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# An Introduction to Chapter 12 Bankruptcy: Restructuring the Family Farm

by
Susan A. Schneider

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# In Introduction to Chapter 12 Bankruptcy: Restructuring the Family Farm

**Susan A. Schneider**
Associate Professor and Director, Graduate Program in Agricultural Law
University of Arkansas

Chapter 12 bankruptcy is a special section of the Bankruptcy Code that provides for the restructuring of the debts of a family farm or family fisherman's business. It provides powerful tools to debtors, sometimes enabling them to reduce their debts or restructure their payments so that they can continue farming or fishing as their livelihood. Chapter 12 was first created in October 1986[1] and was recently made permanent by The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the 2005 Bankruptcy Act).[2] Chapter 12 has been an important tool for farmers in financial distress, both as a bankruptcy option and as a base line for negotiations outside of bankruptcy. This article provides an overview of Chapter 12 as amended by the 2005 Bankruptcy Act.[3]

### Who is eligible for Chapter 12?

For a farmer or a farm business to be eligible for Chapter 12 relief, the farmer or the farm business must be "engaged in a farming operation" and must meet other specific eligibility requirements. These requirements consider the amount of debt, the percentage of the debt that comes from the farming operation, and the percentage of income that comes from the farming operation. For farm businesses, family ownership and control is also required.

An individual or a married couple that engage in a farming operation are eligible for Chapter 12 relief if they meet each of the following specific eligibility requirements:

- The farmer's total amount of debt cannot be greater than $3,237,000.[4] This limit will increase in future years with the Consumer Price Index.[5]

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[1] Bankruptcy Judges, United States Trustees and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, tit. II, § 255, 100 Stat. 3105-3113 (1986) (codified at 11 U.S.C. §§ 1201 - 1231).

[2] The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (codified in scattered sections of 11 U.S.C.) (hereinafter, 2005 Bankruptcy Act).

[3] Most changes made by the 2005 Bankruptcy Act only apply to cases filed on or after October 17, 2005.

[4] 11 U.S.C. § 101(18)(A) and (B)).

[5] 11 U.S.C. § 104(b)).

- At least fifty percent (50%) of the debt must come from the farming operation.[6]

- The farmer must meet a gross income from farming test. More than fifty percent (50%) of the gross income for the taxable year *before the year that the bankruptcy is filed* must be from the farming operation.[7] Or, more than fifty percent (50%) of the gross income *in each of the second and third taxable years before the bankruptcy filing* must come from the farming operation.[8]

A corporation or partnership that engages in a farming operation can also be eligible for Chapter 12 relief if it meets the following specific eligibility requirements:

- More than 50 percent of the outstanding stock or equity in the partnership or corporation must be held by one family, or by one family and the relatives of the members of that family.[9]

- This family or their relatives must conduct the farming operation.[10]

- More than 80 percent of the value of the corporation or partnership must be related to the farming operation.[11]

- The debts of the corporation or partnership must not be greater than $3,237,000.[12] This limit will increase in future years with the Consumer Price Index.[13]

- Not less than fifty percent (50%) of the corporation or partnership debts must arise out of the farming operation that is owned or operated by the corporation or partnership.[14]

- If a corporation issues stock, its stock must not be not publicly traded.[15]

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[6] 11 U.S.C. § 101(18)). In computing this percentage under either the previous law or the new provision, the debtor can exclude the debt for a “principle residence” unless that debt arises out of the farming operation.

[7] 11 U.S.C. § 101(18)(A).

[8] 11 U.S.C. § 101(18)).

[9] 11 U.S.C. § 101(18)(B).

[10] 11 U.S.C. § 101(18)(B).

[11] 11 U.S.C. § 101(18)(B).

[12] 11 U.S.C. § 101(18)(B)).

[13] 11 U.S.C. § 104(b)).

[14] 11 U.S.C. § 101(18) (B)). If there is a mortgage on a house owned by the corporation or partnership and used as a principal residence by a shareholder or partner, this debt does not have to be counted in the percentage unless the home was mortgaged to finance the farming operation. Either way, however, the mortgage debt will count toward the maximum amount of debt allowed.

[15] 11 U.S.C. § 101(18)(B).

