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## Banking and Financial Services Group

*David L. Knudson*

*Robert E. Hayes*

*Charles D. Gullickson*

*Monte R. Walz*

*Timothy M. Gebhart*

*Jonathan P. Brown*

*Catherine A. Tanck*

*Scott B. Anderson*

*Dixie K. Hieb*

*Keith A. Gauer*

*Douglas J. Hajek*

*Brendan W. Reilly*

*Amy M. Ross*

## Changes in Treatment: Nonqualified Deferred Compensation Plans

*By: Robert L. Thomas and Jean H. Bender*

In October 2004 Congress enacted the American Jobs Creation Act of 2004 (the "Act"). The Act adds a new Section 409A to the Internal Revenue Code which significantly changes the operation and taxation of nonqualified deferred compensation arrangements ("NQDC") for amounts deferred or that become vested on or after January 1, 2005.

The Act instructs the IRS to issue regulations and guidance in implementing the new requirements. At the end of December, the IRS issued Notice 2005-1. Although the guidance addresses many important questions, it leaves to subsequent guidance issues relating to certain distributions, plan documentation and consequences of noncompliance with Code §409A.

Below is a brief summary of the Act's rules relating to NQDCs. Under Section

409A, a NQDC plan is any plan that provides for the deferral of compensation other than tax qualified retirement plans (such as a 401(k) Plan) or any bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plans. Therefore, NQDC plans include stock appreciation rights plans (SARs), phantom stock arrangements, and other similar employer equity participation arrangements.

### Effective Date/Plan Amendments

The new law applies to amounts deferred in 2005 or later and generally does not apply to amounts deferred in 2004 or earlier. For this purpose, "deferred" means both earned and vested. Therefore, only vested amounts will be grandfathered under the existing law; amounts that have been deferred before 2005 but do not vest until 2005 or later

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## Home Mortgage Loan Treatment in South Dakota Chapter 13 Reorganization Plans

*By: Robert E. Hayes and Keith A. Gauer*

The Bankruptcy Code provides that a Chapter 13 debtor's Plan of Reorganization may modify the rights of holders of secured claims, with the exception of those claims "secured only by a security interest in real property that is the debtor's principal residence[.]" As a result, mortgage lenders have generally

taken the position that a debtor's Plan may not modify the terms (i.e., length of repayment, interest rate, etc.) of a mortgage loan secured by a debtor's principal residence. In a recent decision, however, the United States Bankruptcy Court for the District of South Dakota held that a debtor's Plan of

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## Changes in Treatment: Nonqualified Deferred Compensation Plans (cont.)

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are subject to the new rules.

An employer has until December 31, 2005 to amend its plan(s) to comply with Code §409A. Pending amendment, effective January 1, 2005, employers must operationally comply with Code §409A and Notice 2005-1.

### Material Modification

Vested balances in existing plans are only grandfathered if there are no material modifications to the plan after October 4, 2004. A material modification will occur if the employer adds or enhances a benefit or right existing as of October 3, 2004. Amending the plan solely to comply with Code §409A generally will not be a material modification, unless it adds or increases a benefit.

### Participant Elections

A plan must provide that compensation for services performed during a taxable year may be deferred at the participant's election only if the election to defer is made no later than the close of the preceding taxable year with a transitional period in 2005. In the case of a participant's first year of eligibility, the election may be made with respect to services to be performed subsequent to the election within thirty (30) days after the participant's eligibility date. In the case of any performance-based compensation based on services performed over a period of at least twelve (12) months, the election may be made no later than six (6) months before the end of the service period.

### Distributions

Under new Section 409A, the time and form of distributions of deferred compensation must be specified either in the plan or by the participant at the time the deferral election is made. Distributions from a NQDC plan only are allowed upon: (1) separation from service; (2) disability of the participant; (3) death; (4) a specified time (or pursuant to a fixed schedule) in the plan determined at the date of deferral; (5) change in the ownership or effective control of a corporation or in the

ownership of a substantial portion of the assets of a corporation; or (6) occurrence of an unforeseeable emergency.

No acceleration of distributions are allowed, except as permitted by future regulations. A subsequent election to defer distributions can only become effective twelve (12) months after the date the election is made. In addition, if the participant is further deferring a payment that was to be made at a specified time, the participant must make the subsequent election at least twelve (12) months in advance of the scheduled payment date, and the new election must defer the payment for at least five (5) years from the time the payment was originally scheduled to be made (except in the case of death, disability, or unforeseeable emergency). Changes in the form of payment (e.g. lump sum to annuity) must also comply with these rules.

