INTERIM REPORT OF THE
JOINT SUBCOMMITTEE STUDYING

Security Interests In Farm Products

TO THE GOVERNOR AND
THE GENERAL ASSEMBLY OF VIRGINIA

Senate Document No. 24

COMMONWEALTH OF VIRGINIA
RICHMOND
1986

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John Watkins
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Legal and Research - Division of Legislative Services

C. William Cramme', III - Senior Attorney
Terry Mapp Barrett - Research Associate
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Administrative and Clerical

Office of Clerk, House of Delegates

Ann Howard and Barbara Hanback

Interim Report of the Joint Subcommittee Studying Security Interests In Farm Products

To: Honorable Gerald L. Baliles, Governor of Virginia
and
The General Assembly of Virginia

January, 1986

INTRODUCTION

The joint subcommittee studying secured interests in farm products was established pursuant to Senate Joint Resolution No. 123 of the 1985 General Assembly. That Resolution reads as follows:

SENATE JOINT RESOLUTION NO. 123

Establishing a joint subcommittee to study Title 8.9 of the Uniform Commercial Code relating to security interests in farm products and equipment.

WHEREAS, buyers of farm products in the ordinary course of business take such products subject to lenders perfected security interest under § 8.9-307 (1) of the Code of Virginia; and

WHEREAS, farmer's selling agents, such as auctioneers, commission merchants and market operators also take such products subject to lenders' perfected security interest under that section; and

WHEREAS, the application of § 8.9-307 (1) results in the double payment for farm products when the farmer debtor fails to remit the sales price to the secured lender and the secured lender pursues the farm product buyer or farmer's selling agent for conversion under this section; and

WHEREAS, farmers farm and sell their farm products in multiple counties and cities; and

WHEREAS, some farm products are both centrally and locally filed, but others are only locally filed; and

WHEREAS, farm product purchasers and farmers' selling agents need immediate access to farm product lien filings if they are to avoid double payment for purchased farm products; and

WHEREAS, the computerized filing of lien information would make that information more easily accessible to farm product buyers; and

WHEREAS, farming, farmer financing, and farm product selling is no longer local in nature but a matter of statewide concern and need; and

WHEREAS, the farmers of Virginia need adequate and reasonably priced credit; and

WHEREAS, the banking and lending institutions require reasonable assurance of repayment of loans on secured farm products; now, therefore, be it

RESOLVED by the Senate, the House of Delegates concurring, That a joint subcommittee be established to study Title 8.9 of the Uniform Commercial Code relating to security interests in farm products and equipment. The joint subcommittee shall investigate: (i) the feasibility of computerized filing of such information in a central file with telephone access by farm product lenders and buyers; (ii) shortening the statute of limitations with respect to § 8.9-307 (1) relating to claims to reduce the buyers' risk; (iii) the possible addition of fraud penalities to farm product sellers who fail to pay liens on secured farm products; (iv) whether buyers of farm products in the ordinary course of business should take those products free of a security interest created by the farmer-seller; (v) whether persons acting as selling agents of farmers should be able to sell the farmers' products free of security interests created by the farmer; and (vi) procedures to reduce, if not eliminate, the risk of a farm product buyer's unknowingly purchasing secured farm products.

The joint subcommittee shall consist of twelve members to be appointed as follows: two members each from the Senate Committees on Agriculture, Conservation and Natural Resources

and on Commerce and Labor, to be appointed by the Senate Committee on Privileges and Elections; two members each from the House Committees on Agriculture and on Corporations, Insurance and Banking, to be appointed by the Speaker of the House; one member each from the agribusiness public sector and banking community, one of whom shall be appointed by the Senate Committee on Privileges and Elections, and one of whom shall be appointed by the Speaker of the House of Delegates.

The joint subcommittee shall complete its work in time to make any recommendations it deems appropriate to the 1986 General Assembly.

The costs of this study, including direct and indirect costs, are estimated to be $19,300.

Senator Frank W. Nolen, of Augusta, was elected Chairman of the subcommittee. Other Senate members appointed to serve were: Richard J. Holland, of Windsor; Robert E. Russell, of Chesterfield; and William A. Truban, of Shenandoah.

Delegate Lewis W. Parker, Jr., of Mecklenburg, was elected Vice-Chairman of the subcommittee. Other members of the House of Delegates appointed to serve were: Charles C. Lacy, of Wythe; Willard R. Finney, of Franklin County; and John Watkins, of Chesterfield.

Two citizen members were appointed to serve on the subcommittee: Jack W. Peoples, of Chesapeake, representing the agribusiness public sector and F. Bruce Spencer, of Farmville, representing the banking community.

C. William Cramme', III, Senior Attorney and Terry Mapp Barrett, Research Associate of the Division of Legislative Services served as legal and research staff for the subcommittee. Ann Howard and Barbara Hanback of the House Clerk's Office provided administrative and clerical staff assistance for the subcommittee.

WORK OF THE SUBCOMMITTEE

The joint subcommittee held meetings on November 26, 1985 and January 7 and January 16 of 1986. The subcommittee noted at its first meeting that it purposely started its study late because of the federal legislation being discussed in Congress and because it wanted to see what would result. During its meetings the subcommittee heard a great deal of testimony and received several pieces of written testimony. The staff and interested parties offered the study group written materials during and in between meetings.

Prior to the subcommittee's first meeting, its staff furnished each member with a copy of an initial staff study pointing out the various issues that the study group should consider and what methods other states were using to address the exemption afforded under § 307 of Part 9 of the Uniform Commercial Code which appears as § 8.9-307 of the Code of Virginia. Appendix 1 of this report contains a portion of the initial staff study submitted to the members of the joint subcommittee.

At its November 26 and January 7 meetings, the joint subcommittee received most of its testimony and made most of its fact finding. The testimony centered around that section in the Uniform Commercial Code, more specifically § 8.9-307 of the Code of Virginia, which affords protection to a buyer in the ordinary course of business. The subcommittee found that that section as it presently appears makes an exception to the general rule for those persons buying farm products from a person engaged in farming operations. Normally, a person buying goods in the ordinary course of business takes free and clear of the security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existance. The farm products exception to that general rule does not afford the same protection to a person buying farm products from a person engaged in farming operations. The subcommittee found that the testimony was divived between those representing banking interests and those representing farming interests. Those persons representing banking interests stated that if the law was changed to eliminate the farm products exception they would like to see a central filing system established in the Commonwealth for the purpose of filing liens on farm products and for the purpose making the lien information available to potential buyers. Those persons representing farming interests, stated that they were in favor of eliminating the exception and the statutory creation of a prenotification system whereby the banks would notify potential buyers of any existing liens.

At its January 16th meeting, the joint subcommittee heard very little testimony and made public its decision to recommend that the exception to the general rule created in the Uniform Commercial Code be eliminated and that the failure to pay off an existing lien within a period

of time after the farmer-seller had sold the farm products would be punishable as a criminal violation. The joint subcommittee also decided that the study should be continued for another year in order that it may more fully study the options of a central filing system and the prenotification system.

At all three of the subcommittee meetings representatives from the following associations appeared and testified: the Virginia Bankers Association, the Virginia Farm Bureau Federation, the Virginia Agribusiness Council, the State Corporation Commission, the law firm of Mays, Valentine, Davenport and Moore, the Virginia Poultry Federation, the Virginia State Feed Association, Continental Grain Company of Norfolk, Virginia, Perdue, Inc., the Virginia Livestock Markets Association, Dominion Bank in Harrisonburg, the Virginia-Carolina Peanut Growers' Association, Sovran Bank, the Richmond Farm Bureau Credit Association and several grain and beef cattle farmers from around the Commonwealth.

Having heard testimony the Subcommittee thoroughly discussed and carefully considered which recommendations to make to the 1986 General Assembly. All of the recommendations were made by unanimous vote by the members of the full joint subcommittee.

RECOMMENDATIONS

After careful consideration the subcommittee decided to offer the following two recommendations to the General Assembly:

I. THAT THE GENERAL ASSEMBLY SHOULD PASS A BILL, AS OFFERED BY THE JOINT SUBCOMMITTEE TO ELIMINATE THE FARM PRODUCTS EXCEPTION IN § 8.9-307 OF THE CODE OF VIRGINIA. THAT THE BILL SHOULD PROVIDE THAT A FARMER-SELLER WHO FAILS TO PAYOFF WITHIN TEN DAYS ANY EXISTING LIEN ON FARM PRODUCTS SOLD SHOULD BE GUILTY OF LARCENY.

II. THAT A JOINT RESOLUTION CONTINUING THIS STUDY SHOULD BE PASSED BY THE 1986 GENERAL ASSEMBLY. THAT THE RESOLUTION SHOULD PROVIDE THAT THE SUBCOMMITTEE CONSIDER THE FEASIBILITY OF THE ESTABLISHMENT AND MAINTENANCE OF A COMPUTERIZED CENTRAL FILING SYSTEM AND CONSIDER THE ESTABLISHMENT OF A PRENOTIFICATION SYSTEM.

REASONS FOR RECOMMENDATIONS

THAT THE GENERAL ASSEMBLY SHOULD PASS A BILL, AS OFFERED BY THE JOINT SUBCOMMITTEE TO ELIMINATE THE FARM PRODUCTS EXCEPTION IN § 8.9-307 OF THE CODE OF VIRGINIA. THAT THE BILL SHOULD PROVIDE THAT A FARMER-SELLER WHO FAILS TO PAY OFF WITHIN TEN DAYS AN EXISTING LIEN ON FARM PRODUCTS SOLD SHOULD BE GUILTY OF LARCENY.

In making this recommendation, the subcommittee heard testimony favoring the elimination of the farm products exception in § 8.9-307 of the Code of Virginia. Those persons representing the banking interests in the Commonwealth stated that should the farm products exception be eliminated, some safeguard should be established by statute to protect the secured party's interest, and they advocated that a central filing system be created by statute to serve as that safeguard. Those persons representing the farming interests, stated that with the elimination of the farm products exception, a prenotification system could be established by statute in order to serve as a safeguard to the secured party's interest. The subcommittee heard testimony from both sides that the federal farm bill recently passed by Congress eliminated the farm products exception from the Uniform Commercial Code, and as a safeguard offered both of these options to the states. See Appendix 2 of this report. The subcommittee found that, although the federal legislaiton was effective December 23, 1986, the states would not be forced to accept one option over the other if they did not act by that date. A third option considered by the subcommittee which it ultimately endorsed was to make it a criminal offense to fail to pay the secured party after the sale of the farm products within a specific period of time. A fourth and fifth option considered were (i) some form of release statement printed on the buyer's check and (ii) a certification plan advising the buyer of existing liens.

A. Central Filing System

Proponents of the central filing system approach pointed out that the reason for the present exception in the Uniform Commercial Code for the sale of agricultural products is that

agricultural products are different from other types of products. For example, they stated, when a car dealership sells a car it has an on-going inventory, but when a farmer sells his products he sells them all at once and that inventory is gone and depleted and is not identifiable. They pointed out that if a retailer wanted to sell a large percentage of its stock at one time, it would have to conform with the Bulk Sales Act under the Uniform Commercial Code which requires prenotification. They added that normally a farmer does not sell the bulk of his operation but usually sells off a little bit at a time and therefore does not fall under that Act. They also pointed out that the sale of agricultural products is different from the sale of other things in that they are not physically located in any one place and the sale can be across county lines or state lines. They stated that they agreed that there is a problem in this area for all that are concerned. Proponents pointed out that the security of the bank and its collateral in the products is very important, that the buyer of the agricultural products faces the possibility of purchasing the products with an existing lien and the possibility of paying twice because of that lien, and that the farmer wants to continue farming and selling his products and wants to finance more crops. The proponents stated that should the exception be eliminated it was their belief that the central filing system plan was the most equitable for all involved. They stated that the establishment of a centrally-located computerized agricultural lien filing system would allow lenders to file their liens and would provide buyers of agricultural products with instant electronic access to that lien information. They stated that that information could be made available on a twenty-four hour basis. The proponents of this approach advised the subcommittee that they were taking this approach because it would enable banks to remain as aggressive as possible in farm lending practices. The proponents suggested that the removal of the exception from the Uniform Commercial Code could ultimately hurt the farmers ability to obtain a loan. They stated, however, that they wanted to continue to serve the farmer and make these types of loans available and that is why they were seeking this approach to the solution.

The proponents stated that the actual procedures to be utilized under the central filing system proposal could be adopted from the federal legislation and regulations. They stated that federal legislation introduced in 1985 requires specific information in the disclosure of the liens. They stated that it requires the filing of liens by product group indexing and requires the farmer to be identified by his name and social security number.

With regard to the cost of establishing such a central filing system, the proponents stated that it is difficult to get a handle on what the costs would be, but noted that there would be some start up costs involved in any proposal that the subcommittee may adopt. They stated that the public concern should be considered when looking at the cost of the central filing system. The proponents pointed out that with regard to the public interest, central filing is not a total solution to the problem but that it is important to remember that the subcommittee, in whatever they recommend, would not want to alleviate anyone from his duty under a secured lien. They explained that presently a borrower cannot check all possibilities for liens, and lenders cannot be sure that they have notified all buyers. They added that there is a need to get more cost information on a central filing system and that they forsaw that all parties would be paying some sort of fee through a fee arrangement.

The State Corporation Commission informed the subcommittee that without bids on the central filing system they could not pinpoint the exact cost of such a filing system. They stated, however, that by looking at other systems they were able to estimate that the first year's cost should range between $672,000 and $902,000 which did not include the cost of hardware. They stated that additional employees, expenses and supplies would cost another $102,000. In making their estimates, they stated that they considered access to the system by telephone and that is why the estimated costs vary. They pointed out that the costs do not consider placing terminals throughout the Commonwealth or for providing communications between states. They pointed out that it is conceivable to utilize existing computer networks within the Commonwealth. The Commission stated further that the cost for the existing grain filing system is $235,000. They pointed out, however, that they cannot add a new central filing system to the existing computer system because the data base requirements for the new system are totally different from what they have now.

With regard to other states that have implemented a central filing system, the subcommittee heard testimony that Montana had passed legislation effective July 1, 1985 that created a central filing system to be functional by July 1, 1986. Testimony revealed that the State of Montana had estimated that 50,000 liens will have to be refiled in order to maintain a first lien position and they are charging a $7 fee for filing. Further, the Secretary of the State of Montana provides each county with lien information by mail each month. The subcommittee found that the State of North Dakota has a law that has been used as a model law. They found that North Dakota has 90,000 liens on its system and has spent $423,000 for computer terminals and programs. They found that the administering agency sends microfiche lien information to a list of subscribers. The subcommittee also heard testimony that the State of Delaware has a central

filing system that is hand operated and has been in operation since 1967. Testimony revealed that 15,000 liens are filed each year in the State of Delaware. The cost of each filing is $5 and the system is self-supporting. Testimony further revealed that Delaware may have to modify its system because of federal law changes. The subcommittee was reminded that the filing of the liens in this type of central system only indicates that a lien exists, and that a financial statement has to be filed in order to perfect the lien. See Appendix 3 of this report for testimony filed with the subcommittee supporting the establishment of the central filing system.

The subcommittee found that the opponents of the central filing system approach were in favor of eliminating the exception to the Uniform Commercial Code but favored the creation of a prenotification system rather than a central filing system. In opposing the central filing system alternative, the opponents stated that no one knew what the cost would be to create a central filing system but they could be considerable and would ultimately be passed on to the farmer through the use of filing fees. They explained, also, that they were concerned about the accessability of the data on the central filing system in a situation involving an immediate sale. The opponents also pointed out that many times during the sale of agricultural products, particularly at the livestock market, when a person goes to buy a head or heads of cattle there is no time to check the record for liens, and that a more practical approach than a central filing system should be considered by the subcommittee. They stated that in that situation many buyers would not be aware of liens and would still be liable for double payment. They pointed out that the credibility of the Commonwealth would be on the line with the central filing system since the state would be liable when inaccurate information was reported. The opponents also suggested that because farmers sell to buyers outside of the Commonwealth they were fearful that those out-of-state buyers may want to go elsewhere so as not to have to deal with subscribing to computer information even if it were available to them in their state. The opponents testified further that they do not feel responsible to those persons to whom banks loan money. They stated that the imposition of a central filing system does not properly place the responsibility for financial risk taking on the banks. They stated that a central filing system would continue to cause buyers to take the risk of having to make double payment for agricultural products. They stated that the financial risk taking and the repayment of the loan should be placed in the hands of the establishment which granted the loan and the person who received it, because these are the two parties who were originally involved in the negotiations. They stated that because of these reasons some approach other than the creation of a central filing system should be considered and adopted by the subcommittee.

B. Pre-notification System

The proponents of the creation of a pre-notification system stated that they favored the elimination of the exception for agricultural products in § 8.1-309 of the Code of Virginia and the establishment of system whereby the farmer who is the borrower/seller could be required by his lender to supply the lender with a list of potential buyers. That type of system could also require the farmer to notify the lender one to two weeks in advance if the farmer wished to sell to someone who was not on the list. They stated that the farmer could also be required to pay the lender within a certain number of days after the sale. They added further that the prenotification system could require the borrower/farmer to be subject to a stiff penalty of a certain amount or a percentage of the value of the product sold if the farmer fails to pay the lender within a certain number of days after the sale of the agricultural product. They stated that in their opinion the prenotification option was the most reasonable, feasible, fair and least costly and harmful of the two options. They stated they forsaw that such a system would not result in problems with the availability of loan funds for farmers. They added that a prenotification system exists in twelve other states and that they had heard of no problems with those systems. The proponents also pointed out that the imposition of a prenotification system rather than a central filing sistem would properly place the risk of lending money on the institutions making those loans. They added that lenders should not be lending money to farmers on the criteria that the buyers would repay the loan.

The proponents of the prenotification system approach stated that under present law the purchaser of agricultural products are exposed to great risk and are acting as credit supervisors for lending institutions. They stated that under the prenotifiation system approach, lending institutions are protected by being allowed to inform buyers of agricultural products of an existing lien whereupon the buyer is obligated to conform with the banks instructions on payments. They stated that under this type of clear title concept the farmers opportunity to use agricultural products as collateral to secure loans is not damaged, and it places the responsibility for financial risk taking and the repayment of the loan in the hands of the lending establishment. Appendix 4 of this report contains written testimony received by the subcommittee from the proponents for the prenotification system option.

The opponents to the prenotification system option, stated that under such a system there is a possibility of the bank's collateral being voided. They explained that if the borrower/farmer chooses not to notify the lender until after the sale, the bank's collateral, the farm product, is gone. They stated that any penalty provided under such legislation creating the prenotification system may not be severe enough. They stated that a prenotification system could hurt the farmers ability to obtain a loan because it would jeopardize the collateral, and noted that they were not speaking about a insignificant amount of farmers. They added that the honest farmer who would pay off his loan would be potentially penalized by the prenotice system since it reduces his flexibility to sell his products for the best price availble. They stressed to the subcommittee that the implementation of a prenotification system would have a significant impact on the ability of the farmers to obtain financing.

The opponents argued that lenders are not known for accepting additional risks without making modifications elsewhere and that if Virginia were to go to a prenotification system, banks would not be able to secure themselves with the borrower's collateral if the commodity itself were used for collateral. They stated that lenders do not wish to place additional burdens on farmers as the economic times for farmers today are the worse since the depression. They pointed out that a significant number of farmers would be affected. They stated that, as lenders, they feel a moral obligation to make agricultural loans particularly to farmers in rural areas and that if they have to restrict such loans, this would not only hurt the farmer, but the overall economy. They stated that in considering the cost of implementing a system, the subcommittee should consider the public concern and welfare.

The opponents stated that there would be several results if the Commonwealth goes to the prenotification system. They stated that there could be additional underwriting costs because of the additional risks involved. They pointed out that there would be a probability of imposition of tighter lending requirements. They stated that such a system would cause the producer/farmer to be in a position to sell to those on the list and if he does so, and cannot repay the loan in a certain number of days the lender would be forced to take legal action. They noted that such a system may cause the lender to be in a position of having to take legal action against someone whom they have had a banking relationship for years. They added that in this situation if the bank lets the farmer/borrower go without making prompt payment, it would be establishing a precedent of no-action. The opponents opined that if a prenotification system were adopted, the larger banks would immediately change their lending practices. They suggested that the smaller banks would continue with their current practices until they were hurt.

One of the opponents to the prenotification system, who is one of the larger agricultural lenders in the Commonwealth, stated that the prenotification system presents issues that violate loan collateral principles and explained that they estimated that if a prenotification system were implimented in the Commonwealth they may be forced to not deal with 42% of their current agricultural borrowers in the future. They stated that that percentage equals 20% of their dollar volume. They stated that their basic fear is that the prenotification option creates the danger that the seller may not choose to notify the lender of his potential buyer prior to the sale and to wait until after the sale to repay the loan. They stated that in such a situation the lender's collateral is gone and the loan may not be repaid. They pointed out that lenders are not likely to get into that position and that if prenotification is required, lending would be reduced.

C. Criminal Penalty Option

After having heard testimony on the central filing system option and the prenotification system option, the subcommittee decided to consider a third option, that of creating a statute that would make it a criminal offense if the borrower/farmer did not pay off an existing lien within a reasonable period of time after the sale of the agricultural product used as collateral on the loan. Because the subcommittee also learned that the federal legislation on this subject in the national farm bill did not require the states to choose between a central filing system or a prenotification system, the subcommittee decided that it was in favor of adopting the approach which would make it larceny for the farmer to fail to pay off the lien within a reasonable period of time after the sale of the agricultural product. See Appendix 5 of this report which contains the legislation agreed to by the subcommittee adopting this approach.

D. Other Approaches

The subcommittee received testimony concerning two other suggested approaches in remedying the situation which the buyers of farm products are now experiencing. These alternatives suggested the printing of release statements on the backs of checks received from the sale of the farm product. The suggestion was that the release would be a statement that

clear title would exist upon the endorsement of the check. The subcommittee found that there was considerable question as to the worth of such a printed release. The subcommittee learned that in order for such a release to be legally binding there would be some need of statutory language to allow for such releases.

A second option offered to the subcommittee involved a certification plan whereby the farmer would give a certificate to the buyer advising the buyer that either a lien existed or that no lien existed on the agricultural product. Under such a plan, if there were a lien existing a joint check would be drawn by the buyer on the bank holding the lien. If no lien existed there would be no need for a joint check.

Although the subcommittee heard some testimony on both of these alternatives, they decided not to recommend either one. In making that decision, the subcommittee had already decided that the study on this issue should be continued for another year. They noted that these two options could be considered in more detail in the study during the next interim.

For the reasons cited above, the joint subcommittee recommends that legislation be introduced in and passed by the 1986 General Assembly to eliminate the farm-products exception presently in § 8.9-307 of the Code of Virginia, and that such legislation include a provision that would make a farmer guilty of larceny for failure to promptly payoff existing liens on collateralized farm products that are sold.

II. THAT A JOINT RESOLUTION CONTINUING THIS STUDY SHOULD BE PASSED BY THE 1986 GENERAL ASSEMBLY. THAT THE RESOLUTION SHOULD PROVIDE THAT THE SUBCOMMITTEE CONSIDER THE FEASIBILITY OF THE ESTABLISHMENT AND MAINTENANCE OF A COMPUTERIZED CENTRAL FILING SYSTEM AND CONSIDER THE ESTABLISHMENT OF A PRENOTIFICATION SYSTEM.

In making this recommendation, the subcommittee found that the federal legislation enacted in the federal farm bill did not mandate either a central filing system or a prenotification system to the states. Because of this the subcommittee felt that it should give more time to the consideration of the cost involved in implementing a central filing system or a prenotification system. Because of the complexity of the issue and the different views of what type of system would be best for the Commonwealth, the joint subcommittee decided that the study should be continued so that they may thoroughly study all the options available. The subcommittee also pointed out that the continuation of the study would allow the subcommittee to monitor the federal legislation in this area and to determine what type of system for addressing this issue would be in the best interest of the Commonwealth. Appendix 6 of this report contains the joint resolution which the subcommittee offers in order to continue the study.

For the reasons cited above, the subcommittee recommends that a resolution be introduced and passed by the 1986 Session of the General Assembly to continue the subcommittee's study.

CONCLUSION

The subcommittee expresses its appreciation to all parties who participated in its study. The subcommittee expresses its desire that all the parties who participated would continue to particiate in its future study of the issues. The study group's recommendations have been offered only after carefully and thoroughly studying the information and data received. The subcommittee believes that its recommendations are in the best interest of the Commonwealth and encourages the General Assembly to adopt those recommendations.

Respectfully submitted,

Frank W. Nolen, Chairman

Lewis W. Parker, Jr., Vice-Chairman

Richard J. Holland

Robert E. Russell

William A. Truban

Willard R. Finney

Charles C. Lacy

John Watkins

Jack W. Peoples,

F. Bruce Spencer

APPENDICES

1. Initial Staff Study and Appendum.
2. Federal Legislation.
3. Testimony Supporting Central Filing System.
4. Testimony Supporting Pre-notification.
5. Recommended Legislation.
6. Resolution Recommended to Continue Study.

APPENDIX 1

THE INITIAL STAFF STUDY FOR THE JOINT SUBCOMMITTEE STUDYING THE UNIFORM COMMERCIAL CODE AS IT RELATES TO SECURITY INTERESTS IN FARM PRODUCTS AND EQUIPMENT

Prepared by

C. William Cramme, III
Division of Legislative Services

Contents

AUTHORITY FOR STUDY

Pursuant to Senate Joint Resolution No. 123 of the 1985 General Assembly, the Joint Subcommittee was established to study the Uniform Commercial Code as it relates to security interests in farm products and equipment, and to study the feasibility of requiring the State Corporation Commission to computerize filings of secured transactions relating to farm activities. A copy of this resolution is attached as Appendix 1 to this study.

PERSONS APPOINTED TO SERVE

Senate Joint Resolution No. 123 requested that the "Joint Subcommittee shall consist of ten members to be appointed as follows: two members each from the Senate Committee on Agriculture, Conservation and Natural Resources, and the Senate Committee on Commerce and Labor, to be appointed by the Senate Committee on Privileges and Elections; two members each from the House Committee on Agriculture and the House Committee on Corporations, Insurance and Banking, to be appointed by the Speaker of the House; one member each from the agribusiness public sector and banking community, one of whom shall be appointed by the Senate Committee on Privileges and Elections, and one of whom shall be appointed by the Speaker of the House of Delegates."

The Senate Committee on Privileges and Elections appointed the following members: Senator Frank W. Nolan of Augusta, Senator R. J. Holland of Isle of Wight, Senator William A. Truban of Shenandoah, Senator Robert E. Russell of Chesterfield, and citizen member Jack W. Peoples of Chesapeake representing the agribusiness public sector.

The Speaker of the House of Delegates appointed the following members: The Honorable Lewis W. Parker, Jr. of Mecklenburg, The Honorable Willard R. Finney of Franklin, The Honorable Charles C. Lacey of Wythe, The Honorable John Watkins of Chesterfield, and citizen member F. Bruce Spencer of Farmville representing the banking community.

OBJECTIVES

It would appear that the joint subcommittee should strive to achieve the following objectives:

(1) To consider and determine whether present practice under current law is resulting in double payment for farm products and equipment. If so, to what extent is this double payment taking place?

(2) To consider methods of improving information flow between the farmer borrower, the farmer lender, and the farm product purchaser in order to reduce the frequency in which farm products are sold without payment or immediate remittance to the lender. As part of this consideration, to determine whether it

would be feasible and cost effective to set up a computerized filing of security interest in farm products in a central file with telephone access by farm product lenders and buyers, including automatic electronic transfer of such information from local circuit courts if local filing is to be retained.

(3) To determine whether local filing with the circuit court clerks should be retained.

(4) As an alternative solution, to determine whether present Section 8.9-307 of the Code of Virginia (see Appendix 2 for a copy of this code section) should be amended to allow buyers of farm products in the ordinary course of business to take those products free of its security interest created by the farmer-seller.

(5) As another alternative solution, to determine whether Section 8.9-307 should be amended to establish procedures to reduce, if not eliminate, the risk of a farm product buyer normally purchasing secured farm products. As part of this solution, to consider the shortening of the 45-day statute of limitations relating to claims, in order to reduce the buyer's risk.

(6) To consider additional statutory language that would establish fraud penalties for farm products sellers who failed to pay liens on secured farm products in a timely manner after those products are sold.

(7) To consider amending the Uniform Commercial Code to require lenders to notify buyers of existing liens. This could be included in (6) above and could also penalize the lender who fails to notify the buyer of the existence of a lien.

(8) To amend the Uniform Commercial Code to require the lender, at the time of the loan, to notify the borrower that conversion of mortgaged property without payment to the lender is a fraud. Also, at the same time require the producers to sign a similar statement.

SCHEDULE OF STUDY

In estimating the direct and indirect costs of the study, the Resolution requests a maximum of four meetings be held in order that the work of the joint subcommittee be completed.

Senate Joint Resolution No. 123 states that the "joint subcommittee shall complete its work in time to make any recommendations it deems appropriate to the 1986 General Assembly." If the subcommittee concludes its deliberations by the end of November, its staff will have ample time, prior to the beginning of the 1986 Session, to draft any legislation or reports desired by the subcommittee.

Due to the nature and complexity of the study, the joint subcommittee's first meeting should not only be organizational in nature but also fact finding. The joint subcommittee will want to consider holding public hearings outside of Richmond in order that farmers and lenders may attend the meetings.

GENERAL OVERVIEW OF THE ISSUE AREAS

Generally, Article 9 of the Uniform Commercial Code promotes an open market rule which permits good faith purchasers to take goods free of perfected security interests. This general rule does not, however, hold true for good faith purchases of farm products (see paragraph 1 of Section 8.9-307 as contained in Appendix 2 of this initial staff study). Nor does Article 9's general open market rule hold true for commission merchants who act as agents in selling farm products. According to the great weight of legal authority, buyers of farm products and commission merchants who act as agents in selling farm products are liable to the secured lender if the borrower-seller fails to account to the security lender for the proceeds of sale, even though the buyer or commission merchant does not know that the farm products were mortgaged. The only exceptions to this general rule of liability are: (1) when a secured lender authorizes the sale, and (2) in a few jurisdictions, where the secured lender has acted so egregiously with respect to the security agreement and sales of farm products that the courts have found some way to negate the liability. Neither of these exceptions arises very often. (The text of this initial staff study section is based entirely on the writings found in Appendices 3, 4, 5, and 6).

The liability of innocent purchasers of farm products and intermediaries who sell farm products is founded principally on the interaction of Paragraph (2) of Section 8.9-306 with Paragraph (1) of Section 8.9-307 and on the tort of conversion.

Paragraph (2) of Section 8.9-306 provides:

> "Except where this Article otherwise provides, a security interest continues in collateral notwithstanding sale, exchange, or other disposition thereof unless the disposition was authorized by the secured party in the security agreement or otherwise and also continues in any identifiable proceeds...."

A buyer of inventory in the ordinary course of business, however, is protected from this continuing security interest by Paragraph (1) of Section 8.9-307, which provides that such a buyer takes free of a security interest created by his seller. This is not so for a buyer of farm products. Because of the special rule for farm products set out in Paragraph (1) of Section 8.9-307, a buyer in the ordinary course of farm products is not protected from the continuing security interest of Paragraph (2) of Section 8.9-306; he takes subject to the security interest (see Appendix 2 of this study for a copy of Section 8.9-306 of the Code of Virginia). Thus, the secured party may reclaim the farm products from the buyer, or he may hold the buyer accountable for the value of the security interest in those farm products. Additionally, if the security agreement makes the borrower's unauthorized sale of the farm products a default entitling the secured party to possession of the collateral and the buyer does not account to the secured party for the collateral, the secured party may hold the buyer liable for conversion because the buyer has wrongfully interfered with the security party's right to possession of the collateral.

Unlike a buyer of farm products, a commission merchant's liability for selling mortgaged farm products is not based on the interplay of Paragraph (2) of Section 8.9-306, and the farm products exception of Paragraph (1) of Section 8.9-307, which, of course, means that simply deleting the farm products exception from Paragraph (1) of Section 8.9-307 will not protect commission merchants from liability. A commission merchant's liability is based on conversion. If the security agreement makes the borrower's unauthorized sale a default entitling the secured party to possession of the collateral and the commission merchant does not account to the secured party for the collateral, the secured party may seek recovery against the commission merchant under either of two theories of conversion. Under the first theory, a commission merchant is liable for conversion because he has, by his exercise of dominion and control over the farm products during the selling process, interfered with the secured party's right to possession of the collateral. Under the second theory, a commission merchant's liability is based upon his acting as agent for the mortgagor. Thus, when a borrower sells mortgaged farm products without the secured party's consent, he is deemed to have tortiously interfered with the secured party's right to possession and the commission merchant, as the borrower's agent, stands in the shoes of his principal. The rationale underlying the agency theory of liability is that inasmuch as an agent is free to deal with, or serve, whomever he pleases, he should be of liable if he chooses to assist a principal, even unknowingly, in the commission of a tort.

An accepted rule of law is that an agent, factor, commission merchant, or auctioneer who receives property from his principal and sells it and pays the proceeds of the sale to him is guilty of conversion if the principal has no right to sell a property, even though the agent acts without knowledge of the defect in title.

REASONS FOR THE RULE

A number of arguments have been advanced for the farm products rule. Some have argued that buyers from farmers should be treated differently because farmers sell their products through agents or sell to financially sophisticated buyers. The exception found in Paragraph (1) of Section 8.9-307 has been justified on the ground that farmers sell to buyers, marketing agents, and brokers who are in a position to determine if their seller has given someone a security interest in his farm products. These business operators are, or should be, aware of the need to check the filed financing statements, which is not the case with most consumer buyers.

Another consideration for keeping the rule is that many farm operations are cyclical in nature. Farm lenders recognize this and generally expect payments only when products are sold. Thus, the lender has all of its expectations and security tied up in one asset. It has been argued that sales of farm products are more closely akin to bulk sales and sales of inventory and deserve to be treated differently. Thus, goes the argument, because farm products are not subject to the

creditor protections afforded by Article 6 of the Uniform Commercial Code, lenders must have the protection afforded by the farm products exception in order to protect their interests.

If the farm products rule were totally eliminated, the lender would lose a substantial protection. Moreover, the lender would have no leverage with the potential buyers concerning who should be named as payee of the check when products subject to a security interest are sold. Also, the creditor would never be able to determine who all of the potential buyers are inasmuch as farm products can be easily transported out of the local area. This is in marked contrast to the noted filing system currently in effect under the Code and makes it possible to determine who might have a security interest. Assuming the creditor is not able to insure being named as a joint payee on the check, it will have to establish procedures to assure that the proceeds from the sale of the covered collateral are identifiable as required by Paragraph (2) of Section 8.9-306. The contrast to other businesses is arguably striking. In many other business operations, particularly dealing with expensive goods, the proceeds will consist of chattel paper, which is fairly easy to police and identify. For the farm lender to keep proceeds identifiable, it would mean keeping the farmer from commingling them with other funds. This has historically been very difficult when farmers are involved, inasmuch as farmers are generally paid by check that is deposited in a general checking account.

Finally, assuming that a change of Paragraph (1) of Section 8.9-307 would create substantially more risks for the lender, it would appear that the lender would loan less, require much more in the way of collateral or guarantors, or raise costs. This reason for retaining the farm products exception is the most frequently cited justification for the exception stating that agricultural enterprises will not be able to secure credit without this "favorable" agricultural lending rule. If this were to happen, this could well put further pressure on the federal government to get more involved in the lending business inasmuch as the Farmers' Home Administration's current requirements are that borrowers are not eligible unless credit is otherwise not available.

REASONS AGAINST KEEPING THE RULE

Not surprisingly, buyers and agents make many arguments supporting their view that the rule is unjustifiable and that there is no reason for the separate classification of farm products within the provisions of Paragraph (1) of Section 8.9-307. One of the criticisms of the farm products exception is in the form of a reply to the traditional rationale for the farm products exception that buyers of farm products are sophisticated enough to know that their seller may have mortgaged the farm products he is selling. Some point out that the problem with this justification for the rule is that a buyer, no matter what his level of sophistication regarding agricultural financing, may not be able to determine whether the goods he is purchasing are mortgaged or not. This justification for keeping the farm products rule stems from the idea that

most agricultural sales differ fundamentally from most non-agricultural sales. The theory is premised on the belief that the sophisticated farm products purchaser, unlike the less sophisticated buyers of other goods, will be aware of the exception to the free market rule and will therefore take steps to protect himself. If, in fact, purchasers from agricultural businesses are large and sophisticated business enterprises, it is reasonable to assume that they ought to be aware of the farm products rule; however, the local filing option reduces to futility any effort on their part to discover the existence of a security interest. Presently, the Code provides that the place to file for farm products is a local filing office in the county of the debtor's residence, or if the debtor is not a resident of the state, then in the county where the goods are kept. When the collateral is growing crops, there must be a filing in the county where the land is located. When a buyer is trying to search the records for a security interest, such an inquiry requires the buyer to discover the identity of the producer, and this type of investigation is complicated by the fact that the buyer may not be dealing with the producer but with the producer's buyer or another intermediate party. The characteristic of a chain of buyers and sellers compounds the inquiry not only for the first buyer but for each subsequent buyer down the chain of buyers until the goods are sufficiently disbursed to render the secured party's attempts to locate them inefficient. If the buyer decides not to search, he cannot be sure that title is good. In summary, the justification for keeping the rule based on agricultural commodity buyers being sufficiently sophisticated to protect themselves by

searching for security interests, and therefore not needing the protection of an open market rule, allowing the buyer to buy free and clear, rests on bad footing.

Even without the difficulties encountered as a subsequent purchaser, buyers and commission merchants are often simply not able, because of time constraints and costs, to check for liens on all the farm products they buy or sell. Farmers do not tell the buyers in advance of sale dates. This is a particular problem for the livestock industry in that many packers buy from multistate areas, and they are required to pay before the close of the next business day. This rule has resulted in many livestock buyers obtaining insurance.

Although the justification for the rule that equates a sale of farm products to bulk sales is more persuasive than the previous justification, it also encounters problems when examined closely. For example, a dairy herd is a constantly changing asset. Poor producers are culled and replaced. It is difficult to see how this continuing turnover for a small number of animals is akin to a bulk sale. Also because of the more sophisticated marketing techniques now being used by farmers, farm products will often not be sold at one time; they will instead be sold over a period of months to take advantage of "off-season prices" and to fulfill forward contracts.

One of the traditional rationales for the farm products exception which is usually resorted to, states that agricultural enterprises will not be able to secure credit without this "favorable" agricultural lending rule. Many say that this justification rings hollow since

presumably agricultural lenders are just as interested in promoting the sale of agricultural commodities as their borrowers are. They state that it is difficult to see how a rule which hinders the ready flow of those commodities can help creditors.

Another argument that is offered as a reason against keeping the rule involves the shifting of the risk of nonpayment to the buyer. Proponents of change say that the free-flow-of-commerce principle, which is the basis of the ordinary buyer taking free of a prior perfected security interest, applies to farm products as well as the inventory of the appliance store; that is to say that farmers should be treated as any other business. The lender will still have a security interest in the proceeds. This criticism of the rule usually centers on the unfairness that attends the fact that purchasers of farm products from farmers are often unaware that the products they buy are encumbered. The critics are especially concerned about the application of the rule to subsequent purchases at the initial inventory sale by the farmer. The buyer-in-ordinary-course doctrine, under the language of Paragraph (1) of Section 8.9-307, applies only to security interests "created by his seller;" that is, the security interest is discharged only if it was one created by the person selling to the buyer in the ordinary course. Therefore, the subsequent purchaser takes subject to the security interest created by the farmer, since the farmer is not "his seller." For example, if a farmer grants a security interest in his farm product to a production credit association and then sales the farm product to an intermediate wholesaler which, in turn, sells it to a broker, neither the

intermediate nor the broker take free of the association's security interests. The intermediate, while it may fit the definition of a buyer in the ordinary course, cannot avail itself of the buyer-in-ordinary-course rule of Paragraph (1) of Section 8.9-307, because it buys from a person engaged in farming operations. The broker also cannot avail himself of this Section because, even though he may rise to the status of a buyer in the ordinary course, he only takes free of security interest created by his seller; the intermediate wholesaler. The farmer created the security interest in question, and the broker, therefore, takes subject to it. The criticism of the rule implicit in this example loses most of its bite, however, in light of the practical obstacles confronting the lender who chooses to pursue distant collateral. Needless to say, a financier will derive little economic benefit from chasing his debtor's farm product in grocery stores or kitchen cupboards. The criticism of the rule gains respectability, on the other hand, in situations where a slaughterhouse, intermediate wholesaler, cotton gin, or broker buys the farmer's products. In this instance, the farm financier enjoys targets far less elusive and diffuse than products sold by grocers and consumers. Cases indicate that financiers are not reluctant to sue such defendants as brokers and slaughterhouses on conversion theories. The basis of the "unfairness objection" is sound. Because of the "his seller" requisite of the buyer-in-ordinary-course rule, farm lenders can follow the collateral to purchasers who cannot buy from the farmer. On the other hand, in a non-farm situation, because the original buyer in the ordinary course

from a non-farmer takes free and clear of the security interest, the buyer may pass the goods on to his buyers free of any such encumbrance. Gauging the fairness of these differences depends in part on whether the purchaser losing the protection is a slaughterhouse or intermediate warehouseman rather than a consumer.

The farm products exception is subject to criticism on the basis of economic consequences. In theory, many buyers of farm products are well aware of the exception and either go to the expense of a filing search or buy at their peril. As a result, such buyers must determine either the cost of the search or of the risk. The buyer then has three alternatives for accommodating these costs: he may increase the price to his customers, decrease the offering price to the farm seller, or accept the cost himself. Whatever alternative he selects, agricultural commerce ultimately bears the cost and the corresponding consequence in the marketplace. Finally, the farm products rule confronts another criticism arising out of the inventory priority rules. Article 9 of the Uniform Commercial Code provides that a purchase-money secured party's rights to inventory will not take priority over a person having an earlier perfected security interest in the same inventory unless the purchase-money party gives notice. Thus, for example, if a debtor grants a bank a floating security interest in inventory, that is a security interest in all of its inventory whether then owned or thereafter acquired, and if the debtor subsequently grants a security interest to a supplier whose credit permits the debtor to acquire additional inventory, the supplier can defeat the bank only if it gives notice to the bank of

the purchase-money transaction. The notice requirement protects the revolving inventory financier (the bank) by virtue of the fact that it prevents the dilution of the collateral without his knowledge. At the same time, it grants priority to a creditor (the supplier) who merits it: a creditor who provided the financial resources to purchase the after-acquired property. In short, the rule provides flexibility for inventory financing by facilitating a new source of credit to the debtor and protecting the original lender from surprise.

At the same time, because farm products are not "inventory," the financing of "farm inventory" (that is, farm products) does not qualify for such flexible treatment. Since farm products are not "inventory" a purchase-money sale of such goods falls within Paragraph (4) of Section 8.9-312, which contains no notice provision, and the revolving agricultural lender loses the benefit of the notice. Thus, the lender may unknowingly be put in the position of being unable to satisfy his debt from the farmer and be forced to pursue the inventory collateral in the hands of subsequent purchasers. As noted above, this inventory may be sufficiently disbursed and make this remedy impractical. This danger may deter the extension of revolving credit to the farmers despite the fact that, as several authorities suggest, agricultural businesses need revolving credit as a result of growing capital requirements. Similarly, because farm products are not inventory, proceeds from their sale elude the revolving lien farm lender although such proceeds continue as collateral for the revolving inventory financier of other industries. In short, the farm products exception from the inventory definition and from

the open market rule, both of which ostensibly protect farmers and farm lenders, create an obstacle to one type of credit farmers need, even though both of these exceptions are ostensibly designed to protect farmers and farm lenders.

INTERESTED PARTIES' POSITIONS

Regardless of the association and their constituency, all the interested parties believe that it is better for the General Assembly to cure present problems presented by Section 8.9-307 than for Congress to act and make broad sweeping changes. They all believe that it is more of the province of the State to regulate these commercial activities than for the federal government to step in.

The Virginia Farm Bureau Federation's position is to amend the Uniform Commercial Code to remove the farm product's exception. They believe that this is a realistic approach which will go far in helping to avoid the consequences that the rule has fostered. There is the opinion that such a change would remove unnecessary fetters on farm financing and allow for agricultural commodities to assume their place in the open market (see Appendix 7 of this study).

The Virginia Agribusiness Council and various lenders in Virginia want to take the approach of creating a central filing system for liens on agricultural commodities in an effort to cure the problems created under Section 8.9-307. They believe that this approach of a central filing system with telephone access, including the consideration of automatic electronic transfer of this information from the local circuit

courts where the information is filed, is far better than deleting existing provisions within the Uniform Commercial Code. They are not sure that it is wise to change existing provisions within the Uniform Commercial Code since the impact that those changes may have upon other provisions is not entirely clear (see Appendix 8 of this study). The Virginia Bankers' Association seem to agree with the conclusion found in the article entitled "UCC Issues" written by Keith G. Myers in the Journal of Agriculture Taxation and Law. Mr. Myers concludes that if buyers and lenders alike could be protected by central filing and very quick access to the filed information, it should be tried. Mr. Myers states that one state, Iowa, has had this in operation for some time. He notes that farm products are filed with the Secretary of State, and there is a private search firm that will provide the information immediately by phone. (See Appendix 5 of this study).

WHAT OTHER STATES AND CONGRESS ARE DOING

WHAT THE STATES HAVE DONE

State legislatures have reacted in a variety of ways. Appendix 9 of this study is a reprint of ten pages which appears with Appendix 3 of this study, a South Dakota Law Review article that lists activities by the states. Also enclosed are statutes from Colorado and Iowa.

CONGRESSIONAL ACTIVITIES

In 1983, Senator Huddleston of Kentucky, and Representative Harkin of Iowa, introduced legislation to remove the agricultural exemption from the Uniform Commercial Code. Both of those bills were considered by Congress during 1984. (See Appendix 10 of this study).

In 1985, Representative Stenholm of Texas, and Representative Gunderson of Wisconsin have introduced a bill, HR 1591, to protect buyers of farm products. A similar bill, S.744, has been introduced in the Senate (see Appendix 11 of this study).

CONCLUSION

The Joint Subcommittee, during its deliberations, will want to consider the various alternative approaches that other states have taken and those that certain interest groups have suggested. The Joint Subcommittee will want to consider among other things:

(1) Maintaining the status quo;

(2) Establishing a central filing system for liens on agricultural products with access by lenders and buyers, including automatic electronic transfer from the local circuit courts;

(3) Eliminating the farm products exemption from Section 8.9-307;

(4) Requiring lenders to notify buyers of existing liens (pre-notice or actuarial notice requirement);

(5) Considering provisions for prosecution of producers who commit fraud, including a provision to require the lender to notify the borrower that conversion of mortgaged property without payment to the lender is a fraud;

(6) Penalizing the lender who fails to notify the potential buyer of the existence of a lien;

(7) Eliminating the commission merchant or selling agent from liability, and;

(8) Others.

RESOURCES

The Joint Subcommittee may consider the following sources of information and data. These associations can supply information data themselves, and also bring in knowledgeable persons to testify:

(1) Virginia Farm Bureau Federation;

(2) Virginia Bankers' Association;

(3) Virginia Agribusiness Council;

(4) State Corporation Commission; and

(5) Association of Circuit Court Clerks.

§ 8.9-306. "Proceeds"; secured party's rights on disposition of collateral. — (1) "Proceeds" includes whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds. Insurance payable by reason of loss or damage to the collateral is proceeds, except to the extent that it is payable to a person other than a party to the security agreement. Money, checks, deposit accounts, and the like are "cash proceeds." All other proceeds are "non-cash proceeds."

(2) Except where this title otherwise provides, a security interest continues in collateral notwithstanding sale, exchange, or other disposition thereof unless the disposition was authorized by the secured party in the security agreement or otherwise, and also continues in any identifiable proceeds including collections received by the debtor.

(3) The security interest in proceeds is a continuously perfected security interest if the interest in the original collateral was perfected but it ceases to be a perfected security interest and becomes unperfected twenty days after receipt of the proceeds by the debtor unless

(a) a filed financing statement covers the original collateral and the proceeds are collateral in which a security interest may be perfected by filing in the office or offices where the financing statement has been filed and, if the proceeds are acquired with cash proceeds, the description of collateral in the financing statement indicates the types of property constituting the proceeds; or

(b) a filed financing statement covers the original collateral and the proceeds are identifiable cash proceeds; or

(c) the security interest in the proceeds is perfected before the expiration of the twenty-day period. Except as provided in this section, a security interest in proceeds can be perfected only by the methods or under the circumstances permitted in this title for original collateral of the same type.

(4) In the event of insolvency proceedings instituted by or against a debtor, a secured party with a perfected security interest in proceeds has a perfected security interest only in the following proceeds:

(a) in identifiable noncash proceeds and in separate deposit accounts containing only proceeds;

(b) in identifiable cash proceeds in the form of money which is neither commingled with other money nor deposited in a deposit account prior to the insolvency proceedings;

(c) in identifiable cash proceeds in the form of checks and the like which are not deposited in a deposit account prior to the insolvency proceedings, and

(d) in all cash and deposit accounts of the debtor, in which proceeds have been commingled with other funds, but the perfected security interest under this paragraph (d) is

(i) subject to any right of setoff; and

(ii) limited to an amount not greater than the amount of any cash proceeds received by the debtor within twenty days before the institution of the insolvency proceedings less the sum of (I) the payments to the secured party on account of cash proceeds received by the debtor during such period and (II) the cash proceeds received by the debtor during such period to which the secured party is entitled under paragraphs (a) through (c) of this subsection (4).

(5) If a sale of goods results in an account or chattel paper which is transferred by the seller to a secured party, and if the goods are returned to or are repossessed by the seller or the secured party, the following rules determine priorities:

(a) If the goods were collateral at the time of sale for an indebtedness of the seller which is still unpaid, the original security interest attaches again to the goods and continues as a perfected security interest if it was perfected at the time when the goods were sold. If the security interest was originally perfected by a filing which is still effective, nothing further is required to continue the perfected status; in any other case, the secured party must take possession of the returned or repossessed goods or must file.

(b) An unpaid transferee of the chattel paper has a security interest in the goods against the transferor. Such security interest is prior to a security interest asserted under paragraph (a) to the extent that the transferee of the chattel paper was entitled to priority under § 8.9-308.

(c) An unpaid transferee of the account has a security interest in the goods against the transferor. Such security interest is subordinate to a security interest asserted under paragraph (a).

(d) A security interest of an unpaid transferee asserted under paragraph (b) or (c) must be perfected for protection against creditors of the transferor and purchasers of the returned or repossessed goods. (1964, c. 219; 1973, c. 509; 1983, c. 204.)

Editor's note. — See § 547(c) of the Bankruptcy Act (11 U.S.C. 547(c)) for the trustee in bankruptcy being precluded from avoiding a purchase money interest as a preference if the purchase money security interest is perfected within ten days after such security interest attached.

The 1973 amendment, effective July 1, 1974, rewrote the first and second sentences and inserted "deposit accounts" in the third sentence of subsection (1), substituted "unless the disposition was" for "by the debtor unless his action was" in subsection (2), rewrote subdivision (a), added present subdivision (b), redesignated former subdivision (b) as (c) and added the second sentence of present subdivision (c), all in subsection (3), added "only in the following proceeds" at the end of the introductory paragraph of subsection (4), added "and in separate deposit accounts containing only proceeds" at the end of subdivision (a), rewrote subdivisions (b) and (d) and substituted "deposit" for "bank" in subdivision (c) of subsection (4).

For transition provisions applicable to the 1973 amendatory act, see §§ 8.11-101 to 8.11-108.

The 1983 amendment substituted "twenty days" for "ten days" in subsection (3) and in subdivision (4)(d)(ii), and "twenty-day period" for "ten-day period" in subdivision (3)(c).

Law Review. — For survey of Virginia commercial law for the year 1972-1973, see 59 Va. L. Rev. 1426 (1973). For article, "Revamping Consumer-Credit Contract Law," see 68 Va. L. Rev. 1333 (1982).

Courts liberally construe this section. Reymet Fed. Credit Union v. Jones, 19 Bankr. 293 (Bankr. E.D. Va. 1982).

No duty owed subordinate interests to enforce remedies. — The priority of a perfected security interest is not affected by the fact that a secured party, in order to assist the debtor and to enhance the likelihood of satisfaction of any indebtedness, agreed not to declare the debtor in default, since a secured creditor does not owe any duty to those holding subordinate interests to proceed to enforce his remedies. National Acceptance Co. of America v. Virginia Capital Bank, 491 F. Supp. 1269 (E.D. Va. 1980).

Notice of third party in a deposit account. — If a bank may be charged with notice of the interest of a third party in a deposit account, it may not apply the account to satisfy a debt owed by the depositor. National Acceptance Co. of America v. Virginia Capital Bank, 491 F. Supp. 1269 (E.D. Va. 1980).

Continuation of security interest after authorized sale. — An electrical contractor's creditor's security interest in electrical supplies to be installed in a school under construction would not continue after disposition of the goods to the school's general contractor where, under the terms of the contract between the general contractor and the electrical contractor, there was an authorized sale as defined by § 8.2-106(1) within the contemplation of the terms of the security agreement. Graves Constr. Co. v. Rockingham Nat'l Bank, 220 Va. 844, 263 S.E.2d 408 (1980).

Financing arrangement, closely resembling an assignment of accounts to third party in return for their face value less an agreed finance charge, constituted an "other disposition of" the secured accounts receivable within the meaning of subsection (1) of this section. National Acceptance Co. of America v. Virginia Capital Bank, 498 F. Supp. 1078 (E.D. Va. 1980), aff'd in part, rev'd in part & remanded, 673 F.2d 1314 (4th Cir. 1981).

Implied authorization to sell in agreement by automobile floor-plan financier. — Even if language of a security agreement between a floor-plan financier and an automobile dealer authorizing sale of cars was absent or unclear, it is customary that when inventory is delivered to a dealer-debtor, the secured party gives an implied if not an express authorization that the collateral is to be sold; thus, it is axiomatic that when a sale is made, the secured party surrenders its claim in the inventory to the one who makes the purchase from the dealer in the ordinary course of business. General Motors Acceptance Corp. v. Frank Meador Leasing, Inc., 6 Bankr. 910 (Bankr. W.D. Va. 1980).

Where an automobile dealer sold an automobile to a leasing company at a discount, and where the dealership and the leasing company were owned by the same person, the transaction was, nevertheless, in the ordinary course of business and extinguished a floor-plan financier's security interest in the automobile. General Motors Acceptance Corp. v. Frank Meador Leasing, Inc., 6 Bankr. 910 (Bankr. W.D. Va. 1980).

Insurance payments are proceeds when they are payable by reason of loss or damage to secured collateral. Reymet Fed. Credit Union v. Jones, 19 Bankr. 293 (Bankr. E.D. Va. 1982).

Proceeds of judgment against broker not insurance proceeds. — Funds received from independent broker on account of a personal judgment obtained against broker for failure to procure collision insurance did not constitute insurance proceeds of collateral vehicle. Reymet Fed. Credit Union v. Jones, 19 Bankr. 293 (Bankr. E.D. Va. 1982).

Applied in Graves Constr. Co. v. Rockingham Nat'l Bank, 220 Va. 844, 263 S.E.2d 408 (1980).

OFFICIAL COMMENT

Prior Uniform Statutory Provision: Section 10, Uniform Trust Receipts Act.

Purposes:

1. This section states a secured party's right to the proceeds received by a debtor on disposition of collateral and states when his interest in such proceeds is perfected.

It makes clear that insurance proceeds from casualty loss of collateral are proceeds within the meaning of this section.

As to proceeds of consigned goods, see Section 9-114 and the Comment thereto.

2. (a) Whether a debtor's sale of collateral was authorized or unauthorized, prior law generally gave the secured party a claim to the proceeds. Sometimes it was said that the security interest attached to the "property" received in substitution; sometimes it was said the debtor held the proceeds as "trustee" or "agent" for the secured party. Whatever the formulation of the rule, the secured party, if he could identify the proceeds, could reclaim them or their equivalent from the debtor or his trustee in bankruptcy. This section provides new rules for insolvency proceedings. Paragraphs 4(a) through (c) substitute specific rules of identification for general principles of tracing. Paragraph 4(d) limits the security interest in proceeds not within these rules to an amount of the debtor's cash and deposit accounts not greater than cash proceeds received within ten days of insolvency proceedings less the cash proceeds during this period already paid over and less the amounts for which the security interest is recognized under paragraphs 4(a) through (c).

(b) Subsections (2) and (3) make clear that the four-month period for calculating a voidable preference in bankruptcy begins with the date of the secured party's obtaining the security interest in the original collateral and not with the date of his obtaining control of the proceeds. The interest in the proceeds "continues" as a perfected interest if the original interest was perfected; but the interest ceases to be perfected after the expiration of ten days unless a filed financing statement covered the original collateral and the proceeds are collateral of a type as to which a security interest could be perfected by a filing in the same office or unless the secured party perfects his interest in the proceeds themselves — i.e., by filing a financing statement covering them or by taking possession. See Section 9-312(6) and Comment thereto for priority of rights in proceeds perfected by a filing as to original collateral.

(c) Where cash proceeds are covered into the debtor's checking account and paid out in the operation of the debtor's business, recipients of the funds of course take free of any claim which the secured party may have in them as proceeds. What has been said relates to payments and transfers in ordinary course. The law of fraudulent conveyances would no doubt in appropriate cases support recovery of proceeds by a secured party from a transferee out of ordinary course or otherwise in collusion with the debtor to defraud the secured party.

3. In most cases when a debtor makes an unauthorized disposition of collateral, the security interest, under prior law and under this Article, continues in the original collateral in the hands of the purchaser or other transferee. That is to say, since the transferee takes subject to the security interest, the secured party may repossess the collateral from him or in an appropriate case maintain an action for conversion. Subsection (2) codifies this rule. The secured party may claim both proceeds and collateral, but may of course have only one satisfaction.

In many cases a purchaser or other transferee of collateral will take free of a security interest: in such cases the secured party's only right will be to proceeds. The transferee will take free whenever the disposition was authorized; the authorization may be contained in the security agreement or otherwise given. The right to proceeds, either under the rules of this section or under specific mention thereof in a security agreement or financing statement does not in itself constitute an authorization of sale.

Section 9-301 states when transferees take free of unperfected security interests. Sections 9-307 on goods, 9-308 on chattel paper and instruments and 9-309 on negotiable instruments, negotiable documents and securities state when purchasers of such collateral take free of a security interest even though perfected and even though the disposition was not authorized.

4. Subsection (5) states rules to determine priorities when collateral which has been sold is returned to the debtor: for example goods returned to a department store by a dissatisfied customer. The most typical problems involve sale and return of inventory, but the subsection can also apply to equipment. Under the rule of Benedict v. Ratner, failure to segregate such returned goods sometimes led to invalidation of the entire security arrangement. This Article rejects the Benedict v. Ratner line of cases (see Section 9-205 and Comment). Subsection (5)(a) of this section reinforces the rule of Section 9-205: as between secured party and debtor (and debtor's trustee in bankruptcy) the original security interest continues on the returned goods. Whether or not the security interest in the returned goods is perfected depends upon factors stated in the text.

Paragraphs (5)(b), (c) and (d) deal with a different aspect of the returned goods situation. Assume that a dealer has sold an automobile and transferred the chattel paper or the account arising on the sale to Bank X (which had not previously financed the car as inventory). Thereafter the buyer of the automobile rightfully rescinds the sale, say for breach of warranty, and the car is returned to the dealer. Paragraph (5)(b) gives the bank as transferee of the chattel paper or the account a security interest in the car against the dealer. For protection against dealer's creditors or purchasers from him (other than buyers in the ordinary course of business, see Section 9-307), Bank X as the transferee, under paragraph (5)(d), must perfect its interest by taking possession of the car or by filing as to it. Perfection of his original interest in the chattel paper or the account does not automatically carry over to the returned car, as it does under paragraph (5)(a) where the secured party originally financed the dealer's inventory.

In the situation covered by (5)(b) and (5)(c) a secured party who financed the inventory and a secured party to whom the chattel paper or the account was transferred may both claim the returned goods — the inventory financer under paragraph (5)(a), the transferee under paragraphs (5)(b) and (5)(c). With respect to chattel paper, Section 9-308 regulates the priorities. With respect to an account, paragraph (5)(c) subordinates the security interest of the transferee of the account to that of the inventory financer. However, if the inventory security interest was unperfected, the transferee's interest could become entitled to priority under the rules stated in Section 9-312(5).

In cases of repossession by the dealer and also in cases where the chattel was returned to the dealer by the voluntary act of the account debtor, the dealer's position may be that of a mere custodian; he may be an agent for resale, but without any other obligation to the holder of the chattel paper; he may be obligated to repurchase the chattel, the chattel paper or the account from the secured party or to hold it as collateral for a loan secured by a transfer of the chattel paper or the account.

If the dealer thereafter sells the chattel to a buyer in ordinary course of business in any of the foregoing cases, the buyer is fully protected under Section 2-403(2) as well as under Section 9-307(1), whichever is technically applicable.

Cross References:

Sections 9-307, 9-308 and 9-309.
Point 3: Sections 1-205 and 9-301.
Point 4: Sections 2-403(2), 9-205 and 9-312.

Definitional Cross References:

"Account". Section 9-106.
"Bank". Section 1-201.
"Chattel paper". Section 9-105.
"Check". Sections 3-104 and 9-105.
"Collateral". Section 9-105.
"Creditors". Section 1-201.
"Debtor". Section 9-105.
"Deposit account". Section 9-105.
"Goods". Section 9-105.
"Insolvency proceedings". Section 1-201.
"Money". Section 1-201.
"Purchaser". Section 1-201.
"Sale". Sections 2-106 and 9-105.
"Secured party". Section 9-105.
"Security agreement". Section 9-105.
"Security interest". Section 1-201.

