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The sword of the law should never fall but on those whose guilt is so apparent as to be pronounced by their friends as well as foes.

— Thomas Jefferson

Chapter 12 does not solve all tax problems

The new Chapter 12 of the Bankruptcy Code does not create a new entity for federal income tax purposes. Consequently, a farmer who files under Chapter 12 will not receive all the tax advantages that are realized under Chapters 7 and 11 of the Bankruptcy Code.

If an individual debtor files under Chapter 7 or 11, the bankruptcy estate becomes a separate tax-paying entity, which gives the debtor several income tax advantages. One advantage is that taxable gain, triggered by transferring assets from the bankruptcy estate to third parties, is treated as income of the bankruptcy estate. The debtor is not liable for the income taxes on that gain.

Another advantage is that the debtor can make an election to end a tax year the day before the bankruptcy petition is filed. That election makes the income taxes due on the income earned prior to the date of filing the petition a seventh priority item in the bankruptcy estate. Consequently, assets of the bankruptcy estate will be used to pay those taxes before they are used to pay unsecured creditors. If there are not enough assets in the estate to pay those taxes, the debtor remains liable for the unpaid portion.

Since there is no separate taxable entity under Chapter 12, there is no opportunity to shift tax liability to the estate, leaving the farmer/debtor without the option of ending a tax year the day before the bankruptcy petition was filed.

One of the income tax advantages of Chapters 7 and 11 is also available under Chapter 12. Debts discharged in a Chapter 12 proceeding qualify for the I.R.C. § 108(a)(1)(A) exception for debts discharged in bankruptcy. Consequently, farmers who file under Chapter 12 and have debts discharged will not have to report the discharged debt as income.

They will have to reduce tax attributes — net operating losses, tax credits, capital loss carryovers, basis and foreign tax credits — to the extent of the discharged debt. If the discharged debt exceeds tax attributes, however, the excess discharged debt has no tax consequences to the debtor.

— Philip E. Harris

Creditors' liability: The lender's response

Agricultural lenders are concerned and are responding to their liability exposure, which is experienced through lending practices. Areas of liability exposure include: fiduciary, contractual, statutory, as well as such common law theories as negligence, fraud, and joint venture arrangements. Many lenders are studying these different theories and the court cases being reported, and are initiating management practices to minimize risks.

Steps which need to be taken by individual lenders are: to study the borrower theories of the various cases, to initiate policies which address the areas of risk, and to conduct educational programs for employees making and supervising loans.

Several lenders have been interviewed to learn their responses to this liability exposure. Many have purposeful programs in place which address this concern. The responses of lenders and their counsel are summarized in this article.

There are several recommended lender practices to minimize liability exposure to claims that a fiduciary relationship has been established. The recommendations are:

1) Do not hesitate to make inspections, ask questions, etc. to exercise prudent lending practices;

2) Do not dominate a debtor's decision-making;

3) Make sure loan documents clearly lay out the rights and responsibilities of both parties, and then follow the agreements;

4) Be sure that all involvement in the debtor's business is primarily to protect the security interests of the creditor;

5) Make sure if the creditor suggests business decisions to be made by the debtor that alternatives are discussed and the final decisions are made by the debtor;

6) Maintain a file of important topics discussed with debtors;

7) Be cautious when using clauses in agreements which create debtor concepts of lender leverage, i.e., "payable on demand" or "deem oneself unsecured";

(continued on next page)

8) Do not maintain a file of statements made by one employee in criticism of another concerning management of a loan;

9) Develop a policy manual for dealing with debtors which recognizes liability concerns;

10) Conduct educational meetings for employees;

11) Have only one employee relate with a customer on all business relationships between the parties to facilitate bank understanding and reduce the risk of conflicting statements;

12) Stand behind bank employee commitments to customers;

13) Be sure the employee performance evaluation relates to many factors in addition to loan volume;

14) Never base pay increases on loan volume; and

15) Remember cases turn on the facts.

Each of these recommendations could be discussed in length, however. for the sake of brevity, one should apply the concept of each to the definition of fiduciary. The fiduciary relationship arises whenever confidence is reposed on the part of the customer in the suggestions made by the lender and the lender, in turn, exercises dominance and influence.

The close relationship between farm customers and bank loan officers, often developed over a period of many years, increases the risks of meeting the criteria of this definition. Also, the knowledge most farm lenders have of the details of farm management increases the opportunity for farm customers to gain confidence in suggestions made by the bank.

These unique characteristics of farm lending increase the fiduciary liability exposure and the need for aggressive efforts to minimize the risk.

Relative to contractual liability, every contract has an implied covenant of good faith and fair dealing, which implies that neither party will do anything which injures the right of the other to receive the benefits of the agreement. This covenant enables each contracting party to rely on representations made by the other. The basis for reliance may be upon representations which were written, oral, expressed or implied.

The list of creditor recommendations to reduce contractual liability is:

1) Take care not to contractually place restrictions on the debtor which are unnecessary to protect the creditor's interests;

2) Do not make oral agreements or positive statements in pre-loan discussions which the debtor may construe as promises;

3) Do not allow an unreasonable amount of time to lapse between loan discussions with a customer and execution of written agreements;

4) Be aware that customs of dealing can provide the basis of a contract;

5) Remember contracts can be modified by course of performance; and

6) Be cautious in imposing new terms or requirements after contracts are executed.

