



Figuring the Federal Farm Products Rule

Buyer Qualifications

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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 address the types of buyers that are protected under the farm products rule and the requirements these parties must satisfy in order to qualify as a protected buyer under the FSA.

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.

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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 affect both creditors and buyers of farm products. Specifically, these provisional rules are important because they determine whether the FSA applies to a buyer's purchase of collateralized farm products. Creditors and farm products purchasers must pay special attention to the other FSA provisional rules in order to satisfy their obligations under the federal law to protect their interests in farm products. If a creditor overlooks these requirements, they risk losing their security interest in collateralized farm products. Alternatively, if a buyer overlooks these requirements, they risk having to pay twice for the same farm products, once to the seller and once to the secured creditor.

II. Discussion

A. FSA Protected Parties

There are many different parties and entities involved in transferring and purchasing farm products, but §1631 only extends protection to certain purchasers of farm products. In general, the farm products rule statute protects buyers in the ordinary course of business. Additionally, in some cases, the federal statute applies to transactions involving commission merchants and selling agents. Because protection extends to



each of these parties, they have the opportunity to take farm products free of a creditor's security interest. However, a party must satisfy certain requirements under the FSA to receive this protection.

1. Buyers in the Ordinary Course

The farm products rule was enacted to protect buyers of farm products, but not just any buyer. Congress aimed to protect the type of buyers who are the most vulnerable to double payment for the same farm product. In other words, the type of buyers that unknowingly violate a creditor's security interest rights when they purchase the farm products. Thus, Congress extended FSA protection to buyers in the ordinary course of business ("BOCB").

Under the federal statute, a BOCB is a person who purchases farm products for business purposes from an agricultural producer who sells farm products.¹ The FSA does not specify what course of business a buyer must conduct to qualify as a BOCB. Because of this, several different business-related transactions fit under §1631's definition of BOCB. Thus, when a business-related purchase of a producer's farm products occurs, the purchaser likely qualifies as a BOCB, and will gain certain protections for their purchase of farm products. Overall, when a BOCB does not receive proper notice from a creditor with an interest in the purchased farm products, a buyer takes the farm products free of a security interest.

For example:

Example 1: Gina, a wheat farmer, visits Ag Credit Bank ("ACB") to finance the upcoming 2020 crop season. ACB provides Gina with a \$100,000 loan and takes a security interest in all of Gina's 2020 wheat crops. The next day, ACB perfects this interest by filing a financing statement. Two weeks later, Gina contracts with Blake to sell him all of her 2020 wheat crop at \$7 a bushel. Blake is in the business of purchasing and reselling farm products to various different buyers. Because Gina sells her farm products in a state that operates a direct notice system, ACB sends Blake a direct notice. This notice informs him that ACB holds a security interest in Gina's 2020 wheat crop. While the notice includes all correct information, but ACB did not indicate which county Gina's farm products were produced or located.

Gina produces 10,000 bushels of wheat and sells all of the wheat to Blake. Blake issues a \$70,000 check payable only to Gina, not ACB. Ultimately, Gina did not use the money to satisfy her debt with ACB and filed for bankruptcy. Because ACB did not receive the proceeds from Gina's 2020 wheat crop, the bank files a lawsuit against Blake to recover the \$70,000 purchase price of Gina's wheat.

In this case, the court will most likely determine that Blake is in fact a BOCB. To determine whether Blake's purchase of Gina's wheat is subject to the bank's security interest, the court would consider whether Blake satisfies the definition of a BOCB under

¹ U.S.C. § 1631(c)(1) (2018).



§1631(c)(1). Under the facts in the example, Blake qualifies as a protected buyer under the federal statute because:

- (1) He purchases wheat—a farm product;
- (2) For a business purpose—to resell the wheat to other farm product purchasers; and
- (3) From Gina—a farmer who sells farm products.

Here, Blake satisfies the definition of a BOCB under §1631, and is protected under the FSA. Because he's a BOCB, ACB was required to provide Blake with direct notice complying with §1631(e). If ACB did so, its security interest followed the wheat after being sold and Blake is liable to the bank for the purchase price of the goods. On the other hand, if ACB's notice did not comply with the federal statute, Blake took Gina's wheat free and clear of ACB's security interest and does not owe the bank for his purchase of the wheat.

There is a split in the courts on what constitutes compliance under the federal statute. Some courts only require a creditor's direct notice to "substantially comply" with the notice requirements provided in §1631(e), which other courts require a creditor's notice to "strictly comply" with each item of information identified under the statutory provision. If ACB filed this lawsuit against Blake in a court that follows the substantial compliance standard, it is likely ACB's notice complied with the FSA. Even though ACB's direct notice did not indicate which county Gina's wheat was produced or located, which is required under §1631, the notice made Blake aware of ACB's security interest in the wheat. Because ACB notified Blake of its interest, a substantial compliance court would likely conclude ACB's direct notice complied and Blake is liable to ACB for the purchase price of Gina's wheat.

