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INTRODUCTION TO CHAPTER 12 FARM REORGANIZATIONS

THE BANKRUPTCY CODE'S BEST KEPT SECRET: HOW CHAPTER 12 CAN PROTECT AND TRANSFORM THE FAMILY FARM

PRESENTED BY:

THE U.S. BANKRUPTCY COURT FOR THE DISTRICT OF VERMONT &

VERMONT LAW SCHOOL'S CENTER FOR AGRICULTURE AND FOOD SYSTEMS

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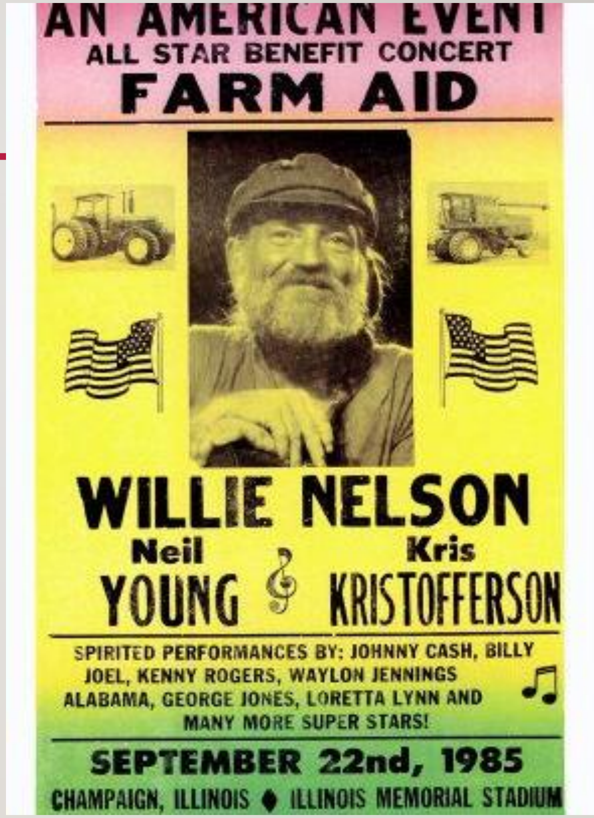
THE HISTORY OF CHAPTER 12

- The farm crisis of the late 1980s gave birth to chapter 12 of the Bankruptcy Code.
- Falling land values and grain prices combined with soaring interest rates and tightening credit gave rise to one of the worst farm crises of the 20th century.
- Farmers responded by driving their tractors to Washington, D.C.
- Congress responded in 1986 by giving farmers a reorganization tool of unprecedented power and efficiency, and in 2005 made chapter 12 a permanent part of the Bankruptcy Code



THE NEW FARM CRISIS

DOWNWARD CYCLE IN FARMING

- Farming income reached high levels in 2010-2011.
- But from 2012-2016 farming income fell 34 percent, more than $50 billion, after adjusting for inflation.
- Farm-sector debt has reached levels near the peak levels of the late 1970s and early 1980s.
- Reduced farm income and increasing debt suggests that some farmers might not be able to repay debt in future years.

WHAT IS A CHAPTER 12 FARM REORGANIZATION?

A CHAPTER 12 REORGANIZATION IS-

- A process, where a farmer, or farm family, under the protection of the U.S. Bankruptcy Court, proposes a ***plan*** for treatment of the farm's creditors which achieves the goals of the farmer, which may include: (1) the **continuation** of the farming operation; (2) **modification or re-scaling** of the farm operation; (3) a **transition to new products** or operations; (4) **passing the farming operation to the next generation**; or (5) **retention of the farm** homestead or (6) **sale** of some or all of the farming operation.
- A ***trustee*** oversees the process and administers the plan.
- A ***bankruptcy judge*** decides if the plan will be ***confirmed*** and hears disputes between the parties which may arise in the case.