### Reporting

Amounts required to be included in income are subject to reporting and federal income tax withholding requirements. Deferred amounts are required to be reported annually to the IRS. Such amounts are reported on an individual's Form W-2 (or Form 1099) for the year deferred even if the amount is not currently includible in income for that taxable year. The rules regarding the timing of an employer's deduction for nonqualified deferred compensation are not affected by these tax law changes.

### Consequences of Noncompliance

For tax years beginning on or after January 1, 2005, unless the NQDC Plan meets the requirements of Section 409A discussed above, all amounts deferred under the NQDC plan will be includible in the employee's gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. If the requirements of Section 409A are not met, in addition to income inclusion, interest at the underpayment rate plus 1% will be imposed and the amount required to be included in income will be subject to a 20% additional tax. DEHS

## Home Mortgage Loan Treatment in South Dakota Chapter 13 Reorganization Plans (cont.)

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Reorganization could modify the provisions of a mortgage loan secured by the debtor's residence where the debt owed to the mortgage lender was secured not only by the mortgage of the real property, but also by an "assignment of rents" provision in the mortgage. *In Re Robinson*, Bankr. No. 04-40674.

In the *Robinson* case, the Court pointed out that the right to rents and profits from real estate is generally tied to possession of the property and that rents are not presumed to be given as part of a mortgage unless the mortgage includes a specific provision assigning the rents. As a result, without an "assignment of rents" provision in the mortgage, the court held that the lender would not be entitled to the rents upon the property until such time as the lender had completed foreclosure of its mortgage. The mortgage upon the debtor's property in the *Robinson* case, which was granted to lender Fairbanks Capital Corporation, included a separate assignment of rents provision indicating that the borrower assigned the lender the rents on the property as security for the debt. The court held that this separate assignment of rents provision amounted to a grant of additional security to Fairbanks Capital Corporation over and above the security interest in the debtor's residence. As a result, the court overruled Fairbanks Capital's objection to the debtor's Plan of Reorganization, which proposed a modification to the interest rate on the loan.

The legal impact of the *Robinson* decision is not entirely clear at this point. Courts in other jurisdictions have reached a different result in connection with similar assignments of rents included in mortgages granted on a debtor's residence. Further, it is unclear whether or not the *Robinson* decision will be appealed. However, mortgage lenders may want to review their mortgage forms to determine whether or not the forms include a separate assignment of rents provision. If they do, the mortgage lender may want to consider amending the mortgage to eliminate the assignment in order to avoid a dispute in the event of

a Chapter 13 bankruptcy by a mortgage loan customer.

In South Dakota, the vast majority of all bankruptcy filings are Chapter 7 proceedings. The decision in the *Robinson* case will have no impact on the treatment of a mortgage loan in a Chapter 7 proceeding. The *Robinson* decision only impacts the permissible terms of a debtor's Plan of Reorganization in a Chapter 13 case. However, the bankruptcy reform legislation recently passed by Congress may have the effect of forcing more debtors to consider Chapter 13 filings. As a result, it may make sense for mortgage lenders to consider the impact of the *Robinson* decision at this time. DEHS

## The Merits of Pre-Filing a Financing Statement

By: Keith A. Gauer

Revised Article 9 of the Uniform Commercial Code, which became effective in July 2001, introduced the concept of advanced filing of a UCC-1 financing statement. Previously, a creditor could not file a financing statement until such time as the note and security agreement had been signed by the debtor and the funds advanced. What advantages does pre-filing provide to a financial institution making a commercial loan?

First, pre-filing allows a creditor to file its financing statement in advance to assure itself of its priority secured position with respect to personal property before the funds are advanced to the customer. In order to pre-file a financing statement, the bank simply needs an authenticated record from the debtor authorizing the filing (such as an e-mail or letter from the customer). Once the authorization is received, the bank can file the financing statement, run a search of the records, and be certain that it will be in its desired priority position upon making the loan. If the negotiations break down, the bank can simply terminate the financing statement.

