Principles of Feedyard Lending and Marketing

Prepared for

Texas Cattle Feeders Association

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Representative Clients

- American Bank of Commerce
- Cactus Feeders, Inc.
- Central Texas Highway Constructors, L.L.C.
- Ferrovial Agroman
- Friona Industries, L P
- JBS USA Holdings, Inc
- Smith Cattle Co.
- Texas Cattle Feeders Association
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Section One

PRACTICAL SUGGESTIONS FOR FEEDYARDS AS LENDERS AND AS CATTLE MARKETERS

I. Introduction

Success in today's feedyard industry may depend as much on protecting financial assets involved in cattle lending and marketing as on providing feeding and care. This paper contains practical suggestions for feedyard management in these two general areas by focusing on problems that often arise during a crisis. Section One addresses issues in summary fashion and more detailed explanations are provided in Sections Two (Lending) and Three (Marketing).

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Section Two

MAKING LOANS: FEEDYARDS ARE LENDERS, TOO

I. CONTRACTUAL LIENS

A lien can arise by statute – as in the case of the agister's lien – or it can arise by contract between the owner of the collateral and the holder of the lien – as in the case of a "security agreement." This Part I will focus on liens that arise by contract.

The traditional extension of credit by a custom cattle feedyard was the feed bill itself. The payment of that bill was secured by the self-executing agister's lien. That traditional model bears little resemblance to today's complex credit relationships. Feedyards now provide funding for transactions that can be protected only by contractual lending. The basic steps required by the Uniform Commercial Code are simple: (1) extension of credit; (2) creation of a security interest; and (3) ensuring the priority of that interest over other creditors. The type of debt instrument is optional and usually depends on whether or not the feedyard management wishes to use a lot-by-lot or line of credit approach. The creation of the security interest and the means used to ensure its priority, however, are not optional and are discussed in detail below.

A. Lien Creation

The applicable statute provides:

> A security interest is not enforceable against either the debtor or any third party with respect to the collateral, and it does not attach until (1) the collateral is in the possession of the secured party pursuant to agreement, or the debtor has signed a security agreement which contains a description of the collateral; (2) value has been given; and (3) the debtor has "rights in the collateral." UCC § 9.203(1) & (2).

The first step is relatively easy – the feedyard must obtain a written security agreement signed by the customer that describes the collateral (possession by agreement, though allowed, is not recommended). Because their customers usually have other secured lending relationships many feedyards describe their collateral by location – eg., "all cattle now located at XYZ Feedyard and at any time thereafter." This may avoid conflicts with general lenders, such as banks, which will require security agreements to cover "all cattle now owned or hereafter acquired."

After the security agreement is signed, the interest it creates does not "attach" to the collateral until the debtor acquires sufficient rights in the collateral.

In the cattle business the issue of "rights in the collateral" can be hard to determine. Lenders sometimes tend to equate possession coupled with the representation of the possessor as unimpeachable evidence of ownership. Brands and ear tags can support such claims' apparent validity. However, in pasture and feedyard situations, cattle often are not in the physical possession of their owners. Mere possession by the debtor will not establish sufficient "rights in the collateral" to permit a lien to attach. *MBank Waco, N.A. v. L & J, Inc.*, 754 S.W.2d 245 (Tex. App. — Waco 1988, writ denied). To the extent the debtor holds any additional rights, however, those "rights" may be subject to claims of the possessor's lender, either by contractual lien, *see Continental Grain Co. v. Heritage Bank*, 548 N.W. 2d 507 (S.D. 1996), *InterFirst Bank of Abilene v. Lull*, 778 F.2d 228 (5th Cir. 1985), or by estoppel. *MBank, supra*; *Pleasantview Farms, Inc. v. Ness*, 455 N.W.2d 602 (S.D. 1990).

Cattlemen create many kinds of profit sharing and risk sharing arrangements often described as "partnering in" cattle, although these arrangements may, and often do not, constitute a legal partnership. This may mean that the apparent owner is not actually the owner at all.

B. How to Perfect under the Uniform Commercial Code.

Perfection of a security interest in goods can be accomplished either (a) by filing a financing statement (UCC § 9.310), (b) by taking possession pursuant to a valid security agreement (§ 9.313), and, as noted below, by special rules covering goods in the possession of third parties.

Note: Perfection of Liens under the UCC is not compliance with the Food Security Act.

1. General Rules.

The general rule under Article 9 (Article 9 is the section of the UCC that pertains to secured transactions) is that there is only one place to file: the debtor's "location." § 9.301; 9.501.

There are two exceptions to this rule in the uniform statute. Local filing is required to perfect a security interest if the collateral is minerals to be extracted, or timber, and if the collateral is goods that are, or are to become, fixtures.

In addition, it appears that Arkansas and Georgia have adopted nonuniform provisions for certain farming operations. In Arkansas filing is required in the county where the farm operation conducts business and in Georgia local filing is required for crops.

The availability of perfection by filing does not preclude perfection by other available means, such as possession or control. In some instances, the secured party will need to choose the manner of perfection because some methods of perfection create a better priority position than others.

2. Location of the Debtor.

Generally, the law of the jurisdiction where the debtor is "located" will govern how to perfect an interest. This means that lenders must first determine where the debtor is located before searching for other competing liens or attempting to perfect an interest.

For example, if the borrower is a Delaware corporation and the interest must be perfected by filing, the filing must be made in the place designated in the Delaware version of Article 9. § 9.307(e) & § 9.301 & § 9.102(a)(71).

Section 9.307 is the key provision for determining the "location" of a debtor. This statute divides debtors into the categories of individuals, "registered organizations," and "organizations."

An individual's "location" is his or her principal residence. § 9.307(b)(1). A "registered organization" is a business entity created under the law of a state or the United States. Examples are corporations, limited partnerships, limited liability corporations, limited liability partnerships, professional corporations, professional associations, cooperatives, and nonprofit corporations. A "registered organization" that is organized under state law is located in that state. Special rules apply for federally created organizations.

Business entities which are <u>not</u> created by registration under state law are defined as "organizations." Examples are partnerships, joint ownership situations, estates and trusts. The location of an "organization" is its place of business <u>if</u> it has only one place of business. If it has more than one place of business, it is located at its "chief executive office." (One can imagine a number of difficulties which may arise as to location of filing in the loose partnerships and joint ventures common in the agriculture business).

3. Location of the Debtor: Foreign Borrowers

An issue that arises sometimes in the cattle business concerns a debtor who is a resident of another country. §9.307(c) says that the rule requiring filing in the debtor's location does not apply unless the debtor is "located in a jurisdiction whose law generally requires information concerning the existence of a non-possessory security interest to be made generally available in a filing, recording, or registration system. If subsection (b) does not apply, the debtor is located in the District of Colombia." Unfortunately, this means that a creditor wishing to perfect a security interest in property of a foreign national may be required to obtain an opinion from local counsel about the filing rules of a particular foreign jurisdiction before making a decision about whether filing in the United States would provide protection.

At the date of preparation of this paper, the best information available to the authors is that Mexico does not qualify under the above cited provisions. Therefore, a filing in the District of Columbia as to a Mexican corporation or individual would not perfect a security interest as against U.S. lien competitors. One possibility is to require formation of a US entity to serve as the borrower, although any transaction of this nature could be scrutinized.

4. The Debtor's Name.

Section 9.503 says how the debtor's name must be stated on a financing statement. The underlying principle is that the name must be specific. For example, with respect to a corporation or other "registered organization," the financing statement must provide the name of the debtor as shown on the public record of the debtor's jurisdiction of organization. Decedent's estates which are debtors must also be identified clearly, as must be trusts. Section 9.503(c) disapproves of "trade names." Section 9.503(a)(4) deals with "organizations." If the "organization" is two persons having a joint or common interest, or a simple partnership, "if the debtor has a name," then the financing statement must provide that name, but "if the debtor does not have a name," then the financing statement must provide the names of the partners, members, associates, or other persons comprising the debtors.

Informal relationships of co-producers in agricultural situations may create filing confusion.

Section 9.506 says that a financing statement is effective even if it has minor errors or omissions, unless the errors or omissions make the financing statement "seriously misleading." Section 9.506 also says that a financing statement that fails to satisfy the 9.503 requirements (see above) is misleading, and therefore ineffective to perfect an interest, unless a computer search run under the debtor's correct name reveals the financing statement with the incorrect name. Thus, the outcome in a perfection dispute may depend on the type of search logic used in the relevant jurisdiction. (Under current practice in Texas, the search system will pick up similar business names, but not necessarily on a statewide basis, because the search service generally requires designation of a city of business location.)

Effective June 16, 2007 the Texas Legislature adopted changes to the "naming" rules. As to individuals, the change provides that a name in a UCC-1 is sufficient if it is the name shown on the individual's drivers license or identification certificate issued by the individual's state of residence. For registered organizations the rules provide that the financing statement should provide "the name of the debtor indicated on the debtor's formation documents that are filed of public record in the debtor's jurisdiction of organization." §9.503 *supra.*

The presence in some foreign derived names, of non-standard punctuation may create problems of identification with respect to computer searches in UCC-1 data bases. The Texas statute described above, may create a "safe harbor" if a UCC-1 is filed under the same spelling and punctuation as is found on the drivers license. The authors are unfamiliar with any similar statute in surrounding states.

