



## **An Agricultural Law Research Article**

# **Federal Legislation Provides Protection for Buyers of Farm Products: Food Security Act Supersedes the Farm Products Exception of UCC Section 9-301(1)**

by

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FEDERAL LEGISLATION PROVIDES PROTECTION FOR  
BUYERS OF FARM PRODUCTS: FOOD SECURITY  
ACT SUPERSEDES THE FARM PRODUCTS  
EXCEPTION OF UCC SECTION 9-307(1)†

Recent federal legislation<sup>1</sup> has drastically affected the rights of both agricultural lenders and buyers of farm products. Section 1324 of the Food Security Act of 1985 (FSA) removes the farm products exception found in section 9-307(1) of the Uniform Commercial Code (Code or UCC).

Under section 9-307(1) of the Code, agricultural lenders with security interests in farm products enjoyed a special protection not available to other lenders. Section 9-307(1) 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.<sup>2</sup>

This provision, known as the "farm products exception," became important in the instances when a farmer defaulted on a farm loan, but had already sold the farm products that secured the loan. Because of the farm products exception, the creditor was not relegated to a hopeless suit against the defaulting farmer. Instead, the creditor could maintain an action against the farm products purchaser.<sup>3</sup> Although

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1. Food Security Act of 1985, Pub. L. No. 99-198, § 1324, 1986 U.S. CODE CONG. & AD. NEWS (99 Stat.) 1354, 1535 [hereinafter cited as FSA]. The Act was signed into law by President Reagan on December 23, 1985 and becomes effective on December 23, 1986.

2. U.C.C. § 9-307(1) (1978) (emphasis added).

3. The "farm products exception" of § 9-307(1) is actually an exception to an exception. The general rule is given in UCC § 9-306(2). That section provides that

[e]xcept where this Article provides otherwise, 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.

U.C.C. § 9-306(2) (1978).

Section 9-307(1) provides an exception to that rule for buyers in the ordinary course of business. A buyer in the ordinary course of business is one "who 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 in the goods buys in ordinary course from a person in the business of selling goods of that kind . . ." *Id.* § 1-201(9).

Thus, while the general rule of § 9-306(2) makes it clear that security interests continue in collateral, § 9-307(1) allows buyers in the ordinary course of business to be exempt from that rule.

this framework gave additional protection to creditors,<sup>4</sup> it had the possible effect of forcing buyers to pay twice for one shipment of goods.<sup>5</sup>

In theory, buyers could protect themselves from double payment by conducting creditor searches for perfected security interests in the products. If a search revealed the existence of such interests, the buyer could obtain authorization from the creditor to complete the purchase. Such authorization would indemnify the buyer against a later suit by the creditor. In practice, however, due to time pressures<sup>6</sup> and varied filing requirements,<sup>7</sup> which necessitated a complicated and expensive search process, buyers of farm products found it impractical, if not impossible,<sup>8</sup> to comply with the lien search necessary to protect their interests.

In response to the problem section 9-307(1) created for purchasers of agricultural products, a number of states adopted changes<sup>9</sup> to that section in an effort to more fairly allocate the risk occasioned by defaulting farm sellers. Although the changes engendered a lack of national uniformity, they were beneficial in that the state amendments highlighted the general problem and presented a number of alternatives<sup>10</sup> for Congress to evaluate during its selection of a federal

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However, § 9-307(1) discriminates against those that buy farm products in the ordinary course of business by not extending the protection from security interests to them.

4. Although a creditor could bring an action against a defaulting farmer, it is not likely that he would collect on any judgment rendered. This is because farmers generally do not have any unencumbered assets on which to levy. Accordingly, by allowing creditors to seek payment from buyers, the farm products exception provided creditors with a solvent party against which to satisfy judgments.

5. If a purchaser was successfully sued by a creditor, the purchaser would have been required to pay him the amount of the security interest represented by the farm products, notwithstanding that the purchaser had already paid the farmer in full.

6. See, e.g., 7 U.S.C. § 228b (1982). Section 228b of the Packers and Stockyards Act requires each packer, market agency, and dealer of livestock to pay for any purchased livestock by the close of the next business day.

7. Uchtmann, *The U.C.C. Farm Products Exception—A Time to Change*, 69 MINN. L. REV. 1315, 1327-29 (1985). Some states require local filing of farm products in the county in which the crops are grown, while others require the filing to be done on a state-wide basis. If the records are found, they may not contain all the information needed by the buyer, because only minimal information is required to be included in the filing. See U.C.C. § 9-402 (1978).

8. See Note, *H. 291: Ohio's Attempt to Remedy Security Interests in Farm Products Under the U.C.C.*, 9 U. DAYTON L. REV. 607, 610 (1984). For example, the operator of a large grain terminal will accept delivery from hundreds of producers from all over the state on a daily basis during the peak harvest season. Compliance with the necessary lien search would require searching records in distant counties and even in other states.

9. See *infra* notes 62-73 and accompanying text.

10. See *id.*

solution.

The drafters of section 1324 of the FSA found that section 9-307(1) of the Code treated buyers of farm products unfairly and that the potential for double payment inhibited free market competition for farm products.<sup>11</sup> Congress further found that this, in turn, constituted an obstruction to interstate commerce in farm products.<sup>12</sup> The purpose of the solution adopted by Congress is to remove this obstruction of interstate commerce<sup>13</sup> and give agricultural lenders and buyers of farm products a workable means by which they may protect their respective interests.

Generally, the newly adopted federal solution protects commission merchants, selling agents, and buyers of farm products.<sup>14</sup> Those who buy farm products in the ordinary course of business will take free of any perfected security interest<sup>15</sup> in the products. Under section 1324 of the FSA, agricultural lenders will still have available methods<sup>16</sup> by which to protect themselves, but will no longer be able to treat buyers of farm products as the guarantors of farmers' debts.<sup>17</sup>

Section 1324 gives each state a choice from two approaches to dealing with secured interests in farm products.<sup>18</sup> One approach requires the lender to mail notice of his security interest to each potential buyer of the farm products, at least one year prior to their purchase.<sup>19</sup> This approach contemplates that the farmers will furnish

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11. H.R. REP. NO. 447, 99th Cong., 1st Sess. 191 (1985).

12. *Id.*

13. *Id.*

14. Section 1324 of the FSA applies to commission merchants and selling agents who sell for the farmer as well as to purchasers of farm products who take physical possession. Food Security Act of 1985, Pub. L. No. 99-198, 1324(g), 1986 U.S. CODE CONG. & AD. NEWS (99 Stat.) 1354, 1539. All references to buyers herein will also include commission merchants and selling agents.

As defined in the FSA, a "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." *Id.* § 1324(c)(1). A "commission merchant" is "any person engaged in the business of receiving any farm product for sale, or commission, on for or on behalf of another person." *Id.* § 1324(c)(3). A "selling agent" is "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." *Id.* § 1324(c)(8).

15. Section 1-201(37) provides: "'Security interest' means an interest in personal property or fixtures which secures payment or performance of an obligation." U.C.C. § 1-201(37) (1978).

16. Food Security Act of 1985, Pub. L. No. 99-198, 1324(e), 1986 U.S. CODE CONG. & AD. NEWS (99 Stat.) 1354, 1538. *See infra* notes 86-88 and accompanying text.

