

# Family Farm Reorganizations Under the U.S. Bankruptcy Code

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## A Basic Introduction to Chapter 12

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### **What is Chapter 12?**

Chapter 12 is a specific part of the U.S. Bankruptcy Code enacted by Congress in the mid-1980s in response to the financial crises confronting farmers<sup>1</sup>. During the 1980s farmers across the country were caught between falling land values and the inability to borrow money to finance their farming operations. As land values fell, lenders refused to extend credit to farmers whose land values had fallen to the point where it provided insufficient equity to secure existing loans. The situation made it impossible for many farmers to finance needed equipment purchases or even the planting of crops. Many farms were going out of business as a result of this credit crunch. This put pressure on Congress to find a remedy to help farmers reorganize. At that time none of the available forms of bankruptcy relief were very helpful to small farmers. Chapter 11, designed for large corporate reorganizations was cumbersome, complex, very expensive and ill-suited to the needs of farm debtors. Chapter 13 was simpler and less costly, but most farm operations exceeded the debt limits of Chapter 13 and relief under this chapter was too restrictive to be much help to farmers, being designed primarily for wage earners.

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<sup>1</sup> The text of Chapter 12 is found at 11 U.S.C. §1201 through §1231.

The purpose behind the creation of Chapter 12 was to provide a bankruptcy reorganization process customized for the specific needs of small farmers. It needed the flexibility of Chapter 11 without the high costs and complexity of that chapter. It needed to offer the greater simplicity of Chapter 13, but not be constrained by the lower debt limits or many of the other restrictions of Chapter 13- most notably the prohibition on mortgage loan modification. In enacting Chapter 12 in 1986 Congress created a reorganization chapter specifically tailored to the needs of small farming operations. In doing so it took the reorganizing power of bankruptcy to its constitutional limits, providing farm debtors with more power to modify loans, including farm mortgages, than any other Chapter of the Bankruptcy Code. Combining that power with unprecedented flexibility in the formulation and confirmation of plans, it gave small farmers a formidable tool to use in re-structuring farm debt and save financially struggling farms.

### **How Does Chapter 12 Work?**

As under all forms of bankruptcy relief, Chapter 12 debtors must complete a bankruptcy petition, schedules and statements disclosing in great detail information on assets, debts, income and expenses, as well as information specific to the debtor's farming operation. The debtor must also propose a plan of reorganization detailing payments to creditors over the three to five year term of the plan. A Chapter 12 trustee is appointed to review the debtor's petition, schedules and plan and investigate the feasibility of the debtor's plan and make recommendations to the bankruptcy court on confirmation. If the plan is confirmed by the bankruptcy court, the plan is binding on the debtor and all creditors. Over the three to five year term of the plan, the debtor makes payments to the trustee who then disburses payments to creditors. After a debtor completes all of the payments to the trustee over the term of the plan, the debtor receives a discharge of any unsecured debts not paid under the plan. Often plans call for direct payments of secured debts, such as mortgage debt after the conclusion of the plan, which the debtor then pays directly.

## Who is Eligible to be a Chapter 12 Debtor?

Title 11 of the U.S. Code at Section 109 (f) states: “Only a family farmer or family fisherman with regular annual income may be a debtor under chapter 12 of this title”. Section 101 (18) and (19A) of Title 11 contain the definition of “family farmer” and “family fisherman”. Sections (19) and (19B) contain the definition of “family farmer with regular annual income” and “family fisherman with regular annual income. Subsection (21) of that section also includes a definition of “farming operation”. A reliable determination of whether a specific individual, individual and spouse or corporation is eligible to file Chapter 12, requires a careful look at each of the above definitions. That said, the requirements essentially come down to the following:

- (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 not over \$4,031,575 (as of 2016);
  - (b) At least 50% of debt is farm related debt (does not include home mortgage, unless the mortgage is a farm mortgage);
  - (c) More than 50% of 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) 50% of shares owned by one family or by one family and farming relatives;
  - (b) Over 80% of the value of the corporate assets consist of assets related to farming;

- (c) Debts not over \$4,031,575 (as of 2016);
- (d) At least 50% of debt is farm related debt;
- (e) Corporation is not publicly traded.

