



## **Figuring the Federal Farm Products Rule**

*Complying with the Notice Requirements*

**Micah Brown**

*Staff Attorney, National Agricultural Law Center*

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### **I. Introduction**

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.

#### **A. Article 9 Farm Products Rule**

In these situations, the farmer-debtor and lender-creditor have entered into a secured transaction which is primarily governed by the Uniform Commercial Code (“UCC”). The UCC is a collection of rules affecting commercial transactions. While the UCC itself is not legally binding—it was originally created as a recommendation or model by private organizations—every state has chosen to enact some version of the rules within it. Once enacted by states, those laws are legally binding on the transactions within their boundaries.

Article 9 of the UCC provides rules for situations where a debtor sells collateral that is subject to a creditor’s security interest. Under §9-320(a) of the UCC, where a secured creditor has a security interest in farm products and the debtor sells those farm products, the creditor’s security interest follows the products. As a result, a debtor’s sale of the collateralized farm products does not end a creditor’s security interest in the farm products. Instead, under the UCC, the buyer of the farm products may have to assume the risk of paying twice for the goods, once to the seller and once to the secured creditor!

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## B. Federal Farm Products Rule

However, in some situations this specific UCC provision has been replaced by a federal law. Because it is a federal law, passed by Congress, it applies to the entire United States and preempts or supersedes laws such as certain UCC provisions passed by state legislatures<sup>1</sup>. Accordingly, when a buyer purchases farm products secured by a creditor's loan, the federal law will apply rather than §9-320(a) of the UCC.

This federal law, called the Food Security Act of 1985 ("FSA"), established a rule known as the federal farm products rule<sup>2</sup>. The farm products rule 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.<sup>3</sup>

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

Creditors who hold a security interest in farm products risk losing this interest if they fail to provide notice to the farm products purchaser. 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). The list of information a creditor must provide in its notice includes:

- (1) the secured creditor's name and address;
- (2) the debtor's name and address;
- (3) the debtor's social security number or taxpayer identification number;
- (4) a description of the farm products covered by the security interest; and

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<sup>1</sup> The FSA **does not** modify the UCC provisions on the creation, perfection, or priority of security interest. *Farm Credit Servs. Of Am., PCA v. Cargill, Inc.*, 750 F.3d 965, 968 (8th Cir. 2014) (citing *Battle Creek State Bank v. Preusker*, 253 Neb. 502, 513, 571 N.W.2d 294, 302 (1997)).

<sup>2</sup> 7 U.S.C. § 1631 (2018).

<sup>3</sup> 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).



- (5) any payment obligations imposed on the buyer as conditions for release of the security interest.<sup>4</sup>

The description of the farm products must also include the amount of the products, crop year, and the counties the farm products are produced or located.<sup>5</sup> 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 above, for a direct notice. An EFS must be filed with the Secretary of State's office to be effective. A list of debtors whose farm products are subject to a security interest is compiled by the Secretary of State and this list is available to registered farm product dealers and other purchasers. If a creditor correctly files an EFS, and does not waive the security interest, the creditor's security interest will still be effective after the sale of the farm products, because the buyer has been notified of the interest. 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.

## 2. Adopting a Notice System

The FSA allowed each state to choose which notice system would be adopted in their state. Section 1631 provides different implementation processes for the two notice systems. States that implemented a direct notice system did not have to take any action. This is because the duty of providing notice to a buyer was left up to the creditor. With no filing requirement in a direct notice system, the creditor must provide the notice directly to the buyer. Therefore, the state has no role in providing notice to a buyer in a direct notice system.

Alternatively, states adopting a central filing system were required to take additional steps to implement this notice system. Under the FSA, a state could not implement a central filing system unless the system was certified by the United States Department of Agriculture ("USDA"). To get certification, the state had to satisfy a few requirements.

These certification requirements include:

- (1) The system has to permit the filing of effective filing statements;
- (2) Allow the state's Secretary of State to compile every EFS into a master list;

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<sup>4</sup> *Id.* § 1631(e)(1)(A)(ii), (v).

