OVERVIEW OF HOW FINANCIAL INSTITUTIONS ADDRESS BANKRUPTCY AND INSOLVENCY ISSUES RELATED TO THE GRAIN INDUSTRY AND GRAIN ELEVATORS

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THE ROLE OF COMMUNITY BANKS

North Dakota banks play a vital role in the development of the communities and people they serve. Currently, 85 banks, including the Bank of North Dakota, are located within the state and 74 of those are North Dakota institutions. The primary role of these banks is to collect deposits, provide services, and supply loans to its customers. The collection of deposits from the community assists in the flow of capital for both the bank and the community. Banks with a steady flow of capital are able to provide services and loans at a better rate for a consumer, which in return allows a city and its citizens to invest more into their community. Additionally, North Dakota banks do more than just give loans and hold deposits; they serve as leaders and philanthropists within their communities by funding development and projects.

STRUCTURE OF AG LOANS

Ag loans generally have three prongs to them. A real estate component, equipment financing and other capital expenditures and lastly annual operating and living expense. It is important to note that repayment of these loans all depend on cash flow of a farming operation and cash flow comes from the sale of farm products.

Because a farmer's or rancher's cash flow is often seasonal or cyclical, appropriate loan structure is critical to managing credit risk within an Ag lending relationship. Each year farmers submit to their lenders budgets and cash flow projections and the lender will make a determination as to how much the Bank can lend to the farmer. These loans will be collateralized by the crops of that the farmer grows as well as the equipment of the farmer and if necessary the land of the farmer. Bankers are careful to understand the Ag borrower's cash flow cycles and structure loans accordingly taking into consideration the cost of growing and harvesting a crop as well as what the farmer needs to support their family until that crop is sold. Therefore, there can be no doubt that the Bank relies completely on the proceeds of that year's crop to repay the operating loan.

If the crop proceeds are not realized by a farmer because of an elevator insolvency the farmer does not have the cash flow to repay its operating loan. If the farmer has enough equity in their equipment, or real estate it might be possible for the Bank to restructure that year's loss over several years in the way of a Term Loan that is collateralized by the land and equipment of the farmer.

If, however, the loss cannot be termed out the farmer might be forced to sell equipment or land to generate income to repay the operating loan. This is excruciating for the farmer and usually creates other unwanted financial consequences such as large tax bills for capital gains on depreciated equipment or land handed down from generation to generation.

Quite often a farmer isn't able to willfully make the decision to downsize or substantially liquidate assets to cover the crop loss caused by an insolvency and a Bank must take legal action to force a liquidation and repayment of the operating loan. Forced liquidation comes in the way of an action to liquidate machinery and other personal property called claim and delivery or an action on the Security Agreement contract that secures the personal property assets for the loan.

CASH FLOW LENDING

Cash flow-based lending allows farmers to borrow money based on their projected future cash flows as an operation. In cash flow lending, a Bank grants a loan based on the farmer's past and future cash flows. An advantage to cash flow lending is that it allows a Bank to account for risk brought on by a sector or an economic cycle. For a farmer, their cash flow comes solely from the crop. The farmer does not have cash flow and ability to repay its operating loan until they receive proceeds from the crop. A Bank tends to worry less about cash flow since farmers generally have physical collateral to pledge, but it’s important to note the collateral isn’t the source of cash flow, it’s the proceeds from the crops.

DEBT SERVICE COVERAGE

Debt service coverage is the measurement of the available cash flow to pay current debt obligations. This includes being able to service the equipment and real estate loans as well. The ratio of debt coverage is based on the net operating income as a multiple of debt obligations due within one year, including interest, principal, sinking-fund and lease payments. Lenders commonly use this ratio to determine whether a borrower would have the necessary cash flow in a year to cover their debts.

If the cash flow isn’t enough, then banks use collateral based lending. Collateral based lending is typically used when a borrower cannot show enough cash flow or cash assets to cover the debt, but receives lending by putting up their own collateral in case of a default. A collateral based loan or line of credit can be secured by inventory, accounts receivable, equipment, or other property owned by the borrower. Banks need to keep in mind that although they may be well collateralized there is still plenty of risk involved. Depending on the collateral, Banks are at the mercy of the market dictating the overall value. Land value has hung consistent but there could eventually be a downturn. Commodity prices are always in flux and are at risk of dropping for a number of reasons. The valuation of equipment can drastically drop over years of use and can be difficult to cover debts. Over-lending, especially to unqualified borrowers, and relying on collateral in case of a default can be recipe for disaster and could lead to similar results as in 2008. If Banks are more reluctant to lend then it also hurts potentially new and qualified borrowers from entering the market.

CLAIM AND DELIVERY

Claim and Delivery, is an action to recover personal such as equipment and other non-real estate assets that are pledged to a Bank to support an Ag loan. Claim and Delivery is a judicial remedy found in the North Dakota Century Code § 32-07. An example for a Claim and Delivery is where a Bank seeks a court order requiring the farmer to turn over the property because of a default on an operating line of credit.