If the dealer thereafter sells the chattel to a buyer in ordinary course of business in any of the foregoing cases, the buyer is fully protected under Section 2—403(2) as well as under Section 9—307(1), whichever is technically applicable.

Cross references:
Sections 9—307, 9—308 and 9—309.
Point 3: Sections 1—205 and 9—301.
Point 4: Sections 2—403(2), 9—205 and 9—312.

Definitional cross references:
"Account". Section 9—106.
"Bank". Section 1—201.
"Chattel paper". Section 9—105.
"Check". Sections 3—104 and 9—105.
"Collateral". Section 9—105.
"Contract right". Section 9—106.
"Creditors". Section 1—201.
"Debtor". Section 9—105.
"Goods". Section 9—105.
"Insolvency proceedings". Section 1—201.
"Money". Section 1—201.
"Purchaser". Section 1—201.
"Sale". Sections 2—106 and 9—105.
"Secured party". Section 9—105.
"Security agreement". Section 9—105.
"Security interest". Section 1—201.

§ 8.9-307. Protection of buyers of goods.—(1) A buyer in ordinary course of business (subsection (9) of § 8.1-201) other than a person buying farm products from a person engaged in farming operations takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence.

(2) In the case of consumer goods, a buyer takes free of a security interest even though perfected if he buys without knowledge of the security interest, for value and for his own personal, family or household purposes unless prior to the purchase the secured party has filed a financing statement covering such goods.

(3) A buyer other than a buyer in ordinary course of business (subsection (1) of this section) takes free of a security interest to the extent that it secures future advances made after the secured party acquires knowledge of the purchase, or more than forty-five days after the purchase, whichever first occurs, unless made pursuant to a commitment entered into without knowledge of the purchase and before the expiration of the forty-five day period. (Code 1950, § 6-558; Code 1950 (Repl. Vol. 1959), § 55-146; 1956, c. 602; 1964, c. 219; 1973, c. 509.)

The 1973 amendment, effective July 1, 1974, deleted "and in the case of farm equipment having an original purchase price not in excess of $500 (other than fixtures, see § 8.9-313)" following "goods" near the beginning of subsection (2) and deleted following "household purposes" near the end of subsection (2) "or his own farming operations" and added subsection (3).

For transition provisions applicable to the 1973 amendatory act, see §§ 8.11-101 to 8.11-108.

Only part of section set out. — As subsection (1) was not changed by the amendment, it is not set out.

Law Review. — For survey of Virginia commercial law for the year 1972-1973, see 59 Va. L. Rev. 1426 (1973). For survey of Virginia commercial law for the year 1977-1978, see 64 Va. L. Rev. 1383 (1978).

For a note on the buyer in the ordinary course of business and on section 1403 of the Federal Aviation Act, see 36 Wash. & Lee L. Rev. 205 (1979).

Effect of Federal Aviation Act recordation procedure on certain State laws. — While Congress has the power to legislate in the field of aircraft conveyancing and to preempt State laws that would otherwise apply, Congress did not intend by adoption of the recordation procedure of the Federal Aviation Act, 49 U.S.C. § 1403, to displace State laws that would otherwise govern priorities of lien and title interests in aircraft. Haynes v. General Elec. Credit Corp., 432 F. Supp. 763 (W.D. Va. 1977), aff'd, 582 F.2d 869 (4th Cir. 1978).

Where an aircraft was purchased in the ordinary course of business from a person in the business of selling goods of that kind, and the purchaser was without actual knowledge that the sale to him was in violation of the ownership rights or the security interest of a lienholder, the purchaser's ownership interest was superior to that of the lienholder even though the lienholder had recorded his security interest in compliance with the Federal Aviation Act prior to the purchase. Haynes v. General Elec. Credit Corp., 432 F. Supp. 763 (W.D. Va. 1977), aff'd, 582 F.2d 869 (4th Cir. 1978).

Subsection (1) was inapplicable and the second purchaser of a mobile home took subject to bank's security interest where the security interest was created not by the seller but by the initial purchaser. First Am. Bank v. Hunning, 218 Va. 530, 238 S.E.2d 799 (1977).

Effect of transfer on secured indebtedness. — Consumers' goods continue to be subject to security interest in the hands of the transferee from purchase. If the seller acquired knowledge of the transaction at a time when it could have asserted its security interest in the property and failed to take reasonable steps to protect its security, the indebtedness secured thereby should be discharged upon purchaser's bankruptcy. Bennett v. W.T. Grant Co., 481 F.2d 664 (4th Cir. 1973).

Where an automobile dealer sold an automobile to a leasing company at a discount, and where the dealership and the leasing company were owned by the same person, the transaction was, nevertheless, in the ordinary course of business and extinguished a floor-plan financier's security interest in the automobile. General Motors Acceptance Corp. v. Frank Meador Leasing, Inc., 6 Bankr. 910 (Bankr. W.D. Va. 1980).

OFFICIAL COMMENT

Prior Uniform Statutory Provision: Section 9, Uniform Conditional Sales Act; Section 9(2), Uniform Trust Receipts Act.

Purposes:

1. This section states when buyers of goods take free of a security interest even though perfected. A buyer who takes free of a perfected security interest of course takes free of an unperfected one. Section 9-301 should be consulted to determine what purchasers, in addition to the buyers covered in this section, take free of an unperfected security interest.

Article 2 (Sales) states general rules on purchase of goods from a seller with defective or voidable title (Section 2-403).

2. The definition of "buyer in ordinary course of business" in Section 1-201(9) restricts the application of subsection (1) to buyers (except pawnbrokers) "from a person in the business of selling goods of that kind"; thus the subsection applies, in the terminology of this Article, primarily to inventory. Subsection (1) further excludes from its operation buyers of "farm products", defined in Section 9-109(3), from a person engaged in farming operations. The buyer in ordinary course of business is defined as one who buys "in good faith and without knowledge that the sale to him is in violation of the ownership rights or security interest of a third party." This section provides that such a buyer takes free of a security interest, even though perfected, and although he knows the security interest exists. Reading the two provisions together, it results that the buyer takes free if he merely knows that there is a security interest which covers the goods but takes subject if he knows, in addition, that the sale is in violation of some term in the security agreement not waived by the words or conduct of the secured party.

The limitations which this section imposes on the persons who may take free of a security interest apply of course only to unauthorized sales by the debtor. If the secured party has authorized the sale in the security agreement or otherwise, the buyer takes free without regard to the limitations of this section. Section 9-306 states the right of a secured party to the proceeds of a sale, authorized or unauthorized.

3. Subsection (2) deals with buyers of "consumer goods" defined in Section 9-109. Under Section 9-301(1)(d) no filing is required to perfect a purchase money interest in consumer goods subject to this subsection except motor vehicles required to be registered; filing is required to perfect security interests in such goods other than purchase money interests and, for motor vehicles, even in the case of purchase money interests. (The special case of fixtures has added complications that are apart from the point of this discussion.)

Under subsection (2) a buyer of consumer goods takes free of a security interest even though perfected a) if he buys without knowledge of the security interest, b) for value, c) for his own personal, family, or household purposes and d) before a financing statement is filed.

As to purchase money security interests which are perfected without filing under Section 9-302(1)(d): A secured party may file a financing statement (although filing is not required for perfection). If he does file, all buyers take subject to the security interest. If he does not file, a buyer who meets the qualifications stated in the preceding paragraph takes free of the security interest.

As to security interests which can be perfected only by filing under Section 9-302: This category includes all non-purchase money interests, and all interests, whether or not purchase money, in motor vehicles, as well as interests which may be and are filed, though filing was not required for perfection under Section 9-302. (Note that under Section 9-302(3) the filing provisions of this Article do not apply when a state has enacted a certificate of title law. Thus where motor vehicles are concerned, in a state having such a certificate of title law, perfection will be under that law.) So long as the security interest remains unperfected, not only the buyers described in subsection (2) but the purchasers described in Section 9-301 will take free of the interest. After a financing statement has been filed or after compliance with the certificate of title law all subsequent buyers, under the rule of subsection (2), are subject to the security interest.

4. Although a buyer is of course subject to the Code's system of notice from filing or possession, subsection (3) makes clear that he will not be subject to future advances under a security interest after the secured party has knowledge that the buyer has purchased the collateral and in any event after 45 days after the purchase unless the advances were made pursuant to a commitment entered into before the expiration of the 45 days and without knowledge of the purchase. Of course, a buyer in ordinary course who takes free of the security interest under subsection (1) is not subject to any future advances. Compare Sections 9-301(4) and 9-312(7).

Cross References:

Point 1: Sections 2-403 and 9-301.
Point 2: Section 9-306.
Point 3: Sections 9-301 and 9-302.
Point 4: Sections 9-301(4) and 9-312(7).

Definitional Cross References:

"Buyer in ordinary course of business". Section 1-201.
"Consumer goods". Section 9-109.
"Goods". Section 9-105.
"Knows" and "Knowledge". Section 1-201.
"Person". Section 1-201.
"Purchase". Section 1-201.
"Pursuant to commitment". Section 9-105.
"Secured party". Section 9-105.
"Security interest". Section 1-201.
"Value". Section 1-201.

This section is in close accord with prior Virginia law. It is elementary that a buyer in ordinary course of business, or a bona fide purchaser, as he is called in the Virginia cases, will prevail over an unperfected, or unrecorded, security interest. General Motors Acceptance Corp. v. Vicars, 153 Va. 149, 153-55, 149 S.E. 266, 270-75 (1933) (bona fide purchaser of slave prevails over mortgagee under unrecorded chattel mortgage).

The UCC adopts and goes beyond the familiar rule of Boice v. Finance and Guaranty Corp., 127 Va. 563, 102 S.E. 591, 10 A.L.R. 654 (1920). The rule of this case is summarized in 127 Va. at 570-71 as follows: "It is true that, as a rule, the seller of personal chattels cannot confer upon a purchaser any better title than he himself has, but if the owner stands by and permits a seller, who is a licensed dealer in such goods to hold himself out to the world as owner, to treat the goods as his own, place them with other similar goods of his own in a public showroom, and offer the same indiscriminately with his own to the public, he will be estopped by his conduct from asserting his ownership against a purchaser for value without notice of his title. The constructive notice furnished by a recorded mortgage or deed of trust in such cases is not sufficient. The act of knowingly permitting the goods to be so handled and used by the seller in the ordinary and usual conduct of his business is just as destructive of the rights of the creditor as if such permission had been expressly granted in the mortgage or deed of trust." The same rule was applied the same day in O'Neil v. Cheatwood, 127 Va. 96, 99-100, 102 S.E. 596 (1920), and later in General Credit, Inc. v. Winchester, Inc., 196 Va. 711, 714-19, 85 S.E.2d 201 (1955).

In Gump Investment Co. v. Jackson, 142 Va. 190, 193-96, 128 S.E. 506, 47 A.L.R. 82 (1925), Virginia extended the rule to cover the situation in which the secured party does not know that the dealer is offering the chattel to the public. The court said in 142 Va. at 195: "One conclusion is that some duty, at least, rests upon an individual, corporate or otherwise, who finances a retail dealer, to see to it that cars upon which he has a lien are not left under the domain and control of such dealer on his sales room floor, to be offered to the public. The business of the Gump Investment Company was to finance retail automobile dealers, and it did finance them for a profit. It assumed some risk both as to the moral and financial standing of every dealer it financed. It took a risk as to the hazard for a profit." This extension of the Boice rule was repudiated in McQuay v. Mount Vernon Bank & Trust Co., 200 Va. 776, 782-83, 108 S.E.2d 251 (1959), commented upon in Rodriguez, Assignments of Security Interests in Dealers' Stocks of Automobiles, 17 Wash. & Lee L. Rev. 173 (1960). The case held that the lienor under a lien noted on the certificate of title would prevail over a bona fide purchaser, where the secured party did not know that the automobile was to be placed in a stock of cars and offered for sale. The UCC eliminates the McQuay limitation on the Boice doctrine and returns Virginia law to the broad principles stated in the Gump case, that is, the buyer in ordinary course of business from a dealer in goods of that kind prevails over a secured party. Under the UCC this is true even though the buyer knows of the security interest. This extension also changes Virginia law, which has required the buyer to be without notice of the secured party's rights in order to prevail under the Boice rule. Garrett v. Rahily & Martin, 132 Va. 226, 227-28, 111 S.E. 110 (1922). It would seem that the same result would be reached under the UCC as in Rudolph v. Farmers' Supply Co., Inc., 131 Va. 305, 312-15, 108 S.E. 638 (1921). In this case Farmers' Supply sold Garman a car under a conditional sale contract, which was duly recorded. Garman sold the car to Davis, a secondhand car dealer, who in turn sold it to Rudolph, a bona fide purchaser. The conditional vendor, Farmers' Supply, was held to be entitled to the car, as against Rudolph, the bona fide purchaser. Rudolph would not be able to rely on subsection 8.9-307(1) because the security interest of Farmers' Supply was not one "created by his seller," as is required under this subsection. Since the car in the hands of Garman would be "consumer goods" and since the security interest was perfected by recording, the secured party would prevail under subsection 8.9-307(2) even as against a bona fide purchaser.

Subsection 8.9-307(1) is in accord with O'Connor v. Smith, 188 Va. 214, 219, 49 S.E.2d 310 (1948), in its holding that the Boice rule does not apply to equipment and fixtures, since these are not sold in the ordinary course of business.

476 (1929) (bona fide purchaser of refrigerator takes priority over vendor under unrecorded conditional sales contract); American Agricultural Chemical Co. v. J. W. Perry Co., 152 Va. 598, 601-03, 148 S.E. 806 (1929) (bona fide purchaser prevails over lienor under unrecorded crop lien); Bird v. Wilkinson, 31 Va. (4 Leigh)

PROBLEMS ARISING FROM THE SALE OF MORTGAGED FARM PRODUCTS

ERNEST H. VAN HOOSER

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FARM PRODUCTS: RECENT LEGISLATIVE CHANGES TO SECTION 9-307

ERNEST H. VAN HOOSER*

This article provides a brief overview of the mortgaged farm products problem and surveys the legislation enacted by the various states to date to limit the liability of persons who buy encumbered farm products and of the commission merchants who act as intermediaries to transfer farm products from seller to buyer.

INTRODUCTION

As a general rule, Article 9 of the Uniform Commercial Code[1] fosters an open market rule which permits good faith purchasers to take goods free of perfected security interests.[2] This general rule does not, however, hold true for good faith purchasers of farm products.[3] Nor does Article 9's general open market rule hold true for commission merchants[4] who act as agents in selling farm products. According to the great weight of legal authority, buyers of farm products and commission merchants who act as agents in selling farm products are liable to the secured lender if the borrower-seller fails to account to the secured lender for the proceeds of sale, even though the buyer or commission merchant does not know that the farm products have been mortgaged.[5] This liability[6] is founded principally on the

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* B.J., University of Missouri – Columbia, 1971; J.D., University of Missouri – Kansas City, 1977; Dean, Van Hooser & Olsen, P.C., Kansas City, Missouri.

1. The UNIFORM COMMERCIAL CODE is hereafter cited as "Code." Unless otherwise indicated, all section references are to the 1972 official version of the Code.

2. U.C.C. § 9-307(1), (2).

3. U.C.C. § 9-307(1). *See* § 9-307, comment 2. U.C.C. § 9-109(3) defines goods as farm products if they are crops or livestock or supplies used or produced in farming operations or if they are products of crops or livestock in their unmanufactured states (such as ginned cotton, wool-clip, maple syrup, milk and eggs), and if they are in the possession of a debtor engaged in raising, fattening, grazing or other farming operations.

4. A commission merchant is "one who receives goods, chattels, or merchandise for sale, exchange, or other disposition, and who is to receive a compensation for his services, to be paid by the owner, or derived from the sale, etc., of the goods." BLACK'S LAW DICTIONARY 339 (4th ed. 1968).

As a general rule commission merchants, especially in the livestock industry, are auctioneers. They do not purchase (take title to) the goods; they act as selling agents only. *See generally* Farmers State Bank v. Stewart, 454 S.W.2d 908, 909 (Mo. 1978); United States v. Gallatin Livestock Auction, Inc., 448 F. Supp. 616, 620 (W.D. Mo. 1978). Greater Louisville Auto Auction, Inc. v. Ogle Buick, Inc., 387 S.W.2d 17 (Ky. 1965); Commercial Credit Corp. v. Joplin Auto Auction, Co., 430 S.W.2d 440 (Mo. 1968).

5. *See, e.g.*, United States v. Sommerville, 324 F.2d 712, 717-18 (3d Cir. 1963), *cert. denied*, 376 U.S. 909, (1964); United States v. McCleskey Mills, Inc., 409 F.2d 1216 (5th Cir. 1969); United States v. Gallatin Livestock Auction, Inc., 448 F. Supp. 616 (W.D. Mo. 1978); Farmers State Bank v. Stewart, 454 S.W.2d 908 (Mo. 1970); Garden City Prod. Credit Ass'n v. Lannan, 186 Neb. 668, 186 N.W.2d 99 (1971).

6. The liability faced by buyers of farm products and commission merchants who sell farm products is often referred to as "double jeopardy" because these persons risk paying for their purchases twice: once to the farmer and again to the lender who held a security interest in the farm products.

interaction of section 9-306(2) with section 9-307(1) and on the tort of conversion.[7]

Section 9-306(2) provides that a security interest continues in collateral notwithstanding sale, exchange or other disposition and in any identifiable proceeds therefrom unless the sale, exchange or other disposition was authorized by the secured party. A buyer of inventory in the ordinary course of business, however, is protected from this continuing security interest by section 9-307(1), which provides that such a buyer takes free of a security interest created by his seller; not so for a buyer of farm products. Because of the special rule for farm products set out in section 9-307(1),[8] a buyer in ordinary course of farm products is not protected from the continuing secur-

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7. United States v. McCleskey Mills, Inc., 409 F.2d 1216, 1218-19 (5th Cir. 1969). Conversion is generally defined as tortious interference with the possessory rights of another to personal property. 18 AM. JUR. 2d *Conversion* §§ 1, 25 (1965). In other words, the gist of conversion is interference with control of the property. W. PROSSER, LAW OF TORTS § 15 at 93 (4th ed. 1971).

8. U.C.C. § 9-307(1) provides: "A buyer in ordinary course of business . . . *other than a person buying farm products from a person engaged in farming operations* takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence." (emphasis added).

The farm products exception of section 9-307 has been justified on the ground that buyers of farm products are sophisticated enough to know that their seller may have mortgaged the farm products he is selling. Coogan, *Public Notice Under the Uniform Commercial Code and Other Recent Chattel Security Laws, Including "Notice Filing,"* 47 IOWA L. REV. 289, 302 (1962); Hawkland, *The Proposed Amendment to Article 9 of the U.C.C.—Part I: Financing the Farmer*, 76 COM. L.J. 416, 418 (1971); Clark, *The Agricultural Transaction: Livestock Financing*, 11 U.C.C. L.J. 106, 112 (1978). The problem with this justification is that a buyer, no matter what his level of sophistication regarding agricultural financing, may not be able to determine whether the goods he is purchasing are mortgaged or not. If, for example, a broker is purchasing grain from an elevator, the broker would expect, as a buyer of inventory, to take free of any security interest in the grain. He would not know the identity of the farmers who had sold grain to the elevator so that he could run lien searches on all of them. Yet, if the elevator had purchased the grain from a farmer who had granted his bank a security interest in the grain, the broker would take subject to the security interest created by the farmer, because the broker only takes free of security interests created by his seller (the elevator), not prior sellers. *See* Coates, *Financing the Farmer*, 20 PRAC. LAW 45, Nov. 1974 at 49; Dugan, *Buyer-Secured Party Conflicts Under Section 9-307(1) of the Uniform Commercial Code*, 46 U. COLO. L. REV. 333, 334 (1975); Dolan, *Section 9-307(2): The U.C.C.'s Obstacle to Agricultural Commerce in the Open Market*, 72 NW. U.L. REV. 706, 713 (1977) (Professor Dolan's article provides an excellent overview of how the farm products exception has "bred sprawling diversity through legislation, common law exceptions, and provisions within the Code itself)." *Id.* at 736.

Even without the difficulties encountered as a subsequent purchaser, buyers and commission merchants are often simply not able, because of time constraints and cost, to check for liens on all the farm products they buy or sell. This is especially true for livestock markets, livestock dealers and packers. Under the Packers and Stockyards Act, livestock markets, dealers and packers are required to pay for livestock by the close of the next business day following the date of the transaction. *See* 7 U.S.C. 228b (1983).

Another justification often cited for the farm products exception is that sales of farm products are more closely akin to bulk sales than to sales of inventory. Thus, goes the argument, because farm products are not subject to the creditor protections afforded by Article 6 of the U.C.C., lenders must have the protection afforded by the farm products exception in order to protect their interests. Although this justification is more persuasive than the first, it also encounters problems when examined closely, especially with respect to livestock. For example, a dairy herd is a constantly changing asset. Poor producers are culled and replaced. Male increase, being outside the normal scope of a dairy farmer's business, are sold. It is difficult to see how this continuing turn over of a small number of animals is akin to a bulk sale. Even grain, because of the more sophisticated marketing techniques now being used by farmers, will often not be sold at one time; it will instead be sold over a period of months to take advantage of "off season prices" and to fulfill forward contracts. *See* Dolan, *supra* this note, at 717; Coogan and Mays, *Crop Financing and*

ity interest of subsection 9-306(2): he takes subject to the security interest. Thus, the secured party may reclaim the farm products from the buyer[9] or he may hold the buyer accountable for the value of the security interest in those farm products. Additionally, if the security agreement makes the borrower's unauthorized sale of the farm products a default entitling the secured party to possession of the collateral and the buyer does not account to the secured party for the collateral, the secured party may hold the buyer liable for conversion because the buyer has wrongfully interfered with the secured party's right to possession of the collateral.[10]

Unlike a buyer of farm products, a commission merchant's liability for selling mortgaged farm products is not based principally on the interplay of subsection 9-306(2) and the farm products exception of section 9-307(1). A

Article 9: A Dialogue with Particular Emphasis on the Problems of Florida Citrus Crop Financing, 22 U. MIAMI L. REV. 13 (1967).

Yet another justification for the farm products exception is that agricultural enterprises will not be able to secure credit without this "favorable" agricultural lending rule. Presumably agricultural lenders are just as interested in promoting the sale of agricultural commodities as their borrowers are, it is difficult to see how a rule which hinders the ready flow of those commodities can help creditors. *See* Dolan, *supra* this note, at 716-17.

In sum, the justifications cited for the farm products exception rest on questionable grounds. When buyers cannot protect themselves without an inordinate expenditure of time and money the result is economic loss for the entire agricultural industry and all those associated with it.

9. *See, e.g.*, Garden City Prod. Credit Ass'n v. Lannan, 186 Neb. 668, 186 N.W.2d 99 (1971) (A Kansas PCA successfully replevied 161 head of cattle from an innocent Nebraska purchaser, despite the fact that the Nebraska purchaser was a buyer in ordinary course from a middleman, rather than from the farmer/debtor).

10. *See* United States v. McCleskey Mills, Inc., 409 F.2d 1216 (5th Cir. 1969). *See also* Oxford Prod. Credit Ass'n v. Dye, 368 So. 2d 241 (Miss. 1979). *Compare* Hedrick Savings Bank v. Myers, 229 N.W.2d 252 (Iowa 1975) (the Iowa Supreme Court struck down the continuance of a security interest in farm products because of a course of dealing not to enforce a requirement of prior written consent) and Anon, Inc. v. Farmers Prod. Credit Ass'n of Scottsburg, — Ind. App. —, 446 N.E.2d 656 (1983) (the Indiana First District Court of Appeals held that a secured party who allowed the debtor standing authority to sell hogs upon the condition that he promptly remit the proceeds of sale to the secured party waived its contractual right to require prior written consent for such sales and its security interest in the hogs was cut off by the sale).

For additional cases dealing with the question of whether the secured lender had authorized sales, *see* First Nat'l Bank & Trust Co. v. Iowa Beef Processors, Inc., 626 F.2d 764 (10th Cir. 1980); United States v. Hansen, 311 F.2d 477 (8th Cir. 1963); United States v. Central Livestock Ass'n, Inc., 349 F. Supp. 1033 (D.N.D. 1972); United States v. E.W. Savage & Son, Inc., 343 F. Supp. 123 (D.S.D. 1972), *aff'd*, 475 F.2d 305 (8th Cir. 1973); United States v. Hughes, 340 F. Supp. 539 (N.D. Miss. 1972); United States v. Big Z Warehouse, 311 F. Supp. 283 (S.D. Ga. 1970); *In re* Cadwell, Martin Meat Co., 10 U.C.C. Rep. Serv. (Callaghan) 710 (E.D. Cal. 1970); United States v. Greenwich Mill & Elevator Co., 291 F. Supp. 609 (N.D. Ohio 1968); Planters Prod. Credit Ass'n v. Bowles, — Ark. —, 511 S.W.2d 645 (1974); Vermilion County Prod. Credit Ass'n v. Izzard, 111 Ill. App. 2d 190, 249 N.E.2d 352 (1969); Ottumwa Prod. Credit Ass'n v. Heinold Hog Market, Inc., 340 N.W.2d 801 (Iowa App. 1983); Ottumwa Prod. Credit Ass'n v. Keoco Auction Co., — N.W.2d —, No. 83-181, Iowa Sup. Ct., March 28, 1984; Lisbon Bank & Trust Co. v. Murray, 206 N.W.2d 96 (Iowa 1973); North Central Kansas Prod. Credit Ass'n v. Washington Sales Co., — Kan. —, 577 P.2d 35 (1978); Wabasso State Bank v. Caldwell Packing Co., 308 Minn. 349, 251 N.W.2d 321, 19 U.C.C. Rep. Serv. (Callaghan) 315 (1976); Charterbank Butler v. Central Cooperatives, Inc. — S.W.2d —, No. 34442, Mo. App., March 13, 1984; Farmers State Bank v. Edison Non-Stock Coop. Ass'n, 190 Neb. 789, 212 N.W.2d 625 (1973); Garden City Prod. Credit Ass'n v. Lannan, 186 Neb. 668, 186 N.W.2d 99 (1971); Clovis Nat'l Bank v. Thomas, 77 N.M. 554, 425 P.2d 726 (1967); Blubaugh v. Ponca City Prod. Credit Ass'n, 9 U.C.C. Rep. Serv. (Callaghan) 786 (Okla. 1971); Baker Prod. Credit Ass'n v. Long Creek Meat Co., 266 Or. 643, 513 P.2d 1129 (1973); Central Washington Prod. Credit Ass'n v. Baker, 11 Wash. App. 17, 521 P.2d 226 (1974). For a discussion of many of these cases, see Skilton, *Buyer in Ordinary Course of Business Under Article 9 of the Uniform Commercial Code (and Related Matters)*, 1974 WIS. L. REV. 1, 72-76.

commission merchant's liability is based on conversion.[11] If the security agreement makes the borrower's unauthorized sale a default entitling the secured party to possession of the collateral and the commission merchant does not account to the secured party for the collateral, the secured party may seek recovery against the commission merchant under either of two theories of conversion. Under the first theory, a commission merchant is liable for conversion because he has, by his exercise of dominion and control over the farm products during the selling process, interfered with the secured party's right to possession of the collateral.[12] Under the second theory, a commission merchant's liability is based on his acting as agent for the mortgagor. Thus, when a borrower sells mortgaged farm products without the secured party's consent, he is deemed to have tortiously interfered with the secured party's right to possession and the commission merchant, as the borrower's agent, stands in the shoes of his principal.[13]

State Legislation

As the mortgaged farm products problem has grown, so has the concern of buyers and commission merchants.[14] They have increasingly sought legislation to protect themselves and to unfetter the flow of agricultural commodities.

Pre-1983 Legislation

Prior to 1983 only six states had enacted legislation specifically aimed at limiting the liability of buyers and commission merchants who buy and sell farm products.

1. Nebraska

The first state to enact legislation relating to mortgaged farm products was Nebraska. In 1963, apparently in direct reaction to a four to three decision handed down by the Nebraska Supreme Court finding an auctioneer

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11. *See* Farmers State Bank v. Stewart, 454 S.W.2d 908, 915 (Mo. 1970). The Missouri [illegible] Court stated:

> The almost universally accepted rule is that an agent, factor, commission merchant or auctioneer who receives property from his principal and sells it and pays the proceeds of the sale to him is guilty of conversion if the principal has no right to sell the property, even though the agent acts without knowledge of the defect in title.

Id. *See also* Annot., 96 A.L.R.2d 208 (1964).

12. *See* United States v. Sommerville, 324 F.2d 712, 718 (3d Cir. 1963) *cert. denied*, 376 U.S. 909 (1964).

13. *Id.* The rationale underlying the agency theory of liability is that inasmuch as an agent is free to deal with, or serve, whomever he pleases, he should be held liable if he chooses to assist a principal, even knowingly, in the commission of a tort.

14. According to statistics released by the Farmers Home Administration in 1983, the FmHA, at the end of fiscal year 1978, had claims valued at $766,663 pending in the U.S.D.A.'s office of General Counsel against buyers and commission merchants for converting the FmHA's interest in secured livestock. At the end of fiscal year 1982, there were claims valued at $6,581,968 pending. At the end of fiscal year 1978, the FmHA had no claims pending against buyers and commission merchants for converting the FmHA's interest in secured grain. At the end of fiscal year 1982, there were claims valued at $7,194,321 pending.

liable to a secured party when the auctioneer sold mortgaged personal property for a farmer, Nebraska enacted section 69-109.01 of the Nebraska Revised Statutes.[15] Section 69-109.01 provides protection for auctioneers and auction companies who sell personal property; it does not protect buyers of personal property. The protection given to auctioneers and auction companies is not absolute, however. In order to gain the protection of section 69-109.01, an auctioneer must (1) sell the personal property at auction, (2) in good faith and without knowledge of a security interest in the property, (3) for a principal whose identity has been disclosed, and (4) have no personal interest in the property being sold.[16]

2. California

In 1974, California enacted legislation (which became effective January 1, 1976) that amended California's version of Section 9-307(1) to read as follows: "A buyer in ordinary course of business (subdivision (9) of Section 1201) takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence."[17] Thus, California became the first and to date the only state to simply delete the farm products exception from section 9-307(1) without making other statutory changes that affect farm products.

3. Georgia

In 1978, Georgia amended section 9-307 of its version of the Code by adding a new subsection (3) which provides:

> A commission merchant who shall sell livestock or agricultural products for another for a fee or commission shall not be liable to the holder of a security interest created by the seller of such livestock or products even though the security interest is perfected where the sale is made in ordinary course of business and without knowledge of the perfected security interest.[18]

Like the Nebraska statute, the Georgia statute does not provide protection for persons who purchase; it protects only commission merchants. Unlike the Nebraska statute, the Georgia statute does not protect intermediaries who sell all types of personal property; it protects only those who sell livestock or agricultural products. Further, unlike the Nebraska statute which would appear to protect the intermediary against liability for any security interest, regardless of whether that security interest was created by the immediate seller or some prior seller, the Georgia statute specifically limits protection to situations where the security interest was created by the immediate seller.

15. State Securities Co. v. Svoboda, 172 Neb. 526, 110 N.W.2d 109 (1961).
16. NEB. REV. STAT. § 69-109.01 (1981); State Securities Co. v. Norfolk Livestock Sales Co., Inc., 187 Neb. 446, 191 N.W.2d 614, 617 (1971).
17. CAL. COM. CODE § 9307 (West 1964 & Supp. 1984).
18. GA. CODE ANN. § 109A 9-307 (Supp. 1982).

4. Montana

Montana, as part of a comprehensive livestock marketing law, enacted section 81-8-301 of the Montana Code Annotated, which provides in pertinent part:

> The department of livestock shall accept and file notices of security agreements, renewals, assignments, and satisfactions covering livestock owned by a person, firm, corporation, or association and bearing its recorded brand and shall list the notices on the official records of marks and brands kept by it. The department shall transfer a copy of the notices and their accompanying brands to the central livestock markets. . . . *A livestock market to which livestock is shipped may not be held liable to any secured party for the proceeds of livestock sold through the livestock market by the debtor unless notice of the security agreement is filed and a copy is transferred as hereinbefore provided.*[19]

The Montana statute, unlike the Nebraska and Georgia statutes, does not base the commission merchant's exemption from liability on whether or not the intermediary had actual notice of the security interest. The Montana statute's exemption is based on whether notices of security agreements are filed with the state's department of livestock and copies of those notices are transferred to the livestock markets prior to the time of sale.

According to the Montana Supreme Court, when ruling on an earlier version of this statute in *Montana Meat Co. v. Missoula Livestock Auction Co.*,[20] the failure of the mortgagee to record as required by the statute precludes liability even when the intermediary had actual notice of the mortgage. Thus, it appears that Montana law requires dual filing (under section 87A-9-401 and 81-8-301) in order for a secured party to have a perfected security interest in livestock.

5. Idaho

Following Montana's lead, Idaho passed legislation in 1981 which provides for the filing of security agreements covering livestock with the state brand board.[21] However, that is where the similarity ends. The Idaho legislation does not provide that a market will not be liable unless the security agreement is filed with the brand board. In fact, the Idaho legislation specifically provides that "the provisions of this section shall not affect the rights and responsibilities of any party under chapter 9, title 28 of the Idaho Code, nor does filing pursuant to this section perfect a security agreement thereunder."[22]

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19. MONT. CODE ANN. § 81-8-301(1) (1983) (emphasis added).

20. 125 Mont. 66, 230 P.2d 955 (1951). *See also* Batey Land & Livestock Co. v. Nixon, 172 Mont. 99, 560 P.2d 1334 (1977); United States v. Public Auction Yard, 637 F.2d 613 (9th Cir. 1980).

21. IDAHO CODE § 25-1117 (Supp. 1983).

22. *Id.* § 25-1117(6).

6. Kentucky

In 1982, Kentucky amended section 9-307 of its version of the Code to provide protection to bona fide purchasers of grain and livestock, as well as to the selling agents who sell livestock.[23] Under the amended Kentucky law, persons who hold either "a current grain storage license issued by the Commonwealth of Kentucky or a current federal warehouse storage license," take title to grain free of any security interest unless, prior to payment of the proceeds, that person receives written notice by certified mail of the security interest.[24] If mortgaged livestock is sold "at public auction through a [duly licensed stockyard] in the ordinary course of business," bona fide purchasers of the livestock take title free of any security interests and the stockyards and selling agents are not liable to the secured party, unless written notice of the security interest is given prior to the time of sale.[25]

1983 Legislation

In 1983, eleven states enacted legislation to help buyers or commission merchants limit their potential liability with respect to mortgaged farm products.

1. South Dakota

In March 1983, South Dakota enacted legislation which provides that a secured party cannot commence an action against an innocent purchaser of farm products, nor against a livestock auction market, nor a public grain warehouse, public terminal grain warehouse or grain dealer unless the action is commenced within twenty-four months from the date the farm products were sold and the secured party has, prior to commencing the action, offered to file a criminal complaint against the seller.[26] In addition, the legislation makes it a crime to sell livestock or grain through any of the entities listed above without notifying them of a security interest in the farm products being sold.[27]

2. North Dakota

Like South Dakota, the North Dakota legislation[28] includes a criminal provision[29] and requires a lender to make an effort to collect from the borrower before the lender tries to collect from the buyer of farm products.[30] At that point, however, the similarity to South Dakota's legislation ends.

The basic element of the North Dakota legislation requires "a merchant

23. KY. REV. STAT. § 355.9-307 (Supp. 1982).
24. *Id.* § 355.9-307(3).
25. *Id.* § 355.9-307(4).
26. S.D.C.L. § 57A-9-503.1 (Supp. 1983).
27. *Id.* § 57A-9-503.2.
28. N.D. CENT. CODE § 41-09-28 (1983).
29. *Id.* § 41-09-28.4 and § 12.1-23-08 (Supp. 1983).
30. *Id.* § 41-09-28.6 (1983).

who purchases or a commission merchant who sells farm products for another"[31] to obtain from the seller, prior to payment, a certificate of ownership, which discloses "the names, social security numbers, addresses and home counties of the owners for five years prior thereto (completion of the certificate), the county of location of the property prior to the sale, and the names of the parties to whom security interests have been given against such farm products. . . ."[32] After obtaining the certificate of ownership, the merchant or commission merchant must "enter on the check or draft (as a joint payee) the name of the secured party disclosed in the certificate, or actually known by the merchant at the time" to exempt himself from liability.[33] However, a merchant or a commission merchant cannot stop once he has obtained the certificate of ownership, because the statute goes on to provide:

> A merchant who purchases from or a commission merchant who sells farm products for another for a fee or commission takes free of security interest created by the seller if:
> a. The merchant has complied with the requirements of subsection 4 [of this section];
> b. In the case where the seller disclosed no security interests, the merchant has requested information from the register of deeds in the counties of the sellers' residences over the five years prior thereto, as disclosed in the certificate, (or from the office of secretary of state if section 41-09-40 provides for filing in that office) as to the existence of financing statements naming the seller, and has received from the filing officer a certificate verifying disclosures obtained by such inquiry, and has entered on the check or draft the names of any secured parties named in the certificate as payees with the seller;
> c. The merchant does not have actual knowledge at the time of transaction of the existence of security interests;
> d. The merchant maintains records of such actions to support any criminal proceedings against the seller for violation of section 12.1-23-08.[34]

3. Tennessee

Tennessee amended its version of section 9-307 by deleting the farm products exception and adding several new subsections which, in essence, provide that if livestock, grain or tobacco is sold through specified entities, bona fide purchasers take free of any security interest in those farm products and selling agents are not liable to the holders of such security interests unless prior written notice is given.[35] The required notice must be given to parties entitled to the notice that are located within seventy-five miles of the

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31. *Id.* § 41-09-28.4.
32. *Id.*
33. *Id.*
34. *Id.* § 41-09-28.7.
35. TENN. CODE ANN. § 47-9-307 (1), (2)(a)-(c) (Supp. 1983).

creditor's principal place of business, must be renewed annually and must include the name and address of the debtor, a proper description of the collateral and the location of the collateral.[36] Moreover, even if the secured party has complied with the notice requirements, he will not be permitted to seek recovery from a public livestock market, buying station, community sale yard, meatpacker, public grain warehouse, or tobacco warehouse unless he has first attempted to collect from the debtor."[37]

4. Nebraska

For the purposes of this article, the most significant portion of the legislation enacted by Nebraska in 1983 is that which adds a fourth subsection to Section 9-307.[38] The new 9-307(4) imposes a duty on buyers of farm products and persons who sell farm products for a fee or commission to require the seller to identify the person who holds the first security interest in the farm products being sold. If the seller is then paid with a check drawn payable to the seller and the named first security holder *and* if the named first security holder authorizes the negotiation of the check, the buyer of the farm products takes free of any security interest.[39] However, the new subsection 4 goes on to state that "[a]ny endorsement for payment made on such check shall not serve to establish or alter in any way security interest priorities under Nebraska law. Unless amended or postponed, section 9-307(4) will terminate on September 1, 1987."[40]

In addition to amending section 9-307 of Nebraska's Code, the new legislation establishes an eighteen month statute of limitations for actions to recover collateral if "(a) the possession and ownership of which a debtor has in any way transferred to another person and (b) which was used as security for payment pursuant to an agreement, contract, or promise in writing which covers farm products . . . or farm products which become inventory of a person engaged in farming."[41]

Finally, with regard to the legislation enacted by Nebraska, it should be noted that although the county clerk's office is still the proper place to file a financing statement on farm products, the county clerk must now transmit financing statements and other documents relating to farm products to the Secretary of State's office so that on or before January 1, 1985 such information will be available through the Nebraska Secretary of State's of[42]

5. Indiana

The legislation enacted in Indiana during 1983 deletes the farm prod-

36. *Id.* § 47-9-307 (2)(d).
37. *Id.* § 47-9-307 (2)(e).
38. NEB. REV. STAT. U.C.C. § 9-307(4) (Supp. 1983).
39. *Id.*
40. *Id.*
41. *Id.* § 25-205.
42. *Id.* U.C.C. §§ 9-401(1), 9-411(3).

ucts exception.[43] However, it then goes on to add that a person buying farm products from a person engaged in farming operations is not protected if he has received prior written notice of the security interest.[44] To qualify as prior written notice, a notice must be received before the buyer has paid for the farm products and must contain all of the following information:

> (1) [t]he full name and address of the debtor, (2) [t]he full name and address of the security party, (3) [a] description of the collateral, (4) [t]he date and location of the filing of the security interest, (5) [t]he date and signature of the secured party and (6) [t]he date and signature of the debtor.[45]

The notice expires eighteen months after the date the secured party signs it or at the time the debt for which the farm products stand as collateral is satisfied, whichever occurs first.[46]

So that secured parties will be able to determine to whom notice should be sent, the Indiana law requires the debtor to provide the secured party with a written list of potential buyers of the farm products if the secured party asks for such a list.[47] If a debtor has given a secured party such a list, he cannot then sell to any buyer who is not on the list unless the secured party has given prior written permission for the debtor to do so or the debtor accounts to the secured party for the sales proceeds within fifteen days of the date of sale.[48] A knowing and intentional violation of this requirement is a class C misdemeanor.[49]

One unique feature in the Indiana legislation is the provision which makes it a class C infraction for a buyer of farm products, on which there is a security interest, to withhold any part of the sales proceeds in order to satisfy a prior debt owed by the seller to the buyer.[50]

Unlike most of the other states that have passed legislation related to the mortgaged farm products problem, Indiana did not address the liability of commission merchants. Its legislation provides protection only for buyers.

6. Ohio

Under legislation enacted by Ohio in 1983 a buyer in ordinary course of business of farm products from a person engaged in farming operations takes free of a security interest created by his seller unless the buyer (1) has received written notice as specified by the statute within eighteen months prior to payment of the sales proceeds and (2) fails to make payment in

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43. IND. CODE ANN. § 26-1-9-307(1) (Burns Supp. 1983).
44. *Id.* § 26-1-9-307(1)(a).
45. *Id.*
46. *Id.*
47. *Id.* § 26-1-9-307(1)(b).
48. *Id.* § 26-1-307(1)(c).
49. *Id.*
50. *Id.* § 26-1-307(1)(d).

accordance with the notice.[51] Unlike Indiana, Ohio specifically addressed the potential liability of commission merchants. It accomplished this by providing that the term "buyer of farm products" includes a buying or selling agent.[52]

If a secured party wants to protect its security interest in farm products, it can ask its debtor for a written list of potential buyers of the farm products and give the required written notice to such buyers.[53] A debtor must provide the list of potential buyers if the secured party requests it and is prohibited under first degree misdemeanor penalties from selling farm products to buyers who are not on the list without the prior written permission of the secured party.[54]

The new Ohio law also contains a number of other provisions which address additional concerns of buyers and sellers. One of the new provisions protects buyers who comply with the payment instructions set out in the notice against a seller who might otherwise assert that his lender was not entitled to be paid according to the stated instructions at the time of sale.[55] Another new subsection prohibits buyers from publicly disclosing the identity of persons named in the prescribed notice.[56]

7. Louisiana

Effective August 30, 1983, owners and operators of livestock marketing agencies in Louisiana cannot be held liable to the holder of a security device affecting livestock which are sold through the marketing agency unless the owner or operator has received a written notice, by certified mail or hand delivery, which sets forth (1) the name and address of the secured party, (2) the name and address of the person who granted the security device, (3) the parish of residence of the person who granted the security device, and (4) information concerning the security device.[57] If a livestock market agency has received the prescribed notice, it must make payment jointly to the owner of the livestock and to the secured party.[58]

Any person who provides false or misleading information concerning the name of the owner of any livestock or the existence of any security device affecting livestock with intent to deprive the secured party of its security subjects himself to a fine of not more than five thousand dollars ($5,000) or imprisonment, with or without hard labor, for not more than ten years, or both.[59]

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51. OHIO REV. CODE ANN. § 1309.26(B)(1)(a), (b) (Page Supp. 1983).
52. *Id.* § 1309.26(B)(5).
53. *Id.* § 1309.26(B)(4).
54. *Id.* § 1309.26(B)(4), (8).
55. *Id.* § 1309.26(B)(3).
56. *Id.* § 1309.26(B)(6).
57. LA. REV. STAT. ANN. § 3: 568(A), (E) (Supp. 1984).
58. *Id.* § 3:568(C).
59. *Id.* § 3:568(F).

8. Oklahoma

Whereas Louisiana sought to protect only those who deal with livestock, Oklahoma amended its version of section 9-307 to protect those who deal with all farm products except livestock.[60] In order to obtain the protection afforded by the new Oklahoma law, however, a merchant who is purchasing or a commission merchant who is selling farm products (other than livestock) (1) must require the seller to provide a "certificate of ownership" which discloses the names of all lenders, if any, who hold a security interest in those products and (2) must enter as a joint payee on the payment instrument the name of any lender disclosed in the certificate.[61] Any merchant or commission merchant who fails to obtain the certificate and to issue the payment instrument accordingly is liable to the secured party.[62]

9. Oregon

In some respects, the legislation enacted by Oregon[63] is quite similar to that enacted by Montana.[64] Basically, it provides that "livestock auction market operators, purchasers of livestock and their agents are not liable to any secured party for proceeds from the sale of cattle, horses or sheep" unless security interest statements have been filed with the Oregon Department of Agriculture, in addition to the required governmental office set forth in Article 9 of the Code.[65] Information regarding the financing statements so filed must be given to livestock auction markets and livestock dealers who request it and must be furnished at sales at locations other than licensed livestock auction markets by notations on brand inspection certificates.[66] The law carries an automatic termination date of July 1, 1987.

10. Illinois

The legislation enacted by Illinois in 1983[67] changes the Illinois U.C.C. by amending sections 9-306.01 and 9-307 and adding sections 9-205.1, 9-306.02, 9-307.1 and 9-307.2. In substance, the new legislation (1) allows secured parties to require that before debtors sell secured collateral, they disclose to the secured parties the names of the persons to whom they intend to sell the collateral;[68] (2) imposes criminal sanctions on debtors who sell to persons other than those disclosed to the secured party;[69] (3) provides that a person buying farm products in the ordinary course of business from a person engaged in farming operations takes free of any security interest created

60. OKLA. STAT. ANN. tit. 12A, § 9-307(1) (West 1981).
61. *Id.* § 9-307(3)(a), (b).
62. *Id.* § 9-307(3)(c).
63. 1983 Or. Laws ch. 626.
64. MONT. CODE ANN. § 81-8-301(1) (1983).
65. 1983 Or. Laws Ch. 626, §§ (2),(6).
66. *Id.* §§ (2),(5).
67. 1983 Ill. Laws 83-69.
68. 1983 Ill. Laws 83-69 (to be codified at ILL. REV. STAT. ch. 26 § 9-205.1).
69. 1983 Ill. Laws 83-69 (to be codified at ILL. REV. STAT. ch. 26 § 9-306.02(1)-(5)).

by the seller, unless, within five years prior to the purchase, the secured party has sent written notice of his interest to the buyer by certified or registered mail;[70] (4) provides that a commission merchant or selling agent shall not be liable to the holder of a security interest in farm products for selling those products in the ordinary course of business unless the secured party has sent written notice of his interest to the commission merchant or selling agent within five years prior to the sale;[71] and (5) requires commission merchants or selling agents who sell farm products and persons who buy farm products in the ordinary course of business to post a notice warning sellers that it is a criminal offense to sell farm products subject to a security interest without making payment to the secured party.[72]

11. Delaware

Delaware amended its version of section 9-307 by adding a new subsection 2 which provides, in substance, that a buyer in ordinary course of grain who is registered with the Delaware Secretary of State as registered grain buyer takes free of any security interest in the grain unless written notice of the lien is mailed, by certified or registered mail, to the grain buyer within one year prior to the time he pays for the grain.[73] Secured parties may obtain a list of all registered grain buyers from the Secretary of State's office upon request.[74]

OTHER RELATED LEGISLATION

In addition to the legislation noted above, at least twelve states have enacted legislation during the past twenty years that requires central filing of financing statements relating to farm products.[75]

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70. 1983 Ill. Laws 83-69 (to be codified at ILL. REV. STAT. ch. 26 § 9-307(1), (4)).
71. 1983 Ill. Laws 83-69 (to be codified at ILL. REV. STAT. ch. 26 § 9-307.1).
72. 1983 Ill. Laws 83-69 (to be codified at ILL. REV. STAT. ch. 26 § 9-307.2).
73. DEL. CODE ANN. tit. 6, § 9-307(2)(a) (Supp. 1983).
74. *Id.* § 9-307(2)(b).
75. California (central filing, except crops); CAL. COM. CODE § 9401 (1964 & Supp. 1984); Connecticut: CONN. GEN. STAT. ANN. § 42a-9-401 (West Supp. 1984); Delaware: DEL. CODE ANN. tit. 6, § 9-401 (1975); Hawaii: HAWAII REV. STAT. § 490: 9-401 (1976); Iowa: IOWA CODE ANN. § 554.9401 (West 1967); Maine: ME. REV. STAT. ANN. tit. 11, § 9-401 (1964); Mississippi (dual filing on farm products): MISS. CODE ANN. § 75-9-401(1)(a) (1981); Nevada: NEV. REV. STAT. § 104.9-401 (1979); Oregon: OR. REV. STAT. § 79.4010 (1983); South Dakota: S.D.C.L. § 57A-9-401 (1980); Utah: UTAH CODE ANN. § 70A-9-401 (1980); Washington, WASH. REV. CODE ANN. § 62A.9-401 (1981).

Although central filing somewhat eases the burden of checking for liens on a county by county basis, it leaves many unsolved problems. In many cases, buyers and commission merchants cannot obtain the information on a timely basis because they are buying and selling at times when the central filing office is closed. This makes it especially difficult for livestock markets and dealers because they are required to pay by the close of the next business day after the transaction. *See supra* note 8. Additionally, central filing, just as local filing, leaves the burden and expense of policing a lender's loan on a buyer or commission merchant rather than the lender who stands to profit by the loan. As stated by one commentator, "the risks inherent in the business of money-lending should be borne by money-lenders, not by innocent buyers in the market place." Knapp, *Protecting the Buyer of Previously Encumbered Goods: Another Plea for Revision of UCC Section 9-307(1)*, 15 ARIZ. L. REV. 861, 892 (1973).

Notwithstanding all of this new legislation by the individual states, the mortgaged farm products problem has not disappeared. Not only have several major agriculture producing states not passed any legislation in this area, but there is genuine concern that the state legislation which has been passed will not protect buyers and commission merchants from one of the nation's largest agricultural lenders, the federal government.

It is a well settled proposition that federal law governs questions involving the rights of the federal government arising under nationwide federal programs such as the FmHA's farm loan programs.[76] What is not so well settled, is what is that federal law? Is it a judicially constructed uniform rule of law or is state law incorporated as the applicable federal law?[77]

Prior to 1979, seven Circuits had ruled on this question. Five of the seven favored a judicially constructed uniform rule of law;[78] two incorporated state law as the applicable federal law.[79]

In 1979, the United States Supreme Court handed down *United States v. Kimbell Foods, Inc.*[80] The question before the Court in *Kimbell* was whether contractual liens arising from certain federal loan programs take precedence over private liens, absent a federal statute that sets priorities. In reaching its decision, the Court analyzed three factors: the need for uniformity in operating the federal loan programs, whether the application of state law would frustrate the specific objectives of the federal programs, and the extent to which the application of a federal rule would disrupt commercial relationships predicated on state law.[81] Based on this analysis, the Court adopted state law as the appropriate federal rule for establishing the relative priority of the competing liens.

Since *Kimbell* three of the seven circuits noted previously have decided cases involving the liability of commission merchants for selling mortgaged farm products.[82] The Fourth Circuit, which already used incorporated state

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76. United States v. Kimbell Foods, Inc., 440 U.S. 715 (1979); Clearfield Trust Co. v. United States, 318 U.S. 363 (1943); D'Oench, Duhme & Co v. Federal Deposit Insurance Corp., 315 U.S. 447 (1942). *See* Mishkin, *The Variousness of "Federal Law": Competence and Discretion in the Choice of National and State Rules for Decision*, 105 U. PA. L. REV. 797, 798-801 (1957).

77. *See* Comment, *Adopting State Law as the Federal Rule of Decision: A Proposed Test*, 43 U. CHI. L. REV. 823 (1976).

78. Third Circuit: United States v. Sommerville, 324 F.2d 712 (3d Cir. 1964); Fifth Circuit: United States v. Hext, 444 F.2d 804 (5th Cir. 1971); Sixth Circuit: United States v. Burnette-Carter Co., 575 F.2d 587 (6th Cir. 1978) and United States v. Carson, 372 F.2d 429 (6th Cir. 1967); Ninth Circuit: United States v. Matthews, 244 F.2d 626 (9th Cir. 1957); Tenth Circuit: Cassidy Commission Co. v. United States, 387 F.2d 875 (10th Cir. 1967).

79. Fourth Circuit: United States v. Union Livestock Sales Co., 298 F.2d 755 (4th Cir. 1962); Eighth Circuit: United States v. Gallatin Livestock Auction, Inc., 448 F. Supp. 616 (W.D. Mo. 1978), *aff'd*, 589 F.2d 353 (8th Cir. 1978) and United States v. Chappell Livestock Auction, Inc., 523 F.2d 840 (8th Cir. 1975).

80. 440 U.S. 715 (1979).

81. United States v. Kimbell Foods, Inc., 440 U.S. at 728. *See also* Comment, *supra* note 77, at 830-34.

82. Fourth Circuit: United States v. Friend's Stockyard, Inc. and United States v. Grantsville Community Sale, Inc., 600 F.2d 9 (4th Cir. 1979); Fifth Circuit: United States v. Southeast Missis-

law as the applicable federal law, cited *Kimbell* as requiring the incorporation of state law.[83] The Fifth and Ninth Circuits, which had used uniform federal law prior to *Kimbell*, now use incorporated state law.[84] Thus, at this time three circuits have decisions on the books whereby the liability of commission merchants for selling mortgaged farm products is determined under a uniform federal rule of law and four circuits have incorporated state law to determine this liability.

Clearly, until federal legislation is enacted[85] or additional cases are decided by the Courts of Appeal, the question of which law applies to mortgaged farm products cases is open to speculation. As Professor Wright has stated, "Whether state or federal law controls on matters not covered by the Constitution or an Act of Congress is a very complicated question, which yields to no simple answer . . . ."[86]

CONCLUSION

As a result of the farm products exception, secured parties and buyers not in ordinary course receive better treatment than buyers in ordinary course of farm products.[87] Commission merchants, as a result of causes of action related to the farm products exception, become "involuntary guarantors of the debtor's compliance with the security agreement."[88]

Many of the individual states have enacted legislation, especially within the previous year, which is aimed at alleviating the Code's bias against those who buy and sell farm products. However, because of the disparate approaches used by the individual states the value of all this legislation is uncertain—the Uniform Commercial Code has become even more disuniform and the federal government's argument against application of state law to federal lenders has been strenghtened.[89] The mortgaged farm products problem, albeit changed to some degree, remains.

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sippi Livestock Farmers Ass'n, 619 F.2d 435 (5th Cir. 1980); Ninth Circuit: United States v. Public Auction Yards, 637 F.2d 613 (9th Cir. 1980).

83. United States v. Friend's Stockyard, Inc., 600 F.2d at 10.

84. United States v. Southeast Mississippi Livestock Farmers Ass'n, 619 F.2d 435 (5th Cir. 1980); United States v. Public Auction Yard, 637 F.2d 613 (9th Cir. 1980).

85. In 1983, Congressman Tom Harkin introduced two bills, H.R. 3296 and H.R. 3297. H.R. 3296 would basically repeal the farm products exception from the federal level. H.R. 3297 would amend the Packers and Stockyards Act, 7 U.S.C. § 181 et. seq. (1982) to accomplish the same result with respect to livestock.

86. C. WRIGHT, LAW OF THE FEDERAL COURTS 388 (4th ed. 1983).

87. Dugan, *supra* note 8, at 362.

88. *Id.*

89. United States v. Kimball Foods, Inc., 440 U.S. 715 (1979). *See also* Comment, *supra* note 77.

STATEMENT
OF
ERNEST H. VAN HOOSER
DEAS, VAN HOOSER & OLSEN, P.C.
ON BEHALF OF
LIVESTOCK MARKETING ASSOCIATION

SUBMITTED TO
LIVESTOCK, DAIRY AND POULTRY SUBCOMMITTEE
OF
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON AGRICULTURE
REGARDING
PROBLEMS ARISING FROM PURCHASE
OF MORTGAGED FARM PRODUCTS

NOVEMBER 16, 1983

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE:

My name is Ernest H. Van Hooser. I am a member of the law firm of Deas, Van Hooser & Olsen, P.C. of Kansas City, Missouri. The following statement is submitted by my firm in its capacity as counsel for Livestock Marketing Association, a national trade association of livestock marketing businesses.

THE PROBLEM

As you will no doubt hear repeatedly today, there is a serious problem in this country caused by the sale of mortgaged farm products. It is a problem for lenders, for farmers, for innocent purchasers of farm products and for commission merchants who sell farm products for others. However, since I am sure the lenders and farm groups will adequately address the problem from their respective positions, I shall attempt to restrict my remarks to the problem as seen by buyers and commission merchants.

According to the overwhelming weight of legal authority, a buyer of farm products and a commission merchant who merely acts as an agent in selling farm products are liable to the secured lender if the borrower-seller fails to account to the secured lender for the sales proceeds, even when the buyer or commission merchant did not know that the farm products were mortgaged.[1/] The only exceptions to this general rule of liability are (1) when the secured lender authorizes the sale and (2), in a few jurisdictions, where the secured lender has acted so egregiously with respect to the security agreement and sales of farm products that the courts have found some way to negate the liability. Neither of these exceptions arises very often.

The liability of innocent purchasers of farm products and intermediaries who sell farm products is founded on the interaction of Uniform Commercial Code (UCC) subsection 9-306(2) with UCC subsection 9-307(1) and on the tort of conversion.[2/]

Subsection 9-306(2) provides that a security interest continues in collateral notwithstanding sale, exchange or other disposition and in any identifiable proceeds therefrom unless the sale, exchange or other disposition was authorized by the secured party.[3] A buyer in ordinary course of business of inventory, however, is protected from this continuing security interest by subsection 9-307(1), which provides that such a buyer takes free of a security interest created by his seller.[4] Not so for a buyer of farm products. Because of the special rule for farm products set out in subsection 9-307(1), a buyer in ordinary course of farm products is not protected from the continuing security interest of subsection 9-306(2): he takes subject to the security interest. Thus, the secured party may reclaim the farm products from the buyer or he may hold the buyer accountable for the value of the security interest in those farm products. Additionally, if the security agreement makes the borrower's unauthorized sale of the farm products a default entitling the secured party to possession of the collateral and the buyer does not account to the secured party for the collateral, the secured party may hold the buyer liable for conversion, because the buyer has wrongfully interfered with the secured party's right to possession of the collateral.

Unlike a buyer of farm products, a commission merchant's liability for selling mortgaged farm products is not based on the interplay of subsection 9-306(2) and the farm products exception of Section 9-307(1), which, of course, means that simply deleting the farm products exception will not protect commission merchants from liability. A commission merchant's liability is based on conversion. If the security agreement makes the borrower's unauthorized sale a default entitling the secured party to possession of the collateral and the commission merchant does not account to the secured party for the collateral, the secured party may seek recovery against the commission merchant under either of two theories of conversion. Under the first theory, a commission

merchant is liable for conversion because he has, by his exercise of dominion and control over the farm products during the selling process, interfered with the secured party's right to possession of the collateral. Under the second theory, a commission merchant's liability is based on his acting as agent for the mortgagor. Thus, when a borrower sells mortgaged farm products without the secured party's consent, he is deemed to have tortiously interfered with the secured party's right to possession and the commissiom merchant, as the borrower's agent, stands in the shoes of his principal. The rationale underlying the agency theory of liability is that inasmuch as an agent is free to deal with, or serve, whomever he pleases, he should be held liable if he chooses to assist a principal, even unknowingly, in the commission of a tort.

STATE LEGISLATION

As concern over the mortgaged farm products problem has grown, buyers and commission merchants have increasingly sought protective legislation.

Prior to 1983 only six states -- not including those states that adopted central filing for farm products -- had enacted legislation to limit the liability of buyers or commission merchants who seal with farm products. Nebraska enacted legislation that protects auctioneers who sell personal property if they do not know there is a mortgage on the property, if they have disclosed the identity of the seller prior to the sale and if they do not have any interest in the property. Georgia enacted legislation that protects commission merchants who sell farm products so long as the security interest was created by the seller of the product and the commission merchant does not have knowledge of the perfected security interest. California simply deleted the farm products exception from Section 9-307(1), thus helping buyers of farm products but doing nothing for

commission merchants. The legislation enacted by Montana provides that a livestock market will not be liable to a lender who has a security interest in livestock unless notice of the security agreement has been filed with the state brand board -- in addition to the County Clerk's Office -- and that the notice has been transmitted to the livestock market prior to the sale. Idaho enacted legislation similar to Montana's but without making dual filing mandatory -- thus accomplishing very little. In 1982, Kentucky enacted legislation that amended Section 9-307 of its UCC. This amendment protects commission merchants and buyers of various farm products if the sale was transacted at a licensed public market and actual written notice of the security interest had not been given by certified mail.

