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Bruce H. Matson

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UNDERSTANDING THE NEW FAMILY FARMER BANKRUPTCY ACT

*Bruce H. Matson**

On October 27, 1986, President Reagan signed into law the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986 (the "Act").¹ The Act provides for the appointment of fifty-two additional bankruptcy judges, the expansion and finalization of the U.S. Trustee system (generally responsible for overseeing the administration of bankruptcy cases), and a new Chapter 12 in the Bankruptcy Code which provides significant new protection for "family farmers."² The Act became effective on November 26, 1986.³ This article attempts to explain the legislation by outlining the relief available to eligible debtors and its consequences for secured and unsecured creditors.

I. BACKGROUND

A. *Legislative History*

Congress enacted Chapter 12 because of the downturn in the farm economy and the perceived inability of farmers to obtain meaningful relief under the existing provisions of the Bankruptcy Reform Act of 1978 (the "Code"). The House originally sought to provide relief for family farmers by broadening the eligibility standards for Chapter 13.⁴ The Senate proposed creating a new, separate chapter for family farmers.⁵ Finally, in August 1986, both houses of Congress passed H.R. 5316. The Senate, however, in-

* Associate, McGuire, Woods, Battle & Boothe, Richmond, Virginia; A.B., 1979, College of William and Mary; J.D., 1983, Marshall-Wythe School of Law, College of William and Mary.

1. Act of October 27, 1986, Pub. L. No. 99-554, 1986 U.S. CODE CONG. & ADMIN. NEWS (100 Stat.) 3088.

2. *Id.* The Eastern District of Virginia has been authorized to receive a fourth bankruptcy judge. *Id.* § 101 (amending 28 U.S.C. § 152(a)(2)).

3. *See id.* § 302(a).

4. *See* H.R. 2211, 99th Cong., 2d Sess. (1986). H.R. 2211 resulted after hearings were held on H.R. 1397 (introduced by Hon. Peter W. Rodino) and on H.R. 1399 (introduced by Hon. Mike Synar).

5. *See* S. 2249, 99th Cong., 2d Sess. (1986).

sisted upon certain amendments and requested a conference. The conference report was completed and approved by the House and Senate in October 1986.

B. *Farmer Reorganization Problems under Chapters 11 and 13*

Prior to the enactment of Chapter 12, farmers who wished to retain their farm and reorganize their farming operations could seek relief pursuant to Chapter 11 or, in more limited circumstances, pursuant to Chapter 13. Both of these chapters, however, include restrictions that make it difficult for the family farmer to obtain relief.

Chapter 13, often referred to colloquially as "reorganization" or "Chapter 11 for individuals," provides a fairly inexpensive and streamlined procedure for debtors to readjust their financial obligations while obtaining at least a partial discharge of their debts. However, only "individual[s] with regular income" are eligible for Chapter 13 relief.⁶ Thus, farmers whose operations were incorporated or were in the form of a partnership could seek reorganization only in Chapter 11.⁷ In addition, the most troublesome hurdle for individual farmers attempting to obtain relief under Chapter 13 was the debt threshold requirements. An individual is ineligible for Chapter 13 if he has unsecured debts in excess of \$100,000 or secured debts in excess of \$350,000.⁸ Because most farmers had debt which exceeded one or both of these ceilings, Chapter 13 was usually not available.

Congress also believed that Chapter 11 did not offer a satisfactory option for farmers. The conference report summarizes the perceived problems as follows: "Many family farmers have found Chapter 11 needlessly complicated, unduly time-consuming, inordinately expensive and, in too many cases, unworkable."⁹ For example, farmers often could not obtain confirmation of a Chapter 11 plan because of the "absolute priority rule."¹⁰ In addition, because of significant administrative requirements, such as preparation and approval of a disclosure statement, Chapter 11 was considered too

6. 11 U.S.C. § 109(e) (1982).

7. See, e.g., *In re Tegtmeier*, 8 Collier Bankr. Cas. 2d (MB) 1372 (Bankr. S.D. Ohio July 21, 1983).

8. 11 U.S.C. § 109(e) (1982).

9. H.R. REP. No. 958, 99th Cong., 2d Sess. 48 (1986).

10. Generally, this rule precludes confirmation of plans without the consent of unsecured creditors unless they are paid in full. See *infra* notes 50-51 and accompanying text.

complicated and too expensive. Thus, the enactment of the new Chapter 12 is best explained by Congress' desire to make bankruptcy relief readily available to family farmers on a simple and inexpensive basis.

The political reasons for the Act cannot be overlooked. Congress conceded that the current crisis in the farm economy was a major factor in enacting this legislation. In fact, viewing the family farm amendments as a measure to deal with a temporary problem, Congress included a "sunset" provision in the Act.¹¹ Thus, Chapter 12 will be repealed automatically on October 1, 1993, unless extended by Congress.¹²

C. *Who is Eligible for Chapter 12?*

Just as Chapter 13 is not available to all debtors, new Chapter 12 is not a haven for all persons engaged in farming activities. Congress did not intend to protect large agricultural operations (such entities may seek reorganization only under Chapter 11). Rather, Chapter 12 was enacted to help "family farmers." Recognizing that family farms are not limited to individuals or sole proprietorships, Congress made Chapter 12 less restrictive than Chapter 13 in defining who was an eligible debtor. Thus, for purposes of Chapter 12, a "family farmer" is defined as: (1) an individual engaged in farming whose debts arise primarily (80%) out of a farming operation owned by such individual and whose income is derived (at least 51%) from such farming operation; or (2) a corporation or partnership engaged in farming owned (at least 51%) by one family (including relatives) which family conducts the farming operation and where at least 80% of its assets are used in and at least 80% of its liabilities arise out of the farming operation.¹³ In addition, a family farmer, whether an individual, corporation or partnership, cannot have total noncontingent debt in excess of \$1,500,000 to be eligible for Chapter 12.¹⁴ The Act does not alter

11. Act of October 27, 1986, Pub. L. No. 99-554, § 302(f), 1986 U.S. CODE CONG. & ADMIN. NEWS (100 Stat.) 3088, 3124. Senator Strom Thurmond speaking in support of the Act commented as follows: "It is important, however, that we remember that the family farm provisions of this bill are an extraordinary response to what is, hopefully, a temporary crisis." 132 CONG. REC. S15,075 (daily ed. October 3, 1986).