The risks related to statutory law continue to be identified. The first step in reducing statutory risks is to keep apprised of laws which are enacted concerning debtor/creditor relationships. Reading and evaluating new court decisions related to debtor/creditor law is essential, as new laws continue to be enacted which require creditor evaluation and adjustments in lending practices. Also, the court decisions relating to new and old statutory requirements may alter lending practices.

The common law theories are self-evident in dictating lender practices. Negligence in lending practices is of great concern if a fiduciary relationship can be proven by a debtor. If negligence can be proven, then the lender may become liable in excess of actual losses experienced by the debtor.

Additional liability can extend to punitive damages. Therefore, lenders need to doubly guard against letting a fiduciary relationship develop, and, in concern that such a relationship can be proven, be sure practices are those of a prudent lender. Lender policies, employee practices and loan portfolios should be reviewed routinely for negligent practices.

Fraud should never be condoned. Practices such as unilaterally changing executed documents, obtaining borrower approval through false statements, etc. are not excusable practices. These types of actions undoubtedly create creditor liability.

Lenders should not engage in practices which foster joint venture arrangements unless that is the intent of the parties. Joint venture arrangements are, in actuality, a partnership. Partnerships may be either oral or written. In determining if a partnership exists or existed, the intention of the parties governs. Written documents, oral statements or practices of the parties are evidence of intentions.

If a partnership can be proven by third-party claimants, then each partner becomes liable for the debts of the business. A partnership is an association of two or more persons for the purpose of carrying on a business together and dividing the profits. The elements of this definition should be guarded against if there is no intention of creating a partnership.

Each creditor needs to be active in reviewing the various areas of liability exposure and take steps to reduce those risks. A thorough study of recent court cases and writings should be initiated and adjustments made in management practices which create undue liability. The friendly, long-term debtor/creditor relationships in the agricultural business — where lenders are knowledgeable of management practices — create a need for extra caution.

— *Paul L. Wright*

Editor's Note: For those desiring a more extensive documentation of the subject with legal references, the reader is referred to Professor Wright's outline presented at the Seventh Annual Meeting of the American Agricultural Law Association in October 1986, in Fort Worth, Texas.

Professor Wright has indicated that he has a limited number of copies of this outline available. He can be reached at Ohio State University, Agricultural Economics Dept., 2120 Fyffe Road, Columbus, Ohio 43210. In addition, Professor Wright's presentation will be published in a forthcoming issue of the University of Alabama Law Review.

Lagoon overflow

Fishel v. Westinghouse Elec. Corp., 640 F.Supp. 442 (M.D. Pa. 1986), is a citizen's suit action against a dump operator. A hazardous waste site contained a lagoon from which there were discharges of unchanneled and uncollected surface water into a stream.

The court followed *O'Leary v. Moyer's Landfill Inc.*, 523 F.Supp. 642, 655 (E.D. Pa. 1981), in concluding that this *was a point source* as defined in the Clean Water Act of 1977, 33 U.S.C. Section 1362(14).

— *John H. Davidson*

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Farmers' tools of the trade

In re LaFond, 791 F.2d 623 (8th Cir. 1986), the Court of Appeals ruled on four questions that arise in farm bankruptcy cases where a debtor seeks to claim as exempt and to avoid liens on tools and implements of the trade.

The issues raised were whether a debtor must meet the definition of "farmer" in the bankruptcy code to be "engaged in the trade of farming;" whether the debtor's wife who draws no salary from the farm is nevertheless "engaged in farming;" whether large items of farm equipment may be considered "implements or tools of the trade;" and whether the disputed items were necessary for the farm operation.

In deciding that a debtor need not meet the 80% of gross income test of the bankruptcy code definition of farmer, the court reasoned that such a test would unfairly preclude many debtors from utilizing lien avoidance remedies in the manner Congress intended.

Further, it was affirmed that Congress intended the given definition of farmer to be applied only where the term is specifically used in the bankruptcy code.

The *LaFond* court affirmed the lower court's views that it is more appropriate to weigh: 1) the intensity of a debtor's past farming activities; and 2) the sincerity of his intention to continue farming in determining (for this lien avoidance purpose) whether a person is engaged in the trade of farming.

Where the debtor/husband worked 100 hours per month as a policeman, the court reasoned that debtor/wife must have been doing farm chores. Notwithstanding the fact that the wife drew no salary for her labor, she was to be considered a farmer for lien avoidance purposes.

In deciding that large farm machinery may be considered implements or tools of the trade, the court followed a line of cases in several jurisdictions that rejects the notion that lien avoidance provisions are available solely on goods of little resale value.

In addition, it was noted that a narrow construction of the definition of tools of the trade and implements would punish the farmer for being inadvertently dependent on expensive tools of the trade — as compared to other trades more dependent on smaller hand tools.

In deciding which tools may be claimed as exempt, the court concluded that the test was not that the equipment be commonly understood as an implement or tool of the farming trade; rather the test was whether the item was reasonably necessary to this debtor in his trade.

