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An Agricultural Law Research Article

## **The Farm Creditor: Preserving Security Interests in Farm Products**

by

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# NOTES

## THE FARM CREDITOR: PRESERVING SECURITY INTERESTS IN FARM PRODUCTS

### I. INTRODUCTION

The Iowa Legislature adopted the Official Text of the 1972 Amendments to the Uniform Commercial Code in 1974.<sup>1</sup> This Note will focus on those changes as they affect secured transactions in farm products under Article 9.<sup>2</sup> The changes have created confusion as to the rights of the lender who has a security interest in the farm products, and the rights of the buyer of those farm products who expects to take them free of any security interest.

This Note will address the situation in which a farmer in need of operating capital seeks a loan from a lender who needs security for the loan. The security will normally consist of crops or livestock. Problems arise when the debtor sells the crops or livestock and does not remit the proceeds from the sale to the creditor. One aspect of this problem for the creditor is that in reality it must expect, and necessarily require, the farmer to sell the collateral to make the payments on the outstanding debt. However, it does not want to give up its claim to the collateral or the proceeds of the sale of the collateral. As a result, the lender must attempt to protect its interest not only by enforcing the security interest against the debtor but also against the buyers of the farm products which were used as collateral. The lender would seem to be protected by various provisions of Article 9,<sup>3</sup> but the Iowa Supreme Court has interpreted these provisions in such a way as to make it extremely difficult for the lender to protect itself.<sup>4</sup>

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1. IOWA CODE § 554 (1983) (all citations will be to the 1983 Code unless otherwise noted).

2. IOWA CODE § 554.9109(3). "Goods" are:

"farm products" if they are crops or livestock or supplies used or produced in farming operations or if they are products of crops or livestock in their unmanufactured states (such as ginned cotton, wool clip, maple syrup, milk and eggs), and if they are in the possession of a debtor engaged in raising, fattening, grazing or other farming operation. If goods are farm products they are neither equipment nor inventory.

*Id.*

3. IOWA CODE §§ 554.9307(1), .1205(4).

4. See *infra* text accompanying notes 67-87.

## II. CODE PROVISIONS AFFECTING THE SECURED PARTY AND THE BUYER OF FARM PRODUCTS

### A. *Creation of the Security Interest*

In general, a farm creditor must follow a two-step process in order to have a valid security interest. There must be security agreement creating a security interest,<sup>5</sup> and the security interest must be perfected.<sup>6</sup>

For the creditor to properly attach the collateral, it must require that the farmer sign a security agreement which properly describes the collateral,<sup>7</sup> it must give value,<sup>8</sup> and the debtor must have "the rights" in the collateral.<sup>9</sup> When all of these conditions have been met, the security interest becomes enforceable between the parties.<sup>10</sup> However, perfection of the security agreement is required to protect the creditor from competing third parties, such as purchasers of farm products.<sup>11</sup> To perfect a security interest in farm products, Iowa requires that the security interest be filed<sup>12</sup> in the office of the Secretary of State.<sup>13</sup> This central filing requirement applies when either crops or livestock listed as collateral are farm products, inventory, or documents of title.<sup>14</sup> If the creditor has correctly attached and perfected its security interest, the "agreement is effective according to its terms between the parties, against purchasers of the collateral and against creditors."<sup>15</sup>

### B. *Buyers of Farm Products*

Normally the "buyer in ordinary course of business"<sup>16</sup> takes free of any

5. IOWA CODE § 554.9203. See generally Meyer, "Crops" as Collateral for an Article 9 Security Interest and Related Problems, 15 U.C.C.L.J. 3, 11-24 (1982) [hereinafter cited as Meyer].

6. IOWA CODE § 554.9301. See generally Meyer, *supra* note 5, at 24-32.

7. IOWA CODE § 554.9203(1)(a). The financing statement must contain a description of the collateral. IOWA CODE § 554.9402. The purpose of this description is to put third parties on notice of the secured party's claim. U.C.C. § 9-402, official comment 2 (1972) [all citations will be to the 1972 text unless otherwise noted]; *First State Bank v. Waychus*, 183 N.W.2d 728, 730 (Iowa 1971) ("financing statement was sufficient to direct inquiry and therefore to impart constructive notice"); Meyer, *supra* note 5, at 29-31.

8. IOWA CODE § 554.9203(1)(b).

9. IOWA CODE § 554.9203(1)(c).

10. IOWA CODE § 554.9203(2).

11. IOWA CODE § 554.9301(1)(c). See U.C.C. § 9-301, official comment 4.

12. IOWA CODE § 554.9302.

13. IOWA CODE § 554.9401(1)(c).

14. *Id.* See also Meyer, *supra* note 5, at 24-29.

