

Overview on Bankruptcy for the Family Farmer*

(June 2005)

Phyllis J. Marquitz and Stephen L. Weber Jr.

Legal Research Assistants

Under the Direction and Supervision of Professor Leslie MacRae

The Agricultural Law Resource and Reference Center

150 S. College Street, Carlisle, PA 17013

717-241-3517

aglaw@psu.edu

www.dsl.psu.edu/centers/aglaw.cfm

Understanding the Principles behind Bankruptcy

Bankruptcy is allowed through the United States Constitution¹ where it gives Congress the power to create uniform laws defining and regulating bankruptcy. The main purpose for allowing bankruptcy is to create a fresh start for debtors that are honest but face serious financial problems and balance that with fairness for unsecured creditors. A fair bankruptcy system will both encourage and require debtors to repay their debts where they are able to do so, and ensure that honest but unfortunate debtors are able to obtain the necessary relief to retain their human dignity and remain productive members of society. However, bankruptcy is not a means for evading obligations to obey the law or to satisfy one's obligation to provide for support of one's spouse and children, and creditors should not be able to abuse their rights under the bankruptcy system in order to preclude debtors from obtaining the benefits they are rightfully entitled to under that system. Recently the bankruptcy laws have been reformed to address perceived abuses of the bankruptcy system. The changes make the bankruptcy laws significantly less favorable to debtors. Some of these changes have already taken effect and the rest take effect on October of 2005. The full effect of these laws will not become clear until they are applied by the Bankruptcy Judges and Federal Appeals Courts.

* This paper is written as an introduction and overview to the U.S. Bankruptcy options available to farmers and farming operations. It does not constitute legal advice in anyway.

¹ Article 1, Section 8, Clause 4 (Bankruptcy)

Individuals, corporations (cooperatives are considered corporations), and partnerships all have the right to file bankruptcy. If the bankruptcy is not voluntarily filed by the party in default, creditors may also bring involuntary actions.

Federal Bankruptcy courts preside over bankruptcies. Bankruptcy judges do not have the same powers as other federal judges, whose authority is granted by the US Constitution. The authority of bankruptcy judges is derived from the various District Courts. The District Courts, which has the original authority over bankruptcy cases, automatically refer them to bankruptcy courts. The court which makes the final disposition in a bankruptcy depends on the nature of the issues. The bankruptcy court makes the final disposition on the bankruptcy issues and makes a recommendation to the district court on issue ancillary to the bankruptcy.

The Federal Rules of Bankruptcy Procedure and local rules of bankruptcy govern the procedural process. The Federal Rules provide for the uniform application of bankruptcy law but each district is free to make its own local rules, so long as they are not inconsistent with the Federal Rules. The rules, both Federal and local, are not meant to alter the substantive rights under the Bankruptcy Code and if there is any conflict, the Code will prevail.

Much of the actual work in the bankruptcy process is administrative. This work is conducted by a bankruptcy trustee, who is appointed to administer the bankruptcy estate by the court.

Understanding the Terminology

Bankruptcy itself is a legal procedure for dealing with debt problems of individuals and businesses; specifically, a case filed under one of the chapters of title 11 of the United States Code (the Bankruptcy Code).

A **Creditor** is the person to whom or business to which the debtor owes money or that claims to be owed money by the debtor.

A **Debtor** is a person who has filed a petition for relief under the bankruptcy laws.

The **Bankruptcy trustee** is a private individual or corporation appointed in all chapter 7, chapter 12, and chapter 13 cases to represent the interests of the bankruptcy estate and the debtor's creditors.

The **Bankruptcy Estate** includes all legal or equitable interests of the debtor in property at the time of the bankruptcy filing. (The estate includes all property in which the debtor has an interest, even if it is owned or held by another person.)

Equity is the value of a debtor's interest in property that remains after liens and other creditors' interests are considered. (Example: If a house valued at \$60,000 is subject to a \$30,000 mortgage, there is \$30,000 of equity.)

An **automatic stay** is an injunction that automatically stops lawsuits, foreclosure, garnishments, and all collection activity against the debtor the moment a bankruptcy petition is filed. There are some collections that are not frozen as a result of an automatic stay such as child support payments, criminal charges, security interests that have already perfected. Under the new bankruptcy laws, there are further limits to an automatic stay, particularly in the event of multiple bankruptcy filings, the fraudulent transfer of real property.

