AGRICULTURAL ECONOMICS

April 19, 2023

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Cornhusker Economics

Things to Consider Before Co-Signing a Loan

This information is provided for educational purposes – it is not intended as legal advice. Whether to sign a loan guarantee and similar borrower-lender questions require a consideration of law and facts unique to each situation. You should not sign a loan guarantee without having the legal document reviewed and explained to you by your attorney and by an independent financial advisor. Failure to obtain legal and financial advice in these circumstances could result in large financial losses.

Parents co-signing loans for their children is common in agriculture. This usually happens when the child needs a loan to purchase land, livestock, or equipment. Lenders are more willing to make the loan to a beginning producer if the parents co-sign. This means the parents promise to repay the loan if the younger producer cannot. Parents have been doing this as a way to help their kids get started in agriculture for decades. If the child turns out to be an effective producer, the risk of the parents being on the hook for the unpaid loan balance is pretty manageable.

There is another situation when parents may be asked to co-sign or guarantee payment of a child's debt–when the younger producer can't pay their existing loans. Lenders may ask the borrower to provide additional loan collateral, such as land, livestock, or equipment that is clear of debt. The request for a parent's loan guarantee is another common way to provide additional security for repayment of a loan that is in trouble.

Obtaining the loan guarantee from the younger producer's parents often ends up being a late step in the ultimate loan foreclosure process, as illustrated in a 1987 Nebraska Supreme Court case (226 Neb. 314). In May 1983 the lender notified the son that the lender would need the father's guarantee of the son's operating loan to continue the loan. The amount owed was over $120,000 and the son's net worth was under $500. The father signed the guarantee, and the lender continued the loan. Five months later–November 1983, the lender called the loan because the son couldn't pay the entire loan balance. After the son's property had been sold, the father paid over $75,000 to cover the unpaid balance. If the father hadn't co-signed, the lender probably would have started foreclosure in May, probably ending up with a substantial loan loss, and Dad would have kept his $75,000.

Here are some general points to consider before you sign a loan guarantee for a family member who is heavily in debt:

1. *Will the loan co-signing work?* Get an outside financial analyst to give you an opinion regarding (a) what it would take to turn the operation around financially and (b) will the loan co-signing help in that process. If the answer to either question is no, see question 4.

2. *Cap the amount of the loan guarantee.* You don't want an open-ended liability, so fix the maximum dollar amount that you will be liable for.

3. *Find out from the lender how much debt payback is needed this year for the lender to continue providing operating financing next year.* If the family member has to pay everything off in one year, that isn't likely to happen unless you believe in miracles (see question number 1). Paying the loan balance over say 4-5 years might be a more feasible approach, and the amount of the loan guarantee could be reduced each year as the outstanding loan balance is paid down. The parents may need to be legally represented in negotiating this type of more complex loan guarantee.

4. *Can you afford to lose the amount of the loan guarantee* (see question 2)? If you can't afford to lose the money (and sadly it is more likely than not that you will lose at least some of it), then you can't afford to sign the loan guarantee.

5. *Farm workout agreement*. The typical loan guarantee may be a one-year agreement, where the producer has one last season to retire all the outstanding debt, often operating debt. Very often, it would take more than just one good year to balance the books. So, the parents should consider conditioning their loan co-signing with giving the younger producer more time to reduce the debt to a manageable level. During the 1980s farm financial crisis these types of multi-year agreements were called "workout agreements," and usually were an alternative to foreclosure and bankruptcy.

Struggling producers often do not have a good handle on their farm finances, including farm record keeping, farm budgets, and production costs. Part of a multi-year loan workout agreement could include deadlines for the younger producer to meet farm record keeping, budgeting, and production cost calculation requirements. Similarly, many struggling producers do not have formal marketing plans. If this were an issue, the workout agreement might require the younger producer to work with a marketing professional to develop and implement a formal marketing plan. Making these types of changes should improve the long-term prospects for successful farm or ranch operation.

Having to consider whether to co-sign a child's loan is a very difficult situation–no one wants to be part of losing part of the family farm or ranch to loan foreclosure. But if the loan guarantee isn't part of a financial turnaround plan that has at least a fighting chance of success, don't sign the guarantee unless you absolutely don't need the money for your own retirement.

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