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# **North Dakota's Central Filing of Security Interests in Agricultural Products and the Food Security Act of 1985**

Patricia B. Fry, Rodney J. Ebertowski, and David M. Saxowsky

## **Joint Agricultural Law/Economics Research Report**

Department of Agricultural Economics  
North Dakota State University  
Fargo, ND 58105-5636

School of Law  
University of North Dakota  
Grand Forks, ND 58202

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## HIGHLIGHTS

The Congress followed a unique course of action by addressing the "farm products rule" of the Uniform Commercial Code because it is an area of law generally considered in the realm of state responsibility. The "farm products rule" allows a creditor who has a security interest in a farmer's crop or livestock to seek payment from the purchaser of those commodities if the farmer does not pay the creditor. This can result in the purchaser paying for the products twice, once to the farmer and a second time to the unpaid creditor.

The federal law repealed the "farm products rule" but enacted two alternatives for states to adopt in order to preserve the protection provided to agricultural creditors. The first alternative is for creditors to directly notify prospective buyers of security interests in agriculture commodities whereas the second scheme requires states to adopt a central filing system which meets federal standards.

North Dakota enacted a central filing system prior to the federal legislation. Questions that arise as a consequence of the Congressional enactment are whether North Dakota intends to adopt the second alternative and whether the current central filing system satisfies the federal criteria.

This report reviews the farm product rule, North Dakota's current central filing system, and the standards established by federal law. The final section is an analysis of whether the current state system meets the federal criteria and what changes may be necessary for certification.

Generally, the North Dakota system aligns with the federal criteria except in the number of commodity categories, who will receive the lists, and what a buyer of farm products must do in order to acquire the commodities free of a lender's lien.

NORTH DAKOTA'S CENTRAL FILING OF  
SECURITY INTERESTS IN AGRICULTURAL PRODUCTS  
AND THE FOOD SECURITY ACT OF 1985

Patricia B. Fry, Rodney J. Ebertowski, David M. Saxowsky\*

State law since the mid-1960s has provided special protection for lenders whose loans to farmers are secured by livestock or crop commodities.<sup>1</sup> This special protection is a legal exception that has not been extended to other commercial loans. The usual rule is that a person who purchases goods in the ordinary course of an indebted seller's business will acquire the items free and clear of any claim by the seller's lender. The exception for farm products, on the other hand, continues a security interest in crops or livestock. Consequently, a purchaser of farm products may have to pay for the commodities twice, once to the farmer and a second time to the unpaid lender who has a security interest in the farm products.

Most states, including North Dakota, require lenders to provide public notice of their security interest by filing information about the lien with the county register of deeds.<sup>2</sup> Prospective purchasers are expected to search the public record to determine if a security interest exists before they purchase farm commodities. Many purchasers consider this expectation burdensome. They instead complete the purchase without conducting a search and assume the risk of an outstanding security interest against the farm products.

The 1985 North Dakota Legislature amended the law to require secured parties to also file their notice with the secretary of state.<sup>3</sup> The intent was to provide a single location for all farm product liens and thereby reduce the burden of conducting a search of the public record. Congress, later the same year, adopted rules as part of the Food Security Act of 1985 (the 1985 Farm Bill), which essentially repeal the farm product exception effective December 23, 1986.<sup>4</sup> The federal legislation, however, does provide that a security interest will continue to encumber farm commodities if the buyer is notified of the interest before the purchase, or the state has a central filing system approved by the secretary of agriculture.

Federal law is supreme in the United States; therefore, the Congressional enactment preempts the North Dakota legislation.<sup>5</sup> Businesses that lend capital to agriculture as well as those that purchase farm products will need to comply with the federal provision. Recognizing this, a fundamental question is whether a central filing system will be certified for North Dakota; otherwise, lenders will need to directly notify buyers of farm products in order to preserve their security interest against the buyer.

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\*Fry is Associate Professor of Law, University of North Dakota, Grand Forks; Ebertowski is a former student researcher, University of North Dakota School of Law, Grand Forks; and Saxowsky is Assistant Professor of Agricultural Economics, North Dakota State University, Fargo.

The purpose of this report is to review both the federal and state legislation and address whether the current North Dakota statutory scheme needs to be amended in order to be certified under the federal law. The first part of this report outlines the basic provisions of the farm products exception. The second section explains changes made by the North Dakota Legislature and the third part addresses new federal standards for notice of agricultural liens. Each of these sections also specifies the procedures a purchaser of farm products should follow in order to acquire them free from the lien of a lender. The final part considers whether any modifications to the North Dakota filing system are necessary before the secretary of agriculture will certify the state system as complying with the federal legislation.

### Basic Farm Products Rule

Farming is a business, and those involved in agriculture are continuing to alter their transactions to reflect this realization. Lending practices between a farm operator and lender are no different. Gone are the days when a loan between a farmer or rancher and the banker was based on a general unsecured line of credit. Currently, a farm loan is treated like other commercial loans with lenders often taking a security interest in crops to be grown, stored or growing crops, livestock, or some other farm product.