The **bankruptcy petition** is the official form that serves as the formal request for the protection of the federal bankruptcy laws.

When a bankruptcy judge approves a plan for reorganization it is called a **confirmation**.

A claim that may be owed by the debtor under certain circumstances, for example, where the debtor is a cosigner on another person's loan and that person fails to pay is considered a **contingent claim**.

A **discharge** is a release of a debtor from personal liability for certain dischargeable debts. (A discharge releases a debtor from personal liability for certain debts known as dischargeable debts (defined below) and prevents the creditors owed those debts from taking any action against the debtor or the debtor's property to collect the debts. The discharge also prohibits creditors from communicating with the debtor regarding the debt, including telephone calls, letters, and personal contact.)

Dischargeable debt is a debt for which the Bankruptcy Code allows the debtor's personal liability to be eliminated.

Exemptions include property that the Bankruptcy Code or applicable state law permits a debtor to keep from creditors. Exempt property is property that a debtor is allowed to retain free from creditors who do not have liens.

Family Farmer - An individual, individual and spouse, corporation, or partnership engaged in a farming operation who meet certain debt limits and other statutory criteria for filing a petition under chapter 12.

Fraudulent transfers - A transfer of a debtor's property made with intent to defraud or for which the debtor receives less than the transferred property's value. These acts can have severe criminal consequences.

A **joint petition** - One bankruptcy petition filed by a husband and wife together.

Lien - A charge upon specific property designed to secure payment of a debt or performance of an obligation.

Liquidation - A sale of a debtor's property with the proceeds to be used for the benefit of creditors.

Liquidated claim - A creditor's claim to accept a fixed amount of money.

Creditors can make a request for a **motion to lift the automatic stay** to take an action against a debtor or the debtor's property that would otherwise be prohibited by the automatic stay.

A **no-asset case** occurs when, in a chapter 7 bankruptcy, there are no assets available to satisfy any portion of the creditors' unsecured claims.

Nondischargeable debt- A debt that cannot be eliminated in bankruptcy.

Prebankruptcy planning - The arrangement (or rearrangement) of a debtor's property to allow the debtor to take maximum advantage of exemptions. (Prebankruptcy planning typically includes converting nonexempt assets into exempt assets.)

Priority - The Bankruptcy Code's statutory ranking of unsecured claims that determines the order in which unsecured claims will be paid if there is not enough money to pay all unsecured claims in full.

Priority claim - An unsecured claim that is entitled to be paid ahead of other unsecured claims that are not entitled to priority status. Priority refers to the order in which these unsecured claims are to be paid.

Property of the estate - All legal or equitable interests of the debtor in property as of the commencement of the case.

Reaffirmation agreement - An agreement by a chapter 7 debtor to continue paying a dischargeable debt after the bankruptcy, usually for the purpose of keeping collateral or mortgaged property that would otherwise be subject to repossession.

Secured debt - Debt backed by a mortgage, pledge of collateral, or other lien; debt for which the creditor has the right to pursue specific pledged property upon default.

Statement of financial affairs - A series of questions the debtor must answer in writing concerning sources of income, transfers of property, lawsuits by creditors, etc. (There is an official form a debtor must use.)

Statement of intention - A declaration made by a chapter 7 debtor concerning plans for dealing with consumer debts that are secured by property of the estate.

Substantial abuse - The characterization of a bankruptcy case filed by an individual whose debts are primarily consumer debts where the court finds that the granting of relief would be an abuse of chapter 7 because, for example, the debtor can pay its debts.

Transfer - Any mode or means by which a debtor disposes of or parts with his/her property.

United States trustee - An officer of the Justice Department responsible for supervising the administration of bankruptcy cases, estates, and trustees, monitoring plans and disclosure statements, monitoring creditors' committees, monitoring fee applications, and performing other statutory duties.

Unliquidated claim - A claim for which a specific value has not been determined.

Unscheduled debt - A debt that should have been listed by a debtor in the schedules filed with the court but was not. (Depending on the circumstances, an unscheduled debt may or may not be discharged.)