15. IOWA CODE § 554.9201.

16. IOWA CODE § 554.1201(9). The "buyer in ordinary course of business" is defined as: a person 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 . . . . "Buying" may be for cash or by exchange of other property or on secured or unsecured credit and includes receiving goods or documents of title under a pre-existing

perfected security interest in goods.<sup>17</sup> However, the purchaser of farm products does not avoid the security interest when buying from a farmer who has entered into a security agreement.<sup>18</sup> The Code states, "A buyer in 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>19</sup> This would apparently place the burden on the buyer of farm products to check with the Secretary of State to determine if the farm product is collateral on any financing statement.<sup>20</sup> If the buyer were to find that the farm products he was about to buy were collateral, the purchaser could avoid liability by not purchasing the product or by making out a joint payee check to the seller and the creditor.<sup>21</sup>

Sections 554.9307(1) and 554.9306(2) indicate that a farm creditor with a properly perfected security interest would be able to protect its financial stake from violations of the agreement by the debtor.<sup>22</sup> It would also seem apparent that, in the absence of consent, the creditor would be able to enforce its security interest against any purchasers of the collateral.<sup>23</sup> Thus a buyer of the farm products would be liable to the creditor for the value of the products.<sup>24</sup>

It should be noted that the security interest extends to the buyer from one who purchased from the farmer. For example, if the farmer has given a valid enforceable security interest in his cattle, which has been perfected by filing with the Secretary of State, to the local bank, then X, a buyer in the ordinary course of business, would not take free of the bank's security interest.<sup>25</sup> But what about the party who purchases from X in the ordinary course of business? While the second party did not purchase "from a person

contract for sale but does not include a transfer in . . . satisfaction of a money debt.

*Id.*

17. IOWA CODE § 554.9307(1). *See also* U.C.C. § 9-201, official comment (security agreement is generally effective against third parties).

18. IOWA CODE § 554.9307(1).

19. *Id.*

20. IOWA CODE § 554.9407.

21. Meyer, *supra* note 5, at 37.

22. IOWA CODE § 554.9307(1).

23. *Id.* at §§ 554.9307(1), .9306(2).

24. *See, e.g.,* Wabasso State Bank v. Caldwell Packing Co., 251 N.W.2d 321, 322 (Minn. 1977) (creditor brought action for conversion of cattle, which were collateral for a security agreement, against buyer of the cattle); United States v. Topeka Livestock Auction, Inc., 392 F. Supp. 944, 948 (N.D. Id. 1975) (conversion action against auctioneer who sold collateral for the debtor); Farmers State Bank v. Edison Non-Stock Coop. Ass'n, 190 Neb. 789, —, 212 N.W.2d 625, 626 (1973) (creditor brought action for conversion against elevator operator which had purchased grain from debtor); Garden City Prod. Credit Ass'n v. Lannan, 186 Neb. 668, —, 186 N.W.2d 99, 100 (1971) (creditor was allowed to bring action in replevin).

25. IOWA CODE § 554.9307(1).

engaged in farming operations,"<sup>26</sup> and could argue that the security interest should be cut off, it must be remembered that section 554.9307(1) indicates that a buyer takes free of a security interest only if the security interest was created by *his seller*,<sup>27</sup> since X did not create the security interest, the subsequent buyer can not take free of it.<sup>28</sup> As a practical matter, the farm creditor would have difficulty pursuing its collateral to ultimate purchasers;<sup>29</sup> however, there are some ultimate buyers whom the creditor has no difficulty pursuing.<sup>30</sup>

### C. The Farm Products Exception

One might wonder why farm creditors are entitled to protection under section 554.9307(1) that is not available to creditors who hold security interests in other classes of goods.<sup>31</sup> Traditionally two arguments have been advanced in support of the farm products exception.<sup>32</sup> The first is that agriculture is a capital intensive industry which would not be able to obtain adequate financing without protecting the creditor's interest.<sup>33</sup> Some would argue, however, that the exception in fact inhibits farm financing by reducing the willingness of buyers to purchase farm products.<sup>34</sup> Such a situation, it is argued, cannot be conducive to promoting the economic welfare of ei-

26. *Id.*

27. *Id.* Coogan & Mays, *Crop Financing and Article 9; A Dialogue with Particular Emphasis on the Problems of Florida Citrus Crop Financing*, 22 U. MIAMI L. REV. 13, 20 (1967) [hereinafter cited as Coogan & Mays] ("9-307(1) cuts off only security interests created by the seller").

28. Dolan, *Section 9-307(1): The U.C.C.'s Obstacle to Agricultural Commerce in the Open Market*, 72 Nw. U.L. REV. 706, 713-15 (1978) [hereinafter cited as Dolan].

29. *Id.* at 714.

30. *Id.* (such as slaughterhouse, grain elevator, or broker who buys the farm products). There are also other parties whom the creditor may have a cause of action against. *E.g.*, *United States v. Topeka Livestock Auction, Inc.*, 392 F. Supp. at 948 (auctioneer who sold collateral for debtor was liable for conversion).

31. While this Note is not intended to resolve this question, it is important to recognize that farm products are treated differently than are other goods, and it is also worthwhile to be familiar with some of the reasons why this has occurred.

32. Dolan, *supra* note 28, at 716-17.

33. *Id.* See also Note, *Agricultural Financing Under the U.C.C.*, 12 ARIZ. L. REV. 391, 411 (1970). [hereinafter cited as *Agricultural Financing*]. One court has stated:

The Uniform Commercial Code, whatever else its objects may be, was designed to close the gap in the classic conflict between the lender and the innocent purchaser and furnish acceptable, certain, and suitable standards which would promote the necessity of and fluidity of farm credit financing in the modern context, and at the same time facilitate the sale and exchange of collateral by furnishing a definable and ascertainable standard which purchasers could rely on.

