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Trustee Talk

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What Every Bankruptcy Lawyer Must Know About Chapter 12



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Although chapter 12 is the focus of this article, it is not primarily for chapter 12 farmer/fisherman reorganization practitioners. This article is for everyone else, primarily for those who really do not know much about chapter 12 and really do not plan on representing any farmers or fishermen or filing any chapter 12 cases. So, why do you need to know anything about chapter 12?

Farmers do not always walk into your offices in overalls with straw hats and boots. Someone who may qualify for chapter 12 relief might at first appear to be just another client. They may not ask about chapter 12, or even if they do identify as a farmer, they may not express much interest in undergoing “a farm reorganization.” They could be someone with a struggling construction business who does some agricultural work on the side. They may not have any apparent nonexempt equity, and perhaps they just want to be done with farming. They may present as a chapter 7 client.

Here is the problem: If you are not screening every client for chapter 12 eligibility, and one slips through and you do not let that client know about the extraordinary relief that chapter 12 offers, you have made a serious (and perhaps costly) professional mistake. If such a client learns, after the bankruptcy you put them through, that they could have filed for chapter 12 relief and you failed to mention it, it might be time to call your carrier. That is why you should read this article.

The good news is that screening for chapter 12 eligibility is easy. There are two simple questions to ask: (1) “Have you had any income from either a farming, agricultural or commercial fishing opera-

tion in the past three tax years?” and (2) “Have you had income from the liquidation of farming assets in the past three tax years?” If the answer to both questions is a clear “no,” then you are done.² That will probably be true for most of your incoming cases. If you have a prospective client answer “yes,” then you really need to run them through a chapter 12 eligibility checklist, which is not difficult (see the exhibit).

Chapter 12 eligibility depends on active involvement in farming or commercial fishing, with an emphasis on debt and income. The income limitations require that for an individual, the person received greater than half of their gross income from farming in either the tax year before filing or both the second and third tax years before filing.³ In addition, at least 50 percent of the aggregated noncontingent liquidated debts must arise from the farming operation.⁴ For family fishermen, at least 80 percent of aggregated noncontingent liquidated debt must arise from the fishing operation.⁵ If the outcome of that analysis is that the debtor is clearly not eligible for chapter 12, then you are free to move on and evaluate their other options. If it looks like the client is eligible or if it is a close case, then you really owe it to that client to recommend a consultation with an experienced chapter 12 practitioner. If the practitioner reaches the conclusion that chapter 12 is not an option, then the practitioner’s duty has been fulfilled.

However, if the practitioner concludes that chapter 12 is an option for that client, then they can brief that client on their options, which protects the interests of the client and the practitioner. For

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² It is best practice to look at the client’s tax returns, including any limited liability company or other pass-through entities’ tax returns, to verify the answers to the questions.

³ 11 U.S.C. § 101(18)(A).

⁴ *Id.*

⁵ 11 U.S.C. § 101(19)(A).

most practitioners, a chapter 12 screening would only involve asking a few additional questions. It could result in a few clients seeking the services of a chapter 12 practitioner, but if those clients were better served by that choice, then you have done well by those clients.

Why Is Discussing the Chapter 12 Option Important?

At this point, you might be wondering, why is consultation about chapter 12 so important for those found eligible? Chapter 12 is the most powerful chapter of the Bankruptcy Code, as it allows debtors to accomplish the following: (1) the sale of land and the depreciated assets, and in some jurisdictions the end product of the farm,⁶ while de-prioritizing any capital gains tax⁷; (2) the cramming down of the claims of secured creditors of *all* collateral to the value of the collateral (including mortgages on the home); (3) the reamortization of all secured loans, including the home mortgage, extending to the useful life of the collateral with interest rates adjusted to the *Till* interest rate (prime rate plus a risk factor) or some other rate approved in your jurisdiction⁸ (for farms and homes, this amortization period can be 30 years); (4) the ability to propose a plan with a flexible payment schedule (seasonal or even annual payments); and (5) the ability to propose and confirm a plan with no credi-

tor voting, which can be confirmed over creditor objections — provided that the bankruptcy court approves the values and interest rate used.