Second, a pre-filed financing statement will trump an intervening lien filed before completion of the loan by the bank. The UCC priority rules continue to provide priority based upon a “first to file or perfect basis.” As an example, consider the following scenario: Very Broke, Inc., comes to AAA Bank #1 for a loan. As part of the initial loan application, AAA Bank #1 has Very Broke, Inc., sign an authorization allowing AAA Bank #1 to file an “all assets” UCC-1 financing statement to perfect a blanket lien in Very Broke, Inc.’s personal property. AAA Bank #1 then proceeds to file the UCC-1 immediately. Very Broke, Inc., and AAA Bank #1 then continue the loan application and underwriting process. In the meantime, Very Broke, Inc., goes to BBB Bank #2 and applies for a loan. BBB Bank #2, desperate for loan customers, quickly approves a loan to Very Broke, Inc., secured by a lien in all of Very Broke, Inc.’s personal property. BBB Bank #2 then files its financing statement. Thereafter, without having any knowledge of Very Broke, Inc.’s double dealing acts, AAA Bank #1

completes its loan review and approval and extends financing to Very Broke, Inc. Subsequently, Very Broke, Inc., files for bankruptcy. In the fight for lien priority between AAA Bank #1 and BBB Bank #2, who wins? The answer, of course, is AAA Bank #1 as it was the first bank to file. Even though AAA Bank #1 had not advanced sums to the debtor when it filed its financing statement, the pre-filing of the financing statement trumps the intervening lien and AAA Bank #1 takes a priority interest in the debtor’s collateral. DEHS

## Security Interests in Livestock Being Held by a Party Other than the Owner: How to Protect Your Collateral

By: Keith A. Gauer and Amanda Van Wybe<sup>1</sup>

Consider the following hypothetical:

The Worry-Free Financial Institution made a loan to farmer Ould McDonald in Minnesota so that he could purchase cattle for his personal livestock operation. At the same time, Worry-Free also executed a security agreement with McDonald for all livestock owned or later acquired. Then, in accordance with McDonald's customary practice, he purchased cattle and shipped them to Penniless Feedlot, Inc. in South Dakota for care and nourishment. Penniless Feedlot, Inc. was a corporation formed under the laws of the state of South Dakota.

While the cattle were at Penniless Feedlot, Inc., its owner, Sam Swindler, obtained a loan for the company from Conscientious National Bank. In order to convince Conscientious National Bank to give the corporation a loan, Sam lied and said that Penniless Feedlot, Inc. owned all the cattle on the feedlot. Although Conscientious National Bank believed Sam's representation that the corporation owned the cattle, it also inspected them, reviewed the corporation's financial statement and tax returns, and did a records search for UCC filings. However, the records search revealed nothing because neither Ould McDonald, as a bailor, nor Worry-Free, as a secured party had filed financing statements in South Dakota on Penniless Feedlot, Inc. Therefore, Conscientious National Bank approved the corporation's loan and took steps to protect its interest by executing a security agreement with the corporation and filing a financing statement on the corporation with the South Dakota secretary of state. Six months later, Penniless Feedlot, Inc. declared bankruptcy. Who will win in a priority dispute over the cattle; (a) the owner, Ould McDonald; (b) the owner's lender, Worry-Free Financial Institution; or (c) the feedlot's lender, Conscientious National Bank?

Before choosing your answer consider the following: SDCL 57A-9-203(1) sets forth three requirements that must be met before a security interest will attach and become enforceable against a debtor or third party (1) the debtor must sign a security agreement

which contains a description of the collateral, or the collateral must be in the possession of a secured party pursuant to an agreement; (2) value has to be given; and (3) the debtor must have rights in the collateral. Based on this statute it would seem that Ould McDonald or Worry-Free Financial Institution should win the priority battle because Penniless Feedlot, Inc. had no legal rights in the collateral to pass on to Conscientious National Bank. However, both Ould McDonald, who could have filed as a bailor, and Worry-Free Financial Institution, which was required to file to protect its security interest, failed to file financing statements in the appropriate place for a UCC-1 filing on Penniless Feedlot, Inc. Therefore, Penniless Feedlot, Inc. appeared to be the actual owner. Hence, Conscientious National Bank will win the priority dispute because McDonald and Worry-Free will be estopped from claiming that Penniless Feedlot, Inc. had no rights in the collateral.

The lesson to take from this hypothetical is that financial institutions lending money to livestock operations need to be cognizant of where the livestock will be located and file in the appropriate venue against the feedlot. Worry-Free Financial Institution would have been able to protect its interests by conducting a field inspection to determine where the collateral were going to be placed. Then, Worry-Free should have filed against Penniless Feedlot, Inc. in South Dakota, the state where it was incorporated, because the rights of the party who has title to the collateral are not determinative of the competing interests in the collateral. It is the outward appearance of the debtor's control and right of ownership in the collateral that determines whether a security interest attaches. DEHS

<sup>1</sup> 2004 Summer Associate at Davenport, Evans, Hurwitz & Smith.

