

*Risk Management*

## Dealing with Financial Stress on Texas Farms and Ranches—Bankruptcy and Non-Bankruptcy Alternatives

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Over past few years agricultural producers have faced a variety of natural disasters—droughts, floods, and insect infestations. At the same time, crop prices have had dramatic swings, and input prices such as fuel, fertilizer, and seed have risen significantly. To make matters worse, it appears that if there is a 2013 farm bill, it will significantly reduce federal farm program benefits. These factors will negatively affect agricultural producers across Texas and the country.

Traditionally agricultural producers have dealt with financial stress (being unable to pay creditors on time) by tightening their belts, and holding on until things got better. Unfortunately, lean times often mean forgoing equipment repairs or replacement which make it difficult to borrow money against these items. At the same time, increased costs have kept many producers from adopting new cropping and conservation practices to preserve soil fertility and maintain long-term profitability.

Many producers simply can't tighten their belts any more or hold on any longer without making drastic changes. Each situation is unique, and only the producer can decide how to effectively solve his operation's financial problems. However, one element common to resolving any case of financial stress is to seek professional legal and tax advice.

Alternatives for resolving financial stress include:

- Doing nothing
- Changing the agricultural operation

- Voluntary debt restructuring
- Partial or total voluntary liquidation
- Bankruptcy

### *Do nothing*

You can always just do nothing when dealing with financial stress. In some cases, this may be the best alternative. However, don't take this choice until you consult with your attorney. Creditors can foreclose on the collateral securing your loans. This means they will sell the collateral to apply against their loans. If the collateral doesn't sell for enough to pay off the loans, creditors can file lawsuits against you for the balance due. The creditors can then use the courts to try to collect deficiencies from any other nonexempt assets you may own.

### *Changing the operation*

If you are experiencing financial stress, you should examine your operation to see if there are changes that would decrease expenses or increase income. You have probably been trying to do this for several years, but may have only considered minor changes. There comes a time when you must evaluate every aspect of the operation—each crop and livestock enterprise must stand on its own. If you need help with this analysis, the Texas A&M AgriLife Extension Service has resources available through the County Extension Agent.



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## *Voluntary debt restructuring*

If you adjust your operation but still cannot make payments as they become due, you may be able to extend loan terms or lower interest rates to bring debt service into line with your operation's cash flow. However, lenders are being asked daily to renegotiate loans and are unlikely to agree unless you can show that the changes will actually solve the problem. You should be able to show the lender any changes you have made in the operation, and have solid production and economic data to support the restructuring request.

If you can convince the lender that your operation is viable under a restructured loan, the lender may be willing. If modifying your loan is only a short-term solution, the lender has no reason to agree to it.

Another factor which may influence the lender's willingness to restructure your loans is whether there are defects in the loan or security documents. For example, if the lender has a security interest in crops and the documentation omits or incorrectly describes some of the farms on which the crops are to be grown, then the lien may not be properly perfected. Promissory notes might not identify you as being personally liable for the debt. In either of these situations, a lender may want to restructure in order to avoid liquidation to satisfy loans that are under collateralized due to paperwork oversight. However, you will need an attorney to determine if this situation applies to you.

## *Partial or total voluntary liquidation*

If you cannot change your operation or restructure loans to service the debt, you should consider partial voluntary liquidation. Initially, analyze whether you could sell enough assets to reduce the debt load to a point where you could make on-time payments. You should consider selling the most heavily encumbered assets first—selling these will reduce debt more than liquidating lesser obligations. However, when deciding whether to sell any given asset, you must compare the **effect** on debt service to the **effect** on net cash flow. It does not help if you sell an asset that contributes more to net cash flow than its sale would lower debt payments. It may be that partial voluntary liquidation needs to be combined with changes in the operation and restructuring the remaining debt. Unfortunately, you still may not be

able to pay debts on time. In this case, you should consider a total voluntary liquidation.

Partial or total voluntary liquidations may have tax consequences. When you sell assets whose values have increased while you owned them, you may incur capital gains taxes. However, it is unlikely the lender will let you to keep enough of the proceeds to pay these taxes. You must consult with your accountant regarding tax consequences before entering into any agreement for partial or total voluntary liquidation.

