Farm Family Adjustments to Financial Stress

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The previous article in this series discussed public sector responses to farm financial stress (Pederson and Eidman). Most of the adjustments, however, are being absorbed in the private sector by farm families, their relatives, and their creditors. This article examines the family adjustments, the farm business organization changes, and the restructuring of farm assets and liabilities which have been made and are being made in response to financial stress.

This article examines a range of options being used by farmers and their lenders. The first section stresses the importance of carefully analyzing the effect of any adjustment being considered before the adjustment is made. It reviews the three major financial statements of the farm business which are used throughout the article. The second section discusses how farm families have “tightened their belts” and increased non-farm income in recent years. The third section shows how adjusting the farm’s production and marketing plan can help increase income and/or decrease expenses.

When adjustments in income and withdrawals by the family are insufficient to solve the problem, farmers typically turn to rescheduling debt payments. In cases of more severe financial stress, farmers and their lenders may choose to restructure liabilities and assets. The implications of these adjustment alternatives are described in the fourth and fifth sections of this article.

The remainder of the article describes several methods of implementing rescheduling and restructuring options. These include the sale and leaseback of assets, the infusion of outside equity, the opportunities for merger of two farms, opportunities for new farmers to enter and for existing farmers to recycle, and the use of bankruptcy to accomplish family objectives.

While some changes can be made quickly, other adjustments may take longer to complete. A farmer can easily change production practices to lower input use. However, the process of restructuring liabilities and assets will take longer—perhaps even one or two years—because more people are involved in and affected by the proposed adjustment. This article is intended to review adjustments that have been made and to serve as a guide to beginning the adjustment process. Each farm and family needs to consider its own individual situation and seek financial and legal advice as needed.

Evaluating the Impact of Alternative Adjustments

An effective manner of discussing the impact of the various adjustments farmers and their creditors can make on the performance of the farm business is to estimate their effect on the three major financial statements: the cash flow statement, the income statement, and the balance sheet. These three statements are used to trace the financial performance of the business over time. If the farm records are in good shape, these statements are relatively simple to prepare. If the records are not in good shape, the task is more difficult, but the rewards can be great. An abbreviated format for each of these three statements is shown in Figure 1.

Cash Flow Statement

The cash flow statement (Figure 1a) lists all sources and uses of cash for a period of time. The sources of cash include the cash in checking and savings accounts at the beginning of the year, operating receipts from the sale of crops and livestock, government program payments, gas tax refunds, custom work, etc., and cash received from the sale of capital items such as machinery and breeding stock. The sources of cash also include money bor-
rowed during the year and nonfarm income from wages and off-farm investments. A reduction in savings or the sale of securities that are owned are potential sources of cash. Obtaining outside equity is less commonly used, but represents a potential source of cash. Gifts, inheritances, allowing another individual to buy into the business (as a partner), and the issue and sale of stock for corporations are examples of outside equity.

The uses of cash are listed in the lower portion of the annual cash flow. Moving cash into savings and purchasing securities represent uses of cash. Ending cash is also a use, making total uses equal to total sources for the period.

The cash flow provides information on the movement of cash through the business. It is used in combination with the other two statements to analyze the ability of the farm business to meet its cash commitments as they come due. This ability to pay the bills over the short run is referred to as the liquidity of the business.

**Income Statement**

The annual income statement is used to measure the profitability of the business (Figure 1b). Unlike the cash flow, it considers noncash as well as cash sources of income and expenses. The income statement considers changes in the amount and value of inventory, the change in the value of capital items (breeding stock, machinery, improvements to land), accounts payable and receivable, and accrued expenses (interest, rent, taxes) to estimate the amount of money which the business made over the specified period. The before-tax return to unpaid labor, equity capital, and management is commonly referred to as net farm income. Subtracting the income tax that must be paid on the year’s income and the estimated market value of the unpaid labor and management ($1,000 per month for 12 months) results in a residual return to equity capital in the business (−$3,300). Dividing by the amount of equity in the business at the beginning of the year ($78,000) results in the average rate of return on equity for the year (−4.2 percent). Thus, the sample income statement in Figure 1b provides three commonly used measures of profitability of the whole-farm business—the before-tax return to unpaid labor, equity capital, and management; the after-tax return to unpaid labor, equity capital, and management; and the rate of return on equity capital.

The bottom portion of the income statement provides a method to calculate the change in owner’s equity that occurs over the period. This provides a link between the income statement and the balance sheet that clearly indicates how the combination of changes in farm income, nonfarm income, and proprietor withdrawals will impact on the owner’s equity in the business. The calculation is illustrated in the final four lines of Figure 1b. The addition to owners’ equity of −$13,100 indicates that equity in the business decreased by that amount over the calendar year 1986.

**Balance Sheet**

The balance sheet lists the value of the assets and liabilities of the business on a specified date (Figure 1c). There is more than one way to value assets, but for purposes of this discussion, we will assume that the entries in the balance sheet are stated as current market values. The comparison of total assets and total liabilities provides a measure of solvency. The dollars of equity in the business (total assets minus total liabilities) is the amount of...
money that would remain with the owners if the business were liquidated on the date the balance sheet is prepared. The amount of equity is another measure of solvency. Many farmers and lenders also prefer to calculate a ratio measure of solvency. Perhaps the most commonly used ratio measure of solvency is the debt-asset (D/A) ratio. This is calculated as total liabilities divided by total assets ($251,000/ $316,000 or 79.5 percent). The ratio measure is used frequently because it indicates at a glance the percentage change in asset values that would result in total assets being equal to total liabilities. This is calculated as 100 minus D/A (100—79.5 = 20.5 percent for the example in Figure 1c). If the market value of assets were to decline 21 percent, the total assets would be slightly less than the total liabilities.

