RM7-20.0
11-98

Texas Agricultural Extension Service
The Texas A&M University System

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

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Financial Stress - the Problem

The term, "financial stress," refers to a situation in which a borrower is unable to pay debts as they become due. Financial stress in the agricultural production sector today is approaching, and in many cases exceeds the levels of financial stress encountered in the 1980's. While it is not the purpose of this publication to attempt to explain the root causes of the current levels of financial stress, it certainly should be noted that agricultural producers have been faced with a barrage of natural disasters over the past few years. At the same time that producers have been attempting to deal with droughts, floods, and insect infestations, crop and livestock prices have fallen, and production input prices have increased. To make matters even worse, the effectiveness of the safety net provided by federal farm programs in the past has been greatly reduced under the 1996 Freedom to Farm Act.

Alternative Ways to Deal with Financial Stress

Risk Management Education

The traditional way that agricultural producers have attempted to deal with financial stress in the past has been to "tighten their belts," and try to "hold on" until things get better. Unfortunately, for many producers, their current financial situation is the result of having applied this strategy for the past several years. This is not to say that this strategy was wrong, but instead, to say that many producers simply can't "tighten their belts" anymore, nor can they "hold on" any longer, without making drastic changes in their operations. While the remainder of this publication will be devoted to a discussion of various alternative strategies for dealing with financial stress, it should be clear that there are no simple answers,

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nor are there any "quick fixes." Each producer and each operation is unique, and only the producer will be able to decide which alternative, or combination of alternatives, will be effective in addressing the financial stress in his operation. However, as the producer goes through the process of analyzing his alternatives, it is imperative that he seek competent legal and tax advice from his attorney and accountant.

Changes in the Operation

The producer should look at her operation to see if there are changes which would allow her to increase income or decrease expenses. She probably has been actively attempting to accomplish these goals for several years, but many producers have limited their efforts in these areas to those changes which would not result in drastic changes in their overall operations. The time has come to look at <u>all</u> possible changes in the operation. In other words, each crop and livestock enterprise must stand on its own. If a producer needs assistance in this analysis, the Texas Agricultural Extension Service has resources which are available through the County Extension Agent.

Voluntary Restructuring of Debt

If the producer is unable to adjust his operation to enable him to pay debts as they become due, he may be able to go to his lenders and work out a plan to extend terms of repayment or lower interest rates to reduce the repayment schedule to meet the cash flow available from his operation. However, the producer needs to be aware that lenders are receiving requests on a daily basis to extend terms and reduce interest rates, and the lender is unlikely to respond favorably unless the producer can demonstrate that such a change will actually solve the problem of financial stress in the operation. Thus, it is important for the producer to be able to show the lender what changes he has made in the operation, and have solid production and economic data to support the restructuring request. While a lender may be willing to restructure a distressed loan if it appears that these changes will place the loan on a "paying basis," the lender is not likely interested in simply "putting off the inevitable." In other words, if the producer can convince the lender that his operation has a high probability of survival if the loan is restructured, the lender may be willing to pursue this alternative. But, if restructuring a producer's loans is only a short-run solution, the lender is not likely to be willing to consider this alternative.

Another factor which may influence the lender's willingness to voluntarily restructure a producer's loans is whether or not there are defects in the loan and/or security documents. For example, if the lender has a security interest in crops, and if the security agreement granting the security interest does not describe all, or incorrectly describes some of the farms on which the crops are to be grown, then the lien may very well not be properly perfected. However, the producer will likely need to consult an attorney early on in the process in order to determine if situations like this exist in his or her particular case.

Partial or Total Voluntary Liquidation

If a producer is unable to make changes in the operation and work out a restructure of her loans so that she can service the debt, the producer should consider the <u>partial</u> voluntary liquidation alternative. Initially, the producer should analyze whether she could sell enough assets to reduce the debt load to a point where she could make the payments as they become due. As a practical matter, the producer should look first at the sale of the assets which are most heavily encumbered with debt because sale of these assets will tend to reduce debt relatively more than the sale of other assets. However, it is important to analyze the effect of sale of a particular asset on debt service requirements as compared to the effect on net cash flow. The producer's situation will not be improved if she sells an asset which contributes more to net cash flow in the operation than the required payments for debt service. She may also find that the partial voluntary liquidation alternative needs to be combined with changes in the operation and a restructuring of the remaining debt. Unfortunately, she may find that she still will not be able to pay her debts as they become due, even after considering drastic changes in her operation, restructuring of her loans, and sale of part of her assets. If this is the case, the producer needs to consider a <u>total</u> voluntary liquidation.

