farmers' legal action
report

2005/2
Volume 20, Issue 2

Bankruptcy Reform: Changes to Chapter 12 – Family Farmer Reorganization

By Susan A. Schneider*

Inside

Federal Register Highlights **5**
FSA Notices **7**
Field Notes **9**
Case Summaries **10**

Visit us on the Web:
www.flaginc.org

FARMERS' LEGAL ACTION GROUP, INCORPORATED

Since October 1986, there has been a special chapter of the Bankruptcy Code designed to allow family farmers a workable option for restructuring their debt and saving the farm. In the years since its creation, Chapter 12 has been an important tool for farmers in financial distress, both as a bankruptcy option and as a baseline for negotiations outside of bankruptcy.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the 2005 Bankruptcy Act) became law on April 20, 2005. While much of the new law is directed toward consumer bankruptcy reform, it also includes a number of important changes to Chapter 12.

This article provides an overview of Chapter 12 and explains the changes made by the 2005 Bankruptcy Act. It remains to be seen how the courts will interpret these new provisions, and farmers are encouraged to discuss the issues with their attorneys.

Chapter 12 Is Now a Permanent Part of the Bankruptcy Code

Chapter 12 was originally passed as emergency legislation in response to the farm debt crisis of the 1980s. It had a sunset provision that provided that it would be repealed on October 1, 1993. In 1993, however, Congress extended Chapter 12 for another five years.

During this extension period, Congress began its debate of overall bankruptcy reform. "Farmer-friendly" changes to Chapter 12, including a provision that would make Chapter 12 a permanent part of the Bankruptcy Code, were among the reforms discussed. There was bipartisan support for making Chapter 12 permanent, but there were many other proposed changes that were very controversial. Reform proponents recognized early on that farm state votes could be critical to the ultimate passage of their bill. Over the decade that Congress debated bankruptcy reform, authorization for Chapter 12 expired and was renewed several times. Each extension of Chapter 12 authorization was short and temporary, to preserve farm state votes for comprehensive bankruptcy reform. Sometimes a Chapter 12 extension came months after Chapter 12 authorization had sunset, creating frustrating gaps in its availability.

The 2005 Bankruptcy Act finally makes Chapter 12 a permanent part of the Bankruptcy Code. Farmers and their attorneys no longer need to wonder if Chapter 12 will be available for them when they need it.

Chapter 12 Eligibility Expanded by 2005 Changes

There are specific eligibility criteria for Chapter 12 relief. When Chapter 12 was enacted, only a "family farmer" who had "regular annual income" was eligible. The Bankruptcy Code provided one definition of "family farmer" that applied to an individual or an individual and spouse. It provided a second definition that applied to family farm corporations or partnerships. The 2005 Bankruptcy Act changes these eligibility standards by expanding the definition of "family farmer" and by extending eligibility to "family fishermen." These changes will become effective on October 17, 2005.

To be eligible for Chapter 12 relief, a farmer or 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 are also required.

An individual or a married couple that engages in a farming operation is eligible for Chapter 12 relief if the following specific eligibility requirements are met:

- Until October 17, 2005, the total amount of debt cannot be greater than $1,500,000. Beginning on that date, under the new law, this limit is increased to $3,237,000. This limit will increase in future years with the Consumer Price Index.

Farmers' Legal Action Report is published four times each year and is supplemented with special Focus Reports that provide in-depth analyses of special topics affecting agriculture as they arise. As always, we appreciate your support and suggestions.

Attorney Editor
Karen R. Krub

Production Editor
Debby Juarez

Copy Editor
Rita Gorman Capes

Interim Executive Director
Linda Tacke

Legal Director
Susan E. Stokes

Staff Attorneys
Stephen Carpenter
Karen R. Krub
Jill E. Krueger
Jess Anna Speier

Farmers' Legal Action Group, Inc. (FLAG) is a nonprofit law center that provides legal assistance, education, training, and technical support to financially distressed family farmers and their attorneys and advocates throughout the country. The information contained here should not be construed as legal advice, and readers are encouraged to consult with an attorney for specific legal assistance.

Farmers' Legal
Action Group, Inc.
360 N. Robert St., Ste. 500
St. Paul, MN 55101
Phone: 651-223-5400
Fax: 651-223-5335
Email: lawyers@flaginc.org
Web site: www.flaginc.org

© Copyright 2005, Farmers' Legal Action Group, Inc. No portion of this newsletter may be reproduced without written permission.

