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Does Your Bank Actually Have a Perfected Security Interest in Crop Insurance Indemnity Proceeds? The Answer Might Surprise You.

Many Minnesota farms either have received, or shortly will receive, crop insurance indemnity payments given the poor growing conditions in 2024. Most banks assume that they have a perfected security interest in indemnity payments made under a crop insurance policy, even in the absence of an executed assignment of indemnity, by virtue of an all assets UCC filing.

But do they really? The answer is not as straightforward as it may appear.

The first question in the analysis under the UCC as enacted in Minnesota is whether the bank can perfect a security interest in crop insurance indemnity payments by virtue of a UCC filing. The answer is yes, but only if the bank has a security interest in the crop itself, as opposed to having only a security interest in accounts or payment intangibles. The reason is that insurance payments directly connected to a bank's other collateral (such as crops or machinery) is considered a "proceed" that is covered by Article 9, whereas insurance payments unconnected to a bank's other collateral (such as life insurance) are not covered by Article 9.

That said, this is not much of a limitation, because it is unlikely that a bank will feel entitled to a crop insurance indemnity payment if it does not also have a lien on the crops themselves.

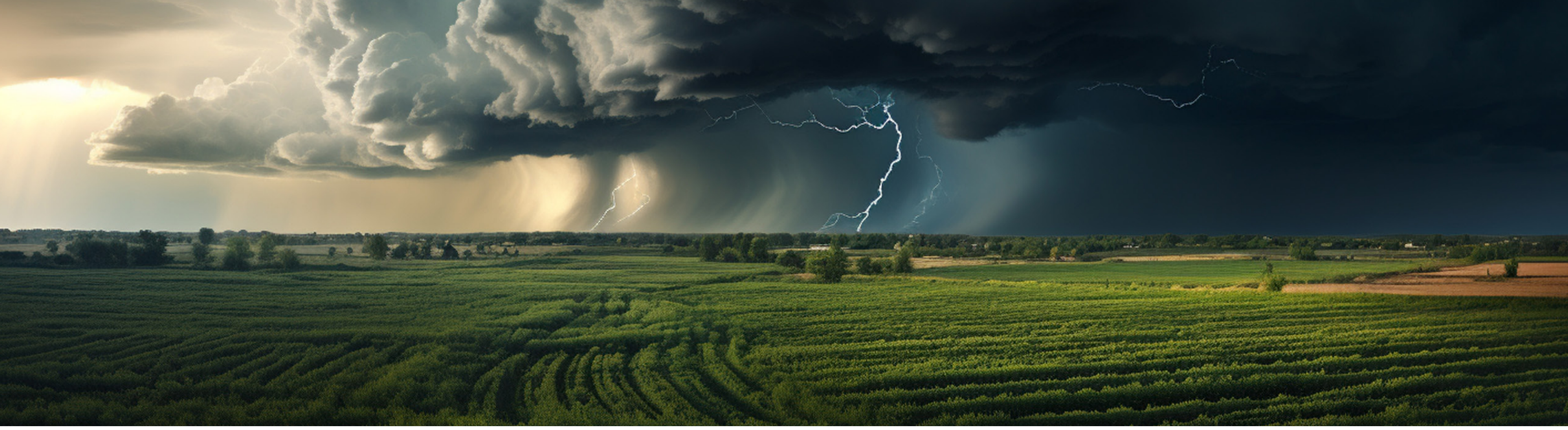
The second question is much stickier—is the entire UCC preempted by the Federal Crop Insurance Act?

There are two applicable federal provisions that come into play in answering this question:

> **7 USC Sec. 1509, which provides that "claims for indemnities under this subchapter shall not be liable to attachment, levy, garnishment, or any other legal process before payment to the insured;" and**

> **7 CFR 400.352, which provides that states may not "Impose or enforce liens, garnishments, or other similar actions against proceeds obtained, or payments issued in accordance with the Federal Crop Insurance Act."**

Taken together, one might assume that the UCC is completely supplanted in the area, and that the only way a bank can obtain a valid perfected security interest in an indemnity payment is through an assignment of indemnity. However, courts that have addressed this issue have been hesitant to reach this conclusion despite the applicable language. The most common view—including the view hinted at in a Minnesota bankruptcy case—is to regard this language as only prohibiting a creditor from taking action to intercept crop insurance proceeds "before" they are made.