Article 9 of the Uniform Commercial Code revolutionized secured lending in the United States and was adopted by the North Dakota Legislature in 1965.<sup>6</sup> One of the major reforms accomplished by that statute was the establishment of a filing system which would furnish notice to third parties whenever credit was secured by a lien on personal property.<sup>7</sup> Drafters of the code, unable to resolve whether notices should be filed locally or on a statewide basis, provided states with several options for their filing systems. North Dakota adopted a system which calls for local filing of notices for farm products.<sup>8</sup>

A security interest is enforceable against third parties such as buyers only after it has been perfected. A security interest is perfected after there has been attachment and perfection,<sup>9</sup> which are explained below. Agricultural lenders, like any other commercial lender, have to follow the necessary procedures to ensure these two steps take place.

### Attachment

Three requirements must be met in order for attachment to occur.<sup>10</sup> One, the lender must have given the borrower something of value either through a cash loan or a credit sale. Second, the debtor must have signed a written security agreement that correctly describes the collateral and creates the security interest in it. A third requirement for attachment is that the debtor has an interest (usually an ownership interest) in the collateral. Attachment normally occurs when the loan agreement, along with any supporting documents, is executed and the debtor has received the borrowed funds. The security agreement is enforceable between the lender and debtor once the security interest is attached,<sup>11</sup> which means a lender can seize the collateral or have it sold for the lender's benefit if the debtor does not repay the obligation according to the terms of the loan agreement.

### Perfection

Perfection of a security interest occurs when a lender files the signed security agreement or financing statement in the appropriate public office.<sup>12</sup> The statement must include names of the debtor and secured party, signature of the debtor, address for the secured party, the debtor's mailing address, and a statement indicating the types or describing the items of collateral.<sup>13</sup> This filing provides public notice that the lender claims a security interest in the goods and priority over any party claiming a subsequent interest in the same goods. Restated, a perfected security interest protects the lender's lien from being subordinated to claims of third parties against the collateral.<sup>14</sup> These other parties may include, but are not limited to, other lenders with a security interest in the same collateral, a trustee in bankruptcy, or a purchaser of the encumbered items.<sup>15</sup>

The Uniform Commercial Code, however, permits a person who purchases goods subject to a perfected security interest to acquire those items free from claims of the secured lender as long as the sale occurred in the ordinary course of the seller's business.<sup>16</sup> Restated, a lender's security interest in or lien on the seller's inventory expires when the goods are purchased as part of conducting the business of the indebted seller. The lender has no legal claim against the purchased goods or the buyer even though the seller does not fully repay the lender. Ordinary course of business implies that the seller is in the business of selling the goods.<sup>17</sup> For example, a furniture store is in the business of selling furniture whereas a farmer is in the business of selling commodities produced as part of the farm operation.

### "Farm Products" Exception

The rule for sales in the ordinary course of business, however, does not apply to farm products.<sup>18</sup> A buyer of crops or livestock from a farmer acquires the commodities subject to any security interests granted by the farmer and perfected by the lender. An unpaid lender with a security interest in farm products is allowed to pursue those products even though they have been purchased and paid for and are in the possession of a buyer.<sup>19</sup> The continuing security interest in the farm product obligates the purchaser to either return the commodities or pay monetary damages to the lender in an amount equal to the value of the product. The lender also could pursue the commodities and recover them or damages from a subsequent purchaser if the first purchaser had resold them. Theoretically, a bank with a lien on cattle could repossess "the steak or meat on the consumer's table" if the lender can prove the food came from one of the encumbered cattle.<sup>20</sup>

This exception pertains only to farm products. For example, when a farmer or rancher purchases a farm implement from a dealer, the general rule applies, and the farmer or rancher acquires the implement free from any security interest that the implement dealer has given to a bank.<sup>21</sup> The purchasing farmer could not be required to pay the secured lender for the goods or return them. However, when that same farmer or rancher sells farm products, the perfected security interest of the agricultural lender follows the commodities into the hands of the purchaser. A secured lender who is not repaid by the farmer can sue the purchaser for damages or the goods.<sup>22</sup> The purchaser effectively is the ultimate guarantor of a loan to an

agricultural borrower,<sup>23</sup> but the maximum amount a purchaser can be required to pay to a secured lender is the value of the commodities or the amount of debt the seller owes the lender, whichever is less.

This special rule for farm products was justified "on the ground that farms sell to marketing agents, auctioneers, and brokers, who are sophisticated enough to know that their seller may have granted a security interest. . ." <sup>24</sup> The burden of searching the records for perfected security interests in farm products rests with the purchaser.<sup>25</sup> A possible further justification is that the rule is needed to maintain consistency within the law. The rationale would be that a farmer selling a year's production more closely aligns with a business that sells its entire inventory outside the ordinary course of business than with a business that sells only a single item from its inventory. Consequently, a buyer of farm commodities should purchase subject to an existing security interest the same as any other purchaser outside the ordinary course of business.

The farm products exception does not apply if a lender consents to the sale of farm products by the farmer to the purchaser.<sup>26</sup> Therefore, purchasers of farm products often argue that they are not obligated to pay a lender because the lender had implicitly or explicitly agreed to the sale. Similarly, purchasers who pay twice have a legal cause of action against the selling farmer, but if the farmer has defaulted on a loan with the lender, the buyer has limited practical opportunity for repayment.

The farm products exception which prevents purchasers from acquiring agricultural commodities free of claims by lenders has created problems in every agricultural state. Purchasers have strenuously resisted not only attempts by lenders to repossess commodities but also lenders' lawsuits demanding the value of the products. The resulting judicial decisions generally have favored the lenders.<sup>27</sup> However, the outcome of such litigation has been relatively uncertain, and both lenders and purchasers have been hampered in their attempts to plan their transactions.

