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M|J|B BANKING LAW TODAY

THE ANATOMY OF A COLLAPSING AG DEAL

The Progression Ag Loans Tend to Follow When they Go Bad

Entering the 2019 harvest, farmers and agricultural banks face a desolate economic landscape. The corn price rally that occurred earlier in the summer has come to an abrupt end, and below average yields are anticipated due to prounced flooding during the planting season. The result is that many operations will fail in Q4 of 2019 and in 2020.

This article examines the progression that typical ag credits tend to follows when they fail.

Phase 1: Trouble on the Horizon

- The Borrower starts requesting financial accommodations such as loan extensions, reamortizations, and interest rate reductions.
- The Borrower starts submitting financials that show either losses, substantially reduced profitability, an increase in creditors/debt, or purportedly benign "mistakes."
- The Borrower starts submitting financials that are unusually positive given the current economic climate.
- The Borrower starts submitting financials where certain numbers stay exactly the same as last year's numbers, when changes would typically be expected (crop on hand, prepaid inputs, etc.).
- Deposit records show that commodities proceeds are wildly different than what was expected in cash flow projections.
- Equipment that appeared on a previous equipment list is inexplicably omitted from the current list.
- The Borrower starts opening up new bank accounts at different banks.

Phase 2: Default

- The Borrower starts making loan payments late or failing to make payments altogether.
- The Borrower starts making representations that they are seeking refinancing elsewhere so that the Bank does not need to take collection action.
- The Borrower starts making representations that they will be looking to voluntarily liquidate some or all of the assets so that the Bank does not need to take collection action.
- The Borrower starts secretly liquidating commodities in a different state and failing to remit the proceeds to the Bank.
- The Borrower starts liquidating commodities through family members or friends and failing to remit the proceeds to the Bank.
- The Borrower starts liquidating equipment and failing to remit the proceeds to the Bank.
- The Borrower fraudulently transfers assets to family members and then claims that the assets were never theirs to begin with (particularly a problem in cattle operations).
- The Bank receives notice that the Borrower has been sued.
- The Bank receives garnishments from creditors of the Borrower.
- The Borrower misappropriates loan proceeds and uses them to pay off other creditors.

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Phase 3: Collection Process

- The Bank assesses liquidation prospects and realizes that it stands to suffer large losses through traditional collection procedures due to: (1) depressed markets for commodities; (2) depressed markets for agricultural land/equipment; (3) improper liquidation of commodities by the Borrower; (4) fraudulent transfers by the Borrower; (5) fraudulently diverted loan proceeds by the Borrower; and (6) improper offests by agricultural good/service providers.
- The Borrower refuses to voluntarily relinquish or liquidate collateral, or they say they will do so themselves as a stall tactic but never follow through.
- Farmer-Lender mediation becomes a vehicle for delay as no resolution is generally possible at the onset, and the Borrower makes proposals that are not reasonable or appropriate.
- The Borrower declares bankruptcy and may even engage in sequential bankruptcies with their spouse in order to maximize disruption and delay.
- A revolving door of attorneys appear to represent the Borrower and then fade back out. These attorneys tend to employ a mix of aggression and implausible resolution proposals.
- Intense intercreditor disputes errupt as it becomes clear that the only way the Bank can be made whole is to: (1) vigorously defend its priority position against other banks and statutory lien creditors who also claim an interest in the Borrower's assets; (2) assert claims against creditors who received fraudulently diverted loan proceeds; (3) assert claims against commodities buyers who failed to observe assignments or CNS financing statements; and (4) assert claims against commodities buyers who improperly offset commodities proceeds against past amounts owed to the buyer by the Borrower.
- The Bank is forced to bring fraudulent transfer claims against the Borrower's family members and friends who were the recipients of fraudulent transfers. These disputes can also involve other banks if the recipient of the fraudulent transfer pledged those assets as collateral for a loan with the other bank.
- Foreclosure proceedings tend to be far more complicated than normal foreclosures given the messy web of lenders, statutory lien creditors, and mechanic's lien claimants that may claim an interest in the agricultural propery.
- Even simple lawsuits can become inexplicably drawn out and difficult given the sympathy judges tend to have for farmers.
- The Bank either needs to walk away from a deficiency judgment against the Borrower or go through a statutorily mandated jury trial, which must occur after the sale of the agricultural property. The Bank might also be forced into this proceeding – even if it would otherwise be willing to walk away from the deficiency – if the loan is an FSA guaranteed loan.
- Given the length of the liquidation process and fluctuations in property values, the bank may realize liquidation proceeds that are markedly different than what was expected at the onset.
- Agricultural property generally sells for less, or even far less, than the forced liquidation value specified in applicable appraisals.
- Traps for the unwary are peppered throughout the collection process, with one particularly noteworthy example being the statutory right of first refusal connected to agricultural property.

