

FARM LEGAL SERIES

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Bankruptcy: The Last Resort

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INTRODUCTION

When a farm operator, or any other business person, is unable to continue to service all of his indebtedness he may face substantial pressure from creditors. This pressure eventually may take the form of legal action. One way a farmer can respond to the pressure of creditors is to seek the protection of the Bankruptcy Code. Farmers should understand bankruptcy procedures, their rights as a debtor and the rights of their creditors during bankruptcy. In addition, a farmer should be aware of and understand both the effect of bankruptcy and the different alternatives to bankruptcy. In the end, bankruptcy should always be considered a last resort.

EFFECT OF BANKRUPTCY

Choosing to seek the protection of the Bankruptcy Code is a serious decision. While the Bankruptcy Code may help alleviate your debt, the choice does not come without consequences.

First of all, bankruptcy petitions are public information and may be published in local newspapers. Many people feel uncomfortable with their private financial difficulties being exposed to the general public. Filing bankruptcy will also be reported to most major credit bureaus.

Second, you and your financial affairs will be subject to scrutiny by your creditors and the

Bankruptcy Court. Many financial decisions will require the approval of the Court.

Finally, particularly when filing for protection under Chapter 7, the farmer may have to bear the loss of many of his assets. In this case, it will be increasingly difficult to continue farming or return to farming in the future.

ALTERNATIVES TO BANKRUPTCY

Because bankruptcy should be only be considered as a last resort, a farmer should first look the alternatives available to debtors that don't result in a bankruptcy petition.

Voluntary workouts

Many farmers prefer to negotiate an arrangement with creditors to restructure their debts or to repay them on terms different from what is specified in their various loan agreements. This type of informal workout may permit a farmer to continue operating his farm while insuring that his creditors are paid. Such agreements are perhaps most common in situations in which the debtor's financial distress is temporary.

A workout may involve reamortizing existing indebtedness over a longer period of time; temporary arrangements to defer payment of principal; or the reduction of the interest rate charged by a creditor. In addition, such arrangements may require the borrower to provide a lender additional collateral to

secure the loan or otherwise provide the lender with additional credit enhancements.

Workout arrangements, however, rarely resolve a current financial situation in a manner that is satisfactory to all parties. For one thing, such arrangements are voluntary. All creditors must agree to participate; the farm debtor can do nothing to force participation. If only some creditors agree to cooperate with the borrower, the likelihood that any workout arrangement will ultimately be successful is limited. There is no court supervision of such arrangements, and there is no discharge of indebtedness given to the debtor. Unless the debtor can get releases from his creditors as a part of a workout arrangement, they could attempt to collect any unsatisfied portion of their claims at a later time.

Debt/Credit Counseling Services

If the farmer is not comfortable negotiating with his creditors personally, he may also seek outside help through debt or credit counseling services. These services are generally nonprofit organizations that work on the debtors behalf to reduce interest rates and/or the amount of outstanding debt. These services can include, for example, the creation of debt management plans and education on money management. Credit counseling is now required for individual debtors filing for protection under Chapter 7.

BANKRUPTCY OPTIONS

If some type of workout cannot be negotiated, bankruptcy may be the only alternative. Although bankruptcy usually is viewed as "throwing in the towel," the Bankruptcy Code actually offers some choices. Under the Bankruptcy Reform Act of 1978, there are several types of bankruptcy protection available, which either involve rearranging the debtor's financial affairs to allow him to continue operating his business

or the liquidation of the debtor's asset. This fact sheet examines the general features of bankruptcy. Separate fact sheets describe in detail the operation and effects of the various alternatives.

Chapter 7 Bankruptcy

Under Chapter 7 proceedings, the debtor's property is collected by a trustee and distributed to creditors according to priorities established in the Bankruptcy Code. Chapter 7 bankruptcy is a liquidation, or straight bankruptcy. Chapter 7 bankruptcy proceedings are described in detail in the fact sheet, *Bankruptcy: Chapter 7 Liquidations*.