These three financial statements indicate that business borrowed more money during the year to meet cash commitments, produced a negative return to equity capital, and suffered a loss in equity. This solution will be referenced throughout the discussion to illustrate the effect of adjustments that farmers and their lenders can make on liquidity, profitability, and solvency of the business.

Adjustments in Proprietor Withdrawals and Nonfarm Income

The severe drop in farm earnings in the 1980s has caused many farm families to re-examine their career goals. Frequently, one or more of the family members has taken an off-farm job to supplement farm earnings. In some cases, a farm-related business has been started or expanded to increase income. The farmer-members of the Southwestern Minnesota Farm Business Management Association reported average non-farm earnings of $2,337 in 1980. In 1985, average non-farm earnings were $6,015; in 1986, $5,517. An increase in off-farm earnings is certainly one method to improve the cash flow position and increase the addition of owners’ equity. Given the low farm earning potential in the current economic environment, some have decided they cannot make a living from farming and have turned to other vocations—at least for now.

In some multi-family farming units, one family (or more) has left the family business. Usually the family departing is the one that can best make the shift. Skill levels, job availability, age, and interest in farming versus available alternative jobs are factors that have influenced who goes and who stays. Or, if a low-return live-stock enterprise, such as beef, has been dropped, the family member who was most involved in that enterprise might be the one to leave the farm or to spend more time in the family’s farm-related business.

The current financial situation has also created problems in rural communities with many businesses curtailing operations or closing their doors. Also, the general U.S. economy has caused some non-farm related industries to close plants in rural areas. These events have reduced employment opportunities in rural areas. Some families have been forced to relocate in order to find employment.

Farm families also have reduced family expenditures during the 1980s. For example, the farmer-members of the Southwestern Minnesota Farm Business Management Association reported that average family use of cash for all purposes dropped from $30,078 in 1980, to $27,378 in 1985, and to $26,570 in 1986. Expenditures for autos, new household equipment, furnishings, or home improvements have been the first to be cut by many families.

Reducing proprietor withdrawals by increasing non-farm income or decreasing family expenditures may provide funds which can be used to reduce current liabilities. This is illustrated by comparing columns 1 and 2 of Figure 2a. The entries in column 2 indicate the outcome that would have occurred if the operator had reduced 1986 proprietor withdrawals by $5,000 and applied the full amount to payment of current liabilities. The action would have increased the addition to owners’ equity (Figure 2b), reduced business liabilities by $5,000, and increased business equity by the same amount (Figure 2c). This example made the simplifying assumption that neither the ending value of personal assets nor the amount of interest paid and accrued would be affected by this shift. In reality, reducing proprietor withdrawals by an amount as large as $5,000 would probably result in changes in both of these items, but would not alter the general result illustrated here.

Farm Income Adjustments

Farm earnings vary greatly. The average difference in net returns between the top and bottom 20 percent of the farm operations in several different record keeping groups in Minnesota has been over $70,000 during each of the past three years. Top return farms excel over low return farms in each component of the in-

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Business: (Cash, Accounts receivable, Livestock and crops held for sale and feed, Farm supplies)</td>
<td>$96,400</td>
</tr>
<tr>
<td>Intermediate Business: (Machinery, Breeding livestock, Moveable buildings, Securities not readily marketed)</td>
<td>$67,800</td>
</tr>
<tr>
<td>Long-Term Business: (Farmland, Permanent buildings and improvements)</td>
<td>$151,800</td>
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<tr>
<td>Total Business Assets:</td>
<td>$316,000</td>
</tr>
<tr>
<td>Personal Assets:</td>
<td>$30,000</td>
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<tr>
<td>Total Assets:</td>
<td>$346,000</td>
</tr>
<tr>
<td>Current Business: (Accounts Payable, Notes payable within 12 months, Principal on longer-term debt that is to be paid within 12 months, accrued interest, taxes and rent)</td>
<td>$75,100</td>
</tr>
<tr>
<td>Intermediate Business: (Deferred principal, Accounts and notes payable, Contingent tax liabilities on intermediate assets)</td>
<td>$6,000</td>
</tr>
<tr>
<td>Long-Term Business: (Deferred principal on real estate loans, Contingent tax liability on long-term assets)</td>
<td>$170,000</td>
</tr>
<tr>
<td>Total Business Liabilities:</td>
<td>$251,100</td>
</tr>
<tr>
<td>Business Equity:</td>
<td>$64,900</td>
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<tr>
<td>Personal Liabilities:</td>
<td>0</td>
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<tr>
<td>Total Liabilities:</td>
<td>$251,100</td>
</tr>
<tr>
<td>Equity</td>
<td>$94,900</td>
</tr>
<tr>
<td>Total Liabilities and Owners’ Equity</td>
<td>$346,000</td>
</tr>
</tbody>
</table>
come formula: volume of production, sales price, and costs.

During the 1970s when the margins (price minus cost per unit) were more favorable, many farmers emphasized volume. In the '80s, in order to survive, many had to redirect their efforts to increasing the margins through controlling costs and improving marketing.

Cost control efforts need to be aimed especially at the largest cost items. For financially stressed farmers, these often are interest, machinery costs, rent, feed, and fertilizer.

Custom hire or exchange work with a neighbor is being used more and more to replace some machinery ownership overhead costs on these farms. Feed costs are being examined more closely. Low return livestock operations usually show higher prices paid for protein feeds as well as more feed per unit of output. Producing higher quality forages, getting help with ration balancing, and shopping more carefully for lower priced protein feeds can help bring these costs under control.

