

JB BANKING LAW TODAY

SOUTH OF THE BORDER, DOWN IOWA WAY

The Problem of Unauthorized Commodity Sales in States without a CNS

Perhaps the most important source of repayment for agricultural loans comes from the proceeds of commodity sales. Banks generally take a security interest in agricultural commodities and, unlike most types of commercial products, their security interests continue on the commodities notwithstanding their sale in the ordinary course of business, provided additional requirements are met. Specifically, the bank must either provide direct, written notice to commodities buyers of their security interest or they must file a CNS Financing Statement with the Minnesota Secretary of State.

If proper notice of the bank's security interest is given and the commodity buyer does not either secure a waiver of the security interest or issue a check in the name of the bank and the farmer, the bank can demand a second, full payment from the commodity buyer in the event that the farmer fails to remit the proceeds of the sale to the bank.

Given the foregoing, most banks think that if they properly file a CNS Financing Statement they are guaranteed to receive the proceeds of the commodity sales, even in the face of misconduct by their borrowers. Unfortunately, this is not always the case.

Iowa, unlike Minnesota, does not have a central notification system where banks can file notice of their security interest in agricultural commodities. As such, when dealing with Iowa commodities, the only way a bank can ensure that its security interest in the commodities continues notwithstanding a sale in the ordinary course of business is to provide direct, written notice to the grain buyer.

That said, many Minnesota banks with Iowa customers are aware of this difference in legal systems and take care to ensure that they provide written notice to all Iowa grain buyers.

However, there is a problematic scenario that many banks have not considered – what if their Minnesota borrower takes commodities grown in Minnesota, ships them down to a grain buyer in Iowa, misrepresents where the crops were grown and then fails to remit the proceeds to the bank? Under these circumstances, case law is flatly unclear as to whether the bank's security interest would continue in the commodity after the sale.

While the borrower could face civil and even criminal penalties associated with this type of fraudulent activity, that is no guaranty that it will never happen. It is remarkable what people are capable of when their backs are really up against the wall.

If the borrower commits this type of fraud, then the bank would be forced to pursue legal action against the grain buyer to recover the value of the commodities sold under a conversion theory. The buyer, in turn, will raise the defense that it had no notice of the lien or even that the crops were grown in Minnesota. It is flatly unclear who would prevail, but it is clear that this would be hard hitting, fact intensive litigation that would be very expensive and high risk for the bank.

So, how can a bank protect against this potentially very serious problem? By proactively notifying major northern Iowa grain buyers of its security interest in the farmer's commodities, even if the bank has no indication that its borrower has ever sold to that particular buyer.

Is this solution cumbersome? Yes, it is cumbersome and also unnecessary in many circumstances. As such, the bank should carefully assess whether it believes this action to be prudent. With a rock solid borrower who has a profitable operation, a bank could very reasonably determine that this action is unnecessary. With a struggling borrower who has already showed a willingness to liquidate collateral without remitting the proceeds to the bank, the bank should give much more

consideration to a proactive notification strategy. The bank simply needs to use its best judgment here.

Ultimately, banks need to be aware of this important issue, understand that a failure to give notice can result in tens of thousands, hundreds of thousands or millions of dollars of loss in the event of fraud, and craft policies and procedures that balance the potential for harm against efficiencies and the practical realities of a given situation.

-Matthew Bialick, Esq.

Outside Insights



A Forum for Thoughts and Articles from
Sources Outside of the Johnson | Bialick Law Firm

The Effect of Interest Rate Increases on Farming Operations in 2019

An Article by Thomas Walker, Jr. of Praeaxis Business Labs

Agribusiness is nothing if not spectacularly volatile, so simple prudence recommends an assessment of the impact of rising interest rates on the viability of farms in Minnesota.

We have no shortage of formidably-credentialed experts proclaiming peace, because the tariff war is cooling, because the worst is over and balance sheets are still strong, because the Federal Reserve has recently gone dovish under Jerome Powell's helmsmanship, etc.

Working directly with those with skin in the game—namely the farmers and lenders who help finance them—gives us a different perspective. They are already baking assumptions of interest rate increases into their forecasts; the only uncertainty on a local level is the severity of the impact.

“This time is never different,” it is said by wise analysts, and I offer as the practical corollary, *if it happened, it can happen again*. As to interest rates, the exposure is

brehtaking. Looking at historical rates reported by the Kansas City Federal Reserve on ag loans, rates were just 4.38% in 2017; the average since 1997 is 6.12% and looking back to 1977 bumps the average to 11.35%. Rates spent 12 long years in double-digit range, with the notorious high in 1981 of 18.46%.

We propose to test a more modest increase of 2.5% for Minnesota farms, on top of a 4.03% base in 2017 (Minnesota farm data, derived from data aggregated at <https://finbin.umn.edu/>). The tour through recent history illustrates that while such an increase is more than we hope for, it is by no means unprecedented—we saw three success years of steep increases in 1979-1981, 2.26%, 3.34%, and 3.23%.

