

FARM LEGAL SERIES

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Bankruptcy: Chapter 11 Reorganizations

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INTRODUCTION

Most people assume that bankruptcy means liquidating all of a debtor's nonexempt assets and distributing the proceeds among his creditors. However, the bankruptcy laws also provide for rehabilitating the debtor. Chapter 11 allows a debtor to enter into an agreement with creditors under which all or a part of the business continues. The debts of the business are restructured so as to allow the debtor to continue his business operation. Chapter 11 is more complex than Chapter 12 (which is the subject of another fact sheet in this series, *Bankruptcy: Chapter 12 Reorganizations*); however, it may provide an option for those farm operators whose businesses are too large for Chapter 12.

CHAPTER 11

Eligibility

If a farm debtor cannot qualify for Chapter 12, Chapter 11 provides similar reorganization possibilities. In general, any partnership, corporation or limited liability entity except a governmental unit may be a debtor in a Chapter 11 case.

Initiating a Chapter 11 Bankruptcy

To initiate a Chapter 11 case, a voluntary petition is filed with the court. A schedule of assets and liabilities and a statement of financial affairs also must be filed.

Debtor-in-Possession

The objective in a Chapter 11 case is to adjust and reorganize a debtor's obligations so as to allow the business to continue. In most cases, the debtor, known as the debtor in possession once the case has begun, remains in possession of his property, develops a plan, and generates funds to pay his debts. If there is evidence of mismanagement or fraud, a trustee may be appointed upon the request of creditors. The ability of the debtor to remain in possession and to continue to operate the business is a substantial reason to file a Chapter 11. The debtor can continue to raise and sell crops and livestock, use equipment, and acquire the necessary inputs to continue the farming operation. A committee of creditors will generally be appointed to oversee the farming operation under the supervision of the debtor in possession once the case has been initiated.

Use of Cash Collateral/Adequate Protection

Although the ultimate goal in any Chapter 11 is the formulation and acceptance of a reorganization plan, rarely does the debtor have a plan developed when the case is filed. There is thus often a period between the filing of the petition and confirmation of a plan during which business will be carried on by the debtor as the debtor in possession. As a debtor in possession, the debtor has all the rights of a bankruptcy trustee. He may generally continue to use assets in the ordinary course of business without court

approval. There are, however, certain restrictions applicable when he uses cash collateral. The debtor in possession cannot use, sell, or lease “cash collateral” unless each creditor with an interest in the collateral consents or unless the court authorizes such use. To obtain court permission to use cash collateral such as proceeds of stored grain, milk proceeds, or the proceeds of livestock sales, the debtor in possession must provide any creditor who holds a lien on such property with adequate protection. In other words, the creditor's secured position must be protected and not harmed by the use of the creditor's collateral.

Besides being able to continue to use the business assets, the debtor in possession is authorized to borrow funds. He may obtain unsecured credit in the ordinary course of business without court approval. And he may obtain secured credit by granting a lien on unencumbered property of the estate or a subordinate lien on encumbered property with court approval. Finally, if the debtor cannot obtain credit on either an unsecured basis or by using previously unencumbered assets, a super-priority lien may be obtained if he can establish that any lender who also has a lien on the property will be adequately protected.

In the case of a farming operation, it is possible to obtain secured credit by using crops that are planted after the filing of the petition as collateral. If the petition has been filed prior to the planting of crops, such crops are free of the lien of any prepetition creditors. In other words, the filing of a bankruptcy petition (including Chapter 7 or Chapter 12) cuts off the after-acquired property clause contained in any prepetition security agreement. However, this rule does not apply to proceeds, products, offspring, rents, or profits of prepetition property. Thus, if a lender has a security interest in livestock and offspring, the security interest

will extend to offspring conceived and born after the filing of the case.

