

CHAPTER 12 - FAMILY FARMER

BANKRUPTCY ACT OF 1986

by

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in

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## VITA

Tim Jason Watts was born April 10, 1958 in Miles City Montana, the son of Audrey and Harry Watts. He, along with one brother and two sisters, was raised on the family farm/ranch 42 miles east of Miles City. He graduated from Custer County District High School in 1976. In 1981, he received a B.S. degree in Agricultural Business from Montana State University. From 1981 through 1983, while working on his masters degree in Applied Economics, he was employed as an Assistant Extension Economist with Montana State University. Since 1983 he has operated a consulting business servicing financially stressed farms and ranches. In 1986, he was contracted by the State of Montana as a financial consultant for the Montana Agricultural Assistance Program. Also in 1986, he formed a management corporation, "Watts and Associates Management Analysis," which has, since its inception, worked with many financially stressed agricultural entities in the northwestern United States and Canada. Since November of 1986, he has worked with several attorneys and agricultural producers in analyzing and preparing farmer reorganizations under Chapter 12 Bankruptcy.

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## TABLE OF CONTENTS

	Page
APPROVAL .....	ii
STATEMENT OF PERMISSION TO USE .....	iii
VITA .....	iv
ACKNOWLEDGMENTS .....	v
TABLE OF CONTENTS .....	vi
LIST OF TABLES .....	x
ABSTRACT.....	xiv
CHAPTER	
1. INTRODUCTION .....	1
General Agricultural Conditions .....	1
Montana Financial Conditions.....	3
History of Chapter 12 .....	4
Purpose of the Study .....	7
Outline of Procedures .....	8
2. HISTORY OF BANKRUPTCY IN THE UNITED STATES JUDICIAL SYSTEM .....	10
Bankruptcy Acts Previous to 1978 .....	10
Bankruptcy Reform of 1978 .....	13
Theory of Legal Reorganization .....	15
Farmer Reorganization under Chapter 11.....	17
Farmer Reorganization under Chapter 13 .....	21
Legal Requirements and Constraints of a Chapter 12 Bankruptcy.....	22
Definition of a Family Farmer .....	22
Demonstration of a Stable Income .....	24
Definition of Farming .....	24
Individual Eligibility for Chapter 12 ..	24
Corporate Eligibility for a Chapter 12..	25
Forced Farmer Bankruptcy .....	25
Filing the Reorganization Plan .....	26
Trustee's Fee .....	28
Definition of Disposable Income .....	28
Definition of the Bankruptcy Estate ....	29
Exempt vs. Nonexempt .....	32

TABLE OF CONTENTS--Continued

	Page
Reducing Secured Debt to the Value of the Collateral .....	34
Classification of Creditors .....	36
Reamortization of Secured Debts .....	37
Codebtor Stay .....	38
Duration of the Bankruptcy .....	39
Confirmation of the Plan .....	39
Summary .....	41
 3. METHODS FOR AGRICULTURAL FINANCIAL ANALYSIS .....	 43
Total Income Calculations .....	46
Government Payments .....	46
Operating Expense Information .....	47
Asset Information .....	48
Miscellaneous Information .....	49
Annual Machinery Replacement Expense .....	49
Income Tax Considerations .....	50
Information on Liabilities .....	50
Typical Year Analysis and Determination of Disposable Income .....	51
Competence of Current Management .....	52
Summary .....	53
 4. CASE STUDY OF DEBT ACCUMULATION .....	 54
Assumptions of the Case Study .....	55
Income Assumptions .....	57
Operating Expense Assumptions .....	58
Cash Flow in 1980 .....	59
Debt Accumulation Due to the Cost Price Squeeze, Drought and Grasshoppers .....	63
Erosion of Net Worth .....	66
Results of the Case Study .....	73
Management Options for the Case Study .....	74
Workout Proposal .....	75
Creditors' Meeting .....	76
Summary for Case Study .....	76
 5. CASE STUDY ILLUSTRATIONS OF CHAPTER 12 .....	 77
Case Study - Non-Confirmable Plan .....	78
Balance Sheet and Cash Flow .....	78
Valuation of Security .....	80

TABLE OF CONTENTS--Continued

	Page
Case Study 2- Committing Other Income	
From Outside the Bankruptcy Estate .....	82
Case Study 3- Farmers Home Administration	
Exclusive Creditor .....	83
Case Study 4- Leased Land and Machinery .....	85
Income from 1980 - 1986 .....	85
Operating Expenses .....	86
Debt Assumption in 1980 .....	87
Cash Flow in 1980 and in 1987 .....	87
Debt Accumulation .....	93
Progression of Balance Sheets	
from 1980 through 1987 .....	96
Chapter 12 Analysis .....	96
Secured vs. Unsecured Debt .....	96
Scaling Down the Debt to the	
Secured Creditor .....	101
Cash flow of the Chapter 12 .....	101
Duration of the Bankruptcy	
and Liquidation Requirements ....	102
Super Priority Loan for	
Operating Funds .....	103
Case Study 5 - Increasing Livestock	
Numbers and Implementing a Loan	
Deferral within the Plan .....	103
Transitional Year Budgeting .....	104
Development of the Annual	
Payment Plans of the Chapter 12 .....	105
Application of the Residual .....	108
Meeting the Liquidation Rule .....	109
Summary .....	109
6. SUMMARY AND CONCLUSIONS .....	111
Areas of Concern and Further Research .....	114
REFERENCES .....	117
APPENDIX .....	118
Bankruptcy Reform Act of 1978, Chapter 12 ...	119
Sec. 1201. Stay of action against	
codebtor .....	119
Sec. 1202. Trustee .....	121
Sec. 1203. Rights and powers of	
debtor .....	123
Sec. 1204. Removal of debtor as debtor	
in possession .....	124
Sec. 1205. Adequate protection .....	124

**TABLE OF CONTENTS--Continued**

	Page
Sec. 1206. Sales free of interests .....	125
Sec. 1207. Property of the estate .....	126
Sec. 1208. Conversion or dismissal .....	126
Sec. 1221. Filing of plan .....	128
Sec. 1222. Contents of plan .....	129
Sec. 1223. Modification of plan before confirmation .....	131
Sec. 1224. Confirmation hearing .....	132
Sec. 1225. Confirmation of plan .....	132
Sec. 1226. Payments .....	134
Sec. 1227. Effect of confirmation .....	135
Sec. 1228. Discharge .....	136
Sec. 1229. Modification of plan after confirmation .....	138
Sec. 1230. Revocation of an order of confirmation .....	139
Sec. 1231. Special tax provisions .....	140

## LIST OF TABLES

Table	Page
1. Montana Farm Finance Balance Sheet by Debt/Asset Ratio .....	4
2. Comparison of Chapter 11 and Chapter 12 Bankruptcy .....	18
3. Example of Disposable Income Calculation ....	44
4. Case Study Disposable Income in 1987 .....	57
5. Projected Income from 1980 - 1987 .....	58
6. The GNP Implicit Price Deflator .....	59
7. Operating Expense for Case Study 1985-1987...	60
8. Operating Expense for Case Study 1984-1982...	61
9. Operating Expense for Case Study 1981-1980...	62
10. Cash Flow in 1980 .....	63
11. Illustration of Debt Accumulation Due to the Cost Price Squeeze, Drought and Grasshoppers 1987.....	64
12. Illustration of Debt Accumulation Due to the Cost Price Squeeze, Drought and Grasshoppers 1986-1985.....	64
13. Illustration of Debt Accumulation Due to the Cost Price Squeeze, Drought and Grasshoppers 1984-83.....	65
14. Illustration of Debt Accumulation Due to the Cost Price Squeeze, Drought and Grasshoppers 1982-1981.....	65
15. Illustration of Debt Accumulation Due to the Cost Price Squeeze, Drought and Grasshoppers 1980 Expected in 1980.....	66

LIST OF TABLES--Continued

Table	Page
16. Average Value per Acre of Farmland in Montana .....	67
17. Balance Sheet for 1987 .....	68
18. Yearly Balance Sheets from 1985 through 1986 .....	69
19. Yearly Balance Sheets from 1983 through 1984 .....	70
20. Yearly Balance Sheets from 1981 through 1982 .....	71
21. Balance Sheet for 1980 .....	72
22. Options Available to the Debtor .....	75
23. Case Study- Balance Sheet for 1987 .....	79
24. Case Study- Prepetition Cash Flow of Non-Confirmable Case .....	80
25. Case Study- Position of the Long Term Lender .....	80
26. Case Study- Value of Security for the Short Term Lender .....	81
27. Case Study- Position of the Short Term Creditor .....	81
28. Case Study- Chapter 12 Cash Flow .....	82
29. Case Study 2- Chapter 12 Cash Flow .....	83
30. Case Study 3- Chapter 12 Cash Flow .....	85
31. Case Study 3- Income from 1980 - 1987 .....	86
32. Case Study 4- Operating Expenses for 1987 - 1986 .....	88
33. Case Study 4- Operating Expenses for 1985 - 1984 .....	89

LIST OF TABLES--Continued

Table	Page
34. Case Study 4- Operating Expenses for 1983 - 1982 .....	90
35. Case Study 4- Operating Expenses for 1981 - 1980 .....	91
36. Case Study 4- Operating Expenses for 1980 ...	92
37. Case Study 4- Cash Flow in 1980 .....	93
38. Case Study 4- Cash Flow in 1987.....	93
39. Case Study 4- Debt Accumulation 1987 - 1986 .	94
40. Case Study 4- Debt Accumulation 1985 - 1984 .....	94
41. Case Study 4- Debt Accumulation 1983 - 1982 .....	95
42. Case Study 4- Debt Accumulation 1981 - 1980 .....	95
43. Case Study 4- Debt Accumulation Expected in 1980 .....	96
44. Case Study 4- Balance Sheets for 1987 and 1986 .....	97
45. Case Study 4- Balance Sheets for 1985 and 1984 .....	98
46. Case Study 4- Balance Sheets for 1983 and 1982 .....	99
47. Case Study 4- Balance Sheets for 1981 and 1980 .....	100
48. Case Study 4- Position of the Short Term Lender .....	101
49. Case Study 4- Chapter 12 Cash Flow .....	102
50. Case Study 4- Total Asset Value .....	102

**LIST OF TABLES--Continued**

Table	Page
51. Case Study 5- Cowherd Numbers from 1988-1992 .....	105
52. Case Study 5- Position of the Creditor .....	105
53. Case Study 5- Disposable Income 1988-1992....	106
54. Case Study 5- Annual Chapter 12 Cash Flow ...	107
55. Case Study 5- Disposable Income Residual 1988-1992 .....	108
56. Case Study 5- Cumulative Residual of the Disposable Income .....	109

**ABSTRACT**

In October of 1986 a new chapter of the United States Bankruptcy Act was enacted. Chapter 12 bankruptcy, referred to as the Family Farmer Bankruptcy Act, was enacted to alleviate some of the financial problems faced by agricultural producers. This study provides background information about bankruptcy, the history of bankruptcy, and of farmer bankruptcy, including the history of Chapter 12.

After specifying the major legal constraints and requirements for a Chapter 12 bankruptcy plan, it was illustrated that Chapter 12 does not mitigate the major financial problems which occurred in Montana and associated regional agriculture. Specific instances wherein a Chapter 12 bankruptcy plan might be feasible were covered.

## CHAPTER 1

### INTRODUCTION

On October 27, 1986, a new chapter was added to the bankruptcy law of the United States. Chapter 12 - The Family Farmer Bankruptcy Act of 1986 was passed to partially alleviate the financial pressures that highly leveraged farms were receiving from creditors. This legislation was an attempt to rectify problems that farmers were having as they attempted to reorganize their debts under Chapter 11 and Chapter 13 of the then existing bankruptcy laws.

#### General Agricultural Conditions

The downturn in commodity prices and the rise in production costs in the late 1970's and early 1980's substantially decreased net income on many farms. This in turn decreased the farm's ability to generate operating capital. In fact, until recent years, many farmers were able to generate their own operating capital internally through the retention of a portion of net income. In some instances the reduction in net income was so severe that the farm's ability to service debt was totally eliminated and it was necessary to borrow not only for the following

12 months operating capital, but also the long term debt payments.

The reduction of net income and the resulting debt accumulation changed the credit worthiness of farms. To further compound the credit problem, the collateral base in 1987 for most agricultural operations had eroded to 62 percent of what it had been in 1982. Farmland that was shown on a balance sheet in 1982 at \$271.00 an acre, was valued by agricultural lending institutions at \$167.00 an acre in 1987. The decline was a sharp contrast to the previous 20 years experience where land value had appreciated at approximately eight percent annually. During the period of appreciation long term landowners had acquired substantial equity in their land. In the 1970's, some long term lenders, and even short term lenders, were lending to farmers through the implementation of second and third mortgages on the land, even though there was a potential annual cash deficit. The result was that some farmers entered the 1980's with a relatively high debt load in comparison to the ability to service debt.

In addition to low commodity prices relative to production costs, and eroded asset values, farmers face other problems which are beyond their control. These problems come in many forms such as hail, floods, drought,

insects and similar hazards. Insurance can be purchased to cover a portion of most of the hazards for farmers, but not for ranchers. One, or a combination of these hazards, often results in the loss of part or all of farm or ranch annual gross income. In instances of extended drought, income may be lost for a period of years.

### Montana Financial Conditions

The Montana farm condition during the 1980s can be characterized by low production (Montana Agricultural Statistics Service, 1986); low production resulting from poor climatological conditions has had a major effect on the ability of these farms to service debt. As a result, there has been significant debt accumulation. Debt accumulation, combined with the decline in asset values, left many farmers in precarious financial condition. From the results of a survey (Montana Department of Agriculture, 1987), it was concluded that farm income for 1985, which was a severe drought year, averaged a \$15,000.00 loss for each farm and ranch in Montana. The results of the survey also made possible the debt/asset distribution featured in Table 1.

History of Chapter 12

Farmers under the cumulative financial pressure of declining asset values, low production, high production costs, and a debt level which could not be serviced with current cash income, became politically active. The

**Table 1. Montana Farm Finance Balance Sheet by Debt/Asset Ratio**

Debt/Asset Ratio Category	Number of Reports		Debt To Asset Ratio Average		Farm Assets Average		Farm Debt Average	
	1985	1986	1985	1986	1985	1986	1985	1986
			-Percent-		-----Dollars-----			
0	112	128	0	0	438,124	476,505	0	0
0-10	96	94	4.5	5.0	732,682	743,485	33,051	37,003
10-20	66	69	15.4	14.8	652,199	811,167	100,731	120,273
20-30	53	73	25.2	24.9	738,728	752,808	186,468	187,657
30-40	69	50	35.1	34.4	672,585	781,258	235,963	269,073
40-50	63	44	44.2	43.7	761,583	768,518	336,638	335,499
50-60	34	35	55.7	54.6	502,950	640,544	280,208	379,748
60-70	25	20	64.6	64.9	533,836	814,458	345,112	528,226
70 +	43	38	89.4	94.5	714,430	404,736	638,896	382,523
<b>TOTAL</b>	<b>561</b>	<b>551</b>	<b>27.8</b>	<b>23.4</b>	<b>623,844</b>	<b>655,786</b>	<b>173,563</b>	<b>153,171</b>

political movement lobbied Congress to pass legislation which would provide a better reorganization bankruptcy tool than was available under the bankruptcy law.

Previous to Chapter 12, farmers could seek reorganization relief under Chapter 13, where the debt limits were restrictive, and Chapter 11, which was designed for large corporations. The political activity culminated in the enactment of Chapter 12.

The legislative history of Chapter 12 is as follows (Anderson and Morris, 1987):

The legislative movement began in both the Senate and House of Representatives in 1985 and continued until enactment of Chapter 12 on October 27, 1986.

The House began its action earlier than the Senate. On March 5, 1985, Representative Peter Rodino (D-NJ) introduced HR 1397, and Representative Mike Synar (D-Okla) introduced HR 1399, both of which bills proposed to create special reorganization relief for family farmers. The House Judiciary Committee's Subcommittee on Monopolies and Commercial Law held hearings on March 27, 1985, to consider these legislative proposals. On June 25, 1985, the Houses passed HR 2211, which incorporated provisions of both HR 1397 and HR 1399 and allowed family farmers to use Chapter 13 as a rehabilitative vehicle. In order to accomplish this, the Chapter 13 debt limits for family farmers were increased to \$1 million. Further, the bill allowed family farmers to restructure secured debt against their residences and extended the normal Chapter 13 time limits for making plan payments.

Subsequently, the Senate was active in studying family farmer relief. On November 6 and 12, 1985, the Senate Judiciary Committee's Subcommittee on Administrative Practice and Procedure, chaired by Senator Charles Grassley (R-Iowa), and its Subcommittee on Courts, chaired by the late Senator John East (R-NC), held joint hearings on HR 2211. After these hearings, the Senate took a different approach than the House, instead of incorporating family

farmer relief into Chapter 13, a new chapter, Chapter 12, was created which was designed to be more like Chapter 11 in its concepts and operation. In essence, the Senate did not believe that the use of Chapter 13 would be sufficient to solve the financial problems faced by family farmers. Further, the Senate believed that more protection was needed for farm lenders and creditors. Thus, on March 26, 1986, Senate Bill 2249 was introduced as legislation by Senators Grassley, Dennis DeConconi (D-Ariz.), Alfonse D'Amato (R-NY), and Edward Zorinsky (D-Neb). Senate Bill 2249 was then combined with the bankruptcy bills on the United States Trustee Program, Additional Bankruptcy Judges Authorization, and Technical Amendments as a substitute amendment for HR 2211. This bundle of bankruptcy legislation passed the Senate as one bill on May 8, 1986, without opposition.

The Senate and House bills were then brought before a House-Senate conference to compromise the competing and conflicting farmer reorganization concepts. The representatives appointed to the conference were Rodino, Edwards, Hughes, Synar, Glickman, Freighan, Fish, Shaw, Moorhead, and Hude. The senators appointed to the conference were Thurmond, Hatch, Grassley, DeConcini, and Heflin. In a protracted meeting, the staffs of the primary sponsors of the family farmer bankruptcy bills arrived at a compromise of the differences between the House and Senate approaches on September 19, 1986; the conferees approved this compromise and made final changes to the compromise on September 26, 1986.

The Conference Report was then filed October 2, 1986, and the Senate Conferees' statements concerning the bill were filed with the Senate on October 2, 1986. 'The entire bankruptcy package, titled The Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, was enacted and signed into law by President Reagan on October 27, 1986. The effective date of the bill which created Chapter 12 was 30 days after the date of its enactment (i.e. November 26, 1986).'

