

Family Farmer Bankruptcy The Basics of Chapter 12

This article is written primarily for farmers and ranchers, in particular those farmers or ranchers who are facing financial distress. It is a summary of Chapter 12 bankruptcy. The intention is to distill the basics of Chapter 12 into useful, reliable, though necessarily general terms.¹

It is worth noting a few things to start. The United States Constitution itself provides that there will be uniform bankruptcy laws. Chapter 12, the family farmer bankruptcy, was first brought into law in 1986, during the height of the farm crisis. It was not made a permanent part of the bankruptcy code until 2005. The purpose of this law, as often stated by the courts, is to give family farmers facing bankruptcy a fighting chance to reorganize their debts and keep their land.

Preliminaries

Let's get a handle on a few basic bankruptcy terms.

Bankruptcy Petition

This is the filing in a bankruptcy court that begins a bankruptcy case. In bankruptcy, many things are defined according to whether they happened or arose before the petition was filed (pre-petition) or afterwards (post-petition). The power of a bankruptcy in many respects extends only over pre-petition matters.

Debtor

The person in bankruptcy, whether an individual or an entity, such as a corporation.

Bankruptcy estate

Property which the debtor owns or has an interest in as of the date the petition is filed. The estate also sometimes includes property that is acquired after the bankruptcy is filed.

Claims

A right to payment. We speak of creditors of the debtor as having claims. In general there are three types of claims in bankruptcy, a secured claim, an unsecured claim and a priority claim. A **secured claim** is one which is secured by a lien on property of the bankruptcy estate, whether real property or personal property. An **unsecured claim** is one that is not secured by a lien on property, that has no collateral underlying it, e.g. many medical debts, credit card debts, and open account purchases, etc. A **priority**

¹ Chapter 12 is also available to family fisherman, as defined by the Bankruptcy Code, and though much of the material in this article is relevant to a bankruptcy analysis for such debtors, there are differences that are not discussed.

claim is one that is given special status under the bankruptcy laws, such as certain claims for taxes, child support, alimony and the costs of the bankruptcy. In general, priority claims have to be paid in full. The treatment of a claim in bankruptcy, i.e. how much of the claim gets paid and under what terms, is often determined by which of these three types of claims it is.

Exemptions

Exemptions are property that the debtor gets to keep. Exemptions differ from state to state depending on whether or not a state has “opted out” of the federal bankruptcy exemptions. A majority of states have opted out and thus define for themselves what exemptions are available to a debtor in bankruptcy. Exemption planning is an important aspect of bankruptcy for debtors and often plays a role in determining what kind of bankruptcy a debtor files, i.e. a liquidation or a reorganization. Attached to this article is a listing of the Nebraska exemptions.²

Liquidation & reorganization

There are two basic types of bankruptcy: liquidation and reorganization. In a **liquidation**, also known as Chapter 7, the debtor seeks to wipe out debts in exchange for giving up non-exempt property. A trustee is appointed to collect and sell the debtor’s assets and pay claims, according to status and priority. The debtor gets to keep exempt property. The goal a debtor seeks in Chapter 7 is the discharge, an order of the court freeing the debtor of personal liability for the pre-petition debts. Chapter 12 works differently; it is a **reorganization** bankruptcy. In a reorganization, the idea is that the debtor keeps possession of the property that he or she wants (or needs) to keep, and pays his or her debts under the terms and conditions of the bankruptcy. In a sense, you pay for what you keep, under bankruptcy terms, and surrender what you don’t want to keep or cannot afford to keep. (A liquidation bankruptcy can sometimes be used as a reorganization, and a reorganization as a liquidation, but such bankruptcy strategies are beyond the scope of this article.)

Discharge

The goal of most bankruptcies is the discharge. This is the court order that makes legally binding many of the things that happened in a bankruptcy, e.g. the forgiveness of debts.

What Chapter 12 Does

It puts up a wall around your operation. This wall (the *automatic stay*) prevents creditors from taking action to collect debt, i.e. repossession of collateral, replevin, garnishments, foreclosure.

² For information on exemptions in various states, see <http://www.nolo.com/legal-encyclopedia/bankruptcy-exemptions-state>.

It stops lawsuits. It therefore gives the debtor a little breathing room, in which to comply with bankruptcy procedures and to propose a plan of reorganization.