5. Identification of the Collateral.

The broadest possible description is allowed in a UCC financing statement. To qualify as a sufficient financing statement, a UCC-1 must, among other things, "indicate the collateral covered by the financing statement." § 9.502(a)(3). Section 9.504(2) provides that the financing statement may indicate that it covers "all assets," or "all personal property."

A general description of this nature is not allowed in a security agreement. A security agreement that grants a security interest in "all the debtor's personal property," without other statements of the collateral description, is not effective because § 9.108(c) provides that such a description does not reasonably identify the collateral. However, Section 9.108(b) provides that a general description by Article 9 category is permissible. For example, a description of "all of the debtor's farm products" would be allowed in a security agreement.

6. The Debtor's Signature.

Revised Article 9 eliminated the requirement that the debtor sign the financing statement (UCC-1). The purpose is to facilitate electronic filing and electronic searches. However, the debtor must authorize the filing in an "authenticated record." § 9.509(a)(2). Section 9.509(b) provides that the signing or authentication of a security agreement automatically authorizes the filing of an initial financing statement and certain amendments.

7. Movement of Debtor's Location.

A security interest perfected by filing in the state where the debtor is located at the time the lien is created could become unperfected four months after the debtor moves to a new "location." (§ 9.316). If the creditor fails to re-perfect within the four months, an intervening creditor could achieve priority.

C. Special Rules for Livestock

1. Definition of Farm Products.

Article 9 describes four mutually exclusive "classes" of collateral within the broader concept of "goods." Section 9.109 lists these four subsets of "goods" as "consumer goods," "equipment," "farm products," and "inventory."

The former formulation for "farm products," included the requirement of "possession" by a "debtor engaged in raising, fattening, grazing or other farming operations." The current definition does not require the debtor to be a "farmer in possession" to have an in interest in "farm products."

Goods can change classification. The Official Comments say that crops, livestock and their products "cease to be 'farm products' when the debtor ceases to be engaged in farming operations with respect to them." They also say that goods cease to be "farm products" when they "come into the possession of a marketing agency for sale or distribution or of a manufacturer or processor as raw materials," at which point they become "inventory." § 9.102 comment 4(a).

2. What are "rights in the cattle"?

As noted above, a debtor must have rights in the collateral in order for an Article 9 interest to attach. But what happens if the borrower grants a lien on cattle it does not own? In *MBank N.A. v. L. & J. Inc.*, 754 S.W. 245 (Tex. App.—Waco 1993, writ denied), the alleged true owners of cattle, the Mamot family, allowed Mr. Young to pasture cattle they owned in Texas, and to place his brands on the cattle. Young borrowed money from MBank and purported to grant a lien on the cattle. The court held that Mamots were estopped from claiming that the bank did not have an enforceable interest because they knowingly gave possession of the cattle to Young and allowed him to place his brands on the cattle and said: "A recorded brand, such as Young's, is evidence of ownership of the cattle on which it is placed. *See DeGarca v. Galvan*, 55 Tex. 53, 57 (1881)."

3. Purchase Money Security Interests.

Section 9.324 contains the Purchase Money Security Interest (PMSI) rules. The holder of a PSMI can trump a pre-existing lender, making this a valuable status. The effect of this statute can best be understood in the context of the pre-2001 rules. Former § 9.312(c) and (d) gave PMSI lenders the chance to achieve priority over pre-existing perfected lenders. If the collateral were inventory, the PMSI lender had to give advance notice to the prior lender, but for other collateral, including farm products (if they were not inventory), no such advance notice was required. In both situations, the PMSI lender had to provide funds to enable the debtor to acquire the collateral and the lien had to be perfected within twenty days after the debtor received possession of the collateral.

Section 9.324 placed livestock under the advance notice rule and it now requires perfection in advance, not after, delivery. Under revised § 9.324, a lender seeking a prior purchase money security interest secured by livestock must take the following steps: (i) The lender must advance funds to enable the debtor to acquire the collateral; (ii) The security interest must be perfected when the debtor receives possession of the livestock; (iii) The purchase money lender must send an "authenticated notification" to the conflicting security interest holder; (iv) The holder of the conflicting security interest must receive the notice within six months before the debtor receives possession of the livestock; and (v) The notice must state that the purchase money lender has or expects to acquire purchase money security interest in the debtor's livestock and describes the livestock. This poses great difficulty. A subordination agreement is preferable.

An argument can be made that if the debtor never receives possession of the goods, the notice provisions of §9.324, which require advance notice to a previous lender, do not apply. The argument is that the notice is required to be given only before the debtor "receives possession," and because the debtor never receives possession, the notices are not required.

First National Bank in Munday v. Lubbock Feeders, L.P., 183 S.W.3d 875 (Tex. App. — Eastland 2006, rev. denied), adopted this reasoning and held that a feedyard that perfected an interest in its customer's cattle was not required to give advance notice to obtain purchase money priority because the customer never received possession of the cattle.

4. Secured Party's Notice to Bailee.

Although creditors will always want to perfect by filing, § 9.313 may supply a useful tool to employ in an emergency. In the livestock context, if a lender finds cattle shortages occurring, it may find some of the missing cattle in the hands of the feedyard, pasture lessor, or livestock commission company. These parties may in some instances be characterized as bailees. If collateral is in the hands of a bailee, perfection may occur by notice to the bailee. The secured party is deemed to have possession from the time the bailee receives notice of the secured party's interest. § 9.313.

5. Owner's Notice to Bailee.

Section 9.505 permits an owner of goods (a "bailor") that are in the possession of another (a "bailee") to file a financing statement that will serve as notice to others, including lenders, that the bailee is not the owner. Presumably, the bailee's lender will check the UCC filings before making a loan based on a false representation of ownership and avoid a dispute. In *American Bank & Trust v. Schaull*, 2004 S.D. 40, 678 N.W.2d 779, 53 UCC Rep. Serv. 2d 367 (2004), the South Dakota Supreme Court affirmed a finding that the bailee/caretaker's lender would have been put on notice by a bailee filing, which would have defeated the lender's claim. Unfortunately for the owner, it did not file the bailee UCC-1.

The current UCC-1 form financing statement contains, at the bottom as item 5, the box labeled "bailee/bailor." Checking this box should allow a bailor to give notice that he has goods in the possession of the bailee that the bailee does not own. The bailor needs written permission from the bailee to file the form.

This procedure may be appropriate for a cattle owner who pastures cattle with others. The appropriate language can be inserted in a grazing agreement, or even in a sales contract. The bailee will need to decide whether to accept this because it could create inquiries from its lenders. Lenders may want to require their borrowers to obtain such authorization from their pasture providers, and require these statements to be filed.

D. "Agricultural Liens" Under the UCC

1. Definition

The 2001 amendments, in §9.102(a)(5), established a new class of lien called "agricultural lien." The key features of an "agricultural lien" are the following:

(1) The debt the lien secures must arise from goods, services or rent furnished in connection with the debtor's "farming operations;"

(2) The lien must arise by operation of law as opposed to the agreement of the parties;

(3) The effectiveness of the statutory lien does not depend on the debtor's possession of the property.

2. Texas Liens Which May Be "Agricultural Liens."

Texas recognizes a number of involuntary statutory liens which arise in connection with agricultural operations. Some are:

(1) The agister's lien on livestock. (TEX. PROP. CODE § 70.003).

(2) The cotton ginner's lien on ginned cotton. (TEX. PROP. CODE § 70.003).

(3) The chemical and seed supplier's lien on crop proceeds. (TEX. AG. CODE CHAP. 128).

(4) The feed supplier's lien on proceeds. (TEX. AG. CODE CHAP. 188).

(5) The lien on livestock, carcasses and products with respect to livestock sold for slaughter. (TEX. AG. CODE §§ 148.021-.030).

(6) The stock breeder's lien on offspring. (TEX. PROP. CODE § 70.201).

(7) The lien on crops of a contract grower. (TEX. PROP. CODE §§ 70.401410).

3. How to Perfect an "Agricultural Lien."

The holder of an "agricultural lien" must comply with the Article 9 requirements for perfection of a security interest, and the lien is subject to the general priority rules of Article 9. The local law of the jurisdiction where the farm products are located governs the perfection and priority of an agricultural lien on farm products. § 9.302.

4. Significance of an "Agricultural Lien."

Section 9.333 gives priority to statutory liens which are dependent on possession. Under 9.333, if a lien is created by statute in farm products, and the effectiveness of that lien depends on the debtor's possession of the goods, the lien has priority over an Article 9 lien and an agricultural lien. Although there are no cases in Texas that discuss this precise issue, the authors believe that a good example of this involves the statutory agister's lien contained at Property Code Section 70.003. The effectiveness of the lien created by that statute is dependent on possession. As a result it should not qualify as an "agricultural lien" and, if the statutory provisions are satisfied, it should have priority over competing contractual liens. The lien on livestock, carcasses and products for livestock sold for slaughter is probably not an "agricultural lien" because it does not secure a supplier's inputs (instead, it secures repayment of the purchase price). The remainder of the liens listed above, however, appear to be "agricultural liens" because they do provide a lien for input costs and do not depend upon possession.