Alternatively, if ACB filed this lawsuit in a court that follows the strict compliance standard, it is unlikely ACB's notice complied with the FSA. In the example, ACB's direct notice did not include each item of specific information §1631(e) requires. Because ACB did not indicate the county where Gina's wheat was produced or located, it did not strictly comply with the FSA, which means ACB's security interest did not follow the wheat once Blake purchased the goods. Therefore, Blake would most likely not be liable to ACB for the purchase price of Gina's wheat in a strict compliance court because he qualifies as a BOCB and did not receive a direct notice which complied with the federal statute.

2. Other Protected Purchasers

Aside from BOCB, the FSA also extends protection to commission merchants and selling agents.² Under §1631, a "commission merchant" is "any person engaged in the business of receiving any farm product for sale, on commission, on for or on behalf of another person."³ An example of this type of party would be a grain elevator company buying a farmer's commodity. The federal statute defines "selling agent" as "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."⁴ In most

² *Id.* §1631(g).

³ *Id.* § 1631(c)(3).

⁴ *Id.* § 1631(c)(8).



circumstances, selling agents help conduct the marketing and selling of a producer's commodity. Individuals and entities that satisfy these definitions under §1631 will gain the same FSA protections provided to BOCB.

3. Creditors as Farm Products Purchasers

In some instances, an individual or entity who qualifies as a protected party under the FSA is also a creditor of the farm products seller. Because of the nature of the agricultural industry, some individuals and entities purchase farm products from the same producer-sellers they extend credit to. Usually, this does not prevent a farm products purchaser from receiving FSA protection. If an individual or entity purchases farm products as a protected buyer under §1631, and not within the capacity as a creditor of the seller, they will most likely have protection under the federal statute. However, when a purchaser performs creditor-like activities when purchasing farm products, they risk losing protection under the FSA.

In general, a BOCB is protected by the FSA, but loses this protection when it acts as a creditor. Most of the courts that have examined this issue have recognized a distinction between someone's actions as an FSA-protected buyer and their actions as a creditor. These courts have recognized that a BOCB is acting as a creditor. Generally, this distinction occurs when they retain the sale proceeds to satisfy a debt owed by the seller. This occurs when an individual or entity takes farm products without issuing payment to the seller, resells the products to other buyers, and then retains the proceeds they earned to satisfy an outstanding debt owed by the seller. Accordingly, these individuals or entities are not "buying" farm products because they are taking the goods from the seller to satisfy a preexisting debt of the seller.⁵ Thus, courts have determined these individuals and entities are excluded from the definition of a BOCB under §1631, and will not have FSA protection.

Nevertheless, these individuals and entities that are creditors of the seller can still gain protection under the FSA when they do not take farm products to satisfy the seller's debt. Instead of retaining the proceeds to offset the seller's debt, they must pay the full amount owed to the seller for the sale of the products. When an individual or entity actually pays the seller for the goods, they are "buying" farm products and can qualify as a protected purchaser under the FSA. Therefore, farm products purchasers who are also creditors of the seller must keep their buying and lending transactions separate to be considered a protected buyer entitled to FSA protection.

⁵ See *Fin-Ag, Inc. v. Pipestone Livestock Auction Mkt., Inc.*, 2008 S.D. 48, 754 N.W.2d 29, certiorari denied 129 S.Ct. 2859, 557 U.S. 934, 174 L.Ed.2d 575.



An example of this is as follows:

Example 2: On January 15, 2020, Crop Credit Bank (“CCB”) loans money to Rick, a rice farmer, for farm inputs and takes a security interest in his 2020 rice crop. The next day, CCB perfects its security interest by filing a financing statement. In the loan agreement with CCB, Rick identifies Farm Grain Company (“FGC”) as a potential purchaser of his 2020 rice crop. However, CCB does not provide FGC with a notice of its security interest in Rick’s rice.

On February 1, FGC provides farm inputs to Rick on credit, takes a security interest in his 2020 crop, and perfects its interest by filing a financing statement. A week later, FGC enters into a contract to purchase all of Rick’s 2020 rice crop for \$250,000. On September 10, Rick delivers all rice due under the purchase contract. In October, FGC sells the rice to other individuals. When FGC receives the proceeds from selling the rice, Rick has still yet to pay FGC for the inputs. Instead of transferring the \$250,000 due to Rick under the crop purchase contract, FGC keeps the proceeds and applies the funds to Rick’s unpaid debt.

Unfortunately, Rick is unable to satisfy his loan with CCB and files for bankruptcy in December. Subsequently, CCB files a lawsuit against FGC to collect the \$250,000. CCB claims it has a superior right to the proceeds over FGC because FGC is not a protected purchaser under §1631, and it perfected its interest before FGC. In defense, FGC claims it qualifies as a BOCB under §1631 and has a superior interest in the proceeds because CCB did not send a notice as required under the federal statute.

