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THE MONTANA FAMILY FARMER UNDER CHAPTER 12 BANKRUPTCY

Barbara Dockery Tremper*

I. INTRODUCTION

BANKRUPTCY-the very word chills the heart of any American farmer and is especially repugnant to the independent Montana family farmer. Nevertheless, when all else fails, the current bankruptcy code¹ offers special advantages to the farmer-debtor including the automatic stay,² discharge from debt,³ opportunity for recovery through reorganization,⁴ and a "fresh start."⁵ Recently, Congress passed the Family Farmer Bankruptcy Act of 1986, enacted as chapter 12 of the bankruptcy code.⁶ Effective November 26, 1986, chapter 12 reduces some obstacles farmers encountered under other chapters of the bankruptcy code and offers new provisions specifically designed for the family farmer in bankruptcy.

Because chapter 12 is so new, court opinions are confined mostly to those issued by local bankruptcy courts. Few of these opinions have undergone the appellate review process. Therefore, a determinative consensus of court interpretations of chapter 12 is just now developing. In areas where sections of chapter 12 closely parallel other well-settled sections of the code, courts may apply pre-chapter 12 case law.⁷ This article is intended as an explanation of the special provisions for the family farmer under chapter 12 rather than as a critical commentary. Montana bankruptcy court rulings will be cited wherever appropriate.⁸

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1. 11 U.S.C. §§ 101-1330 (1978) (as amended 1984 and 1986).

2. 11 U.S.C.S. § 362 (Law. Co-op. 1987) (generally stays any action against a debtor automatically upon his filing a petition in bankruptcy).

3. 11 U.S.C.S. § 524 (Law. Co-op. 1987) (provides that when a bankruptcy court grants a discharge to a debtor, that debtor is no longer liable for pre-petition debts and judgments (with notable exceptions)).

4. Chapters 11 and 13 provide for plans under which a debtor may reorganize payment of his debts.

5. The basic philosophy underlying bankruptcy is to allow the debtor upon discharge to start anew free of old debts and burdens and be given a new chance.

6. The official title is: *Chapter 12-Adjustment of Debts of a Family Farmer with Regular Annual Income*.

7. See *In re Martin*, 4 Mont. Bankr. Rep. (Mont. L. Week) 322 (May 11, 1987), which uses a chapter 11 case as precedent for a chapter 12 case.

8. Hereinafter, citations to the Montana Bankruptcy Court refer to the United States

II. BACKGROUND

Since 1980, an agricultural depression of major proportions has squeezed many farmers into insolvency. While not all insolvencies resulted in bankruptcy, Montana experienced approximately sixty farm bankruptcies per year during 1985 and 1986.⁹

Many current farm failures ironically arose out of the enormous farm successes of the 1970s when bountiful production at high market prices sent farm land values soaring. Liberal lending policies encouraged farmers to borrow and saddle themselves with large debts when interest rates were at an all-time high. Foreign competition from Australia, Canada, Argentina and Brazil sliced U.S. farm exports and depressed farm product prices.¹⁰ Land values have fallen 50 percent since 1981¹¹ leaving farmers with loans higher than the value of their land. Drought and bungled government farm policy also contributed to the farmers' economic woes. The combination of these factors forced an unprecedented number of farm foreclosures and bankruptcies. As a result, not only are farmers suffering, but banks and agricultural lending associations are in trouble as well.¹²

These conditions catapulted Congress into action. At first, Congress tried to amend or patch the existing bankruptcy code,¹³ but soon realized that farmers needed more than a patchwork of special provisions tucked into other chapters of the code. Therefore Congress fashioned a completely new bankruptcy chapter to deal with the crisis in agricultural finance: chapter 12.

III. GENERAL ORGANIZATION OF THE BANKRUPTCY CODE

Chapter 12 is not only a new chapter under the bankruptcy code, but it is unique in one other way. It is the first chapter to be

Bankruptcy Court for the District of Montana, John L. Peterson, United States Bankruptcy Judge, Butte, Montana.

9. In a telephone interview with Mike Bell, clerk of the Bankruptcy Court for the District of Montana, made on November 10, 1987 to Great Falls, Montana, Mr. Bell estimated approximately 60 farm bankruptcies out of 1400 filings during 1986. As of October 31, 1987, this figure increased to 130 farm bankruptcy petitions filed in 1987 including chapters 7, 11, and 12.

10. See generally Bland, *Insolvencies in Farming and Agribusinesses*, Ky. L.J. 795 (1984-85). See also 132 CONG. REC. S15,092 (daily ed. Oct. 3, 1986) (statement of Senator DeConcini) for a good discussion of the farm economy.

11. ECON. RES. SERV., U.S. DEP'T OF AGRIC., AGRICULTURAL LAND VALUES AND MARKETS, OUTLOOK AND SITUATION REPORT 3 (1986).

12. See 132 CONG. REC. S15,092 (daily ed. Oct. 3, 1986) (statement of Senator DeConcini).

13. See H.R. 1399 introduced by Representative Rodino on March 5, 1985 to amend chapter 13 to make it more available to the family farms.

assigned an even number. Except for chapter 12, the bankruptcy code is organized into odd-numbered chapters. Chapter 1 contains general provisions including definitions. Chapter 3 deals with case administration, while chapter 5 covers creditors, debtors and the estate.¹⁴ Unless otherwise provided, chapters 1, 3, and 5 apply to all the other chapters contained in the code.¹⁵