Commentators harshly criticize this separate treatment of the agricultural economy. For example, Professor Barkley Clark, an authority on the Uniform Commercial Code, has written

the farm products exception is hard to justify on the merits. It has led to a welter of litigation that reflects confusion and lack of uniformity. Farmers and ranchers are big kids these days. The farm products exception treats them like innocent consumers. It smacks of paternalism. . .<sup>28</sup>

This and similar criticism has resulted in amendments to commercial laws in at least 12 states. For example, California eliminated the farm products exception,<sup>29</sup> while Oklahoma has deleted the exception with regard to crops.<sup>30</sup> Kentucky,<sup>31</sup> Indiana,<sup>32</sup> Tennessee,<sup>33</sup> and North Dakota<sup>34</sup> have added new provisions to adjust the rights of lenders and purchasers.

North Dakota addressed the farm products rule in 1983 by generally requiring selling farms to disclose the interest of second lenders.<sup>35</sup> This scheme was repealed by the legislature in 1985 and replaced with a modified form of central filing.

1985 Amendments to North Dakota Law

The 1985 North Dakota Legislature amended the law governing the notice procedure that must be followed by lenders in order to perfect their security interests in farm products.<sup>37</sup> An agricultural lender who follows the procedures set forth in the statute is assured that the proceeds of the sale cannot be used by the debtor without the lender's consent.<sup>38</sup> A mechanism also was furnished which ensures that a purchaser can acquire farm products free from a lender's lien if the purchaser complies with the new rules.<sup>39</sup>

The 1985 amendment pertains only to the relation between a secured lender and a purchaser.<sup>40</sup> It does not alter the status between a secured lender and others who may have an interest in the commodities such as another lender or a trustee in bankruptcy. Restated, the 1985 amendment does not eliminate any of the previous requirements for lenders desiring to perfect a security interest; instead, it adds a requirement. Therefore, a lender must continue to follow the pre-existing procedure for filing locally in order to be perfected against nonpurchasers claiming an interest in the commodities plus file a document with the secretary of state in order to be perfected against buyers of farm products. Agricultural lenders who do not complete this additional step will not be able to recover the goods from the buyers nor bring a conversion action for the value of these goods.<sup>41</sup>

Information Required of Lenders

North Dakota's central filing system means the purchaser of farm products only needs to search the lists obtained from the secretary of state and will no longer have to search the county files. A lender who fails to file the necessary document with the secretary of state will not appear on the list and will lose any right to proceed against the buyer. Thus, agricultural lenders will need to implement procedures necessary to comply with the statute in order to retain their rights against subsequent purchasers of farm products.

Filing with the secretary of state requires the secured party to use a form prescribed by that office. The form must contain all of the following information:

1. name and address of the person engaged in the farming operations,
2. county of residence of the operator,
3. social security number of the operator,
4. name and address of the secured party or lien holder,
5. description of the crops or livestock and their amount, if known, that is subject to the security interest, and
6. a legal description of the location of the crops or livestock.<sup>42</sup>

The information required by the new statute does not greatly differ from that previously required for perfection of the security interest.<sup>43</sup> The only new information that needs to be gathered from debtors is their social security number, their county of residence, and the amount of collateral, if known.<sup>44</sup> Lenders, consequently, will need to adapt loan applications or other forms to ensure that the additional information is obtained.

The secretary of state has indicated that a separate form is required despite the similar information needed for a financing statement and a filing with that office.<sup>45</sup> The explanation is that all information furnished to the secretary of state is being distributed. However, a lender's security interest frequently will encumber more than the farm products of a debtor. Therefore, the secretary of state requires lenders to use a form which excludes collateral other than farm products rather than gather information that will not be disseminated. This also simplifies preparation of the lists.

Agricultural lenders are required to provide certain information to debtors at the time the loan is made if the creditor intends to file the security interest with the secretary of state.<sup>46</sup> The information a creditor must give a debtor is that

1. the form will be filed with the secretary of state,
2. information on the form will be part of the central notice system,
3. the debtor's name will appear on the lists provided by the secretary of state,
4. a buyer of crops or livestock is required to make the check or draft payable to both the debtor and the secured creditor, and
5. once the debt is repaid, the debtor may demand that a release of the debt be filed with the appropriate officers within 30 days.<sup>47</sup>

A creditor who does not provide the required notice to a debtor at the time of the loan is not following the dictates of the statute. The sanction for failing to give this notice is not specified in the statute, but it is possible that a borrower or purchaser might resist a lender's efforts to collect the debt on the grounds of the lender's failure to comply. Accordingly, loan personnel must be aware of this requirement and ascertain that all the necessary information is provided to a debtor when a loan is extended.

Creditors may consider providing this information in written form even though not required to do so by the statute. Retaining a copy of the notice as well as a form signed by the debtor acknowledging receipt of the notice may be the preferred method for establishing that the creditor provided the required information.

#### Information From the Secretary of State

The statute mandates that the secretary of state provide two lists for purchasers of farm products.<sup>48</sup> One list will be for crops while a second list will pertain to livestock. The statute requires that the first lists be provided by January 1, 1986.<sup>49</sup> Thereafter, the lists are to be updated and provided to purchasers of farm products monthly at least five business days before their effective day.<sup>50</sup> The secretary of state must provide the lists to anyone requesting them, if the appropriate fee is paid.

