Winter 2017

FINANCIAL newsletter

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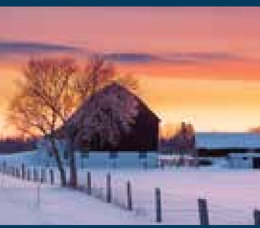
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LENDER LIABILITY REVISITED: WHEN DO BANKER'S EFFORTS TO HELP GO TOO FAR

Many banks offer high quality personal service to their customers and often assist their business borrowers with financial analysis. As a result of experience and training with many different businesses and borrowers bankers may also occasionally attempt to provide direction to their borrowers on the operation of their businesses. This is more common when financial distress is present and the borrower may be struggling to meet its financial obligations. Advice and direction, while valuable, can present a risk to the banker who mandates too much control over a borrower's activities. If the relationship sours, or the borrower gets into financial trouble, they may seek to place the blame for their financial difficulties on the bank.

While an ordinary lender-borrower relationship does not give rise to any special duty on the part of the bank, a bank's relationship with its customers may cross a line which imposes fiduciary obligations under certain circumstances. Case law refers to this kind of relationship as a "special relationship" or a "confidential relationship." In Minnesota, a special

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LENDER LIABILITY REVISITED: WHEN DO BANKER'S EFFORTS TO HELP GO TOO FAR

continued from pg 1

relationship exists if the bank knows, or has reason to know, that the customer is placing their trust and confidence in the bank and is relying on the bank to counsel and inform them. The court may look to the sophistication of the customer, the length of the parties' relationship, and the role of the bank in the transaction.

Something above and beyond the ordinary relationship between a bank and its borrower is necessary for potential liability on the bank. The danger to a banker is that liability can depend on many different factors. Certain types of actions can be more dangerous than others. Any action a banker takes that mandates the borrower run its business in a certain manner can be problematic. Advice and analysis is the hallmark of a banker's service to its client. Dictating a course of conduct and making the decisions for the business owner, however, can potentially expose a bank to liability.

In one Minnesota bankruptcy case, the borrower defaulted on its loan obligations, and the bank had the right to obtain a controlling interest in the borrower's stock as a result. The bank foreclosed its security interests on all of the accounts receivable and contract rights, which depleted the borrower's only source of cash and deprived the borrower's unsecured creditors of any assets from which they could recover. The level of control that the bank had over the borrower required the bank to deal fairly and impartially with the borrower and its creditors. Because the bank's actions were designed solely to protect and enhance the bank's interests, the bankruptcy court ultimately reversed the transfers from the borrower to the bank and subordinated the bank's interests to the unsecured creditors.

Control over a borrower's business might be demonstrated in a number of ways, but courts will look at the whole picture when determining if sufficient control existed to translate into liability. It may take the form of a right of first refusal to purchase the borrower's products, the bank acting as the sole financer for the business, an unrestricted right to entry and inspection, or the right to prohibit the borrower from entering into mortgages, purchasing stock, or issuing dividends without bank approval. The existence of one or even several of these facts may not result in liability, but at some point, the balance will tip. In extreme circumstances, a court may find that not only is the bank liable to the borrower, but the bank is also liable to third-parties who contracted with the borrower while the bank was effectively controlling the borrower's business.

There are no hard and fast rules for when courts will impose additional duties or liability on a bank, so it is important that bankers be aware of the possibilities and guard against them. Exercising rights as a secured creditor or offering advice and guidance to a business customer is not likely to trigger liability, but wielding too much control and making decisions for the borrower may do so. If you have questions about how to best approach your relationships with your business clients without compromising your services, Gislason & Hunter can assist you. ■

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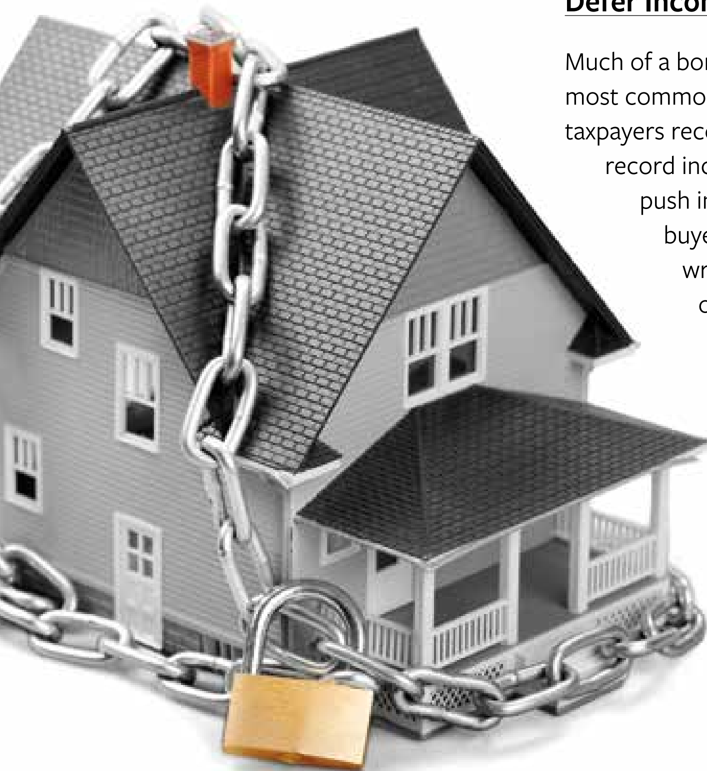
PREPAIDS AND DEFERRED INCOME:
HOW TO PROTECT YOUR COLLATERAL FROM YOUR BORROWER'S TAX PLANNING STRATEGY