That farms are under serious financial stress is widely recognized. Minnesota farms (all data from here forward is from finbin) broke even, with \$30,000 to spare in 2017; various scenarios that our firm has run suggest even bare

breakeven is a pipe dream, on average, for 2018. With no change in interest rates we see a loss of \$50,000, and an erosion of working capital to \$120,000, down from \$200,000 in 2017 and well off the peak of \$470,000 in 2012.

More soberingly, without serious reduction in key costs (crop inputs and land rents dominate calculations here) working capital is entirely gone [negative] by 2020.

What impact from rising rates? Interest charges in 2017 were \$37,000, and with no rate change might be \$42,000 in 2018. An increase from 4.03% to 6.53% would yield a \$67,000 interest charge. The net loss grows to \$75,000 and the zero-working-capital-date moves from 2020 to 2019. What this change does not produce, however, is a sudden, negative reversal of fortune. It merely hurries the decline along.

The big story in a regime of rising rates is not operational, it is valuation. That may be the silver lining, in the long term. Land valuations across the lower half of Minnesota remain north of \$6,000/acre, based on recent sales, and land rents average \$206/acre. \$206 is at least \$50 too high relative to the historical correlation between income from farmland and rents; even so, \$206/acre yields a capitalization rate of well under 3%, itself something like half the historical average.

Cap rates on land, unsurprisingly, correlate strongly to the general rate of interest. What if this 2.5% rise in general interest were attended by a 1.25% rise in cap rate? At

\$206/acre with current real estate taxes, we get \$3,800. As a more striking benchmark, what would a reset of both rents (\$150/acre) and land cap rates (assume 5%) yield in true value? **\$2,500.**

This is not a prediction, but a clear indication of the downward pressure on land values, but also a clear indication of the *need* for a sufficient cost-of-production reset to restore farms to a sufficient level of profitability and begin to rebuild their working capital.

A last note, on this question of what is “sufficient”: the clearest single measure of sufficiency of profit is the return on assets, simply EBIT / assets. For long-term viability it needs to equal the cost of funds; for long term growth and robustness some margin of error is needed additionally. In our Minnesota farm dataset, the average ROA since 1997 is 6.62%; the cost of funds is 5.51%. Since 2013 that pattern has been inverted and unsustainable—in 2017 a 2.2% ROA was matched against a 4.03% interest rate.

So, we see that what is necessary to restore profitability in the long term presents us with a short-term knock to the balance sheets: an adjustment that is certain to be painful but entirely essential to the long-term health of the industry.

-Thomas Walker, Jr., Agricultural Economist with Praevis Business Labs, 651-999-9970

Installment 6 of the Johnson | Bialick Agricultural Webinar Series ***“Successfully Navigating Through Farmer Bankruptcies”***

The troubled agricultural economy has already resulted in a sharp increase in bankruptcy filings, with many more projected in 2019. This webinar will examine the various chapters of bankruptcy that are likely to be filed by farmers and it will provide practical insight on how bankers can successfully navigate through the different types of bankruptcy.

Registration Link: <https://register.gotowebinar.com/register/5426665322927917058>

THE ENLIGHTENING ROUND

Q: What should you do when a customer who is struggling financially comes through with a very large, unexpected payment?

A: Inquire into the source of the funds and document this inquiry and the answer received by the borrower. The payment could have come from the unauthorized sale of the bank's collateral, which itself may be a default under the loan documents. The payment could have come from the liquidation of key equipment necessary for the borrower's operation, which could then render the operation unviable. Or, the payment could have come from the liquidation of another lender's collateral, which could potentially subject the bank to a lawsuit down the road. Asking questions as to the source of the funds serves two purposes. First, it gives the bank valuable insight which may prompt the bank to declare a default, non-renew the credit or reject a payment. Second, it evidences a reasonable inquiry by the bank as to the source of the funds, which could form a defense to subsequent litigation if the borrower obtained the funds through improper means.

Q: Are the procedures for liquidating FSA Guaranteed Loans more or less the same as for normal liquidations or are there additional requirements that I need to be aware of?

A: When liquidating FSA Guaranteed Loans, banks must observe a number of requirements, procedures and documentation standards that are not applicable to traditional agricultural loan liquidations. Failure to follow these guidelines can reduce/invalidate the FSA guarantee and even invalidate the liquidation itself. The applicable procedures are governed by federal law and are set out in the FSA Guaranteed Loan Making and Servicing Guidelines (available online). Additionally, the Johnson | Bialick law firm has distilled the major liquidation requirements down into a 10 page process sheet, which is available to banks upon email request.

Custom Training Sessions for Banks

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- ❖ In furtherance of its commitment to education, the firm offers in-person, telephonic and online training sessions for banks.
- ❖ To schedule a custom training session at your bank, contact Matthew Bialick at matthew@jblawmn.com or 952-239-3095.

