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FINANCIAL newsletter

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INSIDE THIS ISSUE

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AGRICULTURAL DRAINAGE FOR LENDERS

When early settlors first encountered Minnesota, they'd have seen a landscape much different than the grids of corn and soybean feilds prevalent today, including a landscape pockmarked by small lakes, wetlands, and sloughs. Over the past century, thousands of miles of public and private drainage systems have been used to turn Minnesota into one of the top crop-producing states in the country. Though not without controversy, agricultural drainage plays a hugely important role in modern farming. Because drainage can affect the value of land and productivity of a farm operation, a general understanding of drainage issues can be important for lenders.

Drainage System Basics

Agricultural drainage primarily consists of open ditches and buried tile. Open ditches are usually artificial water channels that act as conduits to quickly transfer water into natural rivers and streams. Many ditches were originally natural waterways that were channelized, straightened, and deepened in order to more efficiently move water off the land. Others were simply dug and constructed artificially through the land where no prior watercourse existed.

Drainage tile is a buried pipe that provides a conduit for water under the land, allowing farmers to continue farming the property over the pipe. Early drainage

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AGRICULTURAL DRAINAGE FOR LENDERS

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tile consisted of very short sections of clay or concrete pipe that were laid in a trench and buried. Though concrete pipe is still used today, more common is black plastic pipe that can be installed in an open trench or, in smaller diameters, plowed into the ground using special equipment. Drainage tile works in several ways. Large tile "mains" ranging in size from 6 inch pipe to 36-inch or larger provide the major arteries that funnel water to ditches, lakes, or other outlets. Pattern tile consists of smaller pipes with perforated holes buried in parallel lines across a property spaced around 50 feet apart. Pattern tile soak up excess water from the surface and drain into the main tile lines.

As discussed below, public drainage systems are run by a drainage authority, typically a county board, which uses ditch assessments to fund the construction and ongoing maintenance of a drainage system. Private systems are owned and installed by individuals, either solely on one owners' land, or jointly with neighbors who have a shared interest in eliminating excess water. Prudent landowners will enter into formal drainage easements that specify how the cost of initial installation and ongoing maintenance will be shared among the owners.

Public Drainage Law Primer

Public drainage systems are run by a drainage authority, typically a county board, which uses ditch assessments to fund the construction and ongoing maintenance of a drainage system. For over 100 years, Minnesota has had a system of laws for the establishment of public drainage systems. Minnesota's drainage code is found at Chapter 103E of Minnesota's statutory code. Two of the most common proceedings under the drainage code that lenders should be aware of are "establishment" proceedings—used to create a new public drainage system or convert a private system to a public system, and "improvement" proceedings—used to improve existing systems by, for example, deepening ditches or increasing tile size.

The procedure for either is the similar. First, a certain percentage of affected landowners must file a petition with the drainage authority, asking for the establishment or improvement of the system. An engineer is appointed to complete a preliminary and then detailed study of the proposed drainage project and issue a report and construction plans. "Viewers"—specialized appraisers—are then appointed to calculate the estimated economic benefits of the project. Viewers also calculate damages associated with the project—damages are amounts paid to a landowner whose property is taken by the project. For example, if a ditch cutting through a field will take up five acres of land, that landowner is entitled to be paid for those five acres through this process. If the project is feasible and meets certain environmental standards, it will be approved so long as the benefits determined by the viewers exceed the costs of the project including damages paid to landowners.

What Lenders Need to Know about Public Drainage Proceedings

Drainage will most often be a farmer's concern, not a lender's, but there are some situations where drainage issues may impact the lender's position. First is potential impairment of mortgages on property affected by a public drainage project. As explained above, often a drainage project will involve taking private land to place a new ditch or other drainage feature. Consider a typical ditch crossing a quarter section of land would take over seven acres of land, worth perhaps $50,000 or more. While the impact is not huge on a 160 acre parcel, in a troubled loan situation, this additional land may make the difference between a full recovery or a loss.

The loss of tillable land to drainage proceedings is becoming more common. With the implementation of the buffer law in 2015—requiring 16.5 foot buffers around public drainage ditches—many drainage authorities are completing proceedings to acquire easements for the establishment of buffers and paying landowners for the value of the land and removing the land from production. Many new public drainage improvement projects are implementing storage ponds or restored wetlands to address environmental concerns. These water-storage features can occupy several acres and can be constructed over the landowner's objection through the drainage proceeding. Notably, even a properly perfected mortgage is subject to these drainage improvements, so long as the landowner receives proper notice.

