Selling Collateralized Ag Products – The "Farm Products" Rule; Are Racehorses (and Breeding Rights) an Agricultural Commodity?

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Overview

When a farmer sells farm products such as crops and livestock in the normal course of the farming business, those products often are also serving as collateral for a lender's security interest. So what are the rights of the buyer in that instance? Does the buyer take the goods subject to a pre-existing security interest created by the farmer-seller? That's an important question for both farmer-sellers and buyers of farm products to know. Another question is what the scope of definition of "farm products" includes. Is it broad enough to include racehorses and their breeding rights?

The "farm products rule," and the 1985 Farm Bill modification and its application – it's the topic of today's post.

The Farm Products Rule

Original rule. There is a long history behind the farm products rule. Prior to a change in the law that was contained in the 1985 Farm Bill, the majority rule was that a buyer in the ordinary course of business (BIOC) from a seller engaged in farming operations did *not* take free of a perfected security interest unless evidence existed of a course of past dealing between the secured party and the debtor from which it could be concluded that the secured party gave authority to the debtor to sell the collateral. *UCC § 9-307(1).* Thus, a farmer's sale of secured farm products did not cut off the creditor's right to follow farm products into the hands of buyers, such as grain elevators. This meant that when a farmer failed to settle with secured parties, buyers of farm products sometimes had to pay twice unless the buyer could show that the secured party gave the debtor authority to sell the collateral.

Under the farm products rule, farm products were not considered "inventory" to a farmer. Instead, "farm products" were defined as crops, livestock (including, apparently, fowl) or supplies used or produced in farming operations and products of crops or livestock in their unmanufactured states if they were in the possession of a debtor engaged in the raising, fattening, or grazing of livestock or other farming operations. Under the rule, the holder of the perfected security interest could recover farm products subject to the interest from a bona fide purchaser purchasing watermelons from a roadside stand, steers in carload lots, or a load of corn, if the purchase was from a seller engaged in farming operations. However, crops, livestock, or the products of crops or livestock if in the possession of one *not* engaged in farming ceased to be farm products and were inventory. Similarly, if farm products passed to one engaged in marketing for sale or a manufacturer or processor, they became inventory.

Impact of the rule. The farm products rule was highly protective of secured parties. Purchasers of farm products had to be cautious in all transactions and were given strong incentive to always check the record for filed financing statements, and to have checks made payable jointly to the seller and the lender. However, creditors secured by farm products still needed to have a properly perfected security interest in the crops or livestock and include a specific provision in the security agreement specifying whether the debtor could sell the collateral. If sales were allowed, the lender needed to state clearly how payment was to be made, whether checks were to be sent directly to the lender, whether the debtor and lender were to be joint payees, or, whether a specified percentage of the proceeds was to be remitted directly to the lender. In any event, the provisions on sale and payment of proceeds had to be consistently enforced.

From the mid-1970s until the mid-1980s, several states amended the UCC farm products rule to allow, in various circumstances, purchasers of farm products from a person engaged in farming operations to take free of a perfected security interest. By the end of 1985, about 40 percent of the states had modified the general rule.

1986 – A New Rule

Effective December 23, 1986, the 1985 Farm Bill (Food Security Act (FSA) of 1985) "federalized" the states' farm product rules. The new provision specified that, "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." *7 U.S.C. §1631(d).* 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. *7 U.S.C. §1631(c)(5).*

State options. The FSA provision gave the states two options - adopt a prescribed central filing system or follow an "actual notice" rule. Thus, under the federal rule, if a BIOC buys a farm product that has been "produced in a state" from a seller engaged in farming, the BIOC takes the farm product free of any security interest created by the seller unless:

- Within one year before the sale of the farm products, the buyer has received written notice of the security interest from the secured party (the direct notice exception);
- The buyer has failed to pay for the farm products; or
- In states which have established a central filing system (all states now have adopted central filing), the buyer has received notice from the Secretary of State of an effective filing of a financing statement (EFS) or notice of the security interest in the farm products and has not obtained a waiver or release of the security interest from the secured party (the central filing exception).

To comply with the direct notice exception, a secured creditor had to send the farm products purchaser a written notice listing (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 had to include the amount of the farm products subject to the security interest, the crop year, and the counties in which the farm products are located or produced.

Under central filing, the secured creditor must file a financing statement containing the same information as required in the written notice under the direct notice exception, except the secured creditor need not include crop year or payment obligation information. Also, notwithstanding errors contained in the financing statement, a financing statement in a central filing state remains effective so long as the errors "are not seriously misleading." However, the general rule is that there is no "substantial compliance" rule with respect to the direct notice exception. A secured creditor must comply strictly with the requirements of the direct notice exception. *See, e.g., State Bank of Cherry v. CGB Enterprises, Inc., 984 N.E.2d 449 (Ill. 2013), aff'g., 964 N.E.2d 604 (Ill. Ct. App. 2012).* However, the Kansas Supreme Court has applied a substantial compliance rule to the direct notice exception. *First National Bank & Trust v. Miami County Cooperative Assoc., 257 Kan. 989, 897 P.2d 144 (1995).*

2002 Farm Bill amendments. The 2002 Farm Bill made several changes in the federal farm products rule. Under the legislation, a financing statement is effective if it is signed, authorized or otherwise authenticated by the debtor. A financing statement securing farm products needs to describe the farm products and specify each county or parish in which the farm products are produced or located. Also, the required information on the security agreement must include 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, and the name of each county or parish in which the farm products are produced or located.

