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Agricultural Business Management

June 2015

Farm Legal Series

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The Affordable Care Act—What You Need to Know

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INTRODUCTION

With the passage of the Affordable Care Act ("ACA"), employers are faced with numerous issues to consider in order to ensure they comply with its requirements. The purpose of this fact sheet is to outline those requirements in order to provide assistance in making those assessments. The flow chart at the end of this fact sheet should also provide assistance in navigating these often complex requirements.

THE EMPLOYER MANDATE IN A NUTSHELL

The general premise of the mandate is rather simple: employers need to provide group health coverage to their full-time employees come 2015, or pay the ACA penalty for failing to do so. Of course, as with everything else in this law, the devil is in the details.

First, certain employers are exempt from the mandate. Employers with fewer than 50 full-time employees are not required to comply with the mandate. In 2015, employers with fewer than 100 full-time employees get a pass—they don't have to comply until 2016.

Second, the ACA specifies which employees are considered full-time for purposes of the mandate. Generally, employees working 30 or more hours per week must be considered full-time. This is a departure from the historical position that generally permitted employers to determine the number of hours required to be considered full-time.

Third, employers are now required to offer group health coverage to all full-time employees. Prior to the ACA, to the extent an employer could satisfy either non-discrimination or underwriting considerations, the employer was free to determine workforce coverage on its own.

Fourth, the group health coverage must satisfy two different standards to be considered conforming "affordable" coverage under the ACA. Both the percentage of benefits the plan pays (as compared to a participant's out of pocket cost), and the amount the employee is required to pay for premiums must satisfy specific standards.

Finally, the ACA imposes penalties on employers for failure to comply. If an employee goes to a state or federal exchange and purchases coverage using a government subsidy, the employer may be subject to one of two penalties: (i) the penalty for a failure to offer coverage, or (ii) the penalty for a failure to offer affordable coverage. The remainder of this article will discuss the employer mandate provisions in more detail.

WHO IS SUBJECT TO THE MANDATE?

Employers with 50 or more full-time employees are required to comply under the ACA. An "employer" is determined on a controlled-group basis. This means all employees of related entities must be aggregated to determine whether the 50 employee threshold has been met. Entities can be related directly through an ownership

chain, such as a parent company with one or more subsidiaries. Common ownership of multiple entities by small groups can also create a controlled group.

A parent subsidiary controlled group exists when one corporate entity owns at least 80% of another. For example, consider a company with multiple divisions. It is very common for an umbrella or shell organization to own several operating units, each devoted to different aspects of the business. As long as the shell owns at least 80% of each operating unit, the entire group is considered a single employer for purposes of the ACA.

Entities can also be related through a brother-sister controlled group. In this analysis, if five or fewer persons own at least 80% of each entity, and at least 50% of the ownership is identical, the entities will be a controlled group and considered a single employer. For example, if three friends each own one-third of three different companies, this test would be satisfied. The three friends fit as "five or fewer"; together they own 100% of each of the entities, and 100% of the ownership is identical. Obviously, depending on the number of owners and the ownership percentages, companies may or may not be related enough to be required to include all employees in this determination. For that reason, it is important to consult experienced benefits counsel in making this determination.

To make things even more confusing, there are family attribution rules that require certain family members' ownership to include that of other family members. For example, an individual is considered to own any interest that his or her spouse and, in some cases, child or parent owns. This sometimes makes it difficult for family owned businesses to stay separate enough to avoid the requirements.

Control of nonprofit entities is determined by the ability to control their boards of directors. If 80% or more of the directors of the nonprofit organization are employees of another entity, or are appointed and removed by another entity, that other entity and the nonprofit are in the same controlled group.

Once the entities that must be considered a single employer have been determined, the next step is to count full-time employees. Only employers with 50 or more full-time employees are required to comply with the mandate. For this purpose, an employee working 30 or more hours per week is considered full-time. For organizations that hire part-time employees, a full-time equivalency calculation is used. The employer must first add together all the monthly hours of all part-time employees, then divide that number by 120. The resulting number is the employer's full-time equivalency, which is added to the population of employees working 30 or more hours per week. If the result is 50 or greater, the employer is subject to the mandate.

There is a special exception that may help employers with seasonal employees. If the employer had more than 50 employees for 120 days (4 months) or less, and all employees in excess of 50 are seasonal, the employer is exempt from the mandate.

Employers must use the previous year's employment data to determine whether the 50 employee threshold is met.

WHICH EMPLOYEES MUST BE COVERED?

Full-time employees and their dependents must be covered to avoid the risk of penalties.

The question of who is considered full-time is more complex. An employee who works on average 30 hours per week (130 hours per month) is considered to be full-time for purposes of the ACA. All employees that

employers currently categorize as full-time are likely to meet this standard. However, it is possible that a significant number of employees currently categorized as part-time meet this standard as well. The rules take three kinds of situations into account: (i) ongoing or new employees who are expected to work 30 hours per week or more, (ii) ongoing employees whose hours are variable, and (iii) new employees whose hours are variable. Equivalencies may be used for employees whose hours are not tracked—8 hours for one day, 40 hours for one week. However, these equivalencies must not be less than the actual number of hours worked. For example, if an employee works three days a week, but is paid on salary and hours are not tracked, the employer could credit 8 hours for each day worked. This would result in a total of 24 hours counted per week. However, if that employee is working three 12-hour shifts, the actual number of hours must be credited.

For purposes of the ACA, dependents are the employee's children under the age of 26. Note that spouses are not dependents for this purpose. Therefore, to comply with the mandate, the employer must offer coverage to the employee and his or her children. The employer is certainly allowed to offer coverage to the employee's spouse, but this is not required. The employer does not have to pay for coverage for the dependents. There are affordability requirements for the employee's coverage (see the next section of this article), but not for the dependent coverage. Hence, the employer could pay for the employee's coverage only, and let the employee enroll any children in the plan at his or her own expense.

There are additional rules governing how leaves of absence may be taken into account in measuring hours. If an employee terminates and is rehired 13 weeks or more after the termination, he or she can be considered a new employee for purposes of the measurement periods. If the break in service is shorter, the employer may be able to count the employee as new, depending on how long the first period of employment was.

WHAT KIND OF COVERAGE MUST BE OFFERED?

To avoid penalties, the coverage offered to the employee and his/her dependents must be of "minimum value," and must be "affordable." A plan's coverage meets minimum value if the plan's share of the total allowed costs of benefits provided under the plan is at least 60% of those costs. In other words, at least 60% of covered expenses must be paid by the plan. The employee's out of pocket expenses, such as copays and deductibles (but not including premiums), must not be greater than 40% of covered benefits. The minimum value calculation is an actuarial calculation, and is not related to how much of the premium will be paid by the employer. A minimum value online calculator is available online through the Centers for Medicare and Medicaid Services (http://cciio.cms.gov/resources/regulations/index.html#pm). Most employers will be aided by their brokers and insurers in making this determination. Currently, many if not most employer plans provide a much more robust coverage rate—often in the 75% to 85% range.

The affordability of the plan is determined in relationship to each employee's financial situation. The ACA calls for the determination to be based on household income, but of course employers cannot know what that is. The regulations have provided three safe harbors. The one which is most commonly referred to is the W-2 safe harbor. If the employee portion of the premium is not greater than 9.5% of the employee's W-2 income, the coverage is affordable. The second safe harbor is based

on the rate of pay. If the monthly employee portion of the premium doesn't cost more than 9.5% of the employee's hourly rate, multiplied by 130 hours per month, the coverage is affordable. Finally, a third safe harbor is based on the federal poverty line. If the employee's cost is not greater than 9.5% of the federal poverty line for a single individual, the coverage is affordable. For all of the safe harbors, the calculation is based on employee-only coverage that meets minimum value requirements. If the employer has more than one plan available, the least expensive coverage is used for the calculation.

WHAT ARE THE PENALTIES FOR NON-COMPLIANCE?

The ACA provides two separate penalties for non-compliance with the mandate. The penalties are not cumulative; they would end up being assessed on an "either/or" basis. The penalty for failing to provide affordable coverage to full-time employees will be capped at the amount the penalty would have been for failure to provide coverage at all. This is an important point, as it shows the intent of the regulators to incentivize employers to provide coverage. An employer who tries to comply by offering coverage and falls short with regard to the affordability requirement will not find itself in a position of being worse off, penalty-wise, than if it had not tried at all to comply with the mandate.

Both penalties are only triggered when an employee obtains subsidized coverage through an exchange. If no employee goes to the exchange to obtain coverage, or if an employee that goes to the exchange is not eligible and therefore does not receive a subsidy, then no penalty will be triggered. It always takes an employee getting coverage and subsidy from an exchange for an employer to be in a potential penalty situation.

PENALTY FOR FAILURE TO OFFER COVERAGE

The first penalty is an annual $2,000 per employee. It has earned the nickname "the hammer," because calculation uses an employer's entire full-time employee count as the starting point for assessment <u>even if only one</u> employee goes to an exchange and obtains coverage and a subsidy.

The hammer penalty applies when an employer does not offer group health coverage to its full-time employees. The rule is that coverage needs to be offered to all full-time employees, and the definition of full-time is those that work 30 or more hours a week, under the calculation description above. The original guidance did not provide any exception for error – technically, missing a single employee who fit the full-time standard would have put the employer at risk for the penalty. Fortunately, the newer guidance offered a substantial compliance measurement. An employer that offers coverage to at least 95% of its full-time employees can avoid this penalty. For the 2015 calendar year only, an easier standard of 70% compliance applies.

In calculating the penalty, the regulations allow the first 30 full-time employees not to be counted. Thus an employer subject to this penalty will be assessed an amount according to the following formula: $2,000($n$-30), where n is the number of full time employees. In 2015 only, the first 80 full-time employees will not be counted. The penalties in all years will be calculated on a month-by-month basis.

PENALTY FOR FAILURE TO OFFER AFFORDABLE COVERAGE

The second penalty can apply when an employer offers coverage, but that coverage is not considered "affordable" under the ACA. An employee who goes to an exchange and applies for subsidized coverage will have to demonstrate that the employer-provided group health plan was not affordable. If the employer plan is found not to be affordable, the employer will be subject to a $3,000 penalty for that employee. Unlike the hammer penalty, this one is only assessed for each employee who actually obtains subsidized exchange coverage. Like the hammer penalty, this one will be calculated on a month-by-month basis.

Plan Coverage Analysis

The affordability measurement has two main components as described in more detail above: first, the plan's coverage of expenses must be at least 60% of the cost of those expenses. This is the "minimum value" requirement. This measurement may offer employers a planning opportunity when reviewing how best to comply while reducing costs.

Employee Cost Analysis

The second affordability measurement, also described in more detail above, is the cost to the employee for premiums. This cost cannot exceed 9.5% of the employee's household income. Employers generally do not know an employee's household income, and employers have good reason to continue in this lack of knowledge. There are significant employment and employee relations problems with trying to obtain an employee's household income information. Thus, it is recommended to use one of the safe harbors described above. This creates a smaller number in most cases than would result in using the household income. However, the administrative ease and predictability will make it an obvious choice to use in assessing compliance.

The premium affordability analysis applies on an individual employee basis. This means that the maximum permissible premium amount in terms of dollars will be less for lower paid employees than for more highly compensated employees. Currently, the vast majority of employer provided plans utilize a standardized employee contribution amount or percentage. This new ACA measurement may provide employers with a planning opportunity to redesign the methodology for determining employee premium contributions.

Obtaining a Subsidy on the Exchange

Under the first premise of penalty assessment, an employer will not be subject to either penalty unless an employee goes to an exchange and obtains subsidized coverage. Subsidized coverage will only be available for individuals who satisfy the income requirements for a subsidy. The subsidy will be available on a sliding scale basis for employees who have a household income between 100% and 400% of the current year's Federal Poverty Level. In states that expand Medicaid (such as Minnesota), employees with household income below 138% of the Federal Poverty Level will be eligible for Medicaid. Employees eligible for Medicaid do not get subsidies on the exchange, because they get Medicaid coverage. Employees with incomes that exceed 400% of the Federal Poverty Level will not be eligible for a subsidy at all.

The Federal Poverty Level depends on household size. In 2014, it is at $11,670 for a single person ($46,680 for 400% of the Federal Poverty Level), and $23,850 for a family of four ($95,400 for 400%). Employers

conducting a risk analysis for ACA penalties can use 2014 Federal Poverty Levels to evaluate the likelihood that their employees will be eligible for an exchange subsidy.

The ACA provides a mechanism for employers to respond to exchange decisions to give an employee a subsidy—for example by demonstrating that coverage was offered and refused, or that coverage is affordable for a particular employee. The rules for that process have not yet been fully developed.

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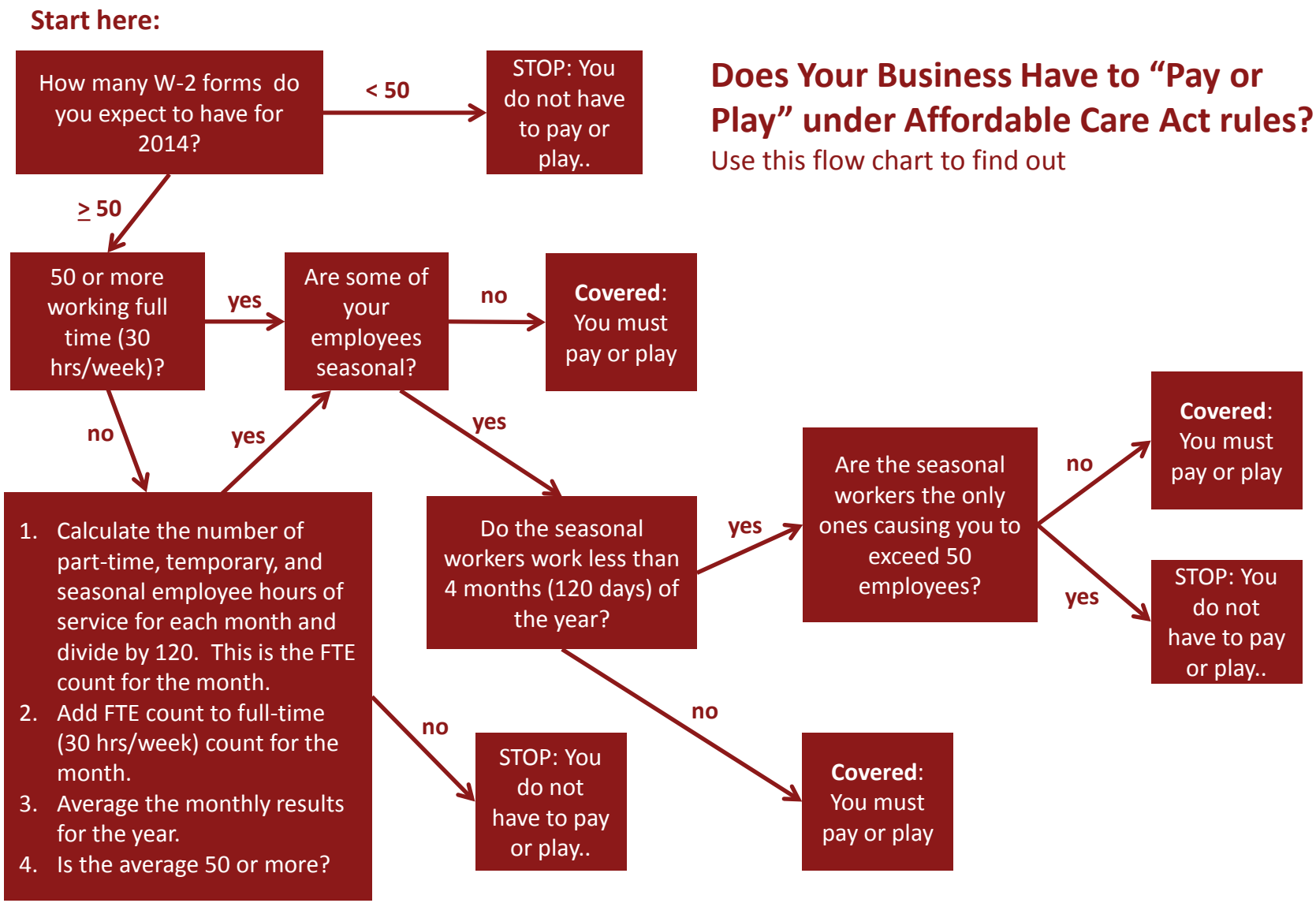
Does Your Business Have to "Pay or Play" under Affordable Care Act rules?

Use this flow chart to find out



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Agricultural Marketing Contracts

Phillip L. Kunkel, Jeffrey A. Peterson
Attorneys, Gray Plant Mooty

INTRODUCTION

Contracts are an increasingly important aspect of agricultural production and marketing. Such contracts may take the form of leases, contracts for deed, production contracts, or marketing contracts. Some of the legal issues surrounding such contracts are discussed in other fact sheets in this series, including *Agricultural Production Contracts; Contracts, Note and Guarantees; Mortgages and Contracts for Deed;* and *Farm Leases.* This fact sheet deals with the legal considerations involved in agricultural marketing contracts.

A long-term marketing contract is an agreement of a fixed term, entered before production begins, under which a producer either agrees to sell or deliver all of a specifically designated crop raised on identified acres in a manner established in the agreement or to sell specific quantities of livestock to the contractor. Under such contracts, the producer is paid according to the payment terms set forth in the contract.

REGULATION OF MARKETING CONTRACTS

Marketing contracts are regulated by both the Federal government and by the State of Minnesota to provide the producer protections when entering into and operating under a marketing contract.

Federal Regulation

An unpaid cash seller of livestock and perishable agricultural commodities may be able to assert a priority claim against the assets of a buyer which fails to pay for such farm products (under the statutory trust provisions of the Packers and Stockyards Act (PSA) nor the Perishable Agricultural Commodities Act (PACA). In 2008, Congress also revised the PSA to include: (a) the producer the right to discuss with certain individuals (regardless of any restrictions in the contract) the terms of a marketing contract that is for a period of one or more years, (b) that the venue for an contractual dispute shall be the federal judicial district in which the contract was performed and the choice of law shall be governed by the state in which the dispute arose (unless otherwise prohibited by the law of the state in which the contract was being performed), and (c) the right of the producer to reject an arbitration provision in the contract. However, this legislation only relates to poultry and swine marketing contracts.

State Regulation

Recent federal laws overlap, to some extent, with laws already enacted in the State of Minnesota. The Minnesota Agricultural Contracts Act contains several provisions designed to protect producers who enter into marketing contracts. Under these provision: (a) any contract for an agricultural commodity must contain a provision calling

for either mediation or arbitration of any contract disputes; (b) parent companies of subsidiaries licensed to purchase agricultural commodities are liable to a seller for any unpaid purchase price or any claim based upon a contract if the contractor fails to perform; and (c) all agricultural contracts must be in plain language, contain risk disclosures and provide for a right of rescission. A producer must be aware of the applicable state restrictions and limitations on the use of such contracts.

OTHER LEGAL ISSUES

Several legal issues may be raised by long-term marketing contracts. As in the case of any contract, the terms of the contract at issue will often be determinative in resolving any contractual dispute. However, there are several important considerations for sellers which are raised by such contracts.

Quantity of Crops/Livestock Subject to Contract

An initial issue to consider when assessing a long-term marketing contract is the quantity of crops or livestock which are to be subject to the contract. Some contracts require specific numbers of animals to be provided each month or week. Such contracts sometimes grant the buyer a first option to purchase any additional marketable production of the seller. Other contracts involve a promise by the seller to sell all his production to the buyer. Contracts which cover all of the seller's production result in an inability on the part of the seller to sell its production on the spot market in the event market prices are in excess of the contract price. Conversely, however, if the contract price is substantially in excess of the market price, such contracts provide the seller with a more attractive marketing outlet for his production.

Determination of Price

A long-term marketing contract will typically set forth in some detail the manner of computing the amount due the producer. For example, some contracts establish the price to be tied to a cost matrix based on costs of inputs. Other contracts are based upon a market price index. Producers must understand the basis for payment set forth in the contract. In addition to understanding the formula, however, both parties must evaluate whether the contract will likely allow for a profit under existing market conditions. For example, if the marketing contract is based upon a market price index, and the cost of inputs increases substantially, the producer may incur significant lose if the market price does not immediately reflect the increased price of the inputs.

Conditions of Payment

A marketing contract will also generally establish various conditions of payment. The quantity of farm products required to be delivered as well as the grade, weight or condition under such a contract will often be carefully defined. Compliance with the buyer's production requirements will generally be required. Premiums or merit adjustments may be provided for crops or livestock which exceed such minimum requirements. These conditions must be understood by both the producer and its lender.

Amounts to be Paid to Seller

Some marketing contracts, particularly in the swine industry, provide for guaranteed minimum prices to be paid the seller regardless of the market price of the hogs at the time of delivery. While the details of such contracts are unique, depending upon the terms of each such contract, there are several common characteristics of such "ledger

contracts." Such contracts generally establish a minimum price for the livestock. The price paid the seller may be greater than the minimum price if the "market price" of the livestock is higher than the minimum price at the time of delivery. The exact amount to be paid the seller in such a case will be determined based upon a formula set forth in the contract. A portion of any amount by which the market price exceeds the minimum price may be accounted for by crediting a reserve account established by the buyer for the seller. Interest may, or may not, accrue on any such amounts owed the seller. However, if the market price for comparable livestock at the time of delivery is lower than the minimum price, the seller will be paid the minimum price. In such a case, the buyer will account for such payments by debiting a reserve account in the name of the seller. Any amounts owed the buyer by the seller on account of such payments may bear interest. Such amounts may be repaid when, and if, the market price again exceeds the minimum price provided in the contract out of the excess via credits to the reserve account.

Any amounts owed under such contracts, regardless of which party to the contract is owed funds by the other, will likely constitute an extension of credit to the other party. If the seller owes the buyer substantial sums as a result of such a contract, it may affect the ability of the seller to obtain continued financing from his lender. Such amounts may trigger defaults under the seller's loan agreements. In addition, some contracts provide that the seller will provide the buyer with a security agreement granting the buyer a security interest in the seller's assets to secure all amounts owed the buyer by the seller. If the seller grants a security interest in his assets to the buyer pursuant to such a contractual provision, the legal relationship between the parties is transformed from that of buyer and seller to that of borrower and secured lender. Depending upon the provisions of the security agreement, the buyer may obtain a security interest in the seller's machinery, equipment, crops and livestock.

Conversely, if the buyer owes the seller pursuant to such a contract, the seller has provided unsecured financing to the buyer. In some cases, this may violate the terms and conditions of the seller's loan agreements. In addition, the seller's remedies in the event of nonpayment by the buyer will be affected by such contracts. The seller will not be able to reclaim any livestock which has been delivered to the buyer under such a contract based upon the nonpayment of any amounts owed the buyer. In addition, it is not clear whether the trust provisions of PSA would apply to the nonpayment of any deferred amounts owed a seller under a ledger contract.

Ultimately, of course, the balances owed under such contracts must be reconciled. Under some contracts, whichever party is in a negative position at the end of the initial term of the marketing agreement may extend the contract in order to liquidate the negative balance owed in the reserve account. Other contracts provide that the amount owed in the reserve account, regardless of which party is the obligor, is payable at the expiration of the term of the agreement. The manner in which any such reserve account is reconciled should be carefully analyzed and understood by both parties to any such contract.

Modification of Terms

Most long-term marketing contracts contain provisions which allow the economic terms of the contract to be modified. While this is necessary inasmuch as such contracts are long-term arrangements, it is critical the producer understands that the economics of

such contracts may be subject to change. Producers should consider not only how pricing terms may be modified by the packer, but how often, under what circumstances and to what extent such modifications will be permitted.

Impossibility

An important provision in any long-term marketing contract is the force majeure term. This essentially frees both parties from liability or obligation when an extraordinary event or circumstance beyond the control of the parties occurs. The production of farm products carries significant production risks. If the contract relates to the production of crops, crop failure due to weather conditions, disease, etc. is not uncommon. Livestock is susceptible to disease problems which can significantly affect the ability of a producer to comply with a marketing contract. Producers and their lenders should be conscious of the impact of such production risks in assessing any marketing contract.

Nonpayment by Buyer

As is true with any contract, a seller of farm products under a marketing contract is always subject to the risk of nonpayment or other nonperformance by the purchaser. Federal and state law may provide an unpaid seller of livestock additional remedies in the case of such a default on the part of the buyer. Minnesota law grants an unpaid seller of agricultural commodities, other than grain and raw milk, with a lien against the commodities delivered to a purchaser and the proceeds of such commodities for the contract price of the commodities. Furthermore, an unpaid seller of livestock may be entitled to assert a secured claim based upon the PSA, which specifically creates a statutory trust for the benefit of all unpaid cash sellers.

Contractors/Buyer's Bankruptcy

Should a buyer file bankruptcy, the rights and remedies of a seller under a long-term marketing contract will be affected. As an executory contract, the marketing contract is subject to rejection by the debtor under Bankruptcy Code §365. If a debtor has failed to make payments to a seller prior to filing bankruptcy, the claim of the unpaid seller for such amounts will generally be an unsecured claim against the bankruptcy estate unless (i) the seller has preserved its PSA or PACA trust rights, if any; (ii) perfected a statutory lien against the livestock delivered to the debtor or (iii) promptly exercised its reclamation rights.

CONCLUSION

Marketing contracts have become an integral part of production agricultural. Due to this increased use (and the extensive use of contracts to bind producer to less than favorable contract terms), the Federal government and the State of Minnesota have adopted laws that are intended to provide additional rights to producers. Being aware of these rights is critical to any producer who is intending to enter into a contract or who is a party to a marketing contract.

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An *agricultural production contract* is a contract by which a producer (sometimes called a "grower") agrees to (i) sell or deliver all of a designated crop raised in a manner set forth in the agreement to a contractor (sometimes called a "processor") and is paid according to a formula established in the contract; or (ii) agrees to feed and care for livestock or poultry owned by the contractor until such time as the animals are removed, in exchange for a payment based on a formula typically tied to the performance of the animals. A production contract usually specifies in detail the production inputs to be supplied by the contractor, the quality and quantity of the particular commodity involved, the production practices to be used, and the manner in which compensation is to be paid to the producer.

While significant attention has recently been focused on production contracts with large, corporate agricultural processors, farmers, themselves, can be contractors. For example, a dairy farmer may contract with a neighbor for the raising and/or breeding of heifers. A swine farmer may simply operate a farrowing business for surrounding farmers.

Agricultural production contracts are not new. Seed contracts, vegetable contracts and even hog contracts have been used in agriculture for several years. However, contracting has been a growing part of U.S. agriculture since at least 1960. According to estimates of the United States Department of Agriculture, agricultural contracts covered 41 percent of the value of U.S. agricultural production in 2005, up from 39 percent in 2003, 36 percent in 2001, 28 percent in 1991, and 11 percent in 1969. Contracts cover some commodities much more than others. Taken together, hogs and poultry (including broilers, turkeys, and eggs) account for nearly 40 percent of all contract production.

Advantages of Production Contracts

There are several potential advantages for producers who may consider a production contract. Such contracts may provide for a more stable income for the producer by reducing traditional marketing risks. Such contracts may allow a producer to benefit from technical advice, managerial expertise and access to technological advances provided by the contractor. An agricultural production contract may provide the

producer with a guaranteed market, provided that the commodities are produced in accordance with the contract. Finally, such contracts may allow a producer to increase the volume of his business with limited capital since the contractor may often supply the necessary production inputs. However, by entering into a production contract which establishes a formula for compensation, the producer may lose the potential for increased profits due to market conditions. In addition, since such contracts are often very specific in their requirements and in limiting the producer's interest in the commodities produced, the producer may become a mere provider of production services for a fee.

From the contractor's perspective, production contracts may provide an orderly flow of uniform commodities so as to allow the contractor to control production costs. And such contracts may allow contractors to better respond to changing market conditions. The use of such contracts may allow a contractor to protect its investment in genetics and other intellectual property associated with a particular commodity.

ALTERNATIVE LEGAL RELATIONSHIPS

Agricultural production contracts take various forms, depending upon the commodities to be produced, the economics of the transaction and local custom. The manner in which such contracts are structured will affect the legal relationship between producer and contractor.

Personal Service Contract

A production contract may be considered a *personal service contract*. Such contracts generally provide that the producer is to provide services, rather than commodities, to the contractor. Under such contracts, the producer will not typically "own" any of the commodities which are the subject of the contract. Rather, he will be providing services and management to the contractor. The Uniform Commercial Code (UCC) provisions relating to sales of commodities will not be applicable to a personal sales contract.

Bailment

Some production contracts, especially those involving seed and vegetables, may be *bailments*. A bailment is the legal relationship which exists when someone else is entrusted with the possession of property, but has no ownership interest in it. A classic example of a bailment is a grain storage contract. The elevator which stores a farmer's grain does not have an ownership interest in the stored grain. Rather, it merely holds the grain for the farmer. Crop production contracts which are structured as bailments provide the contractor with additional protection against the unauthorized distribution of seeds and crops which may be the result of extensive genetic inputs by the contractor. Under such contracts, the contractor retains full ownership to the seed and crop to be produced.

Lease

Finally, some production contracts may be *leases* of facilities, especially if the contracts relate to the production of livestock.

Regardless of the legal relationship created by a production contract, most contracts will contain provisions which specify that the producer is an independent contractor and not an employee or agent of the contractor. Such provisions are designed to limit the liability of the contractor for the actions or omissions of the producer. Similarly, such contracts typically declare that no joint venture or partnership between the producer and contractor is intended.

RISKS ASSOCIATED WITH PRODUCTION CONTRACTS

Before a producer enters into any production contract, he should carefully assess the risks associated with such a contract. There are several risks which must be considered.

Long-term Capital Investment

Frequently, such contracts may require substantial long-term capital investments. For example, if a producer is entertaining a proposal to raise hogs under contract, a significant improvement to existing facilities may be necessary to comply with the contract. This may mean a long term obligation to a lender to finance the costs of such improvements. Certain crops may similarly require specialized equipment in order to raise and harvest the crop. Before entering into any such contract, the producer should pay especially close attention to the provisions of the contract specifying the term of the agreement and the ability of the contractor to terminate the agreement. If a substantial investment is required in order to perform the contract, the producer should ensure that the contract provides sufficient safeguards to allow him to recover his investment. As discussed below, Minnesota law has addressed these concerns.

Manner of Payment

The manner in which the producer is to be paid should be clearly understood. Often, production contracts include formulas which base such payments upon a comparison of the performance of the livestock which are the subject of the contract to other similar livestock. Such a formula should be analyzed carefully before a contract is signed. Other contracts are based upon the capacity of facilities owned by the producer. Regardless of the basis for payment, the producer should clearly understand the basis for compensation under any contract.

Assumed Risks

The risks assigned to the producer under the contract should similarly be understood. The extent to which the producer must bear the risk of casualty losses, crop failure, disease, or adverse weather conditions should be considered by the producer. The contract should clearly set forth the risks which are to be assumed by the contractor and absorbed by the producer.

Risk of Non-payment

As in any contractual relationship, a producer will always be subject to the risk of nonpayment by the contractor. While state law may provide for a limited bond for grain purchasers, there may be no similar protection for a producer who raises certain crops or livestock under contract. Rather, in the event the contractor's business fails, the producer may be an unsecured creditor of the contractor. The rights of unsecured creditors are discussed in another fact sheet in this series, *Rights of Unsecured Creditors*. Should the contractor's business completely fail, a producer who has acquired facilities or equipment in order to perform under a contract may lose any meaningful ability to generate sufficient income to pay for such facilities or equipment.

The best way for a producer to address the risk of nonpayment is to contract with financially responsible contractors. However, state or federal law may provide some relief, depending upon the nature of the contract and the commodity produced. For example, a producer who custom feeds livestock may be provided with a lien by Minnesota law. Generally, any person who keeps, feeds, pastures or otherwise cares for domestic animals is entitled to a lien on the animals for all charges associated with such care. This lien may have priority over the security interest of another party. A producer who delivers perishable fresh fruits and

vegetables, milk and cream, or poultry or poultry products may be protected, at least in part, by a bond which must be posted by dealers in wholesale produce. Finally, an agricultural producer may be entitled to a lien for the contract price or the fair market value of the commodities delivered to a buyer. However, such a lien is not available if federal law allows the buyer of such commodities to acquire them free of any such lien.

REGULATION OF PRODUCTION CONTRACTS

Production contracts are regulated by both the Federal government and by the State of Minnesota; to provide the producer some additional protections when entering into and operating under a marketing contract.

Federal Regulation

Until recently neither the Packers and Stockyards Act (PSA) nor the Perishable Agricultural Commodities Act (PACA), would generally affect the contractual relationship between a contractor and producer under a production contract except as may be available through the enforcement of the acts by the USDA. In 2008, Congress revised and expanded the PSA to incorporate protections already enacted by many Midwestern states (and as discussed below), including: (a) the right to discuss with certain individuals (regardless of any restrictions in the contract) the terms of a production contract, (b) the right of contract producers to cancel production contracts within three (3) business days of the production contract being executed, (c) the requirement that the production contract provides a written disclosure that the contractor may require additional capital investments of the producer during the term of the production contract, (d) that the venue for a contractual dispute shall be the federal judicial district in which the contract was performed and the choice of law shall be governed by the state in which the dispute arose (unless otherwise prohibited by the law of the state in which the contract was being performed), and (e) the right of the contract producer to reject an arbitration provision in the production contract. In addition, Congress has directed the USDA to set promulgate additional regulations to further advance the regulation of production contracts. These new provisions only relate to poultry and swine production contracts.

State Regulation

Recent federal laws overlap, to some extent, laws already enacted in the State of Minnesota. The Minnesota Agricultural Contracts Act contains several provisions designed to protect producers, including laws which require: (a) any contract for an agricultural commodity must contain a provision calling for either mediation or arbitration of any contract disputes; (b) when a producer is "required" to make a capital investment in buildings or equipment that cost $100,000 or more and have a useful life of five or more years, the contractor's ability to terminate or cancel the contract is restricted; (c) parent companies of subsidiaries licensed to purchase agricultural commodities are liable to a seller for any unpaid purchase price or any claim based upon a contract if the contractor fails to perform; and (d) all agricultural contracts must be in plain language, contain risk disclosures and provide for a right of rescission. A producer must be aware of the applicable state restrictions and limitations on the use of such contracts.