Land costs are being reduced by negotiating lower cash rents or shifting from cash to crop share rentals. Financially stressed farmers can also take action to get rid of real estate debt in several different ways as discussed in later sections of this article.

Farm records reveal that, compared to low return crop producers, high return crop producers consistently achieve higher yields per acre with similar or lower input costs. Fertilizer, pesticide, and machinery costs are often greater for low return than for high return crop producers. For example, in 1985 the low return corn grower on cash rented land in the Southwestern Minnesota Farm Business Management Association expended $37.27 for fertilizer compared with $31.17 for the top return grower. The low return grower paid $10 per acre more for cash rent, suggesting that the land should not have been any less productive. Average yield per acre was 30 bushels less for the low producer, however. In general, high return crop producers tend to purchase inputs at more favorable prices and develop a system of production considering timing and placement of inputs for optimum efficiency. For example, many farmers are finding that they can achieve continued high yields with lower phosphate and potash applications. This is being accomplished by careful testing to avoid part of the expense of routine annual maintenance applications commonly made during the 1970s. For example, research at the Minnesota Agricultural Experiment Station shows that there is rarely any economic yield response from phosphate fertilization of corn when the soil tests 35 lbs. or more.

Volume of sales is still important—especially on a per worker basis. Some ways that farmers have found to increase volume have been by more intensive use of livestock facilities, renting unused livestock facilities from neighbors, custom feeding of livestock, renting additional land, and doing custom machine work for others.

Marketing management in the current economic environment requires participation in government wheat and feed grain programs in order to achieve the best returns to the farm. It also requires the use of forward price contracts to lock in returns better than loan rates when available. However, forward contracts and hedging are not always the right marketing techniques. Hog farmers who contracted in early 1986 ‘‘lost’’ income because cash prices rose above contract prices later in 1986. Analysis should be done before contracting and hedging decisions are made.

The impact of an increase in 1986 net cash income is examined in column 3 of Figure 2. The example assumes the operator could have reduced operating expenses by $3,000 while maintaining operating receipts at the same level. This change would have increased the income tax liability. Thus, the after-tax return to unpaid labor, equity capital, and management (Figure 2b) as well as the addition to owners’ equity (Figure 2b) would have increased by $2,500. The simplifying assumption is made that the $2,500 would have been applied to current liabilities in a way that did not alter the interest charges paid during 1986. Thus, compared to not increasing income (column 2), current business liabilities would have declined by $2,500 and equity would have increased by the same amount.

In summary, the current cost-price squeeze puts a premium on practices that pare costs while holding prices as high as possible. But a high volume is required to spread overhead costs and to accumulate a significant net income once a positive margin is achieved.

**Reschedule and Restructure Liabilities**

Many borrowers facing large interest and principal payments have reduced the amount of the payment(s) due within any one year to ease cash flow problems. This

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can be accomplished by “rescheduling” the loan, i.e., changing the term (or length) of a loan and/or the timing of payments. This approach is likely to be preferred over “restructuring” (as discussed below) by the lender because it implies that all interest and principal payments will be made, even though the payments may be made over a longer period of time. Rescheduling can also help the borrower’s cash flow problem by spreading the principal payments over a longer period which reduces the principal and, hence, the total payment per period.

The sample farm has relatively high current business liabilities (Figure 1c). The operator may find it advantageous to refinance part of the current liabilities over several years. For example, suppose the operator refinances $35,000 of current liabilities over five years with equal annual principal payments. Doing so would move $28,000 of liabilities from the current to the intermediate category. The amount of the intermediate loan due within 12 months ($7,000) would remain under the current category. The result of this rescheduling would be $47,100 of current liabilities and $34,000 of intermediate liabilities. The rescheduling would make repayment of the liability more manageable.

An alternative method to change the loan servicing payments per year is to “restructure” the loan. In restructuring a loan, the borrower and lender agree to change the total amount of principal and/or the interest rate to be paid. The borrower is able to “erase” debt, but the lender will have a financial loss with restructuring. Thus, borrowers are likely to favor restructuring and lenders will favor rescheduling.

Restructuring and rescheduling liabilities can be used (1) to keep total principal and interest payments in balance with a firm’s repayment capacity, and (2) to keep current, intermediate, and long-term liabilities in balance with each other. Negotiations between borrowers and lenders often result in a combination of restructuring and rescheduling. The remainder of this section discusses several methods to restructure and reschedule liabilities along with the tax implications of each.

Decrease Principal Payments/Outstanding Principal

Negotiating a principal write-down from commercial lenders and renegotiating contracts for deed are two major methods which have been used for decreasing principal and still retaining ownership of the asset. Lenders may be willing to consider these alternatives when the value of an asset has declined to a level below the debt commitment and/or the repayment ca-
pacity is less than the debt service require-
ment, but this willingness also depends on
the lender's financial condition. The alter-
natives of selling assets or "letting them
go back" also decrease principal and are
discussed in the section "Restructuring
Assets."

Both the farmer and lender (or first
owners) may find write-downs and rene-
gotiations more favorable than the alter-
natives of foreclosure, repossession, and
resale. Even though the renegotiated
amount of the principal will be lower than
the original contract or loan, the renegoti-
at principal may be greater than the net
amount that a lender can obtain from a new
buyer. Furthermore, an institutional lender
may be willing to make concessions, if do-
ing so corrects a borrower's debt structure
imbalance and repayment of the remaining
amount is highly likely. Tax implications
and the desire to keep a good farmer on the
land are other reasons for both sides to seri-
sously consider principal write-downs and
contract renegotiation.

