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## Chapter 12 of the U.S. Bankruptcy Code: Reorganization of a Family Farmer or Fisherman

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### Summary

Chapter 12 of the U.S. Bankruptcy Code dealing with “family farmer” reorganization, temporarily extended 11 times since its original enactment, is made permanent by enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act, P.L. 109-8. It is amended to include “family fisherman” as well. This report surveys the highlights of this chapter.

**Background.** In 1986, Congress added chapter 12 entitled “Adjustments of Debts of a Family Farmer with Regular Annual Income” to the U.S. Bankruptcy Code.<sup>1</sup> It was modeled after chapter 13, which governs consumer reorganization. Chapter 12 was created to provide farmers with the opportunity to reorganize and thus to preserve their farms through a streamlined and expeditious bankruptcy process. Intended to respond to the downturn in the farm economy in the 1980s, it was considered “experimental.”<sup>2</sup> Originally enacted as a temporary measure with a sunset date of October 1, 1993,<sup>3</sup> it was extended 11 times.<sup>4</sup> With enactment of the Bankruptcy Abuse Prevention and Consumer

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<sup>1</sup> P.L. 99-554 (Oct. 27, 1986).

<sup>2</sup> H.Rept. 103-32, 103d Cong., 1<sup>st</sup> Sess. 3 (1993).

<sup>3</sup> P.L. 99-554, §302(f).

<sup>4</sup> P.L. 103-65 (extension through Sept. 30 1998); P.L. 105-277 (extension through April 1, 1999); P.L. 106-5 (extension through October 1, 1999); P.L. 106-70 (extension through July 1, 2000); P.L. 107-8 (extension through June 1, 2001); P.L. 107-17 (extension through October 1, 2001); P.L. 107-170 (extension through June 1, 2002); P.L. 107-171 (extension through January 1, 2003); P.L. 107-377 (extension through July 1, 2003); P.L. 108-73 (extension through Jan. 1, 2004); and P.L. 108-369 (extension through July 1, 2005). With the exception of P.L. 107-377 and P.L. 107-171, which applied the extension prospectively, other extensions applied retroactively.

Protection Act (BAPCPA) it became a permanent chapter of the U.S. Bankruptcy Code.<sup>5</sup> The BAPCPA made additional changes to chapter 12, which are discussed below.

In the absence of chapter 12, insolvent farmers' bankruptcy options included reorganization under chapter 11 or 13, or liquidation under chapter 7.<sup>6</sup> Chapter 11 governs business reorganization and is more expensive and procedurally cumbersome than chapter 12 or 13. Chapter 13 was designed for "individuals with a regular income" or wage earners. The nature of farming is such that many farmers did not realize income on a "regular" schedule comparable to that of wage earners. Also, many farms were not individually owned, but are operated as corporations or partnerships. And, when chapter 12 was enacted in 1986, chapter 13 had a jurisdictional debt limit of \$350,000 in secured debt and \$100,000 in unsecured debt. Farmers' indebtedness often exceeded that limit, so chapter 12 provided a jurisdictional debt limit of \$1,500,000.

The BAPCPA made major revisions to chapter 13, which make it even more unsuitable for farmers than it was previously. A new requirement for chapter 13 debtors is that disposable income reasonably necessary for living expenses (retained by a debtor and deducted from the amount allocated to repayment of creditors) be calculated according to national and local living standards calculated by the Internal Revenue Service (IRS). This requirement alone would appear to make chapter 13 wholly unsuited for family farmers and fishermen.

**Procedural Overview.** The goal of chapter 12, indeed of all the operative bankruptcy reorganization chapters, is to offer a debtor a means of financial rehabilitation outside of liquidation. Historically, the *quid pro quo* for reorganization is the debtor's obligation to commit postbankruptcy income to prebankruptcy indebtedness.<sup>7</sup>

**Definition of "Family Farmer" and "Fisherman."** Previously applying only to "family farmers," the BAPCPA amended the chapter to include fishermen. For chapter 12 purposes, a family farmer includes an individual and spouse, or a family-owned partnership or corporation, with debts of less than \$3,237,000, 50% of which arises from the farming operation. The debtor must derive at least 50% of gross annual income from farming.<sup>8</sup>

A "family fisherman" is an individual and spouse, or a family-owned partnership or corporation, engaged in a commercial fishing operation whose debts are less than \$1,500,000, 80% of which arises from the fishing operation. The debtor must derive at least 50% of gross annual income from fishing.<sup>9</sup>

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<sup>5</sup> P.L. 109-8, § 1001 (2005).

<sup>6</sup> Farmers may not be forced into bankruptcy involuntarily. 11 U.S.C. § 303.

<sup>7</sup> Under chapter 7, prebankruptcy assets are liquidated to pay off prebankruptcy debts. A chapter 7 liquidation does not generally commit the debtor's postbankruptcy assets and/or income, nor will it discharge postbankruptcy debts.

<sup>8</sup> 11 U.S.C. § 101(18).

<sup>9</sup> 11 U.S.C. § 101(19).