In 1983, the drive for legislative action gained momentum. At least eleven states enacted legislation whose avowed purpose was to help buyers and commission merchants limit their liability with respect to mortgaged farm products. 6/ Some of the new legislation covers all farm products. Some covers only grain. Some, such as Louisiana's and Oregon's, covers only livestock. Some, like Oklahoma's, covers ever ything but livestock. Some of the new legislation, such as that enacted in Tennessee, Ohio, Illinois and Indiana, provides protection from liability unless actual notice of the security interest has been given prior to the sale or payment of the sales proceeds. Some, like that enacted in Oklahoma and North Dakota, bases protection from liability on getting a certificate of ownership from the seller and including any secured parties disclosed by the certificate as joint payees. Some, such as that enacted in South Dakota and Nebraska, shortens the statute of limitations for bringing actions against buyers and commission merchants. Some of the new legislation attempts to protect only commission merchants (selling agents); some, only buyers, and some, buyers and commission merchants. Finally,

most of the new legislation establishes criminal penalties for borrower-sellers who either fail to provide information or provide false information with respect to potential buyers or the identity of secured parties.

In addition to the states that actually passed legislation in 1983, several others, such as Missouri, Texas, Arkansas, Iowa, Alabama, Michigan, North Carolina and South Carolina, had legislation introduced but did not pass it. And, it should be added, the legislation introduced in these states was no more uniform than the legislation actually enacted.

FEDERAL GOVERNMENT AS SECURED PARTY

As a result of all this new legislation by the individual states, many buyers and commission merchants are now breathing a sigh of relief. However, I am not sure that is necessarily true for those of us who represent them. As a result of all of this new legislation by the individual states, the Uniform Commercial Code has become even more un-uniform, thereby making it extremely difficult to determine what protection is available to whom on what basis. In addition, and even more importantly, there is genuine concern that all of this state legislation will not protect buyers and commission merchants from that lender of lenders, the federal government -- primarily the Farmers Home Administration.

It is a well settled proposition that federal law governs questions involving the rights of the federal government arising under nationwide federal programs such as the FmHA's farm loan programs. What is not so well settled, is what is that federal law? Is it a judicially constructed uniform rule of law or is state law incorporated as the applicable federal law?

Prior to 1979, seven Circuits had ruled on this question. Five of the seven favored a judicially constructed uniform rule of law;[7/] two incorporated state law as the applicable federal law.[8/] In 1979, the U.S. Supreme Court handed down the U.S. v.

Kimbell Foods, Inc.[9] decision. Based on that decision, one of the Circuits that formerly used the judicially constructed uniform rule of law to determine the liability of a commission merchant who sold mortgaged farm products now uses incorporated state law.[10] Thus, until Congress determines the choice of law issue, either by dictating the use of a judicially constructed uniform law or incorporated state law or by providing the specific substantive law to be followed, the only way to determine what protection, if any, all of this new state legislation will afford buyers and commission merchants against the federal government will be to litigate the issue on a case by case, circuit by circuit basis. In my opinion, not a very healthy environment in which to conduct business.

In summary, Livestock Marketing Association believes that the problems arising from the sale of mortgaged farm products are significant and growing, especially for those who move those vitally important products from producer to consumer, and that the only real solution is for Congress to act quickly and decisively to pass corrective legislation.

Thank you.

E.g., United States v. Sommerville, 324 F.2d 712 (3rd Cir. 1963), cert. denied, 376 U.S. 909, 84 S.Ct. 663, 11 L.Ed.2d 608 (1964); United States v. McClesky Mills, Inc., 409 F.2d 1216 (5th Cir. 1969); United States v. Gallatin Livestock Auction Co., Inc., 448 F. Supp. 616 (W.D. Mo. 1978); Farmers State Bank v. Stewart, 454 S.W.2d 908 (Mo. en banc 1978); Garden City Production Credit Association v. Lannan, 186 N.W.2d 99 (Neb. 1971).

Conversion is generally defined as tortious interference with the possessory rights of another to personal property. 18 Am.Jur.2d Conversion §§ 1,25.

Subsection 9-306(2) provides:

> Except where this article otherwise provides, a security interest continues in collateral notwithstanding sale, exchange or other disposition thereof by the debtor unless his action was authorized by the secured party in the security agreement or otherwise, and also continues in any identifiable proceeds including collections received by the debtor.

Subsection 9-307(1) provides:

> A buyer in ordinary course of business * * * other than a person buying farming products from a person engaged in farming operations takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence.

The farm products exception of 9-307(1) has been justified on the ground that farmers sell to buyers, marketing agents and brokers who are in a position to determine if their seller has given someone a security interest in his farm products. One problem with this justification is that subsequent sales, even if by merchants, will not cut off the lender's original security interest. Thus, even if a buyer purchases from a seller in whose hands the goods are inventory or if a buyer purchases from a seller who has not mortgaged the goods to anyone, the buyer will still take subject to the lender's original security interest in farm products because the security interest was not created by the seller from whom the buyer is purchasing the goods. Another problem with this justification for the farm products exception is that buyers who purchase farm products and commission merchants who sell farm products are often simply not able to check for liens on all the farm products they buy or sell. This is especially true for livestock markets, livestock dealers and packers who are required by Section 409 of the Packers and Stockyards Act (7 U.S.C. § 228b) to pay for livestock before the close of the next business day following the day purchase of livestock.

Another justification often cited for the farm products exception is that sales of farm products are more closely akin to bulk sales than to sales of inventory. Thus, goes the argument, because farm products are not subject to the creditor protections afforded by Article 6 of the UCC, lenders must have the protection afforded by the farm products exceptions in order to protect

their interests. Although this justification is more persuasive than the first justification, it also encounters problems when examined closely, especially with respect to livestock. For example, a dairy herd is a constantly changing asset. Poor producers are culled and replaced. Male increase, being outside the normal scope of a dairy farmer's business, are sold. It is difficult to see how this continuing turn over of a small number of animals is akin to a bulk sale. Even grain, because of the more sophisticated marketing techniques not being used by farmers, will often not be sold at one time; it will instead be sold over a period of months to take advantage of "off season prices" and to fulfill forward contracts.

6/ Delaware, Illinois, Indiana, Louisiana, Nebraska, North Dakota, Ohio, Oklahoma, Oregon, South Dakota, Tennessee.

7/ Third Circuit (United States v. Sommerville, 324 F.2d 712 (3rd Cir. 1964)); Fifth Circuit (United States v. Hext, 444 F.2d 804 (5th Cir. 1971)); Sixth Circuit (United States v. Burnette-Carter Co., 575 F.2d 527 (6th Cir. 1978) and United States v. Carson, 372 F.2d 429 (6th Cir. 1967)); United States v. Matthews, 244 F.2d 626 (9th Cir. 1957); and Tenth Circuit (Cassidy Commission Co. v. United States, 387 F.2d 875 (10th Cir. 1967)).

8/ Fourth Circuit (United States v. Friend's Stockyards, Inc., 600 F.2d 9 (4th Cir. 1979) and United States v. Union Livestock Sales Co., 298 F.2d 755 (4th Cir. 1962) and Eighth Circuit (United States v. Chappell Livestock Auction, Inc., 523 F.2d 840 (8th Cir. 1975).

9/ 440 U.S. 715, 99 S.Ct. 1448, 59 L.Ed.2d 711 (1979).

10/ See, United States v. Public Auction Yards, 637 F.2d 613 (9th Cir. 1980).

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SECTION 9-307(1): THE U.C.C.'S OBSTACLE TO AGRICULTURAL COMMERCE IN THE OPEN MARKET

*John F. Dolan**

INTRODUCTION

The Uniform Commercial Code[1] provides a general open market rule in the Secured Transactions article which permits certain good faith purchasers to take goods free of perfected security interests. That general rule, however, excepts from its application sales of farm products by persons engaged in farming operations. Defenders of the exception proffer two justifications. Some feel that farm producers would not find ample credit if farm lenders faced the possibility of losing collateral to buyers. Others argue that the exception enjoys widespread support among state legislatures and among the federal agencies which account for a significant share of agricultural credit. Thus, this second argument continues, adoption of a rule in the Code which treats farm sales in the same fashion as it treats nonfarm sales would invite deviation from the Code rule by both state and federal systems with a resulting loss of uniformity.

This article holds first, that the farm exception grows out of archaic notions of agriculture and agricultural finance; second, that the exception is basically unfair in that it penalizes unwary buyers who reasonably expect they will buy free of security interests; third, that the exception creates uncertainty and thereby increases transaction costs to the detriment of farm producer and farm lender; and fourth, that the farm exception itself has so contributed to a lack of uniformity that its abrogation could hardly cause more.

DEFINING THE ISSUE

Article 9 of the Uniform Commercial Code takes pains to differentiate four classes of goods:[2] consumer goods, equipment, farm prod-

* LL.B., University of Illinois, 1965; Associate Professor of Law, Wayne State University.

[1] The Uniform Commercial Code is hereinafter cited as "Code." Unless otherwise noted, all section references are to the 1972 official version of the U.C.C., and references to the comments are to those prepared by the sponsoring agencies to the 1972 version.

[2] U.C.C. § 9-105(1)(h) sets forth the general definition of "goods". Hereinafter all U.C.C. section numbers will be referred to by section number only.

ucts, and inventory.[3] This differentiation facilitates disparate treatment of each of the four categories. Consumer goods,[4] for example, are free from certain filing requirements which attend other classes of goods[5] and are subject to different foreclosure rules.[6] These rules arise out of the notion that the nature of consumer transactions justifies treatment different from that afforded transactions in a commercial setting.[7]

Similarly, the Code makes allowance for the inherent dissimilarities between "equipment," which the Code defines to include assets used by a business,[8] and "inventory," which it defines to include assets the business holds for sale or lease or otherwise consumes.[9] The methods of financing these two classes of goods and, more importantly, the probability of selling one and the improbability of selling the other[10] justify their different treatment in connection with the relative priorities of lenders[11] and the protection of persons who buy such goods.[12]

The Farm Products Category

Equipment and inventory are similar to the extent that both are owned for profit or commercial purposes as opposed to the domestic purposes of personal, family, and household uses. There remains, however, a category of goods and which comprises a significant element of commerce but which Code drafters could reconcile with neither the fish of commerciality nor the fowl of domesticity. That specially treated class consists of farm products.

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[3] Section 9-109(1) to (4).

[4] Consumer goods include those goods "used or bought for use primarily for personal, family, or household purposes." Section 9-109(1).

[5] Section 9-302(1)(d).

[6] *See* §§ 9-504(3), 9-505(1) to (2), 9-507(1).

[7] *Cf.* § 2-104, Comment 1 (special rules for merchants).

[8] Section 9-109(2). The definition also serves as a catchall. *See* § 9-109(2), Comment 5.

[9] Section 9-109(4). The important distinction between inventory and equipment appears to be one of duration. Materials used by the business and consumed by it are inventory, whereas machines used or consumed by it are equipment. *Compare* § 9-109(4) *with* § 9-109(2).

[10] Courts have concluded that the term "inventory" in a security agreement includes after-acquired inventory because "inventory by its nature and definition changes from day to day." *In re* Fibre Glass Boat Corp., 324 F. Supp. 1054, 1056 (S.D. Fla.), *aff'd per curiam*, 448 F.2d 781 (5th Cir. 1971).

[11] *Compare* § 9-312(3) *with* § 9-312(4). *See generally* § 9-312, Comment 3.

[12] Although the buyer protection rule of § 9-307(1) does not use the term "inventory," it is clear that this class of goods is the kind to which the section is directed. *See* §§ 9-307(1), 1-201(9), and 9-102, Comment 5. Cases have tended to hold, true to academic consistency but perhaps contrary to the expectations of the parties, that buyers of "equipment" do not benefit from buyer protection rules. *See, e.g.*, Bruce v. Martin-Marietta Corp., 544 F.2d 442 (10th Cir. 1976) (sale of used aircraft by airline not subject to products liability rule); Hempstead Bank v. Andy's Car Rental Sys., 35 App. Div. 2d 35, 312 N.Y.S.2d 317 (1970) (sales of vehicles held for lease, though technically inventory, not subject to the § 9-307(1) rule).

Farm products, by definition, must be in the possession of a farmer,[13] yet the rules which apply to them affect all who deal in agricultural commodities. Clearly, farm products include what would otherwise be inventory: crops, livestock, and the raw materials of farm production, as well as the products both of crops and livestock in their "unmanufactured states."[14] This definition leaves by implication those products which are in their manufactured states (*e.g.*, leather or corn flakes) and which are not his "equipment" as the farmer's only "inventory."[15] In short, with that sole exception for manufactured state inventory, farmers can hold no inventory in the Code sense. They can only hold "farm products."

SPECIAL TREATMENT FOR FARM PRODUCTS

Having constructed this farm products (inventory-which-is-not-inventory) category, the Code drafters fashioned special rules for it. The first concerns the filing requirements, and the second concerns the relative priorities of a secured inventory lender and a purchaser in a subsequent inventory sale.

The first difference is in filing requirements. Section 9-401 poses three filing options for lenders secured by farm products. The first requires central filing; the others require local filing. The Code drafters did not choose among the three options, but an overwhelming majority of the jurisdictions have opted for either the second or the third. Because only five states[16] require central filing for farm products, in nearly all jurisdictions the filing of financing statements covering farm products will be local, with buyers or lenders searching for such financing statements at the county or town level.

The filing options, however, must rank as a relatively minor consideration and are not the reason for the creation of the separate farm products class of goods. Code drafters could have effected the local filing option for farm products in the fashion they effected it for farm equipment. Such equipment is not by definition a separate class of goods but

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[13] Section 9-109(3). The Code wisely eschews the term "farmer" for the terms "debtor engaged in raising, fattening, grazing or other farming operations." It thereby avoids the problem of determining whether, for example, a stock broker can be a farmer.

[14] *Id.*

[15] A farmer's equipment (assuming of course that livestock are not equipment) falls into the "equipment" category of goods. *See* § 9-109(2).

[16] CONN. GEN. STAT. ANN. § 42a-9-401(1) (West Cum. Supp. 1977); DEL. CODE tit. 6, § 9-401(1) (1975); HAW. REV. STAT. § 490:9-401(1) (1968); IOWA CODE ANN. § 554.9401(1) (West Cum. Supp. 1977-78); UTAH CODE ANN. § 70A-9-401(1) (1968). California, Maine, and Oregon require central filing for livestock, though not for other farm commodities. CAL. COM. CODE § 9401(1) (West Cum. Supp. 1977); ME. REV. STAT. tit. 11, § 9-401(1)(a) (West Cum. Supp. 1976-77); OR. REV. STAT. § 79.4010(1) (Oregon Digest 1977). A Montana pre-Code statute requires the secured party to notify the Montana Department of Livestock. MONT. REV. CODES ANN. § 52-319 (Smith 1977). *See generally* Batey Land & Livestock Co. v. Nixon, — Mont. —, 560 P.2d 1334 (1977).

falls into the section 9-109 definition of "equipment." However, the Code provides two options for local filing of "equipment used in farming operations,"[17] even though generally a financing statement covering equipment would be filed centrally.[18]

The second area of different treatment concerns the rights of the lender and the subsequent purchaser of inventory. Where either farm or nonfarm inventory is involved, section 9-306(2) often in practice operates to terminate the creditor's interest in inventory after that transfer. That section provides:

> [A] security interest continues in collateral notwithstanding sale, exchange or other disposition thereof unless the disposition was authorized by the secured party in the security agreement or otherwise . . . .

Because lenders recognize that the purpose of inventory is sales, that a need to perform a filing search inhibits sales, and that sales free and clear of the lender's interest serve the purposes of lender and borrower alike, almost all lenders customarily authorize inventory sales. In effect, then, lenders and their borrowers fashion a private open-market rule through their security agreement which authorizes sales free of the lender's security interest.[19]

This willingness by lenders to authorize sales of secured inventory stems only in part from the protection afforded the lender by the proceeds which arise from that sale.[20] Inventory lenders often do not make inventory loans with the expectation that they will receive proceeds from each sale. Such expectations, while inherent in any discrete, short-term loan, are inconsistent with the indispensable notion of working capital loans of intermediate term secured by inventory. Rather, inventory lenders often make such loans on the assumption that borrowers will utilize proceeds of sale to acquire new inventory and will reduce the working capital loan not as a result of discrete sales but as a consequence of capital needs and cash flow.[21]

In those infrequent situations where the inventory lender does not authorize sale, section 9-307(1) fulfills the expectations of the buyer in

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[17] Section 9-401(1). The second and third alternative subsections lump "equipment used in farming operations" with "farm products" for the purpose of determining the proper place to file.

[18] *Id.*

[19] *See, e.g.*, Lisbon Bank & Trust Co. v. Murray, 206 N.W.2d 96 (Iowa 1973).

[20] Section 9-306(1) defines proceeds as "whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds."

[21] The discrete lien approach stemmed from the commercial loan theory of banking, popular before the 1930's, that all loans must be self-liquidating. The modern banking doctrine, developed in the 1940's and 1950's, of measuring a bank's liquidity in terms of all loans, not just discrete loans, permits commercial lenders to justify the revolving loan so indispensable to inventory finance. *See generally* L. RITTER & W. SILBER, PRINCIPLES OF MONEY, BANKING, AND FINANCIAL MARKETS 102-03 (2d ed. 1977).

ordinary course by imposing the open-market rule by operation of law. That section provides that a buyer in ordinary course of business other than a person buying farm products from a farmer "takes free of a security interest created by his seller even though the security interest is perfected . . . ." By carving out the exception for farm sales, the Code exempts those sales from the open-market rule of section 9-307(1). Significantly, however, the Code does not exempt them from the practical open-market effect of section 9-306(2), which operates only in the event the secured party authorizes the sale in the security agreement "or otherwise."

Most farm lenders do not authorize such sales in the security agreement, and most courts, though not all, have read the "or otherwise" language of section 9-306(2) narrowly. Accordingly, the effect of the farm products exception is to impose a strict security of property rule and to refuse the benefit of open-market precepts to sales comprising a significant measure of commercial activity—agricultural sales.

In brief, local filing is not the only impetus for the separate classification of "farm products." That impetus also derives from a far more significant policy choice favoring security of title over commercial celerity. Since the law of sales as manifested in the "buyer in ordinary course" rules has traditionally struck this balance on the side of commercial celerity, it is necessary to examine the history of, and evaluate the rationale for, this departure in sales involving farm products.

UNIQUE FEATURES OF AGRICULTURAL LENDING

The history of agricultural financing parallels that of the commercial sector with three notable exceptions. First, the mechanization of agriculture tended to occur later than that of other industries.[22] While requirements for credit are no less pressing in agricultural enterprises than in other businesses,[23] these requirements did not develop contemporane-

[22] Commentators seem to agree that it has been only in the last 40 or 50 years that the agricultural industry has demonstrated a marked need for other than real estate financing. *See* Bunn, *Financing Farmers: Existing Kansas Law and the Uniform Commercial Code*, 2 KAN. L. REV. 225 (1954); Bunn, *Financing Farmers: Existing Wisconsin Law, The Green Giant Case and the Uniform Commercial Code*, 1954 WIS. L. REV. 357; Hawkland, *The Proposed Amendment to Article 9 of the U.C.C.—Part I: Financing the Farmer*, 76 COM. L.J. 416 (1971). *See generally* A. NELSON, W. LEE, & W. MURRAY, AGRICULTURAL FINANCE 308-11 (6th ed. 1973).

[23] Statistics indicate that credit requirements are real indeed and are increasing at a rapid rate. One authority estimates that in a ten-year period capital requirements for the "typical" cash grain farm in the corn belt increased from $97,000 to $203,000 and for the "typical" southwest cattle ranch from $141,000 to $205,000. *See Hearings on the Effect of Corporate Farming on Small Business Before the Subcomm. on Monopoly of the Senate Select Comm. on Small Business*, 90th Cong., 2d Sess. 93 (1968).

ously with those of other businesses.[24] More importantly, the primary source of farm collateral prior to and during the initial stages of agricultural mechanization was land, which then was the farmer's single most valuable asset.[25] Finally, the nation's romantic preoccupation with the "yeoman farmer"[26] fostered a paternalistic attitude on the part of courts and lawmakers toward farmers.[27]

All three of these exceptions resulted in treatment of agricultural credit needs disparate from that of the rest of the economy. Generally, the factor's lien acts and the Uniform Trusts Receipt Act, both of which were passed to facilitate secured inventory lending in other sectors of the economy,[28] did not cover agricultural transactions.[29] Rather, agricultural lenders were forced to resort to the chattel mortgage statutes[30] with their kinship to the familiar real estate mortgage.[31]

Pre-Code rules of inventory financing reflect these historic differences. Pressure had exerted itself in nonagricultural settings to foster inventory financing which permitted buyers to take free and clear of the lender's encumbrance.[32] Pre-Code buyers from farmers, however, did not enjoy that protection, because the chattel mortgage statutes did not extend it.[33] Buyers of farm commodities from persons other than farmers, how-

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[24] The technological revolution in agriculture began in earnest when in 1917 the use of the horse reached its zenith. *See generally* E. HIGBEE, FARM AND FARMERS IN AN URBAN AGE 7-44 (1963); Brake, *A Perspective On Federal Involvement In Agricultural Credit Programs*, 19 S.D.L. REV. 567 (1974); Doll, *Farm Debt as Related to Value of Sales*, 49 Fed. Res. Bull. 140 (1963); Leavitt, *A Bank Examiner Looks at Agricultural Lending*, 49 Fed. Res. Bull. 922 (1963).

[25] Real estate, of course, continues to serve as collateral for farm loans, but its predominance as that type of collateral has diminished. *See* Brake, *supra* note 24, at 589, 591-92.

[26] *See generally* R. HOFSTADTER, THE AGE OF REFORM, ch. 1 (1955).

[27] For example, until 1972, the Uniform Commercial Code, out of fear that a farmer could become a "peon" if he were able to encumber his crops for years to come, would not permit a farmer to mortgage future crops. *See* Hawkland, *supra* note 22, at 421. *See also* § 9-204(4)(a) (1962 version); § 9-312(2).

[28] Factor's lien acts were adopted by a majority of states and grew primarily out of the textile industry but were utilized in other industries as well. *See generally* Skilton, *The Factor's Lien on Merchandise—Part I*, 1955 WIS. L. REV. 356. Trust receipts, on the other hand, were originally a common law device and were later broadened by the Uniform Trust Receipts Act. *See generally* 1 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY, ch. 4 (1965).

[29] Professor Skilton argues that the factor's lien acts might apply depending on the language of the particular act, but he cites no evidence that farm lenders resorted to them. *See* Skilton, *supra* note 28, at 389.

[30] *See generally* 1 L. JONES, THE LAW OF CHATTEL MORTGAGES AND CONDITIONAL SALES §§ 54a & c (6th ed. 1933).

[31] *See generally* Gilmore & Axelrod, *Chattel Security: I*, 57 YALE L. J. 517, 529 (1948).

[32] *See generally* Skilton, *supra* note 28, at 363.

[33] It was the general rule of chattel mortgage law that a sale by the mortgagor does not defeat the interest of the mortgagee in the property. *See* Hathaway v. Brayman, 42 N.Y. 322 (1870); *contra*, Uniform Conditional Sales Act § 9; Uniform Trust Receipts Act § 9(2). There

ever, frequently did enjoy that protection. Under the early factor's acts,[34] for example, those who purchased farm commodities from a factor defeated the rights of a true owner if the owner had authorized the factor to sell or had entrusted the factor with a document of title.[35] It mattered not, however, whether the seller had limited the factor's authority. If the factor could sell, the true owner's conditions or limitations did not prevent the good faith purchaser from taking free of these conditions.[36] The Supreme Court held, furthermore, that the Uniform Warehouse Receipts Act yielded a similar result if the true owner entrusted a warehouse receipt to an agent.[37] These rules applied against not only the true owner but also against his creditors.[38] Thus, pre-Code rules favored security of property if the farmer marketed his goods himself, but favored commercial celerity if he marketed them by using documents of title or through a factor with authority to sell.

The drafting of the Code provided an appropriate occasion to re-examine these differences. Although these disparate rules seem to result from the historic forces that fashioned them and not from any conscious policy election, the Code accepted them almost intact.

CRITICISM OF THE RULE

Not surprisingly, commentators, who have traditionally championed the open market, accept the farm products exception with reluctance. While some of these commentators acknowledge the initial premise that farm financing is sui generis,[39] they are unable to articulate persuasive reasons for the separate classification, and they generally disapprove of the farm products exception.[40] Although various criticisms have been

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were exceptions, however, for cases of implied authority to sell, including sales by "traders" in the ordinary course of business. 2 L. JONES, *supra* note 30, §§ 457a-458.

34 The early factor's acts related to sales by factors of goods that were entrusted to them by the true owner. *See* 6 Geo. 4, ch. 94 (1825). These acts differed from the more recent factor's lien acts which related to factors who acted as inventory lenders. *See* N.Y. PERS. PROP. LAW § 45 (McKinney) (repealed 1964).

35 *See, e.g.*, N.Y. PERS. PROP. LAW § 43 (McKinney) (repealed 1964).

36 *See* Gazzola v. Kimball, 156 Tenn. 229, 299 S.W. 1039 (1927).

37 Commercial Nat'l Bank v. Canal-Louisiana Bank & Trust Co., 239 U.S. 520 (1916).

38 *Id.*

39 "Buyers of farm products are presumed to be professionals, and as such they are likely to know that security interests in what they buy are common." Coogan, *Public Notice Under the Uniform Commercial Code and Other Recent Chattel Security Laws, Including "Notice Filing,"* 47 IOWA L. REV. 289, 302 (1962). *See* Hawkland, *supra* note 22, at 418; Hunt & Coates, *The Impact of the Secured Transactions Article on Commercial Practices with Respect to Agricultural Financing*, 16 LAW & CONTEMP. PROB. 165, 170-71 (1951).

40 Professor Skilton, in discussing the official comment to § 9-307(1), expresses dismay that the comment offers little comfort "[t]o one who sees little or no justification in the first place" for the farm products exclusion. Skilton, *Some Comments on the Comments to the Uniform Commercial Code*, 1966 WIS. L. REV. 597, 625. *See also* Coates, *Financing the Farmer*, 20 PRAC. LAW. 45 (1974); Dugan, *Buyer-Secured Party Conflicts Under Section 9-*

forwarded against the farm products exception, two persuasively argue against this exception. The first concerns the unfairness and economic impact of holding that sales are subject to the inventory lender's security interest. The second stems from the fact that a party granted a purchase money security interest in after-acquired inventory need not give notice to the prior farm inventory lender.

Surprise and the "His Seller" Trap

The first criticism of the farm products exception usually centers on the unfairness that attends the fact that purchasers of farm products from farmers are often unaware that the vegetables they buy at the roadside stand are encumbered.[41] Critics are especially concerned about the application of the section to subsequent purchasers after the initial inventory sale by the farmer. The buyer-in-ordinary-course doctrine, under the language of section 9-307, applies only to security interests "created by *his* seller";[42] that is, the security interest is discharged only if it was one created by the person selling to the buyer in ordinary course. Therefore, the subsequent purchaser takes subject to the security interest created by the farmer, since the farmer is not "his seller." For example, if a farmer grants a security interest in his grain to a production credit association and then sells the grain to an elevator which, in turn, sells it to a broker, neither the elevator nor the broker take free of the association's security interest. The elevator, while it may fit the definition of a buyer in ordinary course, cannot avail itself of the buyer-in-ordinary-course rule of section 9-307(1), because it buys from a person engaged in farming operations. The broker also cannot avail himself of the section because, even though he may rise to the status of a buyer in ordinary course, he only takes free of security interests created by *his* seller: the elevator. The farmer created the security interest in question, and the broker, therefore, takes subject to it. Accordingly, commentators speculate in mock horror that a Palm Beach at the haberdasher's,[43] a box of cereal at the grocer's,[44] and a sizzling ribeye on the platter[45] may be subject to the lien of a farmer's lender.[46]

307(1) of the Uniform Commercial Code, 46 U. COLO. L. REV. 333 (1975); Hawkland, note 22 *supra*.

41 The simile is Professor Henson's. R. HENSON, HANDBOOK ON SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE 86 (1973). *See also* Coogan, *supra* note 39, at 301.

42 Section 9-307(1) (emphasis supplied).

43 *See* § 9-315. If goods, such as cotton, become part of a product, such as cloth, a perfected security interest in the cotton continues in the cloth. The rule applies to "cases where flour, sugar and eggs are commingled into cake mix . . . ." Section 9-315, Comment 3.

44 Coates, *supra* note 40, at 49.

45 Garden City Prod. Credit Ass'n v. Lannan, 186 Neb. 668, 677, 186 N.W.2d 99, 104 (1971) (Newton, J., dissenting).

46 "Security interests in farm products survive, regardless of perfection, well into the consumer's digestive tract." Dugan, *supra* note 40, at 362. *But cf.* First Nat'l Bank v.

The criticism implicit in these examples loses most of its bite, however, in light of the practical obstacles confronting the lender who chooses to pursue distant collateral.[47] Needless to say, a wheat crop financer will derive little economic benefit from chasing his debtor's wheat in grocery stores or kitchen cupboards. The criticism gains respectability, on the other hand, in situations where a slaughterhouse, grain elevator, cotton gin, or broker buys the farmer's products. In these instances the farm financer enjoys targets far less elusive and diffuse than products held by grocers and consumers. In fact, the cases indicate that financers are not reluctant to sue such defendants as brokers and slaughterhouses on conversion theories.[48]

The basis of the objection, then, is sound. Because of the "his seller" requisite of the buyer-in-ordinary-course rule, farm lenders can follow the collateral to purchasers who do not buy from the farmer. On the other hand, in the nonfarm situation, because the original buyer in ordinary course from a nonfarmer takes free and clear of the security interest, the buyer may pass the goods on to his buyers free of any such encumbrance.[49] Gauging the fairness of these differences depends in part on whether the purchaser losing the protection is a slaughterhouse or grain elevator rather than a consumer motoring through the countryside on a fine summer evening, and the justification for accepting or rejecting this criticism may well turn upon the way one perceives the farm purchaser.[50]

Boston, — Colo. App. —, 564 P.2d 964 (1977) (security interest in crops does not extend to cattle that ate them).

[47] These comments apply only in the context of agricultural sales. For a discussion of the "his seller" feature in other contexts, see Knapp, *Protecting the Buyer of Previously Encumbered Goods: Another Plea for Revision of UCC Section 9-307(1)*, 15 ARIZ. L. REV. 861 (1973).

[48] *See, e.g.*, United States v. Topeka Livestock Auction, Inc., 392 F. Supp. 944 (N.D. Ind. 1975); United States v. E.W. Savage & Son, Inc., 343 F. Supp. 123 (D.S.D. 1972), *aff'd*, 475 F.2d 305 (8th Cir. 1973); United States v. Hughes, 340 F. Supp. 539 (N.D. Miss. 1972); Farmers State Bank v. Stewart, 454 S.W.2d 908 (Mo. 1970); Farmers State Bank v. Edison Non-Stock Coop. Ass'n, 190 Neb. 789, 212 N.W.2d 625 (1973). Some of the conversion cases, by explaining marketing practices, demonstrate the full implication and adverse impact of imposing conversion liability on defendant brokers and slaughterhouses. For this reason some courts are reluctant to invoke a conversion rule. *See, e.g.*, United States v. Hext, 444 F.2d 804 (5th Cir. 1971).

[49] *See* § 9-307(1). That is not to say, however, that the "his seller" feature poses no problems outside the realm of agricultural commodities. It does, as Professor Knapp explains. *See* Knapp, note 47 *supra*.

[50] Whether it should so turn is another matter. "Perhaps a small country bank holding a small country mortgage makes a more appealing plaintiff than a national finance company doing a multi-million dollar business in inventory financing—but in fact these days the mortgagee is apt to be one of the many agencies of the United States which dabble in the farm credit business." 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 26.10, at 707 (1965). In one case it was not a buyer but a buyer's bank with a security interest in

Regardless of the fairness or unfairness of this subordination of the interests of subsequent purchasers of farm products, the farm products exception is subject to criticism on the basis of economic consequences. In theory many buyers of farm products are well aware of the exception and either go to the expense of a filing search or buy at their peril. As a result, such buyers must determine either the cost of the search or of the risk. The buyer then has three alternatives for accommodating these costs: he may increase the price to his customers, decrease the offering price to the farm seller, or accept the costs himself. Whatever alternative he selects, agricultural commerce ultimately bears the costs and the corresponding consequences in both domestic and international markets.

The Purchase Money Priority Problem

Even without the "unfair surprise" problem, the farm products rule confronts a second and more subtle criticism arising out of the inventory priority rules. Article 9 provides that a purchase-money secured party's rights to inventory will not take priority over a person having an earlier perfected security interest in the same inventory unless the purchase-money party gives notice.[51] Thus, for example, if a debtor grants a bank a floating security interest in inventory, that is, a security interest in all of its inventory whether then owned or thereafter acquired, and if the debtor subsequently grants a security interest to a supplier whose credit permits the debtor to acquire additional inventory, the supplier can defeat the bank only if it gives notice to the bank of the purchase money transaction.[52] The notice requirement protects the revolving inventory financer by virtue of the fact that it prevents the dilution of the collateral without his knowledge.[53] At the same time, it grants priority to a creditor who merits it: a creditor who provided the financial resources to purchase the after-acquired property. In short, the rule provides flexibility for inventory financing by facilitating a new source of credit to the debtor and protecting the original lender from surprise.

At the same time, as Professor Hawkland points out,[54] because farm products are not "inventory,"[55] financing of farm "inventory" (that is, farm products) does not qualify for such flexible treatment. Since farm products are not "inventory," a purchase-money sale of such goods falls within section 9-312(4), which contains no notice provision—and the

after-acquired property which sustained the loss. Baker Prod. Credit Ass'n v. Long Creek Meat Co., 266 Or. 643, 513 P.2d 1129 (1973).

51 Section 9-312(3).

52 *See, e.g.*, Redisco, Inc. v. United Thrift Stores, Inc. (*In re* United Thrift Stores, Inc.), 363 F.2d 11 (3d Cir. 1966).

53 Section 9-312, Comment 3.

54 Hawkland, *supra* note 22, at 418.

55 *See* text accompanying notes 8-15 *supra*.

revolving agricultural lender loses the benefit of the notice.[56] Thus, the lender may unknowingly be put in the position of being unable to satisfy his debt from the farmer and be forced to pursue the inventory collateral in the hands of subsequent purchasers. As we have seen, this inventory may be sufficiently dispersed to make this remedy impractical. This danger may deter the extension of revolving credit to farmers despite the fact that, as several authorities suggest, agricultural businesses need revolving credit[57] as a result of growing capital requirements. Similarly, because farm products are not inventory, proceeds from their sale elude the revolving lien farm lender, although such proceeds continue as collateral for the revolving inventory financer of other industries.[58] In short, the farm products exceptions from the inventory definition and from the open market rule, both of which ostensibly protect farmers and farm lenders, create an obstacle to one type of credit farmers need, even though both of these exceptions are ostensibly designed to protect farmers and farm lenders.[59]

Traditional Rationale for the Farm Products Exception

Notwithstanding these criticisms of the exception, courts and commentators advance two arguments in support of the exception. The first of these, that agricultural enterprises will not be able to secure credit without this "favorable" agricultural lending rule,[60] rings hollow against the arguments set out in the preceding portion of this article. It is difficult to see how a rule which hinders agricultural business, as the farm products exception does, can help the creditors of that business. Presumably, agricultural lenders, whether government-funded or not,[61] are just

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[56] *See* United States v. Mid-States Sales Co., 336 F. Supp. 1099, 1102 (D. Neb. 1971); Burlington Nat'l Bank v. Strauss, 50 Wis. 2d 270, 184 N.W.2d 122 (1971).

[57] *See, e.g.*, Bunn, note 22 *supra*; Clark, *Some Problems in Agricultural Lending Under the UCC*, 39 U. COLO. L. REV. 352 (1967); Hunt & Coates, *supra* note 39, at 180.

[58] This distinction is evident in the language of § 9-312(3) which limits the purchase money inventory priority to "identifiable cash proceeds received on or before delivery of the inventory" to the debtor's buyer. Section 9-312(4) extends the purchase money priority to all proceeds. Thus, § 9-312(3) tends to protect revolving "inventory" lenders' claims to proceeds. Because the intermediate revolving farm lender is not an "inventory" lender, he loses that additional protection. *See* § 9-312, Comment 3.

[59] This discussion does not necessarily apply in jurisdictions which have not adopted the 1972 amendments to article 9. *See generally* R. HENSON, *supra* note 41, § 6-5, at 137-38.

[60] While no one appears enthusiastic about this rationale for the rule, those who support the rule usually resort to it. *See* Note, *Agricultural Financing under the U.C.C.*, 12 ARIZ. L. REV. 391 (1970). *Cf.* 2 N.Y. LAW REVISION COMM'N, HEARINGS ON THE UNIFORM COMMERCIAL CODE 1285 (1954) (bank lawyer objecting to the general rule of § 9-307(1) on the theory that it imperils the lender's security).

[61] Although the article 9 review committee emphasizes the role of the federal government in agricultural lending, the government is not the only source of such credit. Commercial banks make more than 50% of the total non-real estate loans to farmers. Brake, *supra* note 24, at 592. Sellers of farm equipment and supplies to the extent that they sell on credit, also comprise a significant, though difficult to measure, component of the overall credit

as interested in promoting the sale of agricultural commodities and healthy prices as their borrowers are. Similarly, it is difficult to understand how intermediate term agricultural lending is enhanced by a rule which deprives it of the notice and proceeds protection the Code affords the rest of the commercial sector.

A second subtle and rarely articulated justification for the farm products rule stems from the idea that most agricultural sales differ fundamentally from most nonagricultural sales. This theory assumes the farm sale paradigm to consist of a small yeoman farmer selling his annual crop to a large, sophisticated grain company. Accordingly, the theory is premised on the belief that the sophisticated farm products purchaser, unlike the less sophisticated buyers of other goods, will be aware of the exception to the free market rule and will therefore take steps to protect himself.

Certainly not all farm transactions fit the model: the dairy industry and some livestock operations are notable exceptions.[62] Nevertheless, it is reasonable to assume that many, and perhaps most, do fit this model. The farm paradigm survives in part from the nation's historic image of subsistence farming and crafty brokers.[63] It may be inconsistent with modern realities of agricultural commerce[64] to picture all agricultural sales in such fashion, yet it may be consistent with many of those modern realities, and legislatures may design rules based on reasonable presumptions of what the realities of the situations are. It is an acknowledged fact that the drafters of the Code assumed the converse situation of strong sellers and relatively weak buyers as generally the case, and therefore fashioned some of the Code to serve that assumption, even though that assumption is also not always true.[65] Regardless of the reasonableness of

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picture. *See generally* ECON. RESEARCH SERVICE, U.S. DEP'T OF AGRICULTURE, *AFS-3 Agricultural Finance Statistics* (July 1976). [hereinafter cited as *AFS-3*].

[62] *See generally* Comment, *Proposed Anticorporate Farm Legislation*, 1972 WIS. L. REV. 1189, 1194, 1197-98.

[63] One court put the image in the following terms:

> I pay no compliment to that enterprising and intelligent class of men, the dealers in cotton, when I remark, that from personal observation I am persuaded, they are better judges of the quality and value of cotton, and will sooner detect its imperfections, and its intermixture with foreign materials, than even the grower himself, when they have equal opportunities. The grower has no other standard of quality than his own or his neighbor's crop.

Carnochan v. Gould, 17 S.C.L. (1 Bail.) 179, 182 (1829).

[64] "While family farms still exist in this country, farms operating on a subsistence basis rather than operating as businesses must now be a small part of the total occupation of farming." PERMANENT EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE, REVIEW COMMITTEE FOR ARTICLE 9 OF THE UNIFORM COMMERCIAL CODE, *Preliminary Draft No. 2*, at 15 (1970) [hereinafter cited as *Preliminary Draft No. 2*].

[65] "[T]he drafting assumes that the seller is the big fellow and the buyer the little fellow." Kripke, *The Principles Underlying the Drafting of the Uniform Commercial Code*, 1962 U. ILL. L.F. 321, 324.

these assumptions, however, the Code's widely adopted local filing option frustrates the purpose of the distinction.

If, in fact, purchasers from agricultural businesses are large and sophisticated business enterprises, it is reasonable to assume that they are or ought to be aware of the farm products rule. The local filing option reduces to futility, however, any effort on their part to discover the existence of a security interest.[66] A grain transaction illustrates the dilemma.

It is not enough for a Kansas City broker to know that the grain he acquires comes from Texas, Nebraska, or Kansas. He must determine the county where the owner of the grain resides or, if the owner does not reside in the state from which the grain originates, the county where the grain was grown.[67] Such an inquiry requires that the buyer discover the identity of the producer—an investigation which is complicated by the fact that the buyer may not be dealing with the producer but with the producer's buyer or another intermediate party. Thus, a broker may be dealing with an elevator which has acquired its grain from a number of growers. A broker may be dealing with a cattle-feeding operation, which fattens cattle and acts as selling agent for dozens of investors,[68] any of which may have granted a security interest in his own cattle. Finally, the "his seller" characteristic confounds the inquiry not only for the first buyer but for each subsequent buyer down the chain of buyers until the goods are sufficiently dispersed to render the secured party's attempts to locate them inefficient. If the buyer decides not to search, he cannot be sure that title is good.[69]

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[66] Professor Dugan goes a step further: "[I]t is fatuous to expect buyers in ordinary course to check the Article 9 filings." Dugan, *supra* note 40, at 344 n.39.

[67] This example assumes that the local filing rules of the second and third alternatives to subsection (1) of § 9-401 or analogous nonconforming provisions are in force, as indeed they are in all but five jurisdictions. *See* note 16 *supra*. Those alternative subsections provide that the place to file for farm products is the local filing office in the county of the debtor's residence or, if the debtor is not a resident of the state, then in the county where the goods are kept. When the collateral is growing crops there must be a filing in the county where the land is located.

[68] *See, e.g.*, Swift & Co. v. Jamestown Nat'l Bank, 426 F.2d 1099 (8th Cir. 1970); *In re* Charolais Breeding Ranches, Ltd., 20 U.C.C. Rep. Serv. 193 (W.D. Wis. 1976). *See also In re* Cadwell, Martin Meat Co., 10 U.C.C. Rep. Serv. 710 (E.D. Cal. 1970); Bank of Madison v. Tri-County Livestock Auction Co., 123 Ga. App. 768, 182 S.E.2d 687, *rev'd*, 228 Ga. 325, 185 S.E.2d 393 (1971); Clark, note 57 *supra*.

[69] He can rely, of course, on his cause of action for breach of warranty of title under § 2-312. Any suggestion, however, that this cause of action provides buyers with sufficient protection misunderstands the basic presupposition of the open market rule: a cause of action by itself is insufficient. *See generally* Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057 (1954). Several states have anticipated the problem and made provision for central filing of financing statements for livestock. *See, e.g.*, California, Maine, and Oregon versions of § 9-401(1)(c). CAL. COM. CODE § 9401(1)(c) (West Cum. Supp. 1977); ME. REV. STAT. tit. 11, § 9-401(1)(c) (West Cum. Supp. 1976-77); OR. REV.

In sum, the notion that agricultural commodity buyers are sufficiently sophisticated to protect themselves by searching and therefore do not need the protection of an open market rule rests on insecure footing. Practically speaking, such buyers cannot protect themselves, and the consequences are uncertainty and economic loss for the agricultural commodity markets.

THE PERMANENT EDITORIAL BOARD AND THE EXCEPTION: A CRITIQUE OF THE UNIFORMITY RATIONALE

Early drafts of the Code characterized its farm exception to the open market rule as nothing more than the acceptance of a historic rule.[70] The 1950 Proposed Final Draft fostered market freedom in all but farm sales, and achieved the exception in much the same fashion as the present Code by excluding "farm products" from the definition of inventory[71] and by limiting market freedom to sales of inventory.[72] In addition, the 1950 Proposed Final Draft's definition of inventory recognized that the processing of farm products alters the character of those products so that they become the farmer's inventory.[73] In short, Code drafters provided early that a farmer can hold and sell inventory, making him subject to both the open market rule and the inventory rules, but only in the infrequent situation where the farmer has processed his farm products.[74] Subsequent drafts of the Code, while varying the language of the operative sections, maintained and even strengthened this dichotomy between inventory and farm products.[75]

This twenty-year commitment to the farm products exception

STAT. § 79.4010(1) (Oregon Digest 1977). *See also* MONT. REV. CODES ANN. § 52-319 (Smith Cum. Supp. 1975). In Montana a notice of livestock lien must be listed in the office of state stock inspectors stationed at the several "central livestock markets" for an auctioneer to be liable in conversion.

70 *See* § 9-307, Comment 2 (1950 version). Professor Gilmore described it as an instance of article 9 "bowing before the weight of case law authority." 2 G. GILMORE, *supra* note 50, at 714.

71 Section 9-109(5) (1950 version).

72 Section 9-307(1) (1950 version).

73 "Goods" are farm products, the 1950 version said, only if they are in their "unmanufactured state." Section 9-109(4) (1950 version).

74 The present official version lists "ginned cotton, wool-clip, maple syrup, milk and eggs" as being sufficiently "unmanufactured" to fit the farm products definition. Section 9-109(3).

75 The 1951 *Proposed Final Draft No. 2* removed all purchases of agricultural goods, whether farm products or inventory, from the open market rule. *See* §§ 1-201(9), 9-307(1) (1951 version). The official text of 1952, the first of the drafts adopted by the sponsoring agencies, continued this broad exemption of sales by farmers. *See* §§ 1-201(9), 9-307(1) (1952 version). It was not until the 1957 official version that the Code retrenched from the broad farm exception by limiting it to farm products alone as opposed to farm goods, thereby reinstating processed farm products as inventory. *See* § 9-307(1) (1957 version). With minor changes, the balance struck in the 1957 Code prevails today. *See* §§ 9-109(3), 9-307(1).

confronted the review committee appointed by the permanent editorial board to consider changes in article 9.[76] That committee proposed to treat farm sales as any other business sale. The board, however, rejected the change.[77]

The review committee's recommendation assumed that the farm products exception was rooted in pre-Code rules,[78] questioned the advisability of retaining it, and noted: "Feelings run strong on this issue . . . ."[79] It suggested that the federal government "insists on the preservation of its security interest on farm products as against buyers or auctioneers . . . ."[80]

In short, the committee, even though it supported the change, expressed reluctance based on two assumptions: first, the strength of historic forces and local feeling fosters unwillingness among the states to accept such a change; and second, the federal government would resist such a change. Both of these assumptions entail the danger of lack of uniformity,[81] and they may have prompted the board's ultimate decision not to change the rule. The following discussion of the profferred justifications for the farm products rule includes an analysis of these assumptions. That analysis suggests that the assumption that the federal government would resist the change is incorrect, and that lack of uniformity endures even though the states may be hostile to the change.

Role of the Federal Government

In the early 1930's, the federal government's role in agricultural financing broadened from real estate lending to comprehensive agricultural credit.[82] Today, crops, livestock, and equipment serve directly or indirectly as collateral for government loans through a complex network of government agencies[83] which provide credit for a significant percent-

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76 *See* PERMANENT EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE, FINAL REPORT at vii-ix (1971) [hereinafter cited as FINAL REPORT].

77 *See Preliminary Draft No. 2, supra* note 64, at 15-16; FINAL REPORT, *supra* note 76, at 209. The committee suggested the change as an "optional" amendment. *Id.*

78 *Preliminary Draft No. 2, supra* note 64, at 15.

79 FINAL REPORT, *supra* note 76, at 209.

80 *Id.*

81 The Code commands that its provisions be construed liberally and applied to promote its underlying purposes, one of which is "to make uniform the law among the various jurisdictions." Section 1-102(2)(c). The review committee affirmed the importance of uniformity in article 9. "[I]t would be a great mistake to introduce serious nonuniformity into any fundamental aspect of operations under Article 9." *Preliminary Draft No. 2, supra* note 64, at 1. *See also* FINAL REPORT, *supra* note 76, at vii.

82 *See* 2 G. GILMORE, *supra* note 50, § 32.3.

83 The federal government's role in agricultural lending includes both direct loans through the Farmers Home Administration and indirect loans through the farm credit system, which includes federal land bank associations, farm cooperatives, and production credit associations. *See generally* Brake, note 24 *supra*.

age of all agricultural financing.[84] In the past, the government has not hesitated to use the attractiveness of its credit as a lever to direct change in state law to make its position more secure.[85]

Commercial lawyers, including those instrumental in drafting the Code, are ever conscious that the Code is peculiarly state law.[86] Most federal courts hold that federal, not state, law applies to suits in which the federal government is itself a party.[87] If the assumptions of the editorial review committee are correct that the farm products exception benefits farm lenders (to whom the federal government has made substantial commitments), and that federal courts and Congress fashion federal law to protect federal agencies, then a change in the Code's farm products exception might prompt federal courts or Congress to reject the Code rule. Accordingly, these two assumptions merit examination.

Economic Benefit of Farm Product Exception to Farm Lenders.— The previously discussed economic objections to the farm products rule support the argument that the rule does not benefit agricultural lenders. The whole purpose of the open market concept is to foster sales. Except for the unwary buyer, buyers of farm products from the farming enterprise must either inquire as to the state of the title or take it at their peril. Both the inquiry and risk of clouded title clearly impede the free flow of agricultural commodities and thereby may have a depressing effect on farm prices and sales. This economic impact would not benefit agricultural lenders.

The unwary buyer, of course, will fail to compute that peril into his price. He is the most likely prey of the agricultural lender under the present rule. An argument justifying the exception from such a state of facts is hardly persuasive. No supporter of the exception has mustered the temerity to make it expressly. One wonders, however, whether it is not implicit in much of the pressure of the federal agency lobby.

In brief, it is difficult to bottom the farm exception rule on the plight of the unwary buyer and more difficult to defend the rule's harmful consequences for agriculture itself, which, one would assume, Congress

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[84] The most recent data indicate that the federal government's role in farm real estate debt approximates 36% of the amount loaned and in non-real estate farm debt approximates 41% of the amount loaned. *See AFS-3, supra* note 61, Tables 2, 19.

[85] In order to enjoy the full benefit of the farm credit program, many states modified their crop mortgage statutes in the 1930's. *See* Gilmore & Axelrod, *supra* note 31, at 536.

[86] Congress has adopted the Code for the District of Columbia. *See* D.C. CODE § 28:1-101 (1967).

[87] *See, e.g.*, Clearfield Trust Co. v. United States, 318 U.S. 363 (1943); United States v. Hext, 444 F.2d 804 (5th Cir. 1971); Cassidy Comm'n Co. v. United States, 387 F.2d 875 (10th Cir. 1967); United States v. Carson, 372 F.2d 429 (6th Cir. 1967); United States v. Wegematic Corp., 360 F.2d 674 (2d Cir. 1966); United States v. Sommerville, 324 F.2d 712 (3d Cir. 1963), *cert. denied*, 376 U.S. 909 (1964); Cargill, Inc. v. Commodity Credit Corp., 275 F.2d 745 (2d Cir. 1960); United States v. Matthews, 244 F.2d 626 (9th Cir. 1957).

intended to benefit from the agricultural lending program.[88] Accordingly, there is little to commend the position that the rule's justification lies in its benefit to agricultural lenders or that Congress should so view it.

Judicial Alteration of Federal Law to Protect Federal Agencies.— The second assumption which underlies the board's adherence to the farm products exception is the assumption that federal courts fashion rules which are most favorable to federal agencies. The foregoing analysis questioned whether the exception would in fact be beneficial to federal interests. However, even assuming that the exception benefits farm lenders and the federal agencies committed to them, it is questionable that this benefit would motivate federal courts to retain the farm exception rule notwithstanding its elimination from the Code. A close look at the rule of federal cases reveals that uniformity of result is the principal reason for judicial adoption of federal commercial law which differs from state commercial law; and, accordingly, that the uniformity of a Code rejection of the farm products exception would prompt federal adherence to that result regardless of any putative federal benefit of retaining the rule.

The leading case dealing with judicial formulation of federal commercial law different from applicable state law is *Clearfield Trust Co. v. United States*.[89] In *Clearfield Trust* a check issued by the federal government was cashed with a forged indorsement. The payee was not given notice of the forged indorsement until more than fifteen months later, at which time the federal government instituted suit to recover the amounts paid. Rather than apply state negotiable instruments rules, which require prompt notice, and therefore would have yielded a result adverse to the government, the Supreme Court resorted to the "federal law merchant."[90] The Court held that delay in notice was a defense only if actual damage to the payee was shown and, in effect, fashioned a rule to accommodate the bureaucratic vastness of the national government.[91]

While the factual holding in *Clearfield* supports the board's fear that the federal courts would favor the federal government, the language and rationale of *Clearfield* are far more reassuring: "The application of state law . . . would subject the rights and duties of the United States to exceptional uncertainty. It would lead to great diversity in results by making identical transactions subject to the vagaries of the laws of the several states. The desirability of a uniform rule is plain."[92] A proper

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88 *See generally* Brake, note 24 *supra*. *See also* 12 U.S.C. § 2001 (1976).

89 318 U.S. 363 (1942).

90 *Id.* at 367.

91 *Id.* at 369-70.

92 *Id.* at 367. *See also* D'Oench, Duhme & Co. v. F.D.I.C., 315 U.S. 447, 472 (1942) (Jackson, J., concurring) ("Federal law is no juridical chameleon changing complexion to match that of each state wherein lawsuits happen to be commenced because of the accidents of service of process and of the application of the venue statutes.").

reading of *Clearfield*, then, reveals two concerns: first, that the government cannot be subject to rules fashioned for private litigants and therefore unrealistic in their application to the government; and second, that the government should not be subject to the vagaries and uncertainties that obtain in the absence of uniformity.

Lower federal court decisions have carefully observed *Clearfield*'s uniformity rationale and therefore should dispel the concern that federal courts will accede to a federal insistence on the farm products exception. These decisions have held that the federal court prerogative of choosing federal common law over state law arises in those situations where a "genuine federal interest would be subjected to uncertainty by application of disparate state rules."[93] That federal interest prevails especially in instances involving the federal fisc.[94] This is not to say, however, that federal courts must fashion a rule to favor the government in all instances. "Rather, the thrust of this consideration is that federal rights should not be at the mercy of the power of any particular state court or legislature to change the applicable law."[95] While a majority of the circuits favor application of the federal rule in farm sale cases,[96] that majority emphasizes the uniformity rationale of the *Clearfield* line of authority,[97] and those which eschew the federal rule do so on the grounds that the need for uniformity is not compelling.[98] In accord with the uniformity rationale, federal courts reflect a ready willingness, furthermore, to incorporate the

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[93] United States v. Sommerville, 324 F.2d 712, 714-15 (3d Cir. 1963), *cert. denied*, 376 U.S. 909 (1964). Significantly, the *Sommerville* court rejected Pennsylvania's Code, which it saw as peculiarly state law, as it largely was in 1963. *See also* New York, N.H.&H. R. Co. v. Reconstruction Fin. Corp., 180 F.2d 241, 244 (2d Cir. 1950): "[S]uch agencies, being national in their scope and aim, shall not be forced to shape their transactions to conform to the varying laws of the places where they occur, or are to be carried out."

[94] United States v. Hext, 444 F.2d 804, 810 n.18 (5th Cir. 1971); Cassidy Comm'n Co. v. United States, 387 F.2d 875, 878 (10th Cir. 1967); United States v. Sommerville, 324 F.2d 712, 716 (3d Cir. 1963), *cert. denied*, 376 U.S. 909 (1964).

[95] United States v. Hext, 444 F.2d 804 (5th Cir. 1971). Significantly, the *Hext* court, whose opinion reflects strong support for a uniform federal rule, held against the Farmers Home Administration.

[96] *Compare* United States v. Hext, 444 F.2d 804 (5th Cir. 1971); Duvall-Wheeler Livestock Barn v. United States, 415 F.2d 226 (5th Cir. 1969); Cassidy Comm'n Co. v. United States, 387 F.2d 875 (10th Cir. 1967); United States v. Carson, 372 F.2d 429 (6th Cir. 1967); United States v. Sommerville, 324 F.2d 712 (3d Cir. 1963), *cert. denied*, 376 U.S. 909 (1964); United States v. Hughes, 340 F. Supp. 539 (N.D. Miss. 1972), *with* United States v. Union Livestock Sales Co., 298 F.2d 755 (4th Cir. 1962); United States v. Kramel, 234 F.2d 577 (8th Cir. 1956).

[97] United States v. Sommerville, 324 F.2d 712, 715 n.8 (3d Cir. 1963), *cert. denied*, 376 U.S. 909 (1964) ("The necessity of uniformity must decide whether state law should be rejected as the source for the applicable federal rule."). *See* United States v. Union Livestock Sales Co., 298 F.2d 755 (4th Cir. 1962); United States v. Kramel, 234 F.2d 577 (8th Cir. 1956); United States v. Topeka Livestock Auction, Inc., 392 F. Supp. 944 (N.D. Ind. 1975).

[98] *See* United States v. Kramel, 234 F.2d 577, 581 (8th Cir. 1956).

provisions of uniform state laws into the federal common law rules. For example, provisions of the Uniform Sales Act[99] and of the Negotiable Instruments Law[100] found their way into federal common law as have the provisions of article 2.[101] Similarly, the federal bench recognizes that the Code is truly "national law"[102] and accepts it enthusiastically as an indication of what general law should be.[103] One federal opinion refers to article 9 as the "principal fount of general commercial law governing secured transactions."[104]

Not surprisingly, the Code's role as a source of federal law stems not only from its reputation as a work of scholarship,[105] but above all from the uniformity it has achieved.

> When the states have gone so far in achieving the desirable goal of a uniform law governing commercial transactions, it would be a distinct disservice to insist on a different one for the segment of commerce, important but still small in relation to the total, consisting of transactions with the United States.[106]

Accordingly, federal courts carefully avoid peculiarly local variations of the Code and refer instead to the official version.[107] The Second Circuit, which wholeheartedly endorses the Code as a source of federal common law,[108] earlier rejected the Uniform Warehouse Receipts Act as a source upon one question, because state courts divided sharply on the meaning of that statute.[109] It is, therefore, in its role as a restatement that the Code serves as the source of the federal law.[110]

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99 Whitin Mach. Works v. United States, 175 F.2d 504, 509 (1st Cir. 1949).

100 New York, N.H.&H. R. Co. v. Reconstruction Fin. Corp., 180 F.2d 241, 244-45 (2d Cir. 1950).

101 Lea Tai Textile Co. v. Manning Fabrics, Inc., 411 F. Supp. 1404, 1405 (S.D.N.Y. 1975).

102 United States v. First Nat'l Bank, 470 F.2d 944, 946 n.3 (8th Cir. 1973); Fruehauf Corp. v. Yale Express Sys., Inc. (*In re* Yale Express Sys., Inc.), 370 F.2d 433, 437 (2d Cir. 1966).

103 *See* Duvall-Wheeler Livestock Barn v. United States, 415 F.2d 226 (5th Cir. 1969); Cassidy Comm'n Co. v. United States, 387 F.2d 875 (10th Cir. 1967); United States v. Carson, 372 F.2d 429 (6th Cir. 1967); Fruehauf Corp. v. Yale Express Sys., Inc. (*In re* Yale Express Sys., Inc.), 370 F.2d 433 (2d Cir. 1966); United States v. Wegematic Corp., 360 F.2d 674 (2d Cir. 1966). *Cf.*, Mahon v. Stowers, 416 U.S. 100 (1974) (per curiam) (the Court concluded that the applicable federal law (Packers and Stockyard Act) did not override the U.C.C. (TEX. BUS. & COM. CODE)).

104 United States v. Hext, 444 F.2d 804, 809-10 (5th Cir. 1971).

105 Traynor, *Statutes Revolving In Common-Law Orbits*, 17 CATH. U.L. REV. 401, 424 (1968).

106 United States v. Wegematic Corp., 360 F.2d 674, 676 (2d Cir. 1966).

107 *See* United States v. First Nat'l Bank, 470 F.2d 944, 946 n.3 (8th Cir. 1973).

108 *See* Fruehauf Corp. v. Yale Express Sys., Inc. (*In re* Yale Express Sys., Inc.), 370 F.2d 433 (2d Cir. 1966); United States v. Wegematic Corp., 360 F.2d 674, 676 (2d Cir. 1966).

109 Cargill, Inc. v. Commodity Credit Corp., 275 F.2d 745 (2d Cir. 1960).

110 Traynor, *supra* note 105, at 422; Fairbanks, Morse & Co. v. Consol. Fisheries Co., 190 F.2d 817, 822 n.9 (3d Cir. 1951).

Admittedly, nothing in these decisions commands the application of the Code to federal questions. Some courts defer to it in the absence of federal authority,[111] and one respected jurist recently urged Congress to adopt the Code in order to avoid the "disturbing prospect" of disparity between federal commerce law and the Code.[112] Nevertheless, an analysis of the federal cases does not support the eventuality, implicit in the review committee's concern, that the federal courts will insist upon the farm products exception. The federal agencies which are lobbying for the rule do not make federal common law, and federal courts do not fashion that common law in order to favor those federal agencies. Instead, federal courts fashion law to achieve certainty and uniformity and to effectuate the purpose of federal programs.[113] The excision of the farm products exception from section 9-307(1) would not endanger those objectives, making it likely that the federal courts will follow such an amendment and not retain the old exception.

