

Bankruptcy: Chapter 7 Liquidations

Phillip L. Kunkel, Jeffrey A. Peterson, Jessica A. Mitchell

Copyright © 2009 Regents of the University of Minnesota. All rights reserved.

INTRODUCTION

A Chapter 7 bankruptcy is a liquidation proceeding. It is the most logical choice for a farmer who cannot continue to farm and must terminate his farming operation. However, it may not be the best option for a farmer who wishes to remain farming and avoid liquidation. In this situation, the farmer should consider filing a petition under Chapter 11 or Chapter 12 of the Bankruptcy Code. *See Bankruptcy: Chapter 11 Reorganizations; Bankruptcy: Chapter 12 Reorganizations.*

Under Chapter 7, a trustee is appointed to liquidate all nonexempt assets and distribute the proceeds to creditors. Exempt and nonexempt assets are discussed in more detail below. Secured creditors will receive either the value of their collateral or the collateral itself. The proceeds of the debtor's nonexempt assets will be used to satisfy claims according to the priorities established by the Bankruptcy Code. The farm debtor will be able to retain the property claimed exempt, although it may yet be subject to prebankruptcy liens.

In some cases an individual or a business may be forced into an involuntary bankruptcy. As discussed in another fact sheet in this series, *Bankruptcy: The Last Resort*, farmers may not be forced into involuntary bankruptcy. Thus, for farmers, a Chapter 7 proceeding is purely voluntary. Such a proceeding begins when the debtor

files with the clerk of bankruptcy court a voluntary Chapter 7 petition.

CHAPTER 7

Eligibility of the individual — Not all debtors are eligible for Chapter 7 protection. To qualify for relief under Chapter 7, the debtor must be an individual, partnership, corporation, or other business entity. An individual debtor's eligibility for Chapter 7 protection is subject to the "means test." The means test prohibits certain high income or high asset debtors from filing for Chapter 7 protection. The means test applies when the debtor's current monthly income is more than the state median. If this is the case, Chapter 7 protection will be denied, if the debtor's total current monthly income over five years, less some allowed expenses, is more than either \$10,950 or 25 percent of the debtor's nonpriority unsecured debt, if at least \$6,575.

However, if the debtor can show special circumstances that justify additional expenses or adjustments of current monthly income, he will still be able to file under Chapter 7. If not, the case may be converted to a Chapter 11, 12, or 13 proceeding or will be dismissed.

In addition, an individual cannot file under Chapter 7 or any other chapter if a prior bankruptcy petition was dismissed due to the debtor's willful failure to appear before the court or comply with orders of the court, or if the debtor voluntarily dismissed the

previous case after creditors sought relief from the bankruptcy court to recover property upon which they hold liens within the preceding 180 days.

With the exception of emergency situations, an individual debtor must also, within 180 days before filing, receive credit counseling from an approved credit counseling agency. If a debt management plan is developed during the credit counseling, it must be filed with the court. This applies to individual debtors who have primarily consumer debts, as well as those individual debtors with primarily business debts.

The Trustee — Once a Chapter 7 petition has been filed, an impartial trustee is appointed to wind up the business affairs of the debtor. This trustee generally will be an attorney or someone who is familiar with the bankruptcy laws and the courts. The trustee will conduct a meeting of creditors, usually within 40 days after the filing date. The debtor must appear at this meeting and must submit to an examination under oath by both the trustee and interested creditors. The examination generally is limited to questions concerning the extent and whereabouts of the debtor's assets. However, the trustee will ask questions that ensure the debtor is aware of the potential consequences of bankruptcy, including the effect on his credit history, ability to file a petition under a different chapter, the effect of receiving a discharge, and the effect of reaffirming a debt.

The Bankruptcy Estate — The initiation of a case under the Bankruptcy Code creates a bankruptcy estate. The trustee is charged with liquidating all property of the estate. The bankruptcy estate consists of all legal or equitable interests of the debtor in property as of the filing date. Thus, all real property, crops, livestock, machinery and equipment, interests in cooperatives, farm program

entitlements, contract rights, and leases will be included in the bankruptcy estate. Besides property owned when the case is initiated, the property of the estate includes property recovered by the trustee from creditors or other third parties and property that the debtor becomes entitled to acquire within 180 days of the filing of the bankruptcy petition by inheritance, divorce decree, property settlement, life insurance policy, or death benefit plan. The bankruptcy estate does not include exempt property (as described below).

