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## PRIORITY RULES: LANDLORD'S LIEN VERSUS SECURITY INTERESTS

— by Neil E. Harl\*

Over the past decade, the relative standing of liens and UCC security interests has been a matter of far greater importance than had been the case at any time since the development of the Uniform Commercial Code.<sup>1</sup> Of particular concern has been the question of priority of liens versus UCC security interests when both apply to the same collateral. In addition, the standing of liens in bankruptcy has assumed a position of importance. Further, the rights of lien holders as against the purchasers of farm products have posed important issues.

**General priority rule for liens.** Section 9-310 of the Uniform Commercial Code provides the general rules for resolving the matter of priority as between liens and UCC security interests

When a person in the ordinary course of his business furnishes services or materials with respect to goods subject to a security interest, a lien upon goods in the possession of such person given by statute or rule of law for such materials or services takes priority over a perfected security interest *unless the lien is statutory and the statute expressly provides otherwise.* (Emphasis added)

Thus, as a general rule liens take priority over UCC security interests unless subordinated in the lien statute.

The UCC in Section 9-104 makes specific reference to landlord's liens in stating —

"This Article does not apply ...

(b) to a landlord's lien; or

(c) to a lien given by statute or other rule of law for services or materials except as provided in section 9-310 on priority of such liens...."

The courts are in general agreement that landlord's liens, in the usual case, take priority over even a properly perfected UCC security interest.<sup>2</sup> A few courts have disagreed.<sup>3</sup>

With respect to purchasers of farm products, the rights of purchasers are generally subject to a landlord's lien.<sup>4</sup> Illinois, in 1983, modified the priority scheme for landlord's liens by providing that a good faith purchaser takes crops free of a landlord's lien unless, within six months prior to the purchase, the landlord provides written notice of the landlord's lien to the purchaser.<sup>5</sup> A landlord may require the tenant, prior to the sale of any crops grown on the rented land, to disclose the names of persons to whom the tenant intends to sell the crops; the tenant

may not sell the crops to anyone not disclosed to the landlord as a potential buyer of the crops. In that situation, sale to an undisclosed person is a crime. It is a defense to a prosecution that the tenant paid the landlord proceeds from the sale of crops within 10 days, from the sale.

Did the federal preemption of the states' farm products rule on the right of purchasers affect landlord's liens?<sup>6</sup> The legislation recites that Congress finds that —

"certain State laws permit a secured lender to enforce liens against a purchaser of farm products even if the purchaser does not know that the sale of the products violates the lender's security interest in the products, lacks any practical method for discovering the existence of the security interest, and has no reasonable means to ensure that the seller uses the sales proceeds to repay the lender...."<sup>7</sup>

This language, using the term "liens," would suggest that the statute was intended to cover more than UCC security interests. Yet the operative part of the statute specifies that —

"Except as provided..., a buyer who in the ordinary course of business buys a farm product from a seller engaged in farming operations shall take free of a security interest created by the seller, even though the security interest is perfected; and the buyer knows of the existence of such interest."<sup>8</sup>

This language refers only to "a security interest created by the seller."<sup>9</sup> The statute defines "security interest," however, as "an interest in farm products that secures payment or performance of an obligation."<sup>10</sup> Thus, as with other aspects of the federal preemption statute, the scope of the provision is unclear.

**Effectiveness of liens in bankruptcy.** While a lien such as a landlord's lien may well prevail over a properly perfected security interest out of bankruptcy,<sup>11</sup> the priority of liens in bankruptcy falls far short of that. A statutory landlord's lien is ineffective in the event of bankruptcy and can be avoided in bankruptcy.<sup>12</sup> Therefore, a landlord who is concerned that the tenant might file bankruptcy should create and perfect a security interest to secure the payment of rent.

A recent United States District Court case in the Central District of Illinois, *In re Norton*,<sup>13</sup> underscores another potential problem for landowners in bankruptcy. That case, decided in 1990, adds another reason why a UCC filing is a good idea. In that case, the landlord and tenant were operating under a 50-50 crop share lease. The landlord paid half of the seed, lime, fertilizer, insecticide and other inputs (other than herbicide) and received half of the crop. The original lease term ran from January 18, 1985 to

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December 1, 1985 but it had been continued for the following year and became a year to year lease.

On August 22, 1986, the tenant filed Chapter 11 bankruptcy for reorganization of the farm business. The filing was converted to Chapter 7 liquidation on September 9. The 1986 crop was about ready for harvest at the time of the conversion. Indeed, the soybeans were combined on September 10 and 15. The corn was harvested on October 15 and 16. Both crops were sold at the local elevator. After the bankruptcy trustee had completed harvesting the crop, the lease was automatically rejected 60 days after filing — on November 8.

The landlord then filed a claim for her half of the crop as an administrative expense. The trustee insisted that the landlord's claim for rent was valid only for the number of days the bankruptcy trustee had possession of the land. The bankruptcy court agreed with the trustee that the landlord was entitled to 36/365 of the landlord's half of the corn crop and 6/365 of the landlord's half of the soybean crop. The landlord's half of the crop totalled \$2,165.24. But the bankruptcy court allowed the landlord only \$83.43.

