CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

ADVERSE POSSESSION

FENCE. The parties were neighbors and their properties were separated by a barbed-wire fence which was constructed 40 years ago at a time when both properties were owned by the same person, the grandfather of the plaintiffs. A survey of the property line was conducted in 2000 and the fence was determined to be on the defendant's property. When the defendant constructed a new fence on the surveyed property line, the plaintiffs filed suit to quiet title, arguing that they had acquired title to the disputed strip by acquiescence of the boundary line or by adverse possession. The court found that the evidence demonstrated that both parties mowed the grass up to the fence, did not attempt to use property on the other side of the fence and used the fence as the boundary between the properties. The court held that both parties had acquiesced to the fence as the boundary between the properties; therefore, the plaintiffs had acquired title to the disputed land. In addition, the court held that title to the disputed land passed to the plaintiffs by adverse possession through the plaintiff's open and continuous use of the disputed strip for various farming uses over 40 years. **Boyette v. Vogelpohl, 2005 Ark. App. LEXIS 713 (Ark. Ct. App. 2005)**.

ANIMALS

FENCES. The defendant county enacted an ordinance which established two open range areas in which land owners had to "fence out" cattle and other livestock. The ordinance also provided that landowners without fences were to be paid a reasonable rental for the pasture of animals on the unfenced land. The plaintiff owned land in the open range area and sued the county for trespass, nuisance, injunctive relief, taxpayer relief, declaratory relief, inverse condemnation, violation of civil rights and preemption by state law. The plaintiff alleged that cattle from neighbors damaged their land and the open range ordinance placed an unreasonable burden on the landowners to enforce the open range rules, resulting in the loss of value of the land. The court upheld the ordinance as not a taking by the county of land or use of land by the plaintiff. The court held that the statute allowing "fence out" open ranges was still viable in California and that the plaintiff's use and enjoyment of the the land was not prevented by the open range because the plaintiff could prevent intrusion of animals with a fence. **Herzberg v. County of Plumas, 2005 Cal. App. LEXIS 1560 (Calif. Ct. App. 2005)**.

HORSES. The plaintiff was injured while participating on a horse trail ride. The plaintiff had signed a release and indemnification waiver in accordance with Section 6 of the Michigan Equine Activity Liability Act, Mich. Code. Laws § 691.1666. Because the plaintiff had not ridden a horse before, the plaintiff was given a calm horse. The plaintiff complained that the saddle was not secure and the saddle was checked. After several minutes, the trail guide asked all the riders whether they would like to go faster and all agreed. The testimony was mixed as to how fast the horses walked, but the plaintiff was injured when the horses sped up to a trot and the plaintiff fell off the horse. The plaintiff sued for gross negligence, which was not covered by the release and waiver. The testimony from the other ride participants included evidence that the horses did not run, the saddle was secured and that the fall was within the normal risks of horse riding. The trial court granted summary judgment on the issue of gross negligence. The appellate court reversed, holding that summary judgment for the defendant was improper because there was a sufficient issue of fact as to whether the defendant acted with gross negligence in allowing the horses to trot knowing that the plaintiff had no horse-riding experience. The court defined gross negligence as conduct which was so reckless as to demonstrate a substantial lack of concern for whether an injury resulted. **Hawkins v. Ranch Rudolph, Inc., 2005 Mich. App. LEXIS 2366 (Mich. Ct. App. 2005)**.

BANKRUPTCY

FEDERAL TAX

CLAIMS. The debtors, husband and wife, failed to pay their 2000 taxes and the IRS filed tax liens against their property. The debtors filed for Chapter 7, listing the property which would be subject to the tax liens, and the IRS filed two unsecured claims for the taxes. The debtors sought a ruling that the IRS was required to file secured claims for the taxes because the IRS had secured the taxes with the tax liens. The court held that no provision required the IRS to file for secured claims and cases supported the IRS right to surrender its secured status for any claim. The court noted that once the claim was filed by a creditor, the creditor could not change the secured or unsecured status later in the bankruptcy case. **Herckner v. United States, 2005-2 U.S. Tax Cas. (CCH) ¶ 50,600 (D. N.J. 2005)**.