The test for a “family fisherman” is similar except for the operation must consist of a commercial fishing operation and the aggregate debts cannot exceed \$1,868,200 (2016).

The above analysis is a simplification of the statutory language, however the definitions and meeting them is critical for a debtor needing relief under Chapter 12. Since Chapter 12 is a powerful tool that can force creditors to accept reorganization terms that they would frequently not agree to voluntarily, creditors often have a strong incentive to litigate Chapter 12 eligibility whenever it seems like a close issue. For this reason, anyone considering filing for Chapter 12 relief, or any counsel representing them, must take a close look at each of the definitions and make sure the debtor can prove eligibility.

### **How do Chapter Plans Reorganize Farm Debt?**

Chapter 12 Plans provide a tremendous amount of flexibility in addressing secured farm debts such as equipment loans and mortgages. First, plans do not necessarily require monthly payments (as Chapter 13 does). Chapter 12 plans may be funded by annual payments, semi-annual payments, quarterly payments or monthly payments. This generally depends on the type of farming operation. Farms with regular monthly income such as dairy farms typically provide for monthly payments. Farms with annual crops, such as orchards, Christmas tree farms, maple sugaring operations or other farms with annual crops typically call for annual payments corresponding to the timing of the sale of the annual harvest. There are also other options, such as variable monthly payments based on a farm’s projected annual cash flow.

Chapter 12 Plans provide at least three different options for reorganizing farm debt, each of which help to reduce the required monthly debt service on farm loans. These options are: (1) reduction of the loan balance to the value of the

collateral; (2) re-writing the terms of the loan to extend the repayment period and re-amortize the debt; (3) reduction of the interest rate. Each of these modification options has the power to significantly reduce the monthly payment on a loan and the farmer's overall monthly debt service. When used in combination to restructure several loans, the impact can be fairly dramatic.

**(1) Reduction of Loan Balances (cram-down)**

The concept behind this approach is that if a loan is under secured (meaning the collateral is worth less than the amount outstanding on the loan secured by it), the loan should be re-written for a principal balance of no greater than the value of the collateral. For example, if a tractor is collateral for a \$40,000 loan, and the tractor is only worth \$30,000, the loan should be re-written as a \$30,000 loan. In this case, the debtor would save \$10,000, plus the interest on that sum, over the life of the loan. In cases where the value of the real estate is less than the amount due on the mortgages secured by the farm land, farm mortgages can be re-written in this manner with the result of the farm operation saving hundreds of thousands of dollars.

**(2) Extension of the Loan's Repayment Term**

This concept allows a farmer to re-write the outstanding balance of a loan, as if it were a brand new loan, for a term which would be reasonable considering the nature of the collateral and its remaining useful life. With respect to real estate loans, this can potentially allow a debtor to re-amortize a mortgage that may be half way through its term, to a full mortgage term. For example, if a 30 year mortgage is half way through its payment term, the outstanding balance could be re-written for another fully 30 year (or perhaps even longer) term. This approach is sometimes available with respect to equipment loans and cattle loans, but since the term of the re-written amortization is limited to the useful life of the collateral, those loans are not typically longer than the 5 year term of a Chapter 12 plan.

**(3) Reduction of the Interest Rate**

Probably the simplest way to reduce debt service on a loan is to merely reduce the interest rate on the outstanding balance. Under the U.S. Supreme Court decision *Till v. SCS Credit Corp.*, 541 US 465 (2004), the applicable interest rate for a

reorganization plan may well be less than the contract rate which a debtor is obligated to pay under the promissory note. Under the *Till* case, the debtor reduce the interest rate to the prime rate plus a 1-3 % risk factor, with the actual interest rate being determined by the facts of each case. Very often the *Till* rate is less than the contract or note rate, although this is not always the case.