Lenders could exercise their rights typically found in mortgage documents entitling the lender to recover amounts paid on account on a governmental taking. Most mortgages include a condemnation section, entitling the lender to payments made to landowners on account of a taking by a government entity. Depending on the language utilized in the mortgage, the lender likely has a right to insist that the payments made to landowners for buffers or other drainage system features be turned over. While most lenders will not exercise this right for normal drainage proceedings if the mortgage is not in default, if there are problems with the loan, this may be another source of recovery. A lender could also consider including a requirement that borrowers provide them notices of drainage proceedings that might affect mortgaged property.

Lenders should also bear in mind that the costs of drainage projects and repairs are typically assessed through property taxes. Sometimes these assessments can be considerable, though large assessments are usually allowed to be paid off over a number of years with interest like other special assessments. The failure by a landowner to pay drainage assessments can subject the land to tax forfeiture; like other unpaid taxes, lenders can make protective advances if a landowner fails to make payments.

Joint Private Drainage Systems

Joint private drainage systems are common throughout the state and can raise some unique issues for lenders. Often constructed many years or decades ago between cooperative neighbors or family members, as land has changed hands over the years, many landowners find that verbal agreements or abbreviated written easements do not provide sufficiently definite terms, leading to disputes about the timing and cost of maintenance, the addition of new land draining to the system, or other matters. A new written drainage easement can be used to address these types of issues.

Whether a lender's mortgage is subject to a private drainage easement depends on which document is recorded first. If a mortgage already exists when a new drainage easement is entered, the easement will be junior to the mortgage and can be eliminated through a foreclosure of the mortgage. For this reason, landowners seeking to enter an easement may request that mortgage holders subordinate their existing mortgage to the easement or consent to the easement. Sometimes, a written easement adds to the value of land, by formalizing what may be an ambiguous situation concerning the ability to continue draining water over another's land.

However, before agreeing to a subordination or consent, lenders should carefully review the terms to ensure they understand how their mortgage may be affected, particularly on a breach of the easement. For example, some easements allow unpaid ditch maintenance costs to be enforced as a lien against property. A lien could be foreclosed, and if the lender subordinated to easement, the foreclosure could potentially put the mortgage at risk.

While the potential impact of drainage issues may not dramatically change any normal lending practices, having knowledge of these issues should half lenders keep themselves informed concerning their collateral.


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STABLECOIN: AN UPDATE ON THE USE OF VIRTUAL CURRENCIES IN BANKING

Although cryptocurrencies have been around since 2008 when Satoshi Nakamoto released Bitcoin, the technology has only recently gained mainstream acceptance as a possible medium of exchange (beyond a speculative investment asset). PayPal announced that it will support payments made with cryptocurrencies. JPMorgan Chase created the JPM Coin, a virtual currency created to facilitate B2B transactions between its customers. The United States, along with many other countries, is also considering the use of an official digital currency known as a central bank digital currency. See https://www.federalreserve.gov/newsevents/pressreleases/other20210520b.htm.

Like many emerging technologies, cryptocurrencies have the potential to disrupt the way the banking and finance industry conduct business. In particular, stablecoins, a subset of cryptocurrencies, present a unique opportunity to move payment activities onto the blockchain. Banks need to monitor emerging regulatory developments, educate their staff, and prepare for the compliance challenges inherent in using stablecoins.

How Cryptocurrencies Work

Cryptocurrency is a medium of exchange created and stored electronically in the form of digital or virtual currency. The exchange mechanism for most cryptocurrencies is based on two separate technologies—cryptography and distributed ledger technology. Cryptology or cryptographic algorithms create digital code that cannot be altered without the permission of the creator. The code functions as a key to transfer cryptocurrency stored on distributed ledger technology, such as a blockchain.

Cryptographic keys associated with a particular unit of cryptocurrency are stored in computer programs known as "wallets." There are different types of wallets. Hosted wallets are controlled by an identifiable third-party. The third-party receives, stores, and transmits cryptocurrency transactions on behalf of the owner. The owner of the cryptocurrency does not have access to the cryptographic keys. As you would expect, an unhosted wallet is controlled by the owner of the cryptocurrency. Wallets can also be hot—connected to the internet—or cold—stored on physical devices that are offline.