*Garden City Prod. Credit Ass'n v. Lannan*, 186 Neb. 789, —, 186 N.W.2d 99, 102 (1971).

34. Dolan, *supra* note 28, at 716-17. See *Garden City Prod. Credit Ass'n v. Lannan*, 186 Neb. at —, 186 N.W.2d at 104 (Newton, J., dissenting)(the exception restricts the free movement of farm products in commerce).

ther the borrower or the creditor.<sup>35</sup>

A second justification for the farm products exception is based on the theory that the farm products purchaser is better able to understand the section 554.9307(1) exception and protect himself against it, than are buyers of other goods.<sup>36</sup> One commentator has stated "that while the buyer of widgets at a local hardware store is an amateur deserving the law's protection against a professional lender, the typical buyer of farm products is a purchaser at wholesale and more likely to be a 'professional' than is the local banker who financed the crop."<sup>37</sup> Critics of the exception are quick to point out that not all farm transactions fit this model:

[T]he typical milk dealer buys from dozens, hundreds, or thousands of small producers. It is impossible for him to know when Farmer Green gives a chattel mortgage on cow Bessie and her products (including, by definition of 9-109(3), her milk). And when mortgaged Bessie's milk is sold to Mrs. Black, the security interest created by the mortgage on Bessie follows the milk down Baby Black's throat.<sup>38</sup>

A related criticism is that local filing frustrates the ability of buyers to find a security interest, especially when the buyer is engaging in several transactions with a large number of debtors.<sup>39</sup> However, this argument loses its validity in states, such as Iowa, which have adopted the central filing requirement for farm products.<sup>40</sup>

#### D. Waiver of the Security Interest

Although the farm creditor is protected, the protection is not absolute. The secured party can authorize disposition of the collateral or waive its interest pursuant to section 554.9306(2) which states, "[e]xcept 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>41</sup> When there is an express authorization to dispose of the collateral, the farm creditor clearly intends to relinquish his rights to

35. Dolan, *supra* note 28, at 716-17.

36. *Id.* at 717.

37. Coogan & Mays, *supra* note 27, at 20.

38. *Id.*

39. Dolan, *supra* note 28, at 718. In this regard, Dolan notes the following:

If, in fact, purchasers from agricultural businesses are large and sophisticated business enterprise, it is reasonable to assume that they are or ought to be aware of the farm products rule. The local filing option reduces to futility, however, any effort on their part to discover the existence of a security interest.

*Id.*

40. IOWA CODE § 554.9401.

41. IOWA CODE § 554.9306(2) (emphasis added).

the products in the expectation of receiving the proceeds from the sale. However, the "or otherwise" language of section 554.9306(2) has been interpreted to allow waiver of a security interest by a number of actions by the creditor.<sup>42</sup> There is a split in jurisdictions concerning how this section should be applied.<sup>43</sup> While some jurisdictions favor the secured party over the bona fide purchaser of the livestock or crops used as collateral, Iowa<sup>44</sup> and some other states<sup>45</sup> have held for the purchaser when there has been a showing of express authorization, consent, estoppel, or authorization through prior course of dealings or usage of the trade.<sup>46</sup>

### III. SECTIONS 554.9307(1) AND THE "OR OTHERWISE" LANGUAGE OF SECTION 554.9306(2)

In a typical case in which the court must reconcile the rights of the secured party with the expectations of a buyer, who assumes he is taking free of a security interest, the facts can be stated as follows:<sup>47</sup>

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 assume qualifies as a buyer in ordinary course.<sup>48</sup>

The issue in such a situation is whether the bank, by accepting the proceeds from the unauthorized sales, will be able to enforce its security interest in subsequent sales. The Iowa Supreme Court has taken the position that a creditor can waive its security interest by a prior course of dealing in which

42. See *infra* text accompanying notes 65-70.

43. See *infra* text accompanying notes 50-70.

44. See *Hedrick Sav. Bank v. Myers*, 229 N.W.2d 252, 254 (Iowa 1975); *Lisbon Bank and Trust Co. v. Murray*, 206 N.W.2d 96, 98-99 (Iowa 1973).

45. See *First Nat'l Bank and Trust Co. v. Iowa Beef Processors, Inc.*, 626 F.2d 764, 768 (10th Cir. 1980); *North Cent. Prod. Kan. Prod. Credit Ass'n v. Washington Sales Co.*, 223 Kan. 689, \_\_\_, 577 P.2d 35, 41 (1978) (express consent found); *Clovis Nat'l Bank v. Thomas*, 77 N.M. 554, \_\_\_, 425 P.2d 726, 730 (1967).

46. See *infra* text accompanying notes 65-70.

47. For cases with a similar fact pattern see *First Nat'l Bank and Trust Co., v. Iowa Beef Processors, Inc.*, 626 F.2d at 765-66; *North Cent. Prod. Credit Ass'n v. Washington Sales Co.*, 233 Kan. at \_\_\_, 577 P.2d at 36-37; *Wabasso State Bank v. Caldwell Packing Co.*, 251 N.W.2d at 322-23; *Hedrick Sav. Bank v. Myers*, 229 N.W.2d at 253-54; *Garden City Prod. Credit Ass'n v. Lannan*, 186 Neb. at \_\_\_, 186 N.W.2d at 100-02; *Clovis Nat'l Bank v. Thomas*, 77 N.M. at \_\_\_, 425 P.2d at 727-29.

