

# Conflicting Interests in Stored Grain

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## Overview

Farmers often store harvested grain at a grain elevator. The elevator may either be a private elevator or a cooperative. In either event a storer of grain fits the definition of a “warehouse.” As a warehouse, certain statutory and common law remedies exist for the warehouse to recover costs expended for drying and storing grain. These remedies sometimes come into conflict with the farmer’s lender that typically has a secured interest in the farmer’s grain and “proceeds thereof.”

## The Purchase of Farm Products – Special Rule

A creditor seeking to protect a security interest in farm products must comply with the “Farm Products Rule.” The 1985 Farm Bill (Food Security Act) created a set of rules that federalized the farm products rules that had been adopted in different forms in many different states. Under the federal rule, [7 U.S.C. §1631\(e\)](#) of Food Security Act (FSA) (a.k.a. “Farm Products Rule”), states could either adopt a centralized filing system for security interests in farm products or an actual notice system. Presently, 33 states require actual notice and 17 utilize a central filing system.

The Farm Products Rule allows a buyer in the ordinary course to purchase a farm product free and clear unless the buyer has received notice of a security interest in the farm product within one year before purchasing the farm product, or the buyer has received a notice of a filed effective financing statement [EFS] from the Secretary of State’s office and the buyer has failed to fulfill any notified payment obligations.

The direct notice system requires that a secured creditor send the purchaser of farm products a written notice that lists the following: (1) the secured creditor’s name and address; (2) the debtor’s name and address; (3) the debtor’s social security number or taxpayer identification number; (4) a description of the farm products covered by the security interest and a description of the property; and (5) any payment obligations conditioning the release of the security interest.

The description of the farm products must include the amount of the farm products subject to the security interest, the crop year, and the county or counties in which the farm products are located or produced.



The centralized system requires secured parties to file an EFS with the Secretary of State's office. The EFS contains basically the same information as the actual notice document of the direct notice system.

If a lender does not properly comply with the Farm Products Rule, the buyer of the farm products obtains title to the goods free and clear of the lender's security interest. However, the lender still has a perfected security interest against the "proceeds" of the farm products if the security agreement provides that the security interest extends to the proceeds.

### **Warehouse Lien**

Under §7-209 of the Uniform Commercial Code (UCC), a warehouse (a grain storage facility – either a private elevator or ag cooperative) has a lien against the bailor (the farmer) on the goods in the warehouse's possession for unpaid storage, drying and transportation charges. At its most basic, the lien is a specific lien that attaches to the goods that the warehouse holds, but it can expand to a general lien covering "like charges in relation to other goods." See *Official Comment 1 to Model Version of UCC §7-209*. As a result, the warehouse is in a favorable position of having a lien on the goods to help defray the unpaid storage and drying costs and related transportation costs. That is the case when the goods are in the warehouse's possession, and where the lien is a possessory lien such as the Iowa provision. See [Iowa Code §554.7209](#). The lien is lost when the warehouse voluntarily delivers the stored grain. [7 U.S.C. §209\(e\)](#). It is also lost if the warehouse unjustifiably refuses to deliver the goods. *Id.*

### **Priority Issue**

Does a farmer's lender that has a prior perfected interest in "crops and proceeds thereof" under the Farm Products Rule have priority over a warehouse with respect to storage and drying costs on the farmer's grain at the warehouse? Under §9-333 of the UCC the warehouse lien, as a possessory lien, has "priority over a security interest in the goods unless the lien is created by a statute that expressly provides otherwise." In other words, UCC Article 9 provides that if the possessory lien derives from common law, or derives from a statute that is silent as to the lien's subordination to existing security interests, the possessory lien has priority over a previously perfected security interest. See *Official Comment 2 to Model Version of UCC §9-333*. This means that when a warehouse asserts a lien under UCC §7-209 to secure storage and drying fees on stored grain, the lien derives by statute.

UCC §7-209(c) also contains language that could subordinate the warehouse lien because the lien is only "effective against any person that so entrusted the bailor with possession of the goods that a pledge of them



by the bailor to a good-faith purchaser for value would have been valid.” *UCC §7-209(c)*. Thus, the warehouse lien is ineffective as against the secured party unless the circumstances surrounding the farmer’s delivery of the grain to the warehouse was such that “a pledge by the [customer] to a good faith purchaser for value would have been valid.” *Official Comment 3 to UCC §7-209*. Similarly, the warehouse lien is ineffective against a prior perfected security interest of the lender unless the lender entrusted the farmer with possession of the goods that a pledge of the goods by the farmer would have given a “hypothetical bona fide pledgee” priority over the secured lender. *Id.*

### Illustrative Warehouse Lien Scenarios

**Non ag situations.** In [\*K Furniture Co v. Sanders Transfer & Storage Co., 532 S.W.2d 910 \(Tenn. 1975\)\*](#), an individual bought household furniture on credit from the plaintiff for use in his home. He granted the plaintiff a purchase money security interest (PMSI) (which was properly perfected) to secure payment of the purchase price. About four months later, his wife put the furniture in storage with the defendant under a standard warehouse receipt. The husband then defaulted on the PMSI and the plaintiff sought to recover the furniture without paying the storage charge. The defendant asserted its lien rights under UCC 7-209 and the trial court ruled held that the lien beat out the prior perfected PMSI and dismissed the case. On appeal, the appellate court reversed. The appellate court noted that there was nothing in the record to indicate that the secured lender had “delivered or entrusted the furniture to [the wife] with the actual or apparent authority to store the furniture...”. There was also no evidence that the plaintiff acquiesced in the wife procuring any document of title. Thus, the plaintiff’s PMSI had priority over the warehouse lien. It is important to note, however, that the court did not comment on whether it’s holding would have been different if it had been the husband, as the actual buyer of the furniture, had placed the furniture in storage.