As mentioned above, the actual virtual currency and confirmed transactions involving said currency are stored on distributed ledger technology. Distributed ledger technology ("DLT") is simply a shared electronic database that exists across several locations, also known as "nodes." Information, such as the validation of cryptocurrency transfers, are stored on all of the computers/nodes comprising the database. New information is not added until consensus is reached on the network and the loss of one computer will not bring down the system because of the decentralized nature of the database. Blockchain is the type of DLT most commonly associated with Bitcoin.

A cryptocurrency transfer can be thought of as a message signed with a private cryptographic key that is sent along a DLT, authenticated by each of the nodes, and then delivered to the recipient's wallet. The transaction is recorded on all of the nodes in the decentralized database.

The Three Different Types of Stablecoins

A true cryptocurrency, like Bitcoin, doesn't function well as a medium of exchange because of its wildly fluctuating value. The value in these types of cryptocurrencies is completely market driven. The digital currency is not backed by assets and does not grant the owner any rights against the issuer. For example, there is no guarantee that you will be able to use Bitcoin or Ether to pay for goods or that you will be able to redeem the cryptocurrency for

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STABLECOIN: AN UPDATE ON THE USE OF VIRTUAL CURRENCIES IN BANKING

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legal tender.

In contrast, a stablecoin is designed to have a stable value as compared with other types of cryptocurrencies. The most common type of stablecoin is a stablecoin that is backed by fiat currency or some other asset ("Fiat-Asset Collateralized"). Tether (USDT), USD Coin (USDC) and True USD (TUSD) are examples of stablecoins that are pegged to the value of the U.S. Dollar on a 1-to-1 ratio.

Stablecoins can also be collateralized with other more volatile cryptocurrencies ("Crypo-Collateralized"). The underlying digital currency securing the stablecoin may be held in a smart contract that contains elements of a written contact and self-executing code that takes actions to maintain the value of the stablecoin. The last type of stablecoin is not backed by any assets, but is controlled by a sophisticated computer program that seeks to maintain a stable value through monitoring demand and controlling supply of the stablecoin.

Stablecoin transfers on DLT should provide numerous benefits over existing payment technology. Such transactions will likely be instantaneous or nearly instantaneous, and grant parties the ability to make transfers in real time 24 hours a day. Transfers will be cheaper and more efficient, especially for international transactions. Also, because of the DLT there is no single point of failure in the system. Cyberattacks will need to target all nodes on the network simultaneously. Even if one of the nodes fails, transactions should be able to continue in the ordinary course of business.

Regulatory Update

On January 4, 2021, the Office of the Comptroller of the Currency ("OCC") published Interpretive Letter 1174, authorizing national banks and federal savings associations to use "independent node verification networks" and stablecoins to perform "bank-permissible functions." Specifically, national banks and FSAs may validate, store, and record payment transactions by serving as a node on an independent node verification network ("INVN"), a type of DLT. Such banks may even "buy, sell, and issue stablecoin to facilitate payments."

According to the OCC, it has always permitted national banks to adopt new technologies for executing payments so long as those activities are conducted in a manner consistent with safe and sound banking practices and applicable law. The OCC compared the use of stablecoins in electronic payments to debit cards, checks, and electronically stored value systems that convey payment instructions. Whether facilitating payments with traditional methods or stablecoins, the bank's core function is still transmitting payment instructions and validating payments. The technological distinction does not affect the permissibility of the underlying activity.

However, the use of cryptocurrencies in banking raises increased compliance risks. The OCC expects banks engaging in cryptocurrency services to retain employees with the appropriate expertise and to adapt and expand their anti-money laundering and know your customer compliance programs. Banks must still be able to verify the identities of all parties in a stablecoin transaction and have appropriate controls in place to manage risks and protect reserve assets. In Interpretative Letter 1172, the OCC noted that banks should verify at least daily that reserve accounts securing stablecoin have balances equal to or greater than the value of an issuer's outstanding stablecoins. Interpretative Letter 1174 reiterates the 1-to-1 reserve ratio requirement for stablecoins that was contained in Interpretative Letter 1172.