Each of these benefits of chapter 12 involves something that is lacking in other reorganization chapters. When combined in a well-drafted plan, chapter 12 allows debtors to make substantial changes in their operations, including changing the scale of their farm, the type of farming done or even allowing debtors to sell equipment or parts of their farm and retain others, including their home. Even if farmers are determined to scale down, work their way out of farming or pass the farm to the next generation of farmers, chapter 12 offers a unique set of reorganization tools that can make those transitions more successful.

Deprioritization of Governmental Claims

Section 1232 allows a family farmer to deprioritize governmental claims arising due to the sale or other disposition of assets used in the farming operation. In the Eighth Circuit, the tax on the sale of end products (including market hogs and corn) qualifies for deprioritization.⁹ In *Knudsen*, the taxes shown on the tax return before the application of § 1222(a)(2)(A), the predecessor of § 1232, were \$55,319. Application of § 1222(a)(2)(A) deprioritized \$43,248 of the taxes, meaning that the deprioritized taxes would be discharged when the Knudsens received their chapter 12 discharge.

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6 *In re Knudsen*, 389 B.R. 643, 665-69 (N.D. Iowa 2008); *aff'd*, 581 F.3d 696 (8th Cir. 2009).
7 See 11 U.S.C. § 1232.
8 *In re Fuelling*, 601 B.R. 665 (Bankr. N.D. Iowa 2019) (citing *U.S. v. Doud*, 869 F.2d 1144, 1145 (8th Cir. 1989)), for the proposition that the market rate would be the U.S. treasury bond yield of the same maturity with an upward "risk premium."

9 *In re Knudsen*, 389 B.R. 643, 665-69 (N.D. Iowa 2008); *aff'd*, 581 F.3d 696 (8th Cir. 2009).

Chapter 12 Eligibility Checklist

Yes or No?	Characteristic	Individual	Non-Individual
	Debt Limit	Aggregate debts of \$10 million or less (11 U.S.C. § 101(18)(A)).	Aggregate debts of \$10 million or less (11 U.S.C. § 101(18)(B)(ii)).
	Income Qualification	> 50 percent of the gross income is from farming in the year before filing.	None.
	Income Qualification	> 50 percent of the gross income is from farming in both the second and third years before filing.	None.
	Debt Composition	> 50 percent of the aggregate, noncontingent, liquidated debt arises from farming (11 U.S.C. § 101(18)(A)).	None.
	Asset Composition		>80 percent value of its assets consists of assets related to the farming operation. 11 U.S.C. § 101(18)(B)(i).
	Ownership Restrictions	None.	>50 percent of the outstanding stock or equity is held by one family, or by one family and relatives of members of the family and the family's or relatives' farm. 11 U.S.C. § 101(18)(B).
	Publicly Traded	Not Applicable.	Not Allowed (11 U.S.C. § 101(18)(B)(iii)).
	Farming Operation Required	Maybe (11 U.S.C. § 101(18)(A) appears to require the family farmer to be engaged in farming; however, in <i>In re Williams</i> , 2016 WL 1644189 (Bankr. W.D. Ky. 2016), actual engagement in farming is not required).	Yes (11 U.S.C. § 101(18)(B)).

The taxes that were not deprioritized, \$12,701, were required to be paid through the chapter 12 plan. Given the increase in the debt limit to \$10 million, the tax savings will increase dramatically. One of the authors' cases requires the liquidation of more than 600 acres of land and about a quarter of a million dollars in equipment. The anticipated tax savings will exceed \$700,000. If this farmer had liquidated and then filed a chapter 7 case, the taxes would have been nondischargeable. If a farmer with assets encumbered well beyond the value of the debtor's assets filed a chapter 7 before the liquidation of the assets, the bankruptcy trustee would abandon the assets, which would then be sold by the creditors after foreclosure. The taxes would then be measured from the adjusted tax basis to the total value of the encumbrances, thereby dramatically increasing the tax collectible by the taxing authorities.