DISCHARGE. The debtors had operated residential care facilities and in three Tax Court decisions were held to owe taxes resulting from the disregard of sham trusts. The debtors filed for Chapter 7 and sought to have the taxes declared dischargeable. The court held that the Tax Court decisions were entitled to collateral estoppel effect on the issue of the debtors' liability for the taxes, the fraudulent nature of the tax returns and the attempts to evade payment of taxes through the use of sham trusts. The court held that the taxes were nondischargeable under Section 523(a)(1)(C) for filing of a fraudulent tax return and attempt to evade payment

of the taxes. ***In re* Carey, 326 B.R. 816 (Bankr. E.D. Calif. 2005)**.

CONTRACTS

FRAUDULENT INDUCEMENT. The plaintiffs were independent contractor pullet, hatching egg or breeder, and broiler growers who contracted with the defendant to raise chickens for the defendant. The plaintiffs alleged that the defendant fraudulently induced them to enter into the long-term contracts by making false representations as to the costs and incomes of the contracts. The defendant argued that the action was barred by the statute of limitations. The statute of limitations would be tolled if fraudulent concealment was proved by the plaintiffs. The plaintiffs argued that the defendant had complete control and knowledge of the data as to revenues and costs and fraudulently failed to reveal the information before the contracts were executed. The court held that the plaintiffs failed to provide evidence to support their claim of fraudulent concealment in that the plaintiffs did not show an affirmative act by the defendant to conceal any information. In addition, the court held that the plaintiffs failed to show that they used due diligence in attempting to acquire the information alleged to have been concealed. Therefore, the court held that the statute of limitations was not tolled and the action was dismissed. **Sanderson Farms, Inc. v. Ballard, 2005 Miss. LEXIS 660 (Miss. 2005)**.

DEBTOR AND CREDITOR

FARM DEBTORS. The defendant had worked as a farmer for 20 years and incurred a debt to the plaintiff from the farming operations. The plaintiff obtained a judgment against the defendant. The defendant began working as a truck driver and the plaintiff sought to enforce the judgment with a garnishment of the defendant's wages. The garnishment occurred more than three years after the judgment was entered and the defendant argued that Minn. Stat. § 550.366 prohibited the garnishment because the debt was incurred while the defendant was a farmer. The plaintiff argued that the statute of limitations on collection of the judgment should not apply to the defendant because the defendant no longer worked as a farmer. The court held that the statute was clear that it applied to debts incurred by farmers on farm property and had no exception for farmers who later stopped farming. The court held that the garnishment was prohibited by the statute. **Glacial Plains Coop. v. Hughes, 2005 Minn. App. LEXIS 765 (Minn. Ct. App. 2005)**.

FEDERAL AGRICULTURAL PROGRAMS

BLACK STEM RUST. The APHIS has issued proposed regulations which amend the black stem rust quarantine regulations by changing the movement restrictions in order to allow clonally propagated offspring of rust-resistant Berberis cultivars to move into or through a protected area without completing the currently required two year growth period. The proposed regulations also add 13 varieties to the list of rust-resistant Berberis species. **70 Fed. Reg. 59280 (Oct. 12, 2005)**.

