The National Agricultural Law Center

nationalaglawcenter.org
nataglaw@uark.edu
@nataglaw

Factsheet, Series: 2022

This material is based upon work supported by the National Agricultural Library, Agricultural Research Service, USDA

Figuring the Federal Farm Products Rule

Common Transaction Considerations

Micah Brown
Staff Attorney, National Agricultural Law Center

I. Introduction

The Food Security Act of 1985 ("FSA") established a rule known as the federal farm products rule that affects both creditors and buyers of farm products. Before the protections of the rule take effect, however, notice of a creditor's security interest must be given. Although it is important to provide a notice that contains all the required information under the FSA, the federal statute also contains other rules that affect both creditors and buyers of farm products. Specifically, provisional rules are important because they determine whether the FSA applies to a buyer's purchase of collateralized farm products. This fact sheet will discuss how courts determine which state's notice system applies to a transaction, and what rights buyers have under the FSA to off-set a producer's contractual obligations with proceeds earned from selling farm products.

A. Federal Farm Products Rule

The farm products rule allows a buyer in the ordinary course of business purchasing farm products from a seller engaged in farming operations to take the product free and clear of a creditor's security interest, even if the interest is perfected and the buyer knows of its existence. Before the enactment of the FSA, buyers of farm products often purchased farm products that were collateral for a secured creditor's loan. Because a creditor's interest followed the farm products, several buyers of farm products assumed the risk of paying twice for the same goods, once to the seller and once to the secured creditor. Thus, Congress enacted the federal farm products rule to protect farm product purchasers from this risk.

In general, if a buyer meets the requirements of the farm products rule, a creditor's security interest will not follow the farm products purchased unless the creditor put the buyer "on notice" of its interest in the farm product. In other words, whether a buyer of farm products in the ordinary course of business takes the goods subject to a creditor's security interest primarily depends on whether the creditor

The information contained in this document is provided for educational purposes only. It is not legal advice and is not a substitute for the potential need to consult with a competent attorney licensed to practice law in the appropriate jurisdiction.

complied with the notice requirements under the FSA. When the federal farm products rule took effect in 1986, states were given two options: implement a centralized filing system or follow a direct notice system.

1. Statutory Notice Requirements

In a state that follows the direct notice system, a secured creditor must send the buyer of farm products a written notice that includes the list of specific information contained under §1631(e). If a creditor provides direct notice to a buyer one year before the farm products are sold, the creditor's security interest will continue to follow the collateral. States operating a central filing system allow a secured creditor to file an "effective financing statement" ("EFS") or send direct notice to a buyer, as explained under §1631(c)(4). If filing an EFS, creditors must include the same information as required for a direct notice, and it must be filed with the Secretary of State's office to be effective. Thus, before purchasing farm products in a state that operates a central filing system, the buyer is expected to review the list to determine whether the goods are subject to a creditor's security interest. The notice requirements are outlined in more detail as part of the first fact sheet in this series.

2. The Primary Issue

In §1631 cases, the primary issue parties litigate is whether the creditor provided proper notice to a buyer of farm products. If a creditor provided notice, then their security interest followed the farm products after the sale, and the creditor can collect the unpaid money from the buyer. If the creditor did not provide notice that complied with the FSA, then the creditor's security interest did not follow the farm products after the sale and cannot receive payment from the buyer. As a result, providing a detailed notice to the buyer that includes the items listed under §1631 is necessary.

Although it is important to provide a notice that contains all the required information under the FSA, the federal statute contains other rules that affect both creditors and buyers of farm products. Specifically, these provisional rules are important because they determine whether the FSA applies to a buyer's purchase of collateralized farm products. Creditors and farm products purchasers must pay special attention to the other FSA provisional rules in order to satisfy their obligations under the federal law to protect their interests in farm products. If a creditor overlooks these requirements, they risk losing their security interest in collateralized farm products. Alternatively, if a buyer overlooks these requirements, they risk having to pay twice for the same farm products, once to the seller and once to the secured creditor.

II. Discussion

A. Buyers Considering the Farm Products Rule

Creditors who lend money to agricultural producers risk losing their security interest in the collateralized goods if they do not take the FSA into consideration. Depending on the type of notice system adopted in a state, creditors holding an interest in farm products have the duty of providing either direct notice or filing an EFS. When they fail to provide proper notice, a buyer of farm products will take the products free of the secured creditor's interest.

Although creditors must consider §1631 of the FSA when lending to sellers of farm products, buyers must also take the statutory provision into consideration when purchasing farm products. There are certain responsibilities that farm products purchasers must satisfy to ensure they protect their interests. For example, a buyer who considers purchasing farm products in a state that operates a central filing system has a responsibility to review the EFS list in the state. If a buyer does not review the list before purchasing, they risk purchasing farm products that are subject to a creditor's security interest, meaning they may be liable to the creditor for the purchase price of the farm products.

