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NatAgLaw@uark.edu \$ (479) 575-7646

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**Taking From Farm Lenders and Farm Debtors:
Chapter 12 of the Bankruptcy Code**

by

James J. White

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James J. White*

I.	INTRODUCTION	1
II.	BACKGROUND	2
III.	CHAPTER 12.....	7
	<i>A. The Pre-Existing Regime: Chapter 11</i>	7
	<i>B. The New Regime: Chapter 12</i>	11
IV.	JUSTIFICATIONS.....	17
	<i>A. Efficiency</i>	17
	<i>B. Paternalism</i>	20
	<i>C. Morality</i>	20
	<i>D. Redistribution of Wealth</i>	22
V.	CONCLUSION	29

I. INTRODUCTION

In passing Chapter 12¹ of the Bankruptcy Reform Act, Congress has effectively invalidated certain important provisions of existing farm mortgages. Equally significant, Congress has disabled farmers from granting binding mortgages on the full value of their property. Although no court is likely to find the Chapter to violate the fifth amendment,² the Chapter constitutes a substantial and retroactive alteration

*Robert A. Sullivan Professor of Law, University of Michigan Law School. B.A. 1956, Amherst College; J.D. 1962, University of Michigan.

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1. 11 U.S.C.A. §§ 1201-1231 (West Supp. 1987) (codifying Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, §§ 251-57, 100 Stat. 3088, 3104-16 (1986)).

2. In *United States v. Sec. Indus. Bank*, 459 U.S. 70 (1982), the Supreme Court intimated in dicta, in connection with §522(f), that it might find the retroactive abolition of a fully effective security interest to be unconstitutional.

The cases dealing with the Frazier-Lemke Act, a closer analogy to Chapter 12, ultimately held that act to be constitutional despite the fact that it had many of the consequences that Chapter 12 will have. See *Wright v. Union Central Ins. Co.*, 311 U.S. 273 (1940); *Wright v. Vinton Branch of the Mountain Trust Bank of Roanoke*, 300 U.S. 440 (1937). In *Union Central*, in the face of the argument that a foreclosure sale might net a higher price, the Court affirmed the debtor's right to purchase farm real estate at the appraised value, thereby preventing a foreclosure. These cases seem to set the appraised value as the upward boundary of constitutional protection and implicitly permit seizure of values above that level. Because the Chapter 12 debtor can force his creditor to "finance" his purchase of the land by forcing a Chapter 12 plan of reorganization, one might distinguish Chapter 12 from the Frazier-Lemke cases. There is no indication in those cases or in *Security Industrial Bank*, however, that the involuntary loan element of a reorganization plan would cause an otherwise permissible law to become unconstitutional.

of the rights of existing mortgagees and a restriction on the powers of prospective mortgagors to grant valid mortgages.

The thesis of this paper is that Congress was both wrong and shortsighted in its enactment of Chapter 12. Congress was wrong to enact a law that redistributes wealth from existing mortgagees to existing mortgagors. Congress was shortsighted to enact a law that will have the long-run consequence of diminishing the farm debtor's power to mortgage his land and, thus, his capacity to buy credit.³

II. BACKGROUND

Chapter 12 grows out of the same populist soil as the Frazier-Lemke Act of the 1930s.⁴ As far as mortgages are concerned there are striking similarities between the provisions of Chapter 12 and those of Frazier-Lemke.⁵ The outcry against unfair

3. Elsewhere I have argued for the efficiency of personal property security. See White, *Efficiency Justifications for Personal Property Security*, 37 VAND. L. REV. 473 (1984). But see Schwartz, *The Continuing Puzzle of Secured Debt*, 37 VAND. L. REV. 1051 (1984).

To my knowledge, no one, including those most doubtful of the efficiency of security, believes that denial of security to one creditor in a market where it is available to others will leave that creditor's willingness to lend and the price of his lending unaffected. This is particularly true where the beneficiary of the reduction in security is not an unsecured creditor but is the debtor himself.

4. The provisions commonly referred to as the Frazier-Lemke Act constituted parts of § 75 of the Bankruptcy Act. In 1933 Congress enacted §§ 75(a)-75(r) in 47 Stat. 1470 (1933), 11 U.S.C. § 203 (1934). In 1934, Congress added § 75(s) in 48 Stat. 1289, 11 U.S.C. § 203(s) (1934). After the Supreme Court held § 75(s) to be unconstitutional, Congress replaced it in 49 Stat. 943 (1935), 11 U.S.C. § 203(s) (Supp. IV 1938).

5. Under Frazier-Lemke, a debtor first filed a petition in bankruptcy and sought a composition with his creditors. If a debtor was unable to reach agreement with his creditors, he could petition under § 75(s) of the Bankruptcy Act to be adjudicated a bankrupt. A debtor then was permitted to retain possession of his property for a period of three years provided he complied with various orders of the court and paid a reasonable rental for the property he had retained. A debtor could obtain full title to the property free of encumbrances at any time before the end of the three-year period by paying the amount of the appraised value of the property into court.

The provision in § 75(s)(3) that appeared to give the secured creditor the right to force a public auction of the property at which the creditor could bid the value of his debt and, thus, keep the property from the debtor ultimately was construed by the Supreme Court to not grant such a right. Section 75(s) provides as follows:

Any farmer failing to obtain the acceptance of a majority in number and amount of all creditors whose claims are affected by a composition and/or extension proposal, or if he feels aggrieved by the composition and/or extension, may amend his petition or answer, asking to be adjudged a bankrupt. Such farmer may, at the same time, or at the time of the first hearing, petition the court that all of his property, wherever located, whether pledged, encumbered, or unencumbered, be appraised, and that his unencumbered exemptions, and unencumbered interest or equity in his exemptions, as prescribed by State law, be set aside to him, and that he be allowed to retain possession, under the supervision and control of the court, of any part or parcel or all of the remainder of his property, including his encumbered exemptions, under the terms and conditions set forth in this section. Upon such a request being made, the referee, under the jurisdiction of the court, shall designate and appoint appraisers, as provided for in this title. Such appraisers shall appraise all of the property of the debtor, wherever located, at its then fair and reasonable market value. The appraisals shall be made in all other respects with rights of objections, exceptions, and appeals, in accordance with this title: *Provided*, That in proceedings under this section, either party may file objections, exceptions, and take appeals within four

foreclosure carried to Congress through the media and by testimony before congress-

months from the date that the referee approves the appraisal.

(1) After the value of the debtor's property shall have been fixed by the appraisal herein provided, the referee shall issue an order setting aside to such debtor his unencumbered exemptions, and his unencumbered interest or equity in his exemptions, as prescribed by the State law, and shall further order that the possession, under the supervision and control of the court, of any part or parcel or all of the remainder of the debtor's property shall remain in the debtor, as herein provided for, subject to all existing mortgages, liens, pledges, or encumbrances. All such existing mortgages, liens, pledges, or encumbrances shall remain in full force and effect, and the property covered by such mortgages, liens, pledges, or encumbrances shall be subject to the payment of the claims of the secured creditors, as their interests may appear.

(2) When the conditions set forth in this section have been complied with, the court shall stay all judicial or official proceedings in any court, or under the direction of any official, against the debtor or any of his property, for a period of three years. During such three years the debtor shall be permitted to retain possession of all or any part of his property, in the custody and under the supervision and control of the court, provided he pays a reasonable rental semiannually for that part of the property of which he retains possession. The first payment of such rental shall be made within one year of the date of the order staying proceedings, the amount and kind of such rental to be the usual customary rental in the community where the property is located, based upon the rental value, net income, and earning capacity of the property. Such rental shall be paid into court, to be used, first, for payment of taxes and upkeep of the property, and the remainder to be distributed among the secured and unsecured creditors, and applied on their claims, as their interests may appear. The court, in its discretion, if it deems it necessary to protect the creditors from loss by the estate, and/or to conserve the security, may order sold any unexempt perishable property of the debtor, or any unexempt personal property not reasonably necessary for the farming operations of the debtor, such sale to be had at private or public sale, and may, in addition to the rental, require payments on the principal due and owing by the debtor to the secured or unsecured creditors, as their interests may appear, in accordance with the provisions of this title, and may require such payments to be made quarterly, semiannually, or annually, not inconsistent with the protection of the rights of the creditors and the debtor's ability to pay, with a view to his financial rehabilitation.

(3) At the end of three years, or prior thereto, the debtor may pay into court the amount of the appraisal of the property of which he retains possession, including the amount of encumbrances on his exemptions, up to the amount of the appraisal, less the amount paid on principal: *Provided*, That upon request of any secured or unsecured creditor, or upon request of the debtor, the court shall cause a reappraisal of the debtor's property, or in its discretion set a date for hearing, and after such hearing, fix the value of the property, in accordance with the evidence submitted, and the debtor shall then pay the value so arrived at into court, less payments made on the principal, for distribution to all secured and unsecured creditors, as their interests may appear, and thereupon the court shall, by an order, turn over full possession and title of said property, free and clear of encumbrances to the debtor: *Provided*, That upon request in writing by any secured creditor or creditors, the court shall order the property upon which such secured creditors have a lien to be sold at public auction. The debtor shall have ninety days to redeem any property sold at such sale, by paying the amount for which any such property was sold, together with 5 per centum per annum interest, into court, and he may apply for his discharge, as provided for by this title. If, however, the debtor at any time fails to comply with the provisions of this section, or with any orders of the court made pursuant to this section, or is unable to refinance himself within three years, the court may order the appointment of a trustee, and order the property sold or otherwise disposed of as provided for in this title.

sional committees also echoed sounds of the depression.⁶ Perhaps because the words Frazier-Lemke would have made dissonant sounds in the ears of the Republican Senate that passed Chapter 12 and would have tasted foul on the tongue of the conservative President who signed it, the Frazier-Lemke bill was never openly recognized as the antecedent for Chapter 12.⁷

The explicit model for Chapter 12 was the existing Chapter 13 of the Bankruptcy Reform Act of 1978.⁸ Because of its low jurisdictional limit, Chapter 13 applies to few farmers. It formed the basis for many of the provisions and for much of the language in Chapter 12. Also relevant to the provisions of Chapter 12, in a less obvious way, are sections 522(f) and 722. The common thread in Chapter 13, section 522(f), and section 722 is that all three deprive consumers of the power to grant effective security interests in some types of personal property. This Article traces this quality from those sections into Chapter 12.

Section 522(f) is the most obvious and self-conscious application of the principle.⁹ That subsection permits a debtor to avoid a security interest granted in certain assets provided the assets would otherwise be exempt under state or federal law and provided the security interest was not a purchase money security interest.¹⁰ Principal among the items covered by section 522(f) are household furnishings,¹¹ household goods,¹² tools of the trade,¹³ and health aids.¹⁴ It appears that the drafters of the

6. See, e.g., *Crisis in the Rural Economy and its Effect on Small Businesses: Hearings Before the Subcomm. on Export Opportunities and Special Small Business Problems of the House Comm. on Small Business*, House of Representatives, 99th Cong., 1st Sess. (1985); *Farm Bankruptcy Amendments: Hearing on H.R. 1397 and H.R. 1399 Before the Subcomm. on Monopolies and Com. Law of the House Comm. on the Judiciary*, 99th Cong., 1st Sess. (1985); *Farm Bankruptcy: Hearings Before the Subcomm. on Admin. Prac. and Proc., and Courts of the Senate Comm. on the Judiciary*, 99th Cong., 1st Sess. (1985); *The Economic Evolution of Rural America: Hearings Before the Subcomm. on Agric. and Transp. of the Joint Econ. Comm.*, 99th Cong., 1st Sess. (1985).

7. But see *Farm Bankruptcy: Hearings Before the Subcomm. on Admin. Prac. and Proc., and Courts of the Senate Comm. on the Judiciary*, 99th Cong., 1st Sess. 173 (1985) (statement of A. Thomas Small, Bankruptcy Judge, E.D.N.C.). Judge Small makes a passing reference to the Frazier-Lemke Act, but discussion of the Act seems to have been carefully avoided elsewhere.

8. 11 U.S.C. §§ 1301-1330 (1982).

