

What Every Farmer Should Know About Secured Transactions

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Prepared by Christie M. Hayes, Legal Research Assistant*
Under the Direction and Supervision of Professor Leslie M. MacRae
The Agricultural Law Resource and Reference Center
The Dickinson School of Law of The Pennsylvania State University

I. Introduction

Without even realizing it, Pennsylvania farmers utilize secured transactions on a regular basis. Particularly with high-priced farm equipment, the average family farm may not have enough cash on hand to buy the farm product outright. In this situation, the seller of the property or service must decide whether to require cash payment or to extend credit. Credit can be extended without requiring collateral (unsecured credit) or by requiring collateral (secured credit). Typically one party, the debtor, buys a product from another party, the creditor or secured party, but does not pay immediately. The secured party wants to be able to rely on something other than the debtor's promise to ensure payment. A security interest may be defined as a limited right in specific property, the collateral, of the debtor that allows the creditor to take the property should the debtor fail to fulfill his credit obligation. In Pennsylvania, such security interests are governed by Article 9 of the Uniform Commercial Code. These statutes have been recently revised, impacting agricultural transactions in many ways.

The purpose of this paper is to provide an introductory framework for how the law of secured transactions impacts common agricultural business transactions.

* Juris Doctor 2004. The Dickinson School of Law of The Pennsylvania State University. Professor MacRae teaches courses in ocean and coastal law, natural resources law, maritime law, and land use regulation at The Dickinson School of Law of The Pennsylvania State University.

II. The Scope of Article 9

In order for the Uniform Commercial Code (U.C.C.) rules to apply, the personal property or fixture must be of the type that Article 9 governs. Proper categorization of the personal property or fixture is crucial because different perfection and priority rules apply to different types of collateral. Article 9 divides personal property into three distinct categories: (1) Tangible Personal Property (Goods), (2) Semi-Intangibles, and (3) General Intangibles.¹ The collateral's type is determined by its primary use in the hands of the debtor. Most personal property items relating to agriculture fall within the "Goods" category. The U.C.C. defines Goods as:

All things that are movable when a security interest attaches. The term includes (i) fixtures, (ii) standing timber that is to be cut and removed under a conveyance or contract of sale, (iii) the unborn young of animals, (iv) crops grown, growing, or to be grown, even if the crops are produced on trees, vines, or bushes, and (v) manufactured homes.

U.C.C. § 9-102 (44).

The U.C.C. also has a definition for Farm Products. Farm Products are defined as:

Goods, other than standing timber, with respect to which the debtor is engaged in a farming operation and which are:

- (A) crops grown, growing, or to be grown, including:
 - (i) crops produced on trees, vines, and bushes; and
 - (ii) aquatic goods produced in aquacultural operations;
- (B) livestock, born or unborn, including aquatic goods produced in aquacultural operations;
- (C) supplies used or produced in farming operation; or
- (D) products of crops or livestock in their manufactured states.

U.C.C. § 9-102 (34).

The U.C.C. also distinguishes between Farm Products and Inventory. Inventory means

- Goods, other than farm products, that
- (A) are leased by a person as lessor;
- (B) are held by a person for sale or lease or to be furnished under a contract of service;
- (C) are furnished by a person under a contract of service; or
- (D) consist of raw materials, work in process, or materials used or consumed in a business.

U.C.C. § 9-102 (48).

It is therefore possible for a farmer to convert a farm product into inventory. Official Comments suggest that certain processes such as pasteurizing milk are so related to farming operations that they would not constitute manufacturing. However, others such as an extensive canning operation, would constitute manufacturing, therefore converting a farm product into inventory through the manufacturing process.²

III. Creating a Security Interest

A. Attachment

In order for a creditor to enforce a security interest (i.e. repossess the collateral), the security interest must first go through the statutory process of attachment. In order for attachment to occur, three requirements must be met.

