farmers' legal action
report

Focus Report
June 2006

Chapter 12 Bankruptcy Reform: Correcting The Disposable Income Problem

by Karen R. Krub and Susan A. Schneider*

Inside

Visit us on the Web:
www.flaginc.org

FLAG

FARMERS' LEGAL ACTION GROUP, INCORPORATED

As discussed in *Farmers' Legal Action Report 2005-2*, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 became law on April 20, 2005, and most of its provisions became effective on October 17, 2005. This 2005 Bankruptcy Act made a number of important changes to Chapter 12 of the Bankruptcy Code, the reorganization bankruptcy designed for family farmers.

The article in *FLAR 2005-2* provided an overview of both Chapter 12 generally and the changes made to Chapter 12 by the 2005 Bankruptcy Act. This report provides a more in-depth discussion of one specific change made by the new law: the prohibition on retroactive assessment of disposable income in a Chapter 12 reorganization.

This report first presents the history and statutory framework of the original disposable income requirement in Chapter 12. It then explains how the courts misinterpreted this requirement in two key respects: first, by requiring a review of all of the farmer's *actual* income and expenses during the reorganization period; and, second, by computing disposable income to include key farm assets necessary for the continuation of the farming operation. These interpretations placed significant and sometimes insurmountable burdens on family farm reorganizations. This report then presents the new provisions contained in the 2005 Bankruptcy Act and explains how they correct the disposable income problem in Chapter 12 and enhance the likelihood of successful family farm restructuring.

> The 2005 Bankruptcy Act prohibits retroactive assessment of actual disposable income in a Chapter 12 reorganization. It also prohibits certain post-confirmation plan modifications that would unduly burden debtors. These provisions took effect on October 17, 2005.

Introduction

The 2005 Bankruptcy Act's prohibition on retroactive assessment of disposable income has not been widely reported, nor does it appear to have been the subject of significant congressional debate. Yet it is a significant change that promises to increase the likelihood of successful family farm reorganizations throughout the country.

Debtors should be very careful not to incorporate plan terms that remove the protections provided by the 2005 Bankruptcy Act. It is especially important for farmers and their attorneys preparing a Chapter 12 plan to understand that they need not, and in most cases should not, include a plan provision that promises to pay *actual* disposable income over the plan period. Some standing Chapter 12 trustees made a practice of strongly encouraging such agreements under the prior court interpretations, and it is expected that many will continue to encourage such provisions under the new law. Because the confirmed plan governs the rights of the parties, the inclusion of such a plan provision would make the debtor liable for actual disposable income payments regardless of the interpretation of the statutory requirement.

Chapter 12 Was Created to Address Special Circumstances of Family Farmers

Following on the heels of an agricultural boom in the 1970s, farmers in the 1980s saw their net worth decline by more than half as land values, machinery values, and crop prices all declined dramatically. Economic forces outside of the agricultural sector caused a similarly dramatic rise in credit costs as interest rates soared. Farmers with adjustable rate mortgages soon found themselves unable to meet interest payments.

During this financial crisis, which affected farmers throughout the country, Congress recognized that most family farmers in financial distress have too much debt to be eligible for Chapter 13 bankruptcy and that Chapter 11 bankruptcy is often too complicated, expensive, and unworkable. Congress responded by enacting Chapter 12, the Adjustment of Debts of a Family Farmer With Regular Annual Income, to provide a quick and predictable process for reorganizing the debt obligations of family farmers. This law, Public Law Number 99-554, was made a part of the Bankruptcy Code at 11 U.S.C. §§ 1201-1231.

This new bankruptcy chapter limited its eligibility to "family farmer[s] with regular annual income."Family farmers were restrictively defined according to the amount of their farm income, the amount of their farm debt, and their maximum overall debt. It was a powerful new chapter of the Bankruptcy Code designed for a narrow category of debtors.

Modeled after Chapter 13, the reorganization bankruptcy for wage-earners, Chapter 12 provided family farmers an opportunity to restructure their debts while retaining their farm property. Congress used Chapter 13 as the model for Chapter 12 because it realized that the basic framework for Chapter 11 reorganization does not provide a viable alternative for family farm debtors.

Aside from its complexity, the Chapter 11 process includes many provisions that creditors can use to block a debtor's plan from being confirmed. Most relevant for the purposes of this discussion is the "absolute priority rule" under Chapter 11. This rule requires a debtor to pay all unsecured claimholders in full if the debtor wants to retain an ownership interest in any property. Because of this rule, in most cases, if a farmer uses a Chapter 11 bankruptcy, the farmer would not be able to keep the farm unless he or she could pay unsecured claimholders 100 percent of their claims.

In contrast, under Chapter 12, creditors can object to confirmation of a reorganization plan proposed by the debtor, but they cannot vote down the debtor's plan. If the debtor's proposed plan meets specific plan confirmation requirements, the Bankruptcy Code requires that the court "shall confirm" the debtor's plan. Congress also replaced Chapter 11's "absolute priority rule" for unsecured claims with the "disposable income requirement" in Chapter 12, as was already the case for Chapter 13.