There are statutory liens in other states. Statutory liens tend to be "customized" depending upon the whims of the legislature which enacted them. The prospect for confusion abounds because there may be many different ways to perfect the liens and enforce them. In every case, in every state, there is the possible need to determine whether the provisions of Article 9 will trump any more explicit provisions in the relevant statutory involuntary lien.

Because the involuntary statutory liens involving agricultural operations differ from state to state, lenders seeking priority of their interest in the collateral of out of state borrowers will need to exercise great caution.

5. Superpriority

§9.322(g) grants potential "superpriority" status if the statute that creates the agricultural lien provides that it has priority over a conflicting security interest in or agriculture lien on the same collateral. The authors are aware of one case that discussed this issue. *Stockman Bank of Montana v. Mon-Kota, Inc.*, 180 P.3d 1125 (Mont. 2008), concerned an agricultural lien that secured repayment of charges for fertilizer and pesticide. The statute provided for superpriority of that lien, and as a result the court held for the inputs provider over the bank lien.

E. Perfection By Methods Other Than Filing

1. Possession by Bailee

Section 9.313(c) authorizes perfection by possession of goods in the hands of a bailee. A bailee is a third party who has possession of property held for the benefit of another. Grain elevators and feedyards are common examples of bailees involved in agricultural lending. In order to perfect a security interest in goods in the hands of a bailee, without filing, the bailee "authenticates [signs] a record" stating that it is holding the collateral "for the secured party's benefit."

2. Possession by Secured Party

Section 9.313 allows a secured party to "perfect a security interest in negotiable documents, goods, instruments, money, or tangible chattel paper by taking possession of the collateral." The law of the place where the collateral is located governs perfection, the effect of perfection or nonperfection, and priority.

3. Automatic Perfection

Article 9 provides for automatic perfection of security interests in transactions involving the sale of payment intangibles, the sale of promissory notes, and in "supporting obligations," which may be coupled with payment intangibles or promissory notes. *See* §9.308, §9.309. In addition, automatic perfection will apply to purchase money security interests in a broad range of non-certificate of title consumer goods. § 9.309(1).

4. Control

"Control" is also allowed as a method to perfect an interest, and it can factor in priority disputes. For many financial assets, a lender accomplishes "control" with a "three-party" agreement between the debtor, the secured party, and the securities or commodity intermediary. §8.106; §9.106(a),(b). In practice, this concept means that there are two levels of perfection, with differing levels of protection; perfection by filing (UCC-1) and perfection by "control." The lender needs to accomplish both levels of perfection. As a general rule a lender should file a UCC-1 in the central filing location of the debtor's home state with a description reading something like this: ". . . all debtors' interests in general intangibles, commodity contracts, commodity accounts, and securities now owned or hereafter acquired and their proceeds."

Article 9 allows use of control to perfect an interest in deposit accounts, rights in letters of credit, and, for a new class of collateral known as "electronic chattel paper and electronic documents." § 9.314(a). The preferred priority status is control over filing. § 9.328(1) (investment property) and § 9.329(1) (letter of credit rights).

Article 9 recognizes descriptions for "investment property," "commodity accounts," "commodity contracts," as well as financial assets like "securities entitlements" that will apply to hedging and commodities accounts.

Security interests in promissory notes are perfected by actual possession. It is also appropriate to file a UCC-1.

II. JOINT CREDITOR PROBLEMS

A. Need for Agreements.

Producers often have more than one lender. For example, there may be a loan for cattle produced in a cow-calf operation, a separate loan for a stocker operation, and a third loan for a feedyard operation.

The problem arises because after a lien attaches it generally continues even if the debtor places another lien on the same collateral. In the example given above, once the lien was placed by the production lender, that lien continues absent agreement throughout the economic life of the cattle. This would deprive the debtor of available sources of credit, since the second or third lender will not issue credit without assurance of first lien position.

A common problem in multi-lender situations arises when "location-based" financing is in place. A security interest does not attach until a security agreement has been signed, the secured party has given value, and the debtor has acquired "rights in the collateral." § 9.203(a). The arrival of livestock at a location may or may not coincide with the debtor's acquisition of "rights" in the cattle. Other competing liens may have already "attached" by the time the cattle arrived at the designated location.

Purchase money security interests also present problems for lenders to livestock operations. The definition of a "purchase money security interest" limits it to a person who by making advances or incurring an obligation gives value to enable the debtor to acquire rights in or the use of collateral if such value is in fact so used." § 9.103(b). Often, cattle are purchased using funds not provided directly by the lender, which instead "reimburses" the borrower.

Thus, to avoid the effect of lien continuation, or to avoid PMSI disputes, lenders must make agreements. The three most common are release, subordination, and assignment.

B. Release.

This involves a complete release of the security interest.

Most lenders do not want to do this, even if the release is specific as to location. Instead, most lenders want to retain a second lien even if they agreed to subordinate their otherwise first lien position.

If a release is given, it typically will relate to specific locations, for example, cattle located in a specific feedyard.

C. Subordination.

Section 9.339 provides: "This chapter does not preclude subordination by agreement by a person entitled to priority." The cases recognize validity of such agreements, even if verbal. *See AWD v. Salkeld*, 372 N.E.2d 486 (Ind. Ct. App. 1978). The Comments note that "[o]nly the person entitled to priority may make such an agreement." These agreements can be narrowly construed. *See Western Auto Supply Co. v. Brazosport Bank of Texas,* 840 S.W.2d 157 (Tex. App—Houston [1st Dist.] 1992, no writ).

The authors recommend using written subordination agreements in every case in which conflicting interests may arise.

All agreements of this nature should be in writing and signed by all parties. Otherwise, litigation may result. *See, e.g.*, *In re Bishop*, 52 B.R. 470 (Bankr. N.D. Ala. 1985).

D. Assignment.

An assignment is appropriate if one lender is buying out the lien position of another. Section 9.514 authorizes the assignment of the powers of the secured party of record.

This is sometimes used even if no buyout is involved. For example, if the first lender no longer maintains a lending relationship with the borrower, that lender may execute a UCC form assignment.

However, the assignment is only as good as the underlying debt obligation so a lender should not rely only on an assignment to obtain a prior lien position over other lenders. Instead, that lender should obtain subordination, releases, or assignments from every other lender conceivable involved in the debtor's operations.

III. THE "FARM PRODUCTS EXCEPTION"— LIEN CONTINUATION AND THE FOOD SECURITY ACT

A. Lien Continuation

The UCC creates a general rule that after a lien attaches it continues to exist even after the collateral is sold by the debtor. The major exception to this rule protects a "buyer in ordinary course" (a "BOC"). A purchase by a BOC cuts off the lien. UCC § 9.320. A buyer is a BOC if it acts in good faith and without knowledge that the purchase violates a security agreement.

However, to encourage lenders to make loans to farmers, the UCC created an exception to this exception. Under the "farm products exception" a person who otherwise qualified as a "buyer in ordinary course" could not take free of a security interest created by its seller if the goods were "farm products."

The "farm products exception" made possible what is commonly known as the "double payment" problem. This situation occurred when a buyer paid its seller for cattle, but the seller did not pay its lender. The lender, using the farm products exception, could enforce its lien against the buyer, and in effect force the buyer to pay for the cattle twice.

B. The "Created by the Seller" Rule

The UCC created another and even more insidious problem for buyers of farm products.

The lien continuation rule has been combined with the language of 9.320 to create hidden lien problems for cattle buyers. The statute allows buyers to "take free of a security interest created by the <u>buyer's</u> seller." But what happens if the security interest is created by the <u>seller's</u> seller? In this situation, a party otherwise qualifying as a BOC may take subject to a security interest created by a supplier to its seller. *See Conseco Fin. Servicing Corp. v. Lee,* 2004 WL 1243417 54 U.C.C. Rep. Serv. 96 (Tex. App. — Houston [14th District] 2004, no pet.); cases collected at 4 White & Summers, UNIFORM COMMERCIAL CODE, Section 338, note 1214 (Practitioner's Ed. 2006).

To defend a of this nature, a buyer may rely on defenses such as consent to sell, waiver, or estoppel. In addition, there is legal authority to support the defense that this argument fails if the seller is closely related to the party that created the lien. In this situation, the seller and the supplier may be considered to be the same entity, with the result that the security interest is considered to have been created by seller, and thus subject to the lien clearing effect of 9.320. Finally, the buyer may argue that public policy should not allow this result. *See United States v. Continental Grain Co.*, 691 F.Supp. 1193 (W.D. Wis. 1988).

C. The Food Security Act (7 U.S.C. § 1631)

The Federal Food Security Act became law in December 1986. The Act expressly stated that its purpose was to eliminate the "double payment" problem because it created an impediment to the free transaction of commerce in farm products.

The Act concerns transactions in "farm products." The definition of "farm products" in the Act is generally the same as that in the UCC. The Act protects two general classes of persons: "buyers" of farm products, and "marketing agents," which generally includes livestock sale barns and commission agents.

