

Dealing with Defaults on Crop Inventory Carryover Loans

In my experience, perhaps the riskiest—or at least the most potentially problematic—agricultural loan type is a **crop inventory carryover loan**. Even at its very best, this loan type is a bit concerning because it likely signals that the borrower either did not effectively handle, or is not happy with, their crop marketing and is willing to incur storage and interest expenses to carry grain into the next growing season on the bet that prices improve.

At its very worst, this loan type signals that the borrower has circumvented the bank's CNS, liquidated existing grain inventory out of trust, deposited the funds into an account at a different bank and then either transferred the funds to family members, used them to pay other creditors, or used them to get through the planting season. If that occurred, the bank either has a completely unsecured loan to a financially distressed borrower who has committed fraud, or else it has to cannibalize collateral on other loans to recover on the inventory loan—which will almost certainly push the entire credit into an under-secured state.

Another potentially negative scenario (albeit less nightmarish), which is definitely occurring in 2024, is that prices continue to drop into the next growing season, with no foreseeable reprieve in sight. This means that the borrower incurred additional storage and interest costs on a bad bet and the grain inventory has further declined in value. This leads the borrower to the difficult

choice of either incurring further carrying costs on the desperate hope that prices increase (or at least do not decrease further) or selling the grain and locking in the loss. And, it creates the undesirable choice for the bank of either extending an increasingly high risk loan, or else defaulting the borrower for non-payment and potentially toppling the whole operation.

If the borrower and bank decide to go the “delay and pray” route, the risk is further exacerbated by the fact that if the borrower was unhappy with the prices earlier in the year, they are unlikely to have priced their new crop at the start of the growing season, meaning if prices stay low into harvest, they may lock in low prices on two different growing years simultaneously. This, paired with a year of low yields (which is also likely in 2024), can plunge the borrower from having a working capital surplus, to being in a state of financial crisis almost overnight.

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A financial crisis like this means that the bank will either need to get deeper into trouble and make very high risk loans at the start of the next growing season, or will have to force the operation into liquidation in what is now a very likely under-secured scenario.

It also means that the odds that the borrower sells grain out of trust, or starts fraudulently transferring assets to other family members (to keep the farm going, just under someone else's name) increases exponentially.

So, in light of this potential quagmire, what is the best solution for banks when an inventory loan goes into default? In my experience, the (admittedly harsh) answer is to view inventory loans as "last chance" loans from their inception and be very strict about enforcing payment dates.

If payment is not made, I recommend starting by immediately demanding that the borrower allow a grain inventory inspection. This will reveal whether you are dealing with a standard crop inventory default or the nightmare scenario where the borrower has already liquidated the grain out of trust. Refusals to allow inspections by the borrower should be treated as admissions that all or most of the grain has been liquidated out of trust.

If the grain is accounted for, but the borrower still will not make payment, I recommend defaulting the borrower and sending out Farmer-Lender notices. The borrower will have ample time to voluntarily liquidate grain and the bank and borrower will have ample time to negotiate a workout plan during the lengthy Farmer-Lender process.

If the grain is not accounted for, I recommend either petitioning the district court for the right to bring litigation without the need to participate in Farmer-Lender Mediation pursuant to Minn. Stat. 583.27 Subd. 7, or else simply sending out Farmer-Lender notices, depending on the severity of the overall circumstances.

In any legal proceedings initiated in the face of missing grain, a primary goal will be to figure out who purchased the grain. Doing this is so critical because if the sale occurred in Minnesota (or if the sale occurred in another state, but direct notice had been given within one year of the sale) the grain buyer is likely liable to the bank for the full value of the purchases made without naming the bank as a joint payee, regardless of whether the sales were made in the name of the borrower or in the name of a family member/third party affiliate (*See Fin Ag Inc. v. Hufnagle*).

