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Overcoming Farm Financial Distress:

Strategies and Frequently Asked Questions

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Low prices for many farm products and dramatic cuts in the tobacco quota over the last two years have left many North Carolina farmers with sharply reduced incomes. Higher numbers of North Carolina farmers are facing financial difficulty than at any time since the farm crisis of the 1980's. While the total number of North Carolina farms in financial difficulty is much lower than in the 1980's, that is little comfort to an individual farmer facing financial crisis. The good news is that there are solutions. Farms facing financial difficulty can recover from their current problems.

The first step to developing a recovery plan is to honestly assess the current situation. This includes a complete inventory of all personal and real property, all debt, and all sources of income. Real property is land and anything attached to it. The inventory should enumerate each separate tract, noting the owners, and the form of ownership. Information on the debt for which the property serves as security should also be included in the inventory. Any attorney retained will need copies of all deeds and the security agreements associated with debt secured by the property. It is also important for assessing tax implications to have complete records documenting the basis in real property (acquisition price of the property after adjustment). Similar information is needed for all personal property including copies of title documents for titled personal property such as automobiles. In addition, have copies of all security agreements for which the property serves as security. Again, for tax reasons, it is important to have the purchase price and depreciation schedule for personal property. Depreciation schedules for depreciable real property (such as buildings) is also necessary. All debt must be clearly enumerated. This information includes current principal and accrued interest balances, the interest rate, repayment schedules and amounts, the life of the indebtedness, any property serving as security for the debt, the payment status (current or in arrears),and any pending legal actions.

Enumerate all income sources including both on-farm and off-farm income. For each crop produced, develop a five-year production history as well as a detailed budget for each crop and livestock enterprise.

If any business arrangement beyond a sole proprietorship is used for operating the farm business, it is important to differentiate the entity or entities liable for any debt and the owners of the business assets and income. A sole proprietor is a single individual who owns and operates the business and is responsible for all the liabilities of the business. Other forms of business organization include general partnerships, limited partnerships, limited liability companies, and corporations. Each of these of business organizations involve different potential allocations of assets and liabilities (including tax liabilities).

After the inventory is completed, all participants should take part in developing a set of goals for the farm enterprise. A comparison of the goals with the results of the farm inventory will determine whether the goals are realistic. A rule of thumb often applied to farming is that total debt should not exceed 40 percent of the total value of the farm assets. The acceptable ratio for any particular farm will vary depending upon such factors as the type of farm, and whether land is owned or leased. If a farm's debt-to-asset ratio is higher than this, an examination of why debt levels are at this level is needed. High debt levels are not advised for farms because farm commodity prices tend to be cyclical in nature. A high debt level does not make it inevitable that a farm will fail but it is certainly a warning sign. Note, aggressive intervention can even rescue farms with debt well in excess of 100 percent of the farm's total assets!

Communication with creditors is the key to resolving a financial crisis. When a farm fails, it is very costly for the farm's creditors who rarely recover all of the money that is owed. Thus creditors have every incentive to work with farm debtors and have a variety of tools available to help financially distressed farms. These includes skipping payments, reamortizing loans (stretching out the payments to reduce the payment level), new loans to see the farm through the period of financial difficulty, and conversion of short-term debt into long-term debt to cut payment levels and reduce interest rates. Absolute commitment in following a structured and disciplined plan is essential, or a shift from short-term to long-term debt is not advised!

Farmers who keep good records are more successful working with lenders than those who do not. Good records make it possible to identify the source of financial distress and test whether proposed changes in the farming operation will solve the problem. When failing to maintain records, farmers can only resort to using "average" or "ball park" numbers in their plans. Hence, it may be difficult to convince lenders that there are solutions to their problems because they do not have the information to support their proposed solutions. Failure to keep good accounts is itself a sign of poor management. There are many record keeping programs available for farmers that vary from simple paper-based systems to sophisticated, computerized systems. It is never too late to start!

Solutions to farm financial distress are as diverse as North Carolina agriculture. Reducing input costs, increasing yields, and better marketing are standard approaches that have worked for many farmers. Changing the crop mix to more profitable crops is another solution, which is difficult when a wide variety of farm commodities are affected by historically low prices. There are also innovative approaches that may include growing niche crops and direct marketing to consumers.

As farmers examine the financial and technical aspects of farm financial distress, it is important not to forget about the human and emotional side of financial crisis, which often exacerbates physical and mental illnesses, and aggravates family and marital tensions. Counseling may alleviate some of these tensions. Friends, relatives, social and religious organizations can be very important sources of support during times of financial emergency. County offices of the North Carolina Cooperative Extension Service can serve as a starting point. County Extension personnel can help farm families identify resources available to them. Assistance and loan programs are available through the local offices of USDA's Farm Service Agency.

