# Financing the Farm

*A law bulletin series on legal arrangements for farm financing*

April 2021

## About the *Financing the Farm* Law Bulletin Series

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New farmers are exposed to a number of different finance and credit instruments when they start to build their farm businesses. Fortunately, this allows them access to capital for purchasing land, equipment, livestock, inputs and supplies. Unfortunately, lenders do not always explain the legal components and implications of these documents to a beginning farmer.

The *Financing the Farm* law bulletin series provides new and beginning farmers with an overview of the most commonly used documents in agricultural finance. Each law bulletin covers a different type of financial agreement, and explains basic terminology, fundamental legal requirements, and how the arrangement is used in farming operations. In this bulletin, we begin with a quick explanation of finance law and the role an attorney can play in your financing arrangements.

### What is Finance Law?

When we talk about finance, we are referring to cash loans and extensions of credit for purchasing goods. One of the most highly regulated areas of law is finance law. Why? Because it deals with money, and our society values having rules in place on how money is owned, loaned, and transferred. Finance law refers to a wide array of topics and a complex mixture of state and federal law. For the purposes of the *Financing the Farm* law bulletin series, we primarily stay close to state contract law.

**Contract law** governs how people and businesses enter into legally binding agreements to purchase goods and services. A legally binding agreement is an agreement that someone can take to a court in order to have the court enforce the individual's rights under the contract.

Contract law has largely been a creature of state law, meaning that each state gets to decide how contracts are governed in its state, even between private parties. Fortunately, most states have adopted the **Uniform Commercial Code (UCC),** which has helped standardize much of state contract law across the United States.

The Uniform Law Commission designed the UCC with the purpose of encouraging states to voluntarily adopt standard laws and rules in commercial law, which governs many of the financial documents discussed in this series. If a certain law is standard in every state, this means

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that courts in every state should reach the same or a similar decision on a given issue. This makes it easier to conduct business across state lines because it requires you to know one set of rules rather than 50 different laws.

We mention the UCC throughout the *Financing the Farm* law bulletin series. When you see it referenced, you'll know that the law referred to is intended to be standard across the United States. To learn more about the UCC, visit: http://www.uniformlaws.org/acts/ucc.

## Topics in this Series

In this series of law bulletins, we focus on the agreements and tools that a landowner, manufacturer, bank, credit cooperative, or public entity like the USDA use to provide the financing that helps you buy land, machinery, equipment, livestock, and supplies for your farming operation. You will formalize these financial arrangements with legal documents that establish the rights and responsibilities of all parties to the transaction.

Regardless of the source of your finance, a particular type of financial agreement is likely to involve the same types of documents. For instance, if you are seeking a large loan to purchase real estate, you are likely to enter into a mortgage and promissory note regardless of whether you go to a private lender, a cooperative, or the USDA. The details of those agreements may vary, but the basic purpose, legal implications, and processes for using the agreements will be the same.

Here are the law bulletins we've included in this series, and what you can learn about in each:

1. **Mortgages.** A mortgage secures a loan by granting a lender title to real estate and voiding the title upon repayment of the loan. Our first law bulletin explains the legal requirements for mortgages, how farmers use mortgages, the rights a lender receives through a mortgage, and what happens when two or more lenders claim a mortgage interest in the same property. We also examine the relationship between mortgages and promissory notes.

2. **Promissory Notes.** Commonly confused with a mortgage, a promissory note serves as a buyer's promise to repay a loan. Our law bulletin explains provisions and clauses commonly included in promissory notes and how farmers use promissory notes. We also discuss interest rates, legal limits on interest, what happens in the event of default, a lender's right to assign the promissory note, and a promissory note's relationship with a mortgage.

3. **Installment Contracts.** In an installment contract, the buyer repays a loan in a series of payments that typically includes the purchase price plus interest. Our third law bulletin explains installment contracts and how they're used, and addresses the tax consequences of selling depreciable assets, such as machinery and equipment, under an installment contract and using installment contracts with family members. The law bulletin also compares installment contracts to leases and lease-to-own agreements.

4. **Leasing Arrangements.** Leases play an important role in facilitating the agricultural economy. This fourth law bulletin explains what is required to enter into a lease, how farmers use leases, and notes different types of leases used in farming. It also highlights why leases should be in writing, discusses lease-to-own agreements and compares leases to installment contracts.

5. **Secured Transactions.** Secured transactions allow a farmer to secure a loan by granting a lender a security interest in collateral. This fifth law bulletin explains what secured transactions are, how farmers use them, and how they work. In this bulletin, we explain priority of interests, default and redemption, and which creditor has priority to collateral in which other creditors also have an interest.

6. **Statutory Agricultural Liens.** A statutory agricultural lien can protect the provider of agricultural goods or services in the event of non-

payment. In this bulletin, we explain how these liens work, examples of different types of statutory agricultural liens across the states, and their relationship with the Uniform Commercial Code.

**7**. **Personal Guarantees.** It's common for a lender to require a personal guarantee when making a loan to a business entity or new operation. In this bulletin, we discuss the role of the personal guarantee in agricultural loans and what an operator should understand before signing one.

**8**. **Operating Loans**. An operating loan is a common tool used in farming, as it provides necessary capital to put out a crop, expand a herd, or diversify an operation. We explain how operating loans work and how they are used in farming in this bulletin.

## The importance of working with an attorney

The general information we provide in this series does not replace the need to have an attorney review or create your financial agreements. Because you will be legally bound to an agreement that you sign, you want to be sure that you understand what you are promising, what your rights are, and the rights and obligations of the lender with whom you are contracting. An attorney can help you understand the agreement and its terms, and can also help you negotiate the agreement by offering alternative provisions that address your needs and protect your interests. An attorney's involvement might require several hours of his or her time, but the cost for this legal oversight provides an extra layer of assurance that your financial agreements will be sound and in your best interest.

## Resources on Agricultural Finance Law

"Beginning Farmers and Ranchers Loans," *Farm Service Agency*, United States Department of Agriculture, https://www.fsa.usda.gov/programs-and-services/farm-loan-programs/beginning-farmers-and-ranchers-loans/index.

"Farm Legal Series," University of Minnesota Extension Agricultural Business Management (June 2015) https://conservancy.umn.edu/handle/11299/199846.

"Farm Loan Programs," *Farm Service Agency*, United States Department of Agriculture, https://www.fsa.usda.gov/programs-and-services/farm-loan-programs/.

"Farm Operating Loans," *Farm Service Agency*, United States Department of Agriculture, https://www.fsa.usda.gov/programs-and-services/farm-loan-programs/farm-operating-loans/index.

"Finance and Credit," The National Agricultural Law Center, https://nationalaglawcenter.org/research-by-topic/finance-credit/.

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## Mortgages


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Mortgages serve a vital role in helping people buy, sell, and leverage their equity in real estate such as farmland. This bulletin explains mortgages and what a beginning farmer should understand when entering into a mortgage with a lender.

### What is a mortgage?

A **mortgage** is a security interest in real estate that a debtor grants to a creditor in exchange for a loan. In the mortgage context, debtors and creditors take on new names. The debtor is the **mortgagor,** which is the party granting the mortgage. A creditor is the **mortgagee,** which is the party receiving the **security interest** in collateral in exchange for a loan. In a mortgage agreement, the mortgagor grants a security interest in real estate to the mortgagee, who then has the legal right to foreclose and claim title to the real estate in the event that the mortgagor fails to repay the mortgagee.

Mortgages are different than promissory notes, operating loans, and lines of credit. A promissory note documents a promise to repay a loan. Operating loans and lines of credit are for day-to-day operating expenses, and usually do not involve granting a security interest in real estate as collateral for the loan. Instead, banks may require the debtor to give a security interest in collateral such as growing crops, livestock, equipment and machinery for an operating loan.

