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Financing farm products is the bread and butter of many agricultural lenders, literally. However, would your collateral be protected if your borrower sells the farm products? If you rely solely on the Uniform Commercial Code

Financing Farm Products: How Secure Is Your Collateral?

by:
Natalie Garth

Natalie Garth is a member of the law firm of Ridenour, Hienton, Harper & Kelhoffer, PLLC, in Phoenix, Ariz., and represents agricultural lenders, farmers, ranchers and dairy producers throughout the Southwest. She can be reached at (602) 254-9900.

(UCC), your answer is "yes." Your lien survives the transfer. Unfortunately, if you are relying solely on the UCC, your answer is wrong. The Food Security Act of 1985 preempts state law and, as a result, the lien does not survive the transfer unless you take certain steps beforehand.

Under the Food Security Act of 1985 (7 U.S.C. §1631), a person buying farm products from a person engaged in farming operations takes free of a perfected security interest unless the lender complies with the notice provisions in the Act as well as takes steps to perfect security interests under the UCC. If the lender does not take appropriate steps to comply with the Act, the lender's security interest transfers only to identifiable proceeds in the hands of the debtor, and the buyer takes the farm products free of the lender's lien. If a lender fails to understand this principle and to take

*The sale must be
to a "buyer in the
ordinary course
of business,"
commission
merchant
or selling agent.
The collateral
must be
"farm products."*

steps to mitigate its effect, it will not be able to accurately evaluate its collateral position. Although compliance with the Act does not guarantee that a security interest will survive a transfer to a buyer, it certainly will improve the odds.

Why Congress Entered the Picture

In general, the UCC provisions are designed to protect buyers who, for example, buy a refrigerator from a retailer who has pledged its inventory. Under the UCC, a buyer in the ordinary course of business "other than a person buying farm products from a person engaged in farming operations" takes the property free of a perfected security interest created by his or her seller (Section 9-320).

Most buyers do not have the knowledge, or time, required to search the records to determine lien priority (and, certainly, requiring all buyers to search the records would bring impulse shopping to a grinding halt). To facilitate market transfers, the UCC provides that a buyer of inventory in the ordinary course of business takes the inventory free of a security interest, even if the security interest is perfected and the buyer knows about it.

On the other hand, the UCC farm products exception in Section 9-320 (which still exists in Revised Article 9, even though it is preempted by the Food Security Act), protects creditors, not buyers, and retains the security interest even if the farm products are sold. The security interest, however, continues in any identifiable proceeds. The lien remains on the farm products all the way down the chain. So, if your borrower sold farm products to John Doe, who in turn sold the farm products to Jane Ranch, Jane Ranch took the farm products subject to the lien created by your borrower.

This level of protection was justified by the UCC drafters because they believed that buyers of farm products were generally sophisticated and, as such, knew to search the records and, if necessary, obtain a lien release prior to

purchase. They also believed that it was not a tremendous burden to search the records because agricultural transactions occurred infrequently for the average farmer or rancher (in contrast to commercial transactions for the average consumer).

Rather than streamline the sale of agricultural products and facilitate lending practices, the farm products exception served mainly to line the pockets of attorneys with the plethora of litigation that arose out of it. Buyers down the chain would sue their sellers when the first seller's lender asserted the security interest. Meanwhile, lenders were regularly suing buyers to recover the collateral. Buyers and borrowers were defending such actions by claiming the lender authorized the disposition. Language in the UCC – “a security interest continues on collateral notwithstanding sale ... unless the secured party authorized the disposition free of the security interest” – allowed both borrowers (sellers) and buyers to argue that the lender consented to the disposition, even if that consent were implied and not in writing.

The farm products exception of the UCC was not popular, particularly with buyers who paid twice for farm products – once with the original purchase, and again when the lender came knocking. In 1985, Congress entered the picture and

effectively repealed the farm products exception through a provision of the Food Security Act of 1985 entitled “Protection for Purchasers of Farm Products” (7 U.S.C. §1631). In the congressional findings and declaration of purpose, Congress declared that the farm products exceptions exposed purchasers to “double payment and inhibits free competition in the market for farm products.” So, buyers take free and clear of a security interest created by their sellers unless the secured party complies with the notice requirements in the Act.

Most buyers do not have the knowledge, or time, required to search the records to determine lien priority.

The Food Security Act

The Food Security Act changed the result under the UCC so that certain buyers of farm products will take the farm products free of a security interest created by the seller unless (1) the buyer receives direct notice of the security interest, or (2) the secured party files a notice in a special central filing repository created by the state and certified by the USDA. Not all sales are subject to the Act. First, the sale must be to a “buyer in the ordinary course of business,” commission merchant or selling agent. Second, the collateral must be “farm products.”

