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Factsheet, Series: 2022

USDA National Agricultural Library
UNITED STATES DEPARTMENT OF AGRICULTURE

This material is based upon work supported by the National Agricultural Library, Agricultural Research Service, USDA

Figuring the Federal Farm Products Rule

Introduction

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In order to operate, agricultural producers typically borrow money from banks or other lenders. When doing so, the lender will take a security interest in the commodity being financed. A security interest is an interest held by a creditor in property, referred to as "collateral," that has been pledged by a debtor. This interest allows the lender to take possession or sell the collateralized property if the debt is not repaid.

In some situations, a debtor sells collateral that is subject to a creditor's security interest. This occurs frequently in agricultural finance where farm products are serving as collateral for a loan because a farmer-debtor typically sells their products to receive proceeds that are used to repay their loan debt. In these instances where a buyer purchases farm products that are secured by a creditor's loan, a federal law called the Food Security Act of 1985 ("FSA") applies to the transaction[1].

The FSA established a rule known as the "federal farm products rule" which allows a buyer in the ordinary course of business purchasing a farm product from a seller engaged in farming operations to take the product free and clear of a security interest, even if the interest is perfected and the buyer knows of its existence[2]. In general, if a buyer of farm products meets the requirements of the farm products rule, a creditor's security interest will not follow the farm products purchased unless the creditor puts the buyer "on notice" of its interest in farm products. In other words, creditors and buyer must satisfy their individual requirements under the farm products rule in order to protect themselves financially.

[1] A "farm product" means an agricultural commodity, livestock, or products of crops or livestock in their unmanufactured state which are used or produced by a debtor engaged in a farming operation. *See* 7 U.S.C. § 1631(c)(5).

[2] 7 U.S.C. § 1631 (2018).

The *Figuring the Federal Farm Products Rule* fact sheet series focuses on how the federal farm products rule operates and the legal issues that can arise between creditors and buyers when collateralized farm products are sold. Each fact sheet covers different provisions of the farm products rule and explains how courts have previously ruled on certain legal issues under the federal law.

The first fact sheet provides a general overview of the farm products rule and introduces readers to the two different types of notice systems that operate throughout the country: direct notice and centralized filing. This fact sheet explains the differences between each type of notice system and the different compliance standards creditors must satisfy in order to fully comply with the FSA.

The second fact sheet explains when a creditor's notice expires and when a creditor waives their right to enforce an interest in farm products. As explained in this fact sheet, notice expiration and waiver each allow a buyer to take farm products free of a creditor's security interest. The third fact sheet discusses the transactional requirements specified under the farm products rule. Specifically, this fact sheet explains that a sale of farm products must actually occur, and the seller of those goods is the debtor who created the security interest in the products. If these two requirements are not met, the farm products rule does not apply to a transaction.

The fourth fact sheet describes the type of parties which are protected under the farm products rule. Essentially, this fact sheet explains the requirements that farm products purchasers must satisfy in order to be a protected buyer under the FSA. Last, the fifth fact sheet looks at two issues that may affect a creditor's and buyer's ability to gain FSA protection when conducting complex transactions. Specifically, it discusses how creditors and buyers determine which state's notice system applies to a transaction. Also, this fact sheet explains the rights a buyer has to use farm products to off-set contract obligations the seller-producer failed to fulfill.

Because many producer's farm products are secured as collateral for a loan, creditors and farm product purchasers must understand how the federal farm products rule operates, what requirements the rule places on each party, and how they comply with those requirements. Parties that do not consider the farm products rule and its requirements when securing or purchasing farm products may risk the ability to adequately protect themselves financially. While this fact sheet series provides general information on the federal farm products rule, it does not replace the need to seek legal advice from an attorney licensed to practice law in the relevant jurisdiction before decisions are made. Accordingly, please consult with an attorney in your jurisdiction to learn more about the specifics of your situation as it relates to the federal farm products rule.