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Chapter 12—The Long Road Back

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David H. Hahn*

Chapter 12 — The Long Road Back

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I. INTRODUCTION.

The farm crisis exists. Enormous amounts of farm debt will not be repaid by farm families inextricably tied to their land by history, emotion, and, in some cases, spirituality. Congress, in an attempt to provide a mechanism for the restructuring of family farm debt, passed the Family Farmer Bankruptcy Act of 1986.[1] Congress believed that the legislation would make it "easier for a family farmer to confirm a Plan of Reorganization" and would eliminate some of the time-consuming, inordinately expensive, and unworkable provisions of Title 11.[2] The purpose of this article is to provide a brief description of the theoretical basis of Chapter 12, enumerate several practical considerations about Chapter 12, offer practice hints and provide a debtor's viewpoint of the new legislation.

The basic premise of Chapter 12 is that it permits a family farmer to reduce the amount of all indebtedness to the value of non-exempt assets owned by the farmer.[3] Effectively, Chapter 12 allows the family farmer to become 100% leveraged, instead of something more than 100%.[4] This occurs because of the cram-down provisions of Chapter

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1. 11 U.S.C.A. §§ 1201-31 (West Supp. 1987).
2. H.R. REP. NO. 958, 99th Cong., 2d Sess. at 48 (1986).
3. 11 U.S.C.A. § 1225(a)(4) (West Supp. 1987) states that one of the confirmation standards requires that the value of the property to be distributed is not less than the amount than would be paid if the debtor were liquidated under Chapter 7. In addition, 11 U.S.C.A. § 1226(b)(9) (West Supp. 1987) permits the secured claims to be paid over three to five years.
4. In cases where full use has been made of the exemption laws, the family farmer may, in fact, have assets in excess of the value distributed to creditors. Note, however, that a major exemption - annuities - in Nebraska, NEB. REV. STAT. § 44-371

12. Section 1225(a)(4) requires that the property, including deferred cash payments, to be distributed under the plan of reorganization to each unsecured claim, should not be less than the amount to be paid if the estate of the debtor were liquidated under Chapter 7. The court is required to consider the amount that unsecured creditors would receive in a liquidation distribution under Chapter 7. This is commonly known as the "best interest of creditors test." In addition, secured creditors who do not accept the farmer's proposed plan of reorganization, can be required to accept the plan and the "crammed-down" portion of their secured claim.[5]

A typical example of this cram-down in a Chapter 12 case would involve a long-term real estate lender whose total outstanding indebtedness at the time of the filing of the bankruptcy petition is $200,000. The value of the farm real estate which secures that obligation is currently $100,000. Hence, the lender would have a secured claim for $100,000 and an unsecured claim for $100,000. The farmer's plan can contemplate not paying anything on the unsecured claim, since the lender, in a Chapter 7 case, would not receive any distribution on that unsecured claim. In addition, on the secured portion of the lenders claim, the debtor could propose a pay-out of the $100,000 over a period of years, given an adequate discount rate so that the present value of the payment over the years would equal $100,000. The lender is now only receiving $100,000 or the present value thereof, and is "crammed-down."

II. CONSTITUITIONAL CONCERNS.

Because many family farmers may need to sell secured assets in order to generate sufficient cash flow for their Chapter 12 plans, there is a constitutional question with regard to the sale of assets which carry a post-petition lien. In *In re Wobig*,[6] Nebraska Bankruptcy Judge Timothy Mahoney ruled that reorganizing farm debtors may sell livestock which are security for a creditor's lien which continues post-petition pursuant to section 552(b) and still provide adequate protection to the creditor for the value of the assets held by the debtors on the effective date of the plan. The debtors were permitted to sell feeder pigs, in that case, in order to finance their Chapter 12 plan of reorganization, even though a bank's security documents created a lien in those pigs. The lien was not cut off, pursuant to section 552(b), and the court allowed the proceeds to be used for operating expenses, instead of ordering the payment of the proceeds to the bank.[7] As long

(1984), has been modified to a maximum value of $10,000.00. The practitioner should examine applicable state or federal exemptions.