[\*In re Sharon Steel Corporation, 176 B.R. 384 \(Bankr. W.D. Pa. 1995\)\*](#), the debtor filed Chapter 11 bankruptcy. A credit agreement said that the debtor could not “create, enter into any agreement to create, or suffer to exist, nor shall it permit any of its Subsidiaries to create, enter into any agreement to create, or suffer to exist, any Lien upon, or with respect to, any of its or such Subsidiary’s properties, whether now owned or hereafter acquired, or assign, or permit any of its Subsidiaries to assign, any right to receive income, except:...(i) Liens arising by operation of law in favor of materialmen, mechanics, warehousemen...in the Ordinary course of business which secure its obligations to such Person...”. A security agreement granted the creditor a security interest in substantially all of the debtor’s property and stated, in part, “the Grantor will not create, permit or suffer to exist, and will defend the Collateral against and



take such other action as is necessary to remove, any Lien on the Collateral except Permitted Liens, . . .”. Some of the debtor’s inventory and equipment were stored with another party that was listed in an attached Schedule to the security agreement and that party sought relief from the automatic stay to sell the inventory in it’s possession to satisfy its warehouse lien which arose after the creditor had perfected its interest in the same goods.

The bankruptcy court held that the creditor’s interest in the debtor’s inventory was subordinate to the warehouse lien because, “under the loan documentation, the debtor was permitted to incur warehouseman’s . . . liens in the ordinary course of business, and that such liens were ‘permitted liens’ under the security agreement.” The court noted that by permitting the debtor to store inventory with the warehouses and permitting the debtor to incur warehouse liens in the ordinary course of business, the lender effectively permitted the debtor to transfer its inventory to the warehouses as security for the debtor’s payment of the liens. Thus, the lender’s prior perfected security interest was subordinate to the warehouse liens.

**Ag situations.** For a lender that has a UCC Article 9 perfected security interest in a farmer’s “crop and proceeds thereof,” does that security interest in “proceeds” cover storage and drying costs incurred by an elevator upon storage of the grain in the elevator that are deducted from the amount of that grain that is sold to the elevator? If the elevator deducts charges for storing and drying and remits the balance to the farmer’s lender, has the elevator committed conversion? What if the security agreement has potentially contradictory language stating that the farmer borrower shall not, “... permit the collateral to be subject to any lien” but that the farmer must “do, or cause to be done, any and all acts that may at any time be appropriate or necessary to...preserve and protect the collateral.” That language is contradictory when the borrower lacks on farm storage and drying facilities necessary to “preserve and protect” the creditor’s collateral.

Without question, the customary business practice of grain warehouses is to offset its storage and drying costs from the grain sale proceeds paid to farmer’s secured lender. That offset amounts to the collection of a possessory warehouse lien under Article 7. Does that lien beat out the prior perfected farmer’s lender? In reality, the battle between the farmer’s lender and the warehouse is not one over “proceeds” of the sale of grain. Storage and drying costs are not “proceeds” of the sale of grain because they are not “received” on the “sale...or disposition...” of the grain. Rather, they are costs that are covered by a possessory warehouse lien. While a secured creditor can lose its security interest in collateral and not lose it in the proceeds of the collateral, as noted, storage and drying costs are not proceeds.

This all means that the battle between the farmer’s lender and the elevator is one of priorities. A warehouse



must comply with UCC Article 9 provisions applicable to a warehouse lien to have a valid competing interest to the farmer's prior perfected lender in "crops and proceeds thereof." Although the UCC Article 9 provisions on security interests are basically uniform in all the states adopting the UCC, the states are non-uniform with regard to the treatment of agricultural liens. Hence, the answer concerning the priority between perfected security interests and "perfected" agricultural liens will vary from state to state.

### Common Law Applications

Even though a valid UCC warehouse lien might be subordinate to a previously perfected security interest, a common law possessory lien would not be. Under UCC §9-333, a possessory lien has priority over a security interest in the goods unless the lien is created by a statute that expressly provides otherwise." Because a common law lien is not statutorily-based, it does not trigger subordination under UCC §9-333. Similarly, a non-UCC possessory storage lien created by a statute that does not expressly provide for subordination to a security interest should also defeat subordination.