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

unauthorized sales were allowed.<sup>49</sup> Although the status of the law in Iowa may seem to be established, an analysis of cases in other jurisdictions will be useful in determining whether the Iowa Supreme Court has adopted the proper position.

#### A. Significant Cases Holding for the Secured Party

The courts, in determining the buyer and creditor rights, have not applied section 9-306(2)<sup>50</sup> uniformly. Several jurisdictions have held that the farm creditor did not waive the protection granted by section 9-307(1)<sup>51</sup> by allowing prior sales.<sup>52</sup> These courts have applied U.C.C. section 1-205(4)<sup>53</sup> which states:

The express terms of an agreement and an applicable course of dealing or usage of trade shall be construed wherever reasonable is 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>54</sup>

Applying this provision to the example set forth above, the court would allow a conversion or replevin action even though, in its prior dealings, the bank had allowed the Farmer to sell the livestock. Such an action would be allowed since the express requirement of prior written consent could not be waived by the bank's prior course of dealing with the Farmer.<sup>55</sup> One court has explained this conclusion:

[T]he reasonable acceptance of the proceeds of the sale when actually delivered to apply upon the debt, are not acts which indicate intention to waive a security interest, but in the event such unreasonable act is inconsistent and contradictory of the express agreement, then the express terms control both the course of dealing and the usage of trade between the parties.<sup>56</sup>

49. Hedrick Sav. Bank v. Myers, 229 N.W.2d at 254; Lisbon Bank and Trust Co., 206 N.W.2d at 98-99.

50. U.C.C. § 9-306(2); IOWA CODE § 554.9306(2).

51. U.C.C. § 9-307(1); IOWA CODE § 554.9307(1).

52. See, e.g., Fisher v. First Nat'l Bank, 584 S.W.2d 515, 519 (Tex. Civ. App. 1979) (U.C.C. § 1-205(4) dictated that the express terms of agreement control course of dealing so there was no waiver); Wabasso State Bank v. Caldwell Packing Co., 251 N.W.2d at 325 (did not authorize the borrower to sell by not objecting to its previous course of dealing in which the borrower had sold collateral without consent); Garden City Prod. Credit Ass'n v. Lannan, 186 Neb. at —, 186 N.W.2d at 104 (prior sales without consent did not waive right to require written consent prior to sale.).

53. IOWA CODE § 554.1205(4).

54. U.C.C. § 1-205(4); IOWA CODE § 554.1205(4).

55. But see Dugan, *supra* note 48, at 340.

56. Wabasso State Bank v. Caldwell Packing Co., 251 N.W.2d at 324 (quoting Garden City Prod. Credit Ass'n v. Lannan, 186 Neb. at —, 186 N.W.2d at 103).



One of the leading cases protecting the security interest of the creditor is *Garden City Production Credit Association v. Lannan*.<sup>57</sup> In that case, the Nebraska court noted that the security agreement provided a specific means by which the debtor could obtain waiver.<sup>58</sup> Therefore, the court did not construe the PCA's failure to rebuke or object to the sales by the debtor as waiver of the creditor's right to the proceeds of the collateral.<sup>59</sup>

Several jurisdictions have upheld conditional authorizations for sale.<sup>60</sup> These courts have recognized the secured party's right to attach conditions or limitations to its consent to sales of collateral by the debtor.<sup>61</sup> For example, in the situation stated above, if the bank had allowed the sale of the livestock so long as the check for the proceeds was made out jointly to the seller and the secured party,<sup>62</sup> or there had been no prior default by the seller,<sup>63</sup> then jurisdictions following the *Lannan* decision would hold that there was no waiver of the security interest.<sup>64</sup>

57. 186 Neb. 668, 186 N.W.2d 99 (1971).

58. *Id.* at \_\_\_, 186 N.W.2d at 103.

59. *Id.* The court stated:

[W]e fail to see how a failure to rebuke or object contemporaneous with a delivery by the debtor and acceptance of the proceeds to which the security agreement attaches, can be construed as a voluntary and intelligent waiver by the lender of its right under a perfected security agreement against a third party purchaser, and this is particularly true when the security agreement itself provides a specific means for obtaining such waiver.

*Id.*

60. See *North Cent. Kan. Prod. Credit Ass'n v. Washington Sales Co.*, 223 Kan. at \_\_\_, 577 P.2d at 39 (creditor does not waive its security interest when the authorization to sell is conditioned upon a check being made out jointly to the seller and creditor); *Farmer's State Bank v. Edison Non-Stock Coop. Ass'n*, 190 Neb. 789, \_\_\_, 212 N.W.2d 625, 628 (no loss of security interest when consent to sell was conditioned upon no prior default having occurred). *But see First Nat'l Bank and Trust Co. v. Iowa Beef Processors, Inc.*, 626 F.2d at 769. The court stated:

Consent to sell in the debtor's own name "provided" the seller remits by its own check to the bank is not a true conditional sales authorization. In essence, such a condition makes the buyer an insurer of acts beyond its control. The bank has made performance of the debtor's duty to remit proceeds to the bank a condition of releasing from liability a third party acting in good faith. IBP could not ascertain in advance whether this condition would be met, as it could if a condition precedent was involved; nor did IBP have any control over the performance of the condition, as long as it paid Wheatheart. A secured party has an interest in protecting its security by conditioning its consent, but it can place conditions that would afford it protection without great unfairness to the good faith purchaser.