The Original Disposable Income Requirement

The disposable income requirement in effect before the 2005 Bankruptcy Act amendments provided that the court could not approve a debtor's Chapter 12 plan over a creditor's objection unless

> (1) the plan provided that unsecured claimholders would be paid at least the value of their claims,
>
> or
>
> (2) the plan provided that all of the debtor's projected disposable income to be received during the plan period would be applied to make payments under the plan.

In either a Chapter 12 or Chapter 13 reorganization, it is unlikely that a debtor will be able to meet the first alternative in the disposable income requirement, that is, to provide the unsecured claimholders with value equal to the amount of their claims. Most debtors in bankruptcy are not financially able to pay 100 percent of their unsecured debt, even if they were to pay over an extended period of time. Therefore, in almost all cases, if the trustee or any unsecured claimholder objects to a Chapter 12 or Chapter 13 plan, the debtor's plan must include a provision that commits all "projected disposable income" that will be earned over the term of the plan toward the payment of unsecured claims.

"Disposable income" is defined for purposes of Chapter 12 as income that is received by the debtor and is not reasonably necessary to be spent for the support of the debtor and the debtor's dependents or for expenditures necessary for the continuation, preservation, and operation of the debtor's business.

Farmers' Legal Action Report is published four times each year and is supplemented with special Focus Reports that provide in-depth analyses of special topics affecting agriculture as they arise. As always, we appreciate your support and suggestions.

Attorney Editor
Karen R. Krub

Production Editor
Debby Juarez

Copy Editor
Rita Gorman Capes

Executive Director
Susan E. Stokes

Staff Attorneys
Lynn A. Hayes
Stephen Carpenter
Karen R. Krub
Jill E. Krueger
Jess Anna Speier
Jessica A. Shoemaker

Farmers' Legal Action Group, Inc. (FLAG) is a nonprofit law center that provides legal assistance, education, training, and technical support to financially distressed family farmers and their attorneys and advocates throughout the country. The information contained here should not be construed as legal advice, and readers are encouraged to consult with an attorney for specific legal assistance.

Farmers' Legal
Action Group, Inc.
360 N. Robert St., Ste. 500
St. Paul, MN 55101
Phone: 651-223-5400
Fax: 651-223-5335
Email: lawyers@flaginc.org
Web site: www.flaginc.org

© Copyright 2006, Farmers' Legal Action Group, Inc. No portion of this newsletter may be reproduced without written permission.

ISSN 1074-8075

The disposable income requirement raises a number of significant questions for interpretation. The most obvious questions involve the definition of disposable income, including what expenses are considered "reasonably necessary" and what expenditures are considered "necessary for the continuation, preservation, and operation of the debtor's business." At the time Chapter 12 was enacted, the congressional Conference Report provided only the instruction that farmers could include expenses associated with minor non-farm businesses in their deductions from disposable income. The Conference Report's silence on other details affecting disposable income suggests that the conference committee believed the statutory language was otherwise clear.

Modification of the Plan Is Possible to Increase or Decrease Payments If Justified

There is always a risk that the debtor's projected disposable income will be inaccurate. In some cases, the projected income is too low, and creditors would receive less than the debtor is truly able to pay; in other cases, the projected income is too high, and the debtor is obligated to pay more than is actually available. To address this risk of error in projecting the debtor's disposable income, both Chapter 12 and Chapter 13 include a provision that allows for modification of the terms of the plan to increase or reduce plan payments, extend or reduce the time for such payments, or alter the distribution to a creditor if there is a "substantial change in [the debtor's] ability to pay." A modification of the plan terms may be requested by the debtor, the trustee, or any unsecured claimholder.

A review of this provision reveals its particular applicability to changes in disposable income. Among Chapter 12 creditors, only unsecured claimholders are afforded the right to request modification. As such, modification provides an opportunity to protect unsecured claimholders' rights. Thus, the modification provision seems particularly aimed at allowing an unsecured claimholder to seek modification of a debtor's disposable income payments under the plan to prevent the debtor from gaining a windfall from substantially higher-than-projected income. And it must be emphasized that this modification is to be sought during the plan term, not at the discharge hearing. If the disposable income requirement is interpreted to require actual rather than projected income, there would be no purpose for a modification provision.

> Payments required under a Chapter 12 reorganization plan may be modified if there is a substantial change in the debtor's ability to pay. Either the debtor, the trustee, or an unsecured claimholder can request a modification. It appears that most creditors and courts have ignored the modification process set out in Chapter 12.

Contrasting Judicial Interpretations of the Disposable Income Test

Despite the nearly identical language for the disposable income test in Chapter 12 and Chapter 13, federal appeals courts adopted conflicting interpretations of that test for reorganizations in Chapter 12 as opposed to Chapter 13. Decisions in Chapter 13 cases followed the literal language of the statutory provision and treated the disposable income inquiry as solely an issue at the time of plan confirmation. However, courts read the disposable income test to be much more burdensome for Chapter 12 debtors, requiring Chapter 12 debtors to show at the end of the plan period that all actual disposable income was paid to creditors.

