

CHAPTER 12: BANKRUPTCY RELIEF FOR FAMILY FARMERS

Chapter 12 of title 11 was enacted in 1986 to provide specially-tailored bankruptcy relief for “family farmers.”²⁴⁹¹ Chapter 12 was originally scheduled to expire in 1993, but the expiration was extended to October 1, 1998.²⁴⁹² A total of 18,212 Chapter 12 cases have been filed since it was enacted in 1986.²⁴⁹³ The principal Chapter 12 issue facing the Commission, and Congress, is whether Chapter 12 provides necessary relief to family farmers and should become a permanent part of the Bankruptcy Code. The Commission concluded that Chapter 12 should become a permanent form of relief under the Bankruptcy Code. Senator Charles Grassley (R.-Iowa) recently introduced legislation, *The Working Family Farmer Protection Act of 1997* (S. 1024), to make Chapter 12 permanent.

²⁴⁹¹ Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. N. 00-554, 100 Stat. 3105 (1986).

²⁴⁹² Pub. L. No. 103-65, 107 Stat. 311 (1993).

²⁴⁹³ United States Dep’t of Agriculture, *Are Farmer Bankruptcies a Good Indicator of Rural Financial Stress*, 3 (Ag. Info. Bull. No. 724-06 Dec. 1996) [hereinafter *Agric. Info. Bulletin*].

RECOMMENDATIONS

4.4.1 *Sunset Provision and Chapter 12 Eligibility*

The sunset provision should be eliminated. Chapter 12 should be made a permanent addition to the Bankruptcy Code. Section 101(18) should be amended to increase the aggregate debt limits to \$2,500,000. The other eligibility requirements in section 101(18) should remain unchanged.

4.4.2 *Direct Payment Plans*

28 U.S.C. § 586(e) should be amended to clarify that the calculation of the standing trustee's percentage fee should be based upon the aggregate of those payments "made under the plan" on account of claims impaired or modified by operation of bankruptcy law regardless of who makes the payment.

DISCUSSION

Specially-tailored relief for farmers is a relatively new concept under the Bankruptcy Code. As originally enacted, the Bankruptcy Act of 1898 did not accord farmers any special treatment other than protection from the filing of an involuntary bankruptcy case.²⁴⁹⁴ Section 75 of the Bankruptcy Act was the first bankruptcy statute aimed specifically at farmers and was promulgated as part of the Bankruptcy Act of 1933 in response to the economic depression of the 1920s and 1930s.²⁴⁹⁵ Section 75 was enacted as emergency legislation and given only limited duration. The provision permitted an insolvent farmer to propose a “voluntary composition” to the farmer’s creditors, but did not allow a farmer to impair the lien of a secured creditor or reduce the amount of the secured claim without the creditor’s consent.²⁴⁹⁶ The statute proved to be of limited value because a majority of the debtor’s creditors retained the power to disapprove proposed compositions or extensions.²⁴⁹⁷

In 1934, Congress strengthened section 75 by passing the Frazier-Lemke Act,²⁴⁹⁸ which permitted a farmer to retain possession of all farm assets for a five-year period while collection proceedings were stayed upon the payment of a reasonable

²⁴⁹⁴ The Bankruptcy Act of 1898 shielded a “person engaged chiefly in farming or in tillage of soil” from creditor-initiated bankruptcy. *See* Bankruptcy Act of 1898, ch. 541, § 4(b), 30 Stat. 544.

²⁴⁹⁵ Bankruptcy Act of 1933, Pub. L. No. 420, 72d Cong., ch. 204, 47 Stat. 1467. Farm land and commodity prices dropped sharply and continued to plummet throughout the decade. David Ray Papke, *Rhetoric and Retrenchment: Agrarian Ideology and American Bankruptcy Law*, 54 Mo. L. Rev. 871, 881 (1989). It was estimated that by 1929, the average per capita income of farmers amounted to only 36 percent of that for all Americans. *Id.* (citing R. MCELVAINE, *THE GREAT DEPRESSION: AMERICA, 1929-1941*, at 21 (1984)). An overwhelming number of farmers were losing the family farm due to real estate foreclosures. *Id.* (noting that on a single day in 1932, a quarter of all the land in the state of Mississippi was sold at foreclosure auctions).

²⁴⁹⁶ 8 COLLIER ON BANKRUPTCY ¶ 1200.01[b], pp. 1200-2 (Lawrence P. King et al. eds., 15th rev. ed. 1996).

²⁴⁹⁷ A significant indicator of the reform’s limited impact is that during the eight months which followed the enactment of section 75, only *forty* bankrupt farmers sought relief under that section of the Act. John Hanna, *Agriculture and the Bankruptcy Act*, 19 MINN. L. REV. 1, 6 (1934).

²⁴⁹⁸ Act of June 28, 1934, ch. 869, 48 Stat. 1289.

annual rental fee.²⁴⁹⁹ Farmers had the right to purchase the property free and clear of all liens at any time during the five-year period by paying the creditor the property's appraised value.²⁵⁰⁰

Secured creditors were particularly hostile to the Frazier-Lemke Act because its "express purpose . . . imping[ed] upon the rights of secured creditors, . . . [by] provid[ing] a moratorium for farmers to relieve them from overburdening mortgage indebtedness and the harshness resulting from a loss of their farms through foreclosure in a period of unprecedented depression."²⁵⁰¹ Although real estate lenders greeted the Frazier-Lemke Act with much dismay, Congressional supporters of the legislation hailed its virtues.²⁵⁰² Within a year, however, the United States Supreme Court ruled that the Frazier-Lemke Act deprived secured creditors of their property rights in violation of the Fifth Amendment to the Constitution.²⁵⁰³ Congress quickly

²⁴⁹⁹ 11 U.S.C. § 75(s)(3) (repealed 1935).

²⁵⁰⁰ *Id.* § 75(s)(7).

²⁵⁰¹ John C. Anderson, *An Analysis of Pending Bills to Provide Family Farm Debtor Relief Under the Bankruptcy Code*, 132 CONG. REC. S15,076-S15,078 (Oct. 3, 1986) (citations omitted).

²⁵⁰² Representative Charles U. Truax vigorously supported the Frazier-Lemke Act:

When this law becomes effective, I can but wonder what will become of the ruthless money lender when the breath of gold leaves his feculent body and a financial depth stops the rattling of his grasping brain, for he is unfit for the higher realm of life and too foul for the one below. He cannot be buried in the earth, lest he provoke a pestilence; nor in the sea, lest he poison the fish; nor waving in space like Mahomet's coffin, lest the circling worlds, in trying to avoid the contamination, crash together, wreck the universe and bring again the noisome reign of chaos and Satan.