Additionally, buyers of farm products also have the responsibility to provide payment for the goods they purchase from a seller. In some instances, farm products purchasers enter into multiple purchase contracts with the same seller over multiple years. Sometimes, buyers include a set-off clause in these contracts to limit the risk of losing money if the seller fails to deliver all of the farm products due under the contract. Generally, a set-off clause allows the buyer to hold some sale proceeds in order to make up for the losses it suffered as a result of the seller's failure to fulfill contracts fully. Many courts have determined the FSA does not protect the proceeds that buyers retain under set-off clauses. Thus, buyers are responsible for providing full payment to sellers for the farm products they purchase, or risk being liable to a creditor's security interest in the products. Overall, if farm products purchasers do not take the FSA into consideration when purchasing goods, they may lose protection under the federal statute.

1. What State are Products "Produced In"?

Both creditors and buyers must consider the requirements of §1631 when conducting business, but they must also consider what type of notice is appropriate for a transaction. In many cases, farm products are bought and sold among buyers and sellers who reside in the same state. Sometimes, however, farm product transactions become more complex when multiple parties from several different states are involved in a single transaction. Because each state operates either a direct notice

or central filing system, these transactions occasionally involve parties from states that operate different notice systems.

If not familiar with the requirements of a notice system of another state, parties may not comply with the FSA and risk losing their interest in farm products. Ultimately, some multi-state transactions have led to buyer-creditor disputes regarding which notice system applies to a transaction. Consequently, determining which notice system governs a farm products transaction involving parties from states that operate different notice systems has been left for courts to decide.

Unfortunately, the FSA does not expressly state which notice system governs a transaction when multiple notice systems are involved. In situations where a statute's language is unclear, judges must interpret the statute. In other words, judges will consider the purpose of the statute and try to figure out the goal of the legislature in passing the law. Determining the legislative intent of a statute provides a judge with an understanding of what is required under the statute, or what a party must do to comply with the statute. Since the enactment of the FSA, numerous state and federal judges have interpreted the provisions of the farm products rule statute to clarify the specific requirements that creditors must satisfy to retain their security interest in the farm products.

Under the FSA, a buyer will take farm products subject to a creditor's security interest if the product is "produced in a State that has established a central filing system"[1] where the buyer is not registered as a farm products purchaser within the state, and the creditor filed an EFS covering the farm products sold. The FSA does not define the phrase "produced in," so courts have examined Congress' intent for including the phrase within the federal statute. In general, Congress enacted §1631 of the FSA to ensure buyers receive adequate notice of security interests in farm products. Thus, the meaning of "produced in" must reflect that purpose.

Courts have construed the phrase "produced in" to mean the state where farm products are offered for sale to a buyer. Interpreting the phrase this way enables lenders to determine where they must provide their notice, which further determines the type of notice lenders must provide. Further, this interpretation gives buyers a guaranteed way to discover the security interests attached to the farm products. Therefore, courts have generally adopted this interpretation of "produced in" because it advances Congress' intent for the farm products rule.

[1] 7 U.S.C. § 1631(e)(B)(2) (2018) (emphasis added).

An example of this is as follows:

> **Example 1:** Farm Credit Bank ("FCB") loans money to Owen, an Oklahoma cattleman, and takes a security interest in all of Owen's cattle. FCB files an EFS with the Oklahoma Secretary of State because the state operates a central filing system. Afterwards, Candace from Colorado agrees to purchase 200 head cattle from Owen. A few days later, Owen receives 240 head of cattle he recently bought from a Missouri cattle broker. The next day, Owen loaded 200 of the 240 head of cattle he received from Missouri onto trailers and ships the cattle from Oklahoma to Colorado. Once the cattle arrived, Candace issued full payment to Owen. Two months later, Owen defaults on his loan with FCB, and the bank demands payment for the sale of cattle from Candance. Candance informs FCB that she will not provide payment to the bank because it does not have a security interest in the cattle. She claims the bank was required to provide her with direct notice because the cattle were produced in Missouri, a state that has adopted a direct notice system.

If this case[2] was brought before a court, FCB would likely win. Relying on previous interpretations of the phrase, a judge would not agree with Candace's claim that "produced in" means the geographical origin of the cattle. Instead, a judge would likely conclude the cattle were produced in Oklahoma because that is the location that Owen offered the cattle for sale. Because Oklahoma operates a central filing system, FCB placed Candace on notice of its security interest because it filed an EFS that coved all of Owen's cattle. Thus, FCB may enforce its security interest against Candace and require her to pay the purchase price of the 200 head of cattle she bought from Owen.