These radically different interpretations of identical statutory language were very troubling for Chapter 12 debtors and set the stage for further congressional action.

> Courts interpreted the original disposable income test very differently for Chapter 12 than for Chapter 13, despite nearly identical statutory language.

The Disposable Income Test in Chapter 13 – A Reasonable Interpretation of the Test and Modification Provision

To understand how courts were misinterpreting the disposable income test for Chapter 12 debtors before the enactment of the 2005 Bankruptcy Act, it is helpful to understand the proper interpretation that courts were using in Chapter 13 cases. In Chapter 13 cases, the federal courts show general adherence to the principle that the court determines the debtor's projected disposable income at the time of plan confirmation. This determination is based on evidence of income and expenses provided by the debtor to the satisfaction of the court. In most cases, debtors establish current income and expenses, and then these values are multiplied over the three-year plan term. The court then determines what portion of that income is "disposable" under the statutory definition.

Obviously, this process is easiest to apply in cases where the debtor's monthly pre-bankruptcy income has been stable; but fluctuations in income have not deterred Chapter 13 courts from evaluating plan projections for statutory compliance. Courts have used income averaging for the prior three years to project future income when there was significant annual income fluctuation. Wide variations in income for self-employed debtors have been averaged in order to achieve a reasonable projection.

Rather than seek higher income projections at the confirmation hearing, Chapter 12 creditors are more likely to argue that the debtor's income will be too low to carry out the plan.

Regardless of the reason for the challenge, under the interpretation used in Chapter 13 cases, any objection to a Chapter 13 plan's projection of the debtor's disposable income must be raised at the plan confirmation hearing. The possibility that the projections made at the time of plan confirmation might be wrong is addressed, as discussed above, by the statutory provision allowing for post-confirmation plan modification if, after confirmation of the plan, the debtor, trustee, or unsecured claimholder believes that the plan must be modified to, among other things, increase or decrease the payments under the plan.

The case of *In re Anderson* demonstrates how courts interpreted these provisions in most Chapter 13 cases. *Anderson v. Satterlee (In re Anderson)*, 21 F.3d 355 (9th Cir. 1994). In that case, the trustee was trying to require the debtors to sign a "Best Efforts Certification" before the Chapter 13 plan could be confirmed. This certification would have acted as an automatic modification provision in the plan. That is, the debtors would have been bound to pay whatever their actual disposable income might turn out to be, not just the amount projected in the plan. When the debtors refused to sign the certification, the trustee objected to confirmation of their plan. The debtors maintained that their plan included an accurate projection of their disposable income and that the court should have confirmed their plan on that basis. The Ninth Circuit Court of Appeals agreed with the debtors.

The Ninth Circuit found the statutory language to be "clear" in requiring only an examination of the debtors' projected disposable income, not actual calculation of disposable income during the plan. The court noted that to "project" means "to plan, figure or estimate for the future" and held that the debtors' plan need only provide for a reasonable projection of disposable income and a promise to pay that amount.

As to the trustee's insistence that the debtors adjust their projections in the event that their projected income differed from their actual income, the court stated that "the Trustee's efforts to force the [debtors] to agree to a periodic adjustment of their payments without a court order is inconsistent with the procedures established for modifying a debtor's plan." The court held that the proper approach is for the trustee to seek modification of the plan if it believes adjustments are justified.

Thus, in the context of Chapter 13, the disposable income test has been interpreted to allow the parties to litigate the validity of the debtor's projections at the time of plan confirmation or as part of a plan modification when projections prove inaccurate. The courts have rejected any extra-statutory obligation on debtors to establish their actual income at the end of the plan period and pay creditors an excess over the plan projections.

The Disposable Income Test in Chapter 12 – Courts Are Unduly Solicitous of Creditors' Conflicting Interests

In contrast to the interpretation of the disposable income test in Chapter 13 cases, the case law for Chapter 12 before the enactment of the 2005 Bankruptcy Act generally imposed an extra-statutory requirement that, in order to receive a discharge, a Chapter 12 debtor must defend the payment of all actual disposable income over the term of the plan, even if the debtor had paid all amounts that were projected for disposable income at the time of confirmation and that were provided for in the confirmed plan.

The origins of the misinterpretation of the disposable income test in Chapter 12 cases can most likely be traced to Chapter 12 creditors' reluctance to challenge low disposable income projections at the time of plan confirmation. Published court decisions suggest that secured creditors and unsecured claimholders rarely challenge Chapter 12 debtors' computations of projected disposable income at the time of plan confirmation.

Unlike in Chapter 13, where there are numerous reported decisions of creditors seeking higher disposable income projections, Chapter 12 creditors are more likely to argue that the debtor's income will be too *low* to successfully carry out the plan. This approach allows the creditor to seek immediate dismissal of the debtor's bankruptcy case. In particular, undersecured creditors with significant security likely would prefer liquidation. However, creditors' arguments that there is insufficient projected income to fund the reorganization plan undercut any argument that the creditor might make that the debtor's disposable income projections should be higher to provide for payment of more unsecured debt.