First, the debtor must authenticate a security agreement describing the collateral. Generally, authentication means that the debtor signs a writing or places a symbol in a record to identify the sender.³ For example, Big Farmer sells a high priced tractor to Little Farmer. Little Farmer is unable to pay for the tractor in cash so Big Farmer extends credit to Little Farmer. In doing so, Big Farmer wishes to create a security interest in Little Farmer's collateral. Little Farmer must now authenticate a security interest describing the collateral. The agreement need not be formal, but it must show an intent to

grant a security interest. The items of collateral may be described individually by a list or the collateral may be described using the statutorily defined type of collateral (i.e. Farm Product, Equipment, Inventory). The collateral may not be described using exceptionally broad terms such as “all assets” or “all personal property.”⁴ Little Farmer signs a letter, agreeing that Big Farmer takes a security interest in his “farm Products, equipment, and inventory” in order to secure the credit extended for the tractor. Big Farmer can even choose to take a security interest in property acquired after the security agreement is signed by including terms such as “all my present and future equipment.”

Next, the secured party must have given value for attachment to occur. For example, valuing a high-priced tractor at \$1 is usually not considered to be giving value to an item.

The debtor must also have rights in the collateral. For example, Little Farmer does not have to have complete ownership of the equipment listed as collateral in the security agreement. Big Farmer gets only Little Farmer’s interest in the property, even a partial interest, provided that default occurs.

Although attachment defines the relationship between the secured party and the debtor, it says nothing about the security interest in relation to the rest of the world.

B. Perfection

Parties other than the secured party may have right to the collateral of the debtor. To acquire the maximum priority in the collateral over most third parties, it is not enough that the security interest has attached. Rather, the secured party must also perfect the interest. The primary methods of perfection include perfection by 1) filing or by 2) taking possession of the collateral.

The revised version of Article 9, adopted by a majority of the states including Pennsylvania, states that a secured party should perfect its interest in farm products by filing a financing statement in the office of the secretary of state in the state in which the debtor is located. For example, if Big Farmer is in Pennsylvania and Little Farmer is in Maryland, Big Farmer should file his financing statement in Maryland instead of Pennsylvania.⁵ A financing statement is simply a written notice filed to put other potential secured parties on notice that a security interest has already been taken in certain collateral. Notice is given when a financing statement includes the name and mailing address of the debtor, the name and mailing address of the secured party, and an indication of the collateral covered by the financing statement.⁶ Financing statements are indexed under the debtor's name. Although minor errors in the debtor's name will not invalidate the financing statement, the statement must not contain any seriously misleading errors.⁷ A financing statement will sufficiently indicate the collateral if it identifies it specifically or identifies it by category. Even broad descriptions such as "all assets" or "all personal property" are valid for financing statements.

It is worth noting that certain kinds of collateral may be categorized as fixtures. A fixture is collateral that has become so related to particular real estate that an interest in it arises under real estate law.⁸ Each jurisdiction differs in the definition of what constitutes a fixture. For example, gas pumps in gas stations and a pizza oven installed in a restaurant all raise fixture issues. A fixture filing is a special kind of financing statement which is filed with the real estate records and is not filed with the secretary of state.

A security interest is also perfected in goods if the secured party simply takes possession of the property. By taking possession of the property, the secured party alerts other potential third parties that he has a security interest in the collateral already.⁹

IV. Security Interests and Priority

The general principle of priority is that the first person to either file or perfect has priority over competing claims to the same collateral. Priority only becomes an issue when two different parties assert that they have competing interests in the same collateral.