9. 11 U.S.C. § 522(f) (1982). Section 522(f) provides as follows:

Notwithstanding any waiver of exemptions, the debtor may avoid the fixing of a lien on an interest of the debtor in property to the extent that such lien impairs an exemption to which the debtor would have been entitled under subsection (b) of this section, if such lien is—

- (1) a judicial lien; or
- (2) a nonpossessory, nonpurchase-money security interest in any—
 - (A) household furnishings, household goods, wearing apparel, appliances, books, animals, crops, musical instruments, or jewelry that are held primarily for the personal, family, or household use of the debtor or a dependent of the debtor;
 - (B) implements, professional books, or tools, of the trade of the debtor or the trade of a dependent of the debtor; or
 - (C) professionally prescribed health aids for the debtor or a dependent of the debtor.

Id.

10. *Id.* § 522(f)(2).

11. *Id.* § 522(f)(2)(A).

12. *Id.*

13. *Id.* § 522(f)(2)(B).

14. *Id.* § 522(f)(2)(C).

Bankruptcy Reform Act of 1978 were aiming squarely at the finance companies' routine practice of taking a security interest in a debtor's existing household furnishings in circumstances where they were making otherwise unsecured loans. The rationale behind the provision is described as follows by the Commission on Bankruptcy Laws:

The Commission is also of the opinion that non purchase money security interests should not be enforceable as to items of property essential to a debtor's well being, such as wearing apparel, which are of little or no value to a creditor, other than as a means of forcing payment.¹⁵

Because any security interest granted in such assets that is neither possessory nor purchase money can be set aside in bankruptcy, the secured creditor cannot be assured of getting the asset in case of default, and must necessarily adjust the probability of payment by some measure. Some of the items identified are things that will have no market value to others (e.g., a debtor's prosthetic leg); others will have very small value on the open market (e.g., the debtor's used furniture or baby crib). Nevertheless, these items may have relatively high value to the debtor and if the debtor can be threatened with their repossession, presumably he will pay an amount up to his idiosyncratic value in order to keep them if he can do so.

A second provision that limits the debtor's power to grant a security interest in tangible personal property, usually automobiles, is section 722.¹⁶ Under section 722 a debtor may redeem tangible personal property used for personal use from a lien securing a dischargeable debt "by paying the holder of such lien the amount of the allowed secured claim of such holder that is secured by such lien."¹⁷ This is in contrast to U.C.C. section 9-506 that provides for redemption of collateral outside of bankruptcy.¹⁸ Under section 9-506 the debtor must "tender fulfillment of *all obligations* secured by the collateral as well as expenses reasonably incurred

15. HOUSE COMM. ON THE BANKRUPTCY LAWS OF THE UNITED STATES, REPORT OF THE COMMISSION ON BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 137, 93rd Cong., 1st Sess., pt. 1, at 169 (1973).

16. 11 U.S.C. § 722 (1982). Section 722 provides as follows:

An individual debtor may, whether or not the debtor has waived the right to redeem under this section, redeem tangible personal property intended primarily for personal, family, or household use, from a lien securing a dischargeable consumer debt, if such property is exempted under section 522 of this title or has been abandoned under section 554 of this title, by paying the holder of such lien the amount of the allowed secured claim of such holder that is secured by such lien.

Id.

17. *Id.*

18. U.C.C. § 9-506 (1987). Section 9-506, Debtor's Right to Redeem Collateral, provides as follows:

At any time before the secured party has disposed of collateral or entered into a contract for its disposition under Section 9-504 or before the obligation has been discharged under Section 9-505(2) the debtor or any other secured party may unless otherwise agreed in writing after default redeem the collateral by tendering fulfillment of all obligations secured by the collateral as well as the expenses reasonably incurred by the secured party in retaking, holding and preparing the collateral for disposition, in arranging for the sale, and to the extent provided in the agreement and not prohibited by law, his reasonable attorneys' fees and legal expenses.

Id.

by the secured party in retaking, holding and preparing the collateral for disposition."¹⁹ Consider a case in which the debtor's automobile has a fair market value of \$10,000, but is worth \$11,000 to the debtor and is security for a debt with a principal amount of \$12,000. Under U.C.C. section 9-506, the creditor can demand payment of \$12,000 or take the asset. Under section 722 in bankruptcy, the debtor can keep the automobile by paying \$10,000, its current fair market value. Outside of bankruptcy and under the rule in section 9-506, the parties should agree upon a price that is above \$10,000, but below \$11,000. Under section 722 the price should be \$10,000.

A debtor who files in Chapter 13 can achieve the same result. Under Chapter 13 a debtor can force a secured creditor to accept any plan under which the debtor makes payments with a present value equal to the fair market value of the asset. Thus, in the hypothetical described above, the debtor could force a plan on the creditor which provided for payment of \$10,000 over three years together with an appropriate interest rate. In effect, the debtor can write the loan down to the market value of the collateral and force the creditor to finance its purchase.

All of the foregoing seems to have had modest financial impact. Only section 522(f) has stimulated serious challenge. The potential retroactive application of section 522(f) produced *U.S. v. Security Industrial Bank*.²⁰ In *Security Industrial Bank*, the Supreme Court found that Congress could not have intended section 522(f) to apply retroactively, that is, to allow for avoidance of security interests that had arisen prior to the effective date of the Bankruptcy Code.²¹ The Court intimated that section 722 would be unconstitutional if it were applied to security interests that had arisen prior to 1978.²² I know of no similar challenges to section 722 or to the general provisions in Chapter 13.

How consumer lenders have altered their practices to meet those provisions is unclear. Presumably, the finance company that cannot threaten the debtor with repossession of his child's crib, the auto lender who cannot insist upon return of the Corvette absent payment of the full debt, and the consumer lender faced with an involuntary loan in the form of an approved plan to a Chapter 13 debtor, will make marginal adjustments to their lending practices. Unfortunately, such adjustments exist in a sea of other events. It will take a fine filter to divide the influence of other events, such as the rise and fall of the economy, inflation, and change in banking and regulatory laws, from the effect of the modification of the creditors' rights by Chapters 7 and 13. To my knowledge no one has yet produced that filter.²³

19. *Id.* (emphasis supplied).

20. 459 U.S. 70 (1982).

21. *Id.* at 81.

22. *Id.* For a discussion of the constitutionality of Chapter 12, see *supra* note 2.

23. For several reasons the consequences of the enactment of § 522, § 722, and Chapter 13 have been much smaller than expected. By hypothesis, § 522 deals with items that have limited value. The section does not apply to purchase money loans. Most secured loans against items of personal property presumably are purchase money loans and, therefore, are outside of § 522(f).

The inarticulated restriction on the use of § 722 is the requirement that the debtor who wishes to use that section must be able to purchase that asset for cash. Thus, in the hypothetical described in the text, the debtor would have to find cash to purchase his Corvette for \$10,000. If the debtor could not do so, he would not be permitted to use § 722. If the only readily available lender is the one who already holds a security interest in the Corvette, the debtor will be forced to negotiate with his

III. CHAPTER 12

With the passage of Chapter 12, significant restrictions on the power to grant security, like those described above, have arrived in the realm of business loans. To the extent that the farmer values his land more highly than the market, Chapter 12 will have an impact precisely analogous to that in Chapter 13 or under section 722. I will describe how Chapter 12 will prohibit the farmer from granting an effective security interest on that increment of value. Other changes in the law are likely to limit the farmer's ability to grant security in other respects. I will describe those by comparison to the existing Chapter 11 rules.

A. *The Pre-Existing Regime: Chapter 11*

The baseline for measuring the impact of Chapter 12 is the law under Chapter 11. Prior to Chapter 12's enactment, almost all farmers wishing to reorganize had to use Chapter 11 because their debt exceeded the jurisdictional limits of Chapter 13.²⁴

Consider how a farm mortgage would be treated under Chapter 11. As part of his reorganization plan, the farmer typically seeks to rewrite his mortgage. In rewriting the mortgage he will seek to reduce the principal amount to the lowest possible figure, to extend the term as long as possible, and to have the court impose

existing creditor despite the presence of § 722.

The practical impact of Chapter 13 is limited by § 1322(b)(2). Section 1322(b)(2) provides that the plan may "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 . . ." The principal secured debt of most Chapter 13 debtors presumably is the mortgage on their home. The section quoted above prohibits most modifications of that mortgage and greatly diminishes Chapter 13's impact.

Despite that provision, many debtors might choose to "cramdown" the mortgage in circumstances in which the value of the mortgage debt exceeds the value of the house. In those circumstances, the debtor could argue persuasively that the amount of the debt in excess of the value of the house was not "secured" and, therefore, was not subject to the limitation in § 1322(b)(2). For example, assume the case of mortgage debt of \$100,000 on a house worth \$70,000. In such circumstances, the debtor might argue that the mortgagee was unsecured as to \$30,000 and, thus, the \$30,000 could be written down to a much smaller amount and paid by pennies on the dollar. One court has held explicitly that a debtor in Chapter 13 can reduce the unsecured portion to a small amount, notwithstanding § 1322(b)(2). *In re Neal*, 10 Bankr. 535, 538 (Bankr. S.D. Ohio 1981); *accord In re Bruce*, 40 Bankr. 884, 886-87 (Bankr. W.D. Va. 1984); *In re Spadel*, 28 Bankr. 537, 539-40 (Bankr. E.D. Pa. 1983); *In re Smith*, 63 Bankr. 15, 16-17 (Bankr. D. N.H. 1986). *But see In re Coffey*, 52 Bankr. 54, 55 (Bankr. D. N.H. 1985); *In re Stratton*, 30 Bankr. 44, 45 (Bankr. W.D. Mich. 1983).

24. 11 U.S.C. § 109(e) provides as follows:

Only an individual with regular income that owes, on the date of the filing of the petition, noncontingent, liquidated, unsecured debts of less than \$100,000 and noncontingent, liquidated, secured debts of less than \$350,000, or an individual with regular income and such individual's spouse, except a stockbroker or a commodity broker, that owe, on the date of the filing of the petition, noncontingent, liquidated, unsecured debts that aggregate less than \$100,000 and noncontingent, liquidated, secured debts of less than \$350,000 may be a debtor under chapter 13 of this title.

Id.

In Iowa, where much land was selling for \$2,000 per acre and more in 1981, and where, accordingly, a 300 acre farm could have a value in excess of \$600,000, a large share of farmers who borrowed to purchase farms of at least 300 acres have secured debt in excess of \$350,000. Because of these large debts, Chapter 13 cases by farmers are rare. For one example, see *In re Leazier*, 55 Bankr. 870 (Bankr. N.D. Ind. 1985).

the lowest possible interest rate. He will then attempt to get the mortgagee's agreement to such a payment schedule and, failing that, will ask the court to impose it on the creditor.

In Chapter 11 the creditor has three basic protections against an unfair modification of his rights. The basic protection, present under all forms of reorganization—Chapters 11, 12, and 13 alike—is the creditor receives “not less than the amount” it would receive if the debtor were liquidated.²⁵ Thus, the present value of the payments to be made in a plan must at least equal what the creditor would receive on liquidation. If the creditor has a mortgage, these payments must equal at least the liquidation value of the underlying collateral.

The second protection, present only in Chapter 11, and not in Chapters 12 or 13, is the “fair and equitable rule.”²⁶ This rule provides that creditors whose class does not consent to the plan must either be paid in full or the plan must grant nothing to those with junior interests. Such a rule prohibits the shareholders from manipulating a corporate plan in such a way that the shareholders (a junior interest) retain their interest while the creditors are forced to accept only partial payment. In the farm mortgage case the rule protects the mortgagee against the farmer (owner of the equity).

A third protection for the Chapter 11 mortgagee is to elect to receive no payment on the unsecured portion of his claim in the Chapter 11 plan and, in return, to

25. See 11 U.S.C. §§ 1129(a)(7), 1325(a)(4)-(5) (1982); see also 11 U.S.C.A. § 1225(a)(4) (West Supp. 1987).

26. Digging the fair and equitable rule out of the language of § 1129 requires some effort. First, one should look at § 1129(a)(8). Subsection (a)(8) provides that a plan can be confirmed if the class has accepted the plan or if the class is not impaired by the plan. Typically, a class would not be impaired only if it were paid in full or had exactly the same rights after bankruptcy as it had before. If subsection (a)(8) is not met, the plan, nevertheless, may be confirmed if terms set out in § 1129(b) are met. The words “fair and equitable” appear in § 1129(b)(2) and the critical rule is set out in § 1129(b)(2)(B) as follows:

(B) With respect to a class of unsecured claims—

- (i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or
- (ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property.