78 CONG. REC. 11,923 (1933).

²⁵⁰³ See *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555 (1935). In *Radford*, a farming couple from Kentucky defaulted on their mortgages to the Louisville Joint Stock Land Bank, which commenced foreclosure proceedings. The Radfords attempted to obtain the approval of creditors for a composition, but the requisite number of creditors refused to assent. Enactment of the Frazier-Lemke Act two days prior to the court order was the only opportunity the Radfords had to try and save the farm. The Radfords filed amended bankruptcy petitions and the bankruptcy referee granted a five-year stay of all proceedings.

The referee's order was affirmed by the United States district court and by the Court of Appeals for the Sixth Circuit. On appeal to the Supreme Court, numerous private lawyers and attorneys general submitted briefs in support of the legislation. William Lemke, author of the legislation and acting as Special Assistant Attorney General of North Dakota, deplored the arguments of John W. Davis, of Davis Polk & Wardwell, for contending that Congress "cannot extend to a class of citizens who formed the Republic, defended it, and for a century and a half have

responded to the Supreme Court's decision by enacting a revised Frazier-Lemke Act in 1935.²⁵⁰⁴ The revised Act was designed to cure the constitutional deficiencies of the original enactment.²⁵⁰⁵ The Supreme Court upheld the revised act against a constitutional challenge in 1937,²⁵⁰⁶ and it remained in effect until expiring by its own terms in 1949.

After the revised Frazier-Lemke Act expired, the Bankruptcy Act had no specific provision that applied only to farmers other than the original prohibition against the commencement of an involuntary case against a farmer. A financially distressed farmer was generally subject to the same rules as any other debtor. Similarly, when the Bankruptcy Code was enacted in 1978,²⁵⁰⁷ the only special provision for farmers was the prohibition against an involuntary Chapter 7 petition or involuntary conversion of the case to a Chapter 7.²⁵⁰⁸ Despite the lessons of the twenties and thirties and the fact that the 1978 Reform Act represents the single most extensive revision of bankruptcy law in American history, the Bankruptcy Reform Act did not provide any special protection to farmers. Chapters 7, 11 and 13 (assuming that a farmer could satisfy the eligibility requirements) were the only avenues of relief available. Consequently, most farmers seeking to reorganize under the Bankruptcy

been regarded as its backbone, the right . . . to so reorganize their financial affairs that they may remain as the dependable, stable and conservative bulwark of the nation." Brief of Petitioner at 4, *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555 (1935), in 295 RECORDS AND BRIEFS OF CASES DECIDED BY SUPREME COURT OF THE UNITED STATES 495-632 (1935). Lemke argued that the state of affairs prior to the enactment of the legislation "tended to convert our home owning farmers into mere tenants and homeless, impoverished citizens." *Id.* at 42. Only the Act, he contended, saved the farmer "from being reduced to a beggar, a mendicant, a mere homeless man in search of a home and a place to rent at the mercy of his landlord." *Id.*

The Supreme Court struck down the Act as unconstitutional, unanimously ruling that the legislation exceeded the power of Congress. *See Radford*, 295 U.S. at 594-602. Justice Brandeis, writing for the Court, opined that the Act went too far since its "avowed object" was "to take from the mortgagee rights in the specific property held as security." *Id.* at 602.

²⁵⁰⁴ Act of August 28, 1935, ch. 792, 49 Stat. 942, 943-45.

²⁵⁰⁵ Specifically, amended section 75(s) provided for (1) the unqualified retention of the secured creditor's lien with reference to its appraised value; (2) the secured creditor's right to force a public sale; and (3) the unqualified right of the secured creditor to credit bid its debt at the sale. *See* 11 U.S.C. § 75(s)(1)-(6) (repealed 1978). The revised Act also reduced the five-year forced rental period to three years and required semi-annual, rather than annual, rental payments.

²⁵⁰⁶ *See Wright v. Vinton Branch of Mountain Trust Bank*, 300 U.S. 440 (1937).

²⁵⁰⁷ Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549.

²⁵⁰⁸ *See* 11 U.S.C. §§ 1112(1), 1307(e) (1978) (amended).

Code attempted to do so under Chapter 11. The plan confirmation requirements of Chapter 11, however, often proved to be insurmountable barriers to a successful farm reorganization.

The agricultural crisis in the United States, which began in the 1920s and continued through the Great Depression, reappeared in the 1980s. Increases in the loan-to-value ratios of mortgage debt extended to farmers under the Farm Credit Act in 1971, combined with general farm prosperity throughout the 1970s, led to increased leveraging in the agricultural sector of the economy.²⁵⁰⁹ Higher interest rates in the early 1980s made it increasingly difficult for farmers to keep current on the new debt.²⁵¹⁰ In addition, higher production costs and lower commodity prices caused by the 1980 grain embargo, combined with a sharp decrease in the value of farm land, drove many farmers to the edge of a financial cliff.²⁵¹¹ At least one bankruptcy judge clearly recalls that the era was marked with farmers throwing up their hands and parking their tractors and equipment in front of the federal courthouse.²⁵¹²

²⁵⁰⁹ Statement of Wayne D. Rasmussen, Agricultural Historian, 133 CONG. REC. S11651-01. See also, *Agric. Info. Bulletin*, *supra* note 2493 (“The economic climate of the 1970s encouraged farmers to expand production and benefit from export opportunities and strong commodity prices. High rates of inflation and low real interest rates further encouraged investment in farmland. Per acre farmland values increased more than threefold from \$196 in 1970 to \$823, its 1982 peak. Total farm-sector equity grew 255 percent during 1970-80. Total farm business debt nearly quadrupled from \$48.8 billion in 1970 to \$193.8 billion at its peak in 1984. A considerable number of farmers were financially extended and vulnerable to sudden shifts in economic forces.”)

²⁵¹⁰ *Agric. Info. Bulletin*, *supra*, note 2493.

²⁵¹¹ For example, the values of farmland in Nebraska and Iowa fell nearly 50 percent by early 1985. Janet A. Flaccus & Bruce L. Dixon, *The New Bankruptcy Chapter 12: A Computer Analysis of If and When a Farmer Can Successfully Reorganize*, 41 ARK. L. REV. 263 (1988)(citing Econ. Research Serv., U.S. Depot of Agric., *For Farm Finances: Promising Signs of a Cooling Crisis*, 8 FARMLINE NO. 4 (1987)). Indiana, Minnesota, Missouri and Ohio experienced a 40 percent decline in the value of farmland. *Id.*

²⁵¹² Personal Interview with the Honorable William A. Hill, Bankruptcy Judge for the District of North Dakota (1995). There are a number of risk factors unique to farmers: “The concerns about farmer bankruptcies stem from several factors: (1) the long held view of farmers as landowner and patriot; (2) empathy for these rural citizens; (3) concerns that wealthier farmers (and banks and lending institutions) may end up controlling the majority of farms; and (4) the perception that creditors/lenders have an unfair advantage in the legal system. The interaction of bankruptcy policy and farm policy is important because the farm sector is dependent upon a lengthy biological process that generates considerable physical and financial risk. The U.S. farm sector has historically been based on smaller firms that are more vulnerable to these risks. Public concern over farm policy rises when bankruptcy appears to be taking an inordinate toll on smaller farms. . . . Chapter 12 has reduced farmer failure rates, but the short-run gain to financially stressed farmers comes at the