Chapter 12 allows for some debts to be restructured. It allows for some debts to be written off, partially or entirely. It allows for the rejection of certain burdensome contracts and leases. It can erase liens on certain kinds of property. It can also assist in dealing with the tax debts that arise from the sale of farm assets, such as capital gain or recaptured depreciation.

The heart of Chapter 12 is the Chapter 12 Plan. Within the three months after a bankruptcy is filed, the farm debtor is required to file a plan of reorganization demonstrating how the farm or ranch intends feasibly to keep going. (This is a deadline that is sometimes extended.) What goes into this plan? The essence of the plan is the proposed treatment of creditors' claims. Let's take **secured claims** in a Chapter 12, for this is where one of the real strengths of Chapter 12 lies. Chapter 12 allows the debtor to restructure secured claims based on the nature and value of the collateral that secures the claim. A secured claim must be paid at least as much as the value of the collateral that secures the claim.³ The value of collateral relative to the amount of the claim is thus an important determination in the bankruptcy. Once the amount of the secured claim is determined, the claim can be restructured. For example, a claim secured by land may be reamortized over 20-30 years and paid in installments that coincide with the availability of funds. A claim secured by machinery and equipment may be restructured over 3 to 7 years, sometimes longer, depending on the quality of the collateral. A claim secured by livestock may be restructured for payment over 5-10 years, maybe longer. In general, one of the goals for the debtor in Chapter 12 is to obtain as long a payout as possible, with no prepayment penalty, in order to lessen the burden on the cash flow. Another goal is to structure payments so that they come due when the debtor is most likely to have funds, often late winter for row crop farmers, but with livestock operations the timeframes differ. (Cash flows can differ by operation and the important thing is to understand the operation.) Claims are restructured (reamortized) using the bankruptcy rate of interest, which is Wall Street Journal Average National Prime + 2 points. That rate has rested at 5.25% for several years now.

Unsecured claims are treated according to something called the liquidation analysis, or best interests of creditors test. This is a hypothetical liquidation. The idea is this: if the debtor had filed under Chapter 7 instead of Chapter 12, what would the creditors likely have received on their claims: payment in full? fifty cents on the dollar? nothing? The liquidation analysis starts with the value of the property that the farm debtor owns. What is that value? (Value, as mentioned, is an important question in bankruptcy, and one which, in the absence of agreement among the parties, can sometimes require an appraisal.) Once a value is determined, certain things are subtracted (deducted) from that value: the amount of the secured claims, the debtor's

³ If the collateral which secures a claim is worth less than the amount of the claim, the amount in excess of the value of the collateral becomes an unsecured claim, and is treated as such under the plan.

exemptions, and the hypothetical costs of sale of the assets, including tax costs, which the debtor would incur in a liquidation of assets. Once these items are subtracted, any amount that remains in the value of the estate property, if anything, is the bankruptcy equity, or the amount available to be paid pro rata to unsecured creditors. The amount unsecured creditors must be paid can range from nothing to payment-in-full; it depends on the equity, which in turn depends on the value of the farm debtor's property.

Whatever the amount that has to be paid to unsecured creditors, it is typically paid over the term of the Chapter 12 Plan, usually three years, and usually with very little, if any, interest. If the unsecured creditors or the trustee object to treatment of the unsecured claims, then the debtor must devote disposable income for the three years of the plan to payment of those claims. However, there is often very little disposable income during the period of the plan, for disposable income is income net of the amounts necessary for support of the debtor and his or her dependents and for continuation of the farming business.

Priority claims are those claims that in general must be paid in full, regardless of the security position of the claim. Priority claims are typically paid within the term of the plan or, for child support and alimony, in accordance with court orders. Taxes are often priority claims, requiring payment over the term of the plan. Significant delinquent taxes can create a fatal cash flow burden to the reorganization. Sometimes tax claims are not priority claims but general unsecured claims and are paid or not according to the best interests of creditors (liquidation analysis) test. For example, taxes that were first due and owing more than three years before the bankruptcy was filed, and for which the proper tax return was timely filed, can typically be treated as general and not priority unsecured claims. In Chapter 12, and Chapter 12 only, certain tax claims arising from the pre-petition sale of farm assets, such as land or breeding livestock or machinery & equipment, can be treated as general unsecured claims and discharged even where not paid in full. For example, if a farmer sells land or machinery and equipment in the year before the bankruptcy filing, perhaps under pressure from a creditor, and capital gain or other income tax is due as a result of that sale, there is a special Chapter 12 provision which gives the farm debtor the power to treat that tax claim as a general unsecured claim, and not as a priority claim, which means that the tax claim may not have to be paid in full, or, perhaps, at all, before it is finally legally discharged.