The Internal Revenue Service may
view forgiven debt as taxable income,
making the potential tax implications of
principal write-down tremendous. Under
current law (1986), forgiven indebtedness
is considered taxable income unless the
defaulter qualifies for one of the following
exclusions: 1) debt is discharged in a
bankruptcy case; 2) the debtor is insolvent
by more than the forgiven debt; or 3) the
discharged debt can be offset by decreas-
ing the basis of depreciable business
assets. The Tax Reform Bill of 1986
broadens the opportunity for solvent tax-
payers to exclude the discharge of debt
from income. Since this is an extremely
complicated area, expert legal advice
should be used. As a brief, non-legal sum-
mary, let us look at the new law's features
on debt discharge. It allows discharged
indebtedness to be excluded from taxable
income by writing down the basis of
farmland as well as depreciable assets, car-
ryovers, recapture variables, and other tax
attributes. Any debt forgiven which is not
used (or cannot be used) to decrease basis
is considered income to the debtor. Basis
reduction occurs at the beginning of the tax
year following the year in which the debt is
forgiven; this allows for some planning of
asset purchases and sales. Tax losses from
the sale of some assets can be used to offset
other gains, making the timing of asset
sales and the debt restructuring potentially
important.

Negotiating a write-down of part or all
of accounts payable will decrease the level
of current liabilities and improve the liq-
uidity position of the farm. Business peo-
ple who write-down accounts payable will
do so if they perceive that it is the least-loss
way to handle the situation. How much
they can write-down will depend upon
their own financial condition and their
ability to sustain a loss in liquidity.

For the farmer, the advantage of writ-
ing down accounts payable is the improve-
ment in liquidity. The disadvantage is that,
if they are willing to still do business with
the farmer, these businesses will most
likely require cash payment upon purchase
give no credit in the future. This may
be an advantage in that it forces a farmer
to develop a more comprehensive farm plan
including financial and credit consider-
atations. The tax implications of an accounts
payable write-down may be minimal. A
debt forgiven that would have been a de-
ductible expense when paid is not consid-
ered income by the IRS. Accorded interest
that has not been paid (or claimed as a de-
duction under accrual accounting) is not
considered income when it is forgiven. For
example, when a dealer forgives a farmer's
$10,000 fertilizer bill, the farmer's gross
income, cash expenses, and taxable in-
come are unaffected. Thus the advantages
to the farmer of having accounts payable
written off are to reduce cash commitments
and current liabilities. This will improve
the farmer's cash flow, increase net farm
income, and improve the debt asset posi-
tion. It will have the opposite impact on the
financial position of the business forgiving
the account.

It may be possible to renegotiate land
rental agreements to improve liquidity.
Renegotiating a cash lease to lower the
payment will reduce current liabilities.
These adjustments could reflect the higher
return to land which has a wheat or feed
grain base for government acreage pro-
grams. Also, changing a cash lease to a
share lease will reduce current liabilities
and improve liquidity, particularly in poor-
yield and low-price years. Flexible leases
can be used to share production and price
risk between the tenant and the landowner.
These can be developed in many forms
such as bushel leases, flexible cash leases
where the rent depends on yield and/or
commodity prices, or a combination cash
and share lease.

The sample farm has long-term liabili-
ties that exceed the market value of long-
term assets (Figure 2c). Suppose the
operator had negotiated a write-down of
the long-term principal from $170,000 to
the market value of the long-term assets
($151,800) at the beginning of 1986. The
effect is illustrated by comparing columns
3 and 4 of Figure 2. The illustration as-
sumes the interest rate before and after the
write-down is 11 percent and that the oper-
ator was able to reduce the basis of the real
estate by the amount of the write-down
($18,200), thus avoiding any tax liability
on the forgiven debt. A comparison of the
two columns of Figure 2 indicates that
write-down reduces interest payments by
$2,800, but increases taxable income (and
increases the income tax paid), allowing an
additional $2,200 in principal payment.
This additional payment is applied to cur-
rent liabilities. Thus, the effects of the debt
write-down are to increase liquidity, im-
prove profitability through the reduction of
interest expenses, and improve solvency.

Decrease Interest Rate

In some cases, a write-down of the in-
terest rate has been used in conjunction
with, or instead of, a principal write-down.
The Minnesota program of sharing a write-
down between the state and the lender
received $18 million in additional funding
during the recent legislative session. How-
ever, the amount of money provided by the
state again may be insufficient to help all
those who are eligible.

Some institutions will make loans at
two percent above the certificates of de-
posit (CD) rate when the CD's are pledged
collateral. Farmers able to find someone
willing to pledge CD's may find this is a
very good way to obtain a lower, more
manageable interest rate. In some cases, it
may be the only way to obtain an operating
loan. The holders of the CD's do have
the risk of losing their money if the borrower
defaults so they may be cautious about
entering into these arrangements until they
have checked the financial condition of the
farmer and the impacts of the lower interest
rate.

Lengthen Payment Period

Reamortization of the remaining loan
balance over a longer time period may be
difficult to arrange with the same lender.
However, a long-term loan can frequently
be obtained from a second lender to pay off
an obligation with the first lender. The sec-
dond lender will certainly evaluate the
farm's financial condition and loan repay-
ment potential. This option is open to
farmers who have large current and/ or in-
termediate liabilities which are affecting
their liquidity and ability to make pay-
ments, but who have a low long-term debt
relative to the value of their real estate
assets. Farmers with sufficient long-term
debt servicing capacity can use this method
to reduce short-run cash commitments
and to bring the structure of liabilities (current,
intermediate, and long-term) in line with
the farm's ability to pay those liabilities.

