COUNSELOR'S CORNER

Managing Risk in Custom-Feeder Lending: A Case Study

Stinking Up Negotiability

(Part II of III)

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THIS ARTICLE IS THE SECOND INstallment in a three-part series inspired by a recent case in Iowa.[1] It is intended to highlight the risks banks must manage, and the consequences for failing to do so, when lending to feedlots (i.e., feedyards) and feeders. The first installment highlighted the language in a promissory note that destroyed its negotiability, thereby limiting an Iowa bank's ability to enforce the instrument. The final segment will offer recommendations for controlling the inherent risks in a custom-feeder lending relationship. Today, we will explore the specific consequences suffered by a bank when an instrument is non-negotiable.

Quick Recap of the Facts

The Iowa case involved three parties: a bank that financed the feedlot's operation, a feeder that owned cattle, and a feedlot that cared for and marketed the feeder's cattle. The bank drafted a standard form promissory note for execution by the feeder, payable to the feedlot. The bank most likely intended for these instruments to be negotiable, which would allow for transferability of the note and give a holder in due course (the feedlot, initially) confidence in the enforceability of the instrument. However, the negotiability of the instruments was destroyed for two reasons: 1) The principal amount of the note was variable rather than fixed (the principal amount of the note must be fixed in order for it to be negotiable).[2] 2) The language of the note created a conditional promise to pay (the note must contain an unconditional promise to pay to be negotiable).[3] As such, the notes were actually chattel paper, an instrument containing a monetary obligation and a security interest, but which is not negotiable.[4]

The feedlot and the feeder executed a number of these notes, with the feedlot subsequently assigning several of these notes to the bank. Over time, the feedlot ran into financial difficulty and the bank demanded payment on the outstanding notes.

Authenticated Notice of Assignment

The Nebraska Uniform Commercial Code states that absent an authenticated notice of assignment from the assignor or assignee "an account debtor on . . . chattel paper . . . may discharge its obligation by paying the assignor or the assignee" and, furthermore, "after receipt of the notification, the account debtor may discharge its obligation by paying the assignee and may not discharge the obligation by paying the assignor."[5]

In the Iowa case, the feeder (the account debtor) executed the notes payable to the feedlot. The feedlot (or assignor) consequently assigned certain notes to the bank (the assignee), but neither of these parties notified the

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■ **Negotiability** — continued

feeder that the assignment had occurred. Legally speaking, an authenticated notice of assignment had not occurred, and the feeder/account debtor could satisfy the chattel paper by paying *either* the feedlot or the bank.

The Payment

The feeder in the Iowa case paid the amounts due on the notes in question by having the feedlot deduct the principal and interest due from the revenue generated by the sale of the corresponding lot of cattle. After the cattle were fed, marketed, and sold, the feedlot provided the feeder with the profit, if any, and a closeout statement, which reflected the final account settlement between the two parties. In legal terms, the feeder/account debtor had paid the assignor in full, satisfying the feeder's full obligation to both the feedlot and the bank under the notes because, again, the feeder had not received an authenticated notice of assignment prior discharging its obligation.

Consequences to the Bank

The Nebraska Statutes state that if an account debtor does not receive an authenticated notice of assignment, the rights of an assignee are subject to:

> [A]ll terms of the agreement between the account debtor and the assignor and any defense or claim in recoupment arising from the transaction that gave rise to the contract; and any defense or claim of the account debtor against the assignor which accrues before the account debtor receives a notification of the assignment authenticated by the assignor or the assignee.[6]

This statutory provision gives an account debtor (like the feeder) two separate strategies that he may use in responding to a claim by the assignee (like the bank). In the Iowa case, the cattle feeder used both. Because the feeder/account debtor had not received a notice of assignment of the note, the bank/assignee was subject to any of the affirmative defenses that the feeder had at its disposal. Payment to the assignor is one such affirmative defense. Since the feeder had satisfied its full payment obligations by making payment to the feedlot, the bank had no recourse against the account debtor. Additionally, the feeder could assert any *other* claims that the feeder had against the feedlot (even claims that were unrelated to the specific notes being sued on) as a "setoff" against any amount potentially due on the notes. Here, the feeder sent two other pens of cattle to the feedlot that were not subject to a promissory note. When the feedlot sold these cattle, the feedlot failed to send the sale proceeds to the feeder. Therefore, the feeder could assert that to the extent the feeder owed anything on the promissory notes, the feeder was entitled to a credit for the amount the feedlot owed the feeder for these two lots of non-financed cattle.

In retrospect, the bank's options, from a legal standpoint, were severely stunted by failing to: (a) draft a standard-form negotiable instrument; and (b) failing to send a timely authenticated notice of assignment to the account debtor. As a result of these missteps, the bank could only pursue legal action against the feedlot, which was mired in financial disarray and insolvent. Put simply, the bank was up a creek without a paddle.

Managing Risk: A Preview

In the next issue of Nebraska Banker, be on the lookout for the third and final installment of this series, which will highlight various ways in which banks can better manage the inherent risks involved in custom feeder relationships.

[1] *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 (last visited Feb. 28, 2013).

[2] Neb. Rev. Stat. § 3-106 (2001). This series cites to the relevant portions of the Nebraska Uniform Commercial Code, rather than the Iowa provisions cited in *Rolling Hills*.

[3] Neb. Rev. Stat. § 3-104(a) (2001).

[4] Neb. Rev. Stat. § 9-102(11) (2001).

[5] Neb. Rev. Stat. § 9-406(a) (2001).

[6] Neb. Rev. Stat. § 9-404(a)(1), *et. seq.*, (2001).

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