Executory contract

This is a term for a contractual obligation that has not been completed by the parties. For example, the farm debtor may have entered into a contract for the delivery of grain at a certain price, i.e. a forward contract. If this contract price is lower than the current market price, the farm debtor will generally want to reject this contract, in order to be able to sell grain for a higher price. Conversely, if the debtor has forward contracts at a good price relative to the current market, he or she will want to assume those contracts. Equipment leases and some FSA

programs are other types of executory contracts, which may be assumed or rejected. In the current volatility of farm economics, the power to assume or reject contracts can be a significant consideration in a bankruptcy analysis.

One problematic area of executory contracts for Chapter 12 debtors lies in land leases, i.e. where the farm debtor is renting ground from a third-party landowner. In order to keep that lease, to continue to be able to farm the rented ground, the farmer must be current on rental payments and able in general to make rent payments as they come due. If the farm debtor is in arrears on the rent payments, he or she must be able to cure that arrearage, i.e. come up with the money to pay the overdue rent, promptly. There is, of course, no guarantee that a landowner will continue to rent to the farmer in bankruptcy in subsequent years. Consequently, farmers who rent much or all of their land can be more vulnerable in Chapter 12 than those farmers who own all or most of their ground.

Financing

How does one operate in a Chapter 12? Farmers typically borrow money every year in order to farm. Livestock operations also typically borrow money in order to keep operating, though this is perhaps less true of ranching operations. Such operating money is often structured as an annually payable operating line of credit. Generally (though not invariably) the farm debtor's lender will be reluctant to continue loaning money to a farm customer who has filed for (and is in) bankruptcy. Indeed, it may be pressure from that very farm lender that prompted the bankruptcy filing. So where does the necessary operating money come from? In general, one of two places: post-petition financing or use of cash collateral. Let's take these one at time.

Post-petition financing is a phrase that most commonly describes crop financing. If a farmer files bankruptcy before a crop is planted, the lien on that crop (if one existed, and it often does) is cut off. This means that the farmer has a new, prospective crop that can be pledged as collateral to a party that is willing to loan operating funds to the farm debtor. Such financing typically gives the new lender a super-priority lien on the crop, an assignment of crop insurance proceeds and an assignment of FSA program payments. It tends to be a fairly secure position. The question always is whether or not it is secure enough to overcome most lenders' reluctance to loan money "into a bankruptcy." Sometimes a friend or family member of the debtor, if able, will step in to provide bankruptcy financing under a court ordered super-priority position.

Livestock, as opposed to crop, financing is in general more difficult to obtain, in that pre-petition liens on livestock and their offspring are often not cut off by the bankruptcy filing. This brings us to the other possible source of post-petition operating money, the use of cash collateral, or operating under one's own steam. A farm debtor under certain circumstances may be able to sell grain, livestock, or other collateral assets and use the proceeds to operate on. This use of cash collateral (remember, when collateral is sold the lien usually attaches to the proceeds of the

collateral as well) may be obtained either by agreement with the secured creditor or through order of the bankruptcy court.

Understanding and forecasting the need for – and source of - operating money is a critical part of pre-petition bankruptcy analysis. It can make all the difference to bankruptcy success or failure.

What Chapter 12 Requires: Eligibility

A person must be eligible to file for Chapter 12. This means in essence that a Chapter 12 debtor must qualify as a farmer under the Bankruptcy Code definition of family farmer. That definition is made up of two general parts: debt limits and income requirements. In addition to these two requirements, the debtor must be *engaged in* a farming or ranching business. The test for eligibility is meant to restrict use of Chapter 12 only to those persons who meet the definition of family farmer.

Engaged in a Farming Operation

This is a fairly straight forward requirement. Most activities that one would commonly think of as constituting farming or ranching qualify as engagement. Issues can arise where a farmer or rancher has discontinued an operation for financial reasons, e.g. rented out assets and taken an off-farm job. Issues can also arise in the use of certain entities.

Debt Test

A person to be eligible for Chapter 12 cannot have more than \$4,031,575 of debt.⁴ At least 50% of this debt had to have arisen as part of the farming operation, i.e. at least 50% of total debt must be farm debt. (There is a little flexibility in these figures, as the debt on a personal residence may be excluded from the test in certain circumstances. There have also been significant court decisions to provide guidance into what exactly qualifies as farm debt.)