Hearings in the U.S. House of Representatives and the Senate led Congress to conclude that Chapter 11 did not provide effective relief for farmers and that dire economic conditions required immediate action.²⁵¹³ Congress created a separate chapter of the Bankruptcy Code for farm debtors as part of the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986.²⁵¹⁴ Enacted as emergency legislation, Congress provided for a seven-year sunset provision in order to (1) evaluate whether the chapter was serving its intended purpose and (2) determine whether it should be a permanent addition to the Code.²⁵¹⁵ On August 6, 1993, Congress enacted legislation extending the sunset provision to October 1, 1998.²⁵¹⁶

expense of some creditors and, ultimately, other borrowers.” *Agric. Info. Bulletin*, *supra* note 2493, at 1-2.

²⁵¹³ H.R. REP. NO. 99-958, at 45-48 (1986), *reprinted in* 1986 U.S.C.C.A.N. 5227, 5249. Chapter 11 was viewed as an inordinately expensive, needlessly complicated, time-consuming and unworkable for too many farmers. *See id.*; *see also* 132 CONG. REC. 28,593 (1986) (remarks of Sen. Grassley).

²⁵¹⁴ Pub. L. No. 99-554, 100 Stat. 3105 (1986). The impassioned remarks of Congressional leaders shed a powerful ray of light on the necessity for the legislation:

I doubt there will be anything we do that will have such an immediate impact in the grassroots of our country with respect to the situation that exists in most of the heartland, and that is in the agricultural sector. . . .

[T]hose family farmers who are facing that brink of disaster where they would have to be thrown off their farms can now look to this Congress and to this Government for new hope. That new hope is that we are going to give them the same standard that a small businessman or an individual has at this present time, which is the ability to reorganize.

. . . .
So this legislation is significant. It is important, because I think it is sending a message that we here in the U.S. Congress, we in this Government are sensitive to the family farmers who are facing this very terrible plight at this time.

You know, William Jennings Bryan in his famous speech , the “Cross of Gold” almost 60 years ago, stated these words: “Destroy our cities and they will spring up again as if by magic; but destroy our farms, and the grass will grow in every city in our country.” This legislation will hopefully stem the tide that we have seen so recently in the massive bankruptcies in the family farm area.

132 CONG. REC. 28,147 (1986) (statement of Rep. Mike Synar (D.- Okla.)).

²⁵¹⁵ H.R. REP. NO. 99-958, at 45-48 (1986), *reprinted in* 1986 U.S.C.C.A.N. 5227, 5249.

²⁵¹⁶ Pub. L. No. 103-65, 107 Stat. 311 (1993).

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Sunset Provision. The Commission recommends that Chapter 12 be made a permanent part of the Bankruptcy Code. Chapter 12 will *not* be an available avenue of relief for family farmers absent Congressional action on or before October 1, 1998. The test of time has revealed that Chapter 12 generally provides financially distressed family farmers with an effective framework within which to reorganize their operations and restructure their debts.²⁵¹⁷ The available evidence suggests that the primary purpose in enacting Chapter 12 has been achieved, giving “family farmers facing bankruptcy a fighting chance to reorganize their debts and keep their land.”²⁵¹⁸ Chapter 12 has saved literally thousands of family farms,²⁵¹⁹ stabilized farm values, and encouraged more out-of-court negotiations and settlements between lenders and farmers.²⁵²⁰ Accounts of professionals and jurists similarly reveal that the

²⁵¹⁷ An April 2, 1997 article in the *Des Moines Register* discussed the Commission’s Des Moines regional meeting: “[a]ll seven panelists, including university professors, bankruptcy judges, an assistant U.S. attorney and a banker, told the commission that Chapter 12 should be kept, primarily because bad weather, low crop prices or other factors could again put many farmers into bankruptcy.” John McCormick, *Committee: Keep Bankruptcy Code that Aids Farmers*, DES MOINES REG., April 2, 1997, at 10.

²⁵¹⁸ H.R. REP. NO. 99-958, at 48 (1986), *reprinted in* 1986 U.S.C.C.A.N. 5227, 5249. See H.R. REP. NO. 103-32 (1993), *reprinted in* 1993 U.S.C.C.A.N. 373 (indicating that testimony received by the Subcommittee on Economic and Commercial Law in hearings held during the 102d and 103d Congresses revealed that “Chapter 12 is, by and large, operating effectively and serving its intended purpose”).

²⁵¹⁹ U.S. GENERAL ACCOUNTING OFFICE, FARM FINANCE: PARTICIPANT’S VIEWS ON ISSUES SURROUNDING CHAPTER 12 BANKRUPTCY 18-19 (May 1989) (cited in Jonathan K. Van Patten, *Chapter 12 in the Courts*, 38 S.D. L. REV. 52 (1993)).

²⁵²⁰ See, e.g., *To Extend the Period During Which Chapter 12 of Title 11 of the United States Code Remains in Effect: Hearing on H.R. 5322 Before the Subcommittee on Economic and Commercial Law of the House Committee on the Judiciary*, 102d Cong., 2d Sess. 21 (1992) (testimony of Honorable A. Thomas Small, one of the principal drafters of Chapter 12, before the House Judiciary Committee). Chapter 12 has been beneficial in giving the financially distressed farm debtor “something when he comes to the negotiating table with the [lender]. Without that . . . he’s virtually helpless. He would only be liquidated.” *Id.* (quoting testimony of Honorable Richard L. Bohanon).

confirmation and consummation rates in Chapter 12 cases greatly exceed those in Chapter 11 cases.²⁵²¹

A total of 18,212 Chapter 12 cases have been filed since its enactment in 1986 through June 30, 1996.²⁵²² Chapter 12 filings peaked at the 6,664 cases filed during the 13 months following its enactment in 1986.²⁵²³ Chapter 12 filings leveled off after 1986 and have begun to decline despite the marked increases in Chapter 7 and 13 filings over the past few years. For the 12-month period ending June 30, 1997, Chapter 12 filings dropped 5.4% compared to the same period last year.²⁵²⁴ These numbers are not indicative of Chapter 12's usefulness. Commentators agree that Chapter 12 provides a uniform system of debt restructuring that facilitates out-of-court restructurings.²⁵²⁵

Chapter 11 reorganization is still unworkable for effective family farm debt restructuring. Indeed, since the enactment of Chapter 12 in 1986, Chapter 11 has become even more difficult for distressed family farmers than it was when Chapter 12 was first passed. In the 1988 decision of *Norwest Bank Worthington v. Ahlers*,²⁵²⁶ the United States Supreme Court ruled that the absolute priority rule bars Chapter 11 farm debtors from retaining an equity interest in the farm over the objections of

²⁵²¹ *Id.* at 6. Judge Bohanon testified before the House Judiciary Committee that approximately 60 percent of the Chapter 12 cases filed had achieved confirmation and that of those confirmed cases, nearly 90 percent had been successfully completed. *Id.*

²⁵²² *Agric. Info. Bulletin*, *supra* note 2493, at 3.