Due to the short legislative history of Chapter 12, all of the intricate and unique needs of a farmer reorganization bankruptcy could not be considered and incorporated. Thus the Bankruptcy Courts had a wide degree of flexibility and an important role in implementing the provisions of the Chapter 12 Bankruptcy Act.

#### Purpose of the Study

Chapter 12 was enacted to provide a solution to what was essentially a cash flow problem in agriculture. In Montana agriculture, the expansionary incentive during the 1970's, characterized by relatively high prices in grain and reasonably good prices in livestock markets, led to increasing land values and some expansion in farm size. The expansion was accompanied by increased debt loads, which led to increased debt payment requirements and an associated drain on cash income from operations. The termination of the expansionary phase in the early 1980's was simultaneously accompanied by relatively poor weather conditions and other natural disasters such as a major grasshopper infestation in Montana. The combined impact of these factors left some producers with an inability to service debt. In many cases they were unable to service intermediate and long term debt as well as year-to-year

cash operating and family living requirements. It was these problems that led to the lobbying and finally the enactment of Chapter 12.

The concern of this thesis is whether or not Chapter 12, which was designed to alleviate these cash flow problems, can also provide longer term solutions to the basic problem of excess leverage in some Montana agriculture firms. The objectives of this research were:

1. Identify the legal requirements for filing a Chapter 13, Chapter 11, and Chapter 12 bankruptcy. Major differences between these will be identified.
2. Develop a model of a farm-firm which can be used to specify the financial characteristics of Montana farms and ranches.
3. Use the model developed under objective 2 to analyze the impacts of Chapter 12 bankruptcy on illustrative Montana farm-firm operations.
4. Delineate situations in which a Chapter 12 bankruptcy is expected to be helpful to a Montana farm-firm and situations in which it is not expected to be helpful.

#### Outline of Procedures

In Chapter 2 the history of bankruptcy will be outlined to provide an understanding of the reasons for, and the progression of, bankruptcy laws in the United

States. Then an outline of the major provisions of Chapter 13 and Chapter 11 bankruptcy is provided. Also, the legal requirements and constraints imposed by Chapter 12 will be delineated. In Chapter 3 a financial modeling method to determine disposable income, which is defined in Section 1222(b)2 of the Code (Code, 1978), in a typical year is developed. In Chapter 4, a case study will be developed from 1980 through 1987 which will illustrate the effects of debt accumulation due to various factors. In Chapter 5 the case study developed in Chapter 4 will be used to illustrate a nonconfirmable Chapter 12 plan. Then with modifications of the nonconfirmable plan, four case studies that would be confirmable under Chapter 12 will be presented.

## CHAPTER 2

HISTORY OF BANKRUPTCY IN THE UNITED  
STATES JUDICIAL SYSTEM

In this chapter an overview of the legislative history of bankruptcy laws in the United States is presented. After the historical overview, the major differences between Chapter 11, Chapter 12 and Chapter 13 of the current bankruptcy codes are delineated. Then the legal requirements and constraints of a Chapter 12 Bankruptcy are delineated.

Bankruptcy Acts Previous to 1978

The Bankruptcy Act of 1800 was the United States' first Act of federal legislation to address the issue of bankruptcy. This legislation was provided for by Section 8, (1.4) of the Constitution of the United States which reads:

To establish...uniform laws on the subject of bankruptcy throughout the United States.

The Bankruptcy Act of 1800 did not provide for voluntary bankruptcy. Even though it did specifically deal with brokers, merchants and bankers. From Collier Bankruptcy Manual, Volume 1 (Collier, 1979):

By section 2 of that Act of 1800 the judge of the district court of the United States for the district where the debtor resided at the time of the commission of the act of bankruptcy described in section 1...shall have power by commission under this hand and seal, to appoint such good and substantial persons, being citizens of the United States, and resident in such district, as such judge shall deem proper, not exceeding three, to be commissioners of the said bankrupt....

While the commissioners were given the power to discharge virtually all the duties and responsibilities described in the Act of 1800, certain powers remained with the district judges. Duties legislated to district judges were to issue a "certificate of discharge" under section 36, to try certain suits against the commissioners under section 40, and to try certain jury issues under sections 52 and 58.

The Act of July 1, 1898, defined a court of bankruptcy to include the district courts of the United States. The Act of 1898 was important in that it was the first Act to provide for firm reorganizations. The previous Acts only allowed and provided for liquidations. In fact, it was not until March 3, 1933, during the great depression, that Section 75 was added to the Bankruptcy Act. Section 75 was entitled "Provisions for the Relief of Debtors." Section 75 consisted of three sections which were: Arrangements, Relief for Farmers, and Railroad Reorganization.

Under the 1933 Act, the Relief for Farmers allowed farmers to effect extensions of debt and compositions thereof. Additionally, the 1933 Act provided for issuing an automatic stay against all legal proceedings against the farmer's property. Thus, the Act was designed to allow for the continuation of an entity instead of liquidation. An interesting aside is that, at the time, various farm credit groups were arguing in the public press that this would have an adverse effect on the availability of farm credit (Collier, 1979).

In 1934, the Frazier-Lemke Act was enacted to impair the rights of secured creditors in foreclosing on farmland. A secured creditor is a creditor who has collateral securing the loan with a value equal to or greater than the amount of debt owing them. The impairment in effect allowed some leeway for farms if the creditors did not approve the proposed reorganization plan. According to Chapter 12 Farm Reorganizations (Anderson and Morris, 1987) the Frazier-Lemke Act did the following:

Under the Frazier-Lemke Act...after the farmer filed for relief under Section 75, if the plan of composition or extension was not approved, the farmer was adjudged a bankrupt, but had a moratorium of five to six years within which to redeem the property. Under this process, the farmer's property was appraised and exempt property recognized. Thereafter, two redemption options were available to the farmer. The first option provided that if the lienholders consented, the farmer could pay the appraised value of the encumbered property to

creditors over six years, while retaining possession. The redemption was conditioned on acceptance by the secured creditors affected; if consent was not given, the second option was available to the farmer. The second option provided that the farmer could retain property for five years, with the court staying any foreclosure action against it, and if the farmer paid a reasonable rental for the use of the farm property the farmer was allowed to redeem the property at the end of the five-year period by paying its appraised or reappraised value. Hence, under either option, the Frazier-Lemke Act had the controlling purpose of...(preserving) to the mortgagor (farmer) the ownership and enjoyment of the farm property...and the avowed object...to take from the mortgagee rights in the specific property held as security; and 'scale down the indebtedness' to the present value of the property.

The Chandler Act of 1938 repealed the Railroad Reorganization and the Arrangements, but left the Relief for Farmers intact. "Relief for Farmers" continued until March 1, 1947, when it expired.

After the expiration of the Act of 1933, law governing farm bankruptcy reverted back to the previous Bankruptcy Act. Since the farm economy was in relatively good health from 1950 until 1978, the original Act was rarely used as a vehicle for rehabilitation.

#### Bankruptcy Reform of 1978

There was tremendous change brought about in the bankruptcy system by the enactment of the 1978 reform legislation. This legislation was designed to overcome

the shortcomings of bankruptcy legislation that was enacted nearly a century earlier. According to Colliers Bankruptcy Manual Volume 1 (Collier, 1979):

Restructuring of the judicial system to administer the Code was found absolutely necessary in order to achieve the laudable aims of that statute and to correct and overcome the short-comings which were uniformly found to have pervaded the earlier system under the 1898 Bankruptcy Act.

Thus, in order to make the increasing burden on the bankruptcy process workable and efficient before the burden became intolerable, a major feature of the 1978 legislation was a sweeping change of the court system. Bankruptcy courts were established that were independent of the United States district courts. The referee system under which the bankruptcy courts were subordinate adjuncts of the district courts was abolished. By achieving these desired ends through the creation of an independent bankruptcy court, significant contribution would be made with the result that well-qualified judges to the bench would be attracted.

Finally, in recognition of the fact that the bankruptcy court is specialized, (and should be, in order to affirmatively aid the functioning of the bankruptcy process); that its judges are specialists, and that economy of time and resources is desirable; the bankruptcy court was given an all-pervasive grant of jurisdiction....

Under the 1978 act, the code was divided into seven chapters. The chapters and their specific duties are as follows: Chapter 1 - General Provisions; Chapter 3 - Case Administration; Chapter 5 deals with the debtor, creditors, and the definition of the estate; Chapter 7 - Liquidations; Chapter 9 - Reorganization of

Municipalities; Chapter 11 - Reorganization of Business Entities; Chapter 13 - Reorganization of Individuals with Regular Income.

Farm debtors under the Act of 1978 could elect either Chapter 7, Chapter 11 or Chapter 13. Chapter 7 provided the circumstances and processes for a liquidation. If a farmer wanted to reorganize and continue farming, then either Chapter 11 or Chapter 13 were applicable.

#### Theory of Legal Reorganization

Legal workouts, or reorganizations, deal with the financial reworking of business entities under court supervision. Entities include corporations, partnerships and individuals. Reorganization seeks to address and resolve three problems facing any financially distressed person or entity. The three problems are:

1. The specific causes of the financial distress, and the actions to be taken to correct the underlying causes.
2. The correctional steps to be taken in debt structure, and the determination that the steps taken are fair treatment of both creditor and debtor.
3. If salvage of the firm is impossible, then the determination of proper and orderly methods for asset liquidation.

For most businesses, resolution of the above mentioned problems entails the reorganization of debt, possible reamortization of loans and in some instances the implementation of new management strategies. The quotation from Chapter 12 Farm Reorganizations (Anderson and Morris, 1987) is illustrative of the mindset of the legal system in legal reorganization if negotiations cannot be consummated outside the court.

powers are conferred by law upon the bankruptcy court and include the powers:

1. To restrain secured creditors, taxing authorities, landlords, and others from seizing property or canceling beneficial contracts.

2. To allow the debtor to borrow money and secure the borrowings by liens on the debtor's assets equal or superior to the liens of existing creditors.

3. To confirm and bind any objecting creditors to reorganization plans acceptable and beneficial to a majority of creditors.

4. To permit the debtor to propose in the plan various means of reorganization including extensions, moratoria, compositions, exchanges of debt for equity, and such other financial readjustments as may be necessary to return the debtor to the business world in a stable and profitable condition.

These judicial powers must be invoked where necessary, especially where the parties to the farm reorganization cannot agree fully among themselves on all financial and legal decisions. To further enhance the debtor's ability to readjust the stakeholders, a final reorganization principle governs the valuation of the distressed businesses and their assets. Appraised values must apply to fix the value of a debtor's assets and to determine their

disposition and the recovery rights of junior interests, such as junior unsecured lienholders, unsecured creditors, and equity security holders. Reorganization laws foster protection from forced sales in recessionary economic climates. To fulfill the spirit of the statutory reorganization provisions, reorganization values fixed by appraisals generally must be used as substitutes for traditional sale values. Thus, determinations of the value of farmer's property must be made by appraisals, rather than forced sales through the bankruptcy court.

The principles set forth above are at the very core of the bankruptcy reorganization provisions. Within these broad principles, farmers and businesses may work to restore their finances under Chapters 11 and 12.

#### Farmer Reorganization under Chapter 11

It is beyond the scope of this study to give a detailed explanation of Chapter 11 Bankruptcy and all the intricacies of confirming a farm reorganization under Chapter 11. The following table, taken from Chapter 12 Farm Reorganization (Anderson and Morris, 1987), gives a good overview of Chapter 11 Bankruptcy as it compares to a Chapter 12 farm bankruptcy.

A Chapter 11 bankruptcy is initiated by the filing of a petition. Upon filing, the court issues an automatic stay enjoining virtually all creditors' acts to collect debts. After filing, a farmer operates the farm in the same fashion as before filing. The court appoints a

Table 2. Comparison of Chapter 11 and Chapter 12  
Bankruptcy

Chapter 11	Chapter 12
1) Any interested party may file exclusive plan.	1) Only debtor may file plan after filing period.
2) To confirm plan, debtor either must obtain the votes of impaired classes or must have it "crammed down."	2) No vote necessary to confirm plan.
3) Chapter 7 nondischargeability rules apply.	3) Chapter 7 nondischargeability rules apply.
4) No Codebtor stay.	4) Codebtor stay applies to consumer debts.
5) Chapter 11 more expensive and onerous than Chapter 12.	5) Less expensive and onerous than Chapter 11.
6) No limit on debts for eligibility.	6) Strict limit on amount of debt to be eligible for Chapter 12 (i.e., \$1.5 million).
7) Corporations are eligible for Chapter 11.	7) Closely held farm corporations are eligible for Chapter 12.
8) All secured debts may be restructured, but no reduction of debts is normally allowed (rule of absolute priority applies).	8) Secured debt may be restructured and reduced (scaled down) to value of collateral; unsecured debt may be discharged; rule of absolute priority does NOT apply.

Table 2--continued.

Chapter 11	Chapter 12
9) No regular income requirements for eligibility.	9) A farmer must have a sufficiently regular income to be eligible for Chapter 12.
10) No automatic time limit for paying restructured debt.	10) Restructured debt within three years normally, except that secured debt has no time limits for its repayment.
11) No hardship discharge.	11) Hardship discharge is available.
12) Secured creditors must be furnished adequate protection in many cases (which may often be difficult to provide).	12) Less stringent standards for adequate protection apply in Chapter 12 cases.

committee of creditors to oversee the operation of the firm.

The debtor retains possession of the farm, unless the creditors prove fraud, dishonesty, or incompetence of management, in which case they can request the court appoint a trustee to operate the farm. The debtor has the exclusive right to file a reorganization plan for a period of 120 days from the date the petition is filed. Before creditors may be asked to confirm a plan, the debtor must file a disclosure statement with the court. If the court deems that the disclosure statement is acceptable, then

the disclosure statement and the reorganization plan are sent to the creditors. After these steps have been completed, a hearing is held for confirmation of the plan.

Two major criteria must be satisfied to have the plan accepted. First, each class of creditors must accept the plan, and second the court must find the plan to be in the best interest of creditors (that is, the creditors must receive more within the plan than from a liquidation).

Several items in Chapter 11 provide major obstacles for a farmer wishing to reorganize. Section 111(b) of the Code (Code, 1978) allows the secured creditors to have the face amount of the claim allowed in full and not be reduced to the value of its security. If allowed, this reduction would produce an unsecured (a debt which has either no collateral to secure the debt or has less collateral than the total amount of debt) portion of the debt and could be dealt with as such. Additionally, a nonrecourse secured creditor (the creditor has no ability to seek a deficiency judgment) could elect under 111(b) to have its claim treated as though it had full recourse (the ability of the creditor to seek a deficiency judgment) for the total claim. Phrased in a different way this provided an avenue for a nonrecourse partially secured creditor to demand full payment of the property.

A Chapter 11 bankruptcy precludes the debtor writing off unsecured debt without the consent of the creditors. The absolute priority rule almost negates any positive action a farmer could derive from a Chapter 11. The absolute priority rule is a court interpretation of section 11 U.S.C. of the Bankruptcy Code (Code, 1978) which provides that secured creditors must be paid in full in the order of their priority. This rule precludes a partial payment to an undersecured creditor. Since a plan usually calls for a percentage payment to the unsecured creditors and a majority of the unsecured have to approve the plan, this is a major pitfall for farmers using Chapter 11 as a bankruptcy vehicle.

A positive aspect of Chapter 11 is that it does provide for extensions, reorganizations and the rescheduling of existing debt over the dissension of creditors. However, Chapter 11 does not have a special provision regarding crop liens which is a major concern in most farm bankruptcies.

### Farmer Reorganization under Chapter 13

Individuals with a regular income who file for a Chapter 13 have the right to restructure and adjust their debts while retaining all or most of their assets. Even though individual farmers (not corporations) are eligible

for Chapter 13, the debt limitations are such that they exclude many farms in Montana. To be eligible for relief under Chapter 13, the farmer may owe no more than \$450,000.00, with no more than \$350,000.00 in secured debt, and \$100,000.00 in unsecured debt.

In essence, the debtor dedicates projected disposable income to the repayment of secured creditors and the percentage repayment of unsecured creditors. Only the debtor is allowed to file a plan and creditors are not allowed to vote on the plan. Since this study deals with the reorganization of Montana farms and ranches under the United States Bankruptcy Act, and Chapter 13 is extremely restrictive, this Chapter of bankruptcy law will not be pursued further.

#### Legal Requirements and Constraints of a Chapter 12 Bankruptcy

The remainder of this chapter will be devoted to acquainting the reader with the major legal issues which have to be dealt with in a Chapter 12 Family Farmer Bankruptcy proceeding. The following will define and delineate the legal phrases which are utilized.

#### Definition of a Family Farmer

To be eligible for relief under Chapter 12 of the Bankruptcy Codes, an entity must conform to the guidelines

of a "family farmer." Title 11 USC Section 101(17) states  
(Code, 1978):

'Family farmer' means-

(A) individual or individual and spouse engaged in a farming operation whose aggregate debts do not exceed \$1,500,000 and not less than 80 percent of whose aggregate noncontingent, liquidated debts (excluding a debt for the principal residence of such individual or such individual and spouse unless such debt arises out of a farming operation), on the date the case is filed, arise out of a farming operation owned or operated by such individual or such farming operation more than 50 percent of such individual's or such individual and spouse's gross income for the taxable year preceding the taxable year in which the case concerning such individual or such individual and spouse was filed; or

(B) corporation or partnership in which more than 50 percent of the outstanding stock or equity is held by one family, or by one family and the relatives of the members of such family, and such family or such relatives conduct the farming operation, and

(i) more than 80 percent of the value of its assets consists of assets related to the farming operation;

(ii) its aggregated debts do not exceed \$1,500,000 and not less than 80 percent of its aggregate noncontingent, liquidated debts (excluding a debt for one dwelling which is owned by such corporation or partnership and which a shareholder or partner maintains as a principal residence, unless such debt arises out of a farming operation), on the date the case is filed, arise out of a farming operation owned or operated by such corporation or such partnership; and:

(iii) if such corporation issues stock, such stock is not publicly traded....

### Demonstration of a Stable Income

Also, the family farmer should be able to demonstrate stable income. The Code, Section 101(18) provides (Code, 1978):

Family farmer with regular annual income means family farmer whose annual income is sufficiently stable and regular to enable such family farmer to make payments under a plan under Chapter 12 of this title.

### Definition of Farming

Since a family farmer must engage in farming, farming is defined in Section 101(18) as (Code, 1978):

'Farming operation' includes farming, tillage of the soil, dairy farming, ranching production or raising of crops, poultry, livestock, and the production of poultry or livestock products in an unmanufactured state.

