

Priority Among Competing Security Interest

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Overview

Most agricultural operations are dependent on borrowed money or financing for continuing in business. Presently, United States agriculture bears about \$450 billion in total real estate and personal property debt. With this financing comes the need to understand the legal relations created by such debt, and the rights and obligations of the parties involved.

Recently, a bank in Texas got confused on the financing rules governing agricultural crops and lost its security interest as a result.

Ag financing and priority rules among competing security interests – it's the topic of today's post.

Background

Changing form of collateral and “proceeds.” The security interest created by a security agreement is a relatively durable lien. The collateral may change form as the production process unfolds. Fertilizer and seed become growing crops, animals are fattened and sold, and equipment is replaced. The lien follows the changing collateral and, in the end, may attach to the proceeds from the sales of products, at least up to ten days after the debtor receives the proceeds. In other words, a security interest in proceeds is automatically perfected if the interest in the original collateral was perfected. However, a security interest in proceeds ceases to be automatically perfected ten days after the debtor receives the proceeds. To avoid the ten-day rule from eliminating its security interest, a creditor often puts a provision in the security agreement stating that the security interest continues in the “proceeds” of the collateral.

Priority. If a debtor gives a security interest in the same collateral to two or more creditors, and the interests are perfected, it is necessary to determine which one has priority upon the debtor's default. If the interests are perfected by filing, priority is determined by the time of filing. The creditor who filed first, wins. Therefore, because a financing statement may be filed *before* a security agreement is signed or the security interest attaches, a cautious creditor may wish to file early. If one or both are perfected in some manner other than filing, priority is determined by the time of perfection.

PMSI. A special type of security interest, known as a purchase money security interest (PMSI), is taken or retained by the seller of property to secure payment of the purchase price. A PMSI can also be obtained by a lender when it provides funds for the buyer to acquire specific property. But, when funds are loaned to a farmer to buy inputs to plant a crop, does the lender get a PMSI in the resulting



crops that has priority to a different lender that had already loaned money to the farmer and had a perfected security interest in the farmer's "crops and proceeds thereof?"

Recent Case

In *Agrifund, LLC v. First State Bank of Shallowater*, No. 07-22099925-CV, 2022 Tex. App. LEXIS 9010 (Tex. Ct. App. Dec. 9, 2022), a farm couple borrowed money from the plaintiff to finance their farming operation. They received multiple extension of the credit line with the final promissory note executed in December of 2017. The plaintiff perfected a security interest in the couple's crops, among other items. The couple defaulted on the loan on March 15, 2018. Shortly thereafter, the couple borrowed money from the defendant. The couple used the funds to buy cotton seed and chemicals to enable them to put the 2018 cotton crop in the ground. They granted the defendant a security interest in all crops grown or to be grown for the 2018 crop year. The defendant perfected its security interest on June 4, 2018. Upon harvest, the couple sold the resulting cotton crop, and the defendant claimed its security interest beat out the plaintiff's prior perfected interest on the basis that the defendant's interest was a PMSI. The trial court agreed.

Under Texas law, "purchase money collateral" means "goods that secure a purchase-money obligation incurred with respect to that collateral." *Tex. Bus. & Com. Code Ann. §9.103(a)(1)*. A "purchase-money obligation" is "an obligation of an obligor incurred as part or all of the price of the collateral or for value to enable the debtor to acquire rights in or the use of the collateral if the value is in fact so used. *Id. §9.103(a)(2)*. "Goods" are defined as "all things that are movable when a security interest attaches" and includes "crops grown, growing or to be grown...." *Id. §9.102(a)(44)*. The defendant's security interest stated that the property subject to the security interest included "supplies used or produced in a farming operation" and "crops grown or to be grown for the 2018 crop year."

The defendant claimed it had a PMSI because it had a perfected security interest in "crops to be grown" which met the definition of "goods." The appellate court disagreed noting that, by definition, a "purchase money security interest" means that the security interest must be taken in the items actually purchased. The couple borrowed money to produce a crop, not buy one. The appellate court also pointed out that purchased seed is not the same as a "crop to be grown." A crop is distinguishable from the seed and chemicals, the purchase of which the defendant funded with its loan. The appellate court also rejected the defendant's claim that the cotton crop was the "proceeds" of the seed. Texas law defines "proceeds" as "whatever is acquired upon the sale, lease, license, exchange, or other disposition of the collateral...." *Id. §9.102(a)(65)(A)*. As the appellate court pointed out, the resulting cotton crop was not the result of the sale, lease, license, exchange, or disposition of the seed. Crops are not the proceeds of seeds. *See, e.g., Searcy Farm Supply, LLC v. Merchants & Planters Bank*, 256 S.W.3d 496 (Ark. 2007). As a result, the appellate court held that the defendant did not have a PMSI in the farm couple's crop and the plaintiff had priority to the sale proceeds of the crop.

Note: A dissenting judge would have held that the defendant had a PMSI superior to the plaintiff's interest on the basis that the definition of "goods" included "crops to be grown." But, the statute at issue defines "goods" as "all things that are movable when a security interest attaches." At the time of attachment (when the defendant made the loan pursuant to the security agreement executed on



account of the debtor's power to create a security interest), the "crops to be grown" were not in existence because the seeds hadn't yet been planted. Thus, "goods", by definition, could not include "crops to be grown." The dissenting judge simply failed to apply the statute as written and misapplied the concepts of secured transactions law.

PMSI in Crop Rule

A prior version of Article 9 of the Uniform Commercial Code (UCC) provided for a unique limited PMSI that a creditor could obtain in crops to be grown. A perfected security interest in crops for new value, that is given to enable the debtor to produce the crops during the growing season and given not more than three months before the crops become growing crops by planting or otherwise, takes priority over an earlier perfected security interest to the extent that such earlier interest secures obligations due more than six months before the crops become growing crops by planting or otherwise, even though the person giving new value had knowledge of the earlier security interest.

The purpose of this PMSI in crop rule was to permit farmers to obtain financing to allow planting of a current crop in circumstances where current lenders will not advance funds to enable the farmer to put in a crop. This was precisely the situation involved in *AgriFund, LLC*, but the provision was eliminated in 1999. The Texas legislature, unlike Iowa, did not enact an optional provision that would have given priority status to a lender that extends credit to enable a farm debtor to produce crops.

Conclusion

The Texas case illustrates that ag financing rules are important to understand by farmers and lenders alike. While I don't know the backstory of the case, I suspect that the defendant either failed to check the public records to determine if another lender had a prior perfected security interest in the cotton crop before making the loan or got bad legal advice as to the applicability of a PMSI. Of course, an input supply dealer could have financed the purchase of the seed and fertilizer and claimed a lien under Tex. Agric. Code Ann. §§128.001-128.048. That would have given the supplier equal priority to the plaintiff in the proceeds of the crop.

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