Be careful when entering into agreements that will discharge (write off) a portion of your debt. If you agree to sell all of the assets securing a loan from the bank, and the bank agrees to write off any deficiency after the sale, you may incur what is referred to as discharge of indebtedness income, which can be taxable. USDA Agencies will issue an IRS-1099 on debts that are written off. Consult your accountant in advance to ensure you don't take on unexpected tax liabilities.

## *Bankruptcy*

If the alternatives presented above do not solve your financial problems, you may have to consider bankruptcy. Bankruptcy has number of advantages over nonbankruptcy solutions. First, the bankruptcy process is supervised by the court to ensure that the debtor and the creditors are treated fairly. Second, the bankruptcy rules are designed to provide a fresh start for the debtor, whether the creditors agree or not. Third, discharge of indebtedness income is not taxable in bankruptcy. And fourth, capital gains income from the sale of assets may escape taxation in bankruptcy. However, bankruptcy also has disadvantages.

Many producers are concerned that filing bankruptcy will damage their credit. Bankruptcy stays on record for 8 years after filing. Producers are also concerned about the social stigma of filing bankruptcy. However, the large number of bankruptcies caused by crises in oil and gas, real estate, and banking have reduced that stigma. As well, no individual may be a debtor under any chapter of the bankruptcy code unless he or she has received credit counseling from an approved agency within 180 days before filing.

The type of bankruptcy familiar to most people is a Chapter 7 liquidation bankruptcy. Under this form of bankruptcy, the debtor keeps their exempt property (homestead, household goods, etc.), subject to loans against that property. The trustee collects non-

exempt property, converts it to cash, and distributes the funds to the unsecured creditors who have filed proofs of claim. Secured creditors usually use their collateral to satisfy their claims. The debtor gives up all his nonexempt property in return for a discharge of most, if not all of the remaining debt. This discharge releases the debtor from personal liability for prebankruptcy debts.

Another type of bankruptcy, Chapter 12, is the family farmer reorganization bankruptcy. In a reorganization bankruptcy, creditors generally look to satisfy their claims not through the property of the debtor at the time of initiation of the bankruptcy but through future earnings.

For farming operations that exceed the threshold for family sized farms under Chapter 12, there is a third type of bankruptcy that is used mostly by large farming operations—Chapter 11 bankruptcy. Chapter 11 is different from Chapter 12 in that the discharge comes when the plan is confirmed as opposed to when it is completed. Additionally, all the secured creditors and the trustee get to vote to approve or disapprove the plan. Chapter 11 bankruptcies are fast-paced and complex—legal counsel is usually necessary to meet the timeframes.

The following is an explanation of Chapter 12 farm reorganization, Chapter 7 liquidation bankruptcy and, to a lesser extent, Chapter 11 reorganization bankruptcy. The purpose is not to promote bankruptcy as the best solution for resolving financially distressed loans, but to provide information for evaluating alternative strategies.

## **Chapter 12 Farm Reorganization**

Chapter 12 became a permanent part of the bankruptcy code in 2005. This bankruptcy may be particularly relevant when a significant portion of the producer's debts is unsecured or the producer needs to restructure secured debts, but the lender is unwilling to provide the necessary relief.

### **Eligibility**

To qualify for Chapter 12, a producer must be a family farmer with regular income. A family farmer is a producer, and/or producer's spouse, engaged in a farming operation whose aggregate debt does not exceed \$ 3,792,650. At least 50 percent of this debt, excluding the principal residence, must be from the farming operation, and the producer, and/or producer's spouse, must have received more than 50 percent of their gross income from the farming

operation in the tax year preceding the filing date. A "farming operation" includes "farming, tillage of the soil, dairy farming, ranching, production or raising of crops, poultry, or livestock, and production of poultry or livestock products in an unmanufactured state." A corporation or partnership may qualify for this bankruptcy protection.

Insolvency is not required for Chapter 12. It is only necessary that the debtors be unable to pay debts as they come due. This bankruptcy may be used to restructure debts, even though selling all the debtor's assets would be enough to pay all debts.

If a debtor received a discharge of indebtedness in a case filed less than 6 years earlier than the filing date of a second bankruptcy, the debtor cannot receive a discharge in the second bankruptcy. However, there is an exception to this provision if the earlier discharge was in Chapter 12 or 13 and the debtor paid at least 70 percent of the unsecured claims.

