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Legal Rights of Debtors and Creditors

Bankruptcy for Financially Distressed Farmers

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Preface

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This report is the fourth in a series dealing with legal issues that arise when farm operators experience financial stress. The preceding reports are

"Tax Implications of Liquidating a Farm Operation After the Tax Reform Act of 1986," Ag Econ Misc. Report No. 111, October 1987;

"Legal Rights of Debtors and Creditors--Enforcing Real Estate Mortgages," Ag Econ Misc. Report No. 118, September 1988; and

"Legal Rights of Debtors and Creditors--Impact of Debtor/Creditor Relationship on Personal Property," Ag Econ Misc. Report No. 160, November 1991.

Single copies of these reports can be obtained at no cost by contacting the Department of Agricultural Economics, North Dakota State University, Fargo 58105-5636.

This report provides general legal information and is not intended to substitute for competent professional assistance. Individuals with legal questions should seek advice from qualified counsel as to how these and other laws relate to their situation.

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Highlights

Bankruptcy is a federal court procedure intended to benefit both debtors and creditors if a debtor is unable to pay all obligations. Filing bankruptcy stops, or stays, all creditor's debt-collection procedures. The stay is to prevent some creditors from receiving more than their fair share from a financially distressed debtor. A bankruptcy trustee is usually appointed to assist in the fair distribution of the debtor's property. Equitable distribution of the debtor's property also is furthered by the trustee's avoidance powers, the debtor's exempt property, and the court's discharging the debtor from unpaid obligations.

There are two basic types of bankruptcy proceedings--liquidation and reorganization. Chapter 7 liquidation provides for the sale of the debtor's primary assets, distribution of proceeds to creditors, and discharge of remaining unpaid debts. Then, except for property specified as exempt by North Dakota law, the assets of the debtor are sold and the proceeds distributed among the creditors. Subsequently, the debtor is discharged from most remaining debts and given the opportunity to financially "start fresh."

Chapters 11, 12, and 13 of the Bankruptcy Code permit reorganization of the debtor's financial affairs and payment to creditors from the debtor's property and future income. A debtor is granted time to devise a plan of reorganization that may include rescheduling payments, selling some assets to reduce debt, forgiving debt, and implementing changes to increase the business' efficiency and profitability. Chapter 12 bankruptcy is intended to meet the unique problems encountered in reorganizing a farm business.

Legal Rights of Debtors and Creditors--
Bankruptcy for Financially Distressed Farmers

David M. Saxowsky and Gary J. Petersen[‡]

The experience of some sectors of the agricultural industry during the 1980s can be described as a time when a substantial number of farmers with excess debt encountered financial distress. Although the greatest economic pressures may have been upon highly leveraged operators, all producers felt the impact of the world's expanding capacity to produce food and diminishing markets. Many farmers took steps to reduce costs and improve efficiency in production and marketing. Despite these efforts, numerous farmers in the Great Plains still face unpaid obligations or are on the verge of defaulting because of droughts and the changing world economy.

To resolve these situations, farmers and their creditors are and will likely continue to negotiate settlements that reduce obligations and restructure the borrower's farm business. Settlement terms often include reamortized payments, partial or total liquidation, a deed in lieu of foreclosure, reduced interest rates, and written-off principal. Such settlements between the borrower and lender alter their business relationship and serve as a relatively inexpensive and expeditious alternative to litigation and foreclosure.

For debtors and creditors who cannot reach a settlement, bankruptcy is considered the most extreme and expensive form of litigation and is commonly described as the "debtor's last alternative" for reconciling with creditors. These operators and their creditors must have an understanding of the basic principles of bankruptcy law. However, it is just as important for farm operators who avoid bankruptcy by settling with their creditors to be familiar with these principles because bankruptcy, as the last alternative for resolving debtor/creditor issues, establishes the boundaries for negotiating an agreement. That is, debtors and creditors will likely negotiate a settlement that is similar to the probable result of bankruptcy.

Society recognizes that in some situations it is better off to relieve a heavily indebted person of some financial obligations, at a cost to unpaid creditors and others, than to continue the burden of excessive liabilities upon a debtor. One purpose of bankruptcy is to allow our society, through its judicial system, to *discharge* debt, that is, to reduce or eliminate the amount one person owes another. Consequently, bankruptcy can be thought of as "taking a creditor's property--that is, the creditor's right to be paid--and

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giving it to another private[‡] entity, the debtor, without compensation to the creditor." Bankruptcy also could be described as an exception to the constitutional mandate that private property cannot be taken without compensation. To assure that this unique authority is uniformly applied throughout the nation, the privilege of establishing a bankruptcy law was delegated in the United States Constitution to Congress.[1]

Although bankruptcy is federal law, most of the disputed debt obligations and property claims that will be dealt with arise from state law. The relationship between federal bankruptcy law and state credit laws will be addressed again in subsequent sections.

Bankruptcy statutes are organized into eight chapters, each dealing with a particular aspect of bankruptcy law. Chapters 1, 3, and 5 address general administration of a bankruptcy proceeding. Chapters 7, 11, 12, and 13 each prescribes one of the four bankruptcy proceedings available for farmers. Chapter 9 treats bankrupt municipalities and is beyond the scope of this report.

There are two basic types of bankruptcy proceedings: liquidation and reorganization. Termination and liquidation of the farm business is the result of a Chapter 7 bankruptcy in which the debtor transfers all property to a trustee. The trustee sells the property, except for *exempt* property which the debtor retains. Cash proceeds from the sale are distributed among creditors. The debtor is then discharged from remaining unpaid obligations and is able to financially restart.

Financial reorganization of a borrower is the goal of Chapter 11, Chapter 12, and Chapter 13 bankruptcies. In some situations, the debtor and creditors are better off if the debtor continues to operate rather than liquidate all assets. A reorganization bankruptcy should be considered if extending the time for repayment allows the debtor to pay a greater portion of the debt principal.

> Example. A farmer's debt, on a per acre basis, is $400 and requires an annual debt service payment of approximately $60 (8% annual interest for 10 years). Operating the land annually earns the farmer $45 per acre after paying all costs except interest; this amount is not enough to service the debt. The land's market price at this time is $240 per acre which means the creditor would receive about 60% of the principal ($240/$400) if the land was sold now and the proceeds used to pay the debt. But by accepting the $45 per year for 10 years, the creditor would receive $19 per year interest (that is, the $240 at 8%) plus $260 principal ($26 per year ($45 - $19) for 10 years). The farmer would repay 65% of the amount owed (rather than 60%) if the business is financially reorganized.

[‡]Generally, when private property is "taken," it is considered taken for the benefit of the public rather than of a private individual. This distinction reinforces the unique character of bankruptcy law.

In each of the reorganization bankruptcies, the debtor prepares a written plan, detailing payment of debts from earnings and the sale of property over a period of time. Reorganization bankruptcies grant the debtor time to financially restructure.

The chapter under which a farmer files for bankruptcy depends on what the farmer intends to accomplish and whether the farmer meets the requirements of the chapter. A farmer intending to discontinue farming will file a Chapter 7 bankruptcy to liquidate the business. However, if the farmer wants to continue to operate the business, bankruptcy will be filed under one of the reorganization Chapters, either 11, 12, or 13.

Each bankruptcy chapter imposes several unique requirements or limitations that the debtor must meet to file under that specific chapter. Other than these limitations, which are explained in subsequent portions of this report, the chapter under which debtors commence bankruptcy is the debtor's choice.

This report presents an overview of bankruptcy law. Chapter 7 liquidation is discussed first, followed by explanations of Chapter 11 business reorganization, Chapter 13 debt adjustment, and Chapter 12 family farm debt adjustment. There are numerous similarities among the bankruptcy chapters. These basic features are explained in the context of a Chapter 7 proceeding but are referred to in subsequent sections. In addition, a glossary has been included in the appendix to help readers with terminology that applies to this area of law. Numerous issues and complexities of bankruptcy are not discussed in this report. Persons needing more information about bankruptcy should consult an attorney.

Chapter 7 Liquidation

Chapter 7 bankruptcy, sometimes referred to as *straight bankruptcy* or a *liquidation*, is a legal proceeding in which the debtor's property is sold and the proceeds used to satisfy the debtor's unpaid obligations. Debts remaining unpaid at the conclusion of the proceeding are usually discharged. This section is organized in the sequence of events that may occur in a bankruptcy, beginning with the commencement of a bankruptcy proceeding. Other major steps in a Chapter 7 bankruptcy include assembling the debtor's property, identifying creditors and their legal rights, distributing the property, and discharging the debtor from remaining obligations.

Commencing a Bankruptcy Proceeding

A bankruptcy case is initiated by filing a *bankruptcy petition* with the clerk of the United States Bankruptcy Court for the district in which the debtor lives.[2] The petition may be filed by the debtor, a *voluntary bankruptcy*, or in some situations, by one or more creditors, an *involuntary bankruptcy*.[3]

Federal law, however, protects farmers from involuntary bankruptcy, that is, creditors cannot commence a bankruptcy proceeding against an indebted farmer.[4] Congress justified this extra protection for farmers on the basis of the industry's price and yield uncertainty. "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."[5] Therefore, farmers enter a bankruptcy proceeding only upon their own decision.

Bankruptcy law defines *farmers* as persons who, during the year immediately preceding the tax year in which bankruptcy is filed, received more than 80% of their gross income from a farming operation.[6] Congress has defined *farming operation* as the production or raising of crops, poultry, or livestock, dairy farming, and the production of poultry or livestock or products in an unmanufactured state.

Courts have interpreted these definitions as requiring the debtor to be "at risk" in a farm operation to consider the income as received from farming. Therefore, revenue from the cash rent of land or the sale of equipment in a liquidation may not be considered farm income. Farmers who discontinue operating due to financial stress and cash rent their land to another operator for several years will lose their legal status as a farmer. Thereafter, such former farmers may be subject to involuntary bankruptcy.[8] Requiring the debtor to be "at risk" in the farm business also is critical for persons wanting to file a Chapter 12 family farm bankruptcy. The "at risk" requirement will be examined more closely in the section about Chapter 12 bankruptcy.

Individuals are not the only farm entities shielded from involuntary bankruptcy. Corporations and partnerships that operate farm businesses are also granted this protection.[9] This report addresses only the rules for voluntary bankruptcy because operating farm businesses are protected from involuntary proceedings.

The bankruptcy petition that a debtor files must include the debtor's name and address, a statement that the debtor resides within the district of the bankruptcy court, and a statement that the debtor is qualified to petition for bankruptcy.[10] A debtor must also file a list of creditors, and unless the court orders otherwise, a statement of the debtor's financial affairs and a schedule of assets and liabilities.[11] A debtor has the right to supplement and amend this information.[12]

Often in the context of a family farm, the husband and wife are both liable for their debts and co-own most of their property. Consequently, one jointly administered bankruptcy proceeding would simplify the procedure and reduce the cost for debtors and creditors. Bankruptcy law permits married couples to initiate a joint case, if they so desire,[13] as long as creditors are protected from conflict of interests.[14] However, a person cannot take their spouse into bankruptcy without the spouse's knowledge or consent.[15]

Automatic Stay

Bankruptcy has several purposes. Already mentioned is the discharge of obligations that the debtor cannot pay. Other purposes include assuring an equitable distribution of the debtor's property among creditors and providing debtors an opportunity to regain control of and reorganize their financial affairs. Therefore, the first and immediate consequence of filing bankruptcy is to stop all creditor collection actions. Preventing creditors from attempting to force payment provides debtors time to assess their financial situations and determine which creditors are entitled to be paid. Such an *order for relief* is automatic upon a farmer filing a voluntary bankruptcy.[16] This feature of bankruptcy law is referred to as the *automatic stay*.

The automatic stay forbids creditors from taking any action that could interfere with the debtor or the debtor's property, such as:

- initiating or continuing a lawsuit to collect an obligation from the debtor;
- enforcing a judgment against the debtor;
- attempting to possess the debtor's property;
- creating, perfecting, or enforcing liens against the debtor's property;
- collecting claims that arose before bankruptcy; and
- setting off debts the creditor owes the debtor.[17]

Accordingly, bankruptcy prevents creditors from proceeding under state law to collect payment of debts.[‡] Instead, the parties must comply with the procedure established in federal bankruptcy law to resolve conflicting claims even though state law most likely defines the claims.

The automatic stay is one reason that some persons file bankruptcy immediately before a scheduled foreclosure sale. It prevents the collection action--the auction sale in this example--from being continued. However, if the creditor has completed a foreclosure proceeding against a debtor before the bankruptcy petition is filed, the redemption period is generally not stayed. North Dakota is in the 8th Federal Circuit which follows the rule that redemption is stayed only if the creditor is legally required to take

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[‡]The automatic stay does not stop certain legal actions:

- criminal cases against the debtor;
- collection of alimony, maintenance, or spousal support from property that is not part of the bankrupt debtor's estate;
- perfection of a security interest if, under state law, the perfection will relate back to a date before the bankruptcy was filed;
- litigation by a government unit to enforce regulatory powers;
- set off of debts and claims arising from transactions in commodity futures, commodity options, securities, or other leverage transactions;
- federal, state, or local government issuing a notice of unpaid taxes;
- foreclosure actions by Secretary of Housing and Urban Development. 11 U.S.C. §362(b).

additional affirmative action to regain the property.[18] Since North Dakota does not required the creditor to take such action, filing bankruptcy after a foreclosure sale may not prevent the foreclosed property from transferring to the buyer. In North Dakota, the property will transfer at the end of the redemption period or 60 days after the filing of the bankruptcy petition, whichever is later.[19]

Relief from Automatic Stay

The automatic stay substantially impacts creditors by stopping all their collection actions. To prevent abuse of this automatic protection, the stay can be discontinued or modified in some situations to allow the creditor to collect the debt according to state law. For example, the automatic stay terminates when a bankruptcy case is closed or dismissed, or when a debtor is denied discharge.[20] At that point, the bankruptcy proceeding is complete and there is no reason to block creditors from attempting to collect unpaid debts. The court also may terminate the automatic stay if 1) the debtor has no equity in property used as collateral and the property is not necessary for an effective financial reorganization of the business or 2) there is a lack of *adequate protection* for the creditors' interest.[21] Relief from the automatic stay is addressed again in the section explaining Chapter 11 because of its ramifications for financial reorganizations.