11 U.S.C. § 1129(b)(2)(B)(i) & (ii) (1982).

Section 1129(b)(2)(B)(i) rarely will be complied with by a farmer because a farmer will be incapable of paying the unsecured creditors the full amounts of their claims. Thus, the farmer in Chapter 11 would be forced into § 1129(b)(2)(B)(ii) and, stymied by his desire to keep the farm, the result would be an outcome that could not be permitted normally by § 1129(b)(2)(B)(ii) because the farmer, as a junior class, would be receiving or retaining “on account of such junior claim or interest” some property.

The Eighth Circuit Court of Appeals recently has weakened the fair and equitable rules as applied to farmers by its holding in *In re Ahlers*, 794 F.2d 388, 401 (8th Cir. 1986); see also *In re Potter Material Service Inc.*, 781 F.2d 99, 101 (7th Cir. 1986). In *Ahlers*, the court indicated that the farmer could be permitted to keep his land despite § 1129(b)(2)(B)(ii) if he contributed labor to the plan, in a value in excess of what he took out as wages and expenses. Prior to *Ahlers*, it commonly was assumed that a farmer, or any other person holding a junior interest, could retain that interest in a reorganization only by adding new capital,—that is by “buying” the interest, not by “retaining” it. Should the courts continue to extend the ruling in *Ahlers* and *Potter Material Service*, the resulting rules might be quite similar to the Chapter 12 rules.

carry his entire mortgage through the plan and have it remain as a nonrecourse mortgage for the full amount against the land after the plan has been confirmed. This rule protects mortgagees against the possibility the debtor will reorganize at a low point in the real estate market, write his mortgage down, and then sell the property after the real estate market improves. This right appears in section 1111(b)(2)²⁷ of Chapter 11; it is not available in Chapters 12 or 13.

To understand how these rules might work in practice, consider a simple example. Assume a single creditor who holds a first mortgage on the farmer's land securing a debt of \$1,000,000. The land was worth more than \$1,000,000 at the time the loan was written, but has since declined in value to an amount between \$400,000 and \$600,000. The farmer values the land at \$600,000. The "market" values the land at between \$400,000 and \$500,000. In Chapter 11, the farmer will first divide the mortgagee's claim into two claims: a secured claim and an unsecured claim. Under section 506(a), the claim is secured "to the extent of the value of such creditor's interest in the estate's interest in such property"²⁸ One can expect the farmer to propose a plan under which the secured claim is \$400,000 (the farm's lowest plausible fair market value) and the unsecured portion is \$600,000. In the hypothetical case, there are only two classes of creditors. If the proposed plan is not to the satisfaction of the mortgagee, he will vote against the plan. Because the bank has \$600,000 of unsecured debt, the debtor will have to have other unsecured debt in excess of \$1,200,000 in the bank's class to out-vote the bank.²⁹ The likelihood

27. Section 1111(b) is quite cryptic. In relevant part it provides as follows:

(1)(A) A claim secured by a lien on property of the estate shall be allowed or disallowed under section 502 of this title the same as if the holder of such claim had recourse against the debtor on account of such claim, whether or not such holder has such recourse, unless—

(i) the class of which such claim is a part elects, by at least two-thirds in amount and more than half in number of allowed claims of such class, application of paragraph (2) of this subsection; . . .

(2) If such an election is made, then notwithstanding section 506(a) of this title, such claim is a secured claim to the extent that such claim is allowed.

11 U.S.C. § 1111(b)(1)(A)(i) & (b)(2) (1982).

The election spoken of in § 1111(b) is an election by the secured creditor to have a portion of his debt either treated as unsecured (to the extent it exceeds the value of the collateral) and, thus, to receive a payment pro rata with other unsecured creditors or to have the debt treated under § 1129(b)(2) as a "secured claim" under § 506(a). The consequence of a § 506(a) election is that the creditor will receive no payment under the plan as part of the class of unsecured creditors. Furthermore, the creditor will not receive the promise of payment by the reorganized company on the additional portion included as part of the secured claim. What the creditor does receive is a nonrecourse claim against his collateral in the hands of the reorganized company. In Chapter 11 plans under which the unsecured creditors will receive little or no payment, a partially secured creditor gives up little by making the election since he would receive little as a member of the unsecured class in any case. A partially secured creditor, however, does give up the possibility of controlling the reorganization process by exercising his vote as a member of the unsecured class. For a discussion of the operation of § 1111(b)(2), see Klee, *All You Ever Wanted To Know About Cramdown Under the New Bankruptcy Code*, 53 AM. BANKR. L.J. 133 (1979).

28. 11 U.S.C. § 506(a) (1982).

29. Under Chapter 11, the debtor does not have to meet the fair and equitable test set out in § 1129(b) if the class "has accepted the plan." 11 U.S.C. § 1129(a)(8) (1982). Under § 1126(c), an impaired class accepts "if such plan has been accepted by creditors . . . that hold at least two-thirds in amount and more than one-half in number of the allowed claims" 11 U.S.C. § 1126(c) (1982).

of the existence of such unsecured debt willing to vote for a plan is small. If the farmer cannot get the mortgagee's vote, he is faced with distasteful alternatives. Either the farmer must pay the bank the entire \$1,000,000 under the plan or he must propose a plan under which he, as a junior party, has no interest.

Because the very purpose of going into Chapter 11 was to save the farm, the second alternative is unacceptable. The farmer's presence in Chapter 11 shows him incapable of complying with the first. In this setting one would predict that the creditor and the farmer would negotiate a plan under which the farmer would pay the creditor less than \$600,000 farmer's value, but more than the \$400,000 market value. If the creditor had accurate knowledge of the value of the farmer's consumer surplus, presumably, the creditor would hold out until the price reached \$600,000. Then, having struck its best deal, the creditor would agree to a plan which provided for payments at that magnitude. Because the creditor has no certain way of knowing the value of the farmer's consumer surplus, normally a deal should be struck at a somewhat lower price.

In effect, the fair and equitable rule embodied in section 1129(b) forces the farmer either to reach agreement with the mortgagee or to give him the land. In any individual case the creditor does not want the land; he wants the deal with the farmer. By hypothesis, the farmer values the land more highly than any other person and the mortgagee will forfeit an increment of value (consumer surplus) if he takes the land and must sell it to another at the market value of \$400,000. That does not mean the creditor will never foreclose or otherwise insist upon the transfer of the land. Presumably, the creditor will do so when he believes the debtor is incapable of paying \$600,000.³⁰ He may do so in other cases in the hope of establishing the credibility of his threat. The farmer will agree to pay more than the fair market value only if the mortgagee's threat is credible. Thus, one would expect that the parties would reach agreement on a plan and that the present value of the payments would be somewhat in excess of the fair market value, but perhaps below the farmer's idiosyncratic value.³¹

30. No plan can be approved under either Chapter 11 or Chapter 12 unless the plan is "feasible." Under § 1129(a)(11), confirmation must not be "likely to be followed by the liquidation, or the need for further financial reorganization . . ." 11 U.S.C. § 1129(a)(11) (1982). Under § 1225(a), a court "will confirm" if "the debtor shall be able to make all payments under the plan and comply with the plan." 11 U.S.C.A. § 1225(a) (West Supp. 1987). In many cases a creditor will oppose a debtor's plan because the creditor is less optimistic about the debtor's prospects than the debtor. Arguments between a debtor and creditor likely will be fought out in hearings on the "feasibility" of the plan. Conceivably, differences of opinion about the feasibility of a prospective plan account for many of the Chapter 11 cases in which the creditors were unwilling to agree to a debtor's plan even in circumstances in which the debtor apparently was willing to pay more for the property than it would bring on the market. Under Chapter 12, the creditor would be able to raise the same feasibility arguments that he could raise under Chapter 11. The difference between the chapters is that in Chapter 12, the creditor will not be capable of allaying his feasibility concerns by invoking the fair and equitable doctrine.

31. Conflicting testimony about the success of Chapter 11 in a farm setting was presented to the Senate committee considering Chapter 12. Judge Stageman testified that only 13% of the Chapter 11 farm cases filed in his district over three years had reached confirmation. *Farm Bankruptcy: Hearings Before the Subcomm. on Admin. Prac. and Proc., and Courts of the Senate Comm. on the Judiciary, 99th Cong., 1st Sess. 41* (1985) (statement of Richard F. Stageman, Bankruptcy Judge, S.D. Iowa). However, R. Fred Dumbaugh, a lawyer specializing in farm bankruptcies in Cedar Rapids, Iowa, testified that he had obtained confirmation orders in more than thirty Chapter 11 farm bankruptcies "all of which are working." Dumbaugh argues that Chapter 11 works well in the hands of sensible

B. The New Regime: Chapter 12

How does Chapter 12 change all of this? First, it changes it principally by removing any voting requirement and by eliminating the fair and equitable rule now found in section 1129(b). Second, it omits the possibility that the creditor would retain a continuing claim in future appreciation of the land.³² As long as the mortgagee

debtors and creditors. *Id.* at 105-07.

The statements of Judge Stageman and Mr. Dumbaugh are not necessarily inconsistent. A small percentage of confirmations may be attributable to the fact that attorneys, not as skilled as Dumbaugh, file Chapter 11 cases where reorganization is impossible while other attorneys lack the imagination to devise, and the skill to negotiate, workable plans.

32. The critical sections in Chapter 12 that set forth rules about the contents of the bankruptcy plan and standards for confirmation are §§ 1222-1225. 11 U.S.C.A. §§ 1222-1225 (West Supp. 1987). Sections 1222 through 1225 provide as follows:

§ 1222. Contents of plan

(a) The plan shall—

- (1) provide for the submission of all or such portion of future earnings or other future income of the debtor to the supervision and control of the trustee as is necessary for the execution of the plan;
- (2) provide for the full payment, in deferred cash payments, of all claims entitled to priority under section 507 of this title, unless the holder of a particular claim agrees to a different treatment of such claim; and
- (3) if the plan classifies claims and interests, provide the same treatment for each claim or interest within a particular class unless the holder of a particular claim or interest agrees to less favorable treatment.

(b) Subject to subsections (a) and (c) of this section, the plan may—

- (1) designate a class or classes of unsecured claims, as provided in section 1122 of this title, but may not discriminate unfairly against any class so designated; however, such plan may treat claims for a consumer debt of the debtor if an individual is liable on such consumer debt with the debtor differently than other unsecured claims;
- (2) modify the rights of holders of secured claims, or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims;
- (3) provide for the curing or waiving of any default;
- (4) provide for payments on any unsecured claim to be made concurrently with payments on any secured claim or any other unsecured claim;
- (5) provide for the curing of any default within a reasonable time and maintenance of payments while the case is pending on any unsecured claim or secured claim on which the last payment is due after the date on which the final payment under the plan is due;
- (6) subject to section 365 of this title, provide for the assumption, rejection, or assignment of any executory contract or unexpired lease of the debtor not previously rejected under such section;
- (7) provide for the payment of all or part of a claim against the debtor from property of the estate or property of the debtor;
- (8) provide for the sale of all or any part of the property of the estate or the distribution of all or any part of the property of the estate among those having an interest in such property;
- (9) provide for payment of allowed secured claims consistent with section 1225(a)(5) of this title, over a period exceeding the period permitted under section 1222(c);
- (10) provide for the vesting of property of the estate, on confirmation of the plan or at a later time, in the debtor or in any other entity; and

receives no less under the plan than he would receive on liquidation, the plan can be approved even though the farmer keeps the land.

(11) include any other appropriate provision not inconsistent with this title.

(c) Except as provided in subsections (b)(5) and (b)(9), the plan may not provide for payments over a period that is longer than three years unless the court for cause approves a longer period, but the court may not approve a period that is longer than five years.

§ 1223. Modification of plan before confirmation

(a) The debtor may modify the plan at any time before confirmation, but may not modify the plan so that the plan as modified fails to meet the requirements of section 1222 of this title.

(b) After the debtor files a modification under this section, the plan as modified becomes the plan.

(c) Any holder of a secured claim that has accepted or rejected the plan is deemed to have accepted or rejected, as the case may be, the plan as modified, unless the modification provides for a change in the rights of such holder from what such rights were under the plan before modification, and such holder changes such holder's previous acceptance or rejection.

