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Figuring the Federal Farm Products Rule

Transactional Requirements

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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 some of these provisional rules and explain the transactional requirements that must be met in order for the farm products rule to apply to a transaction.

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

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creditor's security interest primarily depends on whether the creditor 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. These notice requirements are discussed 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 should pay special attention to the other FSA provisional rules in order to satisfy their obligations under the federal law and 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. Sale Transaction Requirements

Even though the primary issue that parties litigate under the FSA is whether the creditor has provided proper notice to a farm products purchaser, some creditor-buyer conflicts center around other provisions contained in §1631. In a few cases, parties have litigated issues involving the transaction requirements under the federal statute. There are two important transaction requirements that must be met in order for the FSA to apply to a farm products transaction.

The first transaction requirement is that a sale of farm products must actually occur. This means ownership of the farm products must pass from the seller to the buyer. Second, the FSA requires the buyer actually purchase the farm products from the individual who created the security interest. Under the FSA, "a qualified buyer takes free of a security interest 'created by the seller.'"[1] This means the seller must be the party who gave a security interest in their farm products to a creditor. However, some courts have extended the meaning of "created by the seller." The next two sub-sections will further explain the parameters of the definition.

1. Did a Sale Occur?

The first requirement is that there be an actual sale of farm products. As a general rule, under §1631, ownership or title of the farm products must pass from the seller to the buyer. In other words, a purchaser of farm products is protected by the FSA only if a sale has occurred.[2] It seems unusual that parties argue whether a purchase of farm products actually occurred, but not all transactions involving farm products are clear sell-buy transactions.

[1] *Fin Ag, Inc. v. Hufnagle, Inc.*, 720 N.W.2d 579, 586 (Minn. 2006).
[2] *In re Hatfield 7 Dairy, Inc.*, 425 B.R. 444, 454 (Bankr. S.D. Ohio 2010).

For example:

Example 1: First State Bank ("Bank") loans money to Kelly, and takes a security interest in her cattle. The next month, Agri Lender ("Lender") provides a loan to Angus Corrals ("Angus"), a livestock sales barn. Under this loan, the lender authorizes Angus to purchase 919 head of cattle, which the lender takes a security interest in. Interestingly, Angus is owned and operated by Kelly. Thus, Kelly is indebted to both the bank and the lender. Among the 919 head of cattle Angus purchased, 125 of them were personally owned by Kelly. In other words, Kelly sold 125 of her own cattle to her business. After this transaction, the 125 head continued to stay on Kelly's personal farm.

Six months later, Kelly defaults on both of her loans, and the bank attempts to exercise its security interest by taking possession of Kelly's cattle to sale. However, the lender prevented the bank from doing this by filing a lawsuit. In this lawsuit, the lender argues the bank does not have an interest in all of the cattle because the FSA applies to this case. Specifically, the lender claims the 125 head sold to Angus cut off the bank's security interest because the bank did not provide direct written notice to the buyer.

In this case[3], it is most likely a sale of farm products did not occur, which means the FSA does not apply. In the example, it is unclear whether a sale of farm products actually occurred because the seller (Kelly) and the buyer (Angus) are one in the same. Accordingly, a court would expect Agri Lender to prove a "sale" of the cattle actually occurred. If Agri Lender fails prove a sale occurred, the FSA does not apply and it would lose its interest in the cattle.

If a sale did occur, the FSA applies. This means Angus would take the farm products free of the bank's security interest because the bank did not provide notice to the buyer of the cattle. If a sale did not occur, the FSA does not apply and the bank had no requirement to provide Angus notice of its security interest in the cattle. Thus, the court would require the lender to prove a sale occurred between Kelly and Angus.

To prove a sale occurred, the lender would have to provide evidence to the court showing ownership of the cattle passed from Kelly to Angus. To show this, in most cases, the lender would provide evidence of payment for the total amount of the cattle, such as a check, a bill of sale, delivery of the cattle, or evidence of a contract between the seller and buyer. If the lender lacks this evidence, it is likely the lender cannot support its claim that a sale occurred. As a result, the FSA does not apply and the bank is not required to comply with the §1631 notice requirements. Therefore, the bank holds a security interest in all of Kelly's cattle, including the 125 head of cattle in question.

[3] *First State Bank of Athens Mabank Branch v. Purina Ag Capitol Corp.*, 113 S.W.3d 1 (Tex. App. 1999).

