

FOOD SECURITY ACT

Tim W. Thompson

The Food Security Act was signed by President Reagan in December of 1985. Section 1324 of the Act abrogated the farm products exception to § 9-307(1) of the Uniform Commercial Code that existed at that time. The purpose of § 1324 was to preempt the farm products exception so that buyers could take clear title to commodities and farm products. One of the primary purposes of the Act was to protect grain elevators which had been subjected to double liability or "double jeopardy" by failing to identify lien claimants on grain that the elevators purchased. The Food Security Act set up a procedure whereby the various states, which often had convoluted lien notation processes, could simplify and streamline the process so that a grain buyer could easily verify the lien status of commodities it was purchasing.

Although well intended, the Act and its incorporation and implementation into Nebraska law has not removed liability of grain or livestock purchasers. However, it is not necessarily the system that has resulted in double liability to commodity purchasers. The system itself is quite simple and works rather well. The problem is in the use (or neglect) of Nebraska's Central Filing System by commodity purchasers which, when coupled with dishonest grain or livestock sellers, results in double liability.

The following constitutes some random thoughts on how to avoid turning that \$3.40 corn into \$6.80 corn or those \$1,500.00 bred heifers into \$3,000.00 commercial cows.

I. CNS TRUMPS PNS IN NEBRASKA

When the Food Security Act was passed, the federal government, through the Packers and Stockyards Administration, gave the various states two options from which to select a system of lien notification. In November of 1986, the Nebraska Legislature selected a Centralized Notification System (CNS). Other states, Kansas for instance, selected a Presale Notification System (PNS).

Nebraska opted to set up its CNS through the Nebraska Secretary of State's office. The Secretary of State was charged with the task of organizing a computer system to serve as a clearing house on lien information. The USDA certified Nebraska's CNS on December 16, 1986, and it became effective with § 1631 of the Food Security Act on December 23, 1986.

Food Security Act

Under a CNS system, liens on farm products are centrally collected, organized and recorded and made available to the public through a variety of formats.

Under a PNS system, a lender is required to notify a potential purchaser of the existence of its lien in order to receive protection. In a PNS state, at the time a loan is made or renewed a lender will typically obtain a list of entities or individuals who will buy a borrower's commodity. Notices are then automatically mailed to those potential purchasers and a record is kept of the lender of service of the notice on the potential purchasers. If a purchaser then fails to acknowledge the lien at the time a payment is made to the borrower, then the purchaser can be subject to double liability.

The essential distinction between CNS and PNS is the determination of which party bears the brunt of locating liens. Under a CNS, the purchaser of the commodity is duty-bound to undertake a search to determine whether liens attach to the commodity being purchased. Under a PNS, the lender is obligated to identify who the purchasers will be and then provide them with verifiable notification of the lien.

It is important to note that the state from which the commodity was grown or purchased is the state whose system of lien identification applies. Thus, if a Kansas grain elevator buys Nebraska corn, the Kansas elevator, to be protected, must be a subscriber to Nebraska's central filing system. See: *Ag Services of America, Inc. v. United Grain, Inc.*, 75 F.2d 1037 (1999).

Additionally, it is important to note that CNS and PNS are mutually exclusive alternatives. Once a state adopts CNS, it becomes the exclusive method for providing actual notice to buyers, commission merchants and selling agents of farm products covered by that state's CNS. Even though it may be more convenient and perhaps less costly, lenders are not permitted to choose PNS if they hope the protections of the Food Security Act are to apply to them.

