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Figuring the Federal Farm Products Rule

Notice Expiration & Waiver

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I. Introduction

The Food Security Act of 1985 ("FSA") established a rule known as the federal farm products rule that affects both creditors and buyers of farm products. Before the protections of the rule take effect, however, notice of a creditor's security interest must be given. Although it is important to provide a notice that contains all the required information under the FSA, the federal statute also contains other rules that affect both creditors and buyers of farm products. Specifically, provisional rules are important because they determine whether the FSA applies to a buyer's purchase of collateralized farm products. This fact sheet will discuss two important aspects of the farm products rule: 1) notice expiration, and 2) how creditors waive their right to enforce their security interest in farm products against a buyer.

A. Federal Farm Products Rule

The farm products rule allows a buyer in the ordinary course of business purchasing farm products from a seller engaged in farming operations to take the product free and clear of a creditor's security interest, even if the interest is perfected and the buyer knows of its existence. Before the enactment of the FSA, buyers of farm products often purchased farm products that were collateral for a secured creditor's loan. Because a creditor's interest followed the farm products, several buyers of farm products assumed the risk of paying twice for the same goods, once to the seller and once to the secured creditor. Thus, Congress enacted the federal farm products rule to protect farm product purchasers from this risk.

In general, if a buyer meets the requirements of the farm products rule, a creditor's security interest will not follow the farm products purchased unless the creditor put the buyer "on notice" of its interest in the farm product. In other words, whether a buyer of farm products in the ordinary course of business takes the goods subject to a creditor's security interest primarily depends on whether the creditor complied with the notice requirements under the FSA. When the federal farm products rule took effect in 1986, states were given two options: implement a centralized filing system or follow a direct notice system.

1. Statutory Notice Requirements

In a state that follows the direct notice system, a secured creditor must send the buyer of farm products a written notice that includes the list of specific information contained under §1631(e). If a creditor provides direct notice to a buyer one year before the farm products are sold, the creditor's security interest will continue to follow the collateral. States operating a central filing system allow a secured creditor to file an "effective financing statement" ("EFS") or send direct notice to a buyer, as explained under §1631(c)(4). If filing an EFS, creditors must include the same information as required for a direct notice, and it must be filed with the Secretary of State's office to be effective. Thus, before purchasing farm products in a state that operates a central filing system, the buyer is expected to review the list to determine whether the goods are subject to a creditor's security interest. The notice requirements are outlined in more detail as part of the first fact sheet in this series.

2. The Primary Issue

In §1631 cases, the primary issue parties litigate is whether the creditor provided proper notice to a buyer of farm products. If a creditor provided notice, then their security interest followed the farm products after the sale, and the creditor can collect the unpaid money from the buyer. If the creditor did not provide notice that complied with the FSA, then the creditor's security interest did not follow the farm products after the sale and cannot receive payment from the buyer. As a result, providing a detailed notice to the buyer that includes the items listed under §1631 is necessary.

Although it is important to provide a notice that contains all the required information under the FSA, the federal statute contains other rules that also affect a creditor's direct or central filing notice. Specifically, these provisional rules are important because they determine whether the FSA applies to a buyer's purchase of collateralized farm products. Like §1631's notice requirements, creditors must pay special attention to the other FSA provisional rules in order to satisfy their obligations under the federal law to continue holding their security interest after farm products are sold. If a creditor overlooks these requirements, they risk losing their security interest in collateralized farm products.

II. Discussion

A. Additional FSA Notice Requirements

In the majority of cases, a creditor's security interest will follow collateralized farm products after a sale when they comply with the requirements under §1631. In some instances, however, a creditor risks losing their interest in farm products even when they provide a farm products purchaser with a notice that contains all the information required under the FSA. Complying with the notice requirements under §1631 requires more than simply including accurate information. Creditors must take into consideration the timing of their notice, and the actions they take while managing a debtor's loan. Otherwise, they can lose a perfected security interest in farm products.

1. Notice Expiration

As previously discussed, the FSA established two separate types of notice. Section 1631(e) provides the requirements creditors must follow in direct notice states, while §1631(c)(4) offers the notice requirements creditors must satisfy in central filing system states. They are discussed separately because each type of notice requires creditors to accomplish different tasks when providing proper notice to a farm products purchaser.

Section 1631(c)(4) contains language that details the specific requirements a creditor must satisfy in a central filing system. The central filing section expressly states what a creditor must do to comply with the notice requirements for that type of notice system. However, §1631(e) uses very different, and somewhat vague, language to explain the requirements a creditor must satisfy in a direct notice state. Because some requirements are unclear, creditors may not know how to properly comply with the direct notice section.