**DAVENPORT  
EVANS  
HURWITZ &  
SMITH LLP  
LAWYERS**

206 West 14<sup>th</sup> Street  
P.O. Box 1030  
Sioux Falls, SD 57101-1030

Phone 605.336.2880  
Fax 605.335.3639  
www.dehs.com

Davenport, Evans, Hurwitz & Smith, LLP was founded in 1939. Since that time, the firm has grown steadily and is now one of the largest firms in South Dakota. One of the firm’s primary practice areas is the Banking and Financial Services Group. The firm acts as counsel to many South Dakota banks, financial institutions, holding companies, and service providers. Davenport, Evans was recently recognized in the Chambers USA 2004 client guide as a “leading firm of choice in South Dakota creditor circles” and as a “long established player...recognized for its preeminent banking” practice and its “superlative banking and securities law expertise.”

The firm handles all aspects of banking law, from entity formation, acquisitions, and branching, to operational issues involving lending, compliance, creditors' rights, payment processing (check, ACH, wire transfer), general commercial law, and trust administration. The firm represents banks in all phases of state and federal banking regulation and deals extensively with state and federal banking regulators. The firm understands that keeping up with new regulatory developments is a major challenge for banks today and helps its clients respond to that challenge effectively and efficiently.

South Dakota has become a major center for financial services, with approximately a half dozen credit card processing centers located in the Sioux Falls area alone. The firm has served as counsel to many of these entities and has particular experience and expertise in the areas of credit card issuance, compliance, and receivables securitization.

The firm also represents its bank clients in bankruptcy matters and complex commercial litigation on a regular basis. Davenport, Evans often acts as counsel to lenders in loan workouts and bankruptcy cases filed in South Dakota. The firm’s Banking and Financial Services Group, together with the firm’s strong Litigation Group, also handles commercial litigation such as bank shareholder disputes, complex lender liability cases, bank marketer disputes, federal compliance cases, and many other litigation issues.

Numerous out-of-state and nationwide lenders also retain the firm for review of loan documents, compliance with state and federal law, and assistance in completing major real estate and commercial loans. The firm also assists out of state individuals and entities in the formation and operation of trust companies.

If you have any questions regarding the firm's Banking and Financial Services Group, please feel free to contact us at your convenience.

<u>Attorney</u>	<u>Telephone</u>	<u>@dehs.com</u>
Scott B. Anderson*	605-357-1225	.....sanderson
Jean H. Bender	605-357-1224	.....jbender
Jonathan P. Brown*	605-357-1271	.....jbrown
P. Daniel Donohue	605-357-1226	.....pddonohue
Edwin E. Evans	605-357-1219	.....eevans
Thomas M. Frankman	605-357-1217	.....tfrankman
Keith A. Gauer*	605-357-1256	.....kgauer
Timothy M. Gebhart*	605-357-1243	.....tgebhart
Cheryle Wiedmeier Gering	605-357-1251	.....cgering
Charles D. Gullickson*	605-357-1270	.....cgullickson
Mark W. Haigh	605-357-1220	.....mhaigh
Douglas J. Hajek*	605-357-1227	.....dhajek
Robert E. Hayes*	605-357-1260	.....rhayes
Dixie K. Hieb*	605-357-1277	.....dhieb
Melissa C. Hinton	605-357-1262	.....mhinton
Sandra K. Hoglund	605-357-1253	.....shoglund
Kristi Geisler Holm	605-357-1221	.....kholm

<u>Attorney</u>	<u>Telephone</u>	<u>@dehs.com</u>
David L. Knudson*	605-357-1222	.....dknudson
Roberto A. Lange	605-357-1232	.....rlange
Sarah Richardson Larson	605-357-1228	.....slarson
Michael L. Luce	605-357-1231	.....mluce
Mark F. Marshall	605-357-1246	.....mmarshall
Matthew W. McNamee	605-357-1229	.....mmcnamee
Rick W. Orr	605-357-1292	.....rorr
Dana Van Beek Palmer	605-357-1250	.....dpalmer
Mitchell A. Peterson	605-357-1242	.....mpeterson
Brendan W. Reilly*	605-357-1254	.....breilly
Amy M. Ross*	605-357-1273	.....aross
Eric C. Schulte	605-357-1241	.....eschulte
Susan Brunick Simons	605-357-1263	.....ssimons
Catherine A. Tanck*	605-357-1223	.....ctanck
Robert L. Thomas	605-357-1214	.....rthomas
Monte R. Walz*	605-357-1266	.....mwalz

\*Member of the firm’s Banking and Financial Services Group