Interpretive Letter 1174 only removes legal uncertainty as to whether national banks and FSAs may connect to INVNs and transact payments with stablecoins; it does not apply to other financial institutions. However, Interpretive Letter 1174 demonstrates that lawmakers will continue to scrutinize cryptocurrencies and ramp up regulatory efforts.

For example, the IRS has clarified that cryptocurrency is considered property for federal income tax purposes, the U.S. Commodities Futures Trading Commission will treat cryptocurrency as a commodity under the Commodity Exchange Act, and the U.S Department of Treasury's Financial Crimes Enforcement Network views cryptocurrency as "virtual currency." New issuances of Stablecoins might also be treated as securities under federal law (although this seems unlikely). The SEC has advised issuers to contact FinHub Staff with questions to ensure that cryptocurrencies are structured in compliance with federal securities laws.

Conclusion

Although it is unlikely stablecoins will replace the U.S. Dollar, our society is becoming more and more cashless every year. Demand from customers for faster and more efficient payment systems will only increase as cryptocurrencies become more accepted by mainstream society. Therefore, banks and other financial institutions should continue to monitor regulatory developments carefully and prepare their staff for what seems like the inevitable adoption of a new fintech.

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AGRICULTURAL LENDING CONFERENCE | 2021

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Save the Date

THURSDAY, SEPTEMBER 9, 2021
10:30 a.m.-4:30 p.m.
New Ulm Event Center
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TOPICS INCLUDE:

Back to the Basics
Electronic documents and signatures and special issues with trusts, estates and probates

Case Law and Legislative Update
Changes in the law affecting lenders

Top Issues Affecting Ag Lenders
Hidden liens, the bankruptcy discharge injunction, garnishments and more

Working with Other Lenders
Assignments, participation agreements, subordinations and an M&A primer

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STATUTORY LIENS

With crop prices at record highs for the past six months, lenders may start to become complacent in monitoring agricultural debtor's financial activities. Lenders and their counsel should be aware that agricultural input liens, if properly perfected, may have a higher priority than an earlier perfected lien and therefore may "trump" a blanket lien holder. This is why some agricultural statutory liens are sometimes referred to as "hidden liens". As a result, it is important for lenders to monitor agricultural loans closely and act accordingly if necessary to properly maintain senior creditor status.

1. Crop Liens/Agricultural Input Liens

Crop liens, also referred to as agricultural input liens, are created by statute and require strict compliance with the statute to be effective. Crop liens include what are commonly referred to as landlord liens, harvesters' lien and crop production input lien. A person leasing real property for agricultural production has a lien for unpaid rent on crops produced on the real property for the crop year that is the subject of the lease. Minn. Stat. § 514.964 subd. 1. A person providing harvesting services has a lien on the crops harvested, subject to the condition that the lienor may only get "one lien" and may not also claim a crop production input lien for the same goods or services. Minn. Stat. § 514.964 subd. 2. Finally, a supplier providing a crop production input (the chemical, seeds, petroleum products, custom services, and labor used in planting, cultivating, growing, harvesting, drying, and storing crops) has a lien on the existing crops or the next production crop, depending on the type of input provided. Minn. Stat. § 514.964 subd. 3. All of the agricultural crop liens extend to the proceeds and products of the crops serviced, produced, or harvested by the agricultural lienholder. Minn. Stat. § 514.964, subd. 4.

Perfection of an agricultural crop lien requires the filing of a financing statement under U.C.C. Article 9, rather than a lien statement. Minn. Stat. § 514.964, subd. 5. The financing statement must be filed in the same manner as any other U.C.C. financing statement, with differing time frames depending on the nature of the lien. The statutory agricultural liens must be perfected in the time frame required by the statute or they will not be effective against a prior properly perfected security interest. The crop input lien must be filed within six months after the last date that crop production inputs are furnished, the harvesters' lien must be filed within 15 days after the last date that harvesting services are provided, and the landlord's lien must be filed within 30 days after the crops become growing crops. Minn. Stat. § 514.964 subd. 5.

