

The “EIDL Trap” For Farm Borrowers

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Overview

The CARES Act that was signed into law in early 2020 is a massive “stimulus” bill designed to help offset the negative economic fallout of the shutdowns decreed by various state governors. An aspect of the CARES Act was an expansion of the Economic Injury Disaster Loans (EIDLs) of the Small Business Administration (SBA). Later legislation provided that EIDL “grants” are not included in gross income and that the exclusion will not result in a denial of a deduction (e.g., deductions are allowed for otherwise deductible expenses paid with loan proceeds), reduction of tax attributes, or denial of a basis increase (e.g., tax basis and other attributes are not reduced as a result of the EIDL being excluded from income).

However, for some farmers and ranchers that receive an EIDL, the accompanying blanket security agreement can create a potential trap for unwary recipients. Recently, Joe Peiffer, founder of Ag & Business Legal Strategies of Hiawatha, Iowa, brought to my attention potential problems for farmers that receive an EIDL based on the language of the SBA’s security agreement that a borrower must sign to receive a secured EIDL.

EIDLs and potential issues with associated security agreements – it’s the topic of today’s post.

EIDL Basics

An eligible applicant for an EIDL is a small business, small agricultural cooperative, and most private organizations that suffered “substantial economic injury” as a result of the virus and is not able to obtain credit elsewhere.

Note: A qualified agricultural business is one with 500 or fewer employees that is engaged in the production of food and fiber, ranching, raising of livestock, aquaculture, and all other farming and agricultural related industries. [15 U.S.C. §647\(b\)](#).

“Substantial economic injury” is defined as the business not being able to satisfy its obligations and pay ordinary and necessary operating expenses. For loans approved after April 6, 2021, the maximum loan amount is \$500,000 with a term of 30 years at a 3.75 percent fixed rate (2.75 percent for non-profit businesses). There are no fees and no prepayment penalty.

The proceeds of an EIDL are to be used for working capital of the borrower’s business and to cover normal operating expenses – such things as continuing health care benefits for workers; rent; utilities; and fixed debt payments. The loan is not forgivable, as is a Paycheck Protection Program (PPP) loan.

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SBA security agreement language. An unsecured EIDL can be for up to \$25,000, but collateral is required for an EIDL exceeding that threshold. Indeed, for EIDLs exceeding the \$25,000 amount, the borrower must sign an SBA blanket security agreement. The security agreement states the following in Paragraph 4:



“The Collateral in which this security interest is granted includes the following property that Borrower now owns or shall acquire or create immediately upon the acquisition or creation thereof: all tangible and intangible personal property, including, but not limited to: (a) inventory, (b) equipment, (c) instruments, including promissory notes (d) chattel paper, including tangible chattel paper and electronic chattel paper, (e) documents, (f) letters of credit rights, (g) accounts, including health-care insurance receivables and credit card receivables, (h) deposit accounts, (i) commercial tort claims, (j) general intangibles, including payment intangibles and software and (k) as-extracted collateral as such terms may from time to time be defined in the Uniform Commercial Code. The security interest Borrower grants includes all accessions, attachments, accessories, parts, supplies and replacements for the Collateral, all products, proceeds and collection thereof and all records and data relating thereto.”

Also included in the SBA security agreement is Paragraph 5 entitled, “Restrictions on Collateral Transfer. This paragraph requires the SBA’s consent before the borrower can sell or encumber the collateral subject to the agreement and reads in pertinent part as follows:

“Borrower will not sell, lease, license or otherwise transfer (including by granting security interests, liens, or other encumbrances in) all or any part of the Collateral or Borrower’s interest in the Collateral without Secured Party’s written or electronically communicated approval, except that Borrower may sell inventory in the ordinary course of business on customary terms...”.

The terms of Paragraph 8, entitled “Perfection of Security Interest,” states as follows:

Borrower consents, without further notice, to Secured Party’s filing or recording of any documents necessary to perfect, continue, amend or terminate its security interest. Upon request of Secured Party, Borrower must sign or otherwise authenticate all documents that Secured Party deems necessary at any time to allow Secured Party to acquire, perfect, continue or amend its security interest in the Collateral. Borrower will pay the filing and recording costs of any documents relating to Secured Party’s security interest. Borrower ratifies all previous filings and recordings, including financing statements and notations on certificates of title. Borrower will cooperate with Secured Party in obtaining a Control Agreement satisfactory to Secured Party with respect to any Deposit Accounts or Investment Property, or in otherwise obtaining control or possession of that or any other Collateral.