The statute permits verbal requests for any information contained in the lists. Verbal inquiries may also request written confirmation of the information<sup>51</sup> and thereby provide record of what was received.

Persons interested in purchasing agricultural products will check the lists prepared by the secretary of state. A purchaser will acquire the commodities free and clear if there is no evidence that a security interest encumbers the products or if the purchase price is paid jointly to the debtor and listed creditor.<sup>52</sup> This procedure not only provides a method for buyers to acquire farm products without being subject to a security interest but also assures that the lender is paid.

#### Enforcement By Lenders

By comparison, a buyer will be subject to any security interest in the commodity if the lien is listed but the proceeds are not jointly paid to the indebted seller and secured lender.<sup>53</sup> Legal action cannot be commenced by a secured lender against the buyer (1) until 18 months have expired since date of the check and, (2) during these 18 months, the lender has informed the buyer that the security interest will be enforced. The notice will have to

1. be by certified mail or personal delivery,
2. name the person engaged in farming (the debtor),
3. specify the date of the check,
4. state the secured lender's intent to make a claim against the buyer,
5. indicate the amount of claim,
6. describe the crop or livestock, and
7. state that action has been commenced against the debtor, or that the debtor is in receivership or has filed bankruptcy.

The secured party may bring legal action against the buyer only after

1. a judgment has been obtained against the indebted seller and a good-faith effort has been made to collect it,
2. the required notice to the buyer was provided within 18 months after date of the check, and
3. the secured party lists all other security it has for the debt and describes how the collateral will be applied against the debt.<sup>54</sup>

Any legal action to collect from the buyer must be initiated within five years from the date of the check.<sup>55</sup>

Under the old system, a buyer of farm products had to search county by county for perfected security interests in those farm products. The necessary procedure and time involved dissuaded most buyers from conducting such a search. Even with a diligent search, it was possible that a perfected security interest would not be found, and the purchaser could end up paying twice for the same goods. For example, an elevator manager who failed to discover a perfected security interest and, therefore, completed the sale without the lender's consent might be required to return the property or pay the purchase price again, this time to the lender. Furthermore, anyone who bought the livestock or grain from that broker, agent, or auctioneer also could be required to return the property or pay its value to the lender.<sup>56</sup> This is the situation the new central notice system is designed to prevent.

### Rules for Notice in the 1985 Farm Bill

The "farm products" rule also received the attention of Congress in late 1985. Commercial law has traditionally been left to the states for regulation, but Congress determined that the farm products exception created problems of national scope. In the 1985 Farm Bill, Congress stated

(T)hese laws subject the purchaser of farm products to double payment for the products, once at the time of purchase, and again when the seller fails to repay the lender;

(T)he exposure of purchasers of farm products to double payment inhibits free competition in the market for farm products.<sup>57</sup>

The legislation is effective December 23, 1986, and specifies that a purchaser may acquire farm products free from a security interest created by the operator provided that the purchaser has not received notice of the secured claim.<sup>58</sup> The law sets forth two methods for lenders to provide notice and thereby protect their interest. One method is for the lender to directly notify purchasers that a security interest encumbers the commodities. This notice must be in writing, provided within one year before the purchase, and state the following information:

1. name and address of the secured party,
2. name and address of the debtor,
3. social security or tax identification number of the debtor,
4. a description of the farm products subject to the lien, including the amount of such products where applicable, crop year, county or parish, and a reasonable description of the property, and
5. any payment obligations imposed on the buyer as conditions for waiver or release of the lien.<sup>59</sup>

The statute also specifies that any material changes in the information in the notice must be furnished to the prospective purchaser in writing within three months.<sup>60</sup>

Lenders in states without a central filing system will have minimal protection because it is practically impossible to identify and notify all potential purchasers. Lenders may obligate the borrowers to assist in the identification of possible purchasers by requiring in the security agreement that the borrower furnish a list of persons to whom the commodity may be sold. A decision to sell to someone not on the list obligates the seller to (1) update the list at least seven days before the sale, (2) account for the proceeds no later than 10 days after the sale, or (3) face a fine equal to 15 percent of the commodity's value up to a maximum fine of \$5,000.<sup>61</sup>

### Central Filing System

The second method is available only to lenders in states that have an approved central filing system. Lenders in these states will be assured protection by registering their liens with the central filing system prior to the purchase.<sup>62</sup> A secured lender registers with the secretary of state by filing an "effective financing statement" as defined by the federal legislation, which slightly differs from the Uniform Commercial Code definition of a financing statement. An "effective financing statement" must

- A. contain the following information:
  1. signature of the secured party
  2. signature of the debtor
  3. name and address of the secured party
  4. name and address of the debtor
  5. social security or tax identification number of debtor
  6. description of encumbered farm products including amount (when applicable) and county or parish where located
- B. remain effective for five years after filing but may be extended another five years by filing a continuation statement within six months before expiration,
- C. be amended in writing, signed, and filed within three months after a material change,
- D. lapse on the expiration date or when the secured party files a notice that the statement has lapsed, whichever comes first,
- E. be accompanied by requisite filing fee set by the secretary of state, and,
- F. substantially comply with these requirements despite minor errors that are not misleading.<sup>63</sup>

The Uniform Commercial Code does not require the signature of the secured party, the debtor's social security or tax identification number, nor updates after material changes.