### When do farmers use a mortgage?

A farmer uses a mortgage when taking out a substantial loan with a lender who wants to protect its interests by securing the loan with collateral. Frequently, the collateral is the same real estate that the farmer is purchasing with the loan. However, a lender might want to take a mortgage interest in real estate to secure another loan for purposes other than purchasing the mortgaged real estate. This means that the mortgage tool not only enables the purchase of the real estate used as collateral, but also allows a farmer to leverage equity in real estate to obtain credit for other needs.

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## How does a mortgage work?

As the mortgagor, you must **sign** a mortgage in order for the instrument to have legal effect. A mortgage serves as a claim of right in your property that goes against your own interest, and a signature signals your intent to be legally bound by the agreement. You may sign the mortgage yourself, or you may authorize an agent in writing to sign on your behalf.

Most states require a signature on a mortgage to be **notarized**. States register notaries who serve as official witnesses to signatures for important transactions. A notary's seal confirms that the person whose name appears on the document actually and voluntarily signed the agreement, but notary does not read the document.

A lender will **record** a signed mortgage in the public records. Filing the mortgage in the public record gives notice to others that the lender has a security interest in the property. Public recording plays an important role if you default on the loan or sell the property.

The date of the recording of the mortgage determines a creditor's **priority** in receiving payment if there is a sale or foreclosure on the property. In a sale or foreclosure action, interests filed at an earlier date have first priority over interest filed after that date and are repaid first. If there is money left over, interests with lower priority are paid in order of when their interests took effect. This makes filing of a mortgage an important step for the creditors.

## Mortgages and promissory notes

When you grant a mortgage to a creditor, you will likely also sign a **promissory note** at the same time. Why? The promissory note documents your promise to repay the amount of the loan, with interest, to the creditor. It's a legally binding contract, but a creditor wants more assurance of repayment than a promise on paper. That's where the mortgage comes in. The promissory note is tied to the mortgage interest. If you violate your promise to repay the promissory note, the mortgage kicks in. Your creditor can act on the foreclosure rights granted in the mortgage to recover its financial interests. Read more about promissory notes in our second law bulletin in the *Financing the Farm* law bulletin series.

## Rights granted to the mortgagee

When you sign a mortgage as the mortgagor, you give certain rights to your creditor, the mortgagee. One commonly exercise right is the right of **assignment,** which allows the mortgagee to sell or assign the mortgage to another party. This means that you might not always be dealing with the same lender as you repay the loan that is tied to the mortgage.

Another right is the right to prevent **waste** of the collateral by the mortgagor. A mortgage may contain covenants and rules on how the mortgagor must care for the property, such as paying property taxes and not making changes to the property that decrease the property's value. If the bank believes that the property owner is committing waste, it may seek judicial action to either stop the waste through an injunction, obtain monetary damages to compensate for the loss in the collateral's value, or even foreclose.

Perhaps the most important right given to the mortgagee is the **right to foreclose** on the collateral property if you fail to fulfill the terms of the promissory note, which we explain below.

## Foreclosure on a mortgage

Foreclosure is a legal process through which a mortgagor can claim title to the collateral property in the event that you default on payments due under the promissory note. Upon foreclosure, the mortgagee may choose to sell the property. If so, the proceeds of a foreclosure sale are first used to pay off the debt that you owe the mortgagee. The mortgagor may receive money from the sale if the sale raised enough to first cover all mortgages and liens on the property.

The laws governing foreclosure vary from state to state. States have different rules on the type and timing of notice required, how long the redemption time frame lasts, and whether there are limitations on seeking additional payment from the mortgagor if there are remaining debts after the foreclosure sale.

If you are able to pay the missed payments and bring your account current before the foreclosure sale, your state law might stop the foreclosure from occurring. Known as **redemption**, this requires you to pay all missed payments along with fees and interest. Some states also grant mortgagors a statutory right to redemption after the foreclosure sale for a set number of months. The mortgagor essentially must pay the amount that the property was sold for at the foreclosure sale in order to redeem the property after the sale.

When the money raised through the foreclosure sale does not cover all of your debt, the mortgagee may seek a **deficiency judgment** against you to cover the difference. A deficiency judgment becomes a personal debt that you must pay to the mortgagee. States impose various limitations on deficiency judgments, which an attorney licensed in your state can help you navigate.

## Mortgages and subordination

A lender might require you to obtain a **subordination agreement** from other mortgagees before granting a loan and receiving a mortgage on a property. A subordination agreement is a legal agreement between mortgagees that adjusts their priority positions when they have a security interest in the same collateral. When there are two mortgages on a property, the mortgagees may enter into a subordination agreement that allows one mortgagee to have first priority even if the other mortgagee holds an earlier mortgage.

Subordination agreements are often used in refinancing situations when the property owner wants to refinance the first mortgage. Refinancing effectively counts as a new loan with a new priority date. Having later priority would discourage the first mortgagee from refinancing, but by having a subordination agreement with the second mortgagee, the first mortgagee can retain first priority. A second mortgagee typically agrees to this type of subordination agreement without incident, as long as there is sufficient value in the collateral to address both mortgages.

## Mortgage disclosure laws

When a residence is part of a mortgage transaction, mortgagors have certain protections under federal laws such as the Real Estate Settlement Procedures Act, Home Mortgage Disclosure Act, and Homeowners Protection Act. These federal laws require brokers and lenders to provide a home buyer with certain information so that they may make an informed decision. The information includes a number of disclosures that explain the terms of the mortgage, along with closing and settlement costs.

When the mortgage does not involve a residence, but instead involves assets such as farmland, the government does not require lenders to provide as many disclosures. Purchases of farmland are treated as a business transaction by informed business parties, and therefore require fewer disclosures. This means that a farmer should take care to talk with the lender, know the terms of the mortgage, be aware of its costs, obligations and implications, and make sure that everything promised by the lender is in writing.

## Other titles in the *Financing the Farm* law bulletin series

To continue to learn more about common legal documents for farm financing arrangements, see our law bulletins on *Promissory Notes, Installment Contracts, Leasing Arrangements*, and *Secured Transactions*.

## Resources and References

"Finance and Credit," THE NATIONAL AGRICULTURAL LAW CENTER, https://nationalaglawcenter.org/research-by-topic/finance-credit/.

"Get answers to your mortgage questions," CONSUMER FINANCIAL PROTECTION BUREAU, https://www.consumerfinance.gov/mortgage/.

"Mortgages," *Office of the Comptroller of the Currency*, U.S. DEPARTMENT OF THE TREASURY, https://www.occ.treas.gov/topics/consumers-and-communities/consumer-protection/mortgages/index-mortgages.html.

Phillip L. Kunkel, Jeffrey A. Peterson, & Jason Thibodeaux, "Mortgages and Contracts for Deed," *Farm Legal Series*, UNIVERSITY OF MINNESOTA EXTENSION (June 2015) https://conservancy.umn.edu/bitstream/handle/11299/199838/mortgages-and-contracts-for-deed.pdf.

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## Promissory Notes

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By its definition, a promissory note is simply a written promise to pay a stated sum. As is often the case, however, there can be more complexity to promissory notes than the definition suggests. This bulletin explains promissory notes and what a beginning farmer should understand before signing one.

### What is a promissory note?

A **promissory note** is a written agreement to pay a certain sum of money at a specified time or on demand. A promissory note is a legally binding contractual agreement between a **promisor** who makes a promise to pay the money and the **promisee** who gave the loan. The note ensures that the promisee has a legal mechanism for enforcing the repayment agreement.

### When do farmers use a promissory note?

Farmers use promissory notes in a variety of transactions, sometimes without even realizing it. Perhaps the most common occurrence is when a farmer borrows money to purchase real estate and signs both a promissory note promising to repay the loan and a mortgage that secures the promises with collateral. Loans for other types of goods used in farming might also involve a promissory note stating that the farmer will repay the loan by a certain date or upon demand. Whenever a farmer receives a loan from family members or friends, and promises in writing to repay that person, that is also a promissory note.