If a plan was confirmed despite creditors' objections, creditors who had argued that the debtor's income would be low (in the hopes of getting the plan rejected) found themselves in the post-confirmation position of wanting the debtor's disposable income to be higher. It is these creditors who pushed the courts, with great success, to examine Chapter 12 debtors' actual disposable income over the plan period and require any extra income over the projected level to be paid out to creditors.

Although creditors' conflicting interests are also present in Chapter 13 cases to a certain extent, the nature of farm debt, coupled with the state of the farm economy when Congress enacted Chapter 12, created a situation that was different from that in typical consumer Chapter 13 cases. In Chapter 13, many of the unsecured claimholders are true unsecured creditors, that is, creditors with no security for their debt. Many consumer debts are unsecured obligations (for example, medical bills, most credit card bills, and utility bills). In contrast, under Chapter 12, many of the largest unsecured claimholders are lenders who are secured creditors with insufficient security to support their claims. These creditors' interests are split into a secured claim and an unsecured claim, which creates the conflicting interests in seeing both high and low disposable income projections.

In addition, the relatively late enactment of Chapter 12 led creditors to aggressively react to farm debtors' new authority to file for reorganization relief. Creditors frequently challenged farmers' eligibility for Chapter 12, and a significant body of case law developed around the specific Chapter 12 eligibility requirements.

Also, the early reported Chapter 12 court decisions are filled with analysis of the Chapter 12 "feasibility requirement." This confirmation requirement requires debtors to establish that they "will be able to make all payments under the plan and to comply with the plan." Failure to show feasibility is grounds for denial of confirmation and ultimately dismissal of the debtor's bankruptcy case. In order to show feasibility, the debtor must show income and expense projections that demonstrate the ability to meet the financial obligations of the plan. Creditor objections based on the feasibility requirement have led bankruptcy courts to deny confirmation of many Chapter 12 plans. Given the strict feasibility requirements for Chapter 12, it is not surprising that the early Chapter 12 plans were rarely subject to disposable income challenges, even when the plan promised little or no disposable income for unsecured claimholders.

Although disposable income does not often appear in reported Chapter 12 cases as a confirmation issue, it frequently resurfaces as an objection to discharge. Chapter 12 creditors have successfully argued that the statute's "projected" disposable income test nonetheless imposes a general confirmation standard requiring the ultimate payout of all actual disposable income as determined at the time of discharge. In some cases, this resulted in creditor objection to discharge and intense litigation. Courts have denied discharge for Chapter 12 debtors who are found not to have paid out all actual disposable income, holding that the debtors failed to complete all payments under their plans.

The leading case that used this approach is *Rowley v. Yarnall* from the Eighth Circuit Court of Appeals. 22 F.3d 190 (8th Cir. 1994).

Although disposable income does not often appear as a confirmation issue in reported Chapter 12 cases, it frequently resurfaces as an objection to discharge.

In *Rowley*, the debtors' confirmed Chapter 12 plan contained the requisite promise that all "projected disposable income" would be applied to payments under the plan. But, the plan projected that there would be no disposable income, stating that "[n]o dividend or distribution of any kind is *projected* for [unsecured claimholders]." At the end of the three-year plan period, having made all of their required payments, the debtors filed a motion for discharge, alleging that they had complied with all of the requirements of their plan. The Chapter 12 trustee and two undersecured creditors objected to discharge, arguing that the debtors failed to pay to their unsecured claimholders the actual or net disposable income realized during the plan years.

Several Chapter 12 cases have held that disposable income can be raised as an objection to discharge and that a computation of actual disposable income may be required at that time.

The Eighth Circuit examined the statutory language and noted that, although a "plain reading" of the statute "might appear" to support the debtors' position, such a literal reading would yield "an absurd result." The court concluded that requiring only the payment of projected disposable income, as stated in the confirmed plan, would encourage farmers to put forth a reorganization plan, to be confirmed over creditors' objections, with a "prediction" that disposable income will be zero.

Despite its examination of the statutory framework, the court in *Rowley* failed to understand that parties can litigate the projected disposable income at the time of confirmation, as has been done in numerous Chapter 13 cases. Moreover, the court did not consider that the same income and expense projections that are the basis for feasibility determinations would serve as a basis for rational projected disposable income rulings.

The court then cited general legislative history regarding the purpose of Chapter 12 and made broad statements about congressional intent in creating it. It concluded that Congress designed Chapter 12 "primarily to provide family farmers with a faster, simpler, and cheaper alternative to Chapter 11 and Chapter 13 procedures, while preserving the fair treatment of creditors under those chapters."

In determining what the fair treatment of creditors should be, the court inexplicably discussed Chapter 11 creditor protections, noting the "balancing of power" between creditors and the debtor in Chapter 11. The court then stated that it could not "assume that Congress intended to depart from these general purposes of bankruptcy law when creating an expeditious avenue for farm reorganizations."

The court's reference to Chapter 11 with respect to the rights of unsecured creditors is particularly puzzling because the power afforded unsecured creditors in Chapter 11 is often cited as one of the most significant reasons that Chapter 12 was needed. Similarly, it is puzzling why the *Rowley* court did not discuss the statutory provision for requesting a plan modification if the trustee or an unsecured claimholder believes there has been a substantial change in the debtor's ability to make payments.