Minnesota has also enacted legislation directed specifically at purchasers of perishable fresh fruits and vegetables, milk and milk products and poultry and poultry products. Such purchasers must provide a bond to protect producers of such

commodities. Such a bond is required even if the "purchaser" is the owner of the commodity which is produced by another. Thus, a vegetable processor which obtains raw product through bailment contracts is subject to the bonding requirements of this law. However, any person claiming to be damaged by a breach of a contract must submit a claim to the Commissioner of Agriculture within 40 days after the due date in order to assert a claim against the bond. The purchasers of such products are also subject to civil and criminal penalties for violations of the law.

In addition to state regulation, the federal Packers and Stockyards Act (PASA) and Perishable Agricultural Commodities Act (PACA) may provide additional protection for producers. PACA, in particular, provides significant protection for unpaid producers. Under PACA, a buyer of commodities subject to the act (generally fresh fruits and vegetables) must hold all inventories, receivables or proceeds received from the sale of the perishable commodities in trust for the benefit of unpaid sellers (i.e., producers) until full payment is made.

CONCLUSION

The decision by a producer to enter into a production contract should be carefully considered. While such a contract may provide the producer with several advantages, the terms of the contract and the underlying economics of the contract should be carefully assessed. State and federal laws may provide limited protection to producers. However, the law does not provide complete protection.

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Agricultural Business Management

FARM LEGAL SERIES June 2015

Bankruptcy: Chapter 11 Reorganizations

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INTRODUCTION

Most people assume that bankruptcy means liquidating all of a debtor's nonexempt assets and distributing the proceeds among his creditors. However, the bankruptcy laws also provide for rehabilitating the debtor. Chapter 11 allows a debtor to enter into an agreement with creditors under which all or a part of the business continues. The debts of the business are restructured so as to allow the debtor to continue his business operation. Chapter 11 is more complex than Chapter 12 (which is the subject of another fact sheet in this series, *Bankruptcy: Chapter 12 Reorganizations*); however, it may provide an option for those farm operators whose businesses are too large for Chapter 12.

CHAPTER 11

Eligibility

If a farm debtor cannot qualify for Chapter 12, Chapter 11 provides similar reorganization possibilities. In general, any partnership, corporation or limited liability entity except a governmental unit may be a debtor in a Chapter 11 case.

Initiating a Chapter 11 Bankruptcy

To initiate a Chapter 11 case, a voluntary petition is filed with the court. A schedule of assets and liabilities and a statement of financial affairs also must be filed.

Debtor-in-Possession

The objective in a Chapter 11 case is to adjust and reorganize a debtor's obligations so as to allow the business to continue. In most cases, the debtor, known as the debtor in possession once the case has begun, remains in possession of his property, develops a plan, and generates funds to pay his debts. If there is evidence of mismanagement or fraud, a trustee may be appointed upon the request of creditors. The ability of the debtor to remain in possession and to continue to operate the business is a substantial reason to file a Chapter 11. The debtor can continue to raise and sell crops and livestock, use equipment, and acquire the necessary inputs to continue the farming operation. A committee of creditors will generally be appointed to oversee the farming operation under the supervision of the debtor in possession once the case has been initiated.

Use of Cash Collateral/Adequate Protection

Although the ultimate goal in any Chapter 11 is the formulation and acceptance of a reorganization plan, rarely does the debtor have a plan developed when the case is filed. There is thus often a period between the filing of the petition and confirmation of a plan during which business will be carried on by the debtor as the debtor in possession. As a debtor in possession, the debtor has all the rights of a bankruptcy trustee. He may generally continue to use assets in the ordinary course of business without court

approval. There are, however, certain restrictions applicable when he uses cash collateral. The debtor in possession cannot use, sell, or lease “cash collateral” unless each creditor with an interest in the collateral consents or unless the court authorizes such use. To obtain court permission to use cash collateral such as proceeds of stored grain, milk proceeds, or the proceeds of livestock sales, the debtor in possession must provide any creditor who holds a lien on such property with adequate protection. In other words, the creditor's secured position must be protected and not harmed by the use of the creditor's collateral.

Besides being able to continue to use the business assets, the debtor in possession is authorized to borrow funds. He may obtain unsecured credit in the ordinary course of business without court approval. And he may obtain secured credit by granting a lien on unencumbered property of the estate or a subordinate lien on encumbered property with court approval. Finally, if the debtor cannot obtain credit on either an unsecured basis or by using previously unencumbered assets, a super-priority lien may be obtained if he can establish that any lender who also has a lien on the property will be adequately protected.

In the case of a farming operation, it is possible to obtain secured credit by using crops that are planted after the filing of the petition as collateral. If the petition has been filed prior to the planting of crops, such crops are free of the lien of any prepetition creditors. In other words, the filing of a bankruptcy petition (including Chapter 7 or Chapter 12) cuts off the after-acquired property clause contained in any prepetition security agreement. However, this rule does not apply to proceeds, products, offspring, rents, or profits of prepetition property. Thus, if a lender has a security interest in livestock and offspring, the security interest will extend to offspring conceived and born after the filing of the case.

Sale of Assets

A farm debtor may sell any assets pior to or as part of the debtor’s confirmed Chapter 11 plan. The Bankruptcy Code allows a debtor to sell (and the buyer to acquire) any assets free and clear of any liens or other encumbrances. Any liens of the farm debtor’s creditors will be satisfied with the sale proceeds. If the sale proceeds are not enough to pay off all the liens on the sold property, the property may still be sold and the unpaid lien holder will be left with a general unsecured claim in the bankruptcy. If the sale proceeds are enough to pay off all of the liens on the sold property, the debtor may be able to use the surplus sale proceeds to fund the Chapter 11 plan.

Unsecured Creditors Committee

Immediately upon the filing of the Chapter 11 bankruptcy, the Office of the United States Trustee will send a notice to all creditors of the farm debtor to ask if anyone would like to serve on the creditors committee. If there are interested creditors, the United States Trustee decides to form a committee, and the Court approves the committee, the committee will be an active participant in the bankrutpcy proceeding; protecting the rights of all of the unsecured creditors of the debtor. The fees and expenses of the committee (including the legal fees of the committee) will be an administrative claim; paid by the farm debtor as part of the debtor’s Chapter 11 plan.

Small Business Election

In some circumstances the debtor may qualify as a “small business debtor.” The small business election expedites the bankruptcy case. If the election is properly made, no creditors’ committee may be appointed and only the debtor may file a

plan during the first 180 days of the bankruptcy case (rather than the 120 days allowed for in a traditional Chapter 11 case). This "exclusivity period" may be extended by the court. However, this can only be extended to 300 days if the debtor demonstrates by a preponderance of the evidence that the court will confirm a plan within a reasonable period of time. To qualify for the election, the debtor must be engaged in commercial or business activities (other than primarily owning or operating real property) with total non-contingent liquidated secured and unsecured debts of $2,190,000 or less. The debt limit amount increases every three years to reflect the consumer price index.

CHAPTER 11 PLAN OF REORGANIZATION

Under Chapter 11, only the debtor may submit a plan of reorganization within 120 days of the initiation of the bankruptcy case. Under a typical reorganization plan, the debtor attempts to restructure his debts. Such a plan will generally provide for the repayment of loans secured by real estate to be paid over an extended period of time. Intermediate term loans will be proposed to be paid over the remaining useful life of the collateral, which is typically five to ten years. The interest rate on any such loans may be adjusted under a plan, although it will generally be necessary for the debtor to pay interest at a “market rate” following confirmation of the plan. Most plans will propose that unsecured creditors be paid less than the full amount of their claims in full satisfaction of their claims.

Chapter 11 Plan

A Chapter 11 plan typically classifies claims against the debtor, specifies the treatment to be given each class of claim, and provides the means for carrying out the plan. The plan must be confirmed by the bankruptcy court. There are thus three steps involved in obtaining confirmation of a plan under Chapter 11:

1. The plan is developed by the debtor
2. Acceptance of the plan by creditors is sought by the debtor
3. The confirmation hearing is held and the plan is either confirmed or not confirmed

For a Chapter 11 plan to be confirmed, it must be accepted by at least one class of impaired claims. These are claims of creditors that will not, under the plan, be paid in full or whose legal rights are adjusted by the plan. In addition, the bankruptcy court must determine that the plan is feasible.

Cram-down

Under certain circumstances, the bankruptcy court may "cram-down" a plan over the objection of creditors. In order to confirm a Chapter 11 plan over the objection of a secured creditor, a holder of a secured claim must receive the entire value of the property securing the claim or the entire value of the claim, whichever is smaller. Unsecured creditors must either accept the Chapter 11 plan or the owners of the business must not receive any property under the plan on account of their prebankruptcy interest in the farming operation. Finally, a plan cannot be confirmed if the plan does not pay each claim holder as much as he would have received under a Chapter 7 liquidation unless those who receive less accept the plan.

Objections to Plan

Creditors may object to the confirmation of the debtor’s plan in a Chapter 11 case. Such objections will usually challenge whether the debtor has met the technical requirements of Chapter 11. However, creditors may also challenge the debtor’s valuation of their collateral and the feasibility of the debtor’s plan. As a result, it is usually necessary for

the debtor to obtain expert testimony concerning the current value of machinery, equipment, livestock, and crops. In addition, it will be necessary for the debtor to provide his creditors with detailed financial projections which will assist the bankruptcy court in determining that the business may be successfully restructured.

Competing Plans

As previously mentioned, only the debtor may submit a plan of reorganization within 120 days of the initiation of the bankruptcy case. Any interested party may file a plan thereafter. A plan, including a plan proposed by a creditor, may provide for the liquidation of some or all of the debtor's nonexempt assets. Such a liquidating plan may be proposed and approved by the court even in the case of a farmer.

Confirmation

Confirmation of a plan under Chapter 11 acts as a discharge of all debts, filed or not, excluding those specified as not dischargeable elsewhere in the bankruptcy code. Upon confirmation of a plan, the debtor receives back all his property free and clear of all liens and encumbrances unless such liens are preserved by the plan. Both the debtor and the creditors are bound by the terms of the confirmed plan.

POWERS OF THE DEBTOR IN POSSESSION

Besides continuing the business, like a trustee, the debtor in possession can avoid, or set aside, certain transactions that occurred prior to the filing of the bankruptcy case. These avoidance powers are complex, but a brief summary may be helpful.

Preferences

The debtor in possession can avoid or recover any transfers of property he made within 90 days before the filing of the bankruptcy petition to a creditor on account of a pre-existing debt if such a transfer allows the creditor to receive more than he is otherwise entitled to. Such transfers are called preferences under the Bankruptcy Code. In general, the philosophy of the law with respect to preferential transfers is to take away from creditors any transactions that might result in an improvement in their position on the eve of bankruptcy. This philosophy is in accord with the underlying policy of the Bankruptcy Code to foster equality of treatment among creditors.

The debtor in possession may avoid the granting of any security interest, conveyances of property, or payments that were made within 90 days of the filing date. This 90-day period may be extended to one year for transfers made to insiders. Exceptions to these preference rules are provided in cases of transfers made for new values payments for debts incurred in the ordinary course of business and the perfection of purchase money security interests within a time period required by the Uniform Commercial Code.

Not all transfers made by the debtor within 90 days of filing are avoidable, however. Transfers made for new value, payments for debts incurred in the ordinary course of business, and the perfection of purchase money security interests within the time period required by the Uniform Commercial Code (UCC) do not constitute preferential transfers.

Fraudulent Transfers

The debtor in possession also can avoid fraudulent transfers made within one year before the filing of the bankruptcy petition. Under the Bankruptcy Code, a fraudulent transfer is a transfer made with the intent to hinder, delay, or defraud a creditor. It also includes transfers for which the debtor received less than a reasonably equivalent value in exchange for the transfer.

Finally, the debtor in possession can avoid or set aside transfers that are not properly recorded or perfected under state law. These avoidance powers are potent tools that the debtor in possession can use to formulate and fund his or her plan.

Executory Contracts and Leases

The debtor in possession may assume or reject executory contracts and leases of the debtor. An executory contract is an agreement under which the obligations of both parties to the contract are unperformed. Common examples of such contracts in a farm setting include equipment leases and real property leases. Certain farm program contracts, such as Conservation Reserve Program contracts, are also executory contracts.

If the debtor in possession elects to assume an executory contract, he must either cure any defaults in the contract or provide the other party to the contract with adequate assurances that he will cure the defaults.

A contract for deed in which the debtor is the buyer has been determined by the courts not to constitute an executory contract under the Bankruptcy Code. Therefore, the debtor in possession does not need to determine whether to assume such contracts or cure all defaults under such contracts immediately.

CONCLUSION

Chapter 11 offers a second opportunity to reorganize and restructure the debtor's farming operation. When carefully considered and adopted, a Chapter 11 proceeding can provide meaningful relief for the financially distressed farmer. The rules of the Bankruptcy Code relating to the confirmation of a Chapter 11 plan are extremely complex. The legal issues presented by a contested confirmation are extremely technical. As a result, no business person should consider a Chapter 11 reorganization without competent and experienced legal and financial advice.

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FARM LEGAL SERIES June 2015

Bankruptcy: Chapter 12 Reorganization

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INTRODUCTION

Chapter 12 was added to the Bankruptcy Code in 1986 and subsequently amended in 2005. It is designed specifically for the reorganization of family farms. Chapter 12 is closely modeled after Chapter 13; however, Chapter 12 has higher debt limits intended to enable traditional family farms to be eligible for a reorganizational bankruptcy.

CHAPTER 12

Eligibility

Chapter 12 is only available to persons who meet the definition of "family farmer" set forth in the statute. A family farmer may either be an individual or a corporation or partnership.

Individual
There are several tests which must be met in order to qualify as a family farmer. According to this definition, the farmer's debts cannot exceed $3,544,525. Fifty percent of this index adjusted debt must arise from the farming operation. A farming operation includes "farming, tillage of the soil, dairy farming, ranching, production or raising of crops, poultry or livestock, and the production of poultry or livestock products in an unmanufactured state." For purposes of computing the debt ceiling, any debt on a homestead will not be included unless it was granted in connection with the farm operation. In addition to the debt ceiling, the statute also requires that the farmer debtors must have earned more than one half of their gross income from farming in the year prior to the filing of the Chapter 12 petition. The final requirement for eligibility is regular annual income. This income must be "sufficiently stable and regular to enable such family farmer to make payments" under a Chapter 12 plan.

Corporation or Partnership
A farm corporation or partnership will be eligible to file a Chapter 12 case if it meets four specific conditions. First, at least 50 percent of the stock or equity of the corporation or partnership must be held by one family, with that family conducting the farming operation. Second, more than 80 percent of the value the corporation or partnership's assets must be related to the farming operation. Third, the aggregate debts must not exceed $3,544,525 with not less than 50 percent of that arising from its farming operation. As with an individual, the $3,544,525 debt ceiling is automatically adjusted every three years to reflect any change in the Consumer Price Index.

Since its enactment, there has been a substantial amount of litigation concerning whether a person is eligible for Chapter 12. Generally, the debtor must be actively involved in farming operations in order to be eligible. If he merely rents out his farmland for cash rent, he will not likely be found to be engaged in farming.

Initiating a Chapter 12 Bankruptcy

To initiate a Chapter 12 case, a farm debtor must file a voluntary petition with the court. The debtor must also file a schedule of assets and liabilities and a statement of financial affairs. The farm debtor remains in possession of the farm assets and actions by creditors are automatically stayed. Within 90 days after filing the bankruptcy petition, the debtor must present a plan for repayment of debts to the Bankruptcy Court. A confirmation hearing to consider the plan will be scheduled soon after the filing of the plan. Chapter 12 specifically provides that, except for cause, confirmation hearings must conclude within 45 days after the filing of the plan.

Use of Cash Collateral/Adequate Protection

Between the filing of the Chapter 12 petition and the confirmation hearing on the debtor's plan, the debtor will carry on the farm operation in the ordinary course of business. However, just as in a Chapter 11 bankruptcy, the debtor may not use cash collateral, such as crop or livestock proceeds, without either court or creditor approval. To obtain such approval, the debtor must provide the creditor who holds a lien on such property with "adequate protection." This protection prevents the creditor from being harmed by the debtor's use of the collateral. Similarly, a creditor may also be entitled to "adequate protection" if the creditor can show that the collateral is declining in value during the case. For example, the holder of a security interest in the farmer's equipment may claim a right to this protection for the continued use of the equipment and its depreciation in value due to such use.

Chapter 12 lists ways in which the debtor can satisfy this adequate protection requirement. Making cash payments or granting a secured creditor a replacement lien are two such ways. For real estate, the statute specifically provides that "reasonable rent customary in the community" is sufficient. The issue of whether a crop share arrangement would be acceptable in lieu of cash rent is not addressed. However, if this type of lease is customary, such an arrangement should be satisfactory.

Appointment of Trustee

Although the Chapter 12 debtor is given broad authority to operate the farm business, Chapter 12 requires that a trustee be appointed. While the farmer remains in control of the property, the trustee maintains important functions. Under Chapter 12 he or she is directed to:

1. Receive and be accountable for property and payments turned over by the debtor
2. Object to the allowance of improper claims
3. Make recommendations regarding the discharge of the debtor
4. Provide information to interested parties
5. Investigate the financial affairs of the debtor for cause
6. Investigate the operation of the farm and analyze the feasibility of continuing the business
7. Participate in valuation and confirmation hearings
8. Insure that the debtor makes timely payments under the confirmed plan

Where fraud or gross mismanagement on the part of the debtor is shown, a creditor or the trustee may move to have the trustee placed in control of the farm. The Chapter 12 trustee is paid by the debtor. In addition to the plan payments, the debtor must pay a percentage of all plan payments to the

trustee. This payment must be made at the time of the plan payment.

CHAPTER 12 PLAN OF REORGANIZATION

The debtor is responsible for filing a plan for the fair repayment of debts and the reorganization of the farming operation. Unlike a Chapter 11 case, only the debtor is authorized to file a plan under Chapter 12. The plan may modify the terms of debt repayment of either secured or unsecured creditors. Moreover, the plan may provide for the curing or waiving of a default over a reasonable period of time. In addition, it may provide for the liquidation of farm collateral.

Beyond these powers, however, there are specific requirements which govern the acceptability of a Chapter 12 plan. Consistent with other chapters in the Bankruptcy Code, unsecured debts and secured debts are treated differently.

Unsecured Claim

With regard to unsecured debts, two alternatives are available. Either the plan must provide for total repayment of the unsecured debt, or the debtor must agree to contribute all of his disposable income to the payment of these debts. Such repayment can be extended over a three year period; however, if cause for a longer repayment period is shown, the court may extend the term of the plan for up to five years.

If the plan does not provide for full repayment of unsecured claims, the debtor must agree to contribute his or her entire disposable income to the payment of this debt during the term of the plan. However, the statute specifically defines “disposable income” to include only that income which remains after all farm and living expenses have been paid. Again, the term of the plan must run three years or less, unless the court approves an extension. In no event may a plan run longer than five years. Under either alternative, the plan must offer unsecured creditors at least as much as they would receive through a Chapter 7 liquidation.

Secured Claim

With regard to secured debts, there are also alternatives. For the debtor's plan to be confirmed, the secured creditors must either approve the plan and retain the lien securing the claim while payments are made or receive the collateral. If the debtor’s plan provides for the repayment of a secured debt, the creditor's security interest remains intact during the repayment period. The amount of the debt will generally be reduced to the present value of the secured property. Thus, the valuation of the collateral securing the secured debt is often a disputed issue.

The debtor's plan may provide for a repayment schedule which extends beyond the terms of the original secured debt. The plan itself is limited to five years, but there is an exception for specific long-term debt. Long-term debt may be paid over a period exceeding five years. Typically the repayment period is the economic life of the machinery and equipment and twenty years for real estate. During the repayment period the debtor will pay a market rate of interest on the debt.

Down-scaling the Farm Operation

Another issue regarding the sale of collateral before the confirmation hearing concerns the liquidation of farm assets. Because scaling down the farm operation may be a necessary element to a successful reorganization, Chapter 12 provides that a debtor can liquidate secured assets without the permission of the secured creditor before the confirmation hearing. However, the secured creditor must be given notice and provided a hearing on such a sale, and the proceeds must be remitted to the secured creditor.

Tax Considerations

Legislation creating Chapter 12 did not create a separate tax entity for Chapter 12 debtors. The debtor does not have the option of filing a short tax year federal return. This option is available under both under a Chapter 7 and Chapter 11 bankruptcy. Because of this, the tax options offered by Chapter 11 are not available for a Chapter 12 debtor.

In 2005, Congress amended Chapter 12 to provide debtors capital gain tax relief. Prior to 2005, a debtor in bankruptcy could sell real estate and machinery while in bankruptcy; however, any resulting capital gains from the sale of the property would be a priority claim by the government. Before 2005, the debtor would be required to pay this claim in full during the life of the plan. For a farming operation that had a very low basis in its real estate (and in some cases, its machinery), this often prevented the debtor from obtaining a discharge (or closing his or her Chapter 12 plan). When Congress amended Chapter 12 in 2005, many believed Congress intended to allow any resulting "capital gains" from the sale of assets to be treated as a general unsecured claim—a claim that does not have to be paid in full to obtain a bankruptcy discharge. However, the issue eventually went to the United States Supreme Court which held that any capital gains resulting from the sale of assets during the bankruptcy must be treated as a priority claim (and paid in full). Although the Supreme Court has not addressed, lower courts have held that the Supreme Court decision was limited to assets sold during the bankruptcy and that any capital gains resulting from assets sold before the bankruptcy is filed may be treated general unsecured claims. This remains a disputed area of law. For a discussion of these tax considerations, see another fact sheet in this series, *Tax Considerations in Liquidations and Reorganizations.*

Confirmation

Upon confirmation of the Chapter 12 plan, both the debtor and the creditors are bound by the terms of the confirmed plan. However, unlike a Chapter 11 bankruptcy, the confirmation of a Chapter 12 plan does not discharge all debts. As discussed below, the discharge occurs upon the completion of the plan payments. The confirmation only confirms the ongoing credit relationship between the parties during the life of the Chapter 12 plan.

POWERS OF THE DEBTOR

Avoidance Powers

Besides continuing the business, like a trustee, the debtor in possession can avoid, or set aside, certain transactions that occurred prior to the filing of the bankruptcy case. These avoidance powers are complex, but a brief summary may be helpful.

Preferences

The debtor in possession can avoid or recover any transfers of property he made within 90 days before the filing of the bankruptcy petition to a creditor on account of a pre-existing debt if such a transfer allows the creditor to receive more than he is otherwise entitled to. Such transfers are called preferences under the Bankruptcy Code. In general, the philosophy of the law with respect to preferential transfers is to take away from creditors any transactions that might result in an improvement in their position on the eve of bankruptcy. This philosophy is in accord with the underlying policy of the Bankruptcy Code to foster equality of treatment among creditors.

The debtor in possession may avoid the granting of any security interest, conveyances of property, or payments that were made within 90 days of the filing date. This 90-day period may be extended to one year for

transfers made to insiders. Exceptions to these preference rules are provided in cases of transfers made for new values payments for debts incurred in the ordinary course of business and the perfection of purchase money security interests within a time period required by the Uniform Commercial Code (UCC).

Not all transfers made by the debtor within 90 days of filing are avoidable, however. Transfers made for new value, payments for debts incurred in the ordinary course of business, and the perfection of purchase money security interests within the time period required by the UCC do not constitute preferential transfers.

Fraudulent Transfers

The debtor in possession also can avoid fraudulent transfers made within one year before the filing of the bankruptcy petition. Under the Bankruptcy Code, a fraudulent transfer is a transfer made with the intent to hinder, delay, or defraud a creditor. It also includes transfers for which the debtor received less than a reasonably equivalent value in exchange for the transfer.

Finally, the debtor in possession can avoid or set aside transfers that are not properly recorded or perfected under state law. These avoidance powers are potent tools that the debtor in possession can use to formulate and fund his or her plan.

Executory Contracts and Leases

The debtor in possession may assume or reject executory contracts and leases of the debtor. An executory contract is an agreement under which the obligations of both parties to the contract are unperformed. Common examples of such contracts in a farm setting include equipment leases and real property leases. Certain farm program contracts, such as Conservation Reserve Program contracts, are also executory contracts.

If the debtor in possession elects to assume an executory contract, he must either cure any defaults in the contract or provide the other party to the contract with adequate assurances that he will cure the defaults.

A contract for deed in which the debtor is the buyer has been determined by the courts not to constitute an executory contract under the Bankruptcy Code. Therefore, the debtor in possession does not need to determine whether to assume such contracts or to cure all defaults under such contracts immediately.

Conversion and Dismissal

Chapter 12 specifically provides that a debtor may voluntarily convert a Chapter 12 bankruptcy case to a Chapter 7 bankruptcy or dismiss the case at any time (including after the confirmation of the plan). Creditors, however, may not seek the involuntary conversion of a debtor's Chapter 12 bankruptcy to a Chapter 7 bankruptcy unless fraud is shown in connection with the case. While creditors may not seek to convert a Chapter 12 case to a Chapter 7 liquidation, they may seek the dismissal of the case. Chapter 12 provides that after notice and a hearing, the court may dismiss a case for cause, including:

1. Unreasonable delay or gross mismanagement
2. Nonpayment of fees and charges required
3. Failure to file a timely plan
4. Failure to commence making timely payments under a confirmed plan
5. Denial of confirmation of a plan and denial of a request for additional time for filing of another plan or modification

6. Material default by the debtor with respect to a term of a confirmed plan
7. Revocation of the order of confirmation and denial of confirmation of a modified plan
8. Termination of a confirmed plan by reason of the occurrence of a condition specified in the plan
9. Continuing loss to or diminution of the estate, absent a reasonable likelihood or rehabilitation
10. Fraud in connection with the case

Completion of Confirmed Plan/Discharge of Debts

After completing all payments under the plan, a Chapter 12 debtor will receive a discharge of all debts that have been provided for in the plan except for long-term debt that extends beyond the life of the plan. In most cases, this means that the unsecured debt will be discharged at the end of the three to five year plan term. Any secured debt which extends beyond the term of the plan will remain until the repayment has been completed. Chapter 12 also provides for a hardship discharge which may be granted despite the debtor's inability to complete a plan. Such a discharge is granted if the failure to complete the plan is due to circumstances for which the debtor "should not justly be held accountable." It can only be granted, however, if the unsecured creditors have received at least as much as they would have received through a Chapter 7 liquidation and if modification of the plan is not feasible.

CONCLUSION

Understanding the opportunities and limitations of Chapter 12 may also assist a family farmer with negotiating a voluntary debt restructuring agreement with his lenders. However, if such a voluntary restructuring is not possible, Chapter 12 may provide an alternative for restructuring the debt of a financially stressed family farming operation.

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UNIVERSITY OF MINNESOTA
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Agricultural Business Management

FARM LEGAL SERIES

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Bankruptcy: Chapter 7 Liquidations

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INTRODUCTION

A Chapter 7 bankruptcy is a liquidation proceeding. It is the most logical choice for a farmer who cannot continue to farm and must terminate his farming operation. However, it may not be the best option for a farmer who wishes to remain farming and avoid liquidation. In this situation, the farmer should consider filing a petition under Chapter 11 or Chapter 12 of the Bankruptcy Code. *See Bankruptcy: Chapter 11 Reorganizations*; *Bankruptcy: Chapter 12 Reorganizations*.

Under Chapter 7, a trustee is appointed to liquidate all nonexempt assets and distribute the proceeds to creditors. Exempt and nonexempt assets are discussed in more detail below. Secured creditors will receive either the value of their collateral or the collateral itself. The proceeds of the debtor's nonexempt assets will be used to satisfy claims according to the priorities established by the Bankruptcy Code. The farm debtor will be able to retain the property claimed exempt, although it may yet be subject to prebankruptcy liens.

In some cases an individual or a business may be forced into an involuntary bankruptcy. As discussed in another fact sheet in this series, *Bankruptcy: The Last Resort*, farmers may not be forced into involuntary bankruptcy. Thus, for farmers, a Chapter 7 proceeding is purely voluntary. Such a proceeding begins when the debtor files with the clerk of bankruptcy court a voluntary Chapter 7 petition.

CHAPTER 7

Eligibility of the Individual

Not all debtors are eligible for Chapter 7 protection. To qualify for relief under Chapter 7, the debtor must be an individual, partnership, corporation, or other business entity. An individual debtor's eligibility for Chapter 7 protection is subject to the "means test." The means test prohibits certain high income or high asset debtors from filing for Chapter 7 protection. The means test applies when the debtor's current monthly income is more than the state median income. If the debtor's current monthly income is more than the state median income then, to be eligible for Chapter 7, the debtor's disposable income is examined. If the total disposable income is less than $6,000 for the next five years, the individual is generally eligible for Chapter 7. If the total disposable income more than $10,000 for the next five years, the individual is probably not eligible for Chapter 7. If the disposable income is between $6,000 and $10,000 for the next five years, then the nonpriority unsecured debt of the individual is examined and if the disposable income less than 25 percent of the debtor's nonpriority unsecured debt, the individual may be eligible for Chapter 7.

However, if the debtor can show special circumstances that justify additional expenses or adjustments of current monthly income, the individual will still be able to file under Chapter 7. If not, the case may be converted to a Chapter 11, 12, or 13 proceeding or will be dismissed.

In addition, an individual cannot file under Chapter 7 or any other chapter if a prior bankruptcy petition was dismissed due to the debtor's willful failure to appear before the court or comply with orders of the court, or if the debtor voluntarily dismissed the previous case after creditors sought relief from the bankruptcy court to recover property upon which they hold liens within the preceding 180 days.

With the exception of emergency situations, an individual debtor must also, within 180 days before filing, receive credit counseling from an approved credit counseling agency. If a debt management plan is developed during the credit counseling, it must be filed with the court. This applies to individual debtors who have primarily consumer debts, as well as those individual debtors with primarily business debts.

The Trustee

Once a Chapter 7 petition has been filed, an impartial trustee is appointed to wind up the business affairs of the debtor. This trustee generally will be an attorney or someone who is familiar with the bankruptcy laws and the courts. The trustee will conduct a meeting of creditors, usually within 40 days after the filing date. The debtor must appear at this meeting and must submit to an examination under oath by both the trustee and interested creditors. The examination generally is limited to questions concerning the extent and whereabouts of the debtor's assets. However, the trustee will ask questions that ensure the debtor is aware of the potential consequences of bankruptcy, including the effect on his credit history, ability to file a petition under a different chapter, the effect of receiving a discharge, and the effect of reaffirming a debt.

The Bankruptcy Estate

The initiation of a case under the Bankruptcy Code creates a bankruptcy estate. The trustee is charged with liquidating all property of the estate. The bankruptcy estate consists of all legal or equitable interests of the debtor in property as of the filing date. Thus, all real property, crops, livestock, machinery and equipment, interests in cooperatives, farm program entitlements, contract rights, and leases will be included in the bankruptcy estate. Besides property owned when the case is initiated, the property of the estate includes property recovered by the trustee from creditors or other third parties and property that the debtor becomes entitled to acquire within 180 days of the filing of the bankruptcy petition by inheritance, divorce decree, property settlement, life insurance policy, or death benefit plan. The bankruptcy estate does not include exempt property (as described below).

The estate also includes income from other assets that are the property of the estate. However, a debtor's earnings from personal services performed after the filing of a Chapter 7 petition, but before the termination of the case, are not included in the estate. Thus, income from a debtor's off-farm employment may not be looked to by his creditors once the bankruptcy petition has been filed.

TREATMENT OF CLAIMS

Generally all creditors claim will either be secured or unsecured claims. A secured claim is a claim of a creditor that is secured by a lien in some property of the farm

debtor. An unsecured claim is a claim of a creditor that is not secured by a lien. For example, the debtor may have bought a tractor on credit from John Deere. The obligation owed to John Deere is a claim, and the claim of John Deere is secured by the tractor. John Deere would have a secured claim in the bankruptcy. Alternatively, the farm debtor may have owed the local cooperative for diesel fuel. If the cooperative did not file a lien, the claim of the cooperative is an unsecured claim (since the cooperative would not have a lien on the diesel fuel already used by the debtor).

Treatment of Secured Creditors

A farm debtor may have as many as four options to deal with the secured claim. The debtor may be able to either: (1) redeem, (2) surrender the collateral back to the secured creditor, (3) reaffirm on a secured claim, or (4) retain the collateral and pay the creditor in accordance with the credit agreement.

1. Redeem. To redeem, the debtor must pay the secured creditor in full. In most cases, this is an unlikely scenario.
2. Surrender the Collateral. The debtor may surrender the collateral back to the secured creditor. The creditor may then sell the collateral and any remaining deficiency would be a general unsecured claim in the bankruptcy.
3. Reaffirmation. The debtor may elect to reaffirm the debt or agree to be held under the terms of the original credit agreement in consideration of the debtor being able to retain the collateral. The debtor will remain personally obligated to pay the secured creditor the full amount of its claim (over the repayment terms of the original credit agreement). If the farm debtor has any "equity" in the collateral, this may be a wise decision. However, if the debtor owes more on the collateral than it is worth (or it is not essential to the farming operation), the debtor may not want to reaffirm and elect another option.
4. Retain and Pay. Prior to the amendment of the Bankruptcy Code in 2005, the farm debtor could elect to retain the collateral and pay the secured creditor in accordance with the credit agreement. However, after the 2005 amendments, the availability of this election is contested. In Minnesota, it remains unresolved whether a debtor can "retain and pay" a secured creditor. This election has a significant benefit. Unlike a reaffirmation where the debtor agrees to be held under the terms of the original credit agreement, under a "retain and pay" election the debtor can continue to pay for the collateral, but if the debtor later decides to surrender the collateral (at anytime), the secured creditor does not have the right to assert a deficiency claim against the borrower.

Treatment of Unsecured Creditors

A farm debtor may discharge, or get rid of, any unsecured claims in his/her bankruptcy. To the extent the Trustee as recovered any non-exempt assets, the unsecured creditor would be entitled to share in the disbursement (as discussed below). The unsecured creditor can not come back after the bankruptcy discharge and try to collect any debt. That being said, a farm debtor may elect to voluntarily repay any creditor.

POWERS OF THE TRUSTEE

Under the Bankruptcy Code, the trustee is granted a number of significant powers that enable him to deal with the debtor's property, debts, and creditors.