Understanding the notice requirements is important because a creditor may lose their security interest in farm products when they do not comply with the FSA. An important requirement for both types of notice is the effectiveness period and expiration of a creditor's notice. Both notice sections have different requirements for effectiveness and expiration, and each use different language explaining the requirements.

For a notice in a central filing system state, §1631(c)(4) expressly states the specific time periods which creditors must file their EFS to have an effective security interest. Under this section, an EFS "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."[1] The language used in this section clearly describes when a creditor's EFS becomes effective, when it expires, and how a creditor can extend the period.

Unlike the central filing section, §1631(e) does not expressly define when a creditor's direct notice becomes effective or when it expires. The direct notice section states that "buyers take subject to a security interest if they receive a direct notice . . . within one year before the sale."[2] This phrase does not expressly describe when a direct notice expires. Accordingly, determining what a creditor must do to comply with this direct notice requirement has been left up to the courts.

When a statute contains a phrase that does not expressly define a requirement, courts must consider what Congress intended when enacting the statute. To determine the effectiveness period and expiration date Congress intended for a direct notice, courts have reviewed the meaning behind the farm products rule statute. The analysis went something like this. 1) Congress enacted §1631 to protect buyers of farm products from double payment. 2) To accomplish this, Congress required creditors who held security interests in farm products to provide notice to buyers of this interest.

With these thoughts in mind, although §1631(e) does not expressly define an expiration date, courts have ruled that Congress intended direct notice should expire, because this advances the goal of protecting buyers of farm products. There are two reasons for those rulings. First, Congress established an expiration date for central filing system notices. As stated in the statute, an EFS expires five years from the date of filing. Courts believe Congress did not intend for one type of notice to expire while another type would not. Because Congress provided an expiration for central filing notices, courts conclude that Congress also set an expiration for direct notices.

Second, courts acknowledged that Congress included the phrase "within one year before the sale" in §1631(e) to set an expiration for direct notice. Courts have determined that this phrase established an expiration for direct notice because it allows a creditor's notice to be effective against a buyer if the notice was received within one year before farm products were sold. In other words, a creditor's direct notice will expire one year from the date the buyer received the notice. Thus, a creditor cannot rely on a single notice when a buyer makes purchases after the one-year period. Creditors must send additional direct notices to a buyer when they purchase farm products for longer than one year.

[1] 7 U.S.C. § 1631(c)(4)(E) (2018).
[2] *Id.* § 1631(e)(1)(A).

For example:

Example 1: Felix Farmer obtained a loan from Hometown Bank, and Felix provided the Bank with a security interest in his hogs. The two parties signed a security agreement and the Bank sent direct notice of this security interest to Bonnie Buyer. Bonnie received this notice on April 2, 2018. The notice informed Bonnie that she could extinguish the Bank's security interest if she issued checks jointly to Felix and the Bank whenever Bonnie purchased Felix's hogs. For the next three years, Bonnie made checks payable to both Felix and the Bank each time she purchased Felix's hogs. On April 17, 2021, Bonnie began writing checks payable only to Felix when purchasing his hogs. The Bank filed suit against Bonnie to recover the amount of the checks she had not written jointly.

If the only notice Hometown Bank sent to Bonnie was the original notice, the Bank would likely lose in this case[3]. Without providing additional notices to Bonnie each year, the Bank's notice lapsed and its security interest in Felix's hogs was extinguished. This is because the Bank's notice was only effective one year from the date Bonnie received the notice. Because Bonnie received the Bank's notice on April 2, 2018, that notice had no effect for any purchases she made after April 2, 2019.

Section 1631(e) requires creditors to send a direct notice one year before a purchase is made to retain their security interest. According to the facts, Bonnie purchased Felix's hogs after April 2, 2019. However, she did not receive a notice from the Bank within one year before making any purchase after this lapse date. Because Bonnie did not receive any other notice from the Bank after the original notice expired, the Bank's security interest did not continue in the hogs purchased after April 2, 2019. Therefore, Bonnie would not be liable to the Bank for the checks she made payable solely to Felix.

The example above demonstrates that creditors must not only include accurate information in their notice, but must also provide notice within specific timeframes. If a creditor allows their notice to lapse, their rights to payment from a buyer of secured farm products are lost, because their security interest is no longer effective. As a result, creditors must pay special attention to the date an EFS was filed or a direct notice was received by a buyer.

