

FARM LEGAL SERIES

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Security Interests in Personal Property

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INTRODUCTION

The best protection a lender can have against potential default is to deal with borrowers who have solid reputations and have demonstrated their ability to repay loans. However, even when dealing with the most reputable borrower, lenders typically require borrowers to pledge property (or collateral) to secure the loan. Collateral is real or personal property owned by the borrower that is pledged to the lender as security for the repayment of the debt obligation. In the event of default, the lender may look to the collateral to satisfy the debt. For further discussion, see fact sheets: *Financing the Farm Operation* and *Contracts, Notes and Guaranties*. Lenders who do not require borrowers to pledge collateral make a much riskier investment and become unsecured creditors, as discussed in the fact sheet, *Right of Unsecured Creditors*.

This fact sheet considers general concepts and identifies various problem areas that arise with the use of personal property, such as livestock, machinery, equipment, and crops, as security for a loan. For a discussion on the use of real property, such as land and buildings, as security for a loan, see fact sheet, *Mortgages and Contracts for Deed*.

GOVERNING LAW

The law governing the legal rights of lenders and borrowers who use personal property as collateral is contained in Article 9 of Uniform

Commercial Code (UCC). Article 9 has been adopted in every state and governs virtually all such transactions. It has simplified the use of personal property as collateral by providing for an almost uniform set of rules nationwide. It does not, however, apply to real estate transactions. This fact sheet only summarizes the law in the State of Minnesota.

PERSONAL PROPERTY AS COLLATERAL

As previously mentioned, Article 9 governs the use of personal property as collateral for a loan. Article 9 classifies certain types of personal property. For our purposes, we will discuss tangible personal property (or “goods”), which would include machinery, equipment, livestock (and unborn young of animals), and crops (grown, growing, or to be grown).

Types of Goods

Generally, goods fall into one of four categories: (1) consumer goods; (2) equipment; (3) farm products; or (4) inventory.

Consumer goods are goods used or bought for personal, family, or household purposes.

Farm products include crops grown, growing, or to be grown, livestock, born or unborn, supplies used or produced in a farming operation, or products of crops or livestock

in their manufactured state, if the debtor is engaged in a farming operation.

Inventory includes goods that are leased by a person as lessor, held by a person for sale or lease or to be furnished under a contract of service, furnished by a person under a contract of service, or consist of raw materials, work in process, or materials used or consumed in a business.

Equipment is essentially any good that is not a consumer good, farm product, or inventory.

It is important to note that a good can only fall into one category at a time, although at times it may be a close call. For example, a farmer's truck might be either a consumer good or equipment depending on its primary use. In addition, the category a good falls into may change over time. For example, farm products, such as livestock or crops, may become inventory when they are no longer part of the farming operation.

Lenders can also take security interests in proceeds from a sale or trade of collateral, property acquired by the debtor after the creation of the security interest and deposit accounts such as a checking or savings account.

CREATION OF SECURITY INTERESTS

Under the UCC, a lender may acquire a "security interest" in collateral. A security interest is a property interest over specific assets that secures performance of an obligation, typically the payment of a debt. The security interest is typically created through a document known as a security agreement and signed in conjunction with the execution of a promissory note or another loan document. For a discussion on promissory notes, see fact sheet, *Contracts, Notes and Guaranties*.

There are two general situations when a security interest is created:

1. When a farmer needs to borrow money but cannot obtain the funds unless some collateral is put up for the loan. Funds may be needed to plant crops, acquire livestock, or obtain machinery. In this situation, the borrower may grant a lender a security interest in his or her personal property in order to obtain the necessary money.
2. When a farmer does not have sufficient funds to pay the full price of a desired purchase. In this situation, the seller may provide the necessary financing and retain an interest in the property. Such a security interest is referred to as a "purchase money security interest."

Security Agreements and Attachment

The benefit of obtaining a security interest in a piece of collateral is that the lender may repossess the collateral and utilize other preferential rights upon default by the borrower. However, in order for the security interest to be enforceable by the lender the security interest must be "attached" to the collateral. A security interest attaches to the collateral when it becomes enforceable against the debtor.

Generally, the process of attachment includes three requirements:

1. The lender must give value for the attachment to occur.
2. The debtor must have rights in the collateral or possess the power to transfer rights in the collateral to a secured party. If the debtor does not have complete ownership of the collateral listed, the lender will take

an interest in the amount that the debtor owns.

3. The debtor must authenticate a security agreement that contains a description of the collateral (unless the collateral is in the possession of the lender, then no authentication is required). The collateral may be described individually or by the defined types of collateral discussed above. The security agreement does not need to contain a detailed description of each item of collateral. For example, it is not necessary to include the serial numbers of each piece of farm equipment or the legal description of the land growing the crops subject to the security interest. Broad terms such as “all personal property” or “all assets” are not sufficient, but stating “all farm products” or “all crops to be grown” is sufficient. However, proper descriptions of the property may allow the farmer to limit the breadth of the security interest to certain parcels of land or pieces of equipment. In addition, property acquired after the security agreement has been signed may be subject to the security interest if the agreement included terms such as “all present and future inventory.”