The estate also includes income from other assets that are the property of the estate. However, a debtor's earnings from personal services performed after the filing of a Chapter 7 petition, but before the termination of the case, are not included in the estate. Thus, income from a debtor's off-farm employment may not be looked to by his creditors once the bankruptcy petition has been filed.

TREATMENT OF CLAIMS

Generally all creditors claim will either be secured or unsecured claims. A secured claim is a claim of a creditor that is secured by a lien in some property of the farm debtor. An unsecured claim is a claim of a creditor that is not secured by a lien. For example, the debtor may have bought a tractor on credit from John Deere. The obligation owed to John Deere is a claim, and the claim of John Deere is secured by the tractor. John Deere would have a secured claim in the bankruptcy. Alternatively, the farm debtor may have owed the local cooperative for diesel fuel. If the cooperative did not file a lien, the claim of the cooperative is an unsecured claim (since the cooperative would not have a lien on the diesel fuel already used by the debtor).

Treatment of Secured Creditors — A farm debtor may have as many as four options to deal with the secured claim. The debtor may be able to either: (1) redeem, (2) surrender the collateral back to the secured creditor, (3) reaffirm on a secured claim, or (4) retain the collateral and pay the creditor in accordance with the credit agreement .

(1) Redeem. To redeem, the debtor must pay the secured creditor in full. In most cases, this is an unlikely scenario.

(2) Surrender the Collateral. The debtor may surrender the collateral back to the secured creditor. The creditor may then sell the collateral and any remaining deficiency would be a general unsecured claim in the bankruptcy.

(3) Reaffirmation. The debtor may elect to reaffirm the debt or agree to be held under the terms of the original credit agreement in consideration of the debtor being able to retain the collateral. The debtor will remain personally obligated to pay the secured creditor the full amount of its claim (over the repayment terms of the original credit agreement). If the farm debtor has any “equity” in the collateral, this may be a wise decision. However, if the debtor owes more on the collateral than it is worth (or it is not essential to the farming operation), the debtor may not want to reaffirm and elect another option.

(4) Retain and Pay. Prior to the amendment of the Bankruptcy Code in 2005, the farm debtor could elect to retain the collateral and pay the secured creditor in accordance with the credit agreement. However, after the 2005 amendments, the availability of this election is contested. In Minnesota, it remains unresolved whether a debtor can “retain and pay” a secured creditor. This election has a significant benefit. Unlike a

reaffirmation where the debtor agrees to be held under the terms of the original credit agreement, under a “retain and pay” election the debtor can continue to pay for the collateral, but if the debtor later decides to surrender the collateral (at anytime), the secured creditor does not have the right to assert a deficiency claim against the borrower.

Treatment of Unsecured Creditors — A farm debtor may discharge, or get ride of, any unsecured claims in his/her bankruptcy. To the extent the Trustee as recovered any non-exempt assets, the unsecured creditor would be entitled to share in the disbursement (as discussed below). The unsecured creditor can not come back after the bankruptcy discharge and try to collect any debt. That being said, a farm debtor may elect to voluntarily repay any creditor.

POWERS OF THE TRUSTEE

Under the Bankruptcy Code, the trustee is granted a number of significant powers that enable him to deal with the debtor's property, debts, and creditors.

General Powers — The trustee may use, sell, or lease property in the debtor's estate in the ordinary course of business. In addition, the bankruptcy court may authorize the trustee to operate the debtor's business for a limited period if continued operation is in the best interests of the estate and the creditors. For example, if the farm debtor is in the hog business and the estate consists of hogs of varying sizes, the trustee may be authorized to feed the hogs until they attain market weight so as to maximize the amount recovered by the estate. However, if the livestock owned by a farm debtor is subject to a valid, perfected security interest, the trustee will not, in most cases, undertake the continued care and feeding of the livestock.

Rather, he will likely abandon the property so as to limit the estate's continued responsibility.