### Individual Eligibility for Chapter 12

Therefore, the requirements for an individual to be eligible for Chapter 12 are that:

1. The individual be engaged in farming.
2. Be able to demonstrate a steady income.
3. Aggregate debt does not exceed \$1,500,000.
4. Eighty percent of the noncontingent liquidated debt (excluding debt on the principal residence) is attributable to farming (noncontingent liquidated debt is liquidated if it is subject to ready determination and precision in computation of the

amount due. Contingency means only that there is some extrinsic event that forms a condition precedent to liability).

5. More than 50 percent of the gross income from the tax year preceding the year in which the case is filed, is attributable to farming.

### Corporate Eligibility for a Chapter 12

The requirements for a corporation to be eligible for Chapter 12 are that:

1. The corporation be engaged in farming;
2. More than 50 percent of the outstanding stock or equity is held by one family and/or relative and they conduct the operation of the corporation;
3. More than 80 percent of the corporation assets consist of assets related to farming;
4. Aggregate debts do not exceed \$1,500,000.00;
5. Not less than 80 percent of the noncontingent liquidated debts (excluding a house which one of the family members claims as a principal residence) are attributable to farming; and
6. Issued stock is not traded publicly.

### Forced Farmer Bankruptcy

The bankruptcy code does not allow involuntary farmer bankruptcy. Section 303 states (Code, 1978):

An involuntary case may be commenced only under Chapter 7 or 11 of this title, and only against a person, except a farmer, family farmer, or corporation that is not a moneyed business, or commercial corporation, that may be a debtor under the chapter under which the case is commenced.

This means that if a person or entity qualifies as a farmer, the only way to result in a bankruptcy is through voluntary petition.

#### Filing the Reorganization Plan

According to Section 1221, (Code, 1978) " Filing of Plan," the plan should be filed no later than 90 days after the filing of the bankruptcy. However, the court has the ability to extend this deadline if the need is justified. According to Section 1222, (Code, 1978):

(a) The plan shall-

1. provide for the submission of all or such portion of future earnings or other future income of the debtor to the supervision and control of the trustee as is necessary for the execution of the plan;

2. provide for the full payment, in deferred cash payments, of all claims entitled to priority under section 507 of this title, unless the holder of a particular claim agrees to a different treatment of such claim; and

3. if the plan classifies claims and interests, provide the same treatment for each claim or interest within a particular class unless the holder of a particular claim or interest agrees to less favorable treatment.

(b) Subject to subsections (a) and (c) of this section, the plan may-

1. designate a class or classes of unsecured claims, as provided in section 1122 of this title, but may not discriminate unfairly against any class so designated; however, such plan may treat claims for a consumer debt of the debtor if an individual is liable on such consumer debts with the debtor differently than other unsecured claims;

2. modify the rights of holders of secured claims, or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims;

3. provide for the curing or waiving of any default;

4. provide for payment on any unsecured claim to be made concurrently with payment on any secured claim or any other unsecured claim;

5. provide for the curing of any default within a reasonable time and maintenance of payments while the case is pending on any unsecured claim or secured claim on which the last payment is due after the date on which the final payment under the plan is due;

6. subject to section 365 of this title, provide for the assumption, rejection, or assignment of any executory contract or unexpired lease of the debtor not previously rejected under such section;

7. provide for the payment of all or part of a claim against the debtor from property of the estate or property of the debtor;

8. provide for the sale of all or any part of the property of the estate or the distribution of all or any part of the property of the estate among those having an interest in such property;

9. provide for payment of allowed secured claims consistent with section 1225(a)(5) of this title, over a period exceeding the period permitted under section 1222(c);

10. provide for the vesting of property of the estate, on confirmation of the plan or at a later time, in the debtor or in any other entity; and

11. include any other appropriate provision not inconsistent with this title.

(c) Except as provided in subsections (b)(5) and (b)(9), the plan may not provide for payments over a period that is longer than three years unless the court for the case approves a longer period, but the court may not approve a period that is longer than five years.

Many of the subsections of Section 1222 will be dealt with as separate issues later in this study.

### Trustee's Fee

The trustee is a court appointed individual who will oversee the debtor's activities for the court and creditor. They will take positions on the fairness and feasibility of any plan and will usually act as the dispersing agent under a confirmed plan.

The maximum trustee's fee under a Chapter 12 is referred to in Section 1202 (Code, 1978). In Montana the trustee's fee has been five percent of the disposable income. Therefore, this is the fee that will be used in this study.

### Definition of Disposable Income

According to Section 1225(b)(2) (Code, 1978):

2. For purpose of this subsection, 'disposable income' means income which is received by the

debtor and which is not reasonably necessary to be expended-

(A) for the maintenance or support of the debtor or a dependent of the debtor; or

(B) for the payment of expenditures necessary for the continuation, preservation, and operation of the debtor's business.

For the purpose of this study, disposable income is defined as total income minus operating expenses and family living. Operating expenses are defined as cash expenses, excluding intermediate and long term principle and interest payments, but including short term operating loan interest. Also, an estimate of annual machinery replacement cost is included as an expense.

#### Definition of the Bankruptcy Estate

Once a bankruptcy is filed (7, 11, 12 or 13), an estate is created by federal law. The estate is defined by 11 USC Section 541 as follows (Code, 1978):

(a) The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:

(1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.

(2) All interests of the debtor and the debtor's spouse in community property as of the commencement of the case that is

(A) under the sole, equal, or joint management and control of the debtor; or

(B) liable for an allowable claim against the debtor, or for both an allowable claim against the debtor and an allowable claim against the debtor's spouse, to the extent that such interest is so liable.

(3) Any interest in property that the trustee recovers under section 329(b), 363(n), 543, 550, 553, or 723 of this title.

(4) Any interest in property preserved for the benefit of or ordered transferred to the estate under section 510(c) or 551 of this title.

(5) Any interest in property that would have been property of the estate if such interest had been an interest of the debtor on the date of the filing of the petition, and that the debtor acquires or becomes entitled to acquire within 180 days after such date-

(A) by bequest, devise, or inheritance;

(B) as a result of a property settlement agreement with debtor's spouse, or of an interlocutory or final divorce decree; or

(C) as beneficiary of life insurance policy or of a death benefit plan.

(6) Proceeds, product, offspring, rents, or profits of or from property of the estate, except such as are earnings from services performed by an individual debtor after the commencement of the case.

(7) Any interest in property that the estate acquires after the commencement of the case.

(b) Property of the estate does not include -

(1) any power that the debtor may exercise solely for the benefit of an entity other than the debtor; or

(2) Any interest of the debtor as a lessee under a lease of nonresidential real property that has terminated at the expiration of the

stated term of such lease before the commencement of the case under this title, and ceases to include any interest of the debtor as a lessee under a lease of nonresidential real property that has terminated at the expiration of the stated term of such lease during the case.

(c)(1) Except as provided in paragraph (2) of this subsection, an interest of the debtor in property becomes property of the estate under subsection (a)(1), (a)(2), or (a)(5) of this section notwithstanding any provision in an agreement, transfer instrument or applicable nonbankruptcy law -

(A) that restricts or conditions transfer of such interest by the debtor; or

(B) that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on the appointment of or the taking possession by a trustee in a case under this title or a custodian before such commencement, and that effects or

(2) A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title.

(d) Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage secured by real property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or interest, becomes property of the estate under subsection (a)(1) or (2) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.

Exempt vs. Nonexempt

Certain property is exempt from attachment or use by the bankruptcy estate. These exemptions can either be elected under the Federal exemptions or under State exemptions. Montana House Bill No. 19, (Montana Legislative Council, 1987) by request of the Interim Subcommittee on lien laws, 50th legislature, State of Montana, has redefined the bankruptcy exemptions for the State of Montana and these exemptions were effective on October 1, 1987.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF MONTANA:

NEW SECTION. Section 1. Protection of property of residents. A resident of this state is entitled to the exemptions provided in this part.

NEW SECTION. Section 2. Claim enforceable against exempt property. Notwithstanding any other provision of this part, a creditor may levy against exempt property to enforce a claim for:

- (1) the purchase price of the property; or
- (2) a loan made for the express purpose of enabling the judgment debtor to purchase the property and used for that purpose.

NEW SECTION. Section 3. Property exempt without limitation. A judgment debtor is entitled to exemption from execution of the following:

- (1) professionally prescribed health aids for the judgment debtor or a dependent of the judgment debtor;

- (2) benefits the judgment debtor has received or is entitled to receive under federal social security or local public assistance legislation;
- (3) veterans' benefits;
- (4) disability or illness benefits;
- (5) benefits paid or payable for medical, surgical, or hospital care to the extent they are used or will be used to pay for the care;
- (6) maintenance and child support; and
- (7) a burial plot for the judgment debtor and his family.

NEW SECTION. Section 4. Personal property exempt subject to value limitations. A judgment debtor is entitled to exemption from execution of the following:

- (1) the judgment debtor's interest, not to exceed \$4,500 in aggregate value, to the extent of a value not exceeding \$600 in any item of property, in household furnishings and goods, appliances, jewelry, wearing apparel, books, firearms and other sporting goods, animals, feed, crops, and musical instruments;
- (2) the judgment debtor's interest, not to exceed \$1,200 in value, in one motor vehicle;
- (3) the judgment debtor's interest, not to exceed \$3,000 in value, in any implements, professional books, or tools, of the trade of the judgment debtor or a dependent of the judgment debtor; and
- (4) the judgment debtor's interest, not to exceed \$4,000 in value, in any unmaturing life insurance contracts owned by him.

Section 8. Section 70-32-104, MCA, is amended to read:

70-32-104. Limitation on value. (1) may not exceed in value of \$40,000. In any proceedings instituted to determine the value of such homestead, the assessed value of the land with included appurtenances, if any, and of the dwelling house as appears on the last completed

assessment roll preceding the institution of such proceedings shall be prima facie evidence of the value of the property claimed as a homestead.

Therefore, the value of the estate is defined by 11 USC Section 541, (Code, 1978) with the exception of the exempt assets which are defined by House Bill No. 19 (Montana Legislative Council, 1987) for Montana residents.

#### Reducing Secured Debt to the Value of the Collateral

One of the major advantages of Chapter 12 to debtors is that it allows secured debt to be written down to the value of the underlying collateral. Given the devaluation of land in agricultural operations, this can be a significant benefit to debtors of Chapter 12. Chapter 12 Farm Reorganizations (Anderson and Morris, 1987) states:

Reorganization statutes have historically provided a means to scale down secured debt without the vote and against the will of secured creditors. This is typically done through valuation of the secured creditors' underlying collateral. Under Sec. 506(a), the claim of a creditor secured by a lien on estate property is only allowed and deemed secured to the extent of the value of the collateral. Therefore, a secured creditor is only secured to the extent of the value of the underlying collateral; if his or her debt exceeds the value of such collateral, the creditor holds a partially secured (undersecured) claim which is divided into two separate and independent claims, one a secured claim (to the extent of the value of the collateral) and the other an unsecured claim (to the extent the claim exceeds the value of the collateral).

For example, if a creditor holds a claim of \$1,000,000 secured by property worth \$500,000, then the claim is partially secured. Thus, the secured portion of the claim will be limited to the value of the collateral, that is, the sum of \$500,000; the undersecured portion of the claim in the sum of \$500,000 will be relegated to the status of an unsecured claim and dealt with as such in the Chapter 12 case.

A critical issue will be the valuation of collateral. The second sentence of Sec. 506(a) provides that such 'value shall be determined in light of the purposes of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditors' interest.' Accordingly, the valuation of the collateral must take into consideration the purpose of the valuation and the disposition or use of the collateral. Thus, the Code allows for differing value according to the issues involved.

The Commission on Bankruptcy Laws proposed that (a) benchmark in determining the adequacy of protection (for the use or disposition of property) is the liquidation value of the collateral at the date of the petition. However, these writers expect that, in determining the value of collateral for purposes of determining which creditors are secured, partially secured, or unsecured and of corresponding treatment under the Chapter 12 plan, the bankruptcy courts will generally use the fair market value of the farmer's property in today's economy at the time of the confirmation hearing. Thus, secured claims will be scaled down to the fair market value of the underlying collateral in most cases, and any excess secured debt (over and above the value of the collateral) will be unsecured and treated in the Chapter 12 plan as an unsecured claim.

This part of Chapter 12 is of major concern among creditors. The issue of the effect on farm credit will be broached in the summary and conclusions of this study.

### Classification of Creditors

A Chapter 12 plan may have four types of creditors, super priority creditors, priority creditors, secured creditors and unsecured creditors. Priority creditors are associated with debts such as delinquent property taxes, delinquent IRS taxes, etc. This study will not attempt to list all the priority creditors. These debts, if they exist, need to be completely provided for within the plan.

A creditor is a secured creditor to the extent it has a lien on sufficient collateral to cover its debt. A particular creditor may be placed in two classes concurrently, secured and unsecured. If a creditor is currently undersecured (i.e. its debt exceeds the value of its collateral), the secured portion of the debt is placed in the secured debt category and the remaining portion is placed in the unsecured category. The secured portion of the claim can be paid over a period of years extending beyond the plan.

Unsecured creditors are creditors who have lent money or sold items to the individual prior to the filing of the bankruptcy and have not obtained an interest in assets to secure the debt. These creditors have no collateral to secure their debts. These debts are paid within the term of the bankruptcy.

Additionally, Chapter 12 provides for a creditor classification for super priority status within the plan. This is a very important point within Chapter 12. It allows an operating lender to lend to a Chapter 12 debtor inside the plan (i.e. an operating loan) and have a "super priority" status; that is, they get paid along with administrative expenses of the plan before any of the other creditors, even the secured creditors.

#### Reamortization of Secured Debts

Chapter 12 allows a secured debt to be reamortized at a different interest rate and repayment period than specified when the loan was initiated. Section 1225(a)5(b)(ii) states (Code, 1978):

The value as of the effective date of the plan of property to be distributed by the trustee or the debtor under the plan on account of such claim is not less than the allowed amount of the claim or..."

This states that a secured creditor must be paid the present value of the allowed secured claim as of the date of confirmation of the plan. A claim is an "allowed claim" only to the extent of the value of the collateral securing it. This can be done by either a lump sum payment or by amortizing a loan. The loan can go beyond the term of the bankruptcy. This study will use the lowest interest rate that the creditor offers its customers as the applicable interest rate.

### Codebtor Stay

Chapter 12 provides for a codebtor stay against consumer creditors. Section 1201, Stay Of Action Against Codebtor states (Code, 1978):

(a) Except as provided in subsections (b) and (c) of this section, after the order for relief under this chapter, a creditor may not act, or commence or continue any civil action, to collect all or any part of a consumer debt of the debtor from any individual that is liable on such debt with the debtor, or that secured such debt, unless-

(1) such individual became liable on or secured such debt in the ordinary course of such individual's business; or

(2) the case is closed, dismissed, or converted to a case under Chapter 7 of this title.

(b) A creditor may present a negotiable instrument, and may give notice of dishonor of such an instrument.

(c) On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided by subsection (a) of this section with respect to a creditor, to the extent that-

(1) as between the debtor and the individual protected under subsection (a) of this section, such individual received the consideration for the claim held by such creditor;

(2) the plan filed by the debtor proposes not to pay such claim or

(3) such creditor's interest would be irreparably harmed by continuation of such stay.

(d) Twenty days after the filing of a request under subsection (c)(2) of this section for relief from the stay provided by subsection

(a) of this section, such stay is terminated with respect to the party in interest making such request, unless the debtor or any individual that is liable on such debt with the debtor files and serves upon such party in interest a written objection to the taking of proposed action.

This section would appear to be susceptible to legislative action to further expand the boundaries of the codebtor stay to include agricultural business which would make the codebtor stay more meaningful to farmers.

#### Duration of the Bankruptcy

The length of a Chapter 12 plan is from three to five years. The plan cannot extend past five years and the debtor must show good cause for the court to grant the extension past three years.

#### Confirmation of the Plan

The successful confirmation of the plan is what the debtor is attempting to achieve. In section 1225 it is stated (Code, 1978):

(a) Except as provided in subsection (b), the court shall confirm a plan if-

1. the plan complies with the provisions of this chapter and with the other applicable provisions of this title;

2. any fee, charge, or amount required under chapter 123 of title 28, or by the plan, to be paid before confirmation, has been paid;

3. the plan has been proposed in good faith and not by any means forbidden by law;

4. the value, as of the effective date of the plan, of property to be distributed under the plan on account of each allowed unsecured claim is not less than the amount that would be paid on such claim if the estate of the debtor were liquidated under chapter 7 of this title on such date;

5. with respect to each allowed secured claim provided for by the plan-

(A) the holder of such claim has accepted the plan;

(B)(i) the plan provides that the holder of such claim retain the lien securing such claim; and

(ii) the value, as of the effective date of the plan, of property to be distributed by the trustee or the debtor under plan on account of such claim is not less than the allowed amount of such claim; or

(C) the debtor surrenders the property securing such claim to such holder; and

6. the debtor will be able to make all payments under the plan and to comply with the plan.

(b)(1) If the trustee or the holder of an allowed unsecured claim objects to the confirmation of the plan, then the court may not approve the plan unless, as of the effective date of the plan-

(A) the value of the property to be distributed under the plan on account of such claim is not less than the amount of such claim; or

(B) the plan provides that all of the debtor's projected disposable income to be received in the three year period, or such longer period as the court may approve under section 1222(c), beginning on the date that the first payment is due under the plan will be applied to make payments under the plan.

2. For purpose of this subsection, 'disposable income' means income which is received by the debtor and which is not reasonably necessary to be expended-

(A) for the maintenance or support of the debtor or a dependent of the debtor; or

(B) for the payment of expenditures necessary for the continuation, preservation, and operation of the debtor's business.

(C) After confirmation of a plan, the court may order any entity from whom the debtor receives income to pay all or any part of such income to the trustee."

This section says that unsecured creditors have to be paid at least as much in a Chapter 12 plan as they would receive under a Chapter 7 liquidation unless disposable income is devoted to the plan for three years. It does not state that if all the disposable income is devoted to the plan that the court must confirm the plan.

#### Summary

In this chapter the evolution of bankruptcy law in the United States has been summarized. Additionally, the major differences among a Chapter 11 Bankruptcy, Chapter 13 Bankruptcy and a Chapter 12 Bankruptcy have been delineated. Finally, the major legal points of a Chapter 12 Bankruptcy were covered. There are many legal requirements which were omitted, but these requirements have minor impacts on the financial analysis. Legal

requirements which have direct impacts on the financial analysis have been presented.

CHAPTER 3  
METHODS FOR AGRICULTURAL  
FINANCIAL ANALYSIS

The preparation for a "workout" (development of a plan to turn a business around financially) has two primary objectives; the assessment of profitability, and the assessment of the cash flow capability of the firm. For this study, profitability is measured by the rate of return to total assets. Even though bankruptcy does not deal directly with the issue of profitability, it is an issue in a workout, therefore this study will briefly discuss the concept and present a method for determination of profitability. The cash flow capability will be assessed by the determination of disposable income before and after debt service.