§ 1224. Confirmation hearing

After expedited notice, the court shall hold a hearing on confirmation of the plan. A party in interest, the trustee, or the United States trustee may object to the confirmation of the plan. Except for cause, the hearing shall be concluded not later than 45 days after the filing of the plan.

§ 1225. Confirmation of plan

(a) Except as provided in subsection (b), the court shall confirm a plan if—

(1) the plan complies with the provisions of this chapter and with the other applicable provisions of this title;

(2) any fee, charge, or amount required under chapter 123 of title 28, or by the plan, to be paid before confirmation, has been paid;

(3) the plan has been proposed in good faith and not by any means forbidden by law;

(4) the value, as of the effective date of the plan, of property to be distributed under the plan on account of each allowed unsecured claim is not less than the amount that would be paid on such claim if the estate of the debtor were liquidated under chapter 7 of this title on such date;

(5) with respect to each allowed secured claim provided for by the plan—

(A) the holder of such claim has accepted the plan;

(B)(i) the plan provides that the holder of such claim retain the lien securing such claim; and

(ii) the value, as of the effective date of the plan, of property to be distributed by the trustee or the debtor under the plan on account of such claim is not less than the allowed amount of such claim; or

(C) the debtor surrenders the property securing such claim to such holder; and

(6) the debtor will be able to make all payments under the plan and to comply with the plan.

(b)(1) If the trustee or the holder of an allowed claim objects to the confirmation of the plan, then the court may not approve the plan unless, as of the effective date of

Returning to the hypothetical case, under Chapter 12 the farmer proposes continuation of mortgage payments on a scaled down basis for the life of the mortgage, to a total principal value of \$400,000, the fair market value of the land. He then proposes a token payment to the unsecured creditors that equals what they would receive on liquidation. If the farmer can make the payments on the \$400,000 mortgage, the plan could be approved even though every single creditor of the farmer opposes it and even though the farmer retains the land.

The second omission from Chapter 12 may have the consequence of depriving the debtor of the power of granting a mortgage even on the full fair market value of his property. Assume in the previous example that the creditor was convinced the property would soon rise in value. In a perfect market, the present market price for land should reflect the potential increase in value, but few markets approach perfection. That may be particularly true of the market as found in the bankruptcy court. In that setting, the value to be attributed to the farm would not be based upon an actual sale of the land, but on the testimony of appraisers and other experts brought alternatively by the creditor and by the debtor.³³ In cases in which the judge may be favorably disposed to the creditor or the debtor, or where one may have a uniquely persuasive witness, the potential for the court's arriving at an inaccurate value of the land is considerable. Thus, it should not surprise one that the present value might not include a properly discounted number to represent the

the plan—

(A) the value of the property to be distributed under the plan on account of such claim is not less than the amount of such claim; or

(B) the plan provides that all of the debtor's projected disposable income to be received in the three-year period, or such longer period as the court may approve under section 1222(c), beginning on the date that the first payment is due under the plan will be applied to make payments under the plan.

(2) For purposes of this subsection "disposable income" means income which is received by the debtor and which is not reasonably necessary to be expended—

(A) for the maintenance or support of the debtor or a dependent of the debtor; or

(B) for the payment of expenditures necessary for the continuation, preservation, and operation of the debtor's business.

(c) After confirmation of a plan, the court may order any entity from whom the debtor receives income to pay all or any part of such income to the trustee.

Id. §§ 1222-1225.

33. Section 506(a) of Chapter 11 states that a claim is "secured" to the extent of the value of the collateral. Section 506(a) provides that "[s]uch value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest." 11 U.S.C. § 506(a) (1982). Once that value is determined, a plan can be approved under § 1225(a)(5)(B) by giving the creditor property with a present value equal to the value of the collateral. This "property" is likely to be the secured promise of the debtor. The value of the promise presumably is determined by agreement or by the court after a hearing and some argument about the proper discount rate.

The value of the collateral will be determined either by negotiation between the parties or by a court hearing where each party will provide the kind of testimony heard in proceedings where the value of real estate is in question. This would include the testimony by appraisers, evidence about comparable sales and, conceivably, testimony by the debtor.

prospect of future appreciation—or conversely in other cases, a number so large that it does not allow for the prospect of future depreciation.

If a Chapter 11 mortgagee believes that the value approved in court does not accurately reflect the prospect of future appreciation, he is protected by the section 1111(b)(2) election. In the hypothetical case, the creditor electing under section 1111(b)(2) would not receive anything on his \$600,000 unsecured claim in the plan, but the plan would require that he be carried forward with a mortgage claim of \$1,000,000 against the farm.³⁴ Thus, if the property were later sold for a substantially larger value than the amount it was determined to be worth in the bankruptcy court, the creditor would have the first claim on that appreciation to the full extent of his pre-bankruptcy debt.

In effect, section 1111(b)(2) protects the creditor against unreasonably low estimations of value by the court or by the debtor's appraisers. The absence of such a provision in Chapter 12 means the debtor is free to write the debt down to the value found in court and to take for himself all appreciation in value that occurs thereafter. If there is a systematic bias in the courts and among appraisers to undervalue this prospect for appreciation as part of the present value of the land, a conservative creditor will value the land at this lower number in making his loan.

Is this consumer surplus—this layer of idiosyncratic value on which the mortgage will no longer be effective—likely to be significant? The idiosyncratic value in a dog, a baby's crib, or a debtor's prosthetic device, is obvious and large by comparison with the fair market value of the item. One would not expect an individual farmer to value his own land in an amount as grossly disproportionate to the market value as one would expect in the consumer setting. Nevertheless, there is considerable folklore about the idiosyncratic value that farmers place on their own land.³⁵ First,

34. For a discussion of § 1111(b)(2), see *supra* note 27.

35. The flavor of that folklore is represented in the testimony of Val Farmer of the West River Mental Health Center, Rapid City, S. D., in hearings before the Subcommittee on Agriculture and Transportation. Farmer quotes a series of farmer debtors as follows:

The loss that is traumatic is watching my aging parents get pushed out. My father is in his 70's, he has nowhere to go. There are not many jobs available for someone his age

....

His wife said that he could not face "losing so many things he loved, his very identity," on the farm where he was born. "We were so deep in debt, we knew that we would have to sell. He felt he had nothing to offer us."

....

My grandfather had this farm, my father had it through the depression and now I am losing it.

....

Now . . . he is "spending 14 hours a day, seven days a week, including a couple of hours Sunday afternoon because the hired man has Sunday afternoon off. We're surviving. We're struggling to survive. I'm behind in payments on the feed bills. I'm slightly behind in bank payments . . . (But) I have been able to plateau so we're not going further behind."

The Economic Evolution of Rural America: Hearings Before the Subcomm. on Agric. and Trans. of the Joint Econ. Comm., 99th Cong., 1st Sess., pt. 2, at 18-26 (1985) (testimony of Val Farmer). Mr. Farmer summarizes as follows:

There is a love of the land, a bond between people and the soil, a bond between the steward and the growth of the plant and animal life he nourishes and a spiritual nourishment

the idiosyncratic value may arise out of the sentimental attachment to particular land because the farmer has lived there for a long time or because the land has been owned by the members of his family for several generations. Second, there is the possibility that he values it more highly than others because he has information not available to third parties. Conceivably, this information may enable him to farm it more efficiently. Third, it may have idiosyncratic value for other reasons, such as value attributable to the fact that it abbutts other land owned by the farmer. Almost certainly, any significant consumer surplus is "consumptive" not "productive." The consumer surplus arises out of the particular farmer's desire to live on and farm the land to consume, rather than out of the second and third possibilities relating to idiosyncratic value which would make this farmer more productive than others. The farmer's fabled willingness to work long hours at slaves' wages³⁶ is consistent with the idea that he values the particular land more than an investor whose value would be based exclusively on the revenue that the land would produce. I know of no good data to measure the farmer's consumer surplus. It seems plausible that this layer of idiosyncratic value may be substantial and, thus, that the deprivation of the power to mortgage that increment of value may be significant.

Turning to the second possible impact of Chapter 12, is there likely to be systematic undervaluation of the land because of Chapter 12? No one can say with certainty. In the upper midwest, however, where the farmers' plight is particularly acute, and where many state legislatures have responded, almost annually, with legislation to improve the farm debtor's lot against his creditors,³⁷ it would be

of the steward by the nature he serves. The planting, the cultivating and the harvesting are intrinsically rewarding activities. Besides a livelihood, farmers extract rich meaning from soil and sunlight.

....

Add to this mystical communion with their work, the values of freedom and independence associated with owning one's own business and it is easy to see why farmers are highly satisfied with their profession.

Id. Mr. Farmer concludes that he is describing a "myth" but one that "farmers believe in." *Id.* at 26.

36. See, e.g., *supra* note 35; see generally *supra* note 6.

37. This legislative protection has come in many forms including: right to cure defaults, see Act approved Apr. 19, 1986, LB 999, § 1, 1986 Neb. Laws 1650-51 (sixty day default cure period), amended by Act approved Nov. , 1986, LB 3 § , (cure right restricted to new mortgages); Act approved May 23, 1986, ch. 1214, §§ 10-11, 1986 Iowa Acts 325-26 (forty-five day default cure period); mediation, see Act approved Apr. 15, 1985, ch. 137, § 4, 1985 N.D. Laws 307 (credit review board to "enter into negotiations with the [mortgage] lender, on behalf of the farmer . . . in an attempt to extend the term of the loan, reduce the dollar amount of payments under the loan, or otherwise negotiate a settlement that will allow the farmer to reside in the farm residence and allow the farmer to continue to produce agricultural commodities"); Act approved Mar. 21, 1986, ch. 399, art. 1, §§ 1-19, 1986 Minn. Laws, 401-11 (foreclosure of mortgage or termination of contract for deed securing debt in excess of \$5,000 must be preceded by mediation; initial mediation period of 90 days may be followed by additional periods totalling 240 days if creditor fails to mediate in good faith); Act approved May 23, 1986, ch. 1214, §§ 12-28, 1986 Iowa Acts 326-329 (foreclosure of mortgage or termination of contract for deed securing debt in excess of \$20,000 must be preceded by mediation; mediation period generally cannot exceed 42 days); Act of Mar. 31, 1986, act 153, § 17, 1986 Wis. Laws 971-973 (voluntary mediation); oratorium continuances, see Act approved May 1, 1986, ch. 4, §§ 1-14, 1986 Kan. Sess. Laws 7-13 (execution of mortgage foreclosure judgment may be stayed for up to three successive one-year periods upon mortgagor's payment of interest upon fair market value of land and any decline in fair market value during stay period; stays not available for subsequently created mortgages, and right to stay may be waived as part of debt restructuring); Act approved May 23, 1983, ch. 215, §§ 4-17,

plausible to conclude that judges, too, would be affected by this concern and might favor the farm debtor. Surely, that is the perception of the creditor, and the creditor's perception may be as important as the fact itself.³⁸