Paragraph 14 is entitled, “Borrower Certifications,” and reads as follows:

“Borrower certifies that: (a) its Name (or Names) as stated above is correct; (b) all Collateral is owned or titled in the Borrower’s name and not in the name of any other organization or individual; (c) Borrower has the legal authority to grant the security interest in the Collateral; (d) Borrower’s ownership in or title to the Collateral is free of all adverse claims, liens, or security interests (unless expressly permitted by the Secured Party); (e) none of the Obligations are or will be primarily for personal, family or household purposes; (f) none of the Collateral is or will be used, or has been or will be bought primarily for personal, family or household purposes; (g) Borrower has read and understands the meaning and effect of all terms of this Agreement.”

Implications. This is where Joe’s “heads up” comes into play. He points out that clearly, in accordance with Paragraph 5 of the security agreement, the SBA is requiring a borrower to obtain SBA’s consent before selling or encumbering any EIDL collateral. As noted above, an EIDL is for a term of 30 years – outlasting much farm equipment and other tangible and intangible farm personal property. This poses significant problems for farmers as well as creditors of farm equipment dealers. An SBA release will need to be obtained before engaging in common transactions such as an equipment “trade” – which, for tax years beginning after 2017, is treated as a “sale” of the property and not as a like-kind exchange.

Note: Obtaining the necessary consents from the SBA could be difficult and time-consuming, creating further complications for otherwise ordinary financial transactions.



The requirement contained in Paragraph 8 requiring the EIDL borrower to cooperate with the SBA in obtaining a “Control Agreement” that meets SBA’s approval concerning any deposit accounts or investment property, as well as assisting the SBA in obtaining control or possession of any collateral also raises particular concern. For instance, if a default occurs, all commodity positions of the borrower that are secured by funds in the borrower’s commodity market transactions account (the “hedge” account) would be subject to SBA’s discretion to withdraw. Such a withdrawal would eliminate the farm borrower’s risk management protection via commodity market positions taken in commodities on the Board of Trade.

Uniform Commercial Code, Article 9, Section 320 (UCC §9-320) contains a provision governing a “buyer in the ordinary course of business.” That provision states in subsection (a) that, “Except as otherwise provided in subsection (e), a buyer in ordinary course of business, other than a person buying farm products from a person engaged in farming operations, takes free of a security interest created by the buyer’s seller, even if the security interest is perfected and the buyer knows of its existence.

Note: Each state has codified Article 9. For example, the Kansas version of this provision is found at [Kan. Stat. Ann. §84-9-320](#). The Iowa version is contained in [Iowa Code §554.9320\(1\)](#).

Joe also notes that the protection under UCC §9-320 is not solid. It provides no protection for purchases not within the ordinary course of business. In addition, an exception applies for farm products that are purchased from a person engaged in farming operations. This would include, for example, a livestock operator buying feed or bedding directly from a farmer. Also, the provision only protects security interests that the buyer’s seller creates. It does not afford protection for the seller’s seller or any other party further up the chain. Thus, if a transaction falls within one of these “gaps” and the seller failed to satisfy or obtain lien releases from all of the creditors, those liens and interests will continue in the property.

Note: A buyer of collateral will need to determine how the collateral was acquired and the circumstances surrounding the sale of the collateral. For instance, if a farmer that obtained an EIDL trades equipment to an implement dealer that is subject to SBA’s blanket security agreement, and the dealer does not obtain the release of the SBA’s security interest, the SBA’s interest will continue in the equipment when the dealer sells to its purchasers in the ordinary course of business.

Conclusion

The EIDL program was created in response to the economic shutdowns instituted in many states. It is intended to provide relief to disaffected businesses. However, obtaining an EIDL comes with “strings” that can create a trap for the unwary. The terms of the EIDL security agreements puts significant constraints on EIDL borrowers and can also have implications for others that an EIDL borrower transacts business with.

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