Detection of the identity of the grain buyer, in the face of very likely borrower stonewalling, may seem like a daunting task, but it is less difficult than it appears if the "upstream-downstream" methodology is used. Under this approach, all known grain buyers are subpoenaed for their purchase records, with the aim of identifying the new account opened by the borrower to avoid detection. Once the new account is identified, the bank who provides the account is subpoenaed and those bank account records tend to either show, or lead to, the buyer who purchased the grain.

—Matthew J. Bialick, Esq.



Summer Farm Outlook: Storm Clouds Gather

It isn't lost on us that the figurative economic storm clouds gathering are due at least in part to the literal storm clouds that have overstayed their welcome this summer.

Any historian of economics assumes the inevitability of business cycles, so following the record profits in 2022 we could anticipate, well ahead of 2023, the waning prospects for a continuation of the financial boom in row crop production.

And they did wane. Interest rates rose, crop prices fell, inputs fell rather more slowly and rents held steady as a surfeit of operators continue to vie for more acres to gain some efficiencies of scale. Minnesota crop farm earned, on average, a bare profit, working capital declined, and economically they operated at a loss (return on assets was lower than the cost of capital).

We expected the pinch to be keener this year, with financial breakeven, economic loss, likely the best case.

Hopefully it betrays our practical historical bent more than an ideological orientation: the idea that ZIRP wasn't forever and any return to even average interest rates after such a long scrape along the bottom was bound to be jarring. Memories are short, another apparent inevitability in economic analysis.

Interest rates would inevitably have to rise, and there is a strong inverse correlation between those and crop prices. Corn would likely fall. Is it correlation or causation or both? I have no strong view, except that history repeats or at least rhymes. And here we are, with local corn less than \$4 and interest over 7%, even 8% on operating lines.

It is worth reviewing the long history—this is only *higher*; it is not *high*. Now we have to consider the possibility of below trend yields in Minnesota this year. How much stress is possible?

As ever: it depends. The economics of crop production in the Upper Midwest has had a good run, helped along by falling interest rates (until very recently), ethanol mandates, and amazing advancements in productivity (the yield trends in the formerly marginal counties in MN are astonishing).

We get a decent cross-section of crop production courtesy of the FINPACK database. Averages can hide as much as they reveal, but we have found the samples to be representative of the state of the industry, and with a combination of art and science, a means of forecasting business cycles in farming. For easier comparisons, we confined our dataset to crop farms in the southern half of Minnesota.

Below is a quick summary of key data points, reported '22-'23 and as they might have been forecasted as of planning season last January:

	1000-2000 acres		
	Reported 22	Reported 23	Walker Forecast 24 Winter
Corn price	\$6.16	\$4.94	\$5.00
Corn yield	212	200	205
Net profit	\$524,470	\$47,431	\$130,497
Working capital days	366	257	337
Return on assets	15.42%	2.66%	5.40%

Historic and projected data derived from <https://finbin.umn.edu>

“The economics of crop production in the Upper Midwest has had a good run, helped along by falling interest rates, ethanol mandates, and amazing advancements in productivity.”

Farming is nothing if not volatile, and taken at its face, there is nothing alarming, just the routine ebb-and-flow of the business cycle from '22 to the winter '24 forecast.

