

AN OVERVIEW OF CHAPTER 12 BANKRUPTCY  
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The Family Farm Bankruptcy Act of 1986 was signed by the President on October 27, 1986, and became effective on November 26, 1986. The law will terminate on October 1, 1993 unless the legislature extends it.

Although the new law has received positive review, its use by any farm family should be carefully evaluated by both the family and their counselors. There are advantages and disadvantages to the law.

There are now four different bankruptcy provisions which farmers can use: These are: Chapters 7, 11, 12 and 13. For most farmers the choice will be either Chapter 7 or 12. For tax reasons there are a few situations where a Chapter 11 may be the better choice.

Chapter 12 was written specifically for farm families in light of the current financial dilemma. Courts are expected to make rulings in consideration of this legislative objective that will be of assistance to farmers. This does not mean that all farmers will be able to be successful as they work through a Chapter 12. However, the success rate should be better than has been experienced when using Chapter 11.

The purpose of Chapter 12 is similar to the other provis-

ions of bankruptcy, to provide a fresh start. When more loans are owed then can possibly be paid, debtors are not put in jail but rather the law provides a way of giving them a chance for a new start.

Even if Chapter 12 does appear to be more favorable to farm debtors than the other relief provisions of bankruptcy, one must realize that it is still bankruptcy. Once bankruptcy is filed the debtor is under the jurisdiction of the court. This jurisdiction continues until a discharge has been obtained from the court. Also, there is a stigma which goes with bankruptcy even though it is less than a few years ago.

Chapter 12 relies on many of the concepts of other chapters in the bankruptcy code. Some of these important concepts are automatic stay, adequate protection, priorities of claims, discharge, non discharable claims, fradulent transfers, and preferential transfers. Many of these concepts are not discussed in detail within this paper.

This is a new law and it is expected that several court interpretations will have to be made in the next few months. This being the case, some court procedures will be slowed and additional costs may be incurred by those helping to determine the parameters of the new law.

There continues to be the question of how long negotiations outside of bankruptcy should first be pursued. Many farmers, creditors and their respective counselors have worked hard at finding solutions outside of bankruptcy. Some counselors feel creditors may be even more willing to negotiate before a bankruptcy is filed with the advent of the new Chapter 12 and the favoritism it may present to farmers.

Any farmer electing to file a Chapter 12 will want to be ready to aggressively proceed to develop a work out plan. The debtor is responsible for presenting a plan for restructuring the debt within 90 days of filing. With a Chapter 11 the plan must be presented within 120 days and many of those plans have not been timely filed. The new law allows extensions beyond the 90 day period but this is one provision where courts are expected to monitor closely and to grant extensions sparingly. Under a Chapter 11 creditors are permitted to file a plan if the debtor does not timely file. Under Chapter 12 the creditors do not have the option of filing a plan, rather they can ask to have the case dismissed. Some attorneys are suggesting the plan should be prepared before filing for bankruptcy under this new law.

The plan presented by the farmer is the proposal for restructuring payments to creditors. Within that plan secured creditors are to receive amortized payments based upon the worth of the

assets in which they have security as of the date of filing. Many secured creditors actually have a portion of their debt which is unsecured because the fair market value of the secured assets has dropped below the outstanding loan. The plan must also set forth how unsecured creditors will be paid. Many times unsecured creditors receive little or nothing. The assurance unsecured creditors are to have with a Chapter 12 is that they receive the same amount as they would under a Chapter 7 liquidation. That concept has not changed from that of a Chapter 11 or 13.

A Chapter 12 plan is to be accomplished within three years but the court can grant an extension up to five years. Secured creditor's loans need to be amortized over some reasonable length of time commensurate with traditional loans for the subject assets. Loans secured by real estate, equipment, and breeding livestock may not be able to be paid off during the three to five year period but may be put on a payment schedule which is feasible and practicable for the type of asset. The unsecured creditor portion of the debt will need to be paid within the three to five year period in an amount at least equal to what they would have received if the assets had been liquidated on the date of filing.

