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'TILL DEATH OR FORECLOSURE DO US PART

The Effect of Borrower Divorces on Agricultural Liquidations

The family farm holds a unique place in the Amercian business landscape. Farms are not just businesses but also ways of life. This reality makes farming particularly special in good times and particularly devastating in bad times.

When bad times do occur and persist, not only does the business unravel, the whole family tends to unravel. In a large percentage of the agricultural foreclosures that I see, spousal borrowing parties (whether the non-farming spouse is a co-borrower or simply a signatory on security instruments) are either separated or divorced. In fact, borrowers actually staying married through an agricultural foreclosure tends to be the exception to the rule.

Having to observe this familial disintegration as a banker can be thoroughly heart-wrenching. Additionally, from a purely legal perspective, such an event can inject a distinct series of challenges into the foreclosure process. This article will discuss some of the main workout challenges that arise from borrower divorce during the agricultural foreclosure process.

Challenge 1: Partial or Sequential Bankruptcies

In the vast majority of my cases, the spouse who initiates the divorce is the one who is less actively involved in the day-to-day farming operations. When that spouse leaves, they tend to move out of the farm homestead and discontinue all real connection to the farming operation. And, they tend to view any agricultural debt as "not their problem" given that they have left the operation. The farming spouse tends to share this view of the situation as well.

While this is loosely accurate from a practical perspective – given that the non-farming spouse is not in control of the collateral and generally does not have the level of independent financial resources that makes collection action worthwhile – it is legally inaccurate since they are typically co-borrowers that are jointly and severally liable for the debt.

While this mistaken perception can cause challenges throughout the workout process, it tends to be particularly problematic in the bankruptcy context because agricultural bankruptcies feature an abnormally high prevelence of one spouse filing bankruptcy without the other.

What this means for the bank – in at least the case of a Chapter 7 bankruptcy – is that after the bank brings its lift stay motion in the farming spouse's bankruptcy, it will still need to send a farmer-lender mediation notice to the non-farming spouse, and it still has to contend with the looming threat that the non-farming spouse files a subsequent bankruptcy. As such, it is not uncommon to see farmer bankruptcy → Farmer Lender Mediation → spousal bankrupty → legal proceedings to involuntarily liquidate the collatteral. This progression is both unfortunate and, all to often, throughly unavoidable.

Challenge 2: Fraudulent Transafers to Non-Farming Spouse

Despite the fact that divorce proceedings are pending, the farming borrower often times either wants to still take care of the non-farming spouse, or else they want to park assets in the non-farming spouse's name (if said spouse was not a co-borrower) to avoid collection action by the bank. In either case, the result can be the same – fraudulent transfer.

Fraudulent transfers can come in many forms – the rarist of which tends to be the outright transfer of equipment or other hard assets from one party to the other. The far more common scenarios involve either: (1) an improper liquidation of assets or commodities through the farming spouse with a remission of the proceeds to the non-farming spouse; or (2) selling agricultural commodities through the non-farming spouse's name so as to defeat the bank's CNS filing.

In rare cases, debtors have (in a non-agricultural context) even used a divorce court decree as a vehicle of effectuating a fraudulent transfer. *See Citizens State Bank Norwood Young America v. Brown*, 849 N.W.2d 55 (Minn. 2014). In that case, the debtor thought that transferring property pursuant to a divorce court decree entered as a result of the joint agreement of husband and wife could not possibly be fraudulent. The debtor in that case was sorely mistaken.

The bottom line here is that while fraudulent transfers are always an issue in agricultural foreclosures, they are particularly so in the case of divorcing borrowers.

Challenge 3: Complications Involving Reg B

In the majority – if not vast majority – of agricultural foreclosures that involve borrowers who are married, both spouses are listed as co-borrowers or at least guarantors. This is generally the case even when one spouse has little to do with the farming operation.

Under Regulation B, § 202.7(d)(1), generally a creditor may not require the signature of an applicant's spouse or any other person (other than a joint applicant) on any credit instrument if the applicant qualifies for the amount and terms of the credit requested under the creditor's standards of creditworthiness. However, Reg B does not prohibit a bank from requiring that a spouse sign security instruments necessary for a bank to properly perfect its security interests in agricultural collateral.

Reg B also does not say, or imply, that it is impermissible to have farming spouses as co-borrowers. Such practice is perfectly permissible if the spouses jointly choose to apply for credit, or if the bank legitimately concludes that one spouse alone does not meet creditworthiness requirements (and properly documents these findings). However, it is an issue that arises any time the bank had to push for the spouse to be a co-borrower.

In good times, such a push to include the spouse as a co-borrower is unlikely to result in any real issues given that problems only tend to arise when collection action is taken. In bad times, the issue can come to the forefront when the bank seeks to take collection action against non-farming spousal co-borrowers. The result can be potential regulatory infractions, as well as even actions by the spouse (under ECOA) to invalidate the gaurantee or even the debt itself.

Plus, the Reg B analysis gets amped up any time the Borrowers are divorced. It is easier to sell the concept that the borrowers are generic co-borrowers both involved in the operation when they are married, but when they are separated, it becomes a much harder sell.