— *Patricia A. Conover*

Federal Register in brief

The following is a selection of final rules, proposed rules and notices that have appeared in the *Federal Register* in the last few weeks:

1. FmHA Implementation of Administrative Offset. Interim Rule. 51 Fed. Reg. 42,820. Effective date: Nov. 26, 1986. The FmHA adds a regulation to permit administrative offset against amounts that would otherwise be paid by other federal agencies to delinquent FmHA Farmer Program loan borrowers.

2. Commodity Certificates, In-Kind Payments, and Other Forms of Payments. Interim Rule. 51 Fed. Reg. 43,579. Producers who have commodity certificates issued before Nov. 17, 1986 may transfer such certificates through the expiration date shown on the certificates.

Producers who have commodity certificates issued on or after Nov. 17, 1986 may transfer them through the expiration date shown on the certificates, and may, during the period starting the first day of the sixth month after the months in which the certificates were issued through the expiration date, submit the certificates to the CCC for payment by check. Effective date: Dec. 2, 1986.

3. Certification of Central Filing System for Utah. 51 Fed. Reg. 43,647. Nov. 28, 1986.

4. FmHA Interest Rate Reduction. 51 Fed. Reg. 43,647. Interest rates on Disaster Emergency Program loans reduced to 4.5%. Effective date: Nov. 19, 1986.

5. Guidelines for Groundwater Classification Under the EPA Groundwater Protection Strategy. 51 Fed. Reg. 43,664. Notice of availability of draft document for public comment. Comments due by Feb. 8, 1987.

6. Certification of Central Filing System for Maine. 51 Fed. Reg. 43,941. Dec. 2, 1986.

7. Farm Credit Administration; Funding and Fiscal Affairs; Investment Activities by System Banks. Proposed Rule. 51 Fed. Reg. 44,310. Written comments due by Jan. 8, 1987.

8. Federal Crop Insurance Corp., General Administrative Regulations — Appeal Procedure. Final Rule. 51 Fed. Reg. 44,588. Effective date: Dec. 11, 1986.

9. Farm Credit Administration: Disclosure to Shareholders; Accounting and Reporting Requirements — Correction. Final Rule. 51 Fed. Reg. 44,783. Correction to final rule that appeared in 51 Fed. Reg. 42,084. Dec. 11, 1986.

10. FmHA Implementation of Provisions of Food Security Act of 1985 for Debt Settlement. Final Rule. 51 Fed. Reg. 45,430. Effective date: Jan. 20, 1987.

— *Linda Grim McCormick*

Production Credit Association CEO discharge authorized

The Federal Intermediate Credit Bank (FICB) of St. Louis discharged the chief executive officer of the Osage Production Credit Association. The discharged officer sought declaratory judgment that this action by the FICB exceeded its authority.

The Eighth Circuit upheld the authority of the act of the bank on the grounds that such power was implicit in the statutory scheme created for the Farm Credit Administration. *Bailey v. Federal Intermediate Credit Bank of St. Louis*, 788 F.2d 498 (8th Cir. 1986).

— *John H. Davidson*

AG LAW CONFERENCE CALENDAR

Agricultural Workouts and Bankruptcies.
Feb. 2-3, 1987,
The Ambassador West Hotel,
Chicago, IL.
Feb. 26-27, 1987,
The Halloran House, New York, NY.

Topics include: workouts; keeping the debtor-in-possession providing adequate protection; Chapter 11 disclosure and plans; tax implications; Uniform Commercial Code issues in bankruptcy; and new legislation.

Sponsored by The Practicing Law Institute and the American Bankruptcy Institute. For more information, call 212 765-5700, Ext. 271.

Seminar on Bankruptcy Law and Rules.
March 26-28, 1987, Marriott *Marquis* Hotel, Atlanta, GA.

Topics include farm bankruptcy.

Sponsored by the Southeastern Bankruptcy Law Institute.

For further information, contact Myra Bickerman at 404 396-6677

Farm Reorganization After Chapter 12.
Feb. 13, 1987, Sheraton Midway Hotel, St. Paul, MN.

Sponsored by the Minnesota Institute of Legal Education.

For further information, call 612 379-1128.

Bankruptcy farm relief: The new Chapter 12

By Janet Flaccus

There is no doubt that farmers in financial distress, who have wanted to remain in farming and keep their farm property, have not received much help from the existing Bankruptcy Code. Only Chapters 11 and 13 allow the debtor to keep the property and restructure his or her debts under a plan confirmed by the Court.

Chapter 13 is not available for most farmers, since it applies to individuals with non-contingent, liquidated debts that do not exceed $100,000 in unsecured debts and $350,000 in secured debts. 11 U.S.C. § 109(e) (1982).

Therefore, most farmers have filed in Chapter 11 and found, as discussed below, many problems. On Oct. 27, 1986, President Reagan signed a bill creating a new Chapter 12 in the Bankruptcy Code which applies to certain farmers. This should provide some help.

Who Can File

Individuals, corporations and partnerships can file a Chapter 12 petition. If the farmer is an individual, or an individual and spouse, aggregate debts cannot exceed $1.5 million. Eighty percent of the non-contingent, liquidated debts must have arisen from a farm operation owned by the individual or the individual and spouse. This 80% requirement does not include, however, any debts on the farmer's residence unless such debt arose out of the farming operation.