Chapters 7, 9, 11, 12, and 13 are separate and distinct. Each of these chapters applies only to a specific class of debtor who must qualify and file under that specific chapter. Hence we have the terminologies of "chapter 7 bankruptcy" or "chapter 11 bankruptcy," etc. Chapter 9 applies only to municipalities¹⁶ while chapters 7 and 11 (with exceptions) apply to individuals, partnerships, and corporations.¹⁷ Chapter 12 applies only to family farmers,¹⁸ and chapter 13 applies only to individuals.¹⁹

Farmers have long enjoyed special treatment under other chapters of the bankruptcy code. For example, the code generally denies creditors the right to file an involuntary bankruptcy against a farmer.²⁰ A rationale for special treatment states that "farmers are excepted because of the cyclical nature of their business. One drought year or one year of low prices, as a result of which a farmer is temporarily unable to pay his creditors, should not subject him to involuntary bankruptcy."²¹

Under either state or federal statutes, individual farmers also enjoyed special exemptions for their land, homes, implements and tools, animals, feed, and grain. Under these statutes, farmer-debtors could insulate certain property from the bankruptcy estate and retain it for themselves as necessary for a "fresh start."²² States

14. Under 11 U.S.C.S. § 541 (Law. Co-op. 1987), the estate refers to all the debtor's property, wherever located, as of the commencement of the case.

15. 11 U.S.C.S. § 103(a) (Law. Co-op. 1987).

16. 11 U.S.C.S. § 109(c)(1) (Law. Co-op. 1987).

17. 11 U.S.C.S. § 101(35) (Law. Co-op. 1987) (defines "person" to include an individual, partnership and corporation (but not a government unit)).

11 U.S.C.S. § 109(b) (Law. Co-op. 1987) (states that a person may be a debtor under chapter 7 (but not a railroad, insurance company or financial institution)).

11 U.S.C.S. § 109(d) (Law. Co-op. 1987) (states that any person that may be a debtor under chapter 7 may file under chapter 12 (including railroads, but not stockbrokers or commodity brokers)).

18. 11 U.S.C.S. § 109(f) (Law. Co-op. 1987).

19. 11 U.S.C.S. § 109(e) (Law. Co-op. 1987).

20. 11 U.S.C.S. § 303(a) (Law. Co-op. 1987) (states that an involuntary case (meaning a case where creditors file the petition without debtor's consent) may not be filed against a farmer or family farmer).

21. See H.R. 595, 95th Cong., 1st Sess. 1977, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6278.

22. See *supra* note 5.

may choose to exempt property according to the federal exemptions as listed under section 522(d) or to exempt property according to their own state statutes.²³ Montana elected its own exemption statutes.²⁴ Prior to October 1, 1987, a farmer in Montana could exempt up to 320 acres of land used in farming,²⁵ \$30,000 equity in a home,²⁶ \$6,000 of equipment and implements as "tools of trade,"²⁷ farm animals, feed and grain.²⁸ Montana's legislature in 1987 repealed the 320 acre farmland exemption in favor of a flat \$40,000 homestead exemption.²⁹ Montana also substantially changed other exemption statutes as of October 1, 1987.³⁰

IV. OVERVIEW OF CHAPTERS 7, 11, AND 13

Chapter 12 provides an *additional* bankruptcy remedy which applies only to a special class of debtors defined as "family farmers," but does not eliminate the farmers' choice of filing under other chapters of the code. A very brief overview of chapters 7, 11 and 13 will comparatively highlight farmer provisions.

A. *Treatment for Farmers under Chapter 7*

Chapter 7 provides for a liquidation bankruptcy. Basically, all the farmer's assets (except those which are exempt under Montana statute) are transferred to the hands of a trustee appointed by the court. The trustee has the power to sell or abandon non-exempt assets and to pay creditors in an orderly fashion. Under certain circumstances, the farmer-debtor can retain non-exempt assets by

23. 11 U.S.C.S. § 522(b) (Law. Co-op. 1987).

24. MONT. CODE ANN. § 31-2-106 (1987).

25. MONT. CODE ANN. § 70-32-104 (1985).

26. MONT. CODE ANN. § 70-32-104 (1985).

27. MONT. CODE ANN. § 25-13-612(1)(b) (1985). This statute was liberally interpreted by Montana courts. See, e.g., *In re Taylor*, 4 Mont. Bankr. Rep. (Mont. L. Week) 347 (May 6, 1987) (where a \$52,000 truck and trailer was exempted as "tools of trade"); and *MacDonald v. Mercill*, ___ Mont. ___, 714 P.2d 132 (1986) (exempting a \$37,000 backhoe and trailer).

28. MONT. CODE ANN. § 25-13-612(a) (1985) quaintly exempted "to a farmer: farming utensils or implements of husbandry, not exceeding in value \$600; two oxen or two horses or mules and their harness, one cart or wagon, set of sleds, and food for such oxen, horses, cows, or mules for 3 months; all seed, grain, or vegetables actually provided or on hand for the purpose of planting or sowing the following spring, not exceeding in value \$200."

