

N.D.A.G. Letter to Thane (Jan. 17, 1986)

January 17, 1986

Honorable Russell T. Thane
State Senator
Route 1, Box 142
Wahpeton, North Dakota 58075

Dear Senator Thane:

Thank you for your letter of December 24, 1985, concerning the application of North Dakota's secured transactions law to loans made by the Commodity Credit Corporation (CCC) to various cooperatives for processed sugar. Specifically, your request concerns the central notice filing provisions found in N.D.C.C. Ch. 41-09, particularly §41-09-28 (see 1985 N.D. Sess. Laws 472).

Based on the information you have supplied and the information we have been able to gather, we understand that the CCC is complying with the provisions of the new central notice filing system in regard to loans made on processed sugar. As of January of 1986, the CCC apparently will not be forwarding the proceeds of its loans to sugar cooperatives (processors) until the appropriate information regarding the CCC's security interest in the processed sugar is filed with the Secretary of State and the list of that information is distributed by the Secretary of State as required by the new central notice filing provisions. This CCC policy may result in hardship to the North Dakota cooperatives and their farmer members (producers) who must in some cases wait a substantial period of time before they receive payment for their sugar beets through the cooperative. Apparently, the CCC is treating the processed sugar in the possession of a cooperative as a "farm product" for purposes of N.D.C.C. §41-09-28 (§9-307 of the Uniform Commercial Code).

N.D.C.C. §41-09-28 is a rule for the protection of buyers of goods generally allowing buyers in the ordinary course of business to take free of a security interest created by the buyer's seller even though the security interest is perfected and even though the buyer knows of its existence. However, under North Dakota law, buyers of farm products are excepted from this general rule (the farm products exception). Therefore, the secured party would have recourse against the buyer of farm products if the person engaged in farming operations (the producer) defaulted on the loan.

However, the 1985 North Dakota Legislative Assembly enacted the provisions of the central notice filing system to protect crop or livestock buyers from the results of the farm products exception. A secured party who has a perfected security interest in crops or livestock (farm products) who intends to impose liability for a security interest against a crop or livestock buyer must submit certain information to the Secretary of State which will appear on a list to be distributed by the Secretary of State monthly. If the secured party files the information and the secured party's name appears on the list distributed by the

Secretary of State, the crop or livestock buyer takes free of the security interest of the secured party only if certain conditions are met (e.g., such as issuing checks or drafts for payment to the person engaged in farming operations jointly with any secured parties whose name appears on the Secretary of State's list). See N.D.C.C. §41-09-28(1), (11), and (13).

The intent of the new central notice filing system is to establish a mechanism by which crop and livestock buyers purchasing farm products can avoid what would otherwise be a burden of potential liability that may be imposed because of the farm products exception. The central notice filing system works only between the secured party and any crop or livestock buyer. Rights and priorities of the secured party vis-a-vis other secured parties and other persons are not affected by the central notice filing system provisions. Filing of security agreements for farm products must also be accomplished locally with the register of deeds, which establishes rights and priorities between the secured party and others who are not crop and livestock buyers.

The issue here seems to be whether or not the CCC can adequately protect itself against purchasers of processed sugar under North Dakota law by compliance with the provisions of the new central notice filing system. Central to this issue is whether or not processed or refined sugar is a "farm product" pursuant to North Dakota's version of the Uniform Commercial Code, and for purposes of North Dakota's buyer in the ordinary course of business rule and its farm products exception (N.D.C.C. §41-09-28).

N.D.C.C. §41-09-09(3) defines "farm products" as:

3. "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, woolclip, maple syrup, milk, and eggs), and if they are in possession of a debtor engaged in raising, fattening, grazing, or other farming operations. If goods are farm products they are neither equipment nor inventory. [Emphasis supplied.]

This definition has three parts: (1) the goods must be "crops or livestock or supplies used or produced in farming operations or . . . are products of crops or livestock in their unmanufactured states"; (2) the goods must be in the "possession of a debtor"; and (3) the debtor must be "engaged in raising, fattening, grazing, or other farming operations." These requirements are not self-defining and none are defined in the Uniform Commercial Code. However, the comments to the Uniform Commercial Code (hereinafter referred to as comments) do provide some assistance. Comment 4 to U.C.C. §9-109 (N.D.C.C. §41-09-09) states, in part, as follows

Goods are "farm products" only if they are in the possession of a debtor engaged in farming operations. Animals in a herd of livestock are covered whether they are acquired by purchase or result from natural increase. Products of crops or livestock remain farm products so long as they are in the possession of a debtor engaged in farming operations

and have not been subjected to a manufacturing process. The terms "crops," "livestock" and "farming operations" are not defined; however, it is obvious from the text that "farming operations" includes raising livestock as well as crops; similarly, since eggs are products of livestock, livestock includes fowl.

Products of crops or livestock, even though they remain in the possession of a person engaged in farming operations, lose their status as farm products if they are subjected to a manufacturing process. What is and what is not a manufacturing operation is not determined by this Article. At one end of the scale some processes are so closely connected with farming -- such as pasteurizing milk or boiling sap to produce maple syrup or maple sugar -- that they would not rank as manufacturing. On the other hand an extensive canning operation would be manufacturing. The line is one for the courts to draw. After farm products have been subjected to a manufacturing operation, they become inventory if held for sale.

When crops or livestock or their products come into the possession of a person not engaged in farming operations, they cease to be "farm products." If they come into the possession of a marketing agency for sale or distribution or of a manufacturer or processor as raw materials, they become inventory. [Emphasis supplied.]