²⁵²³ *Id.*

²⁵²⁴ Administrative Office of the United States Courts, Statistics for the Period Ending June 30, 1997 (August 15, 1997).

²⁵²⁵ *See Agric. Info. Bulletin* at 3 (citing that the number of Chapter 12 cases has been stable since 1988 and that "Chapter 12 essentially brought about national farm debt restructuring under fairly uniform rules."). Participants in the Commission's Chapter 12 discussions agree that Chapter 12 is a very successful settlement tool that provides a clear picture of what parties will receive in bankruptcy that facilitates out-of-court restructurings. Discussion Notes - April 1, 1997 Regional Meeting of the National Bankruptcy Review Commission in Des Moines, IA, at 4 (April 5, 1997) (comments of Professor Neil Harl noting that Chapter 12 has an influence beyond the filing numbers. Its very existence, he continued, creates an environment where people are willing to settle their differences without bankruptcy. Close to 32% of the cases he tracked settled, he reported. Assistant U.S. Attorney Clare Hochhalter agreed, stating that Chapter 12 has become a marvelous collection agency.)

²⁵²⁶ 485 U.S. 197 (1988).

unsecured creditors unless those creditors are paid in full.²⁵²⁷ The Court further held that the debtors' promise of future labor ("sweat equity") would not satisfy the "money or moneys worth" requirement of the new value exception.²⁵²⁸ As a consequence of the Court's decision in *Ahlers* and the fact that most farm debtors do not have adequate cash to satisfy the requirements of the absolute priority rule, the use of Chapter 11 in family farm bankruptcies will more than likely result in liquidation or dismissal.

Eligibility Amount. Chapter 12 of the Bankruptcy Code is available only to a "family farmer with regular annual income" who is "engaged" in a "farming operation."²⁵²⁹ The eligibility requirements impose an aggregate debt limitation of

²⁵²⁷ *Id.* at 202-03.

²⁵²⁸ *Id.* at 203.

²⁵²⁹ 11 U.S.C. §§ 109(f), 101(18) (1997). A "family farmer" is defined to mean:

(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 individual and spouse, and such individual or such individual and spouse receive from such farming operation more than 50 percent of such individual's or such individual and spouse's gross income for 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 aggregate 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 the farming operation owned or operated by such corporation or such partnership; and

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

Id. § 101(18) (emphasis added). A "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." *Id.* § 101(19). A "farmer" means (except when such term appears in the term 'family farmer') person that received more than 80 percent of such person's gross income during the taxable year of such person immediately preceding the taxable

\$1,500,000 as well as standards for the nature and character of the income.²⁵³⁰ The purpose of such narrowly-tailored definitional prerequisites for eligibility is to exclude investors and speculators and limit relief to only “true” family farmers.²⁵³¹ Large agribusinesses are excluded from Chapter 12 but are still able to restructure their debts in Chapter 11. The nature of farming as a business does not require special relief, but rather the size and structure of small family farms makes relief under Chapter 11 unworkable. Chapter 12 is specifically geared towards the needs of the small family farmer. Great care was taken during the drafting of Chapter 12 to limit relief to “true” family farmers.²⁵³² In addition to the dollar cap of \$1,500,000, a variety of other safeguards limit the types of individuals and entities eligible for Chapter 12 relief.

Rationale. The eligibility cap in Chapter 12 was set in 1986 when farm land values were low. While farming continues to be a very cyclical industry, farm land values have increased in recent years, enabling family farmers to increase their leverage in order to purchase equipment, grow different crops and generally remain competitive. The Chapter 12 aggregate debt eligibility cap has not been modified accordingly to respond to the changing cost of operating a family farm, despite an increase generally in the eligibility and other dollar amounts in the Bankruptcy Code.²⁵³³ The lower cap precludes Chapter 12 relief for individuals and entities who are rightfully family farmers within the Bankruptcy Code definition.

The Commission voted 5-4 on the proposal to raise the Chapter 12 eligibility cap to \$2,500,000. The Recommendation to raise the Chapter 12 eligibility cap to

year of such person during which the case under this title concerning such person was commenced from a farming operation owned or operated by such person.” *Id.* § 101(20). A “‘farming operation’ includes farming, tillage of the soil, dairy farming, ranching, production or raising of crops, poultry, or livestock, and production of poultry or livestock products in an unmanufactured state.” *Id.* § 101(21).

²⁵³⁰ *Id.*

²⁵³¹ See 130 CONG. REC. 5614 (1986).

²⁵³² The narrow provisions regarding family farmer eligibility were first introduced by Senator Grassed. See S. 2249, 99th Cong., 2d Sess., reprinted in 131 CONG. REC. 6348 (1986).

²⁵³³ Section 108 of the Bankruptcy Reform Act of 1994 increased a number of the dollar amounts set forth in the Bankruptcy Code including the debt limits for Chapter 13 eligibility, the amount of debt required for a creditor to commence an involuntary case, the prepetition wages and benefits priority amount for employees, and the exemption amounts in section 522. In addition, section 104(b) was added to provide consumer price adjustments every three years to the adjusted sections of the Bankruptcy Code listed above. None of the dollar amounts related to Chapter 12 eligibility were included in the 1994 amendments and they have not been changed since adopted in 1986.

\$2,500,000 is consistent with the 1994 inflation adjustments to certain dollar amounts in the Bankruptcy Code. This amount is also consistent with the statistical analysis provided to the Commission, which demonstrates that the weighted average effect of certain economic indicators on farm debt of \$1.5 million in 1986 is \$2,644,731.²⁵³⁴ Raising the cap to \$2,500,000 should capture the majority of family farmers who have been priced out of Chapter 12 relief only because of the effects of inflation.

The Recommendation will not expand Chapter 12 relief to many more family farmers than are currently eligible. There are approximately 2 million family farms in the United States.²⁵³⁵ Of these two million family farms, 99.81% have debt of \$1.5 million or less; .12% have debt between \$1.5 million and \$2.5 million; and .07% have more than \$2.5 million in debt. The .12% of family farms that have between \$1.5 and \$2.5 million in debt represent approximately 2,436 family farms. These are the family farms that would be affected by the Chapter 12 debt ceiling Recommendation.