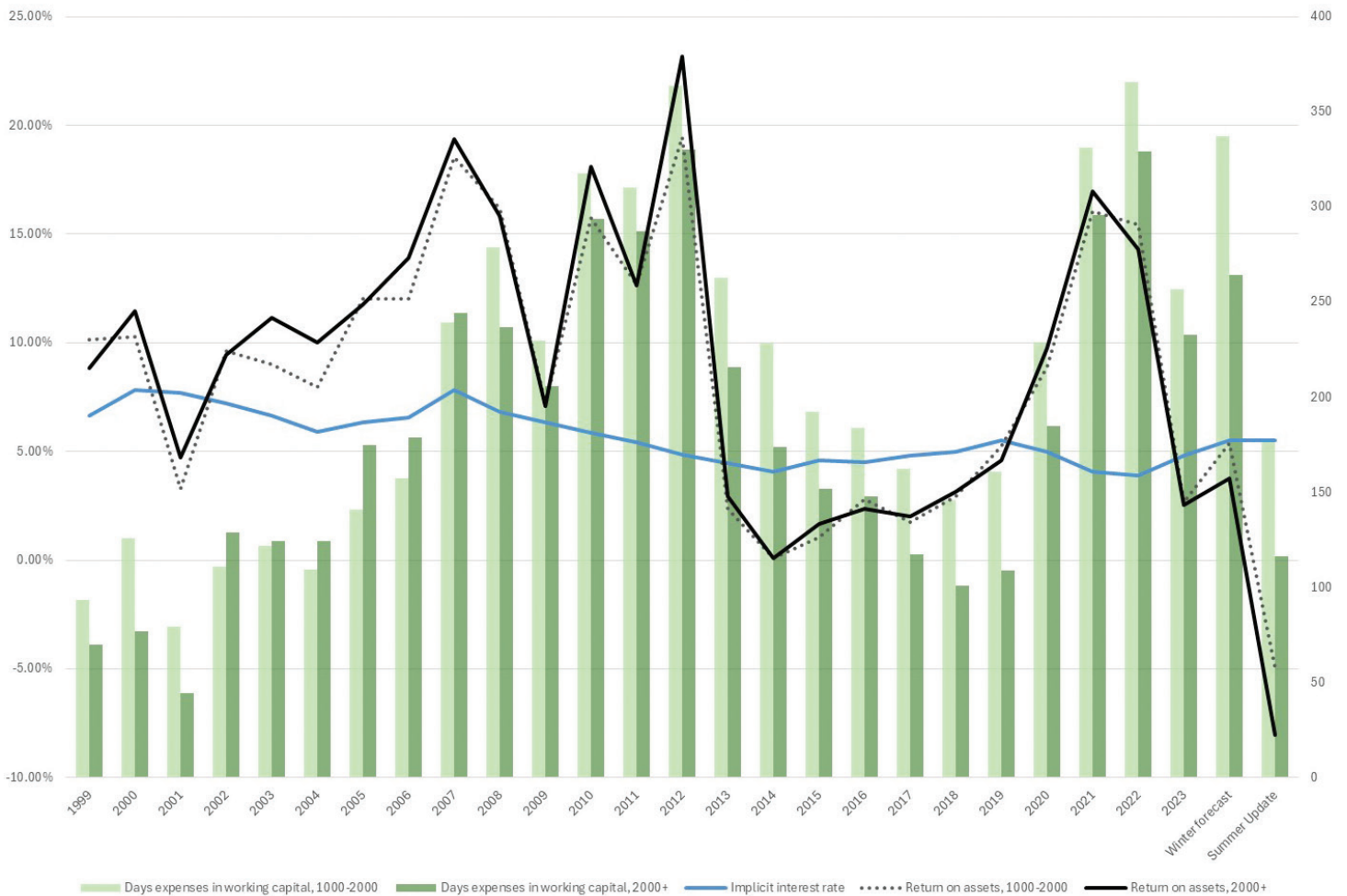
The slippage since Winter is a bit more attention-grabbing:

	1000 - 2000 acres Walker Forecast 24 Update	2000+ acres Walker Forecast 24 Update
Corn price	\$4.00	\$4.00
Corn yield	185	185
Net profit	(\$304,744)	(\$930,440)
Working capital days	177	116
Return on assets	-4.92%	-8.03%

There are so many moving parts. Farming is both volatile AND amazingly complex. This difference above is purely a function of the factors shown (plus a proportionate decline in yield and price prospects for soybeans). The drop in prices is applied to both old and new crop as the tendency in farming is to raise and store crop mostly unhedged. Any hedges or contracts on place on crops old or new would mitigate the damage. The potential loss on '23 crop stored unpriced would be \$170,000 for the mid-sized farms and \$380,000 for the largest.