The producer also needs to be aware that both partial and voluntary liquidation expose her to potential capital gains tax problems. When she sells assets to pay off debts, she may incur capital gains taxes, but it is highly unlikely that her lender will allow her to retain enough of the sales proceeds to pay these taxes. It is imperative that the producer consults with her accountant regarding tax consequences before she enters into any agreement for partial or total voluntary liquidation. Creating a situation in which the producer has eliminated her debts to current creditors, only to find that she has incurred a significant tax indebtedness to the Internal Revenue Service without a means to pay, is a real danger which the producer must guard against.

Caution must also be used in entering into agreements whereby a portion of the producer's debt will be discharged (i.e., written off). For example, if the producer agrees to sell all of the assets securing a loan from the bank, and the bank agrees to write off any deficiency after the sale, the producer may incur what is referred to as discharge of indebtedness income, which may be taxable. Again, the producer should consult her accountant in advance to ensure that she does not find herself faced with unexpected tax consequences.

Do Nothing

As always, "doing nothing" is an alternative for dealing with financial stress, and in some cases, this may actually be the best alternative. However, "doing nothing" is an alternative which should only be selected after careful consultation with the producer's attorney. In any event, the producer should be aware that his creditors can foreclose on the collateral securing their loans. This means the creditors will sell the collateral to apply against their loans. Then, if there is a deficiency (i.e., the collateral doesn't sell for enough to pay off the loans), creditors can file lawsuits against the producer to get a judgment for the deficiencies. The creditors can then file "abstracts of judgment," which will allow them to try to collect the deficiency from any other non-exempt assets which the producer may own.

Bankruptcy

If the alternatives listed above do not provide a solution for his financial distress, the producer should at least consider bankruptcy as an alternative. The type of bankruptcy which is more familiar to most people is a "liquidation" bankruptcy. Under this form of bankruptcy, referred to as Chapter 7 bankruptcy, the debtor keeps his or her exempt property (e.g., homestead, household goods, etc.), subject to the loans which the exempt property secures. The trustee collects the remaining non-exempt property, converts the non-exempt property to cash, and distributes the cash to the unsecured creditors. The secured creditors generally must look to their collateral to satisfy their claims. The debtor gives up all his non-exempt property in return for a discharge of most, if not all of the remaining indebtedness. This discharge releases the debtor from personal liability for pre-bankruptcy debts.

Another type of bankruptcy is a "reorganization" bankruptcy. Chapter 11 is a business reorganization, Chapter 13 is an individual reorganization, and Chapter 12 is a family farmer reorganization. In a reorganization bankruptcy, creditors generally look to future earnings, not the property of the debtor at the time of initiation of the bankruptcy, to satisfy their claims.

Bankruptcy provides a number of advantages over the non-bankruptcy alternatives. First, the bankruptcy process is supervised by the court to ensure that the debtor and the creditors are all treated fairly. Second, the bankruptcy statutes and 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 its disadvantages. Many producers are concerned that filing bankruptcy will damage their credit (although it is questionable whether bankruptcy actually does more harm to their credit than an unresolved financially distressed loan situation). Also, many producers are concerned about the social stigma of filing bankruptcy, but the large number of bankruptcies which resulted from the crises in the oil and gas, real estate, and banking sectors have greatly reduced this social stigma.

The remainder of this publication is devoted primarily to providing a more detailed explanation of Chapter 12 reorganization and Chapter 7 liquidation bankruptcy. The purpose is not to promote bankruptcy as "the" solution for resolving financially distressed loans, but to provide the producer with additional information to evaluate all of the alternative strategies.

Chapter 12 Farm Reorganization

Chapter 12 may be particularly relevant in situations in which a significant portion of the producer's debts are unsecured, and/or the producer needs to restructure secured debts and the lender is unwilling to provide the necessary relief.

Eligibility

In order 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 debts do not exceed $1,500,000. At least 80 percent of this debt (excluding debt for the principal residence) must have arisen from the farming operation, and the producer (and/or producer's spouse) must have received more than 50 percent of his or her gross income from the farming operation in the tax year preceding the date of filing of the bankruptcy. 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." It should also be noted that a corporation or partnership may qualify for bankruptcy protection.

