



## **MANAGING A COOPERATIVE BANKRUPTCY**

No, the title is not in error, but it does suggest a contradiction in terms, i.e., the proficient practice of management should never result in a bankruptcy. Moreover, the act of bankruptcy speaks of the apparent absence of adept management. But, of course, our agribusiness economy is filled with such inconsistencies, and as the current depressed economy persists, bankruptcies, foreclosures, and forced liquidations will continue to provide the fodder for endless newspaper accounts and captured public attention. In large part, agribusiness cooperatives function as off-farm extensions of our nation's basic food production enterprise. It is nearly axiomatic that as agricultural producers suffer and fail, farmer-owned cooperatives will likewise be burdened. And in some cases, adept management alone may prove unable to sustain the viability of the cooperative.

For a vast array of reasons, cooperatives do fail. It must be noted that, in this regard, cooperatives are not unlike their private, investor-owned agribusiness counterparts. Just over a decade ago, nearly 8,000 agricultural cooperatives were operating in the U.S. Our most recent data would suggest that, by 1984, this number had dropped to about 6,000 marketing, farm supply, and related service cooperatives. Mergers, consolidations, and acquisitions no doubt accounted for a large portion of this decrease, but bankruptcies are also evident. Just 15 years ago in Washington state, four regional farm supply cooperatives and four cooperative dairy processors functioned. Today only a single regional farm supply and a single dairy cooperative continue to operate, and bankruptcies (or near bankruptcies) at least affected the demise of most of these firms. Given the nature of our current agricultural economy, other cooperatives (particularly locals) will experience serious economic difficulties. Without addressing the vast array of factors that contribute to cooperative

bankruptcies, and while remaining silent on the stigmas of such action, the facts are that cooperative bankruptcies have, and will continue to occur.

The objective of this paper is to improve understanding of the bankruptcy process for cooperative managers and board members. Every agribusiness entity must, from time to time, adjust its structure and operations to better cope with its economic environment. Bankruptcy, void of any value judgments, is but one tool by which such adjustments can be made. Indeed, under the reorganization provisions of the current Bankruptcy Code, bankruptcy can provide an option for an ailing cooperative to rid itself of persistent burdens and start afresh. But like all else, this process must be well managed (or administered) if the intended objective is to be achieved.

### **A Caveat**

It must be noted that the discussion which follows is designed to complement, not substitute for sound legal advice. My objective is to make the use of professional legal services more efficient and cost effective to a cooperative by merely outlining the basic components of the law. Since the process of filing for bankruptcy is complex, and the provisions differ between states and are sometimes subject to different interpretation, the employment of legal counsel is essential.

### **General Bankruptcy Provisions**

General bankruptcy provisions provide agribusiness cooperatives with one basic advantage in that they establish a legal basis upon which the debtor (cooperative) may be relieved of overbearing financial obligations. Under specified conditions, they may provide a fresh start for the debtor, while seeing to it that creditors are treated in a manner prioritized by law. While these provisions apply to all persons and forms of business enterprise, the option to start afresh is often judged particularly attractive to cooperatives which provide a function or service judged critical to the future

of agricultural producers in the impacted area. In many smaller rural communities, for example, the permanent demise of a cooperative may eliminate a market, forcing producers to travel great distances to secure a comparable function or service.

Upon filing for bankruptcy, the debtor is granted an automatic stay from proceedings initiated by creditors to obtain monies owed them. However, once filed, secured creditors and other interested persons may petition the court for exceptions to the automatic stay. There are currently eight chapters of the U.S. Bankruptcy Code as revised under public law 95-958 in 1978<sup>1</sup>. The chapters are odd-numbered and chapters 1, 3, and 5 apply to any bankruptcy case that is filed. Because not all chapters, nor provisions in a chapter, apply to agribusiness cooperatives, our discussion will focus only on those aspects which generally apply.