ISSN 1074-8075

- Until October 17, 2005, at least 80 percent of the debt must arise out of the farming operation. Beginning on that date, under the new law, this percentage is lowered, and only 50 percent of the debt must come from the farming operation.
- Until October 17, 2005, more than 50 percent of gross income for the taxable year before the year that the bankruptcy is filed must be from the farming operation. The 2005 Bankruptcy Act provides a new alternative. Beginning on October 17, 2005, either the farmer can meet the 50 percent income requirement for the preceding taxable year or the farmer can show that more than 50 percent of the gross income in each of the second and third taxable years before the bankruptcy filing came from the farming operation.

A corporation or partnership that engages in a farming operation can 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.
- This family or their relatives must conduct the farming operation.
- More than 80 percent of the value of the corporation or partnership must be related to the farming operation.
- Until October 17, 2005, the debts of the corporation or partnership must not be greater than $1,500,000. Beginning on that date, under the new law, this limit is increased to $3,237,000. This limit will increase in future years with the Consumer Price Index.
- Until October 17, 2005, at least 80 percent of the corporation or partnership debts must arise out of the farming operation that is owned or operated by the corporation or partnership. Beginning on that date, under the new law, this percentage is lowered, and only 50 percent of the debt must come from the farming operation.
- If a corporation issues stock, its stock must not be publicly traded.

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. This requirement was not changed by the 2005 Bankruptcy Act.

How Does Chapter 12 Work?

A Chapter 12 bankruptcy begins when the debtor files a Chapter 12 petition with the clerk of the bankruptcy court. This filing commences the case, and many rights are set according to this date. For this reason, careful planning prior to the filing is critical. The 2005 Bankruptcy Act imposes additional filing and disclosure requirements on debtors, and credit counseling may be required prior to filing. All creditors will have to receive notice of the bankruptcy, and all of the debtor's assets and obligations will be included in the case.

Within 90 days of filing the bankruptcy petition, the Chapter 12 debtor is required to submit a reorganization plan to the bankruptcy court. Creditors do not have an opportunity to vote on or otherwise reject the debtor's plan, though they may raise objections to the court. Although the debtor need not obtain creditor approval of the plan, court approval or "confirmation" of the plan is required. 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.

The bankruptcy court's initial involvement in a Chapter 12 case may last several months, up until the court confirms the plan. 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 terms of the plan and the involvement of the trustee will last from three to five years. After that time, if the plan requirements have been satisfied, the unsecured debt will be discharged, the trustee will be dismissed, and the debtor will make the scheduled payments to the secured creditors directly.

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, although some courts have restricted this right if fraud is shown. The debtor also has the right to convert a Chapter 12 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.

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. For this reason, it is wise for debtors to 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.

Chapter 12 Plan Requirements – Important Changes Under the New Law

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

- A Chapter 12 plan must have been proposed in good faith, that is, the debtor must be sincere in his or her intention to reorganize the farming operation according to the plan. Chapter 12 is not to be used solely to delay the creditors in enforcing their legal rights.
- The debtor must be able to show the court that the Chapter 12 plan is feasible, that is, that he or she can afford to make all of the payments that are required under the plan. This is likely to require carefully prepared cash flow projections for the full term of the plan. The new law did not change this requirement.
- The plan must provide for payment to the trustee for his or her services. This payment may be up to 10 percent of the total of all of the other payments under the plan. Some courts have allowed debtors to make some payments directly to their creditors and avoid the trustee's fee on those payments. Other courts have held that the trustee's fee applies to all payments. Congress did not clarify this requirement, and the 2005 Bankruptcy Act makes no change to the trustee fee provisions.
- A Chapter 12 plan can modify a debt that is owed to a secured creditor in one of three ways. First, the plan can propose any kind of change that is agreeable to the secured creditor. Second, the plan can provide that the secured creditor will receive the present value of its secured claim and keep the lien on its collateral. 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 current fair market value of its collateral. This amount can be paid over time, often for as long a period as would be appropriate for a new loan of the same type. The creditor will be entitled to receive interest at the market rate during the payment period. The third alternative is that the plan can provide that the collateral will be surrendered to the creditor in satisfaction of the secured claim. The 2005 Bankruptcy Act did not change the treatment of secured claims.
- A Chapter 12 plan must provide that creditors with unsecured claims be paid at least as much as they would receive if the debtor liquidated the farming operation in a Chapter 7 bankruptcy. This means that these creditors must receive the value of the debtor's unsecured assets, less the debtor's exempt property. This is referred to as the "liquidation test." The 2005 Bankruptcy Act did not change this requirement.
- A Chapter 12 plan must provide for full payment, in deferred cash installments, of all "priority claims." Priority claims are certain types of obligations that receive special protection under the Bankruptcy Code. Tax claims are frequently priority claims. Under the 2005 Bankruptcy Act, claims owed to a government unit as a result of the disposition of a farm asset, such as certain capital gains taxes, will no longer automatically be considered priority claims. Provided that the debtor receives a discharge, claims resulting from the disposition of a farm asset can be treated as an unsecured debt. This provision took effect on April 20, 2005, but it will not apply in cases filed before that date.
- A Chapter 12 plan must also commit all of the debtor's "projected disposable income" to the payment of unsecured creditors during the plan term. Disposable income is the income that is not reasonably necessary for family living expenses or for the "continuation, preservation, and operation of the debtor's business." This requirement is referred to as the "disposable income test."