While fewer than 2,500 family farms would be affected by the proposed change, these operations owe over \$4.5 billion dollars, which accounts for over 4% of all reported farm operation debt. It is important to note that these family farms represent a disproportionate amount of total outstanding farm debt. The data obtained from the Department of Agriculture does not indicate the relative financial strength of these family farm sectors. Historically, however, highly-leveraged family farming operations have been hardest hit by adverse growing conditions and weak economic environments.

Competing Considerations. It may be argued that raising the Chapter 12 eligibility cap would permit large agribusinesses to file for Chapter 12 relief. A cap of \$2.5 million, however, still precludes large agribusinesses and, as discussed above, will not significantly expand the universe of eligible Chapter 12 debtors. Even at the family farm level, farming is a debt-intensive business. Farm debt does not only include land and equipment financing, but the cyclical nature of farming requires farmers to finance their working capital on a year-to-year basis.²⁵³⁶

²⁵³⁴ See Letter of M. Nelson Enmark to National Bankruptcy Review Commission (June 3, 1997).

²⁵³⁵ The data was obtained from Jim Ryan, an economist with the Department of Agriculture. A “family farm” was defined in the search as all farm operations excluding nonfamily corporations and cooperatives. As a result, the search results may be over inclusive of those family farm operations that do not meet the income and ownership requirements of Section 101(18). Telephone Interview with Jim Ryan, Economist, U.S. Department of Agriculture (August 19, 1997).

²⁵³⁶ Statement of Wayne D. Rasmussen, Agricultural Historian, 133 CONG. REC. S11,651-01.

The aggregate debt dollar cap is only one component of the rigorous requirements for Chapter 12 eligibility under section 101(18). For example, in addition to the aggregate debt requirements, individual debtors must derive at least 50% of their income from the farming operation in order to qualify for Chapter 12 relief. Similarly, entities must have 50% of stock or interests held by family members; 80% of the assets must be related to the farm operation; at least 80% of the aggregate noncontingent, liquidated debts (excluding a residence) must arise out of the farming operation; and stock, if any, may not be publicly traded. The Proposal limits Chapter 12 eligibility to small family-controlled farming operations. Raising the aggregate debt limits does not unduly expand Chapter 12 to include nonfamily-controlled agribusinesses. Similarly, large (over \$2.5 million in debt), family-controlled agribusinesses are precluded from Chapter 12 relief, which is consistent with Congress' original intent.

4.4.2 *Direct Payment Plans*

28 U.S.C. § 586(e) should be amended to clarify that the calculation of the standing trustee's percentage fee should be based upon the aggregate of those payments "made under the plan" on account of claims impaired or modified by operation of bankruptcy law regardless of who makes the payment.

Like Chapter 13, Chapter 12 requires the appointment of a trustee in each case to, among other things, oversee compliance by the debtor and disburse plan payments. Trustees in these cases are compensated based on a percentage of the payments made under the plan. Problems arise, however, when debtors make payments under the plan directly to the creditor without going through the Chapter 12 trustee. Debtors argue that since the trustee did not disburse the payment, she is not entitled to receipt of the percentage fee. The courts are sharply divided on the issue of whether debtors may make direct payments to creditors whose claims have been impaired or modified in bankruptcy and whether the standing trustee's percentage fee may be avoided on

those direct payments.²⁵³⁷ At least three divergent approaches have emerged in the reported decisions.

The first view holds that all payments to creditors whose claims are modified under a Chapter 12 plan *both* must be collected and disbursed by the standing trustee and are subject to the trustee's fee.²⁵³⁸ A claim is generally deemed to be "modified" or "impaired" if the plan alters the legal, equitable or contractual rights of the creditor.²⁵³⁹

The second view holds that either the trustee or the debtor may disburse a particular plan payment, but without regard to the identity of the party making the actual disbursement, the standing trustee's percentage fee is computed as a percentage of the aggregate of all modified claims. The reference in the Bankruptcy and Judicial Code to payments "made under the plan" focuses on whether the creditors' rights are modified by operation of bankruptcy law.²⁵⁴⁰ Courts embracing this view generally hold that it is the actual treatment of the claim that determines whether the trustee's percentage fee is owing.²⁵⁴¹

²⁵³⁷ The same dispute has arisen in the context of Chapter 13. *Compare In re Aberegg*, 961 F.2d 1307 (7th Cir. 1992) (finding that bankruptcy courts have the discretion to permit debtors to act as disbursing agents and make direct payments, thereby avoiding the trustee's percentage fee); *Foster v. Heitkamp (In re Foster)*, 670 F.2d 478 (5th Cir. 1982) (examining a number of factors, including the degree of debtor responsibility and reasons contributing to the need for relief under Chapter 13, which govern the determination); *In re Gregory*, 143 B.R. 424, 427-28 (Bankr. E.D. Tex. 1992) (requiring justifiable cause as a prerequisite and the balancing of a number of considerations), *with In re Bernard*, 201 B.R. 600, 603 (Bankr. D. Mass. 1996); *In re Harris*, 200 B.R. 745, 748 (Bankr. D. Mass. 1996) (holding that to the extent that plan payments on modified or impaired claims are funded with future income, such payments must be submitted to the trustee and the court may not permit direct payment); *In re Ford*, 179 B.R. 821, 823 (Bankr. E.D. Tex. 1995) (opining that allowing debtors "to pick and choose those claims they will submit to the supervision of the trustee undermines the integrity of the entire trustee system").

²⁵³⁸ *See, e.g., In re Marriott*, 161 B.R. 816, 819 (Bankr. S.D. Ill. 1993); *In re Finkbine*, 94 B.R. 461, 463-67 (Bankr. S.D. Ohio 1988).

²⁵³⁹ *Wagner v. Armstrong (In re Wagner)*, 36 F.3d 723, 725 n.3 (8th Cir. 1994) (defining an impaired claim as "one whose legal, equitable, or contractual rights have been diluted by the bankruptcy plan"). *Cf.* 11 U.S.C. § 1124 (1994). A claim that is in any way modified or impaired by a plan is said to be "provided for by the plan" or "made under the plan." *Marriott*, 161 B.R. at 819-21.

²⁵⁴⁰ *Fulkrod v. Barmettler (In re Fulkrod)*, 126 B.R. 584, 586 (Bankr. 9th Cir. 1991), *aff'd sub nom., Fulkrod v. Savage (In re Fulkrod)*, 973 F.2d 801 (9th Cir. 1992).

²⁵⁴¹ *See, e.g., id.; In re Golden*, 131 B.R. 201, 203 (Bankr. N.D. Fla. 1991); *In re Oster*, 152 B.R. 960, 963 (Bankr. D.N.D. 1993); *In re Cannon*, 93 B.R. 746, 748 (Bankr. N.D. Fla. 1988); *In re Sutton*, 91 B.R. 184, 186 (Bankr. M.D. Ga. 1988); *In re Logemann*, 88 B.R. 938, 941 (Bankr.

