

Chapter 10

Bankruptcy

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Debtor — The person or business that owes money. This book assumes that the farmer is the debtor.

Creditor — The person or business to which the debt is owed—for example, a bank.

III. Planning for Bankruptcy

It is to the farmer's advantage to plan business decisions well before filing bankruptcy, if possible.

A. Prefiling Strategies

Many strategies for managing assets and debts before filing a bankruptcy petition are beneficial and perfectly legal. For example, it is sometimes possible to arrange a farmer's finances and assets to maximize the exemptions available.⁴

However, some financial actions a farmer might take before filing for bankruptcy are illegal.⁵ These can both ruin the bankruptcy and subject the farmer to possible criminal penalties. Unfortunately, recognizing the difference between legal and illegal pre-bankruptcy planning strategies can be difficult.⁶ It is extremely important, therefore, for a farmer to get qualified expert advice well before filing a bankruptcy petition.

B. If Necessary, Last-Minute Filing Possible

Although advance planning will make the bankruptcy more effective, it is possible to file a bankruptcy petition quickly, if needed.⁷ In some cases, a farmer may have no choice but to file a bankruptcy petition without much planning. For example, a filing may be needed to stop a threatened repossession or foreclosure, at least temporarily.

IV. Two General Types Of Bankruptcy: Liquidation and Reorganization

Two general types of bankruptcy are available to farmers and other debtors: reorganization bankruptcy and liquidation bankruptcy. The bankruptcy code provides for several specific types of bankruptcy—commonly known as

chapters. Farmers sometimes use chapters 7, 11, 12 and 13. Chapter 12 reorganization bankruptcy was specifically designed for family farmers.

A. Chapter 7 Liquidation Bankruptcy

Chapter 7 liquidation bankruptcy—sometimes called “straight” bankruptcy—is what comes to mind most often when people think of bankruptcy. In a Chapter 7 bankruptcy, the debtor’s nonexempt assets are typically sold or distributed to creditors.⁸ (Asset exemptions are discussed below.) The proceeds from the liquidation sale are used to pay the debtor’s creditors. Eventually, the debtor receives a “discharge” of most of the rest of the debts. This means the debtor is no longer legally required to pay those debts. Mortgages and other security interests, however, survive even after a discharge. With careful pre-bankruptcy planning, farmers who go through a Chapter 7 bankruptcy may be able to keep significant assets and might even be able to continue a farming operation.

B. Reorganization Bankruptcy

In a reorganization bankruptcy, the debtor proposes a plan to pay some or all of his or her debts over a specified period. The plan is then carried out under court supervision. In a successful reorganization bankruptcy, the farming operation can continue. Farmer bankruptcy reorganizations generally will be under either Chapter 12 or Chapter 11. A Chapter 13 reorganization bankruptcy is also possible.

1. Chapter 13 Wage-Earner Reorganization Bankruptcy

Chapter 13 bankruptcy—sometimes called wage-earner bankruptcy—is designed for individuals.⁹ The debtor follows a court-approved plan to make payments on debts and agrees to commit all disposable income to repaying creditors. The plan must be the debtor’s best good faith effort to repay creditors. The plan also should result in unsecured creditors receiving at least as much as if the debtor filed a Chapter 7 liquidation bankruptcy. Secured creditors should receive at least the value of their security. After the three- to five-year reorganization plan is completed, the debtor’s remaining debts are discharged.

To qualify for Chapter 13 bankruptcy, the debtor must have regular income, his or her unsecured debts must be less than \$307,675, and his or her secured debts must be less than \$922,975.¹⁰ Although not designed with farmers in

mind, Chapter 13 can sometimes be the best bankruptcy option, especially for farmers who cannot qualify under Chapter 12.

2. Chapter 11 Reorganization Bankruptcy

Chapter 11 is a reorganization bankruptcy for businesses. The debtor follows a court-approved plan to reschedule the business's debts over time while the business continues to operate.¹¹ Chapter 11 is the most complex and costly form of bankruptcy, and in some important ways is better suited to a large corporation than a family farm. In general, therefore, family farmers should only use Chapter 11 when Chapter 12 is not available.

