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Lien Priority is more Important than Ever

By Jim Pfau and Adam Hertzke (2/1/2010)

Secured financing can sometimes seem simple: Get a security agreement, file a financing statement, secure a loan. In the pork industry, even the multiple parties with interests in hogs — banks, seedstock and feed suppliers, veterinarians and so on — could all get paid because hogs were profitable enough to satisfy all of the claims.

Unfortunately, this simple view has been challenged as profitability has fallen in recent years.

Let's review several types of entities that may compete for a financial interest in hogs.

Consensual Security Interests

Most farmers rely on secured credit. A bank lends a farmer money; the farmer gives the bank a note and grants it a security interest in his hogs to secure payment of the note. This is a familiar process to most pork industry participants, and in the general world of business. Lawyers, bankers and many farmers know that the granting and enforcement of such consensual security interests is governed by Article 9 of the Uniform Commercial Code.

In many cases, a bank will be the only creditor holding a consensual security interest. In some cases, though, a farmer will grant security interests in the same hogs to multiple parties. For example, a farmer may obtain a general revolving line of credit from a bank secured by a security interest in substantially all of the farmer's assets. However, if the farmer runs out of availability on that credit line when he needs to buy hogs, he may find another lender willing to lend money specifically for that purchase.

The second lender will attempt to document its security interest in the hogs as a purchase-money security interest. The details of purchase-money financing of livestock are beyond the scope of this article, but, if successful, the second lender will have priority over the prior bank financer involving the hogs that are purchased with its funds.

Statutory Liens

Interests in hogs and other livestock are complicated by the existence of statutory liens created by state law to benefit parties that contribute to the livestock. Statutory lienholders could include veterinarians, breeders, feed suppliers, contract producers and packers, among others.

Unfortunately for all parties, statutory liens vary widely from state to state. Each state's law must be consulted to determine whether that state has liens for feed suppliers, veterinarians and others; how those liens are perfected (for example, by filing a financing statement); and the priority of the liens.

To help illustrate the issue let's take a look at an example.

Suppose that a producer running a large hog operation borrows money from an agricultural lender to purchase weaned pigs. The lender then takes a consensual purchase-money security interest in the hogs and fulfills its obligations under the Uniform Commercial Code by filing and perfecting its interest with the ssecretary of state in the state where the producer is located. If no one has filed a financing statement before the lender, the lender will probably feel comfortable that his interest in the hogs is superior to other creditors.

Next, the producer secures a local farmer to raise his hogs on contract. In many states the farmer is now entitled to a statutory lien to secure payment for his services; in some states that lien ranks ahead of the lender's lien.

Let's continue with this example. Suppose the farmer buys feed on credit. Once again, in some states the feed provider is now entitled to a statutory lien against the hogs that ranks ahead of the lender in order to secure payment

Next, the hogs get sick so the farmer calls in the local veterinarian who also provides his services to the farmer on credit. Sticking with the common theme, in some states the veterinarian is now entitled to a lien against the hogs, assuming he follows the perfection requirements. In fact, some states go as far as to give the veterinarian priority ahead of all other lienholders, including the other statutory lienholders.

In short, states have created statutory liens for nearly every person in the pork production value chain, but the liens created by each state are different in scope and enforcement.

Purchasers' Rights

The final complication to be discussed here arises from the hog buyer's rights. Before 1985, a buyer of hogs (or other farm products) was

always subject to security interests created by the seller. To mitigate the risk that they might have to pay twice, regular buyers routinely conducted searches against their sellers and cut checks payable to both their sellers and their sellers' secured creditors.

The Federal Food Security Act of 1985 shifted the burden somewhat in the buyers' favor. The act provides that buyers of farm products take free-of-security interests created by sellers unless the holders of those security interests comply with certain statutory requirements.

Under the act, states may be certified as having an adequate "central filing system." These states are referred to as "central filing states" or "clear title states," in contrast with states that do not have a central filing system, commonly known as "notice states." Unless a state's central filing system has been certified by the Department of Agriculture, the state is a notice state. As of this writing, 19 states have been certified as clear title states for some or all farm products. The published list (which you can access at porkmag.com/business) reveals, for example, that Minnesota and Nebraska are clear title states, but Iowa and Kansas are not.

In clear title states with an approved central filing system, secured parties must file an "effective financing statement" covering their security interest in the filing system of the state where the hogs are "produced." Hog buyers must search the central filing before buying hogs. If any secured parties have filed against the hogs being purchased, the buyer should obtain a release from the secured parties, or at least cut any checks payable to both the farmer and the secured parties.

The contents of the filing required in clear title states are different from those required under the Uniform Commercial Code, but a secured party must file both to be protected. Matters become particularly difficult when multiple states are involved. Under the Food Security Act, the correct state in which to file is the state where the product is produced. Under the UCC, the correct state in which to file is the state where the debtor is located — not where the product is produced. If a hog is grown in multiple states, creditors will generally file an effective financing statement in all states to which the hog is shipped.

In notice states, a buyer of farm products (including hogs) in the ordinary course of business takes free-of-security interests created by the seller unless the secured parties have given the buyer notice of their security interests. For this reason, lenders in notice states often require farm debtors to provide a list of the buyers to whom they will sell hogs. That list should be updated periodically, and the lender should send notices of its interest to the buyers on the list. Still, the lender retains a risk that the producer will sell hogs to a buyer that is not on its lists. In that case, the lender may have a claim for misrepresentation against the producer, but the lender's security interest may be lost.

The ways that statutory liens, the UCC and Food Security Act interact to determine priority vary from state to state. Participants in this industry would be well-served to fully understand lien priority under the states in which they operate.

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