Avoidance Powers — The trustee may avoid, or set aside, certain of the debtor's transactions that were entered into prior to the filing of the bankruptcy case. The laws governing these avoidance powers are complex, but some general comments may be helpful.

Preferences — The trustee may avoid or recover any transfers of property made by the debtor within 90 days before filing the bankruptcy petition to a creditor to repay a pre-existing debt if such a transfer allows the creditor to receive more than he otherwise would be entitled to. Such transfers are called "preferences" under the Bankruptcy Code. In general, the philosophy of the law with respect to preferential transfers is to take away from creditors any transactions that might result in an improvement in their position on the eve of bankruptcy. This philosophy is in accord with the underlying policy of the Bankruptcy Code to foster equality of treatment among creditors.

For purposes of these provisions, a transfer includes transferring ownership or possession of property or granting a security interest in property. This avoidance power can be used by the trustee to set aside any 11th hour security interests that were obtained by zealous unsecured creditors. The 90-day period may be extended to one year for transfers made to insiders of the debtor.

Not all transfers made by the debtor within 90 days of filing are avoidable, however. Transfers made for new value, payments for debts incurred in the ordinary course of business, and the perfection of purchase

money security interests within the time period required by the Uniform Commercial Code (UCC) do not constitute preferential transfers.

Fraudulent Transfers — The bankruptcy trustee also may avoid or recover fraudulent transfers made within one year before the filing. Under the Bankruptcy Code, a fraudulent transfer is a transfer that was made with the intent to hinder, delay, or defraud a creditor. It also includes transfers for which the debtor received less than a reasonably equivalent value in exchange for the transfer. Thus, gifts, assignments, or other transfers made to relatives to shelter certain assets from the claims of creditors in bankruptcy may be avoided by the trustee.

Executory Contracts and Leases — The trustee may assume or reject executory contracts and leases of the debtor. An executory contract is an agreement under which the obligations of both parties to the contract are unperformed. Common examples of such contracts in a farm setting include equipment leases and real property leases. Certain farm program contracts, such as Conservation Reserve Program contracts, are also executory contracts.

If the trustee elects to assume an executory contract, he must either cure any defaults in the contract or provide the other party to the contract with adequate assurances that he will cure the defaults. In a Chapter 7 case, the trustee has 60 days from the filing of the bankruptcy petition to make a determination as to whether such contracts or leases should be assumed. A contract for deed in which the debtor is the buyer has been determined by the courts not to constitute an executory contract under the Bankruptcy Code. Therefore, the trustee need not determine whether to assume such contracts or cure all defaults under such contracts immediately.

Unperfected Liens — The trustee also can avoid or set aside transfers that are not properly recorded or perfected under state law. If, for example, a creditor has failed to perfect a security interest under the UCC, the creditor's lien may be avoided by the bankruptcy trustee in its entirety. In addition, a trustee may avoid certain statutory liens or liens created by operation of law. Among these liens is any statutory lien for rent. As a result, any landlord who is relying upon statutory lien for rent will find that his lien can be avoided by a bankruptcy trustee.

EXEMPT PROPERTY

Exempt property includes both real and personal property of a debtor that cannot be seized or sold to satisfy the claims of creditors. Such exemptions are available only to individual debtors and not to partnerships or corporations. Such exemptions generally are intended to provide individuals with the minimal essentials for starting anew following bankruptcy.

In Minnesota, an individual debtor can select either exemptions that are provided by the Bankruptcy Code or exemptions that are provided by state law, whichever is most advantageous. As a result, it is important in the case of a Chapter 7 bankruptcy for the debtor to carefully review both the bankruptcy exemptions and the Minnesota exemptions to determine the correct course of action. The exemptions are listed in tables 1 and 2.

The value of the exemptions is determined by the fair market value of the various assets. If otherwise exempt property is subject to a lien, the debtor may claim as exempt the value of the property in excess of the lien amount (the "equity" in the

property). In the case of a joint petition filed by a married couple, both spouses must claim the same exemptions, but the value limitations may be doubled. It is not, therefore, permissible for the husband to elect the Bankruptcy Code exemptions and the wife to elect the Minnesota exemptions.