3. Chapter 12 Family Farmer Reorganization Bankruptcy

Chapter 12 is a reorganization bankruptcy designed especially for family farmers.¹² Originally enacted in 1986, Chapter 12 has been repeatedly extended by Congress. Its most recent extension expired on January 1, 2004, when Congress allowed the statute that authorizes Chapter 12 to "sunset."¹³ On October 8, 2004, Congress unanimously approved a temporary reauthorization of Chapter 12.¹⁴ This extension would authorize Chapter 12 bankruptcies through June 30, 2005. It is expected that the President will sign the extension bill, but this had not yet occurred at the time this book was printed.

To qualify for a Chapter 12 bankruptcy, the debtor must be engaged in a farming operation and must have a regular annual income that is stable enough to make payments under the plan.¹⁵ Further eligibility requirements for Chapter 12 bankruptcy are: (1) no more than \$1.5 million in total debt; (2) at least 80 percent of the debt arose out of the farming operation; and (3) more than 50 percent of the debtor's (and spouse's) income came from farming in the tax year preceding the bankruptcy.¹⁶

Because of the lower debt limits and other restrictions on who may use Chapter 13 and the difficulties and expense of Chapter 11, Chapter 12 bankruptcy often provides the best alternative for farmers who can meet its eligibility requirements. This is especially true given the significant leeway that Chapter 12 gives a farmer in dealing with secured creditors.¹⁷ Even farmers who do not file a bankruptcy petition have found that having a Chapter 12 bankruptcy as a fall-back option helps to encourage creditor negotiations.

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In general, Chapter 12 allows a farmer to reorganize if the farmer can: (1) pay secured creditors, over time, the value of their collateral plus interest; and (2) pay unsecured creditors (including secured creditors to the extent that they are undersecured) as much as they would receive if the farmer filed a Chapter 7 liquidation bankruptcy. The farmer proposes a plan to meet these goals. The plan must be the farmer's best good faith effort to repay creditors. In addition, it must provide that the unsecured creditors will be paid any excess income, above the farmer's reasonable operating and living expenses, received by the farmer during the term of the plan (three to five years). The goal—which often is achievable—is to restructure the debts on farm assets and allow the farmer to keep assets and continue farming.¹⁸

V. Important Bankruptcy Features

Several of the important features of a bankruptcy filing are described here.

A. The Automatic Stay: Stopping Creditor Actions

Once a debtor files a bankruptcy petition, the debtor immediately gets the benefit of an “automatic stay.”¹⁹ An automatic stay temporarily stops creditors from taking a number of actions against the debtor to enforce debts. During an automatic stay, for example, a creditor is prohibited from attempting to enforce a judgment, repossess property, enforce a lien, or recover a debt. It is illegal for a creditor to violate the stay, and the stay remains in effect until the case is closed or dismissed, a discharge is granted or denied, or the creditor gets permission from the court to act.

For farmers acting at the last possible moment, an automatic stay may provide the only way to prevent a foreclosure or other creditor action.

B. Exemptions: The Minimum That Can Be Protected From Unsecured Creditors

Each state has laws exempting certain types of property from creditor actions to enforce unsecured debt. “Exempt” property is property that creditors cannot take unless it has been specifically pledged to them. Common state law exemptions include a homestead, a motor vehicle, and household goods.²⁰ Exemptions come into play in bankruptcies. For example, in a Chapter 7

bankruptcy, exempt assets will not be taken or sold for the benefit of unsecured creditors.

In some states, the debtor in bankruptcy can choose between state law exemptions and those set out in federal law.²¹ Federal exemptions include the equity value (up to certain limits) of a homestead, a motor vehicle, household goods, and other property, including the implements and tools of the debtor's trade.²²

In general, if a debtor has given a creditor a security interest in an item of property, the debtor has waived the right to claim that property as exempt from that secured creditor's claims. However, sometimes a debtor can use bankruptcy "lien avoidance" provisions to remove a creditor's security interests.²³

C. Discharge of Unsecured Debts

At the end of a successful bankruptcy, some unsecured debts will likely be discharged—which means that the debtor will no longer be legally required to pay them.²⁴ Not every type of unsecured debt owed by a debtor can be discharged in bankruptcy. For example, debts for child support or alimony, most student loans, and some taxes are not subject to discharge.²⁵ These will remain the debtor's obligation even after the bankruptcy is complete.

D. Voluntary Payments and Reaffirmation of Debts

After a bankruptcy, some farmers may wish to make payments on debts that were discharged in bankruptcy. There could be any number of reasons for someone to voluntarily pay discharged debts, including a desire to keep a business relationship with a certain creditor. Voluntary payments to a creditor after the debt has been discharged are permitted.²⁶ Such payments, however, are never legally required.