General Powers

The trustee may use, sell, or lease property in the debtor's estate in the ordinary course of business. In addition, the bankruptcy court may authorize the trustee to operate the debtor's business for a limited period if continued operation is in the best interests of the estate and the creditors. For example, if the farm debtor is in the hog business and the estate consists of hogs of varying sizes, the trustee may be authorized to feed the hogs until they attain market weight so as to maximize the amount recovered by the estate. However, if the livestock owned by a farm debtor is subject to a valid, perfected security interest, the trustee will not, in most cases, undertake the continued care and feeding of the livestock. Rather, he will likely abandon the property so as to limit the estate's continued responsibility.

Avoidance Powers

The trustee may avoid, or set aside, certain of the debtor's transactions that were entered into prior to the filing of the bankruptcy case. The laws governing these avoidance powers are complex, but some general comments may be helpful.

Preferences

The trustee may avoid or recover any transfers of property made by the debtor within 90 days before filing the bankruptcy petition to a creditor to repay a pre-existing debt if such a transfer allows the creditor to receive more than he otherwise would be entitled to. Such transfers are called "preferences" under the Bankruptcy Code. In general, the philosophy of the law with respect to preferential transfers is to take away from creditors any transactions that might result in an improvement in their position on the eve of bankruptcy. This philosophy is in accord with the underlying policy of the Bankruptcy Code to foster equality of treatment among creditors.

For purposes of these provisions, a transfer includes transferring ownership or possession of property or granting a security interest in property. This avoidance power can be used by the trustee to set aside any 11th hour security interests that were obtained by zealous unsecured creditors. The 90-day period may be extended to one year for transfers made to insiders of the debtor.

Not all transfers made by the debtor within 90 days of filing are avoidable, however. Transfers made for new value, payments for debts incurred in the ordinary course of business, and the perfection of purchase money security interests within the time period required by the Uniform Commercial Code (UCC) do not constitute preferential transfers.

Fraudulent: Transfers

The bankruptcy trustee also may avoid or recover fraudulent transfers made within one year before the filing. Under the Bankruptcy Code, a fraudulent transfer is a transfer that was made with the intent to hinder, delay, or defraud a creditor. It also includes transfers for which the debtor received less than a reasonably equivalent value in exchange for the transfer. Thus, gifts, assignments, or other transfers made to relatives to shelter certain assets from the claims of creditors in bankruptcy may be avoided by the trustee.

Executory Contracts and Leases

The trustee may assume or reject executory contracts and leases of the debtor. An

executory contract is an agreement under which the obligations of both parties to the contract are unperformed. Common examples of such contracts in a farm setting include equipment leases and real property leases. Certain farm program contracts, such as Conservation Reserve Program contracts, are also executory contracts.

If the trustee elects to assume an executory contract, he must either cure any defaults in the contract or provide the other party to the contract with adequate assurances that he will cure the defaults. In a Chapter 7 case, the trustee has 60 days from the filing of the bankruptcy petition to make a determination as to whether such contracts or leases should be assumed. A contract for deed in which the debtor is the buyer has been determined by the courts not to constitute an executory contract under the Bankruptcy Code. Therefore, the trustee need not determine whether to assume such contracts or cure all defaults under such contracts immediately.

Unperfected Liens

The trustee also can avoid or set aside transfers that are not properly recorded or perfected under state law. If, for example, a creditor has failed to perfect a security interest under the UCC, the creditor's lien may be avoided by the bankruptcy trustee in its entirety. In addition, a trustee may avoid certain statutory liens or liens created by operation of law. Among these liens is any statutory lien for rent. As a result, any landlord who is relying upon statutory lien for rent will find that his lien can be avoided by a bankruptcy trustee.

EXEMPT PROPERTY

Exempt property includes both real and personal property of a debtor that cannot be seized or sold to satisfy the claims of creditors. Such exemptions are available only to individual debtors and not to partnerships or corporations. Such exemptions generally are intended to provide individuals with the minimal essentials for starting anew following bankruptcy.

In Minnesota, an individual debtor can select either exemptions that are provided by the Bankruptcy Code or exemptions that are provided by state law, whichever is most advantageous. As a result, it is important in the case of a Chapter 7 bankruptcy for the debtor to carefully review both the bankruptcy exemptions and the Minnesota exemptions to determine the correct course of action. The exemptions are listed in tables 1 and 2.

The value of the exemptions is determined by the fair market value of the various assets. If otherwise exempt property is subject to a lien, the debtor may claim as exempt the value of the property in excess of the lien amount (the "equity" in the property). In the case of a joint petition filed by a married couple, both spouses must claim the same exemptions, but the value limitations may be doubled. It is not, therefore, permissible for the husband to elect the Bankruptcy Code exemptions and the wife to elect the Minnesota exemptions.

If property is claimed by the debtor as exempt, it generally will remain subject to any voluntary liens that the debtor has granted. The Bankruptcy Code, however, grants the debtor the power to avoid or cancel certain consensual security interests that otherwise would attach to certain types of personal property including implements, tools of the trade, household goods, furnishings, and personal effects. It is thus possible to set aside a security interest in such items under the Bankruptcy Code, subject to the value limitations. Although some courts have held to the contrary, in Minnesota it has been held that this lien

avoidance power can be applied to farm machinery.

If it appears that a bankruptcy may be required, Minnesota courts have held that it is perfectly proper and legal to plan for such an event. It may even possible to convert nonexempt assets into exempt property before filing a bankruptcy petition. However, such bankruptcy planning is potentially dangerous and should be undertaken only with careful consideration of the ramifications of any such transactions.

Once the debtor in a bankruptcy case selects his exemptions, the trustee and creditors are given a period of time within which to object to such exemptions. If no one objects, the exemptions will stand.

DISTRIBUTION PRIORITIES

Once the trustee has collected all nonexempt assets and liquidated them, the estate is ready to be closed. Generally, property subject to a valid lien, and in which the debtor has no equity, is used to satisfy the lien. In the event such a creditor has a deficiency, he may file a claim as an unsecured creditor with the bankruptcy court.

The Bankruptcy Code establishes a detailed priority system for payment of claims. Priorities are:

1. Unsecured claim for domestic support obligations
2. Expenses of the administration of the bankruptcy case, including costs and expenses of preserving the estate taxes incurred by the estate, trustee's fees, and attorney's fees for the trustee
3. Claims arising in the ordinary course of the debtor's business or financial affairs during the "gap period" between the filing of an involuntary petition and an order for relief
4. Unsecured claims for wages, salaries, and commissions up to $10,950 per creditor
5. Unsecured claims for contributions to employee benefit plans up to $10,950 per employee, less any amount paid to an employee for wages, salaries, or commissions
6. In the case of a grain elevator bankruptcy, unsecured claims of farmers against the elevator for grain up to $5,400 for each creditor
7. Up to $2,425 per claim on unsecured claims for money deposited with the debtor for purchase or lease of property or for services contemplated for the personal, household, or family use of the debtor that were not provided
8. Unsecured claims of governmental units for taxes and penalties.
9. Claims for death or personal injury resulting from the operation of a motor vehicle or vessel if such operation was unlawful because the debtor was intoxicated from using alcohol, a drug, or another substance

After these priority claims, the next parties in line are general unsecured creditors who filed claims in a timely fashion or who were excused for late filing. Next in line are those creditors whose claim is for a fine, penalty, or damages that are not compensation for direct monetary losses suffered by the claim holder. If property remains after these claimants, all unsecured creditors receive interest at the legal rate from the date the bankruptcy petition was filed. Any funds or property remaining after the payment of interest is paid to the debtor. If the debtor's

assets are insufficient to pay in full all of the claims within a particular classification, all creditors share on a pro-rata basis.

Because there may be numerous disputes between the debtor and creditors or among creditors, complete administration of the estate may take several months. In the absence of any disputes directly involving the debtor, the debtor's involvement with the administration of the case usually will be completed within 120 days from the date the petition was filed. By that time, the debtor will have received a discharge from all liabilities listed on the bankruptcy petition. The discharge does not, however, release any property that the debtor retains from any lien that may have been granted by him prior to filing bankruptcy. Only those liens that may be avoided will be extinguished by the bankruptcy court. All other liens remain intact following bankruptcy.

CONCLUSION

Chapter 7 bankruptcy is designed for farmers who have decided to stop farming. Once a Chapter 7 bankruptcy petition has been filed the debtor cannot continue to operate his business. All his nonexempt property passes to the trustee upon filing of the bankruptcy petition which the trustee collects and uses it to pay unsecured creditors. The debtor will keep the exempt assets. The debtor will receive a discharge order from the Bankruptcy Court discharging all debt owed to creditors except for debt secured by property kept by the debtor.

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Table 1: MINNESOTA EXEMPTIONS[1].	
ITEMS	**EXEMPTION AMOUNT**
(1) Homestead; rents and proceeds of Homestead	Less than 160 acres; $390,000 limit if non-ag or $975,000 limit for ag. whether claimed by one or more debtors
(2) Family bible, library, musical instruments	Unlimited
(3) Church pew and burial lot	Unlimited
(4) (a) Wearing apparel, one (1) watch, utensils, foodstuffs	$10,350
(b) Household furniture, household appliance, phonographs, radio, and television	$10,350
(c) Wedding rings or other religious or culturally recognized symbols of marriage exchanged between the debtor and spouse at the time of the marriage	$2,817.50
(5) Farm machines and implements used in farming by a debtor engaged principally in farming, livestock, farm produce, standing crops, tools, implements (total of (5) and (6) cannot exceed $13,000)	$13,000
(6) Tools, implements, machines, instruments, office furniture, stock in trade (total of (5) and (6) cannot exceed $13,000).	$11,500
(7) Library and tools of students	Unlimited
(8) All money arising from any claim on account of destruction or damage to exempt property	Unlimited
(9) Life insurance proceeds	$46,000 plus $11,500 for each dependent
(10) Police Relief Association, Firemen's Association, or Fraternal Benefit Association Benefits	Unlimited
(11) Manufactured home actually occupied as home	Unlimited
(12) Motor vehicle	$4,600
(13) Vehicle modified for disability	$46,000
(14) 75 percent wages	Unlimited
(15) Public assistance benefits	Unlimited
(16) Earnings of a minor child or proceeds by reason of any liability of debtor not for the special benefit of child	Unlimited
(17) Claim for damages recoverable by any person by reason of levy upon or sale under execution of exempt property	Unlimited

1 In a joint case, these exemptions, other than the homestead exemptions, are available to each spouse. Certain values are adjusted on a biennial basis. The above exemptions are as of July 1, 2014. Certain exemptions will be adjusted again on July 1, 2016.

Table 1 Continued: MINNESOTA EXEMPTIONS.	
ITEMS	**EXEMPTION AMOUNT**
(18) Personal injury or wrongful death claim (General Damages)	Unlimited
(19) Loan value, accrued interest on dividends in life insurance policy	$9,200
(20) Stock bonus, pension, profit sharing benefits, annuity, IRA, employee pension or contract on account of illness, disability, death, age or length of service reasonably necessary for the support of debtor	$69,000
(21) Veteran's benefits	Unlimited
(22) Disability benefits	Unlimited
(23) Public employee and teachers pension benefits	Unlimited
(24) Unemployment benefits	Unlimited
(25) Workers' Compensation benefits	Unlimited
(26) Money arising from the destruction of exempt property	Unlimited

Table 2: FEDERAL BANKRUPTCY CODE EXEMPTIONS[2].
11 U.S.C. Section 522(d)

ITEMS	EXEMPTION AMOUNT
Homestead Real or personal property the Debtor uses as a residence; or a burial plat for the Debtor	$22,975
Motor vehicle	$3,675
Household furnishings, household goods, wearing apparel, appliances, books, animals, crops or musical instruments held for personal, family, or household use.	$12,250 total and no more than $575 in any single item
Jewelry held for personal, family, or household use	$1,550
Any property—wild card.	$1,225, plus up to $11,500 of any unused portion of the homestead exemption
Implements, professional books, or tools of the trade	$2,300
Unmatured life insurance contract	Unlimited
Loan value, accrued dividends, or interest in life insurance policy	$12,250
Professional prescribed health aids	Unlimited
Social Security, unemployment, public assistance	Unlimited
Veteran's benefit	Unlimited
Disability, illness, or unemployment benefits	Unlimited
Alimony, support or separate maintenance to the extent reasonably necessary for the support of the Debtor and dependents	Unlimited
Pension, profit-sharing, stock bonus, annuity benefits necessary for support of Debtor and dependents	Unlimited
Crime victim's reparations	Unlimited
Wrongful death claims	Unlimited
Life insurance proceeds necessary for support	Unlimited
Personal injury claims (not including pain and suffering or compensation for actual monetary losses)	$22,975
A payment in compensation of loss of future earnings of the Debtor necessary for support	Unlimited
Certain retirement funds	Unlimited

2 In a joint case, these exemptions, other than the homestead exemptions, are available to each spouse. Certain values are adjusted every three years. The above exemptions are as of April 1, 2013. Certain exemptions will be adjusted again on April 1, 2016.

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Agricultural Business Management

FARM LEGAL SERIES June 2015

Bankruptcy: The Last Resort

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INTRODUCTION

When a farm operator, or any other business person, is unable to continue to service all of his indebtedness he may face substantial pressure from creditors. This pressure eventually may take the form of legal action. One way a farmer can respond to the pressure of creditors is to seek the protection of the Bankruptcy Code. Farmers should understand bankruptcy procedures, their rights as a debtor and the rights of their creditors during bankruptcy. In addition, a farmer should be aware of and understand both the effect of bankruptcy and the different alternatives to bankruptcy. In the end, bankruptcy should always be considered a last resort.

EFFECT OF BANKRUPTCY

Choosing to seek the protection of the Bankruptcy Code is a serious decision. While the Bankruptcy Code may help alleviate your debt, the choice does not come without consequences.

First of all, bankruptcy petitions are public information and may be published in local newspapers. Many people feel uncomfortable with their private financial difficulties being exposed to the general public. Filing bankruptcy will also be reported to most major credit bureaus.

Second, you and your financial affairs will be subject to scrutiny by your creditors and the Bankruptcy Court. Many financial decisions will require the approval of the Court.

Finally, particularly when filing for protection under Chapter 7, the farmer may have to bear the loss of many of his assets. In this case, it will be increasingly difficult to continue farming or return to farming in the future.

ALTERNATIVES TO BANKRUPTCY

Because bankruptcy should be only be considered as a last resort, a farmer should first look the alternatives available to debtors that don't result in a bankruptcy petition.

Voluntary workouts

Many farmers prefer to negotiate an arrangement with creditors to restructure their debts or to repay them on terms different from what is specified in their various loan agreements. This type of informal workout may permit a farmer to continue operating his farm while insuring that his creditors are paid. Such agreements are perhaps most common in situations in which the debtor's financial distress is temporary.

A workout may involve reamortizing existing indebtedness over a longer period of time; temporary arrangements to defer payment of principal; or the reduction of the interest rate charged by a creditor. In addition, such arrangements may require the borrower to provide a lender additional collateral to

secure the loan or otherwise provide the lender with additional credit enhancements.

Workout arrangements, however, rarely resolve a current financial situation in a manner that is satisfactory to all parties. For one thing, such arrangements are voluntary. All creditors must agree to participate; the farm debtor can do nothing to force participation. If only some creditors agree to cooperate with the borrower, the likelihood that any workout arrangement will ultimately be successful is limited. There is no court supervision of such arrangements, and there is no discharge of indebtedness given to the debtor. Unless the debtor can get releases from his creditors as a part of a workout arrangement, they could attempt to collect any unsatisfied portion of their claims at a later time.

Debt/Credit Counseling Services

If the farmer is not comfortable negotiating with his creditors personally, he may also seek outside help through debt or credit counseling services. These services are generally nonprofit organizations that work on the debtors behalf to reduce interest rates and/or the amount of outstanding debt. These services can include, for example, the creation of debt management plans and education on money management. Credit counseling is now required for individual debtors filing for protection under Chapter 7.

BANKRUPTCY OPTIONS

If some type of workout cannot be negotiated, bankruptcy may be the only alternative. Although bankruptcy usually is viewed as "throwing in the towel," the Bankruptcy Code actually offers some choices. Under the Bankruptcy Reform Act of 1978, there are several types of bankruptcy protection available, which either involve rearranging the debtor's financial affairs to allow him to continue operating his business or the liquidation of the debtor's asset. This fact sheet examines the general features of bankruptcy. Separate fact sheets describe in detail the operation and effects of the various alternatives.

Chapter 7 Bankruptcy

Under Chapter 7 proceedings, the debtor's property is collected by a trustee and distributed to creditors according to priorities established in the Bankruptcy Code. Chapter 7 bankruptcy is a liquidation, or straight bankruptcy. Chapter 7 bankruptcy proceedings are described in detail in the fact sheet, *Bankruptcy: Chapter 7 Liquidations*.

Chapter 11 Bankruptcy

Under Chapter 11, a farmer can attempt to reorganize his business operation as an alternative to liquidation. He may continue operating his farm and propose a plan under which all or part of the farming operation continues and his business debts are repaid. Chapter 11 bankruptcy proceedings are described in detail in the fact sheet, *Bankruptcy: Chapter 11 Reorganizations*.

Chapter 12 Bankruptcy

Chapter 12 bankruptcy is a streamlined reorganization alternative for farmers. This is similar to a Chapter 13 Bankruptcy which allows reorganization of debts for an individual with a regular income. Chapter 12 allows for adjustment of the debts of a family farmer with regular annual income. Chapter 12 proceedings are discussed in detail in the fact sheet *Bankruptcy: Chapter 12 Reorganizations*.

SPECIAL TREATMENT OF FARMERS

In general, a debtor's creditors may petition to have him put into bankruptcy. At least three creditors must join in the petition if the debtor has 12 or more creditors. Such involuntary proceedings are available only

for Chapter 7 liquidations and Chapter 11 reorganizations. Involuntary proceedings may not be initiated under Chapter 12. Because of the uncertainties involved in farming operations, farmers are exempt from such involuntary bankruptcy. Farmers also are exempt from the involuntary conversion of a Chapter 11 case to a Chapter 7 case or from a Chapter 12 case to a Chapter 7 or a Chapter 11.

While a farmer is not subject to an involuntary bankruptcy proceeding, should a farmer undertake a voluntary bankruptcy proceeding under Chapter 11 and then prove unable or unwilling to file a plan of reorganization, a creditor may propose a liquidation plan with the same results as a Chapter 7 liquidation.

The Bankruptcy Code defines a "farmer" to be a person who, during the tax year immediately preceding the year in which the bankruptcy petition is filed, received more than 80 percent of his gross income from a farming operation. A farming operation is defined very broadly under the Bankruptcy Code and includes farming, tillage of the soil, dairy farming, ranching, production or raising of crops, poultry, or livestock. It is not necessary for the debtor to be involved in farming at the time he files a bankruptcy petition. It has been held that an individual who has sold his farm and is not currently involved in farming is, nonetheless, a farmer under the Bankruptcy Code so long as they meet the income test noted above. Unfortunately, not all individuals who consider themselves farmers are entitled to this special protection. A farmer who depends on off-farm income may not be considered a farmer if more than 20 percent of his gross income comes from such off-farm activities.

A family farmer under the Bankruptcy Code is an individual (and spouse, if a joint petition is filed) engaged in farming operations whose (i) total debts do not exceed $4,031,575; (ii) not less than 50 percent of his debts arise out of a farming operation and (iii) during the tax year immediately preceding the year in which the bankruptcy petition was filed, received more than 50 percent of his gross income from a farming operation. Additionally, family farmers include a corporation or partnership in which more than 50 percent of the outstanding stock or equity is held by one family and their relatives, the family or relatives conduct the farming operation, and (i) more than 80 percent of the value of its assets consists of assets related to the farming operation; (ii) its total debts do not exceed $4,031,575 and not less than 50 percent of its debts arise out of the farming operation; and (iii) if such corporation issues stock, the stock is not publicly traded. The $4,031,575 debt ceiling for both individuals and corporations is automatically adjusted every three years to reflect any change in the Consumer Price Index. Only family farmers are eligible for Chapter 12 protection.

AUTOMATIC STAY

Several provisions of the Bankruptcy Code operate to protect the debtor, to give him some breathing space from his creditors. The initiation of any Chapter 7, 11, 12 or 13 case operates as a court order to halt, at least temporarily, a wide range of conduct for collecting a claim or debt against the debtor. In other words, the filing of any bankruptcy petition stops all collection efforts, all harassment, and all foreclosure actions. This automatic stay is one of the fundamental debtor protections provided by our bankruptcy laws. It permits the debtor to attempt a repayment or reorganization plan in the case of a Chapter 11, Chapter 12 or Chapter 13, and it relieves him of the financial pressures that drove him into bankruptcy. The automatic stay is broad in

scope. It is intended to prohibit creditors from taking any action against the debtor that disorganizes his efforts to deal with his financial problems or that interferes with his attempt to reorganize his business operation.

Although the provisions of the automatic stay law are broad, they are not absolute. The automatic stay does not suspend the clock. For example, the automatic stay does not stop the running of a redemption period following a mortgage foreclosure sale or the running of the time period under Minnesota law to reinstate a contract for deed. In addition, creditors may seek court approval to obtain relief from the stay in certain cases. So the automatic stay is by no means permanent. Creditors may, in some instances, be able to obtain court approval to continue or initiate collection proceedings against the debtor.

PROPERTY OF THE BANKRUPTCY ESTATE

When a case under the Bankruptcy Code is begun, a bankruptcy estate is created. The bankruptcy estate consists of all legal or equitable interests of the debtor in property as of the filing date. Thus, all real property, crops, livestock, machinery and equipment, interests in cooperatives, farm program entitlements, contract rights, and leases will be included in the bankruptcy estate. Besides property owned when the case is initiated, the property of the estate includes property recovered by the trustee from creditors or other third parties and property that the debtor becomes entitled to acquire within 180 days of the filing of the bankruptcy petition by inheritance, divorce decree, property settlement, life insurance policy, or death benefit plan. Finally, the estate includes income or profits from other assets that are the property of the estate. Significantly, however, an individual debtor's earnings from services performed after the filing but before the termination of the case are not included in the estate. (This is not the case when a Chapter 12 petition has been filed.) Thus, in a Chapter 7 or Chapter 11 case, income from a debtor's off-farm employment may not be looked to by his creditors once the bankruptcy petition has been filed.

DISCHARGE OF DEBTS

One of the most important features of bankruptcy, regardless of which alternative is chosen, is the opportunity for discharging debts. In general, debts that arose prior to the filing of the bankruptcy petition are dischargeable in bankruptcy. But not all debtors are entitled to a discharge and not all debts are dischargeable. As a general rule, only individuals are entitled to a discharge. Partnerships and corporations may not obtain a discharge in bankruptcy.

Under the Bankruptcy Code, certain debts are not dischargeable. Obligations such as alimony, child support, claims based upon fraud, student loans obtained through a government program, certain taxes, and fines or penalties are not eligible for discharge. Creditors must object to the dischargeability of a particular debt within a time period established by the bankruptcy rules. If they fail to do so, all of the debtor's debts eligible for discharge will be discharged upon the termination of the bankruptcy case. In addition, the conduct of the debtor prior to the filing of the bankruptcy petition may prohibit the discharge of all debts. If, for example, a debtor engaged in fraudulent transactions; concealed, destroyed, or falsified records; or failed to explain the loss of property, his debts might not be discharged. A creditor or the trustee may challenge the debtor’s entitlement to a discharge on such grounds. Moreover, in the case of an individual discharge, the court may deny the discharge if the individual

failed to complete an approved instructional course concerning financial management.

A discharge cannot be obtained if the debtor received a discharge under a Chapter 7 or Chapter 11 case initiated within six years before the filing of the petition in the current bankruptcy case. An earlier discharge under Chapter 12 does not bar a discharge under Chapter 7 within six years if the debtor paid all the unsecured claims in the earlier case or if the debtor paid 70 percent of the unsecured claims and if the plan was proposed in good faith and was the debtor's best effort.

CONCLUSION

Filing any bankruptcy petition should be undertaken only after you have carefully reviewed with your attorney all the other alternatives. If bankruptcy is the only course of action available to you, consider your options carefully. Regardless of which type of bankruptcy protection you seek, you will receive the protection of the automatic stay and you generally will be eligible for the discharge of many of your obligations. Bankruptcy will thus enable you to get a fresh start or will relieve you of many of your financial burdens.

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UNIVERSITY OF MINNESOTA
EXTENSION

Agricultural Business Management

FARM LEGAL SERIES

June 2015

Choosing the Right Business Entity

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INTRODUCTION

There are many types of business entities to choose from through which one or more individuals can conduct a farming operation. There are also numerous factors to consider in determining what type of entity to select. Note that there is no "one-size fits all" or "best choice" of business entity for farming operations. The purpose of this fact sheet is to introduce the most common business entities used to conduct farming operations and present various factors that should be considered when choosing which entity will work best to achieve your goals.

Some of the most common types of business entities used in farming operations include:

- Sole Proprietorships
- Partnerships (general partnerships, limited liability partnerships, family limited partnerships)
- Corporations (C Corporations and S Corporations)
- Limited Liability Companies

Selecting the right business entity for a particular farming operation is a decision that should be made only after considerable thought and analysis. Although this fact sheet will provide general information as to the types of entities and factors to consider, it is vital to also seek professional advice when choosing and forming a business entity. Professional advisors, such as attorneys and accountants, can help determine what business structure will best achieve the goals of the business owners based on the particular facts and circumstances.

Keep in mind that there are often significantchallenges to selecting one business entity and changing to another form at a later time. Often there are significant taxes that may be triggered upon a change in form. This underscores the importance of understanding your own goals and seeking professional advice to determine which type of business entity would be the best fit for you.

FACTORS TO CONSIDER

Before examining characteristics of the various business entities, it is important to consider certain factors that are relevant to the question of which entity to choose.

Limitation of Liability

Liability protection is one of the most important benefits of operating a business through an entity. The level of protection may vary, but certain entities afford business owners the opportunity to limit their personal liability. In other words, although the business entity will be liable for any debt it incurs, operating a business through an

entity can help owners protect their personal assets from the debts of the business.

For example, assume Farmer Fred forms a business entity, and then secures a bank loan. Although the business entity will be liable to repay that debt, Farmer Fred will not be individually liable to the bank unless he signs a personal guaranty. Without a personal guaranty, the bank will be able to collect against assets of the business entity, but will not be able to reach Fred's personal assets.

It is important to note, however, that this type of liability protection does not protect the business itself from liability. Creditors will generally be able to reach business assets. Also, the entity will generally be liable for any other liability that may arise in the conduct of the business, such as liability for accidents and injuries. Thus, business insurance is always an important item to have in place, regardless of the type of business entity.

Taxation

The nature and extent of taxes is another key consideration in choosing a business entity. Some entities are taxed, and may even give rise to double taxation (meaning that both the business and the owners pay tax on business income). Others – so-called pass through entities – are not taxed and the business income flows through to the owners, who report their share of business income on their personal tax returns.

Ownership and Management

Each type of business entity will have a distinct manner of ownership and management issues to consider. Some entities provide great flexibility as to who can be an owner of the business, while others have very rigid ownership rules. For example, entities may or may not permit different classes of ownership. Also, some entities have very specific rules as to how the business must allocate income to the owners, while others generally permit the owners to share income as they see fit.

There are similar distinctions as to the structure of and manner in which the business may be managed and the level of control that an owner may have. The business owners may in some cases vest decision making authority in other individuals. In some cases, a certain type or class of ownership may not have voting rights.

Authority and Business Formalities

When an entity is formed to operate a business, the individual owners must adhere to certain rules regarding business authority, identity and operation. Owners must understand that it is the entity that conducts business, not the individuals who own the business.

For example, when Farmer Fred's business enters into a contract, it is the business entity rather than Farmer Fred who enters into and performs under the contract. It may be that Farmer Fred is the person who actually signs the contract, but he must do so in his official business capacity, such as President or Manager. When the business earns income, it must go into a business bank account rather than directly into Fred's personal account. When Fred would like to buy or sell a business asset or transfer ownership to a friend or relative, Fred must ensure that he has the business authority to do so.

Certain business entities may also have specific rules that either permit or restrict the rights of owners and management. In addition, there may be specific record keeping requirements. Even if an entity structure does not inherently provide such rights or include such limitations, any

business entity with more than one owner should have a written agreement in place between the entity and the owners that sets forth the duties, rights and obligations of the company, owners and management. States have different rules and types of agreements that may apply depending on the type of entity.

Capitalization

It is important to consider how money and assets will be put into the entity, whether at formation or during operation. Owners may contribute money and/or assets, or the entity may borrow money necessary to acquire assets and operate. Various entities have different rules that apply to capitalization issues, particularly with respect to personal contributions and loans from owners or third party lenders.

Transfer of Ownership and Estate Planning

Business entities have different forms of ownership and rules that apply as to the transfer or sale of an ownership interest. These rules may impact how an owner sells an ownership interest to another owner or outsider. There are also certain rules that may apply with respect to estate planning and gifting ownership to the next generation.

Government and Agricultural Programs

Although specific analysis of the various programs is beyond the scope of this fact sheet, there are certain government and agricultural programs that may factor into the business entity choice. The type of entity may impact eligibility or payment limits associated with such programs.

BUSINESS ENTITIES

With the factors noted above in mind, it is now possible to examine various business entities and the specific characteristics, requirements, restrictions, and opportunities that apply to each.

Sole Proprietor

A sole proprietorship is the simplest form of business ownership. There are no organizational rules to follow, and there is virtually nothing that an owner needs to do to begin operating as a sole proprietor. The sole proprietor has total control and decision making authority, and all of the business income will flow through and be reported on the sole proprietor's personal tax return.

The reason for this great amount of flexibility and freedom, however, is that a sole proprietor does not have any personal liability limitation. As such, the owner's personal assets are not protected from business creditors. Also, all business income will be subject to self-employment taxes.

Partnership

A partnership is a legal entity in which two or more people operate a business jointly with the purpose of earning and sharing profit. States have specific rules as to forming and operating a partnership. It should be noted, though, that two or more people working together and representing themselves to the public as a partnership will likely create an informal partnership even if they do not formally organize a partnership entity.

Unless otherwise stated in a partnership agreement, the partnership will be managed by the partners and all partners have the authority to conduct business in the name of and bind the partnership. Given that a partnership requires at least two partners, it is imperative that all partnerships adopt a written partnership agreement that sets forth how the partners will interact with the partnership and one another.

Partners generally transfer money or assets

to the partnership in exchange for a partnership interest. This is usually a tax free exchange at the time of contribution. If the partners agree, new partners may enter the partnership by also transferring money or assets, or an existing partner may sell all or a portion of his or her partnership interest to the incoming partner. Partners may also receive a partnership interest in exchange for services. Special rules apply, however, and partners who perform the normal functions of the partnership are not treated as partnership employees. Partners are liable for self-employment taxes.

Partnerships are pass through entities. Although the partnership will have a tax identification number and must file informational tax returns, all income or losses of the partnership flow through to the individual partners to be reported on their individual tax returns. Although partners generally are allocated profits and losses in accordance with their pro rata share (*i.e.*, two partners would generally share profits 50%-50%), partnerships are afforded great flexibility in that respect and may make special allocations of tax items, subject to certain rules.

In summary, partnerships are generally easy to form, and they provide a great amount of economic and management flexibility. Income is taxed in the same manner as a sole proprietor, but partnerships also have the same disadvantage as a sole proprietor, namely that the partners do not enjoy liability protection and their personal assets may be reached by partnership creditors.

Limited Liability Partnership

A special kind of partnership is one referred to as a limited liability partnership. Although limited liability partnerships are taxed the same as general partnerships, there are key distinctions as to management and liability protection. These distinctions are possible because a limited liability partnership has two classes of partners: limited partners and general partners.

The general partners have total control and management authority over the partnership. The trade-off, however, is that the general partners have no liability protection. Every limited liability partnership must have at least one general partner. If there is more than one general partner, each of them are jointly and severally liable for any partnership obligations.

The limited partners, on the other hand, do have liability protection, but at the cost of not having any management authority or voice, or any power to bind the partnership.

Family Limited Partnership

Another type of partnership is a family limited partnership. As the name suggests, these partnerships are limited by the fact that all partners must be family members.

As such, these partnerships are sometimes used as an estate planning tool to pass a farming operation form one generation to the next. The elder generation may form a family limited partnership with the goal in mind of transferring an interest in the partnership to descendants. If structured properly, and depending on the facts and circumstances, such transfers may be tax-free. The transferring family members may retain management rights, but the transferees will receive the economic rights and resulting tax liabilities associated with the partnership interest.

The benefit of family ownership may turn into a burden, however, if a family member desires to sell his or her interest in the partnership given that only family members may be partners. Also, there will likely be significant tax consequences to the existing

partners whenever the family limited partnership is ultimately dissolved and liquidated.

Family limited partnerships are generally not a common business entity. They are relevant, however, in the family farming business context. One should seek advice from an attorney and an accountant and carefully analyze specific goals to determine whether a family limited partnership is a viable option under the specific facts and circumstances.

C Corporation

Whenever the term corporation is used, it is likely that the type of corporation referred to is a C corporation (so called based on the fact that such corporations are subject to subchapter C of the internal revenue code). Unlike partnerships, corporations may have only one owner, and can only be formed by formally filing paperwork with the secretary of state. There are rules for filing and nominal filing fees, but corporations are not difficult to form. There are also specific record keeping and annual reporting requirements.

The owners of a corporation own shares of stock and are usually referred to as shareholders or stockholders. One benefit of the corporate structure is that owners do not have personal liability for corporate obligations. The only real risk that a shareholder has as an owner is the amount of investment that the shareholder invests in the corporation.

Contributions that shareholders make to a corporation in exchange for stock are generally tax-free. If a shareholder contributes an asset, the asset becomes corporate property, and any appreciation in value accumulates inside the corporation and there is no tax consequence unless the asset is later distributed to a shareholder or the corporation is dissolved and liquidated.

Unlike sole proprietors and partnerships, corporations are taxed as entities distinct from their owners. This means that the corporation pays taxes on corporate profits, and that the shareholders are also subject to tax when the corporation distributes money to them. This potential for tax at both the corporate and the shareholder level explains why the C corporation tax regime is referred to as double taxation.

As to management and authority, corporate shareholders do not inherently have a right to directly control or bind the corporation simply on the basis that they own stock. Generally, shareholders that have voting rights elect a board of directors (note that a corporation may also have different classes of stock, and that some stock may not come with voting rights). The board may run the corporation directly or may also elect or appoint officers, such as a President, that may have the authority to run the day to day affairs of the corporation and have the power to enter into contracts or otherwise bind the corporation.

A corporation remains in existence until it is dissolved under state law. Both the corporation and shareholders will generally have tax consequences upon liquidation.