Assembling the Debtor's Property

When bankruptcy is filed, an estate is created consisting of the debtor's property interests at the time bankruptcy was filed.[22] This is called the *bankruptcy estate*. These property interests include land, buildings, equipment, livestock, cash, and less obvious property interests, such as an obligation owed to the debtor.[23] Similarly, a bank must stop paying checks drawn on a customer's account as soon as the bank learns that the customer has filed bankruptcy because the balance in that account belongs to the estate and can be used only in accordance with bankruptcy law. The estate also includes property the debtor acquires during the first 180 days after bankruptcy is filed by inheritance, divorce decree, property settlement, life insurance policy, or a death benefit plan.[24]

The estate is entitled to receive all income from its assets, such as rent, interest, and sale proceeds.[25] The estate, however, does not include wages the debtor earns during a Chapter 7 or Chapter 11 bankruptcy case. For example, wages the debtor earns from an off-farm job after filing Chapter 7 or Chapter 11 bankruptcy may not be used to pay debts that are part of the bankruptcy. However, a debtor's wages are available for the estate to pay obligations in case of a Chapter 12 or Chapter 13.[26] The debtor must consider this difference in the treatment of off-farm income during a bankruptcy when deciding which bankruptcy chapter should be used.

Trustee

An essential element for a successful liquidation is that someone be responsible for protecting and supervising disbursement of the debtor's

property. To meet this need, the law requires that a trustee be selected after bankruptcy is commenced. Chapter 7 bankruptcy provides that the U.S. Trustee appoint an interim trustee who may become permanent unless the creditors select their own.[27] Under Chapters 12 and 13, the U.S. trustee appoints a trustee.[28] Chapter 11 differs slightly because no trustee is appointed unless there is a showing of fraud, dishonesty, incompetence, or gross mismanagement by the debtor.[29] This section generally explains the trustee's obligations and authority for administering the bankrupt estate and the statutory powers the trustee can exercise in supervising disbursement of the debtor's property.

A bankruptcy trustee, like any other trustee, has a fiduciary responsibility to act in the best interest of some person or group of persons, known as beneficiaries, in this case, the creditors and the debtor. The trustee represents the bankruptcy estate and can sue or be sued on behalf of the estate.[30] The trustee also is charged with assembling the estate property and, if necessary, liquidating it. In summary, the trustee must manage and use the property to maximize the payment of debt owed to creditors.[31] The trustee receives no direct benefit from the property itself, except a management fee.[32] The bankruptcy court specifies the trustee's management fee except that in case of Chapter 12, Congress has specified a maximum management fee.

Debtor Examination

Initial organization of estate property is accomplished at the first creditor's meeting. The debtor must respond, under oath, to questions from creditors and the trustee about operation of the bankrupt business and location of its property.[33] The bankruptcy judge is not present at the meeting. The questions may address the debtor's acts or conduct, the debtor's property, liabilities and financial condition of the debtor, the debtor's right to discharge, and any matter that affects administration of the bankruptcy estate.[34]

Identifying Creditors and Their Relative Legal Rights

The policy of fair treatment for creditors of a bankrupt estate guides the procedure for paying creditors' claims. The first step is to identify all creditors either in documents the debtor filed or in the *proof of claim* the creditor files with the bankruptcy court.[35] A second step is to determine whether the claim is secured or unsecured. A creditor's claim is secured if a valid lien is held on the property included in the debtor's bankruptcy estate. Secured claims include security interests, mortgages, statutory liens, and judicial liens.

Categorizing claims is important in bankruptcy because secured claims are satisfied before unsecured claims. Only after secured claims have been paid will the remaining property of the bankruptcy estate be sold and the proceeds used to pay unsecured claims. If the estate does not have enough property to pay all debts, unsecured creditors will not be paid in full. Similarly, unsecured claims are categorized and prioritized. Then, unsecured

claims with higher priority are paid in full before unsecured claims with lower priority. Usually, few, if any, unsecured creditors are paid the total amount of their claim.

A claim is secured only to the extent of the value of the encumbered property. Any claim for more than the value of the property is considered an unsecured claim. The bankruptcy court decides property values to determine secured status on a case-by-case basis.[36]

Example. A bank holds a valid security interest in a tractor the debtor owns. The amount of the debt is $75,000, but the tractor is valued at only $50,000. Thus, the bank has a secured claim of $50,000 and an unsecured claim of $25,000.

A claim must be *allowed* for the creditor to receive payment. A properly filed claim is considered allowed unless the debtor, trustee, or other interested person objects.[37] If objected to, the bankruptcy court determines the validity of the claim.

Creditors will want to establish that their claim is secured. Unsecured creditors will argue that the claims of other creditors are unsecured. Even though trustees will seek to assure that all claims are properly classified, the fiduciary responsibility to unsecured creditors requires that the trustee argue a claim is unsecured if there is any question about its classification.

Congress has granted the trustee powers to assure that creditors claiming secured status do not frustrate the bankruptcy goal of fair treatment for all creditors. This power is in the form of allowing the trustee to avoid certain transactions, thereby transforming some apparent secured claims into unsecured claims. Restated, when a bankruptcy trustee avoids a secured claim, as explained in the next section, the claim is not eliminated, it is merely rendered unsecured.

Trustee's Avoidance Powers

Bankruptcy does not nullify other laws that establish or define the relationship between a debtor and an unpaid creditor. Instead, bankruptcy is a procedure to assure that the debtor's property is used to pay obligations according to the parties' rights as set forth by these other laws--primarily state laws. The trustee is granted powers to assure that this bankruptcy objective is met. Among the most critical is the trustee's *avoidance power*; that is, the power to invalidate certain transfers of and encumbrances on the debtor's property.[38] When a transaction is avoided or invalidated, the property belongs to the estate.

This section introduces some of the property transactions that a trustee may avoid. It is almost always to the disadvantage of a secured or recently paid creditor to have an interest avoided. In comparison, avoidance rarely is detrimental to the debtor. Unsecured creditors most likely will benefit from the trustee's avoidance power.

Example. A bankruptcy debtor with $18,000 in assets subject to the bankruptcy estate has three creditors: creditor A who is owed $10,000 and claims a security interest in some of the debtor's property; creditor B who is owed $5,000 on an unsecured claim; and creditor C who is owed $15,000 on an unsecured claim. If A's security interest is valid, A will be paid in full while B and C will receive 40% of the amounts they are owed ($8,000/$20,000).

	Amount of debt	Value of Encumbered Assets	Value of Unencumbered Assets	Amount of Repayment	Percent Repaid
creditor A	$10,000	$10,000		$10,000	100
creditor B	5,000			2,000	40
creditor C	15,000			6,000	40
Estate's assets available for unsecured creditors			$8,000		

Example (cont'd). If A's security interest is avoided, the three creditors will receive the same percentage of their claims ($18,000/$30,000 or 60%). The amount B and C are repaid will increase by the amount that A's repayment decreases.

	Amount of debt	Value of Encumbered Assets	Value of Unencumbered Assets	Amount of Repayment	Percent Repaid
creditor A	$10,000			$6,000	60
creditor B	5,000			3,000	60
creditor C	15,000			9,000	60
Estate's assets available for unsecured creditors			$18,000		

Preferences

Congress is skeptical of transfers of property or payments the debtor makes to a creditor shortly before bankruptcy is filed. The suspicion is that the debtor wants to treat one creditor more favorably than others; and to accomplish this, the debtor makes the transaction shortly before filing bankruptcy. Consequently, the remaining creditors would not receive the same share of the bankruptcy estate.

To eliminate the potential for such inequitable treatment among unsecured creditors, Congress empowers the trustee to avoid "eve of bankruptcy" transactions. As a result, transactions that improve the position of one creditor at the expense or harm to other creditors are invalidated. Under the bankruptcy code, such transfers are called *preferences* which the bankruptcy trustee can avoid. The trustee may avoid preference transactions the debtor makes within 90 days before filing bankruptcy if the transaction 1) is to or for the benefit of a creditor, 2) is for or on account of an antecedent debt,[39] 3) is made while the debtor was insolvent, and 4) enables

the creditor to receive more than would have been received in a Chapter 7 liquidation proceeding.[10]

Preferential transfers include cash payments, transfers of ownership or possession of property, and granting a security interest. Thus, the avoidance powers allow the trustee to set aside a security interest that an otherwise unsecured creditor obtained shortly before bankruptcy. The 90-day period may be extended to one year for transfers made to a creditor if the creditor was an insider and the creditor should have known the debtor was insolvent.[11] Insiders include relatives of the debtor, partnerships where the debtor is a general partner, partners of the debtor, and corporations of which the debtor is a director, officer, or person in control.[12] Trustees avoid a transaction by requesting that the court order the creditor to return the property or money to the trustee.

> Example. Farmer Smith is indebted to a supply firm for fertilizer that was delivered and applied last year. Smith realizes that filing bankruptcy may be necessary, but he does not want the unsecured supplier to suffer a loss. Smith and the supplier must recognize that if Smith files bankruptcy within 90 days of paying the debt or granting a security interest, his action likely would be avoided, thereby returning the supplier to the status of an unsecured creditor.

Not all transfers the debtor makes within 90 days of filing are avoidable. Transfers made for new value (paying for a non-credit purchase of goods or services), payments for debts incurred in the ordinary course of business (fuel and electric bills), and the perfection of a *purchase money security interest* within the time period the Uniform Commercial Code requires do not constitute preferential transfers.[13]

Avoiding Fraudulent Transfers

The bankruptcy trustee also may avoid fraudulent transfers made within one year before filing.[14] A transfer is fraudulent if it is made with intent to hinder, delay, or defraud a creditor. A transfer is also considered fraudulent if the debtor received less than a reasonably equivalent value in exchange for the transfer and the debtor was insolvent or was made insolvent by the transaction. The trustee may avoid as fraudulent transfers gifts, assignments, or other transfers made to relatives to shelter certain assets from the claims of creditors in bankruptcy. A mortgage holder's foreclosure of a real estate mortgage, in some instances, may be considered a fraudulent transfer.[15] The treatment of fraudulent conveyances under state law may differ and the trustee may apply the law that gives the trustee the greatest powers to avoid fraudulent conveyances.[16]

Avoiding Statutory Liens

The trustee may avoid liens that arise automatically by statute.[17] Statutory liens subject to avoidance include 1) liens triggered by the debtor's deteriorating financial condition, 2) liens for rent, and 3) liens that could not be enforced against a bona fide purchaser. This last category affects agribusinesses that sell production inputs, such as seed, fuel,

fertilizer, and chemicals to farmers on credit. If the agribusiness relies on a state statute to secure payment, but the lien is not enforceable against a buyer of the commodity that was produced from the supplies, the lien can be avoided under bankruptcy law and the supplier is unsecured.

Example. Farmer Smith purchases fuel from Supply Company and uses it to produce a crop. Smith does not pay for the fuel, so Supply Company, pursuant to state law, files a lien against the crop without Smith's consent. Although this lien should protect Supply Company against other unpaid creditors that subsequently try to seize the crop from Smith, the lien will not protect the supplier if Smith sells the grain to an elevator but keeps the proceeds. Since Supply Company's lien is ineffective against the purchasing elevator under state law, the bankruptcy trustee also can avoid the lien.

Trustee Presumed Lien Creditor

Bankruptcy law allows a trustee to take priority over unsecured creditors by granting the trustee the status that a perfected lien holder or purchaser would have if the lien was imposed or the sale occurred at the time bankruptcy is filed.[48] The purpose of this provision is to prevent a subsequent creditor, an unperfected creditor, or an inconspicuous purchaser from removing property from the bankruptcy estate. Instead, once bankruptcy is filed, the trustee must concur before property can be sold or encumbered. As a result, the estate's property is preserved for the benefit of all unsecured creditors.

Example. At the time Smith filed bankruptcy, no liens encumbered his livestock. Without this provision, Smith could sell the livestock and spend the proceeds as he desired, even though unsecured creditors remain unpaid. This provision, which presumes that the bankruptcy trustee is a lien creditor, prevents Smith (after filing bankruptcy) from spending the proceeds without first paying as much of the unsecured debt as possible.

This provision also protects the property from any undocumented claims that may have arisen before bankruptcy.

Example. A debtor and creditor orally agree that the debtor will grant the creditor a security interest in the debtor's property. However, the debtor files bankruptcy before the necessary documents are prepared. Any interest the creditor may claim in the debtor's property, based on such an undocumented pre-bankruptcy understanding, would fail under this provision. Likewise, a claim that the debtor had agreed to sell property but filed bankruptcy before the sale agreement was documented would also fail.

Retaining Debtor's Rights

A lien that has been avoided under one of the provisions described earlier still can be used by the trustee against other creditors.[49] Likewise, the trustee may use any legal defense the debtor may have to defeat a creditor's claim.[50] This helps defeat unwarranted claims and may thereby accumulate more property for the estate.

Example. Assume Creditor A has sufficiently documented a transaction with the debtor to prevail over Creditor B. But also assume Creditor A has not completely documented the transaction so that the trustee, as a presumed lien creditor, prevails over Creditor A. One way the trustee can prevail over Creditor B is to "step into the shoes" of Creditor A to defeat Creditor B's interest in estate property. That way, the trustee renders A and B unsecured and seizes the assets for the benefit of all unsecured creditors, which now includes A and B. A and B will still receive something (whatever unsecured creditors are entitled to) but they will not receive as much as if they had been able to collect on the basis of their liens.