Sale of Assets

A farm debtor may sell any assets prior to or as part of the debtor's confirmed Chapter 11 plan. The Bankruptcy Code allows a debtor to sell (and the buyer to acquire) any assets free and clear of any liens or other encumbrances. Any liens of the farm debtor's creditors will be satisfied with the sale proceeds. If the sale proceeds are not enough to pay off all the liens on the sold property, the property may still be sold and the unpaid lien holder will be left with a general unsecured claim in the bankruptcy. If the sale proceeds are enough to pay off all of the liens on the sold property, the debtor may be able to use the surplus sale proceeds to fund the Chapter 11 plan.

Unsecured Creditors Committee

Immediately upon the filing of the Chapter 11 bankruptcy, the Office of the United States Trustee will send a notice to all creditors of the farm debtor to ask if anyone would like to serve on the creditors committee. If there are interested creditors, the United States Trustee decides to form a committee, and the Court approves the committee, the committee will be an active participant in the bankruptcy proceeding; protecting the rights of all of the unsecured creditors of the debtor. The fees and expenses of the committee (including the legal fees of the committee) will be an administrative claim; paid by the farm debtor as part of the debtor's Chapter 11 plan.

Small Business Election

In some circumstances the debtor may qualify as a “small business debtor.” The small business election expedites the bankruptcy case. If the election is properly made, no creditors' committee may be appointed and only the debtor may file a

plan during the first 180 days of the bankruptcy case (rather than the 120 days allowed for in a traditional Chapter 11 case). This "exclusivity period" may be extended by the court. However, this can only be extended to 300 days if the debtor demonstrates by a preponderance of the evidence that the court will confirm a plan within a reasonable period of time. To qualify for the election, the debtor must be engaged in commercial or business activities (other than primarily owning or operating real property) with total non-contingent liquidated secured and unsecured debts of \$2,190,000 or less. The debt limit amount increases every three years to reflect the consumer price index.

CHAPTER 11 PLAN OF REORGANIZATION

Under Chapter 11, only the debtor may submit a plan of reorganization within 120 days of the initiation of the bankruptcy case. Under a typical reorganization plan, the debtor attempts to restructure his debts. Such a plan will generally provide for the repayment of loans secured by real estate to be paid over an extended period of time. Intermediate term loans will be proposed to be paid over the remaining useful life of the collateral, which is typically five to ten years. The interest rate on any such loans may be adjusted under a plan, although it will generally be necessary for the debtor to pay interest at a "market rate" following confirmation of the plan. Most plans will propose that unsecured creditors be paid less than the full amount of their claims in full satisfaction of their claims.

Chapter 11 Plan

A Chapter 11 plan typically classifies claims against the debtor, specifies the treatment to be given each class of claim, and provides the means for carrying out the plan. The plan must be confirmed by the bankruptcy court. There are thus three steps involved in

obtaining confirmation of a plan under Chapter 11:

1. The plan is developed by the debtor
2. Acceptance of the plan by creditors is sought by the debtor
3. The confirmation hearing is held and the plan is either confirmed or not confirmed

For a Chapter 11 plan to be confirmed, it must be accepted by at least one class of impaired claims. These are claims of creditors that will not, under the plan, be paid in full or whose legal rights are adjusted by the plan. In addition, the bankruptcy court must determine that the plan is feasible.

Cram-down

Under certain circumstances, the bankruptcy court may "cram-down" a plan over the objection of creditors. In order to confirm a Chapter 11 plan over the objection of a secured creditor, a holder of a secured claim must receive the entire value of the property securing the claim or the entire value of the claim, whichever is smaller. Unsecured creditors must either accept the Chapter 11 plan or the owners of the business must not receive any property under the plan on account of their prebankruptcy interest in the farming operation. Finally, a plan cannot be confirmed if the plan does not pay each claim holder as much as he would have received under a Chapter 7 liquidation unless those who receive less accept the plan.

Objections to Plan

Creditors may object to the confirmation of the debtor's plan in a Chapter 11 case. Such objections will usually challenge whether the debtor has met the technical requirements of Chapter 11. However, creditors may also challenge the debtor's valuation of their collateral and the feasibility of the debtor's plan. As a result, it is usually necessary for

the debtor to obtain expert testimony concerning the current value of machinery, equipment, livestock, and crops. In addition, it will be necessary for the debtor to provide his creditors with detailed financial projections which will assist the bankruptcy court in determining that the business may be successfully restructured.