A buyer in the ordinary course is a “person who, in the ordinary course of business, buys farm

products from a person engaged in farming operations who is in the business of selling farm products." A buyer who regularly buys corn, for example, from a farmer who regularly sells corn, is a buyer in the ordinary course of business. An appliance dealer who buys a truckload of corn to roast outside his store would not be a buyer in the ordinary course. Similarly, a buyer who regularly buys corn, but buys it one time from a lawyer who happens to have a cornfield in her backyard, would not be a buyer in the ordinary course. Unlike the Act, the UCC definition of buyer in the ordinary course requires the buyer to act in good faith and without knowledge that the sale violates the right of another person.

Under the Act, the term "farm product" means "an agricultural commodity such as wheat, corn, soybeans, or a species of livestock such as cattle, hogs, sheep, horses, or poultry used or produced in farm operations, or a product of such crop or livestock in its unmanufactured state (such as ginned cotton, wool-clip, maple syrup, milk, and eggs), that is in the possession of a person engaged in farming operations." On the other hand, Revised Article 9 of the UCC does not require possession, and defines "farm products" as "goods other than standing timber, with respect to which the debtor is engaged in a farming operation and

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which are: (A) crops grown, growing, or to be grown, including (i) crops produced on trees, vines and bushes, and (ii) aquatic goods produced in aquacultural operations; (B) livestock, born or unborn, including aquatic goods produced in aquacultural operations; (C) supplies used or produced in a farming operation, or (D) products of crops or livestock in their unmanufactured state."

The Act protects the rights only of ordinary course buyers of farm products, of commission merchants and of selling agents; it does not affect the right of lenders to enforce liens against other lien creditors such as trustees in bankruptcy. Because of the switch in "protection" from creditors to buyers, a lender is now faced with the administrative burden of complying with these requirements to ensure its lien on farm products survives a transfer. Yet, as shown below, compliance does not guarantee protection because the Act relies, in part, on the accuracy of the system and the integrity of borrowers.

Some Lenders Opt Not to Comply

Although secured parties have the ability to cause their liens to survive

a transfer, many lenders elect not to comply with the Act for a variety of reasons. Admittedly, compliance can be costly and time consuming, and some lenders prefer simply to rely on their security interest in the identifiable proceeds. Sometimes these decisions are made on a case-by-case basis. For those borrowers with an established relationship with the lender or who have sound credit, a lender may opt not to comply. Some lenders believe it to be a marketing nightmare to comply – especially if their competitors do not. This blanket decision not to comply can be a costly mistake. At a

minimum, lenders should evaluate the borrower's credit to determine if compliance is warranted, and adjust that decision depending on circumstances. For example, if a borrower's credit is deteriorating, collateral is disappearing or the loan is in default, the lender should take steps to comply to protect its collateral from further transfers. In all circumstances, the lender's policies should require that the loan write-up contain this analysis to ensure loan officers are considering the impact of the Act on the collateral valuation. The loan documents also should always require the borrower to provide a list of potential buyers so

Sample Direct Notice Form

NOTICE OF SECURITY INTEREST IN FARM PRODUCTS

Pursuant to Section 1324 of The Food Security Act of 1985 (Pub. L. 99-198 7 U.S.C., 1634 et. seq.), you are hereby notified that Debtor has granted (1) a security interest to the farm products described below, and in (2) all proceeds from the sale of such farm products. This notice is effective for one year from the date you receive it.

To:

Milk Buyer, Inc.
P. O. Box 87
Central City, AZ 99999

Date:

This Notice amends Prior
Notice Dated

The Debtor has named you as a
Potential
Purchaser, Commission Merchant

County and State of Transaction:
Yavapai County, Arizona

Debtor: Milk Borrower, LLC
Name:
Address: P.O. Box 92
Central City, AZ 99999
SSN/TIN: 86-111111
 Additional Debtors Attached

Secured Party:

Milk Lender, PCA
P.O. Box 001
Central City, AZ 99999
(602) 438-2515

Type of Farm Product:

Milk and Milk Products

Farm Product Year: All Years
 Other Specify

Amount of Farm Product Encumbered:
 All of Farm Products
 Other Specify

Description of Real Estate Where Farm Products are Located (Legal Description, including county/counties):

N/A

Additional Locations of Farm Products (if subject to movement, e.g., livestock):

At any location

Terms of Release of Security Interest:

All proceeds directly to Secured Party
 Check payable to Debtor and Secured Party
 Other (Specify):

Milk Lender, PCA

BY: _____
Secured Party

the lender can comply effectively if there is a change in circumstance.

