

BANKRUPTCY FOR FARMERS

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Bankruptcy for Farmers

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Documentation

- ▶ It is always good practice for a farmer or any business person to keep important documents in a secure location and organized manner. My firm asks for the following documents to analyze a farmer's financial situation:
 - ▶ Mortgages, real estate contracts, and real estate leases.
 - ▶ All corporate, limited liability company, and partnership organizational documents including Operating Agreements, By-laws, and meeting minutes.
 - ▶ Promissory Notes (unpaid notes and paid notes showing that note was paid in full).
 - ▶ Security Agreements.
 - ▶ Balance Sheets, Income Statements, and Financial Statements provided to any lending institution (always get signed copies that are provided to lenders).
 - ▶ Personal property purchase agreements and leases (equipment and vehicles).
 - ▶ Copies of personal guaranties of any debt owed by any other individual or entity.
 - ▶ Copies of all U.S. Department of Agriculture (Farm Service Agency), Small Business Administration , or other government program contracts.
 - ▶ Appraisals of real estate and equipment within the last three (3) years (ultimately if a farmer needs assistance with negotiating with a creditor or other debt restructuring services, current asset appraisals will be very helpful).
 - ▶ Insurance policies including declaration pages.

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Documentation

- ▶ Tax returns for the last three years.
- ▶ Copies of Certificates of Titles for registered vehicles.
- ▶ Copies of all current credit card statements.
- ▶ A list of creditors.
- ▶ Copies of creditor's account statement for fuel, crop inputs, feed, materials, etc.
- ▶ Copies of any litigation against the farmer and any of his or her companies.
- ▶ Previous six months bank statements.
- ▶ Our office performs UCC-1 Financing Statement Searches and Iowa Courts Online docket searches.
- ▶ As a matter of practice, our office obtains information releases so that we can contact creditors and accountants directly to obtain information.
- ▶ If there are tax issues, we request Power of Attorneys for our client(s) so that we can contact the Internal Revenue Service and/or the Iowa Department of Revenue directly.

Cash Flow

Once the documentation has been organized, a cash flow spreadsheet or budget document can be prepared. The cash flow is an important tool because it helps the farmer quantify the farming operations actual revenue and expenses. While most farmers have a general feeling for the health of his or her farming operation and can point to general concerns which may make the operation unprofitable, sometimes the actual cash flow is obscured by depreciation schedules and accrual accounting. While these elements have their place in analyzing the long term health of an operation, when attempting to restructure an operation and service debt load, cash is king. The farmer must be able to identify his or her ability to make timely payments.

Many times a debtor will wonder why a creditor is uncomfortable with additional lending when the debtor has pledged sufficient collateral to cover a debt. The simple answer is that a collateral's value to the creditor is its sale value. If the debtor cannot make the payments to service the debt, the creditor will seek to liquidate the collateral to apply to the debt. The creditor in many instances does not want to liquidate collateral, it wants the debt serviced, payments made, and ultimately the debt paid off.

Paying off the debt essentially means paying off the note. Naturally, one way a financial institution makes money is by making loans to debtors, charging a variety of fees associated with the loan, and receiving interest payments. So long as the debtor makes the required payments on a note, retires some of the principal amount loaned, and pays interest, the lender is generally satisfied. The lender will roll note balances into new notes, and thereby the debtor pays off a debt.

So long as the amount of collateral is sufficient to meet the lender's debt to equity ratio, and the debtor has sufficient cash flow to service the debt, the lender will generally support the operation and its expansion.

Negotiation for the Reduction of Interest Rates

- ▶ In my experience, negotiation of interest rate reduction is a function of competition, an overtly high interest rate, or a potential for debt restructuring.
- ▶ If a debtor is in a strong financial situation, has sufficient collateral, and sufficient cash flow to service his or her debt, the debtor can contact other lending institutions and see if a better deal is available. When presented with a competitor's offer to lend, the current lender may match or make a better offer to the debtor.
- ▶ If the interest rate on debt is overtly high in relationship to the current market rate, the lender may be induced to "rewrite" a loan in order to keep a quality customer.
- ▶ If a debtor is having difficulty servicing all of his or her debt, there is an opportunity to reach out to the lender to negotiate a reduced interest rate. In this instance, the possibility of a bankruptcy filing, may assist a debtor reaching an agreement for the reduction of the interest rate and the extension of a loan to reduce the payment amount to a level that the debtor can manage. A major factor in negotiating with a secured lender is the value of the collateral and the amount of payments already made. As a general proposition, a lender is more willing to waive interest or reduce an interest rate if it has already or will recover its original principal. Generally, secured creditors are unwilling to reduce a principal debt amount below the value of the collateral that secures the debt.
- ▶ A major factor when negotiating with unsecured creditors is the amount that the creditor can reasonably expect to receive if exercises its collection rights. The potential for recovery can be affected by a bankruptcy filing.

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Negotiation for the Reduction of Interest Rates

- ▶ Negotiation can take place informally at a meeting with a lender's loan officer and other representatives.
- ▶ Negotiation can take place with Iowa Mediation Services providing a trained mediator pursuant to Iowa Code Chapter 654A.

Iowa Code Section 654A.6(a) states that a creditor subject to this chapter cannot begin a proceeding under this chapter until the creditor receives a mediation release. Iowa Code Section 654A.6(b) provides that the requirements of paragraph "a" are jurisdictional. The Iowa Supreme Court has held that the mandatory mediation requirements "are jurisdictional prerequisites to a creditor filing a civil action that initiates a proceeding subject to this chapter." Schaefer v. Putnam and SMP, L.L.C., 841 N.W.2d 68, 81 (Iowa 2013).

- Negotiation can take place in the context of a Chapter 11, 12, or 13 bankruptcy case. Under either Chapter, the creditor and the debtor can negotiate for the treatment of the creditor's claim by the Plan and the creditor's support of the Plan.

A Point About Refinancing

- ▶ Farmers need to be on guard when approached by or approaching financial consultants who claim that they can assist the farmer in obtaining financing. There are a number of consultants who provide good service and help farmers obtain financing for a fee. These consultants oftentimes charge a fee that is a percentage of the financing obtained. When a farmer is in need of new financing or refinancing, the fee charged can be very reasonable under the circumstances.
- ▶ Farmers should read carefully any agreement with a financial consultant and should probably consult an attorney regarding the agreement. Farmers should be very wary of any agreement that creates an “exclusive” agreement under which the consultant gets paid a fee for any financing that a farmer receives during the term of the agreement regardless of whether the consultant obtained the financing or the farmer obtained the financing through other efforts. Such agreements with this type of “exclusive listing” language (similar to real estate listing agreements) exist.

A Point About Interest on Unsecured Debt

- ▶ One place where farmers in general and livestock producers in particular obtain credit is on an “open account.” Generally, an open account is unsecured debt. Oftentimes, a supplier will put on an invoice that the payment terms are “net 30” or payable on delivery and include a statement that after the payment due date any unpaid balance is subject to 1.5% per month interest or 18% annually.
- ▶ This 18% is often subject to negotiation because the supplier normally wants to keep the farmer as a customer so long as the farmer has been making payments.
- ▶ In the course of negotiations with a supplier on an open account, the debtor should always ask for a copy of the credit agreement establishing the open account. Oftentimes, the farmer has been a long term customer of the supplier and has never signed a credit agreement. Lenders often refer to Iowa Code Section 535.17 to hold a debtor to the specific terms of a written credit agreement notwithstanding any verbal or other written representations that have been made. A farmer can likewise use Section 535.17 to his or her advantage regarding the statutory rate of interest on an open account. It is true that Section 535.11(2)(b) provides that if a creditor gives a debtor written notice of an interest rate, the creditor can collect that rate, and the Iowa Court of Appeals has held that an invoice with the interest rate provides sufficient notice of the rate charged by a creditor. See Carson Grain & Implement, Inc. v. Dirks, 460 N.W.2d 483 (Iowa Ct. App. 1990). However, the Iowa Code was revised a number of times in response to the farm crisis of the 1980’s. Neither the Dirks decision or later unpublished citing decisions do an extensive analysis of Chapter 535 as it relates to an “agricultural purpose.” Iowa Code Section 535.13. I have yet to find an Iowa Supreme Court case on the matter.
- ▶ My position is that absent a written agreement, signed by the debtor, a creditor may only charge the statutory interest rate on an open account. See Iowa Code Section 535.2(1)(f). In negotiations on the interest rate to be charged on an open account, the supplier/creditors may be willing to compromise on the interest rate rather than engage in litigation which will need to be ultimately decided by the Iowa Supreme Court. The supplier/creditors may be more willing to negotiate on interest rates because they will have received a profit on the original sale, the interest rate represents their cost of money, and they can recover additional profit and possibly some interest from future sales. If the account is large enough, the supplier/creditors may wish to make the account a “test case.” In that situation, please feel free contact me regarding my analysis of Iowa Code Chapter 535 as it relates to open accounts.

Exemptions

- ▶ Inside or outside of bankruptcy, an individual debtor may hold exempt from judicial execution their interest in certain property. Corporations, limited liability companies, or other legal entities are not entitled to claim exemptions. Below is a nonexclusive list of Iowa exemptions
 - ▶ Equipment, livestock, and feed related to a normal farming operation, not to exceed \$10,000 - Iowa Code § 627.6(12)
 - ▶ Wedding or engagement ring - Iowa Code § 627.6(1)(a)
 - ▶ Jewelry, not to exceed \$2,000 - Iowa Code § 627.6(1)(b)
 - ▶ One shotgun and either one rifle or one musket - Iowa Code § 627.6(2)
 - ▶ Private libraries, family bibles, portraits, pictures and paintings, not to exceed \$1,000- Iowa Code § 627.6(3)
 - ▶ An interment space or an interest in a public or private burying ground, not to exceed one acre - Iowa Code § 627.6(4)
 - ▶ Wearing apparel and household goods such as musical instruments, appliances, radios, TVs, record or tape playing machines, compact disc players, satellite dishes, cable television equipment, computers, software, printers, digital video disc players, video players, and cameras, not to exceed \$7,000 - Iowa Code § 627.6(5)
 - ▶ Life insurance, not to exceed \$10,000 - Iowa Code § 627.6(6)
 - ▶ Professionally prescribed health aids- Iowa Code § 627.6(7)
 - ▶ Pensions, annuities, or similar plans or contracts on account of illness, disability, death, age, or length of service - Iowa Code § 627.6(7)(e)
 - ▶ IRA's - Iowa Code § 627.6(8)(f)(1)(a)(ii)
- ▶ Cash on hand, bank deposits, credit union share drafts, not to exceed \$1,000 - Iowa Code § 627.6(14)
- ▶ Rental deposit, security deposit, utility deposit, rent paid in advance, not to exceed \$500- Iowa Code § 627.6(15)
- ▶ Motor vehicle, not to exceed \$7,000 - Iowa Code § 627.6(9)
- ▶ Accrued wages and tax refunds, not to exceed \$1,000 - Iowa Code § 627.6(10)
- ▶ Personal injury and wrongful death payments - Iowa Code § 627.6(16)
- ▶ Social security benefit, veteran's benefit, disability or illness benefit, alimony, and separate maintenance Iowa Code § 627.6(8)

The Homestead Exemption

- ▶ One of the most important exemptions for farmers is the homestead exemption. “The homestead of every person is exempt from judicial sale where there is no special declaration of statute to the contrary.” - Iowa Code § 561.16
- ▶ The homestead includes a house used as a home and the “appurtenances” used habitually as a homestead. Outside of a city plat, a homestead may contain up to forty acres. - Iowa Code § 561.1 & 2.
- ▶ A homestead may be sold to satisfy “debts contracted prior to its acquisition, but then only to satisfy a deficiency remaining after exhausting the other property of the debtor, liable to execution;” debts “created by written contract by persons having the power to convey, expressly stipulating that it shall be liable, but then only for a deficiency remaining after exhausting all other property pledged by the same contract for payment of the debt;” debts “incurred for work done or material furnished exclusively for the improvement of the homestead;” and “if there is no survivor or issue, for the payment of any debts to which it might at that time be subjected if it had never been held as a homestead.” Iowa Code Section 561.21. Additionally, the Iowa courts have held that Iowa Code Section 598.21 providing for orders for disposition of property in a dissolution of marriage, separation, or annulment proceeding, constitutes a special declaration of statute to the contrary” so that a homestead can be ordered sold by a court in such a proceeding. See in Marriage of Tierney, 263 N.W.2d 533 (Iowa 1978).

Bankruptcy

- ▶ A Bankruptcy filing can be used to assist a farmer in restructuring his or her farming operation. Chapters 7, 11, 12, and 13 provide options for different size operations with different debt loads.

Chapter 7 Liquidation

- ▶ A Chapter 7 case may be beneficial for a farmer who has pledged his or her equipment under a blanket security interest to a lender, pledged real property to a lender, and has no equity in the equipment or real property other than some equity in the homestead.
- ▶ In this situation, a farmer should be able to reject any executory contract including unexpired leases that are unfavorable to his or her operation and discharge any damages for breach of the lease agreement. The farmer should be able to discharge other unsecured debt.
- ▶ To the extent that the equipment and real property is exempt, a Chapter 7 Trustee will not be able to administer that property. To the extent that the equipment is encumbered by a valid security interest, the Chapter 7 Trustee will abandon the property as having no value to the bankruptcy estate.
- ▶ So long as the secured creditor is friendly to the farmer and is willing to continue to work with the farmer, the farmer will emerge from a Chapter 7 bankruptcy, mostly intact and with a more favorable balance sheet due to the discharge of the unsecured debt and rejection of unfavorable leases and contracts.

Liquidation Analysis

- ▶ A liquidation analysis is a necessary part of Chapter 11, 12, and 13 reorganization plans. In order to confirm a reorganization plan, the plan must provide that unsecured creditors will receive not less than the unsecured creditors would have received in a Chapter 7 liquidation.
- ▶ The proper valuation is fair market value, not liquidation value - See In re Felton, 95 B.R. 629, 630 (Bankr.N.D.Iowa 1988). Fair market value is defined as the price a willing buyer and willing seller would agree to buy and sell the property after it has been on the market for a reasonable time. In re Felton, 95 B.R. 629, 630 (Bankr.N.D.Iowa 1988).
- ▶ Current appraisals of real estate and equipment are necessary to do a defensible liquidation analysis.
- ▶ A liquidation analysis is also helpful in determining whether to proceed with a Chapter 7 case.

Chapter 7 Liquidation

- ▶ Qualification Requirements
 - ▶ Because farming is a business operation, so long as more than 50% of the farmer's debts arise from the operation of his or her business, the "means test" is not applicable - 11 U.S.C. § 704(b)(2)
- ▶ The filing fee is \$335 - 28 U.S.C.A. § 1930(a)(1)(A)
- ▶ Debtor may convert the Chapter 7 case to a Chapter 11, 12, or 13 case at any time - 11 U.S.C. § 706(a)
- ▶ Family Farmers are protected from involuntary filings - 11 U.S.C. § 303(a)
- ▶ Tax Consequences
 - ▶ Chapter 7 estates are separate taxable entities - Hall v. U.S., 132 S.Ct. 1882, 1887. 182 L.Ed.2d 840 (2012)
 - ▶ Taxable gains from postpetition liquidations are taxable to the estate and thus dischargeable. The debtor may elect to end the tax year the day before he or she files bankruptcy - Hall v. U.S., 132 S.Ct. 1882, 1887. 182 L.Ed.2d 840 (2012)
 - ▶ The tax claim then becomes a priority expense, which may then be paid as part of the bankruptcy proceedings before unsecured claims are paid - 11 U.S.C. § 1398(d)(2)

Chapter 11 Reorganizations

- ▶ Qualification Requirements
 - ▶ The plan must be confirmed. The absolute priority rule says that a dissenting class of unsecured creditors must be provided for in full before farmers can receive or retain any property - 11 U.S.C. § 1129(b)(2)(B)
- ▶ The filing fee is \$1,717 or \$1,550 (railroad) - 28 U.S.C.A. § 1930(a)(3)
- ▶ Debtor may convert the Chapter 11 case to a Chapter 12 or Chapter 13 case- 11 U.S.C. § 1112(d)
- ▶ Debtor may convert the Chapter 11 case to a Chapter 7 case at any time unless the debtor is not a debtor in possession or if the case originally commenced as an involuntary case under this chapter - 11 U.S.C. § 1112(a)
- ▶ Family Farmers are protected from involuntary filings - 11 U.S.C. § 303(a)
- ▶ Tax Consequences
 - ▶ Chapter 11 estates are separate taxable entities - Hall v. U.S., 132 S.Ct. 1882, 1887. 182 L.Ed.2d 840 (2012)
 - ▶ Taxable gains from postpetition liquidations are taxable to the estate and thus dischargeable - Hall v. U.S., 132 S.Ct. 1882, 1887. 182 L.Ed.2d 840 (2012)
 - ▶ The debtor may elect to end the tax year the day before he or she files bankruptcy. The tax claim then becomes a priority expense, which may then be paid as part of the bankruptcy proceedings before unsecured claims are paid - 11 U.S.C. § 1398(d)(2)

Chapter 11 Reorganizations

Chapter 11 cases are most often used for large farming operations that have aggregate debt exceeding \$4,153,150. The higher debt load prevents these operations from filing under Chapter 12. The administrative cost of a Chapter 11 case is higher than a Chapter 12 case, and it requires soliciting votes for the approval of the Chapter 11 Plan. However, it does have the advantage of having the separate taxable estate which can make the sale of assets during the course of the bankruptcy case somewhat easier.

Chapter 12 Family Farmer Bankruptcy qualifications

▶ Qualification Requirements

- ▶ Debtor must meet the definition of a family farmer- 11 U.S.C. § 101(18)
 - ▶ Aggregate debts can't exceed \$4,153,150 - 11 U.S.C. § 101(18)(A)
 - ▶ Nonrecourse debts are not included - *In re Lands*, 85 B.R 83 (Bankr.E.D.Ark.1988)
 - ▶ The debt for the principal residence of the debtor is not included - *In re Lands*, 85 B.R 83 (Bankr.E.D.Ark.1988)
 - ▶ 50% of the aggregate debts must arise out of a farming operation- 11 U.S.C. § 101(18)(A)
 - ▶ The reason for which the debt was incurred and the use to which the borrowed funds were put are the criteria to determine whether the debt arose out of a farming operation - *In re Douglas*, 77 B.R. 714 (Bankr. W.D. Mo. 1987)
 - ▶ 50% of the gross income must arise out of a farming operation - 11 U.S.C. § 101(18)(A)
 - ▶ The Tax Code's definition of gross income is used, which is figured by deducting the cost of goods sold from the sales price
 - ▶ Income from the sale of farm machinery is income derived from a farming operation- *In re Burke*, 81 B.R. 971, 977 (Bankr.S.D.Iowa 1987)
 - ▶ Income from renting farmland doesn't arise out of a farming operation unless the debtors played an operational role or had an ownership interest in the crop production - *In re Easton*, 883 F.2d 630, 631 (8th Cir. 1989)

Chapter 12 Family Farmer Bankruptcy other characteristics

- ▶ The filing fee is \$275 - 28 U.S.C.A. § 1930(a)(5)
- ▶ Debtor may convert the Chapter 12 case to a Chapter 7 case or dismiss a Chapter 12 case at any time so long as the case has not been previously converted - 11 U.S.C. § 1208(a) & (b)
- ▶ Tax Consequences
 - ▶ Chapter 12 estates are not separate taxable entities - Hall v. U.S., 132 S.Ct. 1882, 1887 182 L.Ed.2d 840 (2012)
 - ▶ Petitioners, not the estate itself, are required to file the tax return and are liable for the taxes resulting from their postpetition farm sale and thus the tax liability is not dischargeable - Hall v. U.S., 132 S.Ct. 1882, 1887 182 L.Ed.2d 840 (2012)
 - ▶ Property used in the farming operation may be sold in the prior tax year, so that tax incurred due to the sale may be treated under 11 U.S.C. Section 1222(a)(2).

Chapter 12 Family Farmer Bankruptcy

- ▶ Chapter 12 was enacted to give the family farmer a fighting chance to reorganize and save his or her land. Originally enacted as a temporary addition to the Bankruptcy Code, Congress has made Chapter 12 permanent.
- ▶ Chapter 12 provides a farmer with the ability to create a plan of reorganization, and so long as the plan meets the requirements of the Bankruptcy Code, the farmer can confirm the Plan without the consent of any creditors. There is no balloting for a Chapter 12 Plan and creditors do not need to accept the Plan for it to be binding on them.

Chapter 13 Wage Earner Plan

- ▶ Qualification Requirements
 - ▶ Only available to individuals - 11 U.S.C. § 109(e)
 - ▶ Farm couples who own and operate property jointly are not automatically considered partners- Ogallala Fertilizer Co. v. Salsbery, 186 Neb. 538, 184 N.W.2d 730 (19771)
 - ▶ The debtor must owe less than \$394,725 in unsecured debts and less than \$1,184,200 in secured debts - 11 U.S.C. § 109(e)
 - ▶ The debtor must have sufficiently stable income in order to have the repayment plan approved- 11 U.S.C. § 109(e)
- ▶ The filing fee is \$310 - 28 U.S.C.A. § 1930(a)(1)(B)
- ▶ Tax Consequences
 - ▶ Chapter 13 estates are not separate taxable entities - Hall v. U.S., 132 S.Ct. 1882, 1887 182 L.Ed.2d 840 (2012)
 - ▶ Petitioners, not the estate itself, are required to file the tax return and are liable for the taxes resulting from their postpetition farm sale and thus the tax liability is not dischargeable - Hall v. U.S., 132 S.Ct. 1882, 1887 182 L.Ed.2d 840 (2012)

Chapter 13 for Farmers

- ▶ A Chapter 13 bankruptcy may make sense for a small farm operator or “hobby” farmer who has offfarm income in an amount that exceeds his or her aggregate farm revenue. By having more than half of his or her revenue be generated “off of the farm”, he or she will not meet the definition of a “family farmer” under 11 U.S.C. Section 101(18). So long as his or her secured and unsecured debts are less than the Chapter 13 limit, and the farmer has regular income, the farmer should be able to propose a Chapter 13 plan of reorganization.