As the comments indicate, what is and what is not a farm product that has been subjected to a manufacturing process is a fact question for the courts to decide. However, it would seem that when sugar beets have been processed into sugar with resulting by-products of molasses and beet pulp, they have been subjected to a manufacturing process not closely connected with farming and they are no longer farm products.

Additional pertinent facts in this case (at least in regard to Minn-Dak Farmers Cooperative) are that the CCC makes loans to sugar cooperatives the membership of which is comprised of sugar beet growers. These loans are made to the cooperative, not to the members, for beet sugar that is manufactured or processed from sugar beets into refined sugar. The sugar and its by-products are then marketed by the cooperative for the members who sell to the cooperative. The sugar cooperative does not itself engage in any farming operations; it is a manufacturing-marketing cooperative. Therefore, whether the cooperative is a "debtor engaged in farming operations" for the purposes of the farm products exception would also seem to be an issue. The resolution of that issue seems to involve mixed questions of fact and law.

According to federal regulations, the price supports to domestic sugar producers for the 1983-1985 crops of sugar beets processed during the applicable crop year is available through non-recourse loans to eligible processors. 7 C.F.R. §1435.113. This price support loan program is probably designed this way because sugar beets without processing are an extremely perishable commodity, unfit for serving as collateral in unprocessed form. Since the cooperative is the entity which accomplishes the processing and actually has possession of the sugar, the loan is made to the processor, which is then required by law to pay producer members of the cooperative for their sugar beets. See generally 7 C.F.R. §1435.110.

Under this program, even though the eligible producer and the processor are two distinct legal entities for purposes of the price support loan program and for other purposes, they seem to be inextricably tied together for purposes of making loans to the eligible producers. It would seem that the result to be achieved by this CCC program is, after all, making payment of price support loans to the eligible producer and not to the cooperative. The cooperative is, however, the legal entity to whom the loans are actually extended. It is the processor-cooperative that makes the request for the loan and that executes the note and security agreement and storage agreement prescribed by the CCC. 7 C.F.R. §1435.115. It is also the processor which has full liability for the loan indebtedness. See, e.g., 7 C.F.R. §1435.117. The cooperative also remains obligated or liable to its producer members for payment on sugar beets marketed through the cooperative.

Nevertheless, it should be noted that under North Dakota law an incorporated cooperative as a form of business is not a pass-through for purposes of liability on a secured debt. Members, stockholders, and patrons of a cooperative are neither obligated to pay, nor liable upon, any cooperative obligation. N.D.C.C. §10-15-31(2).

The facts of this case seem to be that the farmer is a creditor to the cooperative to which he sells his sugar beet crop and the cooperative is a debtor to the CCC and the farmer. When the cooperative receives the proceeds of the CCC loan, it pays the farmer for his crop as it is obligated to do. When the cooperative markets the processed sugar and its by-products, it pays the CCC back the amount of the loan. If the CCC made the loan to the farmer for sugar beets, or even for sugar, the farm products exception would more clearly apply to the buyers of sugar beets.

Certainly, the CCC price support loan system is designed to be a mechanism working up and down scale through producers, processors, and the CCC. However, it must be remembered that the issue in question here involves relationships and interpretation of the law as between buyers of the sugar in the ordinary course of business and the CCC (the secured party). The question is whether a processed sugar buyer, who buys from the cooperative without the approval of the CCC and without making payment of the required indebtedness to the CCC as required by 7 C.F.R. §1435.117, can be liable to the CCC under North Dakota law. For purpose of the CCC price support loan program, processed sugar may still be considered an agricultural commodity or a farm product, and the cooperative may really be a debtor in possession. However, such may not be the case for purposes of state law, priority, and rights under the North Dakota version of the Uniform Commercial Code. The processed sugar may be inventory.

Although there is sometimes a thin line between "farm products" and "inventory" when it comes to crops and livestock, see K. L. Smith Enterprises v. United Bank of Denver, 28 U.C.C. Reporter 534, 2 Bankr. 280 (Bankr. D. Colo. 1980); Farmers State Bank v. Webel, 446 N.E.2d 525 (Ill. App. 1983), a crop presumably constitutes inventory when the debtor is not engaged in farming operations or when the crop is manufactured. Since in this case the loan is made to the cooperative (and we believe the cooperative is a separate legal entity from its members) and the sugar is no longer in the possession of a person

engaged in farming operations, and since the loan is made on manufactured or refined sugar, not on sugar beets, it is our opinion that farm products are no longer involved notwithstanding the provisions of the federal regulations concerning the price support loan program for domestic sugar producers.

Assuming the facts as stated, where the CCC (secured party) has a security interest in processed sugar in the possession of a cooperative not engaged in farming operations, it is our opinion that the farm products exception of N.D.C.C. §41-09-28(1) is inapplicable since a farm product is no longer involved and any buyer in the ordinary course of business from the cooperative would take free of the security interest of the secured party (CCC) created by the buyer's seller (the cooperative). Therefore, there appears to be no need for the CCC to participate in North Dakota's central notice filing system. Participation establishes no rights against crop and livestock buyers. Under this scenario, we believe participation accomplishes nothing for the CCC since a buyer of inventory in the ordinary course of business under North Dakota law would take free of the CCC's security interest.

In summary, we know of no court decisions that have specifically ruled on this issue. Additionally, the U.C.C. comments specifically indicate these sorts of questions are for the courts to decide. Nevertheless, notwithstanding the price support loan mechanism of federal regulation, we believe that the CCC is creating inappropriate and unnecessary hardship for North Dakota cooperatives and farmers by treating processed sugar under CCC loan to cooperatives as a farm product and by participating in the central notice filing system for loans made on that processed sugar.

Sincerely,

Nicholas J. Spaeth

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