To fully protect their interest, creditors in a direct notice system may want to send a subsequent notice to a buyer well before the earlier notice expires. This is because the expiration date does not depend on when the creditor sent the notice, but rather when the buyer received the notice. As a result, it is important to have some overlapping time for the buyer to receive the notice before an earlier notice expires. If an earlier notice

[3] Facts in the example from *First Midwest Bank, N.A. v. IBP, Inc.*, 314 Ill. App. 3d 255, 731 N.E.2d 839 (2000).

expires and the buyer makes a purchase of secured farm products before receiving the creditor's subsequent notice, the creditor's security interest does not follow that purchase of farm products. Accordingly, knowledge of the exact date the buyer received the original notice is useful to a creditor.

Knowing the date the buyer received the notice is important because the direct notice expiration date depend solely on the date the notice was received by the buyer. To determine the exact date a buyer received the notice, a creditor may choose to send every notice by certified mail. If a creditor sends their notice by certified mail, they will receive proof of mailing and a verification that the notice was delivered. The delivery date provides the creditor with the date the buyer received the notice. Therefore, the creditor can use this date to ensure they send each subsequent notice to the buyer before the earlier notice expires.

2. Waiver

After notice is sent or filed, the creditor still has responsibilities to ensure their security interest in the farm products is protected. Sometimes, the creditor waives their security interest in the farm products when they fail to properly manage the transactions between the debtor and buyer. Based on a creditor's actions, a buyer may take the purchased farm products free of a security interest, even if they received accurate and timely notice from the creditor.

Since the enactment of the federal farm products rule, creditors and buyers have litigated many legal issues under the FSA. Most of these cases only deal with legal issues that can be resolved by examining the federal statute itself. However, as more FSA cases have been brought to the courts, other areas of law have come with them. One particularly important area of law is whether a state's waiver law can be used in an FSA case. While creditors have tried to claim that state waiver laws are preempted by the FSA, courts have consistently ruled that state law can be used in these cases. In other words, the FSA does not bar a litigant's ability to use state waiver law in an FSA lawsuit.

Although a buyer may use a state law waiver defense in an FSA case, courts have recognized some limitations. Each state has its own waiver laws, so courts had to decide which state law a buyer may use. Courts require a buyer to use the law of the state where they purchased the farm products. For example, if a buyer purchased cattle from a rancher in Montana, then Montana's implied waiver law applies to that case.

There are situations where a buyer will not be able to use a waiver defense. For example, some states have not enacted a waiver defense law. When a buyer purchases farm products in one those states, an implied waiver defense is unavailable. Also, a few states have created laws that do not allow farm products purchasers to use a waiver defense in FSA cases. Thus, a buyer may only rely on a waiver defense when the state has enacted a waiver law that permits the buyer to raise the defense.

Although courts permit buyers to raise a state's waiver defense in an FSA case, a buyer must have an actual basis for using the defense. Typically in farm products rule cases, a creditor will claim conversion has taken place where 1) a buyer makes payment payable only to the seller; 2) the buyer takes possession of the farm products; and 3) the creditor holds a valid security interest in the products, as determined by the federal farm products rule. Legally speaking, the creditor claims the buyer's possession of the collateral interferes with its rights to enforce its security interest against the seller-debtor. As a result, the creditor demands payment for the sale from the buyer.

To counter the creditor's conversion claim—and avoid paying twice for the same farm products—the buyer may claim the creditor waived their rights in the products. When the buyer raises a waiver defense, the buyer claims the creditor waived their right to hold a security interest in the farm products. If the buyer proves a waiver occurred, then the creditor's security interest did not follow the products sold to the buyer. Accordingly, the creditor cannot recover payment from the buyer for the sale.

In general, waiver occurs when someone voluntarily releases a known legal right. Courts have different standards on what buyers must demonstrate to prove a creditor's conduct waived their rights in the farm products. In some states, courts require the buyer to prove the creditor had knowledge of the transactions that violated the security agreement or notice, but chose to let the sales continue. Other courts require that the buyer to show the creditor's conduct clearly demonstrates an intent to waive their rights. Under any standard, the buyer must provide the court with enough proof to show the creditor impliedly waived their security interest in the farm products.

An individual waives their rights expressly or impliedly. An express waiver occurs when a person clearly states, orally or in writing, that they are waiving their rights. An implied waiver is based on an individual's conduct. When a person acts in a way that contradicts their legal rights, another party may infer the person has impliedly waived their rights.

Most often, when the buyer can use the defense in an FSA case, the buyer will raise an implied waiver defense. It is rare for creditors to expressly waive their security interest in collateralized property. This is because creditors sign security agreements and provide written notices that clearly state they are holding a right in a debtor's farm products. Thus, buyers rely on an implied waiver defense to show the creditor waived their security interest.