<sup>5</sup> *Id.* § 1631(e)(1)(A)(ii)(IV).





disposition of another's property."<sup>7</sup> 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.

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.

### **B. Courts Interpreting FSA's Notice Provisions**

Unfortunately, the federal statute does not expressly state whether a creditor's notice complies with the federal statute when the notice contains errors or excludes information from the list in §1631. In situations where a statute's language is unclear, judges must interpret the statute. In other words, judges will consider the purpose of the statute and try to figure out the goal of the legislature in passing the law. Considering the legislative intent of a statute provides a judge with an understanding of what legislators intended to require under the statute, or what a party must do to comply. Since the enactment of the FSA, numerous state and federal judges have interpreted the provisions of the farm products rule statute to clarify the specific requirements that creditors must satisfy to retain their security interest in the farm products.

With multiple courts attempting to interpret Congress' intent when drafting the farm products rule, some courts have reached different conclusions on what is required for a creditors' notice to comply with the statute. Because of the structure of the court system in the United States, in some situations judges do not have to follow the same reasoning that judges in other courts have established. Whether or not a judge is bound to follow other court's decisions is called "precedence." Precedence is determined by the type and geographical location of the court. In other words, a court within a certain boundary is only bound by the conclusions of law decided by a superior court within that same boundary. This can lead to contradictory decisions, and is an example of how necessary it is to seek legal advice from an attorney licensed to practice law in the relevant jurisdiction before decisions are made.

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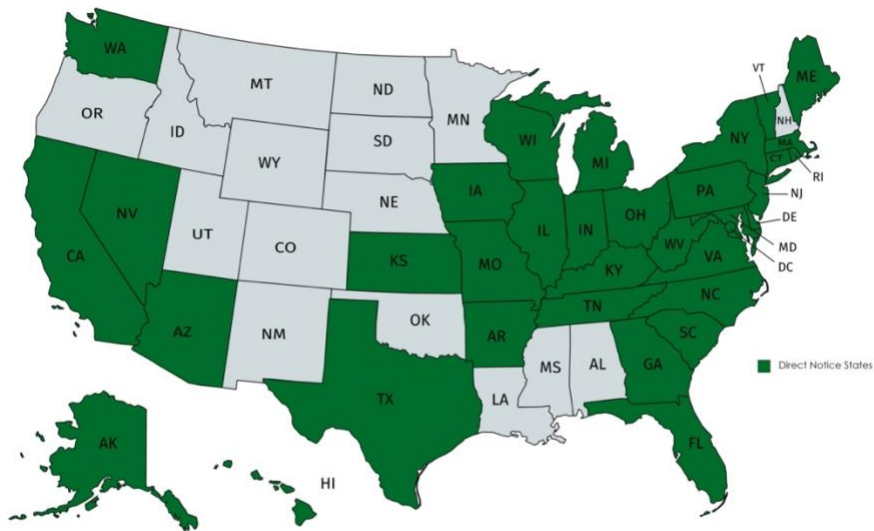
<sup>7</sup> *Integrated Direct Mktg., LLC v. May*, 2016 Ark. 281, at 3, 495 S.W.3d 73, 75.



When it comes to the farm products rule statute, many courts have ruled on the statutory provisions of §1631. Both types of notice systems—direct and central filing—have been litigated and compliance requirements applied by the courts. Consequently, because both types of notice were created by different provisions of §1631 and operate differently, courts have adopted different compliance standards for each system. Please consult with an attorney in your jurisdiction to learn more about the specifics of your situation, including the relevant standard.

## 1. Direct Notice System

One method of notice established under the FSA is the direct notice system. In a state that has adopted a direct notice system, the creditor is responsible for sending a notice directly to the buyer of farm products. In general, the creditor must send the buyer a written notice that includes the specific information listed under §1631(e). However, courts are split on whether a creditor’s notice is sufficient when it does not include all the required information contained under §1631(e). Some courts require strict compliance with the statute, while other courts require only substantial compliance.