In this chapter, the method for determining disposable income is discussed. Disposable income, as discussed in Chapter 2, has to be determined to formulate a plan for either a workout or a Chapter 12 Bankruptcy. Disposable income is defined as total income minus operating expenses and family living. Operating expenses are defined as cash expenses, excluding intermediate and long term principal and interest payments, but including

short term operating loan interest and an estimate of annual machinery replacement cost. To accomplish the determination of disposable income, a substantial amount of information is collected and analyzed. In this chapter, a technique for collecting and analyzing the information is discussed. In Table 3 the data that is collected and the ending format of the determination of disposable income is illustrated.

**Table 3. Example of Disposable Income Calculation**

Income and Expense Items	Dollars
<b>Income Items</b>	
Crop Sales or Loan	
Wheat	\$ 16,319.94
Barley	2,679.68
Livestock Sales	
Cull Cows	\$ 23,598.00
Cull Bulls	4,050.00
Steers	65,726.64
Heifers	38,041.92
Program Payments	
Crop Programs	14,761.18
Total Income	<u>\$165,177.37</u>
<b>Expense Items</b>	
Seed	\$ 525.00
Fertilizer	1,100.53

Table 3--continued.

Income and Expense Items	Dollars
Expense Items	
Herbicides	682.50
Labor	14,400.00
Custom Hire	3,300.00
Repairs	
Mach. & Equip.	7,000.00
Trucking	1,000.00
Vet. & Medicine	1,575.00
Livestock Supplies	5,000.00
Feed	10,000.00
Fuel, Oil, Lube	10,000.00
Farm Share Auto	1,200.00
Utilities	3,500.00
Rent/Lease Exp.	5,000.00
Insurance	4,200.00
Taxes	
Real Estate	11,000.00
Misc. Farm Exp.	4,200.00
Capital Assets	
Breeding Stock	4,500.00
Feeder Livestock	
Mach. & Equip.	10,000.00
Total Farm Expense	<u>\$98,183.03</u>
Non-Farm Expense	
Family Living	7,200.00
Total Non-Farm Exp.	<u>\$ 7,200.00</u>
Total Expense Before Operating Interest	<u>\$105,383.03</u>
Operating Interest	3,413.13
Total Expense	<u>\$108,796.16</u>
Disposable Income	56,381.21
Total Debt Service	91,600.73
Disposable Income after Debt Service	<u>\$(35,219.52)</u>

### Total Income Calculations

Projected total income in a typical year is calculated by utilizing an average of five to seven years of production history (if these records are not available Agricultural Stabilization and Conservation Service effective yields are applicable) and expected future output prices. A historical analysis might be undertaken, after the projected total income for a typical year has been calculated, to analyze past performance as compared to projected performance. The analyst at this time needs to make allowances for natural disasters, changes in government policies, changes in the level of output prices, and many other variables. These allowances become so complex that an argument could be made that the previous three to five years of total income for a farm or ranch in Montana is not an appropriate benchmark for projecting total income. The future output price to be used is usually a difficult issue. A conservative set of output prices should be utilized. Total income is then calculated on an average of five to seven years of production history and conservative output prices.

### Government Payments

Relevant government farm program information should be collected from the Agricultural Stabilization and

Conservation Service (A.S.C.S.). Specific information which should be collected includes: base acres for the farm program on all program crops, (A.S.C.S.) effective yields, and any CRP payments. This information will assist the analyst in determining planted acres if the best allocation of resources is to be in compliance with the farm program, and to determine projected farm program payments.

#### Operating Expense Information

In analyzing the expense side of the firm, a good set of farm records is helpful. In lieu of these records, a three to five year average of farm expenses from the income tax returns may be utilized. Operating Expense items to be obtained are listed in Table 3.

The expenses incurred in the previous year for utilities, taxes, insurance, and leases should be used instead of an average to incorporate the change in rate structures in fixed expenses. This then would reflect the most current information on the future expectations of these fixed expenses.

In some instances where financial stress is being experienced, the short term lenders have either prepared or required a cash flow analysis. The expense items in these budgets some times have been slashed to an

unrealistically low level to facilitate debt payments. Therefore, three to five years of expense history should be analyzed to estimate a realistic future expense level. An atypical (overstated or understated expenses) year should be considered and discounted where appropriate in the budget process. Additionally, former year expense levels should be adjusted upward for inflation. This is done by adjusting the expenses to current year dollars with an index such as the GNP implicit price deflator listed in Table 6. The result is that inflation or deflation is adjusted for and expenses and income are both expressed in current year dollars.

#### Asset Information

Asset information such as number of deeded acres of range, number of deeded acres of cropland, acres of hayland, leased acreages, list of machinery and number of livestock owned needs to be gathered. Additionally, the condition of the assets should be assessed. Issues such as the general repair of the machinery and condition of the land should be addressed and then total asset value determined. This study will not address the issue of different appraisal methods for determining asset value.

### Miscellaneous Information

The following information is collected in an interview method: family living expense, number of mother cows the place will carry (thoroughly researched through the determination of the total AUM's of the ranch), expected crop mix through time, medical expense, other enterprises, etc. In the interview, production information such as weaning weights, weaning percentages, cull rates, death loss, and annual feed consumption should also be pursued.

### Annual Machinery Replacement Expense

An additional expense which needs to be researched is the annual capital replacement budget to retain an adequate machinery complement. It is imperative that this expense be included in the analysis. During periods of financial stress, the capital replacement budget is usually the first item that gets reduced or eliminated in the budgeting process. Usually a calculation of annual economic depreciation (not tax depreciation) should provide a reasonable estimate of the annual capital replacement budget.

### Income Tax Considerations

The income taxes which are incurred through operation need to be included in the cash flow analysis. This is accomplished through the generation of a budget and the estimation of tax liability incurred through the cash flow projections. This study assumes there are sufficient accumulated Net Operating Losses for income tax to negate any income tax liability incurred from current operations. There are some actions such as the sale of capital assets, providing a creditor with a deed in lieu of foreclosure, debt forgiveness and many other restructuring actions which could have income tax consequences. This study does not address the impact of these tax consequences.

### Information on Liabilities

All the outstanding liabilities for the farm need to be collected for the determination of disposable income after debt service. The information needed here is as follows: beginning loan balance, current balance, interest rate, length of loan, delinquent amount and daily interest accrual. This information allows the determination of different workout scenarios on the liability side of the firm. If the liability information is collected in this fashion, annual payments can be

determined and analyzed. Additionally, restructured debt options can be generated.

Typical Year Cash Flow Analysis and  
Determination of Disposable Income

The previously discussed collection of information should allow the determination of what a typical year should generate in total income, farm expenses, family living and disposable income. Then the incorporation of the current debt payments yields disposable income after debt service. It is imperative that the financial analysis be completed in the described manner instead of debt payments being intermingled with the operating expenses. Not only will this facilitate the profitability analysis, it will also enable the analysis of the debt structure. Once the financial analysis is prepared for a typical year, then the following information will be available: percentage debt load, cash flow breakeven analysis, maximum debt load, maximum interest rate affordable and cash flow. Additionally, the analysis should provide information needed to evaluate the farm or ranch when it is fully stocked or utilized. If resources are not fully utilized, transitional year budgets until the time the resources are fully utilized, should be constructed. When the transitional budgets are being prepared, where the number of livestock and/or cropped

acres are changed through the years, the difference between fixed and variable costs should be recognized, and the analysis should be adjusted accordingly.

### Competence of Current Management

At this stage the information collection and analysis of the cash flow capability of the farm has been accomplished. The next issue to address is the profitability of the farm. Several questions need to be addressed: Why is the firm in financial stress? Is the financial stress due to reasons outside the control of the firm or due to poor management, marketing and/or production? Profitability can be measured by a rate of return to total assets, which is accomplished by taking disposable income (defined in the previous section) and adding family living expense and subtracting an estimate of the replacement cost of the unpaid labor and management, which yields a return to total assets. In areas where there is a surplus of farm labor, an argument could be presented that the replacement cost of the unpaid labor and management is closely approximated by the family living that was previously included in the budget. In a locality where there is a shortage of farm laborers, family living costs could understate the replacement cost of unpaid labor and management. The return to total

assets is then divided by the value of total assets to yield a rate of return to total assets. The rate of return can then be compared to other similar firms during a similar time frame to determine relative profitability and in general the competence of current management. If any management problems are identified at this stage, a management plan should be implemented to cure the problems.

#### Summary

In this chapter, the major issues confronted when attempting to develop a typical year's cash flow for a farm have been delineated. The method detailed in this chapter will be utilized to develop the case study presented in Chapter 4.

The issue of profitability is not addressed by the bankruptcy courts. The major concern of the court is that the current value of the assets, or the current debt level, is returned to the creditors. This concern of the court is addressed by examining cash flow and not profitability. Therefore, the rest of this study will be centered around cash flow concerns.

## CHAPTER 4

### CASE STUDY OF DEBT ACCUMULATION

Farmers in eastern Montana have encountered severe financial stress due to drought, grasshoppers, and high production prices since 1980. In some areas within southeastern Montana the drought actually started in 1978 and did not abate until 1987. In some instances, these two natural disasters reduced total income to 50 percent to 75 percent of that projected for a typical year. This reduction in total income led to a situation where for a period of several years some farms and ranches were not able to service some of the cash operating costs, let alone service the initial debt. In fact, debt carryforward from these drought years, in some instances accumulated up to 50 percent of the asset value. The accumulation resulted from the inability to pay back part of the cash operating costs, and the compounding of interest.

At this juncture it is illustrative to develop a case study to demonstrate the effects of low income and resulting equity erosion due to drought, grasshoppers, and the cost price squeeze. The case study shows how a farm which would cash flow and had sufficient collateral for borrowing capacity in 1980 could have a severe cash flow

problem in 1987. The impact of drought and grasshoppers, the cost price squeeze, and the steady erosion of land values after 1982, resulted in a substantial debt accumulation. The accumulated debt was so large that it could not be serviced from cash flow, or even a combination of cash flow and the ability to borrow additional funds.

#### Assumptions of the Case Study

The case study farm/ranch has a stocking capacity of 450 mother cows and annually crops 187.5 acres of wheat and 40 acres of barley. A financial model for the farm was formulated and it was determined that in a typical year the total income, was \$165,177.37 (refer to Chapter 3 for the explanation of the methods and Table 3 for the specific income items). Additionally, there are \$108,796.16 of cash operating expenses and family living expenses (for specific items included in cash operating expenses see Table 3). The result was a disposable income of \$56,381.20.

The assumptions for the debt scenario are delineated in the subsequent paragraphs. The land was purchased in 1980 for \$1,073,762.00, of which \$228,917.10 was financed. The loan was amortized at 12 percent for 30 years. This loan was secured by a first mortgage on all the land with

an amortized annual payment of \$28,418.61. Also in 1980 there was an intermediate term note initiated for \$214,607.72 amortized over seven years at 12 percent interest. The annual payment on this note was \$47,024.36. The intermediate term note was secured by a first mortgage on cattle and machinery. Proceeds from the note were used to buy a portion of the cattle and machinery.

All operating expenses were borrowed with the operating note secured by growing crops and a second mortgage on cattle and machinery. Due to annual cash deficits since 1980, the operating note in 1987 has a current balance carryforward or accumulation of \$526,517.66 (for the illustration please refer to Table 9). The debt carryforward was part of the operating loan which was renewed annually. Since the intermediate term loan was paid out in 1986, (it was a seven year note initiated in 1980) the operating loan has moved into a first mortgage position on cattle, machinery and crops. Therefore, the current disposable income after debt service was calculated as illustrated in Table 4. The rest of this chapter is devoted to detailing the accumulation of the demand note to illustrate the reasons for the political movement leading to the Family Farmer Bankruptcy Act.

Table 4. Net Income after Debt Service in 1987

Debt Service	1987
Disposable Income	\$ 56,381.20
Land Payment	28,418.61
Interest only on Debt Accumulation (\$526,517 at 12% Interest)	63,182.12
Disposable Income After Debt Service	\$ (35,219.52)

#### Income Assumptions

This example assumes that from 1980 to 1986, actual income was 80 percent of projected level due to drought and grasshoppers. The decrease in income is attributed to low or nonexistent crop yields and the reduction of cattle numbers due to low forage production. If cattle are not sold, then the expense is incurred from additional pasture rental. Realistically, the income reduction could be substantially greater than 20 percent, but a conservative assumption is used. In fact, in some instances herds were sold down to 50 percent of the ranch capacity, or even totally liquidated, during the extended drought.

The assumption was also made that projected total income (without the effects from drought and grasshoppers) in a typical year remained steady through this time. In Table 5 is illustrated the projected income from 1980 through 1987. Refer to Chapter 3 for detailed calculation method. Actual income of \$132,141.89 from

Table 5. Projected Income from 1980 - 1987

Source of Income	Projected Income from 1980-1987
Crop Sales or Loan	
Wheat	\$ 16,319.94
Barley	2,679.68
Livestock Sales	
Cull Cows	\$ 23,598.00
Cull Bulls	4,050.00
Steers	65,726.64
Heifers	38,041.92
Program Payments	
Crop Programs	14,761.18
Total Income	<u>\$165,177.37</u>

1980 through 1987 was 80 percent of the projected level of \$165,177.37.

#### Operating Expense Assumptions

Generation of the expense side of the firm is accomplished by taking expenses in 1987 and deflating them by the GNP implicit price deflator, published in the Annual Economic Report of the President, issue (United States Government, 1987). All expenses, with the exception of livestock replacements and interest

Table 6. The GNP Implicit Price Deflator

Year	Index
1986	114.5
1985	111.5
1984	107.9
1983	103.9
1982*	100.0
1981	94.0
1980	85.7

\*Base Year = 1982

on the operating loan and debt payments, are indexed to the specific year utilizing the index in Table 6. Additionally, in the years where drought is a factor, extra feed is included in the budget to compensate for lost hay production. This is apparent in Table 9 where the projected feed budget in 1980 was \$7,484.72 but the actual feed expense was \$23,244.72. In this analysis family living expense is an arbitrary number. Refer to Tables 7, 8 and 9 for the detail of the expenses from year-to-year.

#### Cash Flow in 1980

The projected cash flow scenario in 1980 is generated after adjusting the operating expense back to a 1980 level. Even though disposable income after debt service

Table 7. Cash Operating Expense and Family Living  
for Case Study 1985-1987

Expense Items	1987	1986	1985
Seed	\$ 525.00	\$ 525.00	\$ 511.24
Fertilizer	1,100.53	1,100.53	1,071.70
Herbicides	682.50	682.50	664.62
Labor	14,400.00	14,400.00	14,022.71
Custom Hire	3,300.00	3,300.00	3,213.54
Repairs			
Mach. & Equip.	7,000.00	7,000.00	6,816.59
Trucking	1,000.00	1,000.00	973.80
Vet. & Medicine	1,575.00	1,575.00	1,533.73
Livestock Supplies	5,000.00	5,000.00	4,869.00
Feed	10,000.00	25,760.00	25,497.99
Fuel, Oil, Lube	10,000.00	10,000.00	9,737.99
Farm Share Auto	1,200.00	1,200.00	1,168.56
Utilities	3,500.00	3,500.00	3,408.30
Rent/Lease Exp.	5,000.00	5,000.00	4,869.00
Insurance	4,200.00	4,200.00	4,089.96
Taxes			
Real Estate	11,000.00	11,000.00	10,711.79
Misc. Farm Exp.	4,200.00	4,200.00	4,089.96
Capital Assets			
Breeding Stock	4,500.00	4,500.00	4,500.00
Feeder Livestock			
Mach. & Equip.	10,000.00	.00	.00
-----			
Total Farm Expense	\$98,183.03	\$103,943.03	\$101,750.46
-----			
Non-Farm Expense			
Family Living	\$ 7,200.00	\$ 7,200.00	\$ 7,011.35
-----			
Total Non-Farm Exp.	\$ 7,200.00	\$ 7,200.00	\$ 7,011.35
-----			
Total Expense Before Operating Interest	105,383.03	111,143.03	108,761.82
Operating Interest	3,413.13	3,599.69	3,522.56
Total Expense	\$108,796.16	\$114,742.72	\$112,284.38

**Table 8. Cash Operating Expense and Family Living  
for Case Study 1984-1982**

Expense Items	1984	1983	1982
Seed	\$ 494.74	\$ 476.40	\$ 458.52
Fertilizer	1,037.09	998.65	961.16
Herbicides	643.16	619.32	596.07
Labor	13,569.96	13,066.90	12,576.42
Custom hire	3,109.78	2,994.50	2,882.10
Repairs			
Mach. & Equip.	6,596.51	6,351.97	6,113.54
Trucking	942.36	907.42	873.36
Vet. & Medicine	1,484.21	1,429.19	1,375.55
Livestock Supplies	4,711.79	4,537.12	4,366.81
Feed	25,183.58	24,834.24	24,493.62
Fuel, Oil, Lube	9,423.58	9,074.24	8,733.62
Farm Share Auto	1,130.83	1,088.91	1,048.03
Utilities	3,298.25	3,175.98	3,056.77
Rent/Lease Exp.	4,711.79	4,537.12	4,366.81
Insurance	3,957.90	3,811.18	3,668.12
Taxes			
Real Estate	10,365.94	9,981.66	9,606.99
Misc. Farm Exp.	3,957.90	3,811.18	3,668.12
Capital Assets			
Breeding stock	4,500.00	4,500.00	4,500.00
Feeder livestock			
Mach. & Equip.	.00	9,074.24	8,733.62
<b>Total Farm Expense</b>	<b>\$99,119.38</b>	<b>\$105,270.19</b>	<b>\$102,079.24</b>
<b>Non-Farm Expense</b>			
Family Living	\$ 6,784.98	\$ 6,533.45	\$ 6,288.21
<b>Total Non-Farm Exp.</b>	<b>\$ 6,784.98</b>	<b>\$ 6,533.45</b>	<b>\$ 6,288.21</b>
<b>Total Expense Before Operating Interest</b>	<b>105,904.36</b>	<b>111,803.64</b>	<b>108,367.45</b>
<b>Operating Interest</b>	<b>3,430.02</b>	<b>3,621.08</b>	<b>3,509.79</b>
<b>Total Expense</b>	<b>\$109,334.38</b>	<b>\$115,424.72</b>	<b>\$111,877.24</b>

**Table 9. Cash Operating Expense and Family Living  
for Case Study 1981-1980**

Expense Items	1981	1980 (Actual)	1980 (Projected)
Seed	\$ 431.00	\$ 392.95	\$ 392.95
Fertilizer	903.49	823.72	823.72
Herbicides	560.31	510.83	510.83
Labor	11,821.83	10,777.99	10,777.99
Custom hire	2,709.17	2,469.96	2,469.96
Repairs			
Mach. & Equip.	5,746.72	5,239.30	5,239.30
Trucking	820.96	748.47	748.47
Vet. & Medicine	1,293.01	1,178.84	1,178.84
Livestock Supplies	4,104.80	3,742.36	3,742.36
Feed	23,969.61	23,244.72	7,484.72
Fuel, Oil, Lube	8,209.61	7,484.72	7,484.72
Farm Share Auto	985.15	898.17	898.17
Utilities	2,873.36	2,619.65	2,619.65
Rent/Lease Exp.	4,104.80	3,742.36	3,742.36
Insurance	3,448.03	3,143.58	3,143.58
Taxes			
Real Estate	9,030.57	8,233.19	8,233.19
Misc. Farm Exp.	3,448.03	3,143.58	3,143.58
Capital Assets			
Breeding Stock	4,500.00	4,500.00	4,500.00
Feeder Livestock			
Mach. & Equip.	8,209.61	7,484.72	7,484.72
Total Farm Expense	\$97,170.09	\$90,379.09	\$74,619.09
Non-Farm Expense			
Family Living	\$ 5,910.92	\$ 5,389.00	\$ 5,389.00
Total-Non Farm Exp.	\$ 5,910.92	\$ 5,389.00	\$ 5,389.00
Total Expense Before Operating Interest	103,081.00	95,768.09	80,008.09
Operating Interest	3,338.58	3,101.73	2,591.29
Total Expense	\$106,419.58	\$98,869.81	\$82,599.38

Table 10. Cash Flow in 1980

Cash Flow Items	1980
Total Income	\$165,177.37
Total Operating Expense and Family Living	82,599.38
Disposable Income	82,577.99
Land Payment	28,418.61
Machinery Payment	47,024.36
Disposable Income after Debt Service	7,135.03

is not substantial, the investment criteria in 1980 was that if a cash surplus was projected, either continuing the operation or purchasing the farm, was a good financial decision. The decision was based on the previous and consequently expected land price appreciation. If the farm were to be affected by a drought, etc., in the future, the resulting net loss would be covered by the increased land values.