29. MONT. CODE ANN. § 70-32-104 (1987).

30. MONT. CODE ANN. § 25-13-608 (1987) (property exempt without limitation); MONT. CODE ANN. § 25-13-609 (1987) (personal property exempt subject to value limitations); MONT. CODE ANN. § 25-13-613 (1987) (property necessary to carry out governmental functions); MONT. CODE ANN. § 25-13-614 (1987) (earnings of judgment debtor); MONT. CODE ANN. § 25-13-615 (1987) (homestead-referring to § 70-31-104 (1987)).

reaffirmation³¹ or redemption.³²

The trustee may allow the farmer to continue farm operations for a period of time if the creditors would be better served.³³ For example, the farmer-debtor may be allowed time to harvest the crops or to wait until the calves are ready for market. If conditions improve, the farmer may choose to convert to either chapter 11 or chapter 13.³⁴ However, chapter 7 is usually the end of the line, eventually resulting in the complete termination of farming operations.

B. *Treatment for Farmers under Chapter 11*

Under chapter 11, the farmer seeks court approval of a proposed plan to reorganize the troubled farm business. Chapter 11 is available for an individual farmer as well as those who operate as a corporation or partnership.³⁵ Exemptions allowed individual farmers, however, are not available to corporations or partnerships.³⁶

The farmer continues to operate the farm under the plan of reorganization while retaining control of the operation as a "debtor-in-possession"³⁷ unless the court appoints a trustee for cause.³⁸ Moreover, absent fraud on the part of a farmer-debtor, once a farmer files under chapter 11 no creditor can force conversion to a chapter 7 liquidation.³⁹

31. 11 U.S.C.S. § 524(c) (Law. Co-op. 1987) (allowing reaffirmation or an agreement between the debtor and creditor which allows the debtor to voluntarily repay the debt. Debtors who reaffirm must be able to make such payments. Debtors often choose reaffirmation because they want to retain their interest in the property or because they want to retain good credit rating with that creditor or simply because they wish to keep that specific property.). See generally 3 COLLIER ON BANKRUPTCY ¶ 524.03 (15th ed. 1985).

32. 11 U.S.C.S. § 722 (Law. Co-op. 1987). "The right to redeem amounts to a right of first refusal for the debtor to purchase consumer goods that might otherwise be repossessed." 4 COLLIER ON BANKRUPTCY ¶ 722.01, at 722-2 (15th ed. 1985) (The debtor will usually choose to redeem property he wishes to keep by paying cash where the market value is less than the amount of the secured loan.) "Because section 722 bestows the right upon an 'individual' debtor, partnership and corporate debtors are excluded." *Id.*

33. 11 U.S.C.S. § 721 (Law. Co-op. 1987) (provides that the "court may authorize the trustee to operate the business of the debtor for a limited period, if such operation is in the best interest of the estate and consistent with the orderly liquidation of the estate.").

34. 11 U.S.C.S. § 706(a) (Law. Co-op. 1987).

35. 11 U.S.C.S. § 101(35) (Law. Co-op. 1987).

36. 11 U.S.C.S. § 522(b) (Law. Co-op. 1987) (stating that an "individual debtor" may exempt from property of the estate).

37. With certain exceptions, 11 U.S.C.S. §§ 1101(1) and 1107 (Law. Co-op. 1987) grant to the debtor the right to possess and manage the property of the estate and the operation of the business.

38. 11 U.S.C.S. § 1104(a)(1) (Law. Co-op. 1987) (defines "cause" as "including fraud, dishonesty, incompetence or gross mismanagement of the affairs of the debtor").

39. 11 U.S.C.S. § 1112(c) (Law. Co-op. 1987) (states that the court may not convert a case under chapter 11 to a 7 if the debtor is a farmer).

The farmer must submit the plan within 120 days of filing the original petition.⁴⁰ If that time limit is not met, creditors may propose a plan.⁴¹ In such circumstances creditors have filed plans calling for the complete liquidation of a farmer's assets, thereby circumventing the prohibition against a creditor's converting the farmer-debtor's chapter 11 petition to a chapter 7 liquidation.⁴²

Creditors may accept or reject the plan of reorganization⁴³ and, once all the requirements are met, the bankruptcy court must confirm the plan.⁴⁴ Under what has been termed as the "cram down" provision, the court may confirm a plan where secured creditors are forced to take less than their secured claims if the plan "does not discriminate unfairly" and is "fair and equitable."⁴⁵

A chapter 11 plan can provide for rewriting of existing loans at lower interest rates or longer terms. The plan can allow the farmer to retain equipment under lease by curing defaults and confirming the leases as executory contracts.⁴⁶ The farmer can even use cash collateral for living and operating expenses without the permission of creditors provided the creditors retain a 20 percent equity cushion⁴⁷ as "adequate protection."⁴⁸

Under chapters 11 and 13 reorganization plans, the farmer must be allowed to retain items necessary for the reorganization plan to work, such as farm machinery, land, and livestock for

40. 11 U.S.C.S. § 1121(b) (Law. Co-op. 1987).

41. 11 U.S.C.S. § 1121(c)(2) (Law. Co-op. 1987).

42. See *Matter of Button Hook Cattle Co.*, 747 F.2d 483, 486 (8th Cir. 1984). See also *In re Jorgenson*, 66 Bankr. 104, 107 (9th Cir. 1986) (where the court held "a creditor's liquidating plan may be confirmed over farmer-debtor's objection" even where the farmer's plan was timely filed, and creditor filed a competing plan).

43. 11 U.S.C.S. § 1126(a) (Law. Co-op. 1987).

44. 11 U.S.C.S. § 1129(a) (Law. Co-op. 1987).

45. 11 U.S.C.S. § 1129(b)(1) (Law. Co-op. 1987). "'Cram down' is a popular expression for the power of the bankruptcy court to force confirmation of a reorganization plan notwithstanding the dissent of one or more classes of creditors or ownership interests." 5 COLLIER ON BANKRUPTCY ¶ 1111.02, at 1111-12 n.4 (15th ed. 1985).