1. How to Perfect Under the FSA

The Act generally requires a lender to provide actual notice of its interest but allows states to choose a central filing system. Texas and Kansas are "actual notice" states; Oklahoma and Colorado are "central filing" states.

2. Central Notice

In states that have adopted a central filing system, (www.gipsa.usda.gov/GIPSA contains a list), the secured party files a specialized notice with the state designated authority that gives specific information about the extent of the lien. A buyer of farm products which have been "produced" (see discussion below) in that state take subject to the lender's security interest if the documentation is in order (or if it has received direct notice). Otherwise, the buyer takes free of that security interest.

With respect to these states there is a question as to where to file in multistate transactions. The Act provides that the filing should be made where the farm product is "produced." But livestock may be "produced" where they are born and weaned, put on pasture, or fed to finish weight, in each of several states. It is safest for the lender to file in all possible places and to continue to give, even in central filing states, actual notice to all potential buyers. From the standpoint of the buyer, this means that the buyer could check the central filing records of the state in which the seller resides, become satisfied that no liens exist, and pay the buyer, and end up facing a lien conversion claim arising from a lender in a neighboring state also with a central filing system who had filed where the farm products were located at one time and thus were "produced."

In *First Bank v. Eastern Livestock Co.*, 837 F. Supp. 792, 802 (S.D. Miss. 1993), the lender's debtor, Wells, sold cattle to Eastern Livestock, was paid, but then failed to pay the proceeds to its lender. The court denied summary judgment motions of Eastern and First Bank, but in its ruling held that the lender's description of the collateral in its EFS should be evaluated under the "seriously misleading" standard developed under the Code. This standard provides that a financing statement collateral description is sufficient to perfect an interest if it does not contain errors which are "seriously misleading."

It is not clear that a lender's previously filed Effective Financing Statement which has become inaccurate through the passage of time (for example, in January it describes 300 head of steers, which have, by July, been sold and replaced by 300 head of heifers) continues to be effective protection to the lender. It is therefore suggested that for every new set of cattle financed, a new Effective Financing Statement be prepared, signed and filed.

3. Direct Notice

In "direct notice" states, such as Texas and Kansas, actual notice is required. In these states, the lender then must contact the potential seller and give notice of its security interest. The burden is thus on the lender to contact the buyers.

In *Farm Credit Midsouth, PCA v. Farm Fresh Catfish Co.*, 371 F.3d 450 (2004), the court held that a lender had to comply strictly with the Food Security Act's direct notice provisions. The court held that the lender's letter to its debtor's customer advising of the loan, but failing to state the debtor's social security number or tax identification number and failing to state where the farm products covered by the interest were located did not comply with the Act, and held that the purchaser bought the products free from the security interest even though the purchaser knew of the existence of the interest.

In the Texas Panhandle there is a "newspaper notice" which attempts to provide actual notice to buyers. Lenders subscribe to the newspaper and give the statutory information about their borrowers, and the newspaper is delivered to potential buyers. To our knowledge, the effect of this "newspaper notice" has not been decided by any court.

4. Federal Preemption

In general, the Act governs in the event of conflict between the underlying state law and the Act itself. For example, if under the farm products exception of the UCC a lender attempted to enforce its security interest against a buyer who had not received notice of the security interest as required by the Act, the lender would be unsuccessful because of the Act.

Despite the preemption rule, there are many situations involving farm products which are addressed only under state law. Some of these issues are discussed below, and they mainly concern questions dealing with third party interests.

For example, the Act does not protect a buyer from claims by any party other than a lienholder. Therefore, the Act offers no protection to a buyer who has purchased cattle from a seller under circumstances which will create lack of "title" or "ownership" in the seller. Instead, other bodies of law, such as agency, estoppel and the Code "title" provisions (§§ 2.401-2.403) must be examined. *See First State Bank of Athens v. Purina Ag Capital Corp.*, 113 S.W.3d 1 (Tex. App.—Tyler 1999, no writ) (FSA not applicable because no sale occurred).

D. Lien Continuation Theories under the Act and the UCC Compared.

1. Consent to Sell.

Cases have generally recognized that if a lender has explicitly consented to the sale of the farm products by agreement or implicitly consented by course of performance, it forfeits the right to pursue payment from third-party purchasers. *Weisbart & Co. v. First Nat'l Bank of Dalhart*, 568 F.2d 391 (5th Cir. 1978); (applying Texas law); *Fisher v. First Nat'l Bank of Memphis*, 584 S.W.2d 515, 519520 (Tex. Civ. App. — Amarillo 1979, no writ) (waiver must be explicit). In *Mercantile Bank of Springfield v. Joplin Regional Stockyards, Inc.*, 870 F. Supp. 278 (W.D. Mo. 1994), the court held that waiver was a viable defense even against a lender which properly gave notice under the Food Security Act. *Cf., Ag Services of America, Inc. v. United Grain Inc.*, 75 F. Supp.2d 1037 (D. Neb. 1999)(holding that waiver could not be a defense because of a special Nebraska statute stating that a security interest in farm products should not be considered waived as the result of any course of conduct between parties or any trade usage if the secured party had filed an EFS).

2. Buyer in the Ordinary Course.

The term "buyer in ordinary course of business" under the Code (§ 1.201(9)) is defined more restrictively than the term "buyer in the ordinary course of business" under the Act. 7 U.S.C. § 1631 (c)(1). The Code definition of this term states that such a buyer must act in good faith and without knowledge that its purchase violates a security agreement. The Act requires only that the purchase be made in the ordinary course of business. A federal district court in Nebraska, relying on this difference, held that a person buying farm products is not required to act in "good faith and without knowledge" to take free of a security interest. *Lisco State Bank v. McCombs Ranches, Inc.*, 752 F. Supp. 329 (D. Neb. 1990).

A variation on this argument was addressed in *Consolidation Nutrition L.C. v. IBP, Inc.*, 669 N.W.2d 126 (S.D. 2003). In that case the court held that IBP, as a buyer of hogs, took free of an interest to the extent it acted as a purchaser, because it did not receive the required FSA notice, but held that it did not take free of the interest to the extent that "it acted as a creditor and setoff the sale proceeds to satisfy [the debtor's] preexisting debt under the hog procurement contract."

3. The "Created by the Seller" Rule

The Food Security Act carried forward the same "created by the seller" language as does the U.C.C. in §9.320. That is, the Food Security Act "provides no protection for a buyer of farm products from any valid security interest that was created by someone other than the immediate seller." *Fin Ag, Inc. v. Hufnagle, Inc.*, 700 N.W.2d 579, 582 (Minn. 2006).

In *Hufnagle*, The parties involved were Fin Ag, a lender to Buck Farms, Buck's employee Tooker, and Meschke, a purchaser of corn from Tooker. Fin Ag claimed that Meschke took the corn subject to its security interest because that interest was created by Buck, not created by Tooker, under the theory that the "created by the seller" clause in 7 U.S.C. § 1631 required this result. The Court agreed.

However, another case involving a similar situation reached the opposite result. *Fin-Ag, Inc. v. Cimpl's, Inc.*, 754 N.W.2d 1 (S.D. 2008). In that case, Fin-Ag, Inc. made a secured loan to the Berwalds. The Berwalds had a d/b/a called "C & M Dairy." Cimpl's, a packing plant, bought and paid for cattle from C & M. C & M did not pay Fin-Ag. Fin-Ag sued Cimpl's under the idea that its security interest was created by Berwarld, not by C & M, so it continued to be enforceable against Cimpl's even though it did not comply with the Food Security Act. Fin-Ag lost a summary judgment at trial and the Supreme Court affirmed. The court relied on the Congressional intent to protect buyers from unperfected liens, and on other cases, and said:

> Ultimately, we agree with the Eighth Circuit Court of Appeals, and the Iowa, Arizona, and Oklahoma state courts. These courts either: (1) hold that the created by the seller limitation does not apply; or (2) treat the immediate seller as the entity that created the security interest when the immediate seller and the remote grantor of the security interest are closely related and the remote grantor was instrumental in creating the conflict.

4. Farm Products or Inventory.

Many UCC cases addressed whether goods that appeared to be "farm products" were or became "inventory." The argument was usually advanced by the purchaser of the goods, in defense to a claim by a lender based on the "farm products" exception. If the goods were not "farm products" the lien continuation feature § 9.320 did not apply.

A Texas cattle case on this issue is *Cox v. BancOklahoma AgriService Corp.*, 641 S.W.2d 400 (Tex. App.—Amarillo 1982, no writ). That case was brought by a lender against a buyer who bought cattle from its debtor. The lender relied on the farm products exception. The buyer, pointing to the debtor's affidavit stating that he was "a cattle trader, not a farmer, and that he held the cattle for inventory," argued that the debtor was not a "person engaged in farming operations," and therefore the cattle were not farm products under the Code definition. Although the court denied the defendant's claim on evidentiary grounds, it did not dispute the abstract proposition that a cattle trader or dealer may not be conveying "farm products" but may instead be conveying "inventory" so as to avoid application of the farm products exception.