In brief, *Chapter 1* defines the terminology used throughout the code and, thereby, attempts to clarify it. *Chapter 3* outlines how a bankruptcy case is to be administered, i.e., it establishes the general procedures to be followed and identifies the parties responsible. It also indicates that a case may be either voluntary or involuntary. A cooperative's simple inability to service its current accounts payable as they come due is considered an adequate basis for voluntary filing. An involuntary case may be filed by any one creditor if the debtor has less than twelve creditors, or by any three or more creditors if there are claims by twelve or more creditors against the debtor. It should also be noted that each of the creditors filing a petition for involuntary bankruptcy must hold claims of at least \$5,000 against the debtor. If those creditors possess a general lack of confidence in the debtor, those creditors may also request and elect a trustee to administer the bankrupt estate. In this event, creditors holding at least 20% of the debtor's total liabilities must request election of a trustee at a meeting held shortly after filing of the bankruptcy petition in order for the election to be held. In the absence of such action, the debtor continues to manage the estate and is commonly referred to as the "debtor-in-possession." Either the trustee or the debtor-in-possession must make a final accounting of activities to the court upon completion of all bankruptcy proceedings.

*Chapter 5* identifies the priority rankings for creditor claims, the duties and benefits of the debtor, exemptions allowed the debtor, and powers of avoidance afforded the debtor-in-possession (or trustee). The priority rankings of unsecured creditors are:

1. administrative expenses of the proceedings,
2. certain unsecured claims existing prior to the appointment of a trustee in involuntary cases,
3. unsecured claims for wages and other employee benefits up to \$2,000 per person which were earned within 90 days of filing or the date which the debtor stopped doing business,
4. unsecured claims for contributions to employee benefit plans up to \$2,000 per employee earned within 180 days of filing,
5. up to \$900 per person for unsecured claims due to deposits for the purchase, lease, or rental of services from the debtor which were not delivered, and
6. unsecured claims from governmental units for taxes or customs.

In addition, after filing it is the duty of the debtor to prepare and submit a list of creditors, a list of assets and liabilities, a statement descriptive of its general affairs, and to cooperate with and make records available to the trustee (if appointed), to be present at meetings concerning the discharge of debts, and to attend all creditor meetings.

The U.S. Bankruptcy Code provides many exceptions to the items which must be listed as assets of the estate. The general purpose of such exceptions is to allow the debtor some base from which to restart activities. Because the bulk of these are intended to protect individuals filing personal bankruptcies and because many states have their own lists of exceptions which may or may not overrule the federal exceptions, any listing of the options would grow long and quickly obsolete<sup>2</sup>.

*Chapter 7* bankruptcy, sometimes called a "straight bankruptcy", is the simpler of the two bankruptcy options. It is based on the philosophy that poor but honest debtors should be permitted to sacrifice their nonexempt assets to creditors and receive a legal discharge from most liabilities (although those incurred fraudulently and those which run counter to "social policy" are not dischargeable). Generally speaking, *Chapter 7* comprises the appropriate option if there's no equity remaining in the business and no reasonable hope of paying off creditors. Under these provisions, the trustee or the debtor-in-possession is responsible for assembling the estate, liquidating it, and distributing the proceeds from the liquidation on a priority basis to creditors (which must prove to the court the validity of their claims). If proceeds are insufficient to cover all the claims within a particular class, then payment is made by prorating the claims in that class. Upon payment of the various classes

of creditors, the debtor is granted a discharge. This discharge frees the debtor from most types of debts, but the common exceptions are wage claims, trust amounts, taxes, debts not listed in the petition, debts listed in a prior bankruptcy case, and those arising from fraud. The debtor may elect to waive the discharge of certain debts. This is not uncommon where a debtor seeks to retain a preferred line of credit.

Finally, the debtor has the right to request stoppage of bankruptcy proceedings under *Chapter 7* or request conversion to *Chapter 11* provisions. However, if *Chapter 7* proceedings resulted from a conversion from a *Chapter 11* proceeding, then the debtor may not reconvert to *Chapter 11*.

As noted earlier, *Chapter 11* is the more complex of the two bankruptcy options. In brief, the objective in a *Chapter 11* proceeding is debt adjustment and reorganization rather than liquidation of the debtor's assets. Therefore, the debtor continues to do business and develops a plan to reorganize the cooperative in a manner that will allow it to make a positive contribution to the general welfare of its member-patrons. Because this process entails restructuring the discharge of debt, creditors are given a much larger role in the reorganization process than that allowed under *Chapter 7*.