The federal legislation provides that secured lenders may give notice to prospective purchasers even though the state has an approved central filing system. A creditor may desire to provide such direct notice to protect its lien during any period between the time it is filed for inclusion in the central notice system and the time updated lists would be circulated to purchasers. A lender who notifies the prospective buyer in writing within one year prior to the sale will retain its lien unless the purchaser complies with the conditions for release of the lien, which must be specified in the notice.

The secretary of agriculture is responsible for certifying the central filing systems of the states as complying with the statute.<sup>64</sup> This responsibility is accompanied with authority to promulgate regulations to assist states in implementing and maintaining such systems.<sup>65</sup> Regulations

were published on March 31<sup>66</sup> and were followed by publication of amendments on June 23.<sup>67</sup> These regulations detail what information about operation of the system must accompany a written request for certification. The regulations also specify added detail for an effective financing statement. Consequently, an effective financing statement, in addition to the information described above, will need to specify the farm product name, where the product was produced, and each county the commodities currently are in and may be in during the future. States may require at their discretion that further information be included in an effective financing statement.

### Certification Requirements

Congress specified the requirements for certification in its definition of "central filing system."<sup>68</sup> The major requirements can be summarized as follows.

First, the system must provide for statewide filing and notice of effective financing statements, and it must be implemented by the secretary of state or a person designated to operate the central filing system. Second, the date and hour of filing must be noted. Third, filed information must be initially organized according to commodity. Within each commodity group the information must be subdivided four different ways: alphabetically according to the the debtor's last name or the first name of a debtor's business, numerically by the debtor's social security or taxpayer identification number, geographically by county or parish, and by crop year. Each entry in the various lists must identify the secured party's name and address, the debtor's name and address, the debtor's social security or taxpayer identification number, and a description of the encumbered farm products.

The fourth requirement is that the secretary of state has to maintain a list of persons who register as buyers, commission merchants, or selling agents. Information to be gathered from these parties includes their name and address, their interest in receiving the lists, and the farm products they are interested in. The regulations clarify that buyers may register for specific farm products and counties. Such buyers, however, will be treated as not registered with respect to other commodities and geographic areas. Fifth, the secretary of state must regularly distribute in writing to registered buyers the portion of the list containing the information they are interested in. Sixth, oral response to requests by persons not registered must be within 24 hours of the request and be followed by written confirmation. The state, therefore, has sole responsibility for compiling and disseminating all information received from lenders and prospective buyers.<sup>69</sup>

### Implications for Buyers of Farm Commodities

Purchasers are subject to a security interest under the federal law in only limited circumstances. Buyers will be subject to the security interest if they receive direct notice from a lender (whether or not in a state with a certified system) but then fail to perform the payment obligations set forth by the lender.<sup>70</sup> These obligations are required to be part of the notice provided to a prospective buyer, but the statute does not address what obligations may be imposed. There is no requirement that a lender impose the same obligations on each prospective buyer even though the same indebted

operator and commodity is involved. Lenders must be aware that they may render their debtor unable to market their farm products if their payment obligations are excessively burdensome to a buyer.

Purchasers in states with certified filing systems will acquire farm products subject to a secured lien in two instances.<sup>71</sup> The first instance is when the lender has filed but the buyer has not registered. This outcome should serve as an incentive for buyers to register and is similar to the current North Dakota law which aims to encourage buyers to request a list. The second circumstance occurs when the lender has filed and the buyer has registered but the buyer fails to secure a waiver or release from the lender as to any payment obligation. Such a payment obligation could be included as part of the filing and notice, but the statute does not address that.

A prospective buyer will need to individually contact a lender if the payment obligations are not specified in the filed notice. Individual contact allows lenders to impose different obligations on each purchaser (as permitted with direct notice) as well as prevent payment obligations from becoming public record. A state may decide, however, to exercise its discretionary authority (as mentioned in a preceding section) and require payment obligations to be specified as part of an "effective financing statement." Such a requirement would (1) reduce the amount of time needed for a buyer to determine what is the payment obligation (2) eliminate the opportunity for lenders to impose different obligations upon buyers from the same indebted farmer, and (3) include payment obligations as part of the public record.

Buyers in states that do not require payment obligations to be part of a filed statement should not interpret their absence in a notice as meaning there is no obligation and therefore no need to inquire and secure a release or waiver from the lender. Instead, the suggested interpretation is that responsibility is upon a buyer to ascertain what interest a lender claims and what is needed in order to purchase free from an outstanding lien. This interpretation generally conforms with the intent of the Uniform Commercial Code that a lender claiming a security interest needs only to provide public notice of a lien.

#### Comparison of Statutes

Federal supremacy will render all state laws dealing with the farm product exception ineffective as of December 23, 1986. Even North Dakota's central notice system will be inapplicable before it has been in place for a year unless it is certified by the secretary of agriculture. Without a certified system, lenders will need to directly contact each prospective buyer in order to preserve their security interest after that date. Buyers, on the other hand, will be able to purchase farm commodities without concern as to outstanding security interests as long as they have not been notified by a secured lender. A basic issue is whether the state will apply for certification.

Several factors indicate that North Dakota is likely to strive for a certified central filing system. First, the secretary of state is completing application for certification. Second, the state dealt with the farm products exception in 1983, but it proved unsatisfactory. The issue was again

addressed in 1985 with an apparently more satisfactory result when the current state law was enacted. Agricultural lenders and buyers of farm products whose compromise produced the 1985 legislation are likely to agree a second time on a similar, albeit federal, system.