Fin Ag, Inc. v. Hufnagle, Inc., 700 N.W.2d 579, 582 (Minn. 2006), rejected the farm product/inventory distinction in a FSA situation. The parties were Fin Ag, a lender to Buck Farms, Buck's employee Tooker, and Meschke, a purchaser of corn from Tooker. The court rejected Meschke's argument that he was protected because he bought inventory and not farm products. The Court said that this distinction did not protect Meschke because the Food Security Act applied to farm products, and an effort to distinguish between inventory and farm products "would require us to define seller two different ways in the same analysis without a significant indication that this was the Legislature's intent. No such indication exists here. Accordingly, if we examine the transactions under the UCC, we must conclude that Meschke took this claim subject to Fin Ag's security interest."

5. Auctioneer Liability under the FSA.

Lien continuation problems can arise when farm products are sold through auctioneers. The pre-FSA common law rule was that an auctioneer was liable to a lender under an agency theory if it sold goods burdened with a lien. This theory, described as a rule of strict liability, imputed the sellers' failure to satisfy its lien to the auctioneer. *First Nat'l Bank of Amarillo v. Southwestern Livestock, Inc.*, 859 F.2d 847, 848 (10th Cir. 1988). Although no Texas cases under the Code consider this agency theory, a pre-Code cattle case appears to follow it. *Hagen v. Brzozowski*, 336 S.W.2d 213, 215 (Tex. Civ. App. — San Antonio 1960, no writ). Cases in other jurisdictions held that the farm products exception did not, in and of itself, defeat an auctioneer's agency liability. *See* cases collected in *First Nat'l Bank of Amarillo*, *supra*, 859 F.2d at 847.

One case, although in dicta, held that the FSA preempts this common law rule. *First Nat'l Bank of Amarillo*, *supra*, 859 F.2d 847, 850, n.2. However, some issues may remain. For example, the Act requires the auctioneer to sell "in the ordinary course of business." 7 U.S.C. § 1631(g)(1). If a sale is found not to be in the "ordinary course," the auctioneer may be faced with strict liability under the common law. Also, the distinction between farm products and inventory may continue to be an issue. Thus, if a "trader" sells, through an auctioneer, agricultural commodities that are not "farm products" because they were not in the possession of a "farmer," the Act may not protect the auctioneer. *Fin Ag, Inc. v. Hufnagle, Inc.*, 700 N.W.2d 579, 582 (Minn. 2006).

In addition, the auctioneer may face liability under the "created by the seller" rule if it purchases cattle from a party that did not create the lien. *See* discussion above.

IV. FORECLOSURE SALES OF LIVESTOCK

Section 9.610 allows a creditor to dispose of collateral by public or private sale, in its then existing condition or following any commercially reasonable preparation or processing. if every aspect of the sale is commercially reasonable. Commercial reasonableness is determined by the facts of each case. The duty to dispose of collateral in a commercially reasonable manner cannot be waived or varied. The parties may adopt standards that attempt to define commercially reasonable conduct, but those standards must not be manifestly unreasonable.

A secured creditor is permitted to purchase the collateral at a "public sale" and, in limited situations, at a "private disposition." Although these terms are not defined in Article 9, the Official Comments state that a public sale refers to a sale "at which the price is determined after the public has had a meaningful opportunity for competitive bidding." The term "meaningful opportunity" is "meant to imply that some form of advertisements or public notice must precede the sale and that the public must have access to the sale." Since neither § 9.610 nor the comments discuss the meaning of private disposition, then any disposition that is not a public disposition must be a private disposition.

Under Revised Article 9 a creditor may purchase collateral at a private disposition if the collateral is customarily sold in a recognized market. An example of a recognized market is the New York Stock Exchange, but cattle do not necessarily fit the definition:

> "A market in which prices are individually negotiated or the items are not fungible is not a recognized market, even if the items are the subject of widely disseminated price guides or disposed of through dealer auctions." (Official Comment 9 to § 9.610)

Several courts have found cattle to be nonperishable and some have determined that cattle are not customarily sold on a recognized market. The only Texas cattle case found is *Havins v. First National Bank of Paducah*, 919 S.W.2d 177 (Tex. App. — Amarillo 1996, no writ). There, cows and stocker cattle were repossessed, then sold at a sale barn. The court discussed two lines of cases. One held that cattle were sold on a recognized market as a matter of law, and the other focused on the facts of the case. The court said: "To coin the old adage, if it looks, walks, and talks like a duck then why not consider it a duck. So, we conclude that cattle auctions may indeed be recognized markets if they satisfy the indicia of a recognized market." The court concluded that the evidence was not sufficient to support the trial court's conclusion that the auction in question did qualify, so it remanded the case.

In some situations, the highest price may be offered by a the creditor or party related to the creditor, who will buy at a private sale to reduce transaction costs, or loss of value, such as may be involved if cattle need to be moved during the feeding cycle. In this approach the creditor or a related party acquires the collateral in complete or partial satisfaction of the debt. The generic term for the process is "strict foreclosure." A strict foreclosure involves a direct transfer of collateral to the secured creditor in partial or complete satisfaction of the debt, and eliminates the need for a sale to third parties. After this procedure, the secured party may then dispose of the collateral in any manner it wants to. The UCC allows this, but there are special rules for related parties.

The general procedure requires the secured creditor to propose this process to the debtor, wait 20 days, then go forward if either the debtor consents or fails to object. *See Smith v. Cmty. Nat'l Bank*, 344 S.W.3d 561, 568-569 (Tex. App.—Eastland 2011, rev. denied).

In the language of the UCC a related corporate entity is called a "person related to" a secured party. 9.102(a)(64) Section 9.610, which allows a "secured party" to buy at as public sale but restricts sales at private dispositions, does not impose any restrictions on purchases by "persons related to" the secured party conducting the sale. However, such a sale may lead to a special method for calculating any resulting surplus or deficiency. Under section 9-615(f), if the amount of the sale proceeds are "significantly below the range of proceeds" that a complying disposition to an unrelated party would bring, then the resulting surplus or deficiency is calculated based on such a hypothetical complying disposition to an unrelated party.

This is in contrast to the more generous rules that apply to sales to unrelated parties. In that case, the secured party does not have to defend the hypothetical sale. Instead, it can rely on the rule of 9.627 that defends a price received so long as the sale itself was commercially reasonable. Official Comment 2 to 9.627.

Another approach is to ask for a judicial approval of the sale. This is "commercially reasonable" by statute 9.627(c).

V. INVOLUNTARY LIENS

A. The Agister's Lien.

In Texas, Oklahoma, Colorado, Kansas, New Mexico, Arkansas, and most other states, statutes have been enacted which create liens on livestock as a matter of law in favor of the person who gives feed or care to the livestock. Since the lien arises by operation of law, no underlying contract or agreement is necessary to create the lien or to enforce it. The state laws in each case are different and are summarized on a state-by-state basis below.

1. Texas

Texas provides for an agister's lien and a "feed supplier's lien." The former grants a lien arising as a matter of law in favor of a person who provides care and feeding to animals left in their care. No documents need to be signed or filed to support this lien. The "feed supplier lien" has several statutory requirements which must be closely followed, including a requirement of a notice of intent to claim the lien given at the time the feed is supplied.

The agister's statute is probably superior to contractual liens, although no Texas case has decided this exact point. The "feed supplier's lien" is not superior to previously filed UCC liens and is not superior to an agister's lien.

If the lien is on an animal "fed in confinement for slaughter" the lien may be enforced in any manner which is "commercially reasonable" under the UCC. For other agistment situations, the lien is difficult to enforce. The "feed supplier lien" can be enforced, after it is appropriately perfected, in any manner authorized under the UCC.

The agistment statute requires the caretaker to maintain actual "possession" of the livestock to perfect and enforce the lien. This means that when a feedyard releases possession of livestock without enforcing its lien, it probably also releases the ability to enforce the lien, in the absence of other arrangements. The feed supplier's lien does not require possession.

2. Oklahoma – Agister's Lien

Oklahoma provides for a "herdsman's lien," and a "feedman's lien." The former grants a lien in favor of a person who is engaged in the "feeding, grazing, or herding" of domestic livestock, and the latter applies in favor of a person who has furnished or provided any "corn, feed, forage or hay" to the owner for the sustenance of domestic animals.

The Oklahoma courts hold that the rights of a UCC security interest holder have priority over those of a statutory lien holder unless the secured party has knowledge of the agister's lien and has consented to it.

The Oklahoma agister's lien is not dependent on possession, and the feedman or herdsman does not need to keep possession of the livestock for the lien to continue. These liens arise by operation of law and do not need to be written or filed to be enforced.

3. Oklahoma – Owner's Lien

In response to the Eastern Livestock demise in 2011, Oklahoma created the Livestock Owner's Lien Act of 2011 (Title 4, Oklahoma Statutes § 201.1 et seq.). Under this statute, "every livestock owner is granted a lien in all livestock sold by such livestock owner, for any unpaid portion of the sales price for such livestock" by operation of law. The owner's lien is perfected automatically and no financing statement is required to be filed. Okla. Stat. tit. 4, § 201.4. This lien also takes priority over other liens. *Id.* § 201.7.

The Owner's Lien attaches to all livestock and continues uninterrupted in the livestock or proceeds from the sale of the livestock until the owner receives the full amount of the sales price. If a subsequent purchaser in good faith pays full price for the livestock, then the lien shall transfer to the proceeds paid by the good faith purchaser, who takes the livestock free of the owner's lien. *Id*. § 201.6.