In addition, this individual, or individual and spouse (for the taxable year preceding the bankruptcy filing) must have received more than 50% of gross income from such farm operation. Bankruptcy Judges, United States Trustees and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, §§ 253 and 251(3), 100 Stat. ___ (1986). (Hereinafter, reference will be made solely to section numbers).

A corporation or partnership may file a Chapter 12 petition if at least 50% of the outstanding stock or equity is owned by one family or by the one family and its relatives. Such family or the relatives must conduct the farm operation. In addition, more than 80% of the value of the corporation's or partnership's assets must relate to the farm operation, and the aggregate debts cannot exceed $1.5 million.

Here also, 80% or more of the corporation's or partnership's non-contingent, liquidated debts must arise from the farm operation, but this does not include a debt owed on the principal residence, unless such debt arose out of the farm operation. *Id.*

The family farmer must have a regular income in order to be able to file in Chapter 12. This means that annual income is sufficiently stable to enable the family farmer to make the payments under the plan. *Id.*

Conversion Rights

A bigger question is whether farmers who have already filed under Chapter 11 can convert their cases to Chapter 12. The Act provides that a Chapter 11 or 13 petition can be converted to Chapter 12, but only if such conversion is equitable. § 256.

This section of the Act (as well as all of the sections dealing with Chapter 12), however, are made effective only to cases filed after the effective date of the Act (Nov. 26, 1986). § 302(c). This conflicts with the Conference Report, which states, "[i]t is not intended that there be routine conversion of Chapter 11 and 13 cases, pending at the time of enactment, to Chapter 12. Instead, it is expected that courts will exercise their sound discretion in each case . . .". Conference Report, H. R. Rep. No. 958, 99th Cong., 2nd Sess. 4 (1986).

Clearly, the conferees intended that cases pending at the time of enactment could be converted to the new Chapter 12 if such were equitable. The statutory language says otherwise.

If a farmer can qualify for Chapter 12, it is generally a better situation, especially when compared with the treatment of the same case using Chapter 11. It is less so with respect to Chapter 13. This is because Chapter 12 is modeled primarily after Chapter 13 — not Chapter 11. Since most farmers could file only Chapter 11 petitions before, the new Chapter 12 provisions will be compared with the problems that existed for farm reorganizations in Chapter 11.

Filing a Plan

Debtors under Chapter 11 have 120 days after the petition filing — plus any extension granted for good cause — to file a plan. 11 U.S.C. § 1121(b) (1982). In a voluntary plan, the order for relief occurs with the filing of the petition. 11 U.S.C. § 301 (1982).

If the debtor does not so file, he or she runs the risk that a creditor will file a liquidation plan. Once approved, the farm will be liquidated even over the farmer's objections. *In re Button Hook Cattle Co. Inc.*, 747 F.2d 483 (8th Cir. 1984); *In re Jasik*, 727 F.2d 1379 (5th Cir. 1984).

A lower court has disagreed, however. *In re Lange*, 39 Bankr. 483 (Bankr. D. Kan. 1984).

In contrast, creditors have no right to file a Chapter 12 plan; only the debtor can so file. § 255, Subchapter II, § 1221. The farmer has 90 days after the petition in which to file a Chapter 12 plan. § 255, Subchapter II, § 1221. The court must hold a confirmation hearing on the plan within 45 days of the plan's filing. This time frame should be relatively easy to meet in Chapter 12.

As will be discussed later, unlike Chapter 11, creditors in a Chapter 12 proceeding have no right to vote on the plan. § 255, Subchapter II, § 1225. Negotiation will be much less a part of a Chapter 12 proceeding than was the case under Chapter 11. Therefore, less time should be needed to draw up a Chapter 12 plan.

If no plan is filed on time and an extension of time cannot be obtained from the bankruptcy judge, the petition is merely subject to dismissal (§ 255, Subchapter I, § 1208), not a creditor's plan.

One main drawback of such a dismissal is that the farmer will be precluded from refiling a bankruptcy petition for 180 days. The Act amends section 109 of the Bankruptcy Code by adding "or family farmer" after "individual" in section 109(f), which it redesignates as section 109(g). §253.

Opportunity Costs

Opportunity costs are another big issue under Chapter 11. This is the right of an undersecured creditor to get periodic payments from the debtor prior to plan approval to compensate the secured party for the fact that it cannot sell the collateral and reinvest the proceeds.

The circuit courts are divided on the question of whether undersecured creditors have any right to be compensated for lost opportunity costs. *Crocker National Bank v. American Mariner Industries*, 734 F.2d 426 (9th Cir. 1984) and *Grundy National Bank v. Tandem Mining Corp.*, 754 F.2d 1436 (4th Cir. 1985), hold that an undersecured creditor is entitled to opportunity costs as a matter of law.

In *In re Timbers of Inwood Forest Association Inc.*, 793 F.2d 1380 (5th Cir. 1986) (en banc. review is pending), the Fifth Circuit recently held that an undersecured creditor was not entitled to opportunity costs as a matter of law. The Eighth Circuit held in *In re Briggs Trans. Co.*, 780 F.2d 1339 (8th Cir. 1985), that the trial court had discretion whether or not to award opportunity costs.

