

**FARM LEGAL SERIES****June 2015**

# Bankruptcy: Chapter 12 Reorganization

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## INTRODUCTION

Chapter 12 was added to the Bankruptcy Code in 1986 and subsequently amended in 2005. It is designed specifically for the reorganization of family farms. Chapter 12 is closely modeled after Chapter 13; however, Chapter 12 has higher debt limits intended to enable traditional family farms to be eligible for a reorganizational bankruptcy.

## CHAPTER 12

### Eligibility

Chapter 12 is only available to persons who meet the definition of “family farmer” set forth in the statute. A family farmer may either be an individual or a corporation or partnership.

#### *Individual*

There are several tests which must be met in order to qualify as a family farmer. According to this definition, the farmer's debts cannot exceed \$3,544,525. Fifty percent of this index adjusted debt must arise from the farming operation. A farming operation includes “farming, tillage of the soil, dairy farming, ranching, production or raising of crops, poultry or livestock, and the production of poultry or livestock products in an unmanufactured state.” For purposes of computing the debt ceiling, any debt on a homestead will not be included unless it was granted in connection with the farm operation. In addition to the debt ceiling, the statute also requires that the farmer debtors

must have earned more than one half of their gross income from farming in the year prior to the filing of the Chapter 12 petition. The final requirement for eligibility is regular annual income. This income must be “sufficiently stable and regular to enable such family farmer to make payments” under a Chapter 12 plan.

#### *Corporation or Partnership*

A farm corporation or partnership will be eligible to file a Chapter 12 case if it meets four specific conditions. First, at least 50 percent of the stock or equity of the corporation or partnership must be held by one family, with that family conducting the farming operation. Second, more than 80 percent of the value the corporation or partnership's assets must be related to the farming operation. Third, the aggregate debts must not exceed \$3,544,525 with not less than 50 percent of that arising from its farming operation. As with an individual, the \$3,544,525 debt ceiling is automatically adjusted every three years to reflect any change in the Consumer Price Index.

Since its enactment, there has been a substantial amount of litigation concerning whether a person is eligible for Chapter 12. Generally, the debtor must be actively involved in farming operations in order to be eligible. If he merely rents out his farmland for cash rent, he will not likely be found to be engaged in farming.

### **Initiating a Chapter 12 Bankruptcy**

To initiate a Chapter 12 case, a farm debtor must file a voluntary petition with the court. The debtor must also file a schedule of assets and liabilities and a statement of financial affairs. The farm debtor remains in possession of the farm assets and actions by creditors are automatically stayed. Within 90 days after filing the bankruptcy petition, the debtor must present a plan for repayment of debts to the Bankruptcy Court. A confirmation hearing to consider the plan will be scheduled soon after the filing of the plan. Chapter 12 specifically provides that, except for cause, confirmation hearings must conclude within 45 days after the filing of the plan.

### **Use of Cash Collateral/Adequate Protection**

Between the filing of the Chapter 12 petition and the confirmation hearing on the debtor's plan, the debtor will carry on the farm operation in the ordinary course of business. However, just as in a Chapter 11 bankruptcy, the debtor may not use cash collateral, such as crop or livestock proceeds, without either court or creditor approval. To obtain such approval, the debtor must provide the creditor who holds a lien on such property with "adequate protection." This protection prevents the creditor from being harmed by the debtor's use of the collateral. Similarly, a creditor may also be entitled to "adequate protection" if the creditor can show that the collateral is declining in value during the case. For example, the holder of a security interest in the farmer's equipment may claim a right to this protection for the continued use of the equipment and its depreciation in value due to such use.

Chapter 12 lists ways in which the debtor can satisfy this adequate protection requirement. Making cash payments or granting a secured creditor a replacement lien are two such ways. For real estate, the statute specifically

provides that "reasonable rent customary in the community" is sufficient. The issue of whether a crop share arrangement would be acceptable in lieu of cash rent is not addressed. However, if this type of lease is customary, such an arrangement should be satisfactory.

### **Appointment of Trustee**

Although the Chapter 12 debtor is given broad authority to operate the farm business, Chapter 12 requires that a trustee be appointed. While the farmer remains in control of the property, the trustee maintains important functions. Under Chapter 12 he or she is directed to:

1. Receive and be accountable for property and payments turned over by the debtor
2. Object to the allowance of improper claims
3. Make recommendations regarding the discharge of the debtor
4. Provide information to interested parties
5. Investigate the financial affairs of the debtor for cause
6. Investigate the operation of the farm and analyze the feasibility of continuing the business
7. Participate in valuation and confirmation hearings
8. Insure that the debtor makes timely payments under the confirmed plan

Where fraud or gross mismanagement on the part of the debtor is shown, a creditor or the trustee may move to have the trustee placed in control of the farm. The Chapter 12 trustee is paid by the debtor. In addition to the plan payments, the debtor must pay a percentage of all plan payments to the

trustee. This payment must be made at the time of the plan payment.