The automatic perfection without filing would mean that upstream buyers cannot discover the existence of the owner's lien by lien searches and may be reluctant to buy cattle that are subject to such liens. The Oklahoma statute seems to be designed to mitigate the potential chilling effect of this "hidden" lien by providing that the lien will not continue to encumber livestock after they are sold to a good faith buyer.

4. Colorado

Colorado has an "Agister's Lien Act" which creates a broadly defined agister's lien that secures the unpaid amount due for feeding, herding, pasturing, keeping, ranching, boarding, and caring for livestock. This lien must be filed with the Colorado secretary of state before it may be enforced.

A properly filed agister's lien in Colorado is superior to all other liens and encumbrances on the subject livestock. Enforcement of this lien requires notice, hearing, and a public sale at the nearest public livestock market.

The lien does not require possession to be enforceable. It will continue after sale or other disposition of the livestock. Further, the agister's lien attaches to the proceeds received from a sale or disposition.

5. Kansas

Kansas provides for a "confinement feeding," an "agister's," and a "livestock production input" lien. The confinement feeding lien secures unpaid charges for "feed and care" of confined livestock; the agister's lien secures unpaid rents for pasture land; and the livestock production input lien secures the unpaid retail cost of all other feed and labor furnished to raise livestock.

The confinement feeding and agister's lien both arise by operation of law and do not require a writing or filing to be enforced. The livestock production input lien however, must be filed with the Kansas secretary of state before it may be foreclosed.

The confinement feeding and agister's liens are superior to all other liens and encumbrances. The livestock production input lien will also take priority over other liens, including a contractual lien, if the lien is perfected and proper notice is given to the contractual lender. Each lien must be foreclosed by a public sale for cash after timely notice is provided the owner.

Enforcement of the confinement feeding lien requires possession of the livestock. The agister's and livestock production input liens may be enforced without possession if proper filings are made.

6. New Mexico

New Mexico provides for an agister's lien for persons who board or "furnish feed, shelter or pasture for the property and stock of others." This lien may be enforced without possession if, prior to relinquishment, the lien holder has filed a statement describing the livestock and declaring an intent to retain the lien with the clerk of the county in which the livestock are located.

The agister's lien does not take precedence over prior filed chattel mortgages unless the holder of such mortgage expressly consents in writing.

7. Arkansas

Arkansas provides for an agister's lien for unpaid amounts due for "feeding, herding, pasturing, keeping, or ranching" livestock. Enforcement of the lien requires possession of the livestock, unless the livestock are transported to market for sale in the joint name of both the lien holder and the owner.

The lien is effective only when all written contracts are properly filed and from the date when the last contract is filed. The agister's lien has priority to any conditional sale contract, filed chattel mortgage, or other encumbrance if the agister's lien holder has properly filed all written contracts and has properly notified the other lien holders about the existence of the written contract. However, if the other lien is prior in time to the agister's lien, the other lien holder may retain priority by properly filing or serving a written protest within fifteen days from the date that the other lien holder received notice of the existence of the contract.

B. Liens Provided by Federal and State Prompt Payment Statutes.

1. The Floating Lien Provided By The Packers And Stockyards Act.

In the early 1970's economic dislocation in the meat packing industry caused several packers to go bankrupt. The bankruptcies created massive problems and some important litigation. (*E.g. In re Samuels*, 526 F.2d 1238, 1243 (5th Cir.), *cert. denied sub nom*, 429 U.S. 834, 97 S. Ct. 98, 50 L. Ed. 2d 99 (1976). To attempt to protect livestock producers from serious financial loss, in 1976 Congress amended the Packers and Stockyards Act. One of the additions was 7 U.S.C. § 196 (1980). In part, it says:

> (1) All livestock purchased by a packer in cash sales and all inventories of, or receivables or proceeds from meat, meat food products, or livestock products derived therefrom, shall be held by the packer in trust for the benefit of all unpaid cash sellers of such livestock until full payment has been received by such unpaid seller; and
>
> (2) The unpaid seller will lose the benefit of the trust if the seller does not preserve the trust by filing a claim with the Secretary of Agriculture.

The claim must be filed promptly. For example, if the seller's loss occurs because of dishonor of a payment instrument, the seller must file the claim within fifteen business days after the seller received notice of dishonor.

In re Gotham Provision Co., 669 F.2d 1000 (5th Cir. 1982) is the base case. The contest in *Gotham* was between unpaid livestock producers and a secured lender to Gotham Provision Company, a packer. A secured lender held a security interest in Gotham's inventories, accounts receivable and proceeds. In *Gotham*, the court held (1) that § 196 gives a priority to the unpaid livestock producers over the secured creditor; and (2) that the trust created by the statute is a "floating trust" consisting of the commingled meat products, inventories, accounts receivables and proceeds from cash sales, and that the unpaid producers take priority in all such commingled assets until fully paid.

2. "Cash" or "Credit" Sales to Packers

The Packer Trust allows "cash sellers" to prevail over other creditors in a packer bankruptcy. A "credit seller" is a bad position because the packer's bank or bankruptcy trustee will prevail over the unsecured credit seller, so the feedyard wants to be a "cash seller."

The Packers and Stockyards Act create a presumption that all sales to packers are "cash sales" by stating that "a cash sale means a sale in which the seller does not expressly extend credit to the buyer." 7 U.S.C. 196(c). Even if there is a delay in payment, the transaction is a "cash sale" unless there is an express agreement extending credit from the seller to the buyer. *See The First State Bank v. Gotham Provision Co., Inc. (In re Gotham Provision Co., Inc.),* 669 F.2d 1000, 1004-05 (5th Cir. 1982).

Although it is difficult to determine why a feedyard would want to do this, it can agree to waive its right to claim the status of a "cash seller." A regulation provides form language that satisfies the "express agreement" provision. 9 C.F.R. § 201.200, which was issued by the Secretary of Agriculture under the authority of 7 U.S.C. § 228b, states, in part:

> "No packer ... shall purchase livestock on credit ... unless: (1) Before purchasing such livestock the packer obtains from the seller a written acknowledgment as follows: On this date I am entering into a written agreement for the sale of livestock on credit to ________, a packer, and I understand that in doing so I will have no rights under the trust provisions of section 206 of the Packers and Stockyards Act, 1921, as amended (7 U.S.C. 196, Pub. L. 94–410), with respect to any such credit sale...."

Although this regulation gives the feedyard an argument that if it hasn't signed an express agreement turning its cash sale into a credit sale, it is by default a cash seller, this does not mean that every feedyard that has not signed a waiver has no risk. In a recent packer bankruptcy, feedyards that allowed the packer too long to pay were forced to defend their "cash seller" status. In addition, some older Texas cases that support the idea that failing to insist on normal payment, taking a post dated check, taking a draft that is "not a check" (this is in the statute, and refers to the old fashioned type of drafts that had to be presented to the buyer after the seller deposited them), or, maybe, a course of dealing, might convert a cash sales into a credit sale.

If a feedyard finds itself exposed to this situation, it could send a notice expressly disclaiming credit seller status, require payment on delivery; send reclamation notices, create and perfect a security interest.

3. **State Prompt Payment Statutes**.

TEX. AGRIC. CODE ANN. § 148.021-028, creates a lien in behalf of the seller of livestock which follows the carcass and its products and is expressly superior to any contractual security interest. For comparison, the Oklahoma Prompt Payment Act, 2 OKLA. STAT. § 9.139, imposes no trust or continuing lien.

Section Three

BUYING AND SELLING CATTLE

VI. CATTLE MARKETING AND THE UNIFORM COMMERCIAL CODE

A. Transfers of Ownership.

1. Industry Practices.

Common industry practices often create situations of great legal ambiguity. For example:

- Contracts for the purchase and sale of cattle are routinely made over the telephone with little or no written documentation.

- Even though cattle are not fungible, they are sometimes bought and sold as if they were.

- Cattle often are sold several times during their production cycle. The "Code of the West" is that a buyer does not ask his seller from whom he bought the cattle. Industry custom also is that a "man's word is his bond." As a result, cattle may be bought and sold with marginal, if any, proof of ownership other than the seller's (often unstated) assertions.

- Arrangements for grazing cattle "on the gain," and the wide varieties of arrangements for providing capital, sharing in profits and losses, and division of responsibilities for caretaking are often the subject of simple oral agreements. These arrangements may create a wide variety of legal relationships. Although cattlemen routinely refer to practically all of these relationships as "partnering," almost none of them actually result in a legal partnership.

- Cattle identification markings, such as brands and eartags, are used for many purposes, and are not limited to designations of ownership.

- Individuals in the cattle marketing business may participate in many different types of transactions which involve different legal relationships. For example, a cattle trader may buy and sell on a commission basis; may purchase and sell outright, taking a position which subjects him to market risk; or may buy and sell under strict price guidelines from an ultimate user. In many cases the parties involved are not aware of the legal results created by these relationships.

2. Purchase Contracts

(a) General Requirements

To be enforceable by either buyer against seller or seller against buyer, a sales contract must be in writing and signed by the party against whom enforcement is sought (or by his authorized agent or broker).

