

MINUTES OF THE SENATE COMMITTEE ON JUDICIARY

The meeting was called to order by Senator Elwaine F. Pomeroy at
Chairperson

10:00 a.m./~~p.m.~~ on January 20, 19 83 in room 514-S of the Capitol.

~~All~~ members ~~were~~ present ~~except~~ were: Senators Pomeroy, Winter, Burke, Feleciano, Gaar, Gaines, Mulich, Steineger and Werts.

Committee staff present: Mary Torrence, Revisor of Statutes
Mike Heim, Legislative Research Department
Mark Burghart, Legislative Research Department

Conferees appearing before the committee:

Susie Parmer, Register of Deeds, Leavenworth
Keith G. Meyer, Professor of Law, University of Kansas
Jon Jossierand, Office of the Secretary of State
John Crofoot, Kansas Grain and Feed Dealers Association

Senate Bill 7 - Filing of security statements.

The chairman pointed out the printing error in the bill on page 6; lines 212, 213 and the first word in line 214 should be stricken. He explained the language was stricken in the actual bill and was not stricken in the printed version.

Susie Parmer testified in opposition to the bill. She stated her concerns, and she felt the information could be acquired from the Register of Deeds. During the discussion of installing a telecopier, she stated she didn't see that a telecopier would be beneficial. A committee member inquired if having financial statements on file is a service to the community, and she agreed that it is a service to the community.

Keith G. Meyer stated that he appeared before the committee as a resource person. A copy of his testimony is attached (See Attachment #1). Professor Meyer stated he is very much in favor of central filing; he thinks it should be central filing alone. He urged the committee not to act on the changes in the bill in lines 70 through 91; that there should be some transition amendments. He said the best thing to do is be as simple as possible. Professor Meyer suggested the committee consider going to something other than filing of the name of the debtor, such as by social security or taxpayer identification numbers. Considerable committee discussion with him followed.

Jon Jossierand was recognized, and he stated that what they learned from the Iowa experience was very educational to them. He said Iowa does not have instantaneous service, and they do get behind during the peak periods. There were no further questions of Mr. Jossierand.

John Crofoot was recognized, and he emphasized the importance of getting an immediate check when grain is sold.

Senator Feleciano moved that the minutes of January 18, 1983, be approved; Senator Winter seconded the motion, and the motion carried.

The meeting adjourned.

GUESTS

SENATE JUDICIARY COMMITTEE

NAME

ADDRESS

ORGANIZATION

NAME	ADDRESS	ORGANIZATION
Dinda Fincham	Marysville, Ks.	Register of Deeds
Sue Neustifter	Lawrence, Ks.	" " "
Carol Bickford	Wilton, Ks.	Register of Deeds
Robert Jagers	Salina, Salina Co.	Register of Deeds
Leland E. Rupp	Topeka, Ks.	Ks. State Bd. of Ag.
Gerald J. Litoumeau	Topeka, Ks.	IBP, Inc. & PACKERS
Rosemary Moore	Hutchinson	Register of Deeds
Doris Palmer	Overmuth	Register of Deeds
Carol Beard	Topeka	Sec. of State
Jon Josselyn	Topeka	Secretary of State
Nancy Mantola	Ks Co-op Council	Topeka
Mary Ann Holsapple	Seneca, Ks.	Register of Deeds
William G. Leonard	Ks. Livestock Assn.	Topeka
John Wolff	KAFD	Hutchinson
Jim May	KBA	Topeka
Mervin Chubatz	KAC	Topeka
Keith Meyer	school of law UNIV of KANSAS	LAWYER, Ks
WAYNE SACKMAN	TOPEKA	BUDGET DIV
Michael Hart	Topeka	AIA
David Ross	Overland Park	FIG
Dorothy Morris	Wichita	—
Jeanne Pomeroy	Topeka	Senate Wife
James		Steineger
Rebecca Pilshaw	Lawrence	KU Law

1-20-03

1

SPECIAL COMMITTEE ON JUDICIARY

Need for central filing for perfection of security interests in Farm Products

by
Keith G. Meyer
Professor of Law
University of Kansas

I. I believe amending the definition of farm products in 84-9-109(3) as was proposed last year in S.B. 615 is an inappropriate way to deal with the problem.