Restrictions

Besides the required terms, the security agreement generally will have additional terms that deal with the borrower's right to sell the collateral. Most farm security agreements provide restrictions on the farmer's ability to sell the secured property. Some agreements may completely prohibit any sales without the written consent of the lender. Others may allow such sales subject to restrictions as to how the buyer of the

secured property is to pay the farmer, such as requiring that the lender's name appear on any checks issued in payment for such property.

PERFECTION OF SECURITY INTERESTS

In order for the lender's security interest to be valid against third parties such as another lender with a claim against the borrower, the lender must take action to notify such parties of the lender's interest in the collateral. If the collateral is in the possession of the lender, no additional steps are required. This process of giving public notice of a security interest is called “perfection.”

Financing Statement

The usual method for perfecting a security interest is by filing a financing statement (UCC-1) in the proper place. The financing statement is a brief and relatively simple document. It must (1) provide the name and address of the borrower, (2) provide the name and address of the lender (“secured party”), and (3) describe the collateral. It must also include the tax identification number of the borrower. With respect to the name of the debtor, if the debtor is a registered organization (e.g., a corporation, limited liability company, etc.), only the name that appears on an organization's most recently filed public record which purports to state, amend or restate the name of the organization is deemed sufficient. If the debtor is an individual and possess a state issued driver's license or identification card, the name must be as indicated on the driver's license or identification card. If the debtor is an individual but does not possess a state issued driver's license or an identification card, the debtor's surname and first personal name is sufficient. The borrower's signature is not required but he must authorize the filing of the statement. Similar to the security

agreement, the description of the collateral contained in a financing statement need not be exhaustive and need only to mention the types of collateral covered.

Filing

The financing statement must, in most circumstances, be filed with the secretary of state in the state where the debtor's principal residence is located, likely the Minnesota secretary of state. This can be accomplished by filing with the Minnesota secretary of state directly, online, or with one of the designated satellite offices of the secretary of state. If the debtor is a corporation, limited partnership, or limited liability company, the financing statement must be filed in the state where the debtor is registered. The filed financing statement is valid for five years unless it is terminated. Within the five year period, a continuation statement must be filed to extend the filing for another 5 years. For example, if an initial financing statement is filed on January 1, 2015, and a continuation statement is subsequently filed on December 1, 2019, the financing statement has a renewed lapse date of January 1, 2020.

PRIORITY OF SECURITY INTERESTS

In many cases, two or more creditors may have security interests in the same collateral. This raises the question of who has the first claim to the collateral. If one of the competing creditors has failed to file a financing statement, the holder of a perfected security interest will prevail. When two or more creditors file a financing statement covering the same collateral, the general rule under the UCC is that the first to file prevails, regardless of who actually loaned money first. It makes no difference whether the party who filed first knew when the money was advanced that another lender

already had made a loan on the same collateral.

Purchase Money Security Interest

Despite the general rule stated above, the priority of a perfected security interest in after-acquired property can be overcome by a purchase money security interest. A purchase money security interest arises in a situation when a party loans the debtor the money necessary to finance the purchase of goods, and the same goods are used as collateral to secure repayment of the loan. In order for a purchase money security interest to attach the new lender must file a financing statement within 20 days from the time the borrower takes possession of the goods. If this is done, the purchase money security interest will be given priority over the original creditor with an after-acquired property clause in his or her security agreement. A typical example of such a purchase money financing is the financing provided by the financing affiliates of farm machinery manufacturers. Often such financing is offered directly by agricultural equipment dealers.

Special rules apply to lenders who anticipate obtaining a purchase money security interest in livestock. These lenders must not only file a financing statement in order to trump an earlier filed financing statement, but must provide written notice to the other creditors holding conflicting security interests stating that new lender expects to acquire a purchase money security interest in the livestock. The notice must be received by the other creditors within six months before the debtor receives possession of the livestock.

Statutory Liens

A second exception to the first to file rule is provided for certain liens. If a person furnishes services for materials with respect to goods subject to a security interest and

receives a lien against the goods by law (“possessory lien”), that lien will take priority over a perfected security interest. A common example in the farm setting is the case of a farm machinery repair business. So long as the repaired equipment remains in the possession of the repairman, he or she will retain a priority lien for storage charges, transportation, insurance, labor, and other charges necessary for protecting the equipment.

Agricultural Liens

The UCC carves out state statutory agricultural liens that secure payment or performance of an obligation for goods or services furnished or rent on real property leased by a farmer in connection with a farming operation. The priority of these liens may be governed by the specific state lien statute, not the UCC. These liens can be enforced when the farmer fails to perform any obligation owed to the lienholder.