46. 11 U.S.C.S. § 365(d)(2) (Law. Co-op. 1987) (allows a trustee to assume a debtor's "executory contracts" which are unperformed contracts between the debtor and another party where the debtor's failure to perform would be a material breach excusing the other party from performing). See also Countryman, *Executory Contracts in Bankruptcy, Part I*, 57 MINN. L. REV. 439, 460 (1972-73).

47. "Equity cushion" has been defined as "the value in the property above the amount owed to the creditor with a secured claim, that will shield that interest from loss due to any decrease in value of the property during the time the automatic stay remains in effect." *In re Mellor*, 734 F.2d 1396, 1400 n.2 (9th Cir. 1984) (citing *In re Roane*, 8 Bankr. 997, 1000 (Bankr. E.D. Pa. 1981), *aff'd*, 14 Bankr. 542 (E.D. Pa. 1981)).

48. See *Mellor*, 734 F.2d at 1401 (where the court held a creditor was adequately protected with a 20 percent equity cushion). For a discussion of "adequate protection" see *infra* text accompanying notes 95-105.

operations.⁴⁹

Despite providing an opportunity for the farmer to recover, chapter 11 is by far the most expensive, time consuming, complicated and risky of the bankruptcy options.⁵⁰ However, many farmers choose chapter 11 because they can remain in charge of their own operations during the reorganization period. Even where there is no chance of recovery, chapter 11 provides a way for farmers to continue farming operations while waiting for a sale.

C. *Treatment for Farmers Under Chapter 13*

Chapter 13 provides for "wage earner" reorganizations or "adjustment of debts for individuals." Only the debtor, whether farmer or not, may file a petition under this chapter. In addition, the debtor must be an individual with "regular income."⁵¹ Partnerships and corporations are not eligible for chapter 13 treatment. The debtor must file a reorganization plan. As under chapter 11, the creditors must approve and the court must confirm the plan. While the debtor retains possession of the assets and continues to be in charge of operations, all or a portion of any future earnings or income must be submitted to the supervision and control of the trustee as necessary for the execution of the plan.⁵² The plan must be feasible and must be filed in good faith.⁵³

Chapter 13 was originally intended to include small farmers, but some of its strict eligibility requirements virtually eliminated most farmers. For example, chapter 13's requirement that the debtor have "regular income" excluded most farmers until revision of the definition of "regular income" included those with seasonal income who do not earn regular wages.⁵⁴

Also, to be eligible for chapter 13, bankruptcy debtors must have less than \$100,000 of noncontingent, liquidated and unsecured debt and less than \$350,000 of secured debt.⁵⁵ These debt

49. 11 U.S.C.S. § 1123(a)(5)(A) (Law. Co-op. 1987) (states that the plan must "provide adequate means for the plan's implementation such as . . . retention by the debtor of all or any part of the property of the estate").

50. H.R. Conf. Rep. No. 958, 99th Cong., 2d Sess. 48, *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS 5249.

51. 11 U.S.C.S. § 109(e) (Law. Co-op. 1987).

52. 11 U.S.C.S. § 1325(b)(1)(B) (Law. Co-op. 1987).

53. 11 U.S.C.S. § 1325(a)(6) (Law. Co-op. 1987) (requires that "the debtor will be able to make all the payments under the plan . . ."). 11 U.S.C.S. § 1325(3) (Law. Co-op. 1987) (requires that the plan be proposed in good faith).

54. 11 U.S.C.S. § 101(29) (Law. Co-op. 1987) (defines an individual with regular income as an individual whose income is sufficiently stable and regular to enable such individual to make payments under a plan under chapter 13).

55. 11 U.S.C.S. § 109(e) (Law. Co-op. 1987). (Noncontingent means that debts are

ceilings are unrealistic for most farmers whose debts far exceed the \$100,000/\$350,000 limits.⁵⁶

Individuals only and not corporations or partnerships may file petitions under chapter 13.⁵⁷ Families who farm together as partnerships or corporations cannot qualify. Unfortunately, courts are prone to impose partnerships on "Ma and Pa" farmers and family groups who farm together.⁵⁸ The definition of "farmer" required that 80 percent or more of the farmer's income come from farming. That provision had the effect of excluding those who earned income outside the farm or who had working spouses.⁵⁹

While Congress specifically intended chapter 13 to encompass farmers, most farmers simply cannot qualify. Attempts to amend chapter 13 ended with enactment of chapter 12 which closely follows the pattern of chapter 13 even to the extent of its official title: "Adjustments of Debts of a Family Farmer With Regular Annual Income."

V. CHAPTER 12—ADJUSTMENT OF DEBTS OF A FAMILY FARMER WITH REGULAR ANNUAL INCOME

A. *Who is Qualified to File under Chapter 12?*

Chapter 12 offers debtor relief to a much broader class of farmer than did chapter 13. This new chapter raises the debt ceiling, includes farming corporations and partnerships, and allows the individual farmer to have a higher non-farm income.

The Montana Bankruptcy Court reported that as of October 31, 1987, ninety-one chapter 12 petitions had been filed in Montana as well as seven conversions from other chapters to chapter 12.⁶⁰ Chapter 12 raises the debt limitations from the \$100,000/\$350,000 limits of chapter 13 to \$1,500,000 total debt provided that 80 percent of such debt arises out of farming operations owned or

owed for certain. Unliquidated means that the amount of the debt is not in dispute. Secured debt is debt which has collateral (usually the debtor's property) which the creditor has a right to repossess in case of default under the U.C.C. and property laws of each state).