12. Pub. L. No. 99-554, § 302(f).

13. *Id.* § 251 (to be codified at 11 U.S.C. § 101 (17)).

14. *Id.* A husband and wife filing a joint petition, however, should not be permitted to double the \$1.5 million debt ceiling.

the Code's definition of "farming operation."¹⁵

A final eligibility requirement is that the family farmer have "regular income." Regular income, however, is defined as that which is sufficiently regular to enable the family farmer to make payments under his Chapter 12 plan.¹⁶ Because the definition of regular income is tied to making plan payments and because Chapter 12 has generous provisions for delaying repayment of debt, creditors are not likely to challenge successfully a debtor's eligibility under Chapter 12 on the basis of "regular income." Thus, while eligibility often provided a basis for challenging a Chapter 13 case, neither a farmer's debt structure, the form of his business entity, nor the definition of regular income will provide significant means for contesting a Chapter 12 petition.

II. REORGANIZATION UNDER CHAPTER 12

A. *The Plan*

Congress modeled Chapter 12 generally after Chapter 13. However, certain concepts were borrowed from Chapter 11. Similar to a Chapter 13 case, the eligible family farmer will file a plan that provides for the repayment of debts by committing periodic payments to a trustee who will forward such payments to creditors. Similar to the convention adopted in many Chapter 13 plans, Chapter 12 debtors are likely to provide for the payment of certain secured creditors "outside of the plan."¹⁷ Chapter 12 plans should not provide for payments in excess of 3 years; however, for cause the court can permit up to a 5-year plan.¹⁸ Important distinctions between Chapter 12 and Chapter 13, discussed below, demonstrate just how favorable this new legislation is for those who are eligible.

The family farmer need not file a plan for ninety days, whereas

15. Section 101(18) of the Code defines "farming operation" to include "farming, tillage of the soil, dairy farming, ranching, production or raising of crops, poultry, or livestock, and production of poultry or livestock products in an unmanufactured state." Section 101(18) is redesignated as section 101(20) by the Act. See Act of October 27, 1986, Pub. L. No. 99-554, § 251(2), 1986 U.S. CODE CONG. & ADMIN. NEWS (100 Stat.) 3088, 3104.

16. Pub. L. No. 99-554, § 251(3) (to be codified at 11 U.S.C. § 101(18)).

17. See *infra* note 29 and accompanying text.

18. Act of October 27, 1986, Pub. L. No. 99-554, § 255, 1986 U.S. CODE CONG. & ADMIN. NEWS (100 Stat.) 3088, 3110 (to be codified at 11 U.S.C. § 1222(c)). The substantive law of Chapter 12 is contained primarily in section 255 of Pub. L. No. 99-554. Therefore, for reference to the actual provisions of Chapter 12, the reader's attention is directed to the Code sections where Chapter 12 will be codified, which are delineated within section 255 and are provided in citations parenthetically.

in Chapter 13 the wage earner must file a plan within fifteen days of filing a petition for relief in bankruptcy.¹⁹ Moreover, if substantial justification is shown, the court can permit the farmer additional time to file his plan.²⁰ Similarly, although a Chapter 13 debtor must commence payments to the trustee within thirty days of filing his plan, the new Chapter 12 has no provision requiring immediate payments.²¹ Thus, a soybean farmer's plan filed in November might be confirmed even though it does not provide for any payments until harvest time in the following October. Needless to say, such a reprieve from creditor collection efforts without any corresponding burden to make periodic payments is significant if not extraordinary. Once a plan is filed the court must hold a confirmation hearing within forty-five days.²²

B. *The Trustee*

Chapter 12 requires a trustee, whose role is similar to that of the trustee in Chapter 13 cases.²³ After the trustee's confirmation, the bankrupt makes payments under the family farmer plan to the trustee who then makes disbursements to creditors in accordance with the plan. Upon completion of the plan, the family farmer receives a discharge in bankruptcy.²⁴

Despite the role of the trustee as a conduit for collecting and disbursing plan payments, the family farmer remains a "debtor in possession."²⁵ The family farmer retains possession of his assets and continues to operate his farm. The family farmer, however, can be dispossessed and the trustee placed in sole control of the

19. Compare Pub. L. No. 99-554, § 255 (to be codified at 11 U.S.C. § 1221) with 11 U.S.C. § 1321 (1982) and FED. R. BANKR. P. 3015.

20. Pub. L. No. 99-554, § 255 (to be codified at 11 U.S.C. § 1221).

21. Compare 11 U.S.C. § 1326 (1982 & Supp. III) with Pub. L. No. 99-554, § 255 (to be codified at 11 U.S.C. § 1226).

22. Pub. L. No. 99-554, § 255 (to be codified at 11 U.S.C. § 1224).

23. Compare Act of October 27, 1986, Pub. L. No. 99-554, § 255, 1986 U.S. CODE CONG. & ADMIN. NEWS (100 Stat.) 3088, 3106-07 (to be codified at 11 U.S.C. § 1202) with 11 U.S.C. § 1106 (1982 & Supp. III) (outlining duties of trustees).