For most taxpayers, the double taxation is a negative factor and the key reason that many select an entity other than a C corporation. This is especially true in the case where the entity will be owned privately by family members or only a small number of unrelated individuals.

S Corporation

An alternative to the C Corporation is an S Corporation (so called based on the fact that such corporations are subject to subchapter S of the internal revenue code). Although an S corporation has virtually all of the same characteristics of a C corporation, including

liability protection, S corporations are distinct in that they are taxed in a manner similar to partnerships. There are also restrictions as to ownership, as well limitations regarding the allocation of income and distribution of company profits.

As to ownership, except for a very few exceptions, only individuals can own stock in an S corporation. The number of shareholders is limited to 100 shareholders, all of whom must be US residents. Also, unlike C corporations, S corporations may have only one class of stock.

As to income allocations and distributions of profits, S corporations do not have the flexibility that partnerships do as to special allocations or distributions. S corporation shareholders must be allocated income and receive distributions equal to their percentage ownership of the corporation. If, for example, shareholder A owns 75% of the corporation and shareholder B owns 25%, then shareholder A and B must be allocated 75% and 25% of corporate income, respectively.

To form an S corporation, it is necessary to follow the same procedure for starting a C corporation. The shareholders must then file documents with the IRS within certain time limits to elect S corporation status. There are certain requirements that apply to retain S corporation status, and there may be significant tax consequences for an S corporation that converts to a C corporation.

Limited Liability Company

The most recent type of business entity, and likely the most popular, is a limited liability company. Limited liability companies have the greatest amount of flexibility from an ownership and tax perspective, while affording its owners the personal liability protection of corporations.

Like corporations, one must file documents with the secretary of state to organize a limited liability company. The owners of a limited liability company are referred to as members. Members own a membership interest in the company. Although it is not required, members often refer to such ownership in terms of units (similar to stock in a corporation).

Limited liability companies may be managed by the members, or the members may elect a board or managers to manage company business. The members have the power to bind the company unless the members determine that the company will be run by the board or managers. In all cases, however, members enjoy liability protection.

As to taxation, the limited liability company offers the greatest flexibility. The default rule is that the company will be taxed as a sole proprietor if there is only one member. The single member may elect to be treated as a corporation, however, and subsequently make an election to be taxed as an S corporation. If there are two or more members, the default rule is the company will be taxed as a partnership. Again, the members may elect to be taxed as a corporation. This flexibility is not unlimited, however, and it is important to realize that there may be significant tax consequences for initially electing one manner of taxation and subsequently making an election to be taxed in another manner.

Like corporations, limited liability companies remain in existence until dissolved under state law. There will be tax consequences at that time, but the nature and extent will depend on how the company elected to be taxed.

CONCLUSION

When selecting a business entity, they key is to understand your goals and seek professional advice to determine what form of entity will best achieve those goals. Although conversion from one entity to another may be possible, there may be negative tax consequences associated with such a conversion. Thus, it is best to give careful consideration prior to making a choice to ensure that the entity you select will meet your needs.

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UNIVERSITY OF MINNESOTA EXTENSION

Agricultural Business Management

FARM LEGAL SERIES

June 2015

Contracts, Notes, and Guaranties

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INTRODUCTION

When running a farming business, the operator enters into numerous financial agreements. He may lease land or equipment. He may borrow money from a bank or other lenders to acquire land, livestock, machinery, or equipment. He may purchase land on a contract for deed. He may cosign or guarantee another's commitments. Each of these arrangements involves a contract of some kind.

ELEMENTS OF A CONTRACT

A contract is a binding agreement between two or more parties that is enforceable by law. For an agreement between two parties to be legally enforceable, four requirements must be met:

The parties must be identifiable and competent.

Unless both parties to a contract are known, there is no method of determining who is obligated to meet the terms of the contract. In addition, a party to a contract must be of legal age, over eighteen in Minnesota, and may not be suffering from a mental disability.

The subject matter of the agreement must be legal and not violate public policy.

A contract whose subject matter is illegal or against public policy will not be enforceable. For example, the law imposes certain limitations on the amount of interest that can be charged on certain types of loans. A loan agreement with an interest rate in excess of the legal maximum rate is not a legal contract because the subject matter is not legal.

There must be a mutual agreement.

The parties to a contract must mutually agree to the terms of the contract. Mutual agreement is evidenced by an offer and an acceptance of the offer. The lack of mutual agreement will render the contract unenforceable. For example, in a contract for the sale of a “mustang,” if the buyer believes he is buying a car and the seller believes he is selling a horse, there is not mutual agreement and the contract will likely be unenforceable assuming neither party was aware of the other party’s mistaken belief.

There must be consideration given.

Consideration may consist of money, goods, or services, or merely the promise of future consideration. Essentially, consideration is something given in exchange for something else.

Generally, the agreement does not need to be in writing in order for the contract to be enforceable. However, there are a few important exceptions to this general rule.

To be legally enforceable, the following contracts must be in writing:

1. Contracts that cannot be completed within one year;

2. Contracts for transfers of interests in real estate, including the lease of land, for more than one year;
3. Contracts to sell goods valued at $500 or more;
4. Contracts to lease goods with total payments of $1,000 or more;
5. Credit agreements; and
6. Loan guaranties.

It is good practice to be sure all your contracts are in writing, even if it is not legally required. Without a document memorializing the contract, it may be difficult to enforce the contract or even determine the terms in the future. Having a written contract helps avoid misunderstandings and confusion in the event that a dispute develops later.

The general principles of contract law, discussed above, form the basis for the various contracts that a farmer may enter into during the course of operating a farm business. Several different types of contracts are discussed below.

PROMISSORY NOTES

One type of contract that is used in nearly all transactions in which a farmer borrows money is a promissory note, which is the borrower's written promise to repay a loan. A typical promissory note also includes all the terms and conditions of a loan. In some cases, such terms may be complex and lengthy. When that is true, a loan agreement may be used to further explain the terms and conditions of the loan.

Interest Rates

All promissory notes must state the amount of the loan and the interest rate, which may be either fixed or variable. Fixed interest rates are typically set and do not change over the life of the note. Variable, or floating, interest rates move up and down based on changes of an underlying index rate over the life of the note. Variable interest rates have become common in recent years; however, even where a fixed rate loan is involved, the promissory note may provide that if the borrower fails to make the payment specified by the loan agreement, a different interest rate may be charged. Notes may also provide that if payments are delinquent, late payment charges may be incurred.

Repayment Schedule and Default

The promissory note should set forth in a clear fashion the repayment schedule adopted by the parties. It should specify the amount of each payment, when it is to be made, and where it is to be made. A borrower needs to be sure he understands these terms completely, since even a minor deviation may constitute a default. The borrower should be particularly aware of the clauses in a promissory note that address the lender's rights upon default, for they can have drastic consequences for the defaulting borrower.

Costs of Collection

Most promissory notes contain a provision that obligates the borrower to pay, in addition to all principal and interest provided in the note, all costs of collection in the event legal action must be undertaken by the lender to collect the balance due under the note. A typical clause reads as follows:

> The borrower shall pay all costs of collection of this promissory note including, but not limited to, attorneys' fees, paid or incurred by the lender on account of such collection, whether or not suit is filed and whether or not such costs are paid or incurred, or to be paid or incurred, prior to or after the entry of a judgment.

The Minnesota Supreme Court has ruled that a person who agrees to pay

> attorneys' fees in a contract is entitled to a jury trial to determine both his obligation to pay such fees and the amount he may be required to pay.

Acceleration Clause

Besides increased costs, the failure of a borrower to make all payments as required by the promissory note may result in the acceleration of the loan itself. Most promissory notes contain an acceleration clause, which states that the lender can demand that the loan be paid in full if the borrower fails to make the required payment. A typical acceleration clause reads as follows:

> If any required payment under this note is not paid when due, or if an event of default occurs, the entire outstanding principal balance hereof plus accrued interest thereon shall, at the option of the lender, be immediately due and payable without notice of demand.

Prepayment

Promissory notes should state whether the borrower may prepay all or any part of the loan. Some lenders do not allow prepayments or may impose a fee if prepayment is allowed.

Secured or Unsecured Loans

Finally, the promissory note should specify whether the loan is secured or unsecured. A loan is unsecured if there is no collateral or property of the debtors that secures repayment of the note. If the loan is unsecured, the lender has no priority over other creditors if the borrower defaults. If it is secured, the lender has a claim to certain property owned by the borrower that has been pledged to the lender as collateral. For a more detailed discussion of the legal aspects of such grants of security, see two other fact sheets in this series, *Mortgages and Contracts for Deed* and *Security Interests in Personal Property*.

TYPES OF PROMISSORY NOTES

Several types of promissory notes can be used, depending on the situation.

Simple Note

A simple note is unique in that repayment of the loan is in one lump sum at the end of the note. No periodic payments of interest or principal are contemplated with a simple note. As a result, such notes are generally used for a relatively short period of time.

Demand Note

A demand note provides that a lender may demand repayment at any time. A demand note is therefore very risky for the borrower since the lender may call for payment without any further demand upon the borrower. However, the holder of a demand note must act in good faith when making a demand for payment.

Installment Note

An installment note provides for periodic payments of principal and interest that will reduce the loan balance to zero by the end of the time period specified in the note. In some cases, an installment note may call for a balloon payment prior to the date by which the full amount of the loan would have been paid off if the payments had continued. Such a note combines the features of an installment note and a simple note. The reduction in principal through the use of periodic payments over a period of time is generally referred to as amortization of the loan.

Open-Ended/Revolving Note

An open-ended, or revolving, note is used when a line of credit is arranged by the

parties. Under such an arrangement, the borrower establishes a line of credit with the lender in the amount set forth in the promissory note. The borrower may obtain draws, or advances, under the promissory note up to, in the aggregate, the maximum amount specified in the promissory note and may make additional withdrawals against this line of credit after he has repaid a portion of the amount previously borrowed, or advanced. The advanced and unpaid principal balance of the promissory note may not exceed the maximum amount specified in the promissory note. The open-ended note allows the borrower more freedom in the use of borrowed funds. Farmers often use such revolving loans in obtaining operating funds for a production cycle.

THIRD-PARTY AGREEMENTS

Occasionally a lender may require that someone besides the borrower sign the promissory note. Such requirements may be imposed in cases where the borrower has little additional property that can be used by the lender to secure of repayment. If someone other than the borrower cosigns the note, he or she can be sued for payment if the borrower defaults. The cosigner remains responsible for repaying the loan as long as the borrower and lender operate under the original agreement.

If, rather than cosigning the note, the third party guarantees payment of the loan, the guarantor agrees to pay the lender if the borrower does not. Occasionally a lender requires a guarantor or cosigner to pledge separately owned property as collateral. A guaranty is the separate promise of the guarantor to pay the obligations of another. Most guaranties do not require the lender to first seek payment from the borrower before looking to the guarantor for payment. As a result, it is essential that the cosigner or guarantor be fully aware of all the facts and circumstances surrounding the loan.

REGULATION OF PROMISSORY NOTES

Many states, including Minnesota, have enacted laws that limit the rate of interest a lender can charge. Parties to a contract cannot avoid the maximum interest rate by merely agreeing to a higher interest rate in their contract. The maximum rate of interest that can be charged by a lender in Minnesota depends on the purpose for which the loan is made, the identity of the parties, and the amount of the loan. For example, the interest rate on an agricultural loan in the principal amount of less than $100,000 is limited to no more than 4.5% in excess of the 90-day discount rate of commercial paper published by the Federal Reserve Bank of Minneapolis.

The Federal Truth in Lending Act was enacted to provide borrowers with meaningful disclosure of credit terms and to protect consumers against inaccurate and unfair credit billing practices. The act imposes detailed reporting requirements on lenders. Agricultural transactions, however, are fully excluded from the act.

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Agricultural Business Management

FARM LEGAL SERIES June 2015

Employment Conditions, Wages, & Documentation

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INTRODUCTION

Modern-day farms increasingly utilize both family and outside labor to complete agricultural work. Federal and state laws generally apply to farmers, but both include certain exemptions for farm operations.

WAGES

Minimum Wages

All farm workers are entitled to receive either the federal or state minimum wage, whichever is higher. The federal minimum wage is $7.25 an hour. The Minnesota minimum wage has been recently modified, and it will be steadily increasing through 2016. As a result of the changes to the state minimum wage, the state minimum wage is currently higher than the federal minimum wage and farm employers will need to use the state minimum wage rates. The state minimum wage requirements are set forth below.

WHICH EMPLOYEES	STATE MINIMUM WAGE REQUIREMENTS
Large-Employer Workers	$8.00/hour from 8/1/14—7/31/15 $9.00/hour from 8/1/15—7/31/16 $9.50/hour beginning 8/1/16
Small-Employer Workers	$6.50/hour from 8/1/14—7/31/15 $7.25/hour from 8/1/15—7/31/16 $7.75/hour beginning 8/1/16
90-day Training Wage for Trainees Under 20 Years Old	$6.50/hour from 8/1/14—7/31/15 $7.25/hour from 8/1/15—7/31/16 $7.75/hour beginning 8/1/16
Youth Employees (under 18 years old)	$6.50/hour from 8/1/14—7/31/15 $7.25/hour from 8/1/15—7/31/16 $7.75/hour beginning 8/1/16

After January 1, 2018, Minnesota state minimum wages will be modified by inflation indexing.

Overtime Requirements

Federal laws require employers to pay employees at least 1.5 times the employee's regular rate of pay for hours worked in excess of 40 hours. Minnesota's overtime law requires employers to pay employees at least 1.5 times the employee's regular rate of pay for hours worked in excess of 48 hours.

Exemptions to Federal and State Minimum Wage and Overtime Requirements

Both the federal and state minimum wage and overtime laws provide various exemptions from the minimum wage or overtime requirements. In order to qualify for the exemption employers and employees must meet certain specific requirements. The exemptions specific to the farm industry are described below:

Federal Small Farm Exemption

Small farms are subject to certain limited exemptions from the federal minimum wage and overtime requirements. If an employer does not use more than 500 man-days of agricultural labor, it is exempt from the minimum wage and overtime provisions. Additionally, agricultural employees working in the range production of livestock are also exempted from these same provisions.

Family Farm Exemption

In some circumstances, family farms are exempt from federal minimum wage and overtime provisions. If the employee is a parent, spouse, child, or other member of the immediate family, that employee is exempt if he/she is: (1) a hand harvest laborer paid on the normal piece-rate basis; (2) commutes daily to the farm; or (3) was employed in agriculture for less than 13 weeks the year before.

An employee is also exempt from the federal minimum wage and overtime provisions if the employee is: (1) younger than 16 years; (2) paid piece-rate as a hand-harvest laborer; (3) is employed on the same farm as his/her parent or guardian; and, (4) paid the same rate as employees over the age of 16.

Minnesota State Exemption

Even if farms are exempted from the federal overtime law, they are not necessarily exempt from Minnesota's overtime requirements. However, the state overtime law only applies when an employee has worked more than 48 hours per week.

State overtime wage requirements do not apply to individuals employed in agriculture who are paid a salary greater than if they were paid for 48 hours at the state minimum wage ($6.50 for employers with annual gross revenue of less than $500,000, $8.00 for employers with annual gross revenue of $500,000 or more) plus 17 hours at 1.5 times the state minimum wage per week. Therefore, individuals working at small employers in 2014 are exempt if their annual salary is more than $24,843, while individuals working at large employers in 2014 are exempt if their annual salary is more than $30,576. This exemption does not apply to workers who are paid on an hourly basis. Under this exemption, employees must be paid on a salary basis which means that the employee must be paid a predetermined payment for each workweek without deduction for quantity or quality of work.

Timing of Wages

In Minnesota, employees must be paid at least once every month, unless the employer has agreed to pay wages more frequently. Migrant workers are required to be paid at least every two weeks, and on termination the migrant worker is to be paid within three days. Additionally, migrant workers must be guaranteed a minimum of 70 hours' pay for work in any two successive weeks.

EMPLOYMENT CONDITIONS

Child Labor Exemption

Children under the age of 12 may work in agriculture outside of school hours if employed by a parent or guardian on a farm owned by that person or if employed with the consent of the child's parent or guardian on certain farms. Children 12 or 13 years old may work in agriculture outside of school hours if such employment is with the consent of a parent or guardian or if the child's parent or guardian is employed on the same farm. Children 14 years of age or older may be employed in agriculture outside of school hours without parental consent.

Postings

Farms are required to display certain posters in the workplace. In addition to the standard state and federal wage, safety, and discrimination posters, farms must also display the Migrant and Seasonal Agricultural Worker Protection Act notice, as well as the Fair Labor Standards Act for Agricultural Employees notice.

WORKERS' COMPENSATION

Agricultural employers are generally required to provide workers' compensation insurance, but unlike most employers, agricultural

employers are subject to several exemptions. Family farms, as defined in the state statutes, may elect to cover family members who work on the farm or who serve as corporate officers of a family farm as provided in the workers' compensation insurance statutes; however, they are not required to provide workers' compensation insurance to those family members. Additionally, farms paying less than $8,000 annually for non-family labor are exempted from the workers' compensation insurance requirements.

UNEMPLOYMENT TAXES

An agricultural employer may be subject to both state and federal unemployment tax. A farm is subject to the Federal Unemployment Tax Act tax on cash wages paid to farm employees if its total cash wages in any quarter in the previous calendar year were at least $20,000, or if on at least one day in each of 20 different calendar weeks it had at least 10 farm employees. The federal unemployment tax rate is 6.2% on the initial $7,000 in wages paid to each employee.

A farm is required to register for an employer account with Minnesota Unemployment Insurance if the employer pays $20,000 or more in cash or non-cash wages to employees during a quarter of a calendar year, or if the employer pays at least 4 employees in any part of at least 20 weeks during a calendar year. After registering, the employer must report wages paid to most of its employees, although wages paid to farm workers under the age of 16 and wages paid to an officer or shareholder of a family farm are generally not reportable.

DOCUMENTATION REQUIREMENTS

Agricultural employers must make and keep for three years in or near the employer's premises the following records for all employees:

1. The name, address, and occupation of each employee;
2. Hours worked each day and each work week for each employee; and
3. The pay rate and the amount paid each pay period to the employee.

If an agricultural employer employs migrant workers, it must provide a written statement to the migrant in both Spanish and English which includes the following information:

1. The date the written statement was completed;
2. The name and permanent address of the worker or recruiter;
3. The worker's date of arrival;
4. The crops and operation on which the worker will be employed;
5. The wage rates, terms, and deductions; and
6. Whether housing will be provided

In addition, the agricultural employer must keep the statement for three years.

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Agricultural Business Management

FARM LEGAL SERIES

June 2015

Farm Leases

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INTRODUCTION

Leases play an important role in many farming operations. Many farm operators do not own or own only a portion of the land they farm. The number of farm operators who lease land continues to rise. Yet many farm landlords and tenants are unfamiliar with the legal aspects of the landlord/tenant relationship. In addition, leasing of farm machinery and equipment has become commonplace.

LEASES IN GENERAL

A lease is an agreement that gives someone ability to use or possess real or personal property for a designated period of time in return for some type of payment. Unlike the outright sale of property, a lease does not transfer title, ownership or give an equity interest in the property to the individual in possession of the property.

TYPES OF REAL PROPERTY LEASES

Agricultural leases traditionally are divided into two general categories, the cash lease and the crop share lease.

Cash Lease

The cash lease involves a cash payment of either a specified sum or an amount determined by a formula in exchange for the use of farmland. In other words, the landlord of the farmland receives from the farmer-tenant a certain amount of rent regardless of the crop yields or prices. The farmer-tenant has the sole responsibility for making the management decisions regarding the production of the land.

Crop Share Lease

Under a typical crop share lease, the landlord and farmer-tenant each receive a predetermined percentage of the crop based on their contributions to production. Under this type of lease, both the landlord and farmer-tenant may supply part of the equipment and inputs such as seed, fertilizer, and chemicals. However, in contrast to a cash lease, the landlord and the farmer-tenant may share management responsibilities regarding production of the land. The rent share usually ranges from one-third to one-half, depending on local custom and on the contributions of the farmer-tenant and the landlord.

Although the cash lease and the crop share lease are the most common forms of lease, a farmer-tenant may also encounter a livestock share, labor share or flexible-rent lease.

ELEMENTS OF THE LEASE

A landowner and a farmer-tenant are free to choose the type of relationship that will govern their operation. The lease agreement between the parties is critical in determining what rights and duties exist between landlords and tenants. The following

elements are necessary to create a landlord/tenant relationship:

1. A valid contract;
2. Provisions for payment for the use of the land;
3. The transfer of substantial rights to the tenant;
4. Possession and control of the property by the tenant; and
5. A reversionary interest in the property in favor of the landlord at the conclusion of the term of the lease.

ORAL LEASES

Traditionally, written farm leases have been the exception rather than the rule. One reason may be the assumption that requiring a written lease makes it look like the parties do not trust each other. It is, however, highly desirable to put the terms of any lease agreement in writing. Some of the advantages of a written agreement include:

1. It encourages a detailed statement of the agreement, which insures a better understanding by both parties;
2. It serves as a reminder of the terms originally agreed upon; and
3. It provides a valuable guide for the heirs if either the tenant or the landowner dies.

Under Minnesota law, any lease for a period longer than one year is void unless the contract is in writing and signed by the party by whom the lease is to be made. This law, known as the Statute of Frauds, is in force in every state. To come under the Statute of Frauds, a lease must be wholly oral. The writing required to remove a lease from the application of the Statute of Frauds does not have to be a detailed contract. A memorandum or note is sufficient if it has been signed by a party or for that party.

There is an exception to the Statute of Frauds that has been recognized by most courts, however. Even though a lease is unenforceable because of the Statute of Frauds, it may be enforced if one party relies on the contract and substantially performs under the lease. What action is required on the part of the tenant to constitute such substantial performance must be determined on a case by case basis.

A second exception to the Statute of Frauds has been created by the courts in cases in which one of the parties has misrepresented or otherwise taken advantage of the other party. The Statute of Frauds cannot be used to accomplish a fraud.

CLASSIFICATION OF LEASES

There are two primary classifications of leases: (1) the tenancy from year to year; (2) the tenancy for years.

Tenancy from Year to Year

The tenancy from year to year is a periodic tenancy that is very common in Minnesota. The important characteristic of this tenancy is that it can last indefinitely. In other words, it is deemed to renew itself automatically unless adequate notice to terminate the tenancy is given. Typically a year-to-year tenancy is created by an oral agreement. But a year-to-year tenancy can be, and in many cases is, embodied in a written lease. Such leases are terminated when one party gives the other notice of termination as required in the written agreement. Without a written agreement, a tenancy from year-to-year can be terminated under Minnesota law if three months' notice in writing is given by one party to the other party. If, however, the farmer-tenant fails to pay the rent due under a lease, only 14 days notice in writing must be given by the landlord to the farmer-tenant.

Tenancy for Years

The second type of tenancy is a tenancy for years or a fixed tenancy. The most important characteristic of this tenancy is that it is a tenancy measured by a period of time. A tenancy for years lasts for a specified time agreed upon in the lease. Unless the lease provides otherwise, the farmer-tenant's right of possession automatically terminates at the end of this period without separate notice.

LEASE TERMS

Although farm leases may vary, certain general terms are commonly included in lease agreements.

Time Period and Termination

Leases should expressly provide the time period covered by the lease including when the lease commences and terminates. The lease should also detail the steps a farmer-tenant or landlord must take to effectively terminate the lease.

Failing to include the time period in the lease may lead to future problems. The date a tenancy from year to year terminates is important because the date of termination determines when the written notice has to be given to legally terminate the tenancy. For oral leases (or written leases that do not provide for a termination date), many farm states require that notice of termination be given by December 1st, with an effective termination date of March 1st of the following year. If a crop is still growing on March 1st (as would be the case for winter wheat), the lease would terminate upon harvest. Failure to give timely notice by December 1st would result in the lease not terminating until March 1st of the second year following the notice (some 15 months later; or in the case of winter wheat, almost 20 months later).

In Minnesota, there is no statute that determines when an agricultural tenancy terminates. The Minnesota Supreme Court has determined, however, that farm leases do not terminate in the summer months while the crops are still unharvested. Rather, such tenancies terminate in the spring or in the fall.

Amendments

Most leases require amendments to be in writing and signed by both parties.

Transfer of Property

A lease should state that if the landlord sells or transfers the property, the sale or transfer will be subject to the lease. This will clarify that the farmer-tenant’s interest in the lease will continue even after a sale or transfer of the land.

Right of Reentry

A lease will generally grant a landlord the right to enter the farm at any reasonable time to do things such as make repairs, improvements, or inspections.

Sublease

The lease should specify whether or not the farmer-tenant may sublease all or part of the land to another farmer.

Binding on Heirs

Generally, the lease will bind heirs, executors, administrations and successors of both the landlord and farmer-tenant.

RIGHTS AND DUTIES OF LANDLORD AND FARMER TENANT

In addition to the above lease terms, it is important to understand additional rights and duties of both the landlord and the farmer-tenant.

Farm Operation

Unless a lease provides otherwise, it is presumed that a farmer-tenant will conduct the farming business according to the prevailing customs or usages of the community in which he lives. The farmer-tenant is not required to leave the land in the same condition it was in when he took possession, however.

The farmer-tenant has the right to determine the cropping system and rotation to be applied on the leased property. He must not, however, commit "waste." What constitutes waste must be determined on a case by case basis. In general, the tenant must not allow the real estate to be permanently or substantially damaged. For example, the farmer-tenant may not remove valuable topsoil from the premises. Most courts, however, have held in favor of farmer-tenants who have used poor conservation practices such as permitting land to grow up in weeds and go uncultivated. As a result, it is in a landlord's best interest to include specific provisions in the lease that detail what is expected of the farmer-tenant as part of the normal course of husbandry. For example, the lease may state that the farmer-tenant must use diligence to prevent noxious weeds from growing, control soil erosion, and pay the landlord for damages to the farm.

Ownership of Crops

An issue of increasing importance concerns the ownership of growing crops. It is clear that in the case of a cash rent lease, the crops belong to the farmer-tenant. In the case of a crop share lease, however, the answer is not so clear. Most states have held that title to the crops remains in the farmer-tenant until he harvests the crops and divides them. Other courts, including Minnesota courts, have held that a landlord's interest in the crop attaches after the crop has been planted. As a result, the landlord may sell his share of the crops prior to harvest.

Agricultural Liens

Minnesota law provides special protection for agricultural landlords by giving them a lien for rent upon crops grown or growing on the leased property and their proceeds. In order to protect this lien, the landlord must file a financing statement in the office of the Minnesota Secretary of State within 30 days after the crops are planted. A landlord's lien which is "perfected" by filing a financing statement has priority over all other liens or security interests in the crops grown or produced on the leased property. A possible limitation on the use of such a statutory landlord's lien is presented by the Bankruptcy Code. Even though such a lien is perfected, it may be set aside in a later bankruptcy proceeding of the farmer-tenant.

As a result, it may be more advantageous for an agricultural landlord to include provisions which create a security interest under the Uniform Commercial Code (UCC) in any such lease. However, any such security interest will not obtain the priority granted the landlord by the Minnesota lien law. To insure that his security interest will be the first lien against the crops to be grown on his farm, the landlord should require each and every other party who claims an interest in his tenant's crops to agree to subordinate their claims against the crops to his. The requirements for creating a security interest under the UCC are discussed in another fact sheet in this series, *Security Interests in Personal Property*.

Similarly, Minnesota law provides a special harvester's lien upon the crops for the reasonable value of the services performed to those individuals providing combining, picking, harvesting, hauling, bailing, drying

or storage services in the ordinary course of business. In order to protect this lien, the harvester must file a financing statement in the office of the Minnesota Secretary of State within 15 days after the last harvesting services are provided. This harvester's lien is subject to a perfected landlord's lien.

PERSONAL PROPERTY LEASES

Besides leasing land, today's farm operator may well lease items of personal property such as silos, livestock facilities, or machinery. Leasing provides an alternative way for farmers to acquire the use of assets without ownership.

Finance Lease

Under many leases, the owner of the property recovers the full investment in the property over a specified term. In fact, in many cases, the lessor under such leases may well be a financing company that has purchased the leased property from the manufacturer for the sole purpose of leasing it to a particular farm operator. In such a case the lease is simply a financing device that creates an obligation not unlike that imposed by a formal indebtedness.

The legal relationships may be drastically altered by virtue of this finance lease. If the leased property is defective, it may be much more difficult to enforce any warranty claims against the lessor or dealer. According to the UCC, the implied warranties of fitness and merchantability cannot be enforced against a lessor if the property is defective. However, the farmer may be able to recover against the original supplier or manufacturer. In addition, the farmer's promises under the lease are irrevocable once the farmer has accepted the property regardless of the supplier's or lessor's additional obligations.

Default

Besides warranty difficulties, the lease may provide that in the event of default, the lessee will not only lose possession of the leased property and recover none of the payments made to date, but also be held liable for the balance of the lease payments or some complex calculation of damages. The lease may also provide that in the event of a default, the lessor may repossess the property without notice or resort to the courts. In short, the leasing of personal property may prove to be a risky business unless the farm operator understands the nature of the relationship with the leasing company.

Security Interest or Sales Contracts in Disguise

Many courts have held that arrangements claiming to be leases are, in fact, disguised security interests or sales contracts. The question of whether an arrangement is a true lease or a sales contract must be determined by the facts and circumstances of each case. As a general rule, however, inclusion of a provision in the lease that allows the lessee to purchase the property at the termination of the lease for little or no additional consideration will be construed by a court as conclusive evidence that the arrangement is, in fact, a sales arrangement. If found to be a sales contract, the provisions of the UCC with respect to security interests and termination of security interests may apply in the event of a default. For a more detailed discussion see fact sheets: S*ecurity Interests in Personal Property* and *Termination of Security Interests in Personal Property*. In addition, the provisions of the UCC dealing with warranties may be triggered if the "lease" is a disguised sale contract.

Statute of Frauds

The Statute of Frauds also applies to these leases of personal property. If the total payments under the lease are $1,000 or more, the lease must be in writing or it will be void.

CONCLUSION

Leases have become more and more common in the financing of farming operations. Although the terms of such arrangements are often of critical importance, agricultural real estate leases traditionally have been handled in a very informal manner. However, given their importance in many farming operations, the terms of such leases should be carefully considered and addressed in a written agreement.

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Agricultural Business Management

FARM LEGAL SERIES

June 2015

Financing the Farm Operation

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INTRODUCTION

There are many factors to consider when financing a modern farming operation. The type of farming operation, the commodities produced, the parties involved and the capital requirements of the business will all affect the nature and structure of the financing. Regardless of these factors, however, there are several fundamental concepts to bear in mind in assessing any farming operation.

LOAN CLASSIFICATIONS

A farm operator should be familiar with the different types of loans involved in financing a modern agricultural operation. These classifications of loans correspond roughly to the manner in which liabilities are classified for financial reporting purposes. However, they are also relevant in comparing and evaluating each creditor's legal status.

Land Acquisition Loan

The first type of loan arrangement with which a farm operator should be familiar is a land acquisition loan. Somehow, the farm operator must arrange financing for land that he can use to either grow cash crops or grow crops to feed his livestock. These loans generally require at least annual payments of principal and interest. They are typically secured by a mortgage on the real estate and improvements located on the property.

Intermediate Term Loan

The second type of loan arrangement with which a farm operator deals is an intermediate term loan. Typically, these loans are used for purchasing equipment and breeding livestock, and are payable over a shorter period of time than real estate loans. Sources of such loans include members of the Farm Credit System, the Farm Service Agency, commercial banks and the financing arms of equipment manufacturing companies. Oftentimes, such loans are extended by the same lender who provides operating financing to the farm operator. Occasionally, the cost of acquiring new equipment will be included in the farm operator's operating loan in the year of acquisition. If this added cost is included in the farm operator's annual budget, the normal cash flow of the farming operation will be insufficient to repay the operating loan at the end of the crop year. As a result, it is generally preferable to structure loans for such purposes over a longer period of time, generally corresponding to the useful life of the collateral.

Operating Loan

In its purest form, an operating loan is a loan that is tied to the production cycle of a farm commodity. Typically, such a loan is made at the beginning of the production cycle, with advances made under the loan during the production cycle. The loan is due and payable in full at the end of the production

period. Farm operators should note several characteristics of farm operating loans. One significant characteristic is that lenders who make operating loans require broad security interests to secure the credit advanced the farm operator. At the beginning of the production cycle the value of the commodity to be produced is very low, therefore the lender requires a security interest in all crops as well as any stored crops the farm operator has on hand. The lender also considers the inherent risks of farming. Hail, wind, too much or too little rain can result in significant losses to the farm operator, and hence to the lender. Thus the lender usually requires the farmer to give it a lien on the equipment used in the farming operation as additional collateral.

Because of this broad security interest, most farm operators are forced to look to a single lender to provide all of their operating financing. Operating lenders do not want to finance merely a portion of a farmer's crops or livestock. Problems of priorities and intermingling in the context of farming operations are difficult to resolve. Should multiple lenders participate in financing a farmer's production, an inter-creditor agreement between the lenders will be required.

As security for intermediate term and operating loans, lenders look to personal property — livestock, crops, machinery, and equipment — as their primary collateral, and may also seek a second mortgage on the farmer's real property. The legal issues dealing with the creation and enforcement of security interests in personal property are discussed in other fact sheets in this series, *Security Interests in Personal Property*, and *Termination of Security Interests in Personal Property*.

LOAN SOURCES

Farm Credit System

In Minnesota, the largest lender of long-term land acquisition money for farmers are the members of the Farm Credit System. In addition to loans for acquiring farmland, members can make rural housing loans. Members may make real estate loans that are secured by first mortgages in an amount not to exceed 80 percent of the appraised value of the real estate. Typically, the loans carry a term of not less than five years and no more than 30 years. Interest rates on such loans may be either fixed or bear a variable rate of interest. To obtain a loan from a member of the Farm Credit System, the borrower must usually purchase stock in a nominal amount.

Other Institutional Lenders

Insurance companies and commercial banks also may finance the acquisition of farmland.

Farm Service Agency

The Farm Service Agency (FSA) makes direct loans to farmers and ranchers who cannot otherwise obtain credit to assist the operation and ownership of farms. In addition, FSA will guarantee a loan made to a farmer or rancher by an institutional lender. Finally, FSA also offers programs specifically aimed at helping beginning and socially disadvantaged farmers obtain financing.