56. See H.R. Conf. Rep. No. 958, 99th Cong., 2d Sess. 48, *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS 5249.

57. 11 U.S.C.S. § 109(e) (Law. Co-op. 1987) (states that only an individual may be a debtor under chapter 13).

58. See *In re Tegtmeier*, 31 Bankr. 555 (Bankr. S.D. Ohio 1983) (where three brothers and their wives who farmed together were held to be a partnership although no partnership agreement was contemplated).

59. 11 U.S.C.S. § 101(17) (Law. Co-op. 1984).

60. According to Mike Bell, Clerk of the Bankruptcy Court of the District of Montana in a telephone interview November 10, 1987.

operated by the individual debtor.⁶¹ In the case of corporate or partnership farmers, 80 percent of the debt must be related to assets of the farm.⁶² The debt ceiling figure excludes debt on the family home unless such debt arose out of the farming operation.⁶³

Chapter 12 allows the "Ma and Pa" farm to qualify by defining the "family farmer" as an individual and spouse.⁶⁴ It also includes family farm operations which are partnerships or corporations where 50 percent or more of the stock or equity is held by a family and 80 percent of the total asset value consists of assets related to the farming operation.⁶⁵

The members of the family must actively conduct the farming operation.⁶⁶ Unfortunately chapter 12 fails to provide a definition of "family" so that courts may have to rely on the intent of Congress for an interpretation of "family." Congress clearly intended to exclude large agribusiness corporations, hobby farmers, and tax shelters where non-farm business entities offset large incomes from other sources with farming losses.⁶⁷

To qualify for a chapter 13 reorganization, "farmers" must receive more than 80 percent of their gross income from the "farming operation."⁶⁸ Farmers with outside jobs or working spouses who did not meet the 80 percent criteria found themselves saddled with involuntary bankruptcies filed by creditors. Congress added the definition of "family farmer" to the code's general definitions in 1986 to include individuals and spouses who earn at least 50 percent of their annual gross income from farming operations.⁶⁹

B. *The Plan Under Chapter 12*

Chapter 12 allows debtor reorganization plans but not creditor plans.⁷⁰ The debtor has just 90 days from the filing of the petition to file such a plan.⁷¹ The court must conclude a confirmation hearing within forty-five days after the debtor proposes a plan (with some exceptions).⁷² While the court may extend the time for filing

61. 11 U.S.C.S. § 101(17)(A) (Law. Co-op. 1987).

62. 11 U.S.C.S. § 101(17)(B)(ii) (Law. Co-op. 1987).

63. 11 U.S.C.S. § 101(17)(B)(ii) (Law. Co-op. 1987).

64. 11 U.S.C.S. § 101(17)(A) (Law. Co-op. 1987).

65. 11 U.S.C.S. § 101(17)(B), 101 (17)(B)(i) (Law. Co-op. 1987).

66. 11 U.S.C.S. § 101(17)(B) (Law. Co-op. 1987).

67. 132 CONG. REC. H8998 (daily ed. Oct. 2, 1986) (joint explanatory statement of the Committee of Conference).

68. 11 U.S.C.S. § 101(17) (Law. Co-op. 1984).

69. 11 U.S.C.S. § 101(19) (Law. Co-op. 1987).

70. 11 U.S.C.S. § 1221 (Law. Co-op. 1987).

71. 11 U.S.C.S. § 1221 (Law. Co-op. 1987).

72. 11 U.S.C.S. § 1224 (Law. Co-op. 1987).

a plan for good reason,⁷³ bankruptcy judges have dismissed chapter 12 petitions for failing to meet the strict deadline absent permission for extension.⁷⁴ Such a short time frame suggests that the debtor should prepare a fairly well-organized plan before filing a chapter 12 petition.

Under chapter 12, family farmers may sell farmland or farm equipment not needed for the reorganization without creditor approval.⁷⁵ This provision permits the farmer to scale down operations, reduce debt load and dispose of surplus land and equipment. As a creditor protection, any lien on the farmland or equipment so sold attaches to the proceeds of the sale.⁷⁶ However, a recent Montana bankruptcy case allowed a debtor to use cash proceeds from the sale of secured livestock. The court cited a Nebraska case⁷⁷ holding that "chapter 12 does not absolutely prohibit debtors from using the proceeds of sale of certain collateral . . . if the creditor is protected."⁷⁸ That holding provides the farmer-debtor some leeway to use cash collateral for his operations even where the creditor is secured.

Unlike chapter 11 cases, the court appoints a trustee in every chapter 12 case.⁷⁹ The trustee administers the plan and the debtor must submit his future earnings and income to the supervision and control of the trustee as necessary to meet the cash payments required under the plan.

A plan can provide for both living expenses and farming operations. Where the plan does not propose paying all the creditors in full, all the debtor's "disposable income" must be applied to payments under the plan. "Disposable income" is defined as income received by the debtor which is not necessary for the maintenance and support of debtor and family or for operation of the farm.⁸⁰ Additionally, the farmer-debtor may use income earned outside the farm as a principal source of payment to creditors without destroying the farmer's eligibility as a family farmer under the 50

73. 11 U.S.C.S. § 1221 (Law. Co-op. 1987).

