

J|B BANKING LAW TODAY

2019 PLANTING SEASON PRIMER

3 Things Every Ag Bank Should do Before Planting Season

Planting season is always a hectic and challenging time for farmers and Ag banks alike. Borrower financials are reviewed, renewal decisions are made, loan documentation is executed, FSA approvals are sought and loan proceeds are disbursed, among other things. And, things only get more challenging in a troubled economic climate, like the one farmers and their banks face in 2019.

Going into the 2019 planting season, there are three things that every Ag bank should do:

Conduct Appropriate and Thorough Due Diligence on all Troubled Borrowers.

This one seems like a no brainer, except that it is important to realize that the phrase “appropriate and thorough due diligence” should mean more in distressed financial times than in good financial times. In troubled times, banks need to do more than just look at the numbers and the trends, they need to make sure the numbers are correct using all available sources of data. This means conducting a collateral proceeds audit.

A collateral proceeds audit first involves reviewing cash flow projections over the last 2-4 years and calculating a grand total for projected grain sales over that time period. Then, banks should review deposit accounts records over that time frame to ensure that the actual receipts from grain sales roughly match the projections. A fair amount of deviation is to be expected, given that cash flow projections are just estimates, but if the audit shows

substantial discrepancies between projections and sales, banks should know that they need to ask more questions.

Too little in the way of proceeds could mean that the borrowers are liquidating grain out of trust and depositing the proceeds into another bank account. Too much in the way of proceeds could mean that the borrower is liquidating substantial grain reserves to pay off other creditors, which could signal instability in the operation and could lead to financial misrepresentations if the borrower subsequently represents to the bank that their grain stores remain unchanged. In either event, discrepancies could signal problems that require immediate attention.

Have a System in Place for Ensuring that Loan/Operating Line Proceeds are Used for their Intended Purpose.

One of the most damaging defaults that can be committed by a borrower is to use loan/operating line proceeds for purposes other than their intended use (e.g. purchase of crop inputs). This type of default might seem unthinkable to banks, but it can and does happen.

A problematic scenario in this regard can arise when the borrower starts falling behind with other creditors, lenders or service providers that may or may not have been disclosed to the bank. Said parties might aggressively pursue collection action against the borrower which may cause them to panic and use loan proceeds to pay off prior debt rather than purchase new crop inputs.

This scenario is so damaging because in this case the money is gone, no crops are produced, any corresponding futures contracts become totally valueless and there is often no easy recourse against the creditors that received the improper payment from the borrower.

That said, the bank can protect against this calamitous outcome by asking questions, monitoring the borrower's bank account, requiring prior substantiation on expenditures (quotes, invoices, etc.) and through allowing payments to be made only to suppliers directly (rather than by simply dumping the funds into the borrower's checking account).

While the borrowers may not like increased oversight, it may be absolutely necessary given the consequences of fraud in this regard.

Follow Proper Procedures on FSA Guaranteed Loans/Operating Lines.

The last thing that banks should do to protect themselves around planting season is to follow all FSA procedures regarding servicing, renewing, and liquidating FSA guaranteed loans and operating lines.

This process starts by ensuring that all sales of the 2018 crops are properly applied against outstanding balances on FSA guaranteed loans. This can get very complicated when there are multiple interrelated loans to the borrower with some of the loans being FSA guaranteed loans and some of the loans being non-FSA loans. In such circumstances, collateral proceeds should carefully be applied against the FSA guaranteed loan first -- unless the conditional commitment provides that the FSA has a subordinate lien on the collateral, in which case the proceeds should be applied consistent with the commitment.

The bank should also consider conducting the collateral proceeds audit (discussed above) at this time to ensure that any past commodity sales were properly applied against the FSA loan. If they were not properly applied,

the bank needs to be aware that they might be facing a dollar for dollar reduction on the guaranty payment if the loan ultimately goes into default (e.g. if \$200,000 in grain was sold in late 2018 and not applied against the FSA loan when said loan had a first lien on the grain, the FSA would likely reduce the ultimate guaranty payment by \$200,000). Catching the misapplication early enough could allow the bank to fix the problem through actions such as a refinance.

The next step in the process is for applicable lenders to obtain FSA approval of annual operating plans for lines of credit. This involves submitting accurate and up-to-date financial documentation and cash flow projections. The failure to obtain an approval that was based upon accurate and up-to-date information can result in a reduction or an invalidation of the FSA guaranty.

The final step in the process is to appropriately and decisively attend to FSA liquidations for loans and lines that are non-renewed. Defaults should never simply be swept under the rug when it comes to FSA guaranteed loans. Strict timelines come into play and specific liquidation standards apply the minute an FSA loan goes into default. Delay or failure to follow said guidelines can result in a reduction or invalidation of the FSA guaranty.