To be enforceable, it is not required that the writing be formal or legalistic, nor is it required that it describe every detail of the transaction.

If the party against whom enforcement is sought is a "merchant" (and feedyards, middlemen, and probably most producers, would qualify as "merchants"), and that party receives a contract or purchase confirmation and does not object to it in ten (10) days, that party will be bound to its terms even if it was never signed.

If an oral contract is formed, it may be enforceable if payment has been made and/or delivery has been accepted under the oral contract.

(b) Identifying Cattle to a Contract of Sale

The Code requirement (§ 2.501(a)) that goods be "identified" to a contract before title can pass is sometimes involved in cattle disputes. As applicable here, § 2.501(a) provides that unless the buyer and seller agree otherwise goods are identified "when the contract is made if it is for the sale of goods already existing and identified" or, if the contract is for the sale of "future goods" [goods to be delivered in the future], identification occurs "when the goods are shipped, marked, or otherwise designated by the seller as goods to which the contract refers." § 2.501(a)(2).

Arguments can arise that cattle are not identified to a contract under fact patterns common in the cattle business, such as: (1) commingling of cattle that are not segregated, branded, tagged or otherwise dedicated to a specific contract; or (2) delivery of cattle under buyback agreements.

A commingling issue could arise if cattle in the possession of the seller that are described in purchase invoices sent to a buyer do not match the cattle acquisition records of the seller. This could support an argument that the cattle were not in existence at the time of the contract, and consequently became "future" goods which could not be identified until the cattle were acquired by the seller and "designated" to a particular contract.

Kit Car World, Inc. v. Skolnick, 616 So.2d 1051 (Fla. App. 1993), illustrates the "identification" concept. The contest in that case was between a secured creditor who seized component parts and inventory used to assemble replica car kits and the debtor's customers who had paid the full price for the car kits but to whom delivery was rendered impossible by the seizure. The court held that the buyers did not have an interest in the items because they were commingled and not identified at the time of seizure to any particular contract. The court noted that the identity of the customers who eventually would have received the available kits had the debtor remained in business was a matter of "pure speculation" and as a result held that the interest of the purchasers was inferior to the interest of the secured creditor.

There is an exception to the "future goods" rule if the goods are part of an "identified fungible bulk." Fungible goods are goods in which "any unit is, by nature or usage of trade, the equivalent of any other like unit." § 1.201(17). Official Comment 5 to Section 2.501 says:

> Undivided shares in an identified fungible bulk, such as grain in an elevator or oil in a storage tank, can be sold. The mere making of the contract with reference to an undivided share in an identified fungible bulk is enough under subsection (a) to effect an identification if there is no explicit agreement otherwise.

If this rule were applicable, specific cattle would not have to be designated to a specific contract if the cattle were "fungible." The writer is not aware of dispositive law on the subject and believes that the issue would be decided on a case-by-case basis.

(c) "Buyback" Deals

Cattle deals sometimes involve "buyback" agreements. These have been attacked under the theory that they constitute disguised financing arrangements rather than actual purchase agreements. An example is *In re Porter (Michigan Livestock Credit Corp. v. Porter)*, 202 B.R. 109 (N.D. Ind. 1996). In this case the Porters, who were hog farmers, filed a bankruptcy and in this bankruptcy challenged the interest of Michigan Livestock Credit Corporation. The Porters claimed that the agreements between them and

Michigan Livestock were disguised financing arrangements and not bailment contracts. Michigan Livestock argued that it retained ownership of the hogs under an agreement by which the Porters fed and bred the hogs which were supplied by a firm designated by Michigan Livestock. Michigan Livestock always paid for the animals and credited the purchase price to the Porters' account and after the hogs reached slaughter weight, they were sold in Michigan Livestock's name. The bankruptcy court found that the arrangement was a disguised financing agreement but on appeal the district court found that the arrangement was actually a bailment under which Michigan Livestock retained ownership.

In re Roxford Food Litigation, 790 F.Supp 987 (E.D.Cal 1991), provides a contrasting view to *In re Porter*. *In re Roxford* involved a poultry growing arrangement in which Purina Mills, Inc. was to grow turkeys for Roxford Foods, Inc. Purina sued to collect funds it claimed it was owed for growing the turkeys when Roxford ended operations. Purina claimed protection as a beneficiary under a Packers and Stockyards Act trust. Norbest, Inc. and other lenders who had provided Roxford funds on credit to finance its operations claimed that the relationship between Purina and Roxford was a disguised financing arrangement rather than a poultry growing arrangement, thereby barring Purina's claim to the funds as a beneficiary. The Court held that the relationship between Purina and Roxford was not a disguised financing arrangement because there were not any documents "establishing any kind of lender/borrower relationship such as UCC-1's, security agreements or promissory notes." *In re Roxford Food Litigation*, 790 F.Supp at 995.

(d) Warranties in General

Whether it says so or not, a contract for sale carries a number of warranties which are given by Seller to Buyer. If Seller wants to avoid the warranties, exclusion must be explicit.

(e) Implied Warranties Concerning Sale of Livestock

Several states have modified or excluded implied warranties concerning livestock.

Texas has excluded the implied warranties of merchantability and fitness concerning the sale of livestock in all instances. 2.316(f)

Oklahoma law says that the implied warranties of merchantability and fitness do not apply to the sale of livestock, if the seller "offers sufficient evidence that all state and federal regulations pertaining to the health of such animals were complied with," and says that implied warranties do apply to the sale or barter of horses.

Kansas says that there are no implied warranties concerning the sale of livestock, "other than the sale of livestock for immediate slaughter."

It does not appear that either Colorado or New Mexico have enacted an exclusion of implied warranties in the sale of livestock. In those states, a sale of cattle will carry an implied warranty.

(f) Risk of Death or Loss

The contract may specify when risk of loss passes. If it does not specify, generally risk of loss passes to the buyer when he receives the cattle.

(g) The Importance of Delivery

The concept of delivery of possession is crucial to understand the relationship between buyer and seller to cattle.

The UCC says that despite any agreements between the parties to the contrary, ownership to goods passes no later than delivery of possession. This means that the idea that "title does not pass until the check clears" is not a relevant legal concept when the rights of third parties are involved.

In fact, under the Code, title passes even if a check is given which eventually bounces so long as delivery has been made. However, § 2.511 provides that "payment by check is conditional and is defeated as between the parties by dishonor of the check.," and that the right of the buyer "as against the seller" to retain or dispose of goods is conditional upon payment. § 2.507.

Ownership can transfer even before delivery if the parties make such an agreement

(h) Buyer's Rights if Seller Fails to Deliver

[For purposes of these statements, it is assumed that the contract in question identifies specific cattle to be purchased.]

The existence of a contract to purchase gives the buyer an insurable interest in the cattle, even if they are still in the hands of seller.

If a seller is insolvent, a buyer may attempt to "reclaim" the purchased goods from seller if buyer has paid all or a part of the purchase price. (See discussion below).

Generally, however, the fact that the buyer has a contract with the seller and has made a down payment, will not allow that buyer to take the cattle away from a second buyer who has obtained possession of the cattle, so the disappointed first buyer is left to sue seller for damages.

If the Code does not apply, courts will often turn to concepts drawn from equity. For example, in *MBank Waco, N.A. v. L & J, Inc.*, 754 S.W.2d 245 (Tex. App. -- Waco 1988, writ denied), the court applied the equitable concept that "the one who created the loss should bear the burden of the loss" after analyzing the Code and determining that it did not apply. *See also Farmers Livestock Exchange of Bismark, Inc. v. Ulmer*, 393 N.W.2d 65 (N.D. 1986).

(i) Seller's Rights if Buyer Fails to Perform

GENERAL RULE: If the seller has delivered cattle or other goods and has not been paid (or the buyer's check has not cleared) when an insolvency arises, the seller must seek legal help immediately and its lawyer generally must take certain steps very quickly. This is not the time for "Doing It Yourself."

Assurance of Performance. If the seller believes the buyer is not going to perform when delivery time occurs, the seller can protect itself by requiring assurance of performance by the buyer before a seller relinquishes possession.

Stoppage of Transit. If the goods are actually in transit at the time Seller discovers the insolvency of the buyer, the seller can instruct the carrier to stop delivery.

Reclamation. See below.

(j) Seller's Right to Reclaim Cattle Delivered But Not Paid For

There is a right to "reclamation" (a right to regain possession of delivered goods) recognized by the law, but there are a number of limitations. Nevertheless, where cattle have been sold to a party who files bankruptcy or suddenly disappears, reclamation is the first remedy the seller should consider.

Unless the buyer has given seller a false representation of solvency within three months before delivery, the seller must give written demand for reclamation within ten days of delivery.

The seller's right to reclaim generally will be good only as against its buyer and is not useful as against subsequent buyers and claimants further down the chain of title if they qualify as "good faith purchasers," or "lien creditors."