17. *See Uchtmann, 1985 Farm Bill to Preempt Farm Products Exception of Uniform Commercial Code 9-307(1)*, 3 AGRIC. L. UPDATE 1, 2 (1986).

18. *See infra* notes 89-110 and accompanying text.

19. *See infra* notes 89-99 and accompanying text.

lenders with a list of prospective buyers. In order to take the products free of the security interest, a buyer receiving notice must perform any payment obligations required by the lender.

The other alternative provided by the FSA is a central filing system.<sup>20</sup> Under the central filing system, farm creditors must file a financing statement with state Secretaries of State, who will compile a list of the financing statements, organized by farm product. Farm buyers must then acquire a copy of that list and use it to check for the name of any farmer from whom farm products are purchased. If the buyer finds that one of his producers is on that list, the buyer can secure a release of the security interest by performing any payment obligations imposed by the creditor.

This Comment first examines the rationale for the existence of the farm products exception in section 9-307(1) of the UCC. Following that discussion, judicial interpretations of and state amendments to that exception will be examined. Section II of this Comment provides an overview of the new federal solution, its effect on the parties involved, and the potential problems it creates. Finally, this Comment will examine the alternatives that the new law gives the individual states.

## I. THE FARM PRODUCTS EXCEPTION

### A. *History of the Farm Products Exception*

One might wonder why buyers of farm products were treated differently from other purchasers. Although several theories have been offered to explain the difference, there seems to be no clear reason for the distinction drawn by section 9-307(1).

The best justification given for the farm products exception to 9-307(1) was that added security was necessary to encourage lenders to advance credit on farm product collateral.<sup>21</sup> There can be no doubt that a lender's risk would increase to some extent if this extra security were not provided. It also can be argued that agriculture is a capital-intensive industry that relies on the availability of credit.<sup>22</sup> However, the actual effect of 9-307(1) on the availability of credit for farmers may not have been as great as its anticipated effect. That is because

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20. See *infra* notes 101-10 and accompanying text.

21. Miller, *Farm Collateral Under the U.C.C.: "Those Are Some Mighty Tall Silos, Ain't They Fella?"*, 2 AGRIC. L.J. 253, 276 (1980).

22. *North Cent. Kan. Prod. Credit Ass'n v. Washington Sales Co.*, 223 Kan. 689, 577 P.2d 35, 41 (1978).

most agricultural credit is supplied either by rural banks, which depend on farmers as a major source of business, or by entities that have been created specifically for farm lending.<sup>23</sup> These institutions were fully cognizant of the risks inherent in farm loans, yet nevertheless extended them. In fact, under pre-Code law, loans often were made to farmers even when there was no legal right to attach the farm products that served as collateral.<sup>24</sup> Notwithstanding these considerations, the drafters of section 9-307(1) must have thought that the beneficial effect it would have on farm credit would be substantial enough to subject innocent buyers of farm products to a potential for double payment.

A related explanation for the farm products exception is that the drafters of the Code viewed farmers as a class with poor business judgment and an inability to handle financial transactions.<sup>25</sup> Under this theory, the farmer's only expertise was as a tiller of the soil, and thus, it could have been thought that the farmer was incapable of marketing his products.<sup>26</sup> Concerned that farmers might not receive compensation adequate to meet their debt obligations, the Code drafters provided extra protection for agricultural lenders in section 9-307(1). Again, the possible rationale for providing this protection was to preserve the availability of farm credit. However, the role of the farmer has changed dramatically since the Code was originally drafted. There can be no doubt that the modern farmer must be a capable businessman if he is to survive in today's economy. Therefore, any credibility this theory may have had when section 9-307(1) was originally adopted would certainly not be relevant today.

The commercial status of buyers of farm products is a third possible justification for the farm products exception. Because farm products are normally sold through wholesalers or agents, it was argued that buyers of farm products are financially sophisticated businessmen who should be aware of the need to check for security interests in those products.<sup>27</sup> However, this theory does not explain why buyers of other products are protected, while buyers of farm products are not. For example, section 9-307(1) allows a retailer or a

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23. See *Campbell v. Yokel*, 20 Ill. App. 3d 702, 313 N.E.2d 628 (1974). But see *Sierens v. Clausen*, 21 Ill. App. 3d 450, 315 N.E.2d 897 (1974).

24. *Miller*, *supra* note 21, at 276.

25. Note, "Farm Products" Under the U.C.C.—Is a Special Classification Desirable?, 47 TEX. L. REV. 309, 311 (1969).

26. *Id.*

27. *Meyer*, "Crops" as Collateral Under Article 9, 15 U.C.C. L.J. 3, 33 (1982).

wholesaler who purchases furniture from a manufacturer to take free of a security interest. At the same time, section 9-307(1) requires that a retailer or wholesaler of farm products who buys those products is subject to a security interest created by the products' manufacturer, the farmer. Consumers are not the only persons who are protected by section 9-307(1). That section also protects any wholesaler or financially sophisticated buyer who deals in any product other than farm products.

The justification for the farm products exception is further undermined by the fact that many purchasers of farm products buy from hundreds or thousands of small producers.<sup>28</sup> It is virtually impossible for such buyers to check all the appropriate records to determine whether the collateral is covered and whether the debtor is in default.<sup>29</sup> Thus buyers of farm products are not in any better position to check for security interests than are buyers who take free of security interests under 9-307(1). Nevertheless, buyers of farm products were exposed to a potentially large risk of loss that did not threaten buyers of other products.

Under the farm products exception, in the event that a farm debtor did not remit the proceeds received from the sale of his product to the bank that held a security interest in the products, the buyer of the product and the bank could end up in court. The next section examines the ways in which the courts dealt with this situation.

### *B. Judicial Interpretations*

The facts of a typical case in which the courts have had to decide whether or not to allow the creditor's perfected security interest to continue in farm products are as follows:

Bank holds a perfected security interest in all of Farmer's presently owned and after-acquired livestock. The security agreement prohibits disposition without the Bank's prior written consent. In the past the bank has without objection accepted proceeds from sales made by Farmer in violation of this clause of the security agreement. Without Bank's consent Farmer again sells livestock; but this time he fails to remit the proceeds to Bank. Bank seeks to enforce its security interest, in either a replevin or conversion action against the purchaser, who we as-

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28. Coogan & Mays, *Crop Financing & Article 9: A Dialogue With Particular Emphasis on the Problems of Florida Citrus Crop Financing*, 22 U. MIAMI L. REV. 13, 20 (1967).

29. Note, *supra* note 8, at 610.

sume qualifies as a buyer in the ordinary course.<sup>30</sup>

On this set of facts, jurisdictions favoring farm products buyers would find that the bank had either expressly or impliedly waived its right to a security interest. This waiver would be found to result from the bank's failure to object to the farmer's previously unauthorized sales.<sup>31</sup>

The authority that allows courts to find a waiver of the creditor's security interest is found in section 9-306(2) of the Code. Section 9-306(2) 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 including collections received by the debtor.<sup>32</sup>

When combined with an express consent or a previous course of dealings argument, the "or otherwise" language of section 9-306(2) led some courts to find that the lender had waived his security interest.<sup>33</sup> The creditor's affirmative consent to the farmer to make an otherwise unauthorized sale was considered to be an express waiver of the security interest. An implied waiver theory enabled courts to reach the same result via a different analysis. Creditors were held to have impliedly waived their security interests if they did not vigilantly supervise farmer adherence to debt obligations. If a loan obligation

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30. Dugan, *Buyer-Secured Party Conflicts Under Section 9-307(1) of the Uniform Commercial Code*, 46 U. COLO. L. REV. 333, 337 (1975).