1983 Minn. Laws 654-58, *amended by* Act approved Apr. 25, 1984, ch. 474, §§ 4-8, 1984 Minn. Laws 431-33, and Act approved June 7, 1985, ch. 306, §§ 16-21, 1985 Minn. Laws 1517-19 (mortgage foreclosure proceedings may be stayed for up to 12 months, and contract for deed terminations may be stayed for up to 90 days; redemption period may be reduced by length of stay, but not to less than thirty days; stays not available for mortgages or contracts for deed made after May 24, 1983); Act May 31, 1985, ch. 250, §§ 1-4, 1985 Iowa Acts 520-22, *amended by* Act approved May 23, 1986 ch. 1216, §§ 7-9, 11-12, 1986 Iowa Acts 331-333 (existing statute (IOWA CODE § 654.15) revised to allow mortgage foreclosure proceedings to be stayed for up to two years upon governor's declaration of economic emergency; stays not available for mortgages made after governor's declaration; governor's declaration of October 1, 1985 for period of one year extended by legislature in 1986 to March 30, 1987); deficiency judgment restrictions, *see* Act approved Mar. 21, 1986, ch. 398, art. 19, §§ 1-6, 1986 Minn. Laws 472-75 (separate action for deficiency judgment must be brought within 90 days of foreclosure sale, and deficiency limited to lesser of (i) difference between debt and sale price or (ii) difference between debt and fair market value of land as determined by a jury; deficiency judgments not enforceable against agricultural property after three years from entry of deficiency judgment; enforcement of existing deficiency judgments stayed for one year; deficiency judgments not enforceable against property acquired by mortgagor after entry of deficiency judgment); Act approved May 23, 1986, ch. 1216, §§ 3, 6, 1986 Iowa Acts 330-31 (enforcement of Federal Land Bank deficiency judgments can be stayed until July 1, 1991, but mortgagor who utilizes stay cannot take advantage of increase of personal property exemptions from \$5,000 to \$15,000); fair market value redemption, *see* Act approved Apr. 19, 1986, LB 999, §4, 1986 Neb. Laws 1651-53 (homestead of up to 160 acres can be redeemed for current appraised value), *amended by* Act approved Nov. , 1986, LB 3, § , (existing mortgages subject only to sale procedure in which homestead may be sold separately; new mortgages subject to current appraised value homestead redemption only if mortgagor (i) designates homestead at time mortgage made and (ii) does not waive right to redeem homestead at current appraised value); Act approved May 1, 1986, ch. 4, §7, 1986 Kan. Sess. Laws 11-12 (before end of any stay period mortgagor can redeem part or all of land for greater of (i) fair market value at time stay first obtained or (ii) fair market value at time of redemption, but redemption price cannot exceed amount of original judgment, and if (i), is reduced by any payments previously made for decline in fair market value during stay periods); Act approved Mar. 21, 1986, ch. 398, art. 2, § 2, 1986 Minn. Laws, 412-13 (if mortgagor not afforded right to require separate sale of residence and any part of remaining property, mortgagor may redeem homestead of up to 80 acres for its appraised value plus "the interest attributable to the portion of the debt allocated to the homestead"); Act approved May 23, 1986, ch. 1216, § 2, 1986 Iowa Acts 330 (if designated homestead of up to 40 acres not sold separately, mortgagor may redeem homestead for its fair market value); right to harvest crops after end of redemption period, *see* Act approved Feb. 20, 1986, ch. 177, § 2, 1986 S.D. Sess. Laws 396 (if crop planted before end of redemption period, owner can harvest crop after deed received by sale purchaser); Act approved Mar. 21, 1986, ch. 398, art. 12, §§ 2-6, 1986 Minn. Laws 448-50 (if crop planted before end of redemption period or before termination of contract for deed, owner has lien upon crop and land which successor can satisfy either (i) by paying owner for value of crop and crop inputs, including fair rental value up to time owner's interest in land ceased, or (ii) by allowing owner to harvest crop, with crop subject to lien securing payment to successor of fair rental value of land from time owner's interest in land ceased until time crop harvested); former owner's right of first refusal upon leasing or resale, *see* Act approved Mar. 21, 1986, ch. 398, art. 20, §§ 1-2, 1986 Minn. Laws 474 (former owner has right of first refusal upon leasing or resale within five years of time land is acquired by state or federal agency, or by a corporation other than a family farm corporation or an authorized farm corporation); Act approved May 31, 1985, ch. 252, § 34, 1985 Iowa Acts 538-39 (former owner has right of first refusal upon resale of land acquired by state bank). P. Bauer, 1986 *Midwestern Agricultural Mortgagor Relief Legislation* 3-5 (unpublished paper presented to Section on Agricultural Law, at Association of American Law Schools Annual Meeting, Los Angeles, Cal., Jan. 6, 1987).

38. For assertions by creditor representatives that the enactment of Chapter 12 will cause creditors to be more hesitant to lend, *see Farm Bankruptcy: Hearings Before the Subcomm. on Admin. Prac. and Proc., and Courts of the Senate Comm. on the Judiciary*, 99th Cong., 1st Sess. 141 (1985) (statement of John Dean, Vice-Chairman of the Agricultural-Rural America Comm., Indep. Bankers Ass'n of

In summary, Chapter 12 is tantamount to a law that reads as follows: "It shall be a violation of the law for a creditor to take a mortgage on the value of a farm in excess of the value found by the bankruptcy court." By depriving the creditor of the power to force a sale of the land, Chapter 12 takes a property interest from the debtor that formerly belonged to him. To the extent that the land's utility inheres in its value as collateral, the utility is reduced. Because no binding contract can be made to transfer it, the utility arising out of the consumer surplus as collateral is destroyed. If courts routinely find the value of the land in bankruptcy court to be yet lower than the true market value, an additional increment of value is lost as well.

In the long run, the "taking" probably is from the debtor who will no longer be able to procure the same loan by mortgaging his farm that he could have procured previously. As to mortgages that were written under the legal regime that pre-dated Chapter 12, the "taking" is from the mortgagee not from the farmer. Presumably existing debtors enjoyed all of the benefits of their ability to fully encumber their land at the time existing loans were written. To the extent the conveyance will no longer be recognized because of Chapter 12, the "taking" is from the creditor.

IV. JUSTIFICATIONS

As a general proposition in American law, freedom of contract reigns. This does not mean that all contracts are enforceable, but it means at least that one who would render a form of contract *ultra vires* should have the burden of explaining why a court should not enforce such a contract if the parties desire to make it. Below I discuss four of the arguments that are sometimes given for denying enforcement of a particular contract. The reasons are interrelated, but each is different from the other. I consider in order efficiency, paternalism, morality grounds, and wealth redistribution, each as a justification for Chapter 12.³⁹

A. Efficiency

One might make at least two efficiency arguments on behalf of the Chapter 12 rules that I have described.⁴⁰ First, is the argument that allowing the creditor to take the land from the debtor and sell it on the market destroys value that is not otherwise replaced. In my hypothetical example, \$200,000 might be destroyed. This amount represents the excess of the farmer's value over the low market value (\$600,000 minus \$400,000). If the creditor carries out his threat to take the property or require its sale if he is not paid \$600,000, the entire increment will be destroyed,

America); *Farm Bankruptcy Amendments: Hearing on H.R. 1397 and H.R. 1399 Before the Subcomm. on Monopolies and Com. Law of the House Comm. on the Judiciary*, 99th Cong. 1st Sess. 171 (1985) (statement of Delmar K. Banner, President, The Farm Credit Council); *Id.* at 169 (statement of B.F. Backlund, President, Independent Bankers Association of America).

39. For an interesting discussion of some of these motives and their interrelation, see Kennedy, *Distributive and Paternalistic Motives in Contract and Tort Law, With Special Reference to Compulsory Terms and Unequal Bargaining Power*, 41 *MD. L. REV.* 563 (1982). See also Kronman, *Paternalism and the Law of Contracts*, 92 *YALE L.J.* 763 (1983); Luban, *Paternalism and the Legal Profession*, 1981 *WIS. L. REV.* 454; Whitford, *The Appropriate Role of Security Interests in Consumer Transactions*, 7 *CARDOZO L. REV.* 959 (1986).

40. See *supra* text accompanying notes 24-38.

because, by hypothesis, others value the land at only \$400,000. Thus, the creditor's gain is only \$400,000, yet the loss to the debtor is \$600,000, and there is a \$200,000 net loss. Therefore, one might argue that Chapter 12 is efficient because it preserves the \$200,000 for the debtor at no cost to the creditor.⁴¹

The efficiency argument is not persuasive for several reasons. First, it is not persuasive because one would expect the creditor seldom to carry out the threat of repossession. It is not in the creditor's interest in any individual case to destroy the \$200,000. If the creditor gets the land, he must resell it and, by hypothesis, this particular farmer, the debtor, is the one who will pay the largest amount for it. Thus, if the parties behave rationally, the creditor will carry out the threat only in enough cases to make his threat credible—that number may be zero.

The efficiency argument is unpersuasive for other reasons as well. First, the actual buyer of the land may value it at more than the market. When land is put up for auction, there is no assurance that the auction buyer will be required to pay an amount exactly equal to his value. His bid will never exceed that value, but the value he places on the land could exceed the amount he is forced to pay. Thus, a purchaser at the foreclosure sale might pay \$500,000, yet value the land at \$600,000, and if forced to do so, may be willing to pay \$600,000. Such a conclusion, however, conflicts with the hypothesis of a market between \$400,000 and \$500,000, and this scenario should be an uncommon event. Unless there is a potential buyer who secretly thirsts for this very land, one might treat this land as the last parcel thrown on the market to be purchased by the last incremental buyer whose value would be little, if any, above the lowest market price.

The efficiency equation suggested above is incomplete for yet another reason; it does not include the value gained by the creditor in other transactions by having a credible threat. If it were not worth something to the creditor to have a credible threat, he would never repossess but only threaten to do so. When he repossesses and sells at a lower price than the debtor would have been willing to pay, he does so, not because he is vindictive, but because such sales will validate his threats to other farmers.⁴²

41. For an example of this argument, see Whitford, *supra* note 39. *Contra* Schwartz, *The Enforceability of Security Interests in Consumer Goods*, 26 J. L. & ECON. 117 (1983).

42. Conceivably, some creditors would engage in intransigent behavior in all Chapter 11 cases and routinely refuse to negotiate with debtors in such cases even when the debtor was willing to pay more for the land than any other party in order to keep other debtors from filing a Chapter 11 bankruptcy action. For this strategy to be effective, a number of events, some quite improbable, must occur. The gains from saved lawyer fees and from more favorable workouts from those who do not go into Chapter 11 bankruptcy must outweigh the costs incurred by refusing to reach the most sensible deals with debtors who do file a Chapter 11 action. For the strategy to be successful, it must somehow be communicated to debtors thinking of Chapter 11 bankruptcy and must be acted upon by them. The entire strategy also depends on the assumption the debtor will not be forced into bankruptcy by other creditors.

Is it plausible that any significant number of creditors is following this strategy? First, the strategy could not be openly advocated without incurring the anger of the bankruptcy judges before whom the creditor must appear. It is unlikely that any prominent creditor could withstand the political heat that it would face by publicly taking the position that it was going to stonewall every farmer initiating Chapter 11 bankruptcy and not make reasonable and good faith accommodations in accordance with the congressional intentions expressed in Chapter 11. Second, it is implausible that any creditor has as much power over a set of debtors as assumed by the strategy. If the creditor drives too hard a bargain, it eventually will be in the debtor's interest to go into Chapter 11 bankruptcy irrespective of the creditor's likely attitude in the bankruptcy proceeding. Moreover, the operating creditors may drive the farmer into Chapter 11 even in circumstances in which the mortgagee would be willing to negotiate outside of Chapter 11.

In summary, the first efficiency argument fails unless one can show that the loss of the consumer surplus in the cases in which the threat is carried out outweighs the cumulative gains to the buyer at the foreclosure and to the creditor in other cases in which he uses the threat successfully. While one cannot be confident about numbers in the formula, it seems unlikely that the Chapter 12 regime is more efficient in this sense than the Chapter 11 regime.

A second, more global efficiency argument can be made that the particular farmer who owns the farm is himself the most efficient operator of the land and, thus, society is favored by his farming the land rather than some other person. This argument assumes that the units of production from this farm by the debtor will exceed those of his probable successor by enough to offset the creditor's losses. This, of course, is wild speculation. Moreover, it is speculation that conflicts with at least one piece of evidence present in every single bankruptcy case; namely, the fact that the debtor has failed successfully to operate the farm. Many farm debtors find themselves in bankruptcy through no fault of their agricultural practice, but rather because they incurred debt shortly before the market for their crops changed in ways beyond their control and contrary to their reasonable expectation. But there are others who are in bankruptcy because they made foolish business decisions and because, apart from the business decisions, they are inept farmers. The alternative to a particular debtor's use is not to have his farm lay fallow, but to replace him with another farmer.⁴³ *A priori*, it seems impossible to say that a farmer, who has not yet had a chance to fail with this land, will farm it less efficiently than the debtor would.

It is conceivable, but to me unlikely, that one knowing all the facts could build an efficiency justification for Chapter 12. I would expect the destruction of the consumer surplus to be infrequent because it is in the interest of both creditor and debtor in most cases to negotiate and to save it. I see no reason to conclude that a third party would produce a lower quantity of production from the farm than the debtor. I see at least one reason to suggest that another farmer might do a better job than the current farmer, namely, that each of the current farmers under consideration has failed.⁴⁴

43. In his Senate testimony, Senator Burdick suggested that the consequence of existing farmers' bankruptcies is to leave the land "untended." However, we also need to provide our farmers with a better opportunity to reschedule some of their debt to permit them to pay it off over the longer course rather than shed it through bankruptcy liquidation, thus leaving us with unemployed farmers, untended land, and additional economic problems." *Farm Bankruptcy: Hearings Before the Subcomm. on Admin. Prac. and Proc., and Courts of the Senate Comm. on the Judiciary, 99th Cong., 1st Sess. (1985)* (statement of Sen. Quentin Burdick).

