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Neil E. Harl
Iowa State University

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Guidelines for Debt Restructuring

by Neil E. Harl

In the early stages of debt restructuring in an economic downturn for farm and ranch taxpayers, the emphasis is generally on relatively minor adjustments, in part because the downturn could be reversed if commodity prices were to rise. As the downturn deepens, as it did in the 1980s, the steps taken by lenders often become more draconian and could lead to major steps to reduce the scale of operations or even to force the termination of the operation.

One lesson learned in the 1980s was that debt restructuring may be in the best interests of both the borrower and the lender but the acceptance of debt restructuring is often delayed because of the belief that the downturn may end with better commodity prices because of adverse weather conditions for crop production. For livestock producers, economic recovery often relates to cyclic factors affecting the supply of livestock for slaughter.

What is debt restructuring?

A key question when default may be on the horizon is whether preemptive steps should be taken to minimize the risk of default. While that is often a wise move, and a close working relationship with the lender makes that a more likely step, whenever default actually occurs on a loan or other obligation the question is whether the matter should be resolved through foreclosure on loans, forfeiture of land contracts or bankruptcy. All tend to be disruptive for the farming or ranching operation and may become costly in the long run for both borrower and lender.

Experience from the 1980s suggests that, if a strong working relationship exists between borrower and lender, it may be possible for the parties to work out a debt restructuring plan that minimizes the economic impact on the borrower and reduces the expense generally incurred by lenders in the process.

As an informal procedure, debt restructuring may involve – (1) re-amortization of the obligation (or obligations) over a longer time period, for example, a three year loan on machinery could be stretched to five years; (2) the interest rate could be reduced (although the inclination for lenders to debtors on the brink of default is to increase the interest rate); (3) forgiveness of principal, which may be acceptable for a highly regarded borrower; or (4) some combination of the above.

* Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.
Debt restructuring should always be considered when it is in the lender’s best interests and may be justified when, even though not in the lender’s best short-term interests, it may be in the lender’s long-term interests to keep a good manager in business. That decision, of course, is one for the lender to make. In general, debt restructuring is more likely to occur when collateral values are falling and losses from reduced collateral values loom large which suggests minimizing the time period between default and settlement of the loan matter but legal and accounting fees may reach significant levels if the resolution proceeds through formal channels and interruptions in interest payments become significant. Those costs may exceed the amount necessary to be forgiven to make the borrower stable.

Factors to consider

In determining whether a loan in default should be resolved with formal procedures or whether attention should be given to debt restructuring, several factors are worthy of consideration.

Is the collateral adequately valued? If collateral values have fallen well below the amount of the obligation, losses have already occurred. In such instances, it may be unlikely that full recovery is possible for the lender.

Is the loan documentation adequate? In the 1980s downturn, this was a key factor but, in general, loan documentation today tends to be more formal than was the case going into the farm debt crisis.

Could the borrower be made financially stable? What would be the cost to the lender to accomplish that result?

If restructuring, overall, appears feasible, how willing are the other lenders to absorb an equitable share of the total cost of restructuring? That can be a critical factor.

Is the borrower-lender relationship flawed? In the 1980s, there were charges of conflict of interest and misleading advice involved in some instances.

How important to the lender is “maintaining borrower discipline”? Some lenders may be reluctant to restructure because borrowers may come to expect such treatment whenever they get in financial difficulty.

Making the decision

A comparison of outcomes (restructuring or partial or total liquidation) on a net present value basis can provide guidance as to the most rational approach for both parties, but especially for the lender.

It is generally not rational to liquidate a loan if the loss expected to be taken is greater than what would be necessary to keep the borrower in business by restructuring the loan. That outcome necessarily depends upon (1) the probable net recovery value on the collateral; (2) the extent to which the lender is unsecured; (3) the cost of interruption of interest payments; and (4) whether the borrower, after restructuring, will be able to service the still outstanding debt.

Other factors

Attention should be given, also, to the income tax consequences of the alternatives, principally as those consequences can significantly tip the scale. The income tax consequences in bankruptcy should be reviewed carefully with attention given to the income tax treatment under a Chapter 12 filing (for farm and ranch bankruptcies) which is substantially less favorable to the debtor than the other bankruptcy chapters.

Look for a discussion of those tax consequences in future issues of the Digest.

ENDNOTES


3 See Hall v. United States, 132 S. Ct. 1882 (2012) (tax liability was not incurred by the bankruptcy estate under 11 U.S.C. § 503(b) and thus was not subject to 11 U.S.C. 1222(a)(2) and remained the responsibility of the debtor). See Harl and Peiffer, “The U.S. Supreme Court Settles (For Now) One of the Chapter 12 Bankruptcy Tax Issues,” 23 Agric. L. Dig. 81 (2012).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

BANKRUPTCY

CHAPTER 12

DISCHARGE. In 2010 and 2011, the debtor purchased four tractors from a creditor using loans obtained from the creditor. The creditor perfected security interests in the tractors. The debtor sold the tractors in 2011 and did not pay the proceeds to the creditor. Instead, the debtor continued to make the loan payments through 2014. In 2015, the creditor filed suit to repossess the collateral but that action was stayed by the debtor’s filing for Chapter 12. The creditor was served with all notices of the bankruptcy action, including the deadline of July 1, 2015 for filing objections to dischargeability of the debtor. The creditor filed a motion to lift the automatic stay as to the reposition action and the court granted the motion. The repossession case proceeded and the creditor learned in September 2015 that the tractors had been sold. The creditor spent months trying to determine the