The 2005 Bankruptcy Act expanded Chapter 12 to allow for family fisherman to be eligible for relief.[16] A family fisherman is defined as someone “engaged in a commercial fishing operation.”[17] A commercial fishing operation is defined as “the catching or harvesting of fish, shrimp, lobsters, urchins, seaweed, shellfish, or other aquatic species or products of such species; or . . . aquaculture activities consisting of raising for market” any of these species or products.[18]

For an individual or a married couple, the definition of “family fisherman” requires that their total debt not be more than $1,500,000 and that not less than 80 percent of that debt arise out of their commercial fishing operation.[19] In addition, they must have received more than 50 percent of their gross income from their commercial fishing operation for taxable year preceding the year in which the bankruptcy case was filed.[20]

For a corporation or partnership, more than 50 percent of the outstanding stock or equity must be held by the family and the family must conduct the commercial fishing operation.[21] More than 80 percent of the value of the assets must be related to the commercial fishing operation.[22] It's total debts must not exceed $1,500,000 and not less than 80 percent of the debt must arise out of the commercial fishing operation.[23] If the corporation issues stock, the stock must not be publicly traded.[24]

Regardless of whether the debtor is an individual or a corporation or partnership, a family farmer or a family fisherman, the debtor must have “regular annual income.” This means that there must be income that is “sufficiently stable and regular” to allow the debtor to make payments under a plan.[25] Non-farm income can used to satisfy this requirement.

## How does Chapter 12 work?

Chapter 12 provides many alternatives for reorganizing family farm debts. In many cases, it allows a debtor to reduce a mortgage to the current value of the property and to greatly reduce unsecured

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[16] 11 U.S.C. § 101(19A)).

[17] 11 U.S.C. § 101(19A)).

[18] 11 U.S.C. § 101(7A).

[19] 11 U.S.C. § 101(19A(A)). If there is a mortgage on the individual's home, this debt does not have to be counted in the percentage unless the home was mortgaged to finance the farming operation. Either way, however, the mortgage debt will count toward the maximum amount of debt allowed. *Id*.

[20] 11 U.S.C. § 101(19A)(A)).

[21] 11 U.S.C. § 101(19A(B)).

[22] 11 U.S.C. § 101(19A(B)).

[23] 11 U.S.C. § 101(19A(B)). If there is a mortgage on a house owned by the corporation or partnership and used as a principal residence by a shareholder or partner, this debt does not have to be counted in the percentage unless the home was mortgaged to finance the farming operation. Either way, however, the mortgage debt will count toward the maximum amount of debt allowed.

[24] 11 U.S.C. § 101(19A)(B)).

[25] 11 U.S.C. § 101(19).

obligations. In order to accomplish this type of restructuring, Chapter 12 provides an orderly framework of reorganization.

A Chapter 12 bankruptcy begins when the debtor files a Chapter 12 petition with the clerk of the Bankruptcy Court.[26] This filing begins the case and many rights are set according to this date.[27]
For this reason, careful planning *prior to the filing* is critical. The 2005 Bankruptcy Act imposes additional filing and disclosure requirements on debtors,[28] and *credit counseling by an approved credit counseling service may be required prior to filing*.[29]

All creditors must receive notice of the bankruptcy and all of the debtor's assets and obligations must be included in the case.[30]

Within 90 days of filing the bankruptcy, the Chapter 12 debtor is required to submit a reorganization plan to the bankruptcy court.[31] The creditors do not need to approve of this plan; the creditors will not have an opportunity to vote on the plan. The debtor, however, will have to obtain court approval or "confirmation" of the plan.[32] The confirmation process is the process by which the debtor presents the plan to the court and defends the plan against objections that may be raised by creditors.

In order for a plan to be confirmed, it must meet the specific confirmation requirements set forth in Chapter 12.

1) The plan must have been proposed in good faith, that is, the debtor must have a sincere intention to reorganize the farming operation according to the plan. Chapter 12 is not to be used solely to delay the creditors from enforcing their legal rights.[33]

2) The plan can modify a debt that is owed to a secured creditor in one of three ways. First, the secured creditor can agree to its treatment under the plan. This involves negotiation with the creditor. Second, the plan can provide that the secured creditor receive the "present value" of its "secured claim" and keep its lien on its collateral. A creditor's "secured claim" is the debt reduced to the value of the collateral.[34] This second alternative is the one that is used most often by Chapter 12 debtors. In general terms, it means that the creditor will be paid an amount equal to the fair market value of

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[26] 11 U.S.C. §301.

[27] For example, this date may determine whether an asset is property of the bankruptcy estate. 11 U.S.C. § 541.

[28] 11 U.S.C. § 521(a)).

[29] 11 U.S.C. § 109(h)(2)). A preliminary listing of approved credit counseling agencies is available on the Just Department's U.S. Trustee's Office website at http://www.usdoj.gov/ust/bapcpa/ccde/index.htm Sometimes credit counseling can be done over the phone or the internet.

[30] 11 U.S.C. § 521.

[31] 11 U.S.C. § 1221. It is sometimes possible to get an extension of this time period, provided that the request is made during the 90 day period.

[32] 11 U.S.C. § 1225.

[33] 11 U.S.C. § 1225(a)(3).

[34] 11 U.S.C. § 506.

the collateral. This amount can be paid over time, often for as long a period as would be appropriate for a new loan of that type. The creditor will be entitled receive interest payments at market rate.[35] The third alternative is that the plan can provide that the secured property is surrendered to the creditor in satisfaction of the secured claim. This means that the debtor can give back all or part of the secured property and receive credit at a value determined by the court.