The loan payment period can be
lengthened by other means. A farmer and
lender could agree that only the interest payments are to be made, thus pushing the final payment further into the future. Some lenders may agree to amortize missed payments over a period negotiated between the lender and farmer—from a few months to a few years. These options improve the liquidity of the farm and may solve a temporary cash flow shortfall. Farmers carrying more debt than can be serviced with the current income generating capacity of the business may find these methods are insufficient to solve their problems.

Renegotiate Capital Leases

Lease agreements for machinery, silos, and other equipment also may be renegotiated, but this has not been done frequently. The payment amount, number of payments, and any end-of-lease purchase agreements are variables to be considered. The principal and interest rate may not be explicitly stated, but they affect the farmer’s payment and are subject to renegotiation.

Change Lender

A borrower may have to change lenders to exercise some of the options and alternatives discussed above. As one commercial lender says, “Once financial trouble has become severe, a borrower cannot go back to the original loan officer, even if he/she remains with the same creditor.” A new institution may be able to provide the necessary footing on which to begin. The original credit institution may be unable to offer what the farmer needs to survive due to rules and “damaged” personal relationships. A change to FmHA, for example, has enabled some farmers to obtain a lower interest rate. FmHA may be the lender of last resort for some farmers. However, FmHA has funding limits placed on it by Congress so it has not been able to meet all applications.

Choosing Alternatives

The process for restructuring and rescheduling liabilities has been and will be different for almost every farmer who needs to take this route. The action chosen will probably be a combination of the alternatives discussed. The degree of illiquidity and/or insolvency and the amount of improvement desired will determine the alternatives chosen.

Changing lenders may be necessary to achieve the goal of continuity. Also, management of the liabilities side of the net worth statement cannot be separate from the management of assets and the production practices chosen. If the financial situation is not repairable, the best alternative route may be to end one business and start another—as discussed in the later section, “Entry/Recycling.”

Restructure Assets

The way assets are controlled and their liquidity is referred to as the structure of assets. Real estate can be controlled by owning, leasing with a multi-year arrangement, or renting on an annual or short-term basis. Machinery and equipment can be owned, leased, or custom hired, while breeding stock can often be leased as well as owned. The value of owned assets and the value of longer-term leasing arrangements are included in the net worth statement. When owned real estate has been sold and rented back (as some farmers have done), the value of long-term assets has been reduced and the cash generated has been used to reduce liabilities or increase current assets. Similarly, a few farmers have sold owned machinery and had the operation(s) performed by custom operators; they have reduced the value of intermediate assets and had funds available to reduce debt or increase current assets.

Selecting the Assets to Restructure

A decision to restructure some assets and not others should depend in part on the operator’s goals. Some operators may be willing to quit farming and either retire or obtain off-farm employment. These individuals may want to sell machinery, equipment, and breeding stock, while maintaining ownership of part or all of the land as income producing property to supplement other income.

Other farmers may place a heavy emphasis on continuing to operate a farm business. These farmers may want to restructure low-return/low-liquidity assets such as land, particularly when similar quality land can be rented at competitive prices. In some cases, those selling the land will want to maintain ownership of the farmstead and a limited acreage to be used as a base for future operations with rented land. In addition to maintaining a base of operations, these farmers will want to maintain the intermediate machinery, equipment, and breeding stock assets that have both a high return and high liquidity. Market conditions permitting, farmer debtors can dispose of some machinery and substitute the use of custom hire.

Farmers voluntarily or involuntarily transferring or selling their property to reduce debt may not see income resulting from these transactions. As a result, they may fail to consider the tax consequences in selecting the assets to be restructured. Often a farmer can use alternative assets to satisfy approximately the same amount of debt, but the tax consequences of the several transactions may be quite different. The potential tax liability associated with the sale or transfer is a second factor to consider in describing which assets to restructure.

The tax code changes frequently and differences exist between the federal and state levels. The following discussion only outlines the general implications of tax considerations at these two levels. Farmers choosing financial options should obtain advice from tax consultants before implementing their decisions.

Farmers restructuring assets may incur several types of income tax liability. The sale or transfer of assets may result in ordinary income, capital gains, or the recovery of investment tax credit. Ordinary income may result from the sale or transfer of property such as grain and livestock held for resale. The transfer to a creditor to partially or completely pay off a debt is considered ordinary income regardless of whether the transfer is voluntary or involuntary.

The recapture of previously claimed tax deductions, including depreciation, soil and water conservation expenses, land clearing expenses, and government cost sharing payments excluded from income, is also considered ordinary income.

Capital gains may result from the sale or transfer of depreciable property and real estate. The sale price less the basis of these assets sold (or fair market value at time of transfer less the basis for property transferred) represents the capital gain income (or loss). In previous years, 60 percent of capital gain income was not taxed. The Tax Reform Act of 1986 states that gain from the transfer of depreciable property and real estate after December 31, 1986, will be taxed at 100 percent of its value; the 60 percent deduction has been eliminated.

The farm debtor must include the ordinary income, capital gains, and investment credit recapture from the sale or transfer of assets in calculating the income tax due. Often, the regular income tax can be offset with net operating loss, depreciation, and investment credit. The Internal Revenue Service requires an individual who has benefited from tax preferences to calculate the alternate minimum tax. Some common

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The methods of decreasing taxable income from debt forgiveness is discussed in the previous section on restructuring liabilities.
examples of tax preference items for farmers include accelerated depreciation on real property (buildings and improvements), accelerated depreciation on leased personal property, and the 60 percent capital gain deduction. An experienced lawyer has indicated that the recapture tax imposed by Section 2032A or Section 6166 of the Internal Revenue Code (both of which relate to the payment of the federal estate taxes) has been triggered in some instances.