Courts examining the "produced in" statutory language have adopted a consistent interpretation of the phrase. Essentially, this interpretation advances the purpose of the federal farm products rule because it reveals which state's notice system applies to a transaction. However, farm products purchasers must still be aware of the dual notices systems when transacting across state lines, especially if a purchaser is not familiar with the method of notice in a central filing state. Specifically, if a buyer considers purchasing farm products from a seller in a state[3] that operates a central filing system, the buyer must register with that state's Secretary of State's office as a farm products purchaser, and is expected to review the EFS filing list before purchasing farm products. If the buyer does not register and review the EFS listing before

---

[2] Facts in the example from *Great Plains Nat. Bank, N.A. v. Mount*, 2012 COA 66, 280 P.3d 670.

[3] Clear Title (Central Filing Systems), (USDA Agricultural Marketing Service) https://www.ams.usda.gov/rules-regulations/food-security-act/clear-title. (*Note*: Although nineteen states have received certification of their central filing systems, Maine, Vermont, and West Virginia have never fully implemented their central filing system).

purchasing farm products, they risk buying goods that are secured by a creditor's interest, and may have to pay twice for the same farm products.

2. A Buyer's Right to Set-Off Unfulfilled Contracts

In many instances, buyers of farm products choose to purchase products from a seller over several crop seasons. These buyers and sellers enter into multiple purchase contracts in a single crop season. On occasion, a seller is unable to harvest enough farm products to satisfy one or more of the purchase contracts. Consequently, this may put a buyer at risk of losing income because they may not be able to locate and purchase other farm products they need to operate their business. Therefore, some buyers have placed certain provisions within their purchase contracts to reduce the risk of losing profits when a seller fails to satisfy one or more of their contracts.

One specific type of provision buyers sometimes includes in their farm products purchase contracts is a set-off clause. Buyers include these types of clauses to protect themselves from the risk of losing income when the seller does not deliver all of the farm products due under the contract. In general, a set-off clause allows the buyer to retain some or all of the proceeds they earned from the contracts the seller did fulfill to compensate or counterbalance the buyer's losses resulting from the contract(s) the seller failed to satisfy. In other words, the buyer deducts the seller's payment to make up the profits they lost resulting from the seller's failure to deliver all of the products contracted for. Under a set-off clause, the buyer pays the different between the proceeds due to the seller under the fulfilled contracts and the amount of income the buyer lost due to the unfulfilled contracts.

Under the FSA, buyers of farm products who do not receive a notice that complies with §1631 will take the products free and clear of a creditor's security interest. Hence, a buyer's interest in farm products are protected under the federal statute. However, does this protection continue when the buyer turns the farm products into proceeds? Will the same FSA protection extend to the proceeds a buyer retains when enforcing a set-off clause against a seller?

The FSA does not expressly state whether it protects only farm products, or if that protection also extends to proceeds a buyer retains by enforcing a set-off clause under a purchase contract. In situations where a statute's language does not specify the extent of protection provided under its provisions, judges must interpret the statute. In other words, judges will consider the purpose of the statute and try to figure out the goal of the legislature in passing the law. Understanding the legislative intent allows the judge to understand what is protected under the statute.

The courts have that examined whether the FSA protects farm products and the proceeds a buyer retains under a set-off clause have adopted a consistent interpretation of the federal statute. Essentially, these courts have determined that a buyer's set-off rights are superior to a creditor's security interest when the

FSA applies. For the FSA to apply, a creditor with an interest in farm products and its proceeds must provide a buyer of collateralized products with a notice that complies with the requirements under §1631. If a buyer receives a notice that complies with §1631, but choose to apply a set-off and retain proceeds, that buyer is most likely liable to a creditor for the full amount of the proceeds. A seller's failure to satisfy a purchase contract does not provide a buyer a superior right to retain proceeds over a creditor who has an interest in those proceeds. Thus, a buyer that receives a proper notice should issue payment to both the seller and creditor for the proceeds they owe under the purchase contract, or risk being sued by a creditor who holds a superior, enforceable interest in the proceeds.

On the other hand, when the buyer does not receive a notice that complies with the requirements under §1631, the FSA does not apply to a farm products transaction. When the FSA does not apply, the buyer takes the products and its proceeds free and clear of the creditor's security interest. In other words, the buyer is not liable to the creditor for the proceeds derived from the goods. Accordingly, the buyer can enforce a set-off clause under a purchase contract and retain the proceeds necessary to replace the profits the buyer lost resulting from the unfulfilled contract(s).

In general, the courts that have examined this issue reached this conclusion by interpreting the statutory language of the FSA, that Congress enacted §1631 to protect farm products purchasers from having to pay twice for the same goods. Essentially, the courts' interpretation adheres to Congress' intent for §1631 because buyers are usually not at risk of having to pay double for the products they purchase. When a buyer does set-off an unfulfilled contract and retains proceeds that are subject to a creditor's interest, that buyer is most likely liable for only the proceeds they retained. A buyer will not have to pay a creditor for the proceeds they did not retain if that buyer issued a joint payment to both the seller and creditor. In this situation, the buyer is not at risk of double payment because they retained proceeds that would have been paid to the seller had the buyer not applied a set-off. Thus, the interpretation adopted by the courts provides buyers the protection Congress intended when enacting §1631.