Senator Burdick probably is engaging in a bit of adversarial hyperbole. Liquidation of one farmer will not necessarily leave good land untended. Surely, the creditor's immediate interest is to rent the land and ultimately to sell it to someone who will operate it. To suggest otherwise is merely to cloud the efficiency question.

44. One other efficiency issue deserves mention. This is the possibility in a Chapter 11 regime that a bargaining impasse would occur between the creditor and debtor. If such an impasse occurs, the consumer surplus would be destroyed because the unsuccessful strategic behavior of one of the parties caused the negotiation to abort. Normally the lender and debtor are assumed to have the most information about the risk of not reaching a sensible agreement. Therefore, one would assume that the parties could most efficiently allocate that risk at the time of their original agreement.

In a market where debtors freely were able to grant security interests, inefficiencies possibly will occur if those in the debtor pool find it necessary to exceed their credit worthiness (by giving security interests in consumer surplus) and so invest more than the optimal amount of resources in such signaling behavior.

B. *Paternalism*

A second possible justification for Chapter 12 is paternalism. Perhaps Congress believed that farmers would freely agree to a regime under which not only their consumer surplus but also the future value of their land was mortgaged, but that these farmers failed to understand or lacked the self discipline to protect against the consequences. Perhaps, therefore, Congress passed Chapter 12 to protect them from their own folly.

Protecting farmers for such a reason seems an unlikely explanation. The farmer is a keen businessman. Moreover, the mortgage is not like a security agreement on consumer goods written among a flurry of documents in a hurried consumer credit transaction. The mortgage is an ancient instrument with explicit consequences, well understood by the farm debtor. Of course, the farmer would prefer to have the same loan, at the same terms, and to grant smaller security, but that is not the claim. If Chapter 12 is to be defended on paternalistic grounds, the claim must be that the farmer's best interest would be for him to pay a greater fee and, thus, purchase a mortgage which would deprive the mortgagee of the rights of which he is deprived in Chapter 12.

Whatever the justification for paternalistic behavior in a setting in which the recipient of the legislature's act appears to be of limited competence or one likely to be misled by a complex contract or one involved in a transaction that is difficult to understand, such a setting does not exist in this case. In Washington and Hollywood, farmers have cultivated the image of persons dutifully tilling the land from morning to night, but buffeted by the markets, used by middle men, and savaged by the lenders. No candid farmer or farm banker shares those views. In many ways the farmer is the brightest and ablest of all the classes of American small businessmen. The farmer has repeatedly demonstrated the ability to manipulate subsidy systems to his advantage, to influence the state and federal legislatures, and to adapt his farming techniques not just to the political but also to the economic climate. Surely, therefore, one cannot justify any such legislation on a paternalistic basis. Least of all of us, do farmers need to be told what they really want.⁴⁵

C. *Morality*

Some have defended legislation analogous to Chapter 12 on the ground that it is immoral to permit contracts of the kind outlawed by Chapter 12. As indicated above, section 522(f) avoids nonpurchase money security interests in a range of consumer goods.⁴⁶ By rule, the Federal Trade Commission (FTC) has outlawed

45. Even more doubtful than the paternalism argument previously made is the argument that Chapter 12 is designed to protect the creditor from its own vindictive and self-destructive behavior. This argument would hold if it was not in the creditor's interest to foreclose or to insist on the return of the property under Chapter 11. A law such as Chapter 12 has to be enacted in order to assist the creditor to understand and follow its own true interest. Why a creditor would pursue anything but its own economic self-interest is hard to understand. That creditors who are at least as sophisticated as the farmer should need a law to identify what their own best interests are is bizarre.

46. See *supra* note 9.

nonpurchase money security interests in a similar set of goods.⁴⁷ Some have argued that such laws have an independent moral justification. They argue that it is appropriate for the state to protect one from granting contractual rights that permit an attack on oneself. They argue that the state is acting in a proper and moral way by protecting the individual's autonomy.⁴⁸ In effect, advocates of this position suggest that this is exactly the reason why we will not let Shylock take a pound of flesh from Antonio's hide or permit one to agree to be enslaved.

The argument for protecting individual autonomy is easy to extend to a security interest in a false eye or a wooden leg. But as one moves from items with large symbolic worth but small market value to those of large market value, it becomes progressively less persuasive to argue that a debtor's "autonomy" reaches to those assets. If it is a moral necessity that the legislature protect a part of the debtor's interest in the farm, why is not the same true for a mom and pop grocery store

47. The Federal Trade Commission's (FTC) rule 16 C.F.R. § 444.2 (1987) is similar in scope and function to § 1322(b) of the Bankruptcy Code. This rule, however, accomplishes its purpose outside of bankruptcy. The rule provides in part as follows:

§ 444.2 Unfair credit practices.

(a) In connection with the extension of credit to consumers in or affecting commerce, as commerce is defined in the Federal Trade Commission Act, it is an unfair act or practice within the meaning of Section 5 of that Act for a lender or retail installment seller directly or indirectly to take or receive from a consumer an obligation that:

.....

(2) Constitutes or contains an executory waiver or a limitation of exemption from attachment, execution, or other process on real or personal property held, owned by, or due to the consumer, unless the waiver applies solely to property subject to a security interest executed in connection with the obligation.

.....

(4) Constitutes or contains a nonpossessory security interest in household goods other than a purchase money security interest.

Id. Household goods and antiques are defined in 16 C.F.R. § 444.1(i)-(j) (1987) as follows:

(i) *Household goods.* Clothing, furniture, appliances, one radio and one television, linens, china, crockery, kitchenware, and personal effects (including wedding rings) of the consumer and his or her dependents, provided that the following are not included within the scope of the term "household goods":

(1) Works of art;

(2) Electronic entertainment equipment (except one television and one radio);

(3) Items acquired as antiques; and

(4) Jewelry (except wedding rings).

(j) Antiques. Any item over one hundred years of age, including such items that have been repaired or renovated without changing their original form or character.

Id.

The FTC found that the use of consumer goods as collateral was frequent and widespread. Often, security was taken in "general household goods" leaving debtors unaware of what exactly was being used as collateral. These goods generally had little economic value to creditors, but gave them valuable psychological advantages over debtors. The FTC found, however, that the psychological pressures applied by the creditors often forced debtors to take steps such as refinancing which only worsened their financial situations. Furthermore, they found that default most frequently occurs for reasons not within the control of the debtor. Because they saw seizure and threats of seizure as harmful and disruptive to the debtor and his family, they felt that the costs imposed upon consumer debtors were seriously disproportionate to any benefits received by the creditors. In addition, the FTC believed that allowing purchase money security interests and allowing security interests in certain valuable possessions would leave the debtor with adequate means to obtain financing.

48. See Kronman, *supra* note 39.

or for a piece of land used in any other business? Whatever weight the argument has in other cases, it is unpersuasive in the case of a farm.

Some offer an alternative moral basis for such legislation; namely, that it is immoral to threaten foreclosure when one has no intention of doing it.⁴⁹ Thus, Professor Whitford has argued that it is a "fraudulent representation" to threaten to repossess an item of small resale value when the threat will rarely be carried out.⁵⁰ Rejecting the threat because it gives only indirect benefit hardly seems an adequate moral objection. One punishes and threatens to punish a child not out of a sadistic desire to see the child suffer, but because of the indirect benefit derived, namely to keep the child from doing something dangerous or inappropriate in the future. Why should the rule be different for a creditor who repossesses in one case in order to influence debtors' behaviors in other cases? The benefit may be remote, but it is conceivably greater than if the asset could be sold on the market.

Perhaps there is an evil in the threat itself. Is there some duty of fair disclosure under which the creditor warns: "If you do not pay, there is a one in seventy chance that I will repossess your baby's crib?" Is there a duty on the part of the creditor to reveal to the debtor the true odds of repossession to enable the debtor to make a decision to pay or not with the knowledge of the prospect of the loss of the asset? I see none in the law and I doubt that common moral values would assert one. Indeed much of our criminal law is based on a collection of threats any one of which has a low probability of being carried out against a particular actor. The state is not obligated to reveal to a driver that there is only a one in thirty chance that any particular parking violator or speeder will be ticketed. Nor is there any obligation in the civil law, generally, to reveal to the other party whether one will sue when he threatens to do so. Thus, it is hard to see how enactment of Chapter 12 can be based on the moral need to deprive the creditor of the opportunity to make a threat. It is hard to maintain that a farm is an extension of oneself that should never be taken from the debtor in a moral society. Threats are commonly used by the legislature and in casual and commercial intercourse to train one's children and to influence the behavior of potential criminals and prospective litigants. Given such uses of threats, why should legislatures be driven by a moral obligation to wipe out threats by creditors? I find it difficult, therefore, to find a moral basis upon which to rest Chapter 12.

D. Redistribution of Wealth

One is left with a final and discouraging explanation for the enactment of Chapter 12. In its baldest form this is the idea that Chapter 12 is designed to take money from creditors and give it to debtors, to make farmers richer and banks poorer. Few major changes in the law are completely cost free, yet seldom does one see a law that is not a tax or government subsidy program which is designed explicitly to transfer wealth between two groups of private individuals in our society.

To analyze the potential redistribution and its justification in this case it is important to consider at least two classes of debtors. First, current farmers who are substantially indebted. Second, those not now indebted prospective farmers and

49. See Whitford, *supra* note 39.

50. *Id.* at 989-90.

others who wish to borrow to purchase land and equipment. It is likely that Chapter 12 will have different effects on these two groups.

It seems plausible that Chapter 12 will make current farm debtors richer and current farm creditors poorer. As I have indicated above, Chapter 12 has deprived the current mortgagee of at least two rights. First, Chapter 12 has deprived the creditor of an effective way to lay claim to the farmer's consumer surplus in his land. Formerly, the creditor could do that in Chapter 11 by insisting upon the letter of the fair and equitable rule. Second, Chapter 12 has diminished the creditor's rights by removing the possibility of the section 1111(b)(2) election⁵¹ and, thus, foreclosing the possibility that the creditor could carry his mortgage against the land to the full value of the pre-bankruptcy debt. By making the election, the creditor could lay claim to the appreciation in the land that would occur after the plan had been confirmed. To the extent that the consumer surplus now belongs to the debtor and that the creditor has been deprived of the right to threaten the debtor with its loss, the value of the creditor's collateral is reduced. To the extent that the creditor cannot claim future appreciation in the land (except to the extent that an appraiser raises the current value because of the prospect of appreciation), he has lost. I conclude, therefore, the effect of the enactment of Chapter 12 will redistribute wealth from the creditors to the debtors.⁵²

A priori it is difficult to measure the amount of this wealth transfer. If the folklore about consumer surplus in the farm, and the suggestions about abnormally low valuations in bankruptcy are incorrect,⁵³ the transfer will be small. If, on the other hand, the value of the consumer surplus is great because the typical farmer values his land substantially more than the market does, and if the courts systematically accept valuations that discount the value of prospective future appreciation to zero

51. See *supra* note 27 and accompanying text.

52. Judge Richard F. Stageman, bankruptcy judge for the Southern District of Iowa, made the wealth redistribution argument more explicitly than any other witness before the Senate. After noting that the farmers' plight arose partly because many farmers had too little equity and too much debt and were suffering because the demand for farm commodities had declined, he stated the question as follows:

The question that arises is whether we should ask this small segment of our society [the farm creditors] to bear the cost of the apparent societal desire to give family farmers a break. In short, if the choice is made to attempt to temporarily ease the pain of agriculture's restructuring process, should we ask a small segment of our society—the farm creditors—to pay for this choice or should the cost be spread over all of society.

I wonder if we are all in agreement that the farm debt problem should be thrust on farm credit bond holders, county seat Banks and small town trade creditors in lieu of addressing the problem with tax revenues. I can think of nothing that would more quickly put a chill on farm credit, not only now, but in a hopefully brighter future, than to impose all debt forgiveness on this isolated class of creditors

Farm Bankruptcy: Hearings Before the Subcomm. on Admin. Prac. and Proc., and Courts of the Senate Comm. on the Judiciary, 99th Cong. 1st Sess. 59 (1985) (statement of Richard F. Stageman, Bankruptcy Judge, S. D. Iowa). The rush of filings since Chapter 12 became effective November 27, 1986, suggests that farmer debtors and their lawyers also share the view that Chapter 12 is much more favorable to them than Chapter 11. Between November 27, 1986, and April 5, 1987, there had been 188 filings in Iowa, 220 in Nebraska, and 208 in South Dakota. Are these filings a nonverbal confirmation of the wealth transfer hypothesis?