In general, a perfected security interest has priority over an unperfected security interest. The perfected secured party will have priority over the unperfected secured party even if the person took it with knowledge of the unperfected security interest.¹⁰

Farmers should note an exception to this rule for purchase money security interests (PMSI). A PMSI is a security interest in collateral that is either taken by a supplier of the collateral to finance its purchase price or taken by the third party lender who provided the funds used to purchase the collateral.¹¹ This PMSI superpriority applies to collateral other than inventory if it is perfected within 20 days after the debtor receives possession of the collateral.¹²

If two or more secured parties have PMSIs in the same collateral the general first to file or perfect rule still applies. Under such a situation, priority goes to the secured party who first filed or perfected with the exception that a seller will have priority over a third party lender in that situation. For example, Farmer Small decides to go to the bank to borrow money to purchase the tractor. Farmer Small grants the bank a purchase money security interest in the tractor. Farmer Small then goes to a Dealer and gives the

money he borrowed from the bank as a down payment on a new purchase. He grants the dealer a security interest in the tractor to secure the rest of the purchase price. If both secured parties perfect within 20 days after Farmer Small takes possession of the tractor, the dealer will have priority over the bank (a third party lender), regardless of who files first. Other special rules apply to purchase money security interests and one should consult a competent source in order to ensure that the formalities for priority have been properly taken.

A PMSI may also have priority over another perfected secured party if the purchase money security interest is perfected by the time the debtor receives possession of the collateral and notifies the competing secured party before the debtor receives possession.¹³ This rule would apply to common farm inventory such as cattle and hogs.

A special rule also specifically applies to a buyer of farm products in the ordinary course of business. For farm products, the Federal Food Security Act applies rather than Article 9 of the Uniform Commercial Code. The statute provides in pertinent part that:

A buyer who in the ordinary course of business buys a farm product from a seller engaged in farming operations shall take free of a security interest created by the seller, even though the security interest is perfected; and the buyer knows of the existence of such interest.

7 U.S.C. § 1631 (d).

A “buyer in the ordinary course of business” is a buyer who buys under normal circumstances from a seller who is in the business of selling goods of that kind. For example, the owner of an orchard who sells his peaches to a grocery store would make the store a buyer in the ordinary course of business because the owner of the orchard is in the business of selling goods of that kind (i.e. fruit).

V. Additional Considerations and Conclusion

It should be noted that special rules apply when the debtor defaults on payment to the secured party. For example, the secured party may take possession of the collateral through self help if this can be done without breach of the peace. However, specialized rules apply to default and consulting a competent professional familiar with jurisdictional rules of default would be prudent. A party may often try to disguise a security interest as a lease. Under Pennsylvania law, the test for whether a transaction is a lease or a security interest is whether property with significant value will return to the “lessor” at the end of the lease term. In other words, parties cannot disguise a secured transaction by merely terming it a “lease.” Special rules for agricultural liens may also apply to the parties in the secured transaction.

The law of secured transactions is often complicated and evolving. Special attention should be given to transactions involving high stakes or large sums of money. In such a situation, even a seemingly minor mistake or omission may create problems for the secured party in the event that default does occur. It is important to understand that the creation of the debtor-secured party relationship has special legal implications that need to be considered before a transaction is properly consented to.

This paper was intended to convey a basic understanding of Secured Transactions in Pennsylvania. As with many laws and regulations, the Uniform Commercial Code is complex and holds many exceptions specific to varying situations. The Agricultural Law Resource and Reference Center does not provide legal advice, nor is its work intended to be a substitute for such advice and counsel.

¹ Jeffrey J. Kirk, II. “The Impact of Revised Article 9 of the Uniform Commercial Code on Security Interests and Agricultural Liens in Farm Products and Goods Used in Farming Operation.” American Agricultural Law Association 2002 Annual Meeting.

² U.C.C. § 9-102, Official Comment 4(a).

³ Kirk, page 4.

⁴ Louis F. Del Duca, et al. *Secured Transactions Under the Uniform Commercial Code and International Commerce*. Page 72 (2002).

⁵ U.C.C. § 9-310.

⁶ U.C.C. § 9-502.

⁷ Kirk, page 5.

⁸ U.C.C. § 9-102.

⁹ Kirk, page 6.

¹⁰ U.C.C. § 9-322 (a)(2).

¹¹ Kirk, page 7.

¹² U.C.C. § 9-334.

¹³ U.C.C. § 9-324(d).