The effective date of the federal legislation could result in agricultural credit and farm product purchasers having to adjust to two changes within a short time period. The first change would occur in late 1986 when the current state law is preempted and direct notice by lenders is the only alternative. The second change would occur some time in the future when the state system is certified. Certification of the state's central filing system prior to the effective date of the federal legislation, however, would limit the change to one time.

Whether the North Dakota system will be certified by December 23, depends on how long the process takes and whether the current system is certifiable. An answer to the first question is dependent upon the United States Department of Agriculture. Montana, Idaho, and Mississippi have been certified at the time of this writing. The time to process those applications was no more than several months.

The second question, however, can be more directly influenced by the state and is the subject for the remainder of this report. A discussion of whether the current system is certifiable must begin with a comparison of the two laws.

The central thrust of both the state and federal laws is to protect the purchasers of farm products. This is to be done by having notices centrally filed with the secretary of state or given directly by the creditor to prospective purchasers. Under both the federal and North Dakota notice systems, responsibility to search for valid security agreements remains with the buyer. However, purchasers will only have to review the lists of centrally filed forms rather than conducting an expensive, time-consuming, and uncertain local search.

The two laws are similar on numerous points. For example, verbal requests are permitted under either statute in that they require the state to provide information to requesting parties even though the buyer is not registered.<sup>72</sup> Both systems protect purchasers of farm products by permitting them to quickly obtain information from the secretary of state plus a written confirmation. Similar information is needed under both statutes when a secured creditor centrally files; but the federal law also requires the signature of both the debtor and lender and the location of where the commodity is produced. North Dakota requires a monthly update of the lists whereas the federal law mandates periodic updates. These differences will likely be resolved by the system operator.

There are several major differences between the North Dakota and the federal statutes. The first concerns the lists to be provided by the secretary of state. The federal statute requires that the lists be organized by commodity,<sup>73</sup> whereas the North Dakota statute requires that only two lists be provided, one for crops and another for livestock.<sup>74</sup>

The federal statute requires that the lists be developed for each commodity group. The interim final regulations of the secretary of agriculture specify 96 commodity groups. These groups are to be arranged alphabetically according to the last name of the debtor. Commodity groups also are to be arranged numerically, according to social security or taxpayer identification number. The federal statute requires third and fourth categorizations of the listings by county and crop year.<sup>75</sup> The North Dakota statute requires the same general information in the filed notice as the federal statute requires except the state does not require the crop year to be specified.<sup>76</sup> A major discrepancy and possible stumbling block to approval of the North Dakota system by the secretary of agriculture would be the way in which the lists are organized, even though the information contained within the list is substantially similar.

A second discrepancy lies in who is to receive the lists and the tangible form those lists will take. Under the North Dakota provision, the list will be furnished to any person who makes a request for the list and pays the specified fee.<sup>77</sup> The federal statute, however, requires that the state maintains a compilation of all buyers of farm products, commission merchants, and selling agents who register with the state<sup>78</sup> and that the state furnishes them with a list of secured claims on a periodic basis. State law requires that the information be in printed form and microfiche,<sup>79</sup> whereas federal law mandates the information be written or printed.<sup>80</sup> Federal regulations allow machine-readable data to be provided at the state's discretion.<sup>81</sup>

Although significant, this second discrepancy between the federal and state statutes may not prove to be sufficiently serious to prevent the secretary of agriculture from certifying the North Dakota system. North Dakota's secretary of state should be able to adopt procedures or regulations that would conform the state's procedures to the federal statutes.

A third discrepancy is quite significant for both lenders and purchasers in North Dakota. This difference is that North Dakota law specifies one payment obligation (i.e., to issue the check jointly) whereas the federal law places no limitation upon the payment obligation a lender may impose. The following paragraphs further explain this difference.

North Dakota law permits a purchaser with notice of an existing claim secured by farm products to acquire those farm products without the consent of the lender if the purchaser pays for the goods with a check or draft payable both to the seller and the lender.<sup>82</sup> The lender is assured of payment through its power to refuse to endorse the joint check or draft unless the seller makes satisfactory arrangements to satisfy its claim. Thus, if an operator owes \$50,000 secured by crops or livestock and sells those crops or livestock for \$30,000, the purchaser will make its check for \$30,000 payable to the operator and the lender. The purchaser will acquire the goods free from any claim by the lender. The lender and the purchaser will have to determine which of them will receive the \$30,000 payment and, of course, how the other \$20,000 is to be paid.

The federal provisions are significantly different by granting greater protection to the secured lender. Purchasers notified through the system that a secured claim exists cannot acquire the goods without the consent of the secured creditor.<sup>83</sup> Thus, a purchaser would not be able to acquire the crops

or livestock free from the claim of the secured lender unless the secured lender releases the lien or otherwise consents to the sale.

The goods purchased for \$30,000 in the earlier example will remain subject to the lien if the purchaser had received written notice directly from the secured creditor during the year prior to the sale or if notice was filed with an approved central notice system. Notified purchasers are able to acquire the property free and clear only by complying with the conditions specified in the notice. Purchasers of the farm products who decide not to comply with the specified conditions must assume the responsibility of contacting the creditor prior to completing the sale and negotiating different terms. Any renegotiated terms should, at a minimum, be recorded in writing with a copy provided to both lender and purchaser.

