

## COUNSELOR'S CORNER

### Managing Risk in Custom-Feeder Lending: A Case Study

# Stinking Up Negotiability

(Part I of III)

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**M**OST FEEDLOTS IN NEBRASKA offer custom-feeder services. Normally, the feeder and the feedlot<sup>1</sup> will need financing. Banks must carefully manage the risks associated with these lending relationships. This article is the first in a three-part series that examines lessons learned from a recent Iowa case.<sup>2</sup> Nebraska lenders must take steps to limit exposure to the same risks highlighted in the Iowa case.

Today, we examine language that destroyed the negotiability of a promissory note. Part II will explore the consequences to the Iowa bank of losing negotiability on the note. In the final installment, we will discuss recommendations for managing risk in custom-feeder lending relationships.

#### The Parties

A typical custom-feeder relationship involves three primary parties:

1) a feeder that owns cattle and has them finished at a feedlot; 2) a feedlot that feeds, cares for, and markets cattle provided by the feeder; and 3) a bank that offers financing to the feeder, feedlot, or both.

Banks can choose a direct lending relationship with the feeder. However, in the Iowa case, the bank chose to have a direct lending relationship with the feedlot only. The bank financed the feedlot's operation and also financed the feedlot's extension of credit to feeders.

#### The Lending Arrangement

The Iowa bank provided the feedlot with a standard-form promissory note that was copied by the feedlot every time it received a load of cattle. The note contained blank spaces for the number, weight of cattle, and the estimated cost to feed the cattle to slaughter weight. The bank<sup>3</sup> drafted the note for execution by the feeder, payable to the feedlot. The note included both a monetary obligation to pay back the note and a security interest in the cattle that were the subject of the note. The note was likely intended by the bank to be a negotiable instrument.

When the feedlot received a load of cattle from a feeder, the feedlot filled in the blanks in the note and sent it to the feeder. The feeder then executed and returned the note to the feedlot. Upon receipt of an executed note, the feedlot assigned the note to the bank.

In a separate transaction, the feedlot directed the bank to advance the value of the cattle less \$150.00 of equity per head to the feeder. The bank also advanced funds to the feedlot to feed, care for, and market the cattle.

When the cattle were marketed, the feedlot deposited the packer checks into the bank. The feedlot sent the net proceeds and a closeout statement to the feeder. The feedlot also directed the

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bank to pay off the corresponding loan between the feedlot and the bank.

### **Negotiable Instruments**

By design, negotiable instruments are transferrable and give a holder in due course confidence in the enforceability of the instrument. The maker of a negotiable instrument is unable to raise most defenses to the instrument against a holder in due course. Nebraska's Uniform Commercial Code defines a negotiable instrument, in part, as "an *unconditional promise* or order to pay a *fixed amount* of money . . ."<sup>4</sup> The Iowa bank's standard-form note included language that violated both of these negotiability requirements.

### **The Language of the Note**

The bank's standard-form note stated in part:

The undersigned . . . promise(s) to pay to the order of Feedlot . . . the principal sum of \$\_\_\_\_\_ or so much thereof as is disbursed and remains outstanding hereunder . . . as shown by the Feedlot's liability record . . .<sup>5</sup>

Perhaps contrary to the bank's intention, the note was not a negotiable instrument because it did not contain an unconditional promise to pay a fixed amount of money.

### **Fixed Amount of Money**

The language in the note "or so much thereof as is disbursed and remains outstanding" was likely added because the bank advanced funds to the feedlot one feed bill at a time. As a result, it was possible that the full amount of the note would not be advanced to the feedlot. However, this language made the principal amount due on the note variable. To be a negotiable instrument, the promise or order must be for a fixed principal amount.<sup>6</sup>

### **Unconditional Promise**

In addition to a variable principal amount, the promise to pay was conditional because the amount was determined by a writing other than the note. The Nebraska Uniform Commercial Code states that a promise is unconditional unless it states:

the promise or order is subject to or governed by another writing, or . . . that rights or obligations with respect to the promise or order are stated in another writing.<sup>7</sup>

A reference to "another writing" does not automatically make a note non-negotiable. However, the value of the note cannot be dependent upon "another writing." The note in the Iowa case was "subject to or governed by" the "Feedlot's liability record." Additionally, the "rights or obligations with respect to the promise or order" were stated in the "Feedlot's liability record." Any holder of the note was required to examine the "Feedlot's liability record" to determine its value.

Because the principal amount of the note was variable, and the promise was conditional upon the "Feedlot's liability record,"<sup>8</sup> the negotiability of the note was destroyed.

### **"Toto, I Have a Feeling We're Not in Kansas Anymore."**

When the note lost its negotiability, the Iowa bank was no longer a holder in due course. Under the Nebraska Uniform Commercial Code, because the notes contained both a monetary obligation and a security interest, the notes were chattel paper. "Chattel paper means a record or records that evidence both a monetary obligation and a security interest in specific goods . . ."<sup>9</sup>

<sup>1</sup> The term "feedlot" is used in this series instead of "feedyard."

<sup>2</sup> *Rolling Hills Bank & Trust v. Mossy Creek Farms Ltd. P'ship*, No. 2-909/12-0489 (Iowa Ct. App., Jan. 9, 2013.) available at [www.iowacourts.gov/court\\_of\\_appeals/Recent\\_Opinions/20130109/2-909.pdf](http://www.iowacourts.gov/court_of_appeals/Recent_Opinions/20130109/2-909.pdf) (last visited Feb. 28, 2013).

<sup>3</sup> The original drafter of the note was unknown to the bank.

<sup>4</sup> Neb. Rev. Stat. § 3-104(a) (2001) (emphasis added.) This series will cite to the relevant portions of the Nebraska Uniform Commercial Code, rather than the Iowa provisions cited in *Rolling Hills*.

<sup>5</sup> Emphasis added.

<sup>6</sup> Interest does not destroy the negotiability of a note and is specifically exempted under Neb. Rev. Stat. § 3-112(b) (2001).

<sup>7</sup> Neb. Rev. Stat. § 3-106 (2001).

<sup>8</sup> Further adding to the problem, the note did not define the phrase "Feedlot's liability record" and the parties disagreed on the meaning of the term.



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