In other words, the bank (in the absence of an assignment of indemnity) cannot send a demand for payment to the insurer directly or name the insurer as a party to a lawsuit, but the bank can go after the proceeds after they have been paid to the farmer.

Courts view the broader language in 7 CFR 400.352 as either overstepping the bound of rulemaking authority slightly, or needing to be read in harmony with the more narrow 7 USC Sec. 1509 which only discusses actions "before payment to the insured." However, this result is a bit strange, because it essentially means that indemnity proceeds are unperfected until the moment they are paid to farmers, at which time the perfection immediately and automatically snaps into place. This result is practically challenging as well, because if the borrower has committed fraud, the defrauding borrower will almost certainly gain uncontrolled access to indemnity payments, leaving the bank to chase money after it has been received by the fraudster (which is very challenging).

The second approach adopted by a minority of courts, including a bankruptcy court in the 8th Circuit, is to strictly construe both 7 USC Sec. 1509 and 7 CFR 400.352 and find that the only means of obtaining a perfected security interest in indemnity payments—either before or after payment to the farmer—is to file an assignment of indemnity. If embraced, this means that every bank with a UCC filing, but no assignment of indemnity, has no special rights to recover indemnity payments either before or after payment to the farmer. This is draconian, but fully consistent with federal law.

The final approach, which I have not yet seen adopted by a Court, but which is fully reasonable, is to find that 7 USC Sec. 1509 only applies to attempts by parties who do not have a perfected security interest in the farmer's crop to obtain an interest through a judicial remedy like attachment or garnishment, and then further find that 7 CFR 400.352 either exceeds valid rulemaking authority, or else does not operate to completely preempt the UCC. This could be because the phrase "liens" applies only to things like statutory agricultural liens, rather than UCC security interests, or other statutory reasons. This interpretation is probably the most strained, but it avoids the odd result of a security interest essentially snapping into perfection upon payment to a farmer and it avoids the practical harms that could befall banks by making indemnity payments directly to farmers who could be inclined to defraud their banks.

Ultimately, we simply cannot say for certain how a court in Minnesota (probably a federal court given the issues at play) would rule on the questions of:

1. Whether a bank can seek claim and delivery of crop insurance indemnity payments after they have been made to a farmer; and
2. Whether a bank can permissibly seek claim and delivery of crop insurance indemnity payments from an insurance company, if the bank also names the farmer as a party to the litigation.

In light of this uncertainty, one thing is clear (and disturbing), the only way to guarantee that your bank has a perfected security interest in crop insurance indemnity payments is to take an assignment of indemnity.

Anything less is taking a large risk.

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Navigating Banking Cycles in the Unfolding Agricultural Crisis

Our world runs on cycles. Every morning a new day begins as the sun rises, closes out when it sets and starts again the next day. Water becomes a vapor, condensates into a cloud, then falls as rain to start the cycle over again.

Banking also has cycles. On a core level, we go through the renewal cycle on our credit portfolios where maturing loans need to be reassessed and extended. We are currently seeing two different cycles converging that will stress our banks in the foreseeable future. One of the cycles is related to commercial real estate, the other, which is the topic for this newsletter, is the farm cycle and its impact on our credit portfolio. By being proactive in addressing the threats we are facing, we will be able to protect the integrity of our bank as well as add significant value to our client relationships.

Many of the cycles that impact the banking industry are directly related to the economic marketplace. The financials of any bank are a function of the impact of the factors related to the economy plus bank managements response to the impacts. Making the right decisions, recognizing the threats arising from the marketplace and taking solid action early enough, will save the banks from losses, possible regulatory action and possibly protect your borrowers from losing their business.

Some cycles have inconsistent periods, coming only once in a lifetime. Others are quite short, occurring on a regular basis. Depending on the duration of your career, you may go through several cycles of certain occurrences while others may never happen. The key is to remember the cycles you do go through, recognizing what decisions were good and which ones might have done better.