Actual Disuniformity in Farm Products Cases

The permanent editorial board does not appear to have been any more concerned with rationalizing the farm products exception than were the original drafters of the free market rule when they engrafted the farm products exception onto it. Rather, the concern of both the original drafters and the board in this area was with uniformity. The answer to this concern for uniformity is a historical fact which the board apparently overlooked: state courts and legislatures have already deviated from the exception, so that there is in fact no uniformity. In addition, courts have often done violence to useful principles of commercial law, thereby giving rise to harmful precedent and jeopardizing other achievements of the Code in the area of commercial lending. The remainder of this article will discuss the theories under which courts and legislatures have sought to avoid the effect of the farm products exception.

Waiver.—The 1950 Proposed Final Draft of the Code stipulated in section 9-306 that by taking a security interest in proceeds, an inventory lender gave his debtor authority to sell and waived the lender's security interest when the sale was effected.[114] The rationale for this proposed "rule of construction"[115] presumed that the security interest in proceeds reflects a financing arrangement wherein the lender expects the debtor to

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[111] United States v. Humboldt Fir, Inc., 426 F. Supp. 292, 296-97 (N.D. Cal. 1977).

[112] Bank of America v. United States, 552 F.2d 302, 303 n.1 (9th Cir. 1977) (opinion of Clark, J.).

[113] United States v. Carson, 372 F.2d 429, 432 (6th Cir. 1967) ("Where a decision is likely to have a substantial effect on the implementation of a federal program, then a federal court should declare a rule consistent with the program's demands.").

[114] Section 9-306(2) (1950 version).

[115] *Id.*, Comment 2(b).

sell the goods and expects the buyer, having given value, to take free and clear. Bank spokesmen criticized what they saw as unrelieved market freedom in this and other purchaser provisions of the 1950 and subsequent drafts.[116] Professor Gilmore, one of the chief draftsmen of article 9, defended the notion that the secured party should be satisfied with proceeds.[117] The bankers prevailed, however, when the 1957 Official Draft retreated somewhat by excising any reference in the text of the statute to the notion that taking a security interest in proceeds amounts to a waiver and constitutes authorization for sale. The notion survived, however, in the comments,[118] and Professor Gilmore maintained his original position.[119] It was not until the 1972 revisions that the drafters entirely eliminated from even the comments the idea that the taking of proceeds is an indication of waiver of the security interest on sale.[120]

Nonetheless, section 9-306 stands as strong support for the waiver argument by providing that an authorization to sell the secured collateral destroys the security interest. Such an authorization may be found in the security agreement itself or may arise "otherwise." The term "otherwise" invites courts to construe actions of the creditor as waivers amounting to sale authorization, and the rule of section 1-103, which directs that the law of equity and the principle of estoppel "shall supplement" the provisions of the Code, underscores that invitation. Courts accept the concept of waiver as intrinsic to that section.[121]

As this paper noted earlier, in most industries inventory lenders traditionally recognized the need for intermediate term, working capital loans with inventory as collateral, as opposed to discrete inventory loans. They have authorized the sale of inventory without the bother of prior approval. By virtue of such authority, those sales become free of the lender's lien under section 9-306(2). However, in the agriculture industry farm lenders traditionally have refused to grant such authorization in the security agreement.[122] As this article also suggests, historic features of

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116 2 N.Y.LAW REVISION COMM'N, HEARINGS ON THE UNIFORM COMMERCIAL CODE 1123, 1321-22 (1954).

117 *Id.* at 1184.

118 Section 9-306, Comment 3 (1962 version).

119 2 G. GILMORE, *supra* note 50, § 26.11.

120 In fact, the 1972 drafters were not satisfied with merely deleting the language from the comment. They specifically rejected the notion that the taking of proceeds is any implication of waiver. "The right to proceeds, either under the rules of this section or under specific mention thereof in a security agreement or financing statement does not in itself constitute an authorization of sale." Section 9-306, Comment 3. This change may reflect the fact that the 1972 Code also stipulates, contrary to earlier drafts, that unless the security agreement otherwise provides, the secured party has a security interest in proceeds. Section 9-203(3).

121 Multiplastics, Inc. v. Arch Indus., Inc., 166 Conn. 280, 348 A.2d 618 (1974). *See* 1 ANDERSON'S UNIFORM COMMERCIAL CODE § 1-103:51, at 36 (2d ed. 1970).

122 Even though farm lenders have not authorized sale in the security agreement itself, these lenders in practice have not insisted on notice by the farm debtor prior to an inventory

agricultural lending, rather than logic, explain that refusal. In any event, coupled with the farm products exception of section 9-307(1) (itself a product of those same historic features), that refusal confronts courts with a formidable obstacle to any open market result. A few courts, however, have proved equal to the task.

The leading case reaching an open market result is *Clovis National Bank v. Thomas*.[123] There the lender conducted itself in the fashion often repeated throughout many of these cases and throughout much of agricultural finance. The bank forbade the sale of collateral without its prior written consent. At the same time, true to the reality of intermediate term financing, the bank permitted the borrowing rancher to sell his cattle without that consent. Instead, the bank relied on his honesty to account for the proceeds either by paying the bank or by acquiring new cattle inventory. This "course of conduct," the court ruled, amounted to a waiver of the condition that sale must be consented to in writing. The waiver of the condition left the sale authorized, and, pursuant to the rule of section 9-306(2), such an authorized sale operated to place the collateral in the hands of the purchaser free of the bank's lien.[124]

Some critics promptly attacked the *Clovis* reasoning.[125] They noted the Code's command that express terms control over course of dealing when the two cannot be construed together reasonably.[126] Since the course of dealing in *Clovis* suggests no requirement for written authority

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sale. In Colorado Bank & Trust Co. v. Western Slope Inv., Inc., 36 Colo. App. 149, 539 P.2d 501 (1975), the security agreement forbade sales without the written consent of the bank. The bank's loan officer testified that he never required his borrowers to obtain that consent. He said that he relied on their honesty alone. ***See generally*** Hawkland, *supra* note 22, at 419; Hunt & Coates, *supra* note 39, at 170-71. Other cases indicate that with marked consistency farm lenders, including government agencies, do not insist on such notice as evidenced through their course of dealing or usage of trade. *See, e.g.*, United States v. Hext, 444 F.2d 804 (5th Cir. 1971); Cassidy Comm'n Co. v. United States, 387 F.2d 875 (10th Cir. 1967); United States v. Sommerville, 324 F.2d 712 (3d Cir. 1963), *cert. denied*, 376 U.S. 909 (1964); United States v. Central Livestock Ass'n, 349 F. Supp. 1033 (D.N.D. 1972); United States v. E.W. Savage & Sons, Inc., 343 F. Supp. 123 (D.S.D. 1972), *aff'd*, 475 F.2d 305 (8th Cir. 1973); United States v. Pirnie, 339 F. Supp. 702 (D. Neb. 1972), *aff'd per curiam*, 472 F.2d 712 (8th Cir. 1973); *In re* Cadwell, Martin Meat Co., 10 U.C.C. Rep. Serv. 710 (E.D. Cal. 1970); Planters Prod. Credit Ass'n v. Bowles, 256 Ark. 1063, 511 S.W.2d 645 (1974); Lisbon Bank & Trust Co. v. Murray, 206 N.W.2d 96 (Iowa 1973); Farmers State Bank v. Edison Non-Stock Coop. Ass'n, 190 Neb. 789, 212 N.W.2d 625 (1973); Garden City Prod. Credit Ass'n v. Lannan, 186 Neb. 668, 186 N.W.2d 99 (1971); Clovis Nat'l Bank v. Thomas, 77 N.M. 554, 425 P.2d 726 (1967); Blubaugh v. Ponca City Prod. Credit Ass'n, 9 U.C.C. Rep. Serv. 786 (Okla. Ct. App. 1971); Burlington Nat'l Bank v. Strauss, 50 Wis. 2d 270, 184 N.W.2d 122 (1971). ***See generally*** §§ 1-205(1) & (2). ***But see*** Fort Collins Prod. Credit Ass'n v. Carroll Dairy, 553 P.2d 95, 97 (Colo. App. 1976).

[123] 77 N.M. 554, 425 P.2d 726 (1967).

[124] The tension underlying the *Clovis* situation is not new to agricultural commerce. *See, e.g.*, Patridge v. Minnesota & D. Elev. Co., 75 Minn. 496, 78 N.W. 85 (1899).

[125] *See, e.g.*, 20 BAYLOR L. REV. 136 (1967); 8 NAT. RESOURCES J. 183 (1968).

[126] Section 1-205(4).

and since the express terms do require it, reasonable construction of the two does not obtain, and the Code's preference for express terms applies.

Professor Dugan[127] contends that in situations similar to *Clovis* the course of dealing section is inapposite and that the course of performance section controls.[128] Course of dealing comprises a "sequence of previous conduct between the parties to a particular transaction which is fairly to be regarded as establishing a common basis of understanding . . . ."[129] The term "previous" means "previous to the agreement," according to the comments.[130] Course of performance involves conduct *after* the agreement.[131] Although in *Clovis* it appears that the conduct was pre-agreement,[132] certainly many, if not most, cases will involve post-agreement conduct.

In any event, the same problem is posed for the *Clovis* defenders by the course of performance section—it designates express terms controlling when those terms and course of performance cannot reasonably be construed together.[133] Professor Dugan argues,[134] however, that subsection 3 of the course of performance section renders course of performance "relevant to show a waiver or modification" of any term inconsistent with the course of performance.[135] If this argument is correct, the waiver issue may turn in part on the question whether the conduct occurred before or after the agreement. This position suffers, however, from the fact that the course of performance provision is located in the sales article and by its terms applies only to a "contract for sale." These factors suggest that application of the course of performance provision to a security agreement is inappropriate.[136]

There remains, however, a second criticism of the *Clovis* court's reliance on course of dealing. That criticism stems from the fact that the party benefiting from the course of dealing in *Clovis* was not a party to it, and, so far as the opinion discloses, did not even know about it. The Code

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127 Dugan, *supra* note 40, at 340-41.

128 Section 2-208.

129 Section 1-205(1).

130 Section 1-205, Comment 2.

131 Section 1-205, Comment 2; § 2-208(1).

132 77 N.M. at 557-58, 425 P.2d at 727-28. There had been more than one security agreement. The court found that the bank knew of sales without prior written consent under earlier security agreements but had no actual knowledge of sales during the term of the security agreement under which the bank was claiming.

133 Section 2-208(2). *See* § 1-205(4).

134 Dugan, *supra* note 40, at 340-41.

135 "[T]he preference is in favor of 'waiver' whenever such construction . . . is needed to preserve the flexible character of commercial contracts and to prevent surprise or other hardship." Section 2-208, comment 3.

136 Professor Dugan, however, rejects the notion that the course of performance section applies only to sales contracts. He contends that §§ 9-105(4) and 1-201(3) support extension of the course of performance rule to security agreements. Dugan, *supra* note 40, at 340.

expressly defines course of dealing as dealing "between the parties to a particular transaction."[137] The reason for this limitation is to respond to the reasonable expectations and reliance of the parties and not of some stranger.[138] The course of performance section may be given the same construction.[139] The comments to that section note that the reason for the rule is to "prevent surprise or other hardship."[140] Further support for this construction is found in the fact that the section makes it clear that a course of performance arises out of conduct by one party only when the other party has had an opportunity to object to that conduct.[141]

The *Clovis* decision, by allowing a third party to take advantage of the course of dealing between other parties, does not use the course of dealing provision in this restricted manner. This broader construction, however, is more correct. It does not matter that the effect of this reasoning is to benefit a stranger to the course of dealing, because section 9-306(2) itself operates to carry the effect beyond the immediate parties to that conduct. If the secured party had authorized the sale expressly, a cattle auctioneer ignorant of that authorization would, nonetheless, escape that liability because section 9-306(2) directs that an authorization to sell renders the sale free of the security interest. By the same token, if the course of dealing between the secured party and the debtor results in an authorization to sell, it does not matter that the auctioneer is a stranger to it. The reason behind the course of dealing section does not justify its extension to strangers, but the reason behind section 9-306(2) does.

In addition, some cases criticize the *Clovis* court's use of the waiver doctrine on the grounds that the bank did not intend to waive its security interest. Traditionally, the argument goes, the doctrine of waiver includes a requirement of knowledge.[142] It is only the *knowing* waiver which the law considers. Courts have rejected waiver arguments based on inadvertent conduct or conduct which the actor does not reasonably know will cost him a contract right.[143] In *Clovis*, however, the bank must be charged with the knowledge that since it had not insisted upon prior written approval on previous occasions, the court might conclude that such conduct amounted to a waiver of the prior written approval requirement. It is also fair to infer that waiver of the requirement for prior written consent amounts to an authorization to sell.

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137 Section 1-205(1).

138 *See* Weidinger Chevrolet, Inc. v. Universal C.I.T. Credit Corp., 501 F.2d 459, 463 (8th Cir.), *cert. denied*, 419 U.S. 1033 (1974).

139 The term "other" in § 2-208(1) must be taken to mean the other *party*.

140 Section 2-208, Comment 3.

141 Section 2-208(1).

142 *See* Multiplastics, Inc. v. Arch Indus., Inc., 166 Conn. 280, 288, 348 A.2d 618, 623 (1974) ("Waiver is the intentional relinquishment of a known right.")

143 *See, e.g.*, Kane v. American Nat'l Bank, 21 Ill. App. 3d 1046, 316 N.E.2d 177 (1974).

Courts which eschew *Clovis* nonetheless refuse to accept this reasonable imputation of knowledge of waiver. They reason that while the lender knew it was waiving the *prior consent requirement*, and may reasonably be charged with knowledge it was waiving the prohibition against sale, it did not know it was waiving its *security interest* in the goods.[144]

Those cases, however, require too much, because section 9-306(2) renders it unnecessary to show a waiver of the security interest. It is only necessary to show a waiver of the prohibition of sale. Section 9-306(2) does the rest. It provides that an authorization to sell operates as a rule of law to render the sale free of the security interest. There is nothing in section 9-306(2) which suggests that the rule applies only if the secured party intends to waive its security interest. The waiver by the Clovis Bank of the prohibition against sale clearly falls within the "or otherwise" language of the section, thereby terminating the security interest upon the event of the sale. The better reasoned cases so hold.[145]

Some anti-*Clovis* courts advance the argument that lenders who waive the prior consent requirement do so on condition that the debtor will remit the proceeds to the lender.[146] That argument ignores the language of section 9-306(2), which charges a sale authorization with the legislative implication that the sale will be free of the security interest. Courts which infer such a condition are allowing the private agreement to frustrate not only the reason but also the letter of section 9-306(2). That provision, an open market rule, is designed to protect purchasers.[147] Permitting the lender and seller to modify it by a condition is as unjustified as permitting an entruster and bailee to modify the rule of section 2-403(2) by private agreement.

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144 Rather, these courts conclude that the secured party's knowledge was limited to the fact that it was waiving only the prior written consent requirement. *See, e.g.*, United States v. Sommerville, 324 F.2d 712 (3d Cir. 1963), *cert. denied*, 376 U.S. 909 (1964); Vermilion County Prod. Credit Ass'n v. Izzard, 111 Ill. App. 2d 190, 249 N.E.2d 352 (1969); Farmers State Bank v. Edison Non-Stock Coop. Ass'n, 190 Neb. 789, 212 N.W.2d 625 (1973); Garden City Prod. Credit Ass'n v. Lannan, 186 Neb. 668, 186 N.W.2d 99 (1971).

145 *E.g.*, Farmers Nat'l Bank v. Ceres Land Co., 32 Colo. App. 290, 512 P.2d 1174 (1973); Draper v. Minneapolis-Moline, Inc., 100 Ill. App. 2d 324, 241 N.E.2d 342 (1968); Tanbro Fabrics Corp. v. Deering Milliken, Inc., 39 N.Y.2d 632, 350 N.E.2d 590, 385 N.Y.S.2d 260 (1976); Credit Plan, Inc. v. Hall, 9 U.C.C. Rep. Serv. 514 (Okla. Ct. App. 1971).

146 *See, e.g.*, United States v. Hughes, 340 F. Supp. 539 (N.D. Miss. 1972); United States v. Pirnie, 339 F. Supp. 702 (D. Neb. 1972), *aff'd per curiam*, 472 F.2d 712 (8th Cir. 1973); Baker Prod. Credit Ass'n v. Long Creek Meat Co., 266 Or. 643, 513 P.2d 1129 (1973). *Cf.* South Omaha Prod. Credit Ass'n v. Tyson's, Inc., 189 Neb. 702, 204 N.W.2d 806 (1973) (express condition, known to buyer, prevents operation of § 9-307(1)).

147 Section 9-306(2) is both a security of property provision to the extent that it allows the security interest to follow the collateral into the hands of the purchaser and an open market provision to the extent that it excepts from that rule collateral sold pursuant to a sale that is authorized by the security agreement or otherwise. It is in the second sense that the text of this article refers to § 9-306(2) as an open market provision.

In short, there is a colorable argument for invoking waiver in the frequently occurring *Clovis* situations. Although *Clovis* misconstrues the course of dealing provision, an argument for waiver can be made from the course of performance after the agreement—at least such an argument can be made if courts are willing to apply the course of performance provision to secured transactions under article 9. In any event, *Clovis* has spawned a vigorous line of authority.[148] It should be noted, however, that these cases represent the minority rule; a majority of courts have rejected the waiver theory either because *Clovis* misinterprets course of dealing, or, more spuriously, because courts hold the waiver to be conditioned on the prepayment of sale proceeds to the secured party.[149]

Estoppel.—In addition to the *Clovis* waiver argument, one district court has adopted an estoppel theory which *Clovis* specifically rejected. In *United States v. Gleaners & Farmers Cooperative Elevator Co.*,[150] the defendant grain elevator purchased crops from a farmer that had obtained financing from the United States Department of Agriculture. When the defendant discovered the financing statement filed by the United States, which apparently contained a general description of the collateral, it asked the chief official of the local Farmers Home Administration (FHA) whether the security interest covered the farmer's crops. The official replied that the security interest covered only livestock and farm machinery, and, as a result, the defendant purchased the crops. The district court held that the government was estopped to bring an action for conversion on the basis of its actual lien on the crops because the grain

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[148] *See, e.g.*, Swift & Co. v. Jamestown Nat'l Bank, 426 F.2d 1099, 1104 (8th Cir. 1970); United States v. Central Livestock Ass'n, 349 F. Supp. 1033 (D.N.D. 1972); *In re* Cadwell, Martin Meat Co., 10 U.C.C. Rep. Serv. 710 (E.D. Cal. 1970); Planters Prod. Credit Ass'n v. Bowles, 256 Ark. 1063, 511 S.W.2d 645 (1974); Hedrick Savings Bank v. Meyers, 229 N.W.2d 252 (Iowa 1975); Lisbon Bank & Trust Co. v. Murray, 206 N.W.2d 96 (Iowa 1973); Central Washington Prod. Credit Ass'n v. Baker, 11 Wash. App. 17, 521 P.2d 226 (1974).

[149] *See* United States v. Sommerville, 324 F.2d 712 (3d Cir. 1963), *cert. denied*, 376 U.S. 949 (1964); United States v. Topeka Livestock Auction, Inc., 392 F. Supp. 944 (N.D. Ind. 1975); United States v. E.W. Savage & Sons, Inc., 343 F. Supp. 123 (D.S.D. 1972), *aff'd*, 475 F.2d 305 (8th Cir. 1973); United States v. Hughes, 340 F. Supp. 539 (N.D. Miss. 1972); United States v. Pirnie, 339 F. Supp. 702 (D. Neb. 1972), *aff'd per curiam*, 472 F.2d 712 (8th Cir. 1975); United States v. Big Z Warehouse, 311 F. Supp. 283 (S.D. Ga. 1970); United States v. Greenwich Mill & Elevator Co., 291 F. Supp. 609 (N.D. Ohio 1968); Colorado Bank & Trust Co. v. Western Slope Inv., Inc., 36 Colo. App. 149, 539 P.2d 501 (1975); Vermilion County Prod. Credit Ass'n v. Izzard, 111 Ill. App. 2d 190, 249 N.E.2d 352 (1969); Farmers State Bank v. Edison Non-Stock Coop. Ass'n, 190 Neb. 789, 212 N.W.2d 625 (1973); Garden City Prod. Credit Ass'n v. Lannan, 186 Neb. 668, 186 N.W.2d 99 (1971); First Nat'l Bank v. Calvin Pickle Co., 11 U.C.C. Rep. Serv. 1245 (Okla. Ct. App.), *rev'd on other grounds*, 516 P.2d 265 (Okla. 1973); Blubaugh v. Ponca City Prod. Credit Ass'n, 9 U.C.C. Rep. Serv. 786 (Okla. Ct. App. 1971).

[150] 314 F. Supp. 1148 (N.D. Ind. 1970). *Cf.* Muir v. Jefferson Credit Corp., 108 N.J. Super. 586, 262 A.2d 33 (1970) (nonfarm case).

elevator company was reasonably entitled to rely on the representations made by the highest local official of the FHA.[151]

Estoppel facts, of course, are less likely to arise than are waiver facts, and they probably yield results which are fair and which do not interfere seriously with the availability of farm credit. One difficulty, however, which confronts the estoppel argument is that some courts, unlike the court in *Gleaners*, refuse to apply estoppel against the government.[152] Thus, any significant expansion of the estoppel doctrine would yield a lack of uniformity in the frequent cases where the federal government is the plaintiff. Most courts, however, have rejected estoppel arguments on one theory or another.[153]

Limitations on Parties Subject to Conversion Liability.—In *United States v. Kramel*,[154] the Eighth Circuit applied pre-Code Missouri decisions which held that livestock commission merchants were not liable in conversion for dealing in cattle contrary to the lienholder's rights.[155] The Missouri cases[156] had construed the Federal Packers and Stockyards Act as imposing public utility status on the stockyard along with a duty to provide stockyard services without discrimination. That duty, the Missouri courts felt, relieved the stockyard from conversion liability.

The Missouri Supreme Court's decision to overrule the Missouri precedent on which *Kramel* relies renders *Kramel* suspect.[157] Yet, some states[158] through legislation of their own have effectively neutralized conversion claims against certain classes of defendants and thereby sub-

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151 314 F. Supp. at 1151.

152 *See, e.g.*, United States v. E.W. Savage & Sons, Inc., 343 F. Supp. 123 (D.S.D. 1972), *aff'd*, 475 F.2d 305 (8th Cir. 1973). *Cf.* United States v. Hughes, 340 F. Supp. 539 (N.D. Miss. 1972) (a waiver case).

153 *See, e.g.*, United States v. Topeka Livestock Auction, Inc., 392 F. Supp. 944 (N.D. Ind. 1975); United States v. E.W. Savage & Sons, Inc., 343 F. Supp. 123 (D.S.D. 1972), *aff'd*, 475 F.2d 305 (8th Cir. 1973); Farmers State Bank v. Edison Non-Stock Coop. Ass'n, 190 Neb. 789, 212 N.W.2d 625 (1973); Clovis Nat'l Bank v. Thomas, 77 N.M. 554, 425 P.2d 726 (1967); Blubaugh v. Ponca City Prod. Credit Ass'n, 9 U.C.C. Rep. Serv. 786 (Okla. Ct. App. 1971); Layng v. Stout, 155 Wis. 553, 145 N.W. 227 (1914).

154 234 F.2d 577 (8th Cir. 1956).

155 *Accord*, United States v. Union Livestock Sales Co., 298 F.2d 755 (4th Cir. 1962); United States v. Sommerville, 211 F. Supp. 843 (W.D. Pa. 1962), *aff'd on other grounds*, 324 F.2d 712 (3d Cir. 1963), *cert. denied*, 376 U.S. 909 (1964); States Securities Co. v. Norfolk Livestock Sales Co., 187 Neb. 446, 191 N.W.2d 614 (1971).

156 Cresswell v. Leftridge, 194 S.W.2d 48 (Mo. App. 1946); Blackwell v. Laird, 236 Mo. App. 1217, 163 S.W.2d 91 (1942), *overruled*, Farmers State Bank v. Stewart, 454 S.W.2d 908 (Mo. 1970).

157 Farmers State Bank v. Stewart, 454 S.W.2d 908 (Mo. 1970).

158 *See, e.g.*, GA. CODE ANN. § 109A-9-307(3) to (4) (1973); MONT. REV. CODES ANN. § 52-319 (1975); NEB. REV. STAT. § 69-109.01 (1968). *See also* note 169 *infra*; State Securities Co. v. Norfolk Livestock Sales Co., 187 Neb. 446, 191 N.W.2d 614 (1971).

courts to accept the consequences of the farm products exception—a resistance which, as here, may yield holdings that produce variation, not uniformity, in Code law.

Negotiable Documents of Title.—There remains a subtle challenge to the farm products exception with far reaching implications. An actual case illustrates it best. In *United States v. Hext*[165] the farmer delivered his cotton for marketing to a gin, which processed the cotton and warehoused it against negotiable warehouse receipts. The secured party, the government, knew of the delivery to the cotton gin and knew that the gin company was closely related to the warehouse company. When the warehouse sold the cotton, the government sued it on a conversion theory. The Fifth Circuit reversed the district court's judgment for the government, reasoning, in waiver or estoppel fashion, that the secured party's conduct prevented it from disputing the authority of the defendant warehouse.

More significantly, as an alternate theory for its holding, the court relied on section 7-503. That provision restricts the negotiability of documents of title by providing that the documents confer no right in goods against a person (such as the government in the *Hext* case) who had obtained a security interest in the goods prior to the issuance of the document by the bailee. In short, the section operates in the spirit of security of property principles. The provision, however, does not escape open market precepts altogether, for it stipulates that its security of property rule shall not apply if the secured party "acquiesced" in the procurement by the bailor of the document of title, or if the secured party "delivered or entrusted" the goods to the bailee with actual or apparent authority to "ship, store or sell" or otherwise deal with the products in a fashion that article 2 and article 9 would consider as calling for open market principles.[166] Applying this provision, the court held that the government had entrusted the cotton to the farmer with the apparent authority to store the cotton in the warehouse.[167] The court further held that the government had acquiesced in the procurement of warehouse receipts since it knew that it was the custom of the trade to market cotton in that manner and took no steps to prevent it.[168]

The *Hext* opinion is significant for three reasons. First, the secured party in *Hext* was the Farmers Home Administration. Thus if *Hext* were to arise today in a state limiting the liability of commodity merchants, a court applying federal law would follow rules far different from those commanded by the state statute.[169] *Hext*, then, demonstrates how the

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165 444 F.2d 804 (5th Cir. 1971).

166 Section 7-503(1)(a)-(b).

167 United States v. Hext, 444 F.2d 804, 814-15 n.34 (5th Cir. 1971).

168 *Id.*

169 As the *Hext* opinion noted, the Texas legislature modified the rule of conversion liability of cotton brokers in apparent response to the district court's decision against the

federal law–state law dichotomy can contribute to a lack of uniformity.

Second, because the defendant was a warehouseman, rather than an auctioneer, the court could have relied on section 7-404. That section provides that a warehouseman is not liable in conversion if he observes reasonable commercial standards and in good faith delivers the goods to the holder of negotiable receipts.[170] That specific provision of article 7, of course, contrasts sharply with the rule of liability which generally faces auctioneers and brokers under the Code and under the common law of conversion in most states. Section 7-404 parallels the state statutes, mentioned earlier, that limit conversion liability; it has the same effect of contributing to the diversity of result in these cases.

The *Hext* decision also furthers disuniformity in a much more fundamental and significant way. The "acquiesced" and "entrusted" language of section 7-503, taken with the reference in it to section 2-403, signals an invitation to use waiver and estoppel principles to achieve open market results. Professor Gilmore concludes that any time a lender leaves with the debtor goods which are inventory in nature, such as farm commodities, the lender has entrusted these goods for the purposes of section 7-503.[171] Similarly, if a lender leaves farm goods with a farmer in an area or industry where farmers traditionally warehouse products, and the lender takes no steps to prevent this practice, then for purposes of section 7-503(1)(b) the lender will have acquiesced in the procurement of documents of title. Whether a secured party otherwise "delivered" or "entrusted" with apparent authority, or whether the secured party "acquiesced" in the procurement of the warehouse receipt, are factual issues similar to issues such as "negligence" or "reasonableness." Such concepts lend themselves to characterization and are appropriately resolved by trial; they do not fix parameters or lead to uniformity. To the contrary, their vagueness fosters diversity. This disuniformity feature is likely to be substantial. A significant number of agricultural businesses effect the sale of farm products through negotiable warehouse receipts, and, to the extent that they do, courts may be able to reach results different from those that would obtain under the farm products exception.

CONCLUSION

Out of a desire for uniformity and a need to come to terms with strong local feelings, the Code perpetuates a historic rule excluding many

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cotton broker. 444 F.2d at 809. *See* TEX. REV. CIV. STAT. ANN. art. 5571 (West Cum. Supp. 1978).

170 In fact, the *Hext* court did refer to § 7-404 with respect to the warehouse defendant. 444 F.2d at 814-15 n.34. *Cf.* §§ 8-318, 3-419(3) (which attempt to create similar conversion immunity for agents dealing in investment securities and depository banks, respectively).

171 2 G. GILMORE, *supra* note 50, § 25.4, at 666. The pre-Code cases, using waiver and estoppel theories, support Professor Gilmore. *See, e.g.*, Commodity Credit Corp. v. Usrey, 199 Ark. 406, 133 S.W.2d 887 (1939).

farm sales from open market principles. The exclusion stems first from the origins of agricultural finance, which developed under conditions different from that of other commercial finance; second, from archaic notions of agricultural commerce; and third, from the perception that agricultural sales are sufficiently different from other sales to merit different treatment.

The unique history of agricultural finance goes far in explaining the farm products exception. Agricultural lenders, enjoying protection from the open market, are reluctant to relinquish what they see as their preferred status. The nation's romance with the sturdy, yeoman farmer dies slowly, and even though thoughtful economists agree that agricultural credit needs parallel those of the rest of the economy, the myth persists, thereby impeding entry of agricultural commerce into the open market. The argument that agricultural sales may be unique in that most farm sellers are small and most farm buyers big, falls before the impossible search burdens imposed by the local filing rule and the "his seller" feature of section 9-307(1).

While some may argue that the rule is necessary as a course to achieve uniformity in the face of the insistence of the federal government and many state legislatures, close analysis renders the validity of the argument suspect. There is little in the federal cases to justify the charge that federal courts ignore good sense to fashion law favorable to government agencies. In fact, the cases support the contrary view. On the other hand, the insistence of state legislatures is very real, but no more real than the insistence of other state legislatures and state courts to the contrary.

The attempt to effect uniformity through the farm products exception has not succeeded. It is abundantly clear that in the face of results which strike courts and legislatures as unfair, the farm products rule falls. Furthermore, the Code itself through the "or otherwise" language of section 9-306(2), and the documents of title rules of sections 7-503 and 7-404, provides ample inroads against the rule for the imaginative and resourceful lawyer or judge, thereby further increasing disuniformity. What is more, the farm products exception has resulted in a strong line of cases which seriously misconstrue the Code's course of dealing provision and other Code sections.

The farm products exception has bred sprawling diversity through legislation, common law exceptions, and provisions within the Code itself. The review committee's recommendation that the exception be optional or be deleted altogether was a realistic alternative which, while not achieving the unobtainable uniformity, would have gone far in avoiding the baleful consequences the rule has fostered. In brief, such change would remove unnecessary fetters on farm financing and would permit commerce in agricultural commodities to assume its place in the open market.

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UCC Issues

KEITH G. MEYER*

Should Congress Repeal the Farm Products Rule of Section 9-307(1) of the Uniform Commercial Code?

Section 9-306(2) of the UCC is the starting point for this article. It provides:

> Except where this Article otherwise provides, a security interest continues in collateral notwithstanding sale, exchange or other disposition thereof unless the disposition was authorized by the secured party in the security agreement or otherwise and also continues in any identifiable proceeds. . . .

The major exception to this rule concerns a buyer in the ordinary course[1] and it is found in Section 9-307(1). It provides that a buyer in the ordinary course takes free of a perfected security interest created by his seller. Thus, when a farmer buys a combine from an implement dealer or a television from an appliance dealer who has granted a bank a security interest in inventory, the sale to the farmer severs the bank's interest in the merchandise. Yet, under Section 9-307(1), the buyer in the ordinary course will not take free of a prior perfected security interest when the buyer buys *farm products* "from a person engaged in farming operations."[2] This means that unless the secured party has somehow authorized the sale, a buyer of farm products will take subject to a prior perfected security interest.

There has been a considerable amount of litigation concerning this issue. The courts are split as to who wins.[3] The basic issue is whether

* Professor of Law, University of Kansas, where he teaches courses in Commercial and Agriculture Law.

[1] U.C.C. § 1-201(9).

[2] There is no definition of farming operations in the UCC. Some courts have broadly defined it, see K.L. Smith Enter. v. United Bank of Denver, 28 U.C.C. Rep. (Callaghan) 534, 2 Bankr. 280 (Bankr. Colo. 1980), and some have construed it narrowly *In re* Blease, 24 U.C.C. Rep. (Callaghan) 450 (Bankr. N.J. 1978). See also First State Bank v. Maxfield, 485 F.2d 71 (10th Cir. 1973); United States v. Next, 444 F.2d 804 (5th Cir. 1971); First State Bank v. Producers Livestock Mktg. Ass'n, 200 Neb. 12, 261 N.W.2d 854 (1978); Cox v. BancOklahoma Agri-Serv. Corp., 641 S.W.2d 400 (Tex. App. 1982).

[3] Cases holding for the secured party are, e.g., Duvall-Wheeler Livestock Barn v. United States, 415 F.2d 226 (5th Cir. 1969); United States v. Hughes, 340 F. Supp. 539 (N.D. Miss. 1972); Colorado Bank & Trust Co. v. Western Slope Inv., Inc., 539 P.2d 501 (Colo. App. 1975); Vermillion County Prod. Credit Ass'n v. Izzard, 249 N.E.2d 352 (Ill. App. 1969); Garden City Prod. Credit Ass'n v. Lannon, 186 N.W.2d 99 (Neb. 1971); Fisher v. First Nat'l Bank, 548 S.W.2d 515 (Tex. Civ. App. 1979).

Cases holding for the purchaser are, e.g., First Nat'l Bank & Trust Co. v. Iowa Beef Processors, Inc., 626 F.2d 764 (10th Cir. 1980) (security agreement did not have clause requiring prior written consent to sell); United States v. Central Livestock Ass'n, Inc., 349 F. Supp. 1033 (N.D. 1972)

the lender had authorized the sale.

What the States Have Done

State legislatures have reacted in a variety of ways. California has eliminated the rule; others have modified it. Some have required the farmer to submit a list of potential buyers to the lender who must notify these buyers. If the buyers are notified, they must write a joint payee check unless otherwise directed.[4] Approximately fourteen states had changed Section 9-307(1) as of the fall of 1983. This, coupled with the strong push of the livestock industry, apparently prompted bills to be introduced in the U.S. Senate and House to federally repeal the farm products portion of Section 9-307(1).[5] This column will focus briefly on the validity of the rule and whether Congress should be the body to change it.

Reasons for the Rule

A number of arguments have been advanced for the farm products rule. Some have argued that buyers from farmers should be treated differently because farmers sell their products through agents or sell to financially sophisticated buyers. These business operators are, or should be, aware of the need to check the filed financing statements, which is not the case with most consumer buyers. Another consideration is that many farm operations are cyclical in nature. Most of the products come into existence at one time of the year and are often sold in a large unit. Farm lenders recognize this and generally expect payments only when products are sold. Thus, the lender has all of its expectations and security tied up in one asset. It has been argued that this is like a bulk sale and deserves to be treated differently.[6]

If the farm products rule were totally eliminated, the lender would lose a substantial protection. Moreover, the lender would have no leverage with the potential buyers concerning who should be named as payee of the check when products subject to a security interest are sold. Also, the creditor would never be able to determine who all of the potential buyers are

(authorization given under § 9-306(2)); Hedrick Sav. Bank v. Myers, 229 N.W.2d 252 (Iowa 1975) (prior course of dealing showed authorization); Lisbon Bank & Trust Co. v. Murray, 206 N.W.2d 96 (Iowa 1973) (authorization course of dealing); North Cent. Kansas PCA v. Washington Sales Co., 557 P.2d 35 (Kan. 1978) (express consent or authorization); Clovis Nat'l Bank v. Thomas, 425 P.2d 726 (N.M. 1967) (acquiescence and implied consent, which the legislature amended in § 9-306(2) to read "a security interest in farm products and the proceeds thereof shall not be considered waived by the secured party by any course of dealing between the parties or by any trade usage"). Cf. United States v. Hext, 444 F.2d 804 (5th Cir. 1971).

[4] Examples are Indiana and Ohio.

[5] S.2190, 98th Cong., 1st Sess. (1983) (would have amended the Agriculture & Food Act of 1981), H.R. 3296 and H.R. 3297, 98th Cong., 1st Sess. (1983).

[6] Cf. U.C.C. Art. 6.

inasmuch as grain and livestock can be easily transported out of the local area. This is in marked contrast to the notice filing system currently in effect under the Code that makes it possible to determine who might have a security interest.

Assuming the creditor is not able to ensure being named as a joint payee on the check, it will have to establish procedures to assure that the proceeds from the sale of the covered collateral are identifiable as required by Section 9-306(2). The contrast to other businesses is arguably striking. In many other business operations, particularly dealing with expensive goods, the proceeds will consist of chattel paper, which is fairly easy to police and identify. For the farm lender to keep proceeds identifiable, it would mean keeping the farmer from commingling them with other funds. This has historically been very difficult when farmers are involved, inasmuch as farmers are generally paid by check that is deposited in a general checking account. This means big trouble for a lender because under Section 9-306(4)(d) of the Code, the lender would be entitled *only* to proceeds from the sale of commodities deposited in the account within ten days of insolvency proceedings.[7] Finally, assuming that a change of Section 9-307(1) would create substantially more risk for the lender, it would appear that the lender would loan less, require much more in the way of collateral or guarantors, or raise costs. Also, this could well put further pressure on the federal government to get more involved in the lending business inasmuch as the Farmers Home Administration's current requirements are that borrowers are not eligible unless credit is otherwise not available. Of course, there is always the possibility of the creditor being able to obtain an insurance policy to cover this risk.

Reasons Against Keeping the Rule

Buyers and agents make many arguments supporting their view that the rule is unjustifiable. The risk of nonpayment has been in effect shifted to the buyer. The free-flow-of-commerce principle, which is the basis of the ordinary buyer taking free of a prior perfected security interest, applies to farm products as well as the inventory of the appliance store, i.e., farmers

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[7] *In re* Gibson Prods., 543 F.2d 652 (9th Cir. 1976). Section 9-306(4)(d) provides:

> [I]n all cash and bank accounts of the debtor, if other cash proceeds have been commingled or deposited in a bank account, but the perfected security interest under this paragraph (d) is . . .
>
> (ii) limited to an amount not greater than the amount of any cash proceeds received by the debtor within ten days before the institution of the insolvency proceedings and commingled or deposited in a bank account prior to the insolvency proceedings less the amount of cash proceeds received by the debtor and paid over to the secured party during the ten day period.

should be treated as any other business. The lender will still have a security interest in the proceeds. Moreover, it is too costly and impractical for purchasers of farm products to check the appropriate records. And, farmers do not tell the buyers in advance of sale dates. This is a particular problem for the livestock industry in that many packers buy from multistate areas and they are required to pay before the close of the next business day.[8] This rule has resulted in many livestock buyers obtaining insurance.

As indicated earlier, some states have placed the burden on the farmer to provide a list of buyers to the lender who must notify the buyers. At least two states make it a crime for the farmer to sell to anyone not on the list.[9] It is inappropriate, the author believes, to exercise the criminal process when dealing primarily with a creditor's rights and collection problem.

Moreover, before using the criminal process or eliminating the rule, central filing for financing statements covering farm products with easy and quick access to the filed financing statements should be tried. One state, Iowa, has had this in operation for some time. Farm products are filed with the secretary of state and there is a private search firm that will provide the information immediately by phone. All concerned seem to be happy with this rule.

[8] 7 U.S.C.A. § 228b (West Supp. 1980).

[9] See note 4 *supra*.

It would also seem that with the advance of the computer age, it should be easier to technically provide instate access to filed information through what are called "dumb terminals," or by some other means. One problem cited is cost, but it seems that, if the legislatures will not siphon the revenue, the users, those searching as well as filing, would pay for the system.

Congress Should Not Interfere

Irrespective of whether the rule should be changed, it should not be done by Congress unless it is essentially going to federalize the whole UCC. There are a number of reasons for this. The regulation of commercial transactions has been traditionally done at the state level. The fact that the states have different versions of Section 9-307(1) is not an appropriate justification for federal legislation because this is not the only part of the UCC that is nonuniform. More than twenty states (Arkansas, Florida, Georgia, Indiana, Iowa, Kansas, Kentucky, Michigan, Missouri, Montana, Nebraska, North Dakota, Ohio, Oklahoma, Oregon, South Dakota, Texas, Utah, Washington, Wisconsin, and Wyoming) have amended Section 2-315, which deals with implied warranties when livestock is sold. There are three basic filing rules in effect in the forty-nine states that have adopted the UCC. At least ten states utilize so-called alternative 1, some twenty-three use some version of alternative 2, and fourteen use alternative 3. The others use something else. The

point is that there are a variety of filing rules in effect. There is also a split in the states as to whether a farmer is a merchant for purposes of the Statute of Frauds in Section 2-201(2).[10] Finally, farmers are upset about Sections 2-403 and 7-205, which provide that farmers' stored grain, sold by the storing warehouse, cannot be retrieved by the farmer from a good-faith purchaser or buyer in the ordinary course if the warehouse fails to pay the farmer. State legislatures have been asked in the past to reverse this rule and will be asked again to change the rule. If farmers are unsuccessful at the state level, they would surely seek federal legislation if Section 9-307(1) were to be changed.

Even if Section 9-307 were to be changed, buyers of crops produced on rented land would still have to contend with unpaid landlords in many states. Landlord liens are excluded from coverage of the UCC by Section 9-104(b). Thus, priority battles would be decided by some other law. Some states have by statute provided that a purchaser of crops, produced on rented land, takes subject to a landlord's lien and some states have case law to the same effect. "The person entitled to the rent may recover from the purchaser of the crop, or any part thereof, with notice [actual and constructive] of the lien the value of the crop purchase, to the extent of the rent due and damages."[11] There are also certain cases reaching the same result.[12]

When thinking about this issue, the U.S. Supreme Court decision in *United States v. Kimbell Foods, Inc.*,[13] should be considered. It essentially concluded that there was no need for a federal uniform law that "would disrupt commercial relationships predicated on state law." *Kimbell* dealt with the question of which law should determine priority between a federal lender and private liens where there was not a federal statute setting priorities. It stated:

> To resolve this question, we must decide first whether federal or state law governs the controversies; and second, if federal law applies, whether this Court should fashion a uniform priority rule or incorporate state commercial law. We conclude that the source of law is federal, but that a national rule is unnecessary to protect the federal interests underlying the loan programs. Accordingly, we adopt state law as the appropriate federal rule for establishing the relative priority of these competing federal and private liens.
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> This Court has consistently held that federal law governs questions involving the rights of the United States

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[10] See, e.g., Nelson v. Union Equity Coop. Exch., 548 S.W.2d 352 (Tex. 1977) (farmer is a merchant). Contra Decatur Coop. Ass'n v. Urban, 547 P.2d 323 (Kan. 1976) (farmer is not a merchant). See also Annot., 95 A.L.R.3d 484 (1979).

[11] Kan. Stat. Ann. § 58-2526 (1976).

[12] Cleveland v. McNabb, 312 F. Supp. 155 (W.D. Tenn. 1970); Holmes v. Riceland Foods, Inc., 546 S.W. 414 (Ark. 1977); Pryor v. Rathjen, 199 N.W.2d 327 (Iowa 1972).

[13] 440 U.S. 715 (1979).

> arising under nationwide federal programs. . . .
>
> Guided by these principles, we think it clear that the priority of liens stemming from federal lending programs must be determined with reference to federal law. The SBA and FHA unquestionably perform federal functions within the meaning of Clearfield [Trust Co. v. United States, 318 U.S. 363, 63 S. Ct. 573, 87 L. Ed. 838 (1943)]. . . .
>
> That the statutes authorizing these federal lending programs do not specify the appropriate rule of decision in no way limits the reach of federal law. . . .
>
> Federal law therefore controls the Government's priority rights. The more difficult task, to which we turn, is giving content to this federal rule.
>
> Controversies directly affecting the operations of federal programs, although governed by federal law, do not inevitably require resort to uniform federal rules. . . .
>
> Undoubtedly, federal programs that "by their nature are and must be uniform in character throughout the Nation" necessitate formulation of controlling federal rules. . . . Conversely, when there is little need for a nationally uniform body of law, state law may be incorporated as the federal rule of decision. Apart from considerations of uniformity, we must also determine whether application of state law would frustrate specific objectives of the federal programs. If so, we must fashion special rules solicitous of those federal interests. Finally, our choice of law inquiry must consider the extent to which application of a federal rule would disrupt commercial relationships predicated on state law.
>
> Because the state commercial codes "furnish convenient solutions in no way inconsistent with adequate protection of the federal interest[s]" . . . we decline to override intricate state laws of general applicability on which private creditors base their daily commercial transactions.

While there is no doubt that the economic hard times on the farm have caused many to focus on the farm products rule, the rule should not be rejected without some serious thought being given to what impact it will have upon the availability of credit. Credit has become an essential part of most farm operations today, and if the lenders were to severely cut back on loans, it could have a substantial impact on farmers. Those particularly vulnerable are the younger and not-well-established farmers. Moreover, there is not much hard data establishing that buyers have had to pay twice a substantial number of times. Finally, if buyers and lenders alike could be protected by central filing and very quick access to the filed information, it should be tried. In any event, the appropriate body to consider the problem is the permanent editorial board of the Uniform Commercial Code, not Congress.

Farm products for purpose of Article 9 of the UCC

by Keith Meyer

Under 9-102(1) any credit transaction intended to create a security interest in personal property triggers the application of Article 9. Tangible personal property is divided into four classes of property: "consumer goods, "equipment," "farm products" and "inventory." These classifications are mutually exclusive and correct classification of the goods is crucial to proper creation and perfection of a security interest. Recently there has been considerable interest in the difference between "farm products" and "inventory."

In order to be "farm products" under section 9-109(3) the goods must be a crop or product of a crop or livestock, in the possession of the debtor who is engaged in a farming operation. The possession requirement is probably the most troublesome. Remember, however, that to have farm products all three of the requirements must be satisfied.

The possession issue can arise when a farmer stores grain in a commercial warehouse or when the debtor's cattle are being fattened in someone else's commercial feedlot. Each of these situations will be briefly considered.

At harvest a grain farmer will generally store some or all of the crop on the farm or at a local elevator because cash prices tend to be lowest at harvest. When the farmer stores the harvested grain on his farm there is no problem with the possession requirement inasmuch as the debtor-farmer has physical possession of the grain. The grain stored in an elevator or warehouse is another matter.

Upon deposit of the grain in the elevator, the farmer will generally receive either a negotiable or nonnegotiable warehouse receipt.[1] Clearly, the grain is still owned by the farmer and he will be entitled to sell it whenever he chooses, but he obviously does not have physical possession of the grain. Moreover, since it is a fungible product, the exact grain deposited will have been commingled with other similar grain. Assuming a warehouse receipt has been issued,[2] a document of title[3] is now involved and the question is, can the grain still be classified as "farm products"? While there is a crop or a product of a crop, there is a problem with the requirement that the grain be in the possession of a debtor engaged in farming.

Possession is not defined in the Code and therefore it is unclear precisely what the drafters meant. If possession means physical possession by the farmer who owns the grain, it would mean that the grain deposited in the elevator ceased to be "farm products." Also, the elevator is not engaged in farming and this presents a problem in view of comment 4 to 9-109 which provides in part:

> "When crops or livestock or their products come into the possession of a person not engaged in farming operations they cease to be 'farm products.' If they come into the possession of a marketing agency for sale or distribution or of a manufacturer or processor as raw materials, they become inventory."

Consequently, the creation and perfection of a security interest in the warehouse receipt would be of primary concern.[4]

On the other hand, it can be argued that if the drafters wanted possession to be construed broadly, the warehoused grain could still be considered to be in the possession of the farmer. Some Code sections certainly point in the direction of broad construction of "possession." For example, section 9-205's allowing the debtor significant control over the property might suggest this. Also, section 9-305 could support a broad construction of possession. This section provides in part: "If such collateral other than goods covered by a negotiable document is held by a bailee, the secured party is deemed to have possession from the time the bailee received notification of the secured party's interest."

While 9-305 obviously deals with perfection, the argument can be made that nonnegotiable warehouse receipts in the hands of the farmer should be sufficient to be possession for purposes of the definition of "farm products." And, if there were a negotiable warehouse receipt issued, it would represent ownership of the goods and therefore the farmer possessing the title would be in possession of the goods.[5] In short, the farmer is still the owner of the harvested crop and it is simply in the hands of an agent. The farmer has to pay storage fees and the farmer, not the elevator, decides when to sell. It must also be noted that Professor Gilmore stated in his treatise that "Goods cease to be 'farm Products' when they are subjected to any manufacturing operation...or when they move from the *possession and ownership* of a farmer to that of a non-farmer (canner, cooperative, etc.).[6] In addition, it must be noted the drafters could have simply inserted the word "physical" before the word possession in the definition of farm products.

Assuming *arguendo* it was determined that the stored crops are not to be considered "farm products," the issue is what type of collateral do you have then. One possibility is that the warehouse receipt could some how be considered proceeds of "farm products." The argument would be that the warehouse receipt was received upon "exchange" for the crops.[7] This is probably an unpersuasive argument because the thrust of section 9-306 is that the debtor has given up all control and interest in the collateral.

If the stored grain were to be considered a "good," the only possibility would be "inventory." Comment 3 to section 9-109 states: "The principal test to determine whether goods are inventory is that they are held for immediate or ultimate sale. Implicit in the definition is the criterion that the prospective sale is in the ordinary course of business." But there are severe problems with concluding the grain is "inventory." While most grain farmers will hold their grain for sale,[8] the drafters of the Code chose to treat the farmer differently by not defining the farmer's goods held for sale as "inventory." Also, Professor Gilmore, in describing "farm products" stated:

" 'Farm products' are in effect a farmer's inventory...although there is no 'held for sale' language in the definition, it is in highest degree unlikely that farm products not destined for sale will ever show up as collateral for loans."[9] All this appears to establish the stored grain would still be classified as "farm products." Finally, it must be noted that proper classifications of the good is still important even if the issuance of the warehouse receipt would make the document of title rules applicable.[9]

The recent case of *Garden City PCA v. International Cattle Systems*, 32 UCC Rep. 1207 (DDC Kan. 1981), involved the possession requirement when livestock were the collateral. PCA had a security agreement which covered all of debtors' cattle, including after-acquired cattle. The cattle were not in the physical possession of the debtor-owner. Rather, ICS, a feedlot operation, apparently was fattening the cattle for debtor and always had possession of the cattle. ICA sold the cattle to meat packers. PCA sued ICS and packers in conversion.

The court held the cattle were not "farm products" but were inventory. Its reasoning was that the debtor never had possession

(continued on next page

CA was not viewed as debtor's agent urposes of establishing possession. In , the court seems to read the posses- equirement of 9-109(3) to be limited ysical possession.

ving determined that the cattle in the ıt were inventory, the court concluded the Packer which bought the cattle ICS bought them in the ordinary e of business and took free of any ted security interest in the cattle. The relied upon 9-307(1) which provides he buyer takes free of any security in- created *by his seller*. While not ex- y stating it, the court must have con- d that ICS was acting as an agent of ebtor here when it sold the cattle to r inasmuch as 9-307(1) only applies to ty interests created by the seller. If were considered the seller, 9-307(1) not apply. Assuming that the court is d that the cattle were inventory and was not properly perfected, what if ICS is considered the seller? See §§ 9-201, 301, 1-109 and 2-403(2).

ile the facts are not totally clear in *In- ional Cattle Systems*, the analogy to ored grain is striking. The farmer was ently still the owner of the cattle, he ndoubtly paying the feedlot for its es, and he probably was determining the cattle would be sold. Consequent- e agruments made about possession tored grain apply when owned live- are not in the physical possession of btor. This all assumes the cattle could s be identified.

Kansas legislature responded to the *ational Cattle Systems* case by adding derlined words to the definition of products":

"farm products" if they are crops or estock or supplies used or produced in ming operations or if they are prod- s of crops or livestock in their un- nufactured states (such as ginned cot- n, wool-clip, maple syrup, milk and gs), and if they are in the possession of debtor engaged in raising, fattening, zing or other farming operations *or if y are livestock being held in a feed , as defined in K.S.A. 47-1501, and y amendments thereto.* If goods are m products they are neither equip- nt nor inventory;

nor Carlin, however, vetoed the bill. Governor's veto message suggested his was a substantial change in the rm Commercial Code and all in- ed parties were not given an adequate tunity to pursue the ramifications of roposed change. Part of the opposi- o this suggested change in the Code from cattle buyers. They viewed it s another extension of the protection extended financiers by 9-307(1).

"The questions of what collateral is considered farm products and whether 9-307(1) should be changed exist in most farm states today. As one considers whether it is wise to change any "definitions" in the Uniform Commercial Code, or for that matter 9-307(1), the impact upon other provisions of the UCC must be carefully considered. Also, what impact the changing of the farm products exception of 9-307(1) would have upon the *"financing"* of farmers cannot be overlooked.

1. For definitions of warehouse receipts under the Code, see U.C.C. §§ 1-201(15), 2-201(45), 9-105(1)(f), 7-102(1)(e), 7-201, 7-104.

2. Most times the farmer will receive a weight or scale ticket first and then will receive a warehouse receipt. A weight or scale ticket will normally show the date, the name of the depositor, gross weight of truck or wagon, net weight, test weight of the kind of grain, and the signature of the agent of the elevator. Normally these tickets will be serially numbered. The warehouse receipt which will either be a state or federally approved form will contain, among other things, a statement whether the grain received is to be delivered to bearer, to a specified person, or to his order; the date of the issuance of the receipt, the net weight of the grain along with the grade; and the words "negotiable" or "nonnegotiable." For statutes dealing with the form of the warehouse receipt, see e.g., Iowa Code Ch. 543 (1980); Kan. Stat. Ann. § Ann. § 34.239 (1981); 7 U.S.C.A. § 260 (West 1980). It must also be noted that Section 7-202 prescribes a form for warehouse receipts. The failure to follow it will result in liability for any loss caused by the omission of a required term. Some state-and all federally licensed elevators must issue warehouse receipts. Those that do not issue receipts rely on weight tickets and settlement sheets. Clearly, farmers should obtain warehouse receipts. For cases dealing with the rights of warehouse receipt holders and weight ticket holders, see *United States v. Luther*, 225 F.2d (10th Cir. 1955); *Farmers Elevator Mut. Ins. Co. v. Jewett*, 394 F.2d 896 (10th Cir. 1968); *Hartford Accident & Indem. Co. v. Kansas*, 247 F.2d 315 (10th Cir. 1957); *In re Cheyenne Wells Elevator*, 251 F. Supp. 275 (D. Colo. 1966); *Stevens v. Farmer's Elevator Mut. Ins. Co.*, 197 Kan. 74, 415 P.2d 236 (1966).

3. See U.C.C. § 1-201(15), 1-201(45), 9-105(1)(f), 7-102(1)(e).

4. Clearly, a document of title is a separate type of collateral and can easily be pledged if negotiable. There also are different rules governing the creation and perfection of security interest in them. U.C.C. §§ 9-102(1), 9-203, 9-304, and Comments; cf. § 9-401(3). For general discussion of this area see Meyer, "Crops" as Collateral for an Article 9 Security Interest and Related Problems, 15 U.C.C.L.J. 3, 27-29 (1982).

5. See Comment 2 to U.C.C. § 9-304. The Comment to Section 9-305 reinforces this theory when it states: "Possession may be by the secured party himself or by an agent on his behalf; it is of course clear, however, that the debtor or a person controlled by him cannot qualify as such an agent for the secured party."

For some cases dealing with perfection by possession, see, *e.g., In re Copeland, 531* F.2d 1195 (3d Cir. 1976) (escrow agent can retain possession); *Lee v. Cox*, 18 U.C.C. Rep. 807 (M.D. Tenn. 1976) (registration papers of Arabian horses not possession); *Blumenstein v. Phillips Ins. Center, Inc.* 490 P.2d 1213 (Alaska 1971) (possession not established by creditor removing equipment from boat and preparing it for winter).

6. 1 Gilmore, *Security Interests in Personal Property* § 12.3, at 374 (emphasis added).

7. Section 9-306(1) provides in part: " 'Proceeds' includes whatever is received upon the sale, exchange, collection, or other disposition of collateral or proceeds."

8. 1 Gilmore, note 6 *supra*, at 734. For some cases dealing with when a good is "farm products" or "inventory," see, *e.g., United States v. Hext*, 444 F.2d 804 (5th Cir. 1971); *In re Collins*, 28 U.C.C. Rep. 1520, 3 B.R. 144 (D.S.C. 1980); *K. L. Smith Enterprises, Ltd. v. United Bank of Denver*, 28 U.C.C. Rep. 534, 2 B.R. 280 (D. Colo. 1080); *Oxford Prod. Credit Ass'n v. Dye*, 368 So. 2d 241 (Miss. 1979); *First State Bank v. Products Livestock Mktg. Ass'n Non-Stock Coop.*, 200 Neb. 12, 261 N.W.2d 854 (1978); *In re Charolais Breeding Ranchers, Ltd.*, 20 U.C.C. Rep. 193 (Bankr. W.D. Wis. 1976); cf. *Baker PCA v. Long Creek Meat Co.*, 266 Ore. 643, 513 P.2d 1129 (1973).

9. See U.C.C. §§ 7-502-04, 9-304(2)-9-304(3).

Keith G. Meyer is a professor of law at the University of Kansas School of Law where he teaches courses in agriculture law and commercial law. He is editor-in-chief of the new Journal of Agricultural Taxation and Law and is one of four working on a case book on agriculture law to be published during the summer of 1984.

SUMMARY OF MORTGAGED COMMODITIES PROBLEM

I. Problem --

For a number of years the livestock and grain industries have been plagued by a difficult situation which adversely affects companies that handle sales transactions for farmers, ranchers and other sellers. The problem is created by a small minority of producers who illegally sell livestock which has an outstanding lien and, without paying the security holder, divert the funds to other uses. Third parties, i.e. market agents, packers, elevators and other parties without actual knowledge of the recorded liens, are liable to the security party for the value of the commodity, thus incurring a loss equal to that value. As a result, the injured third party pays for a commodity twice, once to the seller and once to the bank as payment for the sellers loan.

This situation poses an undue financial hardship on markets to whom producers sell their products. We are concerned about any problem which reduces the economic viability of agricultural markets.

II. Cause Of The Problem --

Section 9-307 of the Uniform Commercial Code states, "A buyer in ordinary course of business, other then a person buying farm products from a person engaged in farming operations, takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence." In other words, buyers of products in the ordinary course of business are under no obligation to search for liens. However, because of the exception "...other than a person...in farming operations..." in Section 907, buyers of farm products must search for liens and are liable to repay the loan if a lien exists. This section of the Code, therefore, treats agricultural producers differently than any other businessman and means that the purchaser of a farmer's grain or livestock is liable to pay for commodities twice when the producer fails to repay the lien holder for the mortgaged commodities.

III. Analysis Of The Problem --

For a number of months industry and government representatives have met to analyse the problem and discuss alternative solutions. A summary of the scope of the problem is included in Attachment 1 and a summary of alternative solutions is discussed in Attachment 2.

IV. Solution To the Problem --

Amend the Uniform Commercial Code to remove the farm products exception. This makes transactions for farm products subject to the same laws governing all other commercial transactions and limits the risk liability for livestock and grain markets.

ATTACHMENT 2

ALTERNATIVE SOLUTIONS

I. Legislative Changes

A. Amend U.C.C. Section 9-307 to eliminate the double payment possibility. Requires eliminating the farm products exemption and adding wording eliminating commission merchant or selling agent liability. Requires follow-up work with individual states to pass similar legislation.

B. Amend the U.C.C. to require lenders to notify buyers of existing liens ("pre-notice" or "actual notice" requirement). Includes provisions for prosecution of producers who commit the fraud and for penalizing the lender who fails to notify a market of the existence of a lien. Follow-up action with states.

C. Amend P&S Act to eliminate a livestock buyers liability. Similar amendment to U.S. Grain Standards Act or other legislation to eliminate grain elevator liability.

II. More diligent prosecution of those who commit fraud.

III. Administrative changes:

A. At the time of the loan, notify borrower that conversion of mortgaged property without payment to lender is a fraud. Require producers to sign a similar statement at the time of sale.

B. Restrict the statute of limitations period.

C. State legislation requiring liens to be centrally filed at the Secretary of States office or some other office.

IV. Others -

CONFRONTING THE ISSUES

F, 12

SALE OF MORTGAGED AGRICULTURAL COMMODITIES

Farm Bureau Policy Development
June 1984

The Problem

A minority of producers illegally sell livestock, grain, cotton, etc., which have outstanding liens and, without paying the security holders, divert the funds to c uses. The buyers, i.e. market , packers, elevators and others, ..ut actual knowledge of the recorded ..ens, may be held liable by the secured party for the value of the commodity up to the amount of the lien, thus incurring a loss equal to that value. As a result, the buyer pays for the commodity twice, once to the seller and once to the lien holder as payment for the seller's loan.

Basic Information

The Uniform Commercial Code (UCC) provides that buyers, except farm product buyers, in the ordinary course of business will be protected by being able to take title of goods free and clear of security interests even if the goods are collateral for a loan on which the seller defaults.

