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JB BANKING LAW TODAY

ROBBING PETER TO PAY PAUL

The Problem of Borrowers Converting Collateral Proceeds to Pay Other Creditors

The current agricultural economy is experiencing significant strain – there is just no other way to put it. Commodities prices are down, and have been down for years. In the case of soybeans, prices are way down due in large part to an escalating trade war with China.

> "RESOLVING A DEFAULT THROUGH THE CONVERSION OF COLLATERAL PROCEEDS ONLY COMPOUNDS THE DEFAULT"

However, unlike other recent years, 2018 will likely result in yields that are mixed at best – rather than record setting. The result of this is that many farmers will be in the red for 2018, and working capital will be a major issue.

When working capital is exhausted somebody is not going to get paid, whether it be the bank, other creditors or both. Over the short term, this situation can be dealt with through the bank either advancing more funds, or else through restructuring loan payments to give the borrower more breathing room. However, over the intermediate term and long term this solution is not viable unless profitability improves.

When profitability does not improve over a long enough period of time, defaults turn into collection action, either by the bank or by creditors, or they result in the refusal of providers to offer goods and services necessary to keep the farming operation running. Once this phase is reached, the reality is that the operation has very likely become unviable and will fail.

But, in an effort to delay the inevitable, borrowers will often resort to selling equipment and other assets to pay the providers. The problem with this – the bank has a lien on these assets and the borrower is converting collateral proceeds when they sell the assets and use the proceeds to pay other creditors.

The borrower may feel like this action is helping the situation, but resolving a default through the conversion of collateral proceeds only compounds the default. Now, in addition to potential monetary defaults, there have been non-monetary defaults in the form of violations of the applicable security agreement. Once the borrower reaches this point, there really is no more ambiguity – the bank needs to take stern and decisive action. So, what actions should the bank take?

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Step 1: Notify the borrower in writing that the sale of any assets without the bank's approval violates the security agreement and applicable law.

Step 2: Attempt to physically secure all remaining collateral if you believe the sale was made in bad faith. This can be done through self-help if the bank can accomplish this without a "breach of the peace." Or, if the borrower refuses the bank entry to secure the assets, the bank can bring an emergency petition with the Court to lock down the assets without the necessity of first engaging in farmer-lender mediation.

Step 3: Immediately commence liquidation action. At this point, things have almost always reached the point of no return and the bank will typically suffer greater losses the longer it delays action.

Step 4 (if appropriate): Attempt to locate the transferred assets. The bank still has a valid security interest in the collateral, notwithstanding its sale. The bank can potentially exercise rights against the transferee.

Step 5 (if appropriate): Attempt to regain the proceeds of the asset sale from the creditor who received the converted funds. This is not necessarily easy, but can be done if the creditor took the payment with knowledge of the insolvency.

By taking the above actions, the bank can eliminate, or at least mitigate, the harm caused by inappropriate collateral dissipation. It will also increase the likely guaranty payment in situations where there is an FSA guaranty at play.

-Matthew Bialick, Esq.

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Monthly Attorney Spotlight – Matthew Bialick

- Ten years of experience practicing in the areas of banking, commercial and agricultural finance.
- Licensure in Minnesota and Iowa and pending licensure in Wisconsin.
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- Board Member and Chair of the Development Committee for Conservation Corps of Minnesota and Iowa.
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