that only an improvident lender would make the section 1111(b) election. He argued that a lender will only realize appreciation in the future. Plan payments, in "cold hard cash," on the unsecured portion of debt are a better substitute.[57]

Provision proponents argued that this election should be a part of Chapter 12 because lenders had once approved loans based on farmland values. Victimized by deflation, the only fair thing was to allow lenders the opportunity to share in future appreciation.[58] Properly used, this section would prevent abuses by reorganizing farmers in the event that land values rise.[59] Its elimination would create a windfall to farmers.[60]

Congress chose to exclude the section 1111(b) election from Chapter 12. Although it gave no definite explanation for its action, it can be surmised that any farmland appreciation can only assist the farmer's financial recovery. This, though, leaves the once secured creditor with only its collateral value for the secured claim amount, without an opportunity to recover any losses from future appreciation.

ABSOLUTE PRIORITY RULE

Chapter 11 also contains a specific provision that protects the *unsecured* creditor in cramdown. Section 1129(b)(2)(B)[61] requires the debtor to pay all unsecured claims in full if the unsecured creditors object to the plan and the debtor *retains his property*. Congress considered this protection while discussing Chapter 12 because the significant depreciation in farmland values has created large unsecured portions of mortgage debt.

This Chapter 11 provision, part of the "fair and equitable"[62] condition of cramdown, is called the Absolute Priority Rule. This reorganization rule was judicially created in *Northern Pacific Railway Co. v. Boyd.*[63]

55. *Id.* at ¶ 1111.02[1].
56. Anderson, *supra* note 3, at S15,086.
57. *Hearings on H.R. 1397 and 1399, supra* note 2, at 126.
58. *Id.* at 40 (written statement of the American Bankers Assn.).
59. *Hearings before the Subcomm. on Administrative Practice and Procedure, supra* note 1, at 57 (written statement of R. Stageman, Bankruptcy Judge, S.D. Iowa).
60. Anderson, *supra* note 3, at S15,085.
61. 11 U.S.C. § 1129(b)(2)(B)(ii) (1982 & Supp. III 1985).
62. 11 U.S.C. § 1129(b)(1)-(2) (1982 & Supp. III 1985).
63. 228 U.S. 482 (1913).

The United States Supreme Court held that the reorganization plan was invalid because the former stockholders of the insolvent railroad retained equity ownership in the reorganized business. The Court recognized that former creditors should share in the value of the reorganized business before former equity owners could share.[64] The Court modified its view in *Case v. Los Angeles Lumber Products Co.*[65] The Court stated that a "fresh" contribution by the old equity owners, essential to the reorganization's success, would allow them to share in ownership of the reorganized business.[66] The new contribution must be "in money or money's worth"[67] and limits the new equity share to the equivalent value of that contribution.[68]

Congress modified the Absolute Priority Rule in Chapter 11 of the Bankruptcy Reform Act of 1978. The rule is now available only to a class of unsecured creditors objecting to the plan.[69] This encourages the senior and junior creditor classes to bargain for a mutually acceptable plan. Senior creditors who advocate a plan may be willing to give up a small amount of their plan payments to junior creditors, who would receive less in a liquidation, to gain the junior creditors' votes favoring the plan. Senior classes can give up this value as long as all objecting intervening classes receive full payment.[70]

Congress recognized that including the Absolute Priority Rule in Chapter 12 would preclude the farmer from reorganizing because the farmer must retain ownership and possession of his farmland.[71] Farm reorganization cannot be accomplished unless the farmer retains possession of his farm. Additionally, retaining the Absolute Priority Rule in Chapter 12 might make reorganization impossible for many farmers. It would require full payment of all debt if the farmer were to retain possession of his farmland. Full debt repayment was impossible before Chapter 12 and is the principal reason for Chapter 12's existence. The Absolute Priority Rule would have rendered Chapter 12 useless to many farmers.