If property is claimed by the debtor as exempt, it generally will remain subject to any voluntary liens that the debtor has granted. The Bankruptcy Code, however, grants the debtor the power to avoid or cancel certain consensual security interests that otherwise would attach to certain types of personal property including implements, tools of the trade, household goods, furnishings, and personal effects. It is thus possible to set aside a security interest in such items under the Bankruptcy Code, subject to the value limitations. Although some courts have held to the contrary, in Minnesota it has been held that this lien avoidance power can be applied to farm machinery.

If it appears that a bankruptcy may be required, Minnesota courts have held that it is perfectly proper and legal to plan for such an event. It may even be possible to convert nonexempt assets into exempt property before filing a bankruptcy petition. However, such bankruptcy planning is potentially dangerous and should be undertaken only with careful consideration of the ramifications of any such transactions.

Once the debtor in a bankruptcy case selects his exemptions, the trustee and creditors are given a period of time within which to object to such exemptions. If no one objects, the exemptions will stand.

DISTRIBUTION PRIORITIES

Once the trustee has collected all nonexempt assets and liquidated them, the estate is ready to be closed. Generally, property subject to a valid lien, and in which the debtor has no equity, is used to satisfy the lien. In the event such a creditor has a deficiency, he may file a claim as an unsecured creditor with the bankruptcy court.

The Bankruptcy Code establishes a detailed priority system for payment of claims. Priorities are:

1. Unsecured claim for domestic support obligations
2. Expenses of the administration of the bankruptcy case, including costs and expenses of preserving the estate taxes incurred by the estate, trustee's fees, and attorney's fees for the trustee
3. Claims arising in the ordinary course of the debtor's business or financial affairs during the "gap period" between the filing of an involuntary petition and an order for relief
4. Unsecured claims for wages, salaries, and commissions up to \$10,950 per creditor
5. Unsecured claims for contributions to employee benefit plans up to \$10,950 per employee, less any amount paid to an employee for wages, salaries, or commissions
6. In the case of a grain elevator bankruptcy, unsecured claims of farmers against the elevator for grain up to \$5,400 for each creditor
7. Up to \$2,425 per claim on unsecured claims for money deposited with the debtor for purchase or lease of property or for services contemplated for the personal, household, or family use of the debtor that were not provided

8. Unsecured claims of governmental units for taxes and penalties.
9. Claims for death or personal injury resulting from the operation of a motor vehicle or vessel if such operation was unlawful because the debtor was intoxicated from using alcohol, a drug, or another substance

After these priority claims, the next parties in line are general unsecured creditors who filed claims in a timely fashion or who were excused for late filing. Next in line are those creditors whose claim is for a fine, penalty, or damages that are not compensation for direct monetary losses suffered by the claim holder. If property remains after these claimants, all unsecured creditors receive interest at the legal rate from the date the bankruptcy petition was filed. Any funds or property remaining after the payment of interest is paid to the debtor. If the debtor's assets are insufficient to pay in full all of the claims within a particular classification, all creditors share on a pro-rata basis.

Because there may be numerous disputes between the debtor and creditors or among creditors, complete administration of the estate may take several months. In the absence of any disputes directly involving the debtor, the debtor's involvement with the administration of the case usually will be completed within 120 days from the date the petition was filed. By that time, the debtor will have received a discharge from all liabilities listed on the bankruptcy petition. The discharge does not, however, release any property that the debtor retains from any lien that may have been granted by him prior to filing bankruptcy. Only those liens that may be avoided will be extinguished by the bankruptcy court. All other liens remain intact following bankruptcy.

CONCLUSION

Chapter 7 bankruptcy is designed for farmers who have decided to stop farming. Once a Chapter 7 bankruptcy petition has been filed the debtor cannot continue to operate his business. All his nonexempt property passes to the trustee upon filing of the bankruptcy

petition which the trustee collects and uses it to pay unsecured creditors. The debtor will keep the exempt assets. The debtor will receive a discharge order from the Bankruptcy Court discharging all debt owed to creditors except for debt secured by property kept by the debtor.