31. See, e.g., *Clovis Nat'l Bank v. Thomas*, 77 N.M. 554, 425 P.2d 726 (1967).

32. U.C.C. § 9-306(2) (1978) (emphasis added).

33. The line of cases holding for the buyer of farm products on a waiver of security interest include: *Moffat County State Bank v. Producers Livestock Mktg. Ass'n*, 598 F. Supp. 1562 (D. Colo. 1984) (secured creditor waived its security interest in livestock through course of performance with farmer); *In re Thomas*, 43 Bankr. 201 (Bankr. M.D. Ga. 1984) (FHA held to have waived its security interest in milk proceeds by requiring debtor to assign his milk proceeds from the dairy to FHA); *Anon, Inc., v. Farmers Prod. Credit Ass'n*, \_\_\_ Ind. App. \_\_\_, 446 N.E.2d 656 (1983) (creditor waived his perfected security interest by giving debtor standing authority to sell the collateral upon condition that proceeds be remitted for payment on the loan); *Ottumwa Prod. Credit Ass'n v. Keoco Auction Co.*, 347 N.W.2d 393 (Iowa 1984) (secured party expressly waived its security interest by directing the farmer to sell his inventory through normal sales channels); *Lisbon Bank & Trust Co. v. Murray*, 206 N.W.2d 96 (Iowa 1973) (lender's course of conduct authorized sale of cattle); *North Cent. Kan. Prod. Credit Ass'n v. Washington Sales Co.*, 223 Kan. 689, 577 P.2d 35 (1978) (conversion action against auctioneer dismissed; express consent waives the security interest); *Charterbank Butler v. Central Coops., Inc.*, 667 S.W.2d 463 (Mo. App. 1984) (creditor with security interest in soybeans who allowed debtor to sell the collateral in past years without written permission held to have given the debtor the authority to sell).

required that a farmer receive creditor authorization prior to any sale, but the creditor acquiesced in a sale in contravention of that requirement, such action was held to be an implicit waiver of any security interest in the products sold. Accordingly, the creditor lost his cause of action against the buyer and had to bear the loss caused by the defaulting farmer.

Other courts<sup>34</sup> rejected the waiver theories, on the ground that the mere failure of a creditor to reprimand the farmer for a sale, which the creditor learned of after the fact, should not operate as a waiver of the creditor's perfected security interest.<sup>35</sup> The courts reasoned that, through section 9-307(1), the Code puts the burden on buyers of farm products to check the appropriate records, notwithstanding creditors' seeming acquiescence in the sale. Therefore, some courts held that buyers act at their own risk when they do not make the investigation required by the notice filing system.<sup>36</sup>

### 1. *Express Waiver of the Security Interest*

Courts were likely to find a waiver of the security interest if the actions of the bank's officers had indicated in any way that they affirmatively approved the sale without requiring the farmer to obtain a written authorization from them. In *North Central Kansas Production Credit Association v. Washington Sales Co.*,<sup>37</sup> the Kansas Supreme

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34. The line of cases holding for the creditor include: *In re Ellsworth*, 722 F.2d 1448 (9th Cir. 1984) (creditor's practice of allowing debtor to sell collateral without prior approval held not an authorization to sell collateral because the creditor did not approve of prior sales until proceeds were paid on loan); *Security Nat'l Bank v. Belleville Livestock Comm'n Co.*, 619 F.2d 840 (10th Cir. 1980) (creditor did not impliedly waive its security interest by its course of conduct, custom usage or procedure in accepting proceeds of unauthorized sale of cattle); *In re Coast Trading Co.*, 31 Bankr. 670 (Bankr. D. Or. 1983) (creditor's practice of allowing debtor to sell collateral without prior approval held to not be authorization to sell so as to allow a buyer to take free of the creditor's perfected security interest); *Wabasso State Bank v. Caldwell Packing Co.*, 308 Minn. 349, 251 N.W.2d 321 (1976) (creditor did not authorize borrower to sell collateral by not objecting to course of dealing in which borrower had previously sold collateral without consent); *Garden City Prod. Credit Ass'n v. Lannan*, 186 Neb. 668, 186 N.W.2d 99 (1971) (creditor did not waive its security interest for not objecting to debtor's sale of collateral without permission); *First Tenn. Prod. Credit Ass'n v. Gold Kist, Inc.*, 653 S.W.2d 418 (Tenn. App. 1983) (creditor did not authorize debtor to sell collateral by not objecting to course of dealing in which debtor had previously sold such collateral without consent).

35. See, e.g., *Wabasso State Bank v. Caldwell Packing Co.*, 308 Minn. 349, 251 N.W.2d 321 (1976).

36. See, e.g., *First Tenn. Prod. Credit Ass'n v. Gold Kist, Inc.*, 653 S.W.2d 418, 422 (Tenn. App. 1983). See also Geyer, *Farmers Who Sell Mortgaged Farm Products and Don't Tell; Buyers Who Buy Farm Products and Don't Pay—An Electrifying Solution*, 34 *DRAKE L. REV.* 429, 453-55 (1984-85) for a discussion of whether the standard filing procedures are still practical.

37. 223 Kan. 689, 577 P.2d 35, 41 (1978).

Court held for the buyer of farm products in a creditor's conversion action. The bank officers had told the farmer that he could sell cattle without written permission from the bank, provided that he either apply the proceeds from that sale to his loan obligation or have the check made out jointly to both the farmer and the bank. Notwithstanding the bank's instructions, the farmer sold the cattle, took payment in his own name, and failed to remit the proceeds to the bank. When the bank discovered that the farmer could not pay his loan obligation, the bank attempted to collect from the buyer of the farmer's products. However, because the court found that the bank had expressly consented to the sale, the conversion action failed.<sup>38</sup>

In those situations in which a bank had expressly consented to a farmer's sale, a holding in favor of the buyer was in accordance with section 9-306(2). Express consent was certainly an "authorization" to sell, within that section's terms. The more difficult cases were those in which the creditor knew that the sales were being made, but neither reprimanded the farmer, nor permitted him to make future sales. In those situations, the buyer had to defend on an implied waiver of security interest theory.

## 2. *Implied Waiver of the Security Interest*

Buyers were less successful when their cases rested on an implied rather than an express waiver theory.<sup>39</sup> The rationale for the implied waiver theory was as follows: because creditors knew the farm debtors and the origin of their products, creditors were in a better position to protect their interests than were buyers, who would not normally know the identity of any creditor.<sup>40</sup> If in the prior course of dealings between the bank and the farmer, the bank neither required written consent nor reprimanded the farm debtor for making sales without such consent, the creditor could be deemed to have impliedly waived any requirement of written authorization that appeared in the loan

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38. *Id.*

39. *See, e.g.,* Planter Prod. Credit Ass'n v. Bowles, 256 Ark. 1063, 511 S.W.2d 645 (1974) (secured creditor waived his security interest in collateral in favor of a third party purchaser of the collateral simply by his course of dealing with the debtor rather than by express or written waiver); Clovis Nat'l Bank v. Thomas, 77 N.M. 554, 425 P.2d 726 (1967) (secured creditor declined to exercise its right to require the debtor to obtain written consent before disposing of cattle, therefore the bank acquiesced in and consented to sale of cattle and lost its security interest).

