COUNSELOR'S CORNER

Managing Risk in Custom-Feeder Lending:

A Case Study

Stinking Up Negotiability

Part III of III

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THIS IS THE LAST IN A THREE-PART series inspired by a recent case that brought to light some of the risks involved in lending to custom cattle feeding operations. The first installment addressed language that made a promissory note something other than a negotiable instrument, and the problems that created in enforcing the note. The second installment discussed the risk the bank incurred when it failed to provide an authenticated notice of assignment to the debtor after the feedlot assigned the note to the bank. Today, we look more deeply at these issues and examine how the bank could have avoided some of the problems and risks associated with these loans.

Quick Recap of the Facts

The case involved three parties: a bank (that financed the feedlot's operation), a feedlot (that custom-fed cattle and provided financing to cattle owners), and cattle owners (who borrowed funds to finance their purchase of cattle and feed). Early on, the bank decided it wanted the feedlot to be its customer, not the cattle owners. To accomplish this, the bank drafted standard form promissory notes that cattle owners executed in favor of the feedlot. The feedlot assigned the notes to the bank and the bank advanced money under the notes to the cattle owners (through the feedlot).

Because the cattle owners didn't need the full amount of the notes immediately when their cattle came into the feedlot, the notes were set up to allow the feedlot (but really the bank) to advance funds under the notes for a percentage of the purchase price of the cattle when they were brought into the yard. Then, the bank advanced additional amounts each month as feed bills became due. When the cattle were sold, the feedlot received the proceeds and was supposed to pay off the notes at the bank, sending the remaining proceeds to the cattle owners along with a closeout statement identifying the income and expenses (including the principle and interest on the notes) incurred in feeding the cattle.

Everything went fine until the feedlot fell behind in preparing closeout statements. Suddenly, funds accumulated in the feedlot's cattle account while notes became delinquent. When the notices of default started rolling in, the feedlot began paying off the most delinquent notes from packer proceeds checks without regard to whether the money used to pay off the note came from the pen of cattle that related to the note being paid. The feedlot also began sending "profit" checks to cattle owners based on estimates without being completely sure that the closeouts were accurate. You can see where this is going, right?

Houston, We Have a Problem

Every Ponzi scheme eventually leaves someone holding an empty bag. Here, it was the bank. Importantly, though, it didn't have to end up that way. Let's spend the rest of this article looking at what the bank could have done to better protect its interests. As an assignee of a non-negotiable instrument, the bank faced three big problems.

"If you must take a note on assignment, immediately provide the debtor with an authenticated notice of assignment."

Problem One. The bank's enforcement of a note against a cattle owner was subject to any claim or defense that the cattle owner had against the feedlot arising from the same transaction. So, if a feedlot employee left a gate open and 10 of the owner's steers from this pen of cattle disappeared, the cattle owner's damages arising from the feedlot's negligence becomes a set-off against the bank's enforcement of the note.

Problem Two. Because neither the bank nor the feedlot ever provided the cattle owner with an authenticated notice of assignment of the note, a cattle owner can set off transactionally unrelated claims against the bank's enforcement of the note. If a cattle owner sold the feedlot a truckload of corn three years ago and the feedlot failed to pay the cattle owner for the value of the corn, those damages can be set off against the bank's enforcement of the note. If the feedlot owner backed his F-350 into the cattle owner's 16-year-old daughter's BMW convertible, well, that becomes a set-off against the bank's enforcement of the note as well. Obviously, this can leave the bank subject to a myriad of potentially unknown risks in attempting to enforce the note.

Problem Three. Prior to receipt of a notice of assignment of the note, a cattle owner can satisfy its obligation on the note by paying either the feedlot (the assignor) or the bank (the assignee). That is exactly what happened in this case (along with tidbits of Problems One and Two). The cattle owner successfully argued that the feedlot's receipt of the packer checks coupled with the feedlot's issuance of a closeout and profit check (whether calculated correctly or not) constituted payment of the note. Whether the feedlot then paid the bank was, in short, not the cattle owner's problem. Of course, the bank was still free to pursue the feedlot to recover the wrongfully withheld funds, but there is that whole "can't get blood from a turnip" thing to deal with there.

What to Do?

Direct Lending. At family reunions, in chemistry labs, and in banking, relationships matter. Who ultimately received the benefit from the cattle loans: the feedlot or the cattle owner? Since the cattle owner actually receives the funds (through repayment of cattle procurement costs or as funds advanced in payment of the owner's feed bill), structure a direct lending relationship between the bank and cattle

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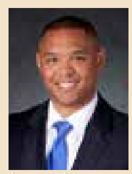
■ **Negotiability** — continued

owner. Put the person who receives the money directly on the dotted line across from the lender that actually provides the funds. When the feedlot was brought into the relationship as essentially a straw man, the bank created more problems than it solved.

Assignments. Remember, whenever you make an assignment, you make an ass out of I and Gnment—okay, that doesn't work. Remember this instead, if you must take a note on assignment, immediately provide the debtor with an authenticated notice of assignment. Immediately. That same day. Do not forget. Do not wait. The notice of assignment is "a notification, authenticated by the assignor or the assignee, that the amount due or to become due has been assigned and that payment is to be made to the assignee." "Authentication" in this circumstance is generally satisfied by sending the notice of assignment on the bank's letterhead or on a form on which the bank's name appears.

Hindsight Is 20/20

It really is true that an ounce of commonsense is worth a pound of cure. The bank could have required that the feedlot inform packers that all checks for cattle proceeds should be made payable jointly to the feedlot and the bank up to the amount of the note related to that lot of cattle. In that case, before sending cattle to the packer, the feedlot would have to call the bank to get the current amount of the note on the cattle being shipped. The bank would know that a particular lot of cattle had been shipped and would know that payment on the note would be forthcoming. Even more importantly, when the packer check arrived, the bank could endorse the check and apply the proceeds to the correct note. In the case we have been discussing, this requirement was included in the assignments, but both the bank and the feedlot decided that this was too much trouble. I am fairly certain they would rethink that decision today. The easiest path is not always the smoothest road in the long run.



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