24. Pub. L. No. 99-554, § 255 (to be codified at 11 U.S.C. § 1228); see also *infra* notes 77-82 and accompanying text.

25. Although not specifically set out in the legislation, as it is in Chapter 11, an overall reading of the new Act indicates that Congress intended that the Chapter 11 concept of "debtor in possession" apply in Chapter 12 cases. Compare 11 U.S.C. § 1101 (1982) with Pub. L. No. 99-554, § 255 (to be codified at 11 U.S.C. §§ 1203, 1204).

family farmer's assets if fraud or gross mismanagement is demonstrated.²⁶

The other duties of the trustee include investigating the financial affairs of the family farmer and evaluating the desirability of him continuing his business. Curiously, the Act requires the trustee to file any state or local income tax returns for the Chapter 12 debtor during the pendency of the case.²⁷ Finally, the trustee may be heard on any issue in a Chapter 12 case relating to confirmation or modification of a plan, conversion or dismissal of the case, the value of property subject to a lien and the sale of any of the farmer's property.²⁸

The trustee receives as compensation a percentage of all funds administered, up to 10%. This may increase the costs of a Chapter 12 case, yet such costs should still be significantly less than the costs in a typical Chapter 11 case. Moreover, if current practice in many Chapter 13 cases carries over to Chapter 12 cases, the debtor may avoid some of this cost by paying larger secured creditors "outside the plan" so that the trustee does not receive a fee on those payments.²⁹

C. *Treatment of Secured Creditors*

Probably the most striking provisions of the Act are those that modify the rights of secured creditors. First, in reaction to some recent case law, including a case out of the Fourth Circuit, Congress has redefined "adequate protection" for purposes of Chapter 12. In all bankruptcy cases, the filing of a bankruptcy petition stays any action by a secured creditor to repossess or foreclose on collateral.³⁰ Such creditor must request relief from the automatic stay before proceeding with his collection efforts. Typically, to defeat this request and retain the collateral, which often is land or equipment critical to any reorganization, a debtor must provide the secured creditor with adequate protection of that creditor's interest in the collateral. This usually takes the form of periodic pay-

26. Pub. L. No. 99-554, § 255 (to be codified at 11 U.S.C. § 1204).

27. *Id.* (to be codified at 11 U.S.C. § 1231(b)).

28. *See id.* (to be codified at 11 U.S.C. §§ 1202(b)(3), 1208(c), 1224).

29. Some case law provides that this practice is not authorized. *See, e.g., In re Foster*, 670 F.2d 478, 490-92 (5th Cir. 1982); *In re Hankins*, 62 Bankr. 831 (Bankr. W.D. Va. 1986). The *Hankins* decision is currently on appeal to the United States Court of Appeals for the Fourth Circuit.

30. 11 U.S.C. § 362(a) (1982).

ments to the secured creditor to protect him from a decline in the value of the collateral or from its "lost opportunity costs" resulting from being stayed from repossessing or foreclosing on the collateral.³¹ Adequate protection can also include providing the creditor with an additional or a replacement lien, or providing the creditor with some other form of compensation that the court considers the "indubitable equivalent" of the creditor's interest in the collateral.³²

For purposes of Chapter 12, Congress has rejected the interpretation of adequate protection adopted in cases such as *In re American Mariner Industries, Inc.*³³ Instead, Congress fashioned a provision that is extremely advantageous for eligible debtors. First, Congress expressly provided that the adequate protection provision applicable in all other bankruptcy cases (section 361) does not apply to Chapter 12 cases.³⁴ In so doing, Congress has attempted to insulate family farmers from being required to make large adequate protection payments to creditors that might be required by section 361 of the Code and current case law such as *American Mariner*, particularly with respect to compensation for a creditor's lost opportunity costs arising from being unable to resell the collateral and reinvest the proceeds.³⁵

Second, Congress has provided that payment of "reasonable rent customary in the community where the property is located" constitutes adequate protection.³⁶ This rent is to be based upon the "rental value, net income, and earning capacity of the property."³⁷ Although the Chapter 12 provision retains most of section 361, it is likely that the "customary rent" standard will be most often relied upon to provide secured creditors with adequate protection and, thereby, prevent a creditor from obtaining relief from the auto-

31. Currently, there is considerable debate regarding recovery of lost opportunity costs to undersecured creditors. Compare *In re American Mariner Indus., Inc.*, 734 F.2d 426, 430-31 (9th Cir. 1984) (ordering adequate protection payments to cover these costs) with *In re Timbers of Inwood Forest Assoc.*, 793 F.2d 1380, 1382, 1407-08 (5th Cir. 1986) (rejecting the requirement for adequate protection payments). Before the *Timbers* decision, the Fourth Circuit adopted the *American Mariner* approach to lost opportunity costs in *Grundy National Bank v. Tandem Mining Corp.*, 754 F.2d 1436, 1440-41 (4th Cir. 1985).

32. See 11 U.S.C. § 361 (1982).

33. 734 F.2d 426 (9th Cir. 1984); see H.R. REP. NO. 958, 99th Cong., 2d Sess. 49-50 (1986).

34. Act of October 27, 1986, Pub. L. No. 99-554, § 255, 1986 U.S. CODE CONG. & ADMIN. NEWS (100 Stat.) 3088, 3107 (to be codified at 11 U.S.C. § 1205(a)).

35. See *supra* note 32.

36. Pub. L. No. 99-554, § 255 (to be codified at 11 U.S.C. § 1205(b)(3)).

37. *Id.*

matic stay to foreclose. It is anticipated that such "rental" payments will be considerably less than the amount the family farmer would otherwise have to pay the secured creditor as adequate protection.