5. *See* 11 U.S.C.A. § 1225(a)(5)(B) (West Supp. 1987)
6. 73 B.R. 292 (Bankr. D. Neb. 1987).
7. *Id.* at 294-295.

as the Chapter 12 plan of reorganization provided that the value of the collateral on the effective date of the plan was at least 110% of the allowed secured claim of the bank, the court found that the bank was adequately protected.

Justice Douglas, in *Wright v. Vinton Branch of Mountain Trust Bank*,[8] ruling upon the Frazier-Lempke Act of 1934,[9] noted that creditors had a constitutional right to have the value of their collateral protected. It would appear that Justice Douglas' opinion in *Wright* supports the cram-down provisions of Chapter 12.

III. DEPARTURES FROM PREVIOUS BANKRUPTCY LAW.

Chapter 12 changes three primary notions of pre-Chapter 12 bankruptcy law: adequate protection, lost opportunity costs and indubitable equivalence.

When the family farmer files bankruptcy under Chapter 12, an automatic stay is placed upon all efforts of creditors to foreclose, reclaim or collect on any debts owed them.[10] Generally, creditors may expect to have their interests "adequately protected" during the course of the case. In Chapter 11 farm bankruptcies, the notion of adequate protection resulted in the required periodic payment of interest on the value of the creditor's claim or by giving additional liens. In addition, failure to provide adequate protection to a creditor was a major reason for lifting the stay and proceeding with collection and foreclosure efforts by the creditor. Commonly creditors asked for "lost opportunity costs" where the value of the collateral was less than the amount of the debt secured by the collateral.[11] The payment of lost opportunity costs required the family farmer to pay interest to an under-collateralized secured creditor. The periodic payment of interest was a substitute for the amount of money an undersecured creditor might earn on the value of the collateral which secured the debt. Given the cyclical nature of agricultural financing, and the fact that most family farmers entering bankruptcy do not have an adequate finance source, the requirement of adequate protection presented a major stumbling block to a successful bankruptcy reorganization under Chapter 11. Congress recognized this difficulty when considering Chapter 12.[12]

Congress modified the notion of adequate protection in Chapter 12 cases. Section 1205 eliminates the necessity for the payment of lost opportunity costs as adequate protection by providing an alternative

8. 300 U.S. 440 (1937).
9. Ch. 792, 49 Stat. 942 (1935).
10. 11 U.S.C. § 362 (1982 & Supp. III 1985).
11. *See In re* American Mariner Indus., Inc., 734 F.2d 426 (9th Cir. 1984); Grundy Nat'l Bank v. Tandem Mining Corp., 754 F.2d 1436 (4th Cir. 1985), *but cf., In re* Ahlers, 794 F.2d 388 (8th Cir. 1986).
12. H.R. REP., *supra* note 2, at 49.

method of providing adequate protection. Section 1205 expands the means of providing adequate protection *for farmland debt* by allowing the family farmer to pay the creditor "the reasonable rent customary in the community where the property is located, based upon rental value, net income, and earning capacity of the property."[13]

Section 1205(4) does not contain language equivalent to 11 U.S.C. § 361(3), which allows a debtor to provide a creditor with the indubitable equivalent of the creditor's interest. Congress intended to remove the indubitable equivalent requirement.[14] At least one court has ruled that it is permissible for a debtor to surrender property other than a creditor's collateral in satisfaction of a creditor's claim.[15]

With these theoretical changes of Chapter 12, the family farmer is permitted to cram-down total indebtedness to the value of all non-exempt assets, pay reasonable rental value for the use of farmland and machinery,[16] and provide for the payment of the value of non-exempt assets which the family farmer elects to retain.[17]