Yearend is approaching, which for many borrowers means it's that time of year when tax planning kicks into high gear. Basic income tax planning techniques can have a substantial impact on how much collateral a borrower has in their possession at any given time throughout the year.

Defer Income and Prepay Expenses: Why Do (Some) Borrowers Do It?

Much of a borrower's tax planning depends on the accounting method it uses. The two most common types of tax accounting methods are cash and accrual. Accrual basis taxpayers record income and expenses as they occur. In contrast, cash basis taxpayers record income and expenses as they are *actually paid*. A cash basis taxpayer can push income into the following year by delivering goods now but asking the buyer to send the check in January, or pull deductions into this year by writing a check in December for supplies they won't need until the middle of next year.

Generally speaking, only small businesses can use the cash method. However, there are exceptions to this rule, the most notable of which is farming businesses. Thus, even farming operations with very large gross receipts often use cash method accounting—and use prepayments and deferral of income as tax planning strategies.

Why Should a Lender Care About Deferred Income and Prepaid Expenses?

When a borrower defers receipt of income or prepays expenses, the borrower is not going to have as much physical collateral in his possession as the lender might expect. Instead of having cash in the

bank, he has a *right* to receive cash from a buyer who agreed to defer payment. Instead of having next year's inputs or a new tractor in the barn, he has a *right* to delivery of the goods in a few months.

What can the lender do to recover when the borrower has rights to payments and assets rather than the payments and assets themselves—and what if the party the borrower is doing business with has their own creditor problems?

What Protections Does the UCC Provide?

Just because the borrower doesn't have physical collateral in hand doesn't mean the lender lacks a perfected security interest. A secured party whose interest has attached can enforce its rights not only against the debtor but also against third parties.

If the borrower's deferred income comes from the sale of an asset in which the lender had a perfected security interest, Revised UCC Article 9 provides that the lender also has a perfected security interest in the account—in other words, the borrower's right to payment—as proceeds of original collateral.

Furthermore, under the "double debtor" rule, the buyer and the buyer's secured creditors take the property subject to the perfected security interest of the seller's lender unless the lender terminated the security interest by consent or the purchaser was a buyer in the ordinary course of business. Farm products are also excepted from the buyer in the ordinary course rule and are instead governed by the Food Security Act. A buyer takes farm products subject to the security interest of the seller's lender if the lender has filed an Effective Financing Statement with the Central Notice System, even in purchased in the ordinary course of business.

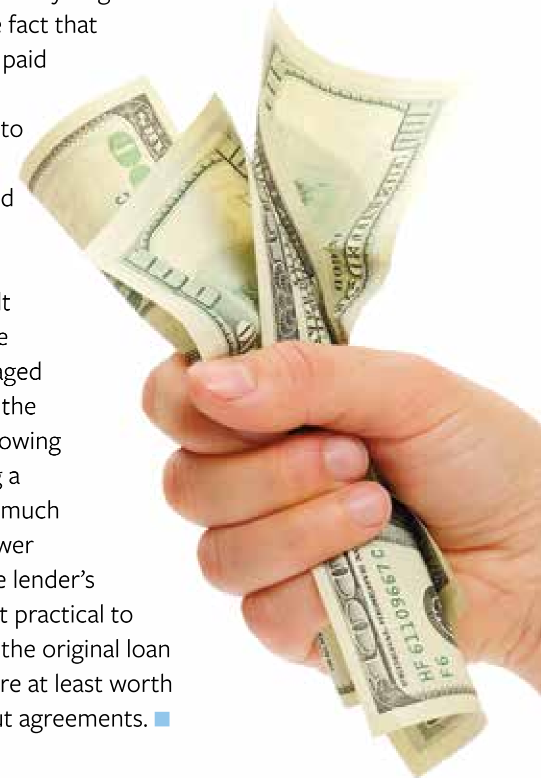
In practice, this means that the lender usually retains priority of their perfected security interest even if the borrower sells operating assets and defers payment. If the buyer defaults in payment, the lender has the option of recovering from the proceeds (the account) or the property sold. Because of the buyer in the ordinary course of business exception, deferred payments on sales of inventory other than farm products usually limits the lender to recovering from the account.