Insolvency is not a requirement for Chapter 12, or any other type of bankruptcy. It is only necessary that the debtors be unable to pay debts as they come due. In other words, bankruptcy may be available to restructure debts, even though a sale of all the debtor's assets would provide sufficient funds to pay all debts.

It is important to note that a debtor generally cannot receive a second discharge of indebtedness within a 6 year period. Thus, if a debtor has received a discharge of indebtedness in a case filed less than 6 years earlier than the date of the filing of a second bankruptcy, the debtor can not receive a discharge in the second bankruptcy. However, there is an exception to this provision if the earlier discharge was in a Chapter 12 or Chapter 13 bankruptcy and the debtor paid at least 70 percent of the unsecured claims in the earlier bankruptcy.

Frequent filing is also restricted by a prohibition against filing a bankruptcy when the debtor has been a debtor in a case in the previous 180 days, if the earlier case was dismissed by the court for willful failure of the debtor to abide by orders of the court, or to appear before the court, or the debtor voluntarily dismissed the earlier case after a creditor requested relief from the automatic stay to foreclose on the collateral securing the creditor's loan. This provision was enacted to prevent debtors from filing for bankruptcy to avoid foreclosure and then dismissing the case as soon as the creditor requests relief from the court. Prior to enactment of this provision, 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 list of creditors' names and addresses, (3) schedules of assets and liabilities, and (4) a statement of financial affairs. In an emergency filing, the debtor(s) has 15 days from the filing of the voluntary petition and list of creditors in which to file the schedules and statement of financial affairs. If the debtor is married, a joint voluntary petition can be filed. The producer must also pay a filing fee of $230 at the time of filing.

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

The Automatic Stay

The filing of the voluntary petition also results in an "automatic stay" of all collection activities by the creditors. This means that the creditors can take no further actions to collect their debts until the court gives permission. All other ongoing litigation to collect debts is stayed, and creditors are prohibited from filing additional law suits in other courts to collect their debts. Creditors are also prohibited from foreclosing on collateral or enforcing judgments without permission from the bankruptcy court. Likewise, informal collection actions such as telephone calls and letters, attempting to collect debts, are stayed (i.e., stopped). In a Chapter 12 bankruptcy, collection activities against a co-debtor are also stayed, but only in situations in which the debt is a consumer debt, not a business debt. Thus, a co-signer for the producer's operating loan or a loan to purchase business assets would not be protected by the co-debtor stay.

The automatic stay will remain in place until the case is dismissed or closed. However, prior to termination of the automatic stay, a creditor can request relief from the automatic stay (1) if the creditor's interest in the security for his loan is not adequately protected, or (2) if the debtor does not have any equity in the encumbered property, and the encumbered 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, which is discussed below, and to disburse payments from the debtor to secured and unsecured creditors. The trustee plays a very important role in a Chapter 12 bankruptcy because the court usually relies heavily on the recommendations from the trustee with respect to confirmation of the plan and continuation of the case. The trustee is compensated from a fee on all payments collected from the debtor and distributed to the creditors.

The debtor will retain possession of the property of the bankruptcy estate, unless the court orders otherwise for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor. As a practical matter, if the court should find that the debtor should be removed as a debtor in possession, the Chapter 12 bankruptcy will more than likely be dismissed because the trustee generally is not in position to take over and continue a farming operation.

Meeting of the Creditors

A meeting of the creditors will be scheduled to take place no sooner than 20 days after filing and no later than 35 days after filing. This meeting is convened by the Chapter 12 trustee, and is generally referred to as a "341 Meeting" because it is conducted under the provisions of Section 341 of the Bankruptcy Code. The purpose of this meeting is to allow the trustee and the creditors to question the debtor(s) regarding property of the estate and other matters relating to the bankruptcy. The bankruptcy judge will not be present and this meeting is not held in the courtroom. However, the debtor(s) must be present, and the debtor(s) will be required to testify under oath. There will not be a court reporter, but instead, the trustee will record the proceedings on tape.

Development of the Chapter 12 Plan

Development of the Chapter 12 plan of reorganization is by far the most important determinant of success in a Chapter 12 bankruptcy. The debtor must file this plan no later than 90 days following the filing of the case. The plan must demonstrate that the debtor(s) can pay reasonable living expenses, all operating expenses, required payments to secured creditors, and payments to unsecured creditors which are at least as great as the unsecured creditors would have received in a total liquidation. The plan must cover at least 3 years, and no more than 5 years. The creditors have a right to object to the plan, but the decision on whether the plan is acceptable or not is made by the bankruptcy judge.