A debtor also may not file a new bankruptcy if he or she filed a case in the previous 180 days that was dismissed for the debtor's willful failure to appear or to abide by orders of the court, or was withdrawn to thwart a creditor's request for relief from the automatic stay in order to foreclose on the collateral. Before the enactment of this prohibition, some debtors used repetitive filings and dismissals to frustrate creditors' efforts to foreclose on their collateral.

### **Commencement of the Case**

A Chapter 12 bankruptcy, or any other type of bankruptcy, is commenced by the debtor(s) filing:

1. A voluntary petition with the court
2. A schedule of assets and liabilities
3. A schedule of current income and expenditures
4. A schedule of executory contracts and unexpired leases
5. A statement of financial affairs.

In an emergency filing, the debtor has 15 days from the filing of the voluntary petition and list of creditors to file the property schedules and statement of financial affairs. A joint voluntary petition can be filed if the debtor is married. The producer must pay a \$246 fee at filing. With the court's permission, the filing fees may be paid in installments provided payment is complete no later than 120 days after filing.

The jurisdiction of the bankruptcy court is invoked at the instant the petition is filed. The case begins the moment the petition is filed, with no signature or other action from the judge.

## The automatic stay

Filing the petition causes an automatic stay of all creditor collection activities. This means creditors can take no further actions to collect until the court gives permission. All other litigation or collection is stayed, and creditors are prohibited from foreclosing on collateral, or enforcing judgments or wage garnishments without court permission. Likewise, telephone calls and letters attempting to collect debts are stayed. The bankruptcy clerk notifies all creditors whose names and addresses are provided by the debtor. In a Chapter 12 bankruptcy, collection activities against a codebtor are also stayed, but only if it concerns consumer debt. A cosigner for an operating loan or a loan to purchase business assets is not protected by the codebtor stay.

The automatic stay remains until the case is dismissed or closed. However, a creditor can request relief from the automatic stay if the creditor's interest in the security for his loan is not adequately protected, or if the debtor does not have any equity in the encumbered property and that property is not necessary to an effective reorganization.

## Trustee and debtor in possession

The Standing Chapter 12 Trustee is appointed by the U.S. Trustee to supervise the debtor's performance of the plan and to disburse payments from the debtor to secured and unsecured creditors. The trustee plays an important role in Chapter 12 bankruptcies because the court often relies on the trustee's recommendations whether to confirm a plan and continue of the case. The trustee is compensated from a fee on all debtor payments that are distributed to the creditors.

The debtor retains possession of the property of the bankruptcy estate unless the court orders otherwise due to fraud, dishonesty, incompetence, or gross mismanagement of the debtor's affairs. If the court finds that the debtor should be removed as a debtor in possession, the Chapter 12 bankruptcy will likely be dismissed because the trustee is generally not in position to run a farming operation.

## Meeting of the creditors

A meeting of the creditors is scheduled for no sooner than 20, nor later than 35 days after filing. The Chapter 12 trustee convenes this meeting. It is known as a 341 Meeting because it is conducted under Section 341 of the bankruptcy code. This is a time for the trustee and the creditors to question the

debtor(s) about the property of the estate and other matters relating to the bankruptcy. The bankruptcy judge is not present nor is this meeting held in the courtroom. The debtor(s) must be present and are required to testify under oath. There is no court reporter—the trustee records the proceedings on tape.

## Developing the Chapter 12 plan

The reorganization plan is central to the success of a Chapter 12 bankruptcy. The debtor must file this plan within 90 days of filing of the case. The plan must show the debtor can pay reasonable living expenses, all operating expenses, required payments to secured creditors, and payments to unsecured creditors that are at least as much as they would have gotten from a total liquidation. The plan must cover 3 to 5 years. Creditors may legally object to the plan, but the bankruptcy judge decides whether the plan is acceptable.

**Exempt property:** Property the debtor owns at the time of filing is classified as exempt or nonexempt. Exempt property is not subject to collection efforts under state or federal law. The debtor is allowed to keep exempt property without further payments except payments for a valid lien. Valid liens against exempt property include purchase money liens and certain nonpurchase money liens. The debtor may choose between federal and state exemptions. Exemptions under Texas law are generally more favorable to the debtor, so in most cases the debtor will choose those.

