

## **Chapter 12 Bankruptcy Hope for Financially Stressed Family Farms**

*Robert Moore*

*Attorney*

*Wright Law Co. LPA*

There are probably few words that have a more negative connotation in the farm business world as bankruptcy. Often seen as giving up or quitting, farmers often try to avoid bankruptcy at all costs as they pride themselves on their independence and self-reliance. However, Chapter 12 bankruptcy is not for quitters. In fact, it is designed for those family farms that are willing to keep fighting to keep their farm going despite being severely financially stressed.

### **What is Chapter 12 Bankruptcy?**

Chapter 12 bankruptcy is a special section of the bankruptcy code that provides debt restructuring for family farms and family fisherman. First created in 1986 during a nationwide farm financial crisis, Chapter 12 was made permanent in 2005. Chapter 12 allows family farms to reduce debt load and restructure debt so that the farm may become viable into the future.

### **Who is Eligible for Chapter 12 Bankruptcy?**

Both persons and business entities engaged in a farming operation are eligible for Chapter 12 bankruptcy. The following is a summary of the requirements for both:

#### Individuals and Married Couples

- Debt does not exceed \$3,544,525<sup>1</sup>
- At least 50% of the debt must come from the farming operation
- More than 50% of the gross income for previous years must be from the farming operation

#### Partnership, Corporations, LLC's

- More than 50% of the stock or equity in the business entity must be held by one family or relatives of that family
- The family or their relatives must conduct the farming operation
- More than 80% of the value of the business entity must be related to the farming operation
- The debts of the business entity must not exceed \$3,544,525

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<sup>1</sup> The debt limit increases with the Consumer Price Index. It may be possible for the debt limit to be applied to multiple persons or entities involved in the farming operation, thus doubling or tripling the debt limit for a farming operation.

- Not less than 50% of the of the business entities debts must arise out of the farming operation
- If a corporation, the stock must not be publicly traded

A debtor cannot file under chapter 12 (or any other chapter) if during the preceding 180 days a prior bankruptcy petition was dismissed due to the debtor's willful failure to appear before the court or comply with orders of the court or was voluntarily dismissed after creditors sought relief from the bankruptcy court to recover property upon which they hold liens.

### **Process of Chapter 12 Bankruptcy**

The bankruptcy code provides for a precise and definite process that is followed in a Chapter 12 bankruptcy. The sequence of events is as follows:

1. Farmer receives credit counseling from an approved credit counseling service
2. Farmer files a Chapter 12 petition with the bankruptcy court<sup>2</sup>
3. 20-35 days after filing petition, the bankruptcy court will hold a meeting of creditors
4. Within 90 days of filing the initial petition, the farmer is required to submit a reorganization plan to the court
5. The court confirms the plan or rejects the plan
6. If confirmed, the farmer will stay in bankruptcy 3-5 years
7. The farmer will be discharged from bankruptcy and continue to make long term debt payments

### **Initial Petition**

The initial petition starts the bankruptcy by notifying the bankruptcy court and all creditors that the farmer is filing for bankruptcy. Unless the court orders otherwise, the farmer must include with the initial petition: (1) schedules of assets and liabilities, (2) a schedule of current income and expenditures, (3) a schedule of executory contracts and unexpired leases, and (4) a statement of financial affairs. The petition is filed in the court serving the farmer's place of residence or place of business and requires an initial filing fee of \$239.

To accurately complete the petition in full, the farmer will need the following information:

1. A list of all creditors and the amounts and nature of their claims;
2. The source, amount, and frequency of the debtor's income;
3. A list of all of the debtor's property; and
4. A detailed list of the debtor's monthly farming and living expenses, *i.e.*, food, shelter, utilities, taxes, transportation, medicine, feed, fertilizer, etc.

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<sup>2</sup> Bankruptcy court is a federal court. Bankruptcy courts are located in the major cities in Ohio.

Filing the petition typically stays all collection actions against the farmer. That is, creditors cannot take action directly against the farmer to collect debts. Lawsuits are not permitted to be initiated or continued, phone calls regarding debt collection must be discontinued, and wage garnishments are not permitted. Rather, the creditors must make any claims through the bankruptcy proceedings.

### **Reorganization Plan**

The reorganization plan is central to a Chapter 12 bankruptcy. The plan provides the bankruptcy court with a detailed description of how the farm intends to continue operating while in bankruptcy and after being successfully discharged from bankruptcy. In essence, the reorganization plan is a short term and long term business plan for the farm. Creditors do not need to approve the plan but do get an opportunity to object to the plan. The typical objections are that payments offered under the plan are less than creditors would receive if the debtor's assets were liquidated, or that the plan does not commit all of the debtor's disposable income for the three-to-five-year period of the plan.

The bankruptcy court will evaluate the reorganization plan and either confirm the plan or reject the plan. If the plan is rejected, the plan may either be modified or the bankruptcy may be converted to a Chapter 7 liquidation bankruptcy.

For a Chapter 12 plan to be confirmed, the following criteria must be met:

1. The plan must be submitted in good faith. That is, the farmer must file the Chapter 12 bankruptcy with true intentions of continuing the family farming operation. The filing cannot be done to simply delay actions by creditors.
2. The plan must address how secured debt will be repaid. Chapter 12 provides for three possible means of modifying debt:
  - a. Negotiating mutually agreeable modified terms with the creditor.
  - b. "Cramming down" the secured debt to the present value of the collateral securing the debt.
  - c. The collateral is turned over to the creditor in satisfaction of the debt.
3. The plan must provide for the full payment of all priority claims. Priority claims include tax liability, child support payments, and alimony.