Congress eliminated the Absolute Priority Rule from Chapter 12. In its place, Chapter 12 requires the debtor to dedicate his entire "disposable income"[72] to plan payments. This allows unsecured creditors to demand that all the farmer's income, after paying business and personal expen-

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64. 5 COLLIER ON BANKRUPTCY ¶ 1129.03[2] (15th ed. 1979).
65. 308 U.S. 106 (1939).
66. *Id.* at 121.
67. *Id.* at 122.
68. *Id.* at 121.
69. 11 U.S.C. § 1129(b)(1) (1982) (applies the "fair and equitable" test of a plan to only a class of claims that is impaired and has not accepted the plan).
70. *See* 124 CONG. REC. H11,104-05 (daily ed. Sept. 28, 1978); 124 CONG. REC. S17, 421-22 (daily ed. Oct. 6, 1978).
71. *Hearings before the Subcomm. on Administrative Practice and Procedure, supra* note 1, at 54 (written statement of R. Stageman, Bankruptcy Judge, S.D. Iowa).
72. Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, § 255, 100 Stat. 3088, 3111 (to be codified at 11 U.S.C. § 1225(b)(2)) ("Disposable income" is income not necessary for support of the debtor or his dependents and not necessary for business operations.).

ditures, be applied to unsecured debt for three years.[73] That is the limited protection Congress gave to unsecured creditors, replacing the Absolute Priority Rule in Chapter 11.

MODIFICATION OF DEBT SECURED BY THE DEBTOR'S PERSONAL RESIDENCE

Congress, in enacting Chapter 12, followed Chapter 13's general format. This was due to the simplicity of Chapter 13 and the expense of Chapter 11.[74] The Chapter 13 format, however, does not allow the debtor to modify the debt secured by his principal residence.[75] Section 1322(b)(2) states that a plan can "modify the rights of holders of secured claims, *other than* a claim secured only by a security interest in real property that is the debtor's principal residence." (emphasis added)[76] The purpose of excepting the debtor's home-secured debt from modification is that allowing modification would affect residential home financing. Congress approved this exception, recognizing that home mortgage lenders provide a uniquely valuable social service.[77] Because the typical Chapter 13 debtor's only long-term debt is his home mortgage, which cannot be modified, he has no need to extend debt payments beyond the allowable three-year term. Congress, accordingly, did not provide for it.

Congress recognized that farmers may have one mortgage that covers both their home and farm even if the home is not located on the farm.[78] Farmers, more likely, live on their farm.[79] Disallowing mortgage debt modification would preclude a successful reorganization. Because farmers cannot realistically pay their original mortgage debt, successful reorganization requires modification of, or "scaling down," this mortgage debt. The same economic considerations apply to the length of repayment of this debt. Realistically, a farmer cannot scale down his debt amount and pay it within three years, the maximum plan term.[80]

After considering the implications of these Chapter 13 provisions, Congress elected to change them in Chapter 12. Section 1222(b)(2)[81] allows a debtor to modify *all* secured claims. Section 1222(b)(9)[82] allows modified

73. *Id.* at 3110, 3112 (to be codified at 11 U.S.C. §§ 1222(c), 1228) (Section 1222(c) provides a maximum plan term of three years unless the court approves a longer period, not to exceed five years. Section 1228 allows a discharge of all debt that is paid under the terms of the plan.).

74. H. CON. REP. No. 958, 99th Cong., 2d Sess. 48, *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS 5246, 5249.

75. 11 U.S.C. § 1322(b)(2) (1982 & Supp. III 1985).

76. *Id.*

77. Grubbs v Houston First Am. Sav. Ass'n, 730 F.2d 236, 245-46 (5th Cir. 1984).

78. H.R. REP. No. 178, 99th Cong., 1st Sess. 7 (1985).

79. *Hearings on H.R. 1397 and 1399, supra* note 2, at 91 (written statement of H. Graves that Oklahoma farmers, and many others, live on the land they farm).

80. 11 U.S.C. § 1322(c) (1982) provides a maximum plan term of three years unless the court extends it for cause, not to exceed five years. H.R. 1399 proposed a plan term of ten years. Even that longer term was criticized as being too short for successful restructuring of a farmer's long-term debt. *Hearings on H.R. 1397 and 1399, supra* note 2, at 77 (written statement of G. Paine, II, Bankruptcy Judge, M.D. Tenn.).

81. Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, § 255, 100 Stat. 3088, 3109 (to be codified at 11 U.S.C. § 1222(b)(2)).