40. *See, e.g.,* Moffat County State Bank v. Producers Livestock Mktg. Ass'n, 598 F. Supp. 1562 (D. Colo. 1984).

agreement between the parties. Accordingly, the creditor could be held to have lost his security interest.

The flaw in the implied waiver theory is that it seems to directly conflict with section 1-205(4) of the Code. Section 1-205(4) provides:

The express terms of an agreement and an applicable course of dealing or usage of trade shall be construed whenever 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.<sup>41</sup>

From this section, it is apparent that a creditor's acquiescence in improper sales should not prejudice the meaning of any express terms. Therefore, many courts that hold in favor of the creditor apply section 1-205(4) and refuse to recognize the prior course of dealing as a waiver of the creditor's security interests.<sup>42</sup>

Some courts that relied on section 1-205(4) reasoned that a creditor's inactivity concerning the farmer's prior sales could never amount to a sale authorization. They reasoned that because the bank was always presented with the sale proceeds after the fact, no other reasonable alternative was available to them. In disposing of the waiver by course of dealing argument, the Minnesota Supreme Court stated:

The fallacy in [the implied waiver] argument is that it ignores the realities of the situation. The bank was not made aware of the sales of collateral before they occurred. Farmers would simply notify the bank of the sales when they came in with the proceeds to pay off the loan. At this point, not only was the bank not harmed by the sale but it was presented with an accomplished fact.<sup>43</sup>

The Minnesota Supreme Court's portrayal of the situation was not realistic. Banks that loan to farm enterprises know that farm products must be sold when the market for them is favorable. The time wasted in obtaining a written authorization could adversely affect a farmer's prices and consequently reduce his ability to pay the loan that is secured by the products. Loan officers typically testify in regard to this matter that their banks do not require written authorization for a farm debtor to sell, unless he is in default or has otherwise

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41. U.C.C. § 1-205(4) (1978).

42. See, e.g., *Security Nat'l Bank v. Belleville Livestock Comm'n Co.*, 619 F.2d 840 (10th Cir. 1980); *Wabasso State Bank v. Caldwell Packing Co.*, 308 Minn. 349, 251 N.W.2d 321 (1976); *Garden City Prod. Credit Ass'n v. Lannan*, 186 Neb. 668, 186 N.W.2d 99 (1971).

43. *Wabasso State Bank*, 251 N.W.2d at 324.

given the bank cause for concern.<sup>44</sup> In addition, banks complained that it would be administratively burdensome to provide written authorization to farmers each time they wished to make a sale. Indeed, banks were content to rely on the honesty of farm debtors to bring in the proceeds of their sales.<sup>45</sup>

A persuasive explanation of the implied waiver theory was stated by the United States Court of Appeals for the Tenth Circuit in *First National Bank and Trust Co. of Oklahoma v. Iowa Beef Processors*.<sup>46</sup> The court stated:

The reality of cattle financing arrangements is that the secured party expects and wants the collateral to be sold continually in order for it to receive payment on the line of credit it has extended. At the same time, however, the secured party is reluctant to give blanket consent to the sales because it would lose its right to go against the purchaser should the debtor default. Consequently, secured parties in this area have tried to protect themselves by placing conditions on sale authorizations.<sup>47</sup>

In jurisdictions that rejected the implied waiver theory, agricultural lenders were in an enviable position. Their security interests in farmers' goods could be protected even though they knew and expected that the terms of their loan agreements would be violated.

A course of performance argument under section 2-208(3) of the Code<sup>48</sup> was the strongest attack that buyers could launch against the shield that section 1-205(4) provided for bankers. Under section 1-205(4), subsequent express terms generally control prior implied terms. However, that section does not deal with the consequences of *postagreement* events.<sup>49</sup> Because a course of performance is a series of *postagreement* events, it is unaffected by section 1-205(4). The establishment of a course of performance requires repeated performances by one party, while another party has knowledge of and an opportunity to object to those performances.<sup>50</sup> In the instant context, a course of performance could be established by a farmer's repeated unauthorized sales, accompanied by a creditor's failure to object to those

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44. *Moffat*, 598 F. Supp. at 1564.

45. *See, e.g., id.* at 1569.

46. 626 F.2d 764 (10th Cir. 1980).

47. *Id.* at 767.

48. Section 2-208(3) provides: "Subject to the provisions of the next section on modification and waiver [§ 2-209], such course of performance shall be relevant to show a waiver or modification of any term inconsistent with such course of performance." U.C.C. § 2-208(3) (1978).

49. Dugan, *supra* note 30, at 340.

50. U.C.C. § 2-208(1) (1978).

sales and its acceptance of sale proceeds.<sup>51</sup>

A buyer's establishment of a course of performance had a potentially significant effect on the outcome of a suit between the creditor and buyer. This was because the buyer could then rely on section 2-208(3), which operated "to show a waiver or modification of any term inconsistent with such course of performance."<sup>52</sup> Through section 2-208(3), the creditor's postcontract conduct overrode the contrary express terms in the security agreement.<sup>53</sup> Accordingly, creditor authorization requirements were neutralized and buyers were able to successfully defend against creditor suits.

The court in *Moffat County State Bank v. Producers Livestock Marketing Association*<sup>54</sup> followed the course of performance rationale to reach a result favorable to a purchaser of farm products.<sup>55</sup> The court held that a prior course of performance between the creditor and farmer had waived the express terms of their loan agreement.<sup>56</sup> Therefore, the court held that the agreement's requirement of written authorization had been waived and that the bank's security interest therefore failed to follow the farm products.<sup>57</sup>

Although the *Moffat* court found for the buyer on the basis of a strong 2-208(3) argument, the underlying rationale of the implied waiver theory seems to be contrary to the expressed intent of the drafters of section 9-307(1) of the Code.<sup>58</sup> The court in *Moffat* found that the main problem was that the Code's treatment of farm security interests does not reflect the actual practice in the trade.<sup>59</sup> The court went on to say that the state legislature must resolve the problem, and that until it does so, a court's choice between two innocent parties must be based on ambiguous distinctions, such as failure to rebuke

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51. Dugan, *supra* note 30, at 340.

52. U.C.C. § 2-208(3) (1978).

53. Dugan, *supra* note 30, at 341.

54. 598 F. Supp. 1562 (D. Colo. 1984).

55. In *Moffat*, the farmer warranted to the purchaser that his cattle were free of liens and encumbrances. The buyer had no knowledge of any contrary information and did not attempt to investigate the truthfulness of the farmer's claim. The buyer subsequently purchased the goods from the farmer, but the farmer never remitted the proceeds to the bank. The prior dealings of the farmer and the bank had been over an eight-year period. The bank knew the farmer had made unauthorized sales throughout this period and had never once required the farmer to obtain written consent before making a sale. *Id.* at 1563-64.

56. *Id.* at 1570.

57. *Id.* at 1568.

58. Miller, *supra* note 21, at 285. Section 9-307(1) expresses a Code policy that farmers do not have the power to sell farm products free of a security interest.