CONSERVATION RESERVE PROGRAM. The plaintiff was a trust which owned farmland enrolled in the conservation reserve program. The CRP contract contained a provision that the trust agreed to comply with Kansas noxious weed laws. Under Kansas law, Kan. Stat. § 2-1314, Johnson grass was a noxious weed and had to be eradicated. An inspection of the plaintiff's land in 1998 by the Natural Resources Conservation Service found Johnson grass on the plaintiff's land. A county noxious weed department inspection in 1999 also found Johnson grass on the CRP acres and the report indicated that the grass had gone to seed, indicating that the plaintiffs made no attempt to control the grass in the previous year. The USDA terminated the CRP contract for 36 of the 86 acres originally enrolled, citing the infestation of Johnson grass on the 36 acres. A new contract was offered for the remaining acres but the plaintiff refused to sign the new contract; therefore, the entire contract remained terminated. The District Court and the appellate court both held that the finding of a violation of the CRP contract was supported by substantial evidence. The courts held that the violation occurred when the plaintiff failed to take steps to eradicate the Johnson grass after the first discovery by the NCRS in 1998. The courts also held that, once a violation of the CRP contract is upheld, the courts were without jurisdiction to review the USDA's decision to terminate the contract because of the violation. The courts reasoned that judicial review was precluded by the wide discretion given to the USDA to terminate a CRP contract for violation of a contract provision, because the courts had no meaningful standard of review by which to judge the propriety of the USDA decision. Therefore, the courts upheld the USDA decision to terminate the CRP contract for the 36 acres because of the violation and to terminate the CRP contract on all acres after the plaintiff's refusal to sign the new contract. **Biller v. Veneman, 2005 U.S. App. LEXIS 21812 (10th Cir. 2005)**.

DISASTER PAYMENTS. The CCC has issued proposed regulations which change the handling of claims for spcified "tropical" regions, including Hawaii and Puerto Rico, for the Noninsured Crop Disaster Assistance Program. Two of the changes are a change in the service fees and removal of the prevented planting credit due to the continuous growing season in these regions. **70 Fed. Reg. 57520 (Oct. 3, 2005)**.

KARNAL BUNT. The APHIS has issued proposed

regulations which amend the Karnal bunt regulations regarding the requirements that must be met in order for a field or area to be removed from the list of regulated areas. The proposed changes would allow a field to qualify for release after five cumulative years of specified management practices, rather than five consecutive years as the current regulations provide, and reorganize the manner in which those management practices are described. **70 Fed. Reg. 58084 (Oct. 5, 2005)**.

MILK. The U.S. Supreme Court has denied certiorari in the following case. The plaintiffs were dairy farmers who challenged the regulations promulgated by the USDA under the federal Milk Income Loss Contract Program, 7 U.S.C. § 7982. Under the program, participants sign a contract with the USDA and receive monthly income payments and a lump sum payment for the period between the beginning of the program and the sign-up date. Annual payments were limited to 2.4 million pounds of milk per producer. The regulations included both the monthly payments and the lump sum payment in this limitation. The plaintiffs challenged the regulations as not authorized by the statute which did not provide for including both payments under the limitation. The court held , however, that the regulations were within the discretion provided to the USDA in interpreting the law because the statute and legislative history were not clear as to which payments were subject to the limitation. **Fullenkamp v. Johanns, 2005 U.S. LEXIS 5521 (Sup. Ct. 2005), *aff'g*, 383 F.3d 478 (6th Cir. 2004)**.

PERISHABLE AGRICULTURAL COMMODITIES ACT. The plaintiffs sold produce to a corporation owned by three shareholders. The corporation failed to fully pay for the produce and the plaintiff filed notice to enforce the PACA trust for payment. The corporation filed for bankruptcy and only a small portion of the amounts owed for the produce was paid from the estate. The plaintiffs then filed an action to enforce the PACA trust against one of the shareholders and officers of the corporation, alleging that the shareholder had breached the fiduciary duty to protect the PACA trust. The defendant shareholder had ceased active participation in the business but the defendant's signature was still used for company checks and the defendant was still listed as an officer on company documents. The defendant denied any control over the company and argued that the statute of limitations on the PACA trust action had expired. The court acknowledged that PACA had no statute of limitations but held that the Pennsylvania two year statute of limitations applied to breach of fiduciary duty actions. The plaintiffs argued that the defendant's breach was continuous up to the filing of their action; however, the court held that the breach, if any, occurred when the company first failed to pay for the produce. Therefore, the court held that the action was barred by the statute of limitations because the first unpaid invoice was submitted more than two years efore the filing of the action against the defendant. **Weis-Buy Services, Inc. v. Paglia, 411 F.3d 415 (3d Cir. 2005)**.