82. *Id.* at 3110 (to be codified at 11 U.S.C. § 1222(b)(9)).

debt payments to extend beyond the term of the plan if the plan meets the standards for confirming a secured claim. Chapter 12 allows the farmer to modify the amount and terms of his mortgage debt from that required by his original loan. Further, plan payments can extend beyond the maximum three-year plan term. Farm mortgage lenders received no offsetting Chapter 12 protections. Apparently, Congress felt that non-farm mortgage lenders provide a more valuable social service than do farm lenders.

ANALYSIS

Economic considerations played a major role in the formation of Chapter 12 provisions affecting debt secured by farmland. Congress eliminated the Chapter 11 creditor protections granted through the section 1111(b) election and the Absolute Priority Rule. It also withdrew the special protection Chapter 13 gives to residential mortgage lenders. This suggests that Congress is more concerned about the benefits Chapter 12 gives to farmers than its detriment to farm lenders. The notion of "fairness" now favors the farmer-debtor.[83] With this swing in the farmer's favor, the lender can be expected to take actions to protect itself.

CHAPTER 12 PROTECTIONS

Section 1225 of Chapter 12, Confirmation of Plan,[84] closely follows section 1325 of Chapter 13. These sections allow plan confirmation only if certain standards are met. First, the plan must comply with all applicable provisions of the Bankruptcy Code.[85] Next, all fees required to be paid before plan confirmation must be pre-paid.[86] The plan must be lawful and proposed in good faith.[87] Also, an *unsecured* creditor must receive plan payments having a present value not less than that it would receive if the debtor were liquidated under Chapter 7.[88] None of those standards will significantly differ when applied to a farmer in Chapter 12 as compared to Chapters 11 or 13. However, Chapter 12's debtor-oriented provisions give creditors more incentive to dispute plan feasibility, the amount of their secured claims, and the proper discount rate to be applied to plan payments.

Feasibility

In order for a plan to be confirmed, section 1225(a)(6)[89] requires the bankruptcy court to find that a debtor can make all his plan payments. This is true even if no creditor objects to the plan. This "feasibility" find-

83. 132 CONG. REC. S15,092 (daily ed. Oct. 3, 1986) (statement of Sen. DeConcini that he feared Congress had tilted the pendulum too far in the direction of the farmer).
84. Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, § 255, 100 Stat. 3088, 3110-11 (to be codified at 11 U.S.C. § 1225).
85. *Id.* at 3110 (to be codified at 11 U.S.C. § 1225(a)(1)).
86. *Id.* at 3111 (to be codified at 11 U.S.C. § 1225(a)(2)).
87. *Id.* (to be codified at 11 U.S.C. § 1225(a)(3)).
88. *Id.* (to be codified at 11 U.S.C. § 1225(a)(4)).
89. Bankruptcy Judges, United States Trustees, and Family Farmers Bankruptcy Act of 1986, Pub. L. No. 99-554, § 255, 100 Stat. 3088, 3111 (to be codified at 11 U.S.C. § 1225(a)(6)).

ing is described as the most important confirmation criterion to promote successful reorganizations.[90] Its purpose is to prevent confirming a plan which is only visionary and promises payments which the debtor cannot make after confirmation.[91]

Farm reorganization cases present some unusual characteristics. Bankruptcy courts review many factors in evaluating a farm plan's feasibility. Historical yields, prices, and costs[92] are primary factors while weather and health problems[93] are also considered. Changes in the nature of an operation[94] affects the feasibility determination. Even inflation during the plan term[95] is considered. Many factors affecting a farmer's financial viability are outside his control. Most courts hold that optimism alone will not overcome farming problems which could easily reappear.[96]

One court, in *In re Hines,*[97] sought to uphold its philosophy that the Bankruptcy Code entitles a debtor to "at least one more chance for rehabilitation."[98] That court optimistically believed that the debtor's former problems, caused by bad weather and the grain embargo, would not reappear. It found that the plan forecast sufficient income to make all payments, *assuming* good weather, fair crop prices, and a market for crops. Those factors were subject only to the providence of the Almighty.[99] That court failed to recognize the inherent risk in farming because many factors are outside the farmer's control. Confirming an optimistic plan only delays a likely liquidation. Bankruptcy courts should follow the advice of Bankruptcy Judge Richard Stageman, a participant in the hearings on Chapter 12. Reorganization "is for restructuring, not resurrecting."[100]