59. *Moffat*, 598 F. Supp. at 1570-71.

previous sales and express consent.<sup>60</sup>

### C. *State Amendments to 9-307(1)*

In response to the criticism of the farm products exception of section 9-307(1), over one-third of the states had adopted some type of amendment to this Code section.<sup>61</sup> The amendments differed in the degree to which the risk of a farmer's default on his loan obligation was allocated to buyers or to lenders. As a result of the divergent state amendments, one of the purposes of the Code—to provide a uniform set of laws for commercial transactions—was thwarted with respect to section 9-307(1).

California took the most drastic approach to solving the section 9-307(1) problem by completely eliminating the farm products exception.<sup>62</sup> Buyers of agricultural products in California took free of a security interest, just as did any other buyer in the ordinary course of business. At the other extreme, some states protected only selling agents and commission merchants who sold farm products for farmers.<sup>63</sup> This approach provided no relief for the majority of those affected by the farm products exception: buyers who take actual possession of farm products.

A third type of amendment that was adopted by some states pro-

60. *Id.* at 1571.

61. See, e.g., CAL. COM. CODE § 9307 (West Supp. 1985); DEL. CODE ANN. tit. 6, § 9-307(2) (Supp. 1984); GA. CODE ANN. § 11-9-307(3) (1982); ILL. ANN. STAT. ch. 26, § 9-307(4) (Smith-Hurd Supp. 1985); IND. CODE ANN. § 26-1-9-307(1)(a) (Burns Supp. 1985); IOWA CODE ANN. § 554-9407(2)-(4) (West Supp. 1984-1985); KY. REV. STAT. ANN. § 355.9-307 (Baldwin 1983); MD. COM. LAW CODE ANN. § 9-307(1)(b) (Supp. 1985); MICH. COMP. LAWS ANN. § 440.9307 (West Supp. 1985); MINN. STAT. ANN. § 336.9-307 (West Supp. 1985); NEB. REV. STAT. § 90-9-307(6) (Supp. 1985); N.D. CENT. CODE § 41-09-28(4) (Supp. 1985); OHIO REV. CODE ANN. § 1309-26(B)(1)(b) (Page Supp. 1984); OKLA. STAT. ANN. tit. 12A, § 9-307(3) (West Supp. 1985); S.D. COMP. LAWS ANN. § 57-A-9-503.1 (Supp. 1984); TENN. CODE ANN. § 47-9-307(2) (Supp. 1985); WASH. REV. CODE ANN. § 62A.9-307(4) (Supp. 1985).

62. CAL. COM. CODE § 9307 (West Supp. 1985). California does not distinguish between purchasers of farm products and purchasers of any other product. While this system has worked well because of the diversity of the California agriculture and California's marketing structure, this approach may not be as successful in other states. California has a much lower ratio of markets to producers than most states, thus making it easier for lenders in California to patrol their farm debtors. Hultquist & Heringer, *Uniform Commercial Code Section 9-307: Can California's Experience be Used to Justify the Repeal of the Farm Products Exception?*, 7 AGRIC. TAX & L.J. 221, 228-31 (1985). Total elimination of the farm products exception in states of "traditional production" is viewed by some as a measure that would severely affect the availability of agricultural financing. See Note, *supra* note 8, at 622.

63. The states that followed this approach were Georgia, Maryland and Washington. See GA. CODE ANN. § 11-9-307(3) (1982); MD. COM. LAW CODE ANN. § 9-307(1)(b) (Supp. 1985); WASH. REV. CODE ANN. § 62A.9-307(4) (Supp. 1985).

vided that creditors must provide buyers with actual written notice of any security interest.<sup>64</sup> Failure to provide such notice resulted in the creditor's loss of his security interest. This type of amendment changed the Code's allocation of burden, in that it required creditors to take affirmative action to protect their security interest. Such amendments required farmers to provide lenders with a list of potential buyers.<sup>65</sup> If such a list were provided, farmers were prohibited from selling to a buyer not on the list, under penalty of criminal charges.<sup>66</sup>

Rather than depending on the farmer's list as the source of potential farm product purchasers, some states combined a buyer registration requirement with a creditor written notice obligation.<sup>67</sup> Such amendments thrust obligations of affirmative action on both lenders and buyers. Buyers were required to register with the state as agricultural buyers.<sup>68</sup> Lenders could then obtain a list of potential buyers

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64. The typical notice requirement was like that of Indiana's. Indiana's written notice required the following information: the full name and address of the debtor; the full name and address of the secured party; a description of the collateral; the date and location of the filing; the date and signature of the secured party; and the date and signature of the debtor. IND. CODE ANN. § 26-1-9-307(1)(a) (Burns Supp. 1985). Other states adopting this approach were Ohio and Illinois. See ILL. ANN. STAT. ch. 26, § 9-307(4) (Smith-Hurd Supp. 1985); OHIO REV. CODE ANN. § 1309-26(B)(1)(b) (Page Supp. 1984).

65. See IND. CODE ANN. § 26-1-9-307(1)(c) (Burns Supp. 1985), which provides:

A debtor engaged in farming operations who has created a security interest in farm products must provide the secured party with a written list of potential buyers of the farm products at the time the debt is incurred if such a list is requested by the secured party.

This method left agricultural lenders with no means of protection if a farmer sold to someone who was not on the provided list. Because buyers would not have received written notice from the lender, they would take the farm products free of any security interest. The agricultural lenders would bear the entire loss even though they had taken all possible steps to protect their security interests.

66. Ohio, for example, made the sale of farm products to unlisted buyers a misdemeanor violation of the first degree. OHIO REV. CODE ANN. § 1309.26(B)(8) (Page Supp. 1984).

While it is true that criminal charges could have been brought against a farmer who sold to unlisted buyers, the deterrent effect of the prospect of such charges was likely to have been minimal. In the words of one commentator: "[O]ne wonders how many elected prosecutors in a rural community would find it politically appealing to pursue a criminal action against a farm producer." Note, *supra* note 8, at 619. The deterrent effect of criminal charges would have been even less influential, considering that the typical farmer who is unable to meet loan obligations is near financial collapse.

67. The states that did so were Delaware, Kentucky, Minnesota and Tennessee. See DEL. CODE ANN. tit. 6, § 9-307(2) (Supp. 1984); KY. REV. STAT. ANN. § 355.9-307 (Baldwin 1983); MINN. STAT. ANN. § 336.9-307 (West Supp. 1985); TENN. CODE ANN. § 47-9-307(2) (Supp. 1985).

68. An example of a typical registration requirement is the Delaware statute which requires buyers of grain products to register with the state in order that they could receive written notice of security interests from agricultural lenders. See DEL. CODE ANN. tit. 6, § 9-307(2)(a) (Supp. 1984). Requirements for registration include providing the Secretary of State with the complete name and

from the state, rather than from farmers. In an effort to limit the expense and burden of potentially unlimited notice requirements, those states that adopted this approach usually restricted the geographic area in which the secured parties were required to send notice.<sup>69</sup>

Another form of state deviation from the Code rule left buyers of farm products with a duty to inquire as to any security interest in farm products.<sup>70</sup> However, states adopting this method made buyer inquiries significantly less difficult to conduct than were inquiries under section 9-307(1). Rather than being required to conduct a credit search, buyers were merely required to obtain from farmers sworn statements regarding any security interests in the farm products.<sup>71</sup>

A fifth approach to amending section 9-307(1) involved a central filing system.<sup>72</sup> This approach required creditors to file their security interests with the state Secretary of State. This data was compiled by the Secretary of State and made available for distribution to farm product buyers. Buyers had a duty to check the Secretary of State's records for security interests in the farm products they wished to buy.<sup>73</sup> This approach was one of two approaches later incorporated into the FSA by Congress.<sup>74</sup>

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mailing address of the registering purchaser. The Secretary of State then compiles a registry of all of the buyers. *Id.* at § 9-307(2)(b).