While this is a significant issue today, look for this to potentially become an even bigger issue in the coming years. If a farm crisis does occur and there is a wave of legal proceedings against non-farming spouses, look for legislators to seek to expand Reg B protections in the agricultural space. While such changes may not necessarily be retroactive, that is actually small comfort given that the issue would arise the next time the bank renews the credit or extends a new line.

Conclusion

While agricultural foreclosures are always difficult, they become particularly challenging when they involve divorcing borrowing parties – which occurs quite frequently. While being aware of the potential issues and challenges does not necessarily make the foreclosures any easier, it can at least help a bank avoid certain missteps and can mitigate the risk that the bank commits a regulatory infraction.

-Matthew J. Bialick, Esq.

Outside Insights

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

Ag Commodity Collateral Management in Today's Lending Environment

An Article by Mike Schaefer of Eide Bailly

Commodity collateral conversion has been an issue for secured agricultural lenders for years. Recently, we have seen an increase in these types of cases.

Ag commodities are unique from the respect of the trust/character perspective lenders demand of their borrower's business to extend credit. Character has always been, and continues to be, one of the main underwriting criteria in originating an agricultural production loan. However, when borrowers are facing deteriorating economic conditions, they sometimes feel forced to act in ways they normally would not, in an effort, to save the farm. This places an emphasis on the premise of "collect the loan when you write it."

Loan structure, proper security documentation and a well written, effectively communicated loan service plan become more paramount.

Generally, the first line of loss in the ag credit finance world is the top section of the balance sheet or production expenses. Recently, considerable pressure has been put on the working capital position of many operations, requiring restructuring of debt down the balance sheet. The well has been tapped for some, but not all. We have seen examples of some 100% living on a cash flow with no well/balance sheet savings account.

How can lenders best manage commodity collateral from loan origination all the way to the harvest and marketing end of those products? The signed loan service agreement should be communicated verbally. It should also contain a signed document or letter of understanding on credits that are carrying financial stress. The signed loan agreements should highlight the covenants and any violations that would create a default of the loan. It should include an outline of the plan and expectations in regard to marketing such as time guidelines to market grain to service debt obligations, inspections and most likely inventory counts as well as potential unannounced third-party measurements.

But how do you monitor inventory? Here are a few items to consider:

1. An accurate balance sheet inventory. The lender should be secured with a Crop Mortgage/CNS filing, an assignment of indemnity of crop insurance coverage (either MPCI/Hail coverage) or most likely both. These policies and assignments should be documented in the file.
2. Presence of an acreage/planting report. This will give a base of coverage/collateral value. It will also give the lender the starting point of what production expectations may be. This should be available by mid-July to Aug 1st.
3. Filing of actual MPCI production report. This could potentially require a loan covenant to report by date XXXX as MPCI does not require final production reporting until later in the spring. You

could require this near harvest completion and amend the covenant in writing if there is a harvest delay. Monitoring commodity collateral at harvest time may need to include delivery points, whether that be to a bin site or elevator delivery point which includes quantity. Bin sites could potentially involve third party measuring services to verify quantity and quality of commodity.

As growing crops are converted to a known inventory and balance sheet numbers are documented, the inventory management plan begins. Having a CNS in place will help ensure that various commodity checks come across the lender's desk. A receipt log will help manage the inventory reduction as the commodity is liquidated. The balance sheet and receipt log should also identify and account for separate crop years. Bushel accounting and value along with any discounts and marketing cost should be accounted for each assembly sheet/check. No proceeds are released without inventory documentation. If needed, a second third party inspection may be required to qualify inventory to the sale log or at any time during the marketing process.

Again, lenders should require unlimited, unannounced inspection in the covenants. Collateral inspections being completed by internal staff could potentially require an additional staff member along-side the relationship manager/loan officer. Also, as size and risk of operations increase third party inspections often arrive at appraisal/collateral values.

Several states recognize the address of the operation for CNS filing. Theoretically, neighboring states should comply with borrowers filing. This does not mean the secured lender will be listed as additional payee or that they will search for secured parties. Sound collateral acumen would suggest to file a CNS in all neighboring states, specifically for a borrower located close to bordering states. Cost to file is minimal and may cover some legal expense in the long term. The same rules hold true for livestock feeders. You should file your position wherever the livestock are being custom fed or where they may be harvested.

A commodity fed to livestock should require a monthly feed consumption/usage report. This may happen more frequently on large volume accounts to reconcile to the B/S inventory.

Livestock inventory management is similar in terms of documentation and periodic reporting. Proceeds advanced for purchase require assembly sheet documentation on head count and valuation along with sale receipts to tie back to purchase numbers. Production/feedlot cost reporting should be reported as frequently as needed. Third party inspections are more common in livestock operations due to large operations and the volatile history of the industry trends. Also, death loss reporting is an area to manage inventory/disappearance. On smaller operations this seems to be where inventory leaves for the neighbor's freezer in the form of death loss.

Borrowers requiring this level of a loan service plan should also have loan covenants in place to address future year prepaids for production inputs and again a violation of this covenant should be an event of default. Line of credit disbursement logs should be in place to document purpose of advance to manage this area.

Collateral conversion is difficult to manage in the agricultural world. However, with proper documentation and a sound, well-written and communicated loan service plan to the borrower, lenders will have done their due diligence in monitoring collateral risk on the commodity front.

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