QUALITY SYSTEMS VERIFICATION PROGRAMS. The AMS has adopted as final regulations establishing a separate user-fee schedule for the Quality Systems Verification Programs (QSVP) and expanding the scope of the QSVP to include all agricultural products and services within the responsibility of the Livestock and Seed Program. A new 7 C.F.R. Part 62 is established for QSVP services. QVSP are a collection of voluntary, audit-based, user-fee programs authorized under the Agricultural Marketing Act of 1946. **70 Fed. Reg. 58969 (Oct. 11, 2005)**.

TRANSPORTATION. The CCC has announced additional actions to reduce stress on the grain transportation system caused by Hurricane Katrina. The industry-focused actions include: (1) assisting with the movement of barges of damaged corn from New Orleans; (2) providing incentives for alternative storage of grain; and (3) encouraging alternative shipping patterns to relieve pressure on the Mississippi River transportation system. CCC is seeking proposals from interested parties for: (1) barge movements of damaged corn from New Orleans; (2) alternative grain storage; and (3) offers to move grain through locations alternative to the Central Gulf. **70 Fed. Reg. 58179 (Oct. 5, 2005)**.

TUBERCULOSIS. The APHIS has issued interim regulations amending the tuberculosis regulations to designate the Upper Peninsula of Michigan as an accredited-free zone. **70 Fed. Reg. 58291 (Oct. 6, 2005)**.

FEDERAL ESTATE AND GIFT TAXATION

MARITAL DEDUCTION. The decedent had created a revocable trust, which, upon decedent's death, distributed property to a marital trust for which the estate claimed a marital deduction. The trust instrument stated that, if the assets in the residue of the probate estate were insufficient to pay the federal estate tax and legal costs, the revocable trust was to pay the federal estate tax and legal costs from property that would otherwise pass to the decedent's surviving spouse. The decedent's will had no provision as to the source of payment of federal estate tax and legal costs if the assets in the residue of the probate estate were insufficient to pay the estate tax and costs. The decedent's residue estate did not have sufficient assets to pay the federal estate tax and legal costs. The estate argued that, under Illinois law, where the will is silent as to the source of payment of estate tax, the tax is apportioned equally among all heirs; therefore, the marital trust bequest and eligible deduction are reduced only by the trust's share of the taxes. The court held that the trust language controlled to provide that all federal estate taxes and legal costs were to be paid from the marital trust, reducing the eligible marital deduction. The appellate court affirmed. **Estate of Lurie v. Comm'r, 2005-2 U.S. Tax Cas. (CCH) ¶ 60,507 (7th Cir. 2005), *aff'g*, T.C. Memo. 2004-19**.

INCOME IN RESPECT OF DECEDENT. In the previous issue of the *Digest*, the summary of *Ltr. Rul. 200537019, May 25, 2005* (see p. 148 *supra*) contained an error. Our summary stated:

"The IRS ruled that the excess of the proceeds of the annuity over the date of death value was income in respect of decedent and included in the estate's taxable income, with a charitable deduction allowed for the distribution of the same amount to the charities." As pointed out by one of our readers, this statement is incorrect. The proceeds from the annuity included post-death interest which was not included in IRD and was income to the estate. The IRD was only the difference between the date of death fair market value of the annuity and the decedent's basis in the annuity and did not include any post-death interest. We regret the error and thank our reader for notifying us of the error.

VALUATION. The decedent owned a one-third interest in a limited liability company and a 95 percent interest in a family limited partnership interest. The LLC assets included only a 1 percent interest in the FLP and the FLP assets were devoted entirely to investments. The court valued the LLC and FLP based on the value of the assets with a minor adjustment for the income of the investments. The court allowed a 12 percent minority interest discount and a 23 percent lack of marketability discount for estate tax purposes. **Estate of Kelley v. Comm'r, T.C. Memo. 2005-235**.