### Types of promissory notes

There's not just one type of promissory note. A promissory note might be a **simple note**, which requires you to repay the entire loan amount in one payment by a specified date. Or it could be an **installment note,** which sets up a payment schedule with principal and interest being paid in

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installments over a period of time. An **open-ended note,** commonly used for operating loans, allows you to make draws on the loan amount over time, and to pay the amount drawn, plus interest, by a stated date. Be wary of a **demand note**, as it allows the creditor to demand full payment from you at any time, as long as the demand is made in good faith.

## Common terms in promissory notes

A promissory note can be quite simple and as short as a paragraph, or may be more detailed and lengthy. The terms in a promissory note can vary from creditor to creditor, but there are a number of important terms that you can expect to see in a promissory note. It is in a farmer's best interest to read through the documents and make sure that he or she understands the terms because, once signed, the note is legally binding.

Here are common terms you might see in a promissory note:

**The parties.** The promissory note should include the names of the promisor who will repay the loan and the promisee who gave the loan as the parties to the agreement.

**Principal loan amount.** This is the dollar value of your initial loan amount.

**Interest rate.** A promissory note should state the interest rate that the promisee is charging you for the loan and how the interest amount is to be calculated.

**Schedule of payments.** Some promissory notes might spell out when payments are to be made and the amount of each payment, including interest. An amortization schedule shows the remaining balance after each payment, including both principal and interest. Others might not include a schedule and simply state that the entire amount is due by a certain date.

**Loan term.** The loan term is the length of time allowed for paying back the loan, and might also address how frequently you must make payments. Sometimes, although not common in farm finance situations, a note might state that repayment may be due "on demand" by the promisee.

**Late payment penalties.** The note might state when a payment is considered "late" and if so, may assess a penalty that you must pay for being late.

Early payment. Paying down the principal early can reduce the amount of interest a creditor will receive, so some creditors might include a provision that prohibits early payment. More common, however, is to include a penalty that you must pay if you choose to pay off the note before it is due. Some states, like Ohio, limit this penalty.

**Default clause.** This provision lays out when you are considered to be in default on the note, such as by being late on a payment for a certain number of days or missing a payment altogether. The default clause might also explain actions the promisee can take if you are in default.

**Acceleration clause.** Be aware of this type of clause, as it allows the promisee to demand the *entire* amount due on the note if you are in default.

**Costs of collection.** It's common for a note to state that you must pay all costs if the promisee has to take legal action to collect on the note.

**Due on sale clause.** A due on sale clause allows the promisee to demand payment of the remaining principal balance if you sell real estate that is tied to the promissory note through a mortgage. However, the clause might also allow the promisee to waive the provision if the new buyer agrees to continue paying on the promissory note.

**Assignment**. This provision allows a creditor to sell the note to another creditor and assign all legal rights under the note to the new creditor. If assignment occurs, your obligations automatically transfer to the new promisee.

## Interest rates and limitations

Promissory notes should include an **interest rate.** This percentage rate can be fixed so that it is always the same percentage, or it can be variable and fluctuate with the market. Depending upon the agreement and when payments are due, the interest may be calculated daily, month, quarterly, annually, or on some other schedule.

State **usury laws** cap the interest rate a creditor may charge for a loan at a certain amount but can contain a number of exceptions. In Ohio, the state prohibits lenders from charging an interest rate above 8 percent, but allows a higher interest rate when the loan is for more than $100,000, is secured by an insured mortgage, or is a business loan, which includes agricultural loans. Note that many states also allow lenders to charge a higher interest rate by consent of the debtor.

You might be familiar with the federal **Truth in Lending Act**, which requires all lenders to disclose credit terms in order to protect consumers against misleading and unfair loan practice. Note that the Truth in Lending Act does not apply to business loans such as those used for farming purposes, however. This places a higher burden on you to make sure that you understand the credit terms in the promissory note.

## Relationship to mortgages

Many people confuse mortgages with promissory notes. The two documents are often signed at the same time and are related, as a mortgage secures a promissory note. While a promissory note represents your promise to repay a creditor, a mortgage provides the security for your promise in the form of collateral. In the event that you default on the promissory note, the mortgage allows the creditor to seek a remedy against the collateral listed in the mortgage.

## Other titles in the *Financing the Farm* law bulletin series

To continue to learn more about common legal documents for farm financing arrangements, see our law bulletins on *Mortgages, Installment Contracts, Leasing Arrangements* and *Secured Transactions*.

## References and Resources

"Finance and Credit," THE NATIONAL AGRICULTURAL LAW CENTER, https://nationalaglawcenter.org/research-by-topic/finance-credit/.

OHIO REVISED CODE § 1343.01, "Maximum rate of interest," http://codes.ohio.gov/orc/1343.01.

Phillip L. Kunkel & Jason Thibodeaux, "Contracts, Notes, and Guaranties," *Farm Legal Series*, UNIVERSITY OF MINNESOTA EXTENSION (June 2015) https://conservancy.umn.edu/bitstream/handle/11299/199829/contracts-notes-and-guaranties.pdf.

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## Leasing Arrangements

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Leases play an important role in facilitating the agricultural economy. These legal agreements allow farmers to use land or equipment of another and provide an important source of revenue to those who own the land and equipment. This bulletin explains what a beginning farmer should understand before entering into a lease.

## What is a lease?

A **lease** is an agreement by an owner of property to grant the right to use, possess, or control that property to another for a set period of time in exchange for a payment or other benefit. The owner of the property is the **lessor** and the leasing party is the **lessee**. When the lease involves real estate, we often call the lessor a **landlord** and the lessees the **tenant**. A valid lease gives both parties the legal right to enforce the other party's obligations under the lease in a court of law.

## When do farmers use leases?

Land and equipment lease are among the most common leases in agriculture today. Retiring farmers and absentee landowners may choose to lease their land and equipment to a tenant farmer rather than to sell the property. The leasing arrangement can allow an existing operation to expand without having to purchase land and equipment. Farmers and landowners also utilize leasing arrangements to lease livestock and buildings to one another. Landowners typically develop resources like oil and gas and solar energy through a leasing arrangement, and many landowners benefit from leasing hunting and other recreational rights on farmland.

## How does a lease work?

A lease is a contract that becomes enforceable when both parties agree to the terms of the agreement. The **terms** of a simple lease include names of the parties, identification of the property being leased, and the payment or benefit to be exchanged for the leasing rights. On the other hand, a lease can be complex and contain rights

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to assign payments to others, default damages, arbitration of dispute requirements, choice of law clauses, and other legal provisions.

A lease grants **limited rights** in the property rather than full ownership, and may impose restrictions on how the lessee uses the property. For example, an equipment lease may limit how much the lessee uses the equipment and charge additional fees if the lessee goes beyond the limit.

A lease lasts for a set period of time, known as the **lease term**, and often includes an option to renew and continue the lease. When a lease does not specify the lease term, state **default** rules apply. These default rules vary from state to state. Often, in the absence of a specified timeframe, the lease term may be established based upon when payments are due. An attorney in your state can help you determine the default lease terms in your state if your lease does not contain a specified lease term.

A lease is a **legally binding contract**. When you sign a lease, you are agreeing to the terms of the lease. A defense of "but I didn't read it" will not provide you with much protection. Note that the consumer protection laws that protect consumers in contracting situations don't apply to farm contracts like leases.

## Understanding types of leases

The content of a leasing agreement varies based upon the type and subject matter of the lease. A farmland lease, for example, is much different than an oil and gas lease or a hunting lease. Even within the area of farmland leases, a lease can be structured as a cash lease, a share lease, or a flexible cash rent lease. It's important, then, to understand the type of lease necessary for a situation and the issues and needs for that type of leasing arrangement. There are many resources for farmers on farmland leases, grazing leases, building leases, equipment leases, livestock leases, oil and gas leases, wind and solar leases, and hunting and recreational leases. Be sure to research the specific issues related to the type of lease needed for your situation.

## Leases should always be in writing

Because we value property rights in this country, states have enacted laws known as **statutes of frauds** that aim to prohibit fraudulent property claims. The laws won't enforce a contract for an interest in land, such as a lease, unless a signed, written agreement exists. This means that in most states, a lease of land must be in writing in order to be enforceable in court.