	2000+ acres		
	Reported 22	Reported 23	Walker Forecast 24 Winter
Corn price	\$6.09	\$5.00	\$5.00
Corn yield	210	205	205
Net profit	\$1,073,464	\$115,340	\$123,308
Working capital days	329	233	264
Return on assets	14.29%	2.56%	3.78%

MN Farms, Profitability & Liquidity
crop farms in southern MN by acreage, finbin.umn.edu



The above chart shows the long view, with Winter and Summer worst-case scenarios tagged at the end.

As a sidebar, we typically split the largest from the mid-sized farms for the sake of competitive analysis. That the largest farm's return on assets is barely higher, and their relative liquidity is in fact less, than the mid-sized group is worth a separate study.

Over time return on assets has to exceed the cost of capital [interest rates] for a farm to remain competitive, even viable. Between 1999-2023, both groups exceeded that threshold, at least 9% average ROA vs. 6% average interest on all debt.

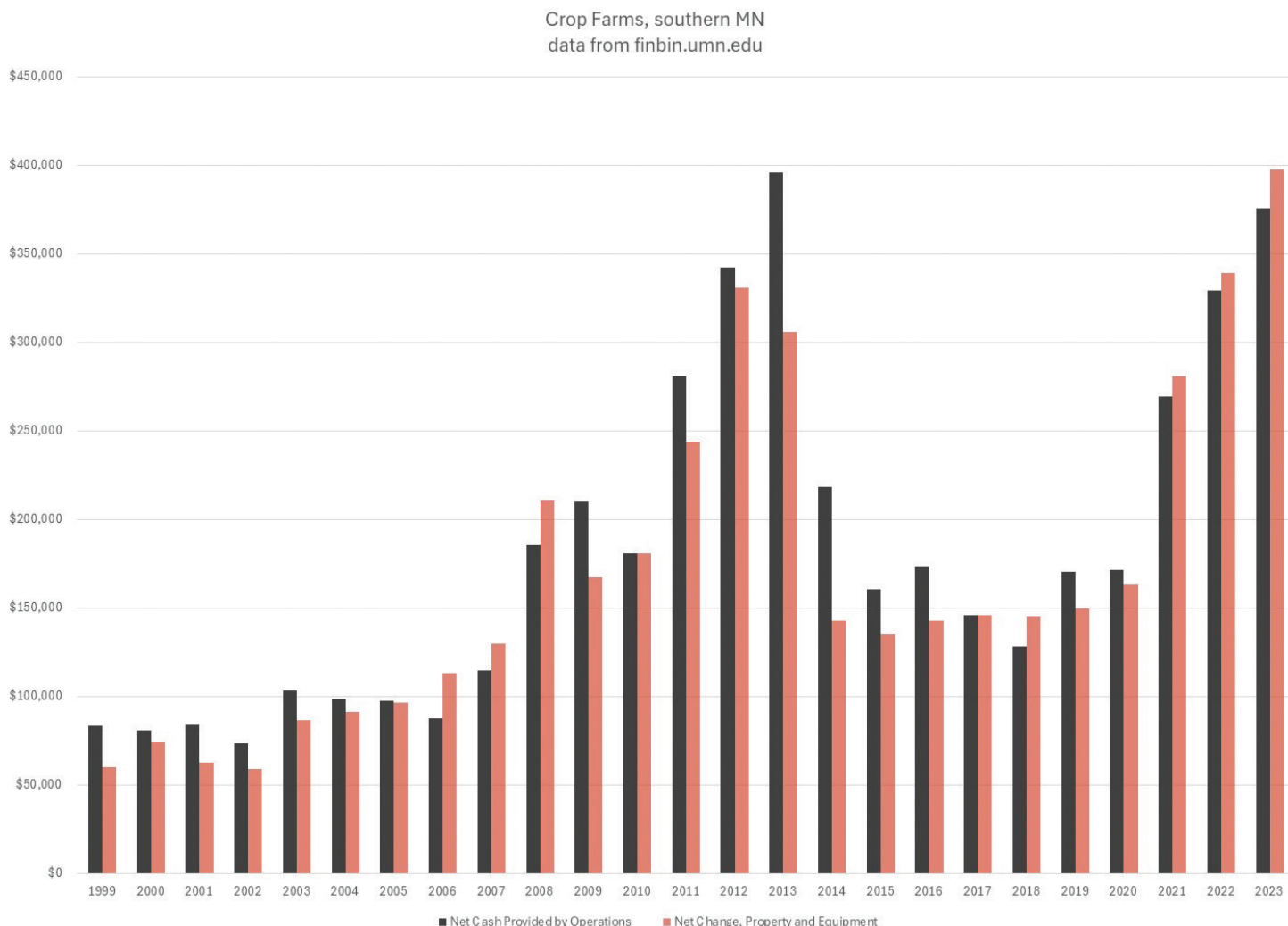
Working capital is still quite positive and even worst case, higher than at the end of the lean times 2013-2019 and much higher than in the late 90s.