Conclusion

2019 presents a level of risk and difficulty that has not been seen in Minnesota since the farm crisis of the 80s. While we are not necessarily in for a repeat of the 80s, prudent banks understand that the risk profile in ag lending has, at the very least, greatly increased and some type of market correction is a distinct possibility. As such, doing things because "that's the way they have always been done," is not a good enough reason anymore. Banks need to be vigilant, diligent, knowledgeable and tight with their lending, workout and FSA practices and procedures to be safe and profitable in 2019 and beyond.

-Matthew J. Bialick, Esq.

Outside Insights



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

The Economic Forecast for Farmers and their Lenders in 2019

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

The ongoing pain in Minnesota agriculture has rather belatedly received attention in the mainstream press. Awaking to the trouble is not inherently useful, unfortunately; the relevant question is always “What can we expect next?”

If not exactly counter-cyclical, conditions in livestock have tended to mitigate rather than amplify the losses, so we will focus on crop production here. The historic mismatch between crop yield and prices, cost of land, and cap rates on owned land have been persistent; so too, the higher costs of personnel, seed, fertilizer, and chemical.

As tends to happen in economic booms—the last one peaked in Minnesota circa 2012—rising output prices pull the inputs up with them, but the inputs are slower to respond to the downward pressure from outputs in the economic bust.

On average, given these challenges, 2018, at least on paper, was less disastrous in crop farming than was economically conceivable. Looking at the crop farmers operating south of I94, we find that on 912 acres (all numbers average across 900+ farms reporting), farm units earned \$15,000 on gross sales of just over \$600,000. Yields were 181/corn and 54/soybean (this rotation dominates the region, on average other crops barely register). Prices received were reported as \$3.37 and \$8.41, respectively.

Many of us have been around long enough to recall when such price and yield combinations were beyond the realm of pipedream in even the most productive counties in Minnesota, much less clocking in as the average. While overhead has largely held steady for some years, the crunch is created by still-high land rents (\$206/acre) and crop inputs (\$254).

Those are details; the cold hard reality is that working capital has continued its bleed-off since reaching a high of \$540,000 in 2012. 2019 opens with less than half that, just under \$200,000. Additionally, return on assets, both a predictor of resilience to risk and of future prospects, continues to bump along at well below the cost of funds, 2.5%.

What then for 2019? Few people expect retracement in rents or land prices, nor in inputs. Prices are little better than last year's, although hope springs eternal, so the pressure to build that into the cash flows to insure positive results is certainly with us again. Using a “hold-the-line” approach to all costs and setting corn and soybean income at entirely reasonable levels, say 190/\$3.30 and 50/\$8.40, our average farm nets us a \$45,000 loss and a further erosion of working capital to \$120,000. It isn't a business-breaker, but with essentially zero-to-negative results since 2013, it does call the question as to how long people will settle for going broke slowly.

It may be more helpful to look at what price/yield it would take to give a return on assets equal to current cost of funds. It is also useful to test a more negative scenario. First, the good: given the projected yields above, \$4 corn and \$10 soybeans give us a ROA of 5.8%. Possible? Of course. Worth the bet? Those with skin in the game might decide otherwise.

And now, the not-so-good: setting our combination at 180/\$3.00 and 45/\$7.50, the farm loses \$150,000 and

experiences a loss of all but \$20,000 in working capital.

If there is a silver lining, it is that the averages suggest there is still time—just--to get one's house in order for a period of significant adjustment in agriculture. And further: for those who do take the time to prepare for the worst case, the economic crisis is also the economic cure.

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

Important Legislation Update

Federal lawmakers have just introduced a bill that would raise the debt limit for a Chapter 12, family farmer bankruptcy, from \$4,153,150 to \$10,000,000. This change allows much larger farming operations to seek the more streamlined reorganization process of a Chapter 12 bankruptcy, as opposed to the longer, more cumbersome process of a Chapter 11 bankruptcy, which was previously the only option for farmers with total debts between five and ten million dollars.

THE ENLIGHTENING ROUND

Q: Does an agricultural supplier furnishing crop inputs need to send separate lien notices for each sale in a given season, or can they simply send one notice indicating that sales have/will occur?

A: Either approach can be legally effective, but the key issue in this regard is whether the lien notice contains an accurate total of the aggregate costs of the crop inputs furnished in a given season. This is important because the applicable statute is clear that the supplier can only get a lien in the dollar amount stated in the notice. As such, if a supplier sells inputs, sends a lien notice stating the costs of the inputs and then subsequently makes additional input sales, they would have the argument that the single notice covered all sales, but they would still be limited to the dollar amount stated in the first notice.

Q: If a crop input lien notice is sent by US Mail is that effective service?

A: No, the statute states that these notices must be sent by certified mail or another verifiable method of delivery for service to be effective.



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