Creditors, whose plan protection comes largely from payments, will closely scrutinize any plan. This is especially true for a lender secured only by farmland, with no equity cushion and no assurance that farm values have stopped declining. Courts reviewing plans which contain long-term payouts have expressed the view that the longer the payout, the more difficult it is to prove feasibility.[101] That prevents a debtor from speculating with a lender's funds.[102]

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90. 5 COLLIER ON BANKRUPTCY ¶ 1325.07 (15th ed. 1979).
91. *Id.* at ¶ 1129.02[11].
92. *In re* Cothran, 45 B.R. 836 (Bankr. S.D. Ga. 1984).
93. *In re* Shorten, 49 B.R. 722, 725 (Bankr. W.D. Mo. 1985).
94. *Id.*
95. *In re* Barnes, 5 B.R. 376, 377 (Bankr. D.C. 1980), *rev'd on other grounds,* 13 B.R. 997 (D. D.C. 1981).
96. *See In re Shorten,* 49 B.R. at 724.
97. 7 B.R. 415 (D. S.D. 1980).
98. *Id.* at 418-19.
99. *Id.* at 418.
100. *Hearings before the Subcomm. on Administrative Practice and Procedure, supra* note 1, at 42.
101. *In re* White, 36 B.R. 199, 203-04 (Bankr. D. Ks. 1983).
102. *Id.* at 202 (citing *In re* 750 Ave. Assocs., 5 Bankr. Ct. Dec. (CRR) 368, 371 (Bankr. S.D. N.Y. 1979)).

Allowed Amount of Secured Claim

Section 1225(a)(5)(B) provides standards for confirming a plan over the objection of a *secured* lender.[103] If the debtor intends to retain the collateral, the plan payments must have a value, as of the plan's effective date, at least as great as the "allowed amount" of the claim.[104] With section 1111(b) excluded from Chapter 12, the lender's secured claim amount is governed exclusively by section 506(a) of the Bankruptcy Code. Section 506(a) states that a claim is secured to the extent of the value of the property securing the debt.[105] Any balance above that value is an unsecured claim.[106]

Many farm mortgage lenders are "undersecured" because farmland has depreciated to a point the lender has an unsecured claim. An undersecured lender has a great incentive to claim the highest value it can support for the farmland. Higher valuation requires higher plan payments to meet the cramdown standards.[107] In addition, the valuation establishes the lien amount retained by the lender.[108] This lien protects the lender against future claims of other creditors against the collateral. Thus, an objecting undersecured creditor will vigorously defend a collateral valuation.

Collateral may be valued at different stages in a bankruptcy case, with a prior valuation having no binding effect on a later valuation.[109] This is because collateral may be valued for different purposes during bankruptcy proceedings.[110] Two views express the purpose of valuation in a reorganization. The first is that valuation determines the amount a creditor would receive if it liquidated the collateral. *In Re Reeder*[111] held that valuation assures that a creditor will receive as much under the plan as it would had it sold the collateral in a commercially reasonable manner.[112] Under this theory, the appropriate valuation measure is the liquida-

103. Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, § 255, 100 Stat. 3088, 3111 (to be codified at 11 U.S.C. § 1225(a)(5)(B)).

104. *Id.* (to be codified at 11 U.S.C. § 1225(a)(5)(B)(ii)).

105. 11 U.S.C. § 506(a) (1982).

106. *Id.*

107. Section 1225(a)(5)(B)(ii) requires the present value of the plan payments to be not less than the allowed amount of the secured claim, the value of the collateral under section 506(a). *See* Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, § 255, 100 Stat. 3088, 3111 (to be codified at 11 U.S.C. § 1225(a)(5)(B)(ii)).

108. *See* Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, § 255, 100 Stat. 3088, 3111 (to be codified at 11 U.S.C. § 1225(a)(5)(B)(i)).

109. *See* H.R. REP. NO. 595, 95th Cong., 1st Sess. 356, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6312; S. REP. NO. 989, 95th Cong., 2d Sess. 68, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5854.

110. 11 U.S.C. § 361 (1982 & Supp. III 1985), for instance, requires "adequate protection" to be given to a creditor whose collateral may decrease in value. A valuation hearing may be required to determine the protected amount. This collateral valuation is for a purpose different than that for plan confirmation.

111. 60 B.R. 312 (Bankr. D. Colo. 1986).