The courts which allow opportunity costs in a Chapter 11 proceeding base that decision on the right of a secured creditor to be adequately protected as defined in section 361. Chapter 12 has its own definition of adequate protection. In three of the four statu-

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tory subsections in this section, payments are provided only if the value of the property is declining in value. § 255, Subchapter I, § 1205(b)(1),(2) and (4).

This does not provide for opportunity costs. Payments for lost opportunity costs are above and beyond payments to compensate the secured party for the declining value of the collateral.

This definition does, however, add a new way of adequately protecting a secured creditor with a security interest in farmland. It provides for a payment of a sum equal to a reasonable rent for land in that area if such farmland is used by the debtor. § 255, Subchapter I, § 1205 (b)(3).

It remains unclear whether an undersecured creditor with a mortgage on farmland is entitled to these rental payments prior to plan confirmation. Unlike the three other subsections in this section, in subsection (3), the statutory language is not limited to the situation where the farmland is depreciating in value. If an undersecured creditor is allowed a rental payment when the value of the land is not declining, this creditor would be getting a form of opportunity cost. If monthly payments are required, this could put some farmers in a difficult position, since farm income does not come in on a monthly basis.

The amount of time elapsing prior to confirmation in Chapter 12 proceedings, however, should be much shorter than it often is during Chapter 11 proceedings. Therefore, lost opportunity costs should be less of a problem in Chapter 12 cases.

Post-Petition Financing and Use of Collateral

Another problem is financing the continued operation of the farm. Most farm bankruptcy petitions are filed in the spring when the farmer is unable to secure needed financing. After filing, many farmers need to use proceeds from the sale of stored farm products to finance the new crop. Such stored products often have a security interest in them, and the lender is often unwilling to allow the sale.

Section 363 of the Bankruptcy Code allows the sale of non-cash collateral in the ordinary course of business, but such sale will not be free of the security interest unless the secured party consents. 11 U.S.C. § 363(f) (1982). There are other bases for sale free and clear of a creditor's lien, but the other grounds are often not applicable.

The Act allows the trustee in Chapter 12 to sell assets free and clear of liens with court approval (§ 255, Subchapter I, § 1206), but it makes the proceeds of such sale subject to the lien. The proceeds would be cash collateral, and cash collateral cannot be used by the farmer without court approval, and adequate protection of the secured creditor's interest. 11 U.S.C. § 363(c)(2),(e) (1982).

The new Act does not provide any special section in Chapter 12 for addressing the issue directly. The problem is that the cash will be used to plant seeds in the spring, and many variables outside the farmer's control can affect harvest. Therefore, a creditor with a security interest in 10,000 bushels of corn, for example, may end up with a substitute lien on 8,000 bushels of corn the next year.

Most courts have allowed the farmer to use the cash collateral as long as crop insurance is provided and a lien is given to the creditor on the future crop. Such was allowed in *In re Sheehan*, 38 Bankr. 859 (Bankr. D.S.D. 1984) and in *In re Nikolasen*, 38 Bankr. 267 (Bankr. D.N.D. 1984).

Problems are created when the farmer wishes to branch into a new type of farming with the proceeds or when the farmer plants crops with proceeds on rented land. In *In re Frank*, 27 Bankr. 748 (Bankr. S.D. Ohio 1983), the debtors wished to use proceeds from soybean and cattle sales to buy more cattle. The court refused, noting that there was no proof that the cattle operation would produce reasonable profits without jeopardizing the replacement liens.

In *In re Berens*, 41 Bankr. 524 (Bankr. D. Minn. 1984), the court refused to allow the use of proceeds when the replacement lien was on future crops grown on rented land. The court noted the potential conflict between the lessor's interest in the future crops and the replacement lien in the crops. The court held that the creditor was, therefore, not adequately protected by a replacement lien in the future crops.

The Eighth Circuit in *In re Martin* lists factors to be considered before forcing a secured creditor to accept this "roll-over" lien. 761 F.2d 472 (8th Cir. 1985). First, the court remanded for a determination of the value of the secured parties' interest in the stored crops. 761 F.2d at 477.

Second, the court noted that several factors had to be considered, since federal crop insurance did not cover crop loss caused by the failure of the farmer to follow good husbandry practices. *Id.*

The court suggested that productivity of the land, husbandry practices of the farmer, crop yields from previous years, health and reliability of the farmer, condition of the farmer's machinery, whether the farmer's machinery might be repossessed prior to harvest, potential liens on the crop by other creditors, and anticipated fluctuation in market price of the farmer's crop were to be taken into consideration in determining whether the value of the secured party's lien in the stored crops was sufficiently protected. *Id.*

These factors should still be the analysis in the new Chapter 12. If a farmer cannot get the court to authorize this roll-over lien, the farmer will have a difficult time remaining in farming, even under Chapter 12. This is one of the main hurdles facing the farmer in Chapter 12

Treatment of Secured and Unsecured Debts

A number of problems under Chapter 11 have been removed by the Act. Many farmers have undersecured creditors i.e., the value of the collateral is lower than the outstanding indebtedness.