II. I believe the appropriate way to deal with the problems dealing with farm products is to move to central filing for farm products and make that information easily accessible. Accordingly, my suggestion to the committee would be to recommend that 84-9-401(1) and 9-407 be changed to read:

A. 84-9-401(1)

1. The proper place to file in order to perfect a security interest is as follows:

- a. when the collateral is timber to be cut or is minerals or the like (including oil and gas), or accounts subject to section 84-9-103, subsection 5, or when the financing statement is filed as a fixture filing (section 84-9-313) and the collateral is goods which are to become fixtures, then in the office where a mortgage on the real estate would be filed or recorded;
- b. when the collateral is consumer goods and when the debtor resides in this state, then in the office of the register of deeds in the county of the debtor's residence;
- c. in all other cases, in the office of the secretary of state.

B. 8-9-407(3)

3. Charging no more than a reasonable estimate of cost, in his discretion the secretary of state or a register of deeds may adopt one or more of the following methods of providing information concerning public filings in his office to persons with an interest in this information that is related exclusively to the purposes of this Article:

Atch. 1

- a. subscription telephone service;
- b. subscription daily, weekly or monthly written summaries;
- c. granting suitable space for the preparation of written summaries and the provision of telephone service by those persons deemed by the secretary of state or a register of deeds to have a legitimate interest in regular examination of the secretary of state's or the register of deeds public files; or
- d. any other appropriate method of disseminating information.

Except with respect to wilful misconduct, the state of Kansas, the secretary of state, a county, a register of deeds and their employees and agents are immune from liability as a result of errors or omissions in information supplied pursuant to this subsection.

III. Information that should be made available.

- A. Iowa has essentially the statute proposed for 84-9-407(3).
- B. Search services have developed in Des Moines.
- C. Phone searches through these private companies have a turn around time in the same day, i.e. a request about a debtor is made in the morning and in the afternoon of the same day the person making the request has the information. In fact, I am told if one is willing to hold, the information will be obtained while the caller waits.
- D. The information made available over the phone is:
 1. Name of secured party(s), number of the financing statement, date of filing, and description of the collateral.
 2. The private search company will in writing confirm the phone information. A copy of the financing statement is sent, if wanted.
- E. The name of one of these private search firms is:

Iowa Public Record Search, Inc., Box 6129 East Des Moines Station, Des Moines, Iowa 50309, phone 515/244-2463.

- IV. Typical farmer situations arising under Art. 9 of the UCC
 - A. Farmer-rancher in need of operating capital seeks a loan from lender who needs security for the loan. The security will normally consist of crops or livestock. Often time problems arise when the farmer sells the crops or livestock and does not remit the proceeds from the sale to the lender.
 - B. A major problem for the lender is that in reality it must expect, and want, the farmer-debtor to sell the collateral to make payments on the outstanding debt. However, it does not want to give up its claim to the collateral or the proceeds of the sale of the collateral.
- V. Article 9 and the lender--K.S.A. 84-9-100-500.
 - A. In general, to have an enforceable security interest against the debtor there must be attachment. For the interest to be valid against third parties there must be attachment and perfection
 - B. Attachment
 - 1. Generally, there must be value given, the debtor must have rights in the collateral and a written agreement must be signed by the debtor granting the lender a security interest and describing the collateral. If growing crops or crops to be grown are involved, there must also be a description of the real estate upon which the crops are growing.
 - 2. The description of the collateral does not have to be in terms of the code such as farm products or inventory or equipment. In fact, it is much better to describe the collateral in ordinary terms.
 - 3. Typical descriptions are:
 - a. grain farmer -- all crops, including but not limited to, wheat, corn, soybeans, milo, and alfalfa, whether growing or to be grown, harvested crops or after-acquired crops wherever stored and any warehouse receipt or scale ticket representing the stored grain. Plus real estate description.

- b. livestock operator -- All livestock now owned or hereafter acquired by Debtor, together with all increases, replacements, substitutions, and additions thereto whether acquired by purchase, trade, procreating or otherwise.

All cattle of or every type presently owned or after-acquired by any means, including but not limited to breeding stock, unborn, bulls, cattle on feed or pasture wherever located. There also may be some brand or tag or other identifying description.