Once the family farmer has held off the secured creditor's repossession or foreclosure efforts by providing adequate protection, he should attempt to bind the secured creditor to his Chapter 12 plan. Unlike Chapter 11, Chapter 12, in a fashion similar to Chapter 13, does not require creditors to vote for or against a Chapter 12 plan. Nonetheless, a secured creditor can be bound to such a plan if he retains his lien and receives payments under the plan which are equivalent to the present value of the property securing the creditor's claim.³⁸ Under Chapter 12, a family farmer may modify the rights of secured creditors by structuring repayment over a length of time in excess of the statutory length of the plan.³⁹ In addition, to the extent that the creditor's claim exceeds the value of the collateral, it will be treated as an unsecured claim.⁴⁰

Thus, a creditor owed \$100,000 from a family farmer that is secured by tractors and equipment valued at \$70,000 will have a secured claim of \$70,000 and an unsecured claim of \$30,000. The creditor can be forced to accept a plan whereby the family farmer pays \$10,000 per year for seven years plus interest on the secured portion of his claim. The interest payment satisfies the requirement that the creditor receive the present value of its secured claim. Chapter 12 cases will likely involve more litigation over the issue of the appropriate discount rate than there has been in Chapter 13 cases because of the farmer's greater ability to alter the term of secured obligations under Chapter 12. The rights of the creditor with respect to the unsecured portion of its claim are discussed below.⁴¹

Chapter 12 significantly differs from Chapter 13 with respect to the rights of creditors secured by the debtor's principal residence. Under Chapter 13, a debtor may use his Chapter 13 plan to cure any arrearages due on his home mortgage and reinstate its terms.⁴² He is prohibited, however, from modifying that obligation in any

38. *See id.* (to be codified at 11 U.S.C. § 1225(a)(5)(B)).

39. *Id.* (to be codified at 11 U.S.C. §§ 1222(b)(9), 1225(a)(5)).

40. 11 U.S.C. § 506(a) (1982).

41. *See infra* notes 50-59 and accompanying text.

42. 11 U.S.C. §§ 1322(b)(2), (5) (1982).

other way.⁴³ Chapter 12 removes this prohibition.⁴⁴ Thus, the family farmer can, in effect, refinance his mortgage without the consent of the mortgagee.

A Chapter 12 plan may also provide for the sale of all or a portion of the property securing a creditor free and clear of such creditor's lien.⁴⁵ This provision expands the rights of debtors in a Chapter 11 proceeding regarding sales of property.⁴⁶ Under state law, a lender holding a mortgage against a 1,000-acre farm could not be required to release his lien on 250 acres of that farm unless the *entire* debt was satisfied. In Chapter 11 or 13, that same lender could prevent the proposed sale of the 250 acres unless the sale proceeds would fully satisfy the farmer's debt to the lender. Therefore, absent the new Chapter 12 provision, the lender could successfully object to a farmer's proposed sale of the 250 acres even though such scaling down of the farmer's operations would assist his reorganization.

Thus, the new legislation permits the family farmer to sell off parcels of farmland or items of farm equipment without regard to blanket liens, provided that the creditor's lien attaches to the sale proceeds. Although notice and a hearing is required, a creditor's only apparent basis for objecting to the proposed sale is that the projected sale proceeds are less than the fair market value of the property being sold. Presumably the creditor is permitted to credit bid at any public sale.⁴⁷

The conference report states that "[m]ost family farm reorganizations, to be successful, will involve a sale of unnecessary prop-

43. *Id.*

44. Compare 11 U.S.C. § 1322(b)(2) (1982) with Pub. L. No. 99-554, § 255 (to be codified at 11 U.S.C. § 1222(b)(2)).

45. See Pub. L. No. 99-554, § 255 (to be codified at 11 U.S.C. § 1206). The language of section 1206 limits this power of sale to the trustee; however, the author has assumed that the family farmer, as debtor-in-possession, may exercise the rights of a trustee under section 1206 as well as the other rights and powers generally available to trustees, such as recovering preferences, 11 U.S.C. § 547 (1982), and avoiding landlord's liens, 11 U.S.C. § 545 (1982). Compare Pub. L. No. 99-554, § 255 (to be codified at 11 U.S.C. § 1203) with 11 U.S.C. § 1107 (1982). Such sales by farmers in Chapter 12 was certainly contemplated by Congress. See H.R. REP. NO. 958, 99th Cong., 2d Sess. 50 (1986) ("This section [§ 1206] . . . allows Chapter 12 debtors to scale down the size of their farming operations by selling unnecessary property").

46. Under Chapter 11, a farmer can only utilize the sale provisions of 11 U.S.C. § 363 (1982).

47. Compare Pub. L. No. 99-554, § 255 (to be codified at 11 U.S.C. § 1206) with 11 U.S.C. § 363(k) (Supp. II 1984).

erty."⁴⁸ Accordingly, the provision is designed to permit the family farmer to scale down his operation. The danger to the secured creditor is that piecemeal division of the farmland might ultimately impair the value of the collateral as a whole. In other words, if the sum of the parts is not greater than the whole, this provision may impair secured creditors' recoveries. Similarly, hasty disposal of currently unutilized or underutilized farmland will foreclose the creditor's ability to obtain a greater recovery if the farm economy rebounds and farmland values appreciate.⁴⁹

D. *Treatment of Unsecured Creditors*

Unsecured creditors, including the unsecured portion of the debt held by secured creditors, are treated in a manner identical to Chapter 13. This means that there is no provision in Chapter 12 similar to the "absolute priority rule" in Chapter 11, which generally precludes confirmation of plans without consent of unsecured creditors unless they are paid in full.