On the other hand, the good faith buyer of farm products is not protected. Such a buyer can end up having to pay twice for the farm products in order to take title—once to the farmer and again to the secured party if the farmer fails to repay his secured loan and the secured party is seeking restitution.

There does not appear to be a valid reason for differentiating between buyers of farm products and buyers of other commercial goods. Treating farm products differently has caused serious problems for buyers, sellers and the courts.

Most bankers argue that eliminating the farm products exemption will increase the cost and availability of money to farmers. However, California eliminated the farm products exemption in 1976 and no adverse effects on farm credit have resulted.

Lenders do not want the farm products exemption in the UCC changed because it lowers risk exposure without any increase in cost. Lenders can be more lax in farm loan supervision because of the added protection granted in the UCC.

Current Farm Bureau Policy

Farm Bureau supports legislation eliminating the farm products exemption in the UCC because:

(1) The double-payment penalty is jeopardizing the financial security of many markets (livestock, grain, cotton, etc.) to whom farmers sell their products. Farm Bureau is interested in eliminating problems which can reduce market opportunities.

(2) It is not only livestock markets or grain elevators that may be forced to pay for commodities twice. Many farmers buy breeding stock, feeder pigs, etc., from other farmers and are forced to pay twice for the commodity.

(3) Losses due to double payments for products are passed on to other producers in terms of higher marketing fees and processing costs.

Questions For Discussion

Several states have enacted compromise legislation with a "pre-notice" or actual notice provision which:

- Requires the producer to identify his potential markets for the lender's benefit at the time the loan is made;
- Requires the lender to notify these markets of the existence of a lien; and
- Eliminates a market's/farmer's liability if the lender fails to provide notice of the existence of a lien.

Does Farm Bureau support this approach?

Produced by the American Farm Bureau Federation • 225 Touhy Avenue • Park Ridge, Illinois 60068

OLSSON AND FRANK, P. C.
ATTORNEYS AT LAW
SUITE 400
1029 VERMONT AVENUE, N. W.
WASHINGTON, D. C. 20005

TELEPHONE
(202) 789-1212

PHILIP C. OLSSON
RICHARD L. FRANK
DAVID F. WEEDA*
DENNIS R. JOHNSON
KATHLEEN M. SANZO*

* ADMITTED IN MARYLAND ONLY
* ADMITTED IN GEORGIA ONLY

MEMORANDUM

January 4, 1985

TO: STEVE KOPPERUD
AMERICAN FEED MANUFACTURERS ASSOCIATION

FROM: OLSSON AND FRANK, P.C.

RE: LENDER PROTECTION IN CALIFORNIA

Pursuant to your request, we have reviewed the various techniques used by California banks to protect their interest in light of the California Commercial Code provision which grants clear title to buyers of farm products. To accomplish this review, we have had numerous discussions with the California Grain Feed Association and various California lending institutions. This memorandum summarizes our findings.

Legal Framework

In January, 1976, California amended its version of the Uniform Commercial Code (UCC) to extend to buyers of farm products the same protections granted buyers of other goods; namely that a buyer takes free and clear of any security interest in the goods if the purchaser is "a buyer in the ordinary course of business."

Under both the UCC as adopted by California and the other 48 states, a buyer in the ordinary course of business is one who purchases "without knowledge that that sale is...in violation of...the security interest of a third party." Accordingly,

under California law, a purchaser of farm products takes free and clear of a lender's security interest if the purchaser is unaware that the sale is in violation of that security interest. Thus, in California if a seller of farm products diverts the funds from his lender and the purchaser has clear title, the lender would suffer a loss. To avoid such losses, California banks have implemented various procedures to assure that purchasers of farm products have "knowledge" of any security interest in the goods. Such "knowledge" would not qualify a purchaser as "a buyer in the ordinary course of business" and he would not take clear title to the goods. The next section discusses the various devices used by California banks.

California Methods

The principal method of protecting a lender's interest has been to notify the purchaser of the farm products of the existence of the lien and how payment should be made consistent with the terms of the security agreement. It must be emphasized that there is no statutory requirement that the lender provide the notice -- however, failure to provide that notice jeopardizes the lender's security interest.

California banks have developed two principal methods to notify potential purchasers of the lien; letters to potential buyers and assignments of returns.

Under the first method, the bank may request the grower/ borrower to provide a list of potential buyers in conjunction

with the loan application. Once the loan is granted, the bank then sends out a letter to all potential buyers identified by the grower to apprise them of the existence of a security agreement in the particular crops and the acceptable manner of payment, normally a check made payable to the grower and lender as joint payees. The receipt of this letter puts any potential buyer on notice of the bank's security interest in the crops and of how the sale is to be made; failure to follow the instructions will deny the purchaser clear title to the crops since the purchaser would have known that the sale was made in violation of the security agreement between the bank and grower.

The second method -- assignment of returns -- is used by banks when a grower deals primarily with a one purchaser. Under this method, in conjunction with the loan application, the grower/borrower will file with the bank an assignment signed by both the grower and the purchaser stating that the grower has assigned all rights to payment to the bank. While such an assignment does not normally include the purchase price, the assignment requires payment directly to the bank as sole payee. With this method, failure of the purchaser to pay the bank will deny him clear title.

Since neither of these methods are required by statute, banks are free to use them as they see fit. Normally, if a bank has a longstanding relationship with a particular grower and the grower has more than adequate capitalization, a bank

may choose not to send letters to potential purchasers or request an assignment of returns. On the other hand, for those growers who are new to a bank and are without more than adequate capitalization, a bank may further protect its interest by conducting monthly audits. Under this system, a bank will conduct a monthly review of the grower's accounts and advance monies only after they are sure that the grower has not diverted the funds but has paid the bank promptly. With this system, a bank can keep a close eye on the grower and keep diversions to a minimum.

Banker's Reactions to the California UCC

Overall, bankers seem to be comfortable with the clear title for farm products. Since banks are free to notify all potential and actual purchasers, they have been able to adequately protect their security interests in farm products, just as they have for other commercial commodities and goods. Furthermore, since the California UCC does not require a particular form or type of notification, the banks are free from any worries as to whether any particular notice was technically proper. In light of California's experience with the clear title for farm products, it would appear that this system is both workable and desirable.

Mr. VOLKMER. Has the gentleman concluded?

Mr. HATCHER. Yes.

Mr. VOLKMER. I have no further questions.

I appreciate you being here.

The chairman may have some questions. He is tied up over at the Capitol right now. I would appreciate it if you would be able to stay for a little while until he returns in order to determine whether or not he has questions he may wish to address.

Thank you very much for your statements. We appreciate your being here. It has been most informative.

At this time we will call our next witness, Mr. Jay Spivak of Denver, Colo., for the National Meat Association; accompanied by Mr. James Kefauver—that is a well-known name—and also Mr. John Carr, director of public affairs.

Mr. Carr, I would appreciate your introducing your witnesses that you have here.

The statements that we have will be made a part of the record, and you may either summarize the statements or review of the statements in full.

Mr. CARR. Thank you, Mr. Chairman.

As you said, my name is John Carr. I am director of public affairs at the National Meat Association.

With me today to present our association's statement is Jay Spivak, on my far left. He is executive vice president, sales and operations, for Pepper Packing Co. in Denver, Colo.

On my immediate left is the association counsel, Mr. Jim Kefauver, to also help answer questions on this issue.

Mr. Spivak.

STATEMENT OF JAY SPIVAK, EXECUTIVE VICE PRESIDENT, PEPPER PACKING CO., ON BEHALF OF THE NATIONAL MEAT ASSOCIATION, ACCOMPANIED BY JAMES KEFAUVER, COUNSEL, AND JOHN CARR, DIRECTOR, PUBLIC AFFAIRS, NATIONAL MEAT ASSOCIATION

Mr. SPIVAK. Good morning.

My name is Jay Spivak. I am executive vice president of sales and operations for Pepper Packing Co. of Denver, Colo. This morning I am representing the National Meat Association, a Washington-based trade association that represents packers and processors nationwide.

We are pleased to have this opportunity to appear before this distinguished panel and discuss the serious double-jeopardy threat we face whenever we buy livestock. Unlike buyers of most commodities, we do not receive clear title to livestock purchases, which leaves us vulnerable to legal actions if the cattle are mortgaged and the sellers do not repay their loans.

The National Meat Association is most qualified to address this issue. Association members handle more than 70 percent of the Nation's beef and substantial portions of the pork and processed meats industries. A majority of these members must purchase livestock daily as the raw materials they need to operate their businesses.

can always make a loan and profit from it, and at the same time be secure in the knowledge that someone will repay him.

Lenders also conjure up a bleak picture of farm loans dwindling if their free loan insurance were eliminated. This suggestion is disproved by concrete evidence.

In 1976, California removed the farm products exemption from its UCC. Did nonreal estate farm credit dry up in California? No. As you can see from this chart on my right, in every year—with the exception of 1978—nonreal estate farm loans in California increased at a more rapid rate than the average for the United States as a whole.

This is significant. I am certain that other witnesses will testify today that if the agricultural exception contained in the Uniform Commercial Code is removed the number of loans made to farmers will decrease.

Please bear in mind the experience in California, which leads the Nation in agricultural production, has proven otherwise. We are confident what transpired in California is indicative of what will occur if the farm products exception is removed nationwide. Rather than a negative effect on farm loans, such action by Congress may, in fact, have a positive effect. See attachment A.

Further, as indicated by the recent Wall Street Journal article, Farm Loan Funds Are Not in Short Supply. See attachment A. Indeed, rural community banks have access to a corporation formed by 12 State banking associations to market their loans to major lending institutions, including international ones.

Opponents of the Harkin bills—that is, those who would defend the status quo—also argue that these bills constitute Federal intrusion into matters traditionally under the control of the States. This argument overlooks the thrust of the Uniform Commercial Code—uniformity. It was a lack of State uniformity in the laws governing commercial transactions that led to the adoption of the UCC in the first place. The Uniform Commercial Code, as its title indicates, does not contemplate that each State do its own thing.

Moreover, because of the plain unfairness of section 9-307, many State legislatures have enacted amendments to this provision. These amendments differ radically in the 12 or so States involved. Some States passed laws to institute a statewide filing system for liens. Other States require sellers to disclose liens to buyers. One State permits a lender to recover from a buyer only after the lender has instituted criminal action against the defaulting borrower. And California, as I mentioned previously, has eliminated the farm products exception altogether. Thus, the uniformity of this code provision among the States has already been eroded. Therefore, a Federal enactment would create uniformity, which was the fundamental purpose of the code in the first place.

The facts, the logic, and plain commonsense support treating buyers of farm products just like buyers of any goods. We are asking for nothing more than this.

In the difficult economic times that farmers and other businessmen are currently going through we can ill-afford such a burdensome and marketing disruptive law that serves only to insure lenders from losses due to imprudent loans or improperly supervised

ATTACHMENT A

NONREAL ESTATE FARM DEBT OUTSTANDING IN
UNITED STATES AND CALIFORNIA, 1977-1982

Jan. 1	United States*	% Change	California**	% Change
1977	37,800,000	+14%	2,730,000	+17%
1978	47,300,000	+25%	3,130,000	+15%
1979	54,800,000	+16%	3,770,000	+20%
1980	63,500,000	+16%	4,750,000	+26%
1981	69,200,000	+ 8%	5,160,000	+ 9%
1982	77,800,000	+12%	6,960,000	+35%

*Figures stated in $1,000's rounded off to nearest $100,000,000

**Figures stated in $1,000's rounded off to nearest $10,000,000.

Source: "Nonreal Estate Farm Debt", Statistical Bulletins 1977-1982, Farm Credit Administration, Economic Analysis Division. (Figures for 1978-1982 include Commodity Credit Corporation loans; figures for 1977 do not.)

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION
BEFORE THE AGRICULTURAL RESEARCH AND
GENERAL LEGISLATION SUBCOMMITTEE OF THE
SENATE AGRICULTURE, NUTRITION AND FORESTRY COMMITTEE
REGARDING MORTGAGED AGRICULTURAL COMMODITIES

Presented by
Ray Mackey, President
Kentucky Farm Bureau Federation

September 26, 1984

My name is Ray Mackey, President, Kentucky Farm Bureau Federation, and a grain, livestock and tobacco farmer from Elizabethtown, Kentucky. I am also a member of the American Farm Bureau Federation Board of Directors.

BACKGROUND

Farm Bureau appreciates the opportunity to testify on the mortgaged agricultural commodities issue which is becoming an increasingly more onerous problem to a broad segment of agriculture. This statement is supported by Farmers Home Administration (FmHA) statistics (See Attachment I) which indicate that the problem in 1982 was larger in grain sales than in livestock sales despite the fact that the value of livestock cases pending showed an 850 percent increase from 1978-82. Cotton is not included in FmHA statistics, but testimony in the House Agriculture Committee indicated that there is a growing problem for this commodity also.

For a number of years the livestock and grain industries have been plagued by a difficult situation which adversely affects companies that handle sales transactions for farmers, ranchers and other sellers. The problem is created by a small minority of producers who illegally sell livestock, grain or other commodities which have an outstanding lien and, without paying the security holder, divert the funds to other uses. Third parties, i.e. market agents, packers, elevators and other parties without actual knowledge of the recorded liens, are liable to the security party for the value of the commodity and incur a loss equal to that value. As a result, the injured third party pays for a commodity twice, once to the seller and once to the bank as payment for the seller's loan.

IMPACT ON AGRICULTURE

We are concerned about this situation for three reasons:

First, it poses an undue financial hardship on markets to which producers sell their commodities. We are interested in any problem which reduces the economic viability of agricultural markets.

Second, as the problem continues to grow, it is adversely affecting individual farmers as well as the markets to whom farmers sell their products. Farmers buy products such as feeder cattle and pigs, and breeding stock from other producers. Under the current lien laws, farmer-buyers are required to make double payments when loans are not repaid to security holders.

Third, the current situation is inequitable. Section 9-307 of the Uniform Commercial Code states, "A buyer in ordinary course of business, other then a person buying farm products from a person engaged in farming operations, takes free of a security interest created by his seller even though the security interest is perfect and even though the buyer knows of its existence." In other words, buyers of products in the ordinary course of business are under no obligation to search for liens. However, because of the exception "...other than a person...in farming operations..." in Section 907, buyers of farm products must search for liens and are liable to repay the loan if a lien exists.

This section of the Code, therefore, treats agricultural producers differently than any other businessmen and means that the purchaser of a farmer's grain or livestock is liable to pay for commodities twice when the producer fails to repay the lienholder for the mortgaged commodities. To avoid the double payment possibility, the buyer is expected to conduct a title search on the hundreds of sales transactions conducted daily. The title could be recorded in a county that is not even in the same state as the sale. The sale could also occur in the evening or on the weekend when county offices are not open.

It is unreasonable for the livestock market or grain elevator to become a credit supervisor for a lending institution. In effect, the buyer of farm products becomes the involuntary guarantor of a loan about which he knew nothing, in which he had no input as to the advisability of the loan or the limit of the credit granted, and for which he receives no compensation in the form of interest to cover risk exposure and jeopardy he has involuntarily and unknowingly assumed.

The inequity is especially apparent for the livestock market which does not have the protection of other buyers in commerce because of the lien laws, but is subject to the prompt payment requirements of Section 201.43 of the Packers and Stockyards Act.

WHY IS THERE A FARM PRODUCTS EXEMPTION?

The answer to this is unclear. The exemption appears to have been adopted by draftsmen of the Uniform Commercial Code because it was the predominant view of case law early in the 1960's. Case law probably supported the exemption because agriculture loans were difficult to supervise early in this country's history. Poor roads and communication made it difficult for lenders to check on loan collateral such as range cattle. However, this is certainly not the case today.

The exemption should be analyzed in terms of its application to modern agriculture. Tremendously improved transportation and communication networks make agricultural loan supervision easier.

Farm products are no different than other products sold in commerce and shouldn't receive different treatment. The current Code treats farmers as if they were unsophisticated businessmen. However, the management skills, technical knowledge and capital requirements in farming today are equal to those in most other businesses.

The inequitable situation faced by the buyer of farm products who pays for commodities twice is in sharp contrast to the favorable situation faced by the lender. For reasons which aren't clear, the agriculture exemption puts the agricultural creditor in a less risky, more advantageous position than the inventory creditor. This inequity, which benefits one small group of individuals to the detriment and exclusion of the rights of others, must be corrected.

HOW WILL FARM CREDIT BE AFFECTED BY ELIMINATION OF THE EXEMPTION?

Lenders argue that the cost of credit will increase and the availability of credit will decrease if the exemption is eliminated. This hypothetical argument used by the lenders is without merit. If our leading state in agricultural production is an example of what will happen to agricultural credit upon removal of the exemption, then this is clearly not the case. In 1976, California eliminated the exemption and non-real estate farm loans increased in every year except one. The increase was at a more rapid rate than the national average. The harm presently being suffered by farmers far outweighs a speculative or unconfirmed concern that the elimination of the exemption might adversely affect farm credit.

When commercial banks throughout the country make loans to farmers, Section 9-307 is not taken into consideration. If it were, we think that farmers would pay less for credit and get more favorable credit terms than anybody else in regular commerce because there is less risk. Since farmers do not receive more favorable credit terms from commercial lenders, we don't feel that elimination of the exemption will have any effect.

Based on these arguments, we believe that agricultural lenders are opposed to elimination of the exemption because it lowers the risk on agricultural loans and allows less stringent loan supervision.

IS A FEDERAL OR STATE SOLUTION APPROPRIATE FOR THIS PROBLEM?

One of the effects of adoption of the Uniform Commercial Code by several states has been to facilitate interstate trade. The underlying purposes and policies of the Code are to clarify and modernize the law concerning commercial transactions; to permit continued expansion of commercial practices through custom, usage and agreement of the parties; and to make uniform the law among the various jurisdictions. Since it is also the specific intent of the Code that the courts be able to develop the law embodied therein in light of unforeseen and new circumstances and practices, it follows that the proper construction of the Code be in view of the above mentioned policies and purposes.

It is also important to note that significant quantities of grain and livestock are marketed across state lines. When encouraging Congress to pass grain elevator bankruptcy legislation, we argued that uniform state laws were necessary to facilitate agricultural trade. The same point is valid in this issue.

For these reasons we feel that a state solution to the problem is not appropriate. Senator Huddleston's bill, S. 2190, enables buyers of farm products to take title free of third-party security interest. This bill, with a minor amendment to protect livestock agents and auction markets, (See Attachment II) is the proper legislative solution.

KENTUCKY EXPERIENCE

In Kentucky, we have taken action to partly resolve the problem that develops when mortgaged agricultural commodities are sold. For example, Kentucky farmers have experienced the misfortune of losing a great deal of money from grain elevators and stockyard bankruptcies.

Often these bankruptcies were brought about because the market place was forced to pay twice for the same commodity which had been sold illegally. The double payment, therefore, jeopardizes the opportunity of other farmers who sell their products legally from receiving payment.

Kentucky's Commercial Code had for several years required that all selling agents, except tobacco warehousemen, be responsible for determining whether a lien exists on any item passing through his sales operation. Otherwise, the agent had been responsible to the lienholder for the amount of the lien. In 1982, we amended our state law by giving the same protection to licensed grain and livestock yard operators as was previously afforded tobacco warehousemen. Lienholders are now required to notify the market place either by certified or registered mail if they desire the market place to be responsible for the amount of the lien should the mortgaged property pass through the operation. If no such notice is given, the market place is not responsible.

Kentucky's law has worked very well, and I might add that agricultural credit is still available and our lending institutions have not fled the state as many might have suggested. Unless Congress takes action to solve the problem, many states will follow the ways of Kentucky by attempting to address the situation by adopting a wide range of legislative solutions. This action could possibly bring about additional problems due to the fact that the various state laws governing commerce will no longer be uniform.

We appreciate the interest and support this Subcommittee has shown in the mortgaged agricultural commodity problem and encourage you to consider a legislative solution similiar to S. 2190.

ATTACHMENT I

FMHA SUMMARY OF MORTGAGED COMMODITIES CASES

L I V E S T O C K

	FISCAL YEAR	NUMBER	AMOUNT	AVERAGE SIZE
Referred to OGC*	1978	105	$ 508,130	$ 4,839
	1982	292	4,004,680	13,714
Collected	1978	56	120,447	2,151
	1982	51	383,055	7,511
Pending at OGC*	1978	128	766,663	5,989
	1982	595	6,581,968	11,062

G R A I N

	FISCAL YEAR	NUMBER	AMOUNT	AVERAGE SIZE
Referred to OGC*	1978	No Info	No Info	
	1982	199	$4,215,940	$21,185
Collected	1978	No Info	No Info	
	1982	54	517,428	9,582
Pending at OGC*	1978	No Info	No Info	
	1982	439	7,194,321	16,387

* USDA's Office of General Counsel

ATTACHMENT II

In order to protect the seller's agent, the following wording should be added to S. 2190:

"A commission merchant or selling agent who sells livestock or other agricultural products for others shall not be liable to the holder of a security interest in such livestock or other agricultural products, even though the security interest is perfected, if the sale is made in the ordinary course of business and without actual knowledge of the security interest."

SENATE JOINT RESOLUTION 123

WHY THE STUDY IS NECESSARY?

The livestock and grain industries have been plagued by a difficult situation which adversely affects companies that handle sales transactions for farmers, and other sellers. The problem is created by a small minority of producers who illegally sell livestock or grain which has an outstanding lien and, without paying the security holder, divert the funds to other uses. Third parties, i.e. market agents, packers, elevators and other parties without actual knowledge of the recorded liens, are liable to the security party for the value of the commodity, thus incurring a loss equal to that value. As a result, the injured third party pays for a commodity twice, once to the seller and once to the bank as payment for the sellers loan.

THE FOLLOWING PROBLEMS ARISE DUE TO THIS SITUATION:

1. The double-payment penalty is jeopardizing the financial security of many markets (livestock, grain, etc.) to whom farmers sell their products. Farm Bureau is interested in eliminating problems which can reduce market opportunities.

2. It's not always livestock markets or grain elevators who are forced to pay for commodities twice. Many farmers buy breeding stock, feeder pigs, etc., from other farmers and are forced to pay twice for the commodity.

3. Losses due to double payments for products are passed on to other producers in terms of higher marketing fees and processing costs.

WHAT IS THE CAUSE OF THE PROBLEM?

Section 9-307 of the Uniform Commercial Code states, "A buyer in ordinary course of business, other then a person buying farm products from a person engaged in farming operations, takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence." In other words, buyers of products in the ordinary course of business are under no obligation to search for liens. However, because of the exception "...other than a person...in farming operations..." in Section 307, buyers of farm products must search for liens and are liable to repay the loan if a lien exists. This section of the Code, therefore, treats agricultural producers differently than any other businessman and means that the purchaser of a farmer's grain or livestock is liable to pay for commodities twice when the producer fails to repay the lien holder for the mortgaged commodities.

WHY ARE THE AMENDMENTS NECESSARY TO SJR 123?

1. A comprehensive broad study is needed to look at all alternative solutions to the problem. The amendments broaden the thrust of the study.

2. A national study has revealed several viable solutions for states to the problem.

3. The farmer will pay any costs associated with statutory solutions - the best most least costly solution is desirable.

Legislative Issues

Lien Legislation: Congressmen Stenholm (D-Tex) and Gunderson (R-Wis) have introduced a bill in Congress which would shift the burden of checking for liens from buyers to lenders. Lenders would have to inform potential buyers that liens exist or they will have no claim against a buyer when the seller didn't use proceeds to pay off the loan. A similar bill is moving through the Senate.

This would indeed solve a serious headache for buyers such as packers, stockyards, grain elevators, etc., but it would create an even more devastating effect on the producer's ability to borrow operating money. If a lender is not able to repossess the collateral used to secure a loan, he will simply stop lending against that type of collateral. What impact would it have on agriculture if lenders refused to lend production money unless it could be secured with equipment or real estate? Obviously many producers would be forced out of business. Granted, buyers have a significant problem under the current system, but this legislation would create havoc for producers and eventually problems for the buyers also. Virginia and several other states have taken steps toward a central filing system for liens on agricultural commodities. This approach, if it can be introduced cost effectively, appears to be a much more sensible solution to the problem, and one which would not require Federal legislative intervention.

MAR 1 2 1985

Place On Calendar

HOUSE FILE 554

BY COMMITTEE ON AGRICULTURE

(Formerly House Study Bill 185)

Passed House, Date_____ Passed Senate, Date_____

Vote: Ayes_____ Nays_____ Vote: Ayes_____ Nays_____

Approved_____

A BILL FOR

An Act relating to the security interest in farm products purchased by a buyer in the ordinary course of business from a person engaged in farming operations and providing penalties.

BE IT ENACTED BY THE GENERAL ASSEMBLY OF THE STATE OF IOWA:

HF 554

S.F. _____ H.F. 554

Section 1. Section 554.9307, subsection 1, Code 1985, is amended to read as follows:

1. A Except as provided in subsection 4, a buyer in ordinary course of business ~~(subsection-9-of-section-554.1201)~~ ~~other-than-a-person-buying-farm-products-from-a-person-engaged-in-farming-operations~~ as defined in section 554.1201, subsection 9, takes free of a security interest created by that person's seller even though the security interest is perfected and even though the buyer knows of its existence. For purposes of this section, a buyer or buyer in ordinary course of business includes any commission merchant, selling agent, or other person engaged in the business of receiving livestock as defined in section 189A.2 on commission for or on behalf of another.

Sec. 2. Section 554.9307, Code 1985, is amended by adding the following new subsection:

NEW SUBSECTION. 4. a. A buyer in ordinary course of business buying farm products from a person engaged in farming operations takes free of a security interest created by that person's seller even though the security interest is perfected and even though the buyer knows of its existence, unless the buyer receives prior written notice of the security interest. "Written notice" means an original financing statement effective under section 554.9402, or a carbon, photographic, or other reproduction of an original financing statement signed by the debtor or a notice on a form prescribed by the secretary of state, or a carbon, photographic, or other reproduction of the form that contains all of the following:

(1) The full name, address, and social security or tax identification number of the debtor.

(2) The full name and address of the secured party.

(3) A description of the collateral.

(4) The date and location of the filing of the financing statement.

(5) The date and signature of the secured party.

(6) The date and signature of the debtor.

b. The written notice expires on the earlier of either of the following dates:

(1) Eighteen months after the date the secured party signs the notice.

(2) When the debt that appears on the notice is satisfied.

c. For the notice to be effective, the buyer of the farm products must have received the notice prior to the time the buyer has made full payment to the person engaged in farming operations. The notice is not effective against any payments made prior to receipt of the notice.

d. Within fifteen days of the satisfaction of the debt, the secured party shall inform in writing each potential buyer listed by the debtor to whom the notice provided in paragraph "e" has been sent that the debt has been satisfied.

e. A debtor engaged in farming operations who has created a security interest in farm products shall provide the secured party with a written list of potential buyers of the farm products at the time the debt is incurred if the secured party requests such a list. The debtor shall not sell the farm products to a buyer who does not appear on the list unless the secured party has given prior written permission or the debtor applies the proceeds the debtor receives from the sale to the debt within fifteen days of the date of sale. A debtor who knowingly or intentionally sells the farm products in violation of this paragraph is guilty of a serious misdemeanor.

f. A buyer of farm products buying from a person engaged in farming operations shall issue a check for payment jointly to the debtor and those secured parties from whom the buyer has received prior written notice of a security interest. A buyer who issues a check jointly payable as specified in this subsection takes the farm products free of a security interest created by that person's seller. A buyer who does not issue a check jointly payable as specified in this subsection does not

take the farm products free of a security interest created by that person's seller. A buyer shall not withhold all or part of the payment to satisfy a prior debt. However, the buyer may withhold the costs incurred by the purchaser to market or transport the farm products if such costs are part of the agreement to purchase the farm products.

EXPLANATION

This bill provides that a buyer in the ordinary course of business who purchases farm products from a person engaged in a farming operation takes free of a security interest created by the seller unless prior to making full payment the buyer receives a notice from the secured party that the secured party has a security interest. The debtor is required to provide the secured party if requested a list of potential buyers. The debtor is guilty of a serious misdemeanor if the debtor knowingly or intentionally sells the farm products to another person unless the secured party has given written permission or the debtor satisfies the debt within fifteen days of the date of sale. A buyer who receives notice of the security interest shall issue any payment check jointly in the name of the seller and the secured party.

First Regular Session

LDO NO. 85 0387/1 Fifty-fifth General Assembly SENATE BILL NO. 36

STATE OF COLORADO

AGRICULTURE, NATURAL RESOURCES & ENERGY

BY SENATOR R. Powers

A BILL FOR AN ACT

CONCERNING THE PROTECTION OF BUYERS OF FARM PRODUCTS SUBJECT TO SECURITY INTERESTS.

Bill Summary

(Note: This summary applies to this bill as introduced and does not necessarily reflect any amendments which may be subsequently adopted.)

Amends the "Uniform Commercial Code" to include, in a provision which allows buyers to take free of security interests, persons buying farm products from persons engaged in farming operations.

Be it enacted by the General Assembly of the State of Colorado:

SECTION 1. 4-9-307 (1), Colorado Revised Statutes, is amended to read:

4-9-307. Protection of buyers of goods. (1) A buyer in ordinary course of business (subsection (9) of section 4-1-201) ~~other--than--a--person--buying--farm-products-from-a person-engaged-in-farming-operations~~ takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence.

Capital letters indicate new material to be added to existing statute.
Dashes through the words indicate deletions from existing statute.

SECTION 2. Safety clause. The general assembly hereby finds, determines, and declares that this act is necessary for the immediate preservation of the public peace, health, and safety.

AMERICAN MEAT INSTITUTE
Serving The Meat Industry Since 1906

ANALYSIS OF THE FARM PRODUCTS EXCEPTION

UCC - 9-307(1)

PREPARED FOR THE AMERICAN MEAT INSTITUTE

BY
RALPH J. ROHNER
PROFESSOR OF LAW
COLUMBUS SCHOOL OF LAW
CATHOLIC UNIVERSITY OF AMERICA
WASHINGTON, D.C.

NOVEMBER 1983

I. INTRODUCTION

A significant problem facing buyers of farm products -- especially the buyers who are packers or processors of livestock, or marketing agencies, -- is that the commercial law applicable in virtually all states generally allows the lending institution that has financed the producer's operations to pursue the farm products collateral for those loans into the hands of buyers in the ordinary course of business. This means that when a producer sells livestock or other farm products, but does not use the sale proceeds to repay the lender's loan, the lender may sue and recover the value of those goods from the buyer. To safeguard the lender's interest, in other words, the buyer may be forced to pay twice for the same goods.

As a result, this state-law rule frustrates the normal expectations of commercial buyers, and leaves the rights of farm products buyers out of line with the rights of all other marketplace buyers in the ordinary course of business.

This "farm products exception" deserves the Subcommittee's serious attention for a number of reasons:

1. That portion of the Uniform Commercial Code that presently protects the lenders instead of the buyers of farm products, i.e., the "farm products exception," is anomalous within the Uniform Commercial Code itself, and out of step with basic commercial law policies. Ordinary-course buyers of commercial inventory routinely take free and clear of security interests created by their sellers, as do buyers of other types of collateral such as negotiable instruments, securities, warehouse receipts and bills of lading. Only in the case of farm products is the otherwise dominant policy of encouraging the free flow of goods in commerce not maintained.

2. Recognizing the anomalous and capricious effect of the farm products exception, a number of courts and state legislatures have sought to modify its impact in various ways; while sometimes helpful to farm products buyers, these state law efforts are sporadic and inconsistent, and in fact create new legal uncertainties and impose new procedural burdens. These state initiatives, however, do confirm the suspect nature of the "farm products exception" itself.

3. The problem is exacerbated for buyers of livestock, because federal law (the Packers and Stockyards Act, as amended in 1976) requires cash buyers of livestock to pay for their purchases on the spot or within twenty-four hours after the sale transaction. This means that processors, meat packers and other livestock buyers (including producers buying from other producers) must part with their purchase money at a time and under circumstances when it is simply impossible for them to protect themselves against undisclosed security interests. The buyers, in short, are compelled by federal law to be insurers for any lender who is not paid off promptly with the proceeds of the sale.

4. Preemption of state law appears to be the only practicable way to produce a fair and uniform rule for application in the increasingly multistate farm products markets. Uniform state legislation to change the farm products rule is not likely in the forseeable future, if ever. Meanwhile utterly inconsistent special rules are being enacted on a state-by-state basis. Preemption of state law is justifiable not only to achieve uniformity, but also to correct the imbalance created by the federal Packers and Stockyards Act. Such preemption, with respect to the state-law Uniform Commercial Code, would not be unprecedented.

The sections below develop each of these points at greater length. There are also attached to this testimony several appendices which summarize the existing state law (including recent state legislation farm products exclusion), and the court decisions involving claims against buyers of farm products.

II. THE "FARM PRODUCTS EXCEPTION" IS AN ANOMALY IN COMMERCIAL LAW.

A. General policy of buyer protection in the UCC

1. UCC provisions.

The so-called farm products exception derives from the language of section 9-307(1) of the Uniform Commercial Code, which provides:

> A buyer in the ordinary course of business . . .
> other than a person buying farm products from a person engaged in farming operations takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence.

The general thrust of this provision is to insulate ordinary-course purchasers from the claims of prior secured parties, but the underscored language explicitly denies that protection to buyers of farm products.

The isolated nature of the farm products rule is clear on an examination of other UCC provisions. Under UCC 9-306(2) a secured creditor waives its rights in any type of collateral if the creditor has authorized the debtor to sell or dispose of the goods, and such authorization to sell may arise from explicit contract language, "or otherwise." UCC 9-308 and 9-309 confirm that bonafide purchasers of chattel paper, negotiable instruments, securities, warehouse receipts and bills of lading may take free and clear of prior

perfected security interests. Outside of the secured financing context, provisions in Articles 2, 3 and 7 of the UCC create broad bonafide purchaser protections for buyers of goods, negotiable instruments and negotiable documents. See UCC sections 2-403, 3-305, and 7-502.

The farm products rule is therefore clearly an exception to the mainstream commercial policy of permitting buyers to take free of prior claims of ownership or security.

2. The purposes of bonafide purchaser protections

It is important to understand why, as a general policy, the UCC favors purchasers over prior claimants. The reasons are basically ones of fulfilling the expectations of the parties, and implementing good public policy.

a. Goods cannot move smoothly through commercial channels if each buyer must initiate an investigation of the origins of the goods and of his seller's authority to sell. The buyer's usual expectation is that goods offered for sale by a merchant are legitimately in the stream of commerce, and that a purchase transaction -- once completed in the ordinary course of business -- will not be overturned or challenged by earlier secured creditors.

b. Protection of bonafide purchasers is also justified on pragmatic grounds. The secured creditor has presumably investigated the debtor's creditworthiness, integrity and business competence, to determine the level of risk in the transaction. Indeed a lender's business routinely includes calculating and taking those kinds of risks. The lender is therefore in a better position to monitor the debtor's conduct, to police the collateral, and to assure that the proceeds from the debtor's sale of collateral are applied on the debt. Purchasers, on the other hand, are generally not in a position to appraise whether the debtor/seller is properly performing its obligations under financing arrangements with various lenders.

c. The UCC confirms this general policy of protecting buyers in a striking fashion. Once the collateral is sold, UCC 9-306(2) gives the original lender an automatic and continuing security interest in the proceeds of that sale. Thus, when a farmer or rancher sells his crop or livestock, receiving in exchange the buyer's check, note or other payment obligation, that payment obligation becomes subject to the original security interest and may be seized by the lender to satisfy the original debt. This right to proceeds is in a very real sense a trade-off for allowing the buyer to take the actual collateral free of the security interest. But in the case of farm products the effect of these rules is that the lender's security interest continues in both the original collateral and the proceeds. The farm products lender gets two bites at the apple.

B. The "farm products exception" has never had clear theoretical or practical justification.

Against the general UCC policies for protection of buyers, just discussed, the "farm products exception" in UCC 9-307(1) stands as a unique rule that has never been adequately justified.

1. Origins of the farm products exclusion.

Protection for lenders on farm products collateral was the prevailing caselaw rule prior to the official promulgation of the Uniform Commercial Code in the early 1950s. Thus it is not surprising that the draftsmen should adopt that dominant view into UCC 9-307(1).

But what were the underpinnings of this special rule for farm products that the UCC draftsmen adopted? The Official Comments to the UCC say nothing about it. The principal draftsman of Article 9 of the UCC, Professor Grant Gilmore, has said that the the farm products exclusion exists "for reasons

which are never precisely articulated." II G. Gilmore, Security Interests in Personal Property §26.10 (1965). The gist of the pre-UCC caselaw was that somehow the purchaser just did not seem to merit treatment as a bonafide purchaser, at least when evaluated against the desire of the lender to retain its security interest protection.

Perhaps the best explanation is suggested by Professor Gilmore, and it is that a "small country bank holding a small country mortgage" made a more instinctively appealing plaintiff than did large commercial lenders. This makes sense. The court holdings that developed the special farm products rule are largely from the late 1800s and the early decades of this century -- times when the privately-owned, farm-community bank was thought to be indispensable to the area's economic progress and well-being.

It is doubtful that the "small country bank" syndrome offers any persuasive support for the farm products exclusion in the 1980s. Even the smallest banks -- with the assistance of trade associations and federal and state supervisory agencies -- have the capacity to operate sophisticated lending programs. If the farm products rule was originally thought necessary to prevent bank failure and the loss of customer deposits and savings, federal and state deposit insurance programs virtually nullify any such risk. Moreover, with the initiation of government financed or government supported farm credit programs under the aegis of the Department of Agriculture, the federal government itself has become a major financer of farm operations and thus a major beneficiary of the farm products exception. It taxes credulity to justify a preferential rule for large government lending programs on the ground that those programs are essentially "small country banks."

2. Nothing in the nature of farm products financing justifies treatment different from inventory financing.

Distinctive treatment for farm products financers could more easily be justified if that kind of financing were significantly different from financing against inventory or receivables. But it seems impossible to find any substantial or consistent difference in the financing patterns.

-- Financers of both farm products and inventory rely on collateral which is necessarily left in the debtor's possession for growing, processing, feeding, storage, exhibition or manufacture. The lender's risk position is the same in either case.

-- The seasonal nature of some farm products collateral is little different than much seasonal inventory (which may in fact consist of processed farm products).

-- Farm products financers as a group seem to be at no particular disadvantage, when compared to inventory financers, in exercising day to day monitoring or supervision of their debtors' handling of the collateral, and assuring proper application of proceeds. Both types of collateral, and both types of debtors, have elements of unreliability.

-- Financers, debtors and purchasers come in all shapes and sizes, regardless of the type of colllateral. There are small country banks, large farming conglomerates, Mom & Pop purchasers of commercial inventory, large government farm-credit institutions, and so on. There seems no basis for distinctions based on the size of the participants. Purchasers of farm products may be acting as brokers, users or processors; inventory buyers may be similarly categorized.

There is not even a clear and universal distinction between goods that are farm products and goods that are inventory. The same crop or livestock may be classified as farm products in one case but as inventory in another. The farm products exception operates only on collateral which, at the time of sale, is farm products as that term is defined in the Uniform Commercial Code. The definition lists crops, livestock and similar items, but imposes two additional specifications: (1) in the case of products of crops or livestock, they must still be in an "unmanufactured" state, and (2) in all cases, to be farm products, the goods must still be in the possession of a debtor engaged in farming operations. Any goods that fall outside this complex definition become "inventory" and so are not subject to the farm products exclusion. The definition indicates how shadowy is the dividing line between farm products and inventory. For example, one court found that where a rancher left livestock at a commercial feedlot and sold them from there, the livestock were "inventory" rather than farm products. Garden City PCA v. International Cattle Systems, 32 UCC Rep. 1207 (D. Kans. 1981).

The point is that there are no differences of significance between farm products and inventory -- yet purchasers of inventory qualify for bonafide purchaser protection while buyers of farm products do not.

Probably the strongest factor sustaining the farm products exception is simply inertia. The rule was incorporated into the UCC based on older judicial precedents, and has not been changed on the statute books of most states. Over time, of course, a protective rule such as this garners staunch defenders among those who benefit from it. But self-interest based on the status quo is not necessarily fair.

C. Specific ways in which the farm products exclusion is anomalous within the Uniform Commercial Code.

The farm products exclusion is inconsistent with the UCC's general policy of protecting the expectations of ordinary-course buyers, as just described. The odd nature of the farm products rule is shown in a number of specific instances.

1. Normally, when inventory collateral is sold off, the financer's security interest shifts from those inventory items to their proceeds. The farm products financer obtains such an enforceable security interest in the proceeds of sale -- the check, note, or other payment instrument -- which the financer can trace into the debtor's bank account if necessary. But by virtue of the farm products exception, that financer also continues to have an effective interest in the goods themselves, despite their sale. Farm products lenders, in other words, have two forms of security, where other lenders have only one.

2. According to UCC 9-301(1)(c), the farm products financer loses to a buyer in the ordinary course of business if the financer's security interest is left unperfected. Perfection usually involves filing a notice in an office in the county where the debtor resides. Yet, as discussed in more detail in the next section, buyers often find it impossible to verify whether financing statements are on file or not, before finalizing their purchases. Thus the farm products rule may or may not operate in the lender's favor, depending not on any particular knowledge by the buyer, but rather on the technicalities of the lender's own paperwork.

3. As noted above, the farm products rule does not apply if the goods are classified as inventory. Whether a particular farm commodity qualifies for the special rule may then depend on whether the goods have in some sense been "manufactured," or on whether they are still in the "possession" of the

farmer/debtor. These characteristics, which would shift a crop or herd of livestock from farm products to inventory, may be largely fortuitous. In other words, the financer may be unaware of, and have no control over, circumstances that change the character of his collateral and no longer subject it to the farm products exclusion.

4. The only interests that are preserved through the farm products exclusion are formal security interests (virtually always held by professional lenders). Other kinds of prior ownership interests can readily be cut off by bonafide purchaser rules elsewhere in the UCC. For example, suppose a rancher buys cattle from a neighbor in exchange for a check that bounces. If in the meantime the rancher resells those cattle to an innocent purchaser, that purchaser takes free and clear of the neighbor's claim of ownership. UCC 2-403. It is difficult to justify protecting the purchaser against this kind of fraud but not against the rancher's failure to pay the bank. It is equally difficult to explain why the professional lender deserves protection but the neighbor does not.

5. Perhaps the most bizarre effect of the farm products exception is that if the lender's security interest survives the debtor's sale to an immediate buyer, then it survives as to all subsequent purchasers as well. Thus a livestock financer, for example, could sue not only the commission merchant to whom the cattle were sold directly, but also the slaughterhouse that purchased from the commission merchant, and the packing plant, processor or other distributor, that bought from the slaughterhouse. Theoretically, the lender could pursue his collateral all the way to the consumer's dinner table. This is clearly the effect of UCC 9-307(1), even though in those subsequent sales the goods are

conventional inventory and no longer farm products. (In sales of inventory, the buyer takes free of security interests created by his immediate seller, but not free of earlier liens). The farm products exception, in other words, frustrates the expectations not only of the first buyer but all buyers in the chain of distribution.

III. STATE-LAW DISAGREEMENT WITH THE FARM PRODUCTS EXCLUSION.

Beyond the analytical weaknesses in the farm products exclusion, there has been substantial disenchantment expressed about it by courts, state legislatures, and UCC draftsmen.

A. Court holdings

Although protection for the farm products lender probably remains the majority rule based on UCC 9-307(1), a number of courts have found openings in the UCC through which the effects of that provision can be avoided.

The most common ground for judicial decisions in favor of the purchaser is that the lender somehow "authorized" the sale, thus relinquishing any continuing security interest in the farm products once they are sold. This notion derives from language in UCC 9-306(2), and the courts have read it as qualifying the farm products rule in 9-307(1). Typically, farm products lenders will specify in their loan agreements with producers that collateral is not to be sold without the lender's permission and without accounting for proceeds. Those courts which have found in favor of buyers have emphasized that despite such contract language a "course of dealing" had developed between the lender and borrower in which the lender acquiesced in sales made without express permission.

Not all courts have agreed on the applicability of this "waiver" theory. Some, intent on protecting the lender's interest, find either that the lender never gave any implied authorization to sell, or that the express terms of the

contract control over the parties' conduct. The minority line of cases recognizes the importance of the actual conduct of lenders, debtors and buyers, rather than simply relying on the literal language of the farm products exception in the UCC. The waiver or "authorization" cases thus show that judges will sometimes be creative, and will not apply the farm products rule unthinkingly in situations where it produces unfair results. Professor Barkley Clark, in his treatise on Secured Transactions Under the UCC, has recently noted that these cases "continue the swing of the pendulum in favor of bonafide purchasers in this area." These expressions of judicial conscience, however, are limited in number, and offer no long-term solution if the rights of the parties must be litigated in every case.

As noted earlier, other courts have found that the farm products financer may not recover from the purchaser for other reasons: either the lender's security interest was unperfected (as by an inadequate description of the collateral), or because the goods were no longer in the possession of a farmer and thus were "inventory" rather than farm products.

Together these cases confirm that the farm products exclusion is neither blindly applied nor universally approved in the courts.

B. A number of state legislatures have enacted statutes to ease the burden of the farm products exception on buyers.

Most of the security interest provisions of Article 9 of the Uniform Commercial Code have been enacted and retained in the form in which the draftsmen promulgated them. But the farm products exception has been the subject of direct or indirect modification in at least sixteen states. Most of these modifications have as their purpose to reduce the risk that farm products buyers may have to pay twice for the same goods, and thus to avoid the discriminatory effect of the farm products exception.

This state legislation is listed and summarized in an attachment to this testimony. The state laws fall into several distinct categories:

1. One state has repealed the farm products exception outright, leaving farm products collateral subject to the same rule as other inventory: i.e., ordinary-course buyers take free and clear of the lender's security interest. It is noteworthy that the state that flatly rejects the farm products rule is California, the nation's largest producer of agricultural commodities. Bills to repeal the farm products exception have been introduced in nine state legislatures in the past two years.

2. Another type of state law provision subjects the debtor to criminal prosecution if the debtor engages in misconduct such as selling collateral without accounting for the proceeds, or selling collateral to buyers not previously listed with the seller. The purpose of these criminal sanctions is to encourage the farm products producer to disclose the lender's involvement to the purchaser. The safe step for the purchaser is then to issue its payment check jointly to the seller and the lender, thus assuring that the lender realizes those proceeds.

3. Perhaps the most frequently used mechanism in these variant state laws is to require that the secured lender give specific notice of its lien to prospective purchasers in advance of sale, as a condition to the continuing validity of the lien against those purchasers. Here too the theory is that, with such notice, the purchaser will take steps to assure that the payment proceeds go to retire the seller's indebtedness to the lender.

4. A related technique in some states is to require the buyer to obtain from the seller a certificate which identifies any outstanding security interests. The buyer must then make payment jointly to the seller and lienholder. Unless the buyer receives such a certificate, and makes payment accordingly, buyer is subject to the lien.

5. A number of states in recent years have changed from county filing to central state filing for security interests in farm products. This limits the number of offices in which records must be checked to verify outstanding security interests, but those offices may still be hundreds of miles away from the point of sale, or in other states altogether.

6. Several states have shortened the statute of limitations applicable to the lender's action over against the purchaser. This reduces the contingent nature of the purchaser's liability to the lender, and may induce the lender to monitor the debtor/seller a bit more closely. But it does nothing to relieve buyers of the basic risk imposed by the farm products exception.

Together these state enactments suggest a growing concern in the state legislatures about the fairness of the farm products rule in UCC 9-307(1). Each of these approaches seeks to alleviate some of the risk for a purchaser who innocently buys farm products without immediately seeing to it that outstanding liens are satisfied. But together they represent only scattered and uneven responses to the problem. For example, a buyer located in one of these states would still be subject to the full force of the farm products exception if it purchased goods at sites outside that state.

C. The Article 9 Review Committee recommendations.

In the light of the more recent state legislative activity just described, it is worth noting that in 1970-71 there was a serious proposal to delete the farm products exception from the official Uniform Commercial Code. At that time the Permanent Editorial Board of the UCC had appointed a Review Committee to draft revisions of Article 9 of the Code. In a preliminary report, the Review Committee recommended that the farm products exception be eliminated,

but in its Final Report in 1971 the Review Committee waffled. Noting the pre-Code origins of the rule, the Committee "questioned whether the pre-Code practice is still sound under modern conditions," but doubted that the states would ever agree on a uniform policy. The Committee therefore softened its recommendation to an "optional" one.

The Permanent Editorial Board deleted the Committee's optional recommmendation, for reasons that are unexplained. In context, it is likely that the PEB simply wanted to avoid making such a schizophrenic optional recommendation on a point that was so controversial in the states. The PEB may also have been deferring to the desires of the federal government, whose farm credit agencies were frequently the lenders insisting on preservation of their security interests against purchasers.

IV. THE PARTICULAR DILEMMAS FOR LIVESTOCK PURCHASERS

The effect of the farm products exception is to force the purchasers of farm products to become either collecting agents on behalf of the lender, or guarantors of the debtor's honesty, or both. Purchasers, however, are in no position and have no skill or means to perform either function, and there seems little reason why they should have those responsibilities.

A. The impossibility of verifying farm products liens

Commercial sales of farm products commonly take place through a variety of market forums -- i.e., through auctioneers, commission merchants, stockyards, warehouses, feed lots, buying stations, sale yards, terminal markets, and the like. Sale locations have tended to shift from large terminal markets to points closer to the farmer's or rancher's operations. Deals are negotiated, struck and consummated quickly, in a setting where complete and reliable information about the seller's outstanding loans and security interests on particular lots of goods may not be immediately at hand.

In this setting, the buyer concerned about protection from possible future claims by the seller's financing institution has some very limited options. The buyer may ask the seller about the existence of liens and the identity of the lienholder. If such information is provided, the purchaser may issue checks payable jointly to the seller and the lienholder, or may seek lien waivers from the lender. But the seller may be unreachable (for example if goods are being handled through brokers or agents); or a seller engaged in widespread farming or ranching operations may not have available the details of financing arrangements covering those specific goods; or the seller may simply misrepresent the true facts. This latter possibility is likely in cases where the seller intends to divert the proceeds, and it is in just these cases that the unpaid lender will later seek a second payment from the purchaser.

Alternatively, and theoretically, the purchaser may check the filed financing statements required of secured creditors under Article 9 of the UCC. Such financing statements, indexed in the name of the debtor, identify the lienholder and contain at least a summary description of the covered collateral. The very purpose of the UCC filings is to alert third parties about outstanding secured claims.

Ironically, however, the UCC filing system that is designed to prevent misrepresentation and secret liens is largely useless for that purpose in the farm products setting.

With filings generally located in the county of debtor's residence or where the crops are grown, the purchaser needs to ascertain the seller's name and the appropriate location. That seemingly simply information may be quite elusive, for sellers operate as sole proprietorships, partnerships,

corporations (with subsidiaries and operating divisions), and through syndications; and they may operate as several different commercial entities simultaneously. The county, even the state, of "residence," or of crop location, may be problematic for widespread production enterprises. Even if a financing statement is found, it may reflect only a general description of collateral -- such as "1983 wheat crop," or "beef cattle" -- without further specification.

Not only is the public record information difficult to find and often imprecise, but distance and time constraints make the problem more acute. Buyers must often settle for purchases on the day of sale or shortly thereafter, while lien information is located in offices that are usually open only during normal business hours. Moreover, those filing offices are likely to be many miles away, or even in different states.

As a practical matter, therefore, farm products purchasers are often powerless to verify and respond to the risk of an undisclosed security interest. Yet the effect of the farm products exception is to force those purchasers to guarantee that payment by them will actually reach the (undisclosed) lienholder.

B. Effect of the "prompt payment" rule of the Packers & Stockyards Act.

Purchasers of livestock (as distinct from other farm products) face a special problem that increases their dilemma. By virtue of Section 409 of the Packers and Stockyards Act, 7 U.S.C.A. § 228b, cash purchasers of livestock must settle for their purchases by check or wire transfer before the end of the next business day after the purchase is made. That is, federal law requires final payment for the livestock within a time frame that is so short

that it becomes virtually impossible to make inquiries of and receive responses from UCC filing offices that may be scattered through numerous states and counties. The purchased livestock itself is held "in trust" for the sellers until those payment checks clear.

This federal "prompt payment" rule was strengthened by statute in 1976, as part of an effort to protect livestock producers from the risk of non-payment. This had happened following the bankruptcy of several large meat packers whose checks for livestock purchases were then dishonored. Properly administered, the PSA prompt payment provision may serve a useful purpose, but its causal relationship to the problems arising from the farm products exception is clear. On the one hand federal law forces livestock buyers to pay promptly to the seller; on the other hand the farm products rule of the UCC forces them to pay again to the seller's financer if the seller misappropriates the original payment. This seems a classic Catch-22 pattern.

There is an irony here as well. The prompt payment rule in section 409 of the Packers and Stockyards Act was created to deal with problems flowing from the collapse of meat packing and processing companies. The indirect effect of the PSA provision is to increase the risk that those packers and processors will have to pay twice for some livestock; this kind of risk can only contribute to the possibility of more meat packer failures.

V. PREEMPTION OF STATE LAW WITH RESPECT TO THE FARM PRODUCTS EXCEPTION SEEMS JUSTIFIED, AND IS NOT UNPRECEDENTED.

A. Preemption is justified to deal with a problem of national scope where state law solutions are inadequate or uneven.

Present agricultural markets generally have relatively fewer (but larger) purchasers of agricultural products for processing and resale than in the past. This tends to blur state lines and create more national (or at least

regional) markets for farm products. Differences in the state law applicable to farm products sales become obstacles to the smooth operation of those national and regional markets, and at such a point federal intervention and preemption may become necessary.

Just such a situation is occuring with respect to the farm products exception. What was once a uniform state rule protecting the farm products lender is now being whittled away by numbers of state statutes and court opinions. Courts in some states continue to apply the farm products exception literally, while courts in other states are inclined to find that the lender has waived the lien by "authorizing" sales of the collateral.

A quarter of the states have acted legislatively to mitigate the farm products exception, imposing various requirements to help assure that farm products purchasers are not unduly burdened. But these approaches are inconsistent from state to state, and that inconsistency undercuts any utility those state innovations may have. Corrective action by one state does not even help its own residents when they purchase farm products elsewhere.

There is no realistic prospect that the Uniform Commercial Code will be amended to adjust the farm products exception at the state level. There are currently no plans for revising Article 9 of the UCC in this regard. Even if an official or "optional" amendment were recommended by the Permanent Editorial Board and the other UCC sponsors, there is little likelihood it would be adopted in uniform fashion throughout the country.

With respect to the Farmers Home Administration and other federal farm creditors, there is an especial reason why a federal statutory rule on bonafide purchaser rights is appropriate. Because of the federal government's interest in those lending programs, the courts have long agreed that the

government's rights as a creditor are not controlled absolutely by state law and may be determined by courts as a matter of federal "common law." But in its decision in United States v. Kimbell Foods, Inc., 440 U.S. 715 (1979), the Supreme Court ruled that governmental entities such as the Small Business Administration and the Farmers Home Administration would be bound, as a matter of federal common law, by non-discriminatory state law of general applicability. The effect is that the rights of the FmHA and similiar lenders are controlled by the Uniform Commercial Code. To the extent those rules begin to vary from state to state with divergent interpretations of the UCC, or with additional state statutory conditions, there is further justification for a standard, nationwide rule.

B. There is an overriding justification for preemption in the case of buyers of livestock.

Beyond the reasons just mentioned for federal preemption of the farm products rule, there is an additional consideration affecting buyers of livestock. This is the fact that part of the problem for livestock buyers is caused by federal law. The "prompt payment" provision in Section 409 of the Packers and Stockyards Act turns the screws several notches tighter for livestock purchasers, who must pay their sellers immediately, usually without opportunity to verify pre-existing liens. This federal provision, intended to cure one difficulty, in fact created a new one.

Congress should acknowledge that its handiwork in 1976 has compounded the problem of livestock purchasers. A preemptive federal law abolishing the farm products exception would be the most appropriate response.

C. Preemption in this context has ample precedent.

If Congress were to preempt the farm products exception in the UCC, it would hardly be the first time federal law has displaced portions of the Uniform Commercial Code.

The most obvious precedent is in Section 410 of the Packers and Stockyards Act, 7 U.S.C.A. § 228c, which specifically preempts state laws dealing with the bonding of packers and with prompt payment by packers for livestock purchases. The "trust" provision of the same federal law, Packers and Stockyards Act § 206, effectively displaces those UCC provisions which some courts had held to deny sellers the right to reclaim the goods if the buyer's checks were dishonored.

Outside of the farm products area, there are numerous examples of federal laws that supersede portions of the Uniform Commercial Code. For example, security interests in ships, aircraft, and railroad rolling stock are subject to federal statutes with respect to perfection and priorities. The Federal Bills of Lading Act controls over Article 7 of the UCC for interstate carriers. Portions of the Magnuson-Moss Warranty Act limit the operation of rules in Article 2 of the UCC. The Federal Reserve Board's Regulation J applies to check collections through the Federal Reserve system, notwithstanding UCC Articles 3 and 4.

The list could be extended. The point is that Congress has not hesitated to act and to preempt even such deep-rooted state law as the UCC when there is justification for doing so.

D. Preemption of the farm products exception should not unduly disrupt farm credit operations.

If Congress were to abolish the farm products exception by federal statute, the immediate consequence is that farm products financers would no longer be able to throw off onto innocent purchasers the risk of loss when the producer fails to apply the sale proceeds on the debt. This, we submit, is

just what the law should provide, in the interests of fairness and to prevent continuing discrimination against purchasers of farm products. Whether such a reallocation of risk would have any disruptive effect on the operations of farm lenders and producers is necessarily a matter of speculation.

A number of factors suggest that the impact of a preemptive federal law would be minimal. For one thing, some farm products financers bear those risks already: there is no farm products exception in California, and court holdings in other states deny its use to lenders who have authorized the sale of collateral. Presumably some lenders, though legally entitled to pursue the purchaser, do not do so for reasons of expediency (distance, likelihood of recovery, litigation expenses, etc.). So the amount of new risk is unclear.

For another, preemption of the farm products rule would not mean that purchasers could never be accountable. The buyer would still have to qualify as a "purchaser in the ordinary course of business." The buyer would have to be acting in good faith and without knowledge that the particular sale was unauthorized. These criteria would permit the lender to recover from any buyer who was a knowing participant in an unauthorized sale.

A reallocation of risk from buyers to lenders is also justifiable if the net amount of losses would be reduced, or if those losses could be absorbed more efficiently by lenders than purchasers. A case can be made for each of these suppositions. Losses from unauthorized sales and unaccounted-for proceeds now fall indiscriminately on buyers. That is, the loss occurs after the sale when a particular producer fails to pay off the secured loan with the sale proceeds. Buyers are powerless to predict in advance the transactions that will cause losses, and powerless to control the debtor/seller's use of

the proceeds once the sale had been finalized. Lenders, on the other hand, generally maintain continuing relationships with their debtors, through which they can periodically check the status of the collateral or demand prompt accounting for collateral that has been sold. It is likely that lenders confronted with a new measure of risk of non-payment will minimize that risk through inexpensive, routinized policing techniques.

Further, lenders are inherently better positioned to absorb and distribute the resulting losses. For example, lenders can reflect actuarial projections of unauthorized-sale losses in their rate and fee structures for distribution among all borrowers. Or insurance against that specific form of risk may be feasible. Under the present law, by contrast, the losses fall fortuitously and randomly on purchasers of different sorts who as a group are much less likely to be able to absorb or distribute the losses through their customer base.

With a clearly preemptive federal rule, financers and producers would be spared the burden and expense of complying with the various recent state laws that impose extensive disclosure or certification duties on them.

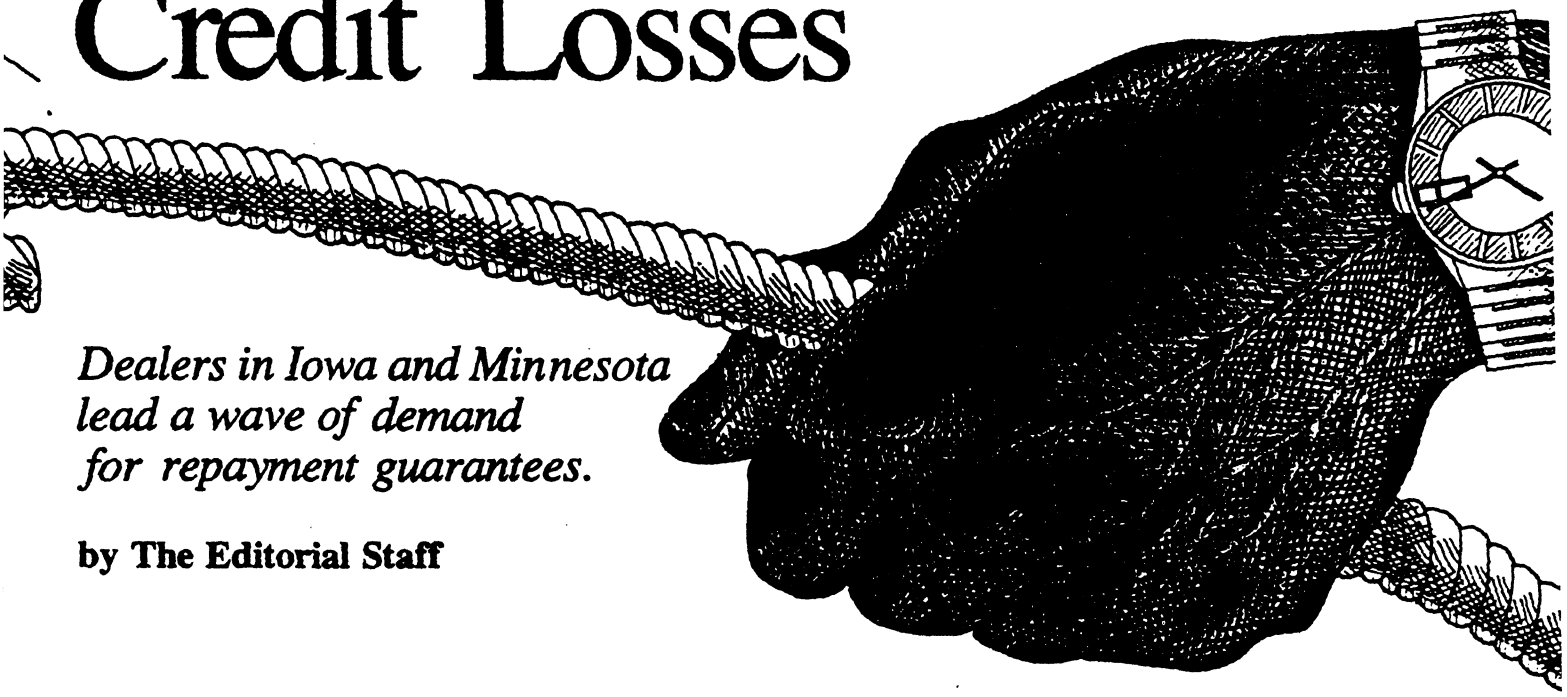
Some may argue that at least a marginal increase in the cost of farm credit is inevitable if the farm products exception is preempted by federal law. This Subcommittee could usefully inquire into just that possibility. We doubt, however, that this Subcommittee or the Congress would find any measurable interference with farm products financing.