Despite the weakness of the analysis in the *Rowley* case, there is little within published Chapter 12 case law to challenge that analysis. Several cases have held that disposable income can be raised as an objection to discharge and that a computation of actual disposable income may be required at that time. Chapter 12 courts have similarly overlooked a literal and historical reading of the Chapter 12 modification provision. Because modification is not discussed in most of the Chapter 12 cases that address disposable income, it appears that most creditors and courts have simply ignored the modification process set forth in the statute. But the modification provision is directly relevant to the disposable income requirement, and it only makes sense as a means of relief when courts interpret the projected disposable income requirement literally.

The Impact of the Chapter 12 Judicial Interpretation of Disposable Income

Based on the history of the development of the disposable income requirement and its interplay with an unsecured claimholder's right to request modification of plan payments, it seems clear that the Chapter 13 cases' interpretation of projected disposable income reflects the most accurate reading of the statutory language. Arguably, courts considering Chapter 12 cases should have interpreted the statute consistently with the holdings in Chapter 13 cases, because Congress implied that interpretation when it adopted the same language for family farm reorganization. Courts are not free to overlook statutes when they find that they would prefer a different approach.

Putting aside the issue of correct interpretation, however, the practical results of the misinterpretation of the disposable income requirement have not only run afoul of the literal language that Congress imposed. They have sometimes thwarted the very intent underlying the adoption of Chapter 12. If interpreting a projected disposable income requirement to be actual instead of projected were simply a mechanism to do what could otherwise be done through plan modification, there would be little practical significance to the misinterpretation. In reality, however, the imposition of an actual disposable income requirement on Chapter 12 debtors has resulted in a process that is subject to abuse, and in some cases has made the continuation of many post-bankruptcy farming operations all but impossible.

As courts have struggled to unwind the complex transactions that comprise an ongoing farming operation in an attempt to determine actual disposable income, they have expanded the definition of disposable income far beyond the scope envisioned in the statute. Thus, the practical problems associated with courts' interpretations of the disposable income requirement are numerous. These problems are discussed here in turn.

Courts Have Inappropriately Expanded and Complicated the Definition of "Disposable Income"

Perhaps the most significant problem that has resulted from the courts' misinterpretation of the disposable income requirement in Chapter 12 is the judicial expansion of the definition of disposable income. When courts in Chapter 13 cases project disposable income at confirmation and determine a fixed obligation, they look to specific annual cash flow statements to arrive at a reasonable assessment. In contrast, courts in Chapter 12 cases have encountered many problems when trying to recreate the exact amount of disposable income available during a plan term.

> Under the original disposable income test, courts have denied discharge for Chapter 12 debtors who were found not to have paid out all *actual* disposable income.

The disposable income requirement applies during the term of the plan, usually a three-year period. The period begins "on the date that the first payment is due under the plan." This structure is consistent with estimated payments based on average annual income and expenses, multiplied by three. When one attempts to determine actual disposable income during this artificially determined time period, problems result.

For example, it is very unlikely that the date the first payment is due under a Chapter 12 plan will coincide with the beginning of the fiscal year for the farm business. More importantly, it is equally unlikely that the date the first plan payment is due will coincide with the production cycle of the farm. Because farms operate based on production and the sale of what is produced, it may be very difficult for a court to assess income and expenses mid-year. For example, on the date that the first plan payment is due, the farm may have assets on hand, such as crops or livestock, that will be sold during the term of the plan. These assets would have been considered property of the bankruptcy estate as of the time of plan confirmation. As such, these assets had value to the estate. Nevertheless, if the assets are sold, the court is likely to consider the sale proceeds to be regular income used in computing actual disposable income. If so, in order to assess disposable income accurately and specifically for the plan term, the debtor should be left with a similar value of assets at discharge. This, however, has not been the case.

To the contrary, the Eighth Circuit Court of Appeals requires that inventories at the end of the plan term be added to the income "received" by the debtor. In *Broken Bow Ranch, Inc. v. Farmers Home Admin.*, the court held that "hay, silage, and corn inventories" with a value of $177,542 should be included in determining the debtor's disposable income. *Broken Bow Ranch, Inc. v. Farmers Home Admin. (In re Broken Bow Ranch, Inc.)*, 33 F.3d 1005 (8th Cir. 1994). The bankruptcy court, affirmed by the Eighth Circuit, characterized

> Perhaps the most significant problem that has resulted from the courts' misinterpretation of the disposable income requirement in Chapter 12 is the judicial expansion of the definition of disposable income.

its disposable income determination as "subtracting its obligations from its inventories." No accounting was done that reflected the debtors' inventories on hand at the beginning of the plan period.