In Chapter 11, the unsecured creditors vote for or against the debtor's proposed plan of reorganization. If the unsecured creditors vote against the plan, the debtor can achieve confirmation through a "cram down," which involves satisfying the "absolute priority rule."⁵⁰ The absolute priority rule has been consistently applied as prohibiting equity security holders (e.g., shareholders) from retaining ownership of an entity (e.g., a corporation) where unsecured creditors receive less than full payment.⁵¹ Thus, just as the debt requirements severely limited farmers' access to Chapter 13, the absolute priority rule made confirmation of Chapter 11 plans very difficult for farmers. Unless farmers could discharge some of their unsecured debt, however, reorganization was unlikely

48. H.R. REP. No. 958, 99th Cong., 2d Sess. 50 (1986).

49. Chapter 12 does not provide for an election similar to the § 1111(b) election in Chapter 11 that permits secured creditors to waive their deficiency claims and retain their lien against the collateral in the full amount of their claim. See *In re Hallum*, 29 Bankr. 343 (Bankr. E.D. Tenn. 1983). But see *In re Ahlers*, 794 F.2d 388, 401 (8th Cir. 1986). For a general discussion of the § 1111(b) election see Pursateri, Swartz & Shaiken, *Section 1111(b) of the Bankruptcy Code: How Much Does the Debtor Have to Pay and When Should the Creditor Elect?*, 58 AM. BANKR. L.J. 129 (1984).

50. 11 U.S.C. § 1129(b)(2)(B)(ii) (1982 & Supp. III). Confirmation of a Chapter 11 plan pursuant to section 1129(b) is often referred to as "cram down" because the debtor can obtain information despite the fact that creditors vote against the proposed plan.

51. See, e.g., *In re Stegall*, 64 Bankr. 296 (Bankr. C.D. Ill. 1986); *In re Pecht*, 57 Bankr. 137 (Bankr. E.D. Va. 1986); *In re Pine Lake Village Apartment Co.*, 19 Bankr. 819 (Bankr. S.D.N.Y. 1982); *In re Landau Boat Co.*, 8 Bankr. 436 (Bankr. W.D. Mo. 1981).

if not impossible. The absence of the absolute priority rule in Chapter 12, therefore, is significant.

Unsecured creditors do not vote for or against a Chapter 12 plan. Two basic provisions found in Chapter 12, however, provide some protection for unsecured creditors. First, a plan cannot be confirmed unless unsecured creditors receive as much under the plan as they would in a Chapter 7 liquidation of the family farm. This typically is referred to as the "liquidation analysis."⁵² Under this analysis the debtor's equity (the value of the debtor's assets less the amount of any liens) in his non-exempt assets, when divided by all unsecured claims, must not exceed the percentage repayment to unsecured creditors proposed under the plan. The following illustration may be helpful. Assume that Joe Farmer has the following assets and liabilities:

<u>Assets</u>		<u>Liabilities</u>	
Residence	70,000	Home Mortgage	50,000
Farmland	200,000	Farm & Equipment Lien	275,000
Farm Equipment	100,000	Automobile Liens	15,000
Automobiles	20,000	Unsecured Loans	60,000
Personal Effects	10,000	Trade Debt (unsecured)	<u>140,000</u>
Investments/Cash	<u>5,000</u>		540,000
	405,000		

Based upon the foregoing, Joe Farmer has equity in the following amounts:

Residence	20,000
Farmland & Equipment	25,000
Automobiles	5,000
Personal Effects	10,000
Investments/Cash	5,000

Assume also that Joe Farmer claims the following exemptions:⁵³

Homestead:	5,000 in residence
Poor Debtors:	All personal effects

Equity After Exemptions	= 50,000
Unsecured Claims	= 200,000

52. Act of October 27, 1986, Pub. L. No. 99-554, § 255, 1986 U.S. CODE CONG. & ADMIN. NEWS (100 Stat.) 3088, 3111 (to be codified at 11 U.S.C. § 1225(a)(4)).

53. See, e.g., VA. CODE ANN. §§ 34-4, 34-26 (Repl. Vol. 1984 & Cum. Supp. 1986). For the sake of simplicity, this article has ignored additional exemption rights that farmers have in many jurisdictions. See, e.g., VA. CODE ANN. § 34-27 (Repl. Vol. 1984 & Cum. Supp. 1986).

In liquidation, unsecured creditors would receive twenty-five cents on the dollar. Thus, under the liquidation test, Joe Farmer's Chapter 12 plan can only be confirmed if he pays at least twenty-five percent of his unsecured debt. Recall that if the absolute priority rule did apply in Chapter 12, the farmer's plan could not be confirmed without unsecured creditor consent because the farmer's retention of his assets (assuming no new equity investment) is considered the receipt of property by a junior class.

The second provision provides that if an unsecured creditor objects to confirmation, the plan can be confirmed only if all unsecured claims are paid in full or the debtor commits all of his disposable income to the plan for distribution thereunder.⁵⁴ "Disposable income" is defined as that income not reasonably necessary for: (1) support of the debtor and the debtor's dependents; or (2) continuation and operation of the debtor's business.⁵⁵ This provision is also in Chapter 13, and has not generated the amount of litigation over reasonable living expenses that one might have expected.

An initial reading of the disposable income requirement suggests that by objecting to confirmation, the objecting creditor may be able to "coerce" the farmer into providing a more favorable treatment to such creditor to get the plan confirmed.⁵⁶ A review of the restrictions on classification of claims, however, reveals that generally the "squeaky wheel" approach should not be fruitful. A plan cannot provide disparate treatment to similar claims.⁵⁷ Creating a separate class for an objecting creditor would preclude a plan's confirmation because classification schemes cannot discriminate unfairly. Therefore, one trade creditor cannot obtain 100% repayment by objecting while other trade creditors receive twenty cents on the dollar. However, some discrimination, such as preference for

54. Pub. L. No. 99-554, § 255 (to be codified at 11 U.S.C. § 1225(b)(1)).

55. *Id.* (to be codified at 11 U.S.C. § 1225(b)(1), (2)). The conference report states that to the extent farmers are involved in "minor businesses not directly related to the farming operation," the expenses of operating such businesses will be included in defining "disposable income." H.R. REP. No. 958, 99th Cong., 2d Sess., pt. 2, at 50 (1986).

56. Section 1225(b)(1) states that if "the holder of an allowed unsecured claim objects to the confirmation of the plan, then the court may not approve the plan unless, . . . the value of the property to be distributed under the plan *on account of such claim* is not less than the amount of such claim." Pub. L. No. 99-554, § 255 (to be codified at 11 U.S.C. § 1225(b)(1)) (emphasis added).

