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Trustee Talk

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Chapter 12 and the Challenge of the New Farm Crisis

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The farm crisis of the late 1980s gave birth to chapter 12[1] of the Bankruptcy Code. Falling land values and grain prices combined with soaring interest rates and tightening credit gave rise to one of the worst farm crises of the 20th century.[2] In 1985, Willie Nelson responded to this by starting Farm Aid.[3] Farmers responded by driving their tractors to Washington, D.C.[4] Congress responded in 1986 by giving farmers a reorganization tool of unprecedented power and efficiency, and in 2005 made chapter 12 a permanent part of the Bankruptcy Code.[5]

New Farm Crisis

Farming is an inherently risky business. Factors such as weather and disease have always impacted farmers, and there have historically been boom and bust cycles in the industry. The current downward cycle in farming can be traced to multiple circumstances.

First, after farm income reached high numbers in the first years of this decade, it then fell 34 percent, more than $50 billion, between 2012-16, after adjusting for inflation.[6] Second, "farm-sector debt has reached levels near the peak levels of the late 1970s and early 1980s."[7] Finally, rising interest rates coupled with reduced income and increased debt suggests that some farmers might not be able to repay debt in future years.[8] As more farmers struggle financially, now is a good time to take a fresh look at chapter 12 and the benefits it offers.

Chapter 12: Simpler and More Powerful than Either Chapter 11 or 13

For chapter 11 and 13 practitioners, chapter 12 will look familiar. Chapter 12 cases are typically administered by a trustee. Many districts have a standing chapter 12 trustee,[9] but others are assigned on a case-by-case basis.[10] Like chapter 13 but unlike chapter 11, chapter 12 cases proceed under a trustee's supervision and the court until completion of the plan, after which a successful debtor receives a discharge,[11] and there is no disclosure statement[12] or voting on the plan by creditors.[13] Also unlike chapter 11, there is no absolute priority rule in chapter 12.[14]

There are great tax advantages to chapter 12, especially after new provisions were added in § 1232 in October 2017 after years of litigation.[15] This section is designed to allow a deprioritization of taxes due on the sale of assets as part of a confirmed plan, allowing farmers to "right-size" their operations and avoid large capital gains taxes that would otherwise be due.[16] Perhaps most importantly, chapter 12 plans can modify mortgages on principal residences by bifurcating undersecured claims under § 506 of the Bankruptcy Code, adjust-

1 11 U.S.C. § 1201, *et seq.* Further references to the Bankruptcy Code will be by section number only.
2 *Bankruptcy: The Next Twenty Years*, National Bankruptcy Review Commission Final Report, at 1012 (1997).
3 For more information about the event, visit farmaid.org/about-us (unless otherwise specified, all links in this article were last visited on Jan. 4, 2019).
4 Marguerite Roby, "Tractorcade," *Smithsonian Inst. Archives* (Feb. 21, 2012) *available at* siarchives.si.edu/blog/tractorcade.
5 Chapter 12 bankruptcy was enacted on Oct. 27, 1986, effective Nov. 26, 1986, Public Law 99-554 Title III § 302(a) and (c). It was expanded to include family fishermen with the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 1007, 119 Stat. 23, 187.
6 Nigel Key, Carrie Litkowski and James Williamson, "Current Indicators of Farm Sector Financial Health," U.S. Dept. of Agric. Econ. Research Serv., *available at* ers.usda.gov/amber-waves/2018/july/current-indicators-of-farm-sector-financial-health.
7 *Id.*
8 *Id.*
9 11 U.S.C. § 1202(a); 28 U.S.C. § 586(b).
10 11 U.S.C. § 1202(a).
11 11 U.S.C. § 1228.
12 11 U.S.C. §§ 1121, 1125.
13 11 U.S.C. § 1126.
14 11 U.S.C. § 1129(b)(2)(B)(ii)
15 *See* Joseph A. Peiffer, "Thirty Years of Asking, 'Are We There Yet?': Congress Rights a Taxing Wrong in Chapter 12," XXXVI *ABI Journal* 12, 8, 68-69, December 2017, *available at* abi.org/abi-journal.
16 *Id.*

ing interest rates, and even re-amortizing mortgage loans beyond a 30-year period.[17]

In addition, debtors can restructure loans secured by equipment and livestock based on the value and the useful life of the collateral, using the same discounted interest rate (typically prime plus a 1-3 percent risk factor) used in chapter 13 cases.[18] Restructuring essentially all of a farm's secured debt can have a dramatic impact on a farm's debt service — even when it does not involve any sale or surrender of equipment or livestock.

