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M|J|B BANKING LAW TODAY

THE PROBLEM WITH HIGH PRICES

The Unexpected Legal Risk that Accompanies a Spike in Commodities Prices

The recent increase in commodities prices has been an indisputably positive development for farmers and their banks. However, even a positive development can be accompanied by unexpected legal consequnces. While the price increase itself is good, a spike in prices can trigger a liquidation of grain reserves by the borrower, which can undermine the bank's security position if the borrower fails to remit the proceeds to the bank.

A nightmare scenario for banks occurs when a borrower secretly liquidates grain and fails to remit the proceeds to the lender – instead opting to either pocket the funds or, far more often, pay off secondary creditors such as agricultural goods/service providers or even relatives to whom the borrower "owes money." The borrower then completes the fraud by representing in their next financial statement that the grain stores remain unchanged, despite the liquidation.

While the bank usually has a CNS financing statement in place to protect against such unauthorized commodity sales, this document often provides less practical protection than banks may presume for three reasons:

REASON 1: Borrower Dishonesty Often Nullifies CNS Financing Statements.

CNS Financing Statements are generally ineffectual in situations where the borrower engages in dishonest sales actions such as selling the commodities to a new buyer in a different state or selling the commodities under a different name (such as the name of a relative). Under these circumstances, the grain buyer arguably does not have sufficient notice of the bank's security interest and thus may not be held liable if the borrower fails to remit the proceeds to the bank. At best, the questionable notice creates a messy legal issue and the potential for heated litigation.

REASON 2: Grain Buyers are Often Fast and Loose with their Procedures Regarding CNS Financing Statements.

Some grain buyers, for better or for worse, simply ignore CNS Financing Statements or else semi-ignore them by depositing payments into the borrower's account via ACH (rather than issuing a check in the name of bank and borrower). While the bank will have recourse against the grain buyer in this scenario, the grain buyer almost certainly will make the bank engage in litigation before it will pay out a dime. Litigation takes time, costs money, and is generally an unpleasant process, so obtaining funds through litigation is never a preferred course of action.

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REASON 3: Recourse Against the Grain Buyer is Meaningless if the Grain Buyer Becomes Insolvent.

The final reason that a CNS may prove ineffectual is that many grain buyers are struggling financially right now and may become insolvent or opt to declare bankruptcy if faced with a large claim by a bank for failure to satisfy the bank's lien. In such a scenario, the most a bank could obtain against a grain buyer is a judgment; however, it is always important to realize that a judgment does not necessarily equal money.

CONCLUSION

High prices create the temptation for borrowers to start liquidating grain stores and misappropriating the proceeds. Once such fraud occurrs, the operation is generally doomed to fail, and the bank will likely suffer some type of loss – often times a substantial one. While a CNS Financing Statement may help mitigate the risk of such a loss, it does not always eliminate it.

Due to current conditions, banks are encouraged to be exceptionally vigilant right now and carefully scrutinize all unexpected commodities checks or ACH payments from grain buyers. If the bank does suspect that improper liquidaiton has occurred, it is well advised to immediately consult with legal counsel experienced in commodity proceed fraud matters.

-Matthew J. Bialick, Esq.

Outside Insights

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

Agricultural Economic Update (July, 2019)

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

Most cash flows forecasts, for 2019, were undoubtedly formulated around the idea of minimizing losses and preserving liquidity. Farms have benefited from the brisk upward march in yields—in fact, the succession of above-trend yields through 2017 maybe well have deferred the onset of crisis. But costs, having risen quickly in response to the boom years culminating in 2012, have been far slower to retrace.

Our sample farms are courtesy of the FINPACK database, with additional transformation and analysis by Walker's Business Labs. Focusing on the relatively homogenous crop farms south of I94, we have a dominantly corn/soybean rotation and 912 acres under the management of each unit, of which 688 is rented.