Exempt Property: The property which the debtor owns at the time of filing is divided into "exempt" and "non-exempt" property. Exempt property is property which is exempt from collection efforts by creditors under either federal or state law. The debtor is allowed to keep her exempt property without further payments other than payments for valid liens. Valid liens against exempt property would include purchase money liens and certain non-purchase money liens. The debtor is allowed to choose between federal and state exemptions. Exemptions under Texas law are generally much more favorable to the debtor, so in most cases the debtor will choose the Texas state exemptions, which serve as the basis for the discussion below.

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

Under the Texas Property Code, the Texas debtor is also entitled to an exemption of $60,000 worth of personal property for a family or $30,000 for a single person. This limitation only applies to the debtor(s)' equity in the personal property. The property claimed for this exemption must fall with the following categories:

- 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 $15,000 for a family or $7,500 for a single person;
- two firearms;
- athletic and sporting equipment, including bicycles;
- a 2-wheeled, 3-wheeled, or 4-wheeled motor vehicle for each member of a family who holds a driver's license or who relies on another person to operate the vehicle for the benefit of the non-licensed person;
- the following animals and forage on hand for their 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; and
  - 120 fowl;
- household pets; and
- 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 in such a way that it does not count against the limits of the Texas Property Code).

The debtor is further entitled to exemption of the following personal property which is not subject to the $60,000 (or $30,000) limits discussed above:

- current wages for personal services (except for the enforcement of court-ordered child support payments);
- 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 (including IRA's);
- any annuity issued by an insurance company; and
- certain life insurance proceeds.

As stated above, if no creditor holds a valid consensual (voluntary) lien on a particular piece of exempt property, the debtor will be allowed to keep the property without further treatment in the plan. 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 could choose to redeem the property by paying the creditor the value of the property in a lump sum. Or the debtor could reaffirm the debt which is secured by the property, meaning that the debtor will continue making the payments on the debt without any changes. The debtor could propose in the plan to restructure the debt by changing either the terms, the interest rate, or both. Finally, the debtor could propose to surrender the property to extinguish the debt.

If the creditor holds a valid non-purchase money lien on exempt property, the debtor still has the options of redeeming, reaffirming, restructuring, or surrendering the property. But, she has an additional option in certain cases of avoiding the lien. Detailed discussion of this option is far beyond the scope of this publication, but there is one situation in which this particular option arises regularly in Chapter 12 cases. In many cases, the producer has actually paid off all purchase money liens against his farm equipment over the years, only to find it necessary to give a lender a non-purchase money lien against the equipment to secure an operating loan. In this situation, the debtor could avoid or eliminate the lien against $10,000 worth of equipment for a family, or $5,000 for a single person.

Non-exempt Property: All other property owned by the debtor at the time of filing is classified as non-exempt property. If the debtor needs or desires to retain this property, he must provide in the plan for payments to either the secured creditors or the trustee (for the benefit of the unsecured creditors) of the value of this property. If the non-exempt property secures a debt, then the debtor must decide whether to redeem the property with a lump sum payment, reaffirm the existing debt, restructure the debt, or surrender the property to the creditor. If the non-exempt property is not encumbered (i.e., there is no lien against the property), the debtor has the choice of either paying the value of the property to the trustee over the period of the plan, or surrendering the property to the trustee. If the property is surrendered, the trustee will sell the property and distribute the proceeds to the unsecured creditors.

Creditors' Claims: The debtor has to list all creditors' claims on the schedules as either a priority unsecured claim, a non-priority unsecured claim, or a secured claim. Priority unsecured claims are debts such as unpaid taxes which are not secured by a lien on the debtor's property. Non-priority unsecured claims are debts which are not secured by a lien on the debtor's property. Secured claims are debts which are secured by liens on the debtor's property. However, it is important to note that when the claims are provided for in the plan, a given debt may be bifurcated (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 which is 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 unsecured claim will be listed with the other unsecured claims and treated in the same manner as any other unsecured claim.

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

If a creditor is over-secured, the debtor must provide in the plan for payment of interest from the date of filing and for 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.