An additional advantage of chapter 12 is that plans are not due until 90 days[19] after the case filing, which allows debtors additional time after the automatic stay has gone into effect to assess claims and negotiate terms before filing the plan. Generally, plan payments in chapter 12 cases are not due until after confirmation,[20] and periodic payments can be structured around the farm's cash-flow cycles, so chapter 12 plans might propose quarterly or even annual payments.

Another advantage to chapter 12 over chapter 13 is § 1224. As opposed to the chapter 13 corollary (§ 1324), § 1224 requires a confirmation hearing to be concluded within a specified time frame. Contrast this to § 1324, which does not require that the confirmation hearing actually be "concluded" and which mandates that chapter 12 be more streamlined and efficient when compared with the similar Code sections.

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Eligibility

Pursuant to § 109(f), "Only a family farmer or family fisherman with regular annual income may be a debtor under chapter 12 of this title." Section 101 defines "family farmer" in § 101(18), "family fisherman" in § 101(19A), "family farmer with regular annual income" in § 101(19), "family fisherman with regular annual income" in § 101(19B), and "farming operation" in § 101(21). A reliable determination of whether a potential debtor is eligible to file for chapter 12 requires a careful look at each of the above definitions, but the basic requirements can be summarized as follows:

(1) Farming: Activities involving the tillage of soil and raising of crops, raising of livestock or poultry, or livestock products in an unmanufactured state;

(2) Family Farmer Test (Individual or Individual and Spouse):

(a) Debts are not over $4,153,150 (as of 2018);

(b) At least 50 percent of debt is farm-related debt (not including home mortgage, unless the mortgage is a farm mortgage); and

(c) More than 50 percent of the debtor's income is from farming (measured by the previous tax year or the two tax years before the previous tax year);

(3) Family Farmer Test (Corporation):

(a) At least 50 percent of shares owned by one family or by one family and farming relatives;

(b) More than 80 percent of the value of the corporate assets consists of assets related to farming;

(c) Debts are not over $4,153,150 (as of 2018);

(d) At least 50 percent of debt is farm-related debt; and

(e) Corporation is not publicly traded; and

(4) The test for a "family fisherman" is similar except that the operation must consist of a commercial fishing operation and the aggregate debts cannot exceed $1,924,550 (2018).[21]

Meeting those definitions is critical for a debtor seeking relief under chapter 12. Since chapter 12 is a powerful tool that can force creditors to accept unfavorable reorganization terms, creditors often have a strong incentive to litigate chapter 12 eligibility. Therefore, counsel for a potential chapter 12 debtor must analyze the definitions in connection with the client to ensure that the debtor is eligible for chapter 12.

Different Uses of Chapter 12

Most chapter 12 plans fall into one of three categories: traditional reorganization plans, downsizing or conversion plans and sale plans. These categories are not mutually exclusive.

Traditional Reorganization

In a traditional reorganization plan, the farm's goal is to preserve its essential nature and scale, but to reorganize in order to reduce debt service, increase efficiency and put the farm back on a profitable path. The need for this type of reorganization sometimes stems from a specific event that disrupted the farm's normal finances, such as a particularly bad crop season, livestock loss, or illness or disability of the farmers.

The initial question is whether the farming operation is still potentially viable with the help of the reorganization. The reduction of debt service and discharge of debt is sometimes enough to return a farm to a profitable status. On the other hand, if a farmer's production costs exceed the market price, no amount of restructuring will return the farm to profitability. If the farm's projected finances based on the existing size and type of operations will not make it profitable, then review other options, such as changing the scale and type of farming, or selling or surrendering land, livestock, or equipment.

Farm Downsizing and Conversion

One of the best uses for chapter 12 is to assist a farm in changing scale while also converting to a

17 *Compare* 11 U.S.C. § 1222(b)(2) *to* § 1322(b)(2).

18 *See Till v. SCS Credit Corp.*, 541 U.S. 465 (2004).

19 11 U.S.C. § 1221.

20 11 U.S.C. § 1226; *compare to* § 1326 (requires payments to begin 30 days after the order for relief).

21 11 U.S.C. § 101(19A).

different or more diverse production base. A perfect example is the conversion of a traditional dairy farm to a crop farm or crop and beef farm. As the price of raw milk continues to fall in response to the decline in consumption of fluid milk and the steady increase of milk production per cow, it is inevitable that some dairy farms will have to close or at least diversify operations or convert to some other type of farm operation.