This example is important for a few reasons. First, this example shows that cases can involve two creditors. While most FSA cases involve a creditor and farm products purchaser, these cases can also involve multiple creditors claiming an interest in the same farm products. Second, this example demonstrates the importance for creditors to keep track of their debtors' transactions. In this case, had the lender required Angus to execute a written contract with Kelly that describes the sale of the 125 head of cattle, the lender could possibly prove a sale occurred. However, when creditors do not retain records of farm products being sold and purchased, a creditor risks not being able to prove a transaction took place.

Although most cases involving the sale of farm products will not require a creditor to prove a sale occurred, creditors must be cautious about the risk of losing their security interest in products when transactions go undocumented. To reduce the risk of losing their interest, creditors may want to require their debtors to provide a contract to them before they are allowed to purchase farm products with the loaned money. This allows the creditor to keep record of each transaction they financed for their debtor.

2. Who is the Seller?

For the FSA to apply to a transaction, the buyer must purchase farm products from the individual who created the security interest in the products. Under the federal farm products rule statute, "[a] buyer of farm products takes subject to a security interest created by the seller . . . ."[4] Courts often refer to this as the *"created by the seller" limitation*.

Like the first transaction requirement discussed above, it seems unusual that parties can disagree whether the seller of farm products was the person who gave the creditor a security interest. However, some farm products transactions involve several parties working separately to conduct a sale of the products. Also, the FSA does not define who qualifies as a "seller" for §1631 purposes. Accordingly, multiple courts have interpreted the meaning of the "created by the seller" limitation to determine who qualifies as a "seller" under §1631.

There is a split in the courts that have interpreted the "created by the seller" limitation. A minority of courts conclude that the party physically selling the farm products is the actual seller. However, most courts determine that many different individuals or entities can be considered the "seller" to a transaction under §1631. Under the majority approach, the court reviews all of the facts surrounding the transaction, including the connections between each party involved in the transaction. Similarly, the minority approach considers the surrounding facts of the transaction, but these courts take a more literal approach to the meaning of "seller."

[4] 7 U.S.C. § 1631(e) (2018).

An example to demonstrate this split is as follows:

Example 2: Clark Farms ("Clark"), which grows corn, borrows money from Agri Financial Bank ("AFB"), and gives AFB a security interest in Clark's corn crops. AFB files an EFS to satisfy the state's central filing system notice requirements. Kent, a buyer of farm products, agrees to purchase corn from Clark. Before purchasing the corn, Kent checks the state's central filing list and notices AFB's security interest in the corn. Therefore, upon purchasing the corn, Kent issues a check payable to both Clark and AFB. Weeks later, a group of sellers called the "Huskers" offers to sell corn to Kent. Unknown to Kent, the sellers that make up the Huskers are Clark Farms employees who are selling Clark's corn that is subject to AFB's security interest. Before agreeing to purchase the corn from the Huskers, Kent reviews the state's central filing list. The Huskers are not listed in the central filing list as having corn subject to a security interest. Kent then purchases the corn and issues a check payable only to the Huskers. The Huskers deposit this check into Clark's bank account. However, Clark does not use the money to satisfy its debt and defaults on its loan with AFB. Afterwards, AFB files suit against Kent to recover payment for the corn he purchased from the Huskers.

The outcome of this case[5] would depend on which approach a court takes on the "created by the seller" limitation. Hence, the courts that have adopted the minority approach will reach a different conclusion compared to the courts that have adopted the majority approach to the statutory limitation.

i. Majority Approach

If AFB filed a lawsuit against Kent in a court that follows the majority approach, Kent will likely not be liable to AFB for the purchase price of the corn he purchased from the Huskers. In cases that involve a debtor and a separate seller, like the example above, the majority of courts consider the relationship between the two parties are related. Accordingly, if the court determines that the two parties are closely related, the court will likely treat the seller as the party who created the security interest.

Courts typically hold that the debtor and seller are closely related under two situations. First, when the seller is an agent of the debtor. A seller is an agent when they are under the direction of the debtor and act on behalf of the debtor, such as an employee. Second, the parties are closely related when the debtor owns or conducts business under a separate entity, and the separate entity is used to sell the debtor's farm products under the entity's name. When a court finds that the debtor and seller are closely related, it treats the seller as a debtor to the security interest.

[5] Facts in the example from *Fin Ag, Inc. v. Hufnagle, Inc.*, 720 N.W.2d 579 (Minn. 2006).