The plan will require the farmer to stay on a strict budget for both the farm and personal living expenses. Farmers in Chapter 12 bankruptcy often find the strict budgeting the most difficult aspect of the plan. Farmers, being autonomous, independent, and self-reliant, can find the transition to adhering to a pre-established budget challenging. For example, the farmer cannot finance a new piece of equipment or spend more than his allotted personal funds without permission from the trustee. Therefore, it is extremely important to develop a plan that the farmer can live within.

It is extremely important that the bankruptcy plan be realistic. Farmers will tend to want to make the plan a bit optimistic to be sure that the plan is confirmed by the judge. This is a dangerous and ill-advised strategy. If the plan is too optimistic and not realistic it will likely fail. If the plan fails, the farmer will likely be forced into a Chapter 7

liquidation bankruptcy. In such a situation, the farmer will have spent considerable money and time on a Chapter 12 bankruptcy only to have it forced into a Chapter 7 liquidation. Therefore, the plan should be realistic to ensure the best chance of success for the bankruptcy.

### **“Cram Down” of Debt**

Perhaps the most beneficial aspect of a Chapter 12 bankruptcy is the ability of the farmer to “cram down” the secured debt. The farmer is able to reduce secured debt to the value of the collateral securing the debt. For example, Farmer borrowed \$300,000 to purchase dairy cows and the cows provide the collateral for the loan. The cows now have a value of \$200,000. If the Farmer were to file a Chapter 12 bankruptcy, the secured debt on the cows would be reduced to \$200,000 and the other \$100,000 of the cow loan would be converted to unsecured debt. Farmer would be required to continue to make payments on the cow loan but at the lower debt level of \$200,000.

### **Role of the Bankruptcy Trustee**

The bankruptcy trustee ensures that the farmer adheres to the terms of the bankruptcy plan. The farmer makes most debt repayments through the trustee instead of to the creditor directly. The trustee takes a percentage of each payment as its fee to administer the bankruptcy estate. The trustee’s fee is typically between 5% and 10% of the payments. If the farmer does not adhere to the terms of the plan, the trustee may ask the court to dismiss the bankruptcy. Creditors may also ask the court to dismiss the bankruptcy if payments are not made according to the plan.

While the trustee monitors the bankruptcy, he has little to do with the day to day operations of the farm. The farmer continues to make management and production decisions as he did before the bankruptcy. The primary exception to the autonomy of the farmer is incurring additional debt. Before taking on more debt, a farmer must receive approval from the trustee. The trustee will often approve taking on new debt for operating expenses and the purchase of equipment and/or machinery if the new debt is necessary and in the best interest of the farm and creditors. The trustee is not likely to allow the farmer to take on more debt to help pay off existing debt.

### **Discharge from the Bankruptcy**

If the farmer has met all terms of the plan, the bankruptcy court will discharge the farmer from bankruptcy. The farmer will be relieved of his debt other than that debt that extends beyond the bankruptcy, typically long term debt. For example, the farmer is relieved of all credit card debt and other unsecured debt. However, the farmer must continue to pay long term secured debt such as mortgages and equipment loans. The discharge means that the farmer is no longer obligated to the terms of the plan nor is under the supervision of the trustee.

### **When to File for Chapter 12 Bankruptcy**

If a farmer believes that he or she may benefit from bankruptcy protection, a consultation with an attorney familiar with Chapter 12 should be sought. A preliminary financial analysis should be done to determine if the farmer is eligible for a Chapter 12 and if a Chapter 12 is warranted. Before entering bankruptcy, the farmer should try to work with creditors to restructure debt. Creditors will often work with the farmer in an attempt to keep the farm out of bankruptcy. Typically, creditors will receive more payback of their debt in a voluntary workout of debt than they will in a bankruptcy.

A Chapter 12 bankruptcy can only work if the farming operation at least has the potential to be a viable operation after bankruptcy. Understandably, farmers will often take drastic measures to keep the farm going to avoid foreclosure or bankruptcy. For example, perhaps a dairy farm sells replacement heifers and/or dry cows to pay bills. Ultimately, the dairy farm is forced into a bankruptcy but it is no longer viable because it lacks replacement animals. Therefore, in this example, a Chapter 12 is not an option because the farm no longer has long term viability and the farm must enter a Chapter 7 liquidation. The point being that a farmer that may believe he/she needs bankruptcy protection should explore bankruptcy while the farm is still a viable operation. Waiting too long to file bankruptcy may jeopardize a successful Chapter 12 bankruptcy.

### **Conclusion**

Chapter 12 bankruptcy is designed to help family farms survive financial stress. However, Chapter 12 can only work if the farm entering bankruptcy has long term viability. While the bankruptcy process is a bit complex and at times can seem overwhelming, farmers with financial difficulties should consider a Chapter 12 bankruptcy.

\*The above discussion is a very basic and general description of Chapter 12 bankruptcy. Anyone considering bankruptcy should seek the assistance of a qualified attorney.