Special attention should be given to analyzing <u>prepetition</u> liens on crops and livestock. Generally, these liens will give the creditor an effective lien on harvested crops on hand at the time of filing, growing crops at the time of filing, offspring of livestock which were born at the time of filing, and proceeds from any of these types of collateral. These types of property are classified as "cash collateral." However, more importantly, prepetition liens on crops and livestock are "cut off" at the date of filing, meaning that they are not effective against crops which are planted after filing or livestock offspring born after filing. Thus, it is important to carefully consider these liens in the decision of <u>when</u> to file the bankruptcy.

Non-dischargeable Claims: There are a number of categories of unsecured debts which are not dischargeable in bankruptcy, and the debtor will need to provide for payment of these debts in the plan. While it is necessary to carefully analyze the dischargeability of each individual debt, the general categories of non-dischargeable debts are, as follows:

- most taxes;
- debts for property obtained through fraud (e.g., based on false financial statements);
- unscheduled debts;
- liabilities as a fiduciary;
- domestic relations (e.g., child support and payments for maintenance or support of a spouse or former spouse);
- liabilities for willful and malicious injury (including unauthorized sale of collateral);
- governmental fines;
- certain educational debts (e.g., student loans);
- DWI debts (i.e., obligations incurred as a result of the debtor's driving which intoxicated); and
- debts covered by a previous bankruptcy in which a discharge was not granted.

Projected Operating Income and Expenses: It should come as no surprise that the projected operating income and expenses are the heart of the Chapter 12 plan because the net cash income from operations, combined with any off-farm income, must fund the other components of the plan. The debtor must ensure that these projections are realistic and supported by credible documentation because the bankruptcy judge cannot confirm the plan unless it is feasible. This means that the debtor must be able to demonstrate that she can generate the projected income, given the projected expenses. Thus, the plan should include a monthly cashflow projection for the entire period of the plan, in addition to the documentation which supports projected yields, weaning weights, crop and livestock prices, production expenses, etc.

Operating Credit: Providing for the necessary operating credit to fund the plan is one of the most difficult aspects of a successful Chapter 12 because most traditional lenders are unwilling to finance an operation in Chapter 12 bankruptcy. However, there are some lenders who will finance debtors in Chapter 12 bankruptcy because they realize that the bankruptcy code and rules actually provide very effective protection for a postpetition lender. The debtor can also petition the court to allow him to use cash collateral (defined above) to finance the operation. And finally, some operations can generate operating capital internally. Obviously, if the plan can be funded internally, this is by far the most advantageous alternative. But, if this alternative is not available in the operation, as it is not in most crop and livestock operations, then the debtor will be required to demonstrate to the bankruptcy judge that he will have the necessary operating capital, either from a third-party lender, or from the use of cash collateral.

Projected Non-farm Income and Expenses: Often the most important determinant of success in development of a feasible Chapter 12 plan is the ability of the debtor(s) to generate off-farm income. For example, if one or both spouses are able to generate additional income from an off-farm job, this increases net cashflow available for other components of the plan, and decreases the risk associated with the farm operation.

Projected Family Living Expenses: The debtor is entitled to a reasonable allowance for family living expenses. However, these expenses should be projected realistically because the trustee will require the debtor to report these expenditures and to live within the projections in the plan. Underestimating family living expenses in order to provide the impression that there is sufficient cashflow to make other required payments is not an acceptable alternative. The debtor may succeed in gaining confirmation of the plan, but such a plan is probably doomed from the outset.

Plan Payments: Plan payments are the payments which the debtor must make to the trustee for disbursement to secured and unsecured creditors. Of course, the plan must provide that these payments will be made, as scheduled, in order to meet the definition of a feasible plan. If the debtor includes a secured claim in the plan without impairment (i.e., the amount, terms, and interest rates remain unchanged), the payments can be made directly to the creditor, rather than through the plan. Otherwise, all payments to the creditors must be made through the plan (i.e., to the trustee).

Trustee Fees: The debtor must provide in the plan for the payment of fees to the trustee in the amount of 11.11 percent of each plan payment. The trustee fee is 3.09 percent for plan payments which exceed $450,000. Since the trustee fees have to be paid at the time each plan payment is made, there is a significant incentive to pay creditors direct, when it is possible to include a claim in the plan without impairment.

Disposable Income: Disposable income is the amount of income which remains after payment of operating expenses, family living expenses, and plan payments. In order to meet the requirements for confirmation, the plan must provide that all disposable income during the period of the plan will be paid to the trustee for disbursement to the unsecured creditors. Essentially, the deal which the debtor makes in a Chapter 12 bankruptcy is that she will 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, the unsecured debts will be discharged and the unsecured creditors will not receive any additional payments.

Executory Contracts and Unexpired Leases: The term "unexpired leases" is probably self-explanatory, but the term "executory contract" needs some definition. An executory contract is a contract which remains partially unperformed on both sides at the time of filing (e.g., Production Flexibility and Conservation Reserve Contracts). The debtor must specify in the plan which executory contracts and unexpired leases will be assumed and which will be rejected. However, the debtor can not restructure contracts or leases. They must be assumed "as is," or rejected. Likewise, the plan must provide that any breach in assumed executory contracts and unexpired leases will be cured prior to assumption.

Confirmation of the Plan

When the debtor files his plan, as discussed at the beginning of this section, he will provide a copy of the plan to each creditor and the trustee. The creditors and the trustee then have a period of time to evaluate the plan and decide whether to object to the plan, or not. In many jurisdictions, the trustee conducts a prehearing conference with creditors and the debtor before the confirmation hearing to attempt to resolve objections in a mutually agreeable fashion. However, if the creditors and the debtor are unable to resolve their disputes, the bankruptcy judge will conduct a hearing on confirmation of the plan. The debtor will present his plan to the bankruptcy judge and the creditors will then present their objections. After hearing the evidence, the bankruptcy judge will decide whether the plan is feasible and whether it properly treats the objecting creditors. At this point, the bankruptcy judge will either confirm the plan or deny confirmation.

Modification of the Chapter 12 Plan

If the debtor encounters unforeseen circumstances (e.g., drought, floods, insect infestation, etc.), she is allowed to attempt to modify the Chapter 12 plan. However, in many jurisdictions, this opportunity is only available in reality if the debtor has been successful in making the first year's plan payments. Also, if the reason for the necessity of a plan modification is a failure to make plan payments in the second or third years, it is likely that the modification will need to provide for an extension of the plan period to 4 or 5 years. The process for approval of the modification is similar to the confirmation process in that notice and hearing is required.

Discharge of Indebtedness

After the debtor has made all payments required by the plan, the remaining unsecured debts will be discharged. This means that the debtor will no longer be personally liable for these debts. But, it is important for the debtor to remember that under Chapter 12, he does not receive a discharge until <u>after</u> completion of all plan payments. There are provisions for the bankruptcy judge to grant a hardship discharge, but such relief is rarely granted.

Dismissal or Conversion

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

The debtor also maintains an absolute right to convert her case to a Chapter 7, Chapter 11, or Chapter 13 bankruptcy, if she qualifies for the case under another chapter. However, the bankruptcy judge can not convert the case to a Chapter 7 liquidation, unless there is a showing, after notice and hearing, that the debtor has committed fraud in her Chapter 12 case.

Other Considerations

Preferences: The debtor should be aware that he will be required to disclose in his schedules any payments of $600 or more to creditors in the 90 day period prior to filing of the bankruptcy. The trustee can avoid (i.e., force the creditor to refund the payment to the bankruptcy estate) any preferences, which are defined as a transfer to or for the benefit of a creditor as payment on a debt already existing at the time of the transfer, if the debtor was insolvent at the time of the transfer and the transfer was made within 90 days of the filing. The transfer can not be avoided if the creditor did not receive more than he or she would have received in a Chapter 7 bankruptcy. The preference period is extended to 1 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) prior to filing the bankruptcy, may be ineffective, and simply result in the trustee compelling the creditor to return the payment to the bankruptcy estate. However, it should be noted that the preference provision does not apply in cases in which if the payments were made for new value, or if the payments were made in the ordinary course of business. For example, in many cases, if a local trade creditor is <u>normally</u> paid by a producer at the end of the crop year, this payment would probably fall within the ordinary course of dealing between the producer and the creditor, and thus would not be classified as a preference.

Fraudulent Transfers: The debtor should also be aware that she must disclose, and the trustee can avoid transfers made within 1 year of the filing by which the debtor intended to hinder, delay, or defraud a creditor, or if the debtor received less than reasonably equivalent value and (1) the debtor was insolvent at the time of the transfer (or immediately following the transfer), (2) the debtor's operation was under-capitalized after the transaction, or (3) the debtor knew that she would incur debts beyond her capacity to repay. In many cases, the debtor may be quite surprised to find that a particular transfer can be characterized as a fraudulent transfer, and it is often difficult to determine in advance whether or not the trustee will attempt to avoid a transfer. Some of the factors which 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 of the debtor?