69. Tennessee, for example, limited the notice requirement to those buyers within 75 miles of the creditor's office. TENN. CODE ANN. § 47-9-307(2)(d) (Supp. 1985).

70. See MICH. COMP. LAWS ANN. § 440.9307 (West Supp. 1985); OKLA. STAT. ANN. tit. 12A, § 9-307(3) (West Supp. 1985); S.D. COMP. LAWS ANN. § 57-A-9-503.1 (Supp. 1984).

71. Oklahoma, for example, allows a buyer to take free of a security interest if the buyer "shall require [the] seller to execute a certificate disclosing the names of all lenders, if any, to whom security interests have been given in such farm products. If no such security interests exist, the certificate shall so state." OKLA. STAT. ANN. tit. 12A, § 9-307(3)(a) (West Supp. 1985).

Because the agricultural lender had to rely on the farmer's representations to the buyer at the time of the sale, the lender was not able to protect his security interest solely through his own efforts. Therefore, this approach did not solve all the problems which were presented under the Code. However, in that this approach does shift the risk of loss to lenders in a default situation where buyers had acquired the signed certificate, the legislatures of these states must have determined that creditors were in a better position to police interests and should bear the loss when two innocent parties are involved.

72. The states that adopted this approach were Iowa, Kansas, Montana, Nebraska and North Dakota. See IOWA CODE ANN. § 554-9407(2)-(4) (West Supp. 1984-1985); KAN. STAT. ANN. §§ 84-9-401-9-410 (Supp. 1984); MONT. CODE ANN. § 81-8-301 (1983); NEB. REV. STAT. § 90-9-307(6) (Supp. 1985); N.D. CENT. CODE § 41-09-28(2) (Supp. 1985).

73. For an explanation of the procedure to follow under a central filing system see *infra* notes 100-08 and accompanying text.

74. See *infra* notes 100-10 and discussion.

## II. FEDERAL PREEMPTION OF SECTION 9-307(1)

In December of 1985, Congress enacted the FSA, which will preempt all state commercial law regarding section 9-307(1) of the Code.<sup>75</sup> The FSA establishes the rights of agricultural lenders and farm product purchasers when dealing with security interests in farm goods. Under the FSA, creditors will be required to take affirmative steps to protect their security interests, either by providing buyers with actual notice or by filing with the state Secretary of State. Buyers of farm products will take them free of any security interest, unless they receive actual notice of some such interest, or they fail to comply with the requirements for release of a security interest.

Congress found that, as originally drafted, section 9-307(1) exposed buyers<sup>76</sup> of farm products to double payment problems.<sup>77</sup> Occasionally, the regime set up by section 9-307(1) required buyers to pay once at the time of purchase and again if the farmer defaulted on his loan obligation.<sup>78</sup> This risk of double payment existed, notwithstanding that buyers had no practical method of discovering the existence of security interests and no reasonable means to ensure that farmers paid their creditors with the sale proceeds.<sup>79</sup> Congress found that the possibility of double payment had inhibited free competition in the market for farm products and had resulted in an obstruction of

75. Section 1324(d) of the FSA provides:

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.

Food Security Act of 1985, Pub. L. No. 99-198, § 1324(d), 1986 U.S. CODE CONG. & AD. NEWS (99 Stat.) 1354, 1538.

76. All references to "buyers of farm products" will include a class made up of buyers who take actual physical possession and, also, commission merchants or selling agents who sell farm products for others. See *supra* note 14 for the definitions of "commission merchants" and "selling agents."

77. Food Security Act of 1985, Pub. L. No. 99-198, § 1324(a)(2), 1986 U.S. CODE CONG. & AD. NEWS (99 Stat.) 1354, 1535.

78. *Id.*

79. Congress found:

[C]ertain 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 sale proceeds to repay the lender.

*Id.* at § 1324(a)(1).

interstate commerce in farm goods.<sup>80</sup>

The problems that state courts and legislatures had with the original version of section 9-307(1) is evidence of the unfairness of that section to buyers of farm products. However, the state attempts to solve the problems engendered by section 9-307(1) resulted in a chaotic state of the law. Indeed, the well-intended state efforts frustrated one of the major purposes underlying the "Uniform" Commercial Code. Accordingly, the divergent amendments created unwarranted confusion and expense for buyers of farm products who did business in more than one state.<sup>81</sup>

For the above reasons, it was apparent that a single rule was needed to give consistency to this area of the law. By enacting section 1324 of the FSA, the federal government adopted a measure that would have taken the states a number of years to reach, had they acted independently. Indeed, it is unlikely that the states ever would have reached a uniform solution to this problem.

Despite the desirability of a consistent rule to command security interests in farm products, the federal solution was not met with unanimous acceptance. Perhaps the greatest barrier to the passage of a federal solution were state interests in the regulation of commercial transactions within their borders.<sup>82</sup> In approving the federal measure, the Secretary of Agriculture stated that despite the Administration's strong belief in the concept of federalism, state action alone was not sufficient to solve the national problem created by section 9-307(1).<sup>83</sup>

The FSA makes the farm products area of commercial law uniform again. Moreover, it reverses the fallen regime of section 9-307(1) by shifting the risk of loss from buyers of farm products to agricultural lenders.<sup>84</sup> Section 1324(d) provides that "a buyer who in

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80. *Id.* at §§ 1324(a)(3)-(a)(4).

81. "Because of the nature of agricultural marketing, [the] State-by-State legal patchwork [became] intolerable for both buyers and sellers of farm products. It has caused unwarranted confusion and great expense for those persons doing business in several States." S. REP. NO. 147, 99th Cong., 1st Sess. 3 (1985).

82. The minority views of Senator Heflin included the following:

The UCC was designed to be state enacted, to allow for local variations addressing the concerns of each individual state while following the basic guidelines of the UCC. The states currently regulate the vast majority of commercial and business transactions through their versions of the UCC which they are free to alter to fit their particular circumstances. Congress need not interfere with that regulation.

*Id.* at 12.

83. *Id.* at 9.

84. Food Security Act of 1985, Pub. L. No. 99-198, § 1324(d), 1986 U.S. CODE CONG. & AD. NEWS (99 Stat.) 1354, 1538.

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 interests."<sup>85</sup>

This reversal of risk reflects Congress' desire to more fairly allocate the loss of a defaulting farm debtor to the party who is in a better position to protect itself—the agricultural lender. Congress has not, however, placed all of the risk on creditors without leaving them some means of protection.<sup>86</sup> The FSA requires each state to choose one of two ways in which it will protect farm creditors. States may adopt either a "creditor notification" approach<sup>87</sup> or a "central filing system" approach.<sup>88</sup> By requiring every state to adopt one of the two approaches, the FSA will promote fairness, uniformity, and predictability in agricultural products transactions.

While both approaches are preferable to section 9-307(1), the two approaches are quite different in application. Each approach has strengths and weaknesses. However, an examination of the two alternatives leads to the conclusion that the central filing system is preferable to the creditor notification approach.