VI. CONCLUSION

In summary, the so-called farm products exception as it now exists in UCC 9-307(1) is anomalous and inequitable. It casts a risk of loss on innocent purchasers that the UCC generally would impose on the lender as a cost of its business. It has the effect of making farm products buyers unwitting guarantors of the seller's honesty, while the buyers are powerless to protect themselves against that exposure. The farm-products exception is fragmenting in the courts and in state legislatures, in a way that makes uniform, preemptive federal law appropriate. Federal preemption is particularly fitting in the case of livestock purchasers because the federal Packers and Stockyards Act contributes to their dilemma. Finally, there is no basis to believe that a reallocation of this risk would seriously disrupt farm credit activities.

We appreciate the opportunity to present these views, and encourage the Subscommittee to take steps to solve this farm products problem. We note the two bills pending on this matter, H.R. 3296 and H.R. 3297, and hope the Subcommittee will pursue them.

Holding the Line on Credit Losses



Dealers in Iowa and Minnesota lead a wave of demand for repayment guarantees.

by The Editorial Staff

"Not since the 1930s has the issue of debtor distress gripped the farm community as it has during the '80s," says Neil Harl, an Iowa State University agricultural economist, who monitors the financial health of American agriculture. Thirty percent of the nation's farmers are fully "loaned-up" and face serious economic problems, he says, while 5 percent are expected to fail by year's end.

News accounts of increased farm foreclosures and predictions that relief is not imminent have sent farm lenders, input suppliers, and a cast of other related businesses scrambling to assess more carefully the financial capabilities of their credit customers—and to cut losses from outstanding accounts.

Declining Equity Positions

Last March, a survey of Iowa farmers found that 28 percent of those polled were carrying debt-to-asset ratios of greater than 40 percent. Much of this problem can be traced back to a 1982 falloff in farmland values that eroded 13 percent of the average farmer's equity. As a result, cropland which had earlier served as loan collateral now represents less security—prompting lenders to reduce the size of production loan allowances, or require farmers to follow other dramatic measures aimed at paring down cash expenditures and bolstering liquid assets critical to servicing debt repayment schedules.

Fertilizer retailers have closely monitored the myriad maneuvers of farm banks to reduce lender vulnerability to questionable agricultural loans and ensure that collateral security agreements remain binding. One such method, say retailers, is lender pressuring of highly-leveraged farmers to look to farm suppliers for a growing share of annual production funds—in the form of retail credit.

In Iowa, dealers have charged the state's banking community with being too lenient on farmers in granting loan requests. Bankers answer these accusations with charges of their own, blasting retailers for being too quick to extend credit in order to land a sale.

To be sure, retailer-supplied credit has long been a fertilizer industry marketing tool. Yet, today, farmers and suppliers alike regard customer credit as much more than a sales aid; it has become a fact of everyday business life.

Laws Are Changing

However, news of the continued deterioration of farmer financial positions has convinced many retailers to seek greater repayment security and more efficient methods of determining customer credit worthiness. Each year, dealers say, farmers increase demand for credit. Yet, under many state laws, farm suppliers are forced to deal with cumbersome and time-consuming credit procedures.

What's more, when account collection problems arise, most retailers find themselves categorized as common creditors—a position which reduces their likelihood of recovering overdue accounts. These and other related frustrations are magnified as farmers increase their demand for still greater amounts of credit.

In Iowa and Minnesota, retailer concern over this issue prompted successful campaigns to give farm suppliers the right to file priority liens against a customer's crops or livestock. As a result, dealers can recover the value of products or services which were provided through prior credit agreements. In addition, both states adopted supplemental legislation requiring lender cooperation in disclosing the financial capabilities of customers seeking credit. And, if the overwhelming dealer support that both campaigns attracted is any measure of sentiment nationwide, a rash of similar contests is likely as retailers respond to reports of deepening farmer financial distress. In-

deed, at least 10 other state fertilizer dealer associations are exploring options for introducing similar legislation.

But, farm supplier interest to establish tougher lien laws isn't a new-found issue. Similar lien legislation already exists in several states, including Nebraska and North Dakota. Opposition from banks and other lending institutions, however, has been sufficiently convincing in most other states to persuade lawmakers that no real need for change exists.

Holding Lenders Accountable

Nevertheless, the recent passage of lien legislation in Iowa and Minnesota underscores the seriousness and determination of retailers to resolve the credit issue. The legislation, which requires mutual cooperation between lenders and suppliers in sharing farmer financial information, is viewed as a pragmatic approach—one which almost all affected factions could support in the final analysis. But perhaps even more extraordinary are mandated procedures that hold lenders accountable for their assessment of customer credit worthiness—procedures which assure repayment of overdue accounts when creditors are previously judged to have sufficient repayment capacity.

The drive to implement crop lien legislation in Iowa began more than two years ago and culminated with a compromise version this past April. Under the legislation, which will become effective with fall fertilizer applications, dealers can now submit financial disclosure forms—signed by the customer seeking credit—to determine if the individual has an adequate cash capacity to cover anticipated purchases. The dealer can also learn if any security agreements have already been filed in connection with existing loan obligations.

Upon receipt of the notice, the customer's lender has two days to inform the supplier whether the applicant has an adequate net worth or credit capacity with the bank to ensure repayment of the season's credit purchases. If the lender indicates the customer doesn't have sufficient equity to assure repayment, such notice serves as fair warning to the retailer that he must accept the risk of nonpayment if he grants the credit request.

However, if the lender acknowledges that the applicant has sufficient collateral to repay planned credit purchases, the lender's letter becomes an irrevocable letter of credit guaranteeing the repayment of all credit purchases indicated under the notification statement. Thus, retailers can make more informed judgments as to whether credit can be safely extended. The procedure assures they're briefed on the likelihood of repayment, and where their lien would stand in respect to collecting compensation, should the customer fail or refuse to satisfy an established repayment schedule.

Confusion Over Collateral

Farm lenders in Iowa and Minnesota, however, had argued against granting fertilizer retailers the ability to secure priority crop liens. They said it clouded the issue of which portion of a growing crop can be guaranteed as secure lender collateral. Lenders warn that this issue could result in restricted credit to marginal farmers.

The Iowa Banker's Association (IBA) was one of the most vocal opponents of retailers in their bid to pass the lien legislation. Neal Conover, chairman of IBA's agricultural legislation task force, says the sales-driven nature of the fertilizer and feed supply business significantly reduces its regard for the overall financial health of a farm operation compared to that of a principal lender. Therefore, once retailers are guaranteed the security of a priority lien position, sales staffs could be inclined to encourage fertilizer purchases over and above those levels actually necessary, or beyond the farmer's repayment capacity.

"If a supplier is going to have first rights on a crop, we may not be able to lend the customer the total amount of production funds he requests because there may be uncertainty over collateral positions," Conover adds. That means suppliers could end up providing more credit to marginal customers than they ever have before, he warns.

"Retailers may have a lien position, but will the strength of their receivables be better than under the present position?" Conover asks. "Just having collateral growing out in the field doesn't help. It's got to be harvested, hauled to the elevator, and be credited to the supplier. There is a lot of room for mistakes."

Lenders, he says, are also concerned about the form of collateral they can actually count on. "A farmer could obligate himself several times over on the same crop in covering the costs of seed, fertilizer and agrichemicals, and other production suppliers—and, as a result, there wouldn't likely be enough money from the crop to compensate all lien holders.

"It's always been a popular notion that there should be enough cash to go around," Conover explains, but in reality, it's much easier for a farmer to get over-extended. In addition, the Iowa bankers contend that the right to file priority liens won't necessarily ensure retailer repayment for outstanding accounts.

Lien Privileges Important

Still, according to Winton Etchen, executive vice president of the Iowa Fertilizer and Ag Chemical Association, even if retailers are only allowed to secure a secondary lien against a customer's crops, they would be in a better position than before the priority lien legislation was adopted. "The new law provides the privilege to file a lien. Before, we would line up with our hand out just like anyone else when a customer went under, even though we supplied a good share of the costs of that crop," Etchen says.

Indeed, almost half the production expenses of a corn crop are represented in the cost of fertilizer and agrichemicals. And, without a crop equity position, retailers didn't have a practical recourse for collecting overdue payments. Now, according to Etchen, if a retailer suspects a potential customer to be a credit risk, he can request that the individual sign a financial disclosure form. And, if he refuses, the association recommends that the dealer operate on a cash-payment basis.

Similarly, if the bank reports that a potential customer isn't good for the amount of credit desired, the retailer has a business decision to make—based on documented facts, not from rumors passed at the coffee shop. And, if the retailer elects to grant credit despite the risks, he also knows at the outset what additional security agreements are pending. "That's still better than being treated as a common creditor," Etchen insists.

Communication Is Key

In Minnesota, where similar supplier lien legislation was recently approved, Rebecca Klein, legislative affairs specialist for the state's Farm Credit Services, says the first and most important step in solving the issue of retailer risk in granting credit is the required communication between suppliers and lenders in evaluating customers suspected of being poor risks. "Most situations that involved retailer absorption of bad credit were a result of an absence of dialogue between suppliers and lenders," she says. "With communication," she adds, "we've found that lenders and suppliers get along very well and are able to work out alternate financing plans."

Iowa's Conover says such cooperation was widely practiced in his state despite the fact that no mandated lines of communication between supplier and lender existed. "Our country bank has seven retail fertilizer suppliers as customers and it's been common for them to discuss their list of farm clients, and determine

:o are acceptable credit risks."

Moreover, he argues that an existing mechanism for securing financial information on prior security agreements and loans was already sufficient. According to Conover, all state loan filings are handled through the secretary of state's office. Retailers could learn the names of a customer's creditors simply by calling that office and then seeking out creditors to gain specific information on the terms and status of any loan.

"If the decision to press for a change in the code was to establish a mechanism for good communication, that mechanism already existed," he says. "However, fertilizer dealers never desired to make use of it. This informal system worked quite well, but it just didn't work to the satisfaction of fertilizer dealers," he maintains. "Still, it's exactly the same mechanism bankers are expected to live with as extenders of credit."

But, this is precisely the point retailers argue most passionately against. "Farm suppliers aren't qualified to accurately judge the credit worthiness of customers. We're in the business of supplying products and services," says Craig Sallstrom, executive director of the Minnesota Plant Food and Chemicals Association. Sallstrom agrees that retailers have played an important role in supplying significant levels of credit, but adds that they'd prefer to remove themselves completely from the credit evaluation process.

Dealers Must Do Homework

But both retailers in Iowa and Minnesota also concede that the recently passed supplier lien legislation won't eliminate all the risks inherent in extending credit. "It's not going to solve all our problems, but it will bring bankers back into the overall decision process," says Sallstrom. "There will still be instances in which someone you never suspected as having financial troubles—a true pillar of the

Iowa's Unique Approach To Ag Lien Laws

Last April, the Iowa Legislature approved a bill that enables fertilizer retailers to file a statutory lien against a marginal credit customer's crops and livestock to secure payment for fertilizers, agrichemicals, seed and any petroleum products that the dealer supplies for the production of a farmer's crops.

Under prior legislation, fertilizer and agrichemical dealers had a secondary security position at best. The state's Uniform Commercial Code system required suppliers to obtain written security agreements and to file financing statements, each signed by all the customer's debtors. For most dealers, the time required to obtain this information, and to secure the signature of every debtor proved overwhelming.

Even if dealers took the time and expense to prepare the necessary documents, chances were they'd still find themselves second in the collection line, due to a clause which grants lending institutions superior liens against crops growing on mortgaged real estate.

But many retailers repeatedly argued that they were entitled to a superior lien for the value of the products and services they provided. On the other side, representatives of the banking industry maintained it was inappropriate for suppliers to have a superior lien on crops already collateralized with the lending institution. However, early last spring, both retailers and lending agencies agreed to support compromise legislation which directs the two groups to help each other in identifying farmers with marginal repayment capabilities.

The resulting legislation requires retailers to contact a potential customer's lending agency to determine if it has a security interest in the customer's collateral, or if the agency is holding any unpaid agricultural notes owed by the customer. The lending agency then has two business days to provide a written acknowledgement stating whether the customer has a sufficient net worth or line of credit to assure payment for all fertilizers or agrichemicals he plans to purchase on credit. If the customer's bank indicates that the individual has the capability to cover his fertilizer credit purchases, the retailer is not entitled to a crop lien with respect to that customer. However, the bank's written response to the dealer becomes an unconditional letter of credit for a period of 30 days following the final payment deadline for the dealer's products and services purchased on credit.

If the customer's bank indicates the individual doesn't have a sufficient net worth or line of credit, the dealer can file a lien. The retailers could still be at risk, however, since the lien is inferior to a prior perfected lien of the lender. Thus retailers achieve a better position to evaluate a customer's repayment capability before having to make the decision to extend credit privileges.

Iowa's lien legislation also requires that lenders provide data that offer a true assessment of customer credit worthiness. Therefore, if a lender's credit information contradicts a customer's actual financial capabilities, retailers can conceivably obtain a lien equal to the previously perfected lien of the lender.

In situations where a customer's lender refuses to provide a letter of credit, retailers can obtain a crop lien for the retail cost of all fertilizers, agrichemicals, seed, petroleum products and labor which a retailer furnishes.

The lien attaches to all crops grown on land to which such products were supplied within 16 months following the last date of application.

However, crop liens must either be filed within 31 days following the initial due date of the customer's credit account, or before September 1 of the current crop year—whichever deadline occurs first.

Each lien must contain:

- The name and address of the dealer and customer;
- An itemized declaration of the nature and retail value of the products and services furnished;
- The last date on which the products and services were furnished;
- The first date on which payment was due from the customer; and
- A legal description of the cropland to which the lien refers.

In addition, the Iowa legislation requires retailers to secure a certificate which lists any existing financing statements or verified liens filed against the individual. Then, the dealer is obligated to notify creditors appearing on the certificate by registered mail.

If all filing requirements are met, the lien retains its superiority over subsequently attaching liens, except those under the state's Landlord, Thresherman's or Cornsheller's lien laws. In addition, crop liens are equal to liens of record or security interest perfected prior to the time the lien was filed.

However, the dealer's lien will be inferior to the lender's prior perfected lien if the lender truthfully informed the dealer that the customer did not have a sufficient net worth or line of credit to cover the dealer's charges.

Iowa's crop lien law is a unique way of addressing retailer credit concerns. Farm suppliers were able to convince substantial majorities in both chambers of the Iowa Legislature that the law was necessary to reduce the large losses experienced by these dealers.

Iowa's approach may be appropriate in other states, but only if lawmakers believe that existing legislation is inadequate to protect essential farm services.

—Steven C. Schoenebaum

ommunity—is found to have serious redit problems," he adds. "We could also ose some customers because they ecome upset when asked to sign a finan- ial disclosure form. But maybe you're etter off having that customer go down he street to somebody else."

Winton Etchen adds that the lien laws hould encourage early identification of narginal credit customers due to the egislation's procedural requirements. Retailers can't wait until the season is pon them to tell a customer who calls up o order fertilizer that he has to come in nd go over his financial information and ign a disclosure release," he says. Retailers will have to do their homework head of the season—which is a good levelopment under any circumstances."

Even Neal Conover agrees that the new egislation provides some worthwhile neasures, such as the stipulation which equires financial disclosure forms signed y the customer. "It will put us in a bet- er position to discuss the features of ustomer credit arrangements," he says. Conover readily admits that some bankers lon't do a thorough job of disclosing in- ormation with farm suppliers: "It's not a erfect world—it's a little tough to find ankers that are all uniform in how they iew dissemination of information—just ike it might be tough to prove that every fertilizer dealer is committed to collecting good credit information."

Final Outcome Unclear

One thing, however, is for sure. Few of the proponents or opponents of the Iowa and Minnesota legislation can predict the long-term effects of their recent actions. Most Iowans and Minnesotans trace their awareness of liens back to 1977, when retailers in Nebraska passed a fertilizer and agrichemical lien law. Robert Anderson, president of the Nebraska Fertilizer & Ag Chemical Institute, dismisses lender claims of potential credit restrictions to financially strained farmers as an utter falsehood. Says he: "Despite continued warnings from bankers that marginal customers would suffer increased rejections of credit due to a fertilizer lien, I have yet to hear of a definite case." Prior to the Nebraska lien law, fertilizer dealers flatly refused credit to marginal farmers if they were cut off by their own bank, Anderson recalls. Now, if a lender restricts credit to 75 percent of the previous year's borrowing capacity, the dealer can secure the crop on which his products are to be applied.

Nebraska's program has been even more important in encouraging an increased emphasis in the proper management of customer credit. "You've got to set goals and establish a structured credit program," Anderson says. "If established procedures are not in place and you're unaware of your sales costs, and how many additional sales are necessary to cover those costs, you can't manage such programs effectively."

The success or failure of the Iowa and Minnesota supplier lien legislation is far from being written, says Neal Harl. "There are probably going to be some problems over who has specific rights under special conditions.

"We clearly need an integrated, coordinated approach to lending and credit extension which takes into account the interest and needs of the vendor, the farmer and the lender," he says. "Thus far, each state is taking the action of implementing it's own lien legislation—a piecemeal approach to a national problem. But it's a step in the right direction," he emphasizes. "It encourages the lender and the vendor to get together and size up the farmer's capability together."

Undoubtedly, the success and interpretation of lien priority positions will require several examinations before long-term difficulties are ironed out. However, the benefits of mandatory cooperation between suppliers and lenders may be a positive step in providing both immediate and long-term gains. ■

98TH CONGRESS
1ST SESSION

S. 2190

To amend the Agriculture and Food Act of 1981 to provide protection for agricultural purchasers of farm products.

IN THE SENATE OF THE UNITED STATES

NOVEMBER 18 (legislative day, NOVEMBER 14), 1983

Mr. HUDDLESTON introduced the following bill; which was read twice and referred to the Committee on Agriculture, Nutrition, and Forestry

---

A BILL

To amend the Agriculture and Food Act of 1981 to provide protection for agricultural purchasers of farm products.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) title XI of the Agriculture and Food Act of 1981 is amended by adding at the end thereof a new section 1123 as follows:

"PROTECTION OF BUYERS OF FARM PRODUCTS

"SEC. 1123. Notwithstanding any provision of Federal, State, or local law, a buyer in the ordinary course of business who buys farm products from a seller engaged in farming operations shall take free of a security interest created by the

seller even though the security interest is prefected and even though the buyer knows of its existence.".

(b) This section shall become effective thirty days after enactment, except that liens made prior to the effective date shall be exempt from the provisions of this section.

O

98TH CONGRESS
1ST SESSION

H. R. 3296

To provide that a buyer in the ordinary course of business who buys farm products from a person engaged in farming operations shall own such goods free of any security interest in such goods created by his seller even though the security interest is perfected in accordance with applicable State law and even though the buyer knows of its existence.

IN THE HOUSE OF REPRESENTATIVES

JUNE 14, 1983

Mr. HARKIN introduced the following bill; which was referred to the Committee on Agriculture

---

A BILL

To provide that a buyer in the ordinary course of business who buys farm products from a person engaged in farming operations shall own such goods free of any security interest in such goods created by his seller even though the security interest is perfected in accordance with applicable State law and even though the buyer knows of its existence.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Farm Products Buyers' Protection Act of 1983".

FINDINGS AND PURPOSE

SEC. 2. (a) The Congress finds that—

(1) certain State laws permit secured lenders to enforce liens against a purchaser of farm products even if the purchaser lacks knowledge that the sale of such products to him is in violation of the ownership rights or security interest of such lenders in such farm products, lacks any practical method for discovering the existence of such a security interest, or lacks any means to assure that the payment of the loan of such lender has been made;

(2) such laws permit purchasers of farm products to be subjected to double payment for the cost of such products, first at the time of purchase, and second when the seller fails to pay a debt which has been secured by the farm products and the holder of the security interest levies against the purchaser;

(3) the exposure of purchasers of farm products to double payment inhibits free competition in the market for farm products by discouraging purchasers from dealing with sellers who have defaulted or may default on loans; and

(4) this double exposure constitutes a burden on and an obstruction to commerce in farm products.

(b) The purpose of this Act is to remove such burden on and obstruction to commerce in farm products.

DEFINITIONS

SEC. 3. For purposes of this Act—

(1) the term "buyer in the ordinary course of business" means 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 of that kind, and buys such farm products in good faith and without knowledge that the sale thereof to him is in violation of the ownership rights or security interest of a third party;

(2) the term "farm products" means—

(A) agricultural commodities,

(B) livestock,

(C) poultry,

(D) supplies used or produced in farming operations or aquacultural operations, or

(E) unprocessed products of agricultural commodities, of livestock, of poultry, or of aquacultural operations, including wool, maple syrup, milk, and eggs,

which are in the possession of a person engaged in farming or aquacultural operations;

(3) the term "knows" or "knowledge" means actual knowledge;

(4) the term "security interest" means an interest in farm products which secures payment or performance of an obligation; and

(5) the term "State" means any of the several States, the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands of the United States, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, the Trust Territory of the Pacific Islands, or any other territory or possession of the United States.

PROTECTION OF BUYERS OF FARM PRODUCTS

SEC. 4. A buyer in the ordinary course of business who buys farm products from a person engaged in farming operations shall own such goods free of any security interest in such goods created by his seller even though the security interest is perfected in accordance with applicable State law and even though the buyer knows of its existence.

EFFECTIVE DATE

SEC. 5. (a) Except as provided in subsection (b), this Act shall take effect upon the date of its enactment.

(b) This Act shall not apply with respect to a security interest in farm products arising before the date of enactment of this Act.

○

MORTGAGED AGRICULTURAL COMMODITIES

Senator Huddleston (D-KY) has introduced a bill, S. 2190, which helps correct the problem created by producers who illegally sell mortgaged livestock, grain, cotton, etc., and use the funds for purposes other than repaying the lender. Farm Bureau has supported legislation to correct this problem because:

1. The double-payment penalty is jeopardizing the financial security of many markets (livestock, grain, cotton, etc.) to whom farmers sell their products. Farm Bureau is interested in eliminating problems which can reduce market opportunities.

2. It's not always livestock markets or grain elevators who are forced to pay for commodities twice. Many farmers buy breeding stock, feeder pigs, etc., from other farmers and are forced to pay twice for the commodity.

3. Losses due to double payments for products are passed on to other producers in terms of higher marketing fees and processing costs.

S. 2190 corrects the problem by deleting the farm products exemption clause in the Uniform Commercial Code (UCC).

The UCC provides that buyers in the ordinary course of business will be protected, except buyers who purchase farm products, by being able to take title of goods free and clear of security interests even if the goods are collateral on a loan that the seller defaults on.

On the other hand, the good faith buyer of farm products is not protected. Such a buyer can end up having to pay twice for the farm products in order to take title--once to the farmer and again to the secured party if the farmer fails to repay his secured loan and the secured party is seeking restitution.

There does not appear to be a valid reason for differentiating between buyers of farm products and buyers of other commercial goods. Treating farm products differently has only caused serious problems for buyers, sellers and the courts.

Most bankers oppose S. 2190 and argue that the cost and availability of money to farmers will increase. However, California eliminated the farm products exemption in 1976 and no adverse effects on farm credit have resulted.

Lenders don't want any change in the farm products exemption in the UCC because it lowers risk exposure without any increase in cost. Banks can afford to be lax in loan supervision because of the added protection granted in the UCC.

United States Senate

COMMITTEE ON
AGRICULTURE, NUTRITION, AND FORESTRY
WASHINGTON, D.C. 20510

February 6, 1984

Dear Colleague:

We invite you to join us in sponsoring S. 2190, a bill to amend the Agriculture and Food Act of 1981 to provide protection for purchasers of farm products. The bill will enable buyers of farm products to take such products free of third-party security interests.

The Uniform Commercial Code, which has been adopted by all States except Louisiana, provides protection for all buyers of goods in the ordinary course of business except buyers who purchase farm products. The Code gives all except agricultural purchasers the right to take title of goods free and clear of security interests even if the goods are collateral on a loan that the seller defaults on. On the other hand, the good faith buyer of farm products is not protected. Such a buyer can end up having to pay twice for the farm products in order to take title--once to the farmer and again to to the secured party if the farmer fails to repay his secured loan.

In an attempt to ease the burden placed on purchasers of farm products, many States have modified, or are now involved in the long and complicated process of modifying, their commercial codes to address the problem. This, however, may only cause further confusion because the States that have, to date, amended their statutes have not used a single, consistent approach. S. 2190 would resolve the problem in a uniform manner for all States and jurisdictions.

We are enclosing copies of a letter that lists a number of groups supporting the enactment of S. 2190 and the statement made upon the introduction of the bill. If you would like to cosponsor S. 2190, please have your staff call Laura Rice (4-5207), Mike Neruda (4-3254), or Ben Baker (4-5207).

Sincerely,

DAVID L. BOREN

WALTER D. HUDDLESTON

MARK ANDREWS

ROGER W. JEPSEN

Enclosures

National
Council of
Farmer
Cooperatives

April 13, 1984

MEMO TO: Product Lien Committee

FROM: Glen Hofer

The joint NCFC/FCC Committee on Product liens met on March 30 in Washington, D.C. in the NCFC Conference Room.

The Issue

The present Uniform Commercial Code contains in Section 9-307 (1), the following exemption:

> "A buyer in ordinary course of business other than a person buying farm products from a person engaged in farming operations takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence."
> (Emphasis added)

This exemption places the buyer of agricultural products from farmers, in the position of buying subject to a crop/livestock lien without any practical means of knowing that the lien exists. The result is that buyers are made unfairly responsible for repayment of the lien when the producer diverts proceeds of the sale to other uses. Thus the balance of ultimate responsibility for liens which secure credit on agricultural products falls on the buyer. The purchasers of agricultural products generally agree that this burden of responsibility is inequitable and seek legislative relief.

Agricultural lenders on the other hand, believe they must have protection from those producers who sell a commodity which has an outstanding lien and then, without paying the security holder, divert the funds to other uses.

The Current Legislative Proposal

H.R. 3296 (Harkin D-Iowa) and S. 2190 (Huddleston D-Kentucky) would remove the agricultural exemption from the U.C.C., thus providing, "that a buyer in the ordinary course of business who buys farm products from a person engaged in farming operations shall own such goods free of any security interest in such goods created by his seller even though the security interest is perfected in accordance with applicable State Laws and even though the buyer knows of its existence".

1800 Massachusetts
Avenue, Northwest
Washington, DC 20036
202/659-1525

Rationale for Compromise

Present situation is unfair to buyers who, with no practical means of protecting their interest, often have to pay for products twice: once at the point of sale and a second time to lien holders, if sales proceeds have been diverted.

Proposed legislation would shift burden of responsibility from buyers to lenders but would not address continuing problem of diversion of proceeds from agricultural sales to uses other than lien payment. It leaves the lender with no means to enlist aid of the buyer in seeing that proceeds are applied.

Various remedies have been legislated at the state level but a lack of standardization has limited their effectiveness, particularly as applied to the large volume of interstate traffic in agricultural commodities.

There is a need for standard procedures, which would create an equitable sharing of responsibility between the lender, the producer and the buyer. To this goal a joint NCFC/FCC Committee (listed below) offers the following outline for remedial legislation.

Bob Andersen	Nebraska Cooperative Council
Sandy Belden	St. Louis Federal Intermediate Credit Bank
Pat Casey	Landmark
Dave Dewey	Wichita Bank for Cooperative
Phil Dukes	Agri Industries Board
Steve Phelps	St. Louis Federal Intermediate Credit Bank
Don Meers	Louisville Federal Intermediate Credit Bank
Gail Tritle	Central Livestock Producers
Del Banner	Farm Credit Council
Glen Hofer	National Council of Farmer Cooperatives

Proposed elements of compromise legislation designed to amend the Uniform Commercial Code in the treatment of security interest in agricultural commodity sales.

Actual Notice Requirement

Buyers will take subject only to liens of which they have received actual written notice (from either the lender or the producer) within 18 months prior to the sale.

Producer's Certificate - N.D & Okla doesn't ... for ...

Within the past 18 months, producer must have provided to the buyer a certificate of ownership for liens outstanding against the commodity. The certificate would include a warning of criminal penalties for false statements and diversion of proceeds.

Joint Check Requirement

Having received such notice within the previous 18 months, the buyer is required by law to include the lienholder(s) so identified as a payee on the check. By so doing, the buyer is relieved of all further liability.

Termination of Notice

Lenders must withdraw actual notice simultaneous with the filing of a termination statement.

Criminal Provisions

1.) Failure to apply proceeds from sale of products against lien would be criminal offense.

2.) Failure to remit within 10 days would be prima facie evidence of fraudulent intent.

3.) False statement on certification would be criminal offense; however, remittance within 10 days would be defense against charge of fraudulent intent.

4.) Criminal charges on transaction values of less than $10,000.00 would be a misdemeanor. Criminal charges on transaction values or more than $10,000.00 would be a felony. (Optional by state)

Statute of Limitations

Should be shortened to two years from date of sale.

ELIMINATE THE FARM PRODUCTS EXEMPTION TO PROTECT BUYERS OF FARM PRODUCTS

I. Farm Bill would be amended by adding the following wording:

SEC. 1123. Notwithstanding any provision of Federal, State, or local law, a buyer in the ordinary course of business who buys farm products from a seller engaged in farming operations shall take free of a security interest created by the seller even though the security interest is prefected and even though the buyer knows of it existence.

(b) A commission merchant or selling agent who sells farm products for others shall not be liable to the holder of a security interest in such farm products, even though the security interest is perfected and even though the commission merchant or sell agent know of its existence, if the sale is made in the ordinary course of business.

(c) This section shall become effective thirty days after enactment, except that liens made prior to the effective date shall be exempt from the provisions of this section.

II. Effect

(a) Establishes an informal pre-notice system by allowing creditors at their option to notify markets of the existence of a lien. The creditor could require that his authorization be given before the sale and/or that payment be made by joint check.

(b) If a market is notified of the lien, the creditor is not responsible for the loss because the market does not fit the definition of buyer in "the ordinary course of business." According to this definition, a buyer must be "without knowledge that the sale to him is in violation of the . . . security interst of a third party." (UCC 1-201(9))

(c) Protection is only provided to buyers who are unaware of the existence of the lien.

The Catholic University of America

The Columbus School of Law
Founded 1895
Washington, D.C. 20064
(202) 635-5140

October 11, 1984

The Honorable Walter D. Huddleston
United States Senate
Dirksen Senate Office Building, Room 262
Washington, D.C. 20510

Dear Senator Huddleston:

At the hearing on S. 2190 which you conducted on September 26, you asked the witnesses to address the form that any remedial legislation should take to afford protection to buyers of farm products. There were several suggestions that legislation modeled on the recent state "notification" laws might be the answer. In expressing AHI's support for your bill, I alluded to the fact that under S. 2190 creditors would be able to protect themselves in the same way they would under the state notification laws. This letter is to elaborate a bit on that point, for inclusion in the hearing record if possible.

If your bill were enacted as is, a buyer of farm products would take free of security interests only if the buyer qualified as a "buyer" in the ordinary course of business." This is a term of art under the Uniform Commercial Code, and presumably would be defined the same way in a federal statute. It requires that the buyer be "without knowledge that the sale to him is in violation of the . . . security interest of a third party." Uniform Commercial Code § 1-201(9) (definition of buyer in the ordinary course of business). In other words, your bill would not operate as blanket protection for all buyers under all circumstances, but only for buyers who were unaware that it was an unauthorized sale.

It would certainly be possible for a secured creditor, in these circumstances, to take steps to notify possible buyers of the existence of the security interest, and to advise such prospective buyers that the sale requires the creditor's authorization. The notice might further state that authorization is given if the sale proceeds are remitted in the form of a joint-payee check or similar arrangement. Once the creditor gave such notice, the buyer would be protected from future claims only if he complies with the restriction.

Your bill does not require that creditors give notice in this fashion, but it clearly permits them to do so. The various state notification laws achieve essentially the same effect, but may impose very detailed requirements about the form, content and timing of the notice. Those requirements will inevitably vary from state to state. It is this feature of those state laws that gives us concern about a blizzard of paper, with conceivably endless haggling (and litigation) over whether the notification was technically correct and timely.

Your bill, as originally introduced, may in fact be a more streamlined way to encourage creditors to monitor their debtors' markets, to identify prospective buyers, and to give them specific notice of the conditions for an authorized sale. The only "legal" question would be whether the buyer had knowledge, and this is a question that, when necessary, the courts have handled satisfactorily for years under the UCC. Secured creditors, under your bill, would have maximum freedom to devise notification systems to suit their own needs and preferences, without the risk of imposing a new layer of intricate paperwork burdens.

Thank you for your continuing interest in this matter. AMI is anxious to work with your Subcommittee and all other interested groups to find the best possible solution to the problem S. 2190 addresses.

Sincerely,

Ralph J. Rohner
Professor of Law.

RJR/gc
CC: Gary Jay Kushner
American Meat Institute

merican Farm Bureau Federation

WASHINGTON OFFICE
600 MARYLAND AVE S.W.
SUITE 600
WASHINGTON D.C. 20024
AREA CODE 202 - 484-2222

December 1, 1983

Honorable Walter Huddleston
United States Senate
Washington, D.C. 20515

Dear Senator Huddleston:

We commend you for the interest you have shown in the mortgaged commodity problem and for introducing S. 2190 which would protect buyers of farm products. We are concerned, however, that this bill will not completely solve the problem for all adversely affected parties. In particular, we feel that livestock agents and auction markets may not be afforded protection under this bill.

The Uniform Commercial Code states that "a buyer..." takes clear title to products but the livestock auction market is not a buyer because there has been no transfer of title. The auction market is an extension of the seller, acting on behalf of the seller in order to dispose of the commodity. Under the provisions of S. 2190, the auction market will still be acting for the seller in committing a common law tort when conversion of the mortgaged livestock occurs.

Therefore, in order to protect the seller's agent, the following wording should be added to S. 2190:

> "A commission merchant or selling agent who sells livestock or other agricultural products for others shall not be liable to the holder of a security interest in such livestock or other agricultural products, even though the security interest is perfected, if the sale is made in the ordinary course of business and without actual knowledge of the security interest."

We solicit your support to make this change.

Sincerely,

John C. Datt
Secretary and Director
Washington Office

99TH CONGRESS
1ST SESSION

S. 744

To amend the Agriculture and Food Act of 1981 to provide protection for agricultural purchasers of farm products.

IN THE SENATE OF THE UNITED STATES

MARCH 26 (legislative day, FEBRUARY 18), 1985

Mr. COCHRAN (for himself and Mr. BOREN) introduced the following bill; which was read twice and referred to the Committee on Agriculture, Nutrition, and Forestry

---

A BILL

To amend the Agriculture and Food Act of 1981 to provide protection for agricultural purchasers of farm products.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) title XI of the Agriculture and Food Act of 1981 is amended by adding at the end thereof a new section 1123 as follows:

"SEC. 1123. (a) Notwithstanding any provision of Federal, State, or local law, a buyer in the ordinary course of business who buys farm products from a seller engaged in farming operations shall take free of a security interest created by the seller even though the security interest is perfect-

ed and even though the buyer knows of its existence: *Provided, however,* That a buyer of farm products takes subject to a security interest created by the seller if: (i) within twelve months prior to the sale of the farm products the buyer has received from the secured party or the seller written notice of the security interest and of any payment obligations imposed on the buyer by the secured party as conditions for waiver or release of the security interest; and (ii) the buyer has failed to perform those obligations.

"(b) A commission merchant or selling agent who sells farm products for others shall not be liable to the holder of a security interest in such farm products, even though the security interest is perfected and even though the commission merchant or selling agent knew of its existence, if the sale is made in the ordinary course of business.

"(c) This section shall become effective thirty days after enactment, except that liens made prior to the effective date shall be exempt from the provisions of this section.".

○

99TH CONGRESS
1ST SESSION

H. R. 1591

To amend the Agriculture and Food Act of 1981 to provide protection for agricultural purchasers of farm products.

IN THE HOUSE OF REPRESENTATIVES

MARCH 19, 1985

Mr. STENHOLM (for himself, Mr. GUNDERSON, Mr. BEDELL, Mr. DASCHLE, Mr. ENGLISH, Mr. MCCURDY, and Mr. TALLON) introduced the following bill; which was referred to the Committee on Agriculture

---

A BILL

To amend the Agriculture and Food Act of 1981 to provide protection for agricultural purchasers of farm products.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) title XI of the Agriculture and Food Act of 1981 is amended by adding at the end thereof a new section 1123 as follows:

"SEC. 1123. (a) Notwithstanding any provision of Federal, State, or local law, a buyer in the ordinary course of business who buys farm products from a seller engaged in farming operations shall take free of a security interest created by the seller even though the buyer knows of its exist-

ence: *Provided, however,* That a buyer of farm products takes subject to a security interest created by the seller if: (i) within twelve months prior to the sale of the farm products the buyer has received from the secured party or the seller written notice of the security interest and of any payment obligations imposed on the buyer by the secured party as conditions for waiver or release of the security interest; and (ii) the buyer has failed to perform those obligations.

"(b) Notwithstanding any provisions of Federal, State, or local law, a commission merchant or selling agent who sells farm products for others shall not be liable to the holder of a security interest in such farm products even though the security interest is perfected and even though the commission merchant or selling agent knew of its existence, if the sale is made in the ordinary course of business: *Provided, however,* That a commission merchant or selling agent of farm products takes subject to a security interest created by the seller if: (i) within twelve months prior to the sale of the farm products the commission merchant or selling agent has received from the secured party or the seller written notice of the security interest and of any payment obligations imposed on the commission merchant or selling agent by the secured party as conditions for waiver or release of the security interest; and (ii) the commission merchant or selling agent has failed to perform those obligations.

"(c) This section shall become effective thirty days after enactment, except that liens made prior to the effective date shall be exempt from the provisions of this section.".

○

THE FARM CREDIT COUNCIL
1800 MASSACHUSETTS AVE, NW · WASHINGTON, DC 20036 · 202/466-4180

Delmar K. Banner
President

May 14, 1985

The Honorable Jesse A. Helms
Chairman, Committee on Agriculture,
Nutrition & Forestry
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

For The Farm Credit Council, the federated trade association representing borrower-owned Farm Credit banks and associations and other cooperative lenders throughout the country, I am writing to give our views on several issues of concern to Farm Credit which may arise during Senate Agriculture Committee mark-up of the 1985 Farm Bill. These involve various provisions contained in three separate bills: S. 744 by Sen. Cochran; S. 466 by Sen. Zorinsky; and S. 1119 by Sen. Melcher.

S. 744

For a number of reasons as outlined below, we continue to have serious reservations about this bill as an appropriate and workable solution to the farm products lien question. Unless amended, therefore, we must oppose S.744 in its present form. We recognize, however, that under the current UCC farm products exception adopted in many states it is not always practical for buyers of farm products to determine whether a security interest exists in the products they purchase. The Farm Credit Council is committed to resolving this issue--but in a way that will permit a balanced sharing of responsibility among the buyer, the lender and the producer.

In our efforts to find a constructive alternative to both the status quo and S. 744, the Council has worked very closely with the National Council of Farmer Cooperatives (NCFC), with which it is affiliated. From the membership of NCFC, which includes both buyer groups and the Farm Credit banks, a task force reflective of those diverse interests and all sides of the issue was assembled. We believe the final product of that joint task force (chaired by a buyer representative) is a "true" and reasonable compromise.

Enclosed for your review is a copy and summary of our proposal. It is designed to result in an equitable sharing of responsibility among all the interested parties--the producer, the lender and the buyer--to deter diversions and see that proceeds are applied to the secured loan. Especially during these stressful times when the unique risks associated with agricultural financing have never been more apparent, what is needed is a

proposal sensitive to the lenders' need for adequate protection of their collateral. Yet it also must provide buyers with a reasonable way of avoiding any liability for double payment in the event the producer wrongfully diverts the proceeds from the sale of a mortgaged commodity. Our proposal achieves both of these goals. Under our proposal, in fact, even if the producer were to make a false statement as to whether a lien exists, simply by obtaining that statement the buyer would still be totally relieved of any liability.

Although S. 744 is at least some improvement over legislation from the last Congress that would simply have eliminated the current UCC farm products exemption, it is not a compromise bill. It has obvious shortcomings. For instance, in effect under S. 744 the one and only means by which lenders might protect their interests would be to notify every prospective buyer. Yet lenders are in no position to know to whom their borrowers will ultimately sell. Borrowers themselves often do not know that at the time they obtain their loans. Inevitably, the result of S. 744 would be to leave lenders with no choice but to blanket the countryside with stacks of unsorted computer-generated lists of borrowers. For all parties, but especially the buyers, this would create a far greater paperwork problem than anticipated.

Another concern with S. 744 is that it may actually facilitate diversions: because the potential buyer list required of sellers under this bill is roughly the equivalent of a road map for a seller intent on committing fraud. The borrower prone to divert would know who he has put on that list for the lenders. The same borrower would also know that he needs only to sell to a borrower not on the list to beat the system. Our proposal corrects this deficiency by coupling the option of actual notice by the lender with some form of producer certification at the point of sale--the one part of the transaction to which the lender is not a party. Under the Council's proposal, each party may take affirmative steps to protect its interests; yet none is required to do so. We urge you to give favorable consideration to the FCC/NCFC proposal.

Farm Credit Act Amendments

It is also our understanding that at least two amendments may be offered at committee mark-up which would amend the basic Farm Credit Act of 1971. One of these could be a revised version of S. 466, a bill that broadens the enforcement authorities of the Farm Credit Administration. In recent testimony before the Committee the Council voiced a number of concerns with such legislation as presently drafted. While we continue to work closely with and appreciate very much the willingness of its chief sponsor, Sen. Zorinsky, to modify the bill so as to address our concerns, we do feel that an issue as complex and specific to the Farm Credit System as this one would best be considered outside the context of the Farm Bill. For the same reason, we would hope that any committee action on a measure by Sen. Melcher to insure the "B" stock of Farm Credit association stockholders might also be deferred at this time and considered later after the benefit of full hearings.

Thank you for considering the views of The Farm Credit Council. We would be pleased to visit further with you or your staff on these or any other matters before the Committee.

Sincerely,

Delmar K. Banner

DKB: alh

cc: Members, Senate Agriculture Committee

Enclosures

SUMMARY OF FCC/NCFC PROPOSAL

Actual Notice Option

Buyers will take subject only to liens of which they have received actual written notice (from either the lender or the producer) within 12 months prior to the sale.

Producer's Certificate

Within the past 12 months, the producer must have provided to the buyer a certificate of ownership for liens outstanding against the commodity. This could be done at the point of sale, the one time when the lender is not a party to the transaction.

Joint Check Requirement

Having received such notice within the previous 12 months, the buyer is required by law to include the lienholder(s) so identified as a payee on the check. By so doing, the buyer is relieved of all further liability--even if the producer has falsified the statement obtained by the buyer as to whether a lien exists on the product.

Criminal Provisions

1. Failure to apply proceeds from the sale of products against a lien would be a criminal offense.

2. Failure to remit within 10 days would be prima facie evidence of fraudulent intent.

3. A false statement on the certification would be a criminal offense; however, remittance within 10 days would be a defense against a charge of fraudulent intent.

4. Criminal charges on transaction values of less than $10,000.00 would be a misdemeanor. Criminal charges on transaction values of $10,000.00 or more would be a felony.

Shortened Statute of Limitations

Set for two years from date of sale.

FCC/NCFC Alternative Bill (Revised 4/30/85)

DRAFT

That this Act may be cited as the "Farm Products Buyers' Equity Act of 1985."

FINDINGS AND PURPOSE

SEC.2.(a) The Congress finds that --

(1) certain State laws permit a secured lender to enforce liens against a purchaser of farm products even if the purchaser does not know that the sale of the products violates the lender's security interest in the products, lacks any practical method for discovering the existence of the security interest, and has no reasonable means to assure that the seller uses the sales proceeds to repay the lender;

(2) such 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);

(3) the exposure of purchasers of farm products to double payment inhibits free competition in the market for farm products; and

(4) this exposure constitutes a burden on and an obstruction to commerce in farm products.

(b) The purpose of this Act is to remove such burden on and obstruction to commerce in farm products.

SEC.3. For purposes of this Act --

(1) the term "buyer in the ordinary course of business" means a person who (A) 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, and (B) buys the products in good faith and without knowledge that the sale is in violation of the ownership rights or security interest of a third party in the products;

(2) the term "farm products" means crops or livestock used or produced in farming operations or products of crops or livestock in their unmanufactured states (such as ginned cotton, wool-clip, maple syrup, milk, and eggs) that are in the possession of a person engaged in farming operations; and

(3) the term "security interest" means an interest in farm products that secures payment or performance of an obligation.

PROTECTION OF BUYERS OF FARM PRODUCTS

SEC.4. Notwithstanding any other provision of Federal, State or local law --

(a) (1) A buyer in the ordinary course of business shall take farm products free of a security interest created by the seller of the products, even though the security interest is perfected, provided the buyer

(A)(i) receives written notice from the secured party identifying the person who created the security interest and the farm products subject to the security interest; or (ii) obtains, if the buyer has not otherwise received written notice under subsection (A)(i), prior to payment of the sale proceeds to the seller written notice from the seller disclosing the existence of a security interest in the farm products and the identity of the secured party, or if no security interest in the products exists, stating that fact; and

(B) includes the name of any secured party disclosed by any such notice as joint payee on the check or other instrument issued in payment for the farm products, unless the secured party gives the buyer written notice of waiver of such requirement.

(2) For purposes of this section, a buyer in the ordinary course of business may rely on the information obtained from the seller in a notice under paragraph (1)(A)(ii) for a period of one year after the date of the notice or until such time as the buyer receives actual notice of a change in the information contained in the notice, whichever first occurs.

(3) For purposes of this section, a notice received from the secured party under paragraph (1)(A)(i) is effective for one year, and a buyer in the ordinary course of business may rely on that information for a period of one year after the date of the notice or until such time as the buyer receives actual notice of a change in the information contained in the notice, whichever occurs first.

(4) A buyer in the ordinary course of business who fails to comply with the provisions of paragraph (1) shall take farm products subject to any perfected security interest in the products created by the seller.

(b) (1) A commission merchant or selling agent who sells farm products for another for a fee or commission shall not be liable to the holder of a security interest in such products, even though the security interest is perfected, provided the commission merchant or selling agent

(A)(i) receives written notice from the secured party identifying the person who created the security interest and the farm products subject to the security interest; or (ii) obtains, if the commission merchant or selling agent has not otherwise received written notice from the secured party under subsection (A)(i), prior to payment of the sale proceeds to the seller written notice from the seller disclosing the existence of a security interest in the farm products and the identity of the secured party, or if no security interest in the products exists, stating that fact; and

(B) includes the name of any secured party disclosed by any such notice as joint payee on the check or other instrument issued in payment for the farm products, unless the secured party gives the buyer written notice of waiver of such requirement.

(2) For purposes of this section, a commission merchant or selling agent may rely on the information obtained from the seller in a notice under paragraph (1)(A)(ii) for a period of one year after the date of the notice or until such time as the commission merchant or selling agent receives actual notice of a change in the information contained in the notice, whichever first occurs.

(3) For purposes of this section, a notice received from the secured party under paragraph (1)(A)(i) is effective for one year, and a commission merchant or selling agent may rely on that information for a period of one year after the date of the notice or until such time as the commission merchant or selling agent receives actual notice of a change in the information contained in the notice, whichever first occurs.

(4) A commission merchant or selling agent who fails to comply with the provisions of paragraph (1) shall be liable to the holder of any perfected security interest in such products created by the seller to the extent the secured party does not receive the proceeds from the sale or other disposition of such products.

(c) A buyer in the ordinary course of business who obtains a notice under subsection (a)(1)(A), or a commission merchant or selling agent who obtains a notice under subsection (b)(1)(A), shall not publicly post or disseminate to any person other than its agents and employees any information contained on such notice.

(d) It is unlawful for a seller of farm products engaged in farm operations who is in the business of selling farm products (1) who has right to sell or otherwise dispose of farm products subject to a securi- interest created by such seller, or (2) who has the right to sell or otherwise dispose of such farm products only on the condition that the secured party receives the proceeds from such sale, to sell or otherwise dispose of the farm products or any part thereof and willfully and wrongfully to fail to pay to the secured party the proceeds from the sale or other disposition. Failure to pay such proceeds to the secured party within ten days after the sale or other disposition of the collateral is prima facie evidence of a willful and wrongful failure to pay under this subsection.

(e) It is unlawful for any person knowingly to make a false statement in any notice obtained by a buyer in the ordinary course of business under subsection (a)(1)(A)(ii) or by a commission merchant or selling agent under subsection (b)(1)(A)(ii). It is an affirmative defense to a prosecution for the violation of this subsection that the secured party received the proceeds from the sale or other disposition of the collateral within ten days after such sale or other disposition.

(f) A person convicted of a violation of subsection (d) or subsection (e) shall, if the value of the farm products involved is $10,000 or more, be guilty of a felony and shall be fined not more than $10,000 or imprisoned for not more than five years, or both, or shall, if the value of the farm products involved is less than $10,000, be guilty of a misdemeanor and shall be fined not more than $5,000 or imprisoned for nc more than one year, or both.

(g) The notice obtained by a buyer in the ordinary course of business under subsection (a)(1)(A)(ii) or by a commission mercant or sellling agent under subsection (b)(1)(A)(ii) shall include a warning that any false statement as to the existence of or identity of any secured party is a criminal offense and shall state the penalties therefor.

(h) An action against a buyer of farm products or against a commission merchant or selling agent who sells farm products for another for a fee or commission for recovery of such farm products or their value must be commenced within two years after the date such farm products are sold.

ADMINISTRATION

SEC.5. The Secretary of Agriculture shall, not later than 180 days after the date of enactment, issue final regulations implementing the provisions of this Act.

EFFECTIVE DATE

SEC.6. The provisions of this Act shall become effective 30 days after the date the Secretary of Agriculture issues final regulations under Section 5, but only with respect to security interests created after such effective date.

The Catholic University of America

The Columbus School of Law
Founded 1895
Washington, D.C. 20064
(202) 635-5140

March 29, 1985

The Honorable Howell Heflin
SH 728 Hart Senate Office Building
United States Senate
Washington, DC 20510

Dear Senator Heflin:

At the March 21, 1985 hearing before the Committee on Agriculture, Nutrition and Forestry, during which I testified on behalf of the American Meat Institute regarding "clear title" legislation, you asked several questions to which I promised followup answers. This letter contains those responses. I am also enclosing for your information a copy of a more extensive analysis of the "farm products exception" that AMI has previously submitted for hearing records in both the House and Senate during the 98th Congress.

1. You asked whether and how the proposed legislation to deal with the "farm products exception" in the UCC would affect commission merchants, sales agents, auctioneers, and similar brokers.

Without explicit statutory protection, such intermediaries are apparently subject to liability in conversion to the farm products lender when they sell property covered by the lender's security interest, even though the sales are made routinely in the ordinary course of the broker's or auctioneer's business. A number of cases to this effect are cited in the enclosed memorandum. Thus it is not only buyers of farm products that are exposed to liability under the UCC, but intermediary sales agents as well.

Repeal or preemption of the "farm products exception" language in UCC 9-307(1), however, would not necessarily help these sales agents since they would rarely if ever be "buyers in the ordinary course of business." Yet their routine handling of farm products, and their inability to verify pre-existing lienholders, makes them as deserving of clear title protection as processors, packers or other ordinary course purchasers.

For this reason, the pending Cochran/Boren clear title bill, S. 744, specifically provides that commission merchants or selling agents are not liable to holders of security interests in farm products if the sales are made in the ordinary course of the commission merchant's or selling agent's business. This would relieve those agents of the burden of becoming involuntary guarantors of the producers' loans.

2. You also inquired how the proposed legislation would affect a situation in which the producer contracted to sell future farm products but a lender acquired a security interest in the goods before they were produced or delivered.

We believe the bill would give the lender in this case the same opportunity to protect itself against dissipation of the sale proceeds as in cases where the security interest attached first and the buyer contracted to purchase at a later date. That is, if the lender notified the buyers prior to the actual "sale" -- i.e., the actual transfer of title to existing goods to the buyer -- the buyer would be on notice of the secured creditor's rights and would need to remit the proceeds by joint-payee check or similar means. In other words, a buyer would gain no advantage over secured lenders by entering into futures contracts for farm products.

The distinction between an executary "contract for sale" of future goods, and a "present sale" of existing goods, is recognized generally in commercial law (see UCC 2-106), and would assuredly be carried over into interpretations of the federal clear title legislation.

I hope this is responsive to your concerns. If I can supply any further information or clarification, please do not hesitate to contact me or AMI.

Sincerely,

Ralph H. Rohner

Ralph H. Rohner

RHR1wc
cc: Senator Thad Cochran

Enclosure

AMERICAN
MEAT
INSTITUTE
ıg The Meat Industry Since 1906

STATEMENT

BY

RALPH J. ROHNER

THE COLUMBUS SCHOOL OF LAW

THE CATHOLIC UNIVERSITY OF AMERICA

ON BEHALF OF THE

AMERICAN MEAT INSTITUTE

REGARDING FARM PRODUCTS BUYERS' PROTECTION

BEFORE THE U.S. SENATE

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

MARCH 21, 1985

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L & H Packing Company

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Dugdale of Nebraska, Inc.

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Leroy O. Lochmann
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Ray McGregor
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John McKenzie Packing Co., Inc.

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Monfort of Colorado

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*As of April 1984
**Immediate Past Chairman

Mr. Chairman and Members of the Subcommittee:

I am Ralph J. Rohner, and I am a Professor of Law at the Catholic University of America in Washington, D.C., where I have taught courses in the commercial law area for twenty years. I appear today on behalf of the American Meat Institute, the national trade association representing packers and processors of meat and meat products. I take this opportunity to bring to this Committee's attention a problem in state law that seriously threatens the economic viability of many in the agricultural community. Accompanying me is Gary Jay Kushner, AMI's Vice President and General Counsel.

We are here today to register AMI's support for the Stenholm/Gunderson "clear title" bill introduced in the House of Representatives on March 19, which would amend the Farm Bill to remedy a situation that is simply fundamentally unfair to the purchasers of agricultural products. A broad-based coalition of other organizations also representing buyers of farm products supports that bill as well. Under the uniform commercial law in all states save California, purchasers who in good faith pay sellers for farm products remain legally subject to the liens of lenders covering those farm products. If a seller/debtor defaults on the loan, or fails to account for the sale proceeds, the buyer can be forced to pay twice for the goods, once at the time of sale and again -- often months or years later -- when the bank or other lender sues the purchaser for conversion of its collateral. This result obtains because of an antiquated limitation on the good faith purchaser rule in section 9-307 of the Uniform Commercial Code. Buyers of commercial inventory generally take free and clear of earlier security interests, but buyers of agricultural inventory -- "farm products" -- do not.

We have earlier submitted to both the Senate and the House an extensive analysis of this state law rule, and we would be happy to supply further copies of that analysis to this Committee and its staff.

Hearings were held on this problem in the House in 1983 and 1984, and in the Senate in 1984. The record of those hearings is replete with first-hand testimony of the hardship and inequity caused by the UCC provision. The aggregate amount of claims filed by lenders against innocent purchasers of crops and livestock easily runs into millions of dollars just based on the statements of prior Congressional witnesses. The typical case is one where a rancher or farmer sells his crop or herd to a buyer who is unaware that there are outstanding liens on the goods. The producer fails to account for the sale proceeds to the lender holding the security interest, and when the producer then defaults on the loan the lender files a claim against the buyer on the theory that the purchaser has unlawfully "converted" the lender's collateral. Such claims force the buyer to pay again for the same goods.

The source of this problem -- the so-called "farm products exception" of the UCC -- is, we submit, an unjustifiable rule of law that ought to be abrogated by federal statute, as the Stenholm/Gunderson bill would do.

Our earlier statements describe the anomalous nature of the farm products exception, its uncertain history, its disfavored treatment by some courts, and its harsh and unpredictable burden on farm products buyers. To summarize:

The special farm products rule runs against the grain of general commercial law which seeks to encourage the free flow of commerce by protecting good faith purchasers from the risk of prior liens. Generally, the law allows buyers who purchase goods in the normal course of business to acquire full ownership. For example, when a customer pays a retailer for a refrigerator, the bank that is financing the retailer's inventory cannot thereafter pursue a claim against the customer. The same rule would apply when the retailer purchases its stock of appliances from the manufacturer: as a buyer in the ordinary course of business, the retailer would be protected from claims by the manufacturer's bank. By contrast, under the special rule for farm products, the continuation of the lenders' security interest frustrates the free movement of goods in commerce, and has never had clear policy justification.

Farm products purchasers are, as a practical matter, utterly unable to verify reliably the existence of security interests at the time of purchase. The UCC filing system which theoretically discloses such liens, is generally based on filings in the producer's home county, a location that is effectively often inaccessible in the short time frames in which farm products sales are conducted, particularly when those sales are conducted on an interstate basis.

The effect of the rule gives the farm products lender a set of involuntary guarantors on every loan it writes. A borrower's failure to account for the proceeds of sale becomes the risk not of the professional lender, but of the various innocent third parties downstream in the distribution chain. The persistence of the rule bodes ill for the financial health of farm products purchasers, especially small operators who simply cannot afford to pay twice for their agricultural commodities.

The Stenholm/Gunderson bill recognizes the basic unfairness of the present farm products exception. The case against the rule is so strong and self-evident -- in law school we would say prima facie -- that Congress' failure to act on it must be based on compelling grounds. We suggest, therefore, that the burden is on the agricultural lending industry to demonstrate a justification for continuing the rule. They have failed to make any case in prior Congressional testimony.

The lenders argue that commerce in farm products is somehow so unique -- compared to other forms of commercial inventory -- that the farm products exception is necessary for one but not the other. We deny any such uniqueness to farm products financing. Decisions to lend in all cases are based on prudent assessments of the borrower's capacity and character. The burdens assumed by commercial inventory lenders always include monitoring their debtors' activities, and one of the inherent risks is the possible loss of collateral to third party buyers in the ordinary course of business; yet inventory financing flourishes. We have heard nothing that supports any claim by farm products lenders that their market uniquely entitles them to protections not available to other commercial financers.

The lenders suggest that the buyers of agricultural products enjoy "inherent advantages" to protect against the risk of seller default. On the contrary, in the hurly-burly of cash sales, buyers are virtually powerless to determine, on their own initiative, the existence of outstanding liens and the identities of the lienholders. They buy blind. The lenders, on the other hand, are risk-taking professionals who ought to be able to monitor their

debtors' activities sufficiently well to prevent dissipation of proceeds. It may well be that the farm products rule has contributed to shoddy lending practices.

Then the lenders raise the bogeyman objection that repeal of the farm products exception would substantially increase their financial losses and thus significantly raise the cost of credit. We disagree. Whatever impact a change in the law might have, its effects on the cost and availability of farm credit are likely to be negligible if even measureable. The state of California repealed the farm products exception in 1976; if there is any evidence that our largest agricultural state, or the lenders or producers within it, are suffering on that account, we are unaware of it. The likely reality is that, with the farm products exception gone, lenders will tighten their administrative supervision of producers to minimize the risk of unaccounted-for proceeds. It could be that changing the law in this regard will reduce lender losses by encouraging more prudent practices across the board.

Finally, the lenders argue that a number of states are experimenting with techniques to ameliorate the effects of the farm products exception, and that federal preemption is therefore inappropriate. The argument collapses on itself. Yes, some states have enacted legislation, but the content and form of those special rules vary in each enacting jurisdiction. The overlay of these recent enactments on the UCC itself creates a new dimension of complexity for lenders, producers and buyers. It is counterproductive in interstate sales settings where the applicability and details of a given state's law may be in doubt.

More fundamentally, what the state legislative activity has produced is substantial non-uniformity among the states on the respective rights and obligations of lenders and buyers of agricultural products. Allowing the states to continue this idiosyncratic tinkering with the UCC can only lead to greater uncertainty as to the controlling law. It is a disingenuous argument to suggest that a problem that arises from a provision of the Uniform Commercial Code should be left to non-uniform resolution by the states.