FEDERAL INCOME TAXATION

BAD DEBT. The taxpayer owned a petroleum products business. One of the taxpayer's customer had trouble paying for the products and had personally borrowed $200,000 in additional credit for the products. The additional credit was supposed to be secured by making the taxpayer a beneficiary of the customer's life insurance policy. The customer died in 1994 without repayment of the amounts owed. The taxpayer attempted to collect on the debt for several years without success. The customer had not made the taxpayer a beneficiary of the life insurance policy. The customer's surviving spouse refused to make any payments and filed for bankruptcy in 1998. The taxpayer claimed a bad debt deduction for $150,000 of the unpaid amount but provided no explanation as to why the lesser amount was used as a bad debt deduction. The taxpayer provided no records or other substantiation for the claimed debt or other aspects of the transaction, claiming that the tax year records were destroyed because the tax year records had already been audited. The taxpayer also claimed that the year of the claimed deduction did not have to be the same year that the bad debt was claimed because the deduction would have been carried over to a later year anyway. The court held that no bad debt deduction would be allowed because the taxpayer failed to provide evidence to substantiate the existence of the loan, the amount of the loan, or the year that the loan became worthless. The court also held that the taxpayer failed to show that the loan, if any, had value at the beginning of 1998 and became worthless in 1998, holding that the deduction could be claimed only in the year the debt became worthless. **Egan v. Comm'r, T.C. Memo. 2005-234**.

COURT AWARDS AND SETTLEMENTS. The taxpayer's child was injured in an automobile accident and recovered a settlement in the resulting lawsuit. Although the taxpayer was not a party to the law suit, a portion of the settlement was directed to be paid to the taxpayer in reimbursement for care of the child. The taxpayer argued that the settlement proceeds paid to the taxpayer were excluded from taxable income because the payment was received as a result of a tort action for physical injuries. The court held that the taxpayer's payment under the settlement was included in income because the taxpayer did not receive the funds as a result of physical injury to the taxpayer. Instead, the taxpayer received the funds as compensation for care services for the child. **Trent v. United States, 2005-2 U.S. Tax Cas. (CCH) ¶ 50,595 (S.D. W. Va. 2005)**.

CORPORATIONS

SHAREHOLDER LOANS. The taxpayer owned 60 percent of the stock of a corporation with one other shareholder. The corporation made distributions to the taxpayer of over $1.5 million in one year. The taxpayer did not include the distributions in income but claimed that the funds were loans from the corporation. The court examined several factors in holding that the distributions were loans: (1) the taxpayer paid interest of over $43,000; (2) the taxpayer repaid $400,000 of the distributions; (3) the taxpayer had sufficient income and assets to repay the full amount; and (4) the corporation reported the interest paid as interest income and treated the distributions as notes receivables on its books. The court acknowledged several factors which indicated that the distributions were constructive dividends but held that these factors were outweighed by the factors favoring treatment as loans: (1) the loans were not secured by any collateral; (2) no fixed repayment schedule was fixed; and (3) no note or other loan agreement was executed. The court noted that these factors were commonly missing from loans from closely-held corporations and did not necessarily indicate intent to not repay the distributions. **Teymourian v. Comm'r, T.C. Memo. 2005-232**.

DEPENDENTS. The taxpayer lived with another person who had a child from a previous relationship. The taxpayer claimed the child as a dependent, filed as head of household based on the child and claimed earned income credit based on the child. However, the taxpayer failed to provide any substantiating evidence that the child lived with the taxpayer during the tax year. The mother of the child did not execute any written waiver of the right to declare the child as her dependent. The court held that, because the taxpayer failed to prove the residency of the child, the taxpayer could not claim the child as a deduction, could not file head of household status and could not claim earned income credit. **Bodiford v. Comm'r, T.C. Summary Op. 2005-149**.