Income Test

There are two ways to meet this test. More than half of a person's income must have come from farming in the taxable year preceding the year the bankruptcy is filed. If this test does not work for eligibility (some farm and ranch families may have taken on off-farm work and rented out their assets in order to keep going), the alternative test is that at least half of the income for the second and third years preceding the year of filing needs to have come from farming. So, for example, if a bankruptcy is filed in 2016, at least half of the income from 2015 needs to have come from farming. If it is less than half for 2015, one can then look at the prior years' income, that is 2014 and 2013, and if *in each of these years* the farm income exceeded the non-farm income, the income test is met.

⁴ This figure is subject to change every three years.

What is meant by the term farm income? In general, it is the farm income reported on the top half of the Schedule F to the 1040, or gross farm income. Cash rents do not typically qualify as farm income. There have been numerous disputes over the years as to whether or not income from certain kinds of activities constitutes farm income. Discussion of this case law is beyond the scope of this article.

If the farmer under Chapter 12 is a corporation, LLC or partnership, the income and debt limit tests for eligibility are the same. Additionally, eligibility requires that one family (including relatives) owns more than half of the entity, that the family conduct the operation, and that more than 80% of the entity's assets be related to the farming operation.

How Does Chapter 12 Work

Most of the work of a Chapter 12 occurs in the months after the petition is filed. As mentioned, the petition commences a Chapter 12 bankruptcy case. The filing fee, paid with the petition or, if allowed, in installments, is \$275. A complete list of creditors with addresses must be filed with the petition. In addition, the debtor is required to file, either with the petition or within two weeks of the petition, a set of bankruptcy schedules and statement of financial affairs. There is also a requirement to obtain a certificate of consumer credit counseling, even though a Chapter 12 is a business bankruptcy. This requirement can be quite simply fulfilled on line, by telephone or in person with nominal cost, i.e. \$25-\$40. In general, these documents paint a present picture of the financial situation of the debtor, including a description of assets, liabilities, exemptions, income, expenditures, executory contracts, and recent financial or property transactions.

Most Chapter 12 debtors will only attend in person one event related to their bankruptcy, which is the 341 Meeting of Creditors. At this meeting the debtor will answer questions related to the bankruptcy estate. Sometimes creditors attend the Meeting of Creditors, sometimes it is only the debtor, with counsel, and the Chapter 12 Trustee.

The main work of the Chapter 12, after preparing the Schedules and Statement of Financial Affairs, consists of negotiating with creditors and putting together a Chapter 12 Plan. Once a Plan is confirmed by the Bankruptcy Court, either with the agreement of the creditors or over their objections by order of the Court, the Chapter 12 Debtor must fulfill the Plan. This often essentially boils down to making the payments as required by the Plan (payments are often made through the Chapter 12 Trustee's office, though not always), and complying with the Chapter 12 Trustee's requests for information. The plan typically runs for three years, after which, if all payments have been made, the discharge order is obtained and the bankruptcy ends. The claims that were restructured over a period of years beyond the three years of the plan (e.g. land, machinery or livestock debt) continue on as restructured.

Some Warnings

Bankruptcy doesn't create money, though it can sometimes free up the use of funds that come from the sale of collateral. It costs money to file and stay in bankruptcy. In some bankruptcies the debtor has to pay not only his or her own lawyer's fees, but the lawyer fees incurred by secured creditors. There are typically trustee fees to be paid as well. A bankruptcy, once filed, will remain on a person's credit report for ten years. In certain agricultural enterprises, where reputation and relationships are critically important to maintaining customers or landlords, it can be problematic to hold on to those relationships, even though the bankruptcy filing may not harm them or put them at risk in any way.

Final Note

Chapter 12 can be a powerful tool. It is usually that last tool that a farmer or rancher in financial distress reaches for. If time and circumstances permit, it is always better to do a careful analysis of the bankruptcy option before a bankruptcy is filed. The best approach is to analyze with respect to the cash flow: what terms of debt repayment can a bankruptcy make possible, i.e. how can debt be restructured and/or written off, and can the farm or ranch meet those terms? The reorganization bankruptcy may be the last chance to keep going. Better to go into it with some sense of whether or not it can work for you.

Legal Aid of Nebraska

- *For additional information, contact your local FSA office.*
- *Information may also be available through the Nebraska Rural Response Hotline (1-800-464-0258).*
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