Also included in what the court termed "inventories" in *Broken Bow Ranch* were two federal farm program payments that were actually received after the end of the plan term. The debtor argued that these should not be included because disposable income is defined as income "received by the debtor" during the term of the plan. The court rejected this argument, holding that the payments were attributable to the debtor's farming operations during the plan period. Yet the court did not account for the fact that the payments received by the debtor during the first year of the plan, and included as plan payment income, would have been "attributable to the debtor's farm operations" during the period prior to the date of the first plan payment.

In a subsequent case decided by the Eighth Circuit Court of Appeals, the court again focused on the debtors' inventories at the time of discharge, as opposed to the income received during the plan period. In *Hammrich v. Lovald*, the court calculated the debtors' "total inventories" and, following its holding in *Broken Bow Ranch*, included farm program payments that had not yet been received by the debtor. *Hammrich v. Lovald (In re Hammrich)*, 98 F.3d 388 (8th Cir. 1996).

In addition, the court further muddied the disposable income waters by holding that the value of 326 calves that were not yet at marketable weight at the time of discharge would also be included in the calculation of the debtors' disposable income. Despite this expansive view of income, the court held that the debtors could deduct neither real estate taxes that were paid for the final year of the plan nor the repayment of a loan because neither obligation actually became due until after discharge.

Chapter 12 debtors have been required to pay out significant lump-sum amounts at the time of discharge, even when they have complied with the disposable income payments that were projected and approved at the time of plan confirmation.

Significant Obligations Beyond Those in the Plan Are Assessed at the End of the Plan Term

Given courts' expansive interpretations of disposable income in Chapter 12 cases, it is unsurprising that Chapter 12 debtors have been required to pay out significant lump-sum amounts at the time of discharge, even when they have complied with whatever disposable income payments were projected and approved at the time of plan confirmation. For example, in *In re Hammrich*, the court found the debtors owed $95,885.86 at the time of discharge. In *Broken Bow Ranch, Inc.*, the court found an obligation of $81,862.

When such an obligation is assessed, the debtor is in a difficult predicament. If the debtor is unable to pay the obligation, the court can dismiss the case, and the entire Chapter 12 reorganization is lost. The Eighth Circuit explained the burden: "Either [the d]ebtor will make the $81,862 disposable income payment and receive a discharge, or it will fail or refuse to make the payment and the case will be dismissed without a discharge."

Although the court referenced a possibility of approving deferred payments, considering the tight cash flows upon which courts base Chapter 12 plans, this obligation might not be possible to sustain, even if paid out over time. Moreover, the debtor, in this position, will be in such a difficult bargaining situation that it will be difficult, if not impossible, to advocate for favorable payment terms.

Objections Are Delayed and Obligations Are Difficult to Assess

Because courts have allowed disposable income objections to be heard at the time of discharge, trustees and creditors in some districts have waited until that time to raise objections, generally not objecting or seeking modification during the plan term. At the time of discharge, often years after the transactions in question have been completed, many debtors are ill-prepared to defend their actions. Moreover, the threat of seeing their case dismissed in its very last stage, after years of effort to satisfy the plan requirements, places undue pressure on debtors to settle the case at any cost.

Retroactive Assessment of Income Does Not Account for Debtor's Use of Available Funds in the Farming Operation

The retroactive nature of the actual income assessment imposed by courts in Chapter 12 cases has meant that a debtor could be expected to pay an obligation based on "disposable income" that may have been invested in the farming operation long ago.

In no reported case in which courts found a disposable income obligation has the court alleged that the debtor had the cash on hand with which to pay the full obligation. Rather, the courts most often find that profit earned in one year of the plan has been used by the debtor in the continuation of the farming operation.

But if a court finds disposable income existed in year one of the plan, and the debtor used this income to plant crops during year two, whether or not any income remains in year three depends on the success of those crops. This problem is exacerbated in situations in which a court, at discharge, assesses income for each year independently. In one case, the Seventh Circuit Court of Appeals refused to offset crop profit in year one with losses in years two and three. *In re Weber*, 25 F.3d 413 (7th Cir. 1994). Because disposable income, by its terms, cannot be a negative figure, the debtor was found to be obligated for the year-one profits.

Expensive Disposable Income Battles at Discharge Leave Debtors Ill-Prepared to Continue the Farming Operation

Litigation over the calculation of actual disposable income at the time of discharge can involve a complicated reconstruction of many years of farming activities. As an example of the extent of the investigations involved, in one South Dakota case, the debtor was served with a subpoena for the production of documents, full-scale discovery was undertaken, and the court held a formal examination. In that case, the creditor, Farm Credit Bank of Omaha, sought administrative compensation of $13,166.35 for its actions against the debtor. This request was initially granted but was eventually overturned on appeal. These costs nonetheless reflect the type of fees that a debtor may owe for the debtor's own counsel.

Similarly, because the courts have not adhered to a more consistent, predictable process of establishing projected disposable income, creditors often pursue aggressive action against debtors. One court described this process as follows:

> Trustee's microscopic examination of Debtors' financial records of income and expenses causes him to claim there is over $218,000 in disposable income which should be distributed. However, in his review, all doubts have been resolved against Debtors on any arguable items, and his approach is extreme. For example, his disposable income calculations include non-cash items, such as a $10,411 "depreciation deduction" and a $14,522 "net operating loss carryover," and a variety of small dividends earned by Debtors, but not actually received on insurance and annuities. Much of the disparity focused upon by Trustee stems from his heavy reliance on budget and tax return figures, instead of actual receipts and disbursements.