Debt Accumulation Due to the Cost Price  
Squeeze, Drought and Grasshoppers

At this juncture it is informative to follow the financial decline of the firm from 1980 through 1987. The annual increase in the operating loan due to debt accumulation is shown in Tables 11 through 15.

Table 11. Illustration of Debt Accumulation Due to the Cost Price Squeeze, Drought and Grasshoppers 1987

Cash Flow Items	Current Situation in 1987
Total Income	\$165,177.37
Total Expense and Family Living	108,796.16
Disposable Income	56,381.20
Long Term Debt Payment	28,418.61
Interest on Debt Carryforward	63,182.12
Disposable Income after Debt Service	(35,219.52)
Demand Note Balance	526,517.66

Table 12. Illustration of Debt Accumulation Due to the Cost Price Squeeze, Drought and Grasshoppers 1986-1985

Cash Flow Items	1986	1985
Total Income	\$132,141.89	\$132,141.89
Total Expense and Family Living	14,742.72	112,284.38
Disposable Income	17,399.18	19,857.51
Long Term Debt Payment	28,418.61	28,418.61
Intermediate Term Debt Payment	47,024.36	47,024.36
Interest on Debt Carry Forward	50,193.63	38,860.16
Disposable Income after Debt Service	(108,237.42)	(94,445.61)
Demand Note Balance (end of year)	526,517.66	418,280.24

Table 13. Illustration of Debt Accumulation Due to the Cost Price Squeeze, Drought and Grasshoppers 1984-1983

Cash Flow Items	1984	1983
Total Income	\$132,141.89	\$132,141.89
Total Expense and Family Living	109,334.38	115,424.72
Disposable Income	22,807.52	16,717.17
Long Term Debt Payment	28,418.61	28,418.61
Intermediate Term Debt Payment	47,024.36	47,024.36
Interest on Debt Carryforward	29,057.06	19,651.75
Disposable Income after Debt Service	(81,692.50)	(78,377.54)
Demand Note Balance (end of year)	323,834.64	242,142.13

Table 14. Illustration of Debt Accumulation Due to the Cost Price Squeeze, Drought and Grasshoppers 1982-1981

Cash Flow Items	1982	1981
Total Income	\$132,141.89	\$132,141.89
Total Expense and Family Living	111,877.24	106,419.58
Disposable Income	20,264.65	25,722.31
Long Term Debt Payment	28,418.61	28,418.61
Intermediate Term Debt Payment	47,024.36	47,024.36
Interest on Debt Carryforward	11,634.24	5,060.51
Disposable Income after Debt Service	(66,812.56)	(54,781.15)
Demand Note Balance (end of year)	163,764.59	96,952.03

Table 15. Illustration of Debt Accumulation Due to the Cost Price Squeeze, Drought and Grasshoppers in 1980 and Expected in 1980

Cash Flow Items	1980	Expected in 1980
Total Income	132,141.89	\$165,177.37
Total Expense and Family Living	98,869.81	82,599.38
Disposable Income	33,272.08	82,577.99
Long Term Debt Payment	28,418.61	28,418.61
Intermediate Term Debt Payment	47,024.36	47,024.36
Interest on Debt Carryforward	.00	
Disposable Income after Debt Service	(42,170.88)	7,135.03
Demand Note Balance (end of year)	42,170.88	

This example illustrates the effect of the cost price squeeze, combined with drought and grasshoppers, on the debt servicing capacity of the firm. The firm is not even able to service a 30 percent debt load on long term assets under the existing conditions.

#### Erosion of Net Worth

In this section the effect of a series of net losses and the steady erosion in the value of long term assets is illustrated. This example utilizes the typical balance sheet items and shows the changes in those items from 1980 through 1987. The assumption is that the value of current assets (cash and feed) remains constant through the term. The value of the livestock remains the same through time

(this assumption coincides with projected gross income remaining stable through time).

Land values are indexed yearly using the change in the average per acre value of Montana land. These data were taken from Agricultural Resource, Economic Research Service, United States Department of Agriculture, April, 1987 (United States Department of Agriculture, 1987).

Table 16. Average Value Per Acre of Farmland in Montana

Year	Average Value per Acre	As a Percentage of 1982 Value per Acre	Index
1980	235	87	1.41
1981	251	93	1.50
1982	271	100	1.62
1983	259	96	1.55
1984	264	97	1.58
1985	222	82	1.33
1986	204	75	1.22
1987*	167	62	1.00

\*Base Year

Utilizing the data previously presented in the case study, the erosion of net worth from 1980 through 1987 is illustrated in Tables 17 through 21.

The balance sheets, through time, indicate the effect of the cost price squeeze, drought and the devaluation of land on the net worth of the entity. Given substantial

Table 17. Balance Sheet for 1987

Assets and Liabilities	1987
<b>Assets</b>	
Current Assets	
Cash	\$ 5,000.00
Feed	3,000.00
Total Current Assets	8,000.00
Intermediate Assets	
Cattle	293,850.00
Machinery	100,000.00
Total Intermediate Assets	393,850.00
Long Term Assets	
Land	763,057.00
Total Long Term Assets	763,057.00
Total Assets	\$1,164,907.00
<b>Liabilities</b>	
Short Term	
Operating Loan Carryforward	\$ 526,517.66
Total Short Term	526,517.66
Intermediate Term	
Machinery Note	.00
Total Intermediate Debt	.00
Long Term Liability	
Mortgage Company	219,347.13
Total Long Term Liability	219,347.13
Total Liabilities	745,864.78
Net Worth	419,042.22
Total Liabilities and Net Worth	\$1,164,907.00
Debt Load in Percentage	64.03

Table 18. Yearly Balance Sheets from 1985 through 1986

Assets and Liabilities	1986	1985
<b>Assets</b>		
Current Assets		
Cash	\$ 5,000.00	\$ 5,000.00
Feed	3,000.00	3,000.00
Total Current Assets	8,000.00	8,000.00
Intermediate Assets		
Cattle	293,850.00	293,850.00
Machinery	100,000.00	100,000.00
Total Intermediate Assets	393,850.00	393,850.00
Long Term Assets		
Land	932,117.53	1,014,363.20
Total Long Term Assets	932,117.53	1,014,363.20
Total Assets	\$1,333,967.53	\$1,416,213.20
<b>Liabilities</b>		
Short Term		
Operating Loan Carryforward	\$ 418,280.24	\$ 323,834.64
Total Short Term	418,280.24	323,834.64
Intermediate Term		
Machinery Note	41,986.03	79,473.56
Total Intermediate Debt	41,986.03	79,473.56
Long Term Liability		
Mortgage Company	221,219.40	222,891.08
Total Long Term Liability	221,219.40	222,891.08
Total Liabilities	681,485.69	626,199.29
Net Worth	652,481.84	790,013.91
Total Liabilities and Net Worth	\$1,333,967.53	\$1,416,213.20
Debt Load in Percentage	51.09	44.22

Table 19. Yearly Balance Sheets from 1983 through 1984

Assets and Liabilities	1984	1983
<b>Assets</b>		
Current Assets		
Cash	\$ 5,000.00	\$ 5,000.00
Feed	3,000.00	3,000.00
Total Current Assets	8,000.00	8,000.00
Intermediate Assets		
Cattle	293,850.00	293,850.00
Machinery	200,000.00	200,000.00
Total Intermediate Assets	493,850.00	493,850.00
Long Term Assets		
Land	1,206,269.75	1,183,423.73
Total Long Term Assets	1,206,269.75	1,183,423.73
Total Assets	\$1,708,119.75	\$1,685,273.73
<b>Liabilities</b>		
Short Term		
Operating Loan Carryforward	\$ 242,142.14	\$ 163,764.59
Total Short Term	242,142.14	163,764.59
Intermediate Term		
Machinery Note	112,944.57	142,829.40
Total Intermediate Debt	112,944.57	142,829.40
Long Term Liability		
Mortgage Company	224,383.65	225,716.30
Total Long Term Liability	224,383.65	225,716.30
Total Liabilities	579,470.36	532,310.29
Net Worth	1,128,649.39	1,152,963.44
Total Liabilities and Net Worth	\$1,708,119.75	\$1,685,273.73
Debt Load in Percentage	33.92	31.59

Table 20. Yearly Balance Sheets from 1981 through 1982

Assets and Liabilities	1982	1981
<b>Assets</b>		
Current Assets		
Cash	\$ 5,000.00	\$ 5,000.00
Feed	3,000.00	3,000.00
Total Current Assets	8,000.00	8,000.00
Intermediate Assets		
Cattle	293,850.00	293,850.00
Machinery	200,000.00	200,000.00
Total Intermediate Assets	493,850.00	493,850.00
Long Term Assets		
Land	1,238,254.17	1,146,870.10
Total Long Term Assets	1,238,254.17	1,146,870.10
Total Assets	\$1,740,104.17	\$1,648,720.10
<b>Liabilities</b>		
Short Term		
Operating Loan Carryforward	\$ 96,952.03	\$ 42,170.88
Total Short Term	96,952.03	42,170.88
Intermediate Term		
Machinery Note	169,512.29	193,336.29
Total Intermediate Debt	169,512.29	193,336.29
Long Term Liability		
Mortgage Company	226,906.17	227,968.55
Total Long Term Liability	226,906.17	227,968.55
Total Liabilities	493,370.49	463,475.72
Net Worth	1,246,733.69	1,185,244.39
Total Liabilities and Net Worth	\$1,740,104.17	\$1,648,720.10
Debt Load in Percentage	28.35	28.11

Table 21. Balance Sheet for 1980

Assets and Liabilities	1980
<b>Assets</b>	
Current Assets	
Cash	\$ 5,000.00
Feed	3,000.00
Total Current Assets	8,000.00
Intermediate Assets	
Cattle	293,850.00
Machinery	200,000.00
Total Intermediate Assets	493,850.00
Long Term Assets	
Land	1,073,762.84
Total Long Term Assets	1,073,762.84
Total Assets	\$1,575,612.84
<b>Liabilities</b>	
Short Term	
Operating Loan Carry Forward	\$ .00
Total Short Term	.00
Intermediate Term	
Machinery Note	214,607.72
Total Intermediate Debt	214,607.72
Long Term Liability	
Mortgage Company	228,917.10
Total Long Term Liability	228,917.10
Total Liabilities	443,524.82
Net Worth	1,132,088.02
Total Liabilities and Net Worth	\$1,575,612.84
Debt Load in Percentage	28.15

losses from 1980 through 1983, the capital budget was eliminated from 1984 through 1986 due to the massive debt carryforward and the resulting management strategy to conserve cash. Even though the capital budget is included in the expected expenses in a typical year, it was not expended in 1984 through 1986. Even though land was probably valued at 1982 levels on the balance sheets for two to three years following 1982, at higher than market value, this analysis shows the actual market value from year-to-year.

From 1980 through 1984, the machinery was carried at a \$200,000.00 value, then due to the massive amount of foreclosures and resulting machinery sales, the machinery value on the balance sheet in 1985 was approximately 50 percent of what it was in 1984. This method of appraising machinery was a rule-of-thumb that was used by agricultural lenders during the time. Therefore, in this study, machinery was valued at \$200,000.00 from 1980 through 1984 and \$100,000.00 from 1985 through 1987.

### Results of the Case Study

From a managerial standpoint, it is imperative to point out the decrease in net worth which was \$1,132,085.00 in 1980 and only \$419,042.00 in 1987, as well as the corresponding increase in debt load from 28

percent in 1980 to 64 percent debt load in 1987. Calculations for maximum debt load assume an average interest rate and an average term of loan. In this case study, a 12 percent interest rate and a term of 30 years was assumed. Given a disposable income of \$56,381.20 (Table 4), this firm could service a maximum debt of \$454,160.90. Using the Total Asset value of \$1,164,907.00 (Table 17), the maximum debt load was 39 percent. In 1987, the current debt was approximately twice the amount the firm could carry given the above assumed interest rate and term. As the available interest rate decreases, the maximum debt load increases. If all debt was amortized at 10 percent over 30 years, the resulting payment would be \$79,120.00. With a disposable income available to service debt of \$56,381.20, this results in a disposable income after debt service of \$(22,738.80). If all debt is amortized at five percent over 30 years, the annual payment is \$48,519.57. Therefore, the firm can handle a maximum interest rate of approximately five percent if all debt is amortized over 30 years.

#### Management Options for the Case Study

Disposable income is equated with restructured debt payments, plus a margin for error, and is then presented via a group of options to management and creditors. At

this juncture, several possible options are available to the debtor. The options and possible consequences to the debtor are shown in Table 22.

**Table 22. Options Available to the Debtor**

Possible Option	Possible Consequence
Continue Management as Before	Face Foreclosure by one of the Several Creditors
File Chapter 7 Bankruptcy	Liquidation of all Assets Except Exempt Assets
File Chapter 12 Bankruptcy	File a Liquidation and/or Continuation Plan with the Court
File Chapter 11 Bankruptcy	File a Liquidation and/or Continuation Plan with the Court
Provide a Deed in Lieu of Foreclosure	Avoid Bankruptcy
Present a Workout Proposal to the Creditors	Continue Operating the Firm
Voluntary Liquidation	Cease Operations

### Workout Proposal

In farm situations, workout proposals should incorporate all the institutional constraints of the farm financial intermediaries. Given federal agencies such as the Farmers Home Administration and large bureaucracies

such as the Farm Credit System, there are many approaches to a workout that may be considered, however there are legal constraints to the options.

### Creditors' Meeting

In a workout, a meeting between the creditors and the debtor is held to determine a course of action. This meeting takes the form of a detailed discussion of the analysis and the presentation of a proposal to the creditors. The creditors are informed of the other options being considered if this proposal or some modification thereof is not accepted.

### Summary for Case Study

The preceding discussion should lend a perspective to the situation of 30 percent of the farms and ranches in Montana (refer to Table 1). Chapter 5 utilizes the scenario to illustrate the effects of a Chapter 12 farm bankruptcy.

## CHAPTER 5

## CASE STUDY ILLUSTRATIONS OF CHAPTER 12

In this chapter information from the first four chapters is combined to complete the bankruptcy case studies. All assumptions stated in Chapter 4 are maintained unless otherwise stated. A nonconfirmable Chapter 12 bankruptcy case and four confirmable case studies are developed in this chapter.

In the nonconfirmable case study, it is shown that a Chapter 12 Bankruptcy does not substantially change the ability of the farm to service debt where all creditors have sufficient security. The second case study is illustrative of the concept that if an entity files bankruptcy, a separate entity might provide funds to the bankruptcy estate to facilitate the reorganization. In the third case study it is shown that when Farmers Home Administration is the major or sole creditor, the bankruptcy estate can service a higher debt load because of the lower interest rate. In the fourth case study an instance where there is leased land and machinery instead of owned assets is portrayed. In this case study, it is shown how the debt can be written down to asset value. In the last case study, there is a plan to increase the

number of cattle on the ranch from a 50 percent stocking rate to a 100 percent stocking rate. The increase in the stocking rate in turn increases disposable income and provides sufficient income to the creditors to confirm a Chapter 12 plan.

#### Case Study - Non-Confirmable Plan

The first case study of a Chapter 12 analysis is very simplistic. It will utilize all the background developed in Chapter 4, with the additional assumption that all other assets are exempt. This assumption is made so the study can focus on Chapter 12 specifically and not bankruptcy in general. Initially the balance sheet, Table 23, and projected income statement are presented, Table 24.

#### Balance Sheet and Cash Flow

This section presents the balance sheet and projected cash flow previous to a Chapter 12. The projected prepetition cash flow of the firm is illustrated in Table 24. It is apparent that the management of this firm has to restructure the cash requirements of the firm.

Table 23. Case Study- Balance Sheet for 1987

Assets and Liabilities	1987
<b>Assets</b>	
Current Assets	
Cash	\$ 5,000.00
Feed	3,000.00
Total Current Assets	8,000.00
Intermediate Assets	
Cattle	293,850.00
Machinery (50,000.00)	100,000.00
Total Intermediate Assets	393,850.00
Long Term Assets	
Land	763,057.00
Total Long Term Assets	763,057.00
Total Assets	\$1,164,907.00
<b>Liabilities</b>	
Short Term	
Operating Loan Carryforward	\$ 526,517.67
Total Short Term	526,517.67
Intermediate Term	
Machinery Note	.00
Total Intermediate Debt	.00
Long Term Liability	
Mortgage Company	219,347.13
Total Long Term Liability	219,347.13
Total Liabilities	745,864.80
Net Worth	419,042.20
Total Liabilities and Net Worth	\$1,164,907.00
Debt Load in Percentage	64.03

**Table 24. Case Study- Prepetition Projected Cash Flow of Non-Confirmable Case**

Cash Flow Items	Dollars
Total Income	\$165,177.37
Total Expense	108,796.16
Disposable Income	56,381.20
Long Term Debt Payment	28,418.61
Interest on Debt Carryforward	63,182.12
Disposable Income	\$(35,219.52)

**Valuation of Security**

Given that the court requires verification of asset values a rural appraiser has indicated that the value associated with the land is appropriate. Additionally, an auctioneer was commissioned to attach a value to the machinery and he/she values the machinery at \$50,000.00 instead of \$100,000.00. This was the value that would be received at a farm auction.