Even if the law doesn't require a certain type of lease to be in writing, such as an equipment lease, a written agreement can benefit both parties. A written lease provides **details and certainty**, so that each party knows its rights and obligations under the agreement. Putting a lease in writing allows the parties to have a clear vision of the leasing arrangement and what happens if something doesn't go as planned. Without a writing, the parties must rely on memory, develop solutions to problems they didn't predict, or take unresolved issues to court.

Hiring an **attorney** to draft or review a written lease can be well worth the expenditure. An experienced attorney will know what terms to include in the lease, points of negotiation, and laws that apply to the leasing arrangement. Likewise, involving an **accountant** can be beneficial to understanding the economic implications of a leasing situation.

## Comparison to installment contracts for tax purposes

An installment contract results in a transfer of property ownership upon completion of the payment provisions. In contrast, a lease is an agreement to grant rights to use, control, or possess the property of another. There is no transfer of ownership.

How the IRS treats these two types of contracts presents an important tax distinction between installment contracts and leases. A lessor's income from each lease payment is treated as income in the year during which each lease payment is due. However, installment contracts for depreciable property such as equipment may result in the seller having to pay taxes for depreciation recapture in the first year. Even if the seller will not receive all payments in year one, recapture taxes are due.

## Lease-to-own agreements

Somewhere between lease agreements and installment contracts are lease-to-own agreements. These contracts provide the lessee with the right to use, possess, or control the lessor's property for the duration of the lease term. At the end of the lease term, the lessee gains ownership of the property, whether automatically or for a fee. While these are leases, they have the same final result as an installment contract.

The taxation of lease-to-own agreements looks at two phases: the lease and the purchase. The lease phase is taxed just like a lease, and income is due in the year the lease payments are made. The purchase phase is then taxed like a purchase, except that when personal property is involved, the asset will have depreciated in value, which results in fewer capital gains taxes being due.

Most states impose **consumer protection** restrictions on lease-to-own agreements. Note that consumer protection laws often do not apply to business situations, however, and a lease-to-own agreement for a tractor used in a farm business will not likely fall under a state's consumer protection laws.

## Other titles in this series

To continue to learn more about common legal documents for farm financing arrangements, see our law bulletins on *Mortgages, Promissory Notes, Installment Contracts* and *Secured Transactions.*

## References and Resources

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# Financing the Farm

*A law bulletin series on legal arrangements for farm financing*

September 2019

## Installment Contracts

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The name itself suggests the unique feature of an installment contract: repayment of a loan to purchase goods occurs over time in installments, rather than all at once. Installment contracts can enable a farmer to finance large purchases over a period of time. This bulletin highlights important rules and tax considerations that a beginning farmer should understand before entering into an installment contract.

### What is an installment contract?

An **installment contract** is a legally binding agreement where the buyer's payments, the seller's performance, or both are spread out over a specified period of time. Rather than a transaction happening all at once, installment contracts intentionally give parties more time to perform their contractual obligations. The contract establishes the time period.

### When do farmers use an installment contract?

Installment contracts are common in agriculture. Farmers use these types of contracts to buy and sell land and goods such as equipment, grains, produce and livestock. Consider a few examples. First, a farmer buys 10 acres of land for $70,000 under a ten-year installment contract, often called a "land contract" or a "contract for deed." The terms of the contract require the farmer to pay $7,000 annually, plus interest. At the end of the agreement, the farmer receives the title to the land. Or, a farmer buys a new tractor from a supplier and enters into a contract that allows for annual payments over a five-year period. The seller maintains a secured interest in the equipment until payment is complete. Farmers might also sell goods under an installment contract. For example, a farmer agrees to provide a grocery with 500 bushels of apples each year for five years. Although the written contract covers five years, the farmer delivers the apples in installments and the grocery pays for each separate delivery.

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## How does an installment contract work?

An installment contract should be in writing and should clearly state what each party must do under the contract.  For the buyer, this usually means explaining on which dates or how frequently payment is due, how much is due, and whether the buyer must pay interest.  For the seller, this usually means explaining when it must deliver its goods or perform its services.

Each party should sign the contract.  If a security interest is taken until the buyer pays off the installment contract, separate documents may be necessary.  For more information, refer to our law bulletin on *Security Agreements*.

A properly executed installment contract is legally enforceable in a court of law.  Sometimes an installment contract does not address every situation, right, or obligation that could arise under the contract, however.  In this event, legal default rules will apply to the contract.  The **Uniform Commercial Code (UCC)** provides the default rules for sales of goods under an installment contract, which the law defines as an agreement "which requires or authorizes the delivery of goods in separate lots."  The UCC does not apply to sales of land under an installment contract.

If an installment contract is for the performance of a service, the **common law** of the state will supply the default rules.  The common law refers to the body of court decisions on a legal issue.  A farmer may need to refer to an attorney to understand the laws, obligations and legal remedies that apply to a particular installment contract situation.

## Installment contracts for land purchases

An installment contract is a frequent tool used for the private financing of a land sale from a seller to a buyer.  This type of "land contract" or "contract for deed" allow the parties to avoid third party lenders.  However, both parties should understand the legal implications of this type of installment contract.  The title to the property being sold remains with the seller until the buyer has paid the entire purchase price and interest.

An installment contract for a land sale therefore should address important issues such as which party is responsible for property insurance and property taxes throughout the duration of the contract.  The contract should also clarify what happens if the buyer falls behind in payments or defaults on the contract.  Often, an installment contract for land provides that a buyer loses all payments and rights to the property upon a default.  A farmer purchasing land under an installment contract must be aware of these legal implications, which differ from purchasing land through a mortgage situation.  See our law bulletin on *Mortgages* in this series for more information.

## Tax implications of installment contracts

Installment sales can raise complex tax questions, based upon how the Internal Revenue Service (IRS) treats a use of an installment contract.  In most cases, each installment is reportable on the seller's tax return in the year that the installment is paid. Referred to as the **installment method**, this is the default rule for when the IRS requires a seller to report income from an installment sale.

To illustrate, a landowner enters into an installment contract with a neighbor for the sale of real estate. The payment will be made in six equal installments, with two installments due each year. Assuming that the neighbor pays as required, the landowner will have to report two installments on this year's tax return, two installments on the following year's tax return, and the final two installments on the tax return for year three.

However, there are a few situations in which the default installment method does not apply, either by choice or by rule. In these situations, a seller must report the entire purchase price in the year the contract is agreed to.

The first situation is when a taxpayer chooses to **elect out** of using the installment method and pay all income or gain in the year when the contract is entered into, even if installments will be paid in later years. Income from interest received under the contract will still be due in the year that the interest is paid.

In a second situation, the IRS does not allow taxpayers to use the installment method for **depreciation recapture**. If an asset has been depreciated, the IRS requires the seller to report all depreciation recapture as income in the year of the sale, even if the seller will not receive all the payments in the year of the sale. This can lead to a high tax bill as a result of an installment sale. However, the taxpayer may report any gain greater than the recapture under the installment method.

Third, taxpayers may not use the installment method when selling **depreciable property to a related party**. In this case, the IRS requires the seller to report all payments that are to be received under the agreement in the year of the sale, even if some payments are not due until later years. However, the IRS does provide an exception that would allow a seller to use the installment method if the seller can prove that the sale will not result in a significant tax deferral benefit.

Beyond these situations, there are special rules for like-kind exchanges, single sales of several assets, sales of a business, disposition of an installment obligation, repossession, and more. With so many special tax rules, a seller in an installment contract may want to talk with an accountant and attorney before entering into an installment contract.

## Installment contracts with family members

A farmer might want to consider selling land, equipment or livestock to the next generation of family members under an installment contract. This arrangement allows the younger generation to spread out the purchase of high value assets over time and provides a continuous source of revenue for the seller. As we explain above, though, a seller may face significant taxes in year one when selling fully depreciated assets or selling to family members under an installment contract.

