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JB BANKING LAW TODAY

'TILL THE COW LOANS COME HOME

3 Things Every Agricultural Banker Needs to Know about Livestock Loans

The agricultural downturn has hit many livestock farmers particularly hard. The current economic challenges make it important for agricultural banks to be as tight as possible with their practices regarding lending, renewing, managing and liquidating livestock operations. This article discusses three imporant legal issues of which every banker with a loan connected to a livestock operation should be aware.

ISSUE 1: STATUTORY LIVESTOCK LIENS ARE VERY MESSY

Just like with goods and services providers connected to crops, livestock goods and services providers gain statutory liens over the livestock benefitting from their goods/services and any farm products resulting therefrom. Also like with crop liens, livestock liens need to be perfected through the filing of a UCC Financing Statement within a statutorily mandated period of time in order for the lien to have super priority over the bank's prior perfected lien over the livestock. However, the analysis of whether perfection has properly occurred for statutory livestock liens can be far more complex than with statutory crop liens for several reasons.

First, crop liens tend to arise at predictable times of the year (planting, harvest, etc.) whereas livestock liens can arise at any time of the year. This erratic timing makes it harder to track the start of the perfection timelines.

Second, the time periods for perfecting livestock liens tend to be longer than for crop liens. The perfection period for crop liens can be as short as 15 days, whereas no livestock lien has a perfection period of less than 60 days. Longer periods make harder to tell if proper perfection has occurred.

Finally, livestock liens can be animal specific, whereas crop liens tend to apply to all crops grown in a given year. It can be quite difficult, if not impossible, to identify if one particular animal is the one that received goods or services (e.g. medical attention) or if it was a different animal and therefore whether it is the animal with the lien. This ambiguity tends to favor the bank given that the bank generally has a blanket lien over all livestock rather than over specific animals, but this ambiguity can also give rise to messy fights when service providers with animal specific liens attempt to enforce their rights.

ISSUE 2: INTRA FAMILY CONVERSION CAN BE A BIG PROBLEM

It is very common for both a farmer and their child to have a livestock operation on the same land. When this occurs, it can be incredibly difficult to keep track of who owns what. When an animal is sold or dies, the question can come up, whose animal was it? The answer, unfortunately, and all to often, tends to be that the farmer will say the animal belongs to whomever would benefit the family the most from the given situation.

Older generations typically have the attitude that if there is a loss, they want to shoulder it, and if they can help out their children by transferring livestock under the radar, they want to do it. This is especially the case when their farming operation is doomed to failure, but they hold out hope that their children can thrive with the right assistance.

Given that there is not necessarily an effective way to tell who owns what, uncovering conversion of livestock either through direct transfer or incorrectly attributing an animal death to the parent's operation rather than the child's operation can be incredibly difficult to uncover. In some cases, the only way to effectively do so is by reviewing multiple years of financials, along with associated purchase and sale records. Even then, it can be a challenging endeavor.

And, the challenge can be compounded by the fact that the child's operation may be funded by a different lender who took a lien on the child's livestock. As such, the bank would not just be fighting with the child in the face of conversion but also the child's lender.

ISSUE 3: COLLATERAL PRESERVATION CAN BE A HUGE PROBLEM AFTER DEFAULT

Unlike with crop operations, which tend to fail at specific times of the year when the crop is not in the ground, livestock operations can fail at any time, and all animals still require proper care when they do.

Given that livestock are living, breathing creatures, the failure to provide appropriate care on a daily basis can cause illness or death. And, in the case of diary cows, even a disruption in milking can damage or destroy future milk production capabilities.

The fact that livestock requires constant care increases the risk that an emergency will arise upon borrower default. While in most cases the borrower is bonded to the animals and does not want to see harm come to them, it is always possible they will just throw up their hands and say "I'm done," in which case the bank has to act immediately to find a company to pick up, properly care for and sell the livestock as quickly as possible. Any delays or mishandling of the animals can significantly dimish their ultimate value.

A similar situation can occur if the borrower drags out the liquidation process by refusing to voluntarily relinquish the animals or by requesting farmer lender mediation but then does not properly care for the animals in the interim. In this case, the bank would be forced to bring an emergency motion with the Court to obtain immediate possession of the animals prior to engaging in farmer lender mediation.

And, even outside of an emergency scenario, it is just plain more challenging to manage a type of collateral that lives, breathes and requires constant care from the moment the bank takes possession. From a practical perspective, this issue can be mitigated through a voluntary sale by the borrower with remission of proceeds to the bank, but the borrower does not always cooperate, especially when they are trying to buy time to attempt to refinance the operation or sell the animals to a family member.

CONCLUSION

Financing livestock operations has a number of unique challenges, even within the broader umbrella of ag lending. While the above listed challenges are some of the most common in the area, dozens of other specific challenges exist in this nuanced area. Education, experience, and vigiliance on the part of bankers is necessary to stay effective and avoid making mistakes that can significantly undermine collateral values in a potential liquidation.