***Expedited Time Frame.*** A chapter 11 debtor has at least 120 days (four months) after filing to submit a proposed reorganization plan. A chapter 12 debtor must submit a proposed plan within 90 days of filing,<sup>10</sup> and the court must hold a confirmation hearing within 45 days.<sup>11</sup> Only the debtor may propose the reorganization plan, which must be completed within a specified three to five-year time frame. The debtor's plan must meet the statutory requirements for chapter 12, but, unlike chapter 11, creditor committees are not appointed, and the plan is not voted on by creditors. The debtor receives a discharge of indebtedness upon completion of all payments under the plan.

***Appointment of a Standing Trustee.*** A trustee is rarely appointed under chapter 11. Although chapter 12 requires the participation of a standing trustee, the trustee's duties are administrative and the debtor retains possession and control of the farm or fishing operation throughout the reorganization.

***Benefits of Chapter 12.*** As noted above, chapter 12 borrowed many debtor-friendly features from chapter 13 (prior to the BAPCPA amendments) and adapts some provisions specifically to the needs of chapter 12 debtors. Among these provisions are:

- *Prebankruptcy credit counseling.* Although individual chapter 12 debtors must undergo credit counseling from an approved nonprofit agency within 180 days prior to filing, their ability to receive a discharge is not conditioned upon completion of an instruction course on personal financial management (as required of chapter 13 debtors);<sup>12</sup>
- *Contents of the plan: nonpriority treatment of certain priority claims.* The plan may treat certain claims owed to the government that might otherwise be considered "priority" claims under § 507 as nonpriority, namely, claims owed to a governmental unit that arise as a result of the sale or transfer of any farm asset used in the farming operation. Likewise, priority claims for domestic support that have been assigned to a governmental unit may be paid in less than full amount so long as the plan provides that all of the debtor's projected disposable income for five years will be applied to payments under the plan. Specified interest payments on unsecured claims that are nondischargeable may also be minimized;<sup>13</sup>
- *Liberalized "cramdown."* Cramdown is a term used in bankruptcy law to refer to the procedure which enables a debtor to modify a creditor's claim over the creditor's objection. Chapter 12 debtors are not bound to "the absolute priority rule" which applies in chapter 11. Hence, secured creditors of a chapter 12 debtor, despite objections they may harbor, have less ability to influence or reject the reorganization plan than chapter 11 creditors. Dissenting creditors may object to the debtor's reorganization

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<sup>10</sup> 11 U.S.C. § 1221.

<sup>11</sup> 11 U.S.C. § 1224.

<sup>12</sup> 11 U.S.C. § 109.

<sup>13</sup> 11 U.S.C. § 1222.

plan. The objection triggers the Code's requirement that all of the debtor's projected disposable income be applied to plan payments. Creditors must receive at least as much payout on their claims in chapter 12 as they would if the debtor were liquidated.<sup>14</sup>

- *Bifurcation of liens or "lien stripping."*<sup>15</sup> A family farmer is permitted to reduce — or "strip" — the value of a lien on secured property.<sup>16</sup> Hence, in situations where there is deflation in the value of the farm property, the debtor may reduce the amount owed to the secured lender and discharge the unsecured portion. Lien stripping is not generally permitted in chapter 7.<sup>17</sup> Although lien stripping is permitted under chapter 11, creditors whose security interests are bifurcated into secured and unsecured claims have greater power to shape and/or veto the debtor's reorganization plan. Chapter 12 also permits repayment of reformed secured claims over a period of time exceeding the plan period. Because chapter 12 provides the debtor with expanded authority to renegotiate with lenders, its influence may extend to informal renegotiations outside of bankruptcy as well.
- *Adequate protection and tax requirements.* Any bankruptcy debtor who retains collateral must provide the creditor "adequate protection" for the value of the collateral subject to the debtor's use.<sup>18</sup> Chapter 12 has its own standards for awarding "adequate protection"<sup>19</sup> and a provision governing "special tax provisions."<sup>20</sup>

Although chapter 12 was enacted as a temporary measure, it was continuously extended prior to becoming a permanent chapter in the Code. It has received significant support in the Congress. The chapter, however, is not without its critics. They question whether the benefits of chapter 12 outweigh its costs; whether it encourages economic inefficiency in the farm sector; and whether the ability of farmers to write off secured debt has a positive impact on agricultural lending.<sup>21</sup>

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<sup>14</sup> 11 U.S.C. § 1225.

<sup>15</sup> When a secured creditor holds a claim in which the value of the collateral is less than the contractual amount owed the creditor, the Bankruptcy Code splits or "bifurcates" it. It is treated as a secured claim up the value of the collateral, and an unsecured claim for the amount which constitutes the discrepancy between the collateral's value and the contractual amount of the claim. 11 U.S.C. § 506. In other words, the claim of a secured creditor is legally protected up to the value of the collateral which secures the claim.

<sup>16</sup> *Harmon v. United States Through Farmers Home Admin.*, 101 F.3d 574 (8<sup>th</sup> Cir. 1996).

<sup>17</sup> *Dewsnup v. Timm*, 502 U.S. 410 (1992).

<sup>18</sup> 11 U.S.C. § 361.

<sup>19</sup> 11 U.S.C. § 1205.

<sup>20</sup> 11 U.S.C. § 1231.

<sup>21</sup> Jerome Stam, "Do Farmers Need a Separate Chapter in the Bankruptcy Code," Information Bulletin No. 724-09, Economic Research Service, USDA (October 1997).

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