## **CHAPTER 12 PLAN OF REORGANIZATION**

The debtor is responsible for filing a plan for the fair repayment of debts and the reorganization of the farming operation. Unlike a Chapter 11 case, only the debtor is authorized to file a plan under Chapter 12. The plan may modify the terms of debt repayment of either secured or unsecured creditors. Moreover, the plan may provide for the curing or waiving of a default over a reasonable period of time. In addition, it may provide for the liquidation of farm collateral.

Beyond these powers, however, there are specific requirements which govern the acceptability of a Chapter 12 plan. Consistent with other chapters in the Bankruptcy Code, unsecured debts and secured debts are treated differently.

### **Unsecured Claim**

With regard to unsecured debts, two alternatives are available. Either the plan must provide for total repayment of the unsecured debt, or the debtor must agree to contribute all of his disposable income to the payment of these debts. Such repayment can be extended over a three year period; however, if cause for a longer repayment period is shown, the court may extend the term of the plan for up to five years.

If the plan does not provide for full repayment of unsecured claims, the debtor must agree to contribute his or her entire disposable income to the payment of this debt during the term of the plan. However, the statute specifically defines “disposable income” to include only that income which remains after all farm and living expenses have been paid. Again, the term of the plan must run three years or less, unless the court approves an extension. In no event may a

plan run longer than five years. Under either alternative, the plan must offer unsecured creditors at least as much as they would receive through a Chapter 7 liquidation.

### **Secured Claim**

With regard to secured debts, there are also alternatives. For the debtor's plan to be confirmed, the secured creditors must either approve the plan and retain the lien securing the claim while payments are made or receive the collateral. If the debtor's plan provides for the repayment of a secured debt, the creditor's security interest remains intact during the repayment period. The amount of the debt will generally be reduced to the present value of the secured property. Thus, the valuation of the collateral securing the secured debt is often a disputed issue.

The debtor's plan may provide for a repayment schedule which extends beyond the terms of the original secured debt. The plan itself is limited to five years, but there is an exception for specific long-term debt. Long-term debt may be paid over a period exceeding five years. Typically the repayment period is the economic life of the machinery and equipment and twenty years for real estate. During the repayment period the debtor will pay a market rate of interest on the debt.

### **Down-scaling the Farm Operation**

Another issue regarding the sale of collateral before the confirmation hearing concerns the liquidation of farm assets. Because scaling down the farm operation may be a necessary element to a successful reorganization, Chapter 12 provides that a debtor can liquidate secured assets without the permission of the secured creditor before the confirmation hearing. However, the secured creditor must be given notice and provided a hearing on such a sale, and the proceeds must be remitted to the secured creditor.

## Tax Considerations

Legislation creating Chapter 12 did not create a separate tax entity for Chapter 12 debtors. The debtor does not have the option of filing a short tax year federal return. This option is available under both under a Chapter 7 and Chapter 11 bankruptcy. Because of this, the tax options offered by Chapter 11 are not available for a Chapter 12 debtor.

In 2005, Congress amended Chapter 12 to provide debtors capital gain tax relief. Prior to 2005, a debtor in bankruptcy could sell real estate and machinery while in bankruptcy; however, any resulting capital gains from the sale of the property would be a priority claim by the government. Before 2005, the debtor would be required to pay this claim in full during the life of the plan. For a farming operation that had a very low basis in its real estate (and in some cases, its machinery), this often prevented the debtor from obtaining a discharge (or closing his or her Chapter 12 plan). When Congress amended Chapter 12 in 2005, many believed Congress intended to allow any resulting “capital gains” from the sale of assets to be treated as a general unsecured claim—a claim that does not have to be paid in full to obtain a bankruptcy discharge. However, the issue eventually went to the United States Supreme Court which held that any capital gains resulting from the sale of assets during the bankruptcy must be treated as a priority claim (and paid in full). Although the Supreme Court has not addressed, lower courts have held that the Supreme Court decision was limited to assets sold during the bankruptcy and that any capital gains resulting from assets sold before the bankruptcy is filed may be treated general unsecured claims. This remains a disputed area of law. For a discussion of these tax considerations, see another fact sheet in this series, *Tax Considerations in Liquidations and Reorganizations*.

## Confirmation

Upon confirmation of the Chapter 12 plan, both the debtor and the creditors are bound by the terms of the confirmed plan. However, unlike a Chapter 11 bankruptcy, the confirmation of a Chapter 12 plan does not discharge all debts. As discussed below, the discharge occurs upon the completion of the plan payments. The confirmation only confirms the ongoing credit relationship between the parties during the life of the Chapter 12 plan.