The first circuit court to address the issue in Chapter 12 was the Court of Appeals for the Ninth Circuit in *Fulkrod v. Savage (In re Fulkrod)*.²⁵⁴² Aligning itself with the courts that have adopted the second view, the Ninth Circuit found that any construction of the statutory scheme that “renders superfluous the trustee fee provision or, for that matter, the trustee himself,” should be avoided.²⁵⁴³ The Ninth Circuit reasoned that it “is fairly certain” that if the debtor is allowed to confirm a direct payment plan and avoid the trustee’s percentage fee, “the trustee will receive nothing.”²⁵⁴⁴ The court therefore concluded that a Chapter 12 debtor may not escape liability for the trustee’s statutory compensation by making payments directly to an impaired creditor.²⁵⁴⁵

The third view focuses on the language of the Judicial Code and holds that the debtor may bypass the trustee and directly disburse payments on modified claims, with the trustee’s fee being calculated only on those payments actually “received” and disbursed by the trustee.²⁵⁴⁶ Some courts under this view impose little or no restriction on a debtor’s ability to make direct payments to secured creditors and thereby shelter those payments from the calculation of the trustee’s percentage fee.²⁵⁴⁷ Other courts hold that a debtor’s right to make direct payments to impaired claimants is not absolute and employ guidelines for determining when direct payments should

S.D. Iowa 1988); *In re Hildebrandt*, 79 B.R. 427, 429 (Bankr. D. Minn. 1987); *In re Hagensick*, 73 B.R. 710, 713-14 (Bankr. N.D. Iowa 1987); *In re Rott*, 73 B.R. 366, 375 (Bankr. D.N.D. 1987).

²⁵⁴² 973 F.2d 801 (9th Cir. 1992).

²⁵⁴³ *Id.*

²⁵⁴⁴ *Id.* at 802.

²⁵⁴⁵ *Id.* at 803 (rejecting the suggestion gleaned from the decision of the bankruptcy appellate panel that “limited circumstances” may justify permitting a debtor to make direct payments on impaired claims without trustee compensation as an unauthorized reading of the statute).

²⁵⁴⁶ See 28 U.S.C. § 586(e)(2) (1994). See, e.g., *Wagner v. Armstrong (In re Wagner)*, 36 F.3d 723, 725 n.3 (8th Cir. 1994). Although the diversity of tests used to reach the result has created confusion and a nonuniform body of law, the majority of the courts have held that, under certain circumstances, a court may confirm a plan proposing a direct payment to creditors whose claims have been impaired or modified under the plan. See Michaela M. White, *Direct Payment Plans*, 29 CREIGHTON L. REV. 583, 598 (1996)(collecting cases); See also 3 COLLIER ON BANKRUPTCY ¶ 326.02[3][c][ii], at 326-16 (Lawrence P. King et al. eds., 15th rev. ed. 1996).

²⁵⁴⁷ See, e.g., *In re Cross*, 182 B.R. 42 (Bankr. D. Neb. 1995), *aff’d sub nom.*, *Lydick v. Cross*, 197 B.R. 321 (D. Neb. 1995); *In re Crum*, 85 B.R. 878, 879 (Bankr. N.D. Fla. 1988); *In re Land*, 82 B.R. 572, 578-80 (Bankr. D. Colo. 1988); *In re Erickson Partnership*, 77 B.R. 738, 747 (Bankr. D.S.D. 1987), *aff’d sub nom.*, *Yarnall v. Erickson Partnership*, 83 B.R. 725, 727-28 (D.S.D.), *rev’d on other grounds*, 856 F.2d 1068 (8th Cir. 1988).

be permitted.²⁵⁴⁸ The Sixth Circuit in *Michel v. Beard (In re Beard)*²⁵⁴⁹ and the Eighth Circuit in *Wagner v. Armstrong (In re Wagner)*²⁵⁵⁰ have allowed debtors to avoid paying the trustee's percentage fee through direct payment plans.

In holding that Chapter 12 debtors may make direct payments on impaired claims and avoid the statutory percentage fee on those payments, the Sixth Circuit in *Beard* noted that the statute is devoid of any reference to "payments that could have been received" or other similar language "which would mandate payment of the percentage fee on a constructive receipt basis."²⁵⁵¹ Similarly, the Eighth Circuit in *Wagner* rejected the trustee's contention that the Bankruptcy Code precluded direct payments to secured creditors whose claims were modified under the plan. The court concluded that "the code does not prohibit plan provisions of this sort."²⁵⁵² Consequently, under *Wagner*, a debtor has the discretion to draft a plan that provides for direct payments, thereby avoiding payment of the trustee's fee. The court expressly rejected the *Fulkrod* analysis, finding that it was based upon policy arguments rather than a close textual analysis. The *Wagner* court found that direct payment provisions in Chapter 12 plans "are not in conflict with the bankruptcy code"

²⁵⁴⁸ See, e.g., *Overholt v. Farm Credit Servs. (In re Overholt)*, 125 B.R. 202, 212-13 (S.D. Ohio 1990); *Westfahl v. Clark (In re Westfahl)*, 168 B.R. 337, 364 (Bankr. C.D. Ill. 1994); *In re Teigen*, 142 B.R. 397, 401-02 (Bankr. D. Mont. 1992); *In re Beard*, 134 B.R. 239, 243-44 (Bankr. S.D. Ohio 1991); *In re Martens*, 98 B.R. 530, 534 (Bankr. D. Colo. 1989); *In re Bettger*, 105 B.R. 607 (Bankr. D. Or. 1989) (enunciating a multi-part test to be used as a template for determining whether direct payments should be allowed); *In re Pianowski*, 92 B.R. 225, 233-34 (Bankr. W.D. Mich. 1988)(setting forth 13 nonexclusive factors courts should consider when determining whether to permit a debtor to serve as a disbursing agent for plan payments). See also *In re McCann*, 202 B.R. 824, 830 (Bankr. N.D.N.Y. 1996) (refusing to impose a multi-factored test which would serve as a scorecard for evaluation in favor of a case-by-case assessment with the caveat that direct payments on modified or impaired claims are the exception, not the rule).

²⁵⁴⁹ 45 F.3d 113 (6th Cir. 1995).

²⁵⁵⁰ 36 F.3d 723 (8th Cir. 1994).

²⁵⁵¹ *Michael*, 45 F.3d at 119 (quoting *Pianowski*, 92 B.R. at 232).