C. Perfection

- 1. Perfection is required to protect the security interest against competing third parties such as purchasers, other creditors and the trustee in bankruptcy.
- 2. There are essentially two ways to perfect.
 - a. Possession of the collateral.
 - b. Filing a financing statement.
- 3. When a financing statement must be filed, the question is where must it be filed. This turns on what kind of collateral is involved.
- 4. There are essentially three possibilities when dealing with crops and livestock: farm products, inventory, and documents of title.
- 5. Perfection of farm products

A financing statement must be filed in the register of deeds' office in the county where the debtor resides.

If growing crops or crops to be grown are involved and the land is located in a different county than the debtor's residence, a second financing statement must be filed.

There also may be need for double filing if the debtor is incorporated and the land crops are growing on or will be grown on is located in a

county other than the corporation's place of business.

6. Perfection of inventory

The financing statement must be filed with the secretary of state.

7. Warehouse receipts

These are documents of title under Article 9. [9-105(1)(f), 1-201(15), 7-201]. The receipt can be either negotiable or nonnegotiable [7-104].

Nonnegotiable receipt

a. Perfection under 9-304(3) is accomplished in one of three ways:

- (1) Issuance of the receipt of the name of the secured party. (This should be set out in the security agreement).
- (2) Elevator or other bailee's receipt of notification of the secured party's interest.
- (3) Filing as to the goods. (Recall that the crops stored off the farm may well be considered inventory. To be on the safe side, file as to both farm products and inventory.)

8. Negotiable warehouse receipts

a. A security interest in a negotiable document of title may be perfected either by filing or by possession. [9-302(1)(a), 9-304(1) and 9-305.] Possession is clearly the safest way.

D. Farm products Defined

1. The current definition of farm products is found in K.S.A. 84-9-109(3). It provides:

Goods are farm products if they are crops or livestock or supplies used or produced in farming operations or if they are products of crops or livestock in their unmanufactured states (such as ginned cotton, wool-clip, maple syrup, milk and eggs), and if they are in the possession of a debtor engaged in raising, fattening, grazing or other farming

operations. If goods are farm products, they are neither equipment nor inventory.

2. There are three requirements to this definition:
 - a. the goods must be crops or livestock or products of crops or livestock,
 - b. they must be in the possession of the debtor and,
 - c. the debtor must be engaged in raising, fattening, grazing or other farming operation.
3. The first requirement is easily met. The other two present some problems.
4. Possession
 - a. It is not defined in the Code
 - b. It can be an issue when there is harvested grain stored in a commercial warehouse

The debtor does not have physical possession, and there most likely will be a document of title involved representing ownership of the grain.

Is the grain still farm products? I think it is.

The farmer is still the owner of the grain, he is paying storage for space rental and he decides when to sell the grain.

There is a bailment relationship.

While the UCC does not define possession, there is evidence that the drafters of the Code intended for possession to be broadly construed. See 9-305, 9-205.

If the stored grain is not considered farm products, it will have to be considered inventory.

- c. Possession can also be an issue when debtor's cattle are not in his physical possession but are being fed out in a commercial feed lot.
 - i. The recent case of Garden City PCA v. International Cattle Systems, 32 UCC Rep. 1207 (D.C. Kan. 1981) is relevant.

PCA had a security agreement which covered all of debtors' cattle, including after-acquired cattle and crops. The cattle were not in the physical possession of the debtor-owner. There apparently never were. Rather, ICS apparently always had possession of the cattle. ICS sold the cattle to meat packers. PCA sued ICS and packers in conversion.

The court held the cattle were not farm products but were inventory. Its reasoning was that the debtor never had possession and ICA was not viewed as debtor's agent for purposes of establishing possession. In short, the court seems to read the possession requirement to be limited to physical possession.

Yet, it was clear that the debtor was the owner of the cattle, not the feedlot operator. Also, it appeared that the debtor would make the decision when to sell and he was apparently paying the feedlot operator to fatten the cattle.