One purpose of the bankruptcy proceeding is to sort out the conflicting claims of creditors. Secured creditors will be given the benefit of their "secured" status if, after careful review of each creditor's claim, the security interest is undeniably legal.

The bankruptcy trustee's powers to avoid security interests are subject to limitations, including time limits for exercising such powers, protection of creditors under state law, and seller's right to reclaim property in certain cases.[51]

Leases and Executory Contracts

The trustee either may reject or honor the debtor's *executory contracts* and leases.[52] An executory contract is an agreement under which the obligations of both parties to the contract have not been performed. Even given that definition, there are often disputes whether an agreement is an executory contract. Examples of executory contracts are equipment leases, installment sales contracts, and land contracts. If the trustee elects to assume an executory contract, the trustee must 1) cure any default or 2) provide adequate assurance the default can be cured, compensate the other party for any damages, and give adequate assurance of future performance.[53] A decision to assume an executory contract grants the other party a higher priority in being paid.[54] An executory contract may be assumed even though the agreement states that bankruptcy voids the contract.[55]

Several additional rules apply to executory contracts. A party whose executory contract is rejected has no claim against the debtor or trustee but only a general claim against the estate.[56] Executory contracts not assumed within 60 days are presumed rejected.[57] Financial institutions generally will not be required to fulfill an executory line of credit even though the debtor tries to assume the contract.[58] When the debtor is a lessor, the lessee may retain possession of the leased property even though the trustee has rejected the executory lease.[59] However, after bankruptcy, the lessee may no longer be able to enforce certain performances required of the debtor before bankruptcy. The complexity of these issues, and bankruptcy in general, mandate that affected persons contact an attorney.

Furthermore, a trustee has the authority to 1) prevent third parties from terminating contracts that are advantageous to the debtor, 2) prevent

acceleration of debts and, in some instances, extend the term and reduce the rate of interest on secured and unsecured loans, and 3) use property of a secured party despite an earlier default.

The trustee also may avoid or set aside transfers that are not properly recorded or perfected under state law. If, for example, a creditor has failed to perfect a security interest under the Uniform Commercial Code, the bankruptcy trustee can avoid the lien in its entirety.

Disbursing the Estate Property

This section addresses disbursement of the estate, beginning with the property that the debtor can retain because it is not available for creditors.

Exempt Property

Exempt properties are a debtor's assets that may not, according to the law, be distributed to creditors. The philosophy for exempting some property from the reach of creditors is to allow the debtor to financially restart. Exemptions are available only to individuals; they are not granted to partnerships or corporations.

The Bankruptcy Code allows debtors to choose between federally specified bankruptcy exemptions and exemptions provided by state statutes.[60] North Dakota law, however, prohibits North Dakotans from using the federal exemptions.[61] Therefore, North Dakota residents are limited to the exemptions provided by North Dakota law. These exemptions are

- family photos, a burial plot, family Bible, all school books, other books not exceeding $100 in value, and all clothing of the debtor and family[62]
- food and fuel the family needs for one year or the money needed to provide these items[63]
- crops and grain on or from 160 acres of land[64]
- a homestead[65] consisting of the house in which the debtor lives and surrounding land within the section, up to a value of $80,000 over and above liens on the property.[66] As an alternative to the homestead exemption, debtors may select 1) their mobile home used as a residence[67] or 2) if a resident of North Dakota, $7,500 cash[68]
- for the head of a family: 1) $5,000 of personal property[69] or 2) family books and musical instruments up to $1,500, household furnishings up to $1,000, livestock and machinery up to $4,500, and tools or equipment of the debtor's trade up to $1,000[70]
- for a single person: up to $2,500 of personal property[71]
- for North Dakota residents: 1) a motor vehicle valued to $1,200; 2) life insurance policies, pensions, and annuities payable to the debtor's dependents with proceeds or surrender values up to $100,000 each, for a maximum of $200,000; 3) up to $7,500 for wrongful death, personal injury, or pecuniary loss; and 4) Social Security and Veteran's disability pension benefits.[72]

Exemptions are generally valued at their fair market value. If exempt property is subject to a lien, the debtor may claim an exemption of the property's value in excess of the lien amount, that is, the debtor's equity in the property.

Example. Assume a debtor owns a car valued at $5,000 but owes $4,000 to the Bank. The $4,000 lien means the debtor has $1,000 equity in the car. If the debtor claims the car as exempt, other creditors may not seize the $1,000 equity but the debtor still may lose the car unless the $4,000 debt is reaffirmed or paid from other sources.

Generally, only unencumbered property is claimed as exempt. In the case of a joint bankruptcy petition a married couple files, some value limitations may be doubled.[73]

A debtor may invalidate some security interests in household furnishings, household goods, clothing, appliances, books, livestock, crops, and musical instruments.[74] Liens can be avoided on implements, professional books, and tools of the trade to the extent the security interests are not purchase money security interests. Purchase money security interests arise from financing the purchase price of the specific property. Exemptions do not protection against consensual liens or statutory liens on specific property.

Example. A farmer has granted a mortgage on the land to the local bank. The land includes the farmstead on which the farmer lives. Even though the house qualifies as the farmer's homestead, it is not exempt from the bank's mortgage. For this farm borrower, the homestead exemption is of little value if the loan to the bank is repaid by liquidating the mortgaged land.

Whether farm equipment is considered a tool of the trade depends on the nature of the debtor's occupation and the importance of the equipment to the debtor's occupation. Some courts have held that this exemption does not apply to large farm equipment;[75] however, the general rule appears to be that large farm machinery are considered tools of the trade.[76] The test is whether the item is reasonably necessary to the debtor's trade rather than whether the equipment is commonly understood to be a tool of the trade.

Whether livestock may be considered tools of the trade also is unclear. Some courts have held that livestock are tools of the trade for ranchers and farmers,[77] while other courts have held the opposite.[78] Whether livestock are tools of the trade will depend on the nature of the ranching or farming operation and which court has jurisdiction over the debtor.

An Iowa bankruptcy court has held that a personal computer the debtor farmer used in the business was exempt. The computer, in that case, was considered to be equipment reasonably related to a normal farming operation.[79] The court stated that recent difficult times have forced farmers to pay more attention to the business aspects of farming; thus, a computer may be important to the operation of the farm.

Conversion of non-exempt property to exempt property before filing bankruptcy is legal and is not a fraudulent conveyance because property is not transferred.[80] Therefore, non-exempt cash, for example, could be used to

purchase exempt property in the days before filing bankruptcy without negative consequences to the debtor. Furthermore, any waiver of exemptions, as part of an agreement with a creditor for example, is unenforceable.[81] However, the trustee can use exempt property to satisfy administrative expenses incurred in establishing the exemptions.[82] Exemptions a debtor claims in the bankruptcy petition are allowed unless a creditor or other interested party makes a timely objection.[83]

Abandonment

The trustee may *abandon* property that is burdensome or of inconsequential value to the estate.[84] For example, an asset encumbered with a debt that exceeds the asset's market value may be considered burdensome or of inconsequential value. Property the trustee abandons is returned to the person entitled to possess it,[85] often the debtor, and the automatic stay is no longer applicable.[86] Accordingly, the secured creditor may proceed under state law to foreclose against the abandoned property as if the debtor had not initiated a bankruptcy. To the secured creditor, abandonment has an effect similar to terminating the automatic stay.

Farmers who file bankruptcy often have real estate debt that exceeds the value of the mortgaged land. Consequently, abandonment often becomes an issue with the debtor arguing that the land should not be made available to the creditor but, instead, retained as part of the estate so the business can be successfully reorganized. The argument may be that the land is worth more than it has been valued or that it is an integral part of the business and its absence would certainly render the operation financially infeasible.

Set-off

In the case that two persons owe each other a payment, the right of set-off allows one party to reduce the amount they owe by the amount they are owed. For example, if a debtor has a savings account and a loan at a financial institution and defaults on the loan, the financial institution (the creditor) may be allowed to offset the savings account balance against the amount owed under the loan.

> Example. A debtor owes a bank $100,000 but has a $20,000 balance in a deposit account at the same bank. If the bank exercises its right to set-off, it still would be owed $80,000 ($100,000 - $80,000) and the account balance would be $0.

Just as a bankruptcy trustee may avoid preferences the debtor makes, set-offs creditors make also may be avoided.[87] The trustee can avoid a creditor's set-off if

1. the debts are not mutual,
2. the creditor's claim was acquired or incurred within 90 days of bankruptcy and while the debtor was insolvent,
3. the debt the debtor owes was incurred within 90 days of bankruptcy, while the debtor was insolvent, and solely for the creditor's purpose of obtaining the right of set-off,[88] or

4. the set-off improves the position of a creditor within 90 days of the debtor filing bankruptcy.[89]

   Example. Assume a debtor files bankruptcy. Ninety (90) days before filing, the debtor owed a bank $100,000 but had a $20,000 balance in a deposit account at the same bank. If the bank had exercised its right to set-off at that time, it still would have been owed $80,000 ($100,000 - $80,000). However 45 days before bankruptcy, the bank exercised its right of set-off, at which time the debtor owed $90,000 and the account had a balance of $35,000. As a result of the set-off, the bank was still owed $55,000 ($90,000 - $35,000). The bank's position improved $25,000 ($80,000 - $55,000) during the 90 days before bankruptcy was filed. The trustee can recover the $25,000 from the bank.

Secured Claims

Encumbered property is used first to satisfy the debts that it secures. The property may be transferred to the creditor or sold with the proceeds given to the secured creditor.[90] A creditor will be treated as unsecured to the extent that the amount owed a secured creditor exceeds the value of the collateral.[91] The bankruptcy court determines the value of property on a case-by-case basis. Liens comprising secured claims include security interests, real estate mortgages, judicial liens, and statutory liens (that have not been avoided).[92] Statutory liens could include mechanic's liens, landlord's liens, repairman's liens, storage liens, agricultural producer's liens, and agricultural supplier's liens.

A secured creditor may obtain the encumbered property from the trustee if the debtor has no equity in the property (that is, the secured claim equals or exceeds the value of the property) and the property is not needed by the estate. A creditor can obtain the property through trustee abandonment or relief from the automatic stay. Otherwise, the trustee will sell the property free and clear of all liens and distribute the proceeds among secured creditors with any remaining proceeds used first to pay administrative costs and then, if any is left, distributed to unsecured creditors. In summary, a creditor with a secured claim receives the lesser of the entire claim or the value of the property on which the lien is held.

Example. A bank has a $50,000 security interest in the debtor's tractor valued at $75,000. The bank will be paid its $50,000 claim in full. The remaining $25,000 will be used to pay administrative costs and distributed among unsecured creditors.

Tax liens are not treated as favorably as most secured claims. They are paid only after other secured claims and priorities are paid.[93] The low priority of taxes can result in the taxes not being paid if the secured and priority claims exceed the value of the estate's property.[94] Although debtors are generally discharged from all debts in bankruptcy, most tax liens remain so that the debtor/taxpayer is still liable for the taxes even after bankruptcy.

Unsecured Claims

A claim is unsecured if the creditor does not have a lien on the bankrupt debtor's property. Unsecured, or general, creditors receive payment of their claims from the bankruptcy estate only if property remains after exemptions are returned to the debtor and secured claims and administrative expenses are paid. Unsecured creditors often receive nothing in a liquidation bankruptcy.

If a net estate remains for the payment of unsecured claims, general creditors who desire payment must file a timely proof of claim with the bankruptcy court. Proof forms usually accompany the notice of bankruptcy sent to creditors listed in the debtor's petition.[95] Alternatively, if the trustee determines that there are no assets with which to pay unsecured claims, the proceeding will be classified as a no-asset bankruptcy and creditors may be told that there is no need to file a claim.

Unsecured claims are divided into categories. All claims within a category must be satisfied before any payment can be made toward claims in the next category. If the assets are insufficient to satisfy the claims within any category, they are distributed pro rata among creditors in that category. Categories relevant to a farm bankruptcy are

1. bankruptcy administration expenses, fees, and charges against the bankruptcy estate,
2. unsecured claims for wages, salaries and commissions earned within 90 days prior to bankruptcy, limited to $2,000 per claimant,
3. claims for employee fringe benefits,
4. certain tax claims, including income taxes for the previous three years, property taxes, withholding taxes, excise taxes, customs duties and penalties,
5. timely filed unsecured claims and unsecured claims tardily filed by creditors who did not know of the bankruptcy,
6. unsecured claims tardily filed,
7. claims for fines, penalties, and punitive damages, and
8. interest on pre-bankruptcy claims accrued since the petition was filed.[96]

Remaining surplus, if any, is returned to the debtor.

In the interest of equity and fairness, the bankruptcy court has the power to subordinate some claims to others with lower priority.[97] For example, the debt of a corporation to its sole shareholder may be subordinated to debts to non-insiders. Thus, the debt to an outside creditor would be paid before the debt owed the sole shareholder. The court also can enforce subordination agreements among creditors.

Payment of claims and the distribution of property may vary according to the chapter of bankruptcy. These differences will be discussed in subsequent sections dealing with the specifics of each chapter of bankruptcy.

Discharge and Closing the Proceeding

Following liquidation and distribution of non-exempt assets, the debtor's remaining debts are discharged, that is, the debtor is released from the obligation of paying debts incurred before bankruptcy.[98] Discharge also voids judgments taken against the debtor and prevents creditors from attempting to collect payment of discharged debts. Discharge does not, however, affect the liability of non-bankrupt co-debtors or guarantors.

Bankruptcy does not affect a valid lien. Although a debt is technically discharged, a creditor still can repossess any collateral, foreclose on mortgages, or exercise other secured creditor's rights to enforce a valid lien. Unsecured creditors are generally precluded from all collection practices after discharge.