A finding of agency may create a result different from what would occur otherwise under the UCC rules described above. An argument that the insolvent middleman is the agent of the disappointed seller may benefit the ultimate buyer; and conversely, an argument that the insolvent middleman is the agent of the buyer may benefit the disappointed seller. In the cattle business, the broke middleman is often alleged to be someone's agent, which allegations raise complicated factual issues. However, some factors which may influence agency questions are:

- How has the alleged principal described his relationship with the middleman, both to the middleman and to third parties?
- What has the middleman said?
- Whose credit did the third party rely on?
- What is the true nature of the business of the middleman? For example, does he take an ownership position, or is he just a broker? Does he always make the same profit, or does he sometimes make a larger profit or sustain a loss?
- Although not every relationship described by the participants as a "partnership" or "joint venture" is a legal partnership or joint venture, the existence of a legal partnership or joint venture or the characterization of such relationship by the parties may be a relevant factor.
- The seller can seek to recover a judgment against the buyer for damages. Generally, the seller will be obligated to try to cover as much of his loss as reasonably possible by reselling.

Sellers sometimes try to use alleged, or actual, joint ventures or partnerships are sometimes involved in cattle disputes created by insolvency to bypass the Code provisions on title or ownership transfer. Thus, an unpaid supplier may argue that his buyer was a "partner" of the now insolvent buyer in an attempt to impose liability. These arguments are sometimes successful. *Heinrich v. Wharton County Livestock, Inc.*, 557 S.W.2d 830 (Tex. Civ. App.Corpus Christi 1977, writ ref'd n.r.e.) (joint venturer not a "buyer in ordinary course"), and *W. H. Hodges & Co. v. Donley County State Bank*, 399 S.W.2d 193 (Tex. Civ. App.Amarillo), *rev'd*, 407 S.W.2d 221 (Tex. 1966) (agreement between cattle owner and pasture provider to split profits did not create a "joint venture" so as to permit caretaker's lender to acquire lien rights).

VII. COMPETITION BETWEEN UNPAID SELLERS AND MULTIPLE BUYERS

Determination of superior rights is the issue. All competing parties may have some rights which are worthy of sympathy and, absent the crisis of insolvency, might be enforceable. Priorities are determined, however, on the basis of superior rights, not necessarily "title," "ownership," or "possession."

An agreement between a seller and a buyer may not be binding on third parties. For example, an attempt by a seller to "reserve title" until full payment, is, after delivery has occurred, no more than a security interest. (If the security interest is unperfected, it does not bind one who purchases in good faith from the insolvent party.)

A. Beware of the Middleman

The most common crisis of insolvency in the cattle industry is the insolvency of a middleman who operates in a number of capacities such as producer, pasture operator, pasture lessee, pasture lessor, cattle dealer and cattle broker.

B. The Effect of Possession in Ownership Disputes

A contract to buy, coupled with delivery of possession, gives the buyer the ability to transfer superior rights to others. In the law this is known as the "shelter provision."

A party who acquires cattle under a transaction of purchase (a contract) has the power to transfer superior rights to its own lender or a downstream purchaser even though the delivery was in exchange for a dishonored check; or the delivery was procured through fraud; or the transferor was deceived as to the identity of the purchaser.

A party who acquires possession of cattle under a transaction of "entrustment" has the power to transfer superior rights to a downstream buyer (but not its own lender). The issue of "entrustment" is a fertile ground for argument between two relatively innocent parties.

The concept of "entrustment" is viewed from an objective standpoint and focuses primarily on the apparent business of the seller as a dealer or merchant in goods of the kind entrusted. However, only a "buyer in ordinary course of business" from the entrustee may benefit from the concept of entrustment. (A lender cannot be a "buyer in ordinary course.")

C. Brands And Bills Of Sale

1. Brands

Brand laws and the effect of brands differ among states. Brands have proven impractical as a means to settle title and ownership disputes because modern husbandry practices do not consistently use brands for the purpose of settling such disputes.

A Texas law enacted in 1848 attempted to suggest that a brand was some evidence of ownership when it said: "No brand, except as . . . [properly recorded] shall be recognized in law as any evidence of ownership." This statute was repealed in 1929. Since then, one case has stated that brands are "some evidence" of ownership, but it appears that Texas law would permit the true owner to show ownership even if its brand was not on cattle in dispute.

In some states, the presence of a recorded brand may be considered "prima facie" evidence of ownership rebuttable by other showings of fact.

Brands may be material to the argument in disputes involving questions of knowledge or lack of knowledge and the buyer's and seller's respective abilities to convey good title.

2. Bills of Sale

A Texas statute dating to 1866, still on the books, states that sales of cattle must be accompanied by a "written transfer" describing the number of head and identifying marks and brands.

Early cases under the statute established that a sale of cattle accompanied by delivery and payment was not rendered unenforceable by the statute if there was no bill of sale. Those early cases are believed to be still good law.

The Colorado Supreme Court has stated that the "majority of jurisdictions that have construed similar statutes" hold that livestock bill of sale laws, even those which state that they establish "prima facia ownership," are still subject to the general rules concerning ownership established by the Uniform Commercial Code.

3. "Bill of Sale" Drafts

A carefully written bill of sale draft can accomplish many objectives from the purchaser's standpoint.

A bill of sale draft can contain a promise by the seller that no liens against the cattle exist.

The same document can also require that if there are any liens, the lienholder's execution of the draft constitutes a release of those liens.

This same document can serve as evidence of the transfer of ownership from the buyer to the seller.

A "bill of sale draft" may be helpful to the purchaser's lender in tracing collateral.

A "bill of sale" draft may give the purchasers some helpful, but not determinative, points of argument as to third parties. However, if the purchaser has a bill of sale from someone who is not the owner, the bill of sale is not much help.

VIII. TIPS FOR PURCHASING FARM PRODUCTS IN TEXAS

1. Cattle Purchased from Dealers

If the seller is clearly and unambiguously a dealer, such as a cattle aggregator, the cattle are arguably "inventory" and the feedyard will be a "buyer in ordinary course of business."

If the cattle are "Inventory" and the feedyard is a "Buyer in Ordinary Course of Business", the feedyard will take free of the dealer's lender's liens.

2. Cattle Purchased from "Cattle Jockeys"

Cattle may or may not be the seller's inventory. If cattle are not "inventory" they are "farm products" and the seller's lender's lien may continue, making the feedyard's purchase subject to the lien.

The feedyard should follow the same protective procedure as with purchases from cattle producers.

3. Cattle Purchased from Producers

The feedyard is very likely to take subject to producer's lender's lien.

The feedyard should honor any actual notices received from lenders requiring joint payment.

The feedyard should honor notice received by virtue of the “newspaper,” that is, the publication of lien filings by the central notification system incorporated.

The feedyard should honor any UCC financing statements discovered by a search. The feedyard’s safety is enhanced by conducting a UCC search.

4. Grain or Hay Purchased from Merchandisers

If the merchandiser is clearly a merchandiser and not a producer, the feedyard should qualify as a “buyer in ordinary course of business.”

If the feedyard is a “buyer in ordinary course of business”, it will take free of the seller’s lender’s lien, and the feedyard is safe not to check filings.

Any explicit notice from the merchandiser’s lender, however, should be heeded, or at least investigated because merchandiser’s lender may realize upon accounts receivable of the merchandiser by giving such a notice.

5. Grain, Ensilage or Hay Purchased from a Producer

The feedyard is very likely to take subject to the producer’s lender’s lien unless the feedyard takes precautions.

The feedyard should honor actual notices received from lenders.

The feedyard should honor notice received by virtue of the “newspaper,” the publication of Central Notification System, Inc.

The feedyard should honor any UCC financing statements discovered by a search.

Section Four

FEEDING AGREEMENTS

Feedyards are historically reluctant to ask their customers to sign feeding agreements. This reluctance appears to stem from fear that customers will feel that the feedyards do not trust them, or that the documents are getting too complicated, and the fear that if they require feeding agreements, and the competitors don't, the customers will go to a feedyard that does not require the agreements. Despite this historical reluctance, more feedyards are now using feeding agreements.

A well drafted feeding agreement will address at least the following concerns:

The TCFA By-Laws permit TCFA members to use the TCFA's arbitration procedures. If the parties are not TCFA members, an arbitration agreement, if properly constructed, is generally enforced by the courts. These provisions can be helpful in reducing litigation expense and time to resolve disputes.

A feeding agreement should contain a provision that the feedyard acquires a "agister's lien" and should also provide for a security agreement using Article 9 language.

The feeding agreement should contain a agreement by the borrower to pay interest on outstanding feed bills.

The feeding agreement should address the authority of the feedyard to negotiate the sale of the cattle after they become fat. The feedyard should be given the ability to accept proceeds for the borrower, deduct the feed bill and other expenses, then pay the remainder to the borrower or the borrower's lender or lenders.

The agreement should cover all cattle that may be delivered to the feedyard. This is necessary because after a customer relationship is established, the niceties of the paperwork often become forgotten, and a feeding agreement relating to 220 head on feed in August of 2011 may be held by a court to have no application to a set of 220 steers placed on feed in August of 2013.

The feeding agreement should also contain some warranty that the person signing the agreement is the owner, or is authorized to act for the owner, of the cattle. All the safeguards, and the dangers, described above with respect to lienholders should also apply to a feedyard seeking to be diligent in caring for the cattle and collecting its feed bill.

Notes