53. See *supra* note 35 and accompanying text.

and systematically undervalue land in other ways, the transfer will be large.⁵⁴ Because

54. In a fascinating study published in 1957, *The Frazier-Lemke Act: Its Impact on Farmers and Lenders*, James Munger and Professor Feder attempted to measure the impact of the Frazier-Lemke Act. Mr. Munger and Professor Feder found that the Act was infrequently used. Only in North Dakota, California, and Texas did the number of petitions exceed 1,000 between 1937 and 1949. Although their sample was limited and the evidence relatively stale, Munger and Professor Feder attempted to test the proposition that land appraisals underestimated the value of the land and, thus, caused creditors to be underpaid in circumstances in which the debtor was permitted to purchase the land for the appraised value under the Frazier-Lemke Act. It appears that creditors who were permitted to foreclose under state proceedings ultimately received relatively higher prices on the resale of the foreclosed land than were received in the Frazier-Lemke buyouts after appraisal. It also appears that the original appraisals of the land were far below its true worth and that the reappraisal, usually at the request of the creditor under the Frazier-Lemke Act, typically found the value of the land to be substantially higher. Comparison of the final appraisal price with the average land values at the locations of the farm appraised, however, does not show that the redemption values were consistently lower than the market prices:

From the information available in this study, it was difficult to evaluate accurately direct or indirect losses sustained by creditors in section 75 cases which resulted from a composition, extension, or redemption. The generally depressed economic conditions of the 1930's caused most lenders to lose on their investments. Many of the secured debts had been contracted during a period of high prices and the security was seriously impaired before proceedings under section 75 were instigated. This was particularly true of real estate mortgages. Hence, it is likely that most creditors would have sustained losses even with a foreclosure sale.

The losses or gains of creditors who were allowed to foreclose after dismissal of a petition are indicated in part by comparing 'prices' of real estate at foreclosure sales with subsequent sales of the same real estate by the creditors. For 70 cases in the nine sample counties, for which the foreclosure and subsequent sales prices were available, an average price of \$8,668 was paid by creditors at the foreclosure sale. These creditors later sold the real estate for an average \$8,378 and hence lost on the average \$290. In 31 cases, the price the farm brought at the subsequent sale exceeded the foreclosure price by approximately \$2,000; while in 29 cases the sales price was nearly \$3,000 below the foreclosure price. In 10 cases, the farms were sold at the same price at which they were foreclosed (table 17). Farms in the first group tended to be held by creditors over a longer period of time than in either of the other two groups. The longer time, in itself, may not explain why these creditors were in better position to recover their investment unless the years during which the property was foreclosed and sold are also taken into account (that is, whether these sales took place during a period of falling, rising, or stable land prices).

Table 17. Average price of real estate in 70 section 75 cases at foreclosure sale and at subsequent sale by creditors: 9 counties, North Dakota, South Dakota, and Nebraska.

Item	Cases ¹ Number	Average price at fore- closure Dollars	Average price at sub- sequent sale Dollars	Average gain or loss Dollars	Average number of years held Years
Sales price exceeded foreclosure price	31	7,751	9,729	+ 1,978	5.2
Foreclosure price ex- ceeded sales price	29	10,959	8,143	- 2,816	4.7
Sales price equaled foreclosure price	10	4,867	4,867	0	.2

many cases will be negotiated in the shadow of the law, Chapter 12's impact will

All cases	70	8,668	8,378	-290	4.3
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¹ In South Dakota and Nebraska, most farms were foreclosed in the 1930s and sold in the 1940s. In North Dakota, most of the farms were foreclosed in the 1940s, and more than half were sold in the same year.

Losses or gains that occurred between the foreclosure and the subsequent sale of the property include neither the interest on investment while the property was held by the creditors nor the costs of maintaining and operating the farm. Nor are rental payments to the foreclosing creditors taken into account. It is known from a study of several farms foreclosed by institutional lenders that, because of poor crops and the need to maintain buildings and land in good repair, expenses often exceeded returns by a substantial margin. If these factors are included, the actual losses of creditors, shown below, may have been considerably larger, or the gains smaller.

Despite the losses of creditors who foreclosed on their mortgages, it is apparent that even greater losses were sustained by creditors when debtors redeemed their real estate under the provisions of section 75. For redemption cases, these losses were shown to amount to an average of \$1,461. These figures do not include rental payments paid by some farmers during the moratorium period. Such rentals reduced the losses of creditors in redemption cases.

The conditions under which foreclosed property was sold differed substantially from the conditions under redemption. In case of foreclosure, creditors could choose a propitious time at which to sell their property. In case of redemption, the price was based on the appraisal value at the time, and the redemption had to take place at the end of the 3-year moratorium. Hence, little latitude was given creditors to affect the redemption price, except through reappraisals. The redemption price also had no relation to the indebtedness of the farmer.

Therefore, it is not surprising to find that losses in redemption cases exceeded losses in foreclosure cases, as the purpose of the law was to rehabilitate financially distressed farmers through a procedure that would adjust their debts in line with prevailing economic conditions.

Farm appraisals and fair market values in redemption cases. A crucial provision of the Frazier-Lemke Act deals with the farm appraisal, or reappraisal, which is the basis for the redemption price of farm property. It has been asserted that the redemption provision unduly harmed creditors through appraisals far below the market values of farm property.

In order to test this assertion, we compared the ratio of redemption prices to original purchase prices with the ratio of general land values in the two periods. It was assumed that if the ratio of the redemption price to the original purchase price was considerably smaller than the change in index of land values, redemption values would tend to be below the corresponding market values of land. In addition, the average per acre values of farmland in the counties in which the redeemed farms were located were used in comparing purchase and redemption prices.

Information was available for 18 farms to compare the prices farmers paid to redeem their land with the prices they paid originally for the same land. One group of 5 farms were purchased at somewhat less than the average price of land that prevailed in the counties where the farms were located at the time they were bought. For this group, redemption prices averaged 109 percent of purchase prices while the average price of land at the time of redemption was only 47 percent of average prices at the time of purchase. A second group of farms were bought at prices near the average price for land that prevailed at the time of purchase. For these farms, redemption prices were 61 percent of purchase prices. The change in average land prices between the time of purchase and redemption was about the same for all 3 groups of farms.

Differential adjustments in land values occurred during this period in many areas. According to census data, land values in Dickey County, North Dakota, dropped much more sharply than those in Burke County, North Dakota, between 1920 and 1940. In 1940, the land values were nearly the same.

go well beyond the cases in which a petition is filed. Each workout will have to be negotiated with the knowledge that the farmer has the alternative of Chapter 12. Consequently, each negotiated settlement entered into after November 1986, should be modified to some extent as a result of Chapter 12.

What does Chapter 12 hold for future debtors? If the effect of Chapter 12 is to prohibit the effectiveness of rights that the creditors value highly, creditors will not be able to escape this consequence in deals already made, but some can withdraw

In conclusion, we find no clear-cut evidence that would substantiate a claim that redemption values were consistently out of line with market prices. It seems apparent that appraisals were difficult to make because there was no active land market during the 1930's, when the majority of redemptions occurred under section 75. Some persons have contended that appraisals should have been made on long-term values rather than on the current market value. Long-term values might have been an easier basis on which to make appraisals but the operation of section 75 would have been greatly different and not as provided by law.

Appraisal and reappraisal. The law provided that redemption values be based on a final appraisal of the property at the time of redemption and not necessarily on the appraisal made at the time of the subsection (s) petition. In most redemption cases, reappraisal was usually at the request of the creditors. In some instances, an appeal was taken to the court which determined the final market value of the farm.

Among 27 cases, the final average value per acre of \$11.32 was two-thirds higher than the initial appraisal value of \$6.72 and in several cases, the upward revision was very sharp. A comparison of first appraisal values and final redemption values in 27 redemption cases showed the following:

Percentage final appraisal was of first appraisal	Number of cases
Less than 100 percent	2
100 percent	2
101-150 percent	4
151-200 percent	11
201-250 percent	4
251-300 percent	4
Total	27

In only two cases, was the final appraisal the same as the first appraisal. As both the land market and the outlook for agricultural conditions improved between the beginning and the end of the subsection (s) procedure, the reappraisal provisions of the law enabled creditors to participate in the rise of market prices.

However, the first appraisal usually was low. For 112 farms for which appraisal data were available in the 9 sample counties, only 11 showed appraised market prices that were equal to or exceeded average county land values, as shown by the census. The average appraisal price per acre for these 112 farms was \$9.07; the average census value was \$23.81. It should be recalled that the census data on land values are based on farmers' estimates and not on actual transfers, while the appraisal prices in section 75 cases are intended to reflect current market prices. This may explain a part of the discrepancy. If we assume that the census data reflected the prevailing market fairly accurately, the tendency toward low initial appraisals may well have discouraged many creditors. These low appraisals may have been one of the reasons for the strong opposition of creditors to the Frazier-Lemke Act.

Had not the land market increased as a result of World War II, creditors would have taken a more severe loss than they actually did and if land prices had decreased further, the redemption values generally would have been below the first appraisals.

from the farm loan market, others can adopt more restrictive loan policies, and some may be able to raise their prices to exact a charge in lieu of the contract that is no longer available.

Yet it is not inevitable that the added costs arising out of Chapter 12 will be passed on to subsequent debtors.⁵⁵ Some creditors, such as the federal farm lenders and small farm banks, cannot readily leave the market. If the farmers, buyers of credit in the farm credit market, place only a low value on what Congress has conferred upon them, the new price sought by the remaining creditors may not fully offset the added costs. On the other hand, if the added cost causes national lenders such as the insurance companies to withdraw from the farm mortgage market, yet leaves the demand for farm credit unchanged, the remaining creditors may be able to raise their prices to offset the cost of Chapter 12.⁵⁶ Indeed, it is conceivable that the enactment of Chapter 12 could have the ironic effect of transferring wealth from future debtors to creditors. This could be the case if creditors in the future were able to raise their prices as a result of the enactment of Chapter 12 by more than the cost of Chapter 12. How could this come about? Presumably, it could happen if Chapter 12 were the incremental event that caused large numbers of creditors to abandon the farm market. If, for example, substantial numbers of farm creditors regarded Chapter 12 merely as a portent of things to come and concluded that their rights would be impaired in other, yet more significant ways by Congress and by state legislatures, it is conceivable that this event could cause substantial numbers of farm creditors to leave the market. In the remaining market, characterized by a substantially reduced supply with a stable or rising demand for credit, conceivably the remaining debtors could charge not only the increment of cost attributable to Chapter 12, but something in addition to that.⁵⁷ Presumably, such a consequence would not last indefinitely; it would be the result of disequilibrium of limited term. A period of stable land values and rising commodity prices would eventually draw the defecting or other creditors into the market. Nevertheless, the potential remains that Chapter 12 will raise, not merely the farmers' cost of credit to offset the costs of the act itself, but also will raise credit costs by an additional increment.

A final probable consequence of Chapter 12 is that creditors will change not merely their prices, but also their lending practices. One might expect lenders to

55. When the sellers of a good have a large fixed investment that cannot be moved readily to another market, the sellers may not be able to raise the price sufficiently to offset the cost of mandatory terms. An example of this might be landlords with a large and immobile investment in apartments who are forced to provide certain terms in their leases. See Ackerman, *Regulating Slum Housing Markets on Behalf of the Poor: Of Housing Codes, Housing Subsidies, and Income Redistribution Policy*, 80 YALE L.J. 1093 (1971).

Conversely, one would expect the costs of required contract terms to be passed on in circumstances in which demand for credit is fairly inflexible and the supply is flexible. As indicated in the text, that is how market should be characterized market for farm mortgage credit.

56. At least one major farm mortgage lender, Metropolitan Life Insurance Company and its affiliated companies, with \$1.7 billion in first mortgage to landowners, announced a moratorium on farm lending in response to Chapter 12's enactment. Des Moines Register, Dec. 4, 1986, at 7S, col. 1 & 2. In their testimony before Congress, representatives of other creditors suggested that farm creditors would change their practices in response to Chapter 12 and, thus, reduce the amount of credit available. See sources cited *supra* note 38.