Because of public policy, certain debts are not discharged. Exceptions to discharge vary according to the bankruptcy chapter filed. Non-dischargeable debts include

- debts not listed in the bankruptcy petition, unless the creditor knew about the bankruptcy,
- most taxes,
- alimony and child support,
- student loans insured, guaranteed, or funded by a governmental entity,
- debts incurred by false pretenses, misrepresentation, fraud, or intentional use of false financial statements that the creditor reasonably relied upon,
- debts for embezzlement, larceny, or fiduciary fraud,
- debts for willful or malicious injury or damage,
- governmental imposed fines, penalties, and forfeitures,
- consumer debts totaling more than $500 for luxury goods or services incurred within 40 days of bankruptcy,
- cash advances totaling more than $1,000 from bank credit cards or overdraft privileges incurred within 20 days of bankruptcy,
- debts for wrongful death or personal injury awards caused during the debtor's unlawful use of a motor vehicle because the debtor was under the influence of alcohol or drugs, and
- debts not discharged due to waiver in a prior bankruptcy.[99]

All debtors in bankruptcy qualify for discharge except

- non-individuals (such as corporations),
- debtors who disposed of property intending to hinder or defraud creditors or the bankruptcy trustee, either before or after bankruptcy is commenced,
- debtors who unlawfully dispose of financial books and records,
- debtors who fail to explain their inability to meet liabilities,
- debtors who refuse to obey court orders or to testify against themselves after being granted immunity, and
- debtors who have previously been granted discharge in bankruptcy within the last six years.[100]

An earlier discharge under Chapter 13 or Chapter 12, however, does not bar a discharge under Chapter 7 within six years if the debtor 1) paid 100 percent of the unsecured claims or 2) paid 70 percent of the unsecured claims, the plan was proposed in good faith, and the plan was the debtor's best effort.[101]

A trustee or creditor may object to discharge if the debtor does not legally qualify.[102] Furthermore, a trustee or creditor may apply for revocation of a discharge on grounds of the debtor's fraud or refusal to obey court orders.[103] If discharge is denied or revoked because of a justifiable objection, all creditors may pursue the debtor as if bankruptcy had never been filed.

A *reaffirmation* is an agreement between a creditor and a bankrupt debtor in which the debtor agrees to pay a discharged debt. Such an agreement is valid in bankruptcy only if 1) it is entered into before discharge, 2) it does not cause hardship, 3) it is in the best interest of the debtor, and 4) the agreement contains a statement advising the debtor of the right to rescind the agreement within 60 days.[104] The bankruptcy court must advise the debtor that 1) reaffirmation is not required by law, 2) the agreement may be rescinded within 60 days, and 3) there are legal effects and consequences of reaffirmation.[105]

Closing the Proceeding

The court will close a bankruptcy case when the estate has been fully administered and the trustee has been released.[106] A closed case may be reopened to disburse additional assets or grant the debtor relief.[107]

Chapter 11 Business Reorganization

The preceding section explained a Chapter 7 bankruptcy wherein the debtor's business is liquidated with the proceeds used to pay creditors. Complete liquidation of the business is not always necessary, however. Chapter 11 bankruptcy allows business debtors to reorganize the business as a going concern rather than liquidate it. In addition, in non-bankruptcy negotiations between the debtor and creditor, the creditor will tend to have more negotiating power over the debtor. Thus, despite the possibility that a debtor can overcome financial difficulties, one or more creditors may force liquidation through enforcement of their security interests.

Chapter 11 bankruptcy can act as an equalizer between parties so that a creditor or creditors cannot unfairly dictate debt negotiations with the debtor or other creditors. Hopefully, both the debtor and the creditors will reach a similar outcome through bankruptcy reorganization as they would through non-bankruptcy negotiations, that is, a reduction in the level of debt through liquidation of some assets, a discharge from debts that are unlikely to ever be paid, and a reaffirmation of as much debt as possible by keeping some assets in what is likely to be a smaller-scale business.

There are many similarities to a Chapter 7 bankruptcy. Chapter 11 reorganization is commenced, just as Chapter 7, with the filing of a petition. In addition, the debtor must file lists of assets and liabilities and a "statement of affairs," which includes 1) answers to questions about the past and present financial situation of the debtor and 2) a balance sheet showing immediate liquidation values rather than historical costs.

Farm businesses, whether owned by one person, a partnership, or a corporation, are eligible to file under Chapter 11. The automatic stay, bankruptcy estate, and exemptions for a Chapter 11 are the same as for a Chapter 7. Generally, financially reorganizing a business takes more time than liquidating the assets, and creditors may be more aggressive in seeking relief from the automatic stay of a Chapter 11 than they may be if the debtor was in Chapter 7.

Relief From the Automatic Stay--Revisited

In addition to the relief from the automatic stay explained in the section on Chapter 7, the stay may be modified or terminated at the request of a *party in interest*,[108] typically a creditor with a security interest in the debtor's property. One basis for seeking modification or termination of the stay is that the creditor's security interest is not *adequately protected*,[109] that is, continued delay in repayment would harm the creditor. The underlying policy is that the value of a secured creditor's interest in the debtor's property should not be allowed to diminish as a result of bankruptcy's automatic stay.

> Example. A creditor has a mortgage of $500 per acre on the debtor's land which had a fair market value of $525 per acre when bankruptcy is filed. By filing bankruptcy, the automatic stay prevents the creditor from foreclosing the mortgage. If the land value decreases to $460 per acre during the stay, the creditor will forego $40 per acre ($500 mortgage minus the $460 value of the security) solely because the automatic stay prevented payment through foreclosure before the price of land dropped. This loss to the creditor may persuade the bankruptcy court to grant the creditor's request to lift the automatic stay so the creditor can foreclose before falling farmland values harms him.

Similarly, the stay terminates for the requesting creditor if the court does not act on the request within 30 days.[110]

Generally, a hearing that involves both the debtor and creditor is necessary for a court to order termination of the automatic stay. However, if the creditor can show that immediate relief is necessary to prevent irreparable injury before the debtor can respond, the court may grant relief without hearing from the debtor.[111] In such a case, the debtor is permitted, after learning of the termination, to request that the stay be reinstated.

Adequate Protection

To avoid termination of the automatic stay for lack of adequate protection, the debtor must assure the bankruptcy court that the creditor's security interest will be preserved throughout the stay's duration. The court

will consider protection of a security interest adequate and approve continuing the stay if the creditor is

- paid cash to compensate for decreases in the collateral's value that the creditor would not incur if bankruptcy had not been filed,
- granted a lien on substitute or additional property, or
- given some other relief that is equivalent to the security interest in the collateral.[112]

Adequate protection generally refers to a situation where a secured creditor is protected from losing any amount of the security interest held in secured property due to depreciation in value. For example, a creditor may be protected from losses in value from depreciation of machinery with regular cash payments approximately equivalent to the declining value of the secured property. If court-approved protection of a secured creditor is inadequate, the creditor gains an *administrative expense priority* for losses sustained, that is, the creditor will be paid the amount of loss before most other obligations of the debtor are paid.[113]

The automatic stay, coupled with the requirement of adequate protection was a major hurdle for farmers seeking to reorganize their farm businesses during the early 1980s. A creditor secured with a land mortgage would argue that the stay prevented foreclosure of the property and that the value of the property was decreasing. Based on this argument, creditors would often request that the court order 1) cash payments from the debtor to compensate for lost land value or 2) lift the stay and allow the creditor to foreclose. The courts often agreed with the creditors based on the statutory language and its underlying policy.

As land values dropped during the 1980s, the courts ordered bankrupt farmers to adequately protect creditors with cash payments that often exceeded their scheduled payment. If farmers were unable to complete the scheduled payments, they could not meet the larger adequate protection payment. This became a major obstacle for farm reorganizations under Chapter 11 and was one reason why Congress enacted Chapter 12. Chapter 12 defines "adequate protection" more narrowly thereby making it more difficult for creditors to establish lack of adequate protection. The provisions of Chapter 12 are addressed in a subsequent section.

Another issue to arise during the 1980s with respect to adequate protection was whether an undersecured creditor was entitled to periodic adequate protection payments to compensate the creditor for lost income due to a delay in foreclosure. Creditors argued that had they been able to foreclose, the proceeds could be reinvested and the creditor would earn some income. The creditors concluded, therefore, that they should be compensated for the lost opportunity to earn income. The requirement that farmers compensate undersecured creditors for lost opportunity devastated many farmers' hopes for restructuring, just as compensating for decreasing asset values hampered reorganization.

The United State Supreme Court in 1988 resolved the "lost opportunity" question by affirming a 5th Circuit decision that adequate protection does not

require bankrupt debtors seeking to reorganize their business to pay undersecured creditors for the income that would not be earned from reinvesting the proceeds of the collateral.[114] This decision, however, was rendered after Congress enacted Chapter 12 to address some of the adequate protection issues.

Creditors Committee

Shortly after the commencement of a Chapter 11 bankruptcy case, the court must appoint a committee of unsecured creditors to represent the interests of all unsecured creditors. Creditors holding the seven largest claims are usually asked to serve on the committee. The bankruptcy court may appoint a committee of secured creditors if necessary to protect secured interests.[115]

The powers and duties of the creditors' committee include

- hiring professional agents,
- consulting with the debtor or trustee about administration of the case,
- investigating the affairs and financial condition of the debtor,
- participating in the formulation of the reorganization plan,
- requesting a trustee if one has not been appointed, and
- conducting other business of interest to the creditors it represents.[116]

Debtor-in-Possession

An essential element for a successful liquidation is someone to be responsible for supervising disbursement of the debtor's property, usually a trustee. In Chapter 11 cases, the debtor may assume responsibility for administering the bankruptcy estate rather than to rely on a trustee.[117] Debtors authorized to administer their own bankruptcy estate are referred to as a *debtor-in-possession*. The debtor-in-possession generally has all the powers, rights, and duties of a trustee, including the power to avoid pre-bankruptcy transfers and to assume or reject leases and contracts.[118] A trustee may be appointed to replace the debtor-in-possession if the debtor is guilty of fraud, dishonesty, or gross mismanagement or, if necessary, to protect the interest of creditors.

Like a Chapter 7 bankruptcy, the estate in a Chapter 11 does not include non-farm wages the debtor earns during the bankruptcy proceeding.

Debtor Examination

As under a Chapter 7, the debtor in reorganization cases must respond under oath to questions from creditors and the trustee about operation of the bankrupt business and location of its property.[119] In reorganization cases, the examination also may address operation of the business and whether it should be continued, the source of cash or property necessary to implement a plan of reorganization, and any topic relevant to reorganizing the business. The creditors' examination is one of the most emotionally difficult aspects of bankruptcy for some debtors.

Borrowing

The debtor or trustee may obtain credit to continue the operation of the business.[120] Favored status is given to financial institutions that lend to a business in Chapter 11 bankruptcy and are given priority over nearly every other debt of the business.

Use of Collateral

Farm bankruptcy proceedings seldom are completed in less than several months and often extend over two or three years if the debtor is attempting to reorganize the business. During this time, the debtor's property will be used to generate income for the benefit of creditors and the debtor. Therefore, the bankruptcy statutes authorize the trustee or the debtor to continue operating the business.[121] Likewise, the debtor/trustee is authorized to use, sell, or lease estate property as long as it is not cash or other liquid assets.[122] Furthermore, encumbered property, such as stored grain, livestock, or machinery, may be used, sold, or leased in the ordinary course of business; however, the secured creditor may demand adequate protection.[123]

Use of Cash Collateral

Operating a bankrupt business requires cash just like any other business. However, if the debtor's liquid assets (*cash collateral*) are encumbered, the trustee may not use the cash unless the secured creditor agrees or the court approves such use of the cash.[124] In the request for court approval to use the cash collateral, the debtor has to demonstrate need and state the protection it will provide the creditor, usually alternative collateral.[125] Seeking permission to use encumbered liquid assets is critical for most bankrupt farm operations and can be a major obstacle if the debtor is unable to offer alternative collateral to protect the creditor.

Reorganization Plan

The debtor has the exclusive right to file a reorganization plan during the first 120 days of a bankruptcy.[126] After that, any creditor may file a plan. As a result, a bankruptcy court will have more than one plan to consider if the debtor and some creditors each file a reorganization plan. Likewise, it is not uncommon for creditors to propose plans that mandate liquidation of the debtor's property, and courts have accepted liquidation plans submitted by creditors.[127]. If no plan is filed within 180 days, the bankruptcy court may order liquidation of the business.[128]

A Chapter 11 plan for reorganization includes provisions dealing with

- designating various classes of creditor claims (such as secured claims on chattels, secured claims on supplies, and unsecured claims),
- specifying treatment of each class of claim as long as all claims within a class are treated equally,
- explaining how the plan will be implemented (such as selling assets and adjusting long-term debt), and

- creditors that are impaired as a result of altering their contractual or legal rights.[129]

Acceptance

Creditors with allowed claims may vote on whether to accept the plan of reorganization.[130] If a class of creditors is scheduled to receive nothing under the plan, those creditors are deemed to have voted against the plan. Creditors in a class that is scheduled to receive all of its allowed claims are deemed to have voted for the plan.

Disclosure

So that all creditors and interested parties are able to make intelligent choices as to acceptance or rejection of a plan, full disclosure of the plan's details is required.[131] Creditors and interested parties must each receive a copy of the summary of the plan and a disclosure statement which the court determines to contain adequate information. The adequacy of the disclosure statement can be a point of contention between the debtor and creditors.