II. EFSSs, UCC-1s, STATUTORY LIENSWHAT IS THE DIFFERENCE AND WHY WOULD ANYONE CARE?

The folks involved in farming or ranching operations who borrow money (and that's most of us) have been asked by their lenders to sign Effective Financing Statement (EFS) forms and UCC-1 forms. These documents are essentially mortgages on personal property. Sample EFS and UCC-1 forms are attached. In

Food Security Act

addition, there are a variety of statutory liens which can apply to agricultural borrowers. Predominant among these are agister's liens for the care and feeding of livestock or thresher's and harvester's liens for those who assist in the harvest of a variety of crops. At the same time as Nebraska was creating and implementing CNS, it also implemented centralized information on UCC farm-related goods and centralized notification of agricultural statutory liens. All of these liens can now be found in the Secretary of State's records. Yet, each of these liens is distinct and the system in place at the Secretary of State's office keeps them separate and independent. Thus, it is important to understand the difference between the three lien interests.

A. EFSs.

EFSs cover only farm products. Essentially, that means crops and livestock but also includes commodities like vetch and agricultural insects such as bees. The farm products covered are spelled out in § 52-1308. Farm products include all of the customary crops that one typically anticipates will be grown in Nebraska, as well as most livestock. The farm products are listed with their code numbers on the backside of the EFS-1.

B. UCC-1s.

UCC-1s usually cover "crops" whether growing, harvested or stored and livestock as well as their progeny. In addition, UCC-1s typically cover equipment used in farming operations, farm products, accounts, general intangibles, inventory and a number of other classifications of collateral. A lender seeking to claim commodity or livestock collateral should always obtain and file both an EFS and an UCC-1, even though they may appear to overlap.

C. STATUTORY LIENS.

Similarly, statutory liens are centrally recorded in the Secretary of State's office under a separate data base. Purchasers of cattle, in particular, will want to review this data base to verify there are no agistment liens on the cattle they are purchasing. The data base also includes statutory liens for veterinary care, fertilizer, seed, electrical energy, repairs to farm equipment, shoeing for horses and mules and, as previously mentioned, thresher's and harvester's liens.

Food Security Act

III. ACCESSING THE DATA BASES.

Any purchaser of a farm product seeking to know whether a seller has used farm-related goods or commodities as collateral or to verify whether any statutory liens have been filed against the crop or livestock have essentially five ways to access the information in the Secretary of State's data bases.

First, you can actually go to the Secretary of State's office and actually inspect the records kept there. Obviously, this is more easily done if one lives in Roca instead of rural Hershey.

Second, you can make a written request or telephone request and seek the salient information from the Secretary of State's personnel who will provide the information during their actual business hours. The problem here, obviously, is that many transactions in the ag community do not take place during regular business hours but before 8:30 and after 5:00 or on weekends and holidays. Telephone inquiries can be directed to (402) 471-4080.

Third, computer access is available 24 hours a day. Note, however, that EFS data accessed through the electronic network shall be for *informational purposes only* and does not provide protection afforded a buyer who registers under the system as described in more detail below. Additionally, computer access is limited to subscribers of Nebraska Online for which one must pay \$50.00 per year. To subscribe to Nebraska Online, you can go to the www.nebraska.gov home page. On the right-hand side of the page you will find "Become a Subscriber". Click on that and about halfway down the next page will be information on how to subscribe.

Fourth, a potential buyer can typically go to the offices of his or her county clerk or cooperative extension agency where "Ag Net" is available. These computers have access to the Secretary of State's UCC information. Again, the primary drawback here is the lack of convenience and the fact that the search has to occur during the normal business hours. Additionally, the buyer may receive the information necessary to put the proper names on the disbursement check from the computer access but the reviewer does not receive the protections he would have if he were a subscriber under the system. See: Neb.Rev.Stat. § 52-1313.01.

Food Security Act

Finally, the safest harbor available to a purchaser of farm products under the Food Security Act under Nebraska's CNS is to be a subscriber or to be "registered" with the Secretary of State's office. The Secretary of State prepares a master list of entities and individuals subject to EFS liens which is published in a booklet form or available on microfiche or CD. The information is published quarterly. The Secretary of State maintains a record of all registrants. Any registrant who reviews the list takes free of any liens created by any EFS that did not appear in the registry assuming the registrant notes the liens on any check issued.