One of the provisions of Chapter 12 which makes it more favorable for farmers than Chapter 11 is that unsecured creditors cannot vote for or against the acceptance of the plan. Secured creditors do

have a right to vote. Unsecured creditors can file an objection to the plan with the court and if that is done then the court must be sure the plan provides for payment in full of unsecured claims OR that all of the debtors disposable income is used to make payments under the plan. Disposable income means income which is received by the debtor and which is not reasonably necessary to expend for (a) the maintenance or support of the debtor and dependents of the debtor; or (b) the payment of expenditures necessary for the continuation, preservation, and operation of the debtor's business. It is this proviso that only the disposable income be used to fund the plan which causes unsecured creditors to be paid less than their claim.

The adequate protection portion of Chapter 12 law has caused concern for secured creditors. The adequate protection provided to secured creditors can be met in one of four ways: requiring payments to secured creditors for any decrease in value of the secured property; allowing an additional lien in property of the estate to offset any decreasing value of secured property; providing reasonable rent payments to the secured party for farmland; or granting other relief which will adequately protect the secured party.

Creditors have been concerned about the possibility of reducing payments made on farmland to the fair rental value. For many farmers the debt payments on farmland are considerably greater than

today's rental market. The possibility of obtaining adequate protection for creditors is granted until a plan gets confirmed. With the shortened time for filing a plan, 90 days from date of filing bankruptcy plus the period of 45 days until confirmation of the plan, at most only 135 days should pass until a creditor's payments are provided for under the plan. After this analysis most creditors should not be so concerned about the possibility of reduced adequate protection until the plan is confirmed.

The debtor, the secured creditors and the unsecured creditors are all going to be very interested in the value placed on assets. Each of the parties has a different perspective. The secured creditors want the secured assets to have a high value. This would permit them to receive a greater percentage of the dollars from the estate over time. The unsecured creditors favor a low value on secured assets and a high value on unsecured assets. This should enable a greater payment to them. The debtor favors a low valuation on all assets which allows more debt to be forgiven.

The feasibility of developing a positive cash flow within a Chapter 12 will be a challenge. In most cases it will be like 100 percent financing. The advantage is that the 100 percent financing will be related to the current value of assets, not the past higher values. For most farming operations 100 percent financing has not been

possible.

Some codebtors will have protection as a Chapter 12 is filed. The law provides that codebtors on consumer debt will enjoy a stay. Debt related to the business of farming is not consumer debt and therefore most codebtors will not enjoy the stay.

A Chapter 12 is like a Chapter 11 in that the farmer continues to operate the farm. The farmer is known as the debtor in possession. There are new bank accounts created in the farmer's name with a suffix, debtor in possession. The farmer can be removed by the court from being the debtor in possession after a motion by a creditor. If a creditor can prove fraud or gross mismanagement, the court will likely be convinced that a removal should be granted.

It is the trustee's responsibility to make the payments to creditors provided under the plan. Such payments are made after the debtor in possession has transferred the funds to the trustee. The trustee can, to some extent, be considered as overseeing the fulfillment of the plan. In a Chapter 11, a trustee is appointed when the debtor is not permitted to be a debtor in possession. In a Chapter 13 the trustee manages the plan.

One concern about the trustee plan is the cost. Trustees get paid a percentage of the payments made under the plan. The trustee fee will likely be 10 percent of such payments. This may threaten the feasibility of some plans.

Another concern is that Chapter 12 does not have some of the tax advantages available in a Chapter 7 or 11. A Chapter 7 or 11 creates a new tax entity for individuals for federal tax purposes. This means taxes generated within bankruptcy are the responsibility of the estate not the individual. Chapter 12, under current tax law, never creates a new tax entity for federal taxes and federal taxes of the estate remain the responsibility of the individual after discharge. Chapter 12 does create a new tax entity for state and local taxes.

Chapter 12 is not a revolutionary new idea. It will not be a panacea for all farmers in financial difficulties. There are some advantages not present in other work out chapters. The major advantages are: no provision for voting by general creditors on the acceptance or nonacceptance of the plan; the adequate protection available to secured creditors' of farmland is lessened, and the plan is to be fulfilled in the three to five year period.