## POWERS OF THE DEBTOR

### Avoidance Powers

Besides continuing the business, like a trustee, the debtor in possession can avoid, or set aside, certain transactions that occurred prior to the filing of the bankruptcy case. These avoidance powers are complex, but a brief summary may be helpful.

### Preferences

The debtor in possession can avoid or recover any transfers of property he made within 90 days before the filing of the bankruptcy petition to a creditor on account of a pre-existing debt if such a transfer allows the creditor to receive more than he is otherwise entitled to. Such transfers are called preferences under the Bankruptcy Code. In general, the philosophy of the law with respect to preferential transfers is to take away from creditors any transactions that might result in an improvement in their position on the eve of bankruptcy. This philosophy is in accord with the underlying policy of the Bankruptcy Code to foster equality of treatment among creditors.

The debtor in possession may avoid the granting of any security interest, conveyances of property, or payments that were made within 90 days of the filing date. This 90-day period may be extended to one year for

transfers made to insiders. Exceptions to these preference rules are provided in cases of transfers made for new values payments for debts incurred in the ordinary course of business and the perfection of purchase money security interests within a time period required by the Uniform Commercial Code (UCC).

Not all transfers made by the debtor within 90 days of filing are avoidable, however. Transfers made for new value, payments for debts incurred in the ordinary course of business, and the perfection of purchase money security interests within the time period required by the UCC do not constitute preferential transfers.

#### **Fraudulent Transfers**

The debtor in possession also can avoid fraudulent transfers made within one year before the filing of the bankruptcy petition. Under the Bankruptcy Code, a fraudulent transfer is a transfer made with the intent to hinder, delay, or defraud a creditor. It also includes transfers for which the debtor received less than a reasonably equivalent value in exchange for the transfer.

Finally, the debtor in possession can avoid or set aside transfers that are not properly recorded or perfected under state law. These avoidance powers are potent tools that the debtor in possession can use to formulate and fund his or her plan.

#### **Executory Contracts and Leases**

The debtor in possession may assume or reject executory contracts and leases of the debtor. An executory contract is an agreement under which the obligations of both parties to the contract are unperformed. Common examples of such contracts in a farm setting include equipment leases and real property leases. Certain farm program contracts, such as Conservation Reserve

Program contracts, are also executory contracts.

If the debtor in possession elects to assume an executory contract, he must either cure any defaults in the contract or provide the other party to the contract with adequate assurances that he will cure the defaults.

A contract for deed in which the debtor is the buyer has been determined by the courts not to constitute an executory contract under the Bankruptcy Code. Therefore, the debtor in possession does not need to determine whether to assume such contracts or to cure all defaults under such contracts immediately.

#### **Conversion and Dismissal**

Chapter 12 specifically provides that a debtor may voluntarily convert a Chapter 12 bankruptcy case to a Chapter 7 bankruptcy or dismiss the case at any time (including after the confirmation of the plan). Creditors, however, may not seek the involuntary conversion of a debtor's Chapter 12 bankruptcy to a Chapter 7 bankruptcy unless fraud is shown in connection with the case. While creditors may not seek to convert a Chapter 12 case to a Chapter 7 liquidation, they may seek the dismissal of the case. Chapter 12 provides that after notice and a hearing, the court may dismiss a case for cause, including:

1. Unreasonable delay or gross mismanagement
2. Nonpayment of fees and charges required
3. Failure to file a timely plan
4. Failure to commence making timely payments under a confirmed plan
5. Denial of confirmation of a plan and denial of a request for additional time for filing of another plan or modification

6. Material default by the debtor with respect to a term of a confirmed plan
7. Revocation of the order of confirmation and denial of confirmation of a modified plan
8. Termination of a confirmed plan by reason of the occurrence of a condition specified in the plan
9. Continuing loss to or diminution of the estate, absent a reasonable likelihood or rehabilitation
10. Fraud in connection with the case

#### **Completion of Confirmed Plan/Discharge of Debts**

After completing all payments under the plan, a Chapter 12 debtor will receive a discharge of all debts that have been provided for in the plan except for long-term debt that extends beyond the life of the plan. In most cases, this means that the unsecured debt will be discharged at the end of the three to five year plan term. Any secured debt which extends beyond the term of the

plan will remain until the repayment has been completed. Chapter 12 also provides for a hardship discharge which may be granted despite the debtor's inability to complete a plan. Such a discharge is granted if the failure to complete the plan is due to circumstances for which the debtor "should not justly be held accountable." It can only be granted, however, if the unsecured creditors have received at least as much as they would have received through a Chapter 7 liquidation and if modification of the plan is not feasible.

#### **CONCLUSION**

Understanding the opportunities and limitations of Chapter 12 may also assist a family farmer with negotiating a voluntary debt restructuring agreement with his lenders. However, if such a voluntary restructuring is not possible, Chapter 12 may provide an alternative for restructuring the debt of a financially stressed family farming operation.

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