### a. Strict Compliance

There is a split in the courts that have examined a creditor’s notice under a direct notice system. Some courts have concluded that a creditor must “strictly comply” with the list of specific information the farm products rule provides under §1631(e). These courts emphasize that a creditor’s notice to a buyer must include each item of



information identified in the federal statute, the information must be entirely accurate, and the creditor must provide the notice within the correct manner and time period.

Courts that require strict compliance have reached this conclusion by interpreting the statutory language. While examining the statute's text, these courts have noticed that the statute allows errors in creditor's notice in a state that follows the central filing system so long as the errors "are not seriously misleading."<sup>8</sup> However, this substantial compliance language does not appear with respect to the direct notice provision of the statute. After comparing the two, courts in strict compliance states have determined that Congress intentionally left this language out of the direct notice provision. Further, courts in strict compliance states believe that the Congressional intent of the farm products rule was to protect buyers from double payment. The easiest way to do so is by requiring creditors to strictly comply with notice requirements under §1631(e), so creditors know exactly what information must be included in their notice, and buyers are provided with sufficient knowledge of the specific products that are acting as collateral for the creditor's security interest. Based on these lines of reasoning, in places that hold to the strict compliance doctrine, creditors must provide buyers with notice that strictly complies with all the requirements of §1631(e).

Some examples of these requirements include:

**Example 1:** Farm Credit Bank loaned money to Claude, a catfish farmer. To secure the loan, Claude gave the Bank a security interest in his catfish. The Bank sent a letter to Brenda, a regular buyer of Claude's catfish, notifying her that it held a security interest in the catfish. However, the letter did not include the Claude's taxpayer identification number, address, or counties where the catfish were produced or located. After Claude failed to repay the loan, the Bank discovered that Brenda purchased catfish with checks payable only to Claude. Farm Credit Bank sued Brenda for converting its security interest because she made the checks only payable to Claude, even after being advised of the Bank's security interest.

If this case<sup>9</sup> was brought before a court that requires a creditor to strictly comply with the direct notice requirements under §1631(e), Farm Credit Bank's notice from the example would not suffice. In the example, even though the Bank provided notice directly to Brenda one year before the sale of the catfish, the letter excluded information that is required under §1631(e). By omitting this information, even

<sup>8</sup> 7 U.S.C. § 1631(c)(4)(H) (2018).

<sup>9</sup> Facts in the example from *Farm Credit Midsouth, PCA, f/k/a E. Arkansas Prod. Credit Ass'n. v. Farm Fresh Catfish Co.*, 371 F.3d 450 (8th Cir. 2004).



accidentally, proper notice has not been provided to Brenda. Because the notice did not comply with the direct notice provision, the Bank's security interest did not follow the catfish after Brenda purchased the products. Thus, the Bank could not receive payment from Brenda because the Bank no longer had enforceable rights in the catfish once the product was sold.

**Example 2:** Crop Credit Corp (“CCC”), an agricultural lender, provided a loan to Grant, a grain farmer, and CCC took a security interest in Grant’s grain. CCC sent Penny Purchaser a letter informing Penny of its security interest in Grant’s grain. The notice CCC sent Penny contained a section to include a description of the property and county where the farm products may be located, but the section was left blank. Instead, CCC checked a box that stated its security interest covered Grant’s grain wherever located and the interest was not limited by the location of the grain.

If Penny did not make payment to CCC, and CCC sued for conversion, it would likely lose against Penny in a strict compliance court<sup>10</sup>. Checking a box would be insufficient to provide Penny with proper notice of the interest in the grain. Under §1631(e), a creditor is required to state the county where the secured farm products are located. Here, CCC did not indicate the actual location of the grain. Even though CCC *almost* complied with §1631(e), it did not *strictly comply* with the statute. Therefore, under these circumstances, Penny would most likely take Grant’s grain free from CCC’s security interest.