In re Wood, 122 B.R. 107, 116 n.11 (Bankr. D. Idaho 1990).

As discussed above, the statutory provision for requests to modify a confirmed Chapter 12 plan provides an opportunity for the trustee or an unsecured claimholder to seek adjustments to a disposable income projection during the plan. Therefore, absent significant changes to the debtor's situation, the debtor should not be forced to litigate issues that the creditor should have raised at confirmation.

Misplaced Reliance on Trustee for Equitable Outcome

The published decisions on the issue of disposable income do not reflect the experience of all debtors. In jurisdictions with particularly conscientious and impartial trustees, the system can work well. For example, in the district serving the West Texas agricultural regions surrounding Lubbock, the trustee has received praise for his efforts. Feasibility issues were thoroughly researched prior to confirmation, debtors were required to provide monthly reports, disposable income was calculated each year, and the debtor was allowed to retain funds for the following year's production costs.

This trustee's efforts in performing his duties in this manner are commendable, and the success of Chapter 12 cases in this area is undoubtedly a direct result. The difficulty, however, is that there is little to assure debtors that they will share this outcome. Trustees are not required to perform the services needed to prevent end-of-plan problems. In fact, because trustees are paid according to the percentage of payments received, some may feel an incentive to seek

Because the courts have not adhered to a more consistent, predictable process of establishing projected disposable income under the original test, creditors often pursue aggressive action against debtors.

and find disposable income at the time of discharge. With federal appeals court case law such as *Rowley* and *Broken Bow Ranch, Inc.*, as precedent, creditors and trustees may have felt empowered to act in a way that undermines the underlying purpose of Chapter 12.

Drafters of the 2005 Bankruptcy Act changes were faced with the odd task of compelling compliance with the projected income requirement in Chapter 12 to bring it in line with interpretations of the *same* statutory language in Chapter 13.

Congressional Action to Revise the Disposable Income Requirement

As Congress debated overall bankruptcy reform over the past decade, legislators with farming constituents also sought amendments to the Chapter 12 bankruptcy provisions. Foremost among the changes sought were efforts to make Chapter 12 a permanent part of the Bankruptcy Code. The problems associated with the disposable income requirement, however, were also the subject of early reform efforts. As early as November 1999, Senator Russ Feingold of Wisconsin succeeded in offering an amendment to the reform package that would prevent courts from retroactively assessing actual disposable income. This amendment provided the language that eventually made its way into law as part of the 2005 Bankruptcy Reform Act.

Through the subsequent years of debate, Senator Feingold's amendment tracked the reform legislation and was eventually enacted as § 1006 of the new 2005 Bankruptcy Act—Prohibition of Retroactive Assessment of Disposable Income. This amendment combines changes to the Chapter 12 confirmation requirements with restrictions on the post-confirmation plan modification provisions. The Collier Special Pamphlet analysis of the 2005 Act interpreted the amendment as follows:

> [Chapter 12 is] modified to provide that the disposable income provisions are based on projected disposable income and that plan payment amounts may not be modified after such payments are due and may not be modified in the last year of the plan in a way that leaves the debtor insufficient funds to carry on the farming operation after the plan is completed.

The 2005 Bankruptcy Act added significant debtor protections to the provision for post-confirmation plan modifications.

- A plan may not be modified to increase the amount of a payment already due at the time the modified plan takes effect.
- Unless requested by the debtor, a modification may not impose a new payment obligation that is greater than what the debtor is able to pay from disposable income for that month.
- Unless requested by the debtor, a plan may not be modified in its final year to require payments that would leave the debtor with insufficient funds to carry on the farming operation after the plan is complete.

How the § 1006 changes accomplish the above result requires further analysis. While the intent is clear, it was somewhat problematic to devise language that would accomplish the intended result. One approach would have been prohibiting creditors from objecting to discharge based on a debtor's failure to pay actual disposable income when projected obligations were satisfied. Wisely, however, the drafters of the new statutory language anticipated that this would have simply led creditors to raise their objections prior to the discharge hearing, perhaps invoking existing modification rights. Without amendment of the modification provision, creditors could seek to modify the plan after the fact, demanding actual disposable income at any point prior to discharge. Given the court decisions that seemed to favor creditors' rights to farm inventory without regard to concerns about the future operation of the farm, drafters of the statutory changes were likely hesitant to offer this possibility to the courts. Therefore, Congress adopted a more complex solution.

Under the changes made by the 2005 Bankruptcy Act, the provision requiring payment of disposable income during the plan term is modified. Three alternatives are offered to the debtor to be eligible for plan confirmation. The first two alternatives remain unchanged. That is, the debtor can pay the full value of the unsecured claims, or the debtor can pay "projected disposable income" under the original language of the disposable income test. However, a new third alternative is also provided: the debtor's plan may provide that the "value of the property to be distributed under the plan . . . is not less than the debtor's projected disposable income."