DISASTER LOSSES. On September 20, 2005, the president determined that certain areas in Florida are eligible for assistance from the government under the Disaster Relief

and Emergency Assistance Act (42 U.S.C. § 5121) as a result of tropical storm Rita, which began on September 18, 2005. **FEMA-3259-EM**. On September 30, 2005, the president determined that all counties in New York are eligible for assistance from the government under the Act as a result of the influx of evacuees from Hurricane Katrina, which began on August 29, 2005. **FEMA-3262-EM**. On September 30, 2005, the president determined that all counties in Delaware are eligible for assistance from the government under the Act as a result of the influx of evacuees from Hurricane Katrina, which began on August 29, 2005. **FEMA-3263-EM**. On September 24, 2005, the president determined that certain areas in Texas are eligible for assistance from the government under the Act as a result of tropical storm Rita, which began on September 23, 2005. **FEMA-1606-DR.** On September 24, 2005, the president determined that certain areas in Louisiana are eligible for assistance from the government under the Act as a result of tropical storm Rita, which began on September 23, 2005. **FEMA-1607-DR** Taxpayers who sustained losses attributable to the disaster may deduct the losses on their 2004 returns.

The IRS has issued a reminder that the Katrina Emergency Tax Relief Act of 2005 (Pub. L. No. 109-73) eliminated the loss limitation provisions for losses sustained in a presidentially-declared disaster area as a result of Hurricane Katrina. The losses may be claimed on an amended 2004 income tax return or on a 2005 income tax return. Taxpayers should write "Hurricane Katrina" in red ink on the top of Form 1040X and Form 4684, Casualty and Thefts should be attached, with the words "Hurricane Katrina" on the dotted line next to line 11. Lines 11 through 17 should be filled in with zeros. If taxpayers have losses other than those caused by Hurricane Katrina, a separate Form 4684 should be filed for the non-Katrina losses. Form 4684 for 2005 will be revised to provide for Hurricane Katrina losses. **IR-2005-119**.

EMPLOYEE EXPENSES. The IRS has announced an update of the simplified per diem rates that employers (or their agents or third parties) can use to reimburse employees for lodging, meals and incidental expenses incurred on or after December 31, 2004 during business travel away from home without the need to produce receipts. **Rev. Proc. 2005-67, I.R.B. 2005-42, *revising*, Rev. Proc. 2005-10, I.R.B. 2005-3**.

GIFT. The taxpayers, husband and wife, owned residential rental property as community property. The property was subject to a mortgage. The taxpayers transferred by gift a one-half interest in tenancy in common in the property to their child; however, the child agreed to pay one-half of the mortgage outstanding on the day of the gift. The property continued as residential rental property but was to become the eventual residence of the child. The IRS ruled that (1) the transfer was a sale or exchange for capital gain tax purposes to the extent of the amount paid to the taxpayers by the child; (2) the transfer was a gift to the extent of the remaining value for which consideration was not received; (3) the transfer did not result in income from discharge of indebtedness; (4) the consideration received equalled one-half of the mortgage amount; and (5) the child's basis in its interest would be the basis of the taxpayers before the transfer plus any gift tax paid. **Ltr. Rul. 200540008, June 24, 2005**.

PASSIVE ACTIVITY LOSSES. The taxpayer owned several rental properties which were managed by the taxpayer who spent approximately 40-50 hours per week on the properties. The taxpayer hired independent contractors for major repair work but did most of the small work personally. The taxpayer aggregated all the properties into one business for purpose of filing Schedule E and declared losses for the tax years involved. However, the taxpayer did not make the election under I.R.C. § 469(c)(7)(A) to treat all the properties as one activity. See also Treas. Reg. § 1.469-9(h). The IRS agreed that the taxpayer would be considered to have materially participated in the rental activities and qualified as a real estate professional, if the rental activities were combined. The IRS disallowed the losses as passive activity losses, except to the extent of $25,000, because the taxpayer failed to file an election to treat the properties as one activity. The taxpayer argued that the filing of one Schedule E over several tax years with all of the activities combined into one activity on the form was sufficient to make the election to treat all properties as one activity. The court held, however, that the taxpayer failed to comply with the election requirements which do not provide for any "deemed election" resulting from consistent taxpayer treatment of the activities over several years; therefore, the taxpayer's passive activity losses were limited to $25,000 per year. **May v. Comm'r, T.C. Summary Op. 2005-146**.