It is anticipated that lenders will often consent to the sale and simply require that the check be issued payable to both the indebted seller and the secured creditor. Creditors on occasion may demand that the check be delivered to them rather than the seller.

The function of the federal system, in practical terms, is to provide an opportunity for purchasers to negotiate with lenders for the release of the lien. The purchaser's alternatives are clear when a lender is not satisfied with the price being received or for some other reasons refuses to consent to the sale. The sale must either be abandoned or the purchaser must assume the risk that the lender will later seek to recover the goods or monetary damages.

### Conclusion

Recent changes in state and federal law should resolve the confusions and uncertainties in the states commercial law created by the separate treatment of purchasers of farm products. However, agricultural lenders need to be aware of changes which have been made and take steps to ensure their compliance with these new provisions. Local filing of financing statements with the county register of deeds is still required in North Dakota to assure that a lien will survive attacks by other lenders or bankruptcy trustees. Lenders also must file with the secretary of state or directly give the required written notice to prospective purchasers to protect their liens against attacks by subsequent purchasers of the collateral.

Lenders should modify their existing forms to ensure that they obtain all information required for both local and state filing at the time the loan is made. In addition, lenders should modify existing notices or prepare new notices for borrowers so all necessary information is furnished at the time the loan is made. Lenders also should be certain that their loan agreements contain provisions requiring debtors to notify them of the identity of any prospective purchasers of the collateral. In this manner, lenders who desire to do so will be able to give direct notice of their claims to parties who may purchase the collateral.

All agricultural lenders should stay abreast of efforts to obtain approval by the secretary of agriculture for the North Dakota filing system. Lenders will have minimal protection against subsequent purchasers if the system is not approved or appropriately modified during the 1987 legislative

session. In the event that the North Dakota notice system is not certified by the secretary of agriculture, lenders must take steps to give notice of their liens directly to prospective purchasers. Purchasers who have received such written notices must be sure to comply with the payment conditions specified in the notice in order to receive the goods free from any claim by the lender. Purchasers not wishing to comply with those conditions will have to decide whether to negotiate with the lender or abandon the transaction.

Certification of the system does not mean purchasers of farm products can acquire them without consent of the lender. Instead, purchasers notified of a lien through the lists prepared by the secretary of state must obtain consent of the lender prior to the sale. Issuance of a check payable both to the farm operator and the lender will not suffice as it would if the North Dakota provisions governed. The list will function only to inform a purchaser of the identity of the lender with whom to negotiate.

Purchasers may receive written notice directly from the lender even though the North Dakota notice system is certified. In that event, the payment conditions specified in the notice must be met in order to acquire the goods free from the lien. A purchaser's choices will be identical to those which would exist in the absence of the central notice system.

Footnotes

1. N.D. Cent. Code 41-09-28 (1)(1983).
2. N.D. Cent. Code 41-09-40 (1)(a)(1983).
3. 1985 N.D. Sess. Laws ch. 472. The provisions were codified at N.D. Cent. Code 41-09-28 and 09-46.
4. Food Security Act of 1985, Pub. L. 99-198 (1985). The pertinent provisions were codified at 7 U.S.C.A. sec. 1631 (West Supp. 1986).
5. U.S. Constitution, art. VI, sec. 2.
6. 1965 N.D. Sess. Laws ch. 296.
7. U.C.C. 9-401 (1978); see Clark, THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE 1-12 (1980) (hereinafter cited as Clark).
8. Local filing is also required for equipment used in farming operations, accounts or general intangibles arising from the sale of farm products, or consumer goods. N.D. Cent. Code 41-09-40 (1983).
9. N.D. Cent. Code 41-09-24 (1983).
10. N.D. Cent. Code 41-09-16 (1983).
11. Id.
12. N.D. Cent. Code 41-09-23, 41-09-40, and 41-09-41 (1983).
13. N.D. Cent. Code 41-09-41 (1983).
14. N.D. Cent. Code 41-09-22 and 41-09-33 (1983).
15. Id.
16. N.D. Cent. Code 41-09-28 (1)(1983).
17. N.D. Cent. Code 41-01-11 (9)(1983).
18. N.D. Cent. Code 41-09-28 (1)(1983).
19. Id.
20. Garden City Production Credit Assoc. v. Lannan, 186 N.W.2d 99 (Neb. 1971); Justice Newton, dissenting.
21. See, e.g., Sherrock v. Commercial Credit Corp., 290 A.2d 648 (Del. 1972).
22. See, e.g., Garden City Production Credit Ass'n. v. Lannan, note 20, supra.
23. Meyer, "The 9-307(1) Farm Products Puzzle: Its Parts and Its Future," 60 N.D.L. Rev. 401 (1984). The idea that the purchaser becomes the guarantor of the agricultural loan was noted in the House Report on an early version of the Food Security Act as follows:  
  
Current state law forces innocent buyers of farm products to become unwilling loan guarantors, in essence assuming the credit supervision responsibilities that really belong with the lender who is making the profit off the loan to begin with. At the same time, farm product buyers have no control over the lender's practice, and receive no compensation in the form of interest to cover the risk exposure and jeopardy unknowingly and unwillingly assumed.  
  