74. See *In re Tezak*, 4 Mont. Bankr. Rep. (Mont. L. Week) 280 (May 1, 1987).

75. 11 U.S.C.S. § 1206 (Law. Co-op. 1987).

76. 11 U.S.C.S. § 1206 (Law. Co-op. 1987).

77. *In re Wobig*, 73 Bankr. 292, 294 (Bankr. D. Neb. 1987).

78. *In re Martin*, 4 Mont. Bankr. Rep. (Mont. L. Week) 513, 529 (May 11, 1987).

79. 11 U.S.C.S. § 1202(a) (Law. Co-op. 1987). See also *In re Danelson*, 77 Bankr. Rep. 261, 265 (Bankr. D. Mont. 1987) (where Judge Peterson outlined the duties of a chapter 12 trustee. The court denied confirmation of the plan for not complying with 11 U.S.C.S. § 1202(a) (Law. Co-op. 1987) holding, "Section 1202(a) provides that a trustee be appointed in every case.")

80. 11 U.S.C.S. § 1225(b)(2) (Law. Co-op. 1987).

percent gross income test.⁸¹

The debtor, the trustee, or a holder of an unsecured claim can modify the plan upon request.⁸² If the farmer-debtor is still unable to make payments or complete the modified plan, the court may grant a discharge where "the debtor's failure to complete such payments is due to circumstances for which the debtor should not justly be held accountable."⁸³ Severe crop failure, drought, or market conditions might qualify the farmer for discharge under this provision.

One of the first problems courts had to resolve regarding chapter 12 was whether debtors could convert petitions filed under other chapters of the code to chapter 12. Confusion still exists. The bankruptcy judge has ultimate discretion in allowing conversion and conversion to chapter 12 is not an absolute right of the debtor.⁸⁴ The language of Public Law No. 99-554 indicates that any case filed before the effective date of November 26, 1986 cannot be converted, but courts have both allowed and disallowed such conversions.⁸⁵ In *In re Big Dry Angus Ranch*,⁸⁶ the Montana Bankruptcy Court followed courts in Colorado and North Dakota in allowing a family farmer to convert from a pending chapter 11 case filed prior to the effective date of chapter 12.⁸⁷ Moreover, courts have freely allowed conversion from chapter 11 cases filed after November 26, 1986 provided they were converted in good faith.⁸⁸ A chapter 7 case generally can be converted to chapter 12.⁸⁹ Interestingly, a recent Montana Bankruptcy Court case allowed a conversion from chapter 12 to chapter 11.⁹⁰

81. See *In re Indreland*, 77 Bankr. 268, (Bankr. D. Mont. 1987) (where the debtor met the definition of a family farmer at petition date, but had to earn more than 50 percent of his income from outside non-farm wages in order to meet the payments under the plan. The court did not disqualify the debtor as a family farmer.).

82. 11 U.S.C.S. § 1229(a) (Law. Co-op. 1987).

83. 11 U.S.C.S. § 1228(b)(1) (Law. Co-op. 1987).

84. 11 U.S.C.S. § 706 (Law. Co-op. 1987) ("The court may convert . . .").

85. The Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, § 302(c), 100 Stat. 3119 (1986). See *In re Erickson Partnership*, 74 Bankr. 670, 671-72 (Bankr. D.S.D. 1987) (for an extensive list of cases allowing conversions and disallowing conversion of bankruptcy petitions pending on the effective date of chapter 12).

86. 4 Mont. Bankr. Rep. (Mont. L. Week) 83 (Feb. 5, 1987).

87. *Id.* at 90.

88. See *In re Turner*, 4 Mont. Bankr. Rep. (Mont. L. Week) 136 (Mar. 5, 1987).

89. 11 U.S.C.S. § 706(a) (Law. Co-op. 1987) (allows a chapter 7 debtor to convert to a case under chapter 12 unless the case had already been converted from a chapter 12).

90. *In re Shearer*, 5 Mont. Bankr. Rep. (Mont. L. Week) 66 (Oct. 5, 1987) (where the farmer was ineligible for chapter 12).

C. *Absolute Priority Rule Abolished Under Chapter 12*

Prior to the enactment of chapter 12, the "absolute priority rule" under other chapters of the bankruptcy code mandated that secured creditors be paid according to the priority of their liens. Secured creditors under the other chapters had to approve the debtor's plan. Such creditors naturally objected if the plan did not provide for payment in full of their secured interests. This veto power of secured creditors effectively cut off claims of unsecured creditors as well as those of creditors having lesser priority. The only protection for unsecured creditors who have not approved the plan is that the court can confirm chapter 11 and chapter 13 plans only if the unsecured creditors will receive at least as much as they would have received under complete chapter 7 liquidations.⁹¹

While secured creditors are protected by the priority of their liens under other chapters, chapter 12 abolishes the "absolute priority rule" and allows the debtor to modify the rights of both secured and unsecured creditors.⁹² As a result, a chapter 12 plan can reduce the secured portion of the loan to market value of the collateral while the remainder of the loan becomes unsecured.⁹³ For example, a \$1,000,000 loan secured by land worth only \$600,000 will be secured only as to \$600,000 while the remaining \$400,000 becomes unsecured and thrown into the pool with other unsecured claims. The only protection the unsecured portion will receive is that without the creditor's approval of the plan, the creditor must receive at least as much as it would receive under a chapter 7 liquidation.⁹⁴ As a result, those loans based on high land values which are now greatly in excess of the current value of their collateral will now be secured only to the extent of the market value of the collateral, and unsecured for any balance.