Competing Plans

As previously mentioned, only the debtor may submit a plan of reorganization within 120 days of the initiation of the bankruptcy case. Any interested party may file a plan thereafter. A plan, including a plan proposed by a creditor, may provide for the liquidation of some or all of the debtor's nonexempt assets. Such a liquidating plan may be proposed and approved by the court even in the case of a farmer.

Confirmation

Confirmation of a plan under Chapter 11 acts as a discharge of all debts, filed or not, excluding those specified as not dischargeable elsewhere in the bankruptcy code. Upon confirmation of a plan, the debtor receives back all his property free and clear of all liens and encumbrances unless such liens are preserved by the plan. Both the debtor and the creditors are bound by the terms of the confirmed plan.

POWERS OF THE DEBTOR IN POSSESSION

Besides continuing the business, like a trustee, the debtor in possession can avoid, or set aside, certain transactions that occurred prior to the filing of the bankruptcy case. These avoidance powers are complex, but a brief summary may be helpful.

Preferences

The debtor in possession can avoid or recover any transfers of property he made within 90 days before the filing of the

bankruptcy petition to a creditor on account of a pre-existing debt if such a transfer allows the creditor to receive more than he is otherwise entitled to. Such transfers are called preferences under the Bankruptcy Code. In general, the philosophy of the law with respect to preferential transfers is to take away from creditors any transactions that might result in an improvement in their position on the eve of bankruptcy. This philosophy is in accord with the underlying policy of the Bankruptcy Code to foster equality of treatment among creditors.

The debtor in possession may avoid the granting of any security interest, conveyances of property, or payments that were made within 90 days of the filing date. This 90-day period may be extended to one year for transfers made to insiders. Exceptions to these preference rules are provided in cases of transfers made for new values payments for debts incurred in the ordinary course of business and the perfection of purchase money security interests within a time period required by the Uniform Commercial Code.

Not all transfers made by the debtor within 90 days of filing are avoidable, however. Transfers made for new value, payments for debts incurred in the ordinary course of business, and the perfection of purchase money security interests within the time period required by the Uniform Commercial Code (UCC) do not constitute preferential transfers.

Fraudulent Transfers

The debtor in possession also can avoid fraudulent transfers made within one year before the filing of the bankruptcy petition. Under the Bankruptcy Code, a fraudulent transfer is a transfer made with the intent to hinder, delay, or defraud a creditor. It also includes transfers for which the debtor received less than a reasonably equivalent value in exchange for the transfer.

Finally, the debtor in possession can avoid or set aside transfers that are not properly recorded or perfected under state law. These avoidance powers are potent tools that the debtor in possession can use to formulate and fund his or her plan.

Executory Contracts and Leases

The debtor in possession may assume or reject executory contracts and leases of the debtor. An executory contract is an agreement under which the obligations of both parties to the contract are unperformed. Common examples of such contracts in a farm setting include equipment leases and real property leases. Certain farm program contracts, such as Conservation Reserve Program contracts, are also executory contracts.

If the debtor in possession elects to assume an executory contract, he must either cure any defaults in the contract or provide the other party to the contract with adequate assurances that he will cure the defaults.

A contract for deed in which the debtor is the buyer has been determined by the courts not to constitute an executory contract under the Bankruptcy Code. Therefore, the debtor in possession does not need to determine whether to assume such contracts or cure all defaults under such contracts immediately.

CONCLUSION

Chapter 11 offers a second opportunity to reorganize and restructure the debtor's farming operation. When carefully considered and adopted, a Chapter 11 proceeding can provide meaningful relief for the financially distressed farmer. The rules of the Bankruptcy Code relating to the confirmation of a Chapter 11 plan are extremely complex. The legal issues presented by a contested confirmation are extremely technical. As a result, no business person should consider a Chapter 11 reorganization without competent and experienced legal and financial advice.

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