112. *Id.* at 314-15 (citing *In re* Cook, 38 B.R. 870, 873 (Bankr. D. Utah 1984)).

tion value of the property.[113] Liquidation value is the fair market value of the property less costs of sale and prior liens. That is the amount a creditor would receive by disposing of property in a customary and commercially reasonable manner.[114]

The other theory of valuation is the replacement cost theory which is based on retention and use of property.[115] Courts adopting this theory premise valuation on the property's fair market value.[116] This is the amount a debtor would pay for the property if he were to purchase it for his business use. This theory arises from equitable principles. "[D]ebtors cannot eat with the hounds and run with the hares. Seeking retention of the property, they cannot insist on liquidation values to be paid to the creditor in installments."[117]

These two theories indicate the wide discretion the Bankruptcy Code vests in bankruptcy courts. Creditors will stubbornly argue that the correct theory is the replacement cost theory. If farmland has a fair market value of $500,000.00, the costs of sale may approach $50,000.00. The replacement cost theory disregards this sale cost amount in determining the secured claim amount. The liquidation theory, however, treats the $50,000.00 as an unsecured claim in the case of an undersecured creditor. Under either theory, creditors will urge the highest fair market value they can support. The high debt amounts for farm mortgages assures an extensive battle over farmland values.

Discount Rate

Section 1225(a)(5)(B)(ii)[118] of Chapter 12 requires that the value of plan payments made on a secured claim, as of the effective date of the plan, be at least the amount of the secured claim. Thus, a bankruptcy court must determine the present value of the proposed plan payments. The purpose of the present value requirement is to put the secured lender in the same economic position it would enjoy had the debtor exercised his option to surrender collateral to the lender. Present value recognizes that interest payments compensate the creditor for the delay the plan imposes before the creditor is fully paid.[119] The "discount rate" is the interest rate required to compensate for this delay.[120] Bankruptcy courts employ one of two theories to reach the proper discount rate; the cost of money theory or the coerced loan theory.

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113. *See id.* at 314.
114. *In re* Paige, 13 B.R. 713, 714-15 (Bankr. S.D. Ohio 1981).
115. *See In re* Crockett, 3 B.R. 365, 367 (Bankr. N.D. Ill. 1980).
116. *In re* Yoder, 32 B.R. 777, 779 (Bankr. W.D. Pa. 1983), *partially rev'd on other grounds*, 48 B.R. 744 (W.D. Pa. 1984).
117. *In re Crockett*, 3 B.R. at 367.
118. Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, § 255, 100 Stat. 3088, 3111 (to be codified at 11 U.S.C. § 1225(a)(5)(B)(ii)).
119. 5 COLLIER ON BANKRUPTCY ¶ 1325.06[4][b][iii][B] (15th ed. 1979).
120. *See id.*

Proponents of the cost of money theory state that the purpose of the discount rate is to compensate the creditor for its cost of money because the creditor must wait to collect. The creditor obtains its cost to replace funds for reinvestment.[121] By setting the discount rate at a creditor's cost of money, the creditor neither profits nor suffers a loss from the delay.[122] This same result is reached by courts which find that the discount rate is a market loan rate less some factor for reduced risk.[123]

Advocates of the coerced loan theory claim that the creditor should receive the same rate it would demand if making a similar loan to a third party. This requires a discount rate equal to the market loan rate of that imaginary similar loan.[124] Bankruptcy courts consider factors such as the original contract rate, prospects for appreciation or depreciation in collateral value, and the risks inherent in long- term loans.[125] One court adopting the market loan rate stated that the purpose of reorganization is to give the debtor a "fresh start." The debtor must pay the market loan rate if he is to successfully emerge from bankruptcy and function normally in the existing economy.[126]

As is true in valuation methods, the bankruptcy courts have no common approach for determining the proper discount rate. This determination is left largely to the bankruptcy judge's discretion. The difference in plan payments on a secured claim can vary greatly with different discount rates. The difference in total payments on a $500,000.00 loan, payable over 30 years, with an interest rate of 9 1/2 percent instead of 8 1/2 percent, is $129,450.00. Lenders will unquestionably litigate the proper discount rate with that much money at stake.

The protections once enjoyed by a lender in Chapter 11 or 13 are unavailable in Chapter 12. Their loss will sharpen both a lender's skill and determination in objecting to a Chapter 12 plan. This is especially true for a mortgage lender, which was once entirely secured by farmland and is now partially unsecured due to drastic declines in farmland values. The debtor can expect close scrutiny of a plan's feasibility, farm value, and discount rate.