#### A. *The Creditor Notification Approach Under Section 1324 of the Food Security Act of 1985*

For a farm creditor's security interest to continue under the creditor notification approach, he must give written notice of that interest to prospective buyers at least one year before the actual purchase of

85. *Id.* The same protection is extended to commission merchants and selling agents through section 1324(g). *Id.* § 1324(g).

86. In a central filing system state, a buyer of farm products takes subject to a security interest created by the seller if: "(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 . . . ." *Id.* § 1324(e)(2).

In the alternative, the buyer will take subject to the security interest if the buyer:

(A) receives from the Secretary of State of such State written notice . . . 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 . . . .

*Id.* § 1324(e)(3).

87. *See infra* notes 91-101 and accompanying text.

88. *See infra* notes 102-12 and accompanying text.

the farm products that secure his loan.<sup>89</sup> To facilitate creditor compliance with this notification requirement, section 1324(h)(1) provides that creditors may seek and receive from the farmer a list of his potential farm products buyers.<sup>90</sup>

The notice must be organized according to the farm products involved and contain the name and address of the secured party, the name and address of the farm debtor, the farmer debtor's social security or taxpayer identification number, a description of the farm products subject to the security interest, and any proposed conditions necessary for the creditor to waive or release his security interest.<sup>91</sup> Under this scheme, the buyer will be liable to the agricultural lender only if he receives notice from the creditor and does not comply with the conditions imposed therein.

The preconditions for a creditor's waiver or release of his security interest take the form of payment obligations to be followed by the buyer. Typically, the payment obligation imposed by creditors will consist of a requirement that buyers tender payment in the form of a joint check made out to both the farm seller and the creditor. The joint check is an excellent safeguard for both creditors and buyers, for it releases buyers from security interests and gives creditors control, if they desire, over the proceeds from sales. Accordingly, one might assume that all agricultural lenders will insist on joint checks and all buyers of farm products will routinely pay by joint checks.

However, such a creditor-imposed payment obligation on purchasers might experience a high level of noncompliance under certain market conditions. This noncompliance is likely to occur when a farmer's yearly income is the result of a limited number of sales and the demand for a farmer's particular product is high. In such a case, the farmer may not want to be bothered with the requirement of clearing each sale proceed check with his creditor.<sup>92</sup> To avoid this obligation, farmers may seek out purchasers who will be willing to

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89. Food Security Act of 1985, Pub. L. No. 99-198, § 1324(e)(1)(A), 1986 U.S. CODE CONG. & AD. NEWS (99 Stat.) 1354, 1538.

90. Section 1324(h)(1) provides:

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.

*Id.* § 1324(h)(1).

91. *Id.* § 1324(e)(1)(A).

92. Uchtmann, *supra* note 7, at 1329.

make payments solely in the farmer's name. Due to the high demand for the farmer's product, buyers would be more likely to assume the risk of doing so.<sup>93</sup>

Likewise, an agricultural lender in a highly competitive credit market may decide not to require joint checks.<sup>94</sup> A reasonable farmer would certainly rather receive a check made out solely in his own name, than one which must be cleared with his creditors. All other things being equal, farmers would probably deal with the bank that did not require joint checks. Thus, to avoid losing potential farm accounts, agricultural lenders might assume the risk of a few defaulting debtors in order to keep their volume of business high.

Both lenders and buyers are free to determine whether the risk of potential business loss outweighs the risk of loss under the security agreement. If either party does not wish to assume the risk presented by disregarding the terms of the FSA, it has a means of protection in that statute.

Another important component of the creditor notification approach is found in section 1324(h)(1), which addresses the method by which lenders are to acquire a list of potential buyers. Under the creditor notification scheme contemplated by section 1324(h)(1), creditors must take the first step, by requesting farmers to provide lists of their prospective purchasers. Upon receipt of such a request, farmers must detail all those buyers to whom they expect to sell products in the upcoming year. This arrangement contains the disadvantage that creditors are subject to a farmer's diligence in providing accurate notice; creditors cannot obtain a list of prospective customers from a source other than the farmer. For this reason, farmers have the unilateral power to circumvent the notice requirement by selling products to a purchaser who does not appear on the list. How-

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93. When demand for a farmer's product is high, for example, the buyer may be willing to forego the protection afforded by joint checks if there is a very high profit potential. Likewise, if a selling agent faces damage claims to other buyers with whom he has contracted, the selling agent/buyer may be willing to make the farmer the sole payee and assume the risk that the farmer will transmit the sale proceeds to his creditor, if the buyer can thereby acquire the goods for a lower price.

94. In a highly competitive credit market, farmers might go to a different lender if the first demanded payments by joint checks. Under § 9-307(1) of the Code, lenders were in an ideal position. Because lenders could fall back against buyers of farm products if the farmers defaulted, lenders did not have to risk alienating farmers by demanding joint checks. Section 1324 of the FSA eliminates this extra protection that lenders enjoyed. Lenders must now demand joint payment or assume the risk of a defaulting debtor.

ever, section 1324(h)(3) should dissuade farmers from derailing the notification scheme in such a way.

Section 1324(h)(3) imposes upon farmers a fine, equal to the greater of five thousand dollars or fifteen percent of the value of the secured farm products, if they make unauthorized sales or do not account for the proceeds of a sale within seven days.<sup>95</sup> While the threat of a significant penalty such as this may be a successful deterrent in most cases, there undoubtedly will be times at which farm sellers will nevertheless make unauthorized sales.<sup>96</sup> That is, notwithstanding that a farmer disobeys the notice requirement, the farmer's creditor will lose his security interest. Therefore, creditors cannot fully protect their interests through a requirement that farmers provide them with the notice information, but are at the mercy of farmers' voluntary compliance.

A better solution would combine the creditor notification approach with a buyer inquiry approach.<sup>97</sup> Such an approach would be identical to the ordinary creditor notification system, with the additional proviso that for a purchaser to take free of a creditor's security interest, the purchaser must obtain from the farmer a sworn statement that the products are free of any security interest. By requiring farm products buyers to obtain such statements, the instances of farmer default on loan obligations would be further reduced. This is because under this combination approach, farmers would have to give false confirmations to both lenders *and* buyers before a default situation was established. Such an amendment to section 1324 was offered during Congress' discussion of the creditor notification system.<sup>98</sup> However, this amendment was not adopted because it would have resulted in a tremendous paperwork burden for buyers of agricultural products.<sup>99</sup>

Because the FSA requires creditors to rely upon farmers to see that their security interests are protected, it will be essential for agricultural creditors to establish trusting relationships with their farm

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95. If farmers make sales to unlisted buyers, they will be subject to the penalties unless they have notified the lender of the unauthorized sale at least 7 days prior to the sale, or have accounted for the proceeds of the sale within 10 days following the sale. Food Security Act of 1985, Pub. L. No. 99-198, § 1324(h)(2), 1986 U.S. CODE CONG. & AD. NEWS (99 Stat.) 1354, 1540.

96. Situations in which farmers are most likely to make an unauthorized sale include those times when: a farmer is desperate for operating cash; the lender has not fully informed the farmer of the significance of such sales; or the penalties are not stringently enforced.