The financing statement must include enough description so that other potential lenders or creditors are put on notice of what specific crops are at issue. If the description is too limited, it may not put other creditors on notice and therefore not attach to the crops. For example, CHS Capital filed a financing statement related to their interest in crops grown by borrower. When a court heard the controversy between CHS Capital and a crop input provider to decide priority, the court found that CHS Capital's broad description of the collateral was sufficient to attach its security interest to any crops grown by the borrower,

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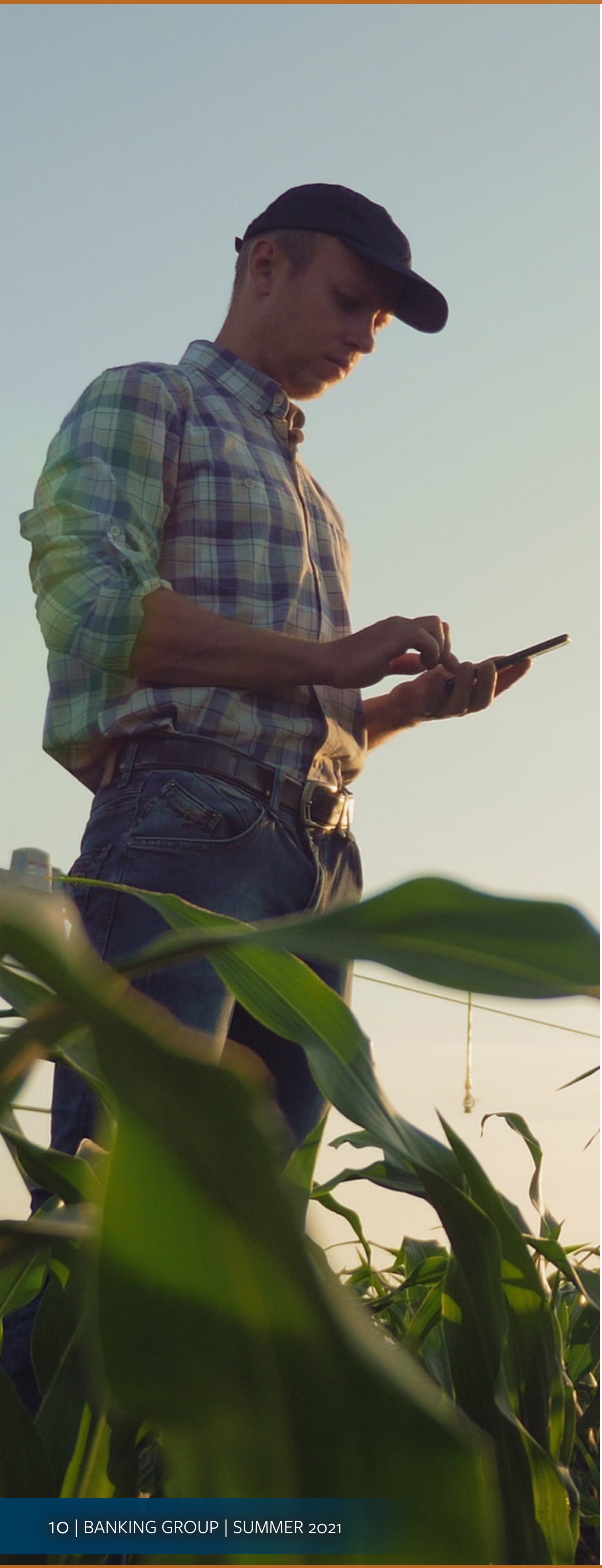

STATUTORY LIENS

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not just crops grown on land owned or leased by borrower. The court used a liberal definition of collateral descriptions "because their essential purpose is to provide notice, not to definitively describe each item of collateral." *CHS Capital LLC v. Lena Farms Prtshp LLC,* 2020 WL 3638806 (Minn. Ct. App. July 6, 2020) (Unpublished).

The statute sets up a scheme of priorities, with the landlord's lien being first; the harvester's lien being second with all "harvesters" sharing pro rata; and the input lien being third, with competing input liens being determined by date of effectiveness. Minn. Stat. § 514.964, subd. 7. All of these liens will trump any other competing security interest, including a blanket security interest, which secured the general operating line for the farm. This is true even when the blanket security interest was first in time.