For example:

Example 2: Weston, a crop farmer, enters into three purchase contracts to sale his 2020 crops to Ag Terminal Co. ("ATC"). Under one contract, Weston agrees to deliver 50,000 bushels of corn to ATC. Another contract specifies that he will deliver 25,000 bushels of wheat. The third contract stipulates Weston must deliver 10,000 bushels of soybeans. Each purchase contract contains a set-off clause giving ATC a right to retain proceeds if Weston fails to satisfy any of the contracts. Afterwards, Weston receives a loan from First Farmer Bank ("FFB") to produce his farm products, and gives FFB a security interest in his 2020 corn, wheat, and soybeans crop. FFB perfects this security interest by filing a financing statement. Also, because the state operates a centralized filing system, FFB files an Effective Financing Statement ("EFS") which complies with §1631.
After harvesting, Weston delivers all the corn and wheat due under the contract, but fails to deliver any soybeans to ATC. Under the fulfilled corn and wheat contracts, ATC owes Weston $450,000. However, ATC determines it lost $200,000 resulting from the unfulfilled soybeans contract because it is unable to resell the goods to processors. ATC applies a set-off to the amount owed to Weston and issues a check payable to Weston and FFB for $250,000.

If FFB files suit against ATC seeking to recover the full amount of proceeds derived from Weston's crops, ATC would likely lose this case[4]. In such a case, the FSA would apply because FFB satisfied the notice requirements contained under §1631 by filing a proper EFS. Because the FSA applies, FFB's security interests continued in the farm products after ATC took the goods from Weston. In other words, FFB has an enforceable interest in the proceeds retained by ATC.

When a buyer takes farm products subject to a creditor's security interest, the creditor's in the product's proceeds is superior to the buyer's set-off rights. In a lawsuit between FFB and ATC, a court would likely determine that FFB's security interest in the proceeds is superior to ATC's set-off rights. This means ATC is liable to FFB for the proceeds derived from Weston's products. Although ATC did not have a right to retain the proceeds due to Weston, it is only liable for the $200,000 it retained. In the example, ATC paid FFB the $250,000 derived from Weston's farm products. Thus, to ensure ATC does not have to pay double for the same products, a court would likely require ATC to only pay the $200,000 it retained to set-off the unfulfilled contract.

Alternatively, if FFB did not file an EFS in the example, the case would have a completely different outcome. In situations where a creditor does not place a buyer on notice, the FSA does not apply. If the FSA did not apply to a case between ATC and FFB, then ATC would not have taken Weston's farm products subject to FFB's interest and would not be liable to pay FFB the proceeds. Thus, in this situation, ATC could enforce its set-

[4] Facts from *Guaranty Bank & Trust Co. v. Agrex, Inc.*, 820 F.3d 790 (2016).

off rights against Weston and retain the $200,000 in proceeds to make up the losses resulting from the unfulfilled soybeans contract.

In either situation, buyers should determine whether the products they purchase are subject to a creditor's security interest. If this determination is not made, buyers may risk becoming liable to a creditor for proceeds they retain under a set-off clause. On the other hand, creditors are also at risk of losing their interest in proceeds. Creditors who do not provide buyers with a notice that complies with §1631 enables buyers to enforce set-off rights under a purchase contract, which means they can retain proceeds owed to the seller and creditor. It is important to consult an attorney licensed to practice law in the relevant jurisdiction before decisions are made.

III. Conclusion

Most of the requirements contained within §1631 of the FSA are directed towards creditors. Generally, creditors have certain obligations under the federal statute to ensure they retain their security interest in farm products after the products are sold to a buyer. However, farm products purchasers must also consider the provisions of the FSA to protect themselves. Consequently, if they do not take §1631 into consideration when purchasing farm products, they risk purchasing goods subject to a creditor's interest, and becoming liable to that creditor for the purchase price of the products.

Under the FSA, the notice system that applies to farm products transactions is the state in which the goods are produced in. Creditors and buyers must be aware of the state where a seller offers to sell their farm products, and the type of notice system that state operates. If the farm products were "produced in" a state that operates a central filing system, creditors must file a proper EFS in that state to place buyers on notice of their security interest in the seller's farm products. Creditors who satisfy this requirement will continue to hold an enforceable security interest in the farm products after the goods are sold to a buyer.

Finally, buyers should consider the FSA when attempting to enforce a set-off clause against a seller because the proceeds buyers attempt to retain may be subject to a creditor's interest. If the FSA applies, a creditor's interest in proceeds retained by a buyer is superior to that buyer's set-off rights.