57. Pub. L. No. 99-554, § 255 (to be codified at 11 U.S.C. §§ 1222(a)(3), (b)(1) & 1225(a)(1)).

creditors holding nondischargeable claims⁵⁸ or consumer claims guaranteed by a relative,⁵⁹ may be permitted.

E. *Additional Remedies for Creditors*

In the event that a creditor is dissatisfied with or does not trust the family farmer, it may seek additional supervision over him or seek to have his assets liquidated. Specifically, creditors may seek: (1) dismissal of the bankruptcy case; (2) conversion of the bankruptcy case to Chapter 7 or 11; or (3) removal of the family farmer as debtor in possession and appointment of the trustee.⁶⁰

1. Dismissal

Creditors can seek dismissal of a Chapter 12 case thereby allowing them to pursue usual state law remedies if they can show any of the following: (1) unreasonable delay; (2) gross mismanagement; (3) failure to file a timely plan; or (4) failure to commence making timely plan payments.⁶¹ Borrowing from case law developed in Chapter 13 cases, creditors may also be able to seek dismissal for "bad faith" filings.⁶² However, because the discharge provisions are less generous in Chapter 12, it is anticipated that "bad faith" allegations will be less likely, or at least less successful than has been the case under Chapter 13. It should be noted here that an amendment contained in the Act now permits the court to dismiss a case under any chapter *sua sponte*.⁶³

2. Conversion

Although a Chapter 12 debtor may convert to Chapter 7 at any time, a creditor's right to seek conversion of a Chapter 12 case to a liquidation proceeding pursuant to Chapter 7 is very limited. In

58. *See id.* (to be codified at 11 U.S.C. § 1222(b)(1)).

59. *Id.*

60. *See* Act of October 27, 1986, Pub. L. No. 99-554, § 255, 1986 U.S. CODE CONG. & ADMIN. NEWS (100 Stat.) 3088, 3108-09 (to be codified at 11 U.S.C. § 1208(c), (d)).

61. Act of October 27, 1986, Pub. L. No. 99-554, § 255, 1986 U.S. CODE CONG. & ADMIN. NEWS (100 Stat.) 3088, 3108-09 (to be codified at 11 U.S.C. § 1208(c)).

62. *See, e.g.,* Neufeld v. Freeman, 794 F.2d 149 (Bankr. 4th Cir. 1986); Deans v. O'Donnell, 692 F.2d 968 (Bankr. 4th Cir. 1982); *In re* McAloon, 1984-85 Bankr. L. Rep. (CCH) ¶ 70,187 (Bankr. E.D. Va. Dec. 3, 1984).

63. Pub. L. No. 99-554, § 203 (to be codified at 11 U.S.C. § 105(a)); *cf. In re* Gusam Restaurant Corp., 737 F.2d 274 (2d Cir. 1984) (decided prior to the Act) and Brockenbrough v. Comm'r, 61 Bankr. 685 (Bankr. W.D. Va. 1986).

Chapter 12, a creditor can only seek conversion upon a showing of fraud by the debtor in connection with the case.⁶⁴ Surprisingly, this is more generous to creditors than Chapters 11 or 13 where a creditor cannot seek conversion for any reason if the debtor is a farmer.

Conversion is often a preferred remedy when creditors are faced with an incapable or untrustworthy debtor because some control is exerted over the debtor's assets. Limiting conversion to cases of fraud means that creditors dissatisfied with the progress of a Chapter 12 case will have to resort to a dismissal, often prolonging the chaos, encouraging unequal dismemberment of the debtor's assets and leaving the debtor in control to dissipate and/or transfer assets.

Presumably the restriction on conversion is akin to the Code prohibition of involuntary bankruptcy cases against farmers.⁶⁵ The legislative history suggests that this additional protection was provided to farmers because of the cyclical nature of the farming business. Thus, just as one drought year should not cause a farmer to be subjected to involuntary bankruptcy, the same policy dictates that such exigencies should not create a basis for conversion to, and liquidation under, Chapter 7.

Similarly, Chapter 12 does not permit a creditor to seek conversion to Chapter 11 or 13 under any circumstances.⁶⁶ Under Chapter 11, a creditor could impose liquidation on a farmer in a limited way by filing a liquidation plan after the farmer's exclusive period for filing a plan (generally 120 days) has expired.⁶⁷ The original House Bill attempted to ameliorate this possibility by suggesting an amendment to the conversion section in Chapter 11 to provide a longer (240 day) exclusive period for farmers.⁶⁸ Because Congress opted for a separate chapter, this amendment to Chapter 11 does not appear in the new legislation. In Chapter 12, however, neither the trustee nor creditors can propose a plan.⁶⁹ Although the trustee

64. Pub. L. No. 99-554, § 255, 1986 U.S. CODE CONG. & ADMIN. NEWS (100 Stat.) 3088, 3109 (to be codified at 11 U.S.C. § 1208(d)).

65. See 11 U.S.C. § 303(a) (1982).

66. See Pub. L. No. 99-554, § 255 (to be codified at 11 U.S.C. § 1208(a)(d)).

67. See, e.g., *In re Jorgensen*, 3 Bankr. L. Rep. (CCH) ¶ 71,489 (Bankr. 9th Cir. Sept. 16, 1986); *In re Button Hook Cattle Co.*, 747 F.2d 483 (Bankr. 8th Cir. 1984); *In re Jasik*, 727 F.2d 1379 (5th Cir. 1984); *In re Huebner*, 58 Bankr. 600 (Bankr. W.D. Wis. 1986).