What these circumstances really indicate, we submit, is the need for a uniform national rule that fairly respects the needs of buyers of agricultural products. A uniform national rule is not likely to emerge from the states or from the UCC sponsors. Congress has not only the prerogative but the responsibility to supply the needed stability and consistency. This is especially true in the case of the agricultural markets for which Congress has already assumed a substantial supervisory role, and for the Federal farm credit programs where state rules would be preempted by Federal policies.

Ultimately, the sole question presented by the Stenholm/Gunderson bill is whether Congress should act to correct an inequitable and capricious state law rule that has inflicted millions of dollars of losses on purchasers of farm products. We certainly believe Congress should so act, along the lines of this bill.

The pending bill offers a temprate, workable solution. Buyers of farm products in the ordinary course of business would be protected from prior liens, but a buyer would not qualify for this protection if the buyer had been

specifically notified of the outstanding lien and had then failed to issue a joint-payee check or otherwise comply with the lender's conditions for release of its lien. Both the lender and the buyer would assume responsibilities for assuring that the sale proceeds were not dissipated. This is an approach all parties should be able to live with, without hardship on either side.

Mr. Chairman, we encourage favorable action by this Committee and the Congress to eliminate or modify the farm products exception. Thank you for considering the views of the American Meat Institute. I will be happy to answer any questions.

FB YAFCA
DCNA 016 GM

MARCH 20, 1985

TO: PRESIDENTS, SECRETARIES AND/OR ADMINISTRATORS, COORDINATORS OF NATIONAL AFFAIRS, DIRECTORS OF INFORMATION, AREA FIELD SERVICES DIRECTORS, PARK RIDGE AND WASHINGTON OFFICE DISTRIBUTION
FR: JOHN C. DATT, EXECUTIVE DIRECTOR, WASHINGTON OFFICE
cc: President Delano
Al Keating

!!ACTION REQUESTED!!

*****N A T I O N A L A F F A I R S B U L L E T I N*****

CLEAR TITLE FOR AGRICULTURAL COMMODITIES

Representative Stenholm (D-TX) and Representative Gunderson (R-WI) have introduced a bill, H.R. 1591, protecting buyers of farm products. The bill gives buyers clear title to agricultural commodities and eliminates the double-payment possibility which arises when the seller does not repay the loan which was used to produce the commodity. Farm Bureau encouraged introduction of this legislation for the following reasons:

> First, as the problem continues to grow, it is adversely affecting individual farmers as well as the markets to whom farmers sell their products. Farmers buy products such as feeder cattle and pigs, breeding stock, grain and hay from other producers and are required to make double payments.
>
> Second, it poses an undue financial hardship on markets to which producers sell their commodities. We are interested in any problem which reduces the economic viability of agri-cultural markets.
>
> Third, losses due to double payments for products are passed on to other producers in terms of higher marketing fees and processing costs.
>
> Fourth, the current law requires buyers of agricultural products to become credit supervisors for loans about which they have no knowledge.

H.R. 1591 is different than the Huddleston bill, S. 2190, which we supported last year. This bill is a "compromised" approach which eliminates the farm products exemption from the Uniform Commercial Code but allows lenders to protect their security interests through "notice" to potential buyers that a lien exists. A description of how this notice requirement works is contained in Data Bank No. 754.

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ACTION REQUESTED
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State Farm Bureaus are encouraged to communicate with their Representatives, particularly members of the House Agriculture Committee, and encourage them to cosponsor this bill. AFBF plans to support this bill at a House Agriculture Subcommittee hearing on

credit issues on March 26, 1985.

(Contact: Stuart E. Proctor, Jr.)

4
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F/2 Federal mortgaged Ag. Commodities

AFDB
DCNA 754 SM

03/20/85 12:16

TYPICAL LENDER/FARMER/BUYER ACTIVITY UNDER THE STENHOLM/GUNDERSON CLEAR TITLE BILL

The legislation to be offered by Representatives Stenholm and Gunderson effectively provides traditional protection to good-faith buyers of farm products by achieving two objectives through federal pre-emption:

1. It deletes the farm products exception from the Uniform Commercial Code (UCC), BUT

2. It provides a mechanism under which lenders may CHOOSE to protect their security interests through notice to potential buyers that a lien exists and what steps the buyer must legally take to satisfy that security interest.

It also provides that a seller may notify the buyer of the security interest if he chooses to in order to protect himself and his credit rating.

The bill does not proscribe the manner in which a lender must notify the buyer. This is to allow lenders the maximum flexibility to set up systems which best meet their individual needs.

HOW PRE-NOTICE WORKS

A typical transaction might operate something like this:

Farmer Jones applies for a production loan at 1st National Bank. He pledges his crop or herd as collateral, thereby creating the security interest for the bank. The bank decides it will routinely notify potential buyers of its security interests, and as part of its loan application requires Farmer Jones to list all potential buyers to whom he is likely to sell his production.

1st National Bank takes that list and, in order to be sure that each potential buyer on the Jones' list receives its notice, sends by certified or registered mail a notice that 1st National has a security interest in the Jones' production. The notice also stipulates to the buyer that the notice legally obligates him to pay for the Jones' production with a check made jointly payable to Jones and 1st National Bank.

Jones decides to sell to XYZ Buyer. XYZ Buyer, on the Jones' list and having received notice, makes out a joint check, and thereby satisfies 1st National's requirement for payment. XYZ Buyer then takes title to the Jones' production free and clear of the bank's security interest.

If Farmer Jones sells to someone not on his original list with the bank and does not pay off his loan, he would be subject to pre-

vailing criminal penalties. The buyer, because he did not receive notice from either Farmer Jones or the lender, would take title to the n products free of the security interest.

The risk is equitably divided in this way: The lender chooses whether or not he will protect himself by whether or not he chooses to pre-notify potential buyers. If he chooses pre-notice, he secures the list from the borrower and sends the notices. The farmer can choose to notify his buyer of the lien against his production, or is obligated to provide an accurate list of possible buyers to his lender. Of course, he is still obligated to repay the loan. The buyer is obligated to follow the lender's repayment instructions once he has received notice of the security interest.

BOTTOM LINE: It's up to the lender how he wishes to protect or not protect his security interest. A lender can be a private bank, S & L, PCA, co-op bank, FmHA or it could be a company or individual selling feed, seed, fertilizer, breeding stock, etc., to a farmer on credit. If the good-faith buyer does not receive a notice of the security interest from either the seller or the lender, he takes title to those farm products free and clear of any security interest.

026
03/21/85 12:33 IN
03/21/85 12:33 OUT

VIRGINIA POLYTECHNIC INSTITUTE AND STATE UNIVERSITY

Blacksburg, Virginia 24061

Department of Agricultural Economics

As promised, I am enclosing a copy of my most recent paper on "Mortgaged

December 3, 1985

Mr. Bill Cramme
Senior Attorney
Division of Legislative Services
P. O. Box 3-AG
Richmond, Virginia 23208

Dear Mr. Cramme:

Farm Products--Is There a Twentieth Century Solution? Or An End Run On The U.C.C." Note, this was updated about October 15 and does not contain the senate provisions. I would be pleased to work with you and your staff or the members of the general assembly as you see fit. As I stated, I have a professional and academic interest in seeing a fair, uniform and effective solution to the problems of lenders, buyers, and farmers.

Sincerely,

L. Leon Geyer
Assistant Professor
Agricultural Law & Economics

LLG:plc

Enclosure

MORTGAGED FARM PRODUCTS--IS THERE A TWENTIETH CENTURY SOLUTION? OR AN END RUN ON THE U.C.C.

By

L. Leon Geyer*
(C)

I. The U.C.C. and Mortgaged Farm Products

Article 9 of the Uniform Commercial Code was designed "to provide a simple and unified structure within which the immense variety of present-day secured financing transactions can go forward with less cost and with greater certainty."[1] Pre-Code secured financing had been characterized by conflicting and arbitrary requirements of each of the numerous financing devices such as the chattel mortgage, the conditional sale and the trust receipt.[2] Professor Gilmore has observed that "(a) tradition going back for hundreds of years stigmatized any security agreement, outside the real property field, in which the debtor was allowed to remain in possession of the collateral as a fraudulent conveyance or the next thing to it."[3] Article 9 has attempted to bring consistency to the method of securing an interest in goods[4] and fixtures[5] by recognizing the similarity of all such transactions and recognizing distinctions between devices only when of "functional utility."[6]

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* Assistant Professor of Agricultural Economics, Virginia Polytechnic Institute and State University, Blacksburg, Virginia 24061.

[1] U.C.C. Sec. 9-101 comment (1978).

[2] Id.

[3] 1 G. Gilmore, Security Interest in Personal Property, Sec. 15.1 at 462 (1965) Hereinafter cited as Gilmore.

[4] U.C.C. 9-105(f) defines "goods" to include all things which are movable at the time the security interest attaches or which are fixtures... See also "Consumer goods," U.C.C. 9-109(1); "equipment", U.C.C. 9-109(2), "farm products", U.C.C. 9-109(3), and "inventory", U.C.C. 9-109(4). Fixtures are defined under state law.

[5] See U.C.C. Sec. 9-105 and 9-313 (1978).

[6] U.C.C. Sec. 9-101 comment (1978) as discussed later, when

Dole[7] describes the basic Article 9 definition as follows:

> Section 1-201(37) provides an Article 9 security interest is an interest in a debtor's personal property or fixtures that secures payment or performance of an obligation and is created by either contract or the Code. Article 9 security interests ordinarily are created by contract.
>
> An agreement that creates or provides for a security interest is a security agreement. A creditor in whose favor a security interest exists is a secured party. A person obligated to pay or otherwise to perform a secured obligation is a debtor. Personal property or a fixture that is subject to a security interest is collateral. Collateral can include: proceeds-personal property or a fixture that is obtained through disposition or collection of any collateral (for example, the purchase price of livestock collateral); and accessions-personal property or a fixture that is attached to other personal property of fixtures without loss of its physical identity (for example, a new motor installed in an automobile).

Article 9 was created to provide security in personal property for lenders similar to the security provided to lenders in real property.

The thrust of Article 9 of the U.C.C. is to ensure that business financing transactions function as planned.[8] Parties to commercial transactions must be able to determine their rights and obligations with a reasonable degree of certainty[9] and a degree of fairness.[10] Commerce knows

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the appropriate political pressures are applied, alternatives are created. See infra notes 73-83 and 100-107 and accompanying text.

[7] Dole, The Article 9 Security Interest,

in 2 A Transactional Guide to the Uniform Commercial Code 984-985 (R. Alderman, ed. 2nd ed. 1983) Hereinafter cited as Dole.

[8] Hawkland, "Uniform Commercial Code Methodology", U. Ill. L.F. 291,294. (1962).

[9] Lockyer v. Offley, 99 Eng. Rep. 1079, 1083 (1786).

[10] Id.

nothing of state boundaries"[11] and increasingly, the sales of agricultural products is being conducted by farmers outside the county of production and on a larger scale due to the concentration of agricultural production.

Section 9-306(2) of the U.C.C. provides:

> Except where this Article otherwise provides, a security interest continues in collateral notwithstanding sale, exchange or other disposition thereof unless the disposition was authorized by the secured party in the security agreement or otherwise and also continues in any identifiable proceeds...[12]

The major exception to this rule is that a buyer in the ordinary course of business[13] "takes free of a security interest if perfected and even though the buyer knows of its existence."[14] The exception to the exception, known as the farm product rule[15] or the double jeopardy rule,[16] states that if a buyer in the ordinary course of business[17] buys farm products[18] from a person engaged in farming operations,[19] the buyer takes the farm products subject to the secured party's lien.[20]

Financial times have accentuated the lack of uniformity in the application of and the content of UCC 9-307(1). The farm products exception rule has produced much litigation

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[11] M. Chalmers, "Address on the Codification of Mercantile Law", 19 Law Q. Rev. 10, 18 (1903).

[12] U.C.C. Sec. 9-306(2) (1978).

[13] U.C.C. Sec. 1-201(9) (1978).

[14] U.C.C. Sec. 9-307(1) (1976).

[15] Meyer, "U.C.C. Issues," J. of Ag. Tax. and Law 455, 455 (1984).

[16] Among farmers, agribusiness and agrilenders, the farm product exception is often called the double jeopardy rule as the buyer may buy the farm product twice.

[17] U.C.C. Sec. 1-201(9) (1978).

[18] U.C.C. Sec. 9-109(3) (1978).

[19] The U.C.C. does not define farming operations. Wheat in the hands of a farmer is a farm product. Wheat in the hands of a commercial elevator operator is inventory. Presumably, wheat gifted to a grandchild would be a farm

and a lot of criticism from farm product buyers. This article will explain the rule, the reasons it was established, and the recent changes and proposed changes in the rule.

II. The Nature of the Farm Product Exception Under U.C.C. 9-307(1)

The typical farm products financing agreement is as follows: Farmer Hayseed needs $10,000 to plant his corn crop. He applies for funds to Uptight PCA. Uptight is willing to loan the money if the PCA can find acceptable collateral. Farmer Hayseed is willing to pledge the crop he will plant as security for payment. In the resulting secured transaction, the PCA is the secured party, Hayseed the debtor, the crops the collateral, and the $5,000 the secured obligation. Farmer Hayseed then grows a crop of 4,000 bushels. Farmer Hayseed harvests the crop and sells the crop for $2.00 per bushel to Earl Elevator. Earl Elevator commingles the corn with other corn purchased or stored in his inventory[21] on day one. Earl Elevator has borrowed $8,000 to purchase corn from Big Bank. Earl Elevator secured his inventory under U.C.C. Article 9. On day 3, Box Car Gill purchases the inventory of Earl Elevator and sells on day 4 to Kelly Log. Kelly Log smashes, grinds, pops, and boxes the corn into Flakes. The Flakes, sold by Ma & Pa Market on day 10 are purchased by Preston Dent, loan officer of Up-

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product. Would the wheat sold by the grandchild be free of grandpa's lender's security interest? Would it be sold free of a lien placed on the wheat by the grandchild?

[20] A buyer in ordinary course of business (subsection (9) of Section 1-102) other than a person buying farm products from a person engaged in farming operations takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence. U.C.C. Sec. 9-307(1) (1978).

[21] Corn and similar agricultural products are defined as "farm products" under U.C.C. Sec. 9-109(3) (1978), when in the hands of the farmer. 'Farm products' ... are crops, ... livestock, supplies used or produced in farming operations, or ... products of crops or livestock in their unmanufactured states (such as ginned cotton, wool-clip, maple syrup, milk and eggs), and if they are in the possession of a debtor engaged in raising, fattening, grazing, or other farming operations. If goods are farm products they are neither equipment nor inventory. Id. The same physical commodity is defined as inventory when it is in the hands of a non-farmer such as an eleva-

APPENDIX 6

1986 SESSION

LD4139129

SENATE JOINT RESOLUTION NO. 44

Offered January 21, 1986

Continuing the joint subcommittee studying security interests in farm products and the feasibility of requiring the State Corporation Commission to computerize filings of certain secured transactions relating to farm activities.

Patrons--Nolen, Holland, R. J., Truban, and Russell. R. E.; Delegates: Finney, Lacy, Parker, L. W., and Watkins

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Referred to Committee on Rules

WHEREAS, pursuant to Senate Joint Resolution No. 123 of 1985 a joint subcommittee was established to study security interests in farm products; and

WHEREAS, the joint subcommittee learned that farm product purchasers need immediate access to farm product lien information so as to avoid double payment, one at the time of purchase and again when the seller fails to repay the lender, and that lenders need reasonable assurance of the repayment of loans on secured farm products; and

WHEREAS, to protect purchasers of farm products from double payment which they feel inhibits free competition in the market for farm products and obstructs interstate commerce in farm products, Congress passed legislation in December, 1985, preempting state laws in this area; and

WHEREAS, such legislation provides that a person who buys a farm product from a seller engaged in farming operations shall take free of a security interest created by the seller even though the security interest is perfected and the buyer knows of such inter except in states that have prenotification or central filing systems; and

WHEREAS, the interest groups testifying before the joint subcommittee had differing views on what type of system would be in the best interest of the farmers and lenders of the Commonwealth; and

WHEREAS, because of the complexity of the issue and the differing views on what type of system would be in the best interest of the Commonwealth, the joint subcommittee feels that the study should be continued so that they may thoroughly study all options available to determine which is best for Virginia; now, therefore, be it

RESOLVED by the Senate, the House of Delegates concurring, That the joint subcommittee studying security interests in farm products and the feasibility of the State Corporation Commission computerizing filings of certain secured transactions relating to farm products is continued to monitor the federal legislation in this area and to determine what type of system addressing this issue would be in the best interest of the Commonwealth.

The membership of the joint subcommittee shall remain the same. In the event a vacancy should occur in the membership, such vacancy shall be filled by the same person or committee as provided in Senate Joint Resolution No. 123 of 1985.

The joint subcommittee shall complete its work in time to make any recommendations it deems appropriate to the 1987 General Assembly.

The costs of this study, including direct and indirect costs, are estimated to be $18,000.

tight PCA. Applying the farm product rule[22]

Uptight PCA could, in fact, retrieve the Flakes from Preston Dent, its loan officer's breakfast table[23] through a suit for conversion. It is equally clear that Big Bank's security interest in Earl Elevator's inventory is defeated in the purchase of the grain by Box Car Gill.[24]

Professor Henson[25] has stated that under 9-307(1):

> The difficulties are aggravated where the security interest is in an annual crop such as wheat which the debtor sells to a grain elevator in violation of a security agreement, and the elevator in turn sells to the manufacturer of breakfast cereal which subsequently sells to distributors, and ultimately retailers sell the cereal to consumers. Under the Code, the farmer's secured party could follow the wheat into the hands of the consumer (although surely not profitably beyond that point), since even buyers in ordinary course take free only of securing interests created by their seller's, not of security interests further back in the chain. The breakfast cereal is a product of the original wheat and the original security interest presumably can be traced.

What the Code provides is relatively clear. A security interest continues in farm products pledged as collateral "not withstanding sale, exchange or other disposition thereof by the debtor unless...the disposition was authorized by the secured party in the security agreement or otherwise,..."[26] Farm products (as long as they remain

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tor-merchant. U.C.C. Sec. 9-109(4) (1978).

[22] U.C.C. Sec. 9-307(1) (1978) and supra notes 12-20 and accompanying text.

[23] R. Henson, Secured Transactions Under the Uniform Commercial Code at 143 (1979). As Henson reports, there has been no reported case where a farmer's financer tried to reclaim steaks from a dinner table or flakes from the lender's table.

[24] Id. See also U.C.C. Sec. 9-307(1) and 9-109(3) (1978).

[25] Id. at 143-144. See also U.C.C. Sec. 9-306(2) (1978). If the right steps were taken to claim "products" in the financing statement, this might be an instance where U.C.C. Sec. 9-315 could be utilized. Apparently no cases have yet applied this section.

unmanufactured by the farmer) pledged as collateral subject to a secured party's security interest in the farmer's crops,[27] livestock,[28] unmanufactured farm products,[29] and supplies used or produced in farming operation[30] do not cease to be "collateral" when purchased by buyer from a "person engaged in farming operations."[31] (Would a farmer be liable for conversion if he manufactures a product from his farm product?)

U.C.C. Sec. 9-307(1) applies when the lender (secured party) sues the buyer of the farm products for conversion of the secured party's collateral[32] when the farm product seller fails to satisfy the lender. The buyer is "surprised" when he is requested to pay for the merchandise twice. The U.C.C. allows the security interest to follow the collateral through a succession of purchasers even if the "goods" are no longer "farm products" but become "inventory" in the hands of a non-farmer.[33]

The special treatment accorded farm product lenders under U.C.C. Section 9-307(1) is historical in origin. Courts and come legislatures resisted business debtors use of inventory as collateral.[34] One of the reasons proferred by the courts was the public policy reason that one who buys goods held out for sale should not have to worry about security interests created by seller.[35] Although farm products have the appearance of "inventory" and the same physical

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[26] U.C.C. Sec. 9-306(2) (1978).

[27] U.S. v. McCleskey Mills, Inc., 409 F. 2d 1216 (5th Cir. 1969). In U.S. v. Hughes, 340 F. Supp. 539 (ND Miss, 1972), the Government's security interest in soybeans under a Farmer's Home Administration loan transaction continued despite the sale of soybeans to defendant, operator of a grain elevator. Defendant did not take free of the security interest under Sec. 9-307(1), since he bought farm products from a person engaged in farming operation. Defendant had constructive notice of the Government's security interest. Lack of actual knowledge was no defense to a claim of conversion. See also Production Credit Association v. Columbus Mills, 220 U.C.C. Rep. Serv. 228 (Wis. Cir. Ct. 1977).

[28] Garden City Production Credit Ass'n v. Lannan, 186 Neb. 668, 186 N.W. 2d 99 (1971); Clovis National Bank v. Thomas, 77 N.N. 554, 425 P. 2d 726 (1967); and Utah Farm Prod. Credit Ass'n v. Dinner, 302 F. Supp. 897 (D.C. Colo. 1969).

[29] U.C.C. Sec. 9-109(3) states that "ginned cotton, wool clips, maple syrup, milk and eggs" are still manufac-

commodity is inventory in the hands of the non-farmer,[36] pre-code common law firmly established a method of distinguishing agricultural collateral on the basis of the holder's status and not the physical characteristics of the product.[37] Professor Rohner[38] develops the rationale for the rule as being grounded in the small town area of the late 1800's and the early decades of this century when the privately-owned, farm-community bank was thought to be indispensable to the area's economic progress and well-being. The rule was thought necessary to prevent bank failure and the loss of customer deposits and pre-dated federal deposit insurance programs.[39]

The logic of the farm product exception rule is also found in the historical difference between farm products and non-farm commercial inventory.[40] Non-farm commercial inventory is sold "off-the-shelf" on a continuous basis to unidentified customers. Proceeds are often used to replace inventory in a continuous cycle which always gives the lender a security interest in the debtor's collateral.[41] Farm products are sold to a few identifiable buyers.[42] Due to the biological nature of agricultural product production, once the steer or grain is marketed, the loan is often paid off.[43] Proceeds are not re-invested in a replacement inventory. Thus, if the producer fails to apply the sales proceeds from his crop to his production loan, the lender will find himself under or unsecured. Not only is the collateral

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tured. Comment 4 to 9-109 elaborates that processes "closely connected to farming" are not manufacturing.

[30] Id.

[31] Cox v. Bancoklohoma Agri-Services Corp., 641 S.W. 2d 400, 401 (Tex. Ct. App. 1982); Weisbart & Co. v. First Nat'l Bank, 568 F. 2d 391 (5th Cir. 1978); and First State Bank v. Producers Livestock Mktg., 200 Neb. 12, 261 N.W. 2d 854, 858 (1978).

[32] In U.S. v. Topeka Livestock Auction, Inc., 392 F. Supp. 944 (N.D. Ind. 1975), an auctioneer was held liable in conversion to the secured party for selling livestock subject to a perfected security interest.

[33] Baker Production Credit Ass'n v. Long Creek Meat Co., Inc., 266 Or. 643, 513 P. 2d 707 (9th Cir. 1983).

[34] Gilmore, supra note 3, Sec. 2.2.

[35] Id. Sec. 2.3

[36] In U.S. v. Topeka Livestock Auction, Inc., 392 F. Supp.

lost, but the primary and often exclusive source for repayment of the loan is lost.[44] Additionally, there may or may not be identifiable proceeds to satisfy the lender.

The principle that a debtor should not be allowed to fraudulently conceal or dispose of his property to the detriment of his creditors has long been imbedded in Anglo-American law. As far back as the Statute of 13 Elizabeth,[45] conveyances made with intent to delay, hinder, or defraud creditors have declared void as against the persons so hindered, delayed, or defrauded.

In addition to protecting private lenders, 9-307(1) protects government financed or government supported farm credit programs. As a major financer of agriculture, the U.S. government has become a major beneficiary of the farm products exception.[46] The U.C.C. Sec. 9-307(1) farm product exception rule was an early attempt to weigh and apportion transaction risk among farm product sellers, lenders, and buyers.[47]

In theory, by filing under Article 9, the secured party has provided all "would be" purchasers of farm products with constructive notice of the secured party's interest in the collateral.[48] The issue that confronts us today is the practicality and results of the filing requirements of Code Sec-

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944 (N.D. Ind. 1975), an auctioneer was held liable in conversion to the secured party for selling livestock subject to a perfected security interest.

[37] Gilmore, supra note 3 Sec. 26.10 at 708. This is consistent with U.C.C. Secs. 9-109(1) and (2) in which a radio is classified as a "consumer good" or "inventory" depending on the status of the processor. U.C.C. Sec. 9-109 comment 2 (1978).

[38] Review of Problems Related to the Purchase of Mortgaged Agricultural Commodities Hearings, 98th Cong., 1st Sess. at 96 (1983) (Statement of Ralph J. Rohner, Professor of Law, Catholic University of America on Behalf of the American Meat Institute) hereinafter cited as Mortgaged Commodities Hearings.

[39] Id.

[40] Id., 142 (Preliminary Report on the Task Force on Farm Product Liens to Farm Credit Council, Sept. 6, 1983).

[41] Id.

tion 9-401[49] in the modern marketing of agricultural or "farm products."

Perfection[50] under the Uniform Commercial Code can be obtained by either possession[51] or filing.[52] Obviously, in modern commercial agriculture, taking possession of "growing crops," "raised livestock," stored grain," or "flowing milk" is not a realistic alternative to perfecting the secured parties interest in farm products.

Access to public files is a key to the validity of keeping the lenders protected against the conversion of lender's collateral by a purchaser of farm products. In an effort to accommodate differing views concerning "central" vs. "local" filing, the Code drafters provided three alternative filing provisions.[53]

With respect to farm products, the U.C.C. provides for (1) central filing, (2) local filing, and (3) central and local filing.[54] States acting on their own have added disunity to these provisions.[55]

A second problem is that public files are not consulted when they should be, regardless of the states filing requirement. Not many agribusinesses have tried to comply with Article 9 and search the records.[56] Failure to search the record has resulted in a number of conversion suits by

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[42] Id., 143.

[43] Id.

[44] Id.

[45] c. 5 (1570).

[46] For example during the first ten months of 1983, 71 1/2 percent of total claims and 55 1/2 percent of the value of the claims filed by insured farm product buyers with one insurance agency where related to Farmer's Home Administration claims. Mortgaged Commodity Hearings, supra note 38, at 257 (statement of Dennis D. Casey, Associate Manager, Livestock Marketing Ass'n).

[47] Mortgaged Commodities Hearings, supra note 38, at 132, 141-149 (Statement of Delmar v. Banner, President, Farm Credit Council).

[48] U.C.C. Sec. 9-401 (1978).

[49] Id.

secured lenders against third party buyers. And with these suits have come a variety of legislative proposals to modify, repeal, and circumvent the farm products exemption to the U.C.C.

III. Rejection or Revision of U.C.C. Sec. 9-307(1) for Farm Products

The application of U.C.C. Sec. 9-307(1) with respect to farm products has resulted in farm product buyers "purchasing" farm commodities twice.[57] The elimination of the farm products exception to U.C.C. 9-307(1) has been adopted in California[58] and has been the subject of legislative and proposals in Congress.[59] In the absence of outright rejection of the farm products exceptions of U.C.C. Sec. 9-307(1), some state courts[60] and legislatures[61] have been revising state law to modify the impact of 9-307(1). The following sections discuss actual and proposed changes to the farm product exception to U.C.C. Sec. 9-307(1).

A. Rejection of Farm Product Exception Rule

California has rejected outright the application of U.C.C. Sec. 9-307(1).[62] By statute, the secured party's security interest does not follow the "farm product" when the farmer sells them to a buyer in California.[63] In other words, the California Code provides the same protection to a

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[50] U.C.C. Sec. 9-303 (1978).

[51] U.C.C. Sec. 9-305 (1978).

[52] U.C.C. Sec. 9-302 (1978).

[53] D. Baker, A Lawyer's Basic Guide to Secured Transactions, at 118 (1983).

[54] U.C.C. Sec. 9-401(1) (1978) (Alternatives 1, 2, 3).

The alternative provision of 9-401(1) (central, local, central and local filing) which have been adopted by the individual states as of June, 1985 follow. 1962 Code provisions and other modification of the three alternative provisions by individual states are noted in parenthesis.

Alternative 1 has been adopted in Deleware (1962), District of Columbia, Connecticut, Georgia, Hawaii, Iowa, Maine, Kansas, Nevada, Oregon, Utah (modified), and Washington. Alternative 2 has been adopted in Alabama, Alaska, Arizona, California, Colorado, Florida, Illinois, Michigan, Minnesota, Montana, Idaho, New Jersey, New Mexico

buyer of farm products in ordinary course of business as it does buyers of non-"farm" goods.[64] Although similar legislation has been introduced in other states, it has not been adopted to date in any place outside of California.

Using California as a model for other states may be inappropriate. The make up of California agriculture and the structure of marketing of agricultural products is different. California lenders use crop or dairy assignments for financing crops and dairy operations.[65] The marketing of agricultural products in California relies more heavily on cooperatives, limited number of processors for crops and livestock, well identified marketing times.[66] Perishable products account for one third of crop production and California accounts for a relative small percent of total U.S. livestock and feed and food grains production.[67]

B. Revision by State Legislation of the Farm Product Exemption

Proposals to modify the farm products exemption under U.C.C. 9-307(1) by legislative alteration have been successful in many states in recent years.[68] The successful and unsuccessful legislation proposals have not been uniform. The legislative changes can be characterized[69] as (1) secured party must give pre-notification of security interest to the buyer, (2) buyer must obtain a statement from seller of

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(1962), New York, North Dakota, Rhode Island, Nebraska, South Dakota, Tennessee (1962), Texas, Virgin Islands, South Carolina (1962), and Wyoming (modified). Alternative 3 has been adopted in Arkansas, Maryland (modified), Massachusetts, Mississippi, Missouri, New Hampshire, North Carolina, Ohio, Pennsylvania, Vermont (1962), Virginia (modified, West Virginia, and Wisconsin (modified). Guam, Kentucky (2nd and 3rd), Oklahoma and Louisiana (has not adopted Article 9) have mixed versions for place to file.

[55] Id. The UCC promoted disunity from the beginning with respect to filing.

[56] Mortgaged Commodities, supra note 38 at 191 (Statement of Professor Keith Meyer, University of Kansas).

[57] See supra text accompanying notes 21-33.

[58] Cal. Com. Code Sec. 9-307(1) (West 1985) omits "other than a person buying farm products from a person engaged in farming operations" from U.C.C. Sec. 9-307(1) (1978).

[59] Mortgaged Commodities Hearings, supra note 38. The U.S.

existing liens, (3) criminal penalties for seller's who don't tell buyers of existing liens, (4) a shorter statute of limitation on conversion suits, (5) exemptions from the application of the farm product rule under 9-307(1) for certain buyers such as auctioneers, and (6) central filing of security interest.

1. State Pre-Notification of Security Interest

Indiana,[70] Kentucky,[71] Delaware,[72] Illinois,[73] Tennessee,[74] and Ohio[75] have adopted provisions removing the lender's protection (the farm product exception rule) unless the lender files written notice with the potential purchaser. The debtor/farmer is required to give the secured party a list of potential buyers upon request. The debtor must sign the date the notice which includes names and addresses of the debtor and the secured party, a description of the collateral, date and location of the filing of the security interest, and the dated signature of the secured party. A buyer with notice of a lien must pay with a check issued to both the debtor and the secured party. A debtor may not sell farm products to a buyer who does not appear on the list given to the secured party unless the secured party has given written permission to the debtor, or the debtor satisfies the debt for the secured party on the farm products he sells within fifteen days of the date of sale. The notice provided under this provision is usually 18 months, less

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Senate, agriculture, Nutrition, and Forestry Committee held hearings during the end of the 98th Congress 2nd Sess. on S. 2190. 63 Farm Bureau News at 1, Col. 1 (Oct. 1, 1984). See H.R. 1591, 99th Cong. 1st Sess. (1985) and S. 744, 99th Cong. 1st Sess. (1985).

[60] See infra notes 119-135 and accompanying text.

[61] See infra notes 73-106 and accompanying text.

[62] Cal. Com. Code Sec. 9-307(1) (West 1985).

[63] Id.

[64] Id.

[65] Hultquist, "California Experience With the Sale of Farm Products Subject to a Perfected Security Interest: A Sound Approach?" Proceedings, 5th Annual Meeting, American Agricultural Law Association, October 1984, Denver Colorado. Assignment is executed by producer and delivered to and accepted by the processor.

[66] Id.

than the current statute of limitations for conversion in most states. The Ohio statute provides for additional duties on the farmer. The farmer is required to inform the handlers of existing liens on commodities at the time the commodity is delivered.[76] The farmer is permitted to deliver a commodity to a buyer whose name is not on the original list furnished to the creditor.[77] However, the farmer in this case must provide the creditor with the name of the buyer fifteen days prior to selling the commodity, i.e., before the title is passed for value.[78] This provision's impact on various pricing alternatives, such as deferred pricing and delayed pricing contracts, is unknown.

Notice statutes adopted in Kentucky, Ohio, Indiana, Illinois, Tennessee, and Delaware to shift the burden of reviewing Article 9 filings by the buyer to notification of a potential buyer by the creditor to the potential buyers. In a real estate transaction, this would be like requiring the mortgagee to notify all prospective real estate buyers of his interest in the property. Buyers not notified would purchase the property free of mortgagee's interest. Placing or increasing the responsibility of the farmer-seller to notify buyers of liens on his product has merit. However, it is unlikely to deter the unethical farm-product sellers.[79]

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[67] Id.

[68] Mortgaged Commodity Hearings supra note 38, at 259 to 266 (statement of Ernest H. Van Hooser on behalf of Livestock Marketing Association). States which have rejected changes: Alabama, Arkansas, Georgia, Michigan, Missouri, North Carolina, South Carolina, and Texas.

[69] Mortgaged Commodities, supra note 38 at 158 to 176 (statement of Delmar Banner, President, Farm Credit Council for a compilation of state statutes). Several state statutes are discussed in greater detail later in this section.

[70] Ind. Code Ann. Sec. 26-19-307(1) (1985).

[71] Ky. Rev. Stat. Ann. Sec. 9-307 (Bobbs-Merril Supp. 1985).

[72] Del. Code Ann. tit. 6, Sec. 9-307(2)(A) (Supp. 1985).

[73] Ill. Ann. Stat. Ch. 26 Sec. 9-205.1, 9-307, 9-307.1, 9-307.2 (Smith-Hurd Supp. 1984-1985).

Effective July 1, 1985, Iowa has added another twist to the pre-notification statute.[80] Iowa provides for pre-notification within a producers trade area if the lender is to retain his security interest in the farm product.[81] The trade area is defined as contiguous counties.[82] Otherwise, the buyer purchases subject to lender's security interest. State modification of U.C.C. Sec. 9-307(1) by notice statutes has shattered the uniformity of the Uniform Commercial Code.

In theory, notice statutes establish a method of notification that provides the lender with a tool by which he can police collateral and the application of collateral proceeds. Under the above mentioned alternative, the lender and buyer share responsibility for policing collateral. The burden of inadequate information shifts to the lender who is thought to have superior information as to the seller's business and financial condition. Just as buyers can never be certain where grain or livestock originated, neither can lenders be certain as to whom the grain or livestock will be sold. The lender cannot always be certain of when and where he must give notice.[83]

2. Buyer Obtains Lien Certification Statement from Seller

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[74] Tenn. Code Ann. Sec. 47-9-307 (Supp. 1985).

[75] Ohio Rev. Code Ann. Sec. 1309.26 (Page Supp. 1985).

[76] Ohio Rev. Code Ann. Sec. 1309.26 (Page Sup. 1985).

[77] Id.

[78] Id.

[79] H.R. 1591, 99th Cong., 1st Sess. (1985). The proposed federal legislation does not address the issue of unethical seller either.

[80] Iowa Code Ann. Sec. 554.9307.

[81] Id.

[82] Id.

[83] With the increasing movement of farm products across county and state lines, marketing decisions being made over a long period of time, the prudent debtor would have to provide the lender with a large number of potential

North Dakota,[84] South Dakota,[85] Nebraska,[86] and Oklahoma[87] require the buyer to obtain from the seller a certificate of ownership in which the seller certifies the condition of title and specifically identifies any security interests outstanding against the farm product. If there is a lien, the buyer is obliged to make payment jointly to the seller and the lienholder. The buyer will take the commodity subject to any outstanding lien unless he can produce the seller's certificate and demonstrate that the proscribed procedures were followed. The certificate of title approach is attractive because it imposes a burden on producers. The certification process at the moment of sale draws to the seller's attention the importance of satisfying the lien, but provides no ironclad protection against sellers who would give a false certificate and divert the proceeds. It is consistent with the historical desire to have evidence of title and to deter fraud.

The lien statement or title alternative imposes an administrative obligation on buyers to obtain certificates in connection with every transaction or assume the financial risk of paying twice for purchased farm commodities. Buyers already ask for such certification in purchase contracts.[88] A five thousand dollar car and a ten-thousand tract of real estate are transferred with title information. Farm product transactions often involve larger sums of money. It seems prudent to require certification of clear title at time of

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buyers even though he might sell to only one or a few. His actual buyer may not be known until the day of sale.

[84] N.D. Cent. Code Sec. 41-09-28 (1985).

[85] S.D. Codified Laws Ann. Sec. 57A-9-307 (1985).

[86] Neb. Rev. Stat. Sec. 90-9-307(4) (1985).

[87] Okla. Stat. Ann. tit. 12A, Sec. 9-307(3)(a) (West, 1985).

[88] Commonly used purchase contracts in the grain and peanut trade have provisions which state "Seller warrants that the farm products are not subject to any liens, encumbrances or prior interests (including landlord's liens, PCA Bank and prior crop contracts) except as listed below.

Seller agrees that all such liens, encumbrances or prior interests will be satisfied prior to delivery of the farm product or will be satisfied from Buyer's payment to Seller, or Buyer may issue joint checks to satisfy such liens.

purchase. Title certification has been proposed by the American Bankers Association as an alternative to federal pre-notification legislation.[89]

3. Criminal Penalties

The laws enacted in Illinois,[90] Indiana,[91] North Dakota,[92] Ohio,[93] Oklahoma,[94] Iowa,[95] and South Dakota[96] impose criminal sanctions on farmer-sellers who provide fraudulent information or otherwise defraud the lender by selling secured farm products without notification to buyer. Such provisions encourage notification of debtor's lien to the farm products buyer by the debtor. With proper notification, the buyer issues a joint check to the lender and farmer-seller. South Dakota[97] requires the secured lender to initiate a criminal action against the farm product seller before a civil suit can be filed for conversion against the buyer.

4. Shorter Statutes of Limitations

A shorter statute of limitation requires lenders to promptly pursue their claims against buyers.[98] By reducing the period of time available to lenders to make their claim, the buyers' exposure to contingent liabilities is reduced. From the lenders' standpoint, in many instances considerable time may have elapsed before the diversion is discovered and

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[89] The essential element of a draft of the proposed "Farm Product Buyers' Equity Act of 1985" states: Notwithstanding any other provision of Federal, State or local law -- 1. A buyer in the ordinary course of business shall take farm products free of a security interest created by the seller of the products, even though the security interest is perfected, provided the buyer-- a. (i) receives from the seller at the time of purchase a certificate stating the farm products are subject to a security interest, and (ii) includes the name of any secured party identified by the certificate as joint payee on the check or other instrument issued in payment for the farm products, or, b. receives at the time of purchase, on a certificate supplied and retained by the buyer, a signed statement from the seller that there is no security interest in the farm products. (2) a buyer in the ordinary course of business who fails to comply with the provisions of paragraph (1) shall take farm products subject to any perfected security interest in the products created by the seller...(from private correspondence held by the Author).

[90] Ill. Ann. Stat Ch. 26 Sec. 9-205.1, 9-307, 9-307.1, 9-307.2 (Smith-Hurd Supp. 1984-1985).

traced to the buyer. Still, the major financial risk of diverted proceeds would rest with the buyer. The reduction in the statute of limitations for conversion suits from five or seven years to one or two years conversion may be a sensible policy alternative. It requires lenders to more closely police their loans and it provides a shorter period of exposure for the buyer. Federal pre-emptive legislation would reduce exposure to a given crop year.[99]

5. Special Exemptions for Auctioneers and Agents

Nebraska[100] Georgia,[101] Montana[102] Louisiana,[103] and Kentucky,[104] provide that auctioneers or commission agents shall generally not be liable to the secured party for the sale of mortgaged farm products. In addition, Kentucky[105] provides that the buyer of the livestock also takes free of the security interest unless written notice by certified mail is provided to the publically licensed stockyard. Montana[106] has a similar notice requirement for stockyards. The notice is centrally filed and dispensed by the state government to central livestock markets.[107] Such modifications of U.C.C. Sec. 9-307(1) by states indicate a trend towards special interest protection for auctioneers, commission markets, and livestock buyers. If a creditor's interest in mortgaged farm products is to be severed like a creditor's interest in inventory held for sale in the ordinary course of business, then should not the creditor's interest be

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[91] Ind. Code Ann. Sec. 26-19-307(1) (1985).

[92] N.D. Cent. Code Sec. 41-09-28 (1985).

[93] Ohio Rev. Code Ann. Sec. 1309.26 (Page Supp. 1985).

[94] Okla. Stat. Ann. tit. 12A, Sec. 9-307(3)(a) (West, 1985).

[95] Iowa Code Ann. Sec. 554.9307.

[96] S. D. Codified Laws Ann. Sec. 57A-9-307 (1985).

[97] Id.

[98] Id.

[99] See infra text accompanying notes 135 to 153.

[100] Neb. Rev. Stat. Sec. 69-109.01 (1983).

[101] Ga. Code Ann. Sec. 11-9-307 (1982).

[102] Mont. Code Ann. Sec. 81-8-301 (1982).

severed in all such transactions for all buyers of farm products and not just special exemption for a selected class auctioneers and commission agents?

6. Central Filing of Farm Product Liens

Alternative 1[108] of the U.C.C. provides for central filing of security liens on farm products. Central filing for farm products was adopted early by 12 states.[109] Montana,[110] Iowa,[111] Kansas,[112] Nebraska,[113] and Virginia[114] have modified their filing rules within the past three years to require central filing for some or all farm products.

Some would argue that the geographical size of the state might tend to encourage or discourage central filing. A single set of files in Texas or Alaska is quite a different matter than in a New England State. The technology of electronic data retrieval does provide an answer to this problem of central filing which was unimaginable when the filing provisions were originally discussed.

As Dole has stated: "(T)ransferring all agricultural filings to the state level will remove this practical compulsion to file everywhere with respect to them. It will remove the severe penalty for loss of perfection and priority that can be imposed for a failure to file everywhere."[115] Central filing would reduce the uncertainty as to where the

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[103] Mortgaged Commodity Hearings, supra note 38 at 59 (statement of Delmar Banner, President, Farm Credit Council Louisiana has not adopted the U.C.C.)

[104] Ky. Rev. Stat. Sec. 355.9-307 (1985).

[105] Id.

[106] Mont. Code Ann. Sec. 81-301 (1982).

[107] Id.

[108] U.C.C. Sec. 9-407(1) (1978).

[109] Alternative 1 has been adopted in Delaware (1962), District of Columbia, Connecticut, Georgia, Hawaii, Iowa, Maine, Kansas, Nevada, Oregon, Utah (modified), and Washington.

[110] Mont. Code Ann. Sec. 81-8-301 (1983) provides for central filing for livestock with the State Department of Livestock.

[111] Iowa Code Ann. Sec. 554.9407(2)-(4) (West Supp.

buyer must check. With computer assisted search of the central file by direct linkage between purchaser and the central data base, the buyer will be able to instantaneously search the record for liens on farm products.[116] In any event California, one of the largest states, requires exclusive state-wide filing for everything except certain types of agricultural collateral.[117] Statewide filing is appropriate with electronic technology.

The central filing solution basically leaves intact the unique treatment of farm products sold in the ordinary course of business. It maintains the long established balance of responsibility between lenders and buyers of farm products. This central filing solution recognizes that buyers' conversion problems is a problem of notice. The solution attempts to deal with the notice problem by establishing within each state a single office at which all farm products' liens must be filed. This solution also recognizes the need for timely and accurate information on farm product liens.

Critics of central filing argue that it is only a partial solution and is not easily implemented. For example:

> Problems of identifying the true owners of farm products remain. Timing problems. Buyers (especially livestock buyers) would still have difficulties unless

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1984-1985).

[112] Kan. Stat. Ann. Sec. 84-9-401-410 (Supp. 1984).

[113] Neb. Rev. Stat. U.C.C. Secs. 9-413-415 (Com. Supp. 1984). Nebraska statute provides local and central filing with the installation of a centralized computer file by 1986.

[114] Va. Code Ann. Sec. 9-407(1) (Supp. 1985) provides for local and central filing for grains, but not other farm products.

[115] Dole, supra note 7 at 1003.

[116] The search can be conducted by the debtor name, variations of name and address, and type of farm product. Most local clerks file by the name given. Thus, Hooker, Thomas J. of RR #1 Farmville is the only listing. When Hooker, T. J. sells his farm products the clerk might overlook Hooker, Thomas, J. in searching the record. The computer, searching on Hooker, T., would provide a listing of Hooker, T.J.; Thomas Jay; Tom; Tom Jay; Thomas Jay; T. Jay; etc. at RR #1, Farmville, Anystate.

the central filing location in each state (presumably the Secretary of State's office) had its records computerized with 24-hour telephone access.

Even if computerized, computers search for exact information. Even minor errors in spelling or descriptions could frustrate accurate reporting of existing liens.

Most states do not now have central filing for farm products collateral, and the costs associated with establishing and maintaining a computerized central filing system are considerable.

Central filing leaves with the buyer the burden of checking the records or buying at his peril[118]

These problems can be diminished if not eliminated over time. This is particularly true if central filing is combined with alternatives such as: requiring seller to certify that he is the title holder (if seller is unknown to buyer, buyer can check driver's license); providing criminal penalties for seller's misrepresentation as to lien status; posting signs in buyers place; conducting educational meetings for farmers; requiring signature on card at time of loan by debtor in which he acknowledges the possibility of criminal sanctions for selling farm products contrary to

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With computer assisted search of the central file by direct linkage between purchaser's microcomputer and central data base or purchaser phone call to the central location, the buyer will be able to instantaneously search the record for liens on seller's farm products. State-wide filing is still a relatively novel and unfamiliar device. As the business and banking communities become familiar with its operation, they may well come to appreciate its merits. This seems to have happened in the limited areas in which state-wide filing has been in force for any period of time. In the absence of centralized computers, but with the establishment of comprehensive state-wide files in any state, private agencies have developed through which file checks can be made as promptly as if the files were located in the county courthouse. A phone call to a central agency in the state capital may be as cheap for a file search (if not cheaper) by a farm product purchaser than a forty mile trip to the county seat (or several county seats) to search for the lien record of farmer-sellers. Because centralized computer filing of Article 9 liens can provide an instantaneous check of the file for farm product liens, it is ideally suited to provide instantaneous information to the farm product buyer. The buyer

terms of the security agreement; secure several convictions under criminal statutes and publicize; and shorten the statute of limitation. Many of the critics' complaints relative to central filing may be resolved by computer system design and proper implementation of central filing. Central filing works for equipment liens, farm equipment liens already centrally filed in some states, and farm product liens in states with central filing as well as all other items which are now centrally filed.

C. Revision of Farm Products Exception by the Courts

Several of the state courts have made modification to the application of U.C.C. Section 9-307(1). Although U.C.C. Section 9-307(1) protects the security interest of the farmer's lender in farm products, the courts have often strictly interpreted the provisions and applications of the security agreement[119] in order to reduce a purchaser's liability for conversion of lender's secured interest. U.C.C. Section 9-306(2) states with respect to secured party's rights on disposition of collateral:

> (2) Except where this Article otherwise provides, a security interest continues in collateral notwithstanding sale, exchange or other disposition thereof unless the disposition was authorized by the secured party in the security agreement or otherwise, and also continues in any identifiable proceeds including collections received by the debtor.[120]

The question of what constitutes "authorization by the secured party in the security agreement or otherwise" has been the subject of litigation. Many security agreements for farm products require that the lender's consent be given orally or in writing for the sale of a farm product by the farmer-debtor.[121] In practice, however, many sales take

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can check the file conveniently and thus, UCC Sec. 9-307(1) will function as intended, giving notice to prevent the conversion of farm products.

[117] Cal. Com. Code Sec. 9-401(1) (West 1985).

[118] Mortgaged Commodity Hearings, supra note 38 at 151 (statement of Delmar Banner, President Farm Credit Industry).

[119] U.C.C. Sec. 9-105(b) (1978).

[120] U.C.C. Sec. 9-306(2) (1978).

[121] Lenders often place words such a "debtor may not sell,

place with or without the lender's implied or expressed permission. The reality of farm product financing is that the secured party wants the collateral to be sold continually in order for the secured party to receive payment on the line of credit it has extended. In this application, the extension of farm credit is similar to inventory financing. The secured party is also reluctant to give blanket consent to sales because it would lose its right to go against the purchaser under U.C.C. Section 9-307(1) should the debtor default. Consequently, secured parties have protected themselves by such judicially recognized conditional sales authorization to sell if payment is made jointly to seller and bank[122] and authorization to sell on condition buyer's drafts drawn on defendant bank were honored and paid,[123] and consent to sell as long as no prior default has occurred.[124]

Under section 9-306(2), where a sale of collateral has been authorized unconditionally either in the instrument or otherwise, the security interest in farm products (other goods as well) does not survive the sale.[125] The secured party's expressed consent and authority to sell contrary to the terms of the security agreement cuts off the security agreement.[126] Terms and conditions of the security agreement can be expressly waived.[127] Waiver has been characterized as a "voluntary abandonment or remainder, by a capable person of a right known to him to exist with the intent that such a right shall be surrendered and such person deprived of its

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lease or otherwise dispose of any collateral unless specifically authorized in separate writing by lender except as provided in this agreement." The security agreement may state that the debtor may sell milk to a particular buyer, sell cattle as long as a joint check is drafted in favor of lender and debtor or similar restrictions.

[122] North Central Kan. Prod. Credit Ass'n v. Washington Sales Co., 233 Kan. 689, 694, 577 p.2d 35, 38 (1978).

[123] Baker Prod. Credit Ass'n v. Long Creek Meat Co., Inc. 266 Or. 643, 648, 513 P.2d 1129, 1134 (1973).

[124] Farmers State Bank v. Edison Non-Stock Coop. Ass'n, 190 Neb. 789, 793, 212 N.W. 2d 625, 628 (1973).

[125] U.C.C. Sec. 9-306(2) (1978). See Baker Prod. Credit Ass'n v. Long Creek Meat Co., Inc., 226 Or 645, 512 P.2d 1129 (1973) and Farmers State Bank v. Edison Non-Stock Coop. Ass'n 190 Neb. 789, 212 N.W.2d 625 (1973).

[126] Id. See also North Central Kansas Prod. Credit Ass'n v. Washington Sales Co., Inc., 223 Kan. 289 577 P.2d 35

benefit."[128] An express waiver need not be communicated to the buyer.[129]

Controversy surrounds implied waiver of security interest; implied waiver of the requirement of prior written permission to sell; and implied waiver inferred from a course of dealing or usage of trade. U.C.C. Section 1-205(4) provides:

> ... the express terms of an agreement and an applicable course of dealing or usage of trade shall be construed wherever reasonable as consistent with each other, but when such construction is unreasonable, express terms control both course of dealing and usage of trade and course of dealing controls usage of trade.252

U.C.C. Section 2-209(4) provides that although an attempt at modification or rescission of agreement does not satisfy the requirements that a writing must be modified in writing under subsection (2) or (30) of U.C.C. Section 2-209 it can operate as a waiver[130]

Based on U.C.C. Section 2-209(4) and U.C.C. Section 1-205(4), some cases[131] have held that certain conduct, course of dealings, or usage of trade and the like may create a waiver of the conditions in a security agreement or a waiver of the security agreement itself. Other cases,

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(1978).

[127] U.C.C. Sec. 1-103 (1978).

[128] Anon, Inc. v. Farmers Prod. Credit Ass'n of Scottsburg, 446 N.E.2d 656 at 659. (Ind. App. 1983). (Citing North Central Kansas Prod. Credit Ass'n v. Washington Sales Co., Inc., 223 Kan. 289, 557 P.2d 35 (1978)).

[129] Id. at 660.

[130] U.C.C. Sec. 2-209(4) (1978).

[131] The following cases have found an implied waiver of the security agreement: Clovis Nat. Bank v. Thomas, 77 N.M. 554, 425 P.2d 726 (1967) (in 1968 New Mexico by statute set aside the Clovis rule). See N.M. Stat. Ann. Sec. 50A-1-2051(3,4); Planters Production Credit Assn. v. Bowles, 256 Ark 1063, 511 S.W.2d 645 (1974); Lisbon Bank & Trust Co. v. Murray, 206 N.W. 2d 96 (Iowa 1973); Hedrick Sav. Bank v. Myers, 229 N.W.2d 252 (Iowa 1975); Central Washington Prod. Credit Ass'n v. Baker, 11 Wash. App. 17, 521 P.2d 226 (1974); In re Caldwell, Martin Meat Co., 10 U.C.C. Rep. 710 (E.D. Cal. 1970)

based on the same fact patterns have refused to find a waiver.[132] The deep cleavage[133] existing between jurisdiction on the problem is illustrated by two recent cases, Anon, Inc. v. Farmers Prod. Credit Ass'n.[134] and First Tennessee Prod. Credit Ass'n v. Gold Kist, Inc.[135] The courts deep cleavage mirrors the myriad efforts in the states' legislatures to resolve the disunification of the Uniform Commercial Code Section 9-307(1).

D. Federal Revision of the Farm Product Exception to U.C.C. 9-307(1).

Federal legislation to remove the application of Sec. 9-307(1) to farm products has also been proposed as an alternative to state-by-state amendment of U.C.C. Sec. 9-307(1) for removal of the "farm product" exception.[136] Proposals introduced as separate legislation have become a part of the farm bills in the 99th Congress.[137] The current legislative proposal is:

> Notwithstanding any provision of federal, state, or local law, a buyer in the ordinary course of business who buys farm products from a person engaged in farming operations shall own such goods free of any security interest in such goods created by his seller even though the security interest is perfected in accordance with applicable state law and even though the

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and United States v. Central Livestock Ass'n Inc., 349 F. Supp. 1033 (S.E.D.N.D. 1972).

[132] The following cases held that U.C.C. Sec. 1-205(4) prohibits implied authority to sell where the security agreement requires written authority. Garden City Prod. Credit Ass'n v. Lannon, 186 Neb. 668, 186 N.W.2d 99 (1971); Baker Prod. Credit Ass'n. v. Long Creek Meat Co., 266 Or. 643, 513 P.2d 1129 (1973); Vermilion County Prod. Credit Ass'n. v. Izzard. 111 Ill. App.2d 190, 249 N.E.2d 352 (1969); Colorado Bank and Trust Co. v. Western Slope Inv. Inc., 539 P.2d 501 (Colo. App. 1975); and United States v. E.W. Savage & Son, Inc., 343 F. Supp. 123 (D.S.D. 1982), aff'd, 475 F.2d 305 (8th Cir. 1973); Burlington Nat'l Bank v. Strauss, 50 Wis. 2d 270, 184 N.W.2d 122 (1971); North Central Kansas Credit Ass'n v. Washington Sales Co., Inc. 223 Kan. 689, 23 U.C.C. Rep. 1343, 577 P2d 35, (1978); Farmers State Bank v. Edison Non Stock Coop. Ass'n., 190 Neb. 789, 212 N.W.2d 625 (1973); Wabasso State Bank v. Caldwell Packing Co., 308 Minn. 349, 251 N.W.2d 321 (1976); and Fisher v. First Nat'l Bank, 584 S.W.2d 515 (Texas Cir. App. 1979). By statute, New Mexico has legislated the same result. See N.M. Stat. Ann. Sec. 50A-1-205(3, 4) (1983).

buyer knows of its existence: Provided however, that a buyer of farm products takes subject to a security interest created by the seller if: (i) within twelve months prior to the sale of the farm products the buyer has received from the secured party or the seller written notice of the security interest and of any payment obligations imposed on the buyer by the secured party as conditions for waiver or release of the security interest, and (ii) the buyer has failed to perform those obligations.

"(b) Notwithstanding any provisions of Federal, State, or local law, a commission merchant or selling agent who sells farm products for others shall not be liable to the holder of a security interest in such farm products even though the security interest is perfected and even though the commission merchant or selling agent knew of its existence, if the sale is made in the ordinary course of business: Provided however, that a commission merchant or selling agent of farm products takes subject to a security interest created by the seller if: (i) within twelve months prior to the sale of farm products the commission merchant or selling agent has received from the secured party or the seller written notice of the security interest and of any payment obligations imposed on the commission merchant or selling agent by the secured party as conditions for waiver or release of the security interest, and (ii) the commission merchant or selling agent has

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[133] The deep cleavage comes in spite of the states purpose of the U.C.C. "to make uniform law among the various jurisdictions" U.C.C. Sec. 1-102 (1978).

[134] Anon, Inc. v. Farmers Production Credit Association, 446 N.E.2d 656 (Ind. Ct. App. 1983).

[135] First Tennessee Prod. Credit Ass'n v. Gold Kist, Inc. 653 S.W. 2d 418 (Tenn. Ct. App. 1983).

[136] S. 2190, H.R. 3296 and H.R. 3297, 98th Cong. 1st Sess. (1983), and H.R. 1591, and S. 744, 99th Cong. 1st Sess. (1985).

[137] H.R. 1591, 99th Cong. 1st Sess. (1985) has become Section 1314 of H.R. 2100, 99th Cong. 1st Sess (1985) and S. 744, 99th Cong. 1st Sess. is part of the Senate Farm Bill. Backgrounder--Clear Title Legislation, Sept. 19, 1985, USDA Office of Information and Committee on Agriculture, U.S. House of Representatives, Summer No. 10, News Release, August 9, 1985.

failed to perform those obligations.[138]

The proposed federal preemption of the UCC is based on the legitimacy on the commerce clause of the Constitution.[139] The proposed legislation implies that the exposure of purchasers of farm products to double payments inhibits free competition in the market for farm products, and such double exposure constitutes a burden on and an obstruction to commerce in farm products.[140]

The legislative proposal provides for written pre-notification to the potential buyer by the lender, if the lenders security in the farm products is to be protected. In operation, the bill would require a borrower to provide a list of potential buyers for his farm products to his lender. The lender would then notify the potential buyers of his security interest. If the commodity was not sold within the twelve months, the bill implies that the lender should have to re-notify the potential buyers. The legislative proposal provides no protection to a secured party whose chattel is sold to a buyer other than buyers pre-notified. During House floor debate on the farm bill, another modification was proposed which would make the provision applicable only in states where central filing had not been adopted.[141]

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[138] H.R. 1591, 99th Cong. 1st Sess. (1985) and S. 744, 99th Cong. 1st Sess. (1985) Uchtman argues, the widespread use of after acquired property clauses in security agreements involving agricultural products, coupled with an ability to extend perfection of an existing security agreement by filing a continuation statement every five years, could allow a lender to enjoy exemption from federal law for decades. Uchtman, Bauer, and Dudek, "The U.C.C. Farm Products Exception--A Time to Change", 69 Minn Law Rev., 101, 128, footnote 139 (1985).

[139] U.S. Const. art. I, S 8, cl. 3.

[140] The bills imply that buyers should not be concerned with sellers who may "steal" lenders' collateral. The burden of enforcement of liens is a legitimate legislative policy issue and in fact the ultimately be a policy call. See generally Mortgaged Commodity Hearings, supra note 38, at 137 to 150 and 188 to 203. The U.C.C. provision should not be blithely overruled. (Author's opinion).

[141] Conversation with Tom Conway, O.G.G. USDA, Sept. 27, 1985. Outcome unknown at writing of this paper.

Another more limited federal approach was proposed in H.R. 3297 in the 98th Cong.[142] This bill would have rejected the application of U.C.C. 9-307(1) only with respect to the livestock industry.[143] H.R. 3296[144] would have rejected the application of U.C.C. Sec. 9-307(1) for all farm products. H.R. 3296 and H.R. 3297,[145] would have allowed the purchaser of farm products to take free and clear of perfected security interest even if buyer knew of the secured parties interest.

The removal of farm products exception to U.C.C. Section 9-307(1) uniformly at the state level or by federal legislation is attractive as a "quick-fix" to the problem as it provides the same treatment to farm products (farmer's inventory) as to other business inventory and it could easily be implemented. It implies, however, that financing of farm products has lost its uniqueness.[146] The farm lender would be weakened in his efforts to police its collateral. The credit was extended in the first place on the strength of a self-liquidating lien. Professor Meyer argues that the removal of the application of the farm products exception to U.C.C. Sec. 9-307(1) would have the following negative impacts:

1. Farm lenders will lose a substantial protection. This includes any leverage to obtain a joint payee check.

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[142] H.R. 3297, 98th Cong. 1st Sess. (1983) states: That section 409 of the Packers and Stockyards Act, 1971 (7 U.C.C. 228b), is amended by adding the following new subsection:

> "(d) notwithstanding any other Federal or State law, any buyer of livestock in the ordinary course of business, including a livestock marketing agency, shall take the livestock free of any security interest created by any person or agency even though the security interest is perfected and even though the buyer knows of its existence."

[143] Id.

[144] H.R. 3296, 98th Cong. 1st Sess. (1983).