Application of revised Article 9. Secured transactions under Article 9 of the Uniform Commercial Code (UCC) involve personal property and fixtures including loans on crops, livestock, inventories, consumer goods and accounts receivable. Effective in 2001, Article 9 was revised such that "farm products" means goods, other than standing timber, with respect to which the debtor is engaged in a farming operation and which are:

- Crops grown, growing or to be grown, including crops produced on trees, vines and bushes; and aquatic goods produced in aquacultural operations;
- Livestock, born or unborn, including aquatic goods produced in aquacultural operations;
- Supplies used or produced in a farming operation; or
- Products of crops or livestock in their unmanufactured states.

"Farming operation" means raising, cultivating, propagating, fattening, grazing or any other farming, livestock or aquacultural operation. As such, the revised definition of "farm products" eliminates the provision explicitly requiring the collateral to be in the possession of a person engaged in a farming operation.

Legal Issues Under the 1985 Rule

Buyer in direct notice state buying farm products in central filing state. Under the farm products rule, before all states became central filing jurisdictions, a question was whether a buyer in a direct notice state that bought farm products produced in a central filing state was subject to a filing in an EFS central notice state. 7 U.S.C. §1631 says the answer to that question is "yes" but does not define what "produced in" means. Is the phrase restricted in meaning only to production activities or does it also include marketing of the farm products? One court has held that "produced in" means "the location where farm products are furnished or made available for commerce." The court believed that "such an interpretation allowed lenders to discern where they must file notice of their security interests and ensures a practical means for buyers to discover otherwise unknown security interests in farm products." *Great Plains National Bank v. Mount, 280 P.3d 670 (Colo. Ct. App. 2012).*

Are thoroughbreds "agricultural commodities"? As noted above, the 1985 rule change also defined a "farm product" as an "agricultural commodity." In a recent Kentucky case, the court was faced with the question of whether thoroughbred racehorses (and their breeding rights) were farm products that fell within the scope of federal preemption under the farm 7 U.S.C. §1631(d) that was codified in Ky. Rev. Stat. §355.9-320(1) such that a purchaser took free of a prior perfected security interest.

Under the facts of the case, the plaintiff entered into a financing agreement with Zayat Stables, LLC (Zayat Stables) which owns, raises, maintains, buys, races, breeds, and sells horses – including American Pharoah, the winner of the 2015 Triple Crown. In 2016 the plaintiff loaned Zayat Stables $30 million secured by "all the property and assets and all interests therein and proceeds thereof now owned or hereafter acquired by any person upon which a lien is granted or purported to be granted by such person as security for all or any part of the obligations, including, without limitation, all equine collateral." Zayat Stables sold a series of horses and breeding rights without notifying the plaintiff, so the plaintiff sued for breach of contract and fraud, seeking to recover $23 million. The plaintiff also sued other purchasers, including the defendant. The trial court and the appellate court both held the purchasers were protected by the 1985 repeal of the farm products rule. The plaintiff claimed that thoroughbreds were exempt from the provision under K.R.S. §355.9-102(1)(ah) because they were not used for farming purposes.

The Supreme Court affirmed the lower courts, noting that there was no carve-out for thoroughbreds in the statute (the provision applied to all horses) and that the USDA had stated that the repeal of the farm products rule applies to "specific commodities, species of livestock, and specific products of crops or livestock" including "cattle & calves, goats, horses, mules, sheep & lambs, other livestock." The Supreme Court stated the list did not put a limitation on types of horses and that the Kentucky legislature had expressed its acceptance of the provision's application to thoroughbred horses through a series of statutory enactments.

The plaintiff further claimed that thoroughbred horses were not "farm products" because they were not an "agricultural commodity" as defined by 7 U.S.C. §1631(c)(5). The plaintiff's position was the thoroughbreds were simply "too exceptional" to constitute a "commodity." However, the Supreme Court determined that the plain language of the FSA demonstrated that thoroughbred horses were

farm products and that such a construction was consistent with how the Kentucky legislature viewed the FSA as applied to all types of horses.

The Supreme Court also held that breeding rights to the thoroughbreds (including those of American Pharaoh) were included under the FSA provision as horses "produced" in a farming operation as well as a "product of such… livestock in its unmanufactured state." Thus, the buyers of the thoroughbreds and their breeding rights took free of the plaintiff's security interest. MGG *Investments Group. LP v. Bemak N.V., Ltd., No. 2021-SC-0561-DG, 2023 Ky. LEXIS 50 (Ky. Sup. Ct. Mar. 23, 2023)*.

Conclusion

In difficult financial times, understanding the rights of creditors of agricultural products is important. The specific rules surrounding the sale of farm products are important to understand.