Chapter 11 Bankruptcy

Under Chapter 11, a farmer can attempt to reorganize his business operation as an alternative to liquidation. He may continue operating his farm and propose a plan under which all or part of the farming operation continues and his business debts are repaid. Chapter 11 bankruptcy proceedings are described in detail in the fact sheet, *Bankruptcy: Chapter 11 Reorganizations*.

Chapter 12 Bankruptcy

Chapter 12 bankruptcy is a streamlined reorganization alternative for farmers. This is similar to a Chapter 13 Bankruptcy which allows reorganization of debts for an individual with a regular income. Chapter 12 allows for adjustment of the debts of a family farmer with regular annual income. Chapter 12 proceedings are discussed in detail in the fact sheet *Bankruptcy: Chapter 12 Reorganizations*.

SPECIAL TREATMENT OF FARMERS

In general, a debtor's creditors may petition to have him put into bankruptcy. At least three creditors must join in the petition if the debtor has 12 or more creditors. Such involuntary proceedings are available only

for Chapter 7 liquidations and Chapter 11 reorganizations. Involuntary proceedings may not be initiated under Chapter 12. Because of the uncertainties involved in farming operations, farmers are exempt from such involuntary bankruptcy. Farmers also are exempt from the involuntary conversion of a Chapter 11 case to a Chapter 7 case or from a Chapter 12 case to a Chapter 7 or a Chapter 11.

While a farmer is not subject to an involuntary bankruptcy proceeding, should a farmer undertake a voluntary bankruptcy proceeding under Chapter 11 and then prove unable or unwilling to file a plan of reorganization, a creditor may propose a liquidation plan with the same results as a Chapter 7 liquidation.

The Bankruptcy Code defines a “farmer” to be a person who, during the tax year immediately preceding the year in which the bankruptcy petition is filed, received more than 80 percent of his gross income from a farming operation. A farming operation is defined very broadly under the Bankruptcy Code and includes farming, tillage of the soil, dairy farming, ranching, production or raising of crops, poultry, or livestock. It is not necessary for the debtor to be involved in farming at the time he files a bankruptcy petition. It has been held that an individual who has sold his farm and is not currently involved in farming is, nonetheless, a farmer under the Bankruptcy Code so long as they meet the income test noted above.

Unfortunately, not all individuals who consider themselves farmers are entitled to this special protection. A farmer who depends on off-farm income may not be considered a farmer if more than 20 percent of his gross income comes from such off-farm activities.

A family farmer under the Bankruptcy Code is an individual (and spouse, if a joint petition is filed) engaged in farming

operations whose (i) total debts do not exceed \$4,031,575; (ii) not less than 50 percent of his debts arise out of a farming operation and (iii) during the tax year immediately preceding the year in which the bankruptcy petition was filed, received more than 50 percent of his gross income from a farming operation. Additionally, family farmers include a corporation or partnership in which more than 50 percent of the outstanding stock or equity is held by one family and their relatives, the family or 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 total debts do not exceed \$4,031,575 and not less than 50 percent of its debts arise out of the farming operation; and (iii) if such corporation issues stock, the stock is not publicly traded. The \$4,031,575 debt ceiling for both individuals and corporations is automatically adjusted every three years to reflect any change in the Consumer Price Index. Only family farmers are eligible for Chapter 12 protection.

AUTOMATIC STAY

Several provisions of the Bankruptcy Code operate to protect the debtor, to give him some breathing space from his creditors. The initiation of any Chapter 7, 11, 12 or 13 case operates as a court order to halt, at least temporarily, a wide range of conduct for collecting a claim or debt against the debtor. In other words, the filing of any bankruptcy petition stops all collection efforts, all harassment, and all foreclosure actions. This automatic stay is one of the fundamental debtor protections provided by our bankruptcy laws. It permits the debtor to attempt a repayment or reorganization plan in the case of a Chapter 11, Chapter 12 or Chapter 13, and it relieves him of the financial pressures that drove him into bankruptcy. The automatic stay is broad in

scope. It is intended to prohibit creditors from taking any action against the debtor that disorganizes his efforts to deal with his financial problems or that interferes with his attempt to reorganize his business operation.