While all of the above mentioned issues/events do not occur in all cases, many do occur in most cases. Knowing what will happen does not necessarily make the process easier or less painful, but it does minimize the risk that the Bank (or its attorney) will make a mistake that severely compromises the Bank's liquidation prospects.

-Matthew J. Bialick, Esq.

Outside Insights

A Forum for Thoughts and Articles from Sources Outside of the M|J|B Law Firm

Assessing the Prospect of a Zero Working Capital Scenario by Year's End

An Article by Tom Walker of Praexis Business Labs

"All models are wrong, but some are useful," goes the aphorism. So too should we regard any of our forecasts for the ag economy, whether macro or micro.

Properly deployed, forecasts set the boundaries between risk and uncertainty. Setting crop farm forecasts, history, industry, and mostly, the experience and knowledge of the owner/manager, set bounds for what is plausible, what is implausible, and what lies between.

Months ago, our Minnesota crop farmers were setting forecasts that they thought were realistically achievable and then presented to loan officers who would offer advice and consent, and in most cases, continued financial backing.

You expect this give-and-take, the intersection of competing and complimentary goals, to lead to sustainable results over time.

In a volatile, one-swing-per-year business such as crop farming, you also expect that not every year is profitable. We are ready for even a sequence of years with results that, stretched long enough, would NOT be sustainable. But the industry ebbs and flows, boom follows bust. Clearly, both farmers and their financiers have been making this historically defensible judgment for the current year.

Last year rendered another breakeven year, with working capital still positive. On the balance, our statistical sample, the FINBIN-reported group of crop farmers in the southern third of Minnesota, remained ready to swing again in 2019.

Last year, however, was the *6th* such year in a succession breakeven (as accounting measures it). This presents the longest stretch of profit-free operations stretching back to 1998.

Moreover, working capital since its peak at the end of 2012, $540,000, is now reported at $200,000.

This year's results remain unknown, although we have much fodder for speculation. Forecasting another year of zero accounting profit requires all costs held at 2018 levels; corn yields and prices of 200 bushels at $3.70 farm gate; soybeans at 55/$9.50. This scenario would also hold working capital steady at $200,000. At least in isolated cases, it is not implausible, for those who used contracts to lock in the until-recently-available higher prices for 2019 production.

Relying on more current crop prices, and the tendency for most crop to be raised and even stored un-hedged, and guesses as to yields relying on anecdote, worse scenarios are at least likely.

How these interact in real time with MFP, prevented plant, and ordinary insurance payments only extends our scope, so in the interest of space, I will summarize: **The complete disappearance of remaining working capital and an attendant loss of $200,000 are plausible with corn yields of 180 bushels and soybeans at 45.**

What does it take to restore the average crop farm to economic breakeven? (Note that I don't refer to accounting breakeven, but rather, a profit sufficient to return to assets the cost of money.) With no retracement in costs, 200 bushel corn at $4, soybeans at 60/$9. Possible? Of course. Probable? You might begin to question the likelihood that sustained high yields would also reliable give us $4 corn.

It seems that a necessary step toward some sustainable profit level in farming is an adjustment in key inputs, namely land and seed/fertilizer/chemical. These rose steeply with prices in the boom leading up to 2012 and have been far stickier in responding to falling prices since then.

Asset price declines are broadly seen as crises, but with respect to returning Minnesota farms to some sustainable level of profit, the crisis may also be the cure.

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

Important Legislation Update
Family Farmer Relief Act

On August 23rd President Trump signed the Family Farmer Relief Act into law. This legislation immediately raises 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. It is anticipated that this change will trigger a number of bankruptcies by farming operations within this debt range

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