When it comes to prepaid expenses for goods not yet delivered, the lender will only have a priority perfected security interest in limited circumstances. Under Revised UCC Article 9, if the borrower made the prepayment to a vendor for property the vendor sells in the ordinary course of his business, the borrower only becomes a buyer in the ordinary course as soon as he possesses the goods or acquires the right to recover the goods under UCC Article 2 (Sales). However, a buyer only has the right to recover goods from an insolvent seller if the seller becomes insolvent within ten days after receipt of the first payment.

Extra Protections for Lenders:

- **If the borrower sells farm products, file an EFS.** Filing an Effective Financing Statement is an extra step, but maintaining a perfected security interest even against buyers in the ordinary course of business is well worth the minimal hassle.
- **Take assignments of major contracts and leases.** If a lender is concerned about substantial prepayments on service contracts or leases, the lender should at least take an assignment of the borrower's rights under the contracts or leases so the lender has the ability to enforce them in the event of the borrower's default.
- **Take extra steps with large prepayments.** If a large prepayment is unavoidable, a lender can sometimes contractually limit risk of the vendor's default. In some circumstances a vendor may agree to hold the borrower's prepayments in escrow until delivery of the finished goods. The vendor is protected from the borrower failing to pay, but the borrower and lender are also protected from the vendor failing to deliver. If the vendor needs to use the prepayments—for example, to custom manufacture large equipment for the borrower—consider requiring the borrower obtain and perfect a security interest in the property, and request that the vendor's creditor subordinate its lien.
- **Recognize that a bird in the hand is worth two in the bush.** Deferring income carries risks that cash-in-hand does not. Prepaying for future delivery of goods or services has similar risks, in addition to the fact that even if the thing being paid for is delivered, it may not be worth as much to the lender as the cash the borrower deposited with the seller.

  This reality can be dealt with by discounting the value of prepaids and aged accounts receivable in the calculation of the borrowing base, or even including a covenant limiting how much or to whom the borrower can prepay without the lender's prior consent. If it's not practical to include these terms in the original loan documentation, they are at least worth considering in work-out agreements. ■



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CASE LAW UPDATE

DUSENBERRY V. HAWKS
MINNESOTA COURT OF APPEALS, 2017

Crown Hydro, LLC owned two generators. In 2006, Crown Hydro entered into a storage and maintenance agreement with Randal C. Olson. Mr. Olson stored the generators in his garage in Jordan, Minnesota, and agreed to rotate the generator shafts monthly. Crown Hydro agreed to pay $2000 a month in return. Mr. Olson never filed any documentation with regard to his interest in the generators, and never filed a UCC financing statement.

In 2013, Katheryn Dusenbery agreed to provide financing for Crown Hydro's proposed hydroelectric plant. Ms. Dusenbery loaned Crown Hydro $250,000.00 secured by an interest in the two generators. Ms. Dusenbery was aware that the generators were kept off site, but did not know that Mr. Olson had possession of them. Ms. Dusenbery filed a UCC financing statement and perfected a first priority secured interest.

In 2014, Crown Hydro defaulted on its debt owed to Ms. Dusenbery. At that time, Mr. Olson possessed the collateral and alleged that Crown Hydro owed him at least $137,000 under their storage and maintenance agreement. Ms. Dusenbery sued, claiming that she had a right to possess the collateral and seeking a declaration of her first priority rights.

The Court of Appeals determined that Mr. Olson was a bailee in continuous possession of the collateral, and therefore had a priority statutory lien. Under Article 9 of the UCC, a party in possession of collateral with a statutory lien has priority over all other security interests, regardless of the date of filing, unless the statute which creates the lien expressly provides otherwise. Because there are no exceptions in the bailee-in-possession statute, Mr. Olson had a first priority security interest in the collateral.

Practice Tip: If you know that your collateral is being kept off-site, identify any other parties who may have an interest in the collateral and obtain subordination agreements.

U.S. BANK NAT'L ASS'N V. RBP REALTY, LLC
MINNESOTA COURT OF APPEALS, 2016

In 2006, RBP Realty, LLC entered into a $7.5 million loan with Wachovia Bank, secured by a mortgage on commercial real property. RBP Realty defaulted on its loan in 2013. The parties entered into a written pre-negotiation agreement where RBP Realty agreed to waive its statutory right of redemption. In 2014, Wachovia foreclosed by advertisement and purchased the property at auction for $4.25 million. RBP Realty attempted to redeem the property, and Wachovia objected based on the parties' written agreement.

The Court of Appeals found that Chapter 580 creates a statutory six month right of redemption, and that a private agreement between the borrower and the lender is not one of the limited reasons why that redemption period may be altered. The borrower cannot voluntarily waive its right of redemption, and any attempt to do so will be unenforceable under Minnesota law. ■

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- Loan and credit agreements
- Subordination and participation agreements

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