LENDER PROTECTIVE MEASURES OUTSIDE THE BANKRUPTCY CODE

Chapter 12's enactment will affect the debtor-creditor relationship outside as well as within the context of bankruptcy proceedings. When assess-

121. *In re* Hardzog, 74 B.R. 701, 703 (Bankr. W.D. Okla. 1987). This Chapter 12 case, though, did recognize that some additional increment of interest should be allowed because the creditor accepts some risk of default under the plan. *Id.* at 704.

122. *In re* Moore, 29 B.R. 27, 28 (Bankr. D. Colo. 1983).

123. *In re* O'Farrell, 74 B.R. 421, 424 (Bankr. N.D. Fla. 1987). The creditor's risk is less because bankruptcy relieves a debtor from paying part of his debts. *Id.*

124. 5 COLLIER ON BANKRUPTCY ¶ 1129.03[4][i] (15th ed. 1979) (commenting on the proper discount rate in a Chapter 11 reorganization). COLLIER'S commentary on the proper discount rate in a Chapter 13 reorganization, however, advocates the cost of money approach. *Id.* at ¶ 1325.06[4][b][iii][B]).

125. *In re* Monnier Bros., 755 F.2d 1336, 1339 (8th Cir. 1985).

126. *In re* Scovill, 18 B.R. 633, 634-35 (Bankr. D. Neb. 1982).

ing the risk of any loan, a lender focuses one eye on how the Bankruptcy Code treats it if a borrower declares bankruptcy, a worst case event. Eliminating the section 1111(b) election limits a secured lender's protection to the *current* value of its collateral.[127] The lender's protection is further limited if it allows itself to become undersecured through declining collateral values. Chapter 12 requires only that a debtor pay "disposable income"[128] to unsecured creditors for three years[129] rather than comply with Chapter 11's Absolute Priority Rule. These changes will constantly direct a lender's attention to a farmer's collateral value.

The debtor most likely to be impacted by this is the marginal farm operator. He has survived the battered economic climate through wise management or through a strong beginning capital base. His current financial condition is thin but solvent. His lender, however, will closely watch collateral values. If farmland values stabilize and he suffers no losses, he may survive. If values decline, the lender will initiate foreclosure actions at the first loan default. Many agricultural lenders, suffering from their own capital depletion, will have no choice but to take this action. Even if forced liquidation is not required, lending policies may require a borrower to maintain an adequate equity cushion. Marginal borrowers will be the first to feel the credit pinch because they have small equity cushions. Should these possibilities occur, Chapter 12 may have given the insolvent farmer, who is eligible for bankruptcy shelter, the upper hand for survival at the expense of the solvent but marginal operator. Lenders' actions will depend largely on the trend in farmland values.

Lenders, in addition to structuring loan policies to match their risk, will take action to mitigate the huge potential losses Chapter 12 may fuel. Creditors will likely raise loan prices by charging higher interest rates. Since the largest farm lender is the Farm Credit System,[130] a borrower-owned lender,[131] this higher cost will be spread amongst many farm borrowers. The weak farmers, those behind Chapter 12's protective shield, will again pass the cost of their hardship on to more viable operators.

Farm lenders are already capital poor due to the huge losses the weak farm economy has inflicted on their borrowers and, ultimately, on them. The federal government's massive involvement and encouragement of farm lending precludes lenders' failure. A huge bailout is inevitable, costing billions of dollars.[132] Chapter 12 did not create this crisis, but its bankrupt-

127. 11 U.S.C. § 506(a) (1982).
128. Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, § 255, 100 Stat. 3088, 3111 (to be codified at 11 U.S.C. § 1225(b)(2)).
129. *Id.* at 3111 (to be codified at 11 U.S.C. § 1225(b)(1)(B)).
130. *See* Comment, *Chapter 13 and the Family Farm*, 3 BANKR. DEV. J. 599, 603 (1986).
131. *Id.* at 605.
132. Less than one year after enactment of Chapter 12, the House is considering a bailout of the Farm Credit System, a $55 billion network of borrower-owned banks that are the nation's largest farm lenders. The Farm Credit System suffered a loss of $4.8 billion in two years and projects a $3 billion loss through the end of 1989. Casper Star-Tribune, Sept. 14, 1987, at 1, col. 5.

cy encouraging provisions may expand it.[133] Despite contentions that Chapter 12 will cost not "one red cent,"[134] the American taxpayer will ultimately pay dearly to keep the farmer on the farm.