The bankruptcy court's decision was appealed to the United States District Court for the Central District of Illinois. The district court upheld the bankruptcy court as to the calculation of rent on a daily basis but held that the trustee had "used" the land from the date of the original Chapter 11 filing (August 22) through November 8 (the date the lease was rejected). Thus, the daily calculation should use a fraction of 67/365, producing a rental figure of \$462.71. That's still a far cry from the landlord's half of \$2,165.24.

The district court noted that fact in commenting that "this case seems troubling due to its apparent harshness." The court observed that the "Congress should consider fine tuning the Bankruptcy Code to deal with this special category of lease." The court added that until Congress changes the law, the courts are bound to treat the crop share lease "as just another unexpired lease."

The court also commented that a landlord could secure the rent claim by perfecting a security interest under the UCC. That would place the landlord in a position of being a secured creditor as to the crop — unless another creditor has a prior claim on the crop, of course.

## FOOTNOTES

<sup>1</sup> See generally Harl, *The Farm Debt Crisis of the 1980s*, ch. 2 (1990) forthcoming).

<sup>2</sup> *In re Henry*, Bkrpcy. No. 85-01865F (Bankr. N.D. Iowa 1986); *Dwyer v. Cooksville Grain Co.*, 37 U.C.C. Rep. 252 (Ill. App. 1983); *In re Findley*, 76 B.R. 547 (Bankr. N.D. Miss. 1987) (landlord's lien on catfish raised on leased land had priority over security interests in catfish). See *Planters Bank & Trust Co. v. Sklar*, 555 So. 2d 1024 (Miss.

1990), see p. 82 *supra* (landlord did not waive lien by allowing tenant to sell crop without prior consent; one-half of rent was required to be paid before harvest of crop).

<sup>3</sup> *In re Zeigler*, 19 U.C.C. Rep. 1210, 1217 (Ill. App. 1976) (court opined that UCC § 9-104 should not be read literally); *McCoy v. Steffen*, 227 Neb. 72, 416 N.W. 2d 16 (1987) (landlord's lien on stored crops junior to another creditor's perfected interest where landlord failed to perfect lien by filing financing statement).

<sup>4</sup> *Prior v. Rathjen*, 199 N.W.2d 327 (Iowa 1972).

<sup>5</sup> Ill. Ann. Stat. ch. 6, § 3-316.

<sup>6</sup> See Food Security Act of 1985, Pub. L. 99-198, Sec. 1324, 99 Stat. 1535 (1985).

<sup>7</sup> *Id.*, § 1324(a).

<sup>8</sup> *Id.* § 1324(d).

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*, § 1324(c)(7).

<sup>11</sup> See discussion *supra* involving UCC §§ 9-104, 9-310.

<sup>12</sup> 11 U.S.C. § 545(3), (4).

<sup>13</sup> 112 B.R. 932 (C.D. Ill. 1990).

# CASES, REGULATIONS AND STATUTES

## BANKRUPTCY

### GENERAL

**AVOIDABLE LIENS.** The debtors, raisers of farm crops and livestock, sought avoidance of nonpossessory, nonpurchase-money liens on hand tools, chain saw and horse trailer in which debtors did not have any equity as a result of the liens which they sought to avoid. The court held that the liens were avoidable as impairing the lien on exempt tools of the trade. *In re Jackson*, 115 B.R. 286 (Bankr. D. Colo. 1990).

**AVOIDABLE TRANSFER.** Debtor had transferred farmland and machinery to his father under a foreclosure action based on land sales contract. The trustee filed a

complaint to avoid the transfer of the farm machinery as a fraudulent conveyance more than two years after the trustee was appointed. The debtor's father pleaded the running of the two year statute of limitations in Section 546 as a defense to the trustee's motion for summary judgment on the complaint. The court held that the bankruptcy code statute of limitations applied and not the longer state statute of limitations on actions involving fraudulent transfers. The case left open the possibility that if the trustee can prove concealment of the fraud by the debtor, the statute of limitations would be tolled until the trustee knew or should have known about the fraud. *In re Hansen*, 114 B.R. 927 (Bankr. N.D. Ohio 1990).

**ESTATE PROPERTY.** The debtor was the beneficiary of an inter vivos spendthrift trust under which the debtor was to receive annual income payments with the trust corpus to be distributed to the debtor when the debtor reached age 50. The debtor was 45 at the time of bankruptcy filing. The trustee argued that the value of the right to receive the trust corpus at age 50 should be included in the bankruptcy estate. The court rejected this argument because it would effectively annul the exclusion of spendthrift trusts from the bankruptcy estate. The trustee also argued that distributions from the trust should be included in the bankruptcy estate under Section 541(a)(5)(A) as property received under a bequest. The court held the annual payments excluded from the bankruptcy estate because an