

FARM LEGAL SERIES

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Farm Leases

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INTRODUCTION

Leases play an important role in many farming operations. Many farm operators do not own or own only a portion of the land they farm. The number of farm operators who lease land continues to rise. Yet many farm landlords and tenants are unfamiliar with the legal aspects of the landlord/tenant relationship. In addition, leasing of farm machinery and equipment has become commonplace.

LEASES IN GENERAL

A lease is an agreement that gives someone ability to use or possess real or personal property (e.g. farm equipment) for a designated period of time in return for some type of payment. Unlike the outright sale of property, a lease does not transfer title, ownership or give an equity interest in the property to the individual in possession of the property, just the right to use or possess the property.

TYPES OF REAL PROPERTY LEASES

Agricultural leases traditionally are divided into two general categories, the cash lease and the crop share lease.

Cash Lease

The cash lease involves a cash payment of either a specified sum or an amount determined by a formula in exchange for the use of farmland. In other words, the landlord

of the farmland receives from the farmer-tenant a certain amount of rent regardless of the crop yields or prices. The farmer-tenant has the sole responsibility for making the management decisions regarding the production of the land.

Crop Share Lease

Under a typical crop share lease, the landlord and farmer-tenant each receive a predetermined percentage of the crop based on their contributions to production. Under this type of lease, both the landlord and farmer-tenant may supply part of the equipment and inputs such as seed, fertilizer, and chemicals. However, in contrast to a cash lease, the landlord and the farmer-tenant may share management responsibilities regarding production of the land. The rent share usually ranges from one-third to one-half, depending on local custom and the contributions of the farmer-tenant and the landlord.

Although the cash lease and the crop share lease are the most common forms of a real property lease, a farmer-tenant may also encounter a livestock share, labor share or flexible-rent lease.

ELEMENTS OF THE LEASE

A landowner and a farmer-tenant are free to choose the type of relationship that will govern their operation. The lease agreement

between the parties is critical in determining what rights and duties exist between landlords and tenants. The following elements are necessary to create a landlord/tenant relationship:

1. A valid contract;
2. Provisions for payment for the use of the land;
3. The transfer of substantial rights to the tenant;
4. Possession and control of the property by the tenant; and
5. A reversionary interest in the property in favor of the landlord at the conclusion of the term of the lease.

ORAL LEASES

Traditionally, written farm leases have been the exception rather than the rule. One reason may be the assumption that requiring a written lease makes it look like the parties do not trust each other. It is, however, highly desirable to put the terms of any lease agreement in writing. Some of the advantages of a written agreement include:

1. It encourages a detailed statement of the agreement, which ensures a better understanding by both parties;
2. It serves as a reminder of the terms originally agreed upon; and
3. It provides a valuable guide for the heirs if either the tenant or the landowner dies.

Under Minnesota law, any lease for a period longer than one year is void unless the contract is in writing and signed by the party by whom the lease is to be made. This law, known as the Statute of Frauds, is in force in every state. To come under the Statute of Frauds, a lease must be wholly oral. The writing required to remove a lease from the application of the Statute of Frauds does not

have to be a detailed contract. A memorandum or note is sufficient if it has been signed by a party or for that party.

There is an exception to the Statute of Frauds that has been recognized by most courts, however. Even though a lease is unenforceable because of the Statute of Frauds, it may be enforced if one party relies on the contract and substantially performs under the lease. What action is required on the part of the tenant to constitute such substantial performance must be determined on a case by case basis.

A second exception to the Statute of Frauds has been created by the courts in cases in which one of the parties has misrepresented or otherwise taken advantage of the other party. The Statute of Frauds cannot be used to accomplish a fraud.

CLASSIFICATION OF TENANCY

Written or oral leases can create two types of tenancy: (1) tenancy-at-will (a lease with no fixed ending date); or (2) tenancy for a defined period.

Tenancy-at-will is terminated by either the landlord or the farmer-tenant upon proper notice. Proper notice is equal to the interval between rent payments or three months, whichever is less. A landlord can also terminate a tenancy-at-will upon 14 days notice if a farmer-tenant fails to pay rent when due.

A tenancy for a defined period terminates at the end of the lease term or as otherwise provided in the lease. A landlord can also terminate the lease and evict a farmer-tenant for failure to pay rent or in the case of a material breach of the lease's terms.

Any farmer-tenant who continues to possess or occupy leased property after the expiration of the lease is a "holdover" tenant, unless the parties enter into another lease.