The long term lender has a first mortgage on the land as security. Therefore, the position of the creditor is as follows:

**Table 25. Case Study- Position of the Long Term Lender**

Value of Asset Land	Loan Pmt. & Delinquencies (as of day of filing)	Secured Value	Unsecured Value
\$763,057.00	\$219,347.13	\$219,347.13	-0-

The short term lender has for collateral all the machinery, cattle and growing crops. Also in 1984, a second mortgage on the land was obtained. Therefore the value of the collateral is as follows:

**Table 26. Case Study- Value of Security for the Short Term Lender**

Value of Security	
Cattle	\$293,850.00
Machinery	50,000.00
Growing Crops	none (this is in January)
2nd Mortgage	543,710.00 (763,057-219,347)
Total	<u>\$887,560.00</u>

**Table 27. Case Study- Position of the Short Term Creditor**

Value of Security	Loan Amount	Secured Assets	Unsecured Assets
\$887,560.00	\$526,517.00	\$526,517.00	-0-

In this example both lenders are totally secured, therefore, all debt will have to be paid off. The annual payment to the mortgage holder will be the amortized payment for \$219,347.00 at eight percent, 30 years. This payment is \$19,484.04. The annual payment to the short term lender will be at least \$69,223.18. This is \$526,517.00, amortized at 10 percent for 15 years (refer

to Chapter 2). Therefore, the Chapter 12 payment plan would be as follows:

**Table 28. Case Study- Chapter 12 Cash Flow**

Cash Flow Items	Dollars
Disposable Income	\$56,381.20
Trustee Fee 5% of Disposable Income	2,819.06
Income Available for Creditors	53,562.14
Payment to Long Term Creditor	19,484.04
Payment to Short Term Creditor	69,223.18
Disposable Income after Debt Service	\$(35,145.00)

Given that this plan cannot provide annual payments to secured creditors (provide the present value of the assets to the secured creditors), this plan is not confirmable. Therefore, it would be expected that the court would dismiss the Chapter 12 proceedings, leaving the debtor with the option to file a Chapter 7. The following case studies will show some special instances where a confirmation of a Chapter 12 would be probable.

Case Study 2- Committing Other Income from  
Outside the Bankruptcy Estate

The assumptions for this case study remain the same as the previous example with the exception that a corporation filed bankruptcy and the owners or owner have major holdings outside the corporation. The holdings produce an available income of \$60,000.00. The owner

and/or owners are willing to commit \$45,000.00 annually to the plan. Therefore, the payment plan would be as follows:

Table 29. Case Study 2- Chapter 12 Cash Flow

Cash Flow Items	Dollars
Disposable Income - \$56,381.20 + \$45,000	\$101,381.20
Trustees Fee - 5%	5,069.06
Income Available for Creditors	96,312.14
Payment to Long Term Creditor	19,484.04
Payment to Short Term Creditor	69,223.18
Residual	\$ 7,604.92

There would be a high probability of confirmation since the plan shows a positive cash flow. This plan provides an insight into the ability of Chapter 12 to reorganize an entity when additional funds are provided by a separate entity.

Case Study 3- Farmers Home Administration  
Exclusive Creditor

Income and assets are assumed to be the same as in the nonconfirmable case study for this example. The only change will be that Farmers Home Administration is the exclusive creditor. The debtor has been relying on the Farmers Home Administration for both the long term and short term credit and there are 15 loans amortized over several different time horizons, with interest rates

ranging from five percent to 10 percent. This number of loans per borrower is not atypical of Farmers Home borrowers. The 15 loans range in term from five to 35 years, and annual payments on these loans total \$100,000.00. Therefore, in a typical year this firm is expected to have a cash deficit of approximately \$45,000.00. The Farmers Home Administration reviewed the borrowers 1987 Farmers Home plan and determined that the farm/ranch will not cash flow. Additionally, the Farmers Home Administration reviewed all of the reamortization and deferral programs available to them and they still could not provide a positive cash flow; therefore, the annual operating loan was denied.

Given that Farmers Home Administration's lowest interest rate is five percent and the longest term is 35 years, this is what the total debt is amortized over for a Chapter 12. The annual payment for a loan amount of \$745,864.13 amortized at five percent, 35 years is \$45,551.20. Therefore, the Chapter 12 plan would be as indicated in Table 30. This plan should be confirmable because the secured creditor is being provided the current value of the secured assets.

Table 30. Case Study 3- Chapter 12 Cash Flow

Cash Flow Items	Dollars
Disposable Income	\$56,381.20
Trustees Fee - 5%	2,819.60
Net Income Available for Creditors	53,562.14
FmHA Payment	45,551.20
Residual	\$ 8,010.94

#### Case Study 4- Leased Land and Machinery

This case study deviates substantially from the previous cases. The production enterprises are more efficient resulting in a higher income level. Specifically, calf weaning weights were increased from 450 and 425 pounds to 525 and 500 pounds for steers and heifers, respectively. Expected yields on wheat and barley were raised from 28 and 32 bushels per acre, to 32 and 34 bushels per acre, respectively. Also, all land and machinery are leased. The capability of the court to reduce the level of the debt to the asset value is shown in this case study.

#### Income from 1980 - 1986

The income produced from the firm is illustrated in Table 31. In this case study actual income has been reduced by 40 percent from 1980 to 1986. Again, as in the first case study, this can be due to low crop yields, a

short term sell-down of cattle and/or more expense in the lease category. Also, projected income has remained

Table 31. Case Study 3- Projected Income from 1980 -1987

Source of Income	Projected Income from 1980 -1987
Crop Sales or Loan	
Wheat	\$16,319.94
Barley	2,679.68
Livestock Sales	
Cull Cows	23,598.00
Cull Bulls	4,050.00
Steers	65,726.64
Heifers	38,041.92
Program Payments	
Crop Programs	14,761.18
Total Income	\$187,620.10

steady through time. Actual income from 1980 through 1987 of \$112,572.06 was at 60 percent of the projected level of \$187,620.10.

### Operating Expenses

As in the nonconfirmable case study, the generation of the expense side of the firm is accomplished by taking projected expenses in 1987 and deflating them by the GNP implicit price deflator. The major change in this example on the expense side is that both the machinery and land are leased instead of being owned. Therefore, instead of

machinery replacement of \$10,000.00 annually, there is a \$15,000.00 annual lease fee. Also, this individual has leased a ranch of sufficient size for \$20,000.00 plus taxes. Given the credit problems in agriculture a \$20,000.00 to \$25,000.00 annual lease for a ranch of sufficient size to carry 450 cows was reasonable. Therefore, the expenses from 1980 through 1987 are as indicated in Tables 32 through 36.

#### Debt Assumption in 1980

The debt assumption in 1980 was that 55 percent of the value of the cattle was borrowed, which was \$162,011.01. The debt was amortized at 12 percent over seven years, which resulted in a \$35,499.49 annual payment. As in the previous cases, projected income remains the same through time.

#### Cash Flow in 1980 and in 1987

After adjusting the expenses back to a 1980 level, it is relatively easy to evaluate the cash flow scenario in 1980. It is obvious that in 1980 the venture appeared to generate a positive cash flow. In the expected scenario a current typical year cashflow is as illustrated in Table 38.

Table 32. Case Study 4- Operating Expenses for 1987-1986

Expense Items	Expected in 1987	1986
Seed	\$ 525.00	\$ 525.00
Fertilizer	1,100.53	1,100.53
Herbicides	682.50	682.50
Labor	14,400.00	14,400.00
Custom Hire	3,300.00	3,300.00
Repairs		
Mach. & Equip.	7,000.00	7,000.00
Trucking	1,000.00	1,000.00
Vet. & Medicine	1,575.00	1,575.00
Livestck Supplies	5,000.00	5,000.00
Feed	10,000.00	25,760.00
Fuel, Oil, Lube	10,000.00	10,000.00
Farm Share Auto	1,200.00	1,200.00
Utilities	3,500.00	3,500.00
Rent/Lease Exp.	25,000.00	25,000.00
Insurance	4,200.00	4,200.00
Taxes		
Real Estate	11,000.00	11,000.00
Misc. Farm Exp.	4,200.00	4,200.00
Breeding Stock	4,500.00	4,500.00
Feeder Livestock	.00	.00
Lease Mach. & Equip.	15,000.00	15,000.00
<hr/>		
Total Farm Expense	\$123,183.03	\$138,943.03
<hr/>		
Non-Farm Expense		
Family Living	\$ 7,200.00	\$ 7,200.00
<hr/>		
Total Non-Farm Exp.	\$ 7,200.00	\$ 7,200.00
<hr/>		
Total Expense Before Operating Interest	130,383.03	146,143.03
Operating Interest	4,222.83	4,733.26
Total Expense	\$134,605.86	\$150,876.29

Table 33. Case Study 4- Operating Expenses for 1985-1984

Expense Items	1985	1984
Seed	\$ 511.24	\$ 494.74
Fertilizer	1,071.70	1,037.09
Herbicides	664.62	643.16
Labor	14,022.71	13,569.96
Custom Hire	3,213.54	3,109.78
Repairs		
Mach. & Equip.	6,816.59	6,596.51
Trucking	973.80	942.36
Vet. & Medicine	1,533.73	1,484.21
Livestck Supplies	4,869.00	4,711.79
Feed	25,497.99	25,183.58
Fuel, Oil, Lube	9,737.99	9,423.58
Farm Share Auto	1,168.56	1,130.83
Utilities	3,408.30	3,298.25
Rent/Lease Exp.	24,344.98	23,558.95
Insurance	4,089.96	3,957.90
Taxes		
Real Estate	10,711.79	10,365.94
Misc. Farm Exp.	4,089.96	3,957.90
Breeding Stock	4,500.00	4,500.00
Feeder Livestock		
Lease Mach. & Equip.	14,606.99	14,135.37
<b>Total Farm Expense</b>	<b>\$135,833.43</b>	<b>\$132,101.91</b>
<b>Non-Farm Expense</b>		
Family Living	\$ 7,011.35	\$ 6,784.98
<b>Total Non Farm Exp.</b>	<b>\$ 7,011.35</b>	<b>\$ 6,784.98</b>
<b>Total Expense Before Operating Interest</b>	<b>142,844.79</b>	<b>138,886.89</b>
Operating Interest	4,626.44	4,498.25
<b>Total Expense</b>	<b>\$147,471.23</b>	<b>\$143,385.14</b>

Table 34. Case Study 4- Operating Expenses for 1983-1982

Expense Items	1983	1982
Seed	\$ 476.40	\$ 458.52
Fertilizer	998.65	961.16
Herbicides	619.32	596.07
Labor	13,066.90	12,576.42
Custom Hire	2,994.50	2,882.10
Repairs		
Mach. & Equip.	6,351.97	6,113.54
Trucking	907.42	873.36
Vet. & Medicine	1,429.19	1,375.55
Livestck Supplies	4,537.12	4,366.81
Feed	24,834.24	24,493.62
Fuel, Oil, Lube	9,074.24	8,733.62
Farm Share Auto	1,088.91	1,048.03
Utilities	3,175.98	3,056.77
Rent/Lease Exp.	22,685.59	21,834.06
Insurance	3,811.18	3,668.12
Taxes		
Real Estate	9,981.66	9,606.99
Misc. Farm Exp.	3,811.18	3,668.12
Breeding Stock	4,500.00	4,500.00
Feeder Livestock		
Lease Mach. & Equip.	13,611.35	13,100.44
<b>Total Farm Expense</b>	<b>\$127,955.78</b>	<b>\$123,913.30</b>
<b>Non-Farm Expense</b>		
Family Living	\$ 6,533.45	\$ 6,288.21
<b>Total Non-Farm Exp.</b>	<b>\$ 6,533.45</b>	<b>\$ 6,288.21</b>
Total Expense Before Operating Interest	134,489.23	130,201.51
Operating Interest	4,355.82	4,216.95
<b>Total Expense</b>	<b>\$138,845.05</b>	<b>\$134,418.46</b>

Table 35. Case Study 4- Operating Expenses for 1981-1980

Expense Items	1981	1980
Seed	\$ 431.00	\$ 392.95
Fertilizer	903.49	823.72
Herbicides	560.31	510.83
Labor	11,821.83	10,777.99
Custom Hire	2,709.17	2,469.96
Repairs		
Mach. & Equip.	5,746.72	5,239.30
Trucking	820.96	748.47
Vet. & Medicine	1,293.01	1,178.84
Livestck Supplies	4,104.80	3,742.36
Feed	23,969.61	23,244.72
Fuel, Oil, Lube	8,209.61	7,484.72
Farm Share Auto	985.15	898.17
Utilities	2,873.36	2,619.65
Rent/Lease Exp.	20,524.02	18,711.79
Insurance	3,448.03	3,143.58
Taxes		
Real Estate	9,030.57	8,233.19
Misc. Farm Exp.	3,448.03	3,143.58
Breeding Stock	4,500.00	4,500.00
Feeder Livestock		
Lease Mach. & Equip.	12,314.41	11,227.07
<b>Total Farm Expense</b>	<b>\$117,694.10</b>	<b>\$109,090.88</b>
<b>Non-Farm Expense</b>		
Family Living	\$ 5,910.92	\$ 5,389.00
<b>Total Non-Farm Exp.</b>	<b>\$ 5,910.92</b>	<b>\$ 5,389.00</b>
<b>Total Expense Before Operating Interest</b>	<b>123,605.02</b>	<b>114,479.88</b>
Operating Interest	4,003.30	3,707.76
<b>Total Expense</b>	<b>\$127,608.33</b>	<b>\$118,187.64</b>

Table 36. Case Study 4- Expected Operating Expenses  
for 1980

Expense Items	1980
Seed	\$ 392.95
Fertilizer	823.72
Herbicides	510.83
Labor	10,777.99
Custom hire	2,469.96
Repairs	
Mach. & Equip.	5,239.30
Trucking	748.47
Vet. & Medicine	1,178.84
Livestck Supplies	3,742.36
Feed	7,484.72
Fuel, Oil, Lube	7,484.72
Farm Share Auto	898.17
Utilities	2,619.65
Rent/Lease Exp.	18,711.79
Insurance	3,143.58
Taxes	
Real Estate	8,233.19
Misc. Farm Exp.	3,143.58
Breeding Stock	4,500.00
Feeder Livestock	
Lease Mach. & Equip.	\$11,227.07
-----	
Total Farm Expense	\$93,330.88
-----	
Non-Farm Expense	
Family Living	\$ 5,389.00
-----	
Total Non-Farm Exp.	\$ 5,389.00
Total Expense Before Operating Interest	98,719.88
Operating Interest	3,197.33
Total Expense	\$101,917.20

Table 37. Case Study 4- Cash Flow in 1980

Cash Flow Items	1980
Total Income	\$187,620.10
Total Operating Expense	101,917.20
Disposable Income	85,702.90
Intermediate Debt Service	35,499.49
Disposable Income after Debt Service	\$ 50,203.41

Table 38. Case Study 4- Cash Flow in 1987

Cash Flow Items	1987
Total Income	\$187,620.10
Total Operating Expense	134,605.86
Disposable Income	53,014.24
Interest on Debt Carry Forward	69,968.23
Disposable Income after Debt Service	\$(16,953.99)

It should be pointed out that this is just servicing the interest on the debt carryforward and no principal payments are being made. Even when no principal payments are made, this firm is expected to be in arrears \$16,953.99 annually.

#### Debt Accumulation

In Tables 39 through 43 it is shown how the debt carryforward reached its present balance. The debt carryforward balance in 1987 was \$583,068.55.

Table 39. Case Study 4- Debt Accumulation 1987 - 1986

Cash Flow Items	Projected 1987	1986
Total Income	\$187,620.10	\$112,572.06
Total Expense	134,605.86	150,876.29
Disposable Income	53,014.24	(38,304.23)
Long Term Debt Payment	.00	.00
Intermediate Term Debt Payment		35,499.49
Interest on Debt Carry Forward	69,968.23	54,564.09
Disposable Income after Debt Service	(16,953.99)	(128,367.81)
Term Note Balance (end of year)		583,068.55
Term Note Balance (beginning of the year)	583,068.55	

Table 40. Case Study 4- Debt Accumulation 1985 - 1984

Cash Flow Items	1985	1984
Total Income	\$112,572.06	\$112,572.06
Total Expense	147,471.23	143,385.14
Disposable Income	(34,899.17)	(30,813.08)
Long Term Debt Payment	.00	.00
Intermediate Term Debt Payment	35,499.49	35,499.49
Interest on Debt Carryforward	41,175.22	29,658.67
Disposable Income after Debt Service	(111,573.88)	(95,971.24)
Term Note Balance	454,700.74	343,126.87

Table 41. Case Study 4- Debt Accumulation 1983 - 1982

Cash Flow Items	1983	1982
Total Income	\$112,572.06	\$112,572.06
Total Expense	138,845.05	134,418.46
Disposable Income	(26,272.99)	(21,846.40)
Long Term Debt Payment	.00	.00
Intermediate Term Debt Payment	35,499.49	35,499.49
Interest on Debt Carry Forward	19,862.48	11,590.15
Disposable Income after Debt Service	(81,634.96)	(68,936.04)
Term Note Balance	247,155.62	165,520.66

Table 42. Case Study 4- Debt Accumulation 1981 - 1980

Cash Flow Items	1981	1980
Total Income	\$112,572.06	\$112,572.06
Total Expense	127,608.33	118,187.64
Disposable Income	(15,036.27)	(5,615.58)
Long Term Debt Payment	.00	.00
Intermediate Term Debt Payment	35,499.49	35,499.49
Interest on Debt Carryforward	4,933.81	.00
Disposable Income after Debt Service	(55,469.56)	(41,115.06)
Term Note Balance	96,584.62	41,115.06

**Table 43. Case Study 4- Debt Accumulation  
Expected in 1980**

Cash Flow Items	1980
Total Income	\$187,620.10
Total Expense	101,917.20
Disposable Income	85,702.90
Long Term Debt Payment	.00
Intermediate Term Debt Payment	35,499.49
Disposable Income after Debt Service	\$ 50,203.41

Progression of Balance Sheets from 1980 through 1987

The balance sheet would have progressed from a net worth of \$213,695.00 in 1980 to \$(281,218.55) in 1987. The annual balance sheets are illustrated in Tables 44 through 47.