In Example 2, a court who holds the majority view will most likely find that Clark and the Huskers are closely related. It would not be difficult for a court to consider that the Huskers were acting as agents for Clark. According to the facts, the Huskers are employees of Clark, sold corn produced by Clark, and deposited money they received from corn sales into Clark's bank account. Under these circumstances, the Huskers are selling corn for Clark as agents, making the two parties closely related.

Alternatively, a court could determine that Clark and the Huskers are closely related because of Clark's involvement with the Huskers. Specifically, the facts in the example indicate that Clark is using an entity—the Huskers—to help sell his corn that was secured by AFB. Even if the Huskers and Clark Farms are technically separate entities, they are closely related because Clark used the group to sell his corn under the Huskers name. Therefore, a court will likely treat the Huskers as the debtor to the AFB security interest within the meaning of §1631(e).

If a court labels the Huskers as the debtor to AFB's security interest, then Kent will take the corn free of that security interest. As previously stated, a buyer that does not receive proper §1631 notice will take the purchased products free of a security interest created by their seller. In the example, AFB filed an EFS to reflect its security interest in the corn, but the Huskers were not listed as a debtor. Accordingly, because the Huskers are treated as a debtor, and are Kent's direct sellers of the corn, he did not receive a notice that complied with the §1631 notice requirements. Therefore, Kent takes the corn sold by the Huskers free of AFB's security interest, and does not owe AFB for the purchase price of the corn.

The example above demonstrates why farm product buyers and creditors must take special precautions when transacting. For buyers in a state that follows the minority approach, they must be aware that their direct seller may be "fronting" the farm product for a debtor to a security interest. While it is important for farm product buyers to review the EFS master list or a direct notice received from a creditor, it may be beneficial for a buyer to discover whether their direct seller received the farm product from another who created a security interest in the product.

On the other hand, creditors in a jurisdiction that follows the majority approach must be aware they can lose their security interest if its notice does not comply with §1631. Whether in a direct notice of central filing system state, creditors may find it helpful to include each name or entity their debtor may use to sale farm products. If creditors leave this information out of their notice, they risk losing their security interest in the farm products.

ii. Minority Approach

Other courts have viewed the "created by the seller" language under §1631(e) in two different ways. Some courts have concluded that the party that directly sold the farm products to the buyer is the "seller" under the meaning of the federal

statute. Other courts have found that the party who physically sold the secured farm products to the buyer were "fronting" the transaction for the actual "seller". In the above example, neither line of reasoning will end with a favorable outcome for Kent.

The first scenario presumes the Huskers to be the direct "sellers" of the corn. In this scenario, the court assumes the Huskers purchase the secured corn from Clark, making the Huskers owners of the corn, then sell the corn to Kent on their own behalf. Thus, Kent would take the corn free of any security interest the Huskers created in the corn because they are considered the "sellers" under §1631. However, the Huskers did not create the security interest in the corn between Clark and AFB. Consequently, Kent purchased the corn subject to AFB's security interest because Kent's seller—the Huskers—did not create that interest, and Kent was put on notice of AFB's interest because a proper EFS was filed on the corn.

In the second scenario, the minority of courts analyze the transaction as if Clark is the "seller" within the meaning of §1631. Here, the court assumes the Huskers are acting as agents for Clark, and "fronting" the sale of the corn. "Fronting" is where a third party sells another person's farm products that are subject to a security interest under the third party's name.[6] The minority-view courts do not consider "fronting" parties to be a buyer's direct seller of farm products, which means Kent's direct seller is Clark. Thus, Kent takes the corn free of a security interest created by Clark if Kent did not receive sufficient §1631 notice. However, AFB filed a proper EFS which put Kent on notice of its security interest in Clark's corn. Therefore, Kent is liable to AFB for the purchase price of the corn he bought from the Huskers.

III. Conclusion

In order to receive FSA protection, it is important to satisfy both transactional requirements under §1631. Under the first requirement, a sale of farm products must actually occur. Therefore, a farm products purchaser must ensure ownership of the products passes from the seller to them.

Under the second transactional requirement, a seller must have created the security interest in the farm products. Unfortunately, the federal statute does not expressly state whether FSA protection extends to buyers who purchase farm products from someone who sells the goods on the debtor's behalf. Consequently, courts have adopted different standards on what constitutes a "seller" under §1631. It is essential to consult with an attorney in your jurisdiction to learn more about the specifics of your situation, including the relevant standard.

[6] *Hufnagle, Inc.*, 720 N.W.2d at 584.