Central Filing States

Under the Act, states have the option of establishing USDA certified central filing systems. The central filing systems of these states simplify the process for lenders and inject some certainty into the process. If a lender does file, in most circumstances it is assured that its lien survives a transfer. Filing has the obvious advantage over complying with the direct notice option (discussed below) in which notices are sent only to buyers known by the lender.

If a USDA certified central filing system is in place, buyers in the ordinary course take subject to security interests that are filed with the Secretary of State or, in a few cases, another state agency. This filing is deemed "constructive notice" and is effective even if the buyer does not have actual notice.

Central filing is **not** the same process as filing a UCC-1 (in most states separate forms are used for central filing and for filing a UCC-1) — nor does it replace the need to properly perfect a security interest in the manner set forth in the UCC. The central filing process is not a recording process; it does not preserve priority against other lien creditors.

In a central filing state, the lender files an "effective financing statement" (EFS) with the Secretary of State's office. This EFS contains the same information as required for direct notice: debtor's name, lender's name, type of farm products, social security number or taxpayer identification number, and legal description of the real estate where the farm products are located. Once filed, an EFS is good for five years and can be continued for another five years by refileing within six months of the initial expiration date. In contrast, the direct notice described below must be received by the buyer within one year before the sale.

The Secretary of State's office is

required to compile and update all EFS data and separate it by farm product and county. The Secretary of State then periodically, depending on the state's requirements, distributes the list to registered buyers. The registration form includes the name and address of a registrant; the farm products and interest of the registrant; the reason for the registrant's interest; and the counties for which the registrant requests a master list.

A buyer who has registered and received a list with the EFS information will take subject to the security interest unless the lender gives a

*An
unregistered
buyer
will take subject
to any EFS
unless the
lender
has
not filed one.*

Sample Certificate of Mailing

**NOTICE OF SECURITY INTEREST
IN FARM PRODUCTS
Certificate of Mailing**

Jane Doe hereby certifies, under penalty of perjury, as follows:

I am over the age of 18 years, and I am employed by Milk Lender, PCA, in the County of Yavapai, State of Arizona. On the 2nd day of June, 2002, I addressed an envelope as follows:

Debtor Nar Milk Borrower, LLC
Mailed to: Milk Buyer, Inc.
P.O. Box 87
Central City, AZ 99999
Date Mailed: _____

I placed in the envelope the original of the attached Notice of Security Interest in Farm Products and sealed said envelope, and deposited it, postage prepaid, in the United States mail.

Signature

release or receives payment as directed. An unregistered buyer will take subject to any EFS unless the lender has not filed one. Thus, the central filing system imposes a requirement on the lender to file the EFS, and on buyers to register with the Secretary of State. This system helps equalize the burden of compliance.

There are some timing issues that can impact whether a lender's security interest survives a transfer because of the gap between the time an EFS is filed and the time the registered buyer receives a master list. For this reason, lenders in central filing states may send direct notice, as well as file EFS, to protect themselves during the gap period. It should be noted that because the Act provides for one system or the other, not both at once, sending direct notice to a buyer in a state which maintains a central filing system may not provide a lender with legal protection. Some lenders elect not to offer loans during the gap period if the time to market farm products is approaching — a practice that may provide legal comfort at the expense of good customer relations.

Sample Form to be Delivered by Borrower to Lender

Milk Lender, PCA

REPORT OF PURCHASERS OF FARM PRODUCTS

As required by the Food Security Act of 1985 (Pub. L. 99-198, 7 U.S.C. 1631 et seq.), the parties listed below are all of the buyers, selling agents, and commission merchants to or through whom the undersigned will sell the listed farm products.

Product: _____

Buyer(s): _____
Address: _____

The undersigned acknowledges that any additions or changes to this list shall be furnished to the above-named Lender, not less than seven (7) days prior to the sale of any farm products security in the indebtedness of the undersigned to Lender. The undersigned also agrees to give Lender immediate written notice of any changes or additions to this Report.

_____, 2002

MILK BORROWER, LLC

By: _____

Its: _____

Direct Notice

Finally, in non-central filing states, the only option to allow lenders to enforce their security interests against ordinary course buyers is to send "direct notice" to potential buyers. (See Sample Direct Notice Form.)

Under direct notice, a buyer in the ordinary course (or a commission merchant or a selling agent) takes the farm products subject to a

perfected security interest if it receives written notice from either the lender or borrower within one year before the sale. The definition of "receipt" is determined under state law. I recommend to my clients that these notices be sent by certified mail, although this certainly can be costly. At a minimum, the lender should have a regular mailing procedure in place, and the individual responsible for sending out the

*Borrowers
can be fined the
greater of \$5,000
or 15 percent
of the value
of the
farm products for
off-list sales.*

Sample Certifications
notices should complete a sworn affidavit of mailing. (See Sample Certificate of Mailing.)