Seller Financing

The seller of the land may also serve as a source of land acquisition money. Sellers may be willing to finance the sale of their land because its allows them receive payment over a period of years, thus providing income tax advantages. In addition, the seller may be able to obtain a secure rate of return through such an installment sale. Finally, the seller may be willing to sell property by a contract for deed, understanding that should the

purchaser be unable to make the payments the seller, rather than a mortgage holder, would take back the property.

Minnesota Family Farm Security Act

Sellers who are reluctant to finance the sale of real property may be able to obtain additional security through the Minnesota Family Farm Security Act. Under this act, a portion of a loan to a young farmer may be guaranteed by the State of Minnesota. Besides providing a guarantee to the seller, participate in this program may provide the seller significant income tax benefits.

Regardless of the lender, the legal issues surrounding the creation and enforcement of a loan secured by real property remain the same. The legal issues associated with creating and enforcing land security agreements are discussed in other fact sheets in this series: *Contracts, Notes, and Guarantees*, *Mortgages and Contracts for Deed*, *Mortgage Foreclosures*, and *Termination of Contracts for Deed*.

FINANCIAL ARRANGEMENTS WITH SUPPLIERS

Besides the secured lenders who finance the acquisition of land and personal property, farm operators deal on a regular basis with suppliers of feed, seed, fertilizer, fuel, and chemicals. Generally, the farm operator simply maintains an account with such suppliers, as well as with the suppliers of services. In times of financial distress, the farm operator may be subject to legal actions initiated by such suppliers. The rights of these suppliers are discussed in another fact sheet in this series, *Rights of Unsecured Creditors.* In some cases, suppliers may be able to obtain an agricultural lien to secure their contributions. The legal issues raised by agricultural liens are discussed in the Fact Sheet *Security Interests in Personal Property*.

FARM LEASES

Yet another financing arrangement with which the farm operator may deal is the farm lease, which may involve leasing either real or personal property. The legal considerations involved in such leasing arrangements are discussed in the fact sheet, *Farm Leases*.

MARKETING AND PRODUCTION CONTRACTS

While many farm operators may not consider them to be a financing device, agricultural marketing and production contracts represent another form of farm financing.

Marketing Contracts

A marketing contract is an agreement, entered before production begins, where farmer either agrees to sell or deliver all of a specifically designated crop raised on certain acres in a manner established in the agreement or to sell specific quantities of livestock to the contractor. Under such contracts, the producer is paid according to the payment terms set forth in the contract.

Production Contracts

A production contract is an agreement where a producer agrees to feed and care for livestock or poultry owned by the contractor, or plant, cultivate and/or harvest a specified crop, until the animals or crops are removed, in exchange for a payment based upon the terms of the contract.

The legal issues raised by such contracts are discussed in the fact sheets, *Agricultural Production Contracts* and *Agricultural Marketing Contracts*.

RESPONSES TO FINANCIAL DISTRESS

When confronted with financial difficulties, farm operators have several options.

Creditors may agree to accept partial payments under various credit agreements. Liquidating all or a portion of the farming operation is another option. Or, the farm operator may seek protection under the Bankruptcy Code for either a reorganization or liquidation. Regardless of which course of action is taken, the farm operator must carefully consider the tax consequences. Legal issues involved in bankruptcy situations are discussed in fact sheets, *Bankruptcy: The Last Resort*, *Bankruptcy: Chapter 7 Liquidations*, *Bankruptcy: Reorganizations*, and *Tax Considerations in Liquidations and Reorganizations*.

Farm Disaster Program

Often times a farmer is faced with financial difficulties due to flooding, hail, tornados, and other natural disasters. If this is the case, the farmer will greatly benefit from inquiring into the many disaster assistance programs provided by the state and federal government to help offset loses to crops, livestock, equipment, and other property.

CONCLUSION

This series of fact sheets has been prepared to provide basic information to farm borrowers and their advisers concerning creditor remedies and debtor rights in the farming context. It is not meant to provide the last word on every issue that might arise in an individual case. The facts in a particular case can drastically alter the outcome. A financially distressed farm operator always should seek competent legal, accounting and financial advice in evaluating a course of action before it is undertaken.

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FARM LEGAL SERIES June 2015

Foreclosure of Security Interests in Personal Property

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INTRODUCTION

Lenders typically require borrowers to pledge property (or collateral) to secure the loan. Collateral is real or personal property owned by the borrower that is pledged to the lender as security for the repayment of the debt obligation. For further discussion, see *Financing the Farm Operation; Contracts, Notes and Guaranties; Mortgages and Contracts for Deed;* and *Security Interest in Personal Property.* In the event of default, the lender may look to the collateral to satisfy the debt.

The process of foreclosing a mortgage in real property and foreclosing a security interest in personal property are very different. In this fact sheet, we will discuss the options available to creditors with a security interest in personal property and review the procedures under Minnesota law that are required to foreclose a security interest in personal property. For further detail on mortgage foreclosures, see *Mortgage Foreclosures.*

DEFAULT

Acts of Default

In order for a lender to exercise its rights under a security agreement, the debtor must have, in fact, defaulted on his obligations. The Uniform Commercial Code (UCC) contains no definition of default, but allows default to be defined by the parties to the transaction in their documents. As a result, virtually every security agreement contains a broad definition of events that constitute a default. Such events include the failure to make an installment payment when due, the sale of collateral without the creditor's prior written consent, the failure to keep the collateral adequately insured or the occurrence of any other event that causes the creditor to deem itself insecure.

Acceleration Clause

Both the promissory note and the security agreement will generally contain an acceleration clause. This clause allows the creditor to demand payment of the loan in full upon the occurrence of any event of default.

SECURED PARTY OPTIONS AFTER DEFAULT

Once a default has occurred, there are a number of options available to the secured party. Not all of these options involve the enforcement of the security interest under the UCC.

Continued Operation of the Farm

In the case of a farming operation, if the primary collateral consists of growing crops, the secured creditor will likely refrain from exercising the right to foreclose upon the crops until the debtor has harvested them. By waiting until after the harvest, the secured creditor generally will be in a much better position than if it enforced its rights immediately upon default. As a result, even though a default may exist, the secured

creditor may actually make additional advances to allow the farmer to continue to operate long enough to harvest the crops.

Allow for Voluntary Sale of Collateral

A second option is to allow the debtor to sell the collateral on his own. The secured creditor may think that a better price can be obtained for the collateral if the sale is held directly by the borrower.

Workout Agreement

A third option, especially in the case of farming operations, is the workout. The typical workout arrangement usually involves other creditors besides the secured creditor. The workout arrangement includes both an extension of time and a payment by the debtor of less than the full amount owed, but occurs outside the formal structure of the bankruptcy court. The purpose of a workout is to restructure the debt to enhance the chances of continuing the business and ultimately repaying all creditors. In some cases, the secured creditor may conclude that its position will be enhanced by encouraging the continuation of the business as a growing concern when compared with what it would receive from the liquidation of the collateral.

Seek Money Judgment

A fourth option available to the creditor is an action against the debtor on the underlying debt. In such a case, the creditor is subject to the rights and duties as set forth in another fact sheet in this series, *Rights of Unsecured Creditors*. This option may be followed when the secured party suspects that the collateral is insufficient to satisfy the unpaid balance of the debt. It is attractive to the secured party, however, only if the debtor has unencumbered nonexempt assets that can be reached to satisfy the underlying obligation. A lender is often hesitant to only seek a money judgment against the farmer, since by making the election to only seek a money judgment the lender may be precluded from foreclosing its security interest in any personal property.

Foreclosure of Security Interests in Personal Property

The final option is the substance of this fact sheet. The lender may look to the personal property for repayment of the debt.

REPOSSESSION

If the secured creditor determines that it prefers to repossess and sell the personal property collateral, it must comply with state law. The UCC, however, is clearly drawn with the protection of the secured party in mind. Once default—as defined by the creditor in the security agreement—occurs, the creditor can repossess the collateral. After repossession, the creditors can dispose of the collateral by public or private foreclosure sale, retain the collateral in satisfaction of the debt, terminate the debtor's right of redemption, add the costs of repossession and foreclosure to the unpaid balance of the debt and pursue the debtor for any remaining unpaid balance or deficiency.

The first step in this process, however, is the repossession of the property. Repossession can either be voluntary (by agreement) or involuntary (by self-help or by court action).

Voluntary Agreement

The first method, and the method initially explored by most lenders, is to negotiate an agreement with the debtor to cooperate voluntarily in a turnover of the secured property to the lender. In fact, in many cases, the sale of the secured property may even be conducted on the debtor's premises. Doing so may be advantageous to the debtor. Since all reasonable expenses of foreclosure (including storage, sale preparation, labor, trucking, repairs, advertising, auctioning, clerking and legal expenses) are added to the

secured debt, the debtor may only be increasing his liability to the lender by not cooperating with the sale.

Involuntary Foreclosure

If the debtor is unwilling to voluntarily turn over secured property to the creditor, the creditor will need to take action to obtain the property. Where the collateral is property used in the farming operation, including equipment, crops and livestock, or where it is serving as collateral on a loan used for farm operations, it is deemed agricultural property. Minnesota's farmer-lender mediation statute generally requires the creditor to offer mediation of the debt to the debtor prior to initiating an action to repossess such property. The farmer-lender mediation statute began requiring mediation in 1986, with the statute's expiration date being extended in the years following original passage. Generally, the statute requires, among other things, that a creditor seeking to repossess agricultural property first send notice to the debtor and offer the debtor the opportunity to mediate a resolution to the debt prior to beginning such action. If the debtor elects to mediate the debt, the creditor's repossession of the property can be suspended for a period of up to 90 days pending completion of the mediation. Where the debt involved has been scheduled by the debtor in a bankruptcy or involved in a previous farmer-lender mediation, the debt is not subject to the farmer-lender mediation statute and the creditor can enforce seek repossession of the property without first offering mediation.

Self-Help Repossession

The secured creditor may repossess the collateral by self-help and without first obtaining a court order so long as no breach of the peace occurs. The UCC contains no definition of breach of the peace, and many courts have struggled with defining it. In general, a secured party may not break any locks, use any physical force, issue any threats or proceed in the face of any commands from the debtor, his family or other representatives to stay away or otherwise refrain from removing the collateral.

Court Action

If self-help is unavailable, the secured party must initiate a court action to obtain possession of the property. In Minnesota, this action is known as a replevin action or action for claim and delivery. Such a lawsuit is an action to obtain the immediate possession of personal property. In most cases, a secured party may obtain possession of personal property over the objections of the debtor only after the debtor has received notice and a hearing. If, at the hearing, the secured party demonstrates that it will succeed at a formal trial in establishing its claim to the property, the court will order the sheriff to seize the property on behalf of the secured party prior to conclusion of a trial on the matter.

If, however, the court finds that (1) the debtor has a defense to the secured party's claim, (2) the debtors interests cannot be adequately protected by a bond filed by the secured party and (3) the harm suffered by the debtor would be greater than the harm suffered by the creditor if the property were not delivered to the creditor prior to a final decision, the court may allow the debtor to retain possession of the property until conclusion of the trial. If the court finds that the debtor is entitled to retain possession, it may require the debtor to make a partial payment of the debt, post a bond or make the property available for inspection. The court can make any other provision that it deems fair. If the court determines that the creditor is entitled to possession of the property, the creditor must post a bond with the court that is one and a half times the fair market value of the property.

In some cases, it may be possible for a creditor to obtain a court order allowing it to obtain possession of the property without notice and a hearing. To do so, however, the creditor must: (1) demonstrate to the court that it has made a good faith effort to inform the debtor of the hearing or that informing the debtor of the hearing would endanger the ability of the creditor to recover the property; (2) that it has shown that it is entitled to possession of the property; (3) that the debtor is about to remove the property in question from the state or to conceal, damage or dispose of the property; or that due to other circumstances the creditor will suffer irreparable harm if it does not obtain possession of the property prior to a hearing. Even in such cases, a hearing must be held at the earliest practicable time.

AFTER REPOSSESSION

Once the creditor has obtained a court order, it has the right to repossess and remove the collateral from the debtor's premises. This is usually done by an order for the sheriff to seize the property and return it to the creditor. Once the creditor takes possession of the property, it may either sell the property and apply the proceeds to the debt, or keep the property to satisfy all or part the debt. The creditor is responsible for storing and taking good care of the collateral pending sale. It also must provide all labor and trucking.

FORECLOSURE SALES

As soon as the secured lender has possession of the property or knows that it can deliver possession to buyers, it will usually arrange to liquidate the collateral.

Commercially Reasonable

The UCC requires that any sale held by a creditor be held in a commercially reasonable manner. The UCC does not define "commercially reasonable," so it varies with the circumstances of each case. It does not require a sale at the highest possible price, but rather that the price is obtained after conducting the sale in a way that is "commercially reasonable under the circumstances." Considerations such as the kind of collateral; its condition; the number, location and identity of likely buyers; seasonable markets; and all other factors that would be considered by a reasonable commercial seller selling such items without regard to any foreclosure would be considered by a court in determining whether a sale was held in a commercially reasonable manner.

Type of Sale

The law allows either a public or private sale. Based on the facts of each case, the lender must determine which is commercially more reasonable. Certain items of collateral—such as grain, which has a recognized market price—may be more appropriate for a private sale. Similarly, if the collateral consisted of livestock that couldn't be sold on the debtor's premises, but were so numerous that they couldn't be kept elsewhere pending a public sale, a private sale would be the likely choice. In most situations, however, a well-advertised public auction generally is the preferred method of sale.

Notice

Regardless of the type of sale, the lender must provide reasonable notification to the debtor and any other secured creditor before any sale. Ten days is considered reasonable notification. The notice generally tells the debtor what will be sold; whether the sale will be public or private; the date, time and place if it is a public sale or the date after which such sale will take place if it is a private sale; the amount of the secured indebtedness; a statement that the debtor may redeem the collateral by paying the

indebtedness and expenses in full before the date of the sale; and how the sales proceeds will be applied.

Application of the Proceeds

Once the sale has been held, the law sets forth the order in which the sales proceeds will be applied to the various claims. This order is as follows:

1. Reasonable expenses involved in the repossession and foreclosure, including reasonable attorneys' fees and legal expenses if provided for in the security agreement;
2. Satisfaction of the foreclosing creditor's debt or agricultural liens.
3. Satisfaction of indebtedness held by subordinate secured parties.

If there is money left over, the surplus must be turned over to the debtor. If, however, there is still a balance owed to the foreclosing creditor, the creditor can pursue the debtor for the remaining balance due. This remaining balance is called a "deficiency." The secured creditor's right to pursue a deficiency may be restricted by a court if the creditor has not followed the procedures of the UCC in foreclosing its security interest. If a deficiency judgment is sought, the secured creditor must follow the procedures set forth in the fact sheet, *Rights of Unsecured Creditors*.

KEEPING THE PROPERTY

The secured creditor may, in some circumstances, retain the collateral in partial or full satisfaction of the underlying debt rather than sell the property. Provided the debtor has not paid 60 percent or more of the debt, or has signed a statement waiving his right to require a sale of the property, nothing in the law prohibits this and nothing in the law requires a secured creditor to sell the collateral.

To retain the collateral, the secured creditor must send a written notice of his proposal to the debtor and any other secured party which has given the creditor written notice of an interest in the collateral. Upon receipt, the debtor and such other secured parties have 20 calendar days to object to the retention of the property by the secured party. Upon objection, the secured party must dispose of the collateral according to the rules set forth above. If no objection is made, the creditor takes title to the collateral and cuts off the debtor's right to redeem the collateral. The creditor can also claim a deficiency against the debtor if the debtor receives from the creditor, and consents to, a written proposal that the creditor will accept the collateral in partial satisfaction of the debt. All other secured parties must also consent to the proposal.

RIGHTS OF REDEMPTION

A debtor or any other secured party has the right to redeem, or get back, the collateral. In order to redeem, the debtor or other secured party must pay the creditor the amount owed on the debt and pay the expenses incurred for taking, holding, and preparing for disposition and, if included in the security agreement attorneys' fees. The debtor or other secured party must exercise this right before the creditor has disposed of the property, contracted to dispose the property, or accepted property in full or partial satisfaction of the debt.

CREDITOR MISBEHAVIOR

If a creditor does not comply with the rules of the UCC, the debtor may seek appropriate sanctions from a court. Such creditor misbehavior may consist of repossession prior to default, repossession with breach of the peace, failure to conduct a sale in a commercially reasonable manner, failure to notify the debtor in advance of the sale,

holding an improper strict foreclosure or obtaining a price that is too low. One sanction that can be obtained in some cases is an injunction against the foreclosure. A debtor must move quickly, however, and must realize that obtaining an injunction may be difficult. A second sanction, available when the disposition already has occurred, is the recovery of damages in an amount equal to any loss caused by failure to comply with the rules of the UCC.

CONCLUSION

The foreclosure of a security interest in personal property under the UCC involves many steps. The events triggering default, the nature of the collateral and the relationship of the parties all contribute to how a foreclosure occurs. The law, however, is designed to aid and assist the secured creditor in exercising its collection rights.

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Agricultural Business Management

FARM LEGAL SERIES

June 2015

Landowner Liability in Minnesota

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INTRODUCTION

Owning agricultural land brings with it certain liabilities that a landowner needs to consider, including liability for activities that happen on your land, activities that happen on a neighboring property and impacts your land, or activities that happen on your land that impacts a neighboring property. These liabilities include negligence by the landowner, dangerous activities of the landowner, and alleged nuisances and trespass activities that interfere with the use and enjoyment of neighboring land.

POTENTIAL LANDOWNER LIABILITIES

Negligence/Duty of Care

A landowner owes a "duty of care" for the activities of individuals who are on the landowner's land. The "duty of care" requires the landowner to adhere to reasonable standards of care while performing acts that could foreseeably cause harm to the individual. If the landowner does not adhere to these standards and the invited guest is injured, the individual could sue the landowner for being negligent. The landowner has a higher "duty of care" if the landowner invited the individual onto the land. The scope of these activities are broad. For example, a landowner may be held liable if an invited guest is injured on farm machinery.

Strict Liability

Strict liability is a theory of law that allows an individual to sue a landowner when the landowner created a situation that was extremely dangerous and the individual was harmed or injured as a result of the dangerous situation. Typically associated with injuries caused by chemicals or explosives being stored on the property, the landowner may be strictly liable for injuries associated with injuries caused by livestock.

Nuisance

A landowner may not interfere with the use and enjoyment of the activities of a neighbor on the land of the neighbor. This situation usually arises when the neighbor complains of the odor of the landowner's agricultural operation. The neighbor could sue the landowner under a nuisance legal theory. Although some activities are protected by the Minnesota "right-to-farm" statute that is discussed below, other activities may not be protected.

Trespass

Trespass is when there is an unpermitted physical invasion onto the land of a neighbor that interferes with the property rights of the neighbor. In the context of agricultural production, trespass may include ground water contamination, odors, dust, chemicals, generic pollen "drift" or livestock that goes on to the property of a neighbor.

LANDOWNER PROTECTIONS

Right-to-Farm Protections

It is common for a new neighbor to complain about the agricultural operations of another neighbor. Minnesota has a "right-to-farm" statute that protects agricultural producers from nuisance lawsuits filed by individuals who move next to an existing agricultural producer and later complains and attempts to stop or limit the agricultural operations of the neighboring producer.

Protected Agricultural Operations
Agricultural producers that are protected by the Minnesota statute are producers that have operations used "for the production of crops, livestock, poultry, dairy products or poultry products, but not a facility primarily engaged in processing agricultural products."

The agricultural operation is protected from nuisance lawsuits if, after two years from its established date of operation, the agricultural operation:

1. is located in an agriculturally zoned area;
2. complies with the provisions of all applicable federal, state, or county laws, regulations, rules, and ordinances and any permits issued for the agricultural operation; and
3. operates according to generally accepted agricultural practices.

Limitations
However, the Minnesota statute does not protect the following:

1. an animal feedlot facility with a swine capacity of 1,000 or more animal units as defined in the rules of the Pollution Control Agency for control of pollution from animal feedlots, or a cattle capacity of 2,500 animals or more;
2. any prosecution for certain crimes of public nuisance of or to an action by a public authority to abate a particular condition which is a public nuisance; or
3. any enforcement action brought by a local unit of government related to certain zoning.

Recreational Land Use Protections

Minnesota law also protects landowners when individuals are given permission by the landowner for the use of the landowner's property for "recreational purposes" in which the landowner does not charge the individual for the land use.

Protected Recreational Activities
Protected recreational purposes include, but are not limited to, hunting, trapping, fishing, swimming, boating, camping, picnicking, hiking, rock climbing, cave exploring, bicycling, horseback riding, firewood gathering, pleasure driving (including snowmobiling and the operation of any motorized vehicle or conveyance upon a road or upon or across land in any manner, including recreational trail use), nature study, water skiing, winter sports, and viewing or enjoying historical, archaeological, scenic, or scientific sites.

Landowner Protections
A landowner that gives written or oral permission for the use of the land for recreational purposes without charging the individual:

1. owes no duty of care to render or maintain the land safe for entry or use by other persons for recreational purpose;
2. owes no duty to warn those persons of any dangerous condition on the land, whether patent or latent;

3. owes no duty of care toward those persons except to refrain from willfully taking action to cause injury; and
4. owes no duty to curtail use of the land during its use for recreational purpose.

Landowner Not Protected from Certain Actions

However, the Minnesota statue does not protect the landowner who gives written or oral permission for the use of the land for recreational purposes without charging the individual for any action that:

1. extends any assurance that the land is safe for any purpose;
2. confers upon the person the legal status of an invitee or licensee to whom a duty of care is owed; or
3. assumes responsibility for or incur liability for any injury to the person or property caused by an act or omission of the person.

Consider a Written Agreement

The recreational land use statute gives some protections to landowners, however, for frequent activities and invited guest or if the landowner is charging the guest for the use of the land, the landowner should further protect themselves by having a written agreement with the individual that contractually acknowledges the risks associated with the recreational activity and waives any liability of the landowner in the event the invited guest is injured. Even though Minnesota courts have historically construed such agreements narrowly, under a new Minnesota statute, if there is a written agreement, the agreement can protect the landowner from any negligence by the landowner that results in damage or injury to the invited guest.

CONCLUSION

A landowner may be liable for activities that happen on the owner's land, activities that happen on a neighboring property and impacts the owner's land, or activities that happen on the owner's land that impacts a neighboring property. These liabilities include negligence by the landowner, dangerous activities of the landowner, and alleged nuisances and trespass activities that interfere with the use and enjoyment of neighboring land. The landowner should be aware of the liabilities and the statutory protections under Minnesota law in considering how the land should be used.

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FARM LEGAL SERIES

June 2015

Managing Counterparty Risk

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INTRODUCTION

Agricultural producers operate in a risky environment, whether such risks are due to weather, markets, global economic performance, human factors or changes in technology. Effective risk management involves anticipating risks which may materialize and adversely affect production. Producers must constantly be assessing the probability such risks will materialize and the adverse consequences should they occur. Such planning does not eliminate all risk, but may reduce the adverse consequences which may result.

Not all producers are the same when assessing or assuming risk. Managing risk involves setting goals and objectives, identifying potential risks, and determining, valuating, selecting and implementing alternatives. Some producers are more willing to tolerate or withstand adverse conditions. Others are extremely cautious, avoiding as much risk as they can avoid. Risk management strategies are also affected by a producer's ability to bear risk. Risk bearing is, to a large degree, directly related to the solvency or liquidity of the producer's financial position.

While there are a host of risks faced by agricultural producers on a daily basis, the purpose of this fact sheet is to address counterparty risks and the potential ways in which agricultural producers can attempt to limit such risk and address nonperformance by the other parties to their contracts. "Counterparty risk" is the risk that the party on the other side of a contract will not perform the contract as agreed.

Losses from this risk may come without warning. And they may be significant. For example, Eastern Livestock Company was one of the largest cattle dealers in the United States before an involuntary bankruptcy petition was filed against it in December, 2010, resulting in millions of dollars of losses for cattle sellers, buyers and livestock dealers with which Eastern Livestock did business. The Eastern Livestock case clearly demonstrates how important it is to manage counterparty risk and how catastrophic the losses may be if not managed appropriately.

COUNTERPARTY RISK FOR AGRICULTURAL PRODUCERS

There are several types of risk that a producer should keep in mind when considering any contract. The nature of the risk may be somewhat different, however, depending upon the type of contract under consideration and the commodities to be produced or marketed under such contracts.

Agricultural producers are often a party to various supply or service agreements. Crop producers may enter into a supply contract for seed, fertilizer and chemicals in advance of the growing season. Livestock producers may enter into supply agreements for feed, or service agreements for veterinary services.

Producers may choose to sell their output on the spot market, or enter into forward contracts, or long-term marketing agreements. Each carries with it differing risks of nonperformance on the part of the counterparty. For a more extensive discussion of agricultural marketing agreements, see the fact sheet, *Agricultural Marketing Contracts*.

Producers may also be parties to agricultural production contracts either as a grower or as a processor/contractor. The counterparty risks associated with agricultural production contracts are different, depending upon which side of the contract the producer is situated. For a more extensive discussion of agricultural production contracts, see the fact sheet, *Agricultural Production Contracts*.

Counterparty risk will also be affected by the commodity which is the subject of the contact. For example, if perishable commodities are involved, the seller of such commodities may be provided protection by the Perishable Agricultural Commodities Act ("PACA"). If a contract relates to the production or sale of livestock, the Packers & Stockyards Act ("PSA") may be applicable. The Minnesota Wholesale Producers Dealers Act ("MWHPDA") law provides limited protection for the seller of perishable commodities, including milk and eggs.

IDENTIFYING AND MANAGING COUNTERPARTY RISKS

Supply/Service Contracts

The principal risk for producers raised by supply or service agreements is the risk the counterparty will not perform as agreed. The feed supplier may not deliver necessary feed as scheduled. Crop inputs may not be delivered in a timely manner. A supplier of services such as a veterinarian, electrician or other service provider may not perform under the contract.

If the contract is a supply contract for the purchase of goods by the producer, Minnesota law provides various remedies for the producer. The producer may be able to cancel the contract as a result of the seller's failure to perform. The producer may also be able to seek recovery of any excess costs incurred by obtaining a substitute supplier, subject to any provisions in the contract which limit the amount of such damages. The buyer will not likely be able to recover lost profits, however.

If the contract is a service contract, the remedies available to the producer will generally be determined by the terms of the contract.

In order to limit the potential impact of the failure of a supplier to perform, it is important for producers to do due diligence on all significant suppliers of goods and services. Comparing experiences with other producers may be helpful. Monitoring a supplier's performance is perhaps the best way to stay on top of its ability and willingness to perform in the future. If the producer reasonably feels there are potential issues with the supplier's ability to perform, it may be possible to demand adequate assurances of due performance of the contract. If the supplier does not provide such assurances, the buyer of goods from the supplier will be excused from performing under the contract. Finally, it may be possible to secure alternative or multiple sources of supply. Of course, this may carry with it increased costs if a single supplier cannot supply all of a producer's requirements for seed, fertilizer, chemical, feed, etc.

Marketing Agreements

In general, the risks presented by sales agreements in which payment is due at the time of delivery, or shortly thereafter, are significantly less than those presented by delayed payment or forward contracts. However, even cash sales present some risk. A buyer's check may be dishonored. A buyer may file bankruptcy before issuing a check. PACA, PSA and MWHPDA may provide some protection for cash sellers. All three statutes provide for a nonsegregated trust on the assets of covered persons to secure nonpayment of covered commodities. However, these protections are only available under PACA and MWHPDA for licensed dealers in the covered commodities. And the packer trust provided by PSA is only available for cash sales to packers. Sales to livestock dealers and brokers are not covered by the packer trust.

Minnesota law provides a seller of grain with a limited remedy for the breach of a cash grain sales contract by a buyer. Minnesota law provides a limited bond in the case of such sales. PACA, PSA and MWHPDA also provide for such bonds. However, the amounts of such bonds are often not sufficient to cover all loses sustained by producers when a buyer of agricultural commodities fails.

Should a buyer file bankruptcy shortly after receiving delivery of agricultural commodities, the Bankruptcy Code may provide some relief for a producer. A seller of goods who delivers such goods to a buyer in the ordinary course of the buyer's business within 20 days of the buyer's bankruptcy may be entitled to an administrative expense claim, ahead of unsecured creditors, for the value of the goods delivered. There are several issues raised by this provision, including when payment for such goods must be made. However, in general, the priority granted by the Bankruptcy Code for such creditors provides at least some protection for agricultural producers who meet the requirements.

If a longer term marketing agreement, deferred pricing agreement or forward contract is involved, the risks of nonpayment for the buyer are increased significantly. The trust provisions of PACA, PSA and MWHPDA will not protect a seller of goods who agrees to provide financing to its buyer by deferring the payment for such goods under the terms of such a contract. The bond provided by Minnesota law for sellers of grain will not cover voluntary extensions of credit. And the Bankruptcy Code provision for sellers of goods does not apply to any goods delivered more than 20 days prior to the filing of the bankruptcy petition.

It is also important to note that, once a buyer of goods acquires rights in the goods (generally upon delivery), any security interest granted by the buyer to its lender will likely attach to those goods. As a result, an unpaid seller of goods will not likely be able to assert a successful claim to the goods previously delivered to the buyer in order to recoup its losses.

Should a seller begin to reasonably believe that its buyer is experiencing financial stress, Minnesota law permits the seller to demand adequate assurances of future performance from the buyer. If the buyer cannot, or will not, provide such assurances, the seller is excused from performing under the contract. In addition, should a buyer fail to pay for one installment under the contract, the seller may be excused from making future deliveries and may even be entitled to stop goods in transit to the buyer.

Production Contracts

Counterparty risks for parties to production contracts depend upon which side of the contract a person is on. For growers, the most significant counterparty risk is the risk of nonpayment by the owner of the commodities. If a grower has made significant capital improvements (e.g., poultry barns or swine finishing facilities), an additional risk is that the owner of the animals will not keep the facilities fully occupied. For animal owners, the principal risk is that the grower in whose care the owners' animals have been placed is unable to continue to provide necessary and appropriate care. Because production contracts are generally not subject to extensive regulation by either the State of Minnesota or the federal government, the responsibilities and remedies for breaches of such contracts will generally be controlled by the terms of the contract.

The risks associated with nonpayment by a livestock owner for a contract grower have been largely addressed by Minnesota law. Under the law in Minnesota, contract growers are entitled to a "feeder's lien" which, if perfected by the filing of a financing statement, will have priority over that of the livestock owner's lender. Some contracts contain provisions which would subordinate this lien to that of the lender. The feeder's lien does not, however, provide protection for feed suppliers.

For livestock owners concerned about their growers' continued performance, it is important that the contract provide access to the grower's facilities, the right to inspect the facilities and animals on a regular basis, and provisions to address animal welfare, health and environmental issues on an expedited basis. Without such provisions, it may be necessary to obtain a court order to obtain access, causing delay which could be disastrous for the livestock owner. The contract should also permit the owner to terminate the contract upon short notice for such breaches.

COMMON RESPONSES TO COUNTERPARTY RISK

Regardless of the type of contract and the commodities produced under such contracts, there are several common approaches to managing counterparty risk.

Due Diligence

It is important that agricultural producers undertake due diligence before entering into a contract with someone other than their usual providers. Once a contract has been agreed upon, carefully monitor the counterparty's performance. Are they timely? Are they truthful? Do they follow through with their promises to take action? Do they try to "cut corners"?

Written Contracts

A written contract will always provide more certainty as to the terms of the relationship. Contracts should include the volume anticipated under the contract, price, payment terms, time of delivery, and any specific provisions to address risk. In addition, a well-drawn contract should include insurance requirements, a provision for notice of claims, any limitations on damages, and, if agreed upon, alternative dispute resolution measures.

Contract Enhancements

In the case of some contracts, it may be possible to obtain contract enhancements such as guaranties, letters of credit, or a bond. Such provisions are not common in most agricultural contracts, but may be used in the appropriate case.

Diversification

It is always a good idea to consider multiple sources of supply, services and outlets for your production. It is never good to concentrate all of your efforts or net worth with a single party.

Avoid Middlemen

If possible, it is advisable to avoid brokers, dealers and other middlemen. Adding additional parties to the chain of title or possession of agricultural commodities increases risks.

Accelerate Payment

If possible, sellers of agricultural commodities may want to seek to accelerate payments under the contract via wire transfers or ACH transactions.

Legal Remedies

All parties should be aware of their legal remedies in the event a counterparty to one of their contracts does not perform its obligations under the contract. It is often necessary to move very quickly to effectively exercise these remedies. As a result, it is important agricultural producers monitor counterparty performance and seek appropriate legal advice promptly when necessary to protect their rights.

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Agricultural Business Management

FARM LEGAL SERIES

June 2015

Minnesota Water Law Basics

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INTRODUCTION

Minnesota has an image of having an abundant water supply. That is good, since water is critical to agriculture. Without water, the production of crops and livestock would be impossible. But Minnesota's water resources are not evenly distributed. And increasing demands from population and economic growth, industrial usage and community water requirements have added pressure on existing water supplies and called attention to the importance of sustainable water usage by agricultural industries.

The allocation of water in Midwestern states is generally left up to each state with little, if any, federal intervention. The rules governing water rights vary depending upon the type of water resource. This fact sheet will address some of the basic questions about classification of water resources, allocation and regulation of water in Minnesota. Because the law surrounding the use of water is constantly evolving and very complex, this fact sheet can provide an introduction to some of the issues which may be raised concerning water usage. The Minnesota Department of Natural Resources ("DNR") website (http://www.dnr.state.mn.us/index.html) contains valuable links and information. The Army Corps of Engineers website (http://www.usace.army.mil/Missions/CivilWorks/RegulatoryProgramandPermits.aspx) can likewise provide specific information to landowners.

Water used in agricultural production generally comes from groundwater or surface waters. It is important to note at the outset that, under Minnesota law, all surface waters and groundwater, except those surface waters that are not confined, but are spread and diffused over the land, are "waters of the state." This includes all lakes, ponds, wetlands, rivers, streams, ditches, springs and waters from underground aquifers regardless of their size or location. As such, all waters of the state are subject to regulation by the State of Minnesota. In addition, it is generally required that any person which appropriates waters of the state must measure and keep a record of the quantity of water used.

Minnesota law also sets forth general priorities for water usage. These priorities, from highest to lowest are as follows: (1) domestic water supplies and power producers which have approved contingency plans; (2) uses of less than 10,000 gallons per day; (3) agricultural irrigation and processing of agricultural products consuming in excess of 10,000 gallons per day; (4) power production without approved contingency plans; (5) other uses in excess of 10,000 gallons per day; and (6) nonessential uses of water.