*Id.*

61. See *supra* note 60.

62. See *North Cent. Kan. Prod. Credit Ass'n v. Washington Sales Co.*, 223 Kan. at \_\_\_, 577 P.2d at 39.

63. See *Farmers State Bank v. Edison Non-Stock Coop. Ass'n*, 190 Neb. at \_\_\_, 212 N.W.2d at 628.

64. *Id.* at 628-29.

### B. Significant Cases Holding for the Buyer

Some courts have interpreted the "or otherwise" language of section 9-306(2)<sup>65</sup> to allow waiver of a security interest through prior course of dealing or usage of trade.<sup>66</sup> In applying this general principle to the example set out above, these courts would consider the bank's prior course of conduct (accepting, without objection, the proceeds from sales made by the Farmer in violation of the agreement) as a waiver of any right to assert there was no prior written consent to sell the livestock. Therefore, the buyer would not be found liable in an action for conversion or replevin, and the creditor would lose its security interest.

The leading decision in this line of cases is *Clovis National Bank v. Thomas*.<sup>67</sup> The security agreement required the debtor to obtain prior written consent to sell the collateral, cattle, but the debtor sold the cattle through a commission agent without the secured party's knowledge or consent and failed to remit the proceeds.<sup>68</sup> The New Mexico court concluded that the secured party had been aware of prior sales made by the debtor without written permission, and therefore, it had waived its right to insist that the debtor obtain written permission to sell the collateral.<sup>69</sup>

The Iowa Supreme Court has followed the *Clovis* rationale.<sup>70</sup> The court first addressed the issue in *Lisbon Bank and Trust Co. v. Murray*.<sup>71</sup> In *Lisbon* the bank properly perfected a security interest in forty-eight heifers.<sup>72</sup> The farmer sold twelve of those heifers, and the bank brought an action against the buyer of those heifers to recover the purchase price.<sup>73</sup> The court found that the farmer had been a customer of the bank for about a year, and a pattern of dealing had developed whereby the farmer was permitted to sell collateral to make payments on his notes or apply the proceeds to substituted collateral.<sup>74</sup> The court, citing *Clovis*, held that authority to sell was implied from a prior course of dealing between the debtor and credi-

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65. U.C.C. § 9-306(2); IOWA CODE § 554.9306(2).

66. See *Hedrick Sav. Bank v. Myers*, 229 N.W.2d 252, 256 (Iowa 1975); *Lisbon Bank and Trust Co. v. Murray*, 206 N.W.2d 96, 98-99 (Iowa 1973); *Clovis Nat'l Bank v. Thomas*, 77 N.M. 554, —, 425 P.2d 726, 730-31 (1967).

67. 77 N.M. 554, 425 P.2d 726 (1967).

68. *Id.* at —, 425 P.2d at 728.

69. *Id.* at —, 425 P.2d at 730. The court recognized that "consent may be established by implication arising from a course of conduct as well as by express words, and that consent to a sale operates as a waiver of the lien or security interest." *Id.* (citing *Farmers' Nat'l Bank v. Livestock Comm'n. Co.*, 53 F.2d 991, 996 (8th Cir. 1931)). However, the dissenting justice noted that U.C.C. section 1-205(4) was not addressed in the majority opinion. *Id.* at —, 425 P.2d at 736 (Carmody, J., dissenting).

70. *Hedrick Sav. Bank v. Myers*, 229 N.W.2d at 255; *Lisbon Bank and Trust Co. v. Murray*, 206 N.W.2d at 99.

71. *Lisbon Bank and Trust Co. v. Murray*, 206 N.W.2d 96 (Iowa 1973).

72. *Id.* at 97.

73. *Id.*

74. *Id.* at 98.

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tor.<sup>75</sup> The court also noted that section 554.1205(4) did not apply because there was no express provision in the security agreement requiring written consent to sell the collateral which would control course of dealing.<sup>76</sup> Two years later, in *Hedrick Saving Bank v. Myer*,<sup>77</sup> a secured party sued a livestock dealer in conversion for purchasing, from the debtor of the bank, ninety-six animals which were subject to the bank's perfected security interest.<sup>78</sup> In *Hedrick*, the security agreement provided that the debtor would not sell the collateral without the prior written consent of the lender.<sup>79</sup> However, the debtor made five separate sales of the collateral to the defendant.<sup>80</sup> Although some of the sales were authorized, the bank argued that the security agreement expressly prohibited the other sales.<sup>81</sup> Therefore, it contended that section 554.1205(4) was controlling the security agreement could not be waived by course of conduct.<sup>82</sup> However, the court, relying on *Lisbon*, concluded that course of dealing was relevant in interpreting the agreement.<sup>83</sup> The court seemed to rely on the fact that the creditor had knowledge of prior sales, and the bank's course of dealing with the debtor:

[The bank] raised no objection, accepted checks from these sales for credit to [the debtor's] account, and clearly relied on [the debtor's] honesty to properly account for the proceeds. This established a course of dealing from which the trial court could find, as it did, implied authority to sell to defendants in the challenged transactions.<sup>84</sup>

While "it is difficult to be sure exactly what it was that the Iowa Court held,"<sup>85</sup> it is certain that the bank's argument regarding section 554.1205(4) was not adequately addressed. The court, after reciting the facts found by the trial court relating to the parties' course of dealing, asked: "Is that finding consistent with the terms of the security instrument by any reasonable construction; or is it unreasonable so that course of dealing must give way to the express prohibition against sale without written consent?"<sup>86</sup> The question of reasonableness raised by the court is not involved in the application of section 554.1205(4). That section clearly states that the express terms

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75. *Id.* at 99.

76. *Id.* at 98-99.

77. *Hedrick Sav. Bank v. Myers*, 229 N.W.2d 252 (Iowa 1975).

78. *Id.* at 254.

79. *Id.*

80. *Id.*

81. *Id.*

82. *Id.* at 255.

83. *Id.* at 256 (the court did note that *Lisbon* was not controlling since there was no express requirement of written consent in *Lisbon*).

84. *Id.* at 255.

85. McDonough, *Recent Statutory and Case Law Developments in Secured Transactions*, 27 *DRAKE L. REV.* 41, 48 (1977-78) [hereinafter cited as McDonough].

86. *Hedrick Sav. Bank v. Myers*, 229 N.W.2d at 255.

control course of dealing.<sup>87</sup> The fact that a course of dealing can reasonably be found should not allow a different interpretation of the statute.

### C. *The Consequences of the Iowa Decisions*

The Iowa Supreme Court, by following the *Clovis* rationale,<sup>88</sup> has stated that course of dealing will be considered when interpreting a security agreement even when the course of dealing is contrary to the express terms of the agreement.<sup>89</sup> Although the *Hedrick* and *Lisbon* decisions seem conclusive, application of the holdings in those cases could raise substantial problems.

One serious problem is determining what action creditors must take to protect their security interest. It would seem apparent "that so small an effort, as only to expressly prohibit a sale in the security agreement by a secured party will be ineffective,"<sup>90</sup> since the court has placed the burden of preserving a security interest on the creditor. However, the court did not define that burden, and there is a significant risk that any farm creditor protection under section 554.9307(1) could be lost by lower court decisions placing a higher duty on the creditor than the Supreme Court intended.<sup>91</sup>

For example, in *Farm Service Credit Corp. v. Western Buyers*,<sup>92</sup> the Iowa Court of Appeals held that the district court could properly consider evidence of the creditor's "failure to supervise, check, or follow up on its security" in determining that the creditor had waived its security interest.<sup>93</sup> In *Western Buyers* the defendant was a hog buyer who had purchased hogs on several occasions from a farmer who had granted a security interest to the local Farm Services Company.<sup>94</sup> The security agreement and promissory notes were assigned to the plaintiff.<sup>95</sup> In previous transactions with the original creditor, the farmer did not have to obtain consent because no security agreement existed.<sup>96</sup> Subsequently, a security agreement was created and assigned to the plaintiff which included the hogs as collateral, but the farmer

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87. IOWA CODE § 554.1205(4).

88. See *supra* note 70 and accompanying text.

89. *Hedrick Sav. Bank v. Myers*, 229 N.W.2d at 255.

90. See McDonough, *supra* note 85, at 48.

91. See *Ottumwa Prod. Credit Ass'n v. Heinhold Hog Market, Inc.*, 340 N.W.2d 801, 803 (Iowa Ct. App. 1983). In this recent case, the Iowa Court of Appeals held that a credit association which did not require compliance with the written consent provision of a security agreement impliedly authorized the sale of part of the collateral. *Id.* at 802. The Court of Appeals concluded that, based on the prior course of conduct between the lender and farmer, the lender waived its security interest. *Id.* at 803. Thus, there was no genuine issue of material fact, and the granting of the buyer's summary judgment motion was affirmed. *Id.*

92. *F.S. Credit Corp. v. Western Buyers*, No. 2-63546 slip op. (Iowa Ct. App. Aug. 26, 1980) (per curiam).

93. *Id.* at 3.

94. *Id.* at 1.