IV. THE FIRST STEPS OF THE LONG ROAD.

The same bill which created Chapter 12, also included a new definition for "family farmer." Only a "family farmer with regular annual income" may become a debtor under Chapter 12.[18] To qualify as a "family farmer," an individual or other entity[19] must be engaged in a farming operation and have a regular annual income sufficient to make payments under a plan of reorganization. In addition, more than 50% of the gross income for the tax year preceding the filing of the Chapter 12 petition must have been obtained from the farming operation. The aggregate debts of the family farmer must not exceed

13. 11 U.S.C.A. § 1205(b)(3) (West Supp. 1987). In many cases, the creditors do not ask for lost opportunity costs. Chapter 12 cases move extremely fast. If a family farmer files a plan with his petition, the plan must be considered within 45 days. 11 U.S.C.A. § 1224 (West Supp. 1987). This does not generally permit the creditor to file and obtain a hearing date for a motion to require adequate protection payments. Obviously, adequate protection relates to post-confirmation activity, but these can be dealt with by paydown provisions in the plan. *See In re* Monnier Bros., 755 F.2d 1336 (8th Cir. 1985).
14. H.R. REP., *supra* note 2, at 50.
15. *In re* Mikkelsen, Inc., 74 B.R. 280 (Bankr. D. Or. 1987).
16. *In re* Rennich, 70 B.R. 69 (Bankr. D.S.D. 1987).
17. *See* Carbiener, *Present Value in Bankruptcy: The Search for an Appropriate Cram-Down Rate*, 32 S.D.L. REV. 42 (1987); *In re* Doud, 74 B.R. 865 (Bankr. S.D. Iowa 1987).
18. 11 U.S.C. § 109(f) (Supp. III 1985).
19. 11 U.S.C.A. § 101 (17)(B) (Supp. III 1985) also permits corporations and partnerships to qualify as a "family farmer" if more than 50% of the outstanding stock or equity is held by one family, or by one family and the relatives of the members of such family, and such family or such relatives conduct the farming operation and the farming operation also meets the debt and stock requirements of Chapter 12.

$1.5 million,[20] and at least 80% of the aggregate, non-contingent, liquidated debt must arise out of the family farming operation.[21]

Upon the filing a Chapter 12 petition, section 362 provides the family farmer and certain co-debtors with the protection of an automatic stay. The co-debtor's stay is directed toward co-debtors who are co-debtors on consumer debts. Since the primary debts involved in a Chapter 12 bankruptcy are not consumer debts, this co-debtor stay provides little relief to other family members or friends who may have assisted the family farmer in pre-petition financing by signing as guarantors or co-debtors on farm debt obligations.[22]

The automatic stay may be lifted for failure to provide adequate protection.[23] Additionally, the court may lift the automatic stay if the plan does not pay the claim of a creditor or if such creditor's interest would be irreparably harmed by continuation of the stay.[24] Even though the stay may be lifted regarding a creditor who will not be paid under the plan, most plans generally provide for the non-payment of a creditor's claim, a discharge of that claim, or a negotiated settlement with regard to the claim.

The family farmer debtor, upon the filing of a Chapter 12 petition, becomes a debtor-in-possession and has the right to operate the farm.[25] The family farmer then, as debtor-in-possession, has the rights, powers, and duties as any other any debtor-in-possession under Chapter 11, subject to limitation by the court. Specifically, however, the farmer-debtor-in-possession does not have a right to compensation.[26]

A family farmer may be removed as a debtor-in-possession for fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor, either *before* or after the commencement of the case.[27] It is important to note that the reasons for removal may have occurred before the filing of a bankruptcy petition. A lawyer must carefully analyze the reasons for the distressed financial situation of the family farmer. If it is due to one of the elements set forth in sec-