SURFACE WATERS

Minnesota law sets water use limits for the use of surface water obtained from streams in order to protect downstream priority uses and to maintain the flow of streams. For

lakes, the regulations are intended to maintain a protective elevation for each lake established by the Department of Natural Resources ("DNR"). In addition, the total of all withdrawals from a lake may not be more than one-half acre-foot per acre per year (i.e., 6 inches of water taken off the surface of the lake). Surface water usage from a lake of less than 500 acres is discouraged by Minnesota law. Finally, the use of waters from designated trout streams is limited to temporary appropriations. A permit for the use of surface water is required unless the anticipated use is less than 10,000 gallons per day and no more than 1,000,000 gallons per year.

NAVIGABLE WATERS

Under Minnesota law, when a stream is navigable, the State of Minnesota owns the bed below the natural ordinary high water level. A stream is navigable when it is used or may be used for travel. The natural ordinary high water level is the high level at which the water has remained long enough to leave its mark upon the land. Generally, it is the point where the natural vegetation changes from predominantly aquatic to predominantly terrestrial. On streams and rivers, it is the top of the bank of the channel.

Landowners who own property abutting water enjoy certain rights arising from the ownership of their property. These rights include the right to wharf out to a navigable depth; to take water for domestic and agricultural production; to use land added by accretion or exposed by erosion; to take ice; and to fish, hunt, boat and swim. The landowners have the right to use the water over its entire surface. However, riparian landowners may exercise their rights only so long as their usage is reasonable and does not interfere with the rights of other owners or damage the ecosystem. They may not interfere with, obstruct or render dangerous waters used by the public. Should the public own property adjacent to a watercourse, such as a public access site, the public holds similar riparian rights.

The use of land adjacent to public waters is governed by local land use regulations which guide the development and land management of such property. These regulations generally fall into either floodplain or shoreland management regulations. Floodplain regulations seek to limit damage to property. Shoreland management seeks to maintain the ecological balance of shoreland areas. Since these regulations are adopted by local units of government, it is important to understand the limitations contained in such regulations before undertaking any development or other change in use of property which may be subject to them.

GROUNDWATER

Much of Minnesota has a good supply of ground water. However, it is not necessarily available for use everywhere. In addition, in recent years, droughts have called attention to the supply of groundwater for both domestic use and for agriculture. As a result, the law in Minnesota is evolving to address the complex issues raised by competing uses of groundwater. In 2010, the legislature passed new sustainability provisions for groundwater appropriations and gave the DNR authority to establish groundwater management areas. In 2013, the legislature passed provisions for preliminary well construction approval and the authority to require general permits for small appropriations (i.e., those of less than 10,000 gallons per day or 1,000,000 gallons per year) within groundwater management areas. And in 2014, the legislature expanded the ability of the DNR to impose administrative penalties for failing to comply with the permitting requirements of Minnesota law and significantly increased the amount of

monetary penalties which may be assessed by the DNR for such violations.

Permits for groundwater appropriations are available only if the DNR determines that the groundwater use is sustainable to supply the needs of future generations and the proposed use will not harm ecosystems, degrade water, or reduce water levels beyond the reach of public water supplies and private domestic wells which are compliant with Minnesota law. In order to assess an application for a groundwater permit, the applicant must supply detailed information regarding the anticipated usage, groundwater quality, an inventory of nearby wells and the results of an aquifer test.

The DNR is required to respond to such applications within 150 days of its receipt of a complete application. Failure to obtain a required permit, or violating the terms of a permit, may result in administrative penalties up to $20,000, depending upon the potential for harm and the nature of the violation. The DNR may also order the violations to be corrected.

Once issued, the water appropriation permit requires a person using groundwater to install a water flow meter and to record the quantity of water used on a monthly basis. Annual reports must be submitted to the DNR. Failure to keep and report on water usage may result in the termination of the permit.

All permits are subject to suspension in the event a water use conflict is suspected and probably due to the water use. The permit may be modified if necessary to resolve any such conflicts.

WETLANDS

Under Minnesota's Wetlands Conservation Act, the draining or filling a wetland will generally require a permit or other authorization. Applicants will be required to show efforts to avoid wetlands and to replace drained or filled wetland areas. Not all wetlands are subject to these requirements, however. "Public water wetlands" governed by the DNR are all Types 3, 4 and 5 wetlands as defined by the U.S. Fish and Wildlife Service that are 10 or more acres in size in unincorporated areas or 2.5 acres or more in incorporated areas.

"Draining" is defined as any method for removing or diverting waters from wetlands. This includes excavation of an open ditch, installation of drainage tile, filling, diking or pumping. "Filling" is defined as adding any solid material that would alter its cross-section, obstruct flow patterns, change the wetland boundary or convert the wetland to a non-wetland. No permits are required for taking action involving a wetland subject to such rules. Rather, the landowner will receive a determination as to whether the submitted replacement plan is acceptable to the applicable local governmental unit, the activity is exempt or the activity will result in no loss of wetlands.

Public water wetlands are subject to regulation by the DNR. Such wetlands have been inventoried by the DNR and are shown on the DNR's map of public waters and wetlands for each county. The DNR has authority to reclassify public water wetlands as public waters or wetland subject to the Wetlands Conservation Act discussed above. The rules of the DNR authorize several activities which may be conducted in public waters without a permit. However, they also set forth a variety of activities for which a permit will not be granted.

If a permit is required, an application may be submitted to the DNR. The application must contain all information necessary to show the basis for the permit under the DNR rule. Copies of the application must be served on the city, watershed district or soil and conservation district if applicable. The

application will be reviewed by the DNR which will generally make an initial decision on granting or denying a permit without a hearing. A contested case hearing may be demanded after the initial grant or denial of the permit by the DNR staff.

Because the failure to obtain necessary permits or determinations for wetland activities can result in criminal sanctions, it is important a landowner clearly understand which system of regulation is applicable.

Finally, a permit must be obtained from the United States Army Corp of Engineers for non-exempt discharges of dredged or fill material into waters of the United States. Under the applicable federal law, navigable waters are waters of the United States. While there are exemptions available for normal farming activities, it is important for a landowner to determine if a planned project is subject to the federal requirements before undertaking the project.

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FARM LEGAL SERIES

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Mortgage Foreclosures

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INTRODUCTION

If a farm debtor is unable to perform under the terms of his real estate mortgage, the rights of the parties are determined by state law. If the farmer defaults under his mortgage, it is possible that the creditor will foreclose on the mortgage. Minnesota law is very specific with respect to the foreclosure of real estate mortgages. Specific time periods are provided by the statutes and must be followed to the letter by the creditor attempting to foreclose its security interest. Failure to follow each step of the foreclosure process properly may result in an invalid foreclosure.

DEFAULT

Acts of Default

A typical real estate mortgage includes several terms that require the farmer (or the "mortgagor") to do more than merely make the necessary periodic payments. For example, the mortgagor is required to maintain insurance on the premises, pay all real estate taxes and maintain the premises for the benefit of both the mortgagor and the creditor (or the "mortgagee"). In addition, mortgages may include a provision prohibiting the sale of all or any portion of the premises without the prior written consent of the mortgagee. Such provisions are known as "due on sale clauses." If the mortgagor fails to abide by any of the terms in the mortgage, he is in default.

Acceleration

If default occurs, most mortgage documents contain acceleration clauses. These clauses allow the mortgagee to require the mortgagor to pay all payments due. For a more detailed discussion on these clauses see fact sheets *Contracts, Notes and Guaranties* and *Mortgages and Contracts for Deed*.

Notice and Cure

Even after default, the terms of the mortgage may give the mortgagor the right to notice and the opportunity to cure the default. If this type of provision is included in the mortgage, the mortgagee must notify the mortgagor if there is a default, the nature of the default (e.g., nonpayment) and allow a reasonable amount of the time to cure that default.

MORTGAGEE'S OPTIONS UPON DEFAULT

Once a default has occurred, the creditor, or the mortgagee, has several available options in addition to foreclosing on the mortgage.

Deed in Lieu of Foreclosure

The mortgagee can negotiate an arrangement with the mortgagor whereby the mortgagor gives the property back to the mortgagee in satisfaction of the underlying debt. Such a procedure is known as the mortgagor giving the creditor a "deed in lieu of foreclosure." When a mortgagor undertakes such action, he is voluntarily surrendering his redemption or reinstatement rights (discussed below). Because such an action results in the transfer

of ownership and the right to possession, Minnesota courts have long held that such transactions are subject to close scrutiny to protect the mortgagor from oppression by the mortgagee. For such an agreement to be upheld by a court, it must not be the result of any oppressive means or overreaching on the part of the mortgagee, and adequate consideration must be given.

Legal Action

A second course of action for the mortgagee is to bring a lawsuit on the underlying debt based on the promises of the mortgagor contained in the promissory note. A mortgage generally will be granted by a mortgagor to secure the performance of the promises of payment contained in a promissory note. If the value of the real property is less than the amount due under the mortgage, the mortgagee may elect to bring an action seeking the payment of the amount due under the promissory note. Such a course of action, however, may not be attractive to a mortgagee unless the mortgagor has other nonexempt assets that can be reached to satisfy the underlying debt.

Mediation

Under the Farmer-Lender Mediation Act, when dealing with a mortgage on farm land, the mortgagee may be required to serve the farmer with notice of the option of mediation. This is discussed in more detail below.

METHODS OF MORTGAGE FORECLOSURE

Under Minnesota law, there are two methods of foreclosing a real estate mortgage, foreclosure by advertisement and foreclosure by action. Foreclosure by advertisement is the most common. Foreclosure by action requires the creditor to bring an action in court to determine its right to foreclose prior to any foreclosure sale. It is therefore more costly and time consuming for the lender and is rarely used.

Where a mortgage encumbers agricultural real estate, Minnesota's farmer-lender mediation statute generally requires the lender to offer mediation of the debt to the borrower prior to beginning foreclosure proceedings. The farmer-lender mediation statute began requiring mediation in 1986, with the statute's expiration date being extended in the years following original passage. Generally, the statute requires, among other things, that a mortgagee seeking to enforce a mortgage on agricultural real estate, either by advertisement or action, first send notice to the mortgagor and offer the mortgagor the opportunity to mediate a resolution to the debt prior to beginning such action. If the mortgagor elects to mediate the debt, the mortgagee's enforcement of the mortgage can be suspended for a period of up to 90 days pending completion of the mediation. Where the debt involved has been scheduled by the mortgagor in a bankruptcy or involved in a previous farmer-lender mediation, the debt is not subject to the farmer-lender mediation statute and the mortgagee can enforce its mortgage without first offering mediation.

Where a mortgage encumbers the home of the borrower (or a rental home owned by the borrower), Minnesota's law requires that the creditor provide certain additional notices to the borrower (and any tenant).

FORECLOSURE BY ADVERTISEMENT

Foreclosure by advertisement is by far the preferred method of foreclosure, as it is faster, simpler and less expensive than a foreclosure by action. Foreclosure by advertisement is only available for mortgages that include a power of sale clause. A power of sale clause simply grants the lender the right to sell the property upon default, and is included in most mortgages. A foreclosure by

advertisement is also only available where there has been no action or proceeding to recover the underlying debt secured by the mortgage, or if the action has been discontinued.

Notice

To initiate a foreclosure by advertisement, the creditor must prepare a notice of mortgage foreclosure sale. The notice must specify (1) the name of the mortgagor and of the mortgagee, (2) the original principal amount secured by the mortgage, (3) the date of the mortgage and when and where recorded, (4) the amount claimed to be due under the mortgage including taxes paid by the mortgagee, (5) a description of the mortgaged premises (e.g., legal description and commonly used street address), (6) the time and place of sale, and (7) the time allowed by law for redemption by the mortgagor. Once the notice has been prepared by the creditor, it must be published in a qualified newspaper in the county where the mortgaged property is located for six weeks prior to the sale.

The notice must be personally served upon the person in possession of the mortgaged premises at least four weeks before the sale. It must be served in a manner similar to that required for service of a summons initiating a civil action.

Designation

Where the property is homestead property, a homestead designation notice must be served, and if the property is agricultural, an agricultural designation notice must be served. Designation notices disclose the rights of the mortgagor to designated for separate sale and redemption the homestead area, or the home and some of the surrounding land, and to similarly designate one or more separate tracts of agricultural property within the total property.

Foreclosure Sale

Following publication and service of the required notice of mortgage foreclosure sale, the sheriff of the county in which the mortgaged property is located conducts the foreclosure sale. The sheriff's sale is conducted as an auction. The mortgage holder is the seller; the sheriff acts as the auctioneer. If a party other than the mortgagee bids at the foreclosure sale, he must pay cash. The sale is made to the highest bidder. In most cases, the highest bidder at the foreclosure sale will be the mortgagee, and in many cases, the mortgagee will bid the amount due the mortgagee. Following the sale, the mortgagee's costs of sale are reimbursed and the debt owed to mortgagee is paid to the extent covered by the sale price. Any bid in excess of the amount owed the mortgagee is a surplus and may be reached by junior lien holders. If no such holders exist, the surplus must be returned to the mortgagor. Any shortage between the sale price and amount due is a called a "deficiency." Where, as in most cases involving agricultural property, the redemption period is twelve months, the mortgagee can obtain a deficiency judgment in the amount of the difference between the fair market value of the property and the amount remaining unpaid on the mortgage by initiating a lawsuit within 90 days following the foreclosure sale.

Certificate of Sale

Upon completion of the sale, the sheriff prepares a certificate of sale, which operates as a conditional conveyance of the mortgaged premises subject to the debtor's rights of redemption. The certificate must contain a description of the mortgage and the property, the price paid, the time and place of the sale, the name of the purchaser, the interest rate in effect on the date of the sale, and the duration of the redemption period.

This certificate must be recorded within 20 days of the sale.

FORECLOSURE BY ACTION

Even though foreclosure by advertisement is the preferred method of foreclosure because it does not require legal action and is less time consuming, foreclosure by action may be required in some instances. For example, if a power of sale clause is not included in the mortgage, a foreclosure by action is the only option. A foreclosure by action may also be elected by the mortgagee for any variety of technical reasons such as erroneous descriptions, a mistaken release of the mortgage or if an issue of priority with another lien holder must be resolved.

Initiation

To initiate a foreclosure by action, a summons and complaint must be served according to the Minnesota Rules of Civil Procedure. The complaint will name as defendants all of the present owners of the property, other lien holders and those with a right to possession of all or a portion of the premises. If no party defends the action, the mortgagee may obtain a default judgment or a determination from the court that it has a valid mortgage. If, however, any of the defendants objects (e.g., interposes an Answer), a trial may be necessary to establish the right of the mortgagee to foreclose.

Notice

Once the court has made its decision regarding the right to foreclose, the sheriff will publish a notice of a foreclosure sale for a six-week period. The notice must include a description of the property and the date, time, and place of the sheriff's sale. In addition, if the debtor is a resident of the county in which the mortgaged premises are located, a copy of the judgment of the court and the sheriff's notice of sale must be served upon the debtor. After serving the notice of sale on the debtor, the sheriff must post the notice of sale for six weeks.

Sale

At the sale, the sheriff may sell the property to cash bidders only, except for the mortgagee, which can bid its total debt. Following the sale, the sheriff reports the sale to the court, which will then confirm the sale. Once the court has confirmed the sale, the statutory period of redemption for the debtor begins. The time periods for redemption are the same as for foreclosure by advertisement as discussed below.

REINSTATEMENT

After the foreclosure notice has been prepared and publication has begun, the debtor may reinstate the mortgage. This applies to both foreclosures by advertisement and foreclosures by action. This right to reinstate is guaranteed by Minnesota law even though the creditor may have accelerated the balance due under the mortgage prior to the initiation of foreclosure proceedings. To reinstate the mortgage, the debtor must pay to the mortgagee the amount constituting the default at the time the mortgage foreclosure proceedings were initiated, including insurance, delinquent taxes, if any, together with all costs of foreclosure that have been incurred to the date of reinstatement, including half of any attorneys' fees allowed by law or $150, whichever is greater. If the debtor reinstates the mortgage, the foreclosure proceeding is annulled. To reinstate the mortgage, however, the required payment must be made prior to the sheriff's sale, which is provided for by the foreclosure proceedings.

Within seven days of a written request by the sheriff, the mortgagee must provide the sheriff: (1) the current payoff amount,

showing outstanding principal, interest, and a daily interest accrual amount, (2) an itemized schedule of the current amounts necessary to reinstate the mortgage, and (3) the identity of the person or entity with authority to act on behalf of the mortgagee. If the mortgagee does not respond to the request in the time required, the sheriff must postpone the sale.

RIGHT OF REDEMPTION

Following the foreclosure sale, the mortgagor has a right under Minnesota law to redeem from the sale. Such a redemption annuls the sale. If there are any junior liens, however, they are revived by the redemption by the mortgagor.

The mortgagor must redeem within six months of the date of the sale unless one or more of the following applies, in which case the redemption period is twelve months:

1. The mortgage was executed prior to July 1, 1967.
2. The amount claimed due and owing as of the date of the notice of foreclosure sale is less than two-thirds of the original principal amount secured by the mortgage.
3. The mortgage was executed prior to July 1, 1987, and the mortgaged property, as of the date of the execution of the mortgage, exceeded ten acres in size.
4. The mortgage was executed prior to August 1, 1994, and the mortgaged property, as of the date of the execution of the mortgage, exceeded ten acres but did not exceed 40 acres in size and was in agricultural use as defined by Minnesota statute.
5. The mortgaged property, as of the date of the execution of the mortgage, exceeded 40 acres in size.
6. The mortgage was executed on or after August 1, 1994, and the mortgaged property, as of the date of the execution of the mortgage, exceeded ten acres but did not exceed 40 acres in size and was in agricultural use, as defined by Minnesota statute.

To redeem from the sale, the mortgagor must pay to either the person who purchased the property at the sale or the sheriff the sum of money for which the mortgaged premises were sold, with interest from the sale date at the rate provided in the mortgage, plus other costs recoverable by statute. These costs include (1) any taxes or assessments upon which penalties would be incurred; (2), any costs of a hazard insurance policy; (3) costs incurred to reduce a mortgagor's redemption period; (4) any fees paid to the county recorder, registrar of titles, or sheriff; (5) any reasonable fees paid to licensed real estate brokers or appraisers; (6) any deed taxes; (7) reasonable attorney fees incurred after the foreclosure sale, not exceeding one-half of the limits imposed by statute; (8) any costs incurred in maintaining the property; and (9) any interest or installment of principal upon any other mortgage, lien, or contract for deed due during the redemption period.

The sheriff may accept a less than the full amount required for redemption provided that the holder of the sheriff's certificate gives written confirmation that he or she agreed to accept a sum less than the full amount required for redemption.

The mortgagor must also provide a copy of the document giving him the right of redemption and an affidavit containing the amount owed. The mortgagor must record these items with the county recorder within 24 hours of redemption. In addition, the mortgagor will receive a certificate of redemption including the mortgagor's name, the amount paid, a description of the

foreclosure sale and the property, and a statement of the source of redemption. The certificate must be recorded within four days after the end of the redemption period.

Possession of the Property During the Redemption Period

During this redemption period, the mortgagor is entitled to remain in possession of the property. He is therefore entitled to the rents, income and profits from the property unless he has made an assignment of an interest in them. No assignment of rents and profits contained in a mortgage is enforceable under Minnesota law unless it was (1) executed after August 1, 1977; (2) secured an original loan in excess of $100,000; and (3) not a lien on property that was entirely homesteaded as agricultural property.

Waiver

It is possible for a mortgagor to waive his right to redemption. In order for a waiver to be valid, it must be contained in a document separate from the mortgage or be executed separately. It must also be recorded by the lender.

RIGHTS OF FIRST REFUSAL

Following the expiration of the redemption period, the mortgagor's ownership rights in the property are terminated. However, with respect to certain foreclosures of agricultural property, the mortgagor continues to have certain rights of first refusal upon resale of the property by the mortgagee, as discussed above with respect to foreclosure by advertisement.

Where the real estate which has been foreclosed is agricultural and the mortgagee is a government agency, limited partnership or corporation, Minnesota law provides the mortgagor with certain rights of first refusal upon the resale of the property by the mortgagee. The mortgagee cannot offer the property for sale or lease until it has provided written notice to the mortgagor at least 14 days in advance. When a third party buyer or lessee is found, the mortgagee must then offer to sell or lease the property to the mortgagor upon the same terms as the offer made by such third party. The mortgagor has a defined period of time within which to exercise his right of first refusal to either buy or lease the property on such terms. For leases, it is within 15 days of the mortgagee's written offer to the mortgagor, and for sales, it is within 65 days of the mortgagee's written offer to the mortgagor. If the mortgagor exercises his right of first refusal, he must fully perform the terms of the sale or lease within ten days of such exercise.

The mortgagor can elect to purchase or lease a portion of the total property involved, but only where the portion is of a size, configuration and location which does not unreasonably reduce access to or the value of the remaining property. The mortgagor is not allowed to resell the property if the sale was arranged prior to his exercise of the right of first refusal. Where the property is resold by him within 270 days of exercising the right of first refusal, there is a presumption, subject to proof to the contrary, that the sale was arranged ahead of the exercise of the right of first refusal. Where the mortgagor violates this prohibition, he will be liable for damages and attorneys' fees.

In addition to Minnesota law creating rights of first refusal, applicable federal law creates similar rights of first refusal in certain circumstances. The mortgagee must be a lender which is a part of the Farm Credit Services system. Changes in this federal law in 1996 have significantly limited the applicability of the federal law rights of first refusal.

JUNIOR LIEN HOLDERS

Under either method of foreclosure, junior lien holders may redeem from the foreclosure sale if the mortgagor fails to do so. Such junior lien holders may redeem if they have filed for record a notice of intention to redeem. Junior lien holder give notice of their intent to redeem at least one week prior to the expiration of the borrower's redemption period. Redemption by creditors is subject to a six percent interest rate from the time of sale, unless the certificate of sale specifies a different rate.

DEFICIENCY JUDGMENTS

If the foreclosure sale does not bring in enough money to pay off the debt, the creditor may be able to obtain a deficiency judgment against the mortgagor. If the statutory redemption period is six months, however, such a deficiency judgment can be obtained against the mortgagor only if the foreclosure was by action. No deficiency judgment can be obtained against the mortgagor if the redemption period is six months and foreclosure was by advertisement. If the redemption period is twelve months, however, a deficiency judgment can be sought. Finally, even if the redemption period is six months, a deficiency judgment can be sought against any guarantors of the promissory note.

SEPARATE TRACTS OF LAND

In the case of farming operations, it is common for a single real estate mortgage to cover several separate tracts of land. If the mortgaged premises consist of separate and distinct farms or tracts, the sheriff must sell such tracts separately. If the mortgaged premises include the homestead, upon demand by the mortgagor, the sheriff must first sell the non-homestead premises.

CONCLUSION

Procedures under Minnesota law for the foreclosure and termination of real estate security agreements are complex and detailed. They prescribe specific time periods within which both parties must take certain actions. Such time periods are critical for both parties. Any person involved in such procedures should carefully examine the specific provisions of state law that apply to his case.

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FARM LEGAL SERIES

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Mortgages and Contracts for Deed

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INTRODUCTION

Purchases of farm real estate are commonly financed with a contract for deed or mortgage. The choice between a mortgage and contract for deed depends on a number of factors, including the rights of the lender or seller in the event of a default by the buyer. This fact sheet explores the legal differences between the use of real property to finance debt through mortgages and contracts for deed in Minnesota. For a discussion on the use personal property to finance debt see fact sheet *Security Interest in Personal Property*.

MORTGAGES

In a typical mortgage transaction, the buyer of the land (also known as the mortgagor) signs a promissory note, which is a promise to pay money, to finance the purchase. For a detailed discussion on promissory notes see *Contracts, Notes, and Guaranties*. As collateral for the note, the buyer executes a mortgage on the land to the lender (also known as the mortgagee) and the lender pays the seller of the property in full. The buyer obtains a deed to the property, but the lender has a lien—or claim—on the property as documented in the mortgage. The mortgage on the land give the lender the ability to foreclose on the property if the buyer defaults on the note. For a detailed discussion of the foreclosure process see *Mortgage Foreclosures.*

Recording

Mortgages are typically recorded in the office of the county recorder where the property is located. Recording gives notice to the public of the mortgage. If mortgage is not recorded properly, the lender's rights in the property with respect to other creditors may be at risk.

Seller as Mortgagee

The mortgagee is not always third-party lender but may be the seller. If the seller agrees to finance a portion of the sales price by means of a mortgage, the buyer will usually make a down payment on the land and execute a mortgage with the seller for the balance of the purchase price. In such a case, this mortgage is known as a purchase money mortgage. A purchase money mortgage given by the mortgagor at the same time he takes a deed from the seller, has priority over any other claim attaching to the property as a result of his ownership in the property. Thus any liens, such as preexisting judgment liens, that relate to the purchaser and attach to the interest he acquires in the land are subordinate to the lien of the mortgage given by him to secure payment of the purchase price. This is an exception to the general rule in Minnesota whereby priority of interests in real estate is determined, in the absence of actual knowledge, by the date when the mortgage was recorded.

Legal Title

Under Minnesota law, even though a mortgage is a conveyance, legal title to the mortgaged property is not transferred to the lender. Minnesota is classified as one of the so-called lien theory states. In lien theory states, the mortgagee has no right to possess the property, but merely has the power to sell the property in connection with a foreclosure.

Rents

As a general rule, a mortgagee is not entitled to the rents derived from mortgaged property. Minnesota law, however, allows a mortgagor of agricultural property to assign the rents to a lender as additional security for the debts secured by the mortgage if the assignment was executed, modified or amended after August 1, 1977; if it secures an original principal loan of $100,000 or more; and if it is not a lien on property that was homesteaded entirely as agricultural property.

Attachments

Issues can arise in the case of agricultural real estate with respect to whether a mortgage covers personal property that has become attached to the real estate. Whether such personal property (such as silos or dairy piping systems) has become so attached to the real estate as to become part of the real estate and thus nonremovable is a question that must be determined by a court based on the facts and circumstances of each case. In general, the controlling consideration will be the intentions of the parties, which are determined by evaluating the nature of the property that has become attached to the real estate, the method of attachment and the extent to which the property is tied to the use of the real property. If the court determines that the personal property has become attached to the real property, the lien interest of the mortgagee will attach to the personal property even though the personal property is not specifically described in the mortgage. To avoid such issues, the parties to a real estate mortgage should stipulate in the mortgage whether certain items of personal property will become part of the real estate subject to the mortgage.

Crops

Closely related to the issue of attached property is the question of whether a mortgage covers crops growing on land that is subject to a real estate mortgage. Crops are personal property, or “goods”, and are usually not covered by a mortgage or contract for deed. To obtain a lien on crops, a lender must comply with the provisions of the Uniform Commercial Code with respect to such claims. These requirements are set forth in detail in another fact sheet in this series, *Security Interests in Personal Property*. Unless a lender complies with the rules relating to such liens, a lien against crops cannot be based on the real estate mortgage.

Default

The terms of the mortgage define what constitutes a default. In general, a buyer will be in default by failing to make a mortgage payment, failing to pay property tax or insurance, or failing to use the property in a way specified by the mortgage.

Options upon Default

A mortgage generally provides that upon a default of the mortgagor under the terms of the mortgage, the mortgagee has the option to accelerate the indebtedness, foreclose the mortgage, sell the mortgaged premises and use the proceeds from the sale to pay the debts secured by the mortgage. The procedures in Minnesota for foreclosing a real estate mortgage are discussed in detail in the fact sheet, *Mortgage Foreclosures*.

A mortgage generally includes a provision known as a power of sale clause. This clause allows the mortgagee to foreclose without instituting a lawsuit. Without such a clause in a mortgage, the mortgagee must initiate a lawsuit in order to foreclose its mortgage.

Besides the power of sale, a real estate mortgage will typically include an acceleration clause that provides for the acceleration of the debt in the event of default in payment. Such clauses are contained in both the promissory note and the real estate mortgage that secures the note. A promissory note and a mortgage are separate instruments that are different in nature and purpose. They are enforceable independently of each other on their own terms. Thus, should a lender desire to do so, it may enforce the promissory note independently of the mortgage, and it is not required to first foreclose the real estate mortgage. An action can be brought against the mortgagor based on the promises contained in the promissory note to compel the payments required by the note.

Most mortgages also contain clauses known as due on sale clauses which permit acceleration of the debt in the event the mortgagor transfers an interest in the property without the prior consent of the mortgagee. Such due on sale clauses can be used to prohibit the assumption of the loan by a subsequent borrower.

Extinguishment and Satisfaction

A real estate mortgage is a conveyance as security for the payment of money or the performance of some duty. The conveyance may be nullified upon the payment of money or the performance of the prescribed duty. Thus, when the loan that is secured by a mortgage is paid in full, the interest, or lien, of the lender is extinguished. When the mortgage debt is paid, the mortgage is discharged and the mortgagee has no further interest in the land. At this time, the mortgagor is entitled to a "satisfaction of the mortgage" certificate. The lender must provide the certificate to the buyer within ten days of its request. This satisfaction certificate should be recorded with the county recorder so that the mortgage will be extinguished in the county records. Until this is done, the recorded mortgage will remain as a cloud on the title.

Divisible Lots

Occasionally, when a tract of land consisting of divisible lots or parcels is mortgaged to secure a single debt, the mortgagor may sell some of the property to one or more buyers who take title to the land. Unless a partial release of the mortgage is obtained, the buyers of the separate parcels take title to the property subject to the first mortgage. In the absence of an agreement in the mortgage or an agreement between the mortgagor and mortgagee providing for partial releases, the mortgagor has no right to compel the mortgagee to give a partial release of a portion of the real estate from the mortgage.

Farmers-Lender Mediation

Where a mortgage encumbers agricultural real estate, Minnesota's farmer-lender mediation statute generally requires the lender to offer mediation of the debt to the borrower prior to beginning foreclosure proceedings. The farmer-lender mediation statute began requiring mediation in 1986, with the statute's expiration date being extended in the years following original passage. Generally, the statute requires that a creditor seeking to collect a debt affecting agricultural property, including real estate and certain personal property, to offer the borrower the opportunity to mediate a resolution to the debt prior to the lender's resort to collection action against agricultural property. Such action can include mortgage foreclosure, contract for deed cancellation,

seeking possession of personal property or executing a judgment. Where the debt involved has been scheduled by the borrower in a bankruptcy or was involved in a previous farmer-lender mediation, the debt is not subject to the farmer-lender mediation statute and the lender can seek collection remedies without first offering mediation.

CONTRACTS FOR DEED

Whereas the mortgage is widely used when a lending institution is involved, the contract for deed is frequently used in transactions between private parties. A contract for deed is also known as a "land contract" or "installment land contract." In a contract for deed, the seller, rather than a lending institution, finances the buyer's purchase of the property. The buyer takes immediate possession of the property and agrees to pay the purchase price of the property in monthly installment. The seller retains the legal title to the property until the last payment is made and the contract is fulfilled.

Benefits to the Buyer

This type of arrangement is attractive to buyers who might not otherwise qualify for a traditional loan. In many cases, a buyer will enter into such a contract because, without such an arrangement, they would not be in a financial position purchase the property. The buyer may also be able to purchase the property with a relatively low down payment. Also, in the event of a default in payments, the buyer need only bring payments current within the time period provided by state law to preserve his equity in the property. This is in contrast to most promissory notes containing acceleration clauses, in which upon default the buyer is responsible for the entire amount remaining under the loan. Contracts for deed are also faster and less costly to finalize than traditional mortgages discussed above. Closing costs, origination fees, and application costs are nonexistent.

Risk to the Buyer

A contract for deed does not come without risk for the buyer. Because the seller keeps legal title to property until the contract price is paid in full, the buyer does not become the owner of the property until he completes his payment obligations and receives title from the seller. If the buyer defaults on the contract, the buyer runs the risk of losing all of the money that he has paid on the contract.

Benefits to the Seller

At least on the surface, the contract for deed is attractive to seller because it is relatively simple to understand and appears to afford the seller a quick method of canceling the transaction in the event of a default. Contract cancellation procedures are set forth in detail in another fact sheet in this series, *Termination of Contracts for Deed*. In general, if the buyer defaults on an installment, the seller (also known as the *vendor*) can cancel the contract, retake the land, retain the payments made and benefit by any improvements that have been made on the premises by the buyer (also known as the *vendee*). The seller may do this without a foreclosure sale or judicial action. Alternatively, the seller may elect to sue the buyer on the contract.

Risks to the Seller

Contracts for deed also places some risk on the seller. The seller runs the risk of not completing ridding itself of the land for many years. If the buyer defaults, the seller will have to take action and may end up taking back the land.

Recording

The buyer must record the contract for deed with the county recorder where the land is located within four months after the contract is signed. Contracts for deed must provide the legal name of the buyer and the buyer's address. Buyers who fail to record the contract within that time are subject to a civil penalty equal to 2 percent of the principal amount of the contract debt.

Contractual Rights and Remedies

The contract for deed is a contract and many of the rights and remedies of the parties are based solely on the provisions contained in it. Provisions such as the time, the place and the amount of payment indicate the continuing contractual relationship between the parties.

The seller agrees to convey the property to the buyer by a specified form of conveyance, usually a warranty deed, once all of the payments are made under the contract, and to furnish an abstract evidencing good title in the seller at the time the contract for deed is executed.

The buyer agrees to pay a purchase price for the property as specified. He also agrees to pay real estate taxes and assessments and to maintain insurance on the premises, including insurance for the benefit of the seller. The buyer also agrees that all buildings and improvements currently on or subsequently added to the land may not be removed, but will remain on the property until the contract is fully performed.

Many other provisions, such as due on sale clauses, contained in a contract for deed are similar to those contained in a mortgage. It may, however, be more common to find a provision in a contract for deed that prohibits the purchaser from prepaying all or any portion of the contract ahead of schedule. The seller may be looking to the contract for deed payments as a source of retirement income and may not desire early payment.

Acceleration clauses are much less common in contracts for deed. There is, however, no legal restriction against including an acceleration clause in a contract for deed. Without an acceleration clause, if a seller wants to forego his claim against the land, he must bring an action for each installment as it comes due under the contract for deed. He cannot accelerate the balance due under the contract.