A Texas debtor is entitled to a rural or an urban homestead. If the debtor lives in town, the homestead is limited to one acre of land, which may be one or more lots with improvements. If the debtor does not live in town, they are entitled to a rural homestead, not to exceed 100 acres for a single person or 200 acres for a family, which may be one or more parcels with improvements. There is no cap on the value of the property under this exemption.

Under the Texas Property Code Sec. 42.001, a Texas debtor is also entitled to an exemption of \$30,000 worth of property for a single person or \$60,000 for a family. This limitation applies only to personal property. Property claimed under this exemption includes:

- Home furnishings, including family heirlooms
- Provisions for consumption
- Farming or ranching vehicles and implements
- Tools, equipment, books, and apparatus, including boats and motor vehicles used in a trade or profession

- Wearing apparel
- Jewelry not to exceed 25 percent of the aggregate limitations prescribed by Section 42.001(a)
- Two firearms
- Athletic and sporting equipment, including bicycles
- One two-, three-, or four-wheeled motor vehicle for each member of a family who holds a driver's license or for nonlicensed members who rely on another person to operate the vehicle for their benefit
- Animals and forage on hand for family consumption:
  - 2 horses, mules, or donkeys and a saddle blanket, and bridle for each
  - 12 head of cattle
  - 60 head of other types of livestock
  - 120 fowl
- Household pets
- The present value of any life insurance policy to the extent that a member of the family or a dependent of a single insured adult is a beneficiary of the policy. In most cases, the cash value of life insurance can be exempted under separate provisions of the Texas Insurance Code such that it does not count against the limits of the Texas Property Code.

The following personal property is also exempt and not subject to the family \$60,000 or individual \$30,000 limits discussed above:

- Current wages for personal services except for the enforcement of court-ordered child support payments
- Professionally prescribed health aids of a debtor or a dependent of a debtor
- Unpaid commissions for personal services not to exceed \$15,000 for a family or \$7,500 for a single person
- Qualified pension plans and retirement accounts
- Any annuity issued by an insurance company
- Certain life insurance proceeds
- College savings plans established under Subchapter F, Chapter 54, Education Code
- Certain savings plans, and contributions to an individual retirement account

If no creditor holds a valid consensual lien on a particular piece of exempt property, the debtor may keep the property. However, if a creditor has a valid

purchase money lien against the debtor's exempt property, the debtor must decide how the property and its debt will be treated in the plan:

- The debtor may redeem the property by paying off the creditor in a lump sum.
- The debtor may reaffirm the debt which is secured by the property and continue making the payments without any changes.
- The debtor may propose restructuring the debt's terms, the interest rate, or both.
- The debtor may offer to surrender the property to extinguish the debt.

If the creditor holds a valid nonpurchase money lien on exempt property, the debtor may still redeem, reaffirm, or restructure the debt; or surrender the property. However, there is another way to avoid the lien.

In many cases, the debtor has actually paid off all purchase money liens against farm equipment over the years, only to give a lender a nonpurchase money lien against the equipment to secure an operating loan. In this situation, the debtor can avoid or eliminate the lien against \$11,700 worth of equipment for a family or \$5,850 for a single person.

**Nonexempt Property:** All other property owned by a debtor at the time of filing is nonexempt. If the debtor wants to retain this property, the plan must provide for payments to the secured creditors or to the trustee for the benefit of the unsecured creditors. If the nonexempt property secures a debt, the debtor must decide whether to redeem the property with a lump sum payment, reaffirm the debt, restructure the debt, or surrender the property to the creditor. If there is no lien against nonexempt property, the debtor may pay the value of the property to the trustee over the period of the plan, or surrender the property to the trustee. The trustee will sell any surrendered property and distribute the proceeds to the unsecured creditors.

### Creditors' claims

The debtor has to list all creditors' claims on the schedules as either secured claims, or priority or non-priority unsecured claims.

- Secured claims are debts that are secured by liens on the debtor's property.
- Priority unsecured claims are debts such as unpaid taxes that are not secured by a lien on the debtor's property.
- Non-priority unsecured claims are debts that are not secured by a lien on the debtor's property.

In a bankruptcy plan, a given debt may be divided into a secured and an unsecured portion. For example, if the debtor owes \$100,000 to a creditor which is secured by a lien on a tract of land worth \$70,000, the creditor has a secured claim for \$70,000 and an unsecured claim for \$30,000. As discussed above, if the debtor intends to retain the tract of land, the plan must provide for repayment of the \$70,000 secured claim. However, the \$30,000 will be listed with the other unsecured claims.