68. See H.R. 2211, 99th Cong., 2d Sess. (1986) and H.R. REP. No. 178, 99th Cong., 1st Sess. 4-5 (1985).

69. Pub. L. No. 99-554, § 255 (to be codified at 11 U.S.C. § 1221); S. REP. No. 989, 95th

and creditors cannot file a liquidation plan in Chapter 12, a family farmer arguably could be liquidated if the debtor is dispossessed and the trustee utilizes the Chapter 12 provision authorizing the sale of the debtor's property.⁷⁰

The Act does not authorize the Chapter 12 debtor to convert to Chapter 11 or 13. This may have been a legislative oversight. Nothing appears in the conference report to suggest Congress' intentions. In the event that courts strictly construe the Chapter 12 conversion provision, Chapter 12 debtors may be able to dismiss their case and refile under the desired chapter. Such dismissals and refilings should be permitted where the debtor is ineligible for Chapter 12, or where the change can be shown to cause no prejudice to creditors. It must be noted, however, that the Code prohibits a debtor from refile for 180 days after a voluntary dismissal if such dismissal was subsequent to a creditor's request for relief from the automatic stay.⁷¹

3. Dispossession of the Family Farmer

Creditors can also seek to have the trustee appointed to take sole control over the assets of the family farmer.⁷² This, of course, is in addition to the trustee's other roles of investigating the debtor's financial affairs and administering a confirmed plan. However, the creditor must demonstrate fraud or gross mismanagement by the debtor before the court can remove the family farmer from control of the farming operations and assets.⁷³ It is significant to note that in most situations the debtor apparently could have the case dismissed if the trustee were placed in control, thereby regaining control over his farm and assets. Thus, creditors with grounds for removing the debtor may want to include a request for conversion of the case to Chapter 7, which, if successful, would preclude the debtor's dismissal of the case.⁷⁴

Cong., 2nd Sess. 141 (1978); *see also* H.R. REP. NO. 595, 95th Cong., 1st Sess. 428 (1977).

70. *See* Pub. L. No. 99-554, § 255 (to be codified at 11 U.S.C. § 1206).

71. 11 U.S.C. § 109(f) (Supp. III 1985).

72. Pub. L. No. 99-554, § 255 (to be codified at 11 U.S.C. § 1204(a)).

73. Act of October 27, 1986, Pub. L. No. 99-554, § 255, 1986 U.S. CODE CONG. & ADMIN. NEWS (100 Stat.) 3088, 3107 (to be codified at 11 U.S.C. § 1204(a)).

74. Pub. L. No. 99-554, § 255 (to be codified at 11 U.S.C. § 1208(b)). Presumably, section 1208(b) should also provide that the debtor may dismiss if the case has not been converted under section 1208(d). The absence of such a provision makes questionable the author's conclusion regarding the debtor's inability to dismiss if converted due to fraud.

Congress apparently anticipated that when the family farmer is removed for fraud or incompetence the trustee (or his designee) would operate the farm. Arguably, the trustee could employ some other farmer on a salary or commission basis to operate the farm. As a practical matter, however, the only function the trustee can reasonably serve in such a situation is to oversee the operations of the debtor.

F. *Post-Confirmation*

After the court confirms a Chapter 12 plan, the family farmer must make payments to the trustee who will forward them to the appropriate creditors. Confirmation of a plan binds all parties in interest whether they accepted or objected to its terms.⁷⁵ Confirmation of a plan also causes all property to revert in the family farmer.⁷⁶

Under a confirmed plan, priority creditors such as the debtor's attorney, the trustee, and taxing authorities usually get paid first.⁷⁷ At a minimum, any priority creditors must be paid in full over the life of the plan.⁷⁸ Secured creditors usually are paid currently or at least regularly, and unsecured creditors often must wait until the second or third (and sometimes fourth or fifth) year of a confirmed plan to receive any distribution. The controversy existing in Chapter 13 cases over whether zero payment plans, i.e., plans where unsecured creditors receive nothing, should be confirmed is likely to arise in Chapter 12 cases also.⁷⁹

The Act permits a Chapter 12 debtor to modify a plan after confirmation to increase or reduce payments in the event that the debtor's financial situation improves or deteriorates.⁸⁰ This provision also permits an unsecured creditor to seek modification to increase payments.⁸¹ Thus, if a creditor knows of the debtor's improved financial position, it may petition the court to increase his percentage repayment. This remedy appears to be little known, or

75. Act of October 27, 1986, Pub. L. No. 99-554, § 255, 1986 U.S. CODE CONG. & ADMIN. NEWS (100 Stat.) 3088, 3112 (to be codified at 11 U.S.C. § 1227(a)).

76. *Id.* (to be codified at 11 U.S.C. § 1227 (b)).

77. *Id.* (to be codified at 11 U.S.C. § 1222(a)(2)).

78. *Id.*

79. See, e.g., *In re Gregory*, 705 F.2d 1118 (9th Cir. 1983); *In re Greer*, 60 Bankr. 547 (Bankr. C.D. Cal. 1986); see also *In re Pecht*, 53 Bankr. 768 (Bankr. E.D. Va. 1985).

80. Pub. L. No. 99-554, § 255 (to be codified at 11 U.S.C. § 1229).

81. *Id.*

at least seldom used by creditors, possibly due to the need to monitor the debtor's situation and the infrequency with which significant improvements occur. Finally, if the debtor obtained confirmation of his plan through fraud, any party in interest can seek an order from the court revoking confirmation of a Chapter 12 plan.⁸²

G. *Discharge and Dischargeability*

The family farmer who successfully completes a confirmed plan will receive a discharge of all debts covered by the plan.⁸³ Of course, this does not mean that secured claims that are continued beyond the length of the plan are discharged.⁸⁴ However, even if the family farmer does not complete his plan, the court can grant a "hardship discharge" if he has paid at least as much to unsecured creditors as they would have received under the liquidation analysis, if modification of the plan is not practicable, and if the debtor's failure to complete the plan is due to circumstances for which he should not be held accountable.⁸⁵