Cramdown of Secured Claims

Section 506 allows an undersecured claim to be bifurcated with the value of the collateral being treated as a secured claim and the excess being treated as an unsecured claim. This applies for all chapters of bankruptcy, but most other chapters disallow the cramming down of certain debts, most notably loans secured by mortgages on a debtor's principal residence.¹⁰

Chapter 12 contains no parallel restriction.¹¹ This is important for family farmers, because often a farmer's principal residence is on the farm, so the ability to modify a mortgage secured by the principal residence can be essential to a successful reorganization. However, this power is not restricted to cases where the debtor's principal residence is associated with the farming or fishing operation.

Reamortization of Secured Loans

Under 11 U.S.C. § 1222(b)(5) and (9), a chapter 12 plan can pay any allowed secured claim over a period longer than the plan term. Courts have interpreted this to allow the reamortization of secured loans over the asset's usable lifespan at the interest rates provided for in *Till* or other favorable rates. For farmland, that can be 25 or 30 years. This amounts to a forced loan extension at a favorable interest rate for a debtor who would likely not qualify for credit on such favorable terms.

Flexible Payment Schedule

As opposed to a chapter 13, where payments must generally start within 30 days of filing the case¹² and generally are made monthly,¹³ a chapter 12 debtor can make payments quarterly, seasonally or annually. In addition, there is no requirement to commence payments prior to plan confirmation. While 11 U.S.C. § 1221 requires a debtor to file a plan within 90 days of the petition date, this period can be extended for cause, and delays in plan confirmation can extend the time before a debtor must begin making plan payments for years.

¹⁰ See 11 U.S.C. §§ 1123(b)(5), 1322(b)(2).

¹¹ See 11 U.S.C. § 1222(b)(2) ("[T]he plan may ... modify the rights of holders of secured claims.")

¹² 11 U.S.C. § 1326(a)(1).

¹³ 11 U.S.C. § 1325(a)(5)(B)(iii)(I) provides that a secured creditor whose claim is modified by a chapter 13 plan may insist on equal monthly payments, and the general practice in chapter 13s is for monthly payments, though this does not appear to be required by the Bankruptcy Code.

A Plan Is Confirmable if a Court Finds that It Meets the Statutory Requirements

In contrast to a non-small business chapter 11, where, in addition to meeting statutory confirmation requirements,¹⁴ a plan must be voted on by creditors,¹⁵ confirmation of a chapter 12 plan is like confirmation of a chapter 13 plan.¹⁶ If the debtor can satisfy the court that the statutory requirements are met, potentially over objections from creditors, the chapter 12 trustee and the U.S. Trustee, then the plan is confirmable. Whereas in a chapter 11 one dissatisfied undersecured creditor might be positioned to prevent confirmation, or prevent the debtor from retaining property under the plan by invoking the absolute-priority rule,¹⁷ in a chapter 12 dissatisfied creditors have only the right to object to the plan, and their objections can be overruled by a judge.

Conclusion

The power available to debtors under chapter 12 makes scenarios where another chapter of bankruptcy is more favorable to an eligible debtor few and far between. Even if you have no interest in filing a chapter 12 yourself, you owe it to clients to ask the questions to determine whether they might be eligible for chapter 12. Not only is it the right thing to do, it is your ethical duty and can prevent a malpractice lawsuit in the future. **abi**

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¹⁴ This includes drafting a disclosure statement (11 U.S.C. § 1125).

¹⁵ See 11 U.S.C. §§ 1126, 1129(a)(7), (8), (10).

¹⁶ Compare 11 U.S.C. §§ 1225 & 1325.

¹⁷ 11 U.S.C. § 1129(b)(2)(B) & (C).