**Procedures to Use in Restructuring**

After the farmer has decided which assets are to be kept, the next step is to develop a plan to maintain control of the desired assets. When loan conditions permit, farmers may want to concentrate machinery payments on those items considered essential to continued operation of the business. The remaining machinery can be disposed of (either sold or transferred) in a manner to achieve the maximum reduction in debt.

Unlike the financing that often exists for machinery and personal property, separate loans exist for real estate and they often exist for separate parcels of real estate. The borrower with real estate loans on each of two or more parcels has several opportunities for asset restructuring. For example, a farmer unable to maintain current principal and interest payments on all real estate loans may concentrate payments on one or more loans. The remaining real estate loan(s) are permitted to go into default. The farmer may be able to renegotiate a lower loan principal based on the current market value of the real estate. If the negotiation effort is unsuccessful, and the lender sells the land, the borrower has the right under Minnesota law to redeem the property within six months after the date of sale. The borrower has up to twelve months to redeem if: 1) the mortgage was signed before June 1, 1967; 2) the amount on the mortgage is less than 2/3 of the original amount; or 3) the mortgaged land is more than ten acres. To redeem, the borrower must pay the lender the full amount that the land was sold for at the sale, plus interest.

Farmers facing foreclosure on real estate may want to establish a homestead exemption for the portion of the property which serves as their homesite. Such opportunities are severely limited, however, if the farming operator has previously been granted a second mortgage on the homestead. The 1986 Minnesota legislature increased the maximum size of a rural homestead from 80 to 160 acres. By filing the homestead property designation, the designated homestead property must be sold separately. The farmer debtor may then redeem the homestead or the remaining property, or both, separately.

Farmers facing bankruptcy may also make use of the homestead designation. Farmers in Minnesota may claim a homestead exemption on an area up to 160 acres in size. Farmers facing bankruptcy would typically be given a lien on all major assets, including the area designated as the homestead. A bankruptcy discharge does not release any property that the debtor retains from any lien the debtor may have been granted prior to filing bankruptcy. In these cases, it may be impractical to retain a larger acreage under the homestead exemption, but the family may be able to retain the house and a limited acreage as a homestead.

The remaining sections discuss several methods which farmers commonly use to restructure assets and liabilities. The general considerations discussed in the two previous sections are emphasized under each method.

**Sale Leasebacks**

For some farm operations, the cash flow costs of ownership are excessive given the original terms of the purchases and the current economic environment. In these circumstances, sale-leaseback arrangements may be quite appropriate. Such strategies will change the asset composition of the firm and, depending upon how the proceeds are used, the debt load and composition as well.

Farmland, in particular, may be an attractive sale-leaseback asset. Cash flow requirements for annual debt servicing (principal and interest) can frequently be reduced from 10-15 percent of a previously established higher land value to cash rental rates which are 7-9 percent of the land value. Leasebacks with crop share rent result in even lower cash flow requirements for operators. Whereas the cash flow from other enterprises in the operation may have made it feasible to own farmland and the capital gain made it a rational economic decision in the past, the current economic climate may favor renting.

Similar arrangements may be an attractive means of restructurings the ownership pattern of improvements and personal property as well. A carefully structured sale-leaseback can reduce the cash flow pressures for the farmer, and enable the operator to use assets efficiently, generating a competitive rate of return for both lessee and lessor. A variation of the sale-leaseback of livestock facilities is the transition of farmer-feeders who traditionally have fed their own livestock in their own facilities to custom feeders who lease space and provide feeding services for investors.

The sale-leaseback may be implemented in two general ways. One method (as noted earlier) is to arrange for the conveyance of the property to the lender (a deedback or voluntary conveyance) with the borrower leasing the property back from the lender. An alternative is to sell the property to a third party on a leaseback basis and use the proceeds of the sale to reduce the debt load of the firm. The 1986 Minnesota farm bill also provides for leasing back of land which has been foreclosed.

An alternative, either to sale-leasebacks or to liquidating assets that may be more desirable when market values are severely depressed, is to increase the utilization of those assets through custom farming or renting them to other farmers. Opportunities may exist for an operator to do custom farming as a means of increasing machine utilization without incurring additional financial risk. Crop share leasing may be an option to generate cash income from owned land that has limited market value. If operating funds cannot be obtained to plant a crop or produce livestock, the farm could be rented out with the proceeds used to service debt obligations.

A fundamental key to survival for many operators is fixed asset utilization and management. When fixed assets are underutilized and fixed costs are not being spread over adequate levels of production, there are only two options: (1) reduce fixed costs through sale or disposition of fixed assets, or (2) reduce fixed costs per unit of production by expanding volume of business.

**Recapitalization/Equity Infusions**

The financial structure of the business could be significantly improved through an infusion of equity from outside the firm, either by a current lender exchanging an obligation for an equity position in the firm, or an outside investor providing additional funds which are used to reduce indebtedness. An equity infusion provided by an outside investor not only increases the cash and liquidity position of the firm, it also reduces the financial risk by increasing the equity capital base. Thus, it may improve the balance sheet and improve the cash flow of the firm when some of the equity is used to satisfy debt. When an equity
infusion occurs through the conversion of debt to equity, the conversion procedure also reduces the debt-servicing requirements. Such a restructuring with an institutional lender may violate Minnesota Statutes Section 500.24, the so-called Corporate Farming Act. Thus, we have not seen any such debt-to-equity conversions in Minnesota.