In restructuring secured debts, the debtor must provide for repayment at prevailing market terms and interest. However, the plan can provide that the secured claims will be repaid over a period that is longer than the plan period. However, priority unsecured claims must be paid in full during the period of the plan, unless the creditor agrees to extend repayment beyond the plan.

If a creditor is over secured, the plan must provide for payment of interest from the filing date and payment of the over secured creditor's legal fees, up to the value of the creditor's collateral. However, if a creditor is undersecured, postpetition interest between the date of filing and the date of confirmation is not required.

Carefully analyze prepetition liens on crops and livestock. Generally, these liens will give the creditor an effective lien on crops that are growing or harvested at the time of filing, as well as the offspring of livestock at the time of filing. These types of property are classified as cash collateral. However, at filing, prepetition liens on crops and livestock are cut off and are not effective against crops planted or livestock born after filing. Consider these liens carefully when scheduling a bankruptcy filing.

### **Nondischargeable claims**

Not all unsecured debts can be discharged in bankruptcy—the debtor must provide for paying these debts in the plan. The dischargeability of debts must be analyzed carefully, however, non-dischargeable debts generally include:

- Most taxes
- Debts for property obtained through fraud (e.g., based on false financial statements)
- Unscheduled debts
- Debts from fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny
- Domestic relations such as child support and alimony

- Liabilities for willful and malicious injury, including unauthorized sale of collateral
- Governmental fines
- Certain educational debts such as student loans
- Debts for death or personal injury caused by the debtor's operation of a motor vehicle while intoxicated
- Undischarged debts from a previous bankruptcy

**Projected operating income and expenses:** Operating income and expenses are central to the Chapter 12 plan because the net cash income from operations and any off-farm income must fund the plan. The debtor must ensure that these projections are realistic and supported by credible documentation. The bankruptcy judge cannot confirm a plan unless it is feasible. The debtor must show the ability to generate the projected income given projected expenses. The plan should include a monthly cash flow projection for the duration of the plan, as well as documentation that supports projected yields, weaning weights, crop and livestock prices, production expenses, etc.

**Operating credit:** Providing for operating credit to fund the plan is one of the most difficult parts of a successful Chapter 12. Traditional lenders generally won't finance an operation in Chapter 12 bankruptcy. However, some lenders will because the code provides effective protection for a postpetition lender. Finally, some operations can generate operating capital internally—such as a dairy with monthly milk checks. Funding a plan internally is the most advantageous alternative. However, if an operation cannot do that, the debtor must show the bankruptcy judge that he can obtain operating capital from a third-party, or through cash collateral.

**Projected nonfarm income and expenses:** The ability to generate off-farm income is often the most important part of a Chapter 12 plan. If one or both spouses can generate income that is independent of the farm operation, risk is reduced and net cash flow to fund the plan increases.

**Projected family living expenses:** The debtor is entitled to a reasonable allowance for family living expenses. However, they should be projected realistically because the trustee will require the debtor to report living expenses and live within the plan. Credit card debt that accumulates in a given year is an important consideration. Mounting credit card debt is typically overlooked and may indicate that family living needs were underestimated. Underes-

timating living expenses to create the illusion of sufficient cash flow for payments is not acceptable. The debtor may get the plan confirmed, but such a plan is probably doomed.

**Payments:** Plan payments are ones the debtor must make to the trustee for distribution to secured and unsecured creditors. For any plan to meet feasibility requirements, it must show that these payments will be made on schedule. If the debtor includes a secured claim without changing the amount, terms, or interest rates, the payments can be made directly to the creditor. Otherwise, payments to creditors go through the trustee.

**Trustee Fees:** The plan must provide for trustee fees. The Chapter 12 fee cannot exceed 10 percent of plan payouts under \$450,000, or 3 percent of plan payouts in excess of \$450,000. Since trustee fees attach to each plan payment he handles, it helps to include unimpaired claims where possible, and pay creditors directly.