20. *In re* Stedman, 72 B.R. 49 (Bankr. D.N.D. 1987) (Chapter 12 petition dismissed because debtor had $1,544,103.48 in debt on date of filling).
21. The 80% requirement can exclude the debt on the principal residence unless that debt also arose out of the family farming operation. 11 U.S.C.A. § 101(17) (West Supp. 1987).
22. 11 U.S.C. § 101(7) (1982) defines consumer debt as a debt that was incurred primarily for a personal, family, or household purpose. Hence, the co-debtor stay might protect the new refrigerator, but not the plow.
23. *See supra* notes 6-15 and accompanying text.
24. 11 U.S.C.A. § 1201(c) (West Supp. 1987).
25. 11 U.S.C.A. § 1203(West Supp. 1987).
26. 11 U.S.C.A. § 1203 modifies the right to compensation under 11 U.S.C.A. § 330 (West Supp. 1987).
27. 11 U.S.C.A. § 1204 (West Supp. 1987).

tion 1204, the family farmer must be prepared to respond to allegations by creditors that he should be removed as debtor-in-possession.

The former law prior to Chapter 12 permitted the sale of assets free and clear of any liens only if the law of the state in which the sale was to occur permitted the sale of such property free and clear of an interest,[28] the family farmer in a bankruptcy often found it difficult to scale down the size of the farm operation. This was particularly true in real estate situations where applicable non-bankruptcy foreclosure law would not permit the piecemeal sale of secured real estate. Chapter 12 does permit the family farmer to scale-down the size of the farm operation, even if the sales required to achieve such scale-down would be considered piecemeal under applicable state law.[29] A scale-down can be achieved under sections 1206 and 1222(8). Section 1206 modifies the general sale provisions of section 363(f) to the extent that the farmland or farm equipment which the reorganizing farmer may not find necessary for a reorganization plan, may be sold without the consent of the secured creditor, prior to confirmation. In addition, the plan, pursuant to section 1222(8), can provide for the sale of assets. The primary requirement of a sale of secured property is that the proceeds from the sale shall be subject to the lien of a pre-petition creditor.[30] As a practical matter, this may permit a family farmer to sell an encumbered asset and use the proceeds from that asset, if the family farmer can adequately protect the interest of the creditor in the proceeds by way of a replacement lien or other adequate protection measures. Other measures include guarantees from third parties, the return to the creditor of other, exempt assets, or the return to the creditor of other non-encumbered properties.

The plan is the centerpiece of the Chapter 12 proceeding. The family farmer is required to file a plan within 90 days of the order for relief.[31] The plan must provide sufficient future earnings for payments under the plan, allow for payments of allowed administrative expenses, and provide for the deferred payment of allowed secured claims.[32] If an unsecured creditor objects to the confirmation of a plan, the plan must also provide that the debtor's projected disposable income to be received in a three-year period will be applied to make payments under the plan, including distribution to allowed unsecured creditors.[33] Disposable income is income which is not reasonably necessary to be expended for the maintenance and support of the family farmer and the farm family, or for payments under the plan and other

28. 11 U.S.C. § 363(f)(1) (1982).
29. 11 U.S.C.A. § 1206 (West Supp. 1987).
30. *Id.*
31. 11 U.S.C.A. § 1221 (West Supp. 1987).
32. 11 U.S.C.A. § 1222 (West Supp. 1987).
33. 11 U.S.C.A. § 1225(b)(1) (West Supp. 1987).

operating costs necessary for the continuation, presentation, and operation of the family farm.

A plan may be modified prior to confirmation so long as the modified plan meets Chapter 12 requirements.[34] A secured creditor who has accepted or rejected a plan will be deemed to have accepted or rejected a modified plan, unless the modifications provide for a change in the rights of the holder of the secured claim.[35]

Confirmation of the plan of reorganization vests all property of the estate in the debtor, except as provided in the plan of reorganization or section 1225.[36]

The debtor may receive a discharge under Chapter 12 after all payments are made under the plan, except as payments made to claimants sections 1222(b)(5) and 1222(b)(10).[37] Debts allowed under section 1222(b)(5) and (10) or under section 523(a), are non-dischargeable.