An equity infusion may at first glance appear to be difficult to orchestrate. Who would want to put equity into a financially troubled firm? In some cases, family members may be willing to provide such an infusion to protect the integrity of a family business. An expected future inheritance of nonbusiness assets could be converted into current cash through sale to other family members. A nonfamily investor might be willing to contribute capital for a larger-than-proportionate share of the ownership of the firm. Some investors may be attracted by the tax shelter available from operating losses; under certain conditions, an operating loss is, in reality, an asset for a high tax bracket investor. And unused tax credits may be available to make the equity infusion more attractive for the investor.

The third source of an equity infusion is a non-institutional lender. In some cases, the financial condition of the firm is such that the lender will incur a significant loss if the note is called, foreclosure occurs, or the operator takes advantage of the bankruptcy procedures. If the firm has current cash flow problems because of high leverage and aggressive growth, but strong management and the potential for reasonable future earnings, the lender may minimize losses or increase the chances for recovery by converting debt obligations into equity. This conversion reduces the current cash flow burden of excessive debt servicing and releases resources (both land and management) to use in more productive activities that will enhance current and future income. In agriculture, this conversion frequently involves contract indebtedness; many installment land contracts are currently being renegotiated by the seller (equity holder) taking back title to the property or restructuring the contract into a risk and return sharing arrangement with the purchaser. Other methods to accomplish this conversion are to form either a partnership or corporation. In the case of a partnership, the former lender would become a limited or perhaps a general partner. When a corporation is formed, the former lender is issued stock. In each case, the former lender assumes an equity position. As stated before, institutional lenders in Minnesota will not follow this option due to possible violation of the “Corporate Farming Act.”

The option of co-signing a note is a common method to substitute the equity base of one individual for another. This has been a common method for reducing financial stress in the past, but given the current uncertainty about the long-run economic future in agriculture, this option is much less feasible today. Most potential co-signers are unwilling to incur the risk associated with an additional debt load.

Merger/Acquisition

A final alternative for some firms is to merge and/or be acquired by another firm. This choice is commonly used in the nonagricultural sector where the firm has established a market position, reputation, and goodwill among its customers which it is believed can be at least partially transferred to another owner. The merger/acquisition option is less likely to be used in production agriculture because the farm’s market position is of little value to another operator. Merger or acquisition may be an option, however, when a smaller farming unit can be absorbed completely by a larger unit. For example, a small (perhaps part-time) farm being operated by a son (or son-in-law) might be acquired by the parents (or parents-in-law) who have a larger unit and can easily absorb the smaller farm’s resources and debt load. In this situation, the newly merged farm may or may not include all of the former operators of two separate farms—the younger generation might move out of farming completely, or the older generation may retire (at least semi-retire) and leave room for the younger generation to manage the merged business. If the older generation is already retired, a creditor may ask them to “unretire” and become more active in management and equity position (i.e., merge) before more debt capital is advanced.

For larger farm businesses as well as agribusiness firms, the merger/acquisition step is more common, e.g., investor acquisition of financially stressed and bankrupt southern plains cattle feedlots during the 1970s, and the Case-International Harvester merger.

Entry/Recycling

The improved chances for survival and success for a beginning or recycling farmer today (compared to the last ten years) are the result of at least five changes: (1) the purchase price of capital assets such as machinery and equipment has declined significantly, allowing a beginning or recycling farmer to obtain the necessary asset base to operate with a significantly lower capital outlay; (2) purchased input prices, including seed, fertilizer, chemicals, and energy, have stabilized and in some cases are declining, thus reducing operating costs as well as the amount of operating capital needed to farm; (3) government programs in the form of the 1985 Food Security Act and the multi-peril crop insurance program administered by the Federal Crop Insurance Corporation provide mechanisms for downside risk protection with respect to both commodity prices and crop yields; (4) land rental options and rental rates are becoming increasingly favorable for tenants; and (5) interest rates are at lower levels and will be less burdensome if they remain at their current levels or continue to fall.

The results of a recent study by Benson and Boelhje indicate that if a crop share rental arrangement is utilized, the risk of not being able to service machinery and operating debt is very low. In contrast, the ownership option of land acquisition results in significantly lower cash incomes after debt servicing and substantially more risk; in fact, with all productivity levels, cash income after debt servicing is negative if land is purchased. This suggests that land purchasing may not be an attractive entry or recycling strategy, but that rental, particularly crop share rental, may provide an attractive option for starting or re-starting in farming.

Bankruptcy

An important legal vehicle for managing the asset and liability adjustment process is bankruptcy. Although bankruptcy may involve immediate liquidation of the assets and a discharge of the indebtedness of the farm (Chapter 7 of the Bankruptcy Act of 1978, Public Law No. 95-593, 92 Stat. 2549, 1978), it can also involve restructuring and rehabilitating the business under Chapters 11, 12, or 13 of the bankruptcy law. Thus, Chapters 11, 12, or 13 provide the legal vehicles to implement the asset readjustment methods described if arrangements cannot be made on a voluntary basis. Our focus here will be on the use of bankruptcy to restructure and continue the business.

Chapter 11

Farmers cannot be forced into an involuntary bankruptcy. A farmer who chooses Chapter 11 bankruptcy proceedings becomes a “debtor in possession”—generally, the farmer continues to manage and
operate the farm, possibly under the surveillance of a creditor's committee. A trustee to manage the property is appointed only in rare cases, so the farmer can continue to operate the farm as long as he develops an acceptable debt reduction plan.