95. *Id.*

96. *Id.*

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continued to sell the hogs as he had done in prior dealings, even though the security agreement expressly required written consent to sell the collateral.<sup>97</sup> These facts led the district court to conclude that the prior course of dealing, the general custom of the area,<sup>98</sup> and the plaintiff's failure to supervise the collateral all brought the case within the "or otherwise" language of section 554.9306(2).<sup>99</sup> Therefore, the district court held that the creditor impliedly authorized and acquiesced in the sales, and thus the provision of the security agreement requiring written consent prior to sale was inapplicable.<sup>100</sup>

Assuming the *Western Buyers* decision is *not* unique it would appear that the burden placed on the creditor by the lower courts, to protect its security interest, will be substantial; perhaps more substantial than the *Hedrick* court anticipated. At this point, it would undoubtedly be safest for the creditor to police its debtor farmers, no matter how objectionable such a task may be.<sup>101</sup> While policing a security interest by on-site inspection of the collateral, objecting to unauthorized sales, and requiring strict compliance<sup>102</sup> with the security agreement may be a means of avoiding the "or otherwise" waiver,<sup>103</sup> one commentator has suggested that secured parties may want to supply potential purchasers with a list of borrowers.<sup>104</sup> Such a list would provide the purchasers with sufficient notice so that the creditor's perfected security interest is preserved.<sup>105</sup>

A serious problem that could result from placing the burden on the creditor to protect its interest is that agriculture, which is an industry which requires a substantial amount of operating capital, may be faced with a

97. *Id.*

98. *F.S. Credit Corp. v. Western Buyers*, No. 56181, slip op. at 15 (Iowa 1st. Jud. Dist. Mar. 31, 1979), *aff'd*, No. 2-63546 slip op. (Iowa Ct. App. Aug. 25, 1980) (per curiam).

99. *Id.* at 18.

100. *Id.* at 17.

101. See McDonough, *supra* note 85, at 48 ("[p]olicing farmers by county banks may be abhorrent to those banks, but it is undoubtedly the safest course to follow to prevent such losses by a secured party").

102. See Meyer, *supra* note 5, at 39.

103. There remains the question of how often collateral must be inspected. It is conceivable that under *Western Buyers* the duty could involve anywhere from annual inspection to daily inspection.

104. See Meyer, *supra* note 5, at 38. The author stated:

On the one hand, the lender does not want to be uncooperative and it is probably tempted to believe that direct notification may well be the most effective way of assuring that its security interest is noted by the purchasers. On the other hand, the lender must be concerned about such questions as: will this violate any confidence on the part of the borrower? will furnishing the list make it obligated to update the lists? will the unintentional omission of a debtor preclude it from asserting its properly perfected security interest against a purchaser if it has otherwise not consented or waived its interest?

*Id.* at 37.

105. See *United States v. Riceland Foods, Inc.*, 504 F. Supp. 1258, 1263 (E.D. Ark. 1981).

shortage of creditors.<sup>106</sup> The Kansas Supreme Court noted that "following the *Clovis* doctrine, would hinder 'the granting of credit to the capital-intensive agricultural industry' in this state; that such a holding is not in the spirit of the U.C.C., is not required by its terms, and would not be in the public interest."<sup>107</sup> Iowa's adherence to *Clovis* may lead to the same conclusion. Therefore, in light of *Hedrick* and *Lisbon*, the Iowa legislature should consider changing the Article 9 provisions dealing with security interests in farm products to effectuate the purpose of those provisions.

#### IV. PROPOSED CHANGES TO THE FARM PRODUCTS EXCEPTION

When the potential problems caused by requiring the secured party to police its security interest are considered, it becomes readily apparent that the Article 9 farm products provisions need to be amended. There is a concern, however, that uniformity is an essential element of the Code, and that changing the Code would result in more serious problems than those raised by following the *Clovis* doctrine.<sup>108</sup> The answer to this concern is that the courts have already deviated from these provisions, "so that there is in fact no uniformity."<sup>109</sup> In fact, a clarification of the Iowa statutory provisions dealing with farm products would help the parties involved in secured transactions to understand their duties and obligations more clearly, rather than create a lack of uniformity. The result could be an agricultural industry with ready access to needed capital.

There are two proposals<sup>110</sup> which the Iowa legislature should consider if it attempts to clarify the rights and obligations of farm creditors and buyers of farm products. The selection of either of these proposals would involve a determination of which party should bear the risk of the debtor's default.

Were the legislature to determine that the creditor should bear the burden of protecting its security interest, it should consider amending the present statutes so that the creditors duty would be clearly expressed. Such changes would define the extent to which a secured creditor would have to police its security interest.

In order to effectively shift this burden to the creditor, the legislature should make two significant changes in the law of farm product security interests. First, section 554.9203 should be amended to add section 554.9203(5) which would state:

A security agreement gives the secured party a right to require that the

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106. See *supra* notes 33-35 and accompanying text.

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

108. Cf. *Dolan*, *supra* note 28, at 725.

109. *Id.*

110. A third alternative would be to eliminate the farm product exception from section 554.9307(1). See CAL. COM. CODE § 9307(1) (West 1983). Again, the concern for an adequate credit supply would rule out this alternative.

debtor include as a part of the security agreement a list of persons to whom the debtor desires to sell or otherwise dispose of the collateral to a person other than a person so disclosed to the secured party, unless the debtor has notified the secured party of his desire to sell or otherwise dispose of the collateral to such person at least seven days prior to the sale or other disposition.<sup>111</sup>

The legislature should then eliminate the "farm products" exception from section 554.9307(1)<sup>112</sup> but allow for an exception in section 554.9307(4) which would state:

A person buying farm products in the ordinary course of business from a person engaged in farming operations takes free of a security interest created by the seller even though the security interest is perfected unless, within [five] years prior to the purchase, the secured party has given written notice of his security interest to the buyer, sent by registered or certified mail. Such notice shall contain the name and address of the seller, a statement generally identifying the farm products subject to the security interest, and an address of the secured party from which information concerning the security interest may be obtained.<sup>113</sup>