A debtor wants to be able to reduce secured claims to the value of the collateral and to pay only the percentage of unsecured debts which he or she can afford. In a Chapter 11 proceeding, this was complicated by a number of different sections.

First, section 1111(b) allowed an undersecured creditor to elect to be treated as fully secured. 11 U.S.C. § 1111(b) (1982). Although this did not require payment in full under the plan (11 U.S.C. § 1129(b)(2)(A) (1982)), it did prevent a cashing out of the claim at the beginning of the plan by paying only the amount the collateral was worth. *In re Griffiths*, 27 Bankr. 873 (Bankr. D. Kan. 1983); *In re Hallum*, 29 Bankr. 343 (Bankr. E.D. Tenn. 1983); *In re Elijah*, 41 Bankr. 348 (Bankr. W.D. Mo. 1983). Thus, a debtor could not sell some farm property to pay off secured debts in the early part of the plan.

There is no counterpart to section 1111(b) in Chapter 12. Undersecured claims can be scaled down to the value of the collateral and the remaining indebtedness is treated as unsecured debt. § 255, Subchapter II, § 1225(a)(5)(B)(ii)

Unsecured debt is also treated differently in Chapter 12. In Chapter 11, the unsecured creditors must agree to accept the plan payments. This is the heart of the negotiation process.

In Chapter 12, the unsecured creditors must be paid only as much as they would have received had the farm been liquidated in Chapter 7. § 255, Subchapter II, § 1225(a)(4). If a farmer has few unencumbered, non-exempt assets, this mandatory amount will not be high.

If unsecured creditors and secured creditors with an unsecured portion of a claim are unhappy with this amount, there is little they can do about it. Unlike Chapter 11, creditors in Chapter 12 do not have the right to approve the debtor's plan. They have no right to vote. Once the plan meets the require-

(continued on next page)

ments of confirmation, the creditors are bound. § 255, Subdivision II, § 1227(a).

No Absolute Priority Rule

The above situation is very different from the operation of Chapter 11. Under those rules, if impaired creditors did not accept the plan, the debtor had to meet the "cram down" rules to bind the creditors — despite their objections.

Central to a Chapter 11 cram down is the absolute priority rule with respect to unsecured debts. This rule means that the debtor cannot receive or retain property of any value unless creditors above in priority (including unsecured creditors) receive payment in full under the plan. 11 U.S.C. § 1129(b)(2)(B)(ii) (1982). Thus, the farmer could not keep the farm property unless unsecured creditors accepted the plan, or were paid in full.

A recent decision by the Eighth Circuit Court of Appeals, *Ahlers v. Norwest Bank of Worthington*, 794 F.2d 388, *reh'g denied*, 794 F.2d 414 (8th Cir. 1986), held that the farmer's work and expertise could be considered contributions from the debtor, which would allow the debtor to share in property of the estate.

The Court held that if, over the life of the plan, the value of the farmer's contributions were worth the value of the farm property retained by the farmer at the end of the plan, the absolute priority rule would be met. 794 F.2d at 400-50.

Lower courts are already beginning to disagree. *In re Stegall*, 64 Bankr. 372 (C.D. Ill. 1986).

There is no absolute priority rule in Chapter 12 since creditors have no right to vote on the plan. Under the plan, the farmer can keep farm assets, and propose to pay the present value of the collateral to secured creditors. Unsecured creditors may receive an amount equal to a hypothetical Chapter 7 payout.

Unsecured creditors who are entitled to section 507 priority, however, such as tax claims, wage claims, administration costs, etc., must be paid in full under the plan. § 255, Subchapter II, § 1222(a)(2).

There is one catch if a creditor objects to the plan, however. During the lifetime of the plan (which will usually be three years and can be no longer than five years), the farmer must pay under the plan all of the farmer's projected disposable income. § 255, Subchapter II, § 1225(b).

Disposable income is defined as income not reasonably necessary for the maintenance or support of the debtor and his or her dependents, and money not reasonably necessary for the continuation, preservation and operation of the debtor's business. § 255, Subchapter II, 1225(b)(2). If the disposable income will pay creditors more than the rules stated above would allow, then the creditors will receive more.

Curing Defaults

Chapter 12 provides for the curing of any defaults by paying such off under the plan within a reasonable time, while maintaining payments on the debt. § 255, Subchapter II, § 1222(b)(5). This provision applies to all debts on which the last payment is due after the date on which final payment under the plan is to be made. This would probably be most farm debts.

For other types of defaults, the statute provides that the plan may cure or waive other types of defaults. § 255, Subchapter II, § 1222(b)(3). Thus, while making regular payments under the plan, additional payments can be made to pay off any amounts in default. In addition, rights of secured and unsecured creditors are modifiable. § 255, Subchapter II, § 1222(b)(2).

Unsecured creditors' claims can be modified both in the amount to be paid and by enlarging the time in which it is to be paid. Secured creditors are entitled to the present value of their collateral, so their claim — to the extent it is secured — cannot be modified in the amount to be paid. The payment period can be modified, however.

Discharge

The discharge rules in Chapter 12 are primarily based on Chapter 13 — with some changes. § 255, Subchapter II, § 1228. As is the case in section 1328, there are two types of discharges in Chapter 12. Once the farmer makes all of the payments under the plan, he or she will be entitled to a discharge under section 1228(a).