The Bank in an action to recover the possession of personal property, at the time of issuing the summons or at any time before answer, may claim the immediate delivery of the property. When a delivery is claimed, the Bank or someone on behalf of the Bank must make an affidavit. The affidavit must state that the Bank is the owner of the property being claimed and is being wrongfully held by the farmer. The Bank must allege a cause for the farmer's holding of the property to the best of their knowledge. The affidavit must state the actual value of the property being held. Finally, that a court issue an order allowing the delivery of the property, either through notice to the farmer and a hearing or without notice under certain circumstances. Those circumstances include: theft or fraud; the property consists of one or more negotiable instruments or credit cards; the property is perishable or will be irreparably harmed before a hearing can be held; or the property is in immediate danger of destruction, harm, concealment, removal from the state, or of sale to an innocent purchaser. The Bank may require in their affidavit that the sheriff of the county the property is in, to take control of the farmer's property and deliver it to the Bank. The other way a Bank will force a liquidation of assets is through a real estate foreclosure.

AG REAL ESTATE FORECLOSURE

After a farmer Ag loan is in default, the foreclosure process begins with the Bank serving a Notice Before Foreclosure upon the farmer(s) of the mortgaged property. The Notice Before Foreclosure identifies the defaults under the mortgage and loan documents and sets out what must be done to cure those defaults and avoid the foreclosure of the mortgage. If the farmer defaults have not been fully cured within 30 days after service of the Notice Before Foreclosure, the lender can start a foreclosure action and seek a judgment from the court that allows the lender to sell the mortgaged property to satisfy the debt. For agricultural property, the debtor has a year from the filing of the complaint, or not less than 60 days after the sheriff's sale, to redeem the property from the purchaser at the sheriff's sale. The foreclosure process for agricultural land can take between 15–20 months, or longer if the case is contested. The Mortgagor is entitled to retain all rents and profits from the foreclosed property throughout the redemption period. Generally, attorney fees are not recoverable in North Dakota foreclosures.

If a deficiency remains after application of proceeds of the foreclosure sale, the mortgagee can seek a deficiency judgment, which be done by commencing a *separate action* within 90 days after the sheriff's sale. The court will make a finding of the property's fair market value before determining if there is a deficiency. There is no presumption that the agricultural land is sold at the sheriff's sale for the fair market value. There is no deficiency judgment unless the FMV is determined to be less than the amount of the foreclosure judgment plus costs. A deficiency judgment on agricultural property is only enforceable by execution within 3 years of date of entry of judgment and will expire at the end of 3 years.

CHAPTER 12 BANKRUPTCY

Background

A Chapter 12 Bankruptcy is designed for "family farmers" or "family fishermen" with "regular annual income." It enables financially distressed family farmers and fishermen to propose and carry out a plan to repay all or part of their debts. The Bankruptcy Code splits "family farmers" into two categories: (1) an individual or individual and spouse, and (2) a corporation or partnership. Under chapter 12, debtors propose a repayment plan to make installments to creditors over three to five years. Farmers must meet each of the following four criteria as of the date the petition is filed in order to qualify for relief under Chapter 12:

1. The individual or husband and wife must be engaged in a farming operation or a commercial fishing operation.
2. The total debts (secured and unsecured) of the operation must not exceed $10,000,000 (if a farming operation). (Increased from $4.1 million to $10 million, as of 8/23/19).
3. If a family farmer, at least 50%, and if family fisherman at least 80%, of the total debts that are fixed in amount (exclusive of debt for the debtor's home) must be related to the farming or commercial fishing operation.
4. More than 50% of the gross income of the individual or the husband and wife for the preceding tax year (or, for family farmers only, for each of the 2nd and 3rd prior tax years) must have come from the farming or commercial fishing operation.

In order for a corporation or partnership to be eligible to file as family farmers or family fishermen, the corporation or partnership must meet each of the following criteria as of the date of the filing of the petition:

1. More than one-half the outstanding stock or equity in the corporation or partnership must be owned by one family or by one family and its relatives.
2. The family or the family and its relatives must conduct the farming or commercial fishing operation.
3. More than 80% of the value of the corporate or partnership assets must be related to the farming or fishing operation.
4. The total indebtedness of the corporation or partnership must not exceed $10,000,000 (if a farming operation).

5. At least 50% for a farming operation or 80% for a fishing operation of the corporation's or partnership's total debts which are fixed in amount (exclusive of debt for one home occupied by a shareholder) must be related to the farming or fishing operation.
6. If the corporation issues stock, the stock cannot be publicly traded.