Presently, there is a \$30.00 registration fee per year. The CD then costs \$165/quarter, the paper booklet \$200/quarter and the microfiche \$25/quarter.

Because the lists are published quarterly, it is likely that the liens of any lender providing operating capital to an ag borrower will have its lien noted in the registry. With only a three month gap between publications, it would be rare (though not impossible) for an ag lender to obtain a lien and properly index it only to have the ag borrower sell the commodity within three months or before the next publication appears. However, statutory liens typically intervene in a more rapid fashion and often only after problems develop with an ag borrower. For instance, an agister's lien typically is not filed until the last pasture rent payment is due or about to become due. The filing of the agister's lien could easily fall within the three month gap. Thus, a review of the quarterly publications from the Secretary of State's office may not identify a valid lien. The safest approach is to be both a registrant with the Secretary of State and to do a computer lien search before issuing a check to the seller of the ag commodity.

IV. OK, I HAVE LOCATED A LIEN, NOW WHAT DO I DO?

As indicated above, Nebraska law provides that a purchaser of an ag commodity takes subject to the liens of any entity which has noted its lien in the CNS unless the purchaser is a registrant under the central filing system or if the purchaser makes a written or oral inquiry from the Secretary of State personnel and the system incorrectly identifies the debtor. Neb.Rev.Stat. § 52-1320.

It is at this point where the double jeopardy problem arises. If a purchaser does not register with the Secretary of State or does not review the information available, she takes subject to the existing lien even though she has paid the seller

Food Security Act

the full purchase price for the farm product. The lender or lienholder can then sue the purchaser for her failure to acknowledge its lien. Because the value of the farm product "converted" in the transaction was established by the transaction itself, the damages due the lienholder essentially become the value of the purchase a second time. Double jeopardy!

There are two methods whereby the purchaser can protect herself once the lien is identified.

First, the purchaser or, as the statute phrases it, the "buyer in the ordinary course of business" can obtain a waiver or release from the secured party or lienholder. The buyer needs to obtain the waiver or release before a check is issued to the seller. The statute does not require the waiver or release to be in writing but, unquestionably, that would be the better practice. Many lenders, when they have a solid working relationship with their borrower, will be willing to waive the notation of its name on the check to the borrower if it is convinced it will receive the funds anyway. Under Nebraska law, a lender can sporadically waive its lien interests without giving up its lien altogether. See: *United Grain, Inc.*, supra; Neb.Rev.Stat. UCC § 9-306(2).

The second way in which a buyer can be protected is by noting the lienholder's name on the check issued to the seller. If the lienholder's name appears on the check and the lender authorizes the negotiation of the check, the buyer is protected. Neb.Rev.Stat. § 52-1320(2).

An interesting situation can arise where the lender's name was placed on a check and then the borrower forged the lender's endorsement on the check in order to negotiate it through a different bank. It would seem under those circumstances that the purchaser would be similarly protected and the lienholder's claim would be against the bank that accepted a forged endorsement.

Another interesting question can arise where the lender's name is not placed on the check but the borrower, nonetheless, negotiates the check using the borrower's lending bank as the depository bank. One would logically think that the bank had access to those same funds and, thus, was not damaged by the fact the lender's name was not placed on the check. However, there is law to the effect that a general deposit, i.e. the lender's name is not noted as a payee on the check, does not protect the purchaser like a purchaser would be protected if the

Food Security Act

lender's name was on the check requiring the lender's endorsement or "special deposit". In *Damrow v. First National Bank*, 300 B.R. 479 (2003), Judge Mahoney of the Nebraska Bankruptcy Court held that a cattle seller who deposited proceeds from the sale of livestock in his lender's bank was not absolved from liability to the bank even though the proceeds from the payment could be traced to a pay down of the seller's loan. Judge Mahoney, citing an opinion in *Miracle Hills Centre, L.P. v. Nebraska National Bank of Omaha*, 230 Neb. 899, 434 N.W.2d 304 (1989), determined that there was a difference between special deposit accounts and general deposit accounts and that the purchaser could have avoided liability by noting the seller's lienholder as an additional payee on the check. Judge Mahoney concluded his opinion by stating:

In this case, Skane [the purchaser] did nothing to protect itself from the application of the Nebraska effective financing statement requirements, nor did it do anything to protect itself from the perfected security interests held by [First National] in all of the Damrow cattle livestock assets. Skane's reliance at this time upon equitable principals is not appropriate.
Damrow at 488.