There are several types of debts excepted from this discharge. First are long-term debts, the final payment on which will take place after the last payment under the plan. These are debts included in section 1222(b)(5) of the new chapter.

The statute is confusing on the second type of debt not subject to discharge. It refers to section 1222(b)(10), which covers the vesting of property of the estate in the debtor. It makes no sense for section 1228(a)(1) to refer to 1222(b)(10). No doubt Congress meant to include section 1222(b)(9) debts as non-dischargeable debts. These are the payments on allowed long-term secured indebtedness. A technical corrections bill should correct this language.

The last type of debt not discharged is section 523(a) debts. This is a major difference from the Chapter 13 discharge. In Chapter 13, alimony and child support found in section 523(a)(5) are the only non-dischargeable debts which are not discharged. All other non-dischargeable debts are discharged under section 1328(a).

In contrast, section 1228(a) excepts all non-dischargeable debts from the Chapter 12 discharge. So, a farmer with a section 523 non-dischargeable debt will not be able to discharge that debt in Chapter 12.

The other type of discharge provided in section 1228 is what is known as a hardship discharge in Chapter 13. A debtor may be eligible for a hardship discharge when the debtor cannot complete payments under the plan — if such inability is due to circumstances for which the debtor should not be held accountable.

A hardship discharge also requires that the amount the creditors actually received under the plan be at least equal to the amount they would have received had the debtor's property been liquidated in a Chapter 7 proceeding. Lastly, the debtor must show that modification of the plan under section 1229 would not be practicable.

This hardship discharge does not discharge sections 1222(b)(5) and (10) debts, nor section 523(a) non-dischargeable debts. This raises the question of in what way the hardship discharge differs from what should be a broader discharge upon completion of plan payments. Section 1228(a) refers to debts "provided for by the plan allowable under Section 503 . . . or disallowed under Section 502 . . .".

On the other hand, Section 1228(b) discharges "all unsecured debts provided for by the plan or disallowed under Section 502 . . .". The first difference is clear. Section 1228(b) discharges only unsecured debt, whereas section 1228(a) discharges both secured and unsecured debt. This makes sense because in the case of a hardship discharge, secured parties will not have received what they would have received in a Chapter 7 liquidation. Therefore, these debts should not be discharged.

The second difference — the reference in section 1228(a) to debts allowed under section 503 — is unclear. Section 503 does not allow or disallow debts. It sets out what claims are to be treated as administrative claims. Thus, a good argument can be made that Congress meant to refer to section 502, not section 503. Court guidance is needed on this point, as the Conference Report does not address it.

Trustee's Fees

The one disadvantage readily apparent under a Chapter 12 proceeding — as opposed to a Chapter 11 proceeding — is the trustee's fee. A trustee is not normally appointed in a Chapter 11 proceeding. Trustees are regularly appointed in Chapter 13 proceedings, and they will be in Chapter 12 proceedings as well. § 255, Subchapter I, § 1202(a).

The fee to which the trustee is entitled is, in part, taken from the cases he or she administers. The trustee does not run the farm in the typical case — he or she just makes the payments under the plan.

The fee taken from the plan payments is not to exceed 10% of the first $450,000 in payments under the plan, and 3% of payments under the plan exceeding $450,000. § 225, Subsection I, § 1202(d). In farm cases, the overall fee could be quite large. Of course, these fees are maximums, and courts can set the fee at a lower percentage.

STATE ROUNDUP

INDIANA. *Right to Deficiency Judgment.* In *Arnold v. Melvin R. Hall Inc.*, 496 N.E.2d 63 (Ind. 1986), the Indiana Supreme Court held that a mortgagee (vendor) who purchases property at a foreclosure sale for less than the amount still owed on the debt need not provide evidence that the property has a fair market value below the debt at the time of sale in order to be entitled to a deficiency judgment.

This case arose out of a mortgage foreclosure proceeding after the Arnolds had defaulted on a seller-financed arrangement. The vendors were the only bidders at the sale, and the amount bid was less than the amount due on the contract.

The Indiana Court of Appeals had overruled the trial court in an important break with past law in Indiana, *Arnold v. Melvin R. Hall Inc.*, 478 N.E.2d 696 (Ind. Ct. App. 1985).

In reversing the trial court's grant of a deficiency judgment, the appeals court stressed that if the burden to show fair market value was less than remaining debt was not placed on the mortgagee (vendor) who purchases the mortgaged property, then the mortgagee might pay a "mere percentage" of the fair market price for the mortgaged property and, in addition, enjoy a judgment for the deficiency. "In essence, the vendor/mortgagee would have the absolute right to reap a double recovery in every case." *Arnold*, 481 N.E.2d at 413.

In reasserting prior law, the Indiana Supreme Court made it clear that if a foreclosure sale is believed to be improper, the mortgagor (vendee) has remedies available under the law. It also stressed that the burden was on the mortgagor to substantiate an inadequate price.