If a landlord consents to the farmer-tenant holding over, then the farmer-tenant may have a tenancy-at-will under the same terms as the prior, expired lease. However, the landlord may evict the farmer-tenant if the landlord does not consent to the farmer-tenant holding over.

Tenancy for Years

The second type of tenancy is a tenancy for years or a fixed tenancy. The most important characteristic of this tenancy is that it is a tenancy measured by a period of time. A tenancy for years lasts for a specified time agreed upon in the lease. Unless the lease provides otherwise, the farmer-tenant's right of possession automatically terminates at the end of this period without separate notice.

LEASE TERMS

Although farm leases may vary, certain general terms are commonly included in lease agreements.

Time Period and Termination

Leases should expressly provide the time period covered by the lease including when the lease commences and terminates. The lease should also detail the steps a farmer-tenant or landlord must take to effectively terminate the lease.

Failing to include the time period in the lease may lead to future problems. The date a tenancy terminates from year to year is important because the date of termination determines when the written notice has to be given to legally terminate the tenancy. For oral leases (or written leases that do not provide for a termination date), many farm states require that notice of termination be given by December 1, with an effective termination date of March 1 of the following year. If a crop is still growing on March 1 (as would be the case for winter wheat), the lease would terminate upon harvest. Failure to give

timely notice by December 1 would result in the lease not terminating until March 1 of the second year following the notice (some 15 months later; or in the case of winter wheat, almost 20 months later).

In Minnesota, there is no statute that determines when an agricultural tenancy terminates. If the crop lease is terminated when the tenant's annual crop is growing on the leased property, the tenant retains possession and the right to harvest the crop. For this reason, the best practice is to have the lease terminate after the growing season. The Minnesota Constitution also voids farm leases of more than 21 years; which is unique to Minnesota and the Constitution's stated purpose, when adopted in 1857, was to prohibit "feudal tenures" by landlords.

Amendments

A tenant may have an equitable claim against the landlord if the tenant prepared the crop land for the next growing season in reliance on a crop lease. For this reason, the best practice is to include language in the lease that any amendments (including any amendment to extend the lease) need to be in writing and signed by both parties.

Transfer of Property

A lease should state that if the landlord sells or transfers the property, the sale or transfer will be subject to the lease. This will clarify that the farmer-tenant's interest in the lease will continue even after a sale or transfer of the land. The best practice would be to record the lease with the register of deeds in the county that the crop land is located so as to give notice as to the restriction on any sales or transfers.

Right of Reentry

A lease will generally grant a landlord the right to enter the farm at any reasonable time

to do things such as make repairs, improvements, or inspections.

Sublease

The lease should specify whether or not the farmer-tenant may sublease all or part of the land to another farmer.

Binding on Heirs

Generally, the lease will bind heirs, executors, administrations and successors of both the landlord and farmer-tenant.

RIGHTS AND DUTIES OF LANDLORD AND FARMER TENANT

In addition to the above lease terms, it is important to understand additional rights and duties of both the landlord and the farmer-tenant.

Farm Operation

Unless a lease provides otherwise, it is presumed that a farmer-tenant will conduct the farming business according to the prevailing customs or usages of the community in which he lives. The farmer-tenant is not required to leave the land in the same condition it was in when he took possession, however.

The farmer-tenant has the right to determine the cropping system and rotation to be applied on the leased property. The farmer-tenant must not, however, commit "waste." What constitutes waste must be determined on a case by case basis. In general, the tenant must not allow the real estate to be permanently or substantially damaged. For example, the farmer-tenant may not remove valuable topsoil from the premises. Most courts, however, have held in favor of farmer-tenants who have used poor conservation practices such as permitting land to grow up in weeds and go uncultivated. As a result, it is in a landlord's best interest to include specific provisions in

the lease that detail what is expected of the farmer-tenant as part of the normal course of husbandry. For example, the lease may state that the farmer-tenant must use diligence to prevent noxious weeds from growing, control soil erosion, and pay the landlord for damages to the farm.

Ownership of Crops

An issue of increasing importance concerns the ownership of growing crops. It is clear that in the case of a cash rent lease, the crops belong to the farmer-tenant. In the case of a crop share lease, however, the answer is not so clear. Most states have held that title to the crops remains in the farmer-tenant until he or she harvests the crops and divides them. Other courts, including Minnesota courts, have held that a landlord's interest in the crop attaches after the crop has been planted. As a result, the landlord may sell his or her share of the crops prior to harvest.