For example, in *Chart One Auto Finance v. Inkas Coffee Distributors Realty*, 2005 WL 1097097 (Conn. Super. Mar. 10, 2005), a lender held a prior perfected PMSI in an automobile. The automobile's owner stored the vehicle in a parking lot. The owner defaulted on the loan, and the secured lender demanded possession of the automobile from the parking lot. The parking lot refused to release the vehicle until its storage fees were paid. The secured lender sued the parking lot in replevin. The parking lot counterclaimed, arguing that its common-law and statutory-lien rights (including a UCC §7-209 lien) were superior to the secured lender's lien. The court agreed, noting that state (CT) law recognized a common-law possessory lien for storage. That meant that the "unless" part of UCC §9-333 didn't apply, and there was no statute that gave the perfected security interest holder priority over the possessory lien.

### What About Equity?

The UCC also provides for the application of equitable principles when Article 9 is concerned. UCC §1-103 (b) states, "Unless displaced by the particular provisions of the Uniform Commercial Code, the principles of law and equity" including the law merchant (undefined) and the law relative to capacity to contract; duress; coercion; mistake; principal and agency relationships; estoppel, fraud and misrepresentation; bankruptcy, and other validating or invalidating cause (undefined) supplement its provisions. This section has been characterized as the "most important single provision in the Code." 1 J. White & R. Summers, *Uniform Commercial Code* § 5. "As such, the UCC was enacted to displace prior *legal* principles, not prior equitable principles." As quoted in [Ninth District Production Credit Association v. Ed Duggan, Inc., 821 P.2d 788 \(Colo. 1991\)](#).



Interestingly, *not* included in the list of general principles of law that can supplement UCC priorities is the equitable principle of unjust enrichment. However, the leading ag-related case allowing an unsecured creditor to assert an equitable principle to prevail against a prior perfected secured creditor involved a claim of unjust enrichment that was utilized to defeat a conversion claim. In that case, [\*Producers Cotton Oil Co. v. Amstar Corp.\*, 197 Cal. App. 3d 638, 242 Cal. Rptr. 914 \(1988\)](#), a farmer sold his beets to the defendant. The plaintiff had loaned money to the farmer and had a prior perfected security interest in the farmer's sugar beet crop and its proceeds. The plaintiff had notified the defendant of its security interest and required the farmer to get the plaintiff's written consent before selling his sugar beets. The farmer notified the plaintiff that he had agreed to sell his beets to the defendant and the sale contracts specified that the defendant would deduct from the sales price amounts for seed, dirt haul, curly top virus assessment and California Beet Growers Association Dues. Harvesting costs were not mentioned. An employee of the plaintiff was in the fields during harvest, and made no objection. Net proceeds from the sale of the beet crop were paid to the plaintiff, and the plaintiff sued for conversion claiming that the deductions violated its security interest. The trial court disagreed, and the appellate court affirmed finding that the plaintiff had been unjustly enriched as a result of implied consent and prior course of dealing. See also [\*Humboldt Trust and Savings Bank v. Entler\*, 349 N.W.2d 778 \(Iowa 1984\)](#); [\*Parkersburg State Bank v. Swift Independent Packing Company\*, 764 F.2d 512 \(8th Cir. 1985\)](#).

Clearly, where a prior perfected lender has knowledge (actual or constructive) of services rendered to its collateral that could give rise to a warehouse lien, equitable principles would give priority to the lienholder. See, e.g., [\*Peoples Trust and Savings Bank v. Security Savings Bank\*, 815 N.W.2d 744 \(Iowa 2012\)](#). That would be the case even if the security agreement between the lender and the farmer does not allow the farmer to allow the collateral to become subject to a lien. That is particularly the case when the services rendered that are subject to the lien add value to the collateral (or prevents loss) that the secured party benefits from. See also [\*11 U.S.C. §557\(h\)\(1\)\*](#). A key point is that it's simply not plausible for an ag lender in an ag state (such as Iowa, for example) to claim lack of knowledge that grain delivered to an elevator incurs storage and drying fees that will be deducted from the proceeds of sale when the crop is later sold to the elevator. That has been a longstanding industry practice. Thus, a warehouse lien can be superior to a prior perfected security interest in situations involving industry practice coupled with actual, constructive or implied knowledge or consent in situations where technical compliance with the UCC is not present.



## Conclusion

The conflict between the security interest of a lender in “proceeds” of crops of a farmer and a warehouse that stores the crops is generally decided in favor of the farmer’s prior perfected lender. However, a warehouse lien may prevail over a prior perfected security interest if the lender consented via the loan agreement or otherwise to the farmer’s placement of the harvested grain in storage with the warehouse. In that instance, the hypothetical “good faith purchaser” or “bona fide pledgee” requirements of UCC §7-209 could be met. In addition, a warehouse might prevail over the farmer’s prior perfected lender via the common law or a statute that gives the warehouse an additional possessory storage lien not subordinated under UCC §9-933. That could also be the result based on equitable principles. Can these principles be altered by contract? Basically, a contract (security agreement) cannot waive a statutory provision unless the statute allows for it; it can waive the common law (either precedent or principle) unless it would violate public policy; and it can waive an equitable principle if doing so is not unconscionable.

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