<u>Procedure</u>

When a chapter 12 petition is filed, an impartial trustee is appointed to administer the case. Filing the petition under chapter 12 "automatically stays" (stops) most collection actions against the debtor or the debtor's property. Chapter 12 also contains a special automatic stay provision that protects co-debtors. Unless the bankruptcy court authorizes otherwise, a creditor may not seek to collect a "consumer debt" from any individual who is liable with the debtor. A creditor can still sue a guarantor on agricultural indebtedness. Between 21 to 35 days after the petition is filed, the chapter 12 trustee will hold a "meeting of creditors." During the meeting the trustee puts the debtor under oath and both the trustee and creditors may ask questions regarding the debtor's financial affairs and the proposed terms of the debtor's repayment plan. The parties typically resolve problems with the plan either during or shortly after the creditors' meeting. Creditors must file their claims with the court within 90 days after the first date set for the meeting of creditors. After the meeting of creditors, the debtor, the chapter 12 trustee, and interested creditors will attend a hearing on confirmation of the debtor's chapter 12 repayment plan.

EFFECT ON MARKET VALUES OF EQUIPMENT AND LAND

North Dakota is major player in the United States for agricultural production. According to the USDA, North Dakota ranks first in production in 10 of 25 major crops recorded. 90% of North Dakota's land is used for agriculture which totals about 40 million acres. Additionally, almost 25% of the state population is employed within the agricultural sector.

Consequently, one or several elevator insolvencies can have a significant effect on a community if that communities' farmers are already struggling to make ends meet and the more forced liquidation sales of equipment and land there are the more the market will be flooded decreasing the land and equipment values making it even more difficult for farmers to sell their property to repay their debt. The devaluation of the farmer's equipment and farm land also may make it impossible for Banks to write a new loan terming out the lost income debt because of the inability to underwrite the loan based on the lower collateral values based on the Bank's federal and state underwriting requirements.

THE STATE'S CREDIT SALE INDEMNITY FUND GOES A LONG WAY TO PROTECT FARMERS FROM LOSS DUE TO AN ELEVATOR INSOLVENCY.

Farmers have the opportunity to invest in crop insurance for loss due to weather and other conditions and North Dakota provides for an indemnification for loss caused by an insolvent grain buyer. Similar to crop insurance participation, the indemnity fund allows farmers to put the proceeds received from the fund towards repaying the operating loan. This allows the farmer, even in a downturn, to continue to stay afloat and continue operations. Additionally, the ability to keep the crop market stable through the indemnity fund, through the ups and downs, helps banks build confidence in lending to their farmers. More confidence ensures a better flow of capital amongst the bank, farmers, and their communities.

BANK FINANCING AN ELEVATOR

In addition to supporting farmers, North Dakota banks also provide operating capital to the elevators. That capital allows elevators to keep their lights on and pay the salaries of their workers. Therefore, it's important to remember that a failing elevator doesn't just hurt itself, but also affects the flow of capital between the bank and its community. A primary issue to be addressed is the enforcement and monitoring of elevator inventory. Whose property is with the elevator? Is it there on a delayed pricing basis waiting to be sold or simply being stored? As stated above, the only repayment comes from the crop. Therefore, if the crop is considered inventory, someone should have a 1st priority lien on the crops. If the crop is being warehoused at the elevator, then rent payments should be paid, which isn't currently being done. The Ag study should focus on these issues and recognize that banks are better equipped at monitoring inventory and should be involved when it comes to elevator insolvencies.

BORROWING BASE

A borrowing base is the amount of money that a Bank is willing to loan an elevator, based on the value of the collateral the elevator pledges. Various assets can be used as the collateral, including accounts receivable, inventory, real estate, and equipment. Thus, it's imperative that there be a clarification as to what the crop is considered while it's being stored. If the crop is considered inventory, then a 1st priority lien should be on the crops. If the crop is being warehoused, then rent payments should be made. This clarification is crucial for Banks to properly lend to an elevator and should be a priority moving forward in the Ag study.

INDEMNITY FUND

The North Dakota Credit-Sale Indemnity Fund was created in 2003 as a measure to protect grain producers that sold their grain via credit-sale contracts to recover a grain warehouse. The fund ensures producers would be able to recover on the contract if the warehouse becomes insolvent. Claimants are currently eligible to receive 80% of the amount owed, not to exceed $280,000.00.

The proposed changes would be to broaden the definition and scope of a credit-sale contract and narrow the definition of a receipt. Additionally, the Fund cap and floor should be raised to keep up with inflation. To provide meaningful protection for growers, the maximum claim amount should be increased to $400,000.00.

The credit-sale contract definition should be changed because it does not reflect agricultural realities. Grain farmers are rarely the ones delivering grain to the elevator/warehouses; they have employees who will deliver grain, sign for the scale ticket, and any other paperwork when the grain is delivered. Trying to get the producer come in and sign a credit-sale contract after delivery grain is unrealistic and nearly impossible. If a producer has stated his intentions to use a credit-sale contract or worked out a deal with the elevator, the contract should not be invalid because it is not signed, and should not change the nature of the transaction.