In this example⁶, most courts would likely determine FGC is not protected by the FSA because it transacted with Rick as a creditor. Here, FGC qualifies as a protected buyer under §1631 because it: (1) purchased rice—a farm product, (2) for a business purpose—to resell the goods for a profit, and (3) from Rick—a farmer who sells farm products. Because the FGC qualifies as a BOCB, it would usually gain FSA protection. Unlike most BOCB, however, FGC transacted with Rick as a creditor rather than a protected buyer. Thus, courts would likely conclude FGC is not protected by the federal farm products rule.

Most courts would recognize FGC acted like a creditor, rather than a BOCB, because FGC did not pay Rick for the rice it took. Instead, FGC used the proceeds it earned from selling the rice and applied it to the unpaid debt Rick owed FGC for the farm inputs. In other words, FGC did not “buy” the rice from Rick because it did not pay for the rice by using the proceeds to satisfy Rick’s preexisting debt. Because FGC acted as a creditor, most courts would conclude it is not protected under §1631, and the FSA does not apply to this case.

Because the FSA does not govern the FGC-Rick “purchase” transaction, CCB had no obligation to provide FGC a direct notice of its interest in Rick’s rice. The FSA protects buyers from taking farm products subject to a creditor’s security interest when a buyer

⁶ Facts in the example from *In re Printz*, 478 B.R. 876 (Bankr. C.D. Ill. 2012).



does not receive a notice that does not comply with §1631. In other words, creditors must typically send a direct notice or file an EFS—depending on the notice system the state operates—that complies with the federal statute to an FSA-protected purchaser in order to enforce their security interest against the buyer. In the example, FGC claims it is not liable to CCB and can keep the proceeds because CCB did not send it a notice that complies with §1631. However, CCB did not have a responsibility to provide FGC with a notice of its security interest in Rick’s rice because FGC not a protected purchaser under the FSA. Therefore, CCB’s security interest in the rice continued after FGC took possession of the products and CCB can enforce its interest to recover the proceeds.

Even though FGC did not gain FSA protection in the example, it could have if it would not have acted like a creditor. In some instances, creditors who lend to farm products sellers can also be protected buyers of that seller’s goods, so long as they keep the transactions separate. Thus, FGC could have gained FSA protection, even if it was a creditor of Rick, if FGC did not act like a creditor when “purchasing” the rice from Rick. For instance, suppose FGC actually paid the \$250,000 that was due to Rick under the purchase contract. In this situation, FGC would be considered a BOCB because it actually paid money to Rick for the farm products, which means FGC would gain FSA protection. This means FGC would take Rick’s rice free and clear of CCB’s security interest because CCB did not send FGC a notice as required under §1631. Accordingly, court would most likely rule in favor of FGC and it would not be liable to pay CCB the proceeds earned from selling the rice.

Overall, the FSA does not prohibit creditors from gaining protection under the federal statute. Usually, if an individual or entity qualifies as a protected purchaser under §1631, they will have protection against creditors attempting to enforce their interest against them. But when these individuals or entities act like creditors when “purchasing” farm products, they will most likely lose FSA protection. In general, courts have determined that someone is acting like a creditor when they use proceeds to satisfy a seller’s preexisting debt. Thus, courts have made it clear that creditors who wish to gain FSA protection when purchasing farm products from their debtors must keep their lending and buying transactions separate, and actually pay the seller for the goods.

III. Conclusion

Under the federal farm products rule, individuals and entities qualifying as a BOCB, commission merchant, or selling agent will gain protection under the FSA. Generally, farm products purchasers want FSA protection because it provides them the opportunity to take farm products free and clear of a creditor’s security interest. However, a buyer who is not protected by the FSA typically takes farm products subject to a creditors interest and risks having to pay twice for the same goods, once to the seller and once to the creditor.

In most instances, a person gains FSA protection when they purchase farm products for a business purpose from an agricultural producer who sells farm products. While the FSA exclusively protects certain farm products purchasers, the federal statute does not limit who can qualify as a protected buyer. In other words, if a person qualifies as a protected buyer under §1631, they usually have FSA protection. This means that even creditors who lend money to farm products sellers can qualify as FSA-protected buyers.



However, creditors who buy farm products from the sellers they lend to must ensure they keep their lending and buying transactions separately, or they risk losing FSA protection.

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.

- 1 Determine whether a state operates a direct notice or central filing system.**
 - This allows a buyer to know whether they should register as a farm products purchaser when they state they are purchasing farm products in operates a central filing system.

- 2 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.

- 3 Gain protection by qualifying as a “buyer” under §1631.**
 - In most cases, this requires a buyer to purchase farm products for a business purpose from a farmer who sells farm products.

- 4 Buyers should provide payment for the farm products they purchase.**
 - Buyers who also extend credit to sellers should keep their buying and lending transactions separate in order to retain the protection offered to buyers under §1631.

- 5 Issue joint payment to both the seller and creditor.**
 - Buyers are generally not liable for proceeds derived from the farm products and can avoid the risk of having to pay twice for the same goods if they issue a payment that is payable to both the creditor and seller of farm products.