There are also tax ramifications for a family member who purchases property under an installment contract. If a buyer would have inherited the property, the buyer would have received a stepped up tax basis in the property. However, a buyer purchasing land or goods under an installment contract does not receive the stepped up tax basis for the property.

## Comparison to a lease

Installment contracts and leases are similar in that payment occurs over a period of time. However, an installment contract transfers ownership of the land or good permanently, while a lease transfers possession, control, and use of the land or good only for the term of the lease.

The taxation of an installment sale under the installment method looks very similar to the taxation of a lease. However, when the installment method of taxation is not used or cannot be used, income generated under the installment contract may result in a large up-front tax burden.

## Comparison to lease-to-own

A lease-to-own agreement falls somewhere between a lease and an installment contract. The initial rights under a lease-to-own mirror a lease: the lessee only has the right to possess, control, and use the property while the lessee continues to pay. Once the lease term ends, the lessee is expected to take ownership of the property, just like in an installment contract.

The taxation of lease-to-own agreements looks at two phases: the lease and the purchase. The lease phase is taxed just like a lease and income is due in the year the lease payments are made. The purchase phase is then taxed like a purchase. When depreciable property is involved, the asset will have depreciated in value over the course of the lease, which results in fewer taxes being due.

## Pros and cons of installment contracts

We hope this law bulletin illustrates that there are both pros and cons to installment contracts. An installment contract allows a farmer to purchase high value goods over a period of time, allows a seller to privately finance a sale to a farmer or family member, and accommodates the sale of cyclical farm goods. But installment contracts can have harsh results when used to purchase land, a seller may have to report the entire purchase price of a sale in the year the parties entered into the contract, and a buyer who would have inherited the property loses its stepped up tax basis. Consulting with an attorney and accountant to understand these implications may be necessary.

## Other titles in the *Financing the Farm* law bulletin series

To continue to learn more about common legal documents for farm financing arrangements, see our law bulletins on *Mortgages, Promissory Notes, Leasing Arrangements*, and *Secured Transactions*.

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# Financing the Farm

*A law bulletin series on legal arrangements for farm financing*

September 2019

## Secured Transactions

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It's common for a lender to require a farmer to put up "collateral" to secure a loan. This gives the lender financial security if the farmer defaults on the loan. We call this type of arrangement a "secured transaction." This bulletin explains secured transactions and what a beginning farmer should understand before entering into one.

### What is a secured transaction?

A secured transaction is a legal arrangement in which a party receives a **security interest** in a piece of **collateral** to secure the payment of a loan. We refer to the farmer who is offering the collateral in exchange for a loan the **debtor** and the lender who is giving the loan and taking a security interest the **secured creditor.** If the debtor fails to pay a secured creditor, the secured creditor may repossess or take control of the collateral property.

A secured interest is similar to a mortgage, but instead of involving real estate as collateral, secured transactions use personal property as the collateral.

### When do farmers use secured transactions?

In farming, perhaps the most common uses of secured transactions are when a farmer takes out a loan for an equipment purchase or for operating funds. A lender usually secures such loans by taking a security interest in the farmer's equipment, livestock, crops, inventory, or other type of personal property. Sometimes, the security interest is in the same equipment being purchased with the loan, referred to as a "purchase money security interest." Other times, a farmer might tap into the equity in other collateral to secure a loan for a new purchase or operating monies.

A farmer may also grant a security interest in the same collateral to different creditors, as long as there is equity in the collateral to satisfy the financial assurance of all creditors.

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## How does a secured transaction work?

Article 9 of the **Uniform Commercial Code (UCC)**, which all states have adopted, regulates secured transactions that use personal property as collateral. This means that the laws regarding secured transactions are uniform across the states.

The UCC first lays out the types of personal property that can be used as collateral, and the rules can vary depending upon the type of collateral. Most commonly used in farming situations are **"goods,"** which broadly includes "all movable things" and **"farm products."** Together, these definitions apply to the following goods that can serve as collateral under the UCC:

- Equipment, machinery and fixtures that can be severed from real estate;
- Crops growing, grown, or to be grown, even if produced on trees, vines, or bushes;
- Livestock and animals, born and unborn;
- Supplies used or produced in a farming operation;
- Aquatic goods produced in aquaculture and algacultural produced in algaculture;
- Products of crops or livestock in their unmanufactured states;
- Standing timber that is to be cut under a contract and minerals such as oil and gas;
- Consumer goods used for personal or household purposes.

In addition to the goods and farm products above, the UCC can also apply to i**nventory**, which extends to goods leased, held for sale or lease, furnished under a contract or service, or consisting of raw materials, works in process or materials used or consumed in a business. A debtor can also use the **proceeds** from any sale or trade of the above types of collateral and **checking, savings and other financial accounts** as collateral for a secured transaction.

Once the parties identify and understand the type of collateral to be used to secure a loan, a creditor must follow the UCC provisions in order to create the security interest and become a secured creditor. A creditor does so by complying with the laws for **attachment and perfection** of the security interest.

Step one, **attachment,** requires a creditor to "attach" its security interest to the farmer's collateral, which involves:

1. The creditor must give something of value to the farmer, which is typically a loan of money;
2. The farmer must have legal rights in the collateral;
3. The farmer must sign a written **security agreement**, which typically occurs at the same time that the farmer signs the loan documents. A security agreement is not required if the creditor maintains possession of the collateral, however. The security agreement must describe the collateral. Farmers should note that the description of the collateral can have significant implications. A description might contain very broad terms such as "all farm products" or "all crops." A description using "after acquired" or "future and present" language could extend to goods obtained or produced after entering into the security agreement. An attorney's review of the collateral description can be very helpful to ensure that it's not more broad than necessary to secure the loan.

Step two, **perfection,** requires a creditor to put other creditors on notice of the security interest so that the interest is valid against other creditors. There are several ways to "perfect" a security interest:

1. The usual method is by filing a **financing statement** with the Secretary of State or county records office in the jurisdiction where the farmer is located. Most states now provide for electronic filing of financing statements. A financing statement must include the names of the debtor and creditor and a description of the collateral. A financing statement remains valid for five years, but the creditor may file a **continuation** to extend the financing statement for additional five-year periods.
2. By taking **possession or control** of the collateral.

## Default

Default occurs when a farmer violates the terms of the loan agreement, such as by failing to make payments. A default triggers the secured creditor's right to collect against the collateral.

If the security interest is in physical property, the secured creditor has the right to possess the property. However, state laws usually prohibit a creditor from "breaching the peace" to claim the collateral. If violence might occur, the creditor must seek judicial approval of the possession.

## Redemption from default

Despite a default, the debtor may have a right of **redemption**. This is a debtor's right to bring their debt current by paying off the missed payment, along with interest, expenses, and any legal fees. The UCC allows debtors to redeem their collateral by paying off the missed payment along with any expenses and attorney's fees, but they must do so before the secured creditor takes possession of the collateral, disposes of it, or has accepted the collateral.

States may vary on the extent of a debtor's right to redeem, with more protections going to consumers purchasing consumer goods. Even if your state has adopted the Uniform Commercial Code, you may want to consult with an attorney to understand how default and redemption operate in your state.

## Priority rules for multiple security interests in collateral

When two or more secured creditors claim a valid security interest in the same piece of collateral, the UCC establishes which creditor has first **priority** to the collateral. Priority rules establish a creditor's place in line to recover or make a claim against the collateral.

Priority is based upon whether the creditors have attached and perfected their interests relative to one another. If one creditor has completed the step of attachment but another creditor has not yet attached to the collateral, then the creditor with the attached interest will have priority in claiming against the asset. If both creditors have attached to the collateral, but only one has perfected its interest, then the creditor with a perfected interest will have first priority to the collateral. If both creditors have completed attachment and perfection of their security interests, then the creditor who completed perfection at the earliest date has first priority to the collateral.