An **unsecured claim** is a claim or debt for which a creditor holds no special assurance of payment, such as a mortgage or lien; a debt for which credit was extended based solely upon the creditor's assessment of the debtor's future ability to pay.

Types of Bankruptcy

There are several types of bankruptcy allowed by the U.S. Code Title 11. Some allow reorganization of assets while some require the selling of everything other than basic necessities. Each Chapter of the Code gives a different option for a type of bankruptcy. Although sometimes more than one Chapter might apply to individual circumstances, there is usually a Chapter better suited for each situation. The debtor must choose which Chapter is most appropriate to file under. Most family farm businesses will file under Chapter 12.

Chapter 7 Bankruptcy is a standard liquidation where most debts are discharged and assets are sold (there are some exceptions like child support, and taxes). Under the new bankruptcy code, which takes effect on October 17, 2005, it will be much harder to file for Chapter 7 bankruptcy. Unless the debtor's income is less than his or her home state's median income or the debtor passes a mean based income test, Chapter 7 bankruptcy cannot be used. The debtor is given the chance to start over with all of their debts removed but the

debtor may not file again for another six years, but in October of 2005 this will be increased to 8 years.

Chapter 9 is reserved for government organizations debt problems.

In Chapter 11, a reorganization type of bankruptcy, the debtor usually remains in possession of his assets and continues to operate any business, subject to the oversight of the court and the creditors committee. The debtor proposes a plan of reorganization which, upon acceptance by a majority of the creditors, is confirmed by the court and binds both the debtor and the creditors to its terms of repayment. Plans can call for repayment out of future profits, sales of some or all of the assets, or a merger or recapitalization. This is usually utilized by corporations and businesses with debts that exceed the Chapter 13 limits.

Chapter 13 is another reorganization repayment plan for individuals with regular income and unsecured debt less than \$307,675 and secured debt less than \$922,975. The debtor keeps their property and makes regular payments to the Chapter 13 trustee out of future income to pay creditors over time (3-5 years). Repayment in Chapter 13 can range from 10% to 100% depending on the debtor's income and the make up of the debt. Certain debts that cannot be discharged in Chapter 7 *can* be discharged in Chapter 13, but the types of debts that a Chapter 13 bankruptcy will discharge will be limited after October 2005. Chapter 13 also provides a mechanism for individuals to prevent foreclosures and repossessions, while catching up on their secured debts. Similar to Chapter 7 bankruptcy, a debtor can't file for Chapter 13 if he or she has done so in the past 2 years. Additionally, a debtor can't file for Chapter 13 if they have filed a Chapter 7, 11, or 12 within a 4 year period.

Under the new bankruptcy law, a debtor must undergo credit counseling before filing bankruptcy under Chapters 7, 11, or 13. To satisfy this requirement, a debtor must receive an individual or group briefing that outlines the opportunity for credit counseling and assist the debtor in performing a budget analysis. In addition to pre-filing counseling, all Chapter 7 and 11 debtors must complete a financial management course before their debts are discharged.

Chapter 12 Bankruptcy is designed to meet the economic realities of the Family Farmer. Chapter 12 eliminates many barriers that family farmers have faced when trying to

reorganize under Chapter 11 or 13. Chapter 12 is less complicated and less expensive than Chapter 11, but works with larger wage earners and debts than Chapter 13 candidates. The Bankruptcy Code provides that only a family farmer with “regular annual income” may file a petition for relief under chapter 12. 11 U.S.C. 101(18), 109(f). The purpose of this requirement is to ensure that the debtor’s annual income is sufficiently stable and regular to permit the debtor to make payments under a chapter 12 plan. Allowance is made under Chapter 12, however, for situations in which family farmers may have income that is seasonal in nature. Relief under this chapter is voluntary and only the debtor can file for Chapter 12 unlike the other Chapters which allow creditor initiated bankruptcy.

Filing for Bankruptcy

Most bankruptcies are filed by debtors that can not pay their debts but creditors may also bring involuntary action (except for Chapter 12). The Chapter 12 exemption makes it important to understand the definition of “farmer” (see definitions section above). If a debtor has more than twelve creditors, three must join to file the action, and claims must total over ten thousand dollars more than the value of a security held by the creditor.