This change, and particularly the difference between the second and third alternatives of the disposable income test, reflects the history of farm debtors' prior problems with courts' interpretation of disposable income. Under a literal interpretation of the unchanged second alternative, the payment of projected disposable income is all that was ever required of the debtor. But, as discussed earlier, the courts had rejected a literal reading of the original disposable income test for Chapter 12 reorganizations. Drafters of the 2005 Bankruptcy Act changes were therefore faced with the odd task of compelling compliance with the projected income requirement in Chapter 12 to bring it in line with interpretations of the *same* statutory language in Chapter 13.

Faced with this dilemma, providing the third alternative is ingenious. It allows the debtor's plan to provide that the value of property distributed will not be less than the amount of projected disposable income as determined at the time of plan confirmation. This affirms the reliance upon *projected* income. In addition, by using the term "value," it offers the debtor the ability to provide for payment of the projected amount through a property distribution. Finally, it offers debtors the right to estimate the value of projected disposable income as of plan confirmation and make arrangements to pay that amount in full, thus completely satisfying the disposable income requirement.

Section 1006 of the new law also amends the modification provision to restrict changes to the plan once it has been confirmed. This provision expressly provides that a debtor's obligations under a confirmed Chapter 12 plan may not be modified to increase the amount of any payment due before the modified plan takes effect. Under this new provision, modifications will be allowed only to create new obligations for the future, capturing future income that is greater than that anticipated when the plan was originally confirmed. This change will prevent courts from looking back to retroactively assess past disposable income obligations.

Section 1006 also provides that no party except for the debtor can call for any increase in plan payments based on disposable income that would "increase the amount of payments to unsecured claimholders required for a particular month so that the aggregate of such payments exceeds the debtor's disposable income for such month." This provision prevents a court from being able to go back into the debtor's past, either at a discharge hearing or during the plan term, to impose a new obligation that is greater than what the individual can afford to pay from disposable income for that month.

Finally, § 1006 provides that a Chapter 12 plan may not be modified "in the last year of the plan by anyone except the debtor, to require payments that would leave the debtor with insufficient funds to carry on the farming operation after the plan is completed." This provision emphasizes the importance of allowing the debtor sufficient income for the continuation of the farming operation, consistent with the definition of disposable income.

Implementation Suggestions

The changes made by the 2005 Bankruptcy Act should unequivocally prohibit the type of retroactive accounting that has been undertaken by courts at the time of discharge when courts have attempted to reconcile early income projections with what the trustee or creditors argue is actual disposable income.

Whenever possible, all disputes regarding projected disposable income should be raised at the plan confirmation hearing, and a reasonable disposable income payment should be determined at that time.

This issue is complicated, however, by the continuing operation of confirmed plans that include a provision requiring the debtor to pay actual disposable income. Although these plans have been the direct result of judicial interpretation of the prior disposable income test as requiring actual accounting at discharge, if payment of actual income is what the debtor's plan provides, the debtor will be bound to the plan's terms regardless of the statutory change.

Given the evidence that Congress intended to correct an erroneous interpretation of the law, one can argue that pre-existing plans that were silent as to the issue of actual

Farmers' Legal Action Group, Inc.
360 Robert Street North, Suite 500
St. Paul, Minnesota 55101-1589

NONPROFIT ORG.
U.S. POSTAGE
PAID
ST. PAUL, MN
PERMIT NO. 7141

or projected disposable income should be interpreted in a manner consistent with the new law. Taking this a step further, it might be possible for debtors to argue that they should be allowed to modify a plan calling for actual disposable income to bring it into conformance with the new statutory language.

Given the changes to Chapter 12, new Chapter 12 debtors should propose plans that reflect the literal interpretation of the projected disposable income requirement. Whenever possible, all disputes regarding projected disposable income should be raised at the plan confirmation hearing, and a reasonable disposable income payment should be determined at that time. Courts can consider the feasibility analysis that is already required for confirmation as a model for assessing projected income and expenses. The fixing of a certain sum as an obligation provides the debtor with a clear benchmark and the creditors with a defined expectation of payment. Changes in income or expenses that occur during the plan term and that are significant should be addressed according to the statutory modification provisions.

Debtors should be careful when drafting new Chapter 12 plans to avoid including language that would commit them to pay actual disposable income over the plan period. Some trustees may continue to encourage such plan terms even under the new law.

Debtors with pre-existing plans that are silent on the issue will want to argue that they should be interpreted in a manner consistent with the new law.

As shown by the difficulty parties have had determining actual disposable income at the end of a Chapter 12 plan period, it is predicted that the courts will find that the literal interpretation of the projected disposable income requirement now mandated by the 2005 Bankruptcy Reform Act will in fact be an easier and fairer standard to apply. ■

* *Susan A. Schneider is a Professor of Law and Director of the Graduate Program in Agricultural Law at the University of Arkansas School of Law in Fayetteville, Arkansas. A former FLAG staff attorney, Susan continues to consult with FLAG and provide valuable assistance on bankruptcy and related issues.*