2. Livestock Liens

Like crop liens, statutes also create liens on behalf of suppliers who service livestock. Those liens include the veterinarian's lien, the breeder's lien, the livestock production input lien and the feeder's lien. Livestock liens are defined at Minnesota Statutes section 514.966. The notification, perfection, attachment, and enforcement provisions for livestock liens parallel the crop lien provisions, including the special notice provisions of the livestock production input liens. Minn. Stat. § 514.966, subd. 3.

Perfected veterinarian liens have first priority over competing security interests and all agricultural liens on the same animals in order of effectiveness. Minn. Stat. § 514.966, subd. 8. Feeders' liens have second priority, breeders' liens have third priority, and livestock input liens have fourth priority. All competing liens within a certain priority group have priority in their order of effectiveness.

Pursuant to Minnesota Statutes section 514.966, subdivision 6, the various liens are perfected under differing time frames:

- The veterinarian's lien must be filed within 180 days after the last item of veterinary service is to be performed;
- The breeder's lien must be filed within six months after the last date that breeding services are provided to the obligor;

- The livestock production input lien must be perfected within six months after the last date that livestock production inputs are furnished, unless a temporary livestock production input lien is perfected within 60 days after the last date that livestock production inputs are furnished; and

- The feeder's lien must be perfected within 60 days of the date of the last service.

Similar to the crop lien, the livestock liens are limited to the price or value of the services furnished. However, each of the liens has its own extent of lien provision. The feeder's lien includes legal fees in the lien amount. Minn. Stat. § 514.966 subd. 4(b). The amount of the veterinarian services lien is stated as "value," not "price." Minn. Stat. § 514.966 subd. 1. The livestock input lien is limited to the unpaid retail cost of the livestock production input, however, the amount of the livestock production input lien may not exceed the amount of the increase in the value of the livestock. Minn. Stat. § 514.966, subd. 3. Similar to the crop liens, subdivision 3(b)(3) includes both the retail cost or anticipated costs. All of the agricultural livestock liens extend to the livestock serviced by the lienholder, and proceeds and products thereof. Minn. Stat. § 514.966, subd. 5.

3. Notification Statement

If a supplier desires to have priority over any security interest of the secured lender, the supplier needs to not only file a financing statement, as discussed above, but must also provide a lien-notification statement to the secured lender who has a security interest in the crops. The purpose of the lien-notification statement is to match the overall scheme of the U.C.C.: to ensure clear and certain priorities. As such, the notification and responses must comply with the requirements of the statute. The statute requires a lender to respond to the supplier with either a letter of commitment to pay for part or all of the retail cost or a written refusal to issue a letter of commitment within 10 calendar days after receiving a lien-notification statement. The response also must be provided "to the person for whom the financing was requested."

If the lender fails to issue a letter of commitment, its priority will be affected accordingly, meaning, a perfected crop production input lien corresponding to the lien-notification statement has priority over any security interest of the lender in the same crops or their proceeds for the lesser of:

(1) the amount stated in the lien-notification statement; or

(2) the unpaid retail cost of the crop production input identified in the lien-notification statement.

Minn. Stat. § 514.964 subd. 3(f). See also Minn. Stat. § 514.966, subd. 3(f).

Courts have strictly enforced the notification requirements. For example, in *Minnwest Bank, M.V. v. Arends*, the appellate court reviewed Minn. Stat. § 514.966 subd. 3 (which parallels Minn. Stat. 514.964 subd. 3) in great detail when deciding the priority of interests in livestock liens. *Minnwest Bank, M.V. v. Arends*, 802 N.W.2d 412 (Minn. Ct. App. 2011). The statute, through its use of the word "shall," requires the specific language "IMPORTANT – LEGAL NOTICE" to be included verbatim on the outside of the envelope containing its lien-notification statement. In *Minnwest Bank, M.V.*, the supplier did not include the phrase "IMPORTANT – LEGAL NOTICE" on the envelope of the lien-notification statement. The court held that because the requirements of subdivision 3 were not met, the lender was not required to respond to preserve its priority and the holder of a perfected livestock production input lien did not obtain priority over the bank.

As such, for secured lenders, it is very important to review any notification statement received, assess the effect, and respond accordingly within the time frame allowed. Statutory agricultural liens are sometimes referred to as "hidden liens" as they are created and may attach without requiring notice to the current, properly-perfected, secured creditor. As such, lenders need to be vigilant when working with agricultural borrowers.

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