The debtor initiates a bankruptcy action by filing a petition, or an order of relief. There is a basic filing fee for this step. The debtor has to provide a list of creditors, a list of assets and liabilities, and declare intent within the first thirty days of filing for which properties the debtor intends to retain and which to surrender. The debtor must appoint a trustee and a hearing takes place for the discharge of debts. The automatic stay is in effect from the date of filing. The trustee works on behalf of the debtor and can review the creditors’ actions to negate any advantages they may try to achieve such as an acceleration of debts, and can reduce interest rates before filing. Creditors that fear the collateral is decreasing in value or being treated poorly can ask for the automatic stay to be lifted. The court can order adequate protection in such cases, requiring debtor to either make payments to alleviate the decrease in value or allow additional liens against the assets. If adequate protection can not be obtained the court can lift the automatic stay.

Certain property is considered by the court to be exempt and after the bankruptcy proceeding is returned to the debtor. Only non-exempt property is used to pay creditors

and the court carefully decides which assets fall into each category. States have the option to accept the federal exemption guidelines or adopt their own. Exemptions include a small portion of the value of the residence, a portion of the value of an automobile, personal belongings with a cap on the value of each item not to exceed \$475 per item, a small amount of personal jewelry, a “wild card exemption” for a small amount of property not considered in the debtor’s residence, an exemption exists for tools and supplies for business or professional use, un-matured life insurance, health benefits and social security, small amounts of dividends, and the right to receive compensatory amounts for incidents like wrongful death or limb loss. The exemption of the residence, or the homestead exemption, is limited by the changes to the bankruptcy laws. For a debtor to claim a state’s residence exemption, the debtor must live in that state for 2 years prior to filing. There is also an absolute limit of \$125,000 of a homestead exemption if the debtor purchased the home within 3 years and 4 months of filing for bankruptcy. Spouses filing a joint petition are each allowed exemptions.

Reorganization has a higher petition fee and gives the debtor less time to create a plan for overcoming their financial problems. A reorganization plan is submitted and must be a feasible proposal to maintain the enterprise while decreasing maximum amount of debt. There is a one-hundred and twenty-day period for the plan to be submitted. If the plan is not submitted in a timely manner creditors may move for the court to allow them to liquidate all assets². This applies to farmers because it applies to all reorganization bankruptcies. If the plan is timely then it must be confirmed by the court and all claims that are impaired, or requested to be paid below the face amount of the claim, must be approved. Each creditor must be paid at least as much as they would have been paid with liquidation rules. Secured interests continue through reorganization bankruptcy. Chapter 12 is not a permanent bankruptcy option and has been extended but not made a permanent part of bankruptcy law by congress.

Eligible Family Farmers

There are certain requirements that have to be met to be eligible to file a Chapter 12 bankruptcy. The purpose of these requirements is to prevent Chapter 12 from being used

² *In re Button Hook Cattle Co., Inc.*, 747 F.2d 483 (8th Cir. 1984)

by people who are not actually farmers. That goal does not mean that the requirements can be ignored; these requirements can catch the unwitting farmer and make them ineligible for Chapter 12.

Eligible “Family Farmers” for Chapter 12 include an individual or an individual and spouse with more than fifty percent of their gross income derived from farming for the taxable year preceding the year of filing, debts not exceeding \$3,237,000, and at least fifty percent of their liquidated debt is from the farming operation owned by the debtor.

The fifty percent gross income from farming requirement can be met either by using the taxable year prior to filing, or for both the second and third tax years preceding filing.

Corporations, business trusts, cooperatives, and partnerships with *more than fifty percent* of the stock held by one family may be a family farmer if; the family conducts the farming operation, more than eighty percent of asset value is related to farming operations, debt does not exceed \$3,237,000 and fifty percent of liquidated assets arose out of farming operations, and interests are not publicly traded. The more that fifty percent stock owned by one family has been strictly interpreted by courts. An example of this would be the bankruptcy of Tobin Ranch Inc.³ This Corporation was owned 50% by Paul and Carol Tobin and 50% by Leo Tobin Farms Inc., which was owned by Paul Tobin and his three sisters. Even though the corporation declaring bankruptcy was engaged in farming and entirely owned by the same family, albeit through a separate corporation, the court ruled that it did not meet the more than 50% owned by the same family test as corporations owned by other corporations can’t satisfy the test. There is no requirement that fifty percent of the income come from farming. But there can be issues if the corporation leases farmland. The amount of the rent must be commensurate with the risk of the farming operation in order to qualify for Chapter 12.⁴