In addition to the provisions of the bankruptcy code which govern fraudulent transfers, the trustee can also utilize applicable state law and other federal law to avoid fraudulent transfers. In Texas, this means that the trustee can go back 4 years to avoid fraudulent transfers, but the debtor is not required to disclose these transfers in the statement of financial affairs which is filed at the initiation of the bankruptcy.

Setoffs: If the debtor owes a prepetition debt to a particular creditor, and that creditor also owes a prepetition debt to the debtor, the creditor can setoff the debt which is owed to the debtor. For example, if the debtor has a prepetition loan with a particular bank and he also has money in a checking account at the same bank on the date of filing of the bankruptcy, the bank can setoff the operating loan against the checking account balance by withdrawing the balance from the debtor's account. Thus, the debtor should carefully evaluate his exposure to setoff <u>prior</u> to filing the bankruptcy. If the debtor has money in an account at a bank to which he owes money, he should withdraw the money from the account prior to filing the bankruptcy and redeposit it in another bank, or simply hold the cash and disclose it in the schedules as cash on-hand. The debtor should also be aware that he may have significant exposure to setoff if he has a loan with the Farm Service Agency, and he is owed Production Flexibility or Conservation Reserve payments from participation in Farm Service Agency programs.

Postpetition Property: The property of the estate in a Chapter 7 bankruptcy essentially consists of the non-exempt property owned by the debtor at the time of filing of the Chapter 7 bankruptcy, plus any property which the debtor receives within 180 days following the date of filing, through inheritance, a divorce settlement, or as a beneficiary of a life insurance policy or death benefit program, <u>if the property would have been part of the bankruptcy estate if it had been owned by the debtor at the time of filing</u>. However, there is a critical difference between a Chapter 7 bankruptcy and a Chapter 12 bankruptcy in that the property of the estate in a Chapter 12 bankruptcy includes any property which would have been property of the estate in a Chapter 7 bankruptcy <u>whether owned at the time of filing, or received at any time prior to the time the case is closed, dismissed, or converted to a case under Chapter 7 plus earnings of the debtor from services performed after the date of filing and prior to the time the case is closed, dismissed, or converted to a case under Chapter 7.</u> 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 a relatively complex process, which means the debtor will usually incur significant legal fees. These fees and their source must be disclosed to the court and are reviewed for fairness, initially by the bankruptcy trustee and the bankruptcy judge. Therefore, the debtor should begin the planning process far enough ahead to ensure that he will be in financial position to employ competent counsel. It is advisable for the debtor to retain counsel as early as possible, rather than waiting until the day before the foreclosure sale. Waiting until the last minute to retain counsel may reduce the likelihood of success for the bankruptcy, but it will not likely reduce the legal fees associated with the bankruptcy.

Chapter 7 Liquidation

The term "liquidation" is somewhat of a misnomer which leads the producer to think that everything he owns will be sold to pay his creditors, leaving him with little or nothing besides the shirt on his back. As discussed above, the debtor in a Chapter 7 bankruptcy will be allowed to keep his exempt property, subject to its liens. In many cases, producers who file Chapter 7 bankruptcy are able to continue to farm by reaffirming debts on equipment and livestock which are necessary to continuation of the operation, while discharging significant levels of unsecured debt.

The Chapter 7 bankruptcy is commenced in the same fashion as the Chapter 12, by filing a voluntary petition, a list of creditors, schedules of assets and liabilities, and a statement of financial affairs.

Comparison to Chapter 12

A trustee will be appointed in a Chapter 7 case from a rotating roster of attorneys (or non-attorneys) who have been approved by the U.S. Trustee. Since there is no operating plan in a Chapter 7 case, the trustee does not play the supervisory role of the Chapter 12 trustee. Instead, the Chapter 7 trustee devotes his or her efforts to administering the estate, which includes (1) identifying the debtor's exempt property; (2) abandoning property which serves as collateral for secured loans, and in which the debtor has no equity, (3) liquidating the remainder of the property; and (4) disbursing the proceeds from these sales to the unsecured creditors.