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THE DIRECT DEPOSIT DILEMMA

The Problem of Commodities Buyers Shifting Towards Direct Deposit Payments

We now live in the age of direct deposits. Automatic deposits and withdrawals seem to permeate every facet of life and business. More and more commodities buyers are opting to direct deposit payment for commodities purchases into a farmer's account. This arrangement is convenient for the farmer, but what about the farmer's lender who has a lien on the commodities?

Traditionally, buyers either obtain a lien waiver from the secured lender or make the check out in the name of the bank and the farmer. These protocols ensure that the bank would be aware of the payment so that the bank can take some definitive action to exercise oversight and control over the commodities proceeds.

While it is true that a bank would technically have some measure of control over proceeds that are direct deposited into a borrower's account with the bank, this control is dependent upon the bank's awareness that the deposit has been made. It is very possible that the money could be tranferred in and out before the bank really knows what is going on.

As commodities proceeds are generally the primary source of repayment for ag loans, if such commodities proceeds are transferred out of an account by a borrower who intends to fraudulently dissipate proceeds before the bank applies the proceeds against loan balances, such action could be devastating to the bank as it could cripple their ability to get repaid on the loan. In short, this procedure does not give banks the protection they need.

So, direct deposit can clearly harm banks vis-à-vis the borrower, but does direct deposit eliminate the bank's recourse against the commodity buyer for failure to obtain a lien waiver? The answer is no; a court would very likely find that the buyer is still liable to the bank if the borrower subsequently absconds with the commodities proceeds after the direct deposit was made. The reason for this is that a lien waiver requires some type of knowing and deliberate action by the bank. The mere fact that the proceeds were deposited into an account at the bank almost certainly would not meet this standard.

That said, buyers are attempting to get around this problem by having the banks annually sign some type of direct deposit authorization form, which buyers believe operates as a prospective waiver of the bank's lien on the farmer's commodities after the proceeds have been transferred into an account at the bank. Would this type of prospective waiver/acknowledgment hold up in court? Honestly, it could go either way. But, what is certain is that even under the best of circumstances, it would make seeking recourse against a buyer for failure to obtain a lien waiver exponentially more difficult.

Banks are well advised to simply avoid this problem all together by refusing to consent to direct deposit. However, the analysis gets further complicated if the buyer adopts a policy that they will only agree to direct deposit. Under this circumstance, the bank very well may be disrupting the borrower's operation if it refuses to consent to direct deposit. This problem could be compounded if other nearby buyers start following suit.

If that is the case and the bank is forced into a situation where it must consent to the direct deposit of commodities proceeds, the bank should at least have safeguards in place to flag all incoming payments from grain buyers so that the bank can deal with the payments immediately and apply the proceeds appropriately.

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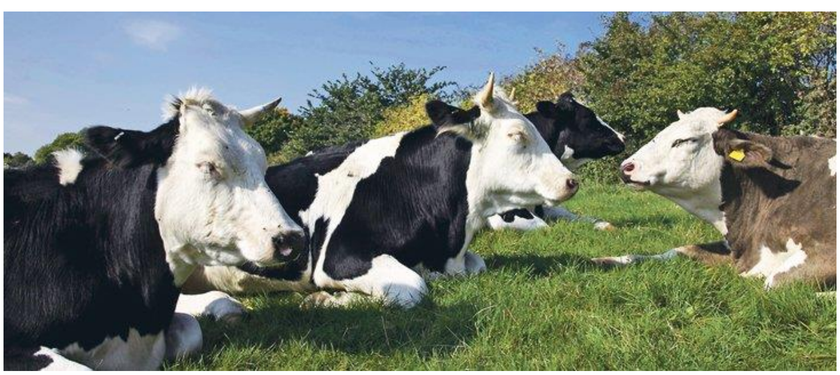

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THE ENLIGHTENING ROUND

Q: Are there any specific provisions that are particularly important to include in livestock loan documents?

A: Among other things, it is particularly important to ensure that the security agreement covers government payments connected to livestock. Given the stress in the industry, new government payments are particularly likely in the future. Not all form security agreements satisfactorily cover future government payments.

Q: Are there any special issues on FSA Guaranteed Loans that are unique to livestock?

A: The main thing that is unique to FSA Guaranteed livestock loans is the increased likelihood that protective advances are necessary to preserve the value of the livestock. Proper FSA procedures should be carefully followed with respect to protective advances to ensure that such advances are covered by the guarantee.

BEST PRACTICE COMMODITY PROCEEDS AUDIT

Every bank with a troubled agricultural borrower should consider conducting a "commodity proceeds audit." Such an audit involves comparing past cash flow projections against deposit account records to ensure that the commodities proceeds deposited in the borrower's bank account roughly match the projections. Large discrepancies between projections and deposits could signal a diversion of proceeds or could indicate that initial projections were false or misguided.

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