97. See *supra* notes 70-71 and accompanying text.

98. H.R. REP. NO. 271, 99th Cong., 1st Sess. 430 (1985).

99. *Id.*

debtors. Lenders must stress to the farmer the importance of compliance with any security agreement, as well as the potential consequences of a violation. The greater risk that lenders must assume under the FSA will probably inhibit lenders from extending credit to those farmers with a poor credit history. However, once a lender does make a farm loan, his interests should be protected by the severity of the penalties for unauthorized sales, combined with the careful maintenance of agricultural loans.

The creditor notification approach is an acceptable and workable solution to the problems created by section 9-307(1). It is preferable to the original version of section 9-307(1) because it allocates risk to lenders, the parties who are in a better position to protect their interests than are buyers. However, the creditor notification system also presents several problems. Many of these problems can be solved by the adoption of a central filing system.

*B. The Central Filing System Approach Under Section 1324 of the Food Security Act of 1985*

Under section 1324 of the FSA, the status quo is that purchasers of farm products take free of creditors' perfected security interests. Under the central filing system approach, creditors may protect their security interests by filing effective financing statements<sup>100</sup> with the Secretary of State for each state in which their farm debtors sell their

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100. 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

products.<sup>101</sup> All purchasers of farm products are under an affirmative duty to check the state-maintained records to ascertain whether any financing statement has been filed for the particular goods they wish to purchase.<sup>102</sup> If a creditor has filed a financing statement for a particular type of goods, and if the buyer either fails to check the records, or checks them but disregards any payment instructions found in the search, the buyer takes subject to the creditor's security interest.<sup>103</sup>

The main advantage of the central filing system over the creditor notice system is that it removes the time and cost of having creditors send actual notice to all potential buyers of farm products. Instead, secured parties need only file effective financing statements or notices of such financing statements with the respective state Secretaries of State.

Once a secured party files or gives notice of an effective financing statement, the state Secretaries of State must compile the statements into a master list for each state.<sup>104</sup> To simplify the search process for buyers, the Secretaries of State must arrange the financing statements by type of farm product.<sup>105</sup> Furthermore, within each product type, the financing statements must be classified as follows: in alphabetical order according to the debtor's last name; in numerical order according to the debtor's social security or taxpayer identification number; geographically by county or parish; and by crop year.<sup>106</sup> State Secretaries of State must regularly distribute the lists to each buyer who has registered with the state.<sup>107</sup> In addition, those buyers who have

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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.

Food Security Act of 1985, Pub. L. No. 99-198, § 1324(c)(4), 1986 U.S. CODE CONG. & AD. NEWS (99 Stat.) 1354, 1538.

101. *Id.* § 1324(e)(2).

102. *Id.* §§ 1324(e)(2)-(e)(3).

103. *Id.*

104. *Id.* § 1324(c)(2)(C).

105. *Id.* § 1324(c)(2)(C)(i).

106. *Id.* § 1324(c)(2)(C)(ii). The requirement of four separate listings for each security interest is a desirable characteristic. To illustrate this point, separate listings should reduce the possibility of human error in the transmission of names and numbers. In addition, the multiple listings should help buyers in agricultural states with large numbers of farm debtors, in that the buyer will be able to quickly locate the security interest in question. Finally, the separate listings should prevent any confusion from occurring when a purchaser finds different farm debtors with the same name. The buyer will merely check the county or numerical listing to solve the confusion.

107. *Id.* § 1324(c)(2)(E).

not registered may receive the lists upon request.<sup>108</sup> Thus, under the central filing system, the buyer's search process is easily accomplished.

The obvious advantage of a central filing system is that it is much easier and quicker to use than any other approach. Modern technology can provide immediate access to the public filings through telephone services and computer terminals.<sup>109</sup> However, the initial cost of setting up an adequate system may deter some states from implementing this approach. In Ohio, for example, a centralized system was discarded because of timing and budgetary constraints.<sup>110</sup>

If the initial cost can be overcome, centralized filing will give both creditors and buyers a readily accessible medium through which they can keep track of security interests. This approach can allay any buyer or creditor worries of dishonest farm debtors by providing efficient access to credit information. The central filing system is also an equitable solution. It imposes an affirmative duty upon both creditors and buyers, and provides a reasonable means by which those duties may be fulfilled.

### C. *The Federal Solution's Effect on the Parties Involved*

Undoubtedly, buyers of farm products will benefit the most from section 1324 of the FSA. Buyers now have a simple and practical means of protection. No longer will they serve as guarantors of agricultural loans. Rather, the protection provided by the FSA will enable buyers to purchase farm products with the confidence that they will not be charged twice. As a result, competition in the farm product market will improve. This will have a positive effect on agriculture in general, in that farmers will be able to sell their products more readily.

The agricultural lender's risk has been increased by the FSA. Although lenders have reasonable and adequate means of protection, buyers of farm products will no longer provide the extra insurance that lenders previously enjoyed. This may affect to some degree the

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108. Section 1324(c)(2)(F) provides:

[T]he 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.

*Id.* § 1324(c)(2)(F).

109. Note, *supra* note 8, at 622.

110. *Id.* at 612.

extension of credit to farmers, in that creditors may refuse to lend money to some farmers to whom they otherwise would have extended credit, had the security of section 9-307(1) been available. However, it has been argued that farmers in states that had previously amended section 9-307(1) did not experience additional problems with obtaining credit.<sup>111</sup> It remains to be seen whether the actual effect of the FSA will be to restrict the availability of agricultural credit.

Under the FSA, lenders have an added incentive to more thoroughly scrutinize potential borrowers. Lenders will now be more cautious when offering credit to farmers who have little or no collateral for their loans.<sup>112</sup> While this may hurt some farmers, it could serve to strengthen the farm economy in general. Lenders will refuse loans to farmers if there is a substantial chance that the farmer will not be able to pay off the loans. A decrease in farm loans should reduce the quantity of farm products on the market, which in turn could increase the return per unit for farmers.

The FSA's solution to the section 9-307(1) problem will obviously affect farmers. While the market for their products may be strengthened by the increased protection for buyers, the cost of credit may also increase. Lenders will probably shift the increased risk that they have assumed onto the farmer in the form of higher interest rates.

Because farm products are typically used as security for short-term loan obligations, the FSA may decrease the supply of short-term agricultural credit. As pointed out earlier, lenders will be more cautious in offering credit to farmers with little or no collateral. This will most severely affect farmers with large amounts of existing debt, as well as young farmers who may be renting a farm to get started. The termination of short-term credit to poor farm managers may not, arguably, be undesirable. However, the young and unestablished farmer may also be hurt if the credit supply becomes tighter. Thus, the largest potential for damage lies with the struggling young farmer who is carrying large levels of debt. However, as also pointed out earlier, those states that have previously amended section 9-307(1) have not experienced additional problems with obtaining credit.

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111. H.R. REP. NO. 271, 99th Cong., 1st Sess. 430 (1985).

112. S. REP. NO. 147, 99th Cong., 1st Sess. 11 (1985).

### CONCLUSION

The farm products exception of UCC section 9-307(1) incited controversy for many years. The various state attempts to solve the problem it presented created nonuniformity and confusion. The passage of section 1324 of the FSA is an equitable solution to the discrimination that buyers of farm products experienced under the UCC. The risk of loss has been shifted from the buyer of farm products to the agricultural lender, but both parties are provided for adequately.

Of the two alternatives given under section 1324, the central filing system seems to carry the most potential for success. While there undoubtedly will be some problems with the newly adopted solution, time should prove that section 1324 is superior to the old law under the UCC and the fragmentary state solutions.

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