Having determined that the cattle in the feedlot were inventory, the court concluded that the Packer which bought the cattle from ICS bought them in the ordinary course of business and took free of any perfected security interest in the cattle. The court relied upon 9-307(1) which provides that the buyer takes free of any security interest created by his seller. While not expressly stating it, the court must have concluded that ICS was acting as an agent of the debtor here when it sold the cattle to packer inasmuch as 9-307(1) only applies to security interests created by the seller. If ICS is considered the seller, 9-307(1) would not apply. Assuming that the court is correct about the cattle being inventory and PCA was not properly perfected and ICS is considered the seller what result? See 9-201, 301, 1-109 and 2-403(2).

The Kansas legislature responded to this case by adding the underlined words to the definition of farm products :

or if they are livestock being held in a feed lot, as defined in K.S.A. 47-1501, and any amendments thereto.

Governor Carlin vetoed the bill.

- ii. S.B. 615 covers this situation as far as the definition of debtor's cattle in another's feedlot but what about cattle on someone else's grass. Also, how will the buyer from the feedlot know whose cattle he is buying and whether they are subject to a financing statement?
5. The third requirement of the definition is that debtor must be engaged in raising, fattening, grazing or other farming operation.
- a. A cattle feeding operation whose primary purpose is to feed out cattle will satisfy this requirement. A cattle dealer will be considered to have cattle classified as inventory not farm products. See Security National Bank v. Belleville Livestock Commission et. al, 619 F.2d 840, 850 (10th Cir. 1979).
 - b. Other farming operations is also not defined.
 - i. Some courts have construed this narrowly and some broadly. For example, a U.S. Bankruptcy court in Colorado construed the clause broadly in Smith Enterprises v. United Bank of Denver, 28 U.C.C. Rep. 534 (Bankr. Ct. Colo. 1980).

The debtor in this case was in the egg production business. The chickens were housed in so-called production units which were large, circular structures containing four concentric circles of caged hens, 10 tiers high. In addition to chickens there were always eggs in the debtor's possession. The Bank had taken a security interest in all inventory and equipment of the debtor. The security agreement did not refer to farm products and the Bankruptcy court held that this prevented the bank from having a security interest in the eggs or the chickens. The court reasoned that the hens were livestock and that the eggs were products of livestock. The Bank's unsuccessful argument was that the eggs had lost their characteristic as farm products because here the sole business of the debtor was the production of eggs, and there were no residents living on the property where the egg production units were. In short, the Bank was saying this was not a farming operation and falls outside of the definition of farm products.

- ii. For another bankruptcy case having language suggesting that the Smith Enterprises" construction of farm products may be wrong, see In re Blease, 24 UCC Rep. 450 (DCDNJ Bankr. J. 1978). There the judge suggested that farming operations is a phrase to be narrowly construed and does not include farm related, farm support or farm-like activities. Farm operations in the definition of farm products are to be defined in terms of a conventional farm operation.
- iii. The prudent lender would treat the eggs and hens as both inventory and farm products for perfection purposes and describe the collateral in the security agreement as all hens and eggs.

E. Priority Problems

1. 9-307(1) provides in part: "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 his seller even though the security interest is perfected and even though the buyer knows of its existence. For purposes of this section only, "farm products" does not include milk, cream and eggs."
2. It means that to be safe the buyer of farm products has to check all of the appropriate records and determine if the collateral is covered and whether the debtor is in default. This is an almost impossible burden to place on buyers of livestock and crops, particularly the very large buyers. While it may be that because of cost and inconvenience of checking the records, the buyers of crops from farmers will choose to rely upon the debtor's past performance and the fact he has possession of the crop rather than check the records, it is clear under 9-307(1) the sale will not cut off the perfected security interest.
3. 84-9-306(2) must be considered and it states:

Except where this Article otherwise provides, a security interest continues in collateral notwithstanding sale, exchange or other disposition thereof unless the disposition was authorized by the secured party in the security agreement or otherwise, and also

continues in any indentifiable proceeds including collections received by the debtor.

4. There has been an extreme amount of litigation concerning whether the lender has given up its security interest. The courts are split on what constitutes waiver.
5. The leading Kansas case is North Central Production Ass'n v. Washington Sales Co., 557 P.2d 35 (Kan. 1978). There a farmer granted a security interest to PCA in his cows, crops and milk. A proper financing statement was filed in the appropriate place and PCA had a perfected security interest in the collateral. The security agreement had the following provision:

The Debtor . . . will not . . . dispose of [the property described] without the written consent of the Secured Party; however, permission is granted for the Debtor to sell the property described herein for the fair market value thereof, providing that payment for the same is made jointly to the Debtor and the Secured Party" (emphasis supplied)

The farmer sold wheat twice to the local elevator receiving from the elevator checks made payable only to him. He deposited one of the checks in his own account and wrote the PCA a personal check for amount of the sale. The other check he endorsed over to the PCA.

