



QUATTLEBAUM, GROOMS & TULL PLLC

www.QGTlaw.com

Who Can Be A Chapter 12 Debtor?

March 20, 2017

By: Mary-Tipton Thalheimer

Contact:

Mary-Tipton Thalheimer

501.379.1742

mthalheimer@QGTlaw.com

Farmers in the United States experienced an economic boom in the 1970s fueled in large part by an increased demand for farm commodities coupled with high inflation and escalating farmland values. In the 1980s, however, the demand for commodities fell and the value of farmland quickly followed suit, resulting in an economic bust that rivaled that of the Great Depression. An estimated twenty-five percent (25%) of the assessed valuation of America's farmland disappeared during that time, and over one-third (1/3) of America's farmers found themselves in serious financial trouble. The number of farm foreclosures soared, and farm bankruptcies reached record highs. For the farmers who wanted to keep their farms, their only bankruptcy options were to file for relief under Chapter 11 or Chapter 13 of the United States Bankruptcy Code (the "Code"). Unfortunately for many farmers, Chapter 11 proved to be too complicated and expensive, whereas the debt limits of Chapter 13 precluded many farmers from qualifying as Chapter 13 debtors.

In response, Congress enacted Chapter 12 of the United States Bankruptcy Code, which is specifically tailored to provide bankruptcy relief for farmers who need financial rehabilitation.¹ A Chapter 12 debtor typically continues the farming operation as a debtor-in-possession, though a trustee will also be appointed to the bankruptcy case. The Chapter 12 debtor must submit a plan of reorganization within ninety (90) days of filing for bankruptcy relief, but no approval of the plan from creditors is necessary. Through the plan, Chapter 12 debtors are permitted to alter their secured debt by reducing the amount owed on the property to the property's fair market value. Chapter 12 also provides benefits in the form of reducing interest rates to the current market rate and extending the payment period of the debt. Moreover, Chapter 12 debtors may propose plans in which they pay only a small fraction of the debt owed to unsecured creditors so long as all of the debtor's disposable income is dedicated to the Chapter 12 plan throughout its duration.

¹ See 132 Cong. Rec. H9001 (daily ed. October 2, 1986) (Rep. Synar stated that chapter 12 would give hope to "family farmers who are facing the brink of disaster where they would have to be thrown off their farms" by giving them the ability to reorganize). Chapter 12 was only meant to be a temporary chapter to the Bankruptcy Code, but Congress made it a permanent chapter when the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 was enacted.

Today, farmland values are once again soaring while the prices of commodities continue to fall. Though conditions today are not identical to those of the 1980s, there is reason to believe another agricultural economic bust could occur in the future, but unlike in the 1980s, Chapter 12 is already in place and provides many benefits to those who qualify to be Chapter 12 debtors. But not all farmers qualify for relief under Chapter 12. The Code sets forth very specific requirements for Chapter 12 eligibility, and any debtor that fails to meet all of the requirements will face dismissal or conversion of his or her Chapter 12 case. Thus, it is important that farmers know whether they qualify for Chapter 12 relief before they file their petition. Likewise, given the many benefits afforded Chapter 12 debtors at the expense of their creditors, creditors should also be aware of the Chapter 12 requirements to ensure only farmers who meet the strict requirements receive its benefits.

I. Family Farmer as Defined by the Code

Bankruptcy courts cannot treat everyone that resides on a farm or carries out some farm-related activities as a “family farmer.” Congress did not enact Chapter 12 for the benefit of part-time farmers, investors, or landlords.² To ensure Chapter 12 relief is only available to those meant to benefit from it, Congress identified very specific criteria to use when determining whether a debtor is eligible to file under Chapter 12. In the Eighth Circuit, the strict letter of the law is applied when considering eligibility for Chapter 12 relief.

Pursuant to Section 109(f) of the Code, only a family farmer or family fisherman³ with regular annual income may be a debtor under Chapter 12.⁴ A “family farmer with regular annual income” means a family farmer whose annual income is sufficiently stable and regular to enable such family farmer to make payments under a Chapter 12 plan.⁵ This does not require a farmer to have regular monthly income, but it does require the farmer to have enough regular and stable income to fund a Chapter 12 plan over a three to five year period.⁶

A. Individual Family Farmer

The definition of an individual family farmer is broken down as follows:

- (1) The family farmer is an individual or an individual and spouse;
- (2) The farmer is engaged in a farming operation;
- (3) The farmer’s aggregate debts do not exceed \$4,153,150.00;
- (4) At least 50% of the farmer’s aggregate, non-contingent, liquidated debts (excluding debt for the principal residence that does not arise out of a farming operation) on the petition date arise out of a farming operation owned or operated by the farmer; and

² *Matter of Krueger*, 104 B.R. 223, 226 (Bankr. D. Neb. 1988). *See also In re Hettinger*, 95 B.R. 110, 112 (Bankr. E.D. Mo. 1989).

³ The focus of this article will only be on family farmers.