Moreover, a chapter 12 plan can force unsecured creditors to accept nothing. Additionally, where the farmland value is much lower than the loan balance, a farmer may be allowed to reduce mortgage payments to reflect the value of the collateral on the date of filing and retain ownership of farm land and equipment.

91. 11 U.S.C.S. §§ 1129(a)(7)(A)(i), (ii) and 1325(a)(4) (Law. Co-op. 1987).

92. 11 U.S.C.S. § 1222(b)(2) (Law. Co-op. 1987). The plan may "modify the rights of holders of secured claims, or of holders of unsecured claims"

93. 11 U.S.C.S. § 506(a) (Law. Co-op. 1987) "separates an undersecured creditor's claim into two parts: He has a secured claim to the extent of the value of his collateral; and he has an unsecured claim for the balance of his claim." See also Notes on Committee on the Judiciary, S. Rep. No. 989, 95th Cong., 2d Sess., as cited in the Historical and Revision Notes of BANKRUPTCY CODE, RULES AND OFFICIAL FORMS 127 (1988).

94. 11 U.S.C.S. §§ 1129(a)(7)(A)(i), (ii), and 1325(a)(4) (Law. Co-op. 1987).

D. Adequate Protection Limited under Chapter 12

"Adequate Protection" as provided in section 361 does not apply in chapter 12 cases.⁹⁵ Rather, chapter 12 contains its own adequate protection provisions.⁹⁶

"Adequate Protection" is a statutory term for a very powerful creditor's remedy. Creditors invoke this remedy when asking the bankruptcy court to lift the "automatic stay" which precludes them from taking any action against the debtor including foreclosure and repossession. In motions to lift the automatic stay, creditors argue that their interest in the collateral is not adequately protected because the value of the collateral will erode before they can recover the property. "Adequate protection" is provided under chapter 3,⁹⁷ one of the general sections of the code which applies to all the other chapters, and therefore is available to creditors under all bankruptcies unless otherwise provided. Secured creditors have used "adequate protection" arguments and remedies to defeat farm reorganizations under other chapters before they had a chance to succeed. Unfortunately, farmer-debtors are forced to spend a great deal of their time and resources in negotiations and litigation involving stay motions.

To obtain relief from the automatic stay, the secured creditor must first prove to the court that the "stay" will result in a deterioration of the value of the creditor's interest in the property. The creditor may then request the court for "adequate protection" in the form of either periodic cash payments⁹⁸ or an additional or replacement lien⁹⁹ for the full value of the secured loan. Where the value of the underlying property is much lower than the loan, creditors can demand replacement liens on farm loans at values far in excess of current land value.

Most disastrous to farm reorganizations under other chapters is the application and court interpretation of "other relief . . . as will result in the realization by (creditor) of the 'indubitable equivalent' of such entity's interest in such property."¹⁰⁰ In a precedent-setting case, *In re American Mariner*,¹⁰¹ the Ninth Circuit Court of Appeals held that under the "indubitable equivalent" language of section 361, a creditor was entitled to "lost opportunity

95. 11 U.S.C.S. § 1205(a) (Law. Co-op. 1987).

96. 11 U.S.C.S. § 1205(b) (Law. Co-op. 1987).

97. 11 U.S.C.S. § 361 (Law. Co-op. 1987).

98. 11 U.S.C.S. § 361(1) (Law. Co-op. 1987).

99. 11 U.S.C.S. § 361(2) (Law. Co-op. 1987).

100. 11 U.S.C.S. § 361(3) (Law. Co-op. 1987).

101. 734 F.2d 426 (9th Cir. 1984).

costs" or what the creditor could have earned by liquidating the collateral and investing the proceeds. The application of "indubitable equivalent" to adequate protection often resulted in a farmer still owing the creditor money even though all the assets of the farm including the land were liquidated.

In enacting chapter 12, Congress clearly intended to nullify the holding in *American Mariner*. Chapter 12 contains a completely new adequate protection section which states plainly: "Section 361 does not apply in a case under this chapter."¹⁰² Instead, Congress gave chapter 12 its own adequate protection provisions which include the same remedy of cash payments and replacement liens as section 361 but specifically exclude the language of "indubitable equivalent."¹⁰³ In addition, chapter 12 adds a new "adequate protection" provision calling for payment to the creditor of reasonable market rent for farm land. The code defines "market rent" as that which is "customary in the community where the property is located, based upon the rental value, net income and earning capacity of the property" for farm land.¹⁰⁴

Practitioners should watch developing case law regarding chapter 12's adequate protection section for answers to such questions as: How will courts calculate "reasonable market rent"?; Will courts apply previous case law in interpreting "adequate protection" under chapter 12 where similarity to other chapters exists?; and Will section 1205 be held unconstitutional as a taking of property without due process as the court held in *American Mariner*?¹⁰⁵

E. Rescheduling of Long Term Debts under the Plan

An important accommodation for farmers under chapter 12 makes possible the rescheduling of payments, interest, and repayment time of long-term farm debts which extend beyond the time of the plan. While plans are limited to three years (or five years where the court permits),¹⁰⁶ family farmers, with court approval, can continue to pay on large loans over a longer period.¹⁰⁷ Rescheduling of debts imposes some statutory restrictions: (1) Rescheduled long-term debts which exceed the term of the plan are

102. 11 U.S.C.S. § 1205(a) (Law. Co-op. 1987).

103. 11 U.S.C.S. § 1205(b) (Law. Co-op. 1987).