Arguably, 900 acres is less than half the size necessary to optimize equipment and provide full employment to the owner/operator. We have to leave that factor aside here, just noting that isolating the larger farms paints a very similar economic picture, if with larger numbers.

Our average farm earned $300,000 in 2012, the height of the boom, or a 15% return on assets—respectable numbers whether scale-challenged or not. The most significant variables, rents and direct costs (primarily seed/fertilizer/chemical/fuel), peaked shortly thereafter, land rents at $231/acre in 2014 and direct costs at $302/acre in 2013.

Since then, while top line is down 34%, rents are only 10% of their peak, and direct costs, 16%. Unsurprisingly, the cumulative profit for our average farm *since* 2012 is $8,000, or a 1.4% return on assets, and well under have the cost of money at even these historic lows. By compassion, the average return on assets for 1999-2012 was 7.4%, somewhat higher than the cost of borrowing during that period.

For long-term health, return on assets must exceed the cost of borrowing. Call it *economic breakeven*. ROA lower than the cost of money means that the business is unable to borrow money profitably. It means the slow erosion of wealth. One symptom, for our group, seems to be the disproportionate erosion of working capital. Whereas as accountants measure it, they broke even, we see the decline of working capital from its peak in 2012 of $540,000 to $200,000 at the beginning of this year.

When cash flow forecasts were being formulated, nothing in the cards suggested that 2019 would do other than extend our zero-profit streak to seven years. And using FINBIN data as a means of projection, we find that if operators held costs to levels seen in 2018 and realized 200 bushel corn at $3.50 and 55 soybeans at $8, they would lose $20,000 and see working capital decline further to $150,000.

Since then we have a striking market rally balanced against a possible discount in yield expectation, and the troublesome wrinkle of prevented plant acreage. Here are a couple alternate scenarios:

- If forecast yields were nonetheless realized, and current prices available on old and new crop secured by hedge or contract, we shift 2019 into a very modest gain of $40,000 with a 4% return on assets.
- If all corn acres were forced into prevented plant, the operating loss extends to $70,000 with a further erosion in working capital to $100,000.

The potential for loss is less worrisome than the fact that even a plausibly positive scenario still leaves our average farm with an economic loss. This, and the historical trends noted, suggest that key to regaining profitable operation for Minnesota crop farms needs a reset in the costs, particularly land rents and inputs. This in turn has implications for presumed asset values that many are (literally) banking on.

- For land rents to reset to match their long-term numerical relationship to crop revenues would require a decline from $206 (2018 data) to $170 per acre.
- Given historical capitalization rents on land, this implies an economic value of $3,000.
- If we had to lean on an adjustment in land rents alone to restore farms to their historical level of profitability, all other costs remaining steady, the price would be a wrenching $75/acre.

That last figure is no prediction, but dramatically illustrates the economic pressure on the farm sector—pressure that has been ongoing for several years. That may be the silver lining; the tandem revaluation of assets that creates a crisis also resets key inputs prices to profitable level. The crisis can also be the cure.

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

THE ENLIGHTENING ROUND

Q: If a relative of a borrower assists with the production of an agricultural commodity, can they assert a statutory lien for the reasonable value of the work they performed?

A: No, statutory agricultural liens are generally only available if the work was performed "in the ordinary course of business." This language implies some type of ordinary, arm's length transaction where one party provides goods or services to the other under the explicit expectation of payment, where normal billing procedures are utilized. Simply providing gratuitous services to a family member, with no expectation of payment, and then essentially billing the bank for the work at a much later date, through a statutory lien, is unlikely to be considered a transaction *in the ordinary course of business*.

Q: If my bank receives notice that all grain proceeds checks will be ACH deposited by a grain buyer and the bank fails to object, does that constitute a waiver of its CNS rights?

A: No, the mere failure to object to such a notice should not constitute a waiver of CNS rights. A waiver typically requires an affirmative and express manifestation of an intent to waive a legal right. The mere failure to object to such a notice would be unlikely to be held to be an enforceable waiver.

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