Farmer also sold a total of 35 head of cattle at separate times over a year period which he did not report to the PCA and did not remit the proceeds. The cattle were sold through the Washington Sales Company and it was clear that neither it nor the buyers of the cattle had actual knowledge of PCA's security interest. They were however on constructive notice of PCA's security interest because of PCA's filed financing statement.

Farmer also sold milk without the consent of PCA but the PCA was not claiming an interest in the proceeds from the sale of the milk.

PCA did not warn or remind farmer that taking payment in his name only was a violation of the express terms of the security agreement.

The Kansas Supreme Court made several conclusions about these facts that are relevant to grain elevators.

- 1) The court held that the inclusion in the security agreement of a clause authorizing the farmer to sell the collateral with prior written consent or permitting sale if the payment for the collateral was made jointly to farmer and PCA did not waive the PCA's security interest and was not a consent to the sale in violation of the express terms of the agreement.
- 2) The PCA's conduct here did not amount to implied consent to the sale of the livestock.
- 3) PCA's past conduct did not amount to a course of dealing which showed it impliedly waived its security interest.
- 4) The doctrine of implied waiver should not be utilized in favor of one [buyer] who has constructive notice of a lien and did not check the public records which are in part maintained for a buyer's protection.
- 5) The security agreement and the prior sales did not amount to an express waiver.

The Court did hold against the PCA because of testimony of the President of the PCA which showed the farmer had been told he could sell the cattle provided he remitted the proceeds or had the check made jointly. The fact that he could sell the cattle providing he would remit the proceeds was considered an express consent to the sale and cut off the security interest.

Also, worthy of particular note is First National Bank and Trust Oklahoma v. Iowa Beef Processors, Inc., 626 F.2d 764 (10th Cir. 1980). The UCC puts a greater burden on the buyer of farm products to check for liens on the collateral because a good faith purchase of those products does not automatically cut off a creditor's security interest therein. However, although defendant beef processor did not check whether a security interest was involved, and if so, what the terms of the agreement were when it purchased from the debtors feedlot cattle in which plaintiff bank had perfected security interest, defendant's failure was irrelevant because the bank had given the debtors actual authority to sell and it was not necessary that authority be communicated to the purchaser.

Plaintiff bank's (secured party) consent to the sale by the debtor provided the seller (debtor)

remitted the proceeds of the sale to the bank by its own check, was not a true conditional sale authorization. Such a condition in essence makes the buyer an insurer of acts beyond its control, making performance of the debtor's duty to remit proceeds to the bank a condition of releasing from liability a third party acting in good faith. The buyer could not ascertain in advance whether the condition would be met, as it could if a condition precedent were involved; nor did the buyer have any control over the performance of the condition so long as it paid the debtor. Consequently, debtor's failure to remit to secured party the proceeds of its sale of collateral, as required by secured party's conditional consent to sale, would not prevent that consent from cutting off the security interest under § 9-306(2). Id. For a case holding that 9-306(2) is not affected by the last sentence of the 1972 UCC 9-402(7) which provides: a filed financing statement remains effective with respect to collateral transferred by the debtor even though the secured party knows of or consents to the transfer. See Matter of Matto's, Inc., 8 B.R. 485 (West 1981).

6. Central filing, with a potential buyer having quick access to the filed financing statements, should take care most of the problems relating to purchases of farm products subject to a prior perfected security interest.
 - a. If the buyer chooses not to check the files he should lose if there was a filed financing statement covering the livestock or grain of the seller.
 - b. Buyer could easily determine if there is a security interest.
 - c. The buyer can make the checks jointly payable to debtor and creditor and then will not have to worry about paying twice.
 - d. Central filing may not solve the Garden City PCA v. International Cattle Sales problem if the buyer of the cattle does not who owns the cattle.
 - e. This is a simple way to avoid most problems connected with farm products sales and perfection problems.