Although the provisions of the automatic stay law are broad, they are not absolute. The automatic stay does not suspend the clock. For example, the automatic stay does not stop the running of a redemption period following a mortgage foreclosure sale or the running of the time period under Minnesota law to reinstate a contract for deed. In addition, creditors may seek court approval to obtain relief from the stay in certain cases. So the automatic stay is by no means permanent. Creditors may, in some instances, be able to obtain court approval to continue or initiate collection proceedings against the debtor.

PROPERTY OF THE BANKRUPTCY ESTATE

When a case under the Bankruptcy Code is begun, a bankruptcy estate is created. The bankruptcy estate consists of all legal or equitable interests of the debtor in property as of the filing date. Thus, all real property, crops, livestock, machinery and equipment, interests in cooperatives, farm program entitlements, contract rights, and leases will be included in the bankruptcy estate. Besides property owned when the case is initiated, the property of the estate includes property recovered by the trustee from creditors or other third parties and property that the debtor becomes entitled to acquire within 180 days of the filing of the bankruptcy petition by inheritance, divorce decree, property settlement, life insurance policy, or death benefit plan. Finally, the estate includes income or profits from other assets that are the property of the estate. Significantly, however, an individual debtor's earnings from services performed after the filing but before the termination of the case

are not included in the estate. (This is not the case when a Chapter 12 petition has been filed.) Thus, in a Chapter 7 or Chapter 11 case, income from a debtor's off-farm employment may not be looked to by his creditors once the bankruptcy petition has been filed.

DISCHARGE OF DEBTS

One of the most important features of bankruptcy, regardless of which alternative is chosen, is the opportunity for discharging debts. In general, debts that arose prior to the filing of the bankruptcy petition are dischargeable in bankruptcy. But not all debtors are entitled to a discharge and not all debts are dischargeable. As a general rule, only individuals are entitled to a discharge. Partnerships and corporations may not obtain a discharge in bankruptcy.

Under the Bankruptcy Code, certain debts are not dischargeable. Obligations such as alimony, child support, claims based upon fraud, student loans obtained through a government program, certain taxes, and fines or penalties are not eligible for discharge. Creditors must object to the dischargeability of a particular debt within a time period established by the bankruptcy rules. If they fail to do so, all of the debtor's debts eligible for discharge will be discharged upon the termination of the bankruptcy case. In addition, the conduct of the debtor prior to the filing of the bankruptcy petition may prohibit the discharge of all debts. If, for example, a debtor engaged in fraudulent transactions; concealed, destroyed, or falsified records; or failed to explain the loss of property, his debts might not be discharged. A creditor or the trustee may challenge the debtor's entitlement to a discharge on such grounds. Moreover, in the case of an individual discharge, the court may deny the discharge if the individual

failed to complete an approved instructional course concerning financial management.

A discharge cannot be obtained if the debtor received a discharge under a Chapter 7 or Chapter 11 case initiated within six years before the filing of the petition in the current bankruptcy case. An earlier discharge under Chapter 12 does not bar a discharge under Chapter 7 within six years if the debtor paid all the unsecured claims in the earlier case or if the debtor paid 70 percent of the unsecured claims and if the plan was proposed in good faith and was the debtor's best effort.

CONCLUSION

Filing any bankruptcy petition should be undertaken only after you have carefully reviewed with your attorney all the other alternatives. If bankruptcy is the only course of action available to you, consider your options carefully. Regardless of which type of bankruptcy protection you seek, you will receive the protection of the automatic stay and you generally will be eligible for the discharge of many of your obligations. Bankruptcy will thus enable you to get a fresh start or will relieve you of many of your financial burdens.

For more information:
extension.umn.edu/agriculture/business