Nature of the Relationship

Under a contract for deed, the buyer does not own the land but rather acquires an equitable estate in the land. This allows the buyer to occupy and farm the land. Although it is generally considered that the seller retains legal title to the land and is so treated for many purposes, the courts have consistently held that the seller has a security title only and that the buyer is the equitable owner of the property. As such, the relationship is in substance similar to that created by a deed and a mortgage.

Completion of the Contract

When the total purchase price has been paid to the seller, the buyer is entitled to the type of conveyance provided for in the contract. Generally this will require the execution and delivery of a warranty deed to the buyer. When the title to real estate is transferred by a warranty deed, the seller is guaranteeing that he has full legal title in the property subject only to those exceptions specifically noted on the deed. In contrast, a quit claim deed transfers all rights in the property of the seller, but provides no guarantee that others do not have prior claims. Once the purchase price has been paid, the seller must convey legal title to the buyer. If the seller has died or is otherwise unable to make the

conveyance, it is the duty of his heirs or representatives to furnish the proper conveyance without any additional cost to the buyer. When the buyer has received the deed from the seller, he should file the deed with the county recorder in the county where the land is located.

Improvements

As noted earlier, improvements a buyer makes on the property may be lost if he defaults on the contract. In the event the buyer plants crops, the crops may likewise be lost if the seller terminates the contract for deed. It is therefore important for a buyer of farmland to make provisions for paying the contract installments during the time that he has growing crops on the land. Otherwise such crops could be forfeited to the seller.

As with the foreclosure of a mortgage, the cancellation of a contract for deed affecting agricultural real estate triggers the provisions of the farmer-lender mediation statute, and may afford the borrower with the right to mediate the debt prior to the lender's starting contract cancellation proceedings.

CONCLUSION

The choice between a mortgage and contract for deed depends on a number of factors, including the rights of the seller in the event of a default by the buyer. A farmer should carefully assess the benefits and risks of both financing methods prior to choosing between a mortgage and a contract for deed.

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FARM LEGAL SERIES

June 2015

Restrictions on Farm Entities

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INTRODUCTION

Agricultural producers have used legal entities to minimize legal liability, transition assets for estate planning purposes and to take advantage of government programs. However, under what is referred to as "corporate farming" laws, Minnesota law restricts certain legal entities from owning agricultural land or engaging in farming. The stated purpose of the statute is to "encourage and protect the family farm" by not allowing outside investment in production agricultural. Whether or not the statute achieves this objective is not the purpose of this article, but, instead, this article addresses the restrictions imposed by the statute and the applicable exceptions and exemptions to the statute.

RESTRICTIONS

Broad Restrictions

Under Minnesota law, no corporation, limited liability company, pension or investment fund, trust or limited partnership shall engage in farming. Nor shall any corporation, limited liability company, pension or investment fund, trust or limited partnership, directly or indirectly own, acquire, or otherwise obtain any interest, in agricultural land other than a bona fide encumbrance taken for purposes of security.

Definition of "Farming"

For purposes of the statute "farming" means the production of agricultural products, livestock or livestock products, milk or milk products, or fruit or other horticultural products. However, "farming" does not include: processing, refining or packaging of said products; provision of spraying or harvesting services by processor or distributor of farm products. Nor does "farming" include production of timer or forest products, production of poultry or poultry products, or the feeing and caring for livestock that are delivered to a corporation for slaughter or processing for up to 20 days before slaughter or processing.

Both the legal entities affected and the scope of the restriction is extremely broad. The analysis is usually not whether the farming activity is within the scope of the restrictions but, instead, whether there are any applicable exceptions or exemptions that the legal entity qualifies for.

EXCEPTIONS/EXEMPTIONS

Exceptions

The Minnesota statute makes an exception for certain "family farm" entities. The "family farm" exceptions generally require one or more persons residing on the farm or

actively engaging in farming to be a shareholder, member or other beneficiary of the legal entity that owns the agricultural land or is farming the agricultural land.

For example, an "authorized farm corporation" may not hold more than 1500 acres, may not have more than 5 shareholders, which all must be natural persons, may have only one class of shares, and its revenue from rent, royalties, dividends, interest and annuities must not exceed 20% of its gross receipts. Further, the shareholders holding 51% of or more of interest in the corporation reside on the farm or are actively engaged in farming.

Petition Exemption

In addition to the exceptions for "family farm" entities mentioned above, the Minnesota statute also gives the Minnesota Commissioner of Agriculture the right to exempt other legal farm entities from the restrictions. To receive this exemption, must meet two criteria:

1. exemption would not contradict purpose of this section, and
2. the petitioning entity would not have a significant impact upon the agriculture industry and the economy.

No Limited Liability Partnership Restriction

Although neither an exception nor exemption, the statute does include a limited liability partnership (LLP) as a prohibited farming entity; therefore, because the statute is silent, limited liability partnerships are exempt from the restrictions.

REPORTING REQUIREMENTS

Initial Report

Even if excluded or exempt, the farm entity is required to do an initial report to the Commissioner of Agriculture prior to owning or commencing the farming operation. The initial report requires:

1. the name of the pension or investment fund, corporation, limited partnership, or limited liability company and its place of incorporation, certification, or registration;
2. the address of the pension or investment plan headquarters or of the registered office of the corporation in this state, the name and address of its registered agent in this state and, in the case of a foreign corporation, limited partnership, or limited liability company, the address of its principal office in its place of incorporation, certification, or registration;
3. the acreage and location listed by quarter-quarter section, township, and county of each lot or parcel of agricultural land or land used for the keeping or feeding of poultry in this state owned or leased by the pension or investment fund, limited partnership, corporation, or limited liability company;
4. the names and addresses of the officers, administrators, directors, or trustees of the pension or investment fund, or of the officers, shareholders owning more than ten percent of the stock, including the percent of stock owned by each such shareholder, the members of the board of directors of the corporation, and the members of the limited liability company, and the general and limited partners and the percentage of interest in the partnership by each partner;

5. the farm products which the pension or investment fund, limited partnership, corporation, or limited liability company produces or intends to produce on its agricultural land;
6. with the first report, a copy of the title to the property where the farming operations are or will occur indicating the particular exception claimed under subdivision 3; and
7. with the first or second report, a copy of the conservation plan proposed by the soil and water conservation district, and with subsequent reports a statement of whether the conservation plan was implemented.

Annual Report

In addition to the initial report, the legal farm entity must do an annual report that contains the same information that was required in the initial report (and that is listed above). The annual report must be filed with the Commissioner of Agriculture prior to April 15 of each year.

Failure to File Report

The failure to file the report subjects the reporter to a $500 civil penalty. The penalty is a lien on the land being farmed until the penalty is paid.

CONCLUSION

The Minnesota corporate farming law broadly restricts legal entities from owning agricultural land or engaging in farming. Individuals should consider the Minnesota corporate farming law before creating and transferring agricultural land into a legal entity to minimize legal liability, transition assets for estate planning purposes or to take advantage of government programs. Individuals should consider the Minnesota corporate farming law before using a legal entity to operate the farm.

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UNIVERSITY OF MINNESOTA
EXTENSION

Agricultural Business Management

FARM LEGAL SERIES

June 2015

Rights of Unsecured Creditors

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INTRODUCTION

The modern farmer establishes ongoing relationships with many businesses for the purchase and payment of necessary supplies in the normal course of business. These transactions usually do not involve the farmer granting the supplier any special protections to secure the repayment of the debt, such as a security interest. These suppliers are considered unsecured creditors; because the debt that is owed to the supplier is not secured by any property of the farmer. This fact sheet discusses the legal remedies and issues surrounding unsecured creditors.

CIVIL ACTIONS

Unfortunately, in times of financial distress, a farmer may have trouble paying both his unsecured creditors and his secured creditors. As a result, unsecured creditors may decide to initiate legal action to collect on the debt. An unsecured creditor who resorts to legal action must initiate a lawsuit in the appropriate court to seek payment of the amount owed him.

Choosing the Court

Subject to legal limitations, the creditor can determine in which court the action is brought. If brought in state court, the action generally will be filed in the county where the debtor farmer (the defendant) resides or in the county the facts involving the lawsuit occurred.

After determining the proper county, the creditor (also known as the plaintiff) must determine in which court to bring the lawsuit. There are two possibilities. The lawsuit may be brought in Conciliation Court, also known as Small Claims Court, if the amount claimed, exclusive of the court filing fee, is $7,500 or less. The alternative, bringing the lawsuit in District Court, may be used regardless of the amount involved.

In some cases, it may be possible for the creditor to bring a lawsuit in federal court. Federal court is limited by law to allow only those lawsuits that involve the interpretation and application of a federal statute or that involve residents of different states. In either case, the amount in controversy must be greater than $75,000. Because of these restrictions, most claims by unsecured creditors against farm operators are heard by one of the two state courts.

Initiating the Lawsuit

If a plaintiff elects to proceed in Conciliation Court, the lawsuit will be handled in an informal manner. Attorneys will not be involved in most cases. To initiate a lawsuit in Conciliation Court the plaintiff must file his claim with the court clerk. The clerk will send a copy of the claim to the defendant and will notify him of the hearing date. At the hearing, each party presents its case and argues its position to the court. The court renders a decision based on the evidence

heard at the hearing. Either party may appeal to the District Court.

Summons and Complaint

The procedures for district court lawsuits are similar. To initiate a lawsuit, the plaintiff must prepare and personally serve upon all defendants a summons and complaint that outlines the claim. In most cases, this complaint need not specify all the facts that gave rise to the claim; rather, it may merely set forth sufficient facts to notify the defendant of the nature of the claim.

Answer

Upon receipt, the defendant has 20 days to respond. The defendant generally responds by serving upon the plaintiff's attorney an answer to the complaint. In his answer, the defendant may assert defenses and/or claims against the plaintiff, other defendants or other third parties that may be responsible to the plaintiff. If the defendant fails to answer within 20 days, the court will grant the plaintiff request though a default judgment.

Discovery

Once the defendant has answered, the parties to the lawsuit may undertake discovery procedures. Court rules allow several procedures that enable the parties to a civil action to identify witnesses, identify documents, develop the facts that gave rise to the lawsuit, limit the contested issues at any trial and foster settlements. Under the court rules, either party may submit a series of written questions to the opposing party. These questions, known as interrogatories, must be answered under oath by the opposing party. The questions may relate to any facts that are or may be in dispute in the lawsuit, to the identity of witnesses that the opposing party will be calling at the trial and to the amount of the plaintiff's claim. The use of interrogatories can be a first step in developing the facts of the case so that each party is aware of the opposing party's position.

Interrogatories frequently are accompanied by requests for inspecting and copying documents. Under the court rules, both parties may compel the other party to produce any and all documents that may be relevant to the lawsuit.

It is possible for either party to examine any potential witness under oath through a deposition. Witness testimony will be preserved by means of a transcript prepared by a court reporter. It also may be preserved by means of a video tape. Examination of a witness can deal with any facts relevant to the lawsuit.

Trial

Once discovery has been completed, the lawsuit, if not already settled, will be ready for trial. It may be possible, at this point, to obtain a ruling from the court without a full trial. In cases in which there are no disputes of fact and it can be shown that one of the parties is entitled to prevail as a matter of law, a motion for summary judgment may be granted by the court. The effect is to obtain an order from the court that results in a determination for either the plaintiff or the defendant. It is rare for a court to grant such a motion because most cases involve factual disputes.

If the case must go to trial, the trial may or may not involve a jury. In general, if a person is being sued for the recovery of money, he is entitled to a jury if he so demands. At the trial, the plaintiff must prove that he is entitled to the amount he claims. The plaintiff may introduce all his evidence before the defendant introduces any of his.

MONEY JUDGMENTS

Issuance of the Judgment

If the court determines that the plaintiff is entitled to recover a sum of money from the defendant or the defendant failed to answer the complaint), the court will order the clerk of court to issue a judgment in favor of the plaintiff. Once this judgment has been obtained, the plaintiff can file it with the clerk of court by filing an affidavit giving the defendant's name, occupation and address. Once this is completed the judgment is considered "docketed."

Creation of a Lien

As soon as the judgment has been docketed, it creates a lien to the extent of the unpaid amount of the judgment on all of the defendant's nonexempt real property located in the county in which it is docketed. To get a lien on other real property located in other counties, the plaintiff must transfer the docketed judgment to the other counties. This docketed judgment creates a lien on real property owned by the judgment debtor at the time of the docketing and on all property that he may later acquire. In other words, the judgment lien automatically attaches to any real property later acquired by the debtor. The judgment lien is not on the judgment debtor's personal property or exempt property. For a general discussion of exempt property, see section titled "Exemptions" below.

Duration of the Lien

This lien is good for 10 years after the judgment is entered, and may be extended for additional 10 year periods. Additional procedures must be followed by the judgment creditor if the judgment debtor owns registered (or "Torrens") property, since the mere docketing of a judgment does not result in the creation of a lien on registered property. However, a judgment for debt on agricultural property, personal property used in the farm operation, owned by a farm debtor is only good for 3 years. Moreover, in this situation, the judgment does not attach to real or personal property acquired by the farm debtor after the judgment is entered.

Priority

Once a judgment lien has been docketed, the judgment creditor has priority over other judgment creditors who obtain later judgments against the debtor. This lien prevents the judgment debtor from selling the property because any potential purchaser of the property will not buy the property unless the judgment has been satisfied. A judgment lien will not, however, grant the judgment creditor priority over a prior mortgage or any purchase money mortgage that the judgment debtor grants to a seller of real property in conjunction with the purchase of additional real property. For a more detailed discussion of mortgages and purchase money mortgages, *See Mortgages and Contracts For Deed*.

COLLECTION OF MONEY JUDGMENTS

A judgment creditor can attempt to collect on the money judgment in two primary ways: 1) through a writ of execution and 2) through garnishment.

Writ of Execution

In addition to acquiring a lien on real property, a judgment creditor may obtain from the court an order authorizing the sheriff, the creditor, or the creditor's attorney to carry out the court's decision in favor of the judgment creditor. This court order is known as a writ of execution. It allows the judgment creditor to have the

judgment debtor's property seized and sold in satisfaction of the judgment.

Such a writ is issued by the clerk of the court in which the judgment was entered. Usually the sheriff serves the writ, but when the judgment creditor proposes to make an execution of not more than $10,000 for money owed to judgment debtor by a third party, the execution may be made by the judgment creditor's attorney. However, only one execution per day may be served on a single third party by a judgment creditor. To do so, the attorney must either send a registered or certified letter of execution to the third party or have it served personally. The third party may also be served by registered or certified mail at their regular place of business.

Levy on Earnings

No notice is required prior to executing with a writ of execution. If, however, the judgment creditor seeks to levy on earnings in the possession of an employer, the creditor must first serve a notice upon the judgment debtor no less than 10 days prior to service of the execution.

Levy on Real and Personal Property

A writ of execution can be used to collect the judgment from real or personal property, provided that the property is not exempt from levy under Minnesota law. For a general discussion of exempt property, see section titled "Exemptions" below.

The writ of execution will direct the sheriff to satisfy the judgment first out of the judgment debtor's non-exempt personal property. Personal property that can be delivered manually is levied on by the sheriff taking physical custody of it. Other personal property is levied on by leaving with the person holding the property a certified copy of the execution and a notice specifying the properly levied on. Growing crops may be levied on after they have been planted, but they may not be sold until they mature. Any judgment levy on personal property will be subject to any pre-existing liens or security interests on the property; meaning that any proceeds from the sale of the personal property by the Sheriff will be first applied against any debt secured by the pre-existing liens or security interests on the personal property before the judgment creditor would receive anything.

If sufficient non-exempt personal property cannot be found to satisfy the judgment, the sheriff may levy on any non-exempt real property owned by the debtor. Like a levy on personal property, if there is a prior lien against the real property, the judgment creditor would receive any sale proceeds after the satisfaction of the debt secured by the prior lien.

Sheriff's Sale

Property that is subject to a levy may be sold by the sheriff to satisfy the judgment. If personal property is involved, the sheriff must give 10 days posted notice of the time and place of the sale. If the sale is to be of real property, he must give six weeks posted and published notice.

If the sale is of personal property and the debtor is a resident of the county, prior to posting notice of sale, the officer must serve a copy of the execution and inventory and the notice upon the judgment debtor. If the sale is of real property, a judgment creditor must serve a copy of the notice, at least four weeks before the sale upon the judgment debtor if a resident of the county. The creditor must also service the notice upon any person in possession of the real property other than the judgment debtor and all persons who have recorded a request for notice.

The sale will be held by the sheriff as an auction. If the personal property sold is capable of manual delivery, it must be sold in the view of those at the sale. If the real property sold consists of several known parcels, the parcels must be sold separately and only to the extent necessary to satisfy the execution.

Redemption

Once the sale has occurred, there is no redemption from the sale in the case of personal property. In the case of real property, the judgment debtor may redeem from the sale within one year of the sale date by paying to the purchaser, the sheriff or the clerk of court the sales price, interest, taxes, assessments and payments on prior liens made by the purchaser. Subordinate lien claimants may redeem from the sale, if, within one year, they file a notice of intention to redeem with the clerk of court where the judgment was entered. They are given a five-day period after the expiration of the redemption period of the debtor within which to exercise their redemption rights.

Garnishment

A judgment creditor often looks to money owed to the judgment debtor by a third party as a source of payment for his claim. Such indebtedness can be reached by writ of execution. It also can be reached by a garnishment.

To use a garnishment, the judgment creditor or his attorney prepares and issues a garnishment summons to the third party, often an employer or a bank. This summons, together with appropriate fees, must be personally served on the third party by the judgment creditor. The third party must disclose, within 20 days of service, the amount of indebtedness owed to the judgment debtor. The garnished party also must retain all property disclosed subject to release or further order of the court. If the third party owes no debt to the judgment debtor, the garnished party will be discharged upon making such a disclosure. If the indebtedness is disclosed, the judgment creditor must collect the property held by the garnished party. This may be done either by obtaining the consent of the judgment debtor or by means of an execution.

Wages

If wages are to be the subject of either an execution or garnishment, an advance notice of 10 days must be given to the judgment debtor. The notice can be served either personally or by first class mail and must inform the debtor that a summons or levy will be served on the debtor's employer in 10 days; that the debtor can serve on the creditor a statement asserting that he is entitled to exemptions from garnishment or execution; that wages are exempt from garnishment in certain cases; that the debtor is entitled to relief if the creditor in bad faith disregards a valid claim of exemption; and that the debtor will be subject to fees and a penalty if he claims an exemption in bad faith or takes any action to frustrate the collection process.

FARMER-LENDER MEDIATION

Where the property to be seized or executed is property used in the farming operation, including equipment, crops and livestock, or where it is serving as collateral on a loan used for farm operations, it is deemed agricultural property and Minnesota's farmer-lender mediation statute generally requires the creditor to offer mediation of the debt to the debtor prior to seizure or execution. The farmer-lender mediation statute began requiring mediation in 1986, with the statute's expiration date being extended in the years following original

passage. Generally, the statute requires, among other things, that a creditor seeking to seize agricultural property first send notice to the debtor and offer the debtor the opportunity to mediate a resolution to the debt prior to beginning such action. If the debtor elects to mediate the debt, the creditor's seizure of the property can be suspended for a period of up to 90 days pending completion of the mediation. Where the debt or obligation involved has been scheduled by the debtor in a bankruptcy or involved in a previous farmer-lender mediation, it is not subject to the farmer-lender mediation statute and the creditor can enforce seek repossession of the property without first offering mediation.

STATUTORY LIENS

At times, a seemingly unsecured creditor may acquire priority over other secured creditors based on a statutory provision. For example, a person who furnishes services for materials with respect to goods subject to a security interest receives a lien against the goods by law. That lien will take priority over a perfected security interest. For a more detailed discussion on statutory liens see fact sheet: *Security Interests in Personal Property.*

EXEMPTIONS

Regardless of the collection procedure used by the judgment creditor, certain property, known as exempt property, remains free from the claims of creditors under Minnesota law (see table 1). Exempt property includes both real and personal property of a debtor that cannot be seized or sold to satisfy the claims of creditors.

The value of the exemptions is determined by the fair market value of the various assets. If otherwise exempt property is subject to a lien, the debtor may claim as exempt the value of the property in excess of the lien amount (the "equity" in the property). In the case of a joint petition filed by a married couple the value limitations may be doubled. If property is claimed by the debtor as exempt, it generally will remain subject to any voluntary liens that the debtor has granted.

To claim such property as exempt, it must be disclosed to the judgment creditor, who gives the debtor an exemption notice. The homestead may be claimed as exempt by filing with the county recorder a declaration of homestead that includes a legal description of the property claimed as exempt.

BANKRUPTCY

Unsecured creditors can be adversely affected if the debtor files for protection under the Bankruptcy Code. First of all, if the debtor initiates a Chapter 7, 11, 12, or 13 case this triggers the automatic stay. The automatic stay operates as a court order to halt, at least temporarily, a wide range of conduct for collecting a claim or debt against the debtor. In other words, the filing of any bankruptcy petition stops all collection efforts. The automatic stay is broad in scope. It is intended to prohibit creditors from taking any action against the debtor that disorganizes his efforts to deal with his financial problems or that interferes with his attempt to reorganize his business operation.

Although the provisions of the automatic stay law are broad, they are not absolute or permanent. Creditors, in some instances, may seek court approval to obtain relief from the stay or obtain court approval to continue or initiate collection proceedings against the debtor.

The Bankruptcy Code also establishes a detailed priority system for payment of claims. Unsecured creditors rank lowest in

priority and are generally paid after the secured and other priority unsecured creditors. The following unsecured creditors have the following priority in bankruptcy:

1. Unsecured claim for domestic support obligations;
2. Expenses of the administration of the bankruptcy case, including costs and expenses of preserving the estate taxes incurred by the estate, trustee's fees, and attorney's fees for the trustee;
3. Claims arising in the ordinary course of the debtor's business or financial affairs during the "gap period" between the filing of an involuntary petition and an order for relief;
4. Unsecured claims for wages, salaries, and commissions up to $12,475 per creditor;
5. Unsecured claims for contributions to employee benefit plans up to $12,475 per employee, less any amount paid to an employee for wages, salaries, or commissions;
6. In the case of a grain elevator bankruptcy, unsecured claims of farmers against the elevator for grain up to $6,150 for each creditor;
7. Up to $2,775 per claim on unsecured claims for money deposited with the debtor for purchase or lease of property or for services contemplated for the personal, household, or family use of the debtor that were not provided;
8. Unsecured claims of governmental units for taxes and penalties;
9. Claims for death or personal injury resulting from the operation of a motor vehicle or vessel if such operation was unlawful because the debtor was intoxicated from using alcohol, a drug, or another substance.

After these priority claims, the next parties in line are general unsecured creditors who filed claims in a timely fashion. If property remains after the general unsecured creditors are paid, all unsecured creditors receive interest at the legal rate from the date the bankruptcy petition was filed. Any funds or property remaining after the payment of interest is paid to the debtor. If the debtor's assets are insufficient to pay in full all of the claims within a particular classification, all creditors share on a pro-rata basis.

CONCLUSION

Unsecured creditors may initiate legal actions against those who owe them money on accounts. They are at a disadvantage when compared to secured creditors because they must, in most cases, obtain a court determination that they are legally entitled to the amount of money they claim. After obtaining a judgment by the court, an unsecured creditor may then utilize the collection procedures authorized by law.

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Table 1: MINNESOTA EXEMPTIONS[1].	
ITEMS	**EXEMPTION AMOUNT**
(1) Homestead; rents and proceeds of Homestead	Less than 160 acres; $390,000 limit if non-ag or $975,000 limit for ag. whether claimed by one or more debtors
(2) Family bible, library, musical instruments	Unlimited
(3) Church pew and burial lot	Unlimited
(4) (a) Wearing apparel, one (1) watch, utensils, foodstuffs	$10,350
(b) Household furniture, household appliance, phonographs, radio, and television	$10,350
(c) Wedding rings or other religious or culturally recognized symbols of marriage exchanged between the debtor and spouse at the time of the marriage	$2,817.50
(5) Farm machines and implements used in farming by a debtor engaged principally in farming, livestock, farm produce, standing crops, tools, implements (total of (5) and (6) cannot exceed $13,000)	$13,000
(6) Tools, implements, machines, instruments, office furniture, stock in trade (total of (5) and (6) cannot exceed $13,000).	$11,500
(7) Library and tools of students	Unlimited
(8) All money arising from any claim on account of destruction or damage to exempt property	Unlimited
(9) Life insurance proceeds	$46,000 plus $11,500 for each dependent
(10) Police Relief Association, Firemen's Association, or Fraternal Benefit Association Benefits	Unlimited
(11) Manufactured home actually occupied as home	Unlimited
(12) Motor vehicle	$4,600
(13) Vehicle modified for disability	$46,000
(14) 75 percent wages	Unlimited
(15) Public assistance benefits	Unlimited
(16) Earnings of a minor child or proceeds by reason of any liability of debtor not for the special benefit of child	Unlimited
(17) Claim for damages recoverable by any person by reason of levy upon or sale under execution of exempt property	Unlimited

1 In a joint case, these exemptions, other than the homestead exemptions, are available to each spouse. Certain values are adjusted on a biennial basis. The above exemptions are as of July 1, 2014. Certain exemptions will be adjusted again on July 1, 2016.

Table 1 Continued: MINNESOTA EXEMPTIONS.	
ITEMS	**EXEMPTION AMOUNT**
(18) Personal injury or wrongful death claim (General Damages)	Unlimited
(19) Loan value, accrued interest on dividends in life insurance policy	$9,200
(20) Stock bonus, pension, profit sharing benefits, annuity, IRA, employee pension or contract on account of illness, disability, death, age or length of service reasonably necessary for the support of debtor	$69,000
(21) Veteran's benefits	Unlimited
(22) Disability benefits	Unlimited
(23) Public employee and teachers pension benefits	Unlimited
(24) Unemployment benefits	Unlimited
(25) Workers' Compensation benefits	Unlimited
(26) Money arising from the destruction of exempt property	Unlimited

Table 2: FEDERAL BANKRUPTCY CODE EXEMPTIONS[2].
11 U.S.C. Section 522(d)

ITEMS	EXEMPTION AMOUNT
Homestead Real or personal property the Debtor uses as a residence; or a burial plat for the Debtor	$22,975
Motor vehicle	$3,675
Household furnishings, household goods, wearing apparel, appliances, books, animals, crops or musical instruments held for personal, family, or household use.	$12,250 total and no more than $575 in any single item
Jewelry held for personal, family, or household use	$1,550
Any property—wild card.	$1,225, plus up to $11,500 of any unused portion of the homestead exemption
Implements, professional books, or tools of the trade	$2,300
Unmatured life insurance contract	Unlimited
Loan value, accrued dividends, or interest in life insurance policy	$12,250
Professional prescribed health aids	Unlimited
Social Security, unemployment, public assistance	Unlimited
Veteran's benefit	Unlimited
Disability, illness, or unemployment benefits	Unlimited
Alimony, support or separate maintenance to the extent reasonably necessary for the support of the Debtor and dependents	Unlimited
Pension, profit-sharing, stock bonus, annuity benefits necessary for support of Debtor and dependents	Unlimited
Crime victim's reparations	Unlimited
Wrongful death claims	Unlimited
Life insurance proceeds necessary for support	Unlimited
Personal injury claims (not including pain and suffering or compensation for actual monetary losses)	$22,975
A payment in compensation of loss of future earnings of the Debtor necessary for support	Unlimited
Certain retirement funds	Unlimited

2 In a joint case, these exemptions, other than the homestead exemptions, are available to each spouse. Certain values are adjusted every three years. The above exemptions are as of April 1, 2013. Certain exemptions will be adjusted again on April 1, 2016.

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Agricultural Business Management

FARM LEGAL SERIES

June 2015

Security Interests in Personal Property

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INTRODUCTION

The best protection a lender can have against potential default is to deal with borrowers who have solid reputations and have demonstrated their ability to repay loans. However, even when dealing with the most reputable borrower, lenders typically require borrowers to pledge property (or collateral) to secure the loan. Collateral is real or personal property owned by the borrower that is pledged to the lender as security for the repayment of the debt obligation. In the event of default, the lender may look to the collateral to satisfy the debt. For further discussion, *see Financing the Farm Operation;* and *see also, Contracts, Notes and Guaranties.* Lenders who do not require borrowers to pledge collateral make a much riskier investment and become unsecured creditors, as discussed in *Right of Unsecured Creditors*.

This fact sheet considers general concepts and identifies various problem areas that arise with the use of personal property, such as livestock, machinery, equipment, and crops, as security for a loan. For a discussion on the use of real property, such as land and buildings, as security for a loan see fact sheet: *Mortgages and Contracts for Deed*.

GOVERNING LAW

The law governing the legal rights of lenders and borrowers who use personal property as collateral is contained in Article 9 of Uniform Commercial Code (UCC). Article 9 was significantly revised in 2001, and then again in 2010, and the substantive revisions have been adopted in every state and govern virtually all such transactions. It has simplified the use of personal property as collateral by providing for an almost uniform set of rules nationwide. It does not, however, apply to real estate transactions. This fact sheet only summarizes the law in the State of Minnesota.

PERSONAL PROPERTY AS COLLATERAL

As previously mentioned, Article 9 governs the use of personal property as collateral for a loan. Article 9 classifies certain types of personal property. For our purposes, we will discuss tangible personal property (or "goods"), which would include machinery, equipment, livestock (and unborn young of animals), and crops (grown, growing, or to be grown).

Types of Goods

Generally, goods fall into one of four categories: (1) consumer goods; (2) equipment; (3) farm products; or (4) inventory.

Consumer Goods are goods used or bought for personal, family, or household purposes.

Farm Products include crops grown, growing, or to be grown, livestock, born or unborn, supplies used or produced in a farming operation, or products of crops or livestock

in their manufactured state, if the debtor is engaged in a farming operation.

Inventory includes goods that are leased by a person as lessor, held by a person for sale or lease or to be furnished under a contract of service, furnished by a person under a contract of service, or consist of raw materials, work in process, or material used or consumed in a business.

Equipment is essentially any good that is not a consumer good, farm product, or inventory.

It is important to note that a good can only fall into one category at a time although at times it may be a close call. For example, a farmer's truck might be either a consumer good or equipment depending on its primary use. In addition, the category a good falls into may change over time. For example, farm products, such a livestock or crops, may become inventory when they are no longer part of the farming operation.

Lenders can also take security interests in proceeds from a sale or trade of collateral, property acquired by the debtor after the creation of the security interest and deposit accounts such as a checking or savings account.

CREATION OF SECURITY INTERESTS

Under the UCC, a lender may acquire a "security interest" in collateral. A security interest is a property interest over specific assets that secures performance of an obligation, typically the payment of a debt. The security interest is typically created though a document known as a security agreement and signed in conjunction with the execution of a promissory note or another loan document. For a discussion on promissory notes see fact sheet *Contracts, Notes and Guaranties*.

There are two general situations when a security interest is created:

1. When a farmer needs to borrow money but cannot obtain the funds unless some collateral is put up for the loan. Funds may be needed to plant crops, acquire livestock, or obtain machinery. In this situation, the borrower may grant a lender a security interest in his personal property in order to obtain the necessary money.
2. When a farmer does not have sufficient funds to pay the full price of a desired purchase. In this situation, the seller may provide the necessary financing and retain an interest in the property. Such a security interest is referred to as a "purchase money security interest".

Security Agreements and Attachment

The benefit of obtaining a security interest in a piece of collateral is that the lender may repossess the collateral and utilize other preferential rights upon a default by the borrower. However, in order for the security interest to be enforceable by the lender the security interest must be "attached" to the collateral. A security interest attaches to the collateral when it becomes enforceable against the debtor.

Generally, the process of attachment includes three requirements:

1. The lender must give value for the attachment to occur.
2. The debtor must have rights in the collateral or possess the power to transfer rights in the collateral to a secured party. If the debtor does not have complete ownership of the collateral listed, the lender will take

an interest in the amount that the debtor owns.

3. The debtor must authenticate a security agreement that contains a description of the collateral (unless the collateral is in the possession of the lender, then no authentication is required). The collateral may be described individually or by the defined types of collateral discussed above. The security agreement does not need to contain a detailed description of each item of collateral. For example, it is not necessary to include the serial numbers of each piece of farm equipment or the legal description of the land growing the crops subject to the security interest. Broad terms such as "all personal property" or "all assets" are not sufficient but stating "all farm products" or "all crops to be grown" is sufficient. However, proper descriptions of the property may allow the farmer to limit the breadth of the security interest to certain parcels of land or pieces of equipment. In addition, property acquired after the security agreement has been signed may be subject to the security interest if the agreement included terms such as "all present and future inventory."

Restrictions

Besides the required terms, the security agreement generally will have additional terms that deal with the borrower's right to sell the collateral. Most farm security agreements provide restrictions on the farmer's ability to sell the secured property. Some agreements may completely prohibit any sales without the written consent of the lender. Others may allow such sales subject to restrictions as to how the buyer of the secured property is to pay the farmer, such as requiring that the lender's name appear on any checks issued in payment for such property.

PERFECTION OF SECURITY INTERESTS

In order for the lender's security interest to be valid against third parties such as another lender with a claim against the borrower, the lender must take action to notify such parties of the lender's interest in the collateral. If the collateral is in the possession of the lender, no additional steps are required. This process of giving public notice of a security interest is called "perfection".

Financing Statement

The usual method for perfecting a security interest is by filing a financing statement (UCC-1) in the proper place. The financing statement is a brief and relatively simple document. It must (1) provide the name and address of the borrower, (2) provide the name and address of the lender ("secured party"), and (3) describe the collateral. It must also include the tax identification number of the borrower. With respect to the name of the debtor, if the debtor is a registered organization (e.g., a corporation, limited liability company, etc.), only the name that appears on an organization's most recently filed public record which purports to state, amend or restate the name of the organization is deemed sufficient. If the debtor is an individual and possess a state issued driver's license or identification card, the name must be as indicated on the driver's license or identification card. If the debtor is an individual but does not possess a state issued driver's license or an identification card, the debtor's surname and first personal name is sufficient. The borrower's signature is not required but he must authorize the filing of the statement. Similar to the security

agreement, the description of the collateral contained in a financing statement need not be exhaustive and need only to mention the types of collateral covered.

Filing

The financing statement must, in most circumstances, be filed with the Secretary of State in the state where the debtor's principle residence is located, likely the Minnesota Secretary of State. This can be accomplished by filing with the Minnesota Secretary of State directly, online, or with one of the designated satellite offices of the Secretary of State. If the debtor is a corporation, limited partnership, or limited liability company, the financing statement must be filed in the state where the debtor is registered. The filed financing statement is valid for five years unless it is terminated. Within the five year period, a continuation statement must be filed to extend the filing for another 5 years. For example, if an initial financing statement is filed on January 1, 2015, and a continuation statement is subsequently filed on December 1, 2019, the financing statement has a renewed lapse date of January 1, 2020.