The costs incurred by the debtor in a Chapter 7 case are considerably lower than those incurred in a Chapter 12 case. First the filing fee is only $175, compared to $230 in the Chapter 12. Second, the debtor does not incur trustee fees in a Chapter 7 case because these fees are paid from the assets which are liquidated by the trustee. Third, the legal fees associated with a Chapter 7 are usually only a fraction of the legal fees incurred in a Chapter 12 because there is no plan to be developed and administered over a period of 3 to 5 years, as in the Chapter 12 case.

Instead of the 3 to 5 year plan period for a Chapter 12 case, during which the debtor is under the supervision of the bankruptcy court, the normal Chapter 7 case is concluded within about 4 months, provided there are no assets to be administered by the trustee. As pointed out above, the Chapter 7 case is commenced in the same manner as the Chapter 12. Likewise, there is a 341 creditors' hearing in both cases. But, there is no plan confirmation hearing because there is no "plan." Therefore, normally, the next step after the 341 creditors' hearing in the Chapter 7 case is the Discharge/Reaffirmation hearing which marks the conclusion of the bankruptcy process in most Chapter 7 cases.

In general, Chapter 7 is less expensive, faster, and much less stressful for the producer than Chapter 12. Thus, the producer should carefully evaluate his or her objectives in making the decision between Chapter 7 and Chapter 12. Obviously, if the producer's objectives are to retain a significant portion of his or her non-exempt assets and/or it is necessary to restructure debts which are associated with the exempt or non-exempt assets to be retained, the producer will probably find that Chapter 12 is the appropriate choice. But, no producer should file a Chapter 12 case without a serious comparison of the benefits and costs of Chapter 12, compared to the benefits and costs of Chapter 7.

Tax Considerations

The filing of a Chapter 12, Chapter 7, or any other bankruptcy may have significant tax consequences. Therefore, it is essential that the producer consult an accountant who is knowledgeable in this area <u>prior to filing the bankruptcy</u>. This will assist the producer and his or her attorney in maximizing the beneficial tax consequences and minimizing any detrimental consequences associated with the filing and administration of the bankruptcy case.

Other Legal Considerations

The producer should not be fearful of the legal processes associated with bankruptcy because the system as a whole is designed and operated in such a way that the debtor is treated courteously and with recognition that one of the primary objectives of bankruptcy is to provide the debtor with a "fresh start." However, no discussion of the bankruptcy process would be complete without a caution to the producer that federal law provides very severe penalties for certain violations which are generally referred to as "bankruptcy crimes." Some examples of these violations would be knowingly and fraudulently concealing assets, making false statements, and transferring or receiving property with the intent to subvert the provisions of the bankruptcy code. However, the honest debtor who makes full disclosures and uses diligence to ensure that his or her oral and written statements are true and correct should not encounter problems in this area.

Summary and Conclusions

This publication has attempted to describe the various alternatives for dealing with financial stress, including changes in the operation, voluntary restructuring of debt, partial or total liquidation, and Chapter 7 or Chapter 12 bankruptcy. It is important to note that none of these alternatives is "better" than the others. Instead, as the producer attempts to deal with financial stress, he or she must continually be looking at all of these alternatives because the final determinant of which alternative the producer should, or must select depends on many factors which are beyond the producer's control. For example, the same forces which have created the financial stress (e.g., weather, prices, government programs, etc.) will also impact the comparative effectiveness of each of these alternatives. Also, the effectiveness of the non-bankruptcy alternatives are usually highly dependent upon the willingness of the creditors to work with the producer to deal with his or her financial problems.

It is also very important for producers to start looking at these alternatives as soon as they become aware that they can no longer deal with financial stress by "tightening their belts" or "holding on" until things get better. Producers also need to seek legal and tax advice early in the process because they need this counsel in deciding which alternative to choose, and to ensure that they have developed sound plans for implementation of whichever alternative they choose. Delay in seeking counsel, making a decision, and implementing the selected alternative will greatly reduce the probability of success -- regardless of which alternative is chosen.

Acknowledgments

The authors wish to express their appreciation to Walter O'Cheskey (Chapter 12 Trustee in the Northern and Eastern Districts of Texas), Byrnie Bass (bankruptcy attorney in Lubbock) and Tommy Swann (bankruptcy attorney in Lubbock) for their assistance in reviewing this publication and making very valuable suggestions for improvement.

Issued in furtherance of Cooperative Extension Work in Agriculture and Home Economics, Acts of Congress of May 8, 1914, as amended, and June 30, 1914, in cooperation with the United States Department of Agriculture. Texas Agricultural Extension Service, The Texas A&M University System.