H.R. Rep. No. 99-271, 99th Cong., 1st Sess. 109, reprinted 1985 U.S. Code Cong. & Ad. News at 1213.
24. Clark, 8-22.
25. N.D. Cent. Code 41-09-28(9) (Supp. 1985).
26. Benson County Co-op. Credit Union v. Central Livestock Assn., 300 N.W. 2d 236 (N.D. 1980).
27. See cases collected by Clark at 8-23 to 8-31.
28. Clark, 8-38.
29. Cal. Comm. Code Sec. 9-307 (West Supp. 1986).

30. Okla. Stat. Ann. Titl. 12A, Sec. 9-307(3) (Supp. 1985).
31. Ky. Rev. Stat. Sec. 355.9-307(2) (Supp. 1985).
32. Ind. Code Ann. Sec. 26-1-9-307(1) (Burns Supp. 1985).
33. Tenn. Code Ann. Sec. 9-307(2) (Supp. 1985).
34. 1985 N.D. Sess. Laws ch. 472.
35. 1983 N.D. Sess. Laws ch. 468.
36. 1985 N.D. Sess. Laws ch. 472.
37. *Id.*
38. N.D. Cent. Code 41-09-28(11) (Supp. 1985).
39. N.D. Cent. Code 41-09-28(13) (Supp. 1985).
40. N.D. Cent. Code 41-09-28(11) (Supp. 1985).
41. N.D. Cent. Code 41-09-28(13)(b) (Supp. 1985).
42. N.D. Cent. Code 41-09-28(9) (Supp. 1985).
43. See discussion corresponding to note 13, *supra*.
44. N.D. Cent. Code 41-09-28(9) (Supp. 1985).
45. Telephone conversation between Fry and Meier on June 24, 1986.
46. N.D. Cent. Code 41-09-26(10) (Supp. 1985).
47. *Id.*
48. N.D. Cent. Code 41-09-46(3) (Supp. 1985).
49. N.D. Cent. Code 41-09-28.1(3) (Supp. 1985).
50. N.D. Cent. Code 41-09-46(4) (Supp. 1985). The office of the secretary of state maintains a subscriber's list, currently numbering approximately 400, containing the names of commodity brokers who receive the lists on a regular basis. Telephone conversation between Fry and Meier on June 24, 1986.
51. N.D. Cent. Code 41-09-46(5) (Supp. 1985).
52. N.D. Cent. Code 41-09-28(13) (Supp. 1985).
53. N.D. Cent. Code 41-09-28(11) (Supp. 1985).
54. N.D. Cent. Code 41-09-28(12) (Supp. 1985).
55. N.D. Cent. Code 41-09-28(11) (Supp. 1985).
56. See *Garden City*, note 20, *supra*.
57. Pub. L. 99-198, Sec. 1324(a).
58. 7 U.S.C.A. 1631(d) and (g) (1) (West Supp. 1986).
59. 7 U.S.C.A. 1631(e) (1) (West Supp. 1986).
60. *Id.*
61. 7 U.S.C.A. 1631(h) (West Supp. 1986).
62. 7 U.S.C.A. 1631(e) (2) (West Supp. 1986).
63. 7 U.S.C.A. 1631(c) (4) (West Supp. 1986).
64. 7 U.S.C.A. 1631(c) (2) (West Supp. 1986). The procedure for filing applications is set forth in the interim final regulations adopted by the secretary of agriculture published 51 Fed. Reg. 10,795 (1986) (to be codified at 9 C.F.R. 205.1, et seq.).
65. 7 U.S.C.A. 1631(i) (West Supp. 1986).
66. Interim final regulations were adopted by the secretary of agriculture effective March 24, 1986, and published at 51 Fed. Reg. 10,795 (1986) (to be codified at 9 C.F.R. 205.1, et seq.).
67. Proposed amendments to the interim final regulations were published for comment at 51 Fed. Reg. 22,814 (1986).
68. 7 U.S.C.A. 1631(c) (2) (West Supp. 1986).
69. 7 U.S.C.A. 1631(c) (2) (C) (West Supp. 1986).
70. 7 U.S.C.A. 1631(e) (1) (West Supp. 1986).
71. 7 U.S.C.A. 1631(e) (West Supp. 1986).
72. N.D. Cent. Code 41-09-46(5); 7 U.S.C.A. 1631(c) (2) (F).

73. 7 U.S.C.A. 1631(c) (2) (C) (i) (West Supp. 1986).
74. N.D. Cent. Code 41-09-46(3) (Supp. 1985). Since the lists required by the federal statute must be more detailed than those required by North Dakota law, it should be possible for the secretary of state to conform the North Dakota lists to the federal statute without further legislative authorization.
75. 7 U.S.C.A. 1631(c) (2) (c) (ii) (West Supp. 1986).
76. N.D. Cent. Code 41-09-28(9) (Supp. 1985).
77. N.D. Cent. Code 41-09-46(4) (Supp. 1985).
78. 7 U.S.C.A. 1631(c) (2) (D) (West Supp. 1986).
79. N.D. Cent. Code 41-09-46(3) (Supp. 1985).
80. 7 U.S.C.A. 1631(c) (2) (E) (West Supp. 1986).
81. 51 Fed. Reg. 10,797 (1986) [to be codified at 9 C.F.R. 205.105 (b)].
82. N.D. Cent. Code 41-09-28(11).
83. 7 U.S.C.A. 1631(e) (3) (B) (West Supp. 1986).