It is a completely different matter, however, if a debtor chooses to "reaffirm" a debt. Reaffirmation is a formal agreement to pay all or part of a debt that would otherwise be discharged in the bankruptcy.²⁷ Reaffirmation therefore has the debtor giving up the benefits of the bankruptcy discharge and remaining legally obligated to repay dischargeable debt. This is usually done to gain some benefit from a creditor, such as a continued line-of-credit, but should only be considered in special cases after careful consultation with a bankruptcy expert. The Bankruptcy Code itself specifies a number of protections to ensure that debtors do not unknowingly enter into reaffirmation agreements.²⁸

E. Future Credit

A bankruptcy generally can be listed in a debtor's credit history for up to ten years.²⁹ It therefore can affect a debtor's future ability to get credit. However, farmers in substantial debt and in default likely already have a poor credit rating even without a bankruptcy. In addition, some potential creditors may be more willing to grant credit once the slate is wiped clean and they do not have to compete with past creditors.

F. Disaster Payments in Bankruptcy

Crop insurance and disaster and payments often play a role in a farm bankruptcy following a natural disaster. These payments generally become the property of the bankruptcy estate.³⁰ They might also be claimed by a creditor that has a security interest in the farmer's crops or farm program payments.³¹ If disaster payments and crop insurance proceeds are covered by a creditor's security interest, the debtor still may be able to use them to fund a reorganization plan so long as the creditor is given additional collateral to protect the secured claim.³²

G. Income Taxes

A number of different aspects of bankruptcy and pre-bankruptcy planning efforts can affect the debtor's income taxes. The tax implications of a bankruptcy are important and often complicated. It is possible, for example, to lose much of the benefit of a bankruptcy due to taxes owed. Although Chapter 11 of this book discusses taxes briefly, it is important to get expert, individualized tax advice before filing a bankruptcy petition.

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- ¹ Helpful general information about bankruptcies can be found in: Phillip L. Kunkel, *Farm Legal Series*, available through the University of Minnesota Extension Service at: <http://www.extension.umn.edu/distribution/businessmanagement/DF7291.html>; National Consumer Law Center, *CONSUMER BANKRUPTCY AND LAW PRACTICE* (6th ed. 2000); Randy Rogers & Lawrence P. King, *COLLIER FARM BANKRUPTCY GUIDE* (1999); Roger E. McEowen & Neil Harl, *PRINCIPLES OF AGRICULTURAL LAW*, ch. 5 (2001); Susan A. Schneider, *The Family Farmer in Bankruptcy: Recent Developments in Chapter 12*, 3 *DRAKE J. AGRIC. L.* 161 (1998); Randy Rogers, *Current Developments in Agricultural Bankruptcies and Insolvencies*, 5 *DRAKE J. AGRIC. L.* 137 (2000); and David S. Yen, *Bankruptcy and the Low-Income Client*, 34 *CLEARINGHOUSE REV.* 709 (Mar.-Apr. 2001).
- ² *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934).
- ³ U.S. Const. Art. I, § 8, cl. 4.
- ⁴ H.R. Rep. No. 95-595, at 361 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6317; S. Rep. No. 95-989, at 76 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5862 (“As under current law, the debtor will be permitted to convert nonexempt property into exempt property before filing a bankruptcy petition. The practice is not fraudulent as to creditors and permits the debtor to make full use of the exemptions to which he is entitled under the law.”). See also, National Consumer Law Center, at 67-68.
- ⁵ For example, some transfers can be regarded as fraudulent. 11 U.S.C. §§ 548, 727(a)(2)(A).
- ⁶ See, for example, *In re Curry*, 160 B.R. 813 (Bankr. D. Minn. 1993); *In re Coates*, 242 B.R. 901 (Bankr. N.D. Tex. 2000).
- ⁷ See 11 U.S.C. § 301; Fed. R. Bank. P. 1007(a)(1), (c); National Consumer Law Center, at 73-74.
- ⁸ 11 U.S.C. §§ 701-728.
- ⁹ 11 U.S.C. §§ 1301-1330.
- ¹⁰ 11 U.S.C. § 109(e). See also 69 Fed. Reg. 8482 (2004).
- ¹¹ 11 U.S.C. §§ 1101-1146.