Confirmation

To be confirmed by the bankruptcy court, a plan must be accepted by all classes of *impaired claims*, that is, claims which will not be paid in full under the plan. A class of claims accepts the plan if over one-half of the voting creditors have voted for it and those that voted for it hold at least two-thirds of the monetary amount of the claims in that class. Even if some classes do not accept the plan, the bankruptcy court may confirm the plan if the plan does not discriminate unfairly, and is fair and equitable to the injured class. This court action is referred to as *cram down*.[132] Only one plan may be confirmed, and a court must confirm the plan if

- it complies with the provisions of Chapter 11,
- it is proposed in good faith,
- full disclosure has been made regarding costs and persons involved in the plan,
- creditors either have accepted the plan or will receive as much or more as would have been received in Chapter 7 liquidation,
- each of the classes has voted for it or is not impaired under the plan,
- each class receives its allowed claim,
- at least one-class of non-insiders has accepted the plan, and
- confirmation of plan is not likely to be followed by liquidation.[133]

Confirmation of a plan binds the debtor and all creditors, even though their claims are impaired under the plan or they voted to reject the plan. The debtor is discharged from all pre-confirmation debts, except those which are included in the plan and those debts which are non-dischargeable. If a debtor defaults on the plan, a creditor's claims are limited to what would have been received under the plan minus what has already been received. In effect, confirmation creates an entirely new debtor/creditor relationship, and

any past relationship is of no effect. The confirmed plan controls all subsequent disputes; this is case for Chapters 12 and 13 bankruptcies.

In a Chapter 11, Chapter 12, or Chapter 13 bankruptcy, the debtor will typically retain most property. Creditors are paid out of income the debtor's property produces and according to the plan for reorganization. Under the plan, unsecured creditors likely will not receive all they claim, but they must receive at least as much as they would have in a Chapter 7 liquidation. If not, the plan will not be approved.

Bankrupt farmers may not be involuntarily converted from Chapter 11 to Chapter 7 liquidation. Some farmers, however, have been liquidated under a Chapter 11 plan proposed by creditors.[31]

Chapter 11 bankruptcies are expensive and cumbersome for farmers seeking relief from debts. The Chapter 11 scheme of debt restructuring appears to be better suited to rehabilitation of non-farm businesses. Farmers and their attorneys have had difficulty gaining approval of disclosure statements and accumulating votes from creditors necessary to confirm reorganization plans. Automatic stay litigation and adversary proceedings involving the use of cash collateral and adequate protection for secured creditors may create insurmountable difficulties for debtors. Because of these difficulties, many farmers filing Chapter 11 bankruptcy are ultimately liquidated in spite of their best efforts.

Chapter 12 bankruptcy proceedings have been established to deal with some of the problems farmers encountered in Chapter 11 reorganization and to address the unique needs of financially distressed farmers. However, before the enactment of Chapter 12, the only alternative was Chapter 13.

Chapter 13 Debt Adjustment

Chapter 13 bankruptcy, also referred to as "adjustment of debts of an individual with regular income," is primarily intended for employed individuals--wage earners. Under Chapter 13, the debtor retains possession of the assets, creditors' debt collection actions are stayed, and the debtor works out a fair plan of repayment.

Eligibility

The limitations of Chapter 13 bankruptcy prevent many farmers from taking advantage of this proceeding. A Chapter 13 bankruptcy is available only to individuals (or an individual and spouse) with regular income. Such income need not necessarily be from regular wages or salaries. Bankruptcy courts have determined farm income to be sufficiently regular to qualify for Chapter 13. To be eligible for Chapter 13, an individual debtor also must owe less than $100,000 in unsecured debts and less than $350,000 in secured debts. These maximum debt requirements often limit the availability of Chapter 13 bankruptcy for farmers.

Commencing the Bankruptcy

A Chapter 13 bankruptcy proceeding is commenced, like any other bankruptcy proceeding, by filing a bankruptcy petition. The bankruptcy estate and exemptions are the same as in a Chapter 7 bankruptcy.

Automatic Stay

The automatic stay which takes effect at the commencement of a Chapter 13 bankruptcy prohibits creditors' actions to collect payments from the debtor, and prohibits actions to collect consumer debts from non-bankrupt co-debtors such as co-signers, guarantors, and spouses with joint liability.[135] This stay does not apply to business debt; therefore, a co-debtor on a farm debt is not protected from a creditor's collection action even though the other debtor has filed a Chapter 13 bankruptcy. The co-debtor stay, however, is intended to encourage bankrupt debtors to pay their own consumer debts by prohibiting creditors from pursuing co-debtors when bankruptcy is filed. A creditor may be relieved from the co-debtor stay if

1. the non-exempt co-debtor actually received the benefit of the debt rather than the bankrupt debtor,
2. the Chapter 13 plan does not intend to fully pay the debt (stay will be lifted to the extent of the deficiency in the plan), or
3. the stay will irreparably harm the creditor's interest (co-debtor will be leaving the country, for example).[136]

Role of Trustee

The trustee in a Chapter 13 bankruptcy has all the powers and authorities of any bankruptcy trustee except the authority to operate the debtor's business.[137] Instead, the debtor continues to operate the business or work the job unless the bankruptcy court orders otherwise. In addition, the trustee has the duty of overseeing the debtor's performance under the plan, advising the debtor, and appearing at bankruptcy hearings involving the plan or property values.[138] Another difference is that the debtor has the same power and duty to use, sell, or lease estate property,[139] but the Chapter 13 trustee does not.

Plan of Reorganization

Like the other rehabilitative bankruptcy chapters, a rehabilitation plan is filed with the court.[140] However, under Chapter 13, only the debtor can file a rehabilitation plan.[141] The bankruptcy court may dismiss a Chapter 13 proceeding or convert it to a Chapter 7 liquidation if the debtor does not file a plan within 45 days.[142] The Chapter 13 rehabilitation plan must

1. provide for the transfer of all or part of future earnings to the trustee for distribution to creditors,
2. equally treat each claim within a particular class of claims, and
3. provide for full payment of priority claims, that is, those claims which are secured and must be paid before all others.[143]

The plan may provide for less than full payment of allowed unsecured claims, as long as claims within each class are treated equally. Furthermore, the plan may modify the rights of secured creditors, except for the holder of a mortgage on the debtor's dwelling.[144]

Confirmation

Creditors and other interested parties may object to a plan at the confirmation hearing; however, confirmation does not depend on the creditor's approval.[145] The bankruptcy court alone determines whether a Chapter 13 rehabilitation plan is to be confirmed or rejected. The court must confirm the plan if[146]

1. the plan complies with Chapter 13,
2. the plan is proposed in good faith,
3. bankruptcy filing and other fees are paid,
4. under the plan, creditors receive at least as much as they would receive in a Chapter 7 liquidation,
5. secured creditors have accepted the plan or their liens are protected, and
6. the debtor will be able to make the payments to creditors as the plan specifies.

As under Chapter 11, confirmation of a Chapter 13 rehabilitation plan binds the debtor and creditors to the terms of the plan.[147]

Discharge

When the debtor completes performance and payments under the confirmed plan, remaining debts are discharged. This is different from a discharge under a Chapter 11 bankruptcy where discharge occurs when the plan is confirmed. If a Chapter 11 plan is not fulfilled, the debtor is not responsible for discharged debts. In comparison, a Chapter 13 debtor is liable for all debts if the plan is not fulfilled because discharge is not granted when the plan is confirmed. Chapter 13 discharge, however, is much broader than discharge under other bankruptcy chapters. The only debts not discharged are

- allowed claims not provided for in the plan,
- child and spousal support obligations,
- student loans less than seven years past due,
- death or personal injury debts caused by debtor's operation of a motor vehicle while under the influence of alcohol or drugs, and
- debts related to criminal restitution.[148]

The bankruptcy court may grant a discharge even if the debtor has not fully performed under the rehabilitation plan. Such a discharge, referred to as a *hardship discharge*, will be granted only if complete performance of the plan is rendered impossible or impractical by circumstances beyond the debtor's control. Payments prior to a hardship discharge must have given creditors at least as much as they would have received under a Chapter 7 liquidation.[149] Moreover, a hardship discharge is subject to all of the exceptions to discharge under Chapter 7 bankruptcy.[150] Thus, a Chapter 13

hardship discharge eliminates the broad discharge debtors have under Chapter 13 rehabilitation.

Following a Chapter 13 bankruptcy proceeding, a debtor may not receive another bankruptcy discharge for at least six years unless the debtor can show that the plan was a best effort and that payments under the plan totaled at least 70 percent of unsecured claims.[illegible]

Conversion and Dismissal

A debtor under Chapter 13 rehabilitation has a non-waivable right to dismiss the Chapter 13 proceeding at any time or to convert it to a Chapter 7 liquidation.[illegible] Furthermore, a creditor may petition the bankruptcy court to dismiss the proceeding or to convert to Chapter 7 for any of the following reasons:

- debtor's unreasonable delay,
- debtor's failure to pay bankruptcy filing fees and charges,
- debtor's failure to file a rehabilitation plan on time,
- debtor's failure to make timely payments under a plan or other material default,
- the bankruptcy court's denial or revocation of plan confirmation, and
- termination of the plan by its own terms.[illegible]

If a Chapter 13 proceeding is converted to Chapter 7 liquidation, property the debtor acquires between the Chapter 13 filing and the conversion becomes property of the bankruptcy estate. Claims arising out of such acquisitions of property become allowed claims of the Chapter 7 bankruptcy estate.[illegible] Farmers in Chapter 13 bankruptcy may not be involuntarily converted to Chapter 7 liquidation.

Compared to Chapter 11, Chapter 13 bankruptcy, in spite of its limitations, has been a less expensive, faster, and less complex alternative for small farmers. Chapter 12 bankruptcy is designed to meet the unique needs of farmers seeking bankruptcy relief but desiring to continue the farm business.

Chapter 12 Family Farm Debt Adjustment

Chapter 11 and Chapter 13 bankruptcies have failed largely to provide an adequate rehabilitation option for farmers. Many farmers who filed under Chapter 11 were eventually forced to liquidate either under Chapter 7 or under a reorganization plan requiring liquidation. Chapter 13 rehabilitation has not provided relief because many farmers do not qualify.

Chapter 12 bankruptcy, also referred to as "adjustment of debts of a family farmer with regular annual income," became available for farmers in November 1986. It was specifically designed to deal with the unique circumstances of family farmers and agriculture's financial situation of the 1980s. Chapter 12 blend concepts from Chapter 11 and Chapter 13, but also includes some new concepts to deal with uniquely agricultural problems. This chapter is set to expire September 30, 1993.

Eligibility

Only *family farmers* are eligible to file for Chapter 12 bankruptcy. A family farmer may be an individual, an individual and spouse, a corporation, or a partnership. Total debts of the farm operation must not exceed $1.5 million and at least 80% of the debt must have arisen out of the farming operation.[155] If the debtor is an individual or individual and spouse, at least 50% of the family's gross income must come from farming. A corporation or a partnership may be a family farmer only if 1) one family or the relatives of members of one family hold more than 50% of the outstanding stock or equity in the entity, and 2) more than 80% of the value of the assets consist of assets related to the farming operation.

An additional requirement for all family farmers is that there must be regular annual income sufficient to make the payments owed after debt restructuring and reorganization.[156] This requirement is similar to the Chapter 13 regular income requirement; however, the addition of the word annual eases eligibility for farmers. In determining whether a family farmer has sufficient annual income to qualify for filing under Chapter 12, one court has stated that both off-farm and farm income should be considered.[157]

The Bankruptcy Code's definition of a Chapter 12 family farmer is more restrictive than its definition of a farmer. Chapter 12 is intended to provide relief to debtors who actively operate small-scale farming operations as a sole proprietorship, partnership, or corporation. Congress enacted the family farmer limitation to "ensure that only family farmers -- not tax shelters or large corporate entities -- will benefit."[158]

To qualify for relief under Chapter 12, the definition of farming operation also must be satisfied. The risk involved in a particular enterprise often is used to determine if the enterprise is a farming operation within the Bankruptcy Code's definition. An Illinois bankruptcy court has stated that Congress intended special bankruptcy treatment and protection for those farmers "whose income is derived from operations that are subject to climate, farm price fluctuation, and uncertain crop production."[159] Thus, a farmer who is no longer actively producing crops or livestock and whose sole source of income is cash farmland rent likely will not be eligible to file under Chapter 12.

Relief From Stay

Like other forms of bankruptcy, filing a Chapter 12 petition stays creditor's collection activities.[160] A secured creditor may be granted relief from the stay if the bankruptcy court determines that the security is not adequately protected or that a particular asset of the debtor is not necessary for effective reorganization of the farming operation.

The concept of adequate protection is more favorable to the bankrupt farmer in Chapter 12 than under other forms of bankruptcy. For example, under Chapters 7, 11, and 13, a creditor is entitled to be paid an amount equal to the depreciation or decrease in value of the encumbered property. This was an

obstacle for farmers as land values fell rapidly during the 1980s. Under Chapter 12 when the creditor's collateral is farmland, an adequate protection payment will be no more than a reasonable rental rate for the land regardless of how much its value has decreased.[51] This provision of Chapter 12 has been beneficial for bankrupt farmers.

The automatic stay under Chapter 12 protects the bankrupt farmer and non-bankrupt co-debtors who are obligated with the farmer on consumer debts.[52] This is similar to the co-debtor stay under Chapter 13. If a creditor files a motion to lift the co-debtor stay, it is automatically lifted unless either the debtor farmer or the co-debtor files a written objection within 20 days.

Role of Trustee

A Chapter 12 trustee has duties and powers similar to those of a trustee under Chapter 13. The trustee collects and distributes the income of the debtor farmer according to the Chapter 12 rehabilitation plan. As compensation for services, the trustee retains a percentage of the amounts collected and distributed.[53] The debtor may be allowed to make payments directly to creditors if this is a more practical method of fulfilling the plan, but the trustee is still paid the required fee. The trustee fee is considered a disadvantage of Chapter 12.