⁴ 11 U.S.C. § 109(g).

⁵ 11 U.S.C. § 101(19).

⁶ *In re Van Fossan*, 82 B.R. 77, 81 (Bankr. W.D. Ark. 1987).

- (5) the farmer receives more than 50% of his income for the tax year preceding the year in which the petition is filed, or each of the second and third years preceding the taxable year in which the petition was filed, from the farming operation.⁷

Based on the Code's definition, qualification as a Chapter 12 debtor does not hinge on possession of farmland, and in fact neither possession nor residence is a requirement for Chapter 12 eligibility.⁸

B. Corporate Family Farmer

In addition to aiding the individual family farmer, Congress also enacted Chapter 12 for the benefit of the family farmer entity that is mostly owned by a family engaged in farming operations, even when some family members with an ownership interest in the entity also have sources of substantial nonfarm income.⁹ Thus, the Code's definition of family farmer includes a corporation or partnership if the following requirements are met:

- (1) More than 50% of the outstanding stock or equity for the entity is held by one family or one family and the relatives of members of the family¹⁰;
- (2) The family and/or relatives conduct the farming operation;
- (3) More than 80% of the value of the entity's assets consist of assets related to the farming operation;
- (4) The entity's aggregate debts do not exceed \$4,031,575;
- (5) At least 50% of the entity's aggregate non-contingent, liquidated debts (excluding debt that does not arise from the farming operation that is owed for a dwelling owned by the entity and used by a shareholder or partner as a principal residence) owed on the petition date arise out of the farming operation owned or operated by the entity; and
- (6) The entity's stock, if any, is not publicly traded.¹¹

Accordingly, for a corporation or partnership to qualify for relief under Chapter 12, at a minimum, some member of the family must play an active role in the farming operation taking place on the corporation or partnership's land.¹² Moreover, a majority of the stockholders must participate in farming and derive substantial portions of their income from farming.¹³ Family involvement is not enough to ensure an entity qualifies to file for relief under Chapter 12 as only certain types of entities qualify. For example, a business trust that operates a farm may qualify as a family farmer if all other requirements are met, but a land trust, which exists solely to hold land to rent out for profit, would not.¹⁴

⁷ 11 U.S.C. § 101(18)(A).

⁸ *In re French*, 139 B.R. 476, 480 (Bankr. D.S.D. 1992).

⁹ *In re Cloverleaf Farmer's Co-Operative*, 114 B.R. 1010, 1012 (Bankr. D.S.D. 1990)

¹⁰ For Chapter 12 eligibility purposes, a relative of a member of the family means an individual related by marriage or blood within the third degree, as well as individuals in a step or adoptive relationship within the third degree.

¹¹ 11 U.S.C. § 101(18)(B).

¹² *In re Tim Wargo & Sons, Inc.*, 869 F.2d 1128 (8th Cir. 1989).

¹³ *Cloverleaf*, 114 B.R. at 1013. *See also* 132 Cong. Rec. 9985 (1986)(Sen. McConnell) (a corporation seeking to file under Chapter 12 must have at least fifty percent (50%) of its stock or equity owned by a person or persons that actually farm).

¹⁴ *See In re Ralph Faber Trust*, 113 B.R. 599 (Bankr. D.N.D. 1990).

II. Farming Operation as Defined by the Code

The most important criteria, regardless of whether the family farmer is an individual, partnership, or corporation, is that the family farmer plays an active role in the farming operation.¹⁵ The definition of farming operation includes general activities inherent in farming and those necessary to perpetuate a farming operation.¹⁶ Such activities include farming, tillage of the soil, dairy farming, ranching, production or raising of crops, poultry, or livestock, and production of poultry or livestock products in an unmanufactured state.¹⁷ The determination as to whether a debtor's income is derived from a farming operation must be based on whether the debtor receives income from his own farming or production efforts or merely benefits from the farming or production efforts of a tenant.¹⁸ Still, courts construe the definition of farming operation liberally to further Congress's purpose of helping family farmers to *continue* farming.¹⁹

When determining whether a debtor is engaged in farming operations, the amount of risk taken on by the debtor is relevant. Accordingly, renting out farmland alone does not constitute farming.²⁰ In other words, to qualify as a family farmer, a debtor that owns farmland must do more than merely negotiate and accept rent payments from a tenant who does all of the hands-on farming.²¹ For a landlord-debtor to qualify for Chapter 12 relief, he must have some significant engagement in, play some significant operational role in, or have an ownership interest in the crop production.²² Similarly, in some cases, a co-operative may qualify as a family farmer. However, the co-operative must engage in more than mere marketing and storing of crops.

When determining whether a debtor is engaged in farming operations, the debtor's intent to continue farming is also relevant. For example, capital gains earned from the sale of farmland may be considered farm income when the sale was done to downsize the operation.²³ However, if the sale was part of an effort to liquidate the farm, any resulting capital gains would not constitute farm income. Likewise, enrolling land in a conservation reserve program ("CRP") is similar to selling farmland or farm machinery in that it can constitute farm income when such enrollment is an attempt to continue the farming operation by scaling back the operation to a size the debtor is

¹⁵ *Cloverleaf*, 114 at 1013.