Although the Act does not require a specific form for direct notice, the required content is set forth in §1631 of the Act. The notice must:

- Be in writing.
- Be organized according to type of farm product.
- Be an original or reproduced copy.
- Contain the names and addresses of the debtor and secured party.
- Contain the debtor's social security number or taxpayer identification number.
- Contain a description of the farm products, "including the amount of such products where applicable, crop year, county or parish, and a reasonable description of the property."
- State any payment obligation as a condition to release (such as the issuance of a joint check payable to debtor and lender).

If the description of the farm products changes, the notice, in order to remain effective, must be resent with the corrected information within three months after the change.

The Act allows lenders to require borrowers to provide a list of potential buyers to the lender: "A security agreement in which a person engaged in farming operations creates a security interest in a farm product may require the person to furnish to the secured party a list of the buyers, commission merchants, and selling agents to or through whom the person engaged in farming operations may sell such farm product." (See Sample Form to be Delivered by Borrower to Lender.)

Accordingly, the lender's security agreement must affirmatively obligate the borrower to provide such a list and to update that list annually. (Remember, these notices must be sent annually.) If the borrower sells to someone not on the list he provided, the borrower is subject to penalties unless he notifies the lender seven days before the sale or delivers the proceeds to the lender within 10 days after the

sale. Borrowers can be fined the greater of \$5,000 or 15 percent of the value of the farm products for off-list sales.

These requirements create headaches for lenders, particularly given that there is no absolute guarantee that the lender's security will remain protected. The lender must decide to undergo the administrative burden of complying with the Act in order to have some assurance that its security interest will survive a transfer, yet compliance does not ensure protection.

The direct notice option is fraught with uncertainty because it relies in part on the accuracy of lists submitted by borrowers. If a borrower sells off the list, a buyer in the ordinary course takes the farm products free of the security interest (even if it has actual knowledge of the security interest), and the lender's sole remedy is to sue the borrower — little comfort if the borrower is already in financial trouble. Some lenders "blanket" the market and send notices to all potential buyers — a practice that can cause borrower discontent and invasion of privacy concerns. If a lender opts for this practice, it should obtain the borrower's consent in the security agreement. Blanket notices probably are not advisable, or economically feasible, for all borrowers, but they certainly could be used for troubled credits.

The Hobson's Choice

Many lenders, especially in direct notice states, and especially those who do not regularly engage in agricultural financing, have no idea that the Food Security Act exists. They assume the UCC governs their security interests, and are comforted by the farm products exception that allows liens to survive transfers. Other lenders, aware of the Act, choose to ignore its ramifications rather than risk the wrath of their borrowers or suffer the burden of compliance.

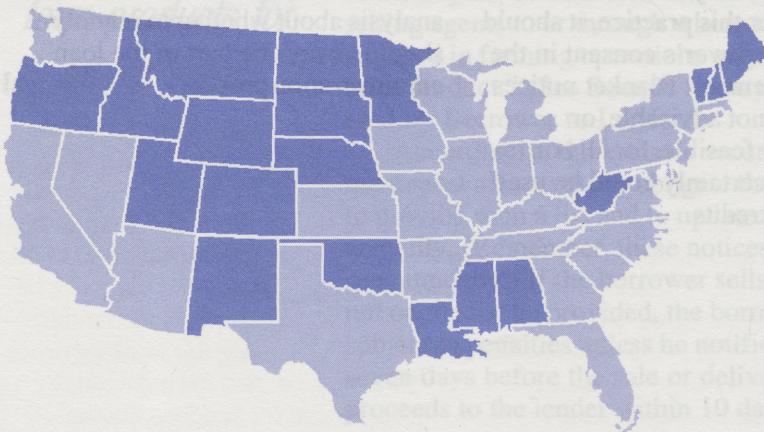
Yet, without at least understanding the Act, lenders cannot make informed decisions about the value of their collateral. The farming and ranching business is filled with regulatory complexity, pricing uncertainty and risk (such as inclement weather) that are outside the control of the market, the borrower and the lender. Thorough underwriting and careful and consistent standards on loan documentation and administration can provide the lender with greater control in an otherwise uncertain lending environment. Compliance with the Act, or at least a reasoned analysis about whether to comply, should always be part of the loan administration process.

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Vermont
West Virginia
Wyoming

Note: With Revised Article 9, some states are rethinking whether to continue with a Central Filing System to take advantage of the National UCC-1 Form. Some of these states use a combined Central Filing and Financing System form. You should check with your Secretary of State's office for the state equivalent to make sure the Central Filing System is still in place



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