Under *Chapter 11*, the law provides for the formation of committees to represent the various classes of creditors. In particular, it requires formation of a committee for unsecured creditors, and states that the court is empowered to appoint additional committees if requested to do so. While the court does have some discretion over the composition of the committees, generally the seven largest creditors within a class form the committee, if they so desire. Once formed, the creditors' committee first engages the professional services that it judges are needed. Next, it negotiates with the trustee or debtor-in-possession and oversees the general conduct of the debtor. Finally, it may request the appointment of a trustee in lieu of the debtor-in-possession.

Grounds for complying with this request are fraud, incompetence of the debtor, or a court judgment that such an appointment would be in the best interest of the creditors. The trustee or debtor-in-possession may request conversion to *Chapter 7* proceedings. In addition, the trustee or debtor-in-possession is responsible for filing, within 120 days of filing for bankruptcy, a plan by which the reorganization is to be accomplished. After this plan has been filed, the various classes of claimants have 60 days within

which to accept the plan, although the attorney for the debtor-in-possession may petition the court for extensions on these time limits. Courts are usually generous with such extensions. If a plan is not filed or accepted within the time allowed, then any interested party may file a plan of its own. Any plan which is filed must specify how the various classes of claimants are to be treated in the reorganization. An impaired class is a class of claimants that receives less than the full amount of its claims. A class is considered unimpaired if one of the following three conditions are met:

1. the plan provides for full payment of claims within that class,
2. the plan leaves the claims of that class unaltered after the reorganization, or
3. the plan reinstates a claim or interest, usually by curing a default.

The status of a particular class can be very important in acceptance or rejection of a plan because unimpaired classes which reject the plan can be overruled by the impaired classes. Thus if the debtor-in-possession wished to employ a plan over the objections of a certain class of creditors, the best means to accomplish this would be to arrange to leave that class unimpaired. The principle of "equitable subordination" can be used to leave a class unimpaired and at the same time give it very little. In the eyes of the law, the rate of interest paid on the debt may be decreased, or the period of time over which the debt is paid back may be increased without impairing the creditor. As long as the face value of the claim is paid, the creditor is classified as an unimpaired creditor. Using this tactic, cooperatives may seek relief from the debt service costs associated with large debts outstanding and unsecured.

In addition to specifying the treatment of creditors, the plan must also provide an outline as to how the reorganization is to be accomplished. This includes descriptions of the estate that is to be retained by the debtor, the transfer of any assets, any business combinations, the liquidation of any part of the estate, changes in the status of liens, indentures, defaults, or securities, reformulation of the cooperative's charter, and any new debt to be issued. Note: the assets may be completely liquidated under *Chapter 11* if the cooperative prefers not to convert to *Chapter 7*.

The plan must also state that the debtor will not issue any further nonvoting equity securities, and provide an outline of voting powers of the various classes of creditors in elections of boards of directors. Executory contracts may be continued or rejected in *Chapter 11*. The plan must state the future of these contracts.

Once the plan has been filed, it is the responsibility of the debtor-in-possession to submit to each claimant a court approved disclosure statement. The disclosure statement is a summary of the plan and the financial status of the cooperative. The purpose of the disclosure statement is to provide each claimant with adequate information by which they may decide to affirm or reject the plan. In short, the disclosure statement is a court proctored sales pitch. It is an important tool which the bankrupt cooperative uses to persuade creditors to affirm the plan. Choice of wording and presentation may change the fate of the plan, so cooperatives should not treat the task lightly.

In order to be affirmed, the plan must receive “yes” votes from at least two-thirds of the creditors in dollars, and more than 50% of the individual claimants who exercise their right to vote. Classes and claimants which accepted the plan prior to filing of the bankruptcy are counted as “yes” votes if the court finds that they were adequately informed at the time.