3) The plan must provide for full payment, in deferred cash payments, of all priority claims.[36] Priority claims are obligations that receive special protection under the Bankruptcy Code.[37] In the past, tax claims were frequently priority claims. Under the 2005 Bankruptcy Act, however, claims owed to a government unit as a result the sale of a farm asset may no longer be afforded priority, provided that the debtor receives a discharge.

4) The plan must provide that creditors with unsecured claims[38] be paid at least as much as they would receive if the debtor liquidated the farming operation in a Chapter 7 bankruptcy.[39] This means the value of the unsecured assets, less the exempt property. This is referred to as the liquidation test.

5) The plan must also provide that the debtor commit all "projected disposable income" to the payment of unsecured creditors. Disposable income is that income that is not reasonably necessary for family living or for the "continuation, preservation, and operation of the debtor's business."[40] This requirement is referred to as the disposable income test. The 2005 Bankruptcy Act amended this test in a way that is very favorable to farm debtors. It rejected some of the harsh interpretations of this test and reaffirmed the importance of leaving the debtor with sufficient income to continue farming after the bankruptcy is over. Disposable income should be determined at confirmation and can only be modified under limited circumstances.[41]

6) Although the debtor will usually be able to continue to manage the farm, a trustee will be appointed to handle the payments made under the plan. The plan must provide for the payment of the trustee for his or her services.[42] This payment may be up to 10% of the total of all of the other payments under the plan. Some courts, however, have allowed debtors to make some payments directly to their creditors and to avoid the

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[35] 11 U.S.C. § 1225(a)(5).

[36] 11 U.S.C. § 1222(a)(2).

[37] 11 U.S.C. § 507.

[38] Unsecured claimholders include traditional unsecured creditors such as a tradesman or input suppliers. Because the Bankruptcy Code provides for the division of an obligation owed to a creditor into secured and unsecured claims, in many cases, a creditor who is secured, but whose security is insufficient in value to cover the debt will be the largest unsecured creditor. *See*, 11 U.S.C. § 506 (2000).

[39] 11 U.S.C. § 1225(a)(4).

[40] 11 U.S.C. § 1225(b)(2).

[41] 11 U.S.C. § 1229.

[42] 11 U.S.C. § 1226.

trustee's fee on those payments.[43] Other courts have held that the trustee's fee applied to all payments.[44]

7) The debtor must be able to show the court that the plan is feasible, that is, that he or she can afford to make all of the payments that are required under the plan.[45] This is likely to require carefully prepared cash flow projections for the full term of the plan. Non-farm income can be used to make plan payments.

In practical terms, in many cases, Chapter 12 allows the debtor to alter the secured debt by reducing the amount owed to the fair market value of the property, reducing the interest rate to the current market rate interest and/or extending the payment period on the debt. Subject to the liquidation and disposable income tests, the debtor may be allowed to pay only a small portion of the unsecured debt.[46]

The bankruptcy court's initial involvement in a Chapter 12 case may last several months, up until the court confirms the plan. The terms of the plan and the involvement of the trustee will last from three to five years.[47] After that time, the trustee will be dismissed, the debtor will be discharged, and the debtor will make the long term scheduled payments to the secured creditors directly.[48]

If the debtor is not able to propose a plan that the court will confirm, the case may be dismissed. The debtor has an absolute right to request the dismissal of the case, unless fraud is shown. The debtor also has the right to convert the case to a case under Chapter 7. The debtor can be forced to convert to a Chapter 7 case and to liquidate if fraud is found.[49]

If the debtor fails to make the payments required under the confirmed plan, the creditors or the trustee can ask the court to dismiss the case.[50] For this reason, it is wise for debtors consider all circumstances in proposing a plan, and it is not wise to be overly optimistic with projections. If something unexpected happens, however, the debtor can petition the court to modify the terms of the plan.[51]

Farmers experiencing financial distress are encouraged to discuss these issues with a bankruptcy attorney. Many of the issues raised here can be very complicated when

[43] *See, e.g.,* Wagner V. Armstrong, (*In re* Wagner), 36 F.3d 723 (8th Cir. 1994).

[44] *See, e.g.*, Fulkrod v. Savage, *In re* Fulkrod, 973 F.2d 801 (9th Cir. 1992).

[45] 11 U.S.C. § 1225(a)(6).

[46] 11 U.S.C. § 1225.

[47] 11 U.S.C. § 1222.

[48] 11 U.S.C. §§ 1222(a)(9), 1228.

[49] 11 U.S.C. § 1208.

[50] 11 U.S.C. § 1208.

[51] 11 U.S.C. § 1229.

applied to specific case. Good legal advice and careful planning are critical aspects to a successful bankruptcy reorganization.