In practical terms, in many cases, Chapter 12 allows the debtor to alter secured debt by reducing the amount owed to the fair market value of the collateral, reducing the interest rate to the current market rate interest, and 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.

Important:

Farmers experiencing financial distress are encouraged to discuss these matters with a bankruptcy attorney. Many of the issues raised in this article can be very complicated when applied to a specific case. Good legal advice and careful planning are critical aspects of a successful bankruptcy reorganization.

New Law Prohibits Retroactive Assessment of Disposable Income

Although the Bankruptcy Code requires that a Chapter 12 plan provide for the payment to unsecured creditors of all disposable income that is "projected" at the time of confirmation, courts have interpreted the provision to mean that payment of actual disposable income is required. Under this interpretation, at the end of the plan term, the debtor can be required to go back and provide a complete accounting; if income exceeded expenses, that excess amount had to be paid to the unsecured creditors before discharge could be granted.

The 2005 Bankruptcy Act prohibits the "retroactive assessment of disposable income." It provides that a Chapter 12 plan can be confirmed either by pledging for payments of all projected disposable income during the plan term (the current requirement) or by pledging to make payments over the plan term amounting to at least the projected disposable income. The new alternative requirement should ensure that a Chapter 12 debtor will receive a discharge at the end of the plan term if he or she pays out the projected disposable income amount, without the need for determining actual income and expenses over the plan term. This new provision goes into effect on October 17, 2005, and will only apply to cases filed on or after that date.

New Law Restricts Plan Modifications That Would Increase Payment Obligations

The 2005 Bankruptcy Act also affects the right of a creditor or the trustee to modify a confirmed plan during the plan term. The new law provides that a Chapter 12 plan may not be modified to increase the amount of any payment that is due before the plan modification is approved. Under this new provision, modifications will be allowed only to create new payment obligations for the future, capturing future income that is greater than what was anticipated when the plan was originally confirmed.

In addition, under the new law, only the debtor can ask for an increase in payments based on disposable income that would increase the amount of payments to unsecured creditors for a particular month to the extent that total payments exceed the debtor's disposable income for that month. This provision also seems to prevent a court from being able to go back into the debtor's past and impose a new obligation that is greater than what the farmer can pay from disposable income in that month.

Finally, the new law provides that a Chapter 12 plan may not be modified in the last year of the plan term by anyone except the debtor to require payments that would leave the debtor with insufficient funds to carry on the farming operation after the plan is completed. This provision emphasizes the importance of allowing the debtor sufficient income for the continuation of the farming operation after the discharge.

These new provisions go into effect on October 17, 2005, and will only apply to cases filed on or after that date.

Additional Protections for Domestic Support Obligations

The 2005 Bankruptcy Act includes a variety of new provisions to protect obligations that a debtor may have under a divorce or separation. These "domestic support obligations" are given priority status, and if the plan does not propose to pay these obligations in full, the debtor must pledge all projected disposable income to make plan payments for a five-year period. Ordinarily, only a three-year commitment is required. Any domestic obligations that come due between the bankruptcy filing and confirmation of the plan must be paid in full prior to plan confirmation. And failure to pay domestic obligations that come due after confirmation will be grounds for dismissal of the bankruptcy or denial of a discharge. These provisions will become effective on October 17, 2005, and will only apply to cases filed on or after that date.

Other Provisions of the New Law May Affect Chapter 12 Debtors

This article's discussion of the 2005 Bankruptcy Act focuses on the specific changes made to Chapter 12. There are many general provisions in the 2005 Bankruptcy Act that might also affect the filing or administration of a Chapter 12 bankruptcy. Farmers who are in bankruptcy or are considering filing for bankruptcy should consult with their bankruptcy attorneys to be sure that all of the new law's effects have been considered. ◻

**Susan A. Schneider is an Associate Professor of Law and Director of the Graduate Program in Agricultural Law at the University of Arkansas School of Law in Fayetteville, Arkansas. A former FLAG staff attorney, Susan continues to consult with FLAG and provide valuable assistance on bankruptcy and related issues.*