²⁵⁵² *Wagner v. Armstrong (In re Wagner)*, 36 F.3d 723, 726 (8th Cir. 1994). The *Wagner* opinion has been broadly interpreted by a number of courts. See, e.g., *In re Cross*, 182 B.R. 42 (Bankr. D. Neb. 1995) (interpreting *Wagner* to hold that debtors have the unfettered right to bypass the trustee and pay any debt directly absent a court order under section 105), *aff'd sub nom.*, *Lydick v. Cross*, 197 B.R. 321 (D. Neb. 1995); *In re Wruck*, 183 B.R. 862, 864 (Bankr. D.N.D. 1995). Indeed, the standing trustee in at least one jurisdiction (North Dakota, the jurisdiction from which *Wagner* arose) is required to seek appointment on a case-by-case basis and seek compensation under sections 326 and 330 of the Bankruptcy Code like any other professional.

and are “valid” even if they preclude the payment of the percentage fees from those payments made directly by the debtor.²⁵⁵³

Standing Chapter 12 trustees argue that direct payments on impaired debt should not be exempt from the statutory percentage fee in 28 U.S.C. § 586(e)(1)(B)(ii). They argue that the Chapter 12 trustee system was modeled after the Chapter 13 trustee system. As a result, trustees play a central role in the administration of Chapter 12 cases.²⁵⁵⁴ Among standing trustees’ statutorily-prescribed duties,²⁵⁵⁵ are a host of services that benefit the court, the debtor, and the creditors. These duties include: accounting for all property received; investigating the financial affairs of the debtor; ensuring that the debtor performs in accordance with the provisions of a confirmed plan; maintaining information regarding the administration of the estate and furnishing information regarding the estate’s administration to creditors and other parties in interest; making a final report and filing a final accounting with the bankruptcy court and the United States trustee; appearing and being heard at any hearing concerning the confirmation of a plan or the sale of property of the estate; and taking control of the debtor’s assets and operating the farming operation if the court removes the debtor as debtor in possession.²⁵⁵⁶

²⁵⁵³ *Wagner*, 36 F.3d at 727-28; *accord* *Pelofsky v. Wallace*, 102 F.3d 350, 353, 356 n.7 (8th Cir. 1996) (affirming the principles set forth in *Wagner* but indicating that because “the meaning of section 586 concerning calculation of the standing trustee’s percentage fee under section 586(e) has split inferior federal courts, perhaps Congress, or the Supreme Court, will clarify the issue”).

²⁵⁵⁴ The United States trustee system, originally constituted in 1978 as a pilot program in a few judicial districts, was permanently adopted in 1986 in virtually every jurisdiction (Bankruptcy Administrators are used in Alabama and North Carolina rather than U.S. trustees). Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, 100 Stat. 3088 (codified as amended at 28 U.S.C. §§ 581-589a (1994)). The system was created to remove case administration responsibilities from the judiciary. H.R. REP. NO. 99-178, at 18-22 (1986), *reprinted in* 1986 U.S.C.C.A.N. 5227, 5229-34. The legislative history reveals that the appointment of private trustees to administer bankruptcy estates adequately separates the administrative and judicial functions and places the administrative duties in the branch of government most capable of exercising independent oversight. *Id.*

²⁵⁵⁵ If the case load in a particular region warrants, the United States trustee for each region may, subject to the approval the Attorney General, appoint and supervise a standing Chapter 12 trustee. 28 U.S.C. § 586(b) (1994).

²⁵⁵⁶ 11 U.S.C. § 1204(a) (1994). It has been recognized that:

The trustee is the nucleus of a reorganization; his or her responsibilities begin the day the case is filed and continue until the day the case is closed. The trustee is a fiduciary to all parties in interest, an adviser to the court and a source of information, education and mediation leading hopefully to confirmation. . . . [I]n the real world of debtors, creditors and the attendant emotions and fragile

Disbursing plan payments is another important duty that standing trustees perform in connection with the administration of Chapter 12 bankruptcy cases.²⁵⁵⁷ The Bankruptcy Code requires the Chapter 12 plan to “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.”²⁵⁵⁸ Additionally, the Code directs the standing trustee to make payments to creditors under the plan “[e]xcept as otherwise provided in the plan or in the order confirming the plan”²⁵⁵⁹

As compensation for performing the services in connection with the administration of the Chapter 12 case, the standing trustee is directed to deduct from “each” of the debtor’s plan payments a percentage based upon payments made under the debtor’s plan.²⁵⁶⁰ The Attorney General, after consultation with the United States trustee, fixes the percentage fee to be charged by the standing trustee. In Chapter 12 cases, the percentage fee may not exceed 10% of the first \$450,000 “made under the plan” plus 3% of payments “made under the plan” after the “aggregate amount of payments made under the plan exceeds \$450,000.”²⁵⁶¹ The standing trustee “shall

psyches, the trustee is often the difference between success and failure. His or her voice is one of reason endeavoring to find a common ground among the various adversaries.

In re McCann, 202 B.R. 824, 830 (Bankr. N.D.N.Y. 1996).

²⁵⁵⁷ 11 U.S.C. § 1202(b) (1994).

²⁵⁵⁸ *Id.* § 1222(a)(1). *Accord id.* § 1322(a)(1).

²⁵⁵⁹ *Id.* § 1226(c). *Accord id.* § 1326(c).

²⁵⁶⁰ *Id.* §§ 1202(d); 1226; 28 U.S.C. § 586(e) (1994). The Bankruptcy Code specifies the order in which plan payments are to be disbursed:

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

- (1) any unpaid claim off the kind specified in section 507(a)(1) of this title; and
- (2) if a standing trustee appointed under section 1202(c) of this title is serving in the case, the percentage fee fixed for such standing trustee under section 1202(d) of this title.

11 U.S.C. § 1226(b) (1994) (emphasis added).

²⁵⁶¹ 28 U.S.C. § 586(e)(1)(B) (1994) (emphasis added).

collect such percentage fee from *all payments received*” by the trustee in the cases in which such individual serves.²⁵⁶²

The amounts levied upon payments made under the plan are applied to offset three costs of the system. First, as previously indicated, a portion of the fee is applied toward the payment of the standing trustee’s personal compensation.²⁵⁶³ Second, a part is used to pay the salaries of the trustee’s staff and other actual overhead expenses.²⁵⁶⁴ Third, a portion of the fee is remitted to the “United States Trustee System Fund.”²⁵⁶⁵

The laudable purpose of the Congressionally mandated payment structure is to maintain a predominantly self-funding program which compensates standing trustees from funds generated by debtors who *elect* to participate in the bankruptcy system. More specifically, Congress intended those who reap the benefits of Chapter 12 to assume a substantial portion of the costs of administering the bankruptcy estate by requiring that a percentage of estate assets be dedicated to funding the trustee system. This purpose is consonant with the long-standing precept under all chapters of the Bankruptcy Code that the payment of administrative expenses should be derived from the assets administered.²⁵⁶⁶

A number of the provisions of the Bankruptcy and Judicial Code governing the distributions to creditors and the trustee’s percentage fee refer to payments “made under the plan” or to claims “provided for by the plan.” This suggests that Congress

²⁵⁶² *Id.* § 586(e)(2) (emphasis added).