**Disposable income:** This is the income left after paying operating and living expenses, and plan payments. To meet confirmation requirements, the plan must provide that all disposable income during the period of the plan will go to the trustee for distribution to the unsecured creditors. The essence of a Chapter 12 bankruptcy is that the debtor agrees to pay the unsecured creditors at least as much as they would have received in a Chapter 7 liquidation, plus all of the disposable income for the period of the plan. Thereafter, unsecured debts will be discharged and unsecured creditors receive no additional payments.

**Executory contracts and unexpired leases:** Unexpired leases are just what the name states. An executory contract is a contract that remains partially unperformed on both sides at the time of filing (e.g., Direct and Counter Cyclical (DCP) and Conservation Reserve Contracts (CRP)). The debtor must specify which executory contracts and unexpired leases will be assumed and which will be rejected. However, the debtor cannot restructure contracts or leases. They must be assumed or rejected as is. Likewise, the plan must provide that any breach in executory contracts and unexpired leases will be cured before the plan begins.

## Confirmation of the plan

When the debtor files his plan, he provides a copy to each creditor and to the trustee. The creditors and the trustee have a period to evaluate the plan and

decide whether to object to the plan. In many jurisdictions, the trustee conducts a conference with the debtor and creditors before the confirmation hearing to resolve objections. If the creditors and the debtor cannot resolve their disputes, the bankruptcy judge will conduct a hearing where the debtor presents his plan and the creditors present objections. The bankruptcy judge then decides whether the plan is feasible and whether it treats the creditors properly. The bankruptcy judge will then confirm or deny the plan.

## Modification of the Chapter 12 plan

If the debtor experiences drought, floods, insect infestation, etc., they may try to modify the Chapter 12 plan. In many jurisdictions, however, this opportunity is only available if the debtor has successfully made the first year's payments. In addition, if the need to modify is a failure to make plan payments in the second or third years, the modification will probably need to extend the plan to 4 or 5 years. The approval process for modification is similar to that for the original confirmation.

## Discharge of indebtedness

After the debtor has made all planned payments, the remaining unsecured debts will be discharged. This means that the debtor is longer be liable for these debts. Under Chapter 12, the debtor does not receive a discharge until after all plan payments are complete. There are provisions for the bankruptcy judge to grant a hardship discharge—it is rare.

## Dismissal or conversion

The debtor maintains an absolute right to dismiss his case, which returns the debtor and his creditors to the positions they held at the time the Chapter 12 bankruptcy was filed. This right cannot be waived by the debtor. The bankruptcy judge can dismiss the case if the debtor fails to file and confirm a plan or perform according to the plan and the bankruptcy rules.

The debtor also maintains an absolute right to convert the case to a Chapter 7, Chapter 11, or Chapter 13 bankruptcy, if they qualify. However, the bankruptcy judge cannot convert the case to Chapter 7 liquidation, unless it is proven in court that the debtor has committed fraud in their Chapter 12 case.

## Other considerations

**Preferences:** The debtor must disclose any payments of \$600 or more to creditors in the 90 days

before filing the bankruptcy. The trustee may force creditors to refund payments to the bankruptcy estate if they were payments on an existing debt, if the debtor was insolvent at the time of payment, or the payment was within 90 days of the filing. The trustee cannot force payment refunds to the bankruptcy if the creditor received less than they would have in a Chapter 7 bankruptcy.

The preference period is extended to one year if the creditor was an insider (e.g., a relative of the debtor). Thus, efforts to pay local trade creditors—who are usually unsecured—before filing the bankruptcy, may simply result in the trustee compelling the creditor to return the payment to the bankruptcy estate. However, the preference provision does not apply if the payments were made for new value, or if the payments were made in the ordinary course of business. If a local trade creditor is normally paid by a producer at the end of the crop year, this payment would probably fall within the ordinary course of business and not be classified as a preference.

**Fraudulent transfers:** The debtor must disclose all payments made within one year of filing. The trustee may compel the refund of payments made within one year of the filing if:

- The debtor intended to hinder, delay, or defraud a creditor
- The debtor received less than reasonably equivalent value
- The debtor was insolvent at or immediately after the transfer
- The debtor's operation was undercapitalized after the transaction
- The debtor knew that they would incur debts they could not repay

The debtor may not know that a particular transfer is deemed fraudulent, and it can be difficult to know in advance if the trustee will try to avoid a transfer.