Under Minnesota law, agricultural liens apply to both crops and livestock. These liens are typically limited to those who supply goods or services in the ordinary course of business.

Landlord’s Lien

A landlord’s lien is granted in favor of a landlord leasing real property for agricultural production, a lien for unpaid rent on the crops produced and their products and proceeds on the land, provided that a financing statement is filed by the landlord within 30 days after the crops begin growing. This lien takes priority over other secured creditors.

Harvester’s Lien

A harvester’s lien is granted in favor of a person who combines, picks, harvests, hauls, bales, dries, or stores crops for a farmer provided that a financing statement is filed

by the custom harvester within 15 days after the harvesting.

Crop Production Input Lien

A crop production input lien grants a lien in favor of a supplier of crop production inputs (chemicals, fertilizer, seeds, labor, fuel, etc.) for the unpaid retail cost of the inputs. The lien attaches to the crops produced by the input and their products and proceeds. However, the supplier must notify any creditor who has filed a financing statement prior to providing the crop production input. The creditor may either decide to extend credit to the farmer (for the purchase of the inputs) or notify the input supplier of its unwillingness to extend additional credit. If the creditor fails to respond within 10 days of the notice, the input supplier may assert a first and priority lien on the crops by filing a financing statement.

Similar liens are provided for veterinarians, livestock breeders, livestock production inputs and livestock feeders.

Subordination

At times, if a new creditor cannot obtain priority through a purchase money security interest or a statutory lien, they may require a subordination agreement. A subordination agreement is a voluntary agreement in which a creditor voluntarily gives up its position of priority for that of a new creditor. These agreements may be necessary for a new creditor to extend financing to a farmer.

SPECIAL PROBLEMS FOR FARMERS AND THEIR LENDERS

Farmers and lenders who take security interests in farm products receive special treatment under the UCC. In addition, the very nature of a farming operation raises special problems for agricultural lenders and their customers.

Crop Insurance

Crop Insurance has become a more critical component of a farmer's risk management plan. As a result, lenders are paying more attention to such insurance. Generally, it will be necessary for a lender to obtain an assignment of a crop insurance policy in order to perfect a security interest in such policies. In addition, it will be necessary for the lender to use a federally mandated form for such an assignment. Perfecting a security interest under Article 9 may not be sufficient.

Farm Program Payments

Farmers may participate in any number of farm programs. Many of them result in program payments to the farmer from the government. These rights to payment may be a source of security for the agricultural lender. Such payments are covered by a proper security interest in crops or in general intangibles, a catch-all category of collateral under the UCC. Most courts which have addressed the question have determined that government program payments are included in this classification. However, unfortunately the law in this area is less than clear. In addition to pledging these payments in a security agreement, the farmer may be asked to sign other documents with the government. To perfect its security interest the lender will need to file a financing statement.

After-Acquired Property

Once a lender obtains a security interest under the UCC, it is a durable lien. By means of an after-acquired property clause, a lender may be given a security interest in property that will be obtained or acquired after the signing of the security agreement. Thus, livestock, crops, or other goods acquired by the farmer in the future may be included as collateral for the present loan.

Future Advances

In addition, the UCC allows the parties to agree that future advances of money may be given when needed without making a new agreement. Such provisions are important since a lender who has been granted a security interest in all crops, including crops to be grown at a future date, will possess a security interest in crops that are planted and harvested in later years even though the lender may not have financed the planting and harvesting of such crops. It is not necessary for a farmer to sign a new security agreement or for the lender to file a new financing statement for each crop year.

Products and Proceeds

Besides covering property that may come into existence at a later date, the security interest under the UCC remains intact even though the collateral itself may change through the stages of production. A lien on crops continues as the crop matures in the field, is harvested, and stored. A lien on livestock, including all after-acquired livestock, creates a valid security interest in offspring, whether or not they were conceived at the time the agreement was signed. Finally, the security interest of a lender extends to proceeds of the collateral. Thus, if a farmer sells farm products, the lien holder is entitled to the sales proceeds by virtue of his or her security interest in the farm products themselves.

If a farmer sells farm products, the purchaser of such products takes the farm products free of the prior perfected security interest in the products unless the lender has filed second notice, called an "effective financing statement," with the Minnesota secretary of state under the provisions of a federal statute. If the lender complies with the federal act, and the farmer sells the crops without the permission of the lender, the

lender can sue either the farmer or the purchaser of farm products to either repossess the goods or get damages for the farmer's unauthorized sale.

CONCLUSION

The rules of the UCC with respect to security interests in personal property are of critical importance for the farm operator and lender alike. The farmer must be aware of the

significance of each of the documents he or she is asked to sign. The lender must take all steps necessary to obtain a perfected security interest in the collateral that has been promised for the loan. Once a perfected security interest has been obtained, it remains in place until terminated by the lender or until five years pass.

For more information:
extension.umn.edu/agriculture/business