Is this a “keep calm, carry on” signal? We can see that farming is a) cyclical, b) on the balance, profitable, and c) liquid. This storm will pass, if indeed it ever arrives?

I rarely meet professionals of any stripe who leave the matter there. As to looming storm clouds—

1. Whereas return on assets has been higher than interest, just, 1999-2023, much of that epoch was dependent on a ZIRP Fed policy. What would it look like as credit lines crowd 9%?
2. Liquidity *could* get very thin and that an operation is profitable *on the average* is irrelevant when illiquidity forces an untimely exit (illiquidity-driven exits are almost guaranteed to be untimely).
3. Farms of all sizes tend to spend 100% of their free cash flow on capex, which is according to FINPACK is not land acquisition but dominantly building and equipment.

#3 is worth charting:



What do we make of all this? Farming's recent history is one of resilience and relative profitability but we have some stiff headwinds which have more than a scent of the 80s to them. History feels inclined to repeat, but the real question is, who of our clients is readiest for it? It is not automatically those with the best risk metrics, but those who can demonstrate they've already considered the possibility of a \$4 corn, 9% interest environment and can show you their plan for navigating it.

—Thomas Walker, Jr.

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Agricultural Banking Case Law Update

Perhaps the most important and useful legal precedent that most ag banks do not know exists is the 2006 Supreme Court case of *Fin Ag, Inc. v. Hufnagle*. This case established that purchasers of fronted farm products (farm products sold by borrowers through family members or business affiliates to avoid a CNS) are strictly liable to the secured lender for the value of the fronted purchases regardless of whether they knew, or had any reason to know, that the farm products were fronted.

The *Hufnagle* case has stood unchallenged for over 15 years, until finally it was re-examined by the Minnesota Court of Appeals earlier this year in the case of *Star Bank v. Robert W. Anderson, et. al.*—which I had the privilege of arguing on behalf of the bank.

In an opinion released on July 15, 2024, the Court of Appeals explicitly reaffirmed the continued validity of *Hufnagle*, even in light of subsequent statutory changes, and clarified that:

1. The bank need not prove with absolute certainty that its borrower owned every bushel of the farm products that were fronted, instead the bank need only come forward with some competent evidence as to ownership and from there the burden shifts to the buyer to offer competing evidence that someone other than the borrower owned the farm products; and
2. Allegations that a secured lender was negligent in its lending or workout practices are legally irrelevant to a fronting claim.

This case represents a great win for Minnesota ag banks, because it both re-established that *Hufnagle* is the law of land and also because it is now less challenging for lenders to prove up the trickiest element of a fronting claim—ownership of the farm products that were sold.

—*Matthew J. Bialick, Esq.*

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