Agricultural Liens

Minnesota law provides special protection for agricultural landlords by giving them a lien for rent upon crops grown or growing on the leased property and their proceeds. In order to protect this lien, the landlord must file a financing statement in the office of the Minnesota Secretary of State within 30 days after the crops are planted. A landlord's lien, which is "perfected" by filing a UCC-1 financing statement with the Minnesota Secretary of State, has priority over all other liens or security interests in the crops grown or produced on the leased property. A possible limitation on the use of such a statutory landlord's lien is presented by the Bankruptcy Code. Even though such a lien is perfected, it may be set aside in a later bankruptcy proceeding of the farmer-tenant.

As a result, it may be more advantageous for an agricultural landlord to also include provisions which create a security interest

under the Uniform Commercial Code (UCC) in any such lease. However, any such security interest will not obtain the priority granted the landlord by the Minnesota lien law. To ensure that his or her security interest will be the first lien against the crops to be grown on his or her farm, the landlord should require each and every other party who claims an interest in his or her tenant's crops to agree to subordinate their claims against the crops to his or her. The requirements for creating a security interest under the UCC are discussed in another fact sheet in this series, *Security Interests in Personal Property*.

Similarly, Minnesota law provides a special harvester's lien upon the crops for the reasonable value of the services performed to those individuals providing combining, picking, harvesting, hauling, baling, drying or storage services in the ordinary course of business. In order to protect this lien, the harvester must file a UCC-1 financing statement in the office of the Minnesota Secretary of State within 15 days after the last harvesting services are provided. This harvester's lien is subject to a perfected landlord's lien.

PERSONAL PROPERTY LEASES

Besides leasing land, today's farm operator may well lease items of personal property such as silos, livestock facilities, or machinery. Leasing provides an alternative way for farmers to acquire the use of assets without ownership.

Finance Lease

Under many leases, the owner of the property recovers the full investment in the property over a specified term. In fact, in many cases, the lessor under such leases may well be a financing company that has purchased the leased property from the manufacturer for the sole purpose of leasing it to a particular farm operator. In such a

case the lease is simply a financing device that creates an obligation not unlike that imposed by a formal indebtedness.

The legal relationships may be drastically altered by virtue of this finance lease. If the leased property is defective, it may be much more difficult to enforce any warranty claims against the lessor or dealer. According to the Uniform Commercial Code (UCC), the implied warranties of fitness and merchantability cannot be enforced against a lessor if the property is defective. However, the farmer may be able to recover against the original supplier or manufacturer. In addition, the farmer's promises under the lease are irrevocable once the farmer has accepted the property regardless of the supplier's or lessor's additional obligations.

Default

Besides warranty difficulties, the lease may provide that in the event of default, the lessee will not only lose possession of the leased property and recover none of the payments made to date (or equity in the leased asset), but also be held liable for the balance of the lease payments or some complex calculation of damages. The lease may also provide that in the event of a default, the lessor may repossess the property without notice or resort to the courts. In short, the leasing of personal property may prove to be a risky business unless the farm operator understands the nature of the relationship with the leasing company.

Security Interest or Sales Contracts in Disguise

Many courts have held that arrangements claiming to be leases are, in fact, disguised security interests or sales contracts. The question of whether an arrangement is a true lease or a sales contract must be determined by the facts and circumstances of each case. As a general rule, however, inclusion of a

provision in the lease that allows the lessee to purchase the property at the termination of the lease for little or no additional consideration will be construed by a court as conclusive evidence that the arrangement is, in fact, a sales arrangement. If found to be a sales contract, the provisions of the UCC with respect to security interests and termination of security interests may apply in the event of a default, benefiting the farmer (and the farmer's lender). For a more detailed discussion, see fact sheets: *Security Interests in Personal Property* and *Termination of Security Interests in Personal Property*. In addition, the provisions of the UCC dealing with warranties may be triggered if the "lease" is a disguised sale contract.

Statute of Frauds

The Statute of Frauds also applies to these leases of personal property. If the total payments under the lease are \$1,000 or more, the lease must be in writing or it will be void.

CONCLUSION

Leases have become more and more common in the financing of farming operations.

Although the terms of such arrangements are often of critical importance, agricultural real estate leases traditionally have been handled in a very informal manner. However, given their importance in many farming operations, the terms of such leases should be carefully considered and addressed in a written agreement.

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