104. 11 U.S.C.S. § 1205(b)(3) (Law. Co-op. 1987).

105. Questions raised by Harold V. Dye, U.S. Bankruptcy Trustee, in his presentation outline at a seminar at Big Sky, Montana, February 13, 1987.

106. 11 U.S.C.S. § 1222(c) (Law. Co-op. 1987).

107. 11 U.S.C.S. § 1222(b)(9) (Law. Co-op. 1987).

not discharged upon termination of the plan;¹⁰⁸ (2) the farmer must prove he is able to make the payments;¹⁰⁹ (3) each secured creditor will retain a lien on collateral securing the debt.¹¹⁰

Rescheduling of long-term debt has been the most litigated issue under chapter 12 thus far. Three economic factors figure in the structure of loans: (1) the present value of the debt, (2) the effective interest rate, and (3) the number of payments which will be made.

It seems clear that under the plan, the secured creditor must receive the present value of its allowed claim.¹¹¹ Present value of the debt is that amount of money which if paid right now would totally extinguish the debt. The present value becomes the basis on which to calculate the monthly payments at any given interest rate.

Courts in a number of chapter 12 cases asking approval for rescheduling of long-term debt have wrestled with what constitutes an appropriate interest rate. In Montana, Judge Peterson wrote a thorough discussion of the interest issue in *In re Martin*¹¹² "in light of the controversy which has surfaced on that issue in almost every Chapter 12 case." In that case, the court relied on a Ninth Circuit chapter 11 ruling which held that "[t]he appropriate interest rate is the prevailing market rate for that type and quality of loan" and that the final determination of the appropriate market rate had to be made on a case by case basis.¹¹³ The Montana Bankruptcy Court then determined that prime rate plus a risk factor is the appropriate rate.¹¹⁴ Montana's most recent case prior to publishing date is *In re Foster*¹¹⁵ which may very well settle the entire

108. 11 U.S.C.S. § 1228(a)(1) (Law. Co-op. 1987).

109. 11 U.S.C.S. § 1225(a)(6) (Law. Co-op. 1987) (states that the court shall confirm a plan if "the debtor will be able to make all payments under the plan."). See also *In re Martin*, 4 Mont. Bankr. Rep. (Mont. L. Week) 513 (May 11, 1987) (where the court did not confirm a chapter 12 because it was not feasible for the debtor to make the required payments under 11 U.S.C.S. § 1225(a)(6) (Law. Co-op. 1987)).

110. 11 U.S.C.S. § 1225(a)(5)(B)(i) (Law. Co-op. 1987) "the plan provides that the holder of such claim retain the lien securing such claim . . ."

111. 11 U.S.C.S. § 1225(a)(5) (Law. Co-op. 1987). See also *In re Indreland*, 77 Bankr. 268, 273 (Bankr. D. Mont. 1987).

112. 4 Mont. Bankr. Rep. (Mont. L. Week) at 517.

113. *In re Welco Indus., Inc.*, 60 Bankr. 880, 883 (9th Cir. 1986).

114. *Martin*, 4 Mont. Bankr. Rep. (Mont. L. Week) at 517. See also *In re Foster*, 5 Mont. Bankr. Rep. (Mont. L. Week) 122, 125 (Nov. 5, 1987) (setting risk factors from 0 percent to 2 percent).

115. 5 Mont. Bankr. Rep. (Mont. L. Week) 108, 118-25 (Nov. 5, 1987) (where the court reaffirmed the basic rule of *Welco*, "[t]hat prime rate plus a risk factor should be the commercial rate in a chapter [12] proceeding, and that the risk factor must be determined by considering the nature of security and feasibility of repayment so as to cover risk of loss.").

rescheduled farm debt problem and set the standard for the entire Ninth Circuit.

Just as controversial as the appropriate interest rate is the issue of how long may the plan extend the repayment period. In Montana, the bankruptcy court has denied plans proposing thirty-year payment schedules,¹¹⁶ although in *Foster* it extended the repayment period for some loans. Additionally, the court refuses to extend loans on equipment beyond the useful life of that equipment.¹¹⁷

VI. CONCLUSION

Congress enacted chapter 12 in response to a troubled farming industry. Rewriting bankruptcy law to solve an economic problem is a novel experiment in bankruptcy legislation. Congress, realizing that chapter 12 should be submitted to the test of time, and that economic factors might change, provided a sunset provision which calls for the automatic repeal of chapter 12 on October 1, 1993.

Critics express concern for agricultural lenders. If the experiment overly favors the farmers and burdens the lenders too heavily, the result could be disastrous to the overall farm economy. Currently, Montana farms loans are extremely difficult to obtain.¹¹⁸ Continued successful operation of our farms depends upon solvent and healthy agricultural lenders whose economic strength is impossible without prosperous farming. Bankruptcy law must balance the interests of lenders with the rights of borrowers. If chapter 12 buys some time for farmers to reorganize and recoup without sacrificing the integrity of our agricultural loans, then the new Farmer Bankruptcy Act will have met its challenge.

116. See *Indreland*, 77 Bankr. at 504 (denying term of 30 years); *Foster*, 5 Mont. Bankr. Rep. (Mont. L. Week) 122.

117. *In re Dunning*, 4 Mont. Bankr. Rep. (Mont. L. Week) 505, 511 (July 27, 1987) (holding that normal term of loans on chattels should not exceed five to seven years).

118. Address by W. Bjarne Johnson, 35th Annual University of Montana School Tax Institute (Nov. 14, 1987).