To establish a successful implied waiver defense, the buyer must prove the creditor's conduct voluntarily waived their security interest rights by their conduct. In other words, the buyer must show the creditor acted in a way that infers they did not intend to enforce its security interest against the debtor or buyer. The buyer may prove this by showing the creditor allowed the debtor and buyer to transact in a way that violated the creditor's security interest. The debtor and buyer violate the creditor's interest when they do not follow the terms of the security agreement and direct or central filing notice. If the creditor does not enforce the agreement or notice terms against the debtor and buyer, the creditor is allowing the parties to violate its interest in the farm products being sold. Therefore, the buyer can show the creditor impliedly waived their security interest by not requiring the parties to obey the terms of the agreement or notice when conducting transactions of secured farm products.

Some examples of this are as follows:

Example 2: Roy Rancher obtained a loan from Farm Credit Bank ("FCB"), and granted FCB a security interest in his cattle. Roy and FCB entered into a security agreement for the loan. The agreement contained a provision that required Roy to obtain prior written consent from FCB before selling any of the collateralized cattle. After Roy signed the agreement, FCB sent an accurate and timely direct notice to the Stockyard, who regularly purchased Roy's cattle. The notice informed the Stockyard that FCB held a security interest in Roy's cattle and instructed the Stockyard that it could protect itself from this security interest if the Stockyard made all checks jointly payable to Roy and FCB when purchasing cattle. For several months afterward, Roy failed to obtain prior written consent before selling his cattle to the Stockyard, and the Stockyard did not make checks payable to the bank on any purchase. During this time, FCB became aware of the transactions because Roy orally informed an FCB executive that he was selling his cattle to the Stockyard, and Roy was also directly applying the checks he received from the Stockyard to the loan with FCB. Eventually, however, Roy stopped paying on FCB's loan. Every Roy-Stockyard transaction occurred in the same state, and that state permits an implied waiver defense.

If FCB brought this case[4] before a court, it would likely lose. The state where the cattle where purchased has an implied waiver law, which allows the Stockyard to raise the defense against FCB. Because the Stockyard can use an implied waiver defense, the Stockyard must convince the court that FCB's conduct results in a waiver of their security interest in Roy's cattle.

Based on the facts in the example, the Stockyard can probably make a strong argument that FCB impliedly waived its security interest. For several months, FCB allowed Roy and the Stockyard to violate FCB's security interest by allowing them to transact without obeying the terms of the security agreement or direct notice. FCB knowingly permitted these transactions to occur because Roy directly applied the checks to his loan, and Roy clearly informed FCB about the violating sales. As a result, the Stockyard

[4] Facts in the example from *Mercantile Bank of Springfield v. Joplin Regional Stockyards, Inc.*, 870 F. Supp. 278 (W.D. Mo. 1994).

can show that FCB voluntarily waived its rights because it had knowledge of the sales, but failed to object to any of the transactions.

If FCB, after learning about the sales, immediately sued the Stockyard for conversion, then a court may find FCB did not waive its security interest. Suing the Stockyard after violating the terms of the direct notice would show that FCB was not waiving its security interest in the cattle. However, based on its actions, FCB waived its interest by not enforcing its security interest against the Stockyard. Therefore, the Stockyard took the cattle free of FCB's security interest and would not owe FCB payment for any purchase of Roy's cattle.

Example 3: Agri Bank lent money to Claire, a crop farmer, and took a security interest in all of her crops. The parties signed a security agreement which stated "Claire must get Agri Bank's consent before selling any secured crop." After this, the Bank filed an effective financing statement ("EFS") with the state's Secretary of State office. Penny Purchaser, a registered buyer of farm products in the state, contracted with Claire to purchase her corn. Penny reviewed the master list of EFS's filed within the state and noticed the Bank's security interest in Claire's corn. However, each time Penny purchases corn from Claire, she only makes checks payable to Claire without including Agri Bank as a payee. Also, Claire never receives the Bank's prior consent before selling her corn, but she does apply every check from Penny directly to her loan with the Bank.

Later, Claire asked the Bank if she could borrow more money. While discussing the loan with the Bank's loan officer, Claire mentioned the transactions with Penny. Claire also explained she always makes timely payments on her current loan balance because Penny continuously purchases her corn. The Bank decided to lend Claire more money. For several months, Penny continues to purchase corn from Claire as usual. However, Claire eventually faces financial stress and stops paying her loans with the Bank. Because Claire's loan debt is unpaid, the Bank sued Penny for conversion to recover the purchase amount Penny paid for the secured corn.