The key to this kind of reorganization is a careful assessment of the resources of the farm — land, equipment, livestock and people — while paying attention to what changes could reduce debt and increase profitability. The sale or surrender of equipment, land and livestock not needed for a smaller operation might reduce the total debt and lower the monthly operating expenses. For example, if a dairy farm is able to sell or surrender unnecessary equipment, land and livestock and convert the remaining land and equipment to raising crops, it might be able to survive — albeit not as a dairy farm. Most dairy farmers are skilled at raising hay and other crops, and if the return earned from those crops is more stable and profitable than fluid milk (which has been below the cost of production for several years now), it might be the solution to saving the farm. Putting pasture land and feed to work raising beef cattle might be more profitable than continuing on as a dairy farm. Also, changing from a strictly wholesale market (like fluid milk) to a more diversified wholesale and retail market (like farmer's markets) might also help a farm find a profitable niche.

Sale Plans

Sometimes, a farmer decides that the rigorous workload, inherent risks (both physical and financial) and unreliable income of farming is no longer what he/she wants. Maybe the farmer wants to save his/her home but not keep the entire farm operating. In this situation, chapter 12 can still play a valuable role. There is no bright line between a sale plan and a downsizing/conversion plan, although a sale plan puts more emphasis on selling assets to satisfy debt.

There are advantages to doing this through chapter 12 as opposed to chapter 7 or nonbankruptcy solutions. First, chapter 12 allows the farmer, as a debtor in possession, to retain a much higher level of control over the marketing of property as opposed to a chapter 7 trustee. Second, chapter 12 has special rules on capital gains taxes on the sale of farm land, which greatly reduce the tax impacts on such sales. Third, compared with a sale outside bankruptcy, a chapter 12 sale plan might allow a farmer to retain his/her home while discharging unsecured debt.

The Most Powerful — Yet Most Underutilized — Chapter of the Code

With all this flexibility and reorganizing power, it seems that chapter 12 would be a popular solution for farmers at a time when the farming industry is struggling. According to the 2012 census of agriculture, there were approximately 2 million farms in the U.S.,[22] yet for the 12-month period ending Sept. 30, 2018, only 468 chapter 12 cases were filed.[23] This is less than 0.025 percent and does not even include fishermen in the total farm count.

Farming and commercial fishing are two of the most financially risky businesses there are, yet the filing rate suggests that chapter 12 is being ignored by the people it was enacted to serve. Why is that? One theory is simple: Not many farmers and fishermen know chapter 12 exists. Support for this theory was demonstrated a few years ago in a presentation about chapter 12 to a group of farm financial planners. The attendees were professionals whose entire focus was assisting farmers with financial-planning and farm-sustainability decisions, yet not one person in this room full of farm financial-planning professionals had any idea that anything like chapter 12 existed. They were shocked to hear about it. The presenters were similarly shocked that the attendees knew nothing about it.

Most bankruptcy attorneys, unless they actually have experience doing chapter 12 work, tend to avoid it. There is an old adage that when your only tool is a hammer, the whole world looks like a nail. The same might be true for bankruptcy attorneys.

When you know chapter 7, but have not done any chapter 13 work, there is a bias toward using chapter 7 — even if chapter 13 would provide more complete relief. Chapter 7 is quicker and easier, and often the attorney is not even required to appear in court before a bankruptcy judge. For practitioners familiar with chapter 7s, business chapter 13s[24] and small business chapter 11s, they focus on the tools they know, even for dealing with farms.

Need to give up farming? All the assets are encumbered or exempt? This looks like a chapter 7. Need to cram down some tractors and pay some tax debt? No problem — the attorney will put a farmer in a chapter 13. Need to do a full reorganization? This is what chapter 11 is all about. The problem with all of these conclusions is that they are reached without the benefit of a comparison to what chapter 12 can offer.

If your firm does small business chapter 11 or 13 cases, but you have never handled a chapter 12 case, it is worth considering. There are a lot of farmers and fishermen out there. Their businesses tend to be highly leveraged, and they operate under tremendous financial and physical risks. Very few of them realize what Congress did to help them three decades ago.

In large measure, they are the ones taking on extraordinary risks every day to feed and clothe consumers. It might be up to each of you in the bankruptcy bar to get the word out that help is available specifically designed with their needs in mind, and to be the ones to provide it. Working with farmers can be very rewarding. If enough bankruptcy professionals are up for the challenge, perhaps there will be more than 500 chapter 12 cases filed next year. abi

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22 USDA 2010 Census of Agriculture (through 2012) and Farms and Land in Farms; 2017 Summary.

23 "U.S. Bankruptcy Courts: Business and Nonbusiness Cases Commenced, by Chapter of the Bankruptcy Code, During the 12-Month Period Ending September 30, 2018," *available at* uscourts.gov/sites/default/files/data_tables/bf_f2_0930.2018.pdf.

24 *See* 11 U.S.C. § 1304 (Debtor Engaged in Business). To clarify that the authors do not mean that an entity can file for chapter 13, but that it is routine for individual debtors who meet the criteria of § 1304 to be referred to as "business chapter 13s."