The effect of this legislation would be to protect the buyer of farm products from liability to a secured party unless the purchaser had actual notice of the security interest. The secured party would not be protected if the farmer sold to a person other than the person disclosed to the secured party, but the farmer could be charged with a misdemeanor for the sale. It should be noted that placing this burden on the secured party may not be justified in Iowa. The rationale in most states for placing the burden of notice on the secured party is that "[t]he secured party can far better supervise the debtor's behavior than the ultimate buyer who is neither privy to the security agreement nor cognizant of its provisions governing disposition."<sup>114</sup> This statement may be true for a state that utilizes a county filing system for security interests in farm products.<sup>115</sup> In these states the buyer has a substantial problem in locating all security interests in farm products it was about to purchase.<sup>116</sup> This problem may justify charging the creditor with an affirmative duty to protect its security interest by providing actual notice to all potential buyers of the collateral. This is not, however, the situation in

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111. A proposal similar to this has been adopted in Illinois. See ILL. REV. STAT. ch. 26, §§ 9-205.1, -306.02 (1983).

112. See ILL. REV. STAT. ch. 26, § 9-307(1) (1983).

113. See ILL. REV. STAT. ch. 26, § 9-307(4) (1983). The Illinois legislature has also provided protection for commission merchants or selling agents who dispose of the collateral. ILL. REV. STAT. ch. 26, §§ 9-307.1, -307.2 (1983).

114. Dugan, *supra* note 489, at 361.

115. The adoption of such a burden on the creditor may have been justified in Illinois since Illinois uses county filing. See ILL. REV. STAT. ch. 26, § 9-401 (1983).

116. Dolan, *supra* note 28, at 736 ("impossible search burdens imposed by the local filing rule and the 'his seller' feature of section 9-307(1)").

Iowa. Iowa has a centralized system for filing security agreements that is effective anywhere within Iowa.<sup>117</sup> Therefore, the Iowa legislature could properly determine that the purchaser should have the burden of checking for any security interest in the farm products it was about to buy.

If the Iowa legislature concluded that the burden of checking for security interests should be placed on the buyer of farm products, then, in light of the *Hedrick* and *Lisbon* decisions, it would be necessary to enforce the farm products exception of section 554.9307(1). That may be accomplished by amending section 554.9306(2) to read:

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. *A security interest in farm products shall not be considered waived nor shall authority to sell, exchange, or otherwise dispose of farm products be implied or otherwise result from any course in dealing between the parties or by any trade usage.*<sup>118</sup>

Iowa's use of a central filing system makes it relatively easy for the buyer to obtain information regarding filed security interests.<sup>119</sup> The buyer could then make payment with a joint payee check to the seller and the creditor to avoid liability under section 554.9307(1).<sup>120</sup>

Adopting this proposal would also eliminate the problems of interpreting course of dealing and trade usage. Therefore, the creditor would not be put in a *Western Buyers* situation of being required to police its security interest.<sup>121</sup> The rights and obligations of the parties would be clarified. The creditor would be responsible for perfecting the security interest,<sup>122</sup> and the buyer would be required to check for a security interest or assume the risk of purchasing subject to the interest.<sup>123</sup>

## V. CONCLUSION

Iowa's Uniform Commercial Code provisions concerning secured trans-

117. IOWA CODE § 554.9401.

118. Statutory provisions similar to this have been adopted in other states. See ARK. STAT. ANN. § 85-9-306(2) (1983); N.M. STAT. ANN. § 55C-9-306(2) (1983) (this statute was amended in response to the *Clovis* decision).

119. Meyers, *supra* note 5, at 26. See IOWA CODE § 554.9407 (explanation of how to obtain filed information).

120. Meyer, *supra* note 5, at 37.

121. *F.S. Credit Corp. v. Western Buyers*, No. 2-63546, slip op. at 3 (Iowa Ct. App. Aug. 25, 1980) (per curiam).

122. See *supra* text accompanying notes 5-15.

123. IOWA CODE § 554.9307(1).



actions in farm products<sup>124</sup> have been interpreted by the Iowa Supreme Court in a manner that does not adequately define what a farm creditor must do to protect its security interest.<sup>125</sup> The problems caused by the court's decisions require legislative action to clarify the rights and obligations of the creditor, debtor, and purchaser. The fact that Iowa has a central filing system for farm products which provides readily available information to the purchaser,<sup>126</sup> combined with the difficulty of determining course of dealing or trade usage<sup>127</sup> justifies the conclusion that the buyer should be responsible for determining whether the farm products are collateral. Therefore, the legislature should amend section 554.9306(2) to expressly prohibit waiver by course of dealing or trade usage.<sup>128</sup> The result would be to insure adequate financing of the individual farmer by protecting the agricultural financier.

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124. IOWA CODE §§ 554.9306(2), .9307(1).

125. See *supra* text accompanying notes 88-104.

126. See *supra* note 118 and accompanying text.

127. See *supra* text accompanying notes 91-104.

128. See *supra* text accompanying note 117.