Tax Implications

Bankruptcy does not allow separate tax implications for debtors. It does not erase tax liability on disposition of assets.⁵ However it does allow for the possibility of discharge

³ *In re Tobin Ranch, Inc.*, 80 B.R. 166 (Bankr. D. Neb. 1987)

⁴ *In re Mary freese Farms, Inc.* 73 B.R. 508 (Bankr. N.D. Iowa 1987)

⁵ *In re Lindsey*, 142 B.R. 447 (Bankr. W.D. Okla. 1992)

of tax burdens from more than three years prior to filing and gives the past three years priority as a claim, but does not erase the tax debt from that period. Taxes for the first year after bankruptcy are also listed as priority and not erased. Taxes for the second year and related to administrative expenses for the bankruptcy are also not forgiven.

Restructuring Tax Implications can be much more complicated. It is suggested that restructuring be reviewed by a tax expert or with a bankruptcy attorney. Major tax planning issues in bankruptcy are: (i) to minimize recognition of income from cancellation of indebtedness, and (ii) to maximize the use of tax attributes, such as net operating losses and basis (total value), after the bankruptcy. Cancellation or modification of indebtedness usually produces income equal to the amount of the debt cancelled or forgiven ("COD income"). The timing of the debt discharge and COD income is usually the effective date of the plan. COD income may also be realized even if the debt is not actually cancelled which means it can be taxed. Therefore, discharge of indebtedness is either granted by the Court or pursuant to a plan approved by the court. A taxpayer who excludes COD income from currently taxable gross income due to the bankruptcy exception is required to reduce tax attributes by the amount of the excluded income.

There are numerous other tax considerations that may arise. These issues are too numerous and specific for this article. However, as a general rule, anytime a corporation has a net operating loss to carry forward, any transfer of the corporation's shares may endanger whether the net operating loss may still be used for debtors benefit in tax implications. A sale of the assets, only, will not allow the purchaser to use any portion of the seller's net operating loss to carry forward. These same rules are applicable to debtor corporation's sale of stock or assets.

Any transfer of assets into or out of the debtor must be scrutinized under the general partnership and corporate tax laws to determine the tax effect of the transfer. Any payments to insiders, owners, or employees must also be scrutinized to determine the tax consequence to the debtor.

This principle is applicable to Farming Operations under Chapter 12 as well. The net operating loss must be proven, and this is done by showing diminished value in the basis,

or total value of the operation. Farmers must be careful when renting their farms after restructuring because income from rent that is not included in the restructuring plan.⁶ If the property is abandoned and sold the profits from that sale are taxable.⁷

The important thing to remember is that debt discharge as part of the bankruptcy is not considered income, and the forgiveness of that debt through the bankruptcy procedure is the ultimate goal, to assist in beginning again.

Another change to the bankruptcy law is a provision that allows a Chapter 12 debtor to treat claims owed to a government unit as a result of a sale or other disposition of a farm asset used in the farming operation to be treated as an unsecured claim, that is not entitled to priority under the bankruptcy code, provided the debtor receives a discharge of debt. This means that the farmer tax debt from the sale of farm assets could be discharged under Chapter 13.

Considerations after Bankruptcy

Credit scores and the willingness for lenders to extend independent credit will both cease after bankruptcy is filed. However, bankruptcy is a last resort, a measure that is taken to restructure restart a financial journey. The consequences of that second chance are not always ideal, but give an opportunity to assess financial status, and come up with a realistic path to freedom from debt and even profitability. It is important that the bankruptcy experience is assessed and the events leading up to bankruptcy analyzed in order to prevent financial distress in the future.

Consultation with a Lawyer

Bankruptcy can be a very confusing and intimidating process. While bankruptcy has the potential to be a great assistance to a farmer who is having financial difficulties, it is very important to consult a lawyer before declaring bankruptcy. This paper is just an overview of bankruptcy law and does not take the place of legal counsel.

⁶ *Lawinger v. Commissioner*, 103 T.C. 428 (1994)

⁷ *In re Olson*, 930 F.2d 6 (8th Cir. 1991)