Like Chapter 11, a farmer in Chapter 12 bankruptcy may remain in possession of and continue to operate the farm enterprise. The debtor farmer has many of the powers of a Chapter 7 trustee, including

- authority to assume or reject unperformed contracts and unexpired leases, and
- authority to avoid certain transfers, such as preferences, fraudulent conveyances, and improperly perfected security interests, which occurred in the days before filing.[54]

A Chapter 12 bankruptcy estate encompasses all the debtor's property at the time of filing plus property and income received during the bankruptcy case until the case is either closed, dismissed, or converted to another chapter.[55] This differs from Chapters 7 and 11 where income the debtor receives after bankruptcy was filed is not part of the estate nor available to pay debts that arose before the bankruptcy. Exposing this income to creditors can be considered another disadvantage of Chapter 12.

A Chapter 7, 11, 12, or 13 trustee may sell property of the estate outside the ordinary course of business, free and clear of other interests and liens, only if the creditors holding the interests or liens consent to the sale or the sale price is sufficient to fully pay all the claims.[56] Sales outside the ordinary course of business are the sale of items which are not normally sold as part of the farm operation, such as equipment and land.

Unique to Chapter 12 is a provision which allows a trustee to sell farmland or farm equipment free of the claims and interests of creditors after notice to the creditors and a hearing.[57] The claims and interests of creditors then attach to the proceeds of the sale. For these two types of

collateral, Chapter 12 eliminates the requirement that the creditor either receive full payment or agree to accept a lower payment. However, the farmer may not use the cash resulting from such sales without the consent of the secured creditor or permission of the bankruptcy court. The additional flexibility this provision provides in reorganizing the farm business benefits bankrupt farmers.

Plan of Reorganization

The debtor alone has the right to file a Chapter 12 rehabilitation plan. Creditors are not allowed to submit reorganization plans (such as the liquidation plans a creditor may file in a Chapter 11 bankruptcy). The debtor must file the plan within 90 days of commencement, but the court may extend this period if an extension is "substantially justified."[illegible]

The Chapter 12 plan must provide that all or part of the debtor's income be submitted to the trustee so it can be paid creditors according to the plan.[illegible] In addition, the plan must provide for full payment of all priority claims (administrative expenses, taxes, wages) and equal treatment of similarly classified creditors. As in Chapter 13, the plan may modify the rights of secured creditors; however, a Chapter 12 plan may modify the rights of a holder of a mortgage on the debtor's dwelling, something which is prohibited under Chapter 13.[illegible]

The plan may provide for payment of unsecured debt at the same time that secured debts are being paid. For example, an agricultural supplier who has not been paid but does not have a valid lien can be paid concurrent with secured creditors. Thus, secured creditors do not necessarily receive their payments first. Furthermore, the plan may provide for the sale and liquidation of all or part of the property or, alternatively, the distribution of property among creditors having security interests in the property. This provision is in contrast to Chapter 11 where liquidating plans (except those filed by creditors) are discouraged, except as a last resort.

Also under Chapter 12, the plan can provide for payment of debt from property of the debtor, not just property of the bankruptcy estate. Again, exposing additional property to creditors may be a disadvantage of Chapter 12. A plan of reorganization is to specify payments for three to five years, except that payment of secured claims may be scheduled to extend beyond the maximum of five years.

Payment of unsecured debt can be scheduled for 3 to 5 years. Any unsecured debt not scheduled to be repaid during that period is expected to be discharged if the plan is otherwise fulfilled. Payments for secured debt can extend beyond 5 years but not longer than is reasonable considering the nature of the collateral.

Another issue under Chapter 12 is determining what interest rate should be used to discount payments to determine their present value. The bankruptcy court will confirm a Chapter 12 plan only if the present value of payments to be received by secured creditors equals or exceeds the amount they would receive if the business was liquidated in a Chapter 7 proceeding. "[I]n

determining the discount rate, the court must consider the prevailing market rate for a loan of a term equal to the payout period, with due consideration for the quality of the security and the risk of subsequent default."[illegible] In other words, an appropriate rate should reflect "the market rate for loans of similar terms and quality and also [take] into account the somewhat reduced risk inherent in situations where the borrower is a Chapter 12 debtor."[illegible] Based on these statements, creditors often argue that the debtor's limited equity justifies a higher interest rate. Debtors, for obvious reasons, argue for a lower interest rate.

Confirmation

A Chapter 12 plan must be confirmed within 45 days after the plan is filed. The bankruptcy court will confirm the plan if the following statutory criteria are met[illegible]

- the plan complies with Chapter 12,
- all fees are paid,
- the plan was proposed in good faith,
- creditors will receive at least as much under the plan as they would under Chapter 7 liquidation,
- secured creditors retain their liens and receive either the value of their collateral or the amount that is owed, whichever is less, or the debtor surrenders the encumbered property to the secured creditor, and
- the debtor demonstrates the feasibility of making all payments as the plan specifies.

Creditors do not have the right to vote on a Chapter 12 plan; however, creditors and the trustee may object to confirmation of a plan.[illegible] Any objections to the plan trigger a requirement that the plan meet criteria specified in the statues to be confirmed. For example, if an unsecured creditor of the trustee objects to confirmation, the bankruptcy court must find that 1) either the claim of the objecting party and every creditor in the same class will be paid in full or 2) the plan provides that all the debtor's *disposable income* will be applied to payments under the plan.[illegible]

Disposable income is that portion of a debtor's income not reasonably necessary for the maintenance and support of the debtor and the debtor's dependents or for the continuation and operation of the debtor's farm enterprise. In spite of valid objections, the bankruptcy court may confirm the Chapter 12 plan if one of these conditions is met. This provision protects debtors by allowing them to withdraw from the business the resources needed to meet reasonable family living expenses. This explicit protection for the debtor's family is not included in Chapter 11.

The bankruptcy court's confirmation of the plan binds the debtor and all creditors to the new relationship the provisions of the plan establish.[illegible] Furthermore, confirmation of the plan vests all of the property of the bankruptcy estate in the debtor. The debtor's status as debtor-in-possession is terminated, and the debtor holds the property free and clear of any claim or interest the plan provides, except for non-dischargeable and long-term obligations.

After confirmation, the court may modify the plan at the request of the debtor, trustee, or an unsecured creditor.[1] Such a modification will be made if the bankruptcy court determines this is in the best interests of the parties. Modifications may increase or reduce the amounts of payments on claims, may extend or reduce the time for payments, or may alter the amount of distributions to creditors.

Chapter 12 includes provisions for the debtor farmer to obtain credit following plan confirmation so that the farm enterprise can continue to operate. The debtor is permitted to secure post-confirmation financing with assets which revert to the debtor at confirmation. Acquiring additional secured credit is limited by the amount to which the provisions of the confirmed plan already encumber the debtor's assets.[29]

Discharge

The bankruptcy court grants a discharge of debts as soon as practicable after the debtor has made all payments under the plan. As under Chapter 7, certain debts are excepted from discharge.[30] In addition, long-term secured debts, those on which the last payment is due after the completion of the plan, are not discharged.

A hardship discharge, as under Chapter 13, may be granted to a debtor under Chapter 12 in certain situations. Such a discharge may be granted before all plan payments are made if the debtor can show that 1) failure to make all the payments is due to circumstances beyond the debtor's control, 2) creditors have received at least as much as they would have under Chapter 7 liquidation, and 3) unlike under Chapter 13, modification of the Chapter 12 plan is impractical.[30] A Chapter 12 discharge may be revoked upon the request of any party within one year of the discharge if the debtor obtained the discharge through fraud, which was not known to the requesting party before the discharge.[31]

Conversion and Dismissal

Unlike under Chapters 11 and 13, the bankruptcy court may involuntarily convert a farmer from Chapter 12 rehabilitation to Chapter 7 liquidation. Such a conversion may be ordered if the debtor has committed fraud in connection with the case.[32] The court can dismiss a Chapter 12 bankruptcy case for several reasons, including

- debtor's unreasonable delay,
- non-payment of bankruptcy fees and charges,
- failure to file a plan on time,
- debtor's failure to properly make payments under the plan, or
- the estate is continually declining in value with no reasonable likelihood of rehabilitation.[33]

Generally, Chapter 12 bankruptcy favors farmer debtors over creditors relative to Chapters 11 and 13. Adequate protection for secured creditors under Chapter 12 forces creditors to absorb more losses than under other chapters. The problem of creditors having to confirm the plan, which is encountered under Chapter 11, does not occur under Chapter 12. In addition,

Chapter 12 offers the advantage of allowing the sale of secured property free and clear of liens without the consent of lienholders.

Because this form of bankruptcy is designed to address the needs of farmer debtors, Chapter 12 is a useful bankruptcy device for farmers needing debt relief and desiring to remain in farming.

Chapter 12 of the Bankruptcy Code is effective only through September 30, 1993.[31] Unless reinstated by Congress, no new Chapter 12 bankruptcy proceedings may be commenced after that date. Chapter 12 bankruptcies filed before October 1, 1993 will be allowed to proceed as if Chapter 12 had not been repealed.

Parting Thoughts

A few closing thoughts may be helpful in completing this introduction to bankruptcy.

Converting Cases From One Chapter to Another

Creditors generally prefer liquidation rather than long-term reorganization because liquidation assures the creditors will receive the proceeds as quickly as possible before the value of the debtor's assets are eroded. By comparison, reorganization plans generally postpone payment and thereby continue to expose creditors to the risk of not being paid. Accordingly, creditors are allowed to request that the court *convert* a reorganization bankruptcy to a Chapter 7 liquidation.[32] However, federal law protects farmers from such conversion for the same reason that a farmer cannot be involuntarily declared bankrupt.[33] Therefore, the bankruptcy court cannot convert a reorganization bankruptcy (Chapters 11, 12, or 13) filed by a farmer to a Chapter 7 liquidation. The primary exception to this rule is if the farmer has filed a Chapter 12 and the creditor convinces the court that the farmer has committed fraud.[34] By comparison, a farmer whose has filed a reorganization bankruptcy may request that it be converted to Chapter 7 liquidation at any time.[35]

Bankruptcy law also allows a Chapter 7 liquidation to be converted to a reorganization bankruptcy. A debtor can convert a Chapter 7 to Chapters 11, 12, or 13.[36] However, creditors may only request a Chapter 7 be converted to Chapter 11; they may not request that a Chapter 7 be converted to a Chapter 12 or Chapter 13.[37] This limitation upon creditors is seldom significant because few farm lenders prefer the debtor to reorganize rather than liquidate.

A Chapter 13 (debt adjustment) proceeding cannot be converted to a Chapter 11 or Chapter 12 unless the farmer requests the conversion.[38] Likewise, a Chapter 11 (business reorganization) can be converted to a Chapter 12 or Chapter 13 only at the debtor's request.[39] There are no statutory provisions to convert a Chapter 12 (family farm debt adjustment) to either a Chapter 11 or Chapter 13.

Dismissing a Bankruptcy Case

An alternative to converting a bankruptcy proceeding from one Chapter to another is for the creditor to request that the proceeding be discontinued or *dismissed.* A bankruptcy court may order dismissal if it determines that 1) discontinuing the bankruptcy best serves the interests of the debtor and creditors or 2) there is a pending bankruptcy in another jurisdiction, and the court deems dismissal as the best economical and expeditious administration of the estate.[33] The court's authority to dismiss a case is intended to be broad enough to end the bankruptcy of a debtor whose financial situation is not so desperate as to warrant bankruptcy protection. A dismissal returns all parties to where they were before bankruptcy, unless the court orders otherwise.[34] Accordingly, a dismissal entitles creditors to resume collecting unpaid obligations as non-bankruptcy law permits.

A Chapter 7 bankruptcy will be dismissed if there is unreasonable delay by the debtor, failure to pay fees, or failure to provide required information.[35] Reorganization bankruptcies can be dismissed if there is 1) continuing loss to the estate and little or no reasonable likelihood of reorganizing, 2) delay by the debtor, 3) failure to propose a plan, 4) denial of plan confirmation or revocation of a confirmed plan, 5) termination, material default, or inability to implement the confirmed plan, 6) nonpayment of fees,[36] or 7) debtor's death or insanity.[37] Chapter 12 can be dismissed if there is gross mismanagement.[38] Finally, Chapters 12 and 13 also may be dismissed upon the debtor's request.[39]

Income Tax Consequences of Bankruptcy

The bankruptcy estate in a Chapter 7 or Chapter 11 bankruptcy is a separate tax-paying entity that is treated as the debtor would have been treated if bankruptcy had not been filed.[40] This feature 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 personally liable for income taxes on that gain. Unpaid income tax liability of the bankruptcy estate does not become a personal liability of the debtor later.

Another advantage is that the debtor can elect to end a tax year the day before the bankruptcy petition is filed.[41] That election makes the income taxes due on the income earned before bankruptcy 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. However, if the estate does not have enough assets to pay those taxes, the debtor remains liable for the unpaid portion.

There is no separate taxable entity under Chapter 12 or Chapter 13.[42] Thus, there is no opportunity to shift tax liability to the estate; the debtor is left without the option of ending a tax year the day before the bankruptcy petition is filed. The tax attributes of the individual debtor in Chapter 12 or Chapter 13 remain with the debtor and do not transfer to the bankruptcy trustee, as in Chapters 7 and 11. This feature may be either an advantage or

a disadvantage to a debtor in bankruptcy, depending upon the particular situation.

Income from cancellation of indebtedness occurs when debt is extinguished in exchange for property with a value less than the amount of the debt.

> Example. Assume that a $500,000 note is entirely satisfied in exchange for farm property valued at $300,000. The result is income to the debtor in the amount of $200,000. This income could be taxable.

In bankruptcy, however, income resulting from the cancellation of indebtedness is non-taxable.[illegible] Consequently, persons who have debts discharged under any bankruptcy chapter do not have to treat the discharged debt as income. Tax attributes, such as net operating losses, tax credits, capital loss carryovers, basis, and foreign tax credits are reduced to the extent of the discharged debt; but if the discharged debt exceeds tax attributes, the excess has no tax consequences to the debtor.

Because taxation of debtors in bankruptcy is so complex and because once a transaction is complete, its tax effects cannot be altered, competent tax advice should be sought before engaging in any debt reduction transactions or filing bankruptcy.[illegible]

Negotiations

Most farm borrowers and their lenders are able to resolve financial difficulties without the debtor filing bankruptcy. Bankruptcy is usually considered to be the "last resort" for debtors. Therefore, bankruptcy sets the parameters for negotiated settlements. The parties recognize that if they are not able to reach a settlement that is satisfactory to the debtor, bankruptcy is a likely option. Similarly, a debtor must recognize that the most he can force a creditor to forsake is what the creditor must give up through bankruptcy. Therefore, bankruptcy, as a last resort, sets the parameters for settling the unpaid claims. The parties must understand bankruptcy, its costs, implications, and outcomes to negotiate a solution that is acceptable to all parties and that leaves none of them in any worse position than they would have been if the debtor commenced a bankruptcy case.

Conclusion

Farmers experiencing financial difficulties often will negotiate with creditors to arrange for restructuring of debts or alternative repayment plans. If such negotiations fail to remedy a farmer's financial problems, bankruptcy may be considered. This report explains bankruptcy proceedings and some of the specific characteristics of Chapter 7, Chapter 11, Chapter 13, and Chapter 12 bankruptcy proceedings. The information presented in this report is not intended as a substitute for competent legal advice. Persons contemplating bankruptcy or needing additional information on this topic should consult an attorney.

Endnotes

1. U.S. Const., Art. I, §8, clause 4.

2. 11 U.S.C. §301 (1988).

3. An involuntary bankruptcy can be commenced by filing a petition under either Chapter 7 or Chapter 11 of the bankruptcy code. Where there are at least 12 unsecured creditors, at least three creditors holding more than $5,000 in claims are required to join the petition. Only one creditor holding more than $5,000 in unsecured debt is necessary to initiate an involuntary bankruptcy against a debtor with less than 12 unsecured creditors. 11 U.S.C. §303(b).

4. 11 U.S.C. §303(a). Only Chapter 7 and Chapter 11 bankruptcies can be initiated involuntarily and only against nonfarmers. Id.

5. House Report No. 95-595, 95th Cong., 1st Sess. 321 (1977); Senate Report No. 95-989, 95th Cong., 2d Sess. 33 (1978).

6. 11 U.S.C. §101(17) (Supp. 1991).

7. 11 U.S.C. §101(18) (Supp. 1991).

8. Armstrong v. Corn Belt Bank, 55 B.R. 755 (C.D. Ill. 1985).

9. See 11 U.S.C. §101(30) (Supp. 1991); *In re* Blanton Smith Corporation, 7 B.R. 410 (M.D. Tenn. [Bkrpcy.] 1980).

10. Official Form No. 1.

11. 11 U.S.C. §521(1) (1988).

12. Bank. Rule 1009, 11 U.S.C. (1988).

13. 11 U.S.C. §302 (1988).

14. Bankr. Rule 1015(b), 11 U.S.C. (1988).

15. House Report No. 95-595, 95th Cong., 1st Sess. 321 (1977); Senate Report No. 95-989, 95th Cong., 2d Sess. 32 (1978).

16. 11 U.S.C. §301 (1988).

17. 11 U.S.C. §362(a) (1988).

18. 13 Harl, Agricultural Law 120.03 [1][a][ii]; *In re* Carver, 828 F.2d 463 (8th Cir. 1987).

19. 11 U.S.C. §108(b) (1988). For a discussion of North Dakota debtor/creditor laws (including redemption rights), see "Legal Rights of Debtors and Creditors--Enforcing Real Estate Mortgages," Agricultural Economics Misc. Report No. 118, and "Legal Rights of Debtors and Creditors--Impact of Debtor/Creditor Relationship on Personal Property," Agricultural Economics Misc. Report No. 160. Both are available from the Department of Agricultural Economics, North Dakota State University, Fargo 58105.

20. 11 U.S.C. §362(c) (1988).

21. 11 U.S.C. §362(d) (1988).

22. 11 U.S.C. §541(a) (1988).

23. Anyone owing a payment to the debtor is required by federal bankruptcy law to deliver the property to the trustee unless such property is of inconsequential value. 11 U.S.C. §542(a).

24. 11 U.S.C. §541(a)(5) (1988).

25. 11 U.S.C. §541(a)(6) - (a)(7) (1988).

26. 11 U.S.C. §§1207(a) and 1306(a) (1988).

27. 11 U.S.C. §§701-702 (1988).

28. 11 U.S.C. §§1202, 1302 (1988).

29. 11 U.S.C. §1104(a) (1988).

30. 11 U.S.C. §323 (1988).

31. For example, see 11 U.S.C. §704(6) (1988).

32. 11 U.S.C. §326 (1988).

33. 11 U.S.C. §343.

34. Bankr. Rule 2004(b), 11 U.S.C.A. (Supp. 1992).

35. 11 U.S.C. §501 (1988); Bankr. Rule 3001-3008, 3013, 11 U.S.C.A. (Supp. 1992).

36. 11 U.S.C. §506 (1988).

37. 11 U.S.C. §502 (1988).

38. 11 U.S.C. §547 (1988).

39. An antecedent debt is a debt incurred before the transfer of property (money or collateral) to a creditor. For example, a loan or a purchase on credit gives rise to a pre-existing debt. A monthly utility bill, which is paid regularly, is not a pre-existing debt. Similarly, no pre-existing debt arises when payment is made at or shortly after the delivery of purchased goods.

40. 11 U.S.C.A. §547(b) (1979 & Supp. 1992).

41. 11 U.S.C.A. §547(b) (4) (B) (Supp. 1992).

42. 11 U.S.C. §101(31) (A) (Supp. 1990).

43. 11 U.S.C.A. §547(c) (1979 & Supp. 1992).

44. 11 U.S.C.A. §548 (1979 & Supp. 1992).

45. *In re* Hulm, 738 F.2d 323 (8th Cir. 1984).

46. 11 U.S.C. §544(b) (1988).

47. 11 U.S.C. §545 (1988).

48. 11 U.S.C. §544 (1988).

49. 11 U.S.C. §551 (1988).

50. 11 U.S.C. §558 (1988).

51. 11 U.S.C. §546 (1988).

52. 11 U.S.C. §365 (1988).

53. 11 U.S.C. §365(b)(1).

54. 11 U.S.C. §365(k) (1988).

55. 11 U.S.C. §365(e) (1988).

56. 11 U.S.C.A. §§365(g), 502(g), (Supp. 1992).

57. 11 U.S.C.A. §365(d)(1) (Supp. 1992).

58. 11 U.S.C.A. §365(c)(2) (Supp. 1992).

59. 11 U.S.C.A. §365(h) (1979 and Supp. 1992).

60. 11 U.S.C. §522(b) (1988).

61. N.D. Cent. Code. §28-22-17 (1991).

62. N.D. Cent. Code §28-22-02.

63. N.D. Cent. Code §28-22-02.

64. N.D. Cent. Code §28-22-02.

65. Id.

66. N.D. Cent. Code §47-18-01.

67. N.D. Cent. Code §28-22-02.

68. N.D. Cent. Code §28-22-03.1.

69. N.D. Cent. Code §28-22-03 (1991).

70. N.D. Cent. Code §28-22-04 (1991).

71. N.D. Cent. Code §28-22-05.

72. N.D. Cent. Code §28-22-03.1 (1991).

73. 11 U.S.C. §522(m) (1988).

74. 11 U.S.C §522(f) (1988).

75. O'Neal v. U.S., 20 B.R. 13 (Bankr. E.D. Mo. 1982).

76. *In re* LaFond, 791 F.2d 623 (8th Cir. 1986).

77. In re Walkington, 42 B.R. 67 (Bankr. W.D. Mich. 1984); *In re* Steward, 110 B.R. 11 (Bankr. Idaho 1989).

78. *In re* Newbury, 70 B.R. 1 (Bankr. D. Kan. 1985); *In re* Heape, 85 B.R. 577 (D. Kan. 1988).

79. In Matter of Eby, 76 B.R. 140 (Bankr. S.D. Iowa 1987).

80. H.R. Rep. No. 95-595, 95th Cong., 2nd Sess. 360-1 (1977) reprinted in 1978 U.S.C.C.A.N. 6317.

81. 11 U.S.C. §522(e) (1988).

82. 11 U.S.C. §522(k) (1988).

83. 11 U.S.C. §522(l) (1988).

84. Bankr. Rule 6007 11 U.S.C.A. (Supp. 1992), and 11 U.S.C. §554 (1988).

85. H.R. Rep. No. 95-595, 95th Cong., 2nd Sess. 377 (1977); reprinted in 1978 U.S.C.C.A.N. 6333.

86. 11 U.S.C. §§554 (1988).

87. 11 U.S.C. §553 (1988 & Supp. 1991).

88. 11 U.S.C. §553(a) (1988 & Supp. 1991).

89. 11 U.S.C. §553 (1988 & Supp. 1991).

90. 11 U.S.C. §725 (1988).

91. 11 U.S.C. §506 (1988).

92. 11 U.S.C. §§101(28), 101(36), 101(37) (1988 & Supp. 1991).

93. 11 U.S.C. §507(a)(1)-(5) (1988 & Supp. 1991).

94. 11 U.S.C. §724(b) (1988); and 11 U.S.C. §507(a)(1)-(5) (1988 & Supp. 1991).

95. 11 U.S.C. §501 (1988).

96. 11 U.S.C. §§726, 507 (1988 & Supp. 1991).

97. 11 U.S.C. §510 (1988).

98. 11 U.S.C. §727(b) (1988).

99. 11 U.S.C. §523(a) (1988 & Supp. 1991).

100. 11 U.S.C. §727(a) (1988).

101. 11 U.S.C. §727(a) (1988).

102. 11 U.S.C. §727(c) (1988).

103. 11 U.S.C. §727(d)-(e) (1988).

104. 11 U.S.C. §524(c) (1988).

105. 11 U.S.C. §524(d) (1988).

106. 11 U.S.C. §350(a) (1988) Bankr. Rule 5009, 11 U.S.C. (Supp. 1991).

107. 11 U.S.C. §350(b) (1988); Bankr. Rule 5010, 11 U.S.C. (1988).

108. 11 U.S.C. §362(d)(1) (1988).

109. 11 U.S.C. §362(d)(1) (1988).

110. 11 U.S.C. §362(e) (1988).

111. Bankr. Rule 4001(a)(2), 11 U.S.C. (Supp. 1991).

112. 11 U.S.C. §361 (1988).

113. 11 U.S.C. §507(b) (1988).

114. United States Assn. v. Timbers of Inwood Forest, 484 U.S. 365 (1988) aff., 808 F.2d 363 (5th Cir. 1987).

115. 11 U.S.C. §1102 (1988).

116. 11 U.S.C. §1103 (1988).

117. 11 U.S.C. §1107 (1988).

118. 11 U.S.C. §1107 (1988).

119. Bankr. Rule 2004, 11 U.S.C. (Supp. 1991); 11 U.S.C. §343 (1988).

120. 11 U.S.C. §364 (1988).

121. 11 U.S.C. §§721 (if it is in the best interest of the estate), 1108 (unless the court orders otherwise), 1203 and 1304 (unless the court orders otherwise) (1988).

122. 11 U.S.C. §363 (1988). Cash and liquid assets may be used after notice to creditors and a hearing.

123. 11 U.S.C. §363 (1988).

124. 11 U.S.C. §363(a) 363(c)(2) (1988); Bankr. Rule 4001(b), 11 U.S.C. (Supp. 1991).

125. Bankr. Rule 4001(b), 11 U.S.C. (1991) (Advisory Committee Note--1987 Amendment).

126. 11 U.S.C. §1121 (1988).

127. *In re* Buttonhook Cattle Company, Inc., 747 F.2d 483 (8th Cir. 1984).

128. 11 U.S.C. §1112 (1988).

129. 11 U.S.C. §1123 (1988).

130. 11 U.S.C. §1126 (1988).

131. 11 U.S.C. §1125 (1988).

132. 11 U.S.C. §1129(b) (1988).

133. 11 U.S.C. §1129(a) (1988).

134. Matter of Jasik, 727 F.2d 1379 (5th Cir. 1984).

135. 11 U.S.C. §1301 (1988).

136. 11 U.S.C. 1301(c) (1988).

137. 11 U.S.C. §1302 (1988).

138. 11 U.S.C. §1302(b) (1988).

139. 11 U.S.C. §§1303-1304 (1988).

140. 11 U.S.C. §1321 (1988).

141. 11 U.S.C. §1321 (1988).

142. 11 U.S.C. §1307(c) (1988).

143. 11 U.S.C. §1322(a) (1988).

144. 11 U.S.C. §1322(b) (1988).

145. 11 U.S.C. §1324 (1988).

146. 11 U.S.C. §1325 (1988).

147. 11 U.S.C. §1327 (1988).

148. 11 U.S.C. §1328(a) (1988 & Supp. 1991).

149. 11 U.S.C. §1328(b) (1988 & Supp. 1991).

150. 11 U.S.C. §1328(c) (1988).

151. 11 U.S.C. §727(a)(9) (1988).

152. 11 U.S.C. §1307(a)-(b) (1988).

153. 11 U.S.C. §1307(c) (1988).

154. 11 U.S.C. §§1305-1306 (1988).

155. 11 U.S.C. §101(18) (Supp. 1991).

156. 11 U.S.C. §101(19) (Supp. 1991).

157. *In re* Hoskins, 74 Bankr. 51, 53 (Bankr. C.D. Ill. 1987).

158. 132 Cong. Rec. S15076 (daily ed. Oct. 3, 1986)(statement of Sen. Grassley).

159. Armstrong v. Corn Belt Bank, 55 B.R. 755, 761 (Bankr. C.D. Ill. 1985), aff'd. 812 F.2d 1024 (7th Cir. 1987), cert. denied, 484 U.S. 925 (1987).

160. 11 U.S.C. §1201 (1988).

161. 11 U.S.C. §1205(b)(3) (1988).

162. 11 U.S.C. §1201 (1988).

163. 11 U.S.C. §1202 (1988).

164. 11 U.S.C. §1203 (1988).

165. 11 U.S.C. §1207 (1988).

166. 11 U.S.C. §1206 (1988).

167. 11 U.S.C. §1206 (1988).

168. 11 U.S.C. §1221 (1988).

169. 11 U.S.C. §1222(a) (1988).

170. 11 U.S.C. §1222(b) (1988).

171. *In re* Edwardson, 74 B.R. 831, 835-6 (Bankr. D.N.D. 1987).

172. *In re* Clays, 81 B.R. 985, 994 (Bankr. D.N.D. 1987).

173. 11 U.S.C. §1225 (1988).

174. 11 U.S.C. §1225(b) (1988).

175. 11 U.S.C. §1225(b) (1988).

176. 11 U.S.C. §1227 (1988).

177. 11 U.S.C. §1229 (1988).

178. 11 U.S.C. §1227 (1988).

179. 11 U.S.C. §1228(a) (1988).

180. 11 U.S.C. §1228(b) (1988).

181. 11 U.S.C. §1230 (1988).

182. 11 U.S.C. §1208(d) (1988).

183. 11 U.S.C. §1208(c).

184. Pub. L. 99-554, Title III, § 302(f) (Oct. 27, 1986) (100 Stat. 3124).

185. 11 U.S.C. §1112 (a)-(b) (1988).

186. 11 U.S.C. §§1112(c), 1307(e) (1988).

187. 11 U.S.C. §1208(d) (1988).

188. 11 U.S.C. §§1112(a), 1208(a), 1307(a) (1988). Bankr. Rule 1019, 11 U.S.C. (Supp. 1991).

189. 11 U.S.C. §706(a) (1988).

190. 11 U.S.C. §706(b) and (c) (1988).

191. 11 U.S.C. §1307(e) (1988).

192. 11 U.S.C. §1112(d) (1988).

193. 11 U.S.C. §305 (1988 & Supp. 1991).

194. 11 U.S.C. §349 (1988).

195. 11 U.S.C. §707 (1988).

196. 11 U.S.C. §§1112(b), 1208(c), 1307(c) (1988).

197. Bankr. Rule 1016, 11 U.S.C. (Supp. 1991).

198. 11 U.S.C. §1208(c) (1988).

199. 11 U.S.C. §§1208(b), 1307(b) (1988).

200. 26 U.S.C. §1398(a) (1988).

201. 26 U.S.C. §1398(d)(2).

202. For state income tax purposes, however, a separate tax entity is created under Chapters 12 and 13. This means that the taxable year of a debtor in Chapter 12 or Chapter 13 terminates for state income tax purposes on the day of the bankruptcy filing. The bankruptcy trustee is required to prepare a tax return for the bankruptcy estate of an individual debtor while the bankruptcy case is pending, before discharge.

203. I.R.C. §108(a)(1)(A).

204. Additional information on this topic can be found in Tax Implications of Liquidating a Farm Operation After the Tax Reform Act of 1986, Agricultural Economics Miscellaneous Report No. 111, Department of Agricultural Economics, North Dakota State University, Fargo, ND 58105.

Glossary

Abandonment: Bankruptcy trustee declaration of no interest in certain estate property which allows any secured creditors to enforce their liens as if bankruptcy had not been filed.

Adequate Protection: Situation where a secured creditor is protected from depreciation in its collateral during the bankruptcy imposed automatic stay.

Affidavit: A written statement declared under oath and used to present evidence.

Antecedent Debt: A debt that arose more than 10 days before a lien was granted or more than 45 days before payment was completed.

Attachment: Refers to when a security agreement becomes effective; the point in time when a creditor legally acquires a security interest in the debtor's property. Attachment occurs after 1) there is a security agreement, 2) the creditor has given the debtor something of value (such as loan proceeds or sold an item on credit), and 3) the debtor has an ownership interest in the property that will be encumbered.

Automatic Stay: Once a debtor is declared bankrupt, federal law prohibits creditors from taking any further acts to reclaim property, perfect liens, collect judgments, or secure payments except as federal bankruptcy law allows. Restated, all proceedings under state law are stopped upon declaration of bankruptcy.

Avoidance Power: Bankruptcy trustee power to invalidate certain transfers of and encumbrances on the debtor's property.

Bankruptcy: A legal proceeding in federal court wherein a debtor who is unable to pay debts on time is protected from further legal action by creditors seeking payment of their obligations. In exchange for this protection, the debtor will arrange to pay as many debts as possible either through liquidation (Chapter 7) or reorganization (Chapters 11, 12, and 13).

Bankruptcy Estate: Includes all property and interests in property the debtor holds at the time of filing the bankruptcy petition, as well as earnings, proceeds, and products of this property.

Bankruptcy Petition: Formal bankruptcy document by which a person declares bankruptcy and initiates the bankruptcy process.

Chapter 7: Bankruptcy proceeding wherein the debtor's nonexempt property is sold (liquidated) with the proceeds used to satisfy unpaid obligations. Debts remaining after liquidation are usually discharged. Also referred to as straight bankruptcy.

Chapter 11: Bankruptcy proceeding in which debtors are allowed to continue operating their businesses in exchange for developing and fulfilling a detailed plan as to how and when debts will be repaid. Reorganization plans often involve delaying payments, extending pay-back periods, reducing amount of indebtedness or interest rate, and partial liquidation.

Chapter 12: Bankruptcy proceeding designed for "family farmers" wherein a farmer files a plan in which the farmer proposes to submit farm income to a trustee who distributes the income to creditors. The goal is to rehabilitate (reorganize) the farm business rather than liquidate the operation.

Chapter 13: Bankruptcy proceeding which provides for the adjustment of debts of an individual with regular income. The debtor makes payments to a trustee who makes a distribution to creditors according to an approved plan.

Creditor: Person or entity that has loaned money, sold property, or provided a service with the understanding that the payment will be made at a later time. Someone who is owed a payment.

Debtor: Person or entity that has borrowed money or purchased property or services but is not expected to complete payment until a later time. Someone who owes a payment.

Debtor-in-possession: A debtor in a Chapter 11 reorganization who assumes the responsibilities of a trustee and retains management of the bankrupt business.

Deficiency: The amount a debtor still owes to a creditor after property upon which the creditor had a lien has been sold and the proceeds used to pay the creditor. Deficiency arises only when proceeds from sale of encumbered property are less than the amount of the debt.

Deficiency Judgment: Court recognition that a deficiency remains after the encumbered property of the debtor has been sold and the proceeds paid to the creditor. After a deficiency judgment, the creditor may proceed against additional property of the debtor to collect the remaining indebtedness.

Discharge: Available only from a federal bankruptcy court; it relieves the debtor of all obligations that the debtor is unable to fulfill. Once discharged, the debt is no longer a legal obligation and the creditor cannot attempt to collect payment. Some debts, by federal law, cannot be discharged. Discharges can be granted no sooner than six years after an earlier discharge.

Encumbrance: A lien.

Encumbered Property: Property that has a lien imposed upon it.

Execution: Procedure to enforce a judgment whereby the sheriff is instructed to seize the debtor's property to satisfy the unpaid obligation. The seized property usually is sold with proceeds (minus cost of sale) remitted to the creditor.

Exempt Property: Property that, according to state law, cannot be seized to satisfy obligations of the debtor.

Farmers: Persons who, during the year immediately preceding the tax year in which bankruptcy is filed, received more than 80% of their gross income from a farming operation.

Farming Operation: The production or raising of crops, poultry, or livestock, dairy farming, and the production of poultry or livestock or products in an unmanufactured state.

Financing Statement: A statement filed for public record in the office of the county register of deeds or the secretary of state listing the debtor's property upon which a creditor has imposed a security interest. Filing a financing statement perfects the security interest.

Foreclosure: A legal procedure to terminate a debtor's equitable redemption right. Generally, it is used in reference to a state court proceeding wherein the debtor is declared delinquent in making payments to a creditor and encumbered property is ordered sold with the proceeds used to satisfy the debt.

Guarantor: A person who obligates oneself to pay the debt of another if that other person (the primary debtor) fails to repay the debt.

Impaired claim: A creditor's claim that will not be paid in full under a Chapter 11 reorganization plan.

Involuntary Bankruptcy: A bankruptcy proceeding creditors of the debtor, rather than by the debtor, initiates. Federal law prohibits farmers from being forced into an involuntary bankruptcy.

Judgment Lien: A lien automatically imposed upon all real property of the debtor after a state court determines that the debtor is indebted to the creditor. The lien encumbers only real property in the county in which the court is located, but the lien can be imposed on real property in other counties by recording the judgment in the other counties.

Lien: A right to have property sold or otherwise used in satisfaction of a debt. The right to have the encumbered property used to fulfill an obligation secures payment of the debt. Although the right is held, it can be exercised only if the debtor does not meet the terms of the obligation.

Lienholder: Any person or entity whose debt is secured by a lien on the debtor's property. Any creditor who has the right to have a debtor's property sold or otherwise used to satisfy a debt.

Liquidation: Converting noncash assets to cash by selling them. Also used to denote a Chapter 7 Bankruptcy.

Loan Agreement: An agreement between a debtor and creditor wherein the debtor promises to repay the debt. The loan agreement contains the terms of the understanding, such as due dates for payments, rate of interest, obligation for the creditor to extend additional credit at a future time.

Mortgage: A voluntary real property lien that the debtor has granted to a creditor. Chattel mortgage (less frequently used today) refers to a lien upon personal property. Mortgages generally are used to secure repayment of a debt to a creditor who has sold land on credit or loaned cash to the debtor.

Mortgagee: A creditor who holds a mortgage upon real property of the debtor.

Mortgagor: A debtor who owns land that has been mortgaged to a creditor; a debtor/mortgagor grants a lien (mortgage) to a creditor/mortgagee.

Note: Same as a loan agreement.

Order for Relief: A bankruptcy court order limiting creditor debt collection activities.

Party in Interest: Any person with a legal interest in the bankruptcy proceeding, and includes the debtor, trustee, and creditors.

Perfection: The act of a creditor providing public notice that the creditor has a security interest in property of the debtor and that the creditor is entitled to have the property or its proceeds returned to the creditor if the debtor fails to fulfill the secured obligation.

Personal Property: All property that is not considered real property; property that is movable, includes both tangible and intangible.

Preference: A transfer of property from the debtor to the creditor or imposition of a lien upon property of the debtor 1) within 90 days before bankruptcy and 2) to satisfy or secure an antecedent debt. Preferences can be avoided by a bankruptcy trustee, rendering the creditor unsecured. The creditor must return any payment considered a preference to the bankruptcy estate.

Priority: Determining which creditor is first entitled to proceeds from sale of encumbered property. Creditors without priority will receive only the amount that remains (if any) after fulfilling obligations of creditors with priority.

Purchase Money Security Interest: A security interest that arises automatically for a person who sold some property on credit or furnished cash for the purchase of property. A purchase money security interest is considered perfected for 20 days after the debtor acquires possession of the property. It is an acknowledgment by the law that filing to perfect a security interest takes some time and that the person who extended credit for the purchase of the property will retain priority as long as the security interest is perfected within a reasonable length of time.

Reaffirmed: Debtor promises to repay an obligation that the court has discharged or is empowered to discharge.

Real Property: Land, buildings, and all property attached to real estate.

Redemption: The right of a debtor (and subordinated creditors) to reacquire property that has been seized to satisfy the claim of a secured creditor. The right to redeem farmland generally expires one year after date of foreclosure sale. The right to redeem personal property terminates upon the sale or acceptance of the property as fulfilling the debt. The amount that

must be paid to redeem land is the amount the property sold for but, for personal property, is all obligations the property secures.

Redemptioner: Other creditors of the debtor who hold liens upon land that is being foreclosed, but the liens are subordinate to the mortgage that is being enforced.

Reorganization: Refers to a Chapter 11 or Chapter 12 bankruptcy proceeding.

Secured Creditor: A creditor with a lien upon property of the debtor. Usually refers to creditors with security interest in personal property.

Security Agreement: A written contract between the debtor and creditor wherein the debtor grants the creditor a lien in some property. Usually used in reference to a security interest.

Security Interest: Refers to a lien granted by a debtor upon personal property, such as livestock, equipment, crops, and inventory.

Set-off: In situations where each party owes the other a payment, the parties may partially or totally settle their accounts by reducing the amount they are owed by the amount they owe the other party.

Statutory Lien: A lien that automatically arises according to state law rather than by agreement wherein the debtor grants a lien to the creditor. These liens generally arise when material or services, sold on credit, benefit or improve specific property of the debtor. The lien encumbers the improved property. State law usually requires the creditor to file a notice with the county register of deeds in order to establish a statutory lien. Examples are mechanic's lien, repairman's lien, agricultural supplier's lien, and agricultural processor's lien.

Straight Bankruptcy: Refers to a Chapter 7 bankruptcy.

Subordinated Mortgage: A mortgage that does not have priority relative to another mortgage upon the same land.

Superior Mortgage: A mortgage that has priority over another mortgage that encumbers the same land.

Voluntary Bankruptcy: A bankruptcy proceeding initiated by the debtor.

Voluntary Lien: A lien that arises from an agreement between the debtor and creditor wherein the debtor grants a lien to the creditor. The lien, in conjunction with a promise to repay a debt, is exchanged for the creditor providing a cash loan or otherwise extending credit. Also referred to as a consensual lien.