¹⁶ *Matter of Armstrong*, 812 F.2d 1024 (7th Cir. 1987).

¹⁷ 11 U.S.C. § 101(21).

¹⁸ *In re Easton*, 883 F.2d 630, 633 (8th Cir. 1989) (courts must identify the farming activities owned or operated by the debtor and determine whether the debtor received more than fifty percent (50%) of his income from those activities).

¹⁹ *In re Watford*, 898 F.2d 1525, 1527 (11th Cir. 1990) (emphasis added). *See also In re Maike*, 77 B.R. 832, 835 (Bankr. D. Kan. 1987) (citations omitted) (legislative history indicates definitions of farmer and farming operation are to be liberally construed).

²⁰ *Easton*, 883 at 634.

²¹ *In re Mary Freese Farms, Inc.*, 73 B.R. 508, 511 (Bankr. N.D. Iowa 1987)

²² *See Easton*, 883 F.2d at 636.

²³ *In re Bircher*, 241 B.R. 11, 16 (Bankr. S.D. Iowa 1999); *But see Van Fossan*, 82 B.R. at 81 (proceeds from sale of real property, not used for farming purposes, did not constitute farm income).

financially capable of maintaining.²⁴ The intent to continue farming must entail realistic or concrete prospects to continue over the duration of the Chapter 12 plan.²⁵

III. Farm-Related Debt and Income Requirements under the Code

The majority of a Chapter 12 debtor's debt must arise out of a farming operation. To determine whether a debt constitutes farm-related debt, courts examine the reason or purpose for which the debtor incurred the debt, as well as the use to which the proceeds of the debt were put.²⁶ Thus, debt owed for a settlement of a lawsuit involving the ownership of farmland may qualify as a debt arising from a farming operation if the relationship between the subject of the settlement and the farming operation is clear and direct.²⁷ Moreover, debt owed to an ex-spouse pursuant to a divorce decree may also constitute a debt arising from a farming operation if the debt is part of a division of farm property because such a division is within the scope of the farming operation.²⁸ While bankruptcy courts have determined that debts that appear to arise from non-farming operations can actually be considered farm-related debt, the burden is on the debtor, the party with the most knowledge of the transaction, to prove the debt constitutes farm-related debt.

Similarly, the majority of an individual debtor's income must arise from the farming operation to qualify for Chapter 12 relief. It should be noted, however, that for a family farmer entity, there is no requirement that the entity derive more than 50% of its income from farming operations.²⁹ As noted above, rent received by a landlord that merely leases farmland to a tenant does not constitute farm-related income whereas courts typically consider income from a crop share arrangement to be farm-related income. Additionally, wages, fees, or payments resulting from a farming activity constitute farm-related income.³⁰

In determining whether a Chapter 12 debtor meets the 50% gross income requirement, the Court need not look beyond the face of the debtor's income tax return for the tax year preceding the year the debtor's petition was filed. Gross income for purposes of the Code has the same meaning as gross income under the Internal Revenue Code.

IV. Conclusion

The one common thread in all farming legislation, including Chapter 12, is the desire to save the family farmer. However, Chapter 12 is only available to those family farmers that meet the Code's several requirements, which are intended to prevent individuals who are not truly farmers from receiving the benefits provided by Chapter 12. Unfortunately, not all debtors that farm meet

²⁴ *In re Paul*, 83 B.R. 709, 713 (Bankr. D.N.D. 1988) (in cases in which CRP payments are integral part of ongoing farming operations, such payments should be included in farm income calculation).

²⁵ *In re Buckingham*, 197 B.R. 97, 106-07 (Bankr. D. Mont. 1996).

²⁶ *In re Douglass*, 77 B.R. 714, 716 (Bankr. W.D. Mo. 1987).

²⁷ *Matter of Rinker*, 75 B.R. 65, 68 (Bankr. S.D. Iowa 1987).

²⁸ *Matter of Marlatt*, 116 B.R. 703, 706 (Bankr. D. Neb. 1990) (court held that amounts owed to ex-wife were farm debt because the debtor had to make payments to ex-wife to keep the farm making the debt "inescapably interwoven" with farming operation).

²⁹ *See id.* *See also In re Cross Timbers Ranch, Inc.*, 151 B.R. 923 (Bankr. W.D. Mo. 1993).

³⁰ *Matter of Burke*, 81 B.R. 971, 977 (Bankr. S.D. Iowa 1987).

the requirements, and any person or entity planning to file for bankruptcy protection under Chapter 12 should ensure he or she is eligible to do so. Otherwise, the debtor can find his or her Chapter 12 case dismissed or converted. Likewise, creditors should carefully examine whether a debtor actually qualifies under Chapter 12 given that the benefits and protections afforded to debtors detrimentally affect the rights of creditors.