One trump card in secured transactions, however, is the **purchase money security interest** (PMSI) mentioned earlier. A creditor with a PMSI who perfects by filing a financing statement within 20 days of the date that the farmer took possession of the collateral purchased under the loan will have first priority over other creditors claiming an interest in the collateral, such as a creditor that attached to the collateral by way of an "after acquired" clause in a financing statement, explained above.

Another exception to the UCC's priority rules regards **statutory liens,** which could have priority over a perfected security interest. State statutory lien laws may address agricultural liens, landlord liens, crop input liens and harvester's liens, and may grant priority to these types of liens over a UCC secured interest. Consult with an attorney in your state to understand the types of liens recognized by state law and how they interact with other security interests in collateral.

Additionally, the federal **Food Security Act** creates another exception to the UCC priority rules. The law states that an "ordinary buyer of farm products" who purchases farm products from a seller engaged in farming receives the farm products free of any security interests. For example, a milk buyer who purchases milk from a dairy farmer can receive and resell the milk even if a creditor holds a perfected security interest in the milk. However, the secured creditor may notify the buyer of the security interest and provide instructions for payment to the secured creditor. When this occurs, the buyer of farm products must give the secured creditor its share of the payment.

## Public records of secured transaction filings

States maintain public records of the UCC financing statements filed by creditors. These public records allow other creditors to conduct research on a farmer to determine other secured interests in a farmer's collateral. Many states maintain the records in an electronic database that is readily available to all and allows creditors to file their financing statements electronically. Check with your Secretary of State or similar state agency to locate your state's UCC filings.

## Other titles in the *Financing the Farm* law bulletin series

To continue to learn more about common legal documents for farm financing arrangements, see our law bulletins on *Mortgages, Promissory Notes, Installment Contracts* and *Leasing Arrangements*.

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# Financing the Farm

*A law bulletin series on common financial documents for farmers*

July 2020

## Statutory Liens and Agriculture

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Today, it is common for farmers to purchase goods and services on credit from providers like veterinarians, seed dealers, animal feed dealers, and custom operators. Likewise, farmers often provide their own goods and services prior to receiving payment, as when delivering grain or in a production contract arrangement. For these situations, there are a variety of risk management tools to ensure payment for the goods and services provided. One such tool is a lien. State statutes across the U.S. authorize various types of liens to protect the interests of providers of agricultural goods, services, and land. In this bulletin, we explain statutory liens used in agriculture and how they work.

### What is a lien?

"**Lien**" is a broad term that refers to "a legal right or interest that a creditor has in another's property, lasting usually until a debt or duty that it secures is satisfied."[1] Essentially, a lien is a legal interest in property that secures a financial obligation. The party holding a lien in another's property is often called a **lienholder**, **claimant**, or **creditor**. The person or entity against whom a party holds a lien is often called a **debtor**.

A lien is created in one of three ways: by statute, by judicial verdict, or by agreement between the creditor and debtor.[2] These three major types of liens—statutory liens, consensual liens, and judicial liens—operate in unique ways. The focus of this bulletin is on statutory liens created for agricultural situations. We discuss consensual liens in two other bulletins in the *Financing the Farm* law bulletin series: *Secured Transactions* explains voluntary liens granted for personal property and *Mortgages* addresses consensual lien rights in real property. The final type of liens, judicial liens, are less common in agriculture than other types of liens and arise from a court verdict that entitles a lienholder to seize certain property belonging to a debtor as payment for a debt.[3]

### How statutory liens work

Statutory liens arise solely by force of statute; they do not require an agreement between the parties, permission from a debtor, or a court ruling for their creation. Statutory liens automatically attach to

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property because of a creditor's relationship to a debtor; they give the lienholder rights in specific property that can ensure the lienholder receives payment for goods, services, land, labor, or other obligations of the debtor. Many are familiar with tax liens and mechanic's liens, common types of statutory liens.[4] Statutory liens such as these aim to minimize the risks of nonpayment for goods or service providers serving agriculture, especially those who are not credit professionals. Managing such risks can help ensure that crop and livestock production goods and services remain available and affordable to farmers.[5] Where a statutory lien is available, a party who has provided land, goods, services, or labor to an agricultural producer or processor can acquire a claim against the crops, livestock, or equipment for which the land, goods, services, or labor were provided by satisfying the requirements of the statute.[6]

**Unique requirements**. Each statutory lien in a state has unique purposes and technical requirements for establishing the lien. For example, the Iowa Code provides a landlord's lien "for the rent upon all crops grown upon the leased premises," and upon personal property of the tenant that is used or kept on the leased land during the lease term. The lien automatically attaches, or becomes effective, on account of a landlord leasing property to a farmer. The landlord does not have to take any additional action to establish the lien.[7] However, certain agricultural liens do require additional steps by the lienholder in order for the lien to have priority over other creditors, which is discussed later in this bulletin.

**Possession versus non-possession.** Some statutes require that the lienholder retain possession of the property that is subject to a lien in order for the lien to be considered valid–-these are called *possessory statutory liens*. Other statutory liens do not require the claimant to retain possession of the property and are called *non-possessory liens*.

**Enforcement**. Once a statutory lien is appropriately established, the enforcement of that lien will also be governed by the statute that created it. However, as one scholar explained, "frequently state statutes are vague about collection rights," so it is important to consult a knowledgeable attorney prior to trying to enforce lien rights. In some instances, enforcing a lien requires some type of judicial action or filing with the appropriate court.[8] In other instances, a lienholder may be able to exercise self-help repossession in property they have properly taken a lien in, so long as a they are entitled to enforce the lien under the statute that created it.[9] Because a lienholder can expose themselves to liability if they try to exercise lien rights improperly, it is important to consult an attorney about the proper method for exercising statutory lien rights.

**Priority rules.** When multiple creditors, including lienholders, claim an interest in the same piece of property, the rights to that property are determined based on each creditor's "priority" status. Priority status is determined by a process called "perfection" in which a creditor files a notice of its interest in property. The statutes that establish statutory liens generally contain their own priority rules.[10] In addition, the **Uniform Commercial Code (UCC)** applies to certain statutory agricultural liens, creating requirements for perfection, rules of priority, and more, as discussed later in this bulletin.[11]

## Types of statutory liens used in agriculture

Statutory liens created by state laws vary widely, reflecting the history and legislative priorities of individual states.[12] As one group of scholars put it, there is a "phenomenal variety" of statutory agricultural liens in the U.S.[13] The National Agricultural Law Center's Statutory Agricultural Lien Rapid Finder Charts compiles the various statutory agricultural liens enacted by state legislatures across the United States.[14] The following examples of liens illustrate the wide variety of these types of state statutory agricultural liens. Note that not all of these types of liens are available in all states.

*Landlord's lien*. In Iowa, a landlord's lien is available to the landlord of property leased to farmers and attaches to the farm products grown or personal property stored on the property.[15]

*Agricultural supply lien*. In Oklahoma, any person selling, furnishing, applying, or providing seed, chemicals, pesticides, herbicides, or fertilizer for the growing of crops may take a lien in the crops for which the materials are supplied.[16]

*Agricultural crop lien*. In Washington, an agricultural landlord or agricultural input supplier, including labor and service input providers, may take a lien in crops. [17]

*Harvester or thresher lien*. In Kansas, a person who harvests or threshes grain or grain crops may take a lien in the grain or grain crops harvested or threshed.[18]

*Equipment lien*. In North Dakota, a blacksmith, machinist, farm equipment dealer, welder, mechanic, or other specified repair person may take a lien in vehicles, including combines, tractors, and other farm equipment.[19]

*Grain handler lien*. In Ohio, claimants such as lenders and producers who've delivered grain to a handler who are owed a financial obligation by the handler holds a lien in the grain possessed by the handler. [20]

*Commodity production lien*. In Iowa, a contract producer who feeds livestock or produces crops owned by another under a production contract holds a lien in the products produced or raised under the contract.[21]

