



Advantages of Chapter 12 of the Bankruptcy Code for “Family Farmers”

By all accounts, the United States remains mired in a historically challenging period for American farmers and, particularly, smaller scale farms, which oftentimes are family-owned. This continued malaise for farmers has seen a material increase in farm bankruptcies filed; however, the high cost of chapter 11 and stringent eligibility requirements for chapter 12 have left certain farmers that could greatly benefit from bankruptcy protection unable to file for relief. Congress may be implementing a very specific change to allow more family farms to be eligible to file under chapter 12.

Farming operations are typically able to file bankruptcy under chapter 7, chapter 11, or chapter 12 of the Bankruptcy Code. A chapter 7 filing will cause the immediate cessation of all farming activity and liquidation of all assets. Generally, a chapter 11 bankruptcy is a business reorganization, whereby a corporation files bankruptcy and attempts to use the bankruptcy laws to either reorganize its debts or liquidate its assets in an orderly fashion. On the other hand, chapter 12 of the Bankruptcy Code allows special rules for “family farmers” under a somewhat simplified statutory framework. Despite obvious similarities, there are a number of nuanced differences between chapter 11 and chapter 12 of the Bankruptcy Code that makes chapter 12 a very attractive option for parties that qualify.

Recent announcements indicate that Congress may be increasing the number of parties that can qualify for chapter 12. In March, it was reported that Sen. Amy Klobuchar, a Democrat presidential candidate and senator from Minnesota, announced plans to reintroduce a bill to increase the debt limits for “family farmers” from the current \$4.153 million to \$10 million. More than doubling the debt limits may allow far more parties to take advantage of chapter 12 with its simplified structure and significantly lower costs. Some of the advantages of chapter 12 when compared to chapter 11 are set forth below.

A. Eligibility and Cost

Either individuals or corporations may file bankruptcy under chapter 11. While there are no debt limits to preclude an individual from filing a chapter 11, individuals with less than \$394,725 in unsecured debt and less than \$1,184,200 in secured debt may file bankruptcy under chapter 13, which has far less restrictions and costs far less than a chapter 11 would. Chapter 11 is a very expensive process, as the filing fee alone costs \$1,717. Moreover, in chapter 11 cases, an official committee of unsecured creditors may be formed, and the costs of such committee’s professionals will be borne by a chapter 11 debtor.

Pursuant to the Bankruptcy Code, only a “family farmer” may file a chapter 12 bankruptcy. In order to qualify as a family farmer as an individual (or an individual and spouse), one’s debts must be less than \$4,153,150 and over 50% of the income generated by the individual must be related to farming. A “family farmer” may also be a corporation or partnership, in which “more than 50 percent” of the shareholders are members of the same family and the family actually conducts the farming operation. In the event a “family farmer” is a corporation or partnership, 80% of the value of its assets must be related to farming, its debts must not exceed \$4,153,150, and 50% of its debts must be related to the farming operations owned by the “family farmer.”

Chapter 12 contains fairly stringent requirements related to eligibility because chapter 12 (as further set forth below) is a far less expensive way to reorganize debts. The filing fee for a chapter 12 bankruptcy is only \$275 (compared to \$1,717 for a chapter 11). Moreover, a committee may not be appointed in a chapter 12 case, which also ensures that professional fees will be reduced. In the event that Congress increases the debt limits, more parties will be able to take advantage of the more cost-effective chapter 12 bankruptcy.

B. Asset Sales

Oftentimes, a debtor in bankruptcy will seek to sell assets either: (a) because such assets are underperforming or not worth the cost, or (b) to attempt to raise funds to continue operations. Debtors in chapter 11 must meet the stringent standards of section 363(f) of the Bankruptcy Code in order to sell property “free and clear” of liens. However, section 1206 of the Bankruptcy Code removes these requirements from a sale that occurs while a debtor is in chapter 12, so long as the property sold is “farmland or farm equipment.” Thus, the sale process in a chapter 12 bankruptcy is likely to be far less contentious than a sale process in chapter 11, in turn reducing attorneys’ fees.

Moreover, there are significant tax advantages to sales in chapter 12. In a chapter 11 bankruptcy, a debtor is responsible for any capital gains generated by a sale of assets. The tax liability is treated as a priority claim and must be paid in full at the time of plan confirmation. However, Congress amended the Bankruptcy Code in 2017 in order to clarify the scope of taxes in a chapter 12 bankruptcy. Congress added section 1232 of the Bankruptcy Code, which allowed any tax arising from “the sale . . . of any property used in the debtor’s farming operation” to be treated as an unsecured liability of the debtor (and be discharged in bankruptcy), instead of a priority tax claim. This is a huge advantage for a debtor under chapter 12, because it allows a debtor to keep the majority of any windfall it is entitled to after a sale.

C. Plan and Confirmation Requirements

Another way that chapter 11 and chapter 12 of the Bankruptcy Code significantly differ is that they have completely different plan confirmation requirements. A chapter 11 plan of reorganization generally requires that a secured creditor be paid at least the value of the secured creditor’s collateral. In addition, unsecured creditors may not be paid anything under a plan unless the debtor’s secured creditors are paid in full.

In a chapter 11, with some exceptions, all parties in interest are entitled to vote on the Plan. Therefore, it is possible for a plan to comply with all of the statutory requirements and still fail to be confirmed, because a number of creditors chose to vote against the plan.

In chapter 12, a secured creditor also must be paid at least the value of the secured creditor’s collateral. However, unsecured creditors may only be paid out of a debtor’s disposable income, which does not include those amounts necessary for the “operation of the debtor’s business” and (in the case of an individual), those amounts necessary for the “maintenance or support” of the debtor and the debtor’s dependents. A chapter 12 debtor therefore is at a great advantage, because a chapter 12 plan allows for the court to consider one’s lifestyle needs, in addition to the capital necessary to continue operating the farming business.

Further, creditors do not vote on the plan in a chapter 12, but have the ability to object to their treatment under the Plan. As long as the plan complies with all of the statutory requirements, a chapter 12 plan may be confirmed over the objection of a creditor.

Finally, chapter 11 debtors have 120 days to file a plan, which time may be extended (oftentimes for over one year). A chapter 12 debtor must file a plan within the first 90 days of the debtor’s case, which may be extended only if the reasons the extension is necessary were “attributable to circumstances for which the debtor should not justly be held accountable.” Thus, the chapter 12 plan process is not only faster, but oftentimes less expensive because the only requirements are statutory. Moreover, in chapter 12, there is no administrative expense associated with tallying votes and gaining creditor consensus.

D. Conclusion

A significant difference between chapter 11 and chapter 12 is the level of potential conflict between the debtor and its creditors, which chapter 12 attempts to eliminate. For example, creditors have much less ability to object to and stop sales of assets or challenge plan confirmation under chapter 12. For those individuals and corporations that qualify as “family farmers,” chapter 12 is, therefore, a less expensive and more efficient option than a chapter 11 bankruptcy.

In the event that Congress does increase the debt limit for a family farmer to \$10 million, far more businesses and individuals may be able to consider a chapter 12 bankruptcy. Moreover, simply being able to negotiate with lenders against the backdrop of a chapter 12 (which may be far less expensive than a chapter 11) may be an extremely beneficial tool to allow those newly-eligible parties to avoid filing bankruptcy altogether.

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