Frequently Asked Questions

What is bankruptcy?

Bankruptcy is a legal procedure authorized under the Constitution for resolving the debts of individuals and businesses that either cannot pay their debts as they come due or are insolvent. The primary purposes of bankruptcy are to protect the interests of creditors, rehabilitate businesses that are salvageable, and provide individual debtors a fresh start. Insolvency means that a business or individual's debt exceeds their assets. Some businesses and individuals may also qualify for bankruptcy even though they are solvent, because they lack the cash flow to pay their debts as they come due. Bankruptcy cases are brought in federal bankruptcy court.

What is the difference between a voluntary and an involuntary bankruptcy?

The debtor files a voluntary bankruptcy. One or more of the debtor's creditors files an involuntary bankruptcy. Farmers are not subject to involuntary bankruptcy.

What is the difference between reorganization and liquidation in bankruptcy?

Restructuring a business or individual's financial affairs to get them back on their financial feet is the goal of reorganization. Chapter 11 of the Bankruptcy Code is designed primarily for business reorganizations although some individuals qualify. Chapter 13 is designed primarily for individual consumer reorganizations although some farms and small businesses may qualify to use chapter 13. Chapter 12 is designed specifically for farm reorganizations. Chapter 12 of the Bankruptcy Code is temporary legislation scheduled to end on October 1, 1999.

Liquidation is a winding up of a business or individual's financial affairs. All assets (except those that are exempt) of the business or individual are sold, and after administrative expenses are paid, the proceeds are divided among the creditors. Chapter 7 (also known as straight bankruptcy) is generally used for liquidations.

May any farm use chapter 12?

No. There are several conditions that a farm must meet in order to qualify. The individual (or individual and spouse) must have total debts not exceeding $1,500,000. Eighty percent of the debts (excluding debt on a personal residence) must arise from the farming operation. More than 50 percent of the gross income of the individual (or individual and spouse) in the taxable year immediately prior to filing under chapter 12 must be farm income. Furthermore, the annual income of the farm must be sufficiently regular or stable to enable the farmer to make payments under a chapter 12 plan.

May a family partnership or corporation use chapter 12?

Yes, if more than 50 percent of the stock or equity in the business is owned by one family and the farm meets the debt restrictions for an individual debtor (or debtor and spouse), then the farm may file under chapter 12.

What are the steps in a chapter 12 bankruptcy?

Bankruptcy proceedings under chapter 12 are initiated when the farmer files for protection with the federal bankruptcy court in the farm's district. The immediate affect of filing is to force creditors to cease all collection actions. The debtor then prepares a reorganization plan. All of the debtor's income in excess of an allowance for family living is used to repay creditors according to their priority. The plan must be filed, unless the court extends the deadline, within 90 days of the bankruptcy filing. Once the court approves the plan, the farmer has three or more years to complete the plan. After successful completion, the court discharges any remaining debts as provided under the terms of the plan.

Is it always better for a farm to file under chapter 12 than chapter 11?

Chapter 12 was enacted by Congress specifically to meet the needs of financially distressed farms; therefore, only under exceptional circumstances would a farm be better served by filing under chapter 11. Chapter 12 does not apply the adequate protection (of creditors' interests) rule used in chapter 11. The rule used in chapter 12 is generally more favorable to debtors.

Will filing for bankruptcy affect my credit?

Credit reporting services generally report bankruptcies for ten years after the date of discharge. After a bankruptcy discharge, obtaining credit at standard interest rates is difficult or impossible.

What is a "workout"?

A workout is a resolution of a debtor's problems outside of bankruptcy. Workouts consist of arrangements between a debtor and creditors to resolve the insolvency or cash flow crisis facing the farm. For a workout to be a viable solution, there must be good communication and cooperation between the debtor and creditors. The advantages of a workout are speed, lower cost to both debtors and creditors, and greater availability of credit to the debtor. Bankruptcy often requires as much as 20-30 percent of the value of the farm assets to pay administrative and other expenses. Most of these expenses are avoided in a workout. Where taxes due are a major issue, a workout may not be achievable.

Can tax obligations be discharged through bankruptcy?

The answer to this question is complex. Some taxes may be discharged, while others may not be. The services of a Certified Public Accountant (CPA) are often needed to resolve these issues.

Do I need an attorney to file for bankruptcy?

The law does not require a debtor to retain an attorney. Since bankruptcy is very complex, few individuals can succeed in bankruptcy without the assistance of an attorney. If you do not know an attorney who can handle farm bankruptcy, you can call the North Carolina Lawyer Referral Service, at 1-800-662-7660 (or 919-677-8574). This service is provided at no charge to the public through the North Carolina Bar Association. Attorneys who participate are self-selected and agree to charge no more than $30 for an initial 30-minute consultation.

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