OTHER BANKRUPTCY REORGANIZATION CHAPTERS

- Chapter 11- typically large corporations
  - Administratively complex, expensive, depends on getting creditors to vote for a plan
  - Generally a low success rate (less than 30%)

- Chapter 13 – geared mostly to consumers and sole proprietors
  - Debt limits of less than $2 million (approx. $400,000 unsecured/ $1.2 million secured)
  - No opportunities to modify mortgages or to modify secured debt beyond 5 years
  - Generally payments must be monthly
  - Limits on modifying auto loans

CHAPTER 12:
SIMPLER AND MORE POWERFUL THAN EITHER CHAPTER 11 OR 13

- Chapter 12 Advantages over Chapters 11 and 13
  - ✓ Plan is not due until 90 days after the case is filed.
  - ✓ Plan payments not due until after confirmation.
  - ✓ No creditor voting on plans
  - ✓ Plan payments can be structured around farm’s cash flow cycles, (monthly, seasonally, annually, variable schedules)
  - ✓ Plan allows the payment of secured creditors, over a period longer than the life of the chapter 12 plan even though the original indebtedness is not so amortized.
  - ✓ Chapter 12 allows modification of the rights of holders of security interests in all real and personal property without regard to its residential nature, so that secured creditors collateralized by the farmstead can be re-amortized without the need for cure of default. Essentially farmers can “re-write” all secured debt in a plan.
  - ✓ Tax advantages: § 1232 allows preferable treatment of taxes due on the sale of assets as part of a confirmed plan, allowing farmers to “right-size” their operations and avoid large capital gains taxes that would otherwise be due.

ELIGIBILITY

- Pursuant to § 109 (f), "Only a family farmer or family fisherman with regular annual income may be a debtor under chapter 12 of this title."
- Farming: Activities involving the tillage of soil and raising of crops, raising of livestock or poultry, or livestock products in an unmanufactured state (Vermont cases have included a trout farm, Christmas tree farm, greenhouse tomato farm, orchards and vegetable farms. Horse farms, which primarily give riding lessons generally do not qualify as farming)

TESTS FOR ELIGIBILITY

FAMILY FARMER (INDIVIDUAL)

- Debts are not over $10,000,000 (as of 2019);
- At least 50 percent of debt is farm-related debt (not including home mortgage, unless the mortgage is a farm mortgage); and
- More than 50 percent of the debtor's income is from farming (measured by the previous tax year or the two tax years before the previous tax year)

FAMILY FARMER (CORPORATION)

- At least 50 percent of shares owned by one family or by one family and farming relatives;
- More than 80 percent of the value of the corporate assets consists of assets related to farming;
- Debts are not over $10,000,000 (as of 2019);
- At least 50 percent of debt is farm-related debt; and
- Corporation is not publicly traded;

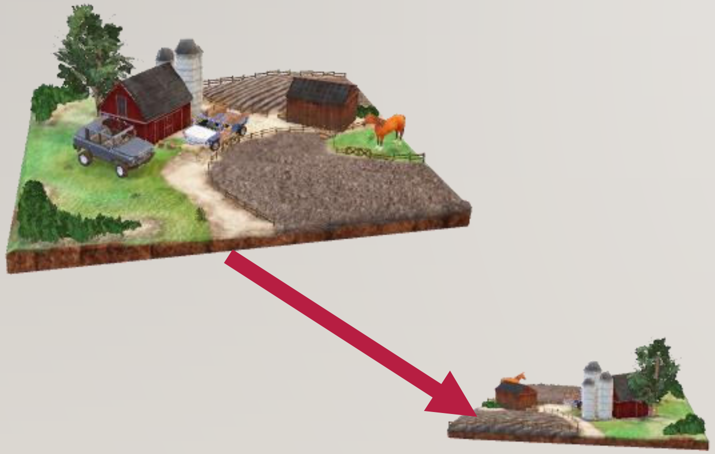
DIFFERENT TYPES OF CHAPTER 12 PLANS

- TRADITIONAL REORGANIZATION

- Goals:
  - Preserve farm's nature and scale
  - Reduce debt service
  - Increase efficiency
  - Return to profitability
- Need stems from a specific event that disrupts finances
- Questions
  - Is the farm still viable with reorganization?
  - What is production cost vs market price?

DIFFERENT TYPES OF CHAPTER 12 PLANS

- DOWNSIZING & CONVERSION



- Goals:
  - Reduce scale of operation
  - Converting to a different or more diverse production base
    e.g. Dairy farm to a crop farm
  - Return to profitability
- Carefully assess resources of the farm and what changes can reduce debt and increase profitability.
- Questions
  - Will the surrender of unnecessary equipment, land or livestock increase profitability?
  - Will changing from a strictly wholesale market (like milk) to a more diversified market (like a farmer's market) be effective?

DIFFERENT TYPES OF CHAPTER 12 PLANS

- SALE

- Goals:
  - Save the home but sell farmland, property, livestock
  - Debtor maintains control over marketing and sale
  - Take advantage of special tax rules on capital gains
- Debtor no longer wishes to work the farm
- Advantages
  - A sale in Chapter 12 allows the debtor more control than a liquidation in a chapter 7
  - The tax implications of a Chapter 12 sale are better than a Chapter 7 liquidation- § 1232 can allow for the de-prioritization of gains taxes
  - A Chapter 12 Plan may facilitate the transfer to family members

THE MOST POWERFUL, YET MOST UNDERUTILIZED CHAPTER OF THE BANKRUPTCY CODE

- There are approximately 2 million farms in the U.S., yet in 2019 there were only 595 Chapter 12 cases filed. Why?
  - Many farmers and fisherman don't know chapter 12 exists.
  - Many attorneys are unaware of the potential for Chapter 12 reorganizations.
  - Many people assume that a farm bankruptcy case means the end of the farm, rather than a useful tool for preserving, reorganizing and even transferring a farm.

WHY IS FEASIBILITY IMPORTANT?

- Proposing or confirming unfeasible plans is a waste of resources and, in the long run, does not assist the farmer
- Requiring feasible plans increases the chances that a plan will succeed and that creditors will get paid
- The Bankruptcy Code requires courts find plans are feasible for confirmation § 1225(a)(6), that "the debtor will be able to make all payments under the plan"

PRE-PLAN COLLABORATION

- **Negotiations with key creditors pre-bankruptcy if possible**
  - informing creditors might minimize likelihood of objections
  - assessing the posture, issues, and goals of creditors and their openness to negotiations will inform plan formulation

- **Creditor representatives may have useful information**
  - *better to hear it early rather than at 341 meeting or in an objection to plan*
- **Gather solid data and build a plan based on reasonable projections**
  - may require use of experts or ag extension services

The Trustee's Role

- **Initiate discussions of potential issues**
  - discuss issues at Sec. 341meeting with the goal of settling any potential disputes
  - mediate disputes between the debtor and creditors, to the extent possible, pre-conf.
- **Visit the farm or hire experts to do so**

THE TRUSTEE'S ROLE

- **Review and test assumptions underlying the Debtor's proposed plan**
  - provide advice, support, and objective feedback to the Debtor's attorney about the proposed plan
  - consider input from creditors and other professionals who advise the debtor and ag market data bearing on the proposed plan
- **Make a recommendation to the Court at the confirmation hearing**
  - to what extent does Trustee take a position at a disputed confirmation hearing? and should Trustee comment on both procedural & substantive issues?

The Court's Role

- Independently assess feasibility as condition for entry of a confirmation order.
- Bankruptcy Code requirements
  - Debtor must present evidence to show debtor has a reasonable likelihood of being able to make all of the plan payments
- The Judge must make statutory findings, including feasibility
- The evidentiary burden on the debtor may be greater when there is a creditor objection to feasibility

Building a Feasible Plan: Projection Basics

- What will the farm produce?
- How much will it produce?
- What will it cost to produce it?
- What price will it sell for?

HOW DO SALES OF FARM PROPERTY IN CHAPTER 12 SAVE TAXES?

- § 1232 of the Bankruptcy Code allows for governmental claims (including taxes) resulting from the sale of property ***used in the farming operation*** to be treated as ***non-priority, dischargeable***, unsecured claims.
- When this section is applied to tax claims, they may be classified and paid pro-rata with other general, unsecured claims and will share whatever divided general unsecured creditors receive and the balance discharged.
- When a tax claim is treated this way and discharged, even if not paid in full, it becomes non-collectable against the debtor and the debtor is permanently excused from the tax obligation.

HOW DO SALES OF FARM PROPERTY IN CHAPTER 12 SAVE TAXES? (CONT.)

- Chapter 12 is the only place this occurs in the Bankruptcy Code and it is only available to family farmers in Chapter 12.
- Whether or not this benefits a particular farmer depends on the degree to which the farmer has equity in non-exempt assets.
- Farmers who are highly leveraged and have less equity are more likely to benefit from this treatment.