[145] H.R. 3296 and H.R. 3297, 98th Cong. 1st Sess. (1983). While it is defensible to create uniform federal legislation in this area as H.R. 3296 would do, it is this author's opinion that it is not defensible to further fragment the problem of special interest legislation embodied in H.R. 3297. Public policy should treat equals

2. It would seem this loss would require lenders to be much more conservative in lending approach, charge higher interest rates, require more collateral, require co-signors or guarantors and not be willing to take chances on young or less established farmers.

3. This could well put much more pressure on the federal government to get more involved in the lending business inasmuch as the Farmers Home Administration's current requirement that borrowers are not eligible unless credit is otherwise not available.

4. When the farmer gores bankrupt, the lenders will have a problem with claiming money in a general checking account in which the farmer has deposit proceeds from the sale of collateral.

The farm credit industry likewise argues that the cost of agricultural credit would be increased and/or the availability of such credit would diminish.[147]

In arguing that the impact of the removal of farm product exemption would be minimal on agricultural credit, Professor Rohner[148] states that:

> 1) ...Presumably some lenders, though legally entitled to pursue the purchaser, do not do so for reasons of expediency (distance, likelihood of recovery, litigation expenses, etc.)...

(farm product purchasers, producer and lenders of milk, chickens, livestock, tobacco, cotton, grain, etc.) unequally with different laws and exceptions.

[146] Backgrounder, supra note 137.

[147] Mortgaged Commodities, Supra note 38 (Appendix, Statement of Delmar K. Banner, President, The Farm Credit Council). A study of the impact of California's exemption could be undertaken to verify or discredit this theory, offered without collaboration.

[148] Mortgaged Commodities, supra note 38, at 89-114 (statement of Ralph H. Rohner, Professor of Law, Catholic University of America on Behalf of the American Meat Institute).

2) ... P reemption of the farm products rule would not mean that purchasers could never be accountable. The buyer would still have to qualify as a "purchaser in the ordinary course of business." The buyer would have to be acting in good faith and without knowledge that the particular sale was unauthorized. These criteria would permit the lender to recover from any buyer who was a knowing participant in an unauthorized sale.

3) A reallocation of risk from buyers to lenders is also justifiable if the net amount of losses would be reduced, or if those losses could be absorbed more efficiently by lenders than purchasers. ...

4) ... L enders are inherently better positioned to absorb and distribute the resulting losses. For example, lenders can reflect actuarial projections of unauthorized sale losses in their rate and fee structures for distribution among all borrowers. Or insurance against that specific form of risk may be feasible. Under the present law, by contrast, the losses fall fortuitously and randomly on purchasers of different sorts who as a group are much less likely to be able to absorb or distribute the losses through their customer base.

Rohner cites no authority for point number one.[149] In fact, other testimony indicates that actions for conversion generally are undertaken when the farm product seller is insolvent.[150] Argument number two is contradicted by proposed legislation.[151] Argument number three assumes that the lenders could inexpensively and routinely police loans. Although the efficiency argument is unsubstantiated, it is an acceptable public policy decision to reallocate the risk from farm product buyers to farm product lenders.[152]

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[149] Id. at 89-114.

[150] Mortgage Commodity Hearings, supra note 38, at 192-194 (Statement of Professor Keith Meyer, University of Kansas).

[151] H.R. 3296, 98th Cong. 1st Sess. Sec. 2 (1983) and H.R. 3297, 98th Cong., 1st Sess (1983) and H.R. 1591, 99th Cong. 1st Sess. (1985) and 5.477, 99th Cong. 1st Sess. (1985).

[152] Gilmore, supra note 3, Sec. 26.10.

Moreover, similar allocation of risk is made with respect to "bulk" transfers and real estate liens and therefore, it is not a "required" policy call to reallocate risk in the area of farm product liens. In this author's opinion, argument number four is perhaps the most persuasive for shifting the transaction risk solely to the lenders. However, this presupposes that there are no acceptable legislative alternatives to resolve the current problem or that the removal of the farm products exemption is sound public policy.[153] What, if any, would be the marginal increase in farm production cost if the exemption for farm products was removed? Unilateral action by the federal government, overriding states rights in the area of commercial law should only be undertaken after the Permanent Editorial Board of the UCC and the states have had the opportunity to re-unify the UCC.[154]

Summary

Regardless of the outcome of legislation, tough financial times have made lenders more aware of policing farm product collateral. Lenders have an obligation to place in bold print and highlight or underline the debtors obligations under an Article 9 secured party loan. The agricultural lender has an affirmative duty to police his/her loans with periodic checks on the debtor's performance under the terms of the loan.

Farm product buyers need not search the files for every buying transaction. Buyers could establish a buying "credit" policy for each of its regular sellers. This would be like a sellers credit policy in reverse. Just as buyers establish a credit sales policy, so could farm product buyers. The list could be periodically updated. Farmers who pay off their liens will bring this information to the attention of the buyer. Otherwise, the buyer can assume the lien is still in place. When a seller sells farm products secured by a lender, the buyer could issue a check payable to both the seller and lender. The buyer would only need an immediate file search on an unknown farm product seller.

If central filing with computer retrieval would be adopted, or under current filing provision, why not have a space on the UCC 1 or similar form which provides as follows:

--Waiver of written consent to sell

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[153] See a discussion of alternatives at text accompanying notes 108-118.

[154] Uchtman, supra note 138.

--No waiver of written consent to sell. Call the Farm Lender for information.

--No waiver of consent to sell

--Make check payable to lender and debtor.[155]

Efforts could also be undertaken to better clarify the description of the collateral.

A movement away from the lender protection is likely to cost the taxpayer more through greater FmHA losses. A shift is also likely to reduce the availability of funds and/or to raise the interest rate on loans and non-land owning farmers, to young farmers, and to less capitalized farmers. This would have both positive and negative effects. Lenders would have to become better policemen for their loans. Promising young farmers might have greater difficulty borrowing money. A transfer of the transaction risk from the buyer who now fails to comply with the notice provisions of Article 9 is a transfer of the risk via the banks to the innocent farmer/borrower. He is likely to pay more for interest as the lender reflects the losses through higher interest rates.

The lender should be required to improve the operation of 9-401 and the lending process if they are to maintain their preferred status in farm products under 9-307(1). In addition to making access to lien information more readily available, stiffer criminal penalties could be provided for those who divert proceeds or otherwise abuse the process. One can make an equally persuasive arguement that the criminal law should not be used to police credit transactions. Producers, buyers, and lenders should be uniformly educated about the process and the requirements of notification on the sale of farm goods through formalized sales/title transfer certificates. When money is borrowed and at the time of sale, farm product sellers should be reminded of their obligations of repayment under an Article 9 transaction.

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[155] It is not inconceivable that coupled with EFT, the lender could say remit X% or $X to lender and remainder to debtor. Both could be done simultaneously. The material could also be in large print with a notice to the lender to read and discuss the issue with debtor.

[156] Uchtman, supra note 138 at 137, Meyer. "U.C.C. Issues", 6 J. of Ag. Tax and Law 460 (1984)., hereinafter, Meyer. Geyer, Proposals for Improvement in Agricultural Marketing Transactions, 29 S.D.L. Rev. 361 (1984), Meyer, The

Several writers[156] have proposed alternatives for re-unifying the U.C.C. The farm product exception could be deleted from the Code. The retention of the rule could be accompanied by required central filing for farm products with instant access to the information via the telephone or through computer terminals.[157] States or Congress could adopt central filing system. The adoption of pre-notification and certification of title are two other alternatives for federal or state adoption. The removal of 9-307(1) protection for lenders for farm products may result in reduced marketing alternatives for farmers. Lenders may require assignment of proceeds as a condition of making the loan. Therefore, a farmer may be forced to market his product prior to borrowing the money.

The burden of the farm product exemption on the buyers may outweigh the benefits to the debtor and secured party lender. The "appropriate body to consider the problem is the permanent editorial board of the Uniform Commercial Code".[158] But if the editorial board fails to act, "federal preemption (is) preferable to no action at all.[159]

The marketing of agricultural products is no longer solely a state matter. The federal government should assert its role to balance the needs of the farm product seller, buyer and lender. The federal government should exercise this option by either passing new federal legislation which would promote uniformity among the states or pre-empt state law if states do not uniformly act to resolve the problem of sellers who don't notify buyers of product liens. The issue is being addressed by the United States Congress.[160] The alternative to federal preemption in what heretofore has been the perogative of the states is for the states to re-unify the U.C.C. It may be too late. Congress, due to the inaction of the Permanent Editorial Board of the U.C.C. may do

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9-307(1) Farm Products Puzzle: Its Parts and Its Future, 60 N.D.L. Rev. 401 (1984), Van Hooser, Problems Arising from the Sale of Mortgaged Farm Products, 29 S.D.L. Rev. 346 (1984).

[157] Whether it is central or central and local, I will leave the issue to the pundits.

[158] Meyer, supra note 156 at 460.

[159] Uchtman, supra note 138 at 138.

[160] (Statement of Dennis D. Casey, Associate Manager, Livestock Marketing Ass'n) Mortgaged Commodities Hearings, supra note 38, and H.R. 1591, 99th Cong. 1st Sess. (1985) and S. 744, 99th Cong. 1st Sess. (1985).

"an end run on the U.C.C." If Congress chooses the end run, it will do so by rejecting twentieth century technology and states' right to control basic commercial lending activity with respect to farm products.[161]

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[161] Could the states do an end run on Congress by redefining farm products out of the code?

APPENDIX 2

PROTECTION FOR PURCHASERS OF FARM PRODUCTS

SEC. 1324. (a) Congress finds that--

(1) certain State laws permit a secured lender to enforce liens against a purchaser of farm products even if the purchaser does not know that the sale of the products violates the lender's security interest in the products, lacks any practical method for discovering the existence of the security interest, and has no reasonable

means to ensure that the seller uses the sales proceeds to repay the lender;

(2) these 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;

(3) the exposure of purchasers of farm products to double payment inhibits free competition in the market for farm products; and

(4) this exposure constitutes a burden on and an obstruction to interstate commerce in farm products.

(b) The purpose of this section is to remove such burden on and obstruction to interstate commerce in farm products.

(c) For the purposes of this section--

(1) the term ``buyer in the ordinary course of business'' means 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.

(2) the term ``central filing system'' means a system for filing effective financing statements or notice of such financing statements on a statewide basis and which has been certified by the Secretary of the United States Department of Agriculture; the Secretary shall certify such system if the system complies with the requirements

of this section; specifically under such system--

(A) effective financing statements or notice of such financing statements are filed with the office of the Secretary of State of a State.

(B) the Secretary of State records the date and hour of the filing of such statements;

(C) the Secretary of State compiles all such statements into a master list--

(i) organized according to farm products;

(ii) arranged within each such product--

(I) in alphabetical order according to the last name of the individual debtors, or, in the case of debtors doing business other than as individuals, the first word in the name of such debtors; and

(II) in numerical order according to the social security number of the individual debtors or, in the case of debtors doing business other than as individuals, the Internal Revenue Service taxpayer identification number of such debtors; and

(III) geographically by county or parish; and

(IV) by crop year;

(iii) containing the information referred to

in paragraph (4)(D);

(D) the Secretary of State maintains a list of all buyers of farm products, commission merchants, and selling agents who register with the Secretary of State, on a form indicating--

(i) the name and address of each buyer, commission merchant and selling agent;

(ii) the interest of each buyer, commission merchant, and selling agent in receiving the lists described in subparagraph (E); and

(iii) the farm products in which each buyer, commission merchant, and selling agent has an interest;

(E) the Secretary of State distributes regularly as prescribed by the State to each buyer, commission merchant, and selling agent on the list described in subparagraph (D) a copy in written or printed form of those portions of the master list described in paragraph (C) that cover the farm products in which such buyer, commission merchant, or selling agent has registered an interest;

(F) the Secretary of State furnishes to those who are not registered pursuant to (2)(D) of this section oral confirmation within 24 hours of any effective financing statement on request followed by written

confirmation to any buyer of farm products buying from a debtor, or commission merchant or selling agent selling for a seller covered by such statement.

(3) The term ``commission merchant'' means any person engaged in the business of receiving any farm product for sale, on commission, or for or on behalf of another person.

(4) The term ``effective financing statement'' means a statement that--

(A) is an original or reproduced copy thereof;

(B) is signed and filed with the Secretary of State of a State by the secured party;

(C) is signed by the debtor;

(D) contains,

(i) the name and address of the secured party;

(ii) the name and address of the person indebted to the secured party;

(iii) the social security number of the debtor or, in the case of a debtor doing business other than as an individual, the Internal Revenue Service taxpayer identification number of such debtor;

(iv) a description of the farm products subject to the security interest created by the

debtor, including the amount of such products where applicable; and a reasonable description of the property, including county or parish in which the property is located;

(E) must be amended in writing, within 3 months, similarly signed and filed, to reflect material changes;

(F) remains effective for a period of 5 years from the date of filing, subject to extensions for additional periods of 5 years each by refiling or filing a continuation statement within 6 months before the expiration of the initial 5 year period;

(G) lapses on either the expiration of the effective period of the statement or the filing of a notice signed by the secured party that the statement has lapsed; whichever occurs first;

(H) is accompanied by the requisite filing fee set by the Secretary of State; and

(I) substantially complies with the requirements of this subparagraph even though it contains minor errors that are not seriously misleading.

(5) 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 farming 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.

(6) The term ``knows'' or ``knowledge'' means actual knowledge.

(7) The term ``security interest'' means an interest in farm products that secures payment or performance of an obligation.

(8) The term ``selling agent'' means any person, other than a commission merchant, who is engaged in the business of negotiating the sale and purchase of any farm product on behalf of a person engaged in farming operations.

(9) The term ``State'' means each of the 50 States, the District of Columbia, the Commonwealth of Puerto Rico, Guam, the Virgin Islands of the United States, American Samoa, the Commonwealth of the Northern Mariana Islands, or the Trust Territory of the Pacific Islands.

(10) The term ``person'' means any individual, partnership, corporation, trust, or any other business entity.

(11) The term ``Secretary of State'' means the Secretary of State or the designee of the State.

(d) Except as provided in subsection (e) and

notwithstanding any other provision of Federal, State, or local law, a buyer who in the ordinary course of business buys a farm product from a seller engaged in farming operations shall take free of a security interest created by the seller, even though the security interest is perfected; and the buyer knows of the existence of such interest.

(e) A buyer of farm products takes subject to a security interest created by the seller if--

(1)(A) within 1 year before the sale of the farm products, the buyer has received from the secured party or the seller written notice of the security interest organized according to farm products that--

(i) is an original or reproduced copy thereof;

(ii) contains,

(I) the name and address of the secured party;

(II) the name and address of the person indebted to the secured party;

(III) the social security number of the debtor or, in the case of a debtor doing business other than as an individual, the Internal Revenue Service taxpayer identification number of such debtor;

(IV) a description of the farm products subject to the security interest created by the

debtor, including the amount of such products where applicable, crop year, county or parish, and a reasonable description of the property and

(iii) must be amended in writing, within 3 months, similarly signed and transmitted, to reflect material changes;

(iv) will lapse on either the expiration period of the statement or the transmission of a notice signed by the secured party that the statement has lapsed, whichever occurs first; and

(v) any payment obligations imposed on the buyer by the secured party as conditions for waiver or release of the security interest; and

(B) the buyer has failed to perform the payment obligations, or

(2) in the case of a farm product produced in a State that has established a central filing system--

(A) the buyer has failed to register with the Secretary of State of such State prior to the purchase of farm products; and

(B) the secured party has filed an effective financing statement or notice that covers the farm products being sold; or

(3) in the case of a farm product produced in a State that has established a central filing system, the buyer--

(A) receives from the Secretary of State of such State written notice as provided in subparagraph (c)(2)(E) or (c)(2)(F) that specifies both the seller and the farm product being sold by such seller as being subject to an effective financing statement or notice; and

(B) does not secure a waiver or release of the security interest specified in such effective financing statement or notice from the secured party by performing any payment obligation or otherwise; and

(f) What constitutes receipt, as used in this section, shall be determined by the law of the State in which the buyer resides.

(g)(1) Except as provided in paragraph (2) and notwithstanding any other provision of Federal, State, or local law, a commission merchant or selling agent who sells, in the ordinary course of business, a farm product for others, shall not be subject to a security interest created by the seller in such farm product even though the security interest is perfected and even though the commission merchant or selling agent knows of the existence of such interest.

(2) A commission merchant or selling agent who sells a farm product for others shall be subject to a security interest created by the seller in such farm product if--

(A) within 1 year before the sale of such farm product the commission merchant or selling agent has received from the secured party or the seller written notice of the security interest; organized according to farm products, that--

(i) is an original or reproduced copy thereof;

(ii) contains,

(I) the name and address of the secured party;

(II) the name and address of the person indebted to the secured party;

(III) the social security number of the debtor or, in the case of a debtor doing business other than as an individual, the Internal Revenue service taxpayer identification number of such debtor;

(IV) a description of the farm products subject to the security interest created by the debtor, including the amount of such products, where applicable, crop year, county or parish, and a reasonable description of the property, etc.; and

(iii) must be amended in writing, within 3 months, similarly signed and transmitted, to reflect material changes;

(iv) will lapse on either the expiration period of the statement or the transmission of a notice signed by the secured party that the statement has lapsed, whichever occurs first; and

(v) any payment obligations imposed on the commission merchant or selling agent by the secured party as conditions for waiver or release of the security interest; and

(B) the commission merchant or selling agent has failed to perform the payment obligations;

(C) in the case of a farm product produced in a State that has established a central filing system--

(i) the commission merchant or selling agent has failed to register with the Secretary of State of such State prior to the purchase of farm products; and

(ii) the secured party has filed an effective financing statement or notice that covers the farm products being sold; or

(D) in the case of a farm product produced in a State that has established a central filing system, the commission merchant or selling agent--

(i) receives from the Secretary of State of such State written notice as provided in subsection (c)(2)(E) or (c)(2)(F) that specifies both the seller

and the farm products being sold by such seller as being subject to an effective financing statement or notice; and

(ii) does not secure a waiver or release of the security interest specified in such effective financing statement or notice from the secured party by performing any payment obligation or otherwise.

(3) What constitutes receipt, as used in this section, shall be determined by the law of the State in which the buyer resides.

(h)(1) 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.

(2) If a security agreement contains a provision described in paragraph (1) and such person engaged in farming operations sells the farm product collateral to a buyer or through a commission merchant or selling agent not included on such list, the person engaged in farming operations shall be subject to paragraph (3) unless the person--

(A) has notified the secured party in writing of the identity of the buyer, commission merchant, or selling agent at least 7 days prior to such sale; or

(B) has accounted to the secured party for the proceeds of such sale not later than 10 days after such sale.

(3) A person violating paragraph (2) shall be fined $5,000 or 15 per centum of the value or benefit received for such farm product described in the security agreement, whichever is greater.

(i) The Secretary of Agriculture shall prescribe regulations not later than 90 days after the date of enactment of this Act to aid States in the implementation and management of a central filing system.

(j) This section shall become effective 12 months after the date of enactment of this Act.

being sold by such seller as being subject to an effective financing statement or notice; and

(B) does not secure a waiver or release of the security interest specified in such effective financing statement or notice from the secured party by performing any payment obligation or otherwise; and

(f) What constitutes receipt, as used in this section, shall be determined by the law of the State in which the buyer resides.

(g)(1) Except as provided in paragraph (2) and notwithstanding any other provision of Federal, State, or local law, a commission merchant or selling agent who sells, in the ordinary course of business, a farm product for others, shall not be subject to a security interest created by the seller in such farm product even though the security interest is perfected and even though the commission merchant or selling agent knows of the existence of such interest.

(2) A commission merchant or selling agent who sells a farm product for others shall be subject to a security interest created by the seller in such farm product if—

(A) within 1 year before the sale of such farm product the commission merchant or selling agent has received from the secured party or the seller written notice of the security interest; organized according to farm products, that—

(i) is an original or reproduced copy thereof;

(ii) contains,

(I) the name and address of the secured party;

(II) the name and address of the person indebted to the secured party;

(III) the social security number of the debtor or, in the case of a debtor doing business other than as an individual, the Internal Revenue service taxpayer identification number of such debtor;

(IV) a description of the farm products subject to the security interest created by the debtor, including the amount of such products, where applicable, crop year, county or parish, and a reasonable description of the property, etc.; and

(iii) must be amended in writing, within 3 months, similarly signed and transmitted, to reflect material changes;

(iv) will lapse on either the expiration period of the statement or the transmission of a notice signed by the secured party that the statement has lapsed, whichever occurs first; and

(v) any payment obligations imposed on the commission merchant or selling agent by the secured party as conditions for waiver or release of the security interest; and

(B) the commission merchant or selling agent has failed to perform the payment obligations;

(C) in the case of a farm product produced in a State that has established a central filing system—

(i) the commission merchant or selling agent has failed to registor with the Secretary of State of such State prior to the purchase of farm products; and

the requirements of this section; specifically under such system—

(A) effective financing statements or notice of such financing statements are filed with the office of the Secretary of State of a State.

(B) the Secretary of State records the date and hour of the filing of such statements;

(C) the Secretary of State compiles all such statements into a master list—

(i) organized according to farm products;

(ii) arranged within each such product—

(I) in alphabetical order according to the last name of the individual debtors, or, in the case of debtors doing business other than as individuals, the first word in the name of such debtors; and

(II) in numerical order according to the social security number of the individual debtors or, in the case of debtors doing business other than as individuals, the Internal Revenue Service taxpayer identification number of such debtors; and

(III) geographically by county or parish; and

(IV) by crop year;

(iii) containing the information referred to in paragraph (4)(D);

(D) the Secretary of State maintains a list of all buyers of farm products, commission merchants, and selling agents who register with the Secretary of State, on a form indicating—

(i) the name and address of each buyer, commission merchant and selling agent;

(ii) the interest of each buyer, commission merchant, and selling agent in receiving the lists described in subparagraph (E); and

(iii) the farm products in which each buyer, commission merchant, and selling agent has an interest;

(E) the Secretary of State distributes regularly as prescribed by the State to each buyer, commission merchant, and selling agent on the list described in subparagraph (D) a copy in written or printed form of those portions of the master list described in paragraph (C) that cover the farm products in which such buyer, commission merchant, or selling agent has registered an interest;

(F) the Secretary of State furnishes to those who are not registered pursuant to (2)(D) of this section oral confirmation within 24 hours of any effective financing statement on request followed by written confirmation to any buyer of farm products buying from a debtor, or commission merchant or selling agent selling for a seller covered by such statement.

(3) The term "commission merchant" means any person engaged in the business of receiving any farm product for sale, on commission, or for or on behalf of another person.

(4) The term "effective financing statement" means a statement that—

)OMINION
FARM LOAN

January 15, 1986

Senator Frank W. Nolan
Room 381
General Assembly Building
Richmond, Virginia 23219

Dear Senator Nolan:

At your Joint Legislative Study Committee meeting on Tuesday, January 7, 1986, the Committee requested information on the number, percentage, and dollar volume of our customers whose loans are secured primarily by agricultural products. In that regard, I have gathered the following information that I hope your Committee will find useful.

Of Dominion Bank of Shenandoah Valley's twelve hundred and twenty five agricultural loan customers, four hundred and two, or 32.8%, have loans that are secured primarily by agricultural products. These customers had total loans outstanding on January 10, 1986, of $19,747,887. This represents 27.6% of our $71,562,000 agriculture loan portfolio, and 12.6% of our $156,763,000 total commercial loan portfolio. As Stan Forbes and I explained at your last committee meeting, if the State fails to set up a central filing system for liens on agricultural products, and elects to go with the Federal option of a pre-notification system, we believe that our liens on agricultural products will in effect become invalid. The above figures would indicate that we may be put in a position of asking many of our customers to provide us with other types of security for their loans. If they are unable to provide such security, they may find it difficult or impossible to obtain the credit that they need to continue a viable farm operation. For these reasons I think to best serve the interest of the farmers, the Committee should recommend a Bill to establish a central filing system for liens on agricultural products.

I do realize that the establishment of this system may carry considerable expense. Therefore, I suggest that the Committee set a cap on the cost of establishing this system and allow for the Secretary of the State Corporation Commission to halt

(10) The term "person" means any individual, partnership corporation, trust, or any other business entity.

(11) The term "Secretary of State" means the Secretary of State or the designee of the State.

(d) Except as provided in subsection (e) and notwithstanding any other provision of Federal, State, or local law, a buyer who in the ordinary course of business buys a farm product from a seller engaged in farming operations shall take free of a security interest created by the seller, even though the security interest is perfected; and the buyer knows of the existence of such interest.

(e) A buyer of farm products takes subject to a security interest created by the seller if—

(1)(A) within 1 year before the sale of the farm products, the buyer has received from the secured party or the seller written notice of the security interest organized according to farm products that—

(i) is an original or reproduced copy thereof;

(ii) contains,

(I) the name and address of the secured party;

(II) the name and address of the person indebted to the secured party;

(III) the social security number of the debtor or, in the case of a debtor doing business other than as an individual, the Internal Revenue Service taxpayer identification number of such debtor;

(IV) a description of the farm products subject to the security interest created by the debtor, including the amount of such products where applicable, crop year, county or parish, and a reasonable description of the property and

(iii) must be amended in writing, within 3 months, similarly signed and transmitted, to reflect material changes;

(iv) will lapse on either the expiration period of the statement or the transmission of a notice signed by the secured party that the statement has lapsed, whichever, occurs first; and

(v) any payment obligations imposed on the buyer by the secured party as conditions for waiver or release of the security interest; and

(B) the buyer has failed to perform the payment obligations, or

(2) in the case of a farm product produced in a State that has established a central filing system—

(A) the buyer has failed to register with the Secretary of State of such State prior to the purchase of farm products; and

(B) the secured party has filed an effective financing statement or notice that covers the farm products being sold; or

(3) in the case of a farm product produced in a State that has established a central filing system, the buyer—

(A) receives from the Secretary of State of such State written notice as provided in subparagraph (c)(2)(E) or (c)(2)(F) that specifies both the seller and the farm product

APPENDIX 4

MY NAME IS SPOTTSWOOD TALIAFERRO. I AM AN ESSEX COUNTY GRAIN FARMER.

I APPRECIATE THE OPPORTUNITY TO SPEAK IN FAVOR OF REMOVING THE AGRICULTURAL PRODUCTS' EXEMPTION FROM THE UNIFORM COMMERCIAL CODE.

THERE ARE FOUR REASONS TO ASK FOR YOUR CONSIDERATION IN REMOVING THIS CLAUSE.

1) THE VOLUME OF FARMER TO FARMER SELLING IS INCREASING. AS A FARMER, I SELL MY GRAIN TO FARMERS-FEEDERS AS FAR AWAY AS HARRISONBURG. IT WOULD BE UNREASONABLE TO EXPECT THAT THEY WOULD COME TO ESSEX COUNTY IN THE MIDDLE PENINSULA TO CHECK FOR LIENS ON MY GRAIN.

2) IT IS UNFAIR TO REQUIRE FEEDERS TO BEAR THE EXTRA EXPENSE OF DEBT COLLECTION. THEY ARE CURRENTLY OPERATING ON EXTREMELY LOW IF NOT NEGATIVE MARGINS. ANY INCREASE IN THEIR EXPENSES WOULD BE PASSED ALONG TO ME AS A GROWER. THIS POSSIBILITY OF ADDITIONAL EXPENSE IS ONE THAT I CAN NOT STAND FINANCIALLY NOR CAN ANY OTHER FARMERS.

3) THERE ARE CURRENTLY 310 LICENSES GRAIN DEALERS IN VIRGINIA. I DO NOT BELIEVE THAT EVEN 10% OF THESE COULD STAND A $50,000 DOUBLE PAYMENT. THIS PAYMENT IS REPRESENTED BY ONLY 335 ACRES OF SOYBEANS EVEN AT TODAYS DEPRESSED MARKET PRICES.

4) A CENTRAL FILING SYSTEM IS NOT THE ANSWER NOR WILL IT WORK. LET ME EXPLAIN. I FARM SEVERAL FARMS SPREAD GEOGRAPHICALLY OVER 10 MILES IN NORTHERN ESSEX COUNTY. JUST LAST WEEK I WAS COMPLETING MY SOYBEAN HARVEST ON BEAVERDAMN FARM. DURING THE HARVEST SEASON I ALSO COMBINED BEANS ON ROCKLAND, LILY MOUNT AND ANTIOCH FARMS. IF LIENS WERE PERFECTED ON ONE OR TWO OF THESE FARMS BUT NOT ON THE OTHERS, HOW COULD THE BUYER TELL WHICH FARM HE WAS BUYING GRAIN FROM. HE COULD NOT DETERMINE THIS EVEN WITH AN ONSITE INSPECTION.

(ii) the secured party has filed an effective financing statement or notice that covers the farm products being sold; or

(D) in the case of a farm product produced in a State that has established a central filing system, the commission merchant or selling agent—

(i) receives from the Secretary of State of such State written notice as provided in subsection (c)(2)(E) or (c)(2)(F) that specifies both the seller and the farm products being sold by such seller as being subject to an effective financing statement or notice; and

(ii) does not secure a waiver or release of the security interest specified in such effective financing statement or notice from the secured party by performing any payment obligation or otherwise.

(3) What constitutes receipt, as used in this section, shall be determined by the law of the State in which the buyer resides.

(h)(1) 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.

(2) If a security agreement contains a provision described in paragraph (1) and such person engaged in farming operations sells the farm product collateral to a buyer or through a commission merchant or selling agent not included on such list, the person engaged in farming operations shall be subject to paragraph (3) unless the person—

(A) has notified the secured party in writing of the identity of the buyer, commission merchant, or selling agent at least 7 days prior to such sale; or

(B) has accounted to the secured party for the proceeds of such sale not later than 10 days after such sale.

(3) A person violating paragraph (2) shall be fined $5,000 or 15 per centum of the value or benefit received for such farm product described in the security agreement, whichever is greater.

(i) The Secretary of Agriculture shall promulgate regulations not later than 90 days after the date of enactment of this Act, to aid states in the implementation and management of a central filing system.

(j) This section shall become effective 12 months after the date of enactment of this Act.

STATEMENT ON AGRICULTURAL LIENS
TO THE
JOINT SUBCOMMITTEE STUDYING SECURITY INTERESTS
IN FARM PRODUCTS
BY CARLTON COURTER, EXECUTIVE DIRECTOR
VIRGINIA AGRIBUSINESS COUNCIL
NOVEMBER 26, 1985

MR. CHAIRMAN, MEMBERS OF THE JOINT SUBCOMMITTEE, MY NAME IS CARLTON COURTER, I AM THE EXECUTIVE DIRECTOR OF THE VIRGINIA AGRIBUSINESS COUNCIL.

THE AGRIBUSINESS COUNCIL REPRESENTS ALL SECTORS OF VIRGINIA'S INDUSTRY OF AGRICULTURE, INCLUDING INDIVIDUAL FARMERS, FARM COMMODITY ASSOCIATIONS, FARM SUPPLY AND SERVICE COMPANIES, PROCESSORS AND MARKETERS OF AGRICULTURAL AND FORESTRY PRODUCTS AND ASSOCIATIONS OF AGRIBUSINESS FIRMS. ALTOGETHER SOME 56 COMMODITY AND AGRIBUSINESS ASSOCIATIONS ARE AFFILIATED WITH THE COUNCIL, HAVING AN AGGREGATE MEMBERSHIP OF MORE THAN 30,000 FARMERS AND AGRIBUSINESS MEN AND WOMEN. WE ATTEMPT TO PROVIDE A UNIFIED POSITION ON ISSUES AFFECTING OUR INDUSTRY.

THE ISSUE OF AGRICULTURAL LIENS IS A COMPLICATED ONE WITH STRONG FEELINGS IN EVERY CORNER OF THE AGRICULTURAL INDUSTRY AFFECTED BY IT. IT HAS BEEN A HOT TOPIC OF DISCUSSION WITHIN OUR ORGANIZATION FOR ALMOST TWO YEARS NOW. THE COUNCIL FORMALLY STUDIED THE ISSUE UNDER A SPECIAL AD HOC COMMITTEE MADE UP OF AGRICULTURAL PRODUCERS, SUPPLIERS, BUYERS AND LENDERS. THIS COMMITTEE CONCLUDED THAT PROBLEMS WITH AGRICULTURAL LIENS COULD BEST BE RESOLVED BY SETTING UP A CENTRALLY-LOCATED COMPUTERIZED AGRICULTURAL LIEN FILING SYSTEM IN WHICH LENDERS WOULD FILE LIENS AND WHICH WOULD PROVIDE BUYERS OF AGRICULTURAL PRODUCTS INSTANT ELECTRONIC ACCESS TO LIEN INFORMATION.

Bankers Say Farm Bill Will Boost Rates on Agricultural Loans

Continued from Page 1

during a purchase — if their state within one year approves a central filing system where lenders register their claims on crops and equipment. But the filing system also must adhere to strict guidelines approved by the U.S. Department of Agriculture.

The bill is silent on how filing systems will be funded.

Enactment of the bill is expected to ignite a rash of state lobbying campaigns to establish central filing systems.

One troublesome requirement of the systems, bankers complain, will be a new form known as an "effective financing statement." The document will be so exhaustive it will "open new vistas in the meaning of paperwork headaches," one banker said.

Detailed regulations are due from the department within 90 days of enactment, but bankers are already worried that their states may simply be unable to establish acceptable filing systems.

"The federal bill makes it impossible," said James Maag, an official with the Kansas Bankers Association. Kansas established its own central filing system in 1984, but will have to revamp it to comply with federal law.

"The farm bill requires all sorts of lists," Mr. Maag said. For example, it requires social security numbers for the hundreds of buyers and farmers whose loans are registered. "This might be possible to start, but we couldn't get them for the ones already filed."

Some Filing Systems Already Exist

State legislative battles over clear title on farm products and filing systems are not new.

Many states already have established various filing systems, including Connecticut, Delaware, Hawaii, Iowa, Kansas, Mississippi, Montana, Nebraska, Nevada, North Carolina, North Dakota, Oregon, Utah, Virginia (for grain only), Washington, and Wyoming.

Iowa maintains a notification system in which lenders must notify farm buyers in the county and all adjacent counties that there is a lien against the products of a particular farmer. In effect, this means that a farmer is paid with two-party checks, signed both by the purchaser and the banker.

"The jury's still out" on whether notification works, commented Randy Steig, executive director of the Iowa Bankers Association. "It increases paperwork for financial institution, and it creates processing for the purchaser."

Central filing can be helpful, according to Kansas bankers. Officers at Union National Bank and Trust Co. of Manhattan, Kan., at least, have no complaints.

"Our system is pretty smooth," said L.W. "Bill" Solzer, chairman and chief executive officer of the $125 million-asset bank. "If they just leave it alone, we'll be fine."

When a Kansas banker makes a farm loan, a security agreement is signed by the borrower, and the banker files it with the Kansas secretary of state. The bank also pays a $3 registration fee.

Should a farmer attempt to circumvent the security agreement, the banker can sue the purchaser. "But I can't even remember an instance of that," said Steven M. Johnson, a commercial loan officer at Union National.

In contrast, California bankers lost the clear-title exemption in the 1970s and the state has no central filing system.

Michael Fitch, a Wells Fargo National Bank vice president, said it has resulted in higher operating costs that are passed on to the borrower in the form of higher interest rates. Wells Fargo maintains the nation's second largest farm-loan portfolio among commercial banks, measuring $746 million.

Mr. Fitch, also chairman of the American Bankers Association's agriculture division, points to several scandals in California. In one, a major cattle firm sold its livestock despite unpaid loans to a bank, causing a substantial loss to the bank.

California's problem is mitigated because many agriculture sales are made through contracts signed well in advance of delivery. This allows bankers to monitor the collateral.

In Washington, shaping the farm bill proved a major battle, pitting every bank lobbyist against the large and formidable farm lobby. While bankers view the provision as a loss, the defeat might have been been more severe. Initially, a House version called for a simple termination of the exemption. Sen. Jake Garn, R-Utah, chairman of the Senate Banking Committee, fought for measures authorizing a central filing system.

The Senate battle focused on establishment of central filing systems and how the systems would be funded. In one version, they were to be funded entirely by bankers. In a subsequent version, the cost was to be shared by all those using the system. In the final version, the question is left unanswered.■

AMERICAN BANKER
December 19, 1985

Bankers Say Farm Bill Will Boost Rates

Title Provision Restricts Claims On Crops Sold by Borrowers

By BARTLETT NAYLOR

WASHINGTON — Bankers are warning that interest rates on agricultural loans will rise because the comprehensive farm bill that Congress is expected to send to President Reagan today eliminates a traditional way of securing a loan.

Agricultural Lending

The omnibus legislation, which basically sets price supports for crops, erases an exemption in the Uniform Commercial Code that allows banks to make a claim on a crop sold by a farmer who owes the bank money. The code governs how merchandise and farm produce are traded and otherwise gives buyers clear title to products.

Farm System Bailout Passed, Page 8

Buyers of farm products lobbied for the change to end the problem of "double" purchases, in which an unscrupulous farmer sells them his crop but a bank claims it to help pay a bad debt.

But without the security of being able to make a claim on a crop, loan rates will rise, predicted Robert Yencik, an official with the Missouri Bankers Association.

"In the worst-case scenario, bankers must make unsecured loans to farmers, so cost of credit will increase, the availabilty of funds will decrease, and regulatory agencies will scrutinize loans more closely," Mr. Yencik said.

Banks can regain the exemption — meaning buyers won't gain clear title

Farm Bill: Page 8

APPENDIX 3

the establishment of such a system, if we find that the cost of adhering to the guidelines that would be handed down by the U.S.D.A. is prohibitive. The Bill should also allow for a ~~presidential~~ veto prior to December 22, 1986, if we do indeed find that such a system would become unworkable.

Obviously, this is a matter that does not affect all tax payers; and therefore, I would recommend that the Committee look into some method of passing the cost of establishing such a system on to those groups who would benefit from its use. These groups would obviously include the purchasers of agricultural products and those businesses; such as, banks, farm credit associations, and other firms that extend credit to the agriculture industry. The system should be set up to where the recording fees carry the normal operating expenses of maintaining this system on an annual basis.

If I can be of any further assistance in this matter, please do not hesitate to call.

Sincerely,

Daniel T. Payne

Daniel T. Payne
Vice President

DTP:nb

cc: Walter Ayers
Doug Flory

(A) is an original or reproduced copy thereof;
(B) is signed and filed with the Secretary of State of a State by the secured party;
(C) is signed by the debtor;
(D) contains,
(i) the name and address of the secured party;
(ii) the name and address of the person indebted to the secured party;
(iii) the social security number of the debtor or, in the case of a debtor doing business other than as an individual, the Internal Revenue Service taxpayer identification number of such debtor;
(iv) a description of the farm products subject to the security interest created by the debtor, including the amount of such products where applicable; and a reasonable description of the property, including county or parish in which the property is located;
(E) must be amended in writing, within 3 months, similarly signed and filed, to reflect material changes;
(F) remains effective for a period of 5 years from the date of filing, subject to extensions for additional periods of 5 years each by refiling or filing a continuation statement within 6 months before the expiration of the initial 5 year period;
(G) lapses on either the expiration of the effective period of the statement or the filing of a notice signed by the secured party that the statement has lapsed, whichever occurs first;
(H) is accompanied by the requisite filing fee set by the Secretary of State; and
(I) substantially complies with the requirements of this subparagraph even though it contains minor errors that are not seriously misleading.

(5) 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 farming 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.

(6) The term "knows" or "knowledge" means actual knowledge.

(7) The term "security interest" means an interest in farm products that secures payment or performance of an obligation.

(8) The term "selling agent" means any person, other than a commission merchant, who is engaged in the business of negotiating the sale and purchase of any farm product on behalf of a person engaged in farming operations.

(9) The term "State" means each of the 50 States, the District of Columbia, the Commonwealth of Puerto Rico, Guam, the Virgin Islands of the United States, American Samoa, the Commonwealth of the Northern Mariana Islands, or the Trust Territory of the Pacific Islands.

THE COUNCIL'S CURRENT POSITION, ADOPTED BY OUR STATE AFFAIRS COMMITTEE ON NOVEMBER 7 TO BE RECOMMENDED TO OUR MEMBERSHIP FOR ADOPTION AT OUR ANNUAL MEETING ON JANUARY 15, 1986 IS AS FOLLOWS:

> "THE VIRGINIA AGRIBUSINESS COUNCIL URGENTLY REQUESTS THE STATE TO SET UP A CENTRAL COMPUTERIZED AGRICULTURAL LIEN FILING SYSTEM."

THE COUNCIL AND IT'S LEADERSHIP CONTINUES TO MAINTAIN THAT THIS ISSUE SHOULD BE ADDRESSED AND RESOLVED AT THE STATE LEVEL IRREGARDLESS OF PENDING FEDERAL LEGISLATION. IT IS ALSO OUR UNDERSTANDING THAT PENDING FEDERAL LEGISLATION, IF ENACTED, WOULD BE PRE-EMPTED BY STATE EFFORTS TO RESOLVE THIS MATTER AT THE STATE LEVEL.

WE CONCUR THAT THE PRESENT SET-UP DOES NOT SPREAD THE LIABILITY OF AGRICULTURAL LIENS EVENLY AND FAIRLY. HOWEVER, WE DO NEED TO BE CAREFUL THAT WE DON'T CREATE MORE OF A PROBLEM THAN WE CURRENTLY HAVE. WE STAND READY TO WORK WITH THIS COMMITTEE TO CLOSELY SCRUTINIZE AGRICULTURAL LIENS AND TO DEVELOP A WORKABLE SOLUTION. THANK YOU FOR THE OPPORTUNITY TO APPEAR BEFORE YOU.

PROTECTION FOR PURCHASERS OF FARM PRODUCTS

SEC. 1324. (a) Congress finds that—

(1) certain State laws permit a secured lender to enforce liens against a purchaser of farm products even if the purchaser does not know that the sale of the products violates the lender's security interest in the products, lacks any practical method for discovering the existence of the security interest, and has no reasonable means to ensure that the seller uses the sales proceeds to repay the lender;

(2) these 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;

(3) the exposure of purchasers of farm products to double payment inhibits free competition in the market for farm products; and

(4) this exposure constitutes a burden on and an obstruction to interstate commerce in farm products.

(b) The purpose of this section is to remove such burden on and obstruction to interstate commerce in farm products.

(c) For the purposes of this section—

(1) the term "buyer in the ordinary course of business" means 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.

(2) the term "central filing system" means a system for filing effective financing statements or notice of such financing statements on a statewide basis and which has been certified by the Secretary of the United States Department of Agriculture; the Secretary shall certify such system if the system complies with

THE PRIOR NOTIFICATION SYSTEM THAT ASCS HAS BEEN USING FOR MANY YEARS HAS SERVED THEM WELL. WHEN I TAKE OUT A CROP LOAN SECURED BY GRAIN STORED ON MY FARM, I NOTIFY ASCS TO WHOM I SELL GRAIN IN THE NORMAL COURSE OF BUSINESS. ASCS NOTIFIES THE BUYERS THAT A LIEN EXISTS. WHEN I SELL THE GRAIN, I GET A RELEASE FROM ASCS AND THEY NOTIFY THE BUYER AND THE CHECK IS MADE JOINTLY.

STATEMENT MADE BY TYRE SIDDEN

President, Virginia Poultry Federation

to the

JOINT SENATE HOUSE COMMITTEE REGARDING SENATE JOINT RESOLUTION 123

November 26, 1985
10:00 a.m.
Richmond, Virginia

My name is Tyre Sidden and I am president of the Virginia Poultry Federation, a 1,200-member non-profit trade association which serves the needs of Virginia's poultry and egg industries. I am also representing the Virginia State Feed Association, one of our major affiliate organizations.

Our organization strongly supports implementing, at the state level, the concepts embodied in federal "clear title" bills, H.R. 1591 and S. 744, which eliminates the "farm products exception" from the Uniform Commercial Code and allows purchasers to take possession of agricultural products free of third-party security interests.

Under current law, a purchaser of agricultural products can be forced to make double payment, once to the seller and again to the seller's lending institution, if a lien exists on the agricultural product and if proceeds from the sale are not used to repay the secured loan. To avoid double jeopardy, buyers are, in essence, forced to conduct an extensive search for liens against the product in every city, county, or state in which the seller may have a market.

The current law is clearly inequitable for several reasons. It discriminates against the buyer of agricultural products. Buyers of other commercial goods are not subject to this portion of the law. Why are buyers of farm products treated differently?

Purchasers of agricultural products are exposed to a great risk under this law and are credit supervisors for the lending institutions. We have had no input into the loan making process and see absolutely no reason why we should be performing a function which clearly is the responsibility of the lending institution.

If agricultural purchasers continue to see no relief from current conditions, some potentially solid sales may not be completed simply due to the risk of being in the position of credit supervision and not knowing with absolute certainty that a lien does not exist. This situation could definitely have a negative economic impact on local, area, and even state markets.

Under the "pre-notification system" embodied in H.R.1591 and S.744, lending institutions are protected by being allowed, but not required, to inform buyers of agricultural products of an existing lien, whereupon the buyer is obligated to conform with the bank's instructions on payment.

With the current credit problems facing agriculture today, lending institutions have expressed the opinion that "clear title" legislation would jeopardize the use of crops as collateral. The "clear title" concept, in our opinion, does not damage the farmers opportunity to use agricultural products as collateral to secure loans. It simply places the responsibility for financial risk-taking and repayment of the loan in the hands of the establishment which granted the loan and the person who received it. These are the two parties which were originally involved in loan negotiations. Why should the responsibility for repayment fall elsewhere?

Concepts similar to the "pre-notification system" are in operation in 12 states, most of which are major agricultural states. In these states, it is reported that the pre-notification system works and there has been no

noticable impact upon the availability of agricultural credit to farmers.

The Virginia Poultry Federation supported Senate Joint Resolution 123 in the last General Assembly which called for a study of the current situation involving security interests on farm products. We are very willing to actively participate in trying to address the situation.

We're simply asking for relief from a law which is clearly inequitable to agricultural product purchasers and saddles us with a risk-taking burden which clearly belongs elsewhere.

Mr. Chairman/Committee Members

My name is John Hickerson. I am the Senior Merchandiser of Continental Grain Company, Norfolk, Virginia.

Continental Grain Company buys grain in Virginia and the rest of the United States, and is a worldwide merchandiser of export grain.

Due to our participation in the grain business at all levels, we are particularly concerned with the Mortgaged Commodity Problem being discussed here today.

We support legislation advanced by the National Grain and Feed Association and presently before Congress requesting that the agricultural exemption be removed from the Uniform Commercial Code and be replaced by a lender notification procedure.

Under current law buyers of agricultural products, failing to be aware of commodity liens filed at county courthouses face the risk of paying for the commodity twice, once to the farmer and once to the lender.

Many years ago when trade was limited to a very small area, these may have been a practical method of securing loans, but with the expansion of transportation and trade it is no longer feasible for the buyer to adequately protect himself.

Continental Grain Company at Norfolk currently buys grain from individuals located in thirty-five counties. Prior to barley and wheat harvest in late May we sent two employees to Richmond where they spent three days checking our farmer list with the Central Filing System.

In the past we have sent our personnel to county courthouses across the state, hired a titling agency at a cost of several thousand dollars, and telephoned various county ASCS, PCA and FHA offices for lien information.

Unfortunately even with all this effort our protection is still limited to liens filed at that point in time and covers only the county to which we mail the producers check.

Continental Grain Company is still at risk even after pursuing all possible lien information channels and we consider this very unfair.

Many states have altered or amended the Uniform Commercial Code; therefore, it is no longer a uniform code.

We therefore support an Equitable Solution to the Mortgaged Commodity Problem as proposed by the National Grain and Feed Association and the Virginia Farm Bureau whereby any farmer who executes a mortgage on grain or livestock notify the mortgage holder of the names and addresses of other persons to whom he will market those products. The mortgage holder, if he wishes to have a joint check drawn, shall be required to notify the potential buyers by certified mail of the existence of a lien. Failure of the mortgage holder to so notify shall release the buyer from liability. Criminal penalties shall be assessed against a producer who sells to a buyer other than those specified in advance to the mortgage holder in the event the loan is not repaid.

VIRGINIA FARM BUREAU FEDERATION

NOVEMBER 26, 1985

TESTIMONY BEFORE JOINT SUB-COMMITTEE STUDYING THE FARM PRODUCTS EXCEPTIONS UNDER THE UNIFORM COMMERCIAL CODE.

THE VIRGINIA FARM BUREAU FEDERATION SUPPORTS ELIMINATION OF THE FARM PRODUCTS EXCEPTION UNDER SECTION 9-307 OF THE UNIFORM COMMERCIAL CODE. WITH THE ELIMINATION OF THE FARM PRODUCTS PROVISION, FARM BUREAU WOULD SUPPORT AS A COMPROMISE A PRE-NOTIFICATION PROVISION TO ALLOW AGRICULTURAL LENDERS THE OPPORTUNITY TO PROTECT THEIR INTEREST IN MORTGAGED COMMODITIES BY NOTIFYING POTENTIAL PURCHASERS OF THE EXISTENCE OF THE SECURITY INTEREST. THE AMERICAN FARM BUREAU FEDERATION ALONG WITH TWENTY-SIX OTHER AGRICULTURAL ORGANIZATIONS HAVE DETERMINED AFTER CAREFUL STUDY, THAT THIS SOLUTION IS THE MOST FAIR AND EQUITABLE DISTRIBUTION OF RESPONSIBILITY BETWEEN THE FARMER-BORROWER, BUYER AND LENDER.

WHY DO WE BELIEVE THIS IS THE BEST SOLUTION?

1) FROM TESTIMONY ALREADY HEARD, IT IS OBVIOUS THAT ONLY A VERY FEW FARMER-BORROWERS ARE CAUSING THE PROBLEM - IT IS UNFAIR TO PENALIZE ALL FARMERS THROUGH INCREASED MARKETING COSTS OF A COMPUTERIZED CENTRAL FILING SYSTEM.

2) A PRE-NOTIFICATION SYSTEM WOULD PERMIT THE LENDER TO NOTIFY POTENTIAL BUYERS OF HIGH RISK BORROWERS THEREBY PROTECTING THEIR SECURITY INTEREST. AFTER ALL THE LENDER IS IN A BETTER POSITION THAN ANYONE INVOLVED IN THE TRANSACTION TO DETERMINE THE CASH-FLOW CONDITION OF THE BORROWER. THIS PROCEDURE WOULD REDUCE BURDENSOME PAPERWORK AND INCREASED COSTS ASSOCIATED WITH A CENTRAL FILING SYSTEM.

3) THROUGHOUT THE THREE YEARS THAT FARM BUREAU HAS BEEN INVOLVED ON THE NATIONAL LEVEL ON THIS ISSUE, REPRESENTATIVES OF LENDERS HAVE ISSUED STATEMENTS IN OPPOSITION TO ANY CHANGE IN THE UNIFORM COMMERCIAL CODE.

THESE STATEMENTS HAVE INCLUDED CLAIMS THAT AGRICULTURAL CREDIT WOULD BECOME MORE EXPENSIVE, THAT PRODUCERS COULD NOT USE FARM PRODUCTS AS COLLATERAL FOR LOANS AND THAT AGRICULTURAL CREDIT WOULD DRY UP UNDER A PRE-NOTIFICATION SYSTEM. IN 13 STATES WHERE AN ACTUAL NOTICE LAW HAS BEEN ADOPTED THESE PREDICTIONS HAVE NOT BEEN REALIZED. IN FACT, IN THESE STATES SUCH AS ILLINOIS, CREDIT HAS CONTINUED TO BE AVAILABLE TO AGRICULTURE AND INTEREST RATES HAVE CONTINUED TO FLUCTUATE IN CONFORMANCE WITH INTEREST RATE CHANGES IN NEIGHBORING STATES.

4) FARM BUREAU BELIEVES IT TO BE INEQUITABLE AND UNFAIR TO BUYERS TO HAVE AN EXCEPTION FOR FARM-PRODUCTS IN THE UNIFORM COMMERCIAL CODE. THERE DOES NOT APPEAR TO BE A VALID REASON FOR DIFFERENTIATING BETWEEN BUYERS OF FARM PRODUCTS AND BUYERS OF OTHER COMMERCIAL GOODS. TREATING FARM PRODUCTS DIFFERENTLY HAS ONLY CAUSED PROBLEMS FOR BUYERS AND FARMERS BY JEOPARDIZING THE INTEGRITY AND VIABILITY OF AGRICULTURAL MARKETS.

5) THE PRE-NOTIFICATION PROVISION IS EQUITABLE TO ALL PARTIES. THE LENDER CHOOSES WHETHER OR NOT HE WILL PROTECT HIMSELF BY PRE-NOTIFYING POTENTIAL BUYERS. IF THE LENDER CHOOSES PRE-NOTICE, HE SECURES THE LIST FROM THE BORROWER AND SENDS THE NOTICES. THE FARMER-BORROWER CAN CHOOSE TO NOTIFY HIS BUYER OF THE LIEN AGAINST HIS PRODUCTION, OR IS OBLIGATED TO PROVIDE AN ACCURATE LIST OF POSSIBLE BUYERS TO HIS LENDER. THE BUYER IS OBLIGATED TO FOLLOW THE LENDER'S REPAYMENT INSTRUCTIONS ONCE HE HAS RECEIVED NOTICE OF THE SECURITY INTERESTS.

6) THE USE OF EITHER A CENTRALIZED FILING OR NOTIFICATION SYSTEM RAISES SERIOUS CONCERNS ABOUT THE SPEED AND ACCURACY OF POSTING FINANCING STATEMENTS INTO THE SYSTEM. BUYERS COULD FACE GREAT UNCERTAINTY ABOUT RELIABILITY OF THE STATE-OPERATED FILING SYSTEM IF CONFIDENCE IS QUESTIONED BECAUSE OF TIME LAGS IN UPDATING THE SYSTEM OR THE ACCURACY

OF THE INFORMATION DISTRIBUTED THROUGH SUCH A SYSTEM. THE STATE MAY ALSO NEED TO ASSURE LIABILITY IN CASES WHEN INACCURATE INFORMATION IS DISTRIBUTED THROUGH SUCH A SYSTEM. IN KANSAS, WHERE A CENTRAL FILING SYSTEM IS CURRENTLY USED, THERE ARE PENDING SUITS AGAINST THE STATE FOR DISTRIBUTION OF INACCURATE LIEN INFORMATION.

I FEEL OBLIGATED TO INFORM THIS COMMITTEE ON WHAT IS TRANSPIRING AT THE NATIONAL LEVEL ON CLEAR TITLE LEGISLATION. SINCE FARM PRODUCTS ARE INVOLVED IN INTERSTATE COMMERCE A NATIONAL SOLUTION TO THIS PROBLEM IS PROBABLY BEST TO ASSURE UNIFORMITY OF LAWS AMONG STATES. THIS ISSUE IS ONE PROVISION OF THE FARM BILL PRESENTLY BEING CONSIDERED BY CONGRESS. ON THE HOUSE SIDE, THE FARM PRODUCTS SECTION WAS DELETED FROM THE UNIFORM COMMERCIAL CODE WITH A MECHANISM PROVIDED TO ALLOW PRE-NOTIFICATION BY LENDERS. ON THE SENATE SIDE JUST THIS PAST WEEKEND, THE FARM PRODUCTS PROVISION WAS ELIMINATED FROM THE UNIFORM COMMERCIAL CODE WITH AN OPTION THAT STATES COULD ESTABLISH A STATE NOTIFICATION SYSTEM THAT NOTIFIES REGISTERED BUYERS OF LIENS THAT EXIST. A SENATE-HOUSE CONFERENCE COMMITTEE MUST WORK OUT DIFFERENCES. IT IS UNCLEAR AT THIS POINT WHAT WILL HAPPEN TO THIS VERY CONTROVERSIAL FARM BILL.

I HOPE IT WILL BE THE PLEASURE OF THIS COMMITTEE TO RECOMMEND THAT THE FARM PRODUCTS EXCEPTION IN THE UNIFORM COMMERCIAL CODE BE ELIMINATED WITH A PRE-NOTIFICATION PROVISION TO ALLOW LENDERS TO PROTECT THEIR SECURITY INTERESTS. FARM BUREAU BELIEVES THIS TO BE THE MOST EQUITABLE AND REASONABLE SOLUTION TO THE CLEAR TITLE PROBLEM.

LD1705129

SENATE BILL NO. 259

Offered January 21, 1986

A BILL to amend and reenact § 8.9-307 of the Code of Virginia and to amend the Code of Virginia by adding in Part 2 of Title 8.9 a section numbered 8.9-209, relating to the sale of secured farm products; penalty.

Patrons--Nolen, Holland, R. J., Truban, and Russell, R. E.; Delegates: Lacy, Parker, L. W., Watkins, and Finney

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Referred to Committee on Commerce and Labor

Be it enacted by the General Assembly of Virginia:

1. That § 8.9-307 of the Code of Virginia is amended and reenacted and that the Code of Virginia is amended by adding in Part 2 of Title 8.9 a section numbered 8.9-209 as follows:

§ 8.9-209. Unlawful to sell secured farm products without paying proceeds to secured party; penalty.--A. Notwithstanding any other provision of law, it shall be unlawful for a seller of farm products engaged in farm operations who is in the business of selling farm products (i) whose right to sell or otherwise dispose of farm products is subject to a security interest created by such sale or (ii) who has the right to sell or otherwise dispose of such farm products only on the condition that the secured party receives the proceeds of such sale, to sell or otherwise dispose of the farm products or any part thereof and willfully and wrongfully to fail to pay to the secured party the proceeds from the sale or other disposition. Failure to pay such proceeds to the secured party within ten days after the sale or other disposition of the farm products shall be prima facie evidence of willful and wrongful failure to pay under this section.

B. A person convicted of a violation of this section shall be guilty of larceny.

§ 8.9-307. Protection of buyers of goods.--(1) A buyer in ordinary course of business (subsection (9) of § 8.1-201) ~~other than a person buying farm products from a person engaged in farming operations~~ takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence.

(2) In the case of consumer goods, a buyer takes free of a security interest even though perfected if he buys without knowledge of the security interest, for value and for his own personal, family or household purposes unless prior to the purchase the secured party has filed a financing statement covering such goods.

(3) A buyer other than a buyer in ordinary course of business (subsection (1) of this section) takes free of a security interest to the extent that it secures future advances made after the secured party acquires knowledge of the purchase, or more than forty-five days after the purchase, whichever first occurs, unless made pursuant to a commitment entered into without knowledge of the purchase and before the expiration of the forty-five day period.

Official Use By Clerks	
Passed By The Senate	**Passed By The House of Delegates**
without amendment ☐	without amendment ☐
with amendment ☐	with amendment ☐
substitute ☐	substitute ☐
substitute w/amdt ☐	substitute w/amdt ☐
Date: _____	Date: _____
Clerk of the Senate	Clerk of the House of Delegates

1986 SESSION

LD2170129

SENATE BILL NO. 259
AMENDMENT IN THE NATURE OF A SUBSTITUTE
(Proposed by the Senate Committee on Commerce and Labor on February 10, 1986)
(Patron Prior to Substitute—Senator Nolen)

A BILL to amend and reenact §§ 8.9-307 and 18.2-115 of the Code of Virginia, relating to the sale of secured farm products; penalty.

Be it enacted by the General Assembly of Virginia:

1. That §§ 8.9-307 and 18.2-115 of the Code of Virginia are amended and reenacted as follows:

§ 8.9-307. Protection of buyers of goods.—(1) A buyer in ordinary course of business (subsection (9) of § 8.1-201) ~~other than a person buying farm products from a person engaged in farming operations~~ takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence.

(2) In the case of consumer goods, a buyer takes free of a security interest even though perfected if he buys without knowledge of the security interest, for value and for his own personal, family or household purposes unless prior to the purchase the secured party has filed a financing statement covering such goods.

(3) A buyer other than a buyer in ordinary course of business (subsection (1) of this section) takes free of a security interest to the extent that it secures future advances made after the secured party acquires knowledge of the purchase, or more than forty-five days after the purchase, whichever first occurs, unless made pursuant to a commitment entered into without knowledge of the purchase and before the expiration of the forty-five day period.

§ 18.2-115. Fraudulent conversion or removal of property subject to lien or title to which is in another.—Whenever any person is in possession of any personal property, including motor vehicles *or farm products* , in any capacity, the title or ownership of which he has agreed in writing shall be or remain in another, or on which he has given a lien, and such person so in possession shall fraudulently sell, pledge, pawn or remove such property from the premises where it has been agreed that it shall remain, and refuse to disclose the location thereof, or otherwise dispose of the property or fraudulently remove the same from the ~~State~~ *Commonwealth* , without the written consent of the owner or lienor or the person in whom the title is, or, if such writing be a deed of trust, without the written consent of the trustee or beneficiary in such deed of trust, he shall be deemed guilty of the larceny thereof.

In any prosecution hereunder, the fact that such person after demand therefor by the lienholder or person in whom the title or ownership of the property is, or his agent, shall fail or refuse to disclose to such claimant or his agent the location of the property, or to surrender the same, shall be prima facie evidence of the violation of the provisions of this section. *In the case of farm products, failure to pay the proceeds of the sale of the farm products to the secured party, lienholder or person in whom the title or ownership of the property is, or his agent, within ten days after the sale or other disposition of the farm products shall be prima facie evidence of a violation of the provisions of this section.* The venue of prosecutions against persons fraudulently removing any such property, including motor vehicles, from the ~~State~~ *Commonwealth* shall be the county or city in which such property or motor vehicle was purchased or in which the accused last had a legal residence.

This section shall not be construed to interfere with the rights of any innocent third party purchasing such property, unless such writing shall be docketed or recorded as provided by law.

2. That the provisions of this act shall become effective December 23, 1986.