57. Creditors cannot raise credit prices infinitely because each increase of the cost of credit also increases the probability of default. That fact alone will put a limit on the price of credit even if farmers were willing to pay any rate.

refuse loans to farmers who are perceived to be most risky yet to continue to make loans to the most stable and risk-free debtors. This rationing would have the effect of benefiting the strong debtor at the cost of the weak; it would cause the intended beneficiaries of Congress' goodwill to bear a disproportionate share of the cost.

Which of these scenarios is most likely to occur in the long term? Putting aside federal farm lending programs, which necessarily must lend to farmers, there is no law that requires any lenders to stay in the farm market. The national and regional banks can easily withdraw from the farm market. The insurance companies are nationwide lenders and have a large array of potential debtors available to them, and even the farm bank has alternatives.⁵⁸ The farm bank can lend to businesses that are not farmers. Such a bank can lend to those outside the farm community by the purchase of participations and by buying investments such as treasury bills and bonds. Moreover, all creditors who stay in the market can adopt more restrictive loan policies. The current farm credit market does not seem to be characterized by fixed supply that cannot be directed elsewhere. Some of the supply is highly mobile and much of it is moderately so. Moreover, to the extent that farm banks fail, as many have done over the past few years, the supply of credit may decline further.

It is clear that private lenders will attempt to recover any increase in costs caused by Chapter 12. To the extent that alternative and more desirable loan

58. One "alternative" for agricultural banks that was frequently referred to in the hearing is the alternative of liquidation. In Ewen M. Wilson's testimony before the Subcommittee on Administrative Practice and Procedure, and Courts, of the Senate Committee on the Judiciary he stated as follows:

In 1984, loan charge-offs at agricultural banks amounted to 1.2 percent of total loans outstanding—a rate more than double that experienced by other small banks, and nearly six times the charge-off rate experienced by agricultural banks before the farm crisis [T]welve percent of agricultural banks reported negative net income for 1984. Since 1981 there has been an eight-fold increase in the number of annual bank failures, with much of the increase coming among agricultural lenders. As of October 31 [1985], 94 commercial banks have failed in 1985—a post-depression high. According to the Federal Deposit Insurance Corporation, 49 of the failed banks were agricultural banks

The following chart was attached to Wilson's testimony.

Table 2. Problem and Failed Commercial Banks

Date	Problem bank account		Failed banks (year to date)	
	Total	: Agricultural ^a	Total	: Agricultural ^a
	-Number-	Percent	-Number-	Percent
12/31/83	603	146 24.2	44	7 15.9
12/31/84	800	288 36.0	78	25 32.1
09/30/85	1007	390 38.7	85	46 54.1
10/31/85	na	na na	94	49 52.1

na—not available

^a An agricultural bank is one with 25 percent or more of its loan portfolio in agricultural loans. Problem bank counts represent the number of commercial banks on the FDIC's problem bank list on the date indicated. The number of failed banks include all commercial bank failures for the period January 1 until the date indicated.

Source: Federal Deposit Insurance Corporation.

Farm Bankruptcy: Hearings Before the Subcomm. on Admin. Prac. and Proc., and Courts of the Senate Comm. on the Judiciary, 99th Cong., 1st Sess. 93 (1985) (statement of Ewen M. Wilson, Deputy Assistant Secretary of Econ., U.S.D.A.).

opportunities will be available to lenders, it seems plausible they will be successful in passing on some, if not all, of the increase in costs resulting from Chapter 12 as well as more. Of course, if the federal government decides to subsidize farm lending yet further by pumping additional funds into the federal farm credit system, the cost of Chapter 12 may yet be born by the taxpayers, at least if the federal farm credit system chooses to make loans at less than the rate private lenders would charge.

V. CONCLUSION

To speak of the Congressional intent is to indulge in a fiction. Senator DeConcini's statement on the Senate floor at the time of Chapter 12's passage shows that he at least saw this as a bill to transfer money from creditors to debtors in the short run.⁵⁹ That such transfer will occur is the creditor's perception. The analysis of the

59. 132 CONG. REC. S15, 091 (daily ed. Oct. 3, 1986) (statement of Sen. DeConcini). Senator DeConcini stated as follows:

Finally, Mr. President, I want to comment for a moment on section 255 of the bill which creates a new chapter 12 of the bankruptcy code especially designed to accommodate the family farmer. This chapter is in response to the tremendous hardship that has afflicted many segments of the farm community with the large resulting number of bankruptcies. It was concluded that the present structure of the bankruptcy code simply didn't fit the special economic circumstances that attend the family farmer. I was proud to support the original Grassley bill on this subject in the Senate and I do feel that there is some merit in attempting to address the needs of the farmer through a separate chapter to the bankruptcy code. However, I am troubled by some provisions of the new chapter 12 which I fear might inadvertently cause substantial economic dislocation and bring about an unfair result.

I am very worried that the extremely debtor oriented provisions of this chapter may force our farm lender to write off hundreds of millions of dollars of farm debt with no hope of recovering this debt when the farm crisis ends. Can our credit community afford this? Can our rural banks, teetering now, take another hit? Can the Farmer Credit System take yet another significant economic reversal? Is it fair to ask the creditor to absorb the huge losses that can reasonably be expected to result from this bill? Will there be credit available for farmers in the future, or will this bill result in shutdown of credit in the agricultural area?

These are serious and far reaching questions to which I do not have the answer, but I fear we have tilted the pendulum too far in the direction of the financially troubled farmer. The result may well be that a domino effect will occur that in the long run will prove detrimental to the farm sector.

The provision of this bill that troubles me the most is the provision that will permit a family farmer to go into bankruptcy, write down the secured debt to the current value of the land, and then begin to pay the creditor based on what amounts to a new mortgage based on the value of the farm. The thought that a person cannot pay their debt and yet may retain their property and only continue payments based on the value of the property as of the filing of the bankruptcy is entirely new—and dangerous. Why won't every farmer with a substantially undercollateralized loan against his farm declare bankruptcy?

Let me put the theory into numbers. Let us assume that in the State of Iowa in 1980, a farmer purchased a piece of land for \$1.2 million and took out a \$1 million mortgage on the property. In the past 6 years, on the average, there has been a 60-percent decrease in land values in Iowa. In rough terms then, the farm purchased for \$1.2 million is now worth \$500,000. Another way to look at it is that the secured creditor now has a secured loan for \$500,000 and an undercollateralized, unsecured loan for \$500,000. Now what will happen under this bill? If the farmer declares bankruptcy under

bill given above leads me to believe that the creditors are correct. That such a bill could be fostered by two Republican senators, one an arch conservative,⁶⁰ passed by a Republican Senate, and signed by a conservative President, is ironic. The bill's effect on mortgages is reminiscent of the effect of the Frazier-Lemke bill passed by Congress in the 1930s at the behest of a President of a different stripe. Frazier-Lemke was held unconstitutional by the Supreme Court⁶¹ and was upheld by that

the new chapter 12, the farmer will (1) wipe out for all intents and purposes the \$500,000 unsecured portion of the loan; (2) the farmer will only have to make payments on the new, depressed value of the farm—\$500,000; and (3) the farmer keeps the farm! Why won't any farmer who finds himself in a situation like the above, where the farmer has a large debt service on property that has substantially depreciated, go into bankruptcy? I fear that we have created a legal atmosphere that may well encourage farm bankruptcies and that farmers who can now manage to work things out with their creditors in some satisfactory manner to both will no longer have that incentive to reach mutual agreement.

Figures on the amount of undercollateralized debt are hard to come by but I will throw out just a few by way of example of the potential magnitude of the problem. My best estimate is that about 40 percent of all farm debt held by institutional investors is undercollateralized. In dollar amounts, the figure exceeds \$20 billion. Ninety percent of all debt is held by farmers whose debt is less than \$1.5 million, the ceiling under this bill for farmers to take advantage of this chapter. In other words, almost all farmers will be eligible for this chapter. The Farm Credit System lists \$2.1 billion in substantially undercollateralized debt. Who knows how much debt that is undercollateralized is held by the Farmers Home Administration—clearly a figure in the billions.

Mr. President, I don't want to be a pollyanna crying wolf needlessly, but it is my most sincere fear that we may regret our actions tonight. The farm title has substantially revised long held doctrines of the bankruptcy code such as the absolute priority rule and the theories of adequate protection. This bill by not including the doctrines embraced by 1111(b) of the bankruptcy code has precluded a creditor from any hope of participating in an upswing in the value of its collateral. In many other ways, our actions tonight are based on the utmost in good intent—but with no real knowledge of the implications. I urge the proponents of this new farm chapter, Senator Grassley and Congressman Synar, to monitor the ramifications of this chapter closely and to resolve to redress inequities that may result in a prompt fashion. I greatly admire both of these gentlemen, and I fervently hope that my judgment is misplaced and that their judgment is fully rewarded.

Id.

Other congressional statements were more disingenuous. Compare Senator DeConcini's statements with Representative Synar who stated as follows:

Our legislation . . . simply does this, it simply allows our family farmers to stay on the farm, to continue on their land. And who benefits from that? Well, they benefit, because they can continue to be productive citizens in this country.

And who also benefit[s] are farmers and ranchers who adjoin that property, whose equity will go down when these neighbors are foreclosed, and, therefore, a domino effect would occur throughout this country. The bankers and the creditors will also benefit. Granted, they will have to take payments over a longer period of time, but I know that the sensitive bankers in the financial community want to stay with American agriculture and not turn their back like this administration has.

Our legislation simply entitles our creditors and our farmers and ranchers to get the same deal that they would receive if they were a corporation or an individual. And finally, our legislation gives the flexibility we need to reorganize the debt structure of this country with respect to agriculture.

Farm Bankruptcy Amendments: Hearing on H.R. 1397 and H.R. 1399 Before the Subcomm. on Monopolies and Comm. Law of the House Comm. on the Judiciary, 99th Cong., 1st Sess. 16 (1985) (statement of Rep. Mike Synar).

60. Sponsors of the bill in the Senate were Senators East and Grassley.

61. See *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555 (1935).

Court only after it was amended.⁶² In Chapter 12 we have a depression bill taking money out of the pockets of the creditors and putting it into the pockets of the debtors, fostered and signed by those who are thought to represent the creditors' interests.

If the farmer must be helped,⁶³ why should he not be helped by a subsidy from all of the taxpayers? What is it about creditors who have loaned to these farmers that entitles Congress to force them to subsidize the farm debtors? I fear that Chapter 12 is a cynical act by a Congress fearful of raising taxes and of imposing the cost openly on the taxpayers. At least for existing farm debtors, Congress has produced the same consequence covertly by imposing the cost on one industry.

Even more unfortunate than this covert tax on one industry is the possibility that Chapter 12 will foreclose or unduly burden future borrowers. This would not be the first time Congress has served short-term political goals at the cost of long-term interests, but it would be truly unfortunate if the effect of Chapter 12 ultimately is to reduce the quantity of farm credit available and to increase the cost of what is available. Moreover, it would be particularly unfortunate if this increase in cost, in fact, outweighed the costs of Chapter 12 and so forced future farm debtors to buy the unasked for benefits of Chapter 12 at a price even higher than their cost to creditors.

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62. See *Wright v. Vinton Branch of the Mountain Trust Bank of Roanoke*, 300 U.S. 440 (1937).

63. Ample evidence was given in the congressional hearings to show the farmer's dire plight. One witness testified as follows:

If current farm income conditions are maintained with no financial assistance measures or if financial programs . . . offered by commodity support programs are elevated, the loan losses could be in the range of \$20 to \$25 billion.

Finally, loan losses of \$20 to \$25 billion are expected to increase short term interest rates by 75 to 125 basis points, reduce total employment by 175,000 to 275,000 jobs, reduce total GNP by \$30 to \$50 billion over 8 years, and increase the Federal debt by \$14 to \$21 billion by 1993.

Crisis in the Rural Economy and its Effect on Small Businesses: Hearings Before the Subcomm. on Export Opportunities and Special Small Business Problems of the House Comm. on Small Business, 99th Cong. 1st Sess. 156 (1985) (statement of Dr. Abner W. Womack, Dep't of Agric. Econ., U. of MO. at Columbia).