*Livestock liens*. In California, a person or entity who provides services for another's livestock may take a lien in the livestock serviced. Another California statute allows providers of livestock breeding services to take a lien in the female animal bred or offspring resulting from the breeding.[22]

*Disease control lien*. In Georgia, the Georgia Commissioner of Agriculture may take a lien in cotton subject to an assessment for boll weevil eradication. Other states may have similar provisions that apply more generally or for other specific pests or diseases.[23]

*Veterinarian's lien*. In Alabama, a state licensed veterinarian may take a lien in an animal kept, fed, or surgically treated.[24]

*Carrier's lien*. In Vermont, a carrier, or a shipper that publicly operates a business for the transportation of goods, may take a lien in goods covered by a bill of lading.[25]

*Laborer's lien*. In Texas, certain workers, including farm hands, mill operators, and loggers employed under contract, may take a lien in things of value created by the worker's labor that are owned, controlled, or possessed by the employer.[26]

*Timber or log lien*. In Wisconsin, a person who performs services or provides supplies for obtaining logs and timber products may take a lien in the logs or timber and products manufactured from them.[27]

*Warehouse lien*. In North Carolina, a warehouse can claim a lien in goods covered by a warehouse receipt or storage agreement, or the proceeds thereof.[28]

## "Agricultural liens" under the UCC

Certain types of statutory liens used in agriculture can be subject to the **Uniform Commercial Code (UCC)** and its unique laws that govern security interests and other types of commercial transactions. Specifically, under Article 9 of the UCC, certain statutory liens that deal with agriculture (which we will call "UCC agricultural liens") must be "perfected" according to the requirements of the UCC in order for the lienholder to have "priority" over other creditors claiming interests in the same property. Generally, to "perfect" a UCC agricultural lien, the lien must have become effective under state law and the lienholder must file a sufficient financing statement in the appropriate office.

In general, perfected UCC agricultural liens, like perfected security interests, rank in priority according to the time they were filed. This is known as the first in time, first in right principle. However, the state statute that creates the UCC agricultural lien might provide different rules for priority than this first in time, first in right principle.[29]

For example, if a state statute specifies that an agricultural lien will have priority over previously perfected security interests, and the UCC agricultural lien is properly perfected, that lien will have priority over security interests that were perfected *before* the UCC agricultural lien.[30] Because of this, lenders may hesitate to allow farm products or property that can be subject to a UCC agricultural lien to be used as collateral at full value, since a statutory lien could arise in the products later under state law that gives the lienholder priority over the lender's security interest. In some instances, lenders taking assets as collateral may request that a debtor obtain lien waiver agreements with other parties like landlords to ensure the value of the collateral.

Note that a perfected UCC agricultural lien or security interest will always have priority over an unperfected UCC agricultural lien in the same property.[31]

The rules for perfecting and maintaining perfection of a UCC agricultural lien are complex and the consequences of failing to perfect a UCC agricultural lien can be severe, so readers who are interested in utilizing these types of liens or who have had a lien filed against their property should consult a knowledgeable attorney.

**Definition of "agricultural lien."** Due to the UCC laws, it's important to know what types of statutory agricultural liens are subject to the perfection and priority rules of the UCC. In other words, what is a UCC "agricultural lien"?

Specifically, UCC requirements for agricultural liens apply to those interests in *"farm products"* that secure payment or performance of an obligation for, (1) goods or services furnished in connection with a debtor's farming operation, or (2) rent on real property leased by a debtor in connection with its farming operation, and which is created by statute in favor or a person that, (1) in the ordinary course of its business, furnished goods or services to a debtor in connection with a debtor's farming operation, or (2) leased real property to a debtor in connection with the debtor's farming operation, and whose effectiveness does not depend on the person's possession of the personal property.[32] Essentially, this definition refers to a non-possessory, statutorily created lien in "farm products" that secures a farmer-debtor's obligation to either a person or business that regularly furnishes goods or services to a farmer or a person who leases real property to a farmer.

*Farm products,* as defined by the UCC, are goods, other than standing timber, with respect to which the debtor is engaged in a farming operation and which are:

- Crops grown, growing, or to be grown, including crops produced on trees, vines, and bushes and aquatic goods produced in aquacultural operations,
- Livestock, born or unborn, including aquatic goods produced in aquacultural operations,
- Supplies used or produced in a farming operation, or
- Products of crops or livestock in their unmanufactured states.[33]

## Other laws can affect statutory liens

In addition to the UCC, there are other laws that may impact the status of a statutory agricultural lien. Examples include the Packers and Stockyards Act,[34] Food Security Act,[35] Perishable Agricultural Commodities Act,[36] and the Bankruptcy Code.[37]

For example, where a debtor files bankruptcy, the bankruptcy trustee may void liens against their property in certain instances, meaning that the lienholder's rights in the property are removed and the property is available to the bankruptcy estate.[38]

## Know the lien laws in your state

Liens are tools that give a party a legal right or interest in another's property. They can arise in agriculture in a variety of ways to secure the performance of obligations like the payment of cash rent for farmland, the repayment of operating loans or equipment loans, payments due to suppliers and vendors like veterinarians or laborers, and many other business contexts. Farmers should understand both the potential for their creditors to use and enforce liens as well as the ways they might use liens to secure obligations owed to them. Knowing the applicable statutory lien laws in the state is an important risk management practice for farmers.

Remember that statutory lien laws are state specific and vary tremendously from state-to-state. Additionally, the relationship between statutory liens and the UCC can be complicated and other laws might affect a lien situation. The advice of an **agricultural attorney** experienced in federal agricultural laws and the farm finance laws in the state where the farmer operates should prove useful and necessary to further reducing financial risk.

## Other titles in the Financing the Farm law bulletin series

To continue to learn more about common legal documents for farm financing arrangements, see our law bulletins on *Promissory Notes, Installment Contracts, Leasing Arrangements, and Secured Transactions.*

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[20] OHIO REV. CODE ANN. §926.021.
[21] IOWA CODE ANN. §579B.
[22] CAL. CIV. CODE §3062; CAL. CIV. CODE §3080.
[23] GA. CODE ANN. §2-7-156.
[24] ALA. CODE §35-11-390.
[25] VT. STAT. ANN. tit. 9A, §7-307.
[26] TEX. PROP. CODE ANN. §58.
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[28] N.C. GEN. STAT. ANN. §25-7-209.
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[30] Schneider, *supra* note 9, at 6.
[31] *Id.*
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[33] U.C.C. §9-102(a)(34).
[34] 7 U.S.C. §§ 181-229.
[35] 7 U.S.C. § 1631.
[36] 7 U.S.C. §§ 499a-499t.
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# Financing the Farm

*A law bulletin series on legal arrangements for farm financing*

April 2021

## Understanding Farm Operating Loans

*Peggy Kirk Hall, Associate Professor*
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Farming is a capital-intensive business, often requiring high cash outputs long before receiving any sales income. An operating loan, also called a line of credit, can be a lifeline for providing the farm's capital. This bulletin explains operating loans and highlights what a beginning farmer should understand about using them.

### What is a farm operating loan?

A farm operating loan is a line of credit that typically follows a farm's production cycle. Unlike a term loan, an operating loan is not a single lump-sum disbursement repaid over a long period of time. Instead, a farmer draws on operating loan funds as needed. Repayment is usually due at the end of the production cycle, when the farmer sells the commodity produced, but could also be set up on a periodic schedule.

A **revolving** loan allows a farmer to borrow funds repeatedly as the farmer repays the loan balance. This arrangement might continue for several years and is common for farm operating loans. A **non-revolving** loan is a one-time loan that is not available again after its pay-off.

### When do farmers use operating loans?

An operating loan is typically used to provide liquidity to fund a farming activity in the short-term. For example, an operating loan can provide the capital necessary to purchase seed, fertilizer, pesticides and other inputs for planting a crop. After harvest, the producer repays the loan funds. An operating loan can provide start-up funds to diversify the operation or make improvements, such as purchasing livestock, adding an orchard, produce crop or agritourism activity. A loan can also cover general operating expenses when cash flow is limited. This type of loan is not for funding long-term purchases such as land and facilities, which typically involve lump-sum disbursements and term loans repaid over a long time period.