The key to successful use of the bankruptcy vehicle to restructure the farm and continue the business is the plan for repayment of creditors and the time that is provided by the court to develop and implement this plan. Once a bankruptcy petition is filed, an automatic stay prevents almost all litigation and other actions of lien enforcement on the part of creditors. The debtor is given a period of time (often from 6 to 12 months) to develop a plan for repaying creditors; this plan must be accepted by the creditors and confirmed by the court if the farmer is to continue operating.

The plan may include the rescheduling and extension of the repayments on debt obligations; reductions in interest rates that will leave more cash flow for principal repayment; writing down or writing off unsecured, as well as secured, obligations to reduce the total debt load; renegotiation of lease and other contract obligations to reduce cash expenses; sale or lease of capital assets to increase cash income available for debt servicing; changes in enterprise mix and marketing strategy to improve financial performance; and other appropriate adjustments to improve efficiency and the long-run survivability of the firm. Although most, if not all, of the same adjustments can be made without recourse to the bankruptcy proceedings, the bankruptcy rules provide a vehicle to force decisions about such adjustments if they cannot be made between borrower and lender in a mutually agreeable fashion.

The mandatory mediation provisions enacted recently by the state legislature provide a vehicle and mechanism to facilitate voluntary agreement between borrower and lender concerning appropriate and necessary adjustments to improve the chances of firm survivability. Voluntary or mandatory mediation is an important step in the restructuring process for most farm firms, but it does not preclude access to bankruptcy provisions for restructuring irrespective of the outcome of the mediation.

Congress recently approved, and President Reagan signed, a bill authorizing a new chapter in the federal bankruptcy code written exclusively for farmers. Entitled Chapter 12, it removes some of the restrictions farmers have faced when reorganizing under Chapters 11 or 13. Chapter 11 is used by larger corporations, but it often does not provide an opportunity for farmers to reorganize because the individual reorganization plans must be approved by creditors. Some farmers have considered using Chapter 13, which is designed for smaller businesses. It is unsuitable for many farmers because of its limitations on debt size, $350,000 in secured debt and $100,000 in unsecured debt, and because it is limited to individuals. Chapter 13 cannot be used by corporations and partnerships.

### Chapter 12

Chapter 12 is intended to help family farmers reorganize their operations. Eligibility is limited to an individual or closely held corporation or partnership whose aggregate debt is $1.5 million or less. The filee must derive more than 80 percent of the debt and 50 percent of the gross income from farming.

Chapter 12 has several provisions of particular interest to farmers. First, farmers have 90 days after filing for Chapter 12 protection to submit a plan for reorganization and the bankruptcy court must approve or disapprove it within 45 days. Reorganization plans under Chapter 12 do not require creditor approval. Second, the value of the secured loan would be reduced to the current value of the collateral. This allows the farmer to repay debts based on the current market value of the collateral, not its purchase cost. The difference between the collateral value and the amount of the loan is treated as an unsecured claim. Third, foreclosure by a lender is prohibited if the farmer can pay the equivalent of fair market rent on the asset. Under this provision, farmers whose land values have sunk below the mortgage value can reduce their debt servicing; changes in enterprise mix and marketing strategy to improve financial performance; and other appropriate adjustments to improve efficiency and the long-run survivability of the firm. Although most, if not all, of the same adjustments can be made without recourse to the bankruptcy proceedings, the bankruptcy rules provide a vehicle to force decisions about such adjustments if they cannot be made between borrower and lender in a mutually agreeable fashion.

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Chapter 12 legislation does not deal with one of the major reasons for filing bankruptcy to reorganize the business: to deal with the potential income tax liability on the disposition of assets. The new law does not create a separate tax entity for Chapter 12 filers for federal tax purposes. This shortcoming may be remedied by additional legislation. Until that is done, Chapter 12 does not offer a fresh start from income tax liability on assets liquidated in bankruptcy.

Chapter 12 of the bankruptcy code became effective November 26, 1986, for a period of seven years. It is untested as this is written, but the provisions suggest that Chapter 12 will enhance farmers' abilities to restructure assets and liabilities.

### Chapter 7

If restructuring under bankruptcy provisions is not successful, a secondary benefit to the creditor of the bankruptcy rules is the exemption of specific property from creditors' claims. Such exemptions are specified by state or federal law with the flexibility in Minnesota to choose either set of exemptions. Exemptions under federal law include: (1) up to $7,500 in value of property used by the debtor or dependent of the debtor as a residence; (2) up to $1,200 in value in one motor vehicle; (3) up to $200 in value per item in all items that are household furnishings, household goods, wearing apparel, appliances, books, animals, crops, or musical instruments held by the debtor or a dependent of the debtor primarily for personal, family, or household use; (4) up to $500 in total value of jewelry held for personal, family, or household use; (5) $400, plus up to $7,500 of the amount not used for the exemption for the debtor's residence in (1) above, in any property; (6) up to $750 in total value of implements, professional books, or tools of the trade of the debtor or a dependent of the debtor; (7) any unmatured life insurance contract owned by the debtor except credit life insurance; (9) professionally prescribed health aids; (10) the debtor's right to receive certain benefits and payments, such as social security, unemployment, veteran's benefits, disability, alimony, annuities, stock bonus or similar plans, and certain pensions; and (11) the debtor's right to receive certain compensatory awards, such as awards under crime victims' reparation law and awards for wrongful death, bodily injury, or loss of future earnings (Hart).

Under Minnesota law, exempt property includes: (1) personal goods including apparel and household items not exceeding $4,500 in value, with this limit indexed to account for inflation; (2) farm machines and implements not exceeding $10,000 in value; (3) tools and instruments reasonably necessary in the trade or business of the
Many farmers with relatively high profitability and cash flow, as well as the family will achieve more of its goals through the financial adjustments being made.

References