Chapter 12 is Congress' admitted band-aid[135] to stop the bleeding from a huge wound inflicted by harsh weather, grain embargoes, high interest rates, and a multitude of other factors. Chapter 12 will give the farmer, who can reorganize by complying with its provisions, a "fighting chance" to stay on the farm. This supposedly benefits the American public through increased competition and low food prices.[136] Saving the family farm through Chapter 12 is absurd. The farmer's major problem *is* low prices. Maintaining low prices only harms the still viable farm operator in an effort to save the insolvent operator.

During Chapter 12's pendency, Congress proposes to pass a new farm bill and reassess trade and tax policies. This will supposedly "revitalize" the farm economy.[137] Congress admits its past legislation has failed to produce a healthy farm economy. Although it expects to overcome those failures, nothing could be further from the truth. Today's economy is international in scope. Any effort to legislate favorable farm trade conditions will be opposed by other special interest groups. Congress can neither satisfy all these groups nor legislate a financially viable farm climate. Variables outside Congress' control (international politics, demand for foodstuffs, competing loan demand), preclude successful legislation. The American farmer can produce more than the consumer demands. Until this changes, low prices will continue, and farmers will suffer.

Chapter 12, though designed to be temporary, will have a permanent effect on farm lenders. Private lenders may decide to reallocate loan resources to other credit markets which are viewed as less risky. Public lenders may continue their credit supplying role but require large public funding.[138] Some lenders may fail, causing significant financial loss to their owners and great social cost to the communities they serve. Chapter 12 is a futile effort to support the farm sector. It only delays the exit of weak operators from an overefficient goods-producing sector. Chapter 12's enticing environment for debt forgiveness places this burden squarely on the lender without curing the underlying problem.

CONCLUSION

Chapter 12 excludes the protections Chapter 11 gives to a lender through the section 1111(b) election and the Absolute Priority Rule. It also excludes Chapter 13's special protection which denies a debtor the

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133. 132 CONG. REC. S15,092 (daily ed. Oct. 3, 1986) (statement of Sen. DeConcini). The Clerk of the Bankruptcy Court, D. Wyo., reported that fifty-three Chapter 12 cases had been filed in Wyoming as of Aug. 11, 1987.

134. 131 CONG. REC. H4770 (daily ed. June 24, 1985) (statement of Rep. Synar).

135. *Id.* at H4769.

136. *Id.* at H4770.

137. *Id.* at H4769.

138. The Wyoming Farm Loan Board, a public lender, is a creditor in sixteen Chapter 12 cases in Wyoming. Wyo. Farm Loan Board Report (May 19, 1987).

right to modify claims secured by his personal residence. Chapter 12 represents a Congressional attitude specifically favoring the farm debtor. Proponents justify this legislation because farmers have special problems due to circumstances beyond their control, fueled by government programs. Chapter 12 is billed as a temporary haven for insolvent farmers, giving them a "fighting chance" to stay on the farm while Congress takes other steps to revitalize the farm economy.

In the meantime, secured lenders will seize every opportunity to protect themselves by opposing all defects in debtors' reorganization plans. The greatest controversies concern plan feasibility, the amount of the lenders' secured claims, and the discount rate applied to those claims. Creditors have a significant stake in these areas because of the reduced cramdown protection given to secured and unsecured claims. Mortgage lenders, once fully secured by farmland but now only partially secured due to the rapid decline in farmland values, are especially affected because they have both secured and unsecured claims.

Chapter 12's existence may well change the lending policies of farm lenders by increasing interest rates or reducing credit availability. The victim may be today's marginal farm operator who has survived until now but has little equity capital. Congress will undoubtedly propose additional legislation to assist the farmer, but the complexities of the international marketplace present an insurmountable barrier to the legislation's success.

Chapter 12 only delays the liquidation of insolvent, weak producers in an overcrowded industry. Its costly burden will fall directly on farm lenders who will perish or be bailed out. Congress must, then, once again deal with the staggering social and dollar cost of the farming sector.

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