Chapter 12 is to be repealed on October 1, 1993.[38] Apparently, this will permit Congress to evaluate the effectiveness of Chapter 12 and to decide whether the legislation should be continued.[39]

V. PRACTICAL CONSIDERATIONS

Chapter 12 is designed to allow the reorganizing family farmer an opportunity to rearrange the debt structure of the farm so that the family farmer will have a reasonable chance of success in the future. The lawyer should see it as an opportunity not only to hold off a foreclosure sale or permit the family farmer to stay on the farm without any intention to make operational changes which would increase the farm efficiency. The family farmer must be required to analyze and determine which profit centers in the farm can assist in the reorganization, and determine whether a scale-down is necessary. The family farm client should be urged to consider the amount of personal and emotional capital which will need to be invested in any plan of reorganization. The farmer still must be able, however, to support the readjusted debt structure.

The lawyer will need to review all debt documents including notes, UCC agreements, installment sales agreements, accounts payable, statements of account, judgments, liens and contracts. Also, the client should gather for a pre-Chapter 12 review all titles, deeds, mortgages, trust deeds, contracts, security agreements, financing statements, effective financing statements and leases. These documents will provide

34. 11 U.S.C.A. § 1223(a) (West Supp. 1987).
35. 11 U.S.C.A. § 1223(c) (West Supp. 1987).
36. 11 U.S.C.A. § 1227(c) (West Supp. 1987).
37. 11 U.S.C.A. § 1228 (West Supp. 1987).
38. Act of Oct. 27, 1986, P. L. 99-554, Title III, § 302(f), 100 Stat. 3124.
39. 132 CONG. REC. § 15076 (daily ed. Oct. 3, 1986)(statement of Sen. Grassley).

answers concerning the secured status of various creditors, whether an oversecured creditor may be entitled to costs and attorney's fees associated with the enforcement of its rights in the collateral and the nature of the debt.

Association with other professionals such as farm managers, agricultural specialists at universities and state colleges, and certified public accountants is important. In a Chapter 12 proceeding, the lawyer may not have the time or ability to individually analyze the economic dynamics of the farm operation. The economic dynamics, however, are relevant to the initial eligibility for Chapter 12 and feasibility of a proposed plan.

VI. SUMMARY

Chapter 12 provides a family farmer with an unparalleled opportunity to restructure debt. The benefit of Chapter 12 is that debt may be written down to present value of collateral and the terms of obligations to secured creditors may be modified.[40] A family farmer may cram-down debt and make adequate protection payments to creditors based upon the fair rental value of assets. These assets include both farm real estate and other farm property.[41] A family farmer can also scale-down the farm operation in an effort to maximize the income-producing stream from the most promising collateral. Such an opportunity has never existed for farmers in the United States.[42] Chapter 12 does not require that a farmer be in default on obligations before a Chapter 12 case can be initiated. While the family farmer is still highly leveraged, even with the best plan of reorganization, the entire debt structure of the farm can be rewritten and all creditors dealt with in one forum rather than various piecemeal deals with individual creditors, which was often the case prior to Chapter 12. Chapter 12 is a viable option for those family farmers who desire to stay on the farm, work hard, and take the long road back to increased income, equity, and a better way of life.

40. *See In re* McKeag, No. BK87-71 (Bankr. D. Neb. 1987).
41. *In re* Rennich, 70 B.R. 69 (Bankr. D.S.D. 1987).
42. Under the Frazier-Lempke Act, Ch. 869, 48 Stat. 1289 (1934), farmers could retain their farm for five years, paying reasonable rental value during that five years and then redeeming the property at the end of the five-year period by paying the appraised value of the real estate, or the farmer could pay the appraised value of the encumbered property to the creditor over a six-year period, with the creditor's consent.