**Table 1
MINNESOTA EXEMPTIONS***

ITEMS

Homestead; rents and proceeds of Homestead	Less than 160 acres; \$300,000 limit if non-ag or \$750,000 limit for ag. whether claimed by one or more debtors
Family bible, library, musical instruments	Unlimited
Church pew and burial lot	Unlimited
Wearing apparel, one (1) watch, utensils, foodstuffs	Unlimited
Household furniture, household appliance, phonographs, radio, and television	\$9,450
Wedding rings or other religious or culturally recognized symbols of marriage exchanged between the debtor and spouse at the time of the marriage	\$2572.50
Farm machines and implements used in farming by a debtor engaged principally in farming, livestock, farm produce, standing crops, tools, implements	\$13,000
Tools, implements, machines, instruments, office furniture, stock in trade	\$9,000
Total farm machines and implements and tools, implements, machines, etc., not to exceed:	\$13,000
Library and tools of students	Unlimited
All money arising from any claim on account of destruction or damage to exempt property	
Life insurance proceeds	\$42,000 plus \$10,500 for each dependent
Police Relief Association, Firemen's Association, or Fraternal Benefit Association Benefits	Unlimited

Manufactured home actually occupied as home	Unlimited
Motor vehicle	\$4,200
Vehicle modified for disability	\$42,000
75 percent wages	Unlimited
Public assistance benefits	Unlimited
Earnings of a minor child or proceeds by reason of any liability of debtor not for the special benefit of child	Unlimited
Claim for damages recoverable by any person by reason of levy upon or sale under execution of exempt property	Unlimited
Personal injury or wrongful death claim (General Damages)	Unlimited
Loan value, accrued interest on dividends in life insurance policy	\$8,400
Stock bonus, pension, profit sharing benefits, annuity, IRA, employee pension or contract on account of illness, disability, death, age or length of service reasonably necessary for the support of debtor	\$63,000
Veteran's benefits	Unlimited
Disability benefits	Unlimited
Public employee and teachers pension benefits	Unlimited
Unemployment benefits	Unlimited
Workers' Compensation benefits	Unlimited
Money arising from the destruction of exempt property	Unlimited

* **In a joint case, these exemptions other than the homestead exemptions, are available to each spouse.**
 Certain values are adjusted on a biannual basis.

Table 2
FEDERAL BANKRUPTCY CODE EXEMPTIONS*
 11 U.S.C. Section 522(d)

ITEMS

Homestead Real or personal property the Debtor uses as a residence; or a burial plat for the Debtor	\$20,200
Motor vehicle	\$3,225
Household furnishings, household goods, wearing apparel, appliances, books, animals, crops or musical instruments held for personal, family, or household use.	\$10,775 total and no more than \$525 in any single item
Jewelry held for personal, family, or household use	\$1,350
Any property—wild card.	\$1,075, <u>plus</u> up to \$10,125 of any unused portion of the homestead exemption
Implements, professional books, or tools of the trade	\$2,025
Unmatured life insurance contract	Unlimited
Loan value, accrued dividends, or interest in life insurance policy	\$10,775
Professional prescribed health aids	Unlimited
Social Security, unemployment, public assistance	Unlimited
Veteran's benefit	Unlimited
Disability, illness, or unemployment benefits	Unlimited
Alimony, support or separate maintenance to the extent reasonably necessary for the support of the Debtor and dependents	Unlimited
Pension, profit-sharing, stock bonus, annuity benefits necessary for support of Debtor and dependents	Unlimited
Crime victim's reparations	Unlimited
Wrongful death claims	Unlimited
Life insurance proceeds necessary for support	Unlimited
Personal injury claims (not including pain and suffering or compensation for actual monetary losses)	\$20,200
A payment in compensation of loss of future earnings of the	Unlimited

Debtor necessary for support

Certain retirement funds

Unlimited

* **In a joint case, these exemptions are available to both spouses.**
Certain values are changed every three years.

Phillip L. Kunkel
Attorney
Gray Plant Mooty

Jeffrey A. Peterson
Attorney
Gray Plant Mooty

Jessica A. Mitchell
Attorney
Gray Plant Mooty

www.extension.umn.edu/agbusiness

For Americans with Disabilities Act accommodations, please call 800-876-8636.
University of Minnesota Extension is an equal opportunity educator and employer.