Some of the factors the trustee will examine are:

- Did the debtor receive market value for the transfer?
- Was the transfer to an insider?
- Did the debtor retain possession or control of the property after the transfer?
- Was the transfer concealed?
- Was the debtor sued or threatened with suit before the transfer?
- Did the transfer include all or substantially all of the debtor's assets?

- Did the transfer occur shortly before or after a substantial debt was incurred?
- Did the debtor transfer the assets to a creditor who subsequently transferred the assets to an insider?

In addition to the provisions that govern fraudulent bankruptcy transfers, the trustee can also use applicable state and federal laws to avoid fraudulent transfers. Though the debtor is only required to report payments made within one year of filing, in Texas the trustee can go back 4 years to seek refund of fraudulent transfers.

**Setoffs:** If, before the filing date, the debtor owes money to a particular creditor, and the creditor also owes money to the debtor, the creditor can set off the amount he owes the debtor. For example, if the debtor has a loan with a bank and has money in a checking account at the same bank on the date of filing, the bank can set off the loan against the checking account by withdrawing the balance. The debtor should evaluate his exposure to setoff before filing bankruptcy. If the debtor has money at a bank to which he owes money, he should withdraw the money and deposit it elsewhere before filing, or simply hold it and disclose it as cash on hand. The debtor may have significant exposure to setoff if he has a loan with the Farm Service Agency, and they are owed Direct and Counter Cyclical Program or Conservation Reserve payments etc., from participation in Farm Service Agency programs.

**Postpetition property:** The property of the estate in a Chapter 7 bankruptcy consists of the nonexempt property owned by the debtor at the time of filing Chapter 7. It also includes any property the debtor receives within 180 after filing, through inheritance, a divorce settlement, or from a life insurance policy or death benefit program, if it would have been part of the bankruptcy estate had the debtor owned it at the time of filing. A critical difference between a Chapter 7 and Chapter 12 is that the property of the estate in Chapter 12 includes anything that would have been property of the estate in Chapter 7 whether owned at the time of filing, or received before the case is closed, dismissed, or converted to Chapter 7. This includes earnings from services performed after the filing and before the case is closed, dismissed, or converted to Chapter 7. Thus, if the Chapter 12 debtor receives a windfall (e.g., he wins the lottery) or a large inheritance in the last month of his Chapter 12 plan, he could find that his windfall or inheritance goes to his creditors.

**Legal Fees:** Chapter 12 bankruptcy is complex—the debtor will usually incur significant legal fees. These fees must be disclosed to the court and are reviewed by the trustee and the bankruptcy judge. The debtor must ensure that he will have funds to employ competent counsel. The debtor should retain counsel as early as possible. Though waiting until the last minute can hurt chances for a successful bankruptcy, it is unlikely to reduce the associated legal fees.

### **Chapter 7 liquidation**

Liquidation does not mean that everything a producer owns will be sold to pay his debts. In a Chapter 7 bankruptcy, the debtor is allowed to keep exempt property subject to its liens. Producers who file Chapter 7 bankruptcy are often able to continue farming by reaffirming debts on equipment and livestock that they need to keep operating, while discharging significant levels of unsecured debt.

The Chapter 7 bankruptcy, like Chapter 12, starts with filing a voluntary petition, a list of creditors, schedules of assets and liabilities, and a statement of financial affairs.

A trustee is appointed in a Chapter 7 case from a rotating roster of attorneys or nonattorneys that have been approved by the U.S. trustee. Since there is no operating plan in Chapter 7, the trustee does not play the supervisory role of the Chapter 12 trustee. Instead, the Chapter 7 trustee:

- Identifies the debtor's exempt property
- Abandons collateral property for secured loans, in which the debtor has no equity
- Liquidates the remainder of the property
- Disburses the proceeds from these sales to the unsecured creditors in a prorated fashion based on their proof of claim.

Chapter 7 cases cost the debtor less than Chapter 12. Though the filing fee is \$306, compared to \$246 for Chapter 12, the Chapter 7 debtor does not incur trustee fees because these are paid from the assets which the trustee liquidates. Chapter 7 legal fees are usually only a fraction of those in Chapter 12 because there is no 3- to 5-year plan to develop and administer.

The normal Chapter 7 case concludes within about 4 months provided there are no assets for the trustee to administer. The Chapter 7 case convenes 341 creditors' hearing, but there is no confirmation hearing because there is no plan. Normally, the 341 meeting in a Chapter 7 case is followed by the Dis-

charge/Reaffirmation hearing, which concludes most Chapter 7 cases.