PRIORITY OF SECURITY INTERESTS

In many cases, two or more creditors may have security interests in the same collateral. This raises the question of who has the first claim to the collateral. If one of the competing creditors has failed to file a financing statement, the holder of a perfected security interest will prevail. When two or more creditors file a financing statement covering the same collateral, the general rule under the UCC is that the first to file prevails, regardless of who actually loaned money first. It makes no difference whether the party who filed first knew when the money was advanced that another lender already had made a loan on the same collateral.

Purchase Money Security Interest

Despite the general rule stated above, the priority of a perfected security interest in after-acquired property can be overcome by a purchase money security interest. A purchase money security interest arises in a situation when a party loans the debtor the money necessary to finance the purchase of goods, and the same goods are used as collateral to secure repayment of the loan. In order for a purchase money security interest to attach the new lender must file a financing statement within 20 days from the time the borrower takes possession of the goods. If this is done, the purchase money security interest will be given priority over the original creditor with an after-acquired property clause in his security agreement. A typical example of such a purchase money financing is the financing provided by the financing affiliates of farm machinery manufacturers. Often such financing is offered directly by agricultural equipment dealers.

Special rules apply to lenders who anticipate obtaining a purchase money security interest in livestock. These lenders must not only file a financing statement in order to trump an earlier filed financing statement, but must provide written notice to the other creditors holding conflicting security interests stating that new lender expects to acquire a purchase money security interest in the livestock. The notice must be received by the other creditors within six months before the debtor receives possession of the livestock.

Statutory Liens

A second exception to the first to file rule is provided for certain liens. If a person furnishes services for materials with respect to goods subject to a security interest and

receives a lien against the goods by law ("possessory lien"), that lien will take priority over a perfected security interest. A common example in the farm setting is the case of a farm machinery repair business. So long as the repaired equipment remains in the possession of the repairman, he will retain a priority lien for storage charges, transportation, insurance, labor, and other charges necessary for protecting the equipment.

Agricultural Liens

The UCC carves out state statutory agricultural liens that secure payment or performance of an obligation for goods or services furnished or rent on real property leased by a farmer in connection with a farming operation. The perfection and priority of these liens are governed by the specific state lien statute; and not the UCC. These liens can be enforced when the farmer fails to perform any obligation owed to the lienholder.

Under Minnesota law, agricultural liens apply to both crops and livestock. These liens are typically limited to those who supply goods or services in the ordinary course of business.

Landlord's Lien

A landlord's lien is granted in favor of a landlord leasing real property for agricultural production a lien for unpaid rent on the crops produced and their products and proceeds on the land provided that a financing statement is filed by the landlord within 30 days after the crops begin growing. This lien takes priority over other secured creditors.

Harvester's Lien

A harvester's lien is granted in favor of a person who combines, picks, harvests, hauls, bales, dries, or stores crops for a farmer provided that a financing statement is filed by the custom harvester within 15 days after the harvesting.

Crop Production Input Lien

A crop production input lien grants a lien in favor of a supplier of crop production inputs (chemicals, fertilizer, seeds, labor, fuel etc.) for the unpaid retail cost of the inputs. The lien attaches to the crops produced by the input and their products and proceeds. However, the supplier must notify any creditor who has filed a financing statement prior to providing the crop production input. The creditor may either decide to extend credit to the farmer (for the purchase of the inputs) or notify the input supplier of its unwillingness to extend additional credit. If the creditor fails to respond within 10 days of the notice, the input supplier may assert a first and priority lien in the crops by filing a financing statement.

Similar liens are provided for veterinarians, livestock breeders, livestock production inputs and livestock feeders.

Subordination

At times, if a new creditor cannot obtain priority through a purchase money security interest or a statutory lien, they may require a subordination agreement. A subordination agreement is a voluntary agreement in which a creditor voluntary gives up its position of priority for that of a new creditor. These agreements may be necessary for a new creditor to extend financing to a farmer.

SPECIAL PROBLEMS FOR FARMERS AND THEIR LENDERS

Farmers and lenders who take security interests in farm products receive special treatment under the UCC. In addition, the very nature of a farming operation raises

special problems for agricultural lenders and their customers.

Farm Program Payments

Farmers may participate in any number of farm programs. Many of them result in program payments to the farmer from the government. These rights to payment may be a source of security for the agricultural lender. Such payments are covered by a proper security interest in crops or in general intangibles, a catch all category of collateral under the UCC. Most courts which have addressed the question have determined that government program payments are included in this classification. However, unfortunately the law in this area is less than clear. In addition to pledging these payments in a security agreement, the farmer may be asked to sign other documents with the government. To perfect its security interest the Lender will need to file a financing statement.

After-Acquired Property

Once a lender obtains a security interest under the UCC it is a durable lien. By means of an after-acquired property clause, a lender may be given a security interest in property that will be obtained or acquired after the signing of the security agreement. Thus, livestock, crops, or other goods acquired by the farmer in the future may be included as collateral for the present loan.

Future Advances

In addition, the UCC allows the parties to agree that future advances of money may be given when needed without making a new agreement. Such provisions are important since a lender who has been granted a security interest in all crops, including crops to be grown at a future date, will possess a security interest in crops that are planted and harvested in later years even though the lender may not have financed the planting and harvesting of such crops. It is not necessary for a farmer to sign a new security agreement or for the lender to file a new financing statement for each crop year.

Products and Proceeds

Besides covering property that may come into existence at a later date, the security interest under the UCC remains intact even though the collateral itself may change through the stages of production. A lien on crops continues as the crop matures in the field, is harvested, and stored. A lien on livestock, including all after-acquired livestock, creates a valid security interest in offspring, whether or not they were conceived at the time the agreement was signed. Finally, the security interest of a lender extends to proceeds of the collateral. Thus, if a farmer sells farm products, the lien holder is entitled to the sales proceeds by virtue of his security interest in the farm products themselves.

If a farmer sells farm products, the purchaser of such products takes the farm products free of the prior perfected security interest in the products unless the lender has filed second notice called an “effective financing statement” with the Minnesota Secretary of State under the provisions of a federal statute. If the lender complies with the federal act, and the farmer sells the crops without the permission of the lender, the lender can sue either the farmer or the purchaser of farm products to either repossess the goods or get damages for the farmer's unauthorized sale.

CONCLUSION

The rules of the UCC with respect to security interests in personal property are of critical importance for the farm operator and lender alike. The farmer must be aware of the

significance of each of the documents he is asked to sign. The lender must take all steps necessary to obtain a perfected security interest in the collateral that has been promised for the loan. Once a perfected security interest has been obtained, it remains in place until terminated by the lender or until five years pass.

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Agricultural Business Management

FARM LEGAL SERIES June 2015

Tax Considerations in Liquidations and Reorganizations

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INTRODUCTION

Generally, when a person is experiencing extreme financial distress, income tax liability is not a major concern. After all, the lack of income is at least partially responsible for the person's financial difficulties. In the case of farming operations, however, income tax liabilities present real difficulties.

For farm debtors using the cash method of accounting, the income tax basis of raised animals or stored grain is zero. Machinery and equipment have often been depreciated rapidly, with a resulting low basis, and land that was purchased some time ago frequently has a low basis derived from the original purchase price and adjusted for improvements made in depreciation claimed. Thus, there is a potential income tax liability created when assets are sold or turned over to creditors. In addition, income taxes may be generated when debt is forgiven.

There are several options available to the farmer in dealing with these income tax problems.

LIQUIDATION LIABILITIES

If farm assets are liquidated outside of bankruptcy, any resulting tax liability is solely the responsibility of the debtor as the taxpayer. In the event of a liquidation, tax liabilities may take several forms:

1. Ordinary income will result from the sale of assets—such as grain or livestock—held for resale.
2. Ordinary income will result from the recapture of certain previously claimed tax benefits such as depreciation, soil and water conservation expenses, land clearing expenses, and government cost sharing payments excluded from income.
3. If capital assets such as real estate are sold to pay debts, capital gains may result from the sale.
4. An alternative minimum tax may be imposed on preference income that includes the portion of capital gains that individuals do not include as income. Although most farming expenses are treated the same for regular tax and minimum tax purposes, there are farming expenses that may generate minimum tax consequences.

If, rather than selling assets, a taxpayer turns assets over to a creditor in partial or total satisfaction of the debt or the creditor exercises the right to foreclose on the assets, such debt forgiveness will also usually generate income. In the event that the fair

market value of the property exceeds the debt, then a transfer of property to a creditor or a foreclosure is treated as a sale of the property for an amount equal to the property's fair market value.

To illustrate, assume that Fred Farmer borrows $200,000 to purchase a combine that costs $200,000. Farmer Fred takes $75,000 of depreciation deductions during his ownership of the combine, so that his tax basis in the combine is $125,000. Fred then defaults on his loan when the balance is $150,000, and the fair market value of the combine is $175,000. If the bank accelerates the $150,000 balance and forecloses on the combine, Fred is deemed to have sold the combine to the bank for $175,000. As Fred's tax basis is $125,000, Fred realizes gain of $50,000.

In the event, however, that the debtor is personally liable for the debt and the fair market value of the property is less than the indebtedness, the transfer of property or foreclosure is treated as a deemed sale, the proceeds of which are deemed to be applied to the debt. The balance of the indebtedness results in debt discharge income.

To illustrate this example, assume that Fred Farmer borrows the same $200,000, purchases the same combine for $200,000, and takes the same depreciation deductions of $75,000. However, assume that Fred defaults on his loan when the balance is $175,000, and the fair market value of the combine is $150,000. If the bank accelerates the $175,000 balance and forecloses on the combine, Fred is deemed to have sold the combine to the bank for $175,000. As Fred's tax basis is $125,000, Fred realizes gain of $50,000. In addition, Fred has debt discharge income of $25,000, which is the difference of the indebtedness over the fair market value of the combine.

This income from discharge of indebtedness may or may not be recognized, depending on whether Fred was solvent, insolvent, or in bankruptcy. If he was in bankruptcy when the debt was forgiven, he does not have to report the forgiven debt as income. If he was not in bankruptcy when the debt was forgiven but was insolvent, he is treated as though he were in bankruptcy. If, however, he was solvent, he may be able to exclude from income the forgiven debt if the debt was classified as "qualified farm debt" and Fred meets several other special rules.

Even if such debt discharge income is not recognized, the debtor's tax attributes will be reduced to the extent of such debt discharge income. The law sets forth a detailed order in which the tax attributes are reduced:

1. Net operating loss.
2. Certain credit carryovers, namely, investment tax credit and other credits not applying to farmers.
3. Capital loss carryovers.
4. Basis reduction by reducing basis of property of the taxpayer.

But Fred's problems are not confined merely to gain from the disposition of the combine and debt discharge income. He also may be subject to the alternative minimum tax.

The alternative minimum tax was included in the tax code to prevent a taxpayer with substantial economic income (income without regard to special exclusions or deductions) from avoiding substantial tax liability by using tax exclusions, deductions, and credits to reduce their taxable income. The alternative minimum tax calculation starts with the taxpayer's regular taxable income for the tax year.

The taxpayer must then make adjustments and add back certain tax preferences to arrive at the taxpayer's alternative minimum taxable income. Some common examples of tax preferences and adjustments that affect farmers include the excess of accelerated depreciation over straight-line depreciation on real property, accelerated depreciation on leased personal property and an increase to gain on the sale of property sold or foreclosed on. Certain itemized deductions must be added back for alternative minimum taxable income calculations. State and local taxes are not allowed.

The taxpayer's alternative minimum taxable income is then reduced by the allowed exemption to arrive at the taxpayer's taxable excess income. The allowed exemption amount for calculating alternative minimum tax depends on the filing status of the taxpayer. For a taxpayer who is married and files jointly, the allowed exemption is $82,100 for 2014. For a single person or head of household, it is $52,800 for 2014. For a married taxpayer filing separately, it is $41,050 for 2014. The allowed exemptions begin to phase out when the taxpayer's alternative minimum taxable income exceeds certain thresholds. For example, the allowed exemption is reduced by 25% of the amount by which alternative minimum taxable income exceeds $156,500 for married couples filing jointly, $117,300 for single taxpayers, and $78,250 for a married taxpayer filing separately.

This calculation is illustrated using the following formula:

	Regular taxable income
+	Tax preferences (and adjustments)
	Alternative minimum taxable income
–	Allowed exemption amount
	Taxable excess

The taxable excess is then taxed at 26% up to $175,000 ($87,500 for married filing separately) with the remainder taxed at 28% to arrive at the taxpayer's tentative minimum tax. The taxpayer's alternative minimum tax liability equals the taxpayer's tentative minimum tax minus the taxpayer's regular taxable income.

	Taxable excess
X	26% (or 28%)
	Tentative minimum tax
–	Regular tax liability
	Alternative Minimum Tax

Thus, the alternative minimum tax can result in significant additional income tax liability for Fred. If Fred has capital gain for the tax year, the computation of tentative minimum tax is more complicated in light of rules that consider applicable capital gains rates.

CHAPTER 7 AND 11

In the event that the debtor seeks protection of the Bankruptcy Code, additional results and planning opportunities follow. If an individual debtor files bankruptcy under either Chapter 7 or 11, a new taxable entity is created. The bankruptcy estate is a taxable entity that is separate and distinct from the debtor. All property owned by the debtor at the time the bankruptcy case is initiated passes by operation of the Bankruptcy Code to the bankruptcy estate. The transfer of assets by the debtor to the bankruptcy estate is not treated as a taxable disposition. Thus, the transfer does not require income tax to be paid on the gain in the assets involved. Nor does the transfer trigger income tax liability from the recapture of depreciation, recapture of soil and water conservation or land clearing expense, recapture of government cost sharing payments excluded from income, or recapture of investment tax credit. The estate is treated as the debtor

would have been treated had he not filed for bankruptcy.

After the bankruptcy case has been initiated, income generated from assets included in a bankruptcy estate is included in the bankruptcy estate's income. Thus, if the bankruptcy estate disposes of assets or suffers a foreclosure and triggers income tax liability in the process, the income tax liability is a priority claim in the estate as an administrative expense. As a result, the tax due is paid ahead of general unsecured creditors. Any income tax liability remaining does not pass back to the debtor, however.

Besides automatically transferring all the debtor's property to the estate, the initiation of a bankruptcy case gives an individual debtor one significant choice. He may elect a short tax year, ending the day before the bankruptcy filing. He thus creates two short tax years for himself. His income tax liability in the first short year becomes a priority claim against assets in the bankruptcy estate. That is because the bankruptcy estate is responsible for all the debtor's liabilities at the time of bankruptcy, including income taxes that accrue before the date of bankruptcy. As a result, electing to end a tax year before the day of bankruptcy causes the taxes on the income earned to that date to become a debt of the bankruptcy estate. If there are insufficient assets to pay the income tax, the remaining liability is nondischargeable. Any remaining income tax liability for the first short year returns to the debtor and can be collected from him later.

In the event the debtor does not elect a short year, the tax on the income earned during the tax year in which his bankruptcy occurs will accrue after the date of bankruptcy and will therefore not become a debt of the estate. As a result, none of the debtor's income tax liability can be collected for the year of bankruptcy filing for the bankruptcy estate. To illustrate, assume that a farmer who is a calendar year taxpayer is in financial difficulty and sells some assets in January to pay debts. On the 1st of May, she decides to file for bankruptcy. If she does not elect two short tax years, the gain she realizes on the sale of the assets will be included on the return she files for the full year. Those taxes will not be a debt of the bankruptcy estate. If she elects two short years, the income taxes on the gain from the sale of the assets will accrue before the bankruptcy was filed. Therefore, the taxes on the gain will become a debt of the bankruptcy estate and will be properly payable out of the estate assets.

The debtor's selection of a single tax year or two short years also affects the amount of tax attributes that pass from the debtor to the bankruptcy estate. The bankruptcy estate receives the tax attributes of the debtor as of the beginning of the tax year in which the bankruptcy was initiated. Therefore, if the debtor chooses a single tax year, the attributes that he or she has at the beginning of that year will pass to the bankruptcy estate and cannot be used by the debtor on the tax return for that year. If the debtor chooses two short tax years, the attributes do not pass to the bankruptcy estate until the beginning of the second short year. Therefore, the debtor can apply the tax attributes on his or her return for the short year first.

In most cases, if the debtor has income before the date the bankruptcy was initiated, it is usually to his advantage to choose short tax years. By doing so, the debtor not only makes the taxes on that income a debt of the estate, but also reduces the amount of taxes owed on that income.

CHAPTER 12

Unlike Chapter 7 and 11, the legislation creating Chapter 12 did not create a separate tax entity for a Chapter 12 debtor. Instead, the debtor must propose a plan to pay his

creditors over 3-5 years. Since a separate entity is not created, the debtor does not have the option of filing a short tax year federal return. Furthermore, in 2005, Congress amended Chapter 12. It was believed that the amendments would provide debtors capital gain tax relief. Prior to 2005, if a debtor in bankruptcy sold real estate and machinery while in bankruptcy, the resulting capital gains from the sale of the property would be a priority claim by the government. The debtor would pay this claim in full during the life of the plan. For a farming operation that had very low basis on its real estate (and in some cases, its machinery), this often prevented the debtor from obtaining a discharge (or closing his or her Chapter 12 plan). When Congress amended Chapter 12 in 2005, it was believed by many that Congress amended the Bankruptcy Code to allow any "capital gain" taxes of the debtor to be a general unsecured claim of the government—a claim that does not have to be paid in full to obtain a bankruptcy discharge. The government disagreed with this interpretation and in 2012 the United States Supreme Court ruled that any capital gain taxes realized from the sale of farm assets sold during the bankruptcy must be paid in full during the 3-5 year term of the Chapter 12 plan. The United States Supreme Court did not address capital gain taxes realized from the sale of farm assets before the bankruptcy is filed. A number of lower courts have held that these taxes can be treated as a general unsecured claim.

To illustrate, assume that Fred Farmer purchased his farm in 1985 for $100,000. A few years later Fred borrowed money to buy and operate a small hog feeding operation adjacent to his farm for $200,000. The farm was used as collateral for the hog operation loan. The farmland drastically appreciated in value, and Fred Farmer leveraged the appreciated value to increase the size of his hog operation. Fred now owes the bank $650,000. Fred Farmer files a Chapter 12 bankruptcy and elects to keep the hog feeding operation and sell the farmland. The farmland is sold for $450,000. Fred Farmer would have a $350,000 capital gain. For most taxpayers, net capital gains are taxed at no higher than 15%, although there is a 20% rate on net capital gain rate that may apply based on certain taxable income thresholds. Assuming that Fed Farmer is taxed at the 15% rate, Fred Farmer would owe $52,500 in capital gains taxes. Under the 2012 United States Supreme decision Fred Farmer would have had to pay the $52,500 in full over the 3 to 5 years life of his Chapter 12 plan.

However, under a growing number of lower court decisions, had Fred sold the farmland before he filed bankruptcy, Fred Farmer could treat the $52,500 as a general unsecured claim and, in most circumstances, no payment would need to be made through his Chapter 12 plan. Upon completion of his plan Fred Farmer would discharge any capital gain liability on the sale of the farmland. Whether Farmer Fred, in our illustration, can treat the capital gain taxes realized from the sale of farm assets before the bankruptcy is filed remains an unsettled area of law.

CONCLUSION

Tax planning is as important for farmers in financial distress as for those who are making a profit. Income tax consequences are triggered by the sale of assets, the foreclosure of debts, and the forgiveness of debts. The difference in income tax treatment for the liquidation of assets provides a strong motivation to file for bankruptcy. The difference in income tax treatment also may be important to creditors. A secured creditor may obtain a larger payment in bankruptcy than if the debtor sells the property and

remits the after-tax balance to the creditor. When contemplating bankruptcy or liquidation, farmers must carefully consider the effect of their decisions from a tax point of view.

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Agricultural Business Management

FARM LEGAL SERIES

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Termination of Contracts for Deed

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INTRODUCTION

If a farm debtor is unable to perform under a contract for deed, the rights of the parties are determined by state law. In general, if the farmer defaults on his contract for deed, the seller will have the right to terminate the contract and take the land back. Minnesota law is very specific with respect to the process of terminating a contract for deed. Specific time periods are provided by the statutes and must be followed to the letter by the creditor who is attempting to terminate a contract for deed. Failure to follow each step of the termination process properly may result in an invalid termination.

DEFAULT

A typical contract for deed includes several terms that require the purchaser to do more than merely make the necessary periodic payments. For example, the purchaser is required to maintain insurance on the premises, pay all real estate taxes and maintain the premises for the benefit of both the purchaser and the seller. In addition, contracts for deed may include provisions prohibiting the sale of all or any portion of the premises without the prior written consent of the seller. Such provisions are known as due on sale clauses. If the purchaser fails to abide by any of the terms in the contract he is in default.

The standard form contract for deed in use in Minnesota provides that the time of performance by the purchaser of the terms of a contract is an essential part of the contract. Thus, in most cases, the failure of the purchaser to comply with the terms of a contract for deed on the date specified by the contract constitutes a default.

CREDITOR'S OPTIONS UPON DEFAULT

Once a default has occurred the creditor has several available options besides simply terminating the contract for deed.

Deed in Lieu of Termination

The creditor can negotiate an arrangement with the debtor whereby the debtor gives the property back to the creditor in satisfaction of the underlying debt. Such a procedure is known as the debtor giving the creditor a "deed in lieu of termination." When a debtor undertakes such action, he is voluntarily surrendering his redemption or reinstatement rights (discussed below). Because such an action results in the transfer of ownership and the right to possession, Minnesota courts have long held that such transactions are subject to close scrutiny to protect the debtor from oppression by the creditor. In order for such an agreement to be upheld by a court, it must not be the result of any oppressive means or overreaching on the part of the creditors and adequate consideration must be given.

Legal Action

A second course of action for the creditor is to bring a lawsuit on the underlying debt based on the promises of the debtor contained in the contract for deed. If the value of the real property is less than the amount due under the contract for deed the creditor may well elect to bring an action seeking payment of the amount due.

A significant difference between a mortgage and a contract for deed may be realized if the lender decides to sue. A promissory note and mortgage both typically include an acceleration clause, but the standard form contract for deed in use in Minnesota does not. As a result, the seller under a contract for deed, should he elect to sue his purchaser for the purchase price, must do so for each installment payment as it comes due. That is, without such a clause, he cannot bring one lawsuit for the entire balance due under the contract for deed. This limitation may make such an alternative a less attractive proposition to the seller. Such a course of action may be unattractive to a creditor unless the purchaser has other nonexempt assets that can be reached to satisfy the underlying debt.

Mediation

Where a contract for deed involves agricultural real estate, Minnesota's farmer-lender mediation statute generally requires the seller to offer mediation of the obligation to the purchaser prior to beginning contract for deed cancellation proceedings. The farmer-lender mediation statute began requiring mediation in 1986, with the statute's expiration date being extended in the years following original passage. Generally, the statute requires, among other things, that the seller under a contract for deed on agricultural real estate seeking to cancel the contract first send notice to the purchaser and offer the purchaser the opportunity to mediate a resolution to the contract for deed obligation prior to beginning such action. If the purchaser elects to mediate the obligation, the seller's cancellation of the contract for deed can be suspended for a period of up to 90 days pending completion of the mediation. Where the debt involved has been scheduled by the purchaser in a bankruptcy or involved in a previous farmer-lender mediation, the debt is not subject to the farmer-lender mediation statute and the seller can initiate cancellation proceedings without first offering mediation.

STEPS IN TERMINATION OF CONTRACTS FOR DEED

Minnesota law clearly sets forth the steps that must be taken to terminate a contract for deed. Once a default exists and the seller has decided to terminate the contract for deed, a notice of termination must be served upon the purchaser under the contract for deed. The notice must set forth the following information:

1. The nature of the default (e.g., nonpayment).
2. The period of time within which the purchaser may reinstate.
3. A statement that the purchaser must either make payments in the amount owed, plus costs of service, attorneys' fees incurred and other amounts due under the cancellation statute depending on the date of the contract (discussed below); or secure a court order suspending termination of the contract for deed.
4. The name, address and telephone number of the seller or an attorney authorized by the seller to accept payments.
5. Certain specific language required by law that notifies the purchaser of the

consequences of his failure to comply with the notice, including that the contract will be terminated, that the purchaser will lose his right to possession of the property, and that the purchaser will lose all the money paid on the contract.

Special Requirements

For contracts for deed executed on or after May 1, 1980, the notice also must state that the purchaser must pay any additional payments due the seller under the contract for deed through the date payment is made, rather than the date of the notice. For contracts for deed executed on or after August 1, 1985, the notice must state that the purchaser is further required to pay two percent of the amount in default at the time of service of the notice, not including balloon payment, taxes, assessments, mortgages or prior contracts assumed by the purchaser.

For the seller to recover attorneys' fees under a contract for deed executed on or before July 31, 1985, some part of the conditions of default must have existed for at least 45 days prior to the date of service of the notice upon the purchaser. For contracts for deed executed on or after August 1, 1985, this period of default is reduced to 30 days.

Notice

The notice must be served upon the purchaser in the same manner as a summons according to the Minnesota Rules of Civil Procedure. Three weeks' published notice has the same effect as personal service of the notice upon the purchaser' provided that certain procedures are followed, but the cure period is expanded to 90 days where service is by publication. Besides serving the purchaser, serving other parties—such as mortgagees, judgment creditors or other lien claimants—may be required.

Termination

The right of the purchaser to reinstate the contract is absolute, provided that he complies with the payment of all sums required. If the purchaser fails to comply with the notice, the contract will terminate.

Upon termination the purchaser will lose all sums that have previously been paid on the contract, the right to possession of the property and the right to assert any claims or defenses against the sellers. He may be evicted from the premises by the seller. Once the termination has been completed, however, the seller can no longer maintain any action for a deficiency judgment against the purchaser.

Cure or Reinstatement Period

The period allowed to cure the defaults and the conditions of a contract for deed varies, depending on the date on which the contract was executed and on the percentage of the purchase price that has been paid by the purchaser, as follows:

CONTRACT DATE	PERCENTAGE PAID	CURE PERIOD
Before August 2, 1976	Any	30 Days
After August 1, 1976 and *Before* May 1, 1980	Less than 30%	30 Days
	Between 30-50%	45 Days
	50% or More	60 Days
On or After May 1, 1980 and *Before* August 1, 1985	Less than 10%	30 Days
	Between 10-25%	60 Days
	25% or More	90 Days
August 1, 1985 or *Later*	Any	60 Days

Right of First Refusal

Where the real estate subject to contract for deed cancellation is agricultural land or a farm homestead and the seller is a government agency, limited partnership or corporation, Minnesota law provides the purchaser with certain rights of first refusal upon the rental or resale of the property by the seller. The seller cannot offer the property for sale or lease until it has provided written notice to the purchaser at least 14 days in advance. When a third party buyer or lessee is found, the seller must then offer to sell or lease the property to the purchaser upon the same terms as the offer made by such third party. The purchaser has a defined period of time within which to exercise his right of first refusal to either buy or lease the property on such terms. For leases, it is within 15 days of the seller's written offer to the purchaser, and for sales, it is within 65 days of the seller's written

offer to the purchaser. If the purchaser exercises his right of first refusal, he must fully perform the terms of the sale or lease within ten days of such exercise.

The purchaser can elect to purchase or lease a portion of the total property involved, but only where the portion is of a size, configuration and location which does not unreasonably reduce access to or the value of the remaining property. The purchaser is not allowed to resell the property if the sale was arranged prior to his exercise of the right of first refusal. Where the property is resold by him within 270 days of exercising the right of first refusal, there is a presumption, subject to proof to the contrary, that the sale was arranged ahead of the exercise of the right of first refusal. Where the purchaser violates this prohibition, he will be liable for damages and attorneys' fees.

CONCLUSION

Procedures under Minnesota law for terminating a contract for deed are complex and detailed. They prescribe specific time periods within which both parties must take certain actions. Such time periods are critical for both parties. Any person involved in such procedures should carefully examine the specific provisions of state law that apply to his case.

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FARM LEGAL SERIES June 2015

Using Trusts: Legal Issues and Options

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INTRODUCTION

Trusts are a commonly used estate planning tool. They can take a variety of forms and there are many terms used to describe them – revocable, irrevocable, and testamentary are just a few. Trusts are often utilized by farmers. For example, revocable trusts are frequently used as will substitutes. If a person has a revocable trust and moves all of his property to his revocable trust during life, he can prevent his beneficiaries from having to do a probate on his death.

Sometimes trusts are testamentary, meaning they are created at a person's death by his will or other document. The trust is funded with the decedent's assets and may be created for the benefit of the decedent's beneficiaries. Oftentimes, people create trusts for their children at death, so that the assets in the trust are protected from creditor claims, or to prevent a child's misuse of the inherited property. While trusts are useful and have a variety of purposes, owners of agricultural land need to be aware of the issues associated with using a trust and understand the necessary steps to avoid those potential pitfalls.

THE CORPORATE FARM ACT AND ITS LIMITS ON TRUSTS

Minnesota's Corporate Farm Act, found in Minn. Stat. Section 500.24, is intended to protect the family farm. Trusts in all forms are subject to the Corporate Farm Act and its restrictions. Trusts that hold farmland must complete the corporate farm application and submit it to the Minnesota Department of Agriculture. As long as the trust satisfies the requirements of the statute, the Commissioner will sign a certificate stating that the trust is in compliance with the law.

In order to conform to the requirements of the Corporate Farm Act, the trust must be a "family farm trust," as defined in Minn. Stat. Section 500.24, subd. 2(d). One type of family farm trust, which is the most common, must comply with the following elements:

1. The majority of the current beneficiaries of the trust must be people who are related to each other within the third degree of kindred, or their spouses.
2. All of the current beneficiaries must be natural people or nonprofit corporations or trusts.
3. One of the family members, who is a current beneficiary, must reside on or actively operate the farm. Alternatively, if there is no family member who meets that description, the trust must lease the agricultural land to an entity that complies with Minn. Stat. Section 500.24. Those eligible entities are the following: a family farm unit, a family farm corporation, an authorized farm corporation, an authorized livestock farm corporation, a family farm limited liability company, a family

farm trust, an authorized farm limited liability company, a family farm partnership, or an authorized farm partnership.

There are two other types of trusts that can be defined as family farm trusts. Certain charitable remainder trusts (defined in I.R.C Section 664) and charitable lead trusts (defined in I.R.C. Section 170(f)) are eligible for family farm trust status. A charitable remainder trust is, in short, a trust that pays out either a specified amount or percentage at least annually to one or more people for a certain number of years. After the term of years is complete, the trust terminates and all property remaining in the trust is distributed to the charity, which is the remainder beneficiary. The longest term of years permissible for a charitable remainder trust is twenty years.

Charitable lead trusts can also be family farm trusts. A charitable lead trust is in essence the opposite of a charitable remainder trust. It must pay either a specified amount or percentage at least annually to a charitable organization for a certain number of years. After the term of years is over, the trust will terminate and all property must be distributed to one or more people.

It is also possible for trusts to be grandfathered into the family farm trust definition. If the trust had an interest in agricultural land prior to May 16, 2000, and the trust does not acquire more than 20% of what the trust owned as of the grandfather date in any five year period, then it may also be defined as a family farm trust. The restriction on the addition of land does not include any acreage that is owned to meet pollution control requirements.

If a trust violates the Corporate Farm Act, the violator can be subject to a fine and gross misdemeanor charges for the violation. For that reason alone, it is extremely important to ensure that any trust you want to have hold your farm – whether it is revocable, irrevocable, testamentary, or charitable – is in compliance with the Corporate Farm Act and that you complete the required application.

AGRICULTRAL HOMESTEAD WHEN PROPERTY IS HELD IN TRUST

When agricultural property is held in trust, there are specific agricultural homestead classifications available for that property, which give the property preferred tax treatment. Those classifications are the following: grantor occupied agricultural homestead; agricultural relative homestead; and special agricultural homestead. Agricultural property held by a trust is eligible for one of these agricultural homestead classifications only if it meets certain requirements.

First, the land must be held by an authorized trust. An authorized trust is a family farm trust, as described above, that complies with the Corporate Farm Act. The type of trust that owns the property is not the main concern of this law. The agricultural property can be owned by a revocable trust or an irrevocable trust, and that trust could be established at death or during life.

The grantor of the trust is the creator of the trust. If the grantor wants to claim homestead of agricultural property in trust, the grantor must be a beneficiary of the trust. For example, the land cannot be in a trust that benefits only the grantor's children if the grantor is the individual claiming the homestead. In addition, the grantor must be a Minnesota resident. The grantor of the trust can claim grantor occupied agricultural homestead in the following situations:

1. The grantor occupies the property and uses it as a homestead.
2. The grantor lives in a town within four contiguous cities or townships or a

combination thereof from the land and the grantor, the grantor's spouse, or a grandchild, child, sibling, or parent of the grantor or grantor's spouse is actively farming the land.

Agricultural property held in trust can also be agricultural relative homestead. If the property is occupied and used as a homestead by a qualifying relative of the grantor of the trust, the property is eligible for agricultural relative homestead classification. Spouses are not considered relatives for homestead purposes. A qualifying relative of the grantor is any of the following: a grandchild, child, sibling, or parent of the grantor or the grantor's spouse. The grantor must be a Minnesota resident and neither the grantor, nor the grantor's spouse, can receive another agricultural homestead in Minnesota. In addition, the qualifying relative may not claim another agricultural homestead in Minnesota, as this homestead classification is limited to one per family. When applying for a relative agricultural homestead, the qualifying relative should complete the homestead application.

The grantor of the trust does not need to be alive for a qualifying relative to claim relative agricultural homestead. In fact, the grantor may have created a trust that receives the agricultural property at grantor's death, rather than during grantor's life. If a qualifying surviving relative of the grantor is a beneficiary of that trust and occupies the trust property, using it as a homestead, the surviving relative is eligible for relative agricultural homestead.

Trust-held property can also be eligible for "actively farming" special agricultural homestead. Actively farming special agricultural homesteads are generally granted under Minn. Stat. 273.124, subdivision 14. Special agricultural homestead is sought when neither the grantor, nor the grantor's spouse, nor any qualifying relatives lives on the agricultural property or occupies it as a homestead. In these circumstances, