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Issues of Chapter 12 Bankruptcy
Legislation: Analysis of Chapter 12
Bankruptcies in South Dakota

by

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Issues of Chapter 12 Bankruptcy Legislation:
Analysis of Chapter 12 Bankruptcies in South Dakota*

Abstract

Telephone interviews were conducted with South Dakota attorneys and Extension farm management specialists. Major areas of agreement and disagreement on the effectiveness of Chapter 12 bankruptcies are discussed. Discussion points include asset valuations, timeliness of assistance provided and reorganization process, and suggestions for improvement of the Chapter 12 bankruptcy process.

* This paper has been accepted as a forthcoming presentation at the 1989 Western Agricultural Economics Association Meetings and will be published in the Proceedings of that meeting.

**Issues of Chapter 12 Bankruptcy Legislation:
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Financial stress in the agricultural economy during the early and mid-1980s brought financial hardship for many agricultural producers. Debt service placed impossible demands on cash flows, forcing many farmers and ranchers to restructure their finances. Restructuring often involved renegotiating terms (interest rates and/or amortization schedules) or principal writedowns of outstanding debt. If voluntary negotiations failed, mediation or bankruptcy became necessary.

The incidence of farm bankruptcy filings in South Dakota steadily and dramatically increased throughout the 1980s from 37 filings in 1980-81, to a high of 622 filings in 1987. Most of these farm bankruptcies have been reorganization filings. Chapter 12 has replaced Chapter 11 as the preferred filing option since its adoption in November of 1986. Chapter 12 legislation was adopted to enable qualifying agricultural producers to reorganize their financially stressed operations to make them financially viable. The number of filing dropped during 1988 to 179 because of improvements in farm financial conditions.

It is apparent from the dramatic shift of farm bankruptcy filings to Chapter 12, that this law provides the best opportunity for farmers to reorganize their farm business. However, reorganization cannot, by itself, be viewed as a successful outcome of the bankruptcy process. Successful reorganization can only be accomplished by the restoration of long term financial viability to the farm business. It remains to be seen whether Chapter 12 actually enhances the prospects for successful reorganization.

An integral part of the reorganization petition is the plan for restructuring the operating environment for a particular farm. In some cases, this plan is simply a restructured financial situation with debt obligations altered so that they can be paid on time. In other cases, the plan for operating the farm under a Chapter 12 reorganization involves new and different enterprises as well as off-farm employment for the operator, the spouse, or both.

Regardless of the restructured operating plan's complexity, few agricultural producers complete their plans without some assistance from outside sources. The primary sources of assistance for these producers are their attorneys and the South Dakota State University Cooperative Extension Service. This section concentrates on the role of these outside agencies in providing assistance to agricultural producers filing Chapter 12 reorganization petitions.

ANALYSIS OF CHAPTER 12 FARM BANKRUPTCIES IN SOUTH DAKOTA

To obtain a better understanding of how Chapter 12 is working in South Dakota, telephone interviews were conducted with South Dakota attorneys actively practicing bankruptcy law, and Extension farm management specialists actively assisting producers with financial management (1). These individuals are qualified to give insight as to how Chapter 12 is working, suggestions for changes and improvements, and some recommendations on how and when Chapter 12 should be used.

Opinions were solicited from four Extension specialists and 10 attorneys working with "creditor" clients (2). As expected, there were major areas of agreement and also differing viewpoints on the effectiveness of Chapter 12 bankruptcy between classes of attorneys, and between the attorneys and farm management staff. These agreements and differences are important in understanding the overall picture of Chapter 12 and will be highlighted.

"Pre"-Chapter 12

The steps leading to filing for relief under Chapter 12 of the U.S. Bankruptcy code varies with each situation. The current economic condition of the industry, the debtor's particular economic condition, the attitude of the debtor, and the attitude of their creditor(s) all play a role in when, how, or even if a case proceeds toward filing. Those surveyed felt that a majority of potential Chapter 12 cases reach an out-of-court settlement prior to filing.

Debtor's Position

Most debtor clients try to solve their own financial difficulties, and generally approach an attorney only when financial problems are evident and something more needs to be done. Most have not made any decision at this point to file Chapter 12. Conversely, approximately 50 percent of those producers contacting Extension staff are already in the bankruptcy process. Petitions have been filed and producers, at the encouragement of their attorneys, contact Extension staff for assistance in developing the reorganization plan. The remaining cases use Extension staff as their first contact for assistance with their financial situation.

Those assisting producers will first examine available financial records and seek to understand the difficulty. To properly do this, these professionals need to be provided with the client's accounting records; five years of income tax records, all security agreements; all promissory notes, mortgages and contracts; and an updated personal property inventory. However, this task can be difficult because debtor clients often have poor to nonexistent records.

Probably the area of closest agreement among those surveyed was in farm records. Survey respondents indicated that clients' records were generally inadequate and may have been at least partially responsible for the financial

difficulties experienced. However, some producers filing Chapter 12 had very detailed records. One respondent commented that farmers in bankruptcy had no better or no worse records than farmers in general.

After the records have been examined, the attorney can give the debtor a list of options and recommendations. Occasionally, Extension staff are asked for a similar list of options. While the Extension staff can explain options available to the producer, they cannot make recommendations. In either case, the client always makes the ultimate decision of what action(s) to take. The first option and recommendation is usually a continuation or opening of negotiations with their creditors. From this point, negotiations are done with the assistance of the debtor's attorney.

Although negotiation resolves most difficulties, the debtor is encouraged to see the situation as a broad one that encompasses the entire farm business, all the creditors, and the business's future financing needs. A reoccurring danger is reaching a settlement with one creditor only to find other obligations can not be met later. Other important considerations are the tax consequences of any settlement. Any forgiveness of debt outside of bankruptcy, is income to the debtor on which tax must be paid.

The attorney's recommendation is based on the overall position of the debtor, but a great deal of emphasis is placed on projected cash flow statements. This information should indicate the possibility of developing a realistic reorganization plan or the need for liquidation. This is the time when the Extension staff can be most helpful. They can combine farm level information with reorganization ideas to develop a workable operating plan. The Extension staff felt that too much emphasis is placed on short-term cash flow analysis. They would like to see longer term analysis conducted and combined cash flow with

whole farm long-range farm budgeting.

Creditors Position

Most creditors conduct their own negotiations with debtors having difficulty making payments. The creditor's attorney is usually not involved with the case until Chapter 12 is filed. While some creditors deliberately involve their attorney in earlier negotiations, most do not take an active role until negotiations fail, or the creditor feels there is no option other than foreclosure. However, negotiations do not usually come to an end when the debtor files for court protection.

As with the debtor's attorney, a complete understanding of the situation is important for the creditor's attorney. The creditor's attorney will collect information needed for continuing negotiations. Most of this information will come from the filing itself, which includes a cash flow statement in South Dakota. Other information comes from: tax returns, bank records, security interest filings, title reports, and legal deposition of the debtor (3).

Asset Valuation

Asset valuations are critically important in Chapter 12 negotiation, because the extent of repayment is based largely on asset value. All parties agree that the most important and most difficult issue to settle is asset valuation. While the Extension staff recognize the influence of asset valuation in the reorganization process, they do not get involved with valuing assets. Both sides agree that it is usually better to reach an agreement on valuation without going through a court hearing. In fact, most attorneys report a very high percentage of valuation agreements are reached out of court. Both sides seem to be reasonably satisfied with the outcome of these agreements. It was also pointed out by both sides that there is much more involved in a valuation agreement than

the value of that asset. The "value" of any particular asset is directly connected to the terms of any agreement by the creditor to continue financing the asset's purchase. For example - if the debtor wants a lower interest rate on the loan, the secured creditor wants a higher asset valuation, which in turn means a larger loan amount in the repayment plan.

Both debtors and creditors agree that original asset valuations are often inaccurate, but disagree on the nature and extent of inaccurate valuation. Debtor's attorneys feel that both sides are involved in inflating and deflating asset values, but that it is not a critical problem because the valuation process is just part of any negotiations. Creditor's attorneys, on the other hand, feel inaccurate asset valuations are much more likely to be done by the debtor than by the creditor. Inaccuracy is something they feel they must watch for and guard against.

The main source of valuation information for the debtor's attorney is from the debtor. This is backed up with information of recent farmland sales in the locality and past experience of the attorney. At this point, a negotiated valuation settlement is attempted. If there is no settlement, a professional appraisal may be done. The creditor is much more likely to start with, or go to, a professional appraisal (4).

Length of Time in Chapter 12

Another key procedural issue discussed was the time-line in Chapter 12 from filing to approval/rejection of the reorganization. Federal bankruptcy statutes specify a maximum 90 day period from time of filing to a proposed reorganization plan, and another 45 days to confirmation/rejection of the plan. This was a major change from other Chapters of the Bankruptcy code, which allow for a bankruptcy action to stay in the court for many months, even years, before a

reorganization plan goes into effect or liquidation is carried out. This change was requested and accomplished by the finance industry, but not without some reservation about whether it is an achievable standard.

Based on sample data from Chapter 11 and 12 filings, the average time from filing to an approved reorganization plan is five to six months, compared to an average of 15 to 17 months in a Chapter 11 farm bankruptcy.

Creditor's attorneys feel the time-line used in Chapter 12 is great for the creditor and that there has been no difficulty in meeting its requirements. One advantage is that debtors under Chapter 12 do not get as long of a time period during which no interest accrues and payments to some creditors may be suspended. From the creditors' view point there is no need to extend this time period.

Debtor's attorneys agree, if not as enthusiastically, that the time-line in Chapter 12 has worked and that there is no need to push for a change. They do feel, however, that there are situations where a little more time might have taken off some of the pressure of the negotiations, which would have resulted in a somewhat better reorganization plan.

Extension staff echo this thought and, as mentioned earlier, would like to see more time devoted to developing a reorganization plan. Too often, the reorganization plan is based on the next year's cash flow projection. Longer-term projections are needed, as are some mechanisms for follow-up on the reorganization plans. The reorganization plan must be adjusted as conditions in the operating environment change. Farmers' records should be monitored, analyzed at least yearly, and reasons provided when reorganization plans do not work.

Outcomes of Chapter 12

The debtor's attorneys and Extension staff strongly and enthusiastically state that Chapter 12 has worked well for their clients. A high percentage of these debtor clients have reorganizational plans which are realistic, workable programs allowing them to go forward in their business. Several respondents expressed that they felt it was part of their professional obligation to their client to keep working until a reorganization plan with a reasonable probability of success was developed, or to recommend options other than Chapter 12.

There was, however, the recognition that many reorganization plans were going to be "close" and would require good management and economic conditions to make the the plans work. Most felt that their clients would need to be better managers, especially in the areas of record keeping, planning and cash flow management to be successful. These comments were not given as a criticism of farmers. Most survey respondents recognized the emotional ties to the operation that farmers have, and know that it is a subconscious decision to state that management will improve after reorganization. Those professionals strongly indicated that many of their clients are good farmers/business people that were "caught" in adverse economic conditions. These professionals were particularly optimistic about the ultimate success of this group's reorganization plans.

The creditor's attorneys have a different point of view when asked if their clients were helped or hurt by Chapter 12. First, bankruptcy, any bankruptcy, is never good for creditors. Having said that, if bankruptcy can not be avoided, Chapter 12 has not hurt secured creditors more than other bankruptcy alternatives. While it is still too early to determine, secured creditors seem to be recovering about the same on their claims as they would have under a Chapter 11 bankruptcy. Actually, Chapter 12 is better in some ways for secured

creditors because it can be completed within a shorter time frame and is less expensive. Unsecured creditors do not have the same protection provided by Chapter 11 and are, therefore, disadvantaged by the debtor's use of Chapter 12.

The creditor's attorneys are also not as convinced that Chapter 12 is producing realistic, workable reorganization plans. By the very nature of Chapter 12, the farm/ranch must operate with a debt/asset ratio very close to 1.0. This leaves little or no room for error. A down turn in the economy, drought, or a poor business decision will leave the farm/ranch in difficulty again and with little financial strength left to withstand it. For this reason, the Extension staff indicated the some plan should be implemented where an annual review of the reorganization plan is conducted. This would aid the producers in pointing out where actual conditions differed from projected conditions. Also, the court would have a better understanding of why reorganizations plans may need to be modified.

Creditor's attorneys indicated that Chapter 12 may be delaying the inevitable for up to 50 percent of those with a reorganization plan. (5) Creditor's attorneys expressed the belief that too many debtors with reorganization plans do not necessarily change the way they conduct business. Some attorneys are hopeful that the debtor has learned something about their business from the bankruptcy experience which will help them to be successful. However, most feel it is likely that the debtors will continue to operate much as they have in the past. It was noted that many creditors are the ones who learned the most from the bankruptcy experience(s) and will conduct their business differently in the future.

Recommendation for Improvement of Chapter 12 Bankruptcy

Respondents were asked what they would like to see added, subtracted or changed to improve Chapter 12. Most of them expressed strong feeling that Chapter 12 has worked well in South Dakota. They also believe that it has improved as the pressure on the system has decreased and debtors, creditors, and attorneys have become aware of how the law operates and how it affects them. There were, however, several recommendations made for possible changes and improvements.

First, debtor's attorneys and Extension staff indicated that most farmers wait far too long before they contact outside help in the "pre-Chapter 12" negotiation stages. All respondents were in favor of modifying or eliminating the trustee requirement. Currently each Chapter 12 reorganization plan must include a trustee, to discover and stop fraud by the debtor, prevent abuses, and generally oversee the reorganization plan. Payments to creditors must go through the trustee. The trustee collects a 10 percent fee on these funds to pay for the services provided by the trustee's office. This system was included in Chapter 12 at the request of the finance industry for the industry's protection. While this 10 percent fee is technically paid by the debtor, creditor attorneys agree that they have seen no real need for a trustee. More importantly, these funds could be spent to lower debt or increase income for the farm. This would improve the chance of a successful reorganization plan which is ultimately to the advantage of both the debtor and the creditor.

One attorney indicated that any abuses by the debtor that may be present tended to hurt unsecured creditors more than secured creditors. Unsecured creditors are entitled to payments from the debtor's "disposable" income. Disposable income is that income that is not needed to operate the farm, make

payments to secured creditors, or provide a "basic" income to the farmer/rancher. Payments to unsecured creditors are limited to a five year recovery period, while a longer payback plan is allowed under a Chapter 11 bankruptcy. The outcome is to effectively limit most unsecured creditors' recovery under a Chapter 12 bankruptcy. This attorney's perception is clearly validated by sample data results, which indicates an average of less than 3 percent recovery of principal.

A plea was made for a better valuation system that would be fair to all parties involved and yet easier to use. Some safeguards to prevent non-reporting of assets which can occur in any bankruptcy proceeding could be included. Another issue closely related to valuation, is the reporting and accounting for the sell-out of assets by the debtor. Under Chapter 11, if the debtor elects to liquidate rather than follow the reorganization plan they must account for the actual value received to the creditor. (6) Chapter 12 does not require this.

A rather inconsistent provision of the code limits the debtor client to only 60 days to assume or reject all real estate leases and contracts they may hold. (7) This is not consistent with the 90-day period allowed for the debtor client to develop and submit a reorganization plan under Chapter 12. If the debtor wants to assume any of these contracts, they must notify the other party or the contracts are considered rejected. The decision to assume or reject contracts, especially real estate leases, are important and are made in the context of the overall reorganization plan. The recommendation is that all contracts be assumed or rejected within the same 90 day period.

Farmers have, and will continue to have, some special protection under the U.S. Bankruptcy laws. A creditor can not force a farmer into bankruptcy or, once in bankruptcy, ask the court to involuntarily move a farmer into a Chapter 7 liquidation. It can happen that a few farmers abuse the system by going in an

out of bankruptcy. One recommendation was that the definition of fraudulent filing be clarified making it more difficult to abuse the system.

Predicting the Future

The debtor's attorneys and Extension staff feel that Chapter 12 has worked well and, while this crisis may be coming to an end, there will always be a need for it. Without changes, Chapter 11 just does not fit the needs of most farm debtors. Creditor's attorneys, with some reservations, supported the continuation of Chapter 12 in the bankruptcy codes because they felt there would be both a continuing and reoccurring need because of the inherent economic instability within the agricultural sector. However, Chapter 12 was considered a reaction to, and not a fundamental cure of, farm economic problems.

Whether Chapter 12 will be extended beyond December 1993 or not, few respondents were willing to predict. Some indicated that we may have seen the last big farm bail-out from the federal government and by 1993 farmers may be on their own. Only time will tell.

ENDNOTES

- (1) Twenty attorneys interviewed were selected from a list of attorneys associated with 101 Chapter 12 cases randomly selected for statistical analysis. Those selected were involved in most of the cases examined. Letters of explanation and a list of interview questions were sent to each attorney one week prior to a telephone interview. Interviews were conducted between November 1 and December 10, 1988.
- (2) A nearly equal number of debtor and creditor attorneys were selected. A possible bias was evident in reviewing the collected information. Most creditor attorneys represented secured creditors. Only one attorney interviewed regularly represented unsecured creditors.
- (3) Most creditor attorneys rarely use a legal deposition. It is, however, available if the attorney feels they are not getting all the information they need.
- (4) Most creditor attorneys say a formal appraisal is an automatic step in their valuation process. Both debtor and creditor attorneys agree that formal appraisals are expensive and should be avoided as much as possible.
- (5) Why are creditors not more upset with reorganizations plans? Secured creditor's attorneys say that if the reorganization plan works, the secured creditors will usually receive a better payback than if there was immediate liquidation. If the reorganization plan doesn't work, the secured asset will still be available, particularly if it is land. Thus, the secured creditors are not much worse off than if there had been a liquidation in the first place. Also, farmland and machinery sale prices have started increasing again. The benefits of a successful reorganization plan are worth a little additional risk.
- (6) 11 USCA 1111(b)
- (7) 11 USCA 365

APPENDIX 1

RECOMMENDATIONS

Several respondents made recommendations as to when they would like to first see the farmer/rancher to be of the most use to them. While there is some duplication in their recommendations, several are paraphrased here to reinforce their content.

- 1) A) Prior to borrowing for the next crop year and definitely before planting the new crop. Once planted, the crop and proceeds become secured property. This gives you more room to negotiate.
B) Prior to any judgment against them. If the debtor receives a notice of court action, see an attorney.
- 2) The best time is usually fall. If you have payments due and are having a difficult time making payments, go to your attorney now. If you are thinking about it, go before calving season. You have a little more room to negotiate. "The day before the sale is a little late."
- 3) As soon as there are signs of trouble - difficulty making payments. Most farmers wait too long.
- 4) Before turning your annual income over to your major lender.
- 5) Go to see your attorney when you have your first serious problems with a major creditor. Don't make the mistake of starting to liquidate to "get by". See your attorney first.
- 6) Don't wait until you are in default on your loans. Many come to me too late.
- 7) See your attorney as early as possible!!
- 8) Seeing your attorney is a business decision you are making. Be aware of the effect the situation's stress may have on your judgment.

Negotiations

- 9) When negotiating on your own be sure you are looking at your total economic situation. How are you going to handle all of your creditors? Can you do a realist/reasonable projected cash flow statement which will meet all the demands on your business.
- 10) Be aware of the tax consequences of having part of a loan forgiven. If you are no longer required to repay money which you had a legal obligation to repay, you will be considered to have income on which federal income tax is due.