The Supreme Court agreed that equity ought to provide a remedy for such a wrong. A mortgagor who feels the price is inadequate may bring the matter before the court. "[M]ere inadequacy of price alone may be sufficient to justify setting the sale aside. To have this effect, however, the disparity between the value of the property sold and the price paid must be so great as to shock the sense of justice and right." *Branch v. Foust*, 30 N.E. 631, 633 (1891).

In this case, the Arnolds argued the deficiency judgment violated principles of equity, but they did not present evidence of a defective sale, or that the price was "wholly insufficient."

Justice DeBruler, in dissent, felt it was fairer and more administratively sound to require the party seeking the deficiency judgment to be required to make out a case for its appropriateness. Generally, the court has no knowledge of what is a fair value, nor of who was present at the sale, while the mortgagee who purchases at the sale has all this information.

Further, defaulting mortgagors often lack the economic means to defend against a deficiency sale. DeBruler would follow the general rule that he who initially seeks relief (deficiency judgment) in both law and equity must bear the burden of proving the right to that relief.

Sheriff's Sale Vacated Because of Mortgagee's Erroneous Bid. In *Lafayette Production Credit Association (PCA) v. Robert R. Bradbury, Madge M. Bradbury, and Metropolitan Life Insurance Co.*, Cause No. C-460-85, Tippecanoe County Circuit Court (July 24, 1986), it was held that a sheriff's sale could be vacated because of a mistaken bid by the mortgagee's counsel.

It was clear in the foreclosure proceedings brought by the Lafayette PCA that Metropolitan Life Insurance Co. held a first mortgage in the two parcels of land on which the PCA was seeking a foreclosure of its second mortgage. Since Metropolitan did not cross claim as a senior lienholder, its prior mortgage was not foreclosed by the court.

The PCA received a judgment of $108,636 in principal and accrued interest. Metropolitan's mortgage lien was $70,504 at the time of the foreclosure proceedings. Fair market value for the two parcels was determined by the court to be $126,300.

In its summary judgment upon the notes by the Bradburys for the PCA, the court ruled that the PCA was entitled to a deficiency judgment of $52,840 ($108,636 minus $55,796) where $55,795 ($126,300 minus 70,504) was the anticipated PCA bid — the "determined value" less Metropolitan's first mortgage.

The PCA's counsel, however, bid the full "determined value" of $126,300 at the sheriff's sale. Apparently, the counsel bid the $126,300 based on the mistaken notion that a new Indiana case, *Arnold v. Melvin R. Hall Inc.*, 478 N.E.2d 696 (Ind. App. 1985) (see discussion above), required such a bid in order to protect the right to a deficiency judgment.

Arnold, a 1985 case, had held that a mortgagee/vendor (who was a successful bidder at a sheriff's sale) must explain to the court why the sale price was less than the outstanding debt in order to protect the mortgagee's right to a deficiency judgment. The lesson of *Arnold*, which was subsequently overturned, offered little basis for the PCA's bidding error.

Nevertheless, the court had little difficulty in vacating the sale resulting from the "erroneous" bid, voiding the resulting sheriff's deed, and ordering a new sale. It was reasoned that "this mistake was made, notwithstanding LPCA's counsel's good faith efforts to fully comply with the correct foreclosure sale procedure." The court noted that neither the Bradburys nor any other third party had changed its position or would be prejudiced.

— *Gerald A. Harrison*

Under Chapter 13, there is one way (allowed by some courts) of avoiding some of this percentage fee. Debts on the debtor's residence are usually the largest debts in a Chapter 13 case. To avoid the trustee's fee on these debts, Chapter 13 debtors have tried to devise plans which treat the residential debt as outside the plan.

Since long-term indebtedness is not dischargeable anyway, treating such debt outside the plan does not interfere with dischargeability. The Fifth Circuit Court of Appeals stated in *Matter of Foster*, 670 F.2d 478 (5th Cir. 1982), that Chapter 13 debtors could treat fully secured residential debt outside the plan and, therefore, eliminate the trustee's fee on long-term debt as long as the plan was not being used to cure any defaults or modify the debt in any way.

The court held that once arrearages are being treated under the plan, categorizing the regular mortgage payments as outside the plan and arranging to make these payments by the debtor is not sufficient to avoid the trustee's fee. 670 F.2d at 486-90.

The court did note, however, that the percentage fee should be reduced if the debtor acts as disbursement agent on a debt being included in the plan. 670 F.2d at 490-93. Since almost all Chapter 12 sections are modeled after Chapter 13 sections, a good argument can be made that the *Foster* reasoning should apply to fully secured long-term indebtedness in Chapter 12 as well.

This is just an overview. As can be seen, Chapter 12 will be a help to many farmers. It remains to be seen how much of a help.

Address Correction Requested

Agricultural Law Update

6201 Howard Street
Niles, IL 60648

AMERICAN AGRICULTURAL LAW ASSOCIATION NEWS

1987 AALA MEMBERSHIP RENEWAL. Increased costs of the newsletter and other services led the American Agricultural Law Association (AALA) to increase dues at the annual meeting in Fort Worth. Membership dues for 1987 are due February 1. For the 1987 calendar year, dues are as follows: regular membership, $45; student membership, $20; sustaining membership, $75; institutional membership, $125; and foreign membership (outside U.S. and Canada), $65. Please note that the membership mailing notice neglected to mention the student membership category.

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