Penny purchased corn from Claire in only one state, and that state recognizes a waiver defense law, but has also passed a statute that states "an interest in farm products cannot be waived as a result of conduct, performance, or dealing between parties when a secured party has filed an effective financing statement."

This case[5] is very similar to the previous one. However, the Bank would likely win its conversion claim against Penny. Similar to the previous example, Claire is violating the terms of the security agreement, and Penny is violating the terms of the Bank's notice. Additionally, the Bank is aware of the transactions, but fails to enforce its security

[5] *AG Services of Am., Inc. v. United Grain, Inc.*, 75 F. Supp. 2d 1037 (D. Neb. 1999).

interest against Penny. But these facts do not help Penny overcome the Bank's conversion claim because she cannot assert an implied waiver defense.

Although the state allows an implied waiver defense, the state has enacted a statute that limits the use of this defense in certain cases. The statute prohibits implied waiver because it states mentions "conduct, performance, or dealing" will not constitute a waiver. Implied waiver requires the buyer to show the creditor's actions inferred a voluntary release of their security interest. Thus, when a creditor files an EFS, their actions will not waive their security interest in the secured farm products and the buyer cannot rely on the defense.

Also, the statute is specifically directed towards FSA cases. The statute does not allow "an interest in farm products" to be impliedly waived. When a party has a security interest in farm products, the FSA applies. Accordingly, the state statute was enacted to prevent a buyer from raising a waiver defense in an FSA case.

Based on the Bank's conduct, it seems possible it waived its security interest. However, Penny cannot claim an implied waiver defense because the Bank satisfied the two requirements under the statute. The Bank has an interest in farm products—Claire's corn—and filed an EFS. Because of this, the Bank's dealings, conduct, or actions cannot be used by Penny to show the Bank waived its interest. Therefore, the Bank's security interest followed Claire's corn and Penny is liable for the purchase amount.

The two previous examples demonstrate the importance for creditors to continuously manage their security interests in farm products. In both examples, the state's waiver law dictates whether an implied waiver defense can be used by the buyer in an FSA case. Some states will allow buyers to raise an implied waiver defense, while others may have a statute specifically prohibiting the defense in FSA cases. This is important because if a buyer is permitted to raise an implied waiver defense and succeeds, the creditor's opportunity to receive payment from the buyer is destroyed. However, creditors can likely avoid waiving their security interests by sending or filing proper notice, keeping track of their debtor's transactions, and enforcing the terms of their agreements and notices.

III. Conclusion

Generally, a creditor who complies with the notice requirements under §1631 will hold a security interest in farm products after a sale. However, simply sending direct notice or filing an EFS will not allow a creditor to completely comply with the requirements under the federal statute. It is necessary for a creditor's notice to be timely, and ensure that the notice does not expire. Additionally, a creditor must actively manage their debtor's loan and act if a party is violating their interest in secured farm products. If a creditor fails to comply with each of these things, they can lose a perfected security interest in farm products.

A checklist for working through federal farm products rule legal issues

The issues discussed in this fact sheet have been condensed into a checklist to aid in working through federal farm products rule issues. It is not a complete list of every legal issue that can arise under §1631, but it aims to provide a good starting point. Remember, courts in different jurisdictions have adopted different compliance standards for the notice systems. Before decisions are made, you should seek legal advice from an attorney licensed to practice law in the relevant jurisdiction to review your situation and reduce your legal risk.

❶ Determine whether a state operates a direct notice or central filing system.

- If a seller-debtor is offering secured farm products for sale in a direct notice state, a creditor should send a written notice directly to each potential buyer of the goods.
- If farm products are offered for sale in a state that operates a central filing system, a creditor should file an effective financing statement (EFS) and a buyer should register as a purchaser with the state's Secretary of State.

❷ Make sure a notice contains all necessary and accurate information.

- If not, a creditor's notice may not comply with the FSA and their interest will likely not follow secured farm products sold to a buyer.

❸ Keep track of notice expiration dates.

- For direct notice, a creditor's notice will expire one year from the date the buyer received the notice, so a creditor must send an additional notice if they purchase farm products for longer than a year.
- For central filing systems, an EFS remains effective for five years from the date of filing, and a creditor can extend the effectiveness for additional periods of five years by refiling an EFS or filing a continuation statement within six months before the expiration of the initial five-year period.

❹ Creditors should avoid actions that infer they waive their enforcement rights.

- Creditors must actively enforce the terms of their agreements and notices to ensure they retain the right to enforce their security interest in farm products against a buyer.

❺ Before purchasing farm products in a central filing system state, buyers should review the state's EFS filing list.

- This allows buyers to discover possible security interest in the farm products they consider purchasing.