Certain debts are excepted from any discharge a debtor receives under Chapter 12. Specifically, section 523(a) of the Code, which applies in Chapter 12, excepts the following debts from being discharged: taxes, fraud debts, unscheduled debts, debts arising from a defalcation while acting in a fiduciary capacity, support obligations, willful and malicious torts, fines, educational loans, and judgments against the debtor as a result of a vehicular accident occurring while the debtor was intoxicated.⁸⁶ This differs significantly from Chapter 13 where the debtor receives a broad discharge from all liabilities and debts except alimony and support obligations.⁸⁷

The Chapter 12 discharge provisions may be the only creditor-oriented aspect of the Act. Creditors holding nondischargeable claims should act promptly to file complaints seeking a determina-

82. Pub. L. No. 99-554 § 255 (to be codified at 11 U.S.C. § 1230).

83. Act of October 27, 1986, Pub. L. No. 99-554, § 255, 1986 U.S. CODE CONG. & ADMIN. NEWS (100 Stat.) 3088, 3112 (to be codified at 11 U.S.C. § 1228(a)).

84. *Id.*

85. *Id.* (to be codified at 11 U.S.C. § 1228(b)).

86. See 11 U.S.C. 523(a)(1982 & Supp. III); Pub. L. 99-554, § 255 (to be codified at 11 U.S.C. § 1228(a)(2)).

87. 11 U.S.C. § 1328 (1982). In addition, most tax obligations must be paid in full in any Chapter 13 case because section 1322(a)(2) requires that section 507 claims be paid in full, and section 507(a)(7) addresses tax obligations. See 11 U.S.C. §§ 1322(a)(2), 507(a)(7).

tion of the nondischargeable nature of their claim. In addition, creditors holding nondischargeable claims should consider insisting that the Chapter 12 debtor classify such claim separately and provide for a more favorable treatment (e.g., 100% repayment) of such claims in the plan. As suggested above, this should be a reasonable classification of claims.⁸⁸

H. *Co-Debtor Stay*

Chapter 12 has a "co-debtor stay" provision nearly identical to that found in Chapter 13.⁸⁹ In essence, this stay broadens the reach of the automatic stay to protect, at least temporarily, certain parties that are liable with the Chapter 12 debtor for consumer debts. This co-debtor stay is not found in either Chapter 7 or 11. The legislative history to the Chapter 13 co-debtor stay states: "It is designed to protect a debtor operating under a Chapter 13 individual repayment plan case by insulating him from indirect pressures from his creditors exerted through friends and relatives that may have co-signed an obligation of the debtor."⁹⁰ Presumably it appears in Chapter 12 for similar reasons. It is important to recall that this provision applies only to consumer debts, offers only limited protection when applicable, and provides creditors with a simple and expedient procedure for obtaining relief.⁹¹

I. *Effect on Pending Cases*

Because of the very generous provisions contained in the Act for family farmers, it is likely that many of those eligible under Chapter 12, but currently in a Chapter 7, 11, or 13 proceeding, will want to convert their cases to the new chapter. The conference report anticipates this desire and *apparently* authorizes conversions from Chapters 7, 11, or 13 to Chapter 12, but "only where it is equitable to do so."⁹² Routine conversion of pending cases is not intended.

88. See *supra* note 56 and accompanying text. This strategy should be particularly useful in farm bankruptcies where the debtor has sold collateral without secured creditor consent. See, e.g., *Clark v. Taylor*, 58 Bankr. 849 (Bankr. E.D. Va. 1986).

89. Act of October 27, 1986, Pub. L. No. 99-554, § 255, 1986 U.S. CODE CONG. & ADMIN. NEWS (100 Stat.) 3088, 3105-06 (to be codified at 11 U.S.C. § 1201). The co-debtor stay should not prove to be a significant hurdle for most creditors. Significant farm debt, such as equipment financing is not likely to be characterized as a "consumer debt." See, e.g., *In re Ikeda*, 37 Bankr. 193 (Bankr. D. Haw. 1984).

90. H.R. REP. No. 595, 95th Cong., 1st Sess. 426 (1977).

91. See Pub. L. No. 99-554, § 255 (to be codified at 11 U.S.C. § 1201).

92. H.R. REP. No. 958, 99th Cong., 2d Sess. 48 (1986).

To accommodate such conversions, sections 706, 1112, and 1307 of the Code have been amended as part of the Act.⁹³ However, the provisions relating to the effective dates of the Act state that the family farmer amendments to the Bankruptcy Code "shall not apply with respect to cases commenced under title 11 of the United States Code before the effective date of this Act."⁹⁴ Thus, despite the admonitions and apparent intentions of the conference committee, the better interpretation of the statute is that debtors currently in a Chapter 7, 11, or 13 proceeding cannot convert their cases to the new Chapter 12.

III. CONCLUSION

Congress has responded to the current crisis in the farm economy by enacting a broad, remedial statute which provides extraordinary relief for those eligible. Creditors should expect delay and uncertainty as farmers take advantage of this new legislation. The prospects of dealing with a farmer under Chapter 12, however, may further discourage lenders from making credit readily available to the farm community. Considering that 90% of this country's farmers do not have debt in excess of \$1.5 million and that 40% of farm loans are currently under-collateralized,⁹⁵ the need for new bankruptcy judgeships and for an expanded U.S. Trustee System may have been severely underestimated. Moreover, the need for counseling and representation by both creditors and debtors alike is likely to be significant.

93. See Act of October 27, 1986, Pub. L. No. 99-554, §§ 229, 256, 257(q), 1986 U.S. CODE CONG., & AD. NEWS (100 Stat.) 3102 (to be codified at 11 U.S.C. § 701).

94. Pub. L. No. 99-554, § 302(c) (1986).

95. 132 CONG. REC. S15,075, S15,092 (daily ed. October 3, 1986).