In general, Chapter 7 is less expensive, faster, and less stressful than Chapter 12. The producer should evaluate their objectives in deciding between Chapter 7 and Chapter 12. If the producer wants to retain a significant portion of their nonexempt assets or restructure debts associated with the exempt or nonexempt assets, the producer will probably find Chapter 12 is appropriate. However, no producer should file a Chapter 12 case without seriously comparing of the benefits and costs of Chapter 7.

### **Tax considerations**

Filing Chapter 12, Chapter 7, or any other bankruptcy can have significant tax consequences. It is essential that the producer consult a knowledgeable accountant before filing the bankruptcy. This will help the producer and his attorney optimize the tax consequences of filing and administering a bankruptcy case.

### **Other legal considerations**

The producer should not fear the legal processes of bankruptcy. The design and operation of the system treats the debtor courteously and recognizes that a primary objective of bankruptcy is to give the debtor a fresh start. However, no discussion of bankruptcy is complete without a caution that federal law penalizes bankruptcy crimes. These crimes include knowingly concealing assets, making false statements, and transferring or receiving property in order to subvert the bankruptcy code. However, a debtor who makes full disclosures and ensures that their oral and written statements are true and correct should be within the law.

Debtors must understand that if they have existing DCP or CRP executory type contracts when they file for bankruptcy, they must assume/reaffirm these contracts before the case is discharged. Failure to do this will terminate the contracts and may, in the case of the CRP contract, have long term financial consequences for the debtor.

### **Chapter 11 reorganization**

Chapter 11 is the least common of the three bankruptcies for farming operations. However, anyone eligible to file under Chapter 7 may file under Chapter 11. The purpose of Chapter 11 reorganizations is not to liquidate the debtor's estate, but to stop creditor actions so that a business or personal financial

estate can be reorganized and become profitable again. Chapter 11 is better suited to corporations, sole proprietorships, or partnerships. Like the Chapter 12 bankruptcy, the debtor proposes a plan. However, unlike the chapter 12 the creditors get to vote whether to accept the plan. A major difference is that the discharge occurs when the plan is confirmed—in Chapter 12, the discharge typically comes after successfully completing year 3 or 5 depending on the plan.

Filing a voluntary petition for relief, invokes an order whereby the debtor automatically becomes the debtor in possession. This means the debtor will keep possession and control of their assets during the reorganization. The debtor will remain a debtor in possession until the reorganization plan is confirmed, dismissed, converted to a chapter 7, or a trustee is appointed. Few trustees are appointed in Chapter 11 cases as the debtor in possession typically performs many of the trustee functions under other chapters. The debtor usually does not have to pay a trustee and on larger operations this represents considerable savings.

In Texas, large dairies or cattle ranches that operate as corporations have used Chapter 11 bankruptcy. These cases take preparation and timing. Typically they need cash weekly to buy necessary feed and meet payroll after the filing. In the case of a dairy, legal counsel will typically file an emergency motion to use cash collateral—the milk checks—simultaneously with the voluntary petition. The creditors will often be contacted just before the filing

with a proposed agreed order that includes replacement postpetition liens on milk. Timing is essential because disrupting the labor, feed, or upkeep can devastate the operation moving forward.

This discussion of Chapter 11 bankruptcy is intended simply as an overview of a third option. Using this bankruptcy chapter requires experienced legal representation.

## Summary

Alternatives for dealing with financial stress include doing nothing, changing in the operation, voluntary debt restructuring, partial or total liquidation, and bankruptcy under chapters 7, 11, or 12. As a producer evaluates how to solve financial stress, they must consider each of these alternatives. Which the producer finally chooses often depends on factors that are beyond his control. The same forces that create financial stress (e.g., weather, prices, government programs, etc.) will also influence the effectiveness of each of these alternatives. As well, nonbankruptcy solutions usually depend on the creditor's willingness to work with the producer.

Producers should start evaluating alternatives as soon as they see that tightening their belts or holding on will no longer work. Producers need legal and tax advice early in the decision process, in order to make an informed choice and develop a sound plan. Delay in seeking counsel, making a decision, and implementing a strategy will greatly reduce the probability of achieving the desired outcome.

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