²⁵⁶³ *Id.* § 586(e)(2)(A), (B)(i).

²⁵⁶⁴ *Id.* § 586(e)(2)(B)(ii).

²⁵⁶⁵ *Id.* § 586(e)(2).

²⁵⁶⁶ George H. Singer, *Zeroing Out the Standing Trustee’s Percentage Fee: The Eighth Circuit Approves “Outside the Plan” Payments for Chapter 12 Debtors*, 11 NORTON BANKR. L. ADVISER 7 (1994). It is important to note that a Chapter 12 standing trustee assumes significant financial risks. A trustee receives absolutely no remuneration for the services performed in any case in which the plan is not confirmed by the court. The compensation structure’s economy-of-scale results in trustees often receiving no compensation in cases in which substantial effort and outlay have been expended and receive increased compensation in other cases where the labor and expense have not been as great. See *In re Harris*, 200 B.R. 745, 748 (Bankr. D. Mass. 1996) (quoting with approval *In re Savage*, 67 B.R. 700, 706-08 (D.R.I. 1986) (“The ‘no asset’ or ‘meager asset’ cases can be handled professionally, because the system is not dependent on each individual matter to generate its own fees.”)).

contemplated that certain payments might not be “made under the plan” or that there may be claims which are not “provided for by the plan.”²⁵⁶⁷ The directive is not, however, clear on whether those payments can be sheltered from the statutory fee. Seizing the permissive grant of authority in the Code,²⁵⁶⁸ Chapter 12 debtors have drafted plan provisions that enable them to act as disbursing agents in order to make “direct payments” (often referred to in bankruptcy parlance as “outside the plan” payments), thereby avoiding payment of the statutory fee.²⁵⁶⁹

Rationale. The Proposal clarifies that the calculation of the statutory percentage fee should be based upon payments made on account of all claims that are “impaired” or “modified” under a plan of reorganization. The Proposal does not disrupt the provisions in Chapter 12 which allow a debtor to make certain payments directly in limited circumstances.²⁵⁷⁰ There may be legitimate reasons for permitting such direct payments. The bankruptcy court should have the discretion to make the determination. Such direct payments, however, if made on claims that are impaired or modified “under the plan,” would not be exempt from the calculation of the percentage fee.

²⁵⁶⁷ See, e.g., 11 U.S.C. §§ 1225(a)(5), 1226(b) & (c) (1994); 28 U.S.C. § 586(e) (1994).

²⁵⁶⁸ Section 1225, which sets forth the requirements of plan confirmation, provides:

(a) . . . the court *shall* confirm a plan if—

...

(5) with respect to each allowed secured claim provided for by the plan—

...

(B)(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

11 U.S.C. § 1225(a)(5)(B)(ii) (1994) (emphasis added). *Accord id.* § 1226(c) (set forth *supra* at text accompanying note 2485). Notably, the ostensibly affirmative grant contained in section 1225(a)(5)(B)(ii) is absent from Chapter 13 despite its many mirror-image similarities. See *id.* § 1325(a)(5)(B)(ii).

²⁵⁶⁹ It is frequently argued that if a Chapter 12 plan provides for direct payments, submitting that portion of the income to the standing trustee is not necessary for the execution of the plan, as required under the statute, because the plan specifically provides for the debtor to deal with that creditor’s claim in a manner separate and apart from the plan itself. See Jason S. Brookner, *Primer on Debtor Direct Payments in Chapter 12 Cases*, 15 AM. BANKR. INST. J. 26, 26 (1996); see also 11 U.S.C. §§ 1222(a)(1), 1226(c), 1322(a)(1), 1326(c) (1994).

²⁵⁷⁰ It should be recognized that permitting a debtor to act as a disbursing agent for payments made under the plan makes it difficult for a standing trustee, who is required to monitor the plan payments and make an accounting of disbursements, to perform its fiduciary obligations. The impetus for making payments directly, however, will vanish in many cases, if a debtor can no longer escape liability for the statutory fee.

The inconsistent case law that has emerged from an interpretation of the labyrinthine language in section 586(e) threatens the integrity of the Chapter 12 trustee program. The present state of the law on direct payments in some jurisdictions impairs the bankruptcy system's ability to attract and retain qualified individuals to serve as standing trustees and assume the fiduciary obligations imposed by the Bankruptcy Code.

Competing Considerations. The Proposal calls into question the necessity of a standing trustee in Chapter 12. Does a principled basis exist for differentiating between a Chapter 12 debtor in possession and a Chapter 11 debtor in possession. If the Commission views the oversight and administrative functions performed by the standing trustee in Chapter 12 as necessary to the administration of Chapter 12 cases, the fundamental question then becomes how best to ensure an adequate compensation structure in order to fund the system. Absent an adequate assurance of remuneration for the services provided, the United States trustee will simply be unable to attract and retain qualified individuals willing to serve as standing trustees.

It has been argued that standing trustees should be compensated like all other professionals based upon the reasonable value of the services rendered.²⁵⁷¹ Similarly, the reasonableness of that compensation in an individual case should be subject to judicial review. The genesis for this contention is that the statutory percentage fee in Chapter 12 (due to the often very substantial debt payment being serviced under a plan) is disproportionate to the amount of time and resources actually expended in administering an individual case. Although this argument has some facial appeal, it fails to accord proper consideration to the fact that the percentage fee structure contemplates an economies-of-scale method of compensation in order to fund the administration of the entire system.²⁵⁷² Under a self-funding system entirely dependent upon fees based on a percentage of payments, some debtors inevitably will pay more than their share of the costs of the trustee program. This is, however, necessary because other debtors that avail themselves of the system will pay less, or nothing at all.

The statutory percentage fee, in some cases, adversely affects the feasibility of a plan of reorganization because the larger debt service can make the fee substantial. Additionally, the imposition of the percentage fee on payments made on modified claims under a plan effectively reduces, and often eliminates, the amount of disposable income that otherwise would be available for unsecured creditors. The steep ten percent fee may also have the undesirable effect of enabling marginal family

²⁵⁷¹ See, e.g., 11 U.S.C. §§ 328-330 (1994).

²⁵⁷² See Singer, *supra* note 2566 (noting that standing trustees receive no remuneration for the services performed in any cases which do not result in a confirmed plan since the fee is calculated based upon disbursements made under the plan).

farms to restructure out of court (to avoid the trustee surcharge) and forcing the cases that are least able to afford a 10 percent surcharge into Chapter 12. The collective proceeding that Chapter 12 offers is voluntary and benefits both debtors and creditors, however, who each must share the concomitant risks and costs of administration.