PENSION PLANS. For plans beginning in September 2005 for purposes of determining the full funding limitation under I.R.C. § 412(c)(7), the corporate bond weighted average is 5.81 percent with the permissible range of 5.23 to 5.81 percent (90 to 100 percent permissible range). The 30-year Treasury securities rate for this period is 4.89 percent, the 90 percent to 105 percent permissible range is 4.40 percent to 5.13 percent, and the 90 percent to 110 percent permissible range is 4.40 percent to 5.38 percent. **Notice 2005-71, I.R.B. 2005-42**.

RETURNS. The IRS has posted a draft of Form 8873 (2005), Extraterritorial Income Exclusion in the Topics for Tax Professionals section of its web site. See http://www.irs.gov/taxpros/topic/index.html under Draft Tax Forms. Advance proof copies of IRS tax forms are subject to change and Office of Management and Budget approval before they are officially released.

TRUSTS. When the taxpayers were married, they had established a charitable reminder unitrust which provided them with 20 years of annual payments based on a percentage of the value of the trust assets. The taxpayer were divorced and the marriage settlement agreement provided for splitting the trust into two trusts with each taxpayer as a beneficiary of one of the trusts. The trusts were identical in terms to the original trust but provided that if either taxpayer died before the termination of the trust, that trust would pass to the survivor for the remainder of the term. The survivor could change the charitable beneficiary only to another qualified charity. The IRS

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ruled (1) the split trusts would continue to qualify as qualified charitable remainder unitrusts; (2) no gain or loss would be recognized from the split; (3) the holding period and basis of the assets would pass to each taxpayer; and (4) no taxable gift resulted from the split. **Ltr. Rul. 200539008, June 13, 2005**.

SECURED TRANSACTIONS

INVENTORY. The plaintiff sold agricultural products to an agricultural supply store. The store also purchased supplies from the defendant. In 1983 the plaintiff and store executed an agreement that granted the plaintiff a purchase money security interest in inventory supplied by the plaintiff but not secured by other inventory. The store did not keep records of the sources of its inventory. In 1998, the store signed a "draw note-fixed rate" agreement for a line of credit in exchange for the store's account receivables. The agreement was secured by a security interest in all inventory, accounts receivable and equipment. The defendant received payment through the receivables over the next seven to eight months. In early 1999, the plaintiff received information that the store was insolvent, although the store was current on its obligations to the plaintiff. The plaintiff did not attempt to enforce its security agreement at that time. A physical inventory of the store was taken and was found to be short. The store defaulted on a payment to the plaintiff soon after and the plaintiff first learned about the factoring agreement with the defendant. The plaintiff sued the defendant for conversion for the amounts received under the factoring agreement. The plaintiff claimed that the accounts receivables resulted from the sale of inventory supplied by the plaintiff, arguing that a proportional amount of the inventory came from the plaintiff and was subject to the purchase money security interest. The court found that the burden of proving that the inventory sold was supplied by the plaintiff, and was, therefore, subject to the plaintiff's security interest, was on the plaintiff. The court also found that the plaintiff failed to provide sufficient evidence that any of the inventory sold was supplied by the plaintiff because the store did not track any of the inventory from supplier to sale. The plaintiff attempted to surpass this problem by arguing that the inventory could be determined using the proportion of the inventory from all sources and allocating that proportion to the sale of the inventory. However, the court rejected that approach as less than accurate, given the poor recordkeeping of the store. The court held that the defendant was not liable for conversion because the plaintiff could not trace the inventory sold which generated the accounts receivables collected by the defendant. **Van Diest Supply Co. v. Shelby County State Bank, 2005 U.S. App. LEXIS 21385 (7th Cir. 2005)**.

PRINCIPLES OF AGRICULTURAL LAW

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