After the claimants have accepted the plan, it must be confirmed by the court. For confirmation, the plan must be legal, and all payments and provisions for promotion of directors must be disclosed. Further, all holders of claims or interests must have either received a settlement of at least what they would have received in liquidation, or have accepted the plan. Secured creditors must receive full value for their claims. A plan may be approved over the objections of a class of impaired creditors, if it meets court standards of equity. This is called the “cram down” option. It is seldom used because it is difficult to prove the legal conditions necessary for its implementation. Perhaps its existence is sufficient, because the threat of cram down can be an effective bargaining tool in negotiations with obstreperous creditors. Other conditions for court approval are that priority claims be paid in the order of their priority, that at least one class of claimants accepts the plan, that the intent of the plan not be the avoidance of taxes, and that the plan appear feasible.

Upon confirmation of the plan, the debtor is discharged from all debts that were incurred prior to confirmation, except non-dischargeable debts (certain taxes, wage claims, trusts, etc.), and debts which will be paid under the plan. This discharge may be revoked if it is found that the debtor used fraudulent techniques to obtain the requisite approvals for the plan.

## Summary and Conclusions

There are no special provisions in the United States Bankruptcy Code for cooperatives filing for bankruptcy. There are many provisions which do not generally come into use with cooperative petitions and these are not discussed in this paper. Cooperative bankruptcy takes one of two forms: liquidation or reorganization. Liquidation is the simpler of the two. In a liquidation, the cooperative’s assets are sold off, and the proceeds of the sale are distributed to creditors and stockholders according to a legally ordained hierarchy.

A reorganization under bankruptcy is much more complex because the changes in the corporate structure must gain the approval of certain interested creditors. More people are involved, making it more difficult to find a solution. Creditors must be paid off completely (in legal jargon, they must be unimpaired), or they must vote to approve the reorganization plan. As in liquidation proceedings, a hierarchy of creditors exists. A plan may be approved over the objections of subordinate impaired creditors if priority creditors vote to accept it. The plan must also be subjected to the “best interest” test, which means that creditors must receive more in the reorganization than they would have in a liquidation, unless they vote to approve the plan. The debtor is required to provide creditors with a “Disclosure Statement” outlining the proposed changes to be carried out in the reorganization. The “Disclosure Statement” is accompanied by a ballot.

Debtors usually have several different types of creditors. For a class of creditors to approve a plan, two-thirds of the class in dollar terms, and at least one half of the class in terms of numbers must vote “yes” on the plan. Creditors are advised by court appointed committees. These committees are generally made up of the seven largest creditors in the class.

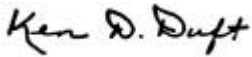
The advantage that a reorganization under the bankruptcy law offers a cooperative business is that it provides an opportunity to free the firm of overbearing debts and liabilities, while at the same time allowing it to continue its operations. A reorganization can save a business. It is most often recommended when the cooperative retains some viable components, but because of bad luck or unprofitable divisions, it is unable to pay its debts. The bankruptcy provides a means of separating the viable portion of a cooperative from those aspects of its operations which are dragging it down.

If a cooperative is having serious difficulties across the board, then a reorganization will probably not save the business.

The timing of a bankruptcy petition is crucial to a firm's success after the reorganization. Many firms resist bankruptcy too long, allowing their business to deteriorate too far before attempting a reorganization. Other firms have been guilty of the opposite mistake; they file too early, while other less expensive options still exist.

Under current law, it is possible for a debtor to void a labor union contract while continuing operations under bankruptcy proceedings<sup>3</sup>. The AFL-CIO is currently seeking legislation that would eliminate this employer option. Should this option be lost, it may alter, if not restrict, a cooperative's ease of transition into combined or reorganized forms under *Chapter 11*.

Finally, a debtor cooperative should not contemplate bankruptcy without first acknowledging the magnitude of the legal costs involved. Because legal counselors are priority claimants against the debtor, the cost of such services may materially affect the final outcome of the bankruptcy settlement<sup>4</sup>.



Ken D. Duft  
Extension Economist

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## References

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- <sup>2</sup> Harl, Neil E. *Legal and Tax Guide for Agricultural Leaders*. Century Communications Inc., Shokie Illinois, 1984, pp. 241-260.
- <sup>3</sup> "Legislative Alert! Bankruptcy Bill Pushed to Big Victory in House:" *AFL-CIO News*, Vol. 29, No. 13, p. 8, March 31, 1984.
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