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- ¹² 11 U.S.C. §§ 1201-1231.
- ¹³ Pub. L. No. 108-73, 117 Stat. 891 (2003) (codified at 11 U.S.C. § 1201 note).
- ¹⁴ S. 2864, 108th Cong., 2nd Sess. (2004). An earlier bill to extend authorization for Chapter 12 bankruptcies through June 30, 2004, passed the United States Senate on November 25, 2003, but failed to pass in the House. S. 1920, 108th Cong., 1st Sess. (2003).
- ¹⁵ 11 U.S.C. §§ 101(18)-(21), 109(f). The definition of a family farmer is limited for bankruptcy purposes. Farm corporations and partnerships are considered to be “family farmers” only if they meet certain specific criteria, including requirements that more than 50 percent of the stock or equity in the farm be held by one family and their relatives and that the family conduct the farming operation. 11 U.S.C. § 101(18)(B).
- ¹⁶ 11 U.S.C. § 101(18).
- ¹⁷ 11 U.S.C. §§ 1221, 1222, 1225(a)(5). See also, National Consumer Law Center, at 419-20, 466-74.
- ¹⁸ One study concluded that a large percentage of Chapter 12 filers manage to keep their land and continue farming, and that the financial position of Chapter 12 filers tends to improve markedly after filing. Chris Faiferlick & Neil E. Harl, *Experience Shows Chapter 12 Works*, AGRI FINANCE, October 1995, at 32.
- ¹⁹ 11 U.S.C. § 362. See also, National Consumer Law Center, at 113-52.
- ²⁰ See, for example, A.C.A. § 16-66-218 (Arkansas); O.C.G.A. § 44-13-100 (Georgia); and N.D. Cent. Code, §§ 28-22-02, 28-22-03.1 (North Dakota). For a general discussion of exemptions, see National Consumer Law Center, at 153-204.
- ²¹ 11 U.S.C. § 522(b).
- ²² 11 U.S.C. § 522(d). In general, the fair market value is used for federal exemptions. The maximum values of several federal exemptions are automatically adjusted every third year to reflect inflation. 11 U.S.C. § 104. For property exemption values effective beginning April 1, 2004, see 69 Fed. Reg. 8482 (2004).
- ²³ 11 U.S.C. § 522(f). See also, National Consumer Law Center, at 173-204. For example, secured creditors will generally be considered secured only to the

extent of the fair market value of their collateral. The balance of the debt will be unsecured.

²⁴ 11 U.S.C. § 524. See also, National Consumer Law Center, at 325-401.

²⁵ 11 U.S.C. § 523(a).

²⁶ 11 U.S.C. § 524(f).

²⁷ 11 U.S.C. § 524(c), (d); National Consumer Law Center, at 109-10, 386-90.

²⁸ See 11 U.S.C. § 524(c), (d). Protections include: (1) requiring, among other things, “clear and conspicuous” statements in the reaffirmation agreement allowing the debtor to rescind the agreement within 60 days and advising the debtor that the agreement is entirely voluntary; (2) for debtors represented by counsel, requiring an affidavit from counsel that the debtor was fully advised of the consequences of the agreement and that the agreement does not pose a hardship; and (3) for debtors not represented by counsel, requiring the judge to hold a hearing to ensure that the debtor is fully advised of the consequences and voluntary nature of the agreement and that the agreement is in the debtor’s best interests.

²⁹ 15 U.S.C. § 1681c(a)(1).

³⁰ 11 U.S.C. §§ 541, 1207, 1306. See *In re Boyett*, 250 B.R. 822 (Bankr. S.D. Ga. 2000); *Drewes v. Lesmeister*, 242 B.R. 920 (Bankr. D.N.D. 1999); *Kelley v. Ring*, 169 B.R. 73 (Bankr. M.D. Ga. 1993).

³¹ See *In re FarmPro Services, Inc.*, 276 B.R. 620 (D.N.D. 2002); *Mercantile Bank v. Norville*, 249 B.R. 127 (Bankr. C.D. Ill. 2000); *Drewes v. Lesmeister*, 242 B.R. 920 (Bankr. D.N.D. 1999).

³² 11 U.S.C. §§ 361, 363. If the secured creditor does not agree to the use of the payments in the reorganization plan, permission must be obtained from the court. 11 U.S.C. § 363(c)(2); Fed. R. Bankr. Proc. 4001(b).