We are now in the midst of a rather nasty agriculture cycle that is turning into a perfect storm. Because of a drought a couple of years ago, trade policies that allow for political leverage but negatively impact the farmers, as well as an inflation cycle, the worst in 40 years, our farm clients are getting pummeled. We are actually still on the front side of this farm crisis. How bad it actually gets depends on what your bank management does right now.

Our last true farm crisis was in the early 1980's, few of us were in banking back then, but the cycle is beginning to repeat itself. In that farm crisis many of the same marketplace impacts were affecting farmers that we are seeing today. Low crop prices and ever increasing crop inputs due to high energy prices caused an issue with farmers repaying their seasonal financing. Bankers at that time refinanced the short term loans into longer term financing by relying on the high land prices. Sadly, collateral does not repay debt, cash flow does. As farmland values crashed, banks were forced to foreclose, creating a volatile environment not seen since the depression of the 1930's.

In the fall of 2022, most of our farmers were flush with cash. Banks financed the crop input needs in early 2023 with the expectation that the debt would be paid at harvest. During the summer of 2023 crop prices collapsed. That fall farmers requested extensions as they felt commodity prices would rebound and the debt outstanding could be paid in early 2024. The bankers went along with the request. Sadly, prices have remained low. Compounding the problem, the banks provided crop input funding for 2024 without changing any of their behavior regarding credit structure.

Farmers promised to sell their existing crop holdings as well as the 2024 crop when it was harvested. As prices remain at post pandemic lows, to a point where farmers are reluctant to sell yet again, the debt remains unpaid. At the level of debt outstanding for many farmers, the continued crop prices being beneath a break-even point, and cash flow on the farm at critical levels, it is hard to imagine how farmers will be able to plant anything in 2025.

On the bank side, we are currently faced with a number of risk management decisions, none of which are pleasant. As prior financing matures, we can not continue to extend without changing our terms, otherwise we risk creating a course of dealing, which will make it harder to call a default in the future. Restructuring the existing debt into a term loan, ala the 1980's, only creates more problems as the farms are not generating enough cash flow to repay the interest on the lines, let alone trying to amortize the debt.

As bankers we need to solve our clients' problems which is going to require some very difficult decisions. We need to immediately have all our agriculture files reviewed by legal counsel to assure we have bomb proof documentation and that our files are in perfect order.

The next step is critical, we need to assess whether our clients have a liquidity issue or a solvency issue. Bankers need to get out of the office and into the field. They need to personally inspect the collateral pledged. This means measuring the amount and quality of the crop in storage. Crops held since 2023 have to be proven to still exist and most importantly, are still of the quality that the market will purchase at the going price.

Before discussing any type of financing extension on any of the short term debt, the bank has to come to a firm understanding, can the currently held crop be sold at this time to cover the existing debt? If so, the borrower has a liquidity issue. The negotiations need to ensue with the outcome to have the farmer sell a sufficient amount of inventory to repay the bank by the most amount possible. Going forward requires that the farmer enter into a forward contract to assure a full repayment as promised on any new crop input loans. Otherwise, the farmer is carrying you along with the risk they are taking on. With a forward contract you can be assured of timely repayment and managed credit risk.

> **"As bankers, we need to solve our client's problems which is going to require some very difficult decisions."**

If the currently held crop is insufficient to fully cover the outstanding debt, a determination must be made on the break even point of the crop price, how far away is the break-even point per ton or bushel and what is the probability that it will be reached in the near term. In this case the borrower has a solvency problem and the bank has an impaired loan.

The bank will have to negotiate with the borrower to reduce the outstanding debt by selling the collateral at a loss if necessary. The relationship has to be downgraded to substandard and the proper loss allowance recognized. Yes, adding the real estate as collateral is required, but under no circumstances do you term out the short term debt or advance more funds. That does not solve the farmers problem, it just creates more issues.

Examiners are already keying in on the troubles of the farm. They are aggressively downgrading carry over credits. In order to protect your bank, making the right decisions that address the reality of the current marketplace as well as solving your client's problem to reduce the debt while properly structuring future financing is crucial at this time.

—Brad Stevens

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