Chapter 12 Analysis

By 1986, the lender is substantially undersecured and has probably declined to finance the operating loan in the future. The operation is faced with a debt load which is approximately twice the asset value. Given this situation, the case study will illustrate a Chapter 12 plan which meets the requirements for confirmation.

Secured vs. unsecured debt. In this example the short term lender has a debt of \$583,068.55 and has the cattle and crops, and all income from cattle and crops, as

Table 44. Case Study 4- Balance Sheets for 1987 and 1986

Assets and Liabilities	1987	1986
<b>Assets</b>		
Current Assets		
Cash	\$ 5,000.00	\$ 5,000.00
Feed	3,000.00	3,000.00
Total Current Assets	8,000.00	8,000.00
Intermediate Assets		
Cattle	293,850.00	293,850.00
Machinery	.00	.00
Total Intermediate Assets	293,850.00	293,850.00
Long Term Assets		
Land	.00	.00
Total Long Term Assets	.00	.00
Total Assets	\$301,850.00	\$301,850.00
<b>Liabilities</b>		
Short Term		
Operating Loan Carryforward	583,068.55	454,700.74
Total Short Term	583,068.55	454,700.74
Intermediate Term		
Cattle Note	.00	31,695.97
Total Intermediate Debt	.00	31,695.97
Long Term Liability		
Mortgage Company	.00	.00
Total Long Term Liability	.00	.00
Total Liabilities	583,068.55	486,396.71
Net Worth	-281,218.55	-184,546.71
Total Liabilities and Net Worth	\$301,850.00	\$301,850.00
Debt Load in Percentage	193.16	161.14

Table 45. Case Study 4- Balance Sheets for 1985 and 1984

Assets and Liabilities	1985	1984
<b>Assets</b>		
Current Assets		
Cash	\$ 5,000.00	\$ 5,000.00
Feed	3,000.00	3,000.00
Total Current Assets	8,000.00	8,000.00
Intermediate Assets		
Cattle	293,850.00	293,850.00
Machinery	.00	.00
Total Intermediate Assets	293,850.00	293,850.00
Long Term Assets		
Land	.00	.00
Total Long Term Assets	.00	.00
Total Assets	\$301,850.00	\$301,850.00
<b>Liabilities</b>		
Short Term		
Operating Loan Carryforward	\$343,126.87	\$247,155.62
Total Short Term	343,126.87	247,155.62
Intermediate Term		
Cattle Note	59,995.94	85,263.77
Total Intermediate Debt	59,995.94	85,263.77
Long Term Liability		
Mortgage Company	.00	.00
Total Long Term Liability	.00	.00
Total Liabilities	403,122.81	332,419.40
Net Worth	-101,272.81	-30,569.40
Total Liabilities and Net Worth	\$301,850.00	\$301,850.00
Debt Load in Percentage	133.55	110.13

Table 46. Case Study 4- Balance Sheets for 1983 and 1982

Assets and Liabilities	1983	1982
<b>Assets</b>		
Current Assets		
Cash	\$ 5,000.00	\$ 5,000.00
Feed	3,000.00	3,000.00
Total Current Assets	8,000.00	8,000.00
Intermediate Assets		
Cattle	293,850.00	293,850.00
Machinery	.00	.00
Total Intermediate Assets	293,850.00	293,850.00
Long Term Assets		
Land	.00	.00
Total Long Term Assets	.00	.00
Total Assets	\$301,850.00	\$301,850.00
<b>Liabilities</b>		
Short Term		
Operating Loan Carryforward	\$165,520.66	\$ 96,584.62
Total Short Term	165,520.66	96,584.62
Intermediate Term		
Cattle Note	107,824.34	127,967.70
Total Intermediate Debt	107,824.34	127,967.70
Long Term Liability		
Mortgage Company	.00	.00
Total Long Term Liability	.00	.00
Total Liabilities	273,345.00	224,552.32
Net Worth	28,505.00	77,297.68
Total Liabilities and Net Worth	\$301,850.00	\$301,850.00
Debt Load in Percentage	90.56	74.39

Table 47. Case Study 4- Balance Sheets for 1981 and 1980

Assets and Liabilities	1981	1980
<b>Assets</b>		
Current Assets		
Cash	\$ 5,000.00	\$ 5,000.00
Feed	3,000.00	3,000.00
Total Current Assets	8,000.00	8,000.00
Intermediate Assets		
Cattle	293,850.00	293,850.00
Machinery	.00	.00
Total Intermediate Assets	293,850.00	293,850.00
Long Term Assets		
Land	.00	.00
Total Long Term Assets	.00	.00
Total Assets	\$301,850.00	\$301,850.00
<b>Liabilities</b>		
Short Term		
Operating Loan Carryforward	\$ 41,115.06	\$ .00
Total Short Term	41,115.06	.00
Intermediate Term		
Cattle Note	145,952.85	162,011.01
Total Intermediate Debt	145,952.85	162,011.01
Long Term Liability		
Mortgage Company	.00	.00
Total Long Term Liability	.00	.00
Total Liabilities	187,067.91	162,011.01
Net Worth	187,067.91	139,838.99
Total Liabilities and Net Worth	\$301,850.00	\$301,850.00
Debt Load in Percentage	61.97	53.67

security. The Chapter 12 plan is filed just after the calves are sold in the fall and the operating lender has received all income from the sale and has just turned down the operating loan for the coming year. The lender's position is as follows:

**Table 48. Case Study 4- Position of the Short Term Lender**

Value of Collateral	Amount of Loan	Secured Value	Unsecured Value
\$293,850.00	\$583,068.55	\$293,850.00	\$289,218.55

It is also assumed in this case study that the longest term cattle loan the bank makes is 10 years and that the best customers receive eight percent interest on these loans.

Scaling down the debt to the secured creditor. The Chapter 12 plan would have to provide an amortized payment of \$43,792.32 to the secured creditor. This is an amortized payment for \$293,850.00 at eight percent, 10 years.

Cash flow of the Chapter 12. Given the above information, a Chapter 12 plan would be as illustrated in Table 49. It is shown that the Chapter 12 plan can provide the present value of the assets to the secured creditor.

Table 49. Case Study 4- Chapter 12 Cash Flow

Cash Flow Items	
Disposable Income	\$53,014.24
Trustees Fee - 5%	2,650.71
Disposable Income Available to Creditors	50,363.53
Payment to Secured Creditor	43,792.32
Residual to Unsecured Creditor	6,571.21

Duration of the bankruptcy and liquidation requirements. The assumption is that this bankruptcy is filed for a three year term. This plan meets the liquidation rule because it provides more to the creditors within the plan than under a liquidation. Again, as before, we assume that either this is a corporation or all personal assets are exempt assets. Therefore, the total nonexempt assets are as follows:

Table 50. Case Study 4- Total Asset Value

Value of Assets	
Cash	\$ 5,000
Feed	5,000
Cattle	293,850
Total Assets	\$301,850

The plan needs to generate more to the creditors than a Chapter 7 liquidation would. Therefore, the plan needs to

provide at least \$301,850.00 through the term of the plan. It provides \$293,850.00 to the secured creditor, and \$6,571.21 annually for three years to the unsecured portion of the debt. This totals \$313,563.63 through the term of the plan. This is greater than the liquidation value of \$301,850.00. This plan provides for the unsecured portion of the debt to be paid at seven percent, or seven cents on the dollar.

Super priority loan for operating funds. At this juncture, the problem is the lack of operating funds for the coming year. A solution would be to find a lender who would lend to the bankruptcy estate within the plan. This lender could be given a super priority status (refer to Chapter 2) within the plan. In fact, the plan would show a \$53,014.24 (the disposable income) positive cash flow to the lender.

Case Study 5 - Increasing Livestock  
Numbers and Implementing a Loan  
Deferral within the Plan

This case study differs in that the creditor is Farmers Home Administration (FmHA) and that 50 percent of the cattle were sold in 1984. The resulting debt carryforward is \$450,000.00; which is comprised of several loans, these loans are amortized over three to 35 years, and have interest rates from five to 10 percent. FmHA has

reviewed all restructuring options available to them but cannot reorganize the debt sufficiently to provide a positive cash flow. Therefore, FmHA has accelerated all loans. In the Chapter 12 plan that is presented it is shown how a cattle herd can be rebuilt to former levels within the plan.

#### Transitional Year Budgeting

It is possible to design a plan for this firm to build the herd under the protection of the court. Herd build-up would be accomplished by implementing a FmHA deferral within the bankruptcy. Such a plan would allow the farm to cover only cash operating expenses for the first four years of the plan. The plan requires transitional year budgeting. Transitional years are necessary to allow for the retention of heifers to build up the herd from 1988 through 1990, then all heifers in 1991 would be sold. By 1992 the firm will have achieved a stocking rate in excess of 100 percent. In 1992, 10 percent of the herd would be culled above and beyond the normal culling rate to delete the cows that are not of average productive capacity. The herd build-up and culling in 1992 would result in a breeding herd of 450 cows. Therefore, the cow herd will be as follows in the transitional years:

Table 51. Case Study 5- Cowherd Numbers from 1988-1992

Year	Number of Head
1988	225
1989	263
1990	330
1991	405
1992	450

In 1992 this farm would reach a physical capacity in cattle numbers.

Development of the Annual Payment  
Plans of the Chapter 12

A Chapter 12 initial analysis to evaluate the position of the creditor would be as follows:

Table 52. Case Study 5- Position of the Creditor

Value of Security	Loan Amount	Secured Value	Unsecured Value
\$163,250.00	\$450,000.00	\$163,250.00	\$286,750.00

The amortized payment for a Chapter 12 would be \$9,969.96. This would be a loan of \$163,250.00 amortized at five percent for 35 years.

Annual plans need to be developed for the term of the bankruptcy. Since it will take five years to reach a physical capacity, the court is petitioned to allow a

five year plan. Additionally, since in 1991 and 1992 the farm can service a substantial debt load (refer to Table 55), the plan provides for a three year deferral of payments. Since FmHA provides loan deferrals in the normal course of business, it is reasonable to request a deferral within Chapter 12. To provide FmHA an incentive to accept the plan, the firm could offer to provide a lien on all cattle that are retained after the filing of the bankruptcy. The equity in the herd build-up should provide "adequate protection" to the secured creditor.

After the transitional years budgets are completed, the disposable income for the years of 1988 through 1992 is as shown in Table 53. It is illustrated in Table 53 that disposable income increases until 1992 when all physical resources are utilized.

**Table 53. Case Study 5- Disposable Income 1988-1992**

Year	Disposable Income
1988	\$ 3,803.24
1989	5,490.85
1990	11,054.27
1991	45,815.01
1992	56,381.27

The annual Chapter 12 plans for this case study are illustrated in Table 54. In Table 54 it is shown how the

disposable income increase through the years is incorporated into the Chapter 12 plan.

**Table 54. Case Study 5- Annual Chapter 12 Cash Flow**

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Chapter 12 Plan - 1988	
Disposable Income	\$3,803.24
Trustee's Fee	190.16
Residual to Unsecured Creditors	3,613.16
Chapter 12 Plan - 1989	
Disposable Income	\$5,490.85
Trustee's Fee	274.54
Residual to Unsecured Creditors	5,216.31
Chapter 12 Plan - 1990	
Disposable Income	\$11,054.27
Trustee's Fee	552.71
Residual to Unsecured Creditors	10,501.56
Chapter 12 Plan - 1991	
Disposable Income	\$45,915.01
Trustee's Fee	2,290.75
Net Income Available	43,524.26
Payment To FmHA	9,969.96
Residual to Unsecured Creditors	33,554.30
Chapter 12 Plan - 1992	
Disposable Income	\$56,381.27
Trustee's Fee	2,819.06
Net Income Available	53,562.21
Payment to FmHA	9,969.96
Residual to Unsecured Creditors	43,592.25

---

Application of the Residual

The plan could provide that all residual is accumulated by the trustee through the term of this plan. This "cushion" will only be used by the firm if there are any natural disasters, unexpected cash costs, etc. At the end of the plan the fund would have accumulated the residuals from five years. The residuals are as follows:

**Table 55. Case Study 5- Disposable Income Residual  
1988-1992**

Year	Residual
1988	\$ 3,613.16
1989	5,216.31
1990	10,501.56
1991	33,554.30
1992	43,592.25
Total	<u>\$96,477.58</u>

FmHA, in agreeing to this plan, would have foregone any interest on the secured portion of their debt for three years. The annual interest at five percent on \$163,250.00 is \$8,162.50.00. Assuming no lost opportunity cost of the compounding of interest, the total foregone interest over three years is \$24,487.50. Therefore, the plan provides that FmHA receive \$24,487.50 at the end of the five years for past interest. The cumulative result of the residual amount is as follows:

**Table 56. Case Study 5- Cumulative Residual  
of the Disposable Income**

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Calculations of the Residual

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Residual at the end of Five Years	\$96,477.58
Past Interest Compensation	24,487.50
Payments to Unsecured Portion of the FmHA Debt	\$71,990.08

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Meeting the Liquidation Rule

The value of the assets at the beginning of the bankruptcy is \$5,000.00 in cash, \$3,000.00 in feed and \$163,250.00 in livestock. Therefore, there has to be provided in the plan at least \$171,250.00. Since the plan provides for \$163,250.00 secured value plus \$71,990.08 going to the unsecured portion of the debt, this plan meets the liquidation rule.

Summary

Given that the secured creditor or creditors are willing to negotiate, and that all disposable income is devoted to the plan, it is reasonable to assume that a Chapter 12 plan to rebuild the herd can be confirmed. In fact, if this plan did not have a positive cash flow from 1988 through 1990, it is feasible to provide a super priority loan status to a creditor, with a lien on the increase of the herd, to provide sufficient funding to

result in a confirmed Chapter 12 plan. Then, within the plan, the resulting debt could be amortized and paid annually.

## CHAPTER 6

### SUMMARY AND CONCLUSIONS

Chapter 12 Bankruptcy, The Family Farm Bankruptcy Act of 1986, was passed to partially alleviate the financial pressures that highly leveraged farms were receiving from their creditors. In Chapter 2 of this study the history of bankruptcy and the inability of Chapter 11 and Chapter 13 of the Bankruptcy Code to efficiently handle a farm reorganization were discussed. Additionally, the major requirements for farmer reorganization under a Chapter 12 bankruptcy were defined.

In Chapter 3, a method for determining disposable income before and after debt service was discussed. If disposable income after debt service was negative, then a workout analysis should have been implemented. If there were no palatable options for management besides bankruptcy, an analysis of a Chapter 12 bankruptcy would have been prepared.

In Chapter 4 a case study was presented that illustrated the effects of the cost price squeeze, drought and grasshoppers which led to debt accumulation. Then the detrimental effect of debt accumulation combined with

declining land value on the credit worthiness of the farm was shown.

In Chapter 5 there were five case study examples of a Chapter 12 bankruptcy presented. The first Chapter 12 plan presented was the culmination of all the assumptions presented in Chapter 4. This example was a non-confirmable Chapter 12 plan since the farm was unable to generate sufficient cash flow to pay the secured creditors the present value of the assets of the estate. Phrased differently, this farm could not generate sufficient net income to service a 60 percent debt load. In this case study, all creditors were secure. Therefore, both the long term creditor and short term creditor have to be paid the present value of their loans so the debt could not be reduced. From the debtor's viewpoint, this case study was very interesting, even though the debtor had equity and would like to continue farming, that was not an option. If the debtor continued farming, the equity would probably be negated within three years. It is appropriate to point out that Chapter 12 would not alleviate the firm's primary problem; a 60 percent debt load. Given projected disposable income, the firm can feasibly service a 30 percent debt load. Even though some interest rate concessions can be gained and sometimes more agreeable terms obtained, Chapter 12 does not substantially change

the ability of the firm to service debt, except in special instances. The special instances were then detailed in 4 case studies.

The second case study presented utilized all of the assumptions presented in the non-confirmable Chapter 12 plan with one exception. The exception was that the owners of the agricultural corporation owned assets outside the corporation and were willing to devote part of the net income from the outside assets to the plan. Thus, the cash flow requirements of the Chapter 12 were met.

The third case study also utilizes all the assumptions presented in the nonconfirmable Chapter 12 plan with one exception. The exception in this case was that all of the debt was to Farmers Home Administration. All the debt was re-amortized at five percent over 30 years. The lower interest rate reduced the annual debt service sufficiently to project a positive cash flow. Thus, a confirmable Chapter 12 plan was possible.

The fourth case study deviated substantially from the previous case studies. The production enterprises were assumed to be more efficient, which resulted in a higher gross income. Secondly, this case study assumed that land and machinery were leased, rather than being owned assets. The leased assets resulted in a large unsecured debt accumulation. This case study illustrated the "debt write

down" capability of Chapter 12. The result was a confirmable plan.

In the fifth case study a specific scenario to rebuild a cattle herd within the Chapter 12 was presented. This case study was included to illustrate that annual scenarios can be generated with either an increasing or decreasing payment to creditors.

In this thesis, information on the applicability of Chapter 12 in specific instances, was provided. It was illustrated that Chapter 12 does address the issue of debt accumulation, but does not substantially change the inability of southeastern Montana farms to service a debt load in excess of 30 to 40 percent. It was shown that in specific instances, Chapter 12 bankruptcy can be utilized to reorganize farms.

#### Areas of Concern and Further Research

There was no discussion in this study about farm survival after a Chapter 12 plan had been confirmed and successfully completed. Even though farm survival was not directly discussed there are some conclusions that can be drawn. If a Chapter 12 plan is successfully completed, but the ending result is that the farm has a debt load in excess of 40 percent, and an average interest rate of more than eight percent, the farm will likely incur cash flow

problems again. The socioeconomic costs of confirming these plans, as compared to denying the confirmation, should be examined.

A subject that is worthy of research is the expected effect of Chapter 12 on the availability of agricultural credit. If Chapter 12 does reduce the availability of credit and subsequently increases the average interest rate for farm borrowers, does this in turn increase the number of farm bankruptcies?

It was beyond the scope of this study to research the applicable bankruptcy interest rates for different classes of creditors. Additional research is needed to determine the appropriate interest rates to provide the present value of the assets to the secured creditors.

Finally, an area of research for the legislative system is the codebtor stay for consumer debts in Chapter 12. If the bankruptcy is providing the present value of the assets to the creditors, should the creditors be allowed to collect from a codebtor? If the codebtor stay is not expanded to include business debt, does this then encourage joint bankruptcies to include all codebtors?

**REFERENCES**

## REFERENCES

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**APPENDIX**

**Bankruptcy Reform Act of 1978, Chapter 12**

Bankruptcy Reform Act of 1978, Chapter 12

(as amended by the Bankruptcy Amendments and Federal Judgeship Act of 1984 and by the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986)

CHAPTER 12

Adjustments of Debts of a Family Farmer  
With Regular Annual Income

SUBCHAPTER 1

Officers, Administration, and the Estate

Sec. 1201. Stay of action against codebtor

(a) Except as provided in subsections (b) and (c) of this section, after the order for relief under this chapter, a creditor may not act, or commence or continue any civil action, to collect all or any part of a consumer debt of the debtor from any individual that is liable on such debt with the debtor, or that secured such debt, unless-

(1) such individual became liable on or secured such debt in the ordinary course of such individual's business;  
or

(2) the case is closed, dismissed, or converted to a case under chapter 7 of this title.

(b) A creditor may present a negotiable instrument, and may give notice of dishonor of such an instrument.

(c) On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided by subsection (a) of this section with respect to a creditor, to the extent that-

(1) as between the debtor and the individual protected under subsection (a) of this section, such individual received the consideration for the claim held by such creditor;

(2) the plan filed by the debtor proposes not to pay such claim or

(3) such creditor's interest would be irreparably harmed by continuation of such stay.

(d) Twenty days after the filing of a request under subsection (c)(2) of this section for relief from the stay provided by subsection (a) of this section, such stay is terminated with respect to the party in interest making such request, unless the debtor or any individual that is liable on such debt with the debtor files and serves upon such party in interest a written objection to the taking of proposed action.

Sec. 1202. Trustee

(a) if the United States trustee has appointed an individual under section 586 (b) of title 28 to serve as standing trustee in cases under this chapter and if such individual qualifies as a trustee under section 322 of this title, then such individual shall serve as trustee in any case filed under this chapter. Otherwise, the United States trustee shall appoint one disinterested person to serve as trustee in the case or the United States trustee may serve as trustee in the case if necessary.

(b) the trustee shall-

(1) perform the duties specified in section 704 (2), 704 (3), 704(5), 704 (6), 704 (7) and 704 (9) of this title;

(2) perform the duties specified in section 1106 (a)(3) and 1106 (a)(4) of this title if the court, for cause and on request of a party in interest, the trustee, or the United States trustee, so orders;

(3) appear and be heard at any hearing that concerns-

- (A) the value of property subject to a lien;
- (B) confirmation of a plan;
- (C) modification of the plan after confirmation;
- or
- (D) the sale of the property of the estate;

(4) ensure that the debtor commences making timely payments required by a confirmed plan; and

(5) if the debtor ceases to be a debtor in possession, perform the duties specified in sections 704(8), 1106(a)(2), 1106(a)(6), 1106(a)(7), and 1203.

(c) If the number of cases under this chapter commenced in a particular judicial district so warrants, the court may appoint one or more individuals to serve as standing trustee for such district in cases under this chapter.

(d)(1) A court that has appointed an individual under subsection (a) of this section to serve as standing trustee in cases under this chapter shall set for such individual-

(A) a maximum annual compensation not to exceed the lowest annual rate of basic pay in effect for grade GS-16 of the General Schedule prescribed under section 5332 of title 5; and

(B) a percentage fee not to exceed the sum of-

(i) not to exceed ten percent of the payments made under the plan of such debtor, with respect to payments in an aggregate amount not to exceed \$450,000; and

(ii) three percent of payments made under the plan of such debtor, with respect to payments made after the aggregate amount of payments made under the

plan exceeds \$450,000; based on such maximum annual compensation and the actual, necessary expenses incurred by such individual as standing trustee.

2. Such individual shall collect such percentage fee from all payments under plans in the cases under this chapter for which such individual serves as standing trustee. Such individual shall pay annually to the Treasury-

(A) Any amount by which the actual compensation received by such individual exceeds five percent of all such payments made under plans in cases under this chapter for which such individual serves as standing trustee; and

(B) any amounts by which the percentage fee fixed under paragraph (1)(B) of this subsection for all such cases exceeds-

(i) such individual's actual compensation for such cases, as adjusted under subparagraph (A) of this paragraph; plus

(ii) the actual, necessary expenses incurred by such individual as standing trustee in such cases.

#### Sec. 1203. Rights and powers of debtor

Subject to such limitations as the court may prescribe, a debtor in possession shall have all the

rights, other than the right to compensation under section 330, and powers, and shall perform all the functions and duties, except the duties specified in paragraphs (3) and (4) of section 1106(a), of a trustee serving in a case under Chapter 11, including operating the debtor's farm.

Sec. 1204. Removal of debtor as debtor in possession.

(a) On request of a party in interest, and after notice and a hearing, the court shall order that the debtor shall not be a debtor in possession for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor, either before or after the commencement of the case.

(b) On request of a party in interest, and after notice and a hearing the court may reinstate the debtor in possession.

Sec. 1205. Adequate protection

(a) Section 361 does not apply in a case under this chapter.

(b) In a case under this chapter, when adequate protection is required under section 362, 363, or 364 of this title of an interest of an entity in property, such adequate protection may be provided by-

1. requiring the trustee to make a cash payment or periodic cash payments to such entity, to the extent

that the stay under section 362 of this title, use, sale, or lease under section 363 of this title, or any grant of a lien under section 364 of this title results in a decrease in the value of property serving a claim or of an entity's ownership interest in property;

2. providing to such entity an additional or replacement lien to the extent that such stay, use, sale, lease, or grant results in a decrease in the value of property securing a claim or of an entity's ownership interest in property;

3. paying to such entity for the use of farmland the reasonable rent customary in the community where the property is located, based upon the rental value, net income, and earning capacity of the property; or

4. granting such other relief, other than entitling such entity to compensation allowable under section 503(b)(1) of this title as an administrative expense, as will adequately protect the value of property securing a claim or of such entity's ownership interest in property.

Sec. 1206. Sales free of interests

After notice and a hearing, in addition to the authorization contained in section 363(f), the trustee in a case under this chapter may sell property under section

363(b) and (c) free and clear of any interest in such property of an entity other than the estate if the property is farmland or farm equipment, except that the proceeds of such sale be subject to such interest.

Sec. 1207. Property of the estate

(a) Property of the estate includes, in addition to the property specified in section 541 of this title-

1. all property of the kind specified in such section that the debtor acquires after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7 of this title, whichever occurs first; and

2. earning from services performed by the debtor after the commencement of the case but before the case is closed, dismissed, or converted to a case under Chapter 7 of this title, whichever occurs first.

(b) Except as provided in section 1204, a confirmed plan, or an order confirming a plan, the debtor shall remain in possession of all property of the estate.

Sec. 1208. Conversion or dismissal

(a) The debtor may convert a case under this chapter to a case under chapter 7 of this title at any time. Any waiver of the rights to convert under this subsection is unenforceable.

(b) On request of the debtor at any time, if the case

has not been converted under section 706 or 1112 of this title, the court shall dismiss a case under this chapter. Any waiver of the rights to dismiss under this subsection is unenforceable.

(c) On request of a party in interest, and after notice and a hearing, the court may dismiss a case under this chapter for cause, including-

1. unreasonable delay, or gross mismanagement, by the debtor that is prejudicial to creditors;

2. nonpayment of any fees and charges required under chapter 123 of title 28;

3. failure to file a plan timely under section 1221 of this title;

4. failure to commence making timely payments required by a confirmed plan;

5. denial of confirmation of a plan under section 1225 of this title and denial of a request made for additional time for filing another plan or a modification of a plan;

6. material default by the debtor with respect to a term of a confirmed plan;

7. revocation of the order of confirmation under section 1230 of this title, and denial of confirmation of a modified plan under section 1229 of this title;

8. termination of a confirmed plan by reason of the occurrence of a condition specified in the plan; or

9. continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation.

(d) On request of a party in interest, and after notice and a hearing, the court may dismiss a case under this chapter or convert a case under this chapter to a case under Chapter 7 of this title upon a showing that the debtor has committed fraud in connection with the case.

(e) Notwithstanding any other provision of this section, a case may not be converted to a case under another chapter of this title unless the debtor may be a debtor under such chapter.

#### SUBCHAPTER 11 THE PLAN

##### Sec. 1221. Filing of plan

The debtor shall file a plan not later than 90 days after the order for relief under this chapter, except that the court may extend such period if an extension is substantially justified.

Sec. 1222. Contents of plan

(a) The plan shall-

1. provide for the submission of all or such portion of future earnings or other future income of the debtor to the supervision and control of the trustee as is necessary for the execution of the plan;

2. provide for the full payment, in deferred cash payments, of all claims entitled to priority under section 507 of this title, unless the holder of a particular claim agrees to a different treatment of such claim; and

3. if the plan classifies claims and interests, provide the same treatment for each claim or interest within a particular class unless the holder of a particular claim or interest agrees to less favorable treatment.

(b) Subject to subsections (a) and (c) of this section, the plan may-

1. designate a class or classes of unsecured claims, as provided in section 1122 of this title, but may not discriminate unfairly against any class so designated; however, such plan may treat claims for a consumer debt of the debtor if an individual is liable on such consumer debts with the debtor differently than other unsecured claims;

2. modify the rights of holders of secured claims, or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims;

3. provide for the curing or waiving of any default;

4. provide for payment on any unsecured claim to be made concurrently with payment on any secured claim or any other unsecured claim;

5. provide for the curing of any default within a reasonable time and maintenance of payments while the case is pending on any unsecured claim or secured claim on which the last payment is due after the date on which the final payment under the plan is due;

6. subject to section 365 of this title, provide for the assumption, rejection, or assignment of any executory contract unexpired lease of the debtor not previously rejected under such section;

7. provide for the payment of all or part of a claim against the debtor from property of the estate or property of the debtor;

8. provide for the sale of all or any part of the property of the estate or the distribution of all or any part of the property of the estate among those having an interest in such property;

9. provide for payment of allowed secured claims consistent with section 1225(a)(5) of this title, over a period exceeding the period permitted under section 1222(c);

10. provide for the vesting of property of the estate, on confirmation of the plan or at a later time, in the debtor or in any other entity; and

11. include any other appropriate provision not inconsistent with this title.

(c) Except as provided in subsections (b)(5) and (b)(9), the plan may not provide for payments over a period that is longer than three years unless the court for the case approves a longer period, but the court may not approve a period that is longer than five years.

**Sec. 1223. Modification of plan before confirmation**

(a) The debtor may modify the plan at any time before confirmation, but may not modify the plan so that the plan as modified fails to meet the requirements of section 1222 of this title.

(b) After the debtor files a modification under this section, the plan as modified becomes the plan.

(c) Any holder of a secured claim that has accepted or rejected the plan is deemed to have accepted or rejected, as the case may be, the plan as modified, unless the modification provides for a change in the rights of such holder from what such rights were under the plan

before modification, and such holder charges such holder's previous acceptance or rejection.

Sec. 1224. Confirmation hearing

After expedited notice, the court shall hold a hearing on confirmation of the plan. A party in interest, the trustee, or the United States trustee may object to the confirmation of the plan. Except for cause, the hearing shall be concluded not later than 45 days after the filing of the plan.

Sec. 1225. Confirmation of plan

(a) Except as provided in subsection (b), the court shall confirm a plan if-

1. the plan complies with the provisions of this chapter and with the other applicable provisions of this title;

2. any fee, charge, or amount required under chapter 123 of title 28, or by the plan, to be paid before confirmation, has been paid;

3. the plan has been proposed in good faith and not by any means forbidden by law;

4. the value, as of the effective date of the plan, of property to be distributed under the plan on account of each allowed unsecured claim is not less than the amount that would be paid on such claim if the estate

of the debtor were liquidated under chapter 7 of this title on such date;

5. with respect to each allowed secured claim provided for by the plan-

(A) the holder of such claim has accepted the plan;

(B)(i) the plan provides that the holder of such claim retain the lien securing such claim; and

(ii) the value, as of the effective date of the plan, of property to be distributed by the trustee or the debtor under the plan on account of such claim is not less than the allowed amount of such claim; or

(C) the debtor surrenders the property securing such claim to such holder; and

6. the debtor will be able to make all payments under the plan and to comply with the plan.

(b)(1) If the trustee or the holder of an allowed unsecured claim objects to the confirmation of the plan, then the court may not approve the plan unless, as of the effective date of the plan-

(A) the value of the property to be distributed under the plan on account of such claim is not less than the amount of such claim; or

(B) the plan provides that all of the debtor's projected disposable income to be received in the

three year period, or such longer period as the court may approve under section 1222(c), beginning on the date that the first payment is due under the plan will be applied to make payments under the plan.

2. For purpose of this subsection, "disposable income" means income which is received by the debtor and which is not reasonably necessary to be expended-

(A) for the maintenance or support of the debtor or a dependent of the debtor; or

(B) for the payment of expenditures necessary for the continuation, preservation, and operation of the debtor's business.

(C) After confirmation of a plan, the court may order any entity from whom the debtor receives income to pay all or any part of such income to the trustee.

#### Sec. 1226. Payments

(a) Payments and funds received by the trustee shall be retained by the trustee until confirmation or denial of confirmation of a plan. If a plan is confirmed, the trustee shall distribute any such payment in accordance with the plan. If a plan is not confirmed, the trustee shall return any such payments to the debtor, after deducting-

1. any unpaid claim allowed under section 503(b) of this title; and

2. if a standing trustee is serving in the case, the percentage fee fixed for such standing trustee.

(b) Before or at the time of each payment to creditors under the plan, there shall be paid-

1. any unpaid claim of the kind specified in section 507(a)(1) of this title; and

2. if a standing trustee appointed under section 1202(d) of this title is serving in the case, the percentage fee fixed for such standing trustee under section 1202(e) of this title.

(c) Except as otherwise provided in the plan or in the order confirming the plan, the trustee shall make payments to creditors under the plan.

Sec. 1227. Effect of confirmation

(a) Except as provided in section 1228(a) of this title, the provisions of a confirmed plan bind the debtor, each creditor, each equity security holder, and each general partner in the debtor, whether or not the claim of such creditor, such equity security holder, or such general partner in the debtor is provided for by the plan, and whether or not such creditor, such equity security holder, or such general partner in the debtor has objected to, has accepted, or has rejected the plan.

(b) Except as otherwise provided in the plan or the order confirming the plan, the confirmation of a plan vests all of the property of the estate in the debtor.

(c) Except as provided in section 1228(a) of this title and except as otherwise provided in the plan or in the order confirming the plan, the property vesting in the debtor under subsection (b) of this section is free and clear of any claim or interest of any creditor provided for by the plan.

Sec. 1228. Discharge

(a) As soon as practicable after completion by the debtor of all payments under the plan, other than payments to holders of allowed claims provided for under section 1222(b) (5) or 1222(b)(10) of this title, unless the court approves a written waiver of discharge executed by the debtor after the order for relief under this chapter, the court shall grant the debtor a discharge of all debts provided for by the plan allowed under section 503 of this title or disallowed under section 502 of this title, except any debt-

1. provided for under section 1222(b)(5) or 1222(b)(10) of this title; or

2. of the kind specified in section 523(a) of this title.

(b) at any time after the confirmation of the plan and after notice and a hearing, the court may grant a discharge to a debtor that has not completed payments under the plan only if-

1. the debtor's failure to complete such payment is due to circumstances for which the debtor should not justly be held accountable.

2. the value, as of the effective date of the plan, of property actually distributed under the plan account of each unsecured claim is not less than the amount that would have been paid on such claim if the estate of the debtor had been liquidated under Chapter 7 of this title on such date; and

3. modification of the plan under section 1229 of this title is not practicable.

(c) A discharge granted under subsection (b) of this section discharges the debtor from all unsecured debts provided for by the plan or disallowed under section 502 of this title, except any debt-

1. provided for under section 1222(b)(5) or 1222(b)(10) of this title; or

2. of a kind specified in section 523(a) of this title.

(d) On request of a party in interest before one year after a discharge under this section is granted, and after

notice and a hearing, the court may revoke such discharge only if-

1. such discharge was obtained by the debtor through fraud; and

2. the requesting party did not know of such fraud until after such discharge was granted.

(e) After the debtor is granted a discharge, the court shall terminate the services of any trustee serving in the case.

**Sec. 1229. Modification of plan after confirmation**

(a) At any time after confirmation of the plan but before the completion of payments under such plan, the plan may be modified, on request of the debtor, the trustee, or the holder of an allowed unsecured claim, to-

1. increase or reduce the amount of payments on claims of a particular class provided for by the plan;

2. extend or reduce the time for such payments;

or

3. after the amount of distribution to a creditor whose claim is provided for by the plan to the extent necessary to take account of any payment of such claim other than under the plan.

(b)(1) Sections 1222(a), 1222(b), and 1223(c) of this title and the requirements of section 125(a) of this title

apply to any modification under subsection (a) of this section.

(2) the plan as modified becomes the plan unless, after notice and a hearing, such modification is disapproved.

(c) A plan modified under this section may not provide for payments over a period that expires after three years after the time that the first payment under the original confirmed plan was due, unless the court, for cause, approves a longer period, but the court may not approve a period that expires after five years after such time.

Sec. 1230. Revocation of an order of confirmation

(a) On request of a party in interest at any time within 180 days after the date of the entry of an order of confirmation under section 1225 of this title, and after notice and a hearing, the court may revoke such order if such order was procured by fraud.

(b) If the court revokes an order of confirmation under subsection (a) of this section, the court shall dispose of the case under section 1207 of this title, unless, within the time fixed by the court, the debtor proposes and the court confirms a modification of the plan under section 1229 of this title.

Sec. 1231. Special tax provisions

(a) For the purpose of any State or local law imposing a tax on or measured by income, the taxable period of a debtor that is an individual shall terminate on the date of the order for relief under this chapter, unless the case was converted under section 706 of this title.

(b) The trustee shall make a State or local tax return of income for the estate of an individual debtor in a case under this chapter for each taxable period after the order for relief under this chapter during which the case is pending.

(c) The issuance, transfer, or exchange of a security, or the making or delivery of an instrument of transfer under a plan confirmed under section 1225 of this title, may not be taxed under any law imposing a stamp tax or similar tax.

(d) The court may authorize the proponent of a plan to request a determination, limited to questions of law, by a State or local governmental unit charged with responsibility for collection or determination of a tax on or measured by income, of the tax effects, under section 346 of this title and under the law imposing such tax, of the plan. In the event of an actual controversy, the court may declare such effects after the earlier of-

1. the date on which such governmental unit responds to the request under this subsection; or

2. 270 days after such request.