There are benefits to using an operating loan rather than a traditional term loan. The short-term nature of an operating loan minimizes interest charges only to funds actually used and over a short time period. The infusion of capital to grow the operation and quick pay-off can enhance the farm's balance sheet.

### How does an operating loan work?

As with other loans, an operating loan or line of credit requires a borrower to submit a loan application to a lender. Farm operating loans are available through government agencies such as the Farm Service Agency, which specifically targets beginning farmers

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who are unable to receive loans from other sources. Institutional and commercial lenders also provide farm operating loans, and some of these loans may be backed and guaranteed by the government. **Loan features** such as interest rate, how funds are accessed, and renewal terms can vary.

**Loan approval** may depend on factors such as credit history, program eligibility, production history, farm management experience, and a farm business plan. As with other types of loans, the parties will enter into a written **loan agreement** that sets the approved maximum loan amount and covers other terms such as interest, repayment, access to funds, and default.

A lender will seek to secure an operating loan with a **security interest** in collateral. The commodity produced with the operating loan is a likely source of collateral, and a lender may seek security interests in additional collateral such as stored grain, livestock, farm goods, accounts receivable, or farm machinery and equipment. A lien or a Uniform Commercial Code ("UCC") filing consisting of a security agreement and financing statement will secure the assets pledged as collateral. (Learn more in our *Secured Transactions* bulletin in this series).

It is common for a farm operator to obtain a revolving operating loan from the same lender from season to season. Annual price and market fluctuations will affect how much capital is needed each year. A lender and operator in a revolving loan situation usually conduct an **annual review** in anticipation of the next year's operating loan.

### Using farm operating loans

A farm operating loan is a useful tool for managing cash flow through the capital-intensive periods of a farming operation and avoiding long-term debt obligations. Operating loans can vary from lender to lender, making it important to compare different types of farm operating loans. Although a farm operating loan plays out in short-term periods that repeat with production cycles, an operating loan sets up a long-term relationship with a lender. A farmer should carefully review lenders and their operating loan products to ensure a loan arrangement and lender relationship that works best for their operation.

### Other titles in the *Financing the Farm* law bulletin series

To learn more about common legal documents for farm financing, see our law bulletins on Mortgages, Promissory Notes, Installment Contracts, Leasing Arrangements, Secured Transactions, Statutory Liens and Personal Guarantees, available in OSU's Farm Office library at https://farmoffice.osu.edu/ag-law-library/farm-finance-law.

### References and additional resources

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# Financing the Farm

*A law bulletin series on legal arrangements for farm financing*

April 2021

## Personal Guarantees and Agricultural Loans

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Lenders often ask a farm operator to sign a personal guarantee when extending credit to the operator's business entity. Why does a lender do so, and what are the implications of entering into a personal guarantee? This bulletin explains personal guarantees and what a farmer should know before entering into a personal guarantee.

**What is a personal guarantee?**

A personal guarantee is a legal promise by a third party **"guarantor"** to be liable for a borrower's loan with a lender. If the borrower fails to repay any portion of the loan, the lender can seek payment from the guarantor. By adding the guarantor as a third party to the transaction between a lender and a borrower, a personal guarantee provides the lender another party to turn to for repayment of the loan funds. Unlike a "co-signing" situation, the guarantor is not an applicant for the loan but is guaranteeing payment for the loan.

There are two different types of personal guarantees. A **limited personal guarantee** is often used when there are multiple business owners. If the business defaults on its loan, the business owners share the burden of repayment. An **unlimited personal guarantee** is an agreement by a single guarantor to be responsible for repaying the entire amount owed to the lender.

**When do lenders use personal guarantees?**

It is common to use a personal guaranty in several different types of loan situations. One is when the borrower is a **formal business entity** such as a corporation or a limited liability company. Organizing as a formal entity can legally shield the entity's owners from personal liability for the affairs of the business. Because of this legal protection from personal liability, the lender may require the owners to individually guarantee a loan for their business entity.

A lender might also want a personal guarantee when dealing with a **new business** that may not have an established credit history or own assets to secure the loan. Requiring the business owners to enter into personal guarantees would assure the lender that individual assets are available to recoup the outstanding loan if the business assets are insufficient.

Another scenario for using a personal guarantee is when the assets of an established business are subject to **other creditor and lender obligations**. The personal guarantee brings personal assets and funds into the financial picture. If other creditors use up the business assets, the lender may pursue the guarantor's personal assets for repayment purposes.

**How does a personal guarantee work?**

A lender might advise a business during the loan application process that a personal guarantee is necessary. A guarantor's willingness to sign a personal guarantee for a borrower can be a determining factor in whether the borrower receives a loan. But some business loans automatically include business owners or members as guarantors within the loan documents without formal discussion of the arrangement.

Most states require that any promise to repay another's debt, as is the case with a personal guarantee, must be **in writing and signed** to be legally enforceable. But there is no standard written form or separate document a lender must use, and it is common for personal guarantee language to be included along with other provisions within a loan document. The words "guarantee" or "guaranty" are not required for formation of the guarantee and might not appear in the document. Instead, any words that clearly establish a promise of the guarantor to pay for the debts of the borrower will suffice.

Examples of language sufficient to create a personal guarantee promise include:

- "Party agrees to immediately undertake the obligations of borrower upon written notice of default from the creditor."
- "Creditor has the right to 'call' upon LLC manager to make payments due."
- "LLC member agrees to be 'responsible for' an obligation when due."

**Signing a personal guarantee: issues and implications**

Nearly any type of extension of credit can involve a personal guarantee, so it is imperative that farmers understand the significance of signing a document that includes a personal guarantee.

Here are several issues and implications to consider:

*A personal guarantee trumps LLC and corporation protection.* As explained above, formally organizing as an LLC or corporation means that the debts and liabilities of the business are solely the responsibility of the business and the personal assets of the business owners are not subject to liability. A business owner or member who signs a personal guarantee loses this personal liability "shield." But the personal guarantee applies only to the loan and the personal asset shield remains in place for liabilities arising out of other contracts or torts.

*The personal guarantee might live beyond the original transaction.* A personal guarantee might apply not only to the current loan but also to future loans from the lender. Clear language such as "now or at any time hereafter" or "all obligations however and whenever incurred" express the intent for a guarantor to repay additional future obligations with the lender. However, many states like Ohio allow a guarantor to revoke a continuing personal guarantee prior to additional future loans.

*Many personal guarantees are "unlimited."* Where there are multiple owners, members or managers of a business, it is common to use the "unlimited" personal guarantee explained above. Doing so establishes joint and several liability for all who sign the document, and each person who signs will be responsible for the full amount of the debt.

*There could be ways to negotiate a personal guarantee.* A lender might be willing to negotiate the personal guarantee requirement. Alternatives to securing the lender's interest might be possible, such as a larger deposit or a letter of credit. A lender might be willing to limit the personal guarantee to certain identifiable personal assets or to remove the guarantee at a certain endpoint, such as when the debt reaches a stated amount.

*Ignorance is not bliss*. A guarantor who signs a contract containing personal guarantee language will have an uphill battle if claiming unawareness that the contract contained a personal guarantee. Unless the lender made a fraudulent representation or omission during the loan process, it is difficult to void a personal guarantee based upon ignorance.

## Legal review is critical

A personal guarantee might be necessary for many business loans, but it can have lasting financial consequences for a guarantor who becomes legally responsible for business debt. Yet because there is no standard form or language used to create a personal guaranty, it might not be obvious when someone is entering into this type of agreement. The terms of personal guarantees can vary from lender to lender and loan to loan and may be negotiable.

The issues and implications of personal guarantees highlight the importance of legal review of loan documents. Working with an attorney to fully understand the implications of a personal guarantee is an excellent financial risk management tool and is likely to be money well spent.

## Other titles in the *Financing the Farm* series

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