Thus, if the state or federal courts were to adopt Judge Mahoney's reasoning, the mere fact that the funds ultimately were within the grasp of the lienholding lender may not be enough to protect a farm product purchaser who fails to specifically note the lender's name as a payee on the disbursement check.

V. BEWARE OF GHOULIES AND GHOSTIES AND THREE-LEGGED BEASTIES AND THINGS THAT GO BUMP IN THE NIGHT, AS WELL AS THE FOLLOWING:

- 1) The non-regional seller.
- 2) The producer who asks (or instructs) that the grain be sold in his wife's/children's/parent's name/hired man's name/harvester's name/new entity. Or, the brand on the cattle does not match the name the seller supplies.
- 3) The producer who indicates the commodity is owned by an entity which is "lien free" when the producer is "liened up".

Food Security Act

4) The producer who indicates that his lender (& lien holder) has authorized the check be issued in producer's name alone.

5) The producer who asserts the check should be in his name alone "because we've always done it that way".

6) Ignoring similar, but not identical, appearing entities.

7) The innate fear of offending a customer by asking too many questions.

8) The seller who indicates the lien is only on the prior year's crops or prior year's calves.

9) The seller who indicates the lien (or debt) was discharged in bankruptcy.

VI. HOW TO REDUCE RISKS.

1) Do a thorough check - frequently.

2) Determine who the producer actually is
-under FSA records: what is the FSA Farm #?
-who owns the land?
-from which tracts did the crop come?

3) Call the lienholder if suspicions are raised
-lien waived
-similar entity
-in wife's name
-liened up producers, lien free seller

4) Get all lien waivers in writing if possible. (Not required to be in writing, but it is sure nice evidence to have.) Neb. Stat. 9-315(2) Do a CYA letter if you can't get a written waiver in time but receive a verbal release from lienholder.

5) In border State areas, determine from which State the crop was grown and then comply with that State's laws.

6) When in doubt - better to include too many payees than not enough (Hostage Check Stat).

7) If unable to complete a search, stall until one can be completed.

Food Security Act

8) Ask if there are liens on the farm product being purchased.

9) Do not risk more than you can afford to lose. The bigger the amount converted, the larger the target you become.

VII. CONCLUSION.

Do not work for free. If the person with whom you are doing business is honest and forthright, he will have no problem disclosing the proper ownership of the farm product or having his lender's name added to the check. Do not let your feelings of guilt or embarrassment for inquiring about ownership and lien status blind you to the adverse effects of not following the law. If you receive objections from the seller of your intent to add his lender's name to the check, either do business with someone else or do what most right-thinking folks would do - blame your lawyer and add the lienholder's name anyway!



KELLEY, SCRITSMIER & BYRNE, P.C.

a Limited Liability Organization

Attorneys at Law

221 West Second Street, Suite 100 P.O. Box 1669

North Platte, Nebraska 69103-1669

(308) 532-7110

Fax: (308) 534-0248

email: ksb@ksblawoffice.com

www.ksblawoffice.com

This site is for informational purposes only and does not constitute legal advice. Any information in this article may be general in nature and may not apply in your particular circumstances. Therefore, you should seek professional legal advice regarding your specific situation before acting upon any information contained herein.

This information or any portion thereof may not be copied or disseminated in any form or by any means or downloaded or stored in an electronic database or retrieval system without the express written consent of Kelley, Scritsmier & Byrne, P.C..