### **Combined Impact**

Although each of these three approaches to loan restructuring could be used independently, the most common approach is to use all of them. This allows the debtor to re-write loan obligations to significantly lower periodic payments. For example, if a mortgage loan in the original amount of \$600,000 has an outstanding balance of \$400,000, and the collateral securing it is only worth \$300,000, the Chapter 12 plan will require the debtor to repay only \$300,000, not \$400,000. Additionally, if the original loan was to be paid over a 30-year term and was taken out 15 years ago, the remaining (now crammed down) balance of \$300,000 could be re-amortized out to 30 years. Finally, although the promissory note interest rate may have been 7%, the debtor may re-compute the interest rate and amortize the \$300,000, over 30 years, with a lower, interest rate, perhaps as low as 4.5%. The combined impact of these three changes is to take a loan that had monthly payments based on a \$600,000 original loan, amortized at 7% and re-write it into a new 30 year loan for \$300,000 at 4.5%. Needless to say the combined impact of such a modification can be significant.

### **How are Priority Unsecured Debts Treated?**

In addition to secured debt, some farms have debts which are classified by the Bankruptcy Code as priority unsecured debts. Such debts must be paid in full in Chapter 12 Plans even though they are not secured by any lien or collateral. The most common of these are state and federal tax debts. Typically, a Chapter 12 Plan will pay priority unsecured debts over the life of the Plan along with secured claims.

## **How are Unsecured Non-priority Debts Treated?**

Finally, debts which are neither secured by collateral nor classified as priority debts are referred to as general unsecured debts. This category includes credit card debt, repair bills, feed bills or credit card debt. Whether or how much the debtor must pay to the holders of unsecured debts depends on the debtor's income and expenses, as well as the value of the debtor's non-exempt assets.

The Bankruptcy Code allows debtors to "exempt" certain assets, and those assets are not included in the computation of the dividend a debtor must pay to the holders of general unsecured claims. In the event the debtor claims most of the equity in his or her assets as exempt, the dividend the debtor would be required pay to the unsecured creditors would be a small percentage of what is owed, with the balance of the claims being discharged at the end of the case. By only paying part of the total of the unsecured claims, the Plan can enable debtors to obtain relief from crushing unsecured debt loads while simultaneously significantly reducing the required monthly payment on secured debt, and get the "fresh start" the Bankruptcy Code offers.

### ***Illustration***

The attached chart demonstrates the combined impact of the modification of several secured farm loans, including several mortgages, equipment and cattle loans. In this example the pre-bankruptcy debt service on all secured loans and payments on unsecured debt (spread over 3 years) was over \$17,000 per month. After the loans are modified by a Chapter 12 Plan, a modest dividend to unsecured creditors is added (8%) and the Chapter 12 Trustee fees are added in, the monthly debt service drops to below \$8,000 per month, a savings of nearly \$9,000 per month, \$108,000 per year or potentially \$540,000 over the life of a 5-year plan.

## **What Can Chapter 12 Do? And What Can It Not Do?**

Chapter 12 is not a government program nor is it charity. It is a legal tool which is part of the U.S. Bankruptcy Code designed to help financially struggling small farmers reorganize their debt in order to keep farms in business. Keeping well managed and productive farms in business is good for our country, our state and our communities. The farm economy is a crucial component of the national, our state and local economies and even more important- all of us are fed by what farms produce.

What Chapter 12 cannot do is turn a poorly run or mismanaged farm into an efficient, productive farm. The mere reorganization of debt is no guarantee of success for farms that have serious management issues or lack the productive resources to farm efficiently. Evaluating whether Chapter 12 is the right choice for a farm in need of financial reorganization requires a careful assessment of whether a farm has sound management and the necessary resources, (productive land, equipment and labor) to perform under a Chapter 12 reorganization plan. Chapter 12 is probably not the answer for every struggling farm, but when a farming operation needs a financial second chance it can serve as a unique and powerful tool to reorganize farm debt and provide a financial fresh start.