The most recent cases addressing direct notice compliance issue have ruled that a strict compliance standard is required under §1631(e). In other words, a creditor’s notice was not sufficient to keep their security interest in the farm products purchased if the notice contained even one error. Creditors must be aware that they risk losing their security interest if their notice contains a single error or omits one item of required information. Although there are some courts that have applied a substantial compliance standard to a creditor’s direct notice, creditors cannot rely on this standard being applied. To ensure their security interest continues in farm products after the products are sold, creditors must include complete and accurate information that contains each item required under §1631(e).

#### **b. Substantial Compliance**

A few courts have interpreted the statutory language of §1631(e) differently. These courts have determined that a creditor must only “substantially comply” with the notice requirements provided in the federal statute to retain its security interest in

<sup>10</sup> Facts in the example from *State Bank of Cherry v. CGB Enterprises, Inc.*, 2013 IL 113836, 984 N.E.2d 449.





the farm products sold. These courts conclude a creditor's flawed notice may still comply with the notice requirements and as a result its security interest survives a sale of the secured farm products. Thus, a buyer may be forced to pay twice for the same products even after receiving notice that did not strictly comply with the §1631 requirements.

Because the direct notice provision was unclear about what level of compliance was necessary, courts reviewed Congress' intent for enacting the farm products rule. Unlike the strict compliance states, "substantial compliance" courts determined that Congress only intended buyers to be made aware of a creditor's security interest. In other words, because the farm products rule was enacted to protect a buyer from double payment, this goal is accomplished even if the creditor's notice contained an error. Thus, these courts conclude that Congress had no intention of allowing buyers to ignore a creditor's notice if it contained a single immaterial error.

An example of this is as follows:

**Example 3:** Casey, a crop farmer, borrows money from First Farmer Bank and provides the Bank a security interest in his crops and crop proceeds. The Bank notifies Becky Buyer of its security interest in Casey's crops. This notice does not include a description of the real property where Casey's crops are grown, the county where the crops are grown, and does not specify the type of crops covered by the bank's security interest. When purchasing Casey's crops, Becky does not always include the Bank as a payee. The Bank files an action against Becky to recover the proceeds from the crops sold to her by Casey.

When applying a substantial compliance standard to the facts of this example<sup>11</sup>, the Bank will likely win. Even though the Bank's notice did not include information that is required under §1631(e), a substantial compliance court may find that this was not material to Becky. Although all the statutory requirements were not included in the Bank's notice, the notice still informed Becky that there is a security interest in some of Casey's crops. Thus, a substantial compliance state would probably determine the Bank's notice complied with §1631(e) because it made Becky aware that such an interest exists. As a result, the Bank could receive payment from Becky because its security interest in Casey's crops continued after the sale.

Although some courts have adopted a substantial compliance standard, it seems that courts are more prone to adopt a strict compliance standard when presented with a direct notice issue. As more courts are presented with cases that raise the compliance issue, strict compliance may become the more heavily adopted standard. However,

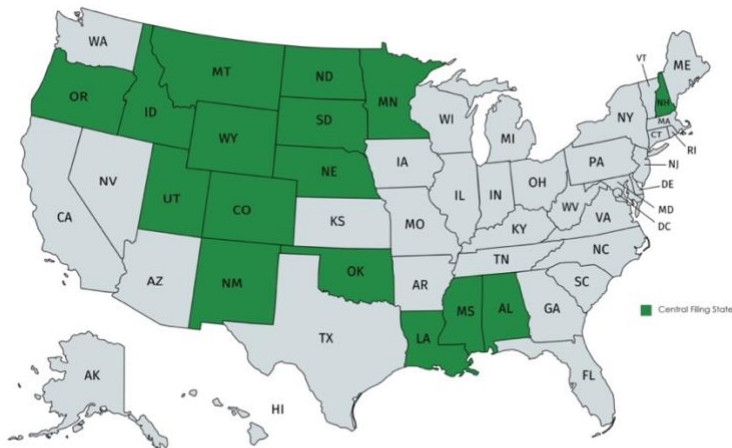
<sup>11</sup> Facts in the example from *First Nat. Bank and Trust v. Miami County Co-op Ass'n*, 257 Kan. 989, 897 P.2d 144 (1995).



no matter the standard, each court that has ruled on the compliance standard issue have made it clear that creditors must take extra precautions when notifying farm product purchasers of its security interest.

## 2. Central Filing System

The other method of notice established under the FSA was the central filing system. In a state that has adopted this type of notice system, a creditor has the option to either send a buyer direct notice or file an effective financing statement (“EFS”) with the state’s Secretary of State, as explained under §1631(c)(4). Unlike direct notice systems, there is no split in the courts on notice compliance under a central filing system. The courts have determined a substantial compliance standard applies to a creditor’s notice under a central filing system.



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Courts addressing notice compliance in a central filing system have adopted a consistent standard. Unlike the courts dealing with compliance of direct notice, the courts in central filing systems are not tasked with interpreting the federal statute. This is because §1631(c)(4) contains language that clearly indicates a creditor’s EFS notice must only substantially comply with the central filing system notice requirements under the statute. Under §1631(c)(4), a creditor’s EFS will be sufficient even if the notice contains minor errors, so long as the errors are not “seriously misleading.”

Although a substantial compliance standard is applied to EFS notices, what constitutes “substantial compliance” is left up to a judge’s discretion. In other words, a judge decides whether an EFS substantially complies with §1631(c)(4). The central filing provision specifically indicates that a creditor’s EFS does not substantially comply with the statute if it “seriously misleads” a buyer. Thus, the primary question a



judge must decide is whether a creditor's EFS seriously misled a purchaser of farm products. If a judge determines that the notice has misled the buyer, the EFS is ineffective and the creditor no longer holds a security interest in the farm products.

To determine whether a creditor's notice seriously misled a buyer, judges must examine the information the creditor included in its EFS. Many courts have determined that vague descriptions of information in the notice can make an EFS seriously misleading. A vague description makes a creditor's notice seriously misleading if a buyer reading the EFS might not realize that the farm products sought to be purchased are subject to a creditor's security interest. Additionally, a notice which contains errors can make an EFS seriously misleading. Consequently, a creditor's security interest will not continue in farm products after being sold if vague descriptions or errors seriously mislead the buyer.

However, courts have also determined that not all errors or vague descriptions make a creditor's notice seriously misleading. An EFS containing vague descriptions or errors is not seriously misleading if it puts a buyer on notice of a security interest in a seller's farm products. In other words, an EFS will not be seriously misleading if it indicates to a buyer that further steps must be taken to discover whether farm products are subject to a preexisting security interest. Courts agree that once a buyer is placed on notice of a possible security interest in farm products, it becomes the buyer's duty to investigate whether the farm products are subject to a creditor's security interest. Therefore, judges will consider the language of the notice and determine whether a buyer could have been seriously misled by the information provided in the creditor's EFS notice.

**Example 4:** Agri Bank provides a loan to Randy Rancher. To secure this loan, the bank takes a security interest in Randy's cattle. Afterward, the bank files an EFS with the Secretary of State's office which states "Agri Bank holds a security interest in all of Randy's presently owned and later acquired cattle kept on real estate owned by Felicia Jones and located on HWY 71 in Saline County." One month later, Randy's lease ends with Felicia and he enters into a lease with Taylor. Randy moves all his cattle to Taylor's property, located on Frog Bayou Road. Two months later, Patricia Purchaser contacts Randy to purchase his cattle. The two parties meet at Taylor's property so Patricia can inspect the cattle, and she enters into a contract to purchase Randy's cattle. Before the sale, Patricia examines the Secretary of State's EFS list to check for security interests in Randy's cattle. She comes across Agri Bank's interest in his cattle, but determines the cattle she is purchasing is not subject to the Bank's security interest because she knew she was buying Randy's cattle located on Frog Bayou Road. Four days later, Patricia pays Randy for the cattle and takes possession of the cattle. Randy stops paying on his loan with Agri Bank, the bank sues Patricia for conversion.



In this example<sup>12</sup>, Agri Bank’s notice substantially complied with the requirements under §1631(c)(4). Although the Bank’s collateral description is not entirely clear, most courts ruling on this case would conclude it does not seriously mislead Patricia. The description is vague because it does not indicate to the reader whether the Bank has a security interest in all of Randy’s cattle, or just cattle located at Felicia’s property. However, this ambiguity does not seriously mislead Patricia.

The location of the cattle subject to Agri Bank’s security interest did not make the notice seriously misleading. The notice was sufficient enough to warn Patricia that all or some of Randy’s cattle is subject to Agri Bank’s security interest. Thus, it became Patricia’s duty to take further steps to determine which cattle were subject to Agri Bank’s security interest. Consequently, Agri Bank’s interest continued in the collateral after the sale to Patricia, and the Bank was entitled to receive proceeds from the sale.

Although the creditor’s notice in the example above would most likely substantially comply with the requirements under §1631(c)(4), that may not be the outcome in every case. Judges will determine whether a creditor’s EFS is seriously misleading, based on the facts of the case. Because judges have differing opinions on what constitutes “seriously misleading,” not all cases with similar facts will reach the same outcome. Just because a creditor’s notice was found to substantially comply with the notice requirements does not mean that a different judge ruling on the same case would have found the same conclusion. Thus, creditors in central filing system states must ensure that their EFS notice provides accurate information that makes it unmistakably clear a security interest exists in the seller’s farm products.

### III. Conclusion

Since the enactment of the FSA, litigation between buyers of farm products and creditors has greatly decreased. This is primarily due to the notice requirements Congress established under §1631. The federal statute has established a guideline for creditors who take a security interest in farm products. For both direct notice and central filing systems, §1631 specifies the information a creditor must include in their notice to ensure their security interest in the farm products continues after the goods are sold. Thus, creditors who include each item of information required under §1631 will have certainty that they provided a buyer of secured farm products with proper notice.

Although the statute provides a clear list of information that creditors must include in their notice, the statute has also created some uncertainty. Section 1631(e)—the direct notice provision—does not indicate whether a creditor’s notice must strictly or substantially comply with statutory requirements. Because there is no language indicating which standard applies, this has led to a split in the courts. Additionally, even though a creditor’s central filing notice must only substantially comply with

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<sup>12</sup> Facts in the example from *First Bank v. E. Livestock Co.*, 837 F. Supp. 792 (S.D. Miss. 1993).



the requirements under §1631(c)(4), the statute allows judges to decide whether a creditor's notice substantially complied with the statutory requirements. This has led to different outcomes in several cases. One judge may believe a creditor's notice substantially complied while another judge in a different case concludes a creditor's notice did not comply, even though the two notices are the same. However, this uncertainty can be avoided.

In either a direct notice or central filing system, creditors have the ability to provide proper notice under any situation. So long as a creditor's notice contains the list of information provided under the statute, the notice will most likely comply with §1631 every time. Thus, if a creditor's notice includes correct and accurate information and provides the farm products purchaser with notice in a timely manner, the creditor's security interest will continue in the farm products after the sale.

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### 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 enables a creditor to provide the correct type of notice to a buyer.

**2 If the state operates a direct notice system, a creditor should obtain a list of all potential buyers.**

➤ Creditors can then send a direct notice to each of these buyers to ensure their security interest follows the farm products after being purchased by one or more of these buyers.

**3 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.

**4 If a state operates a central filing system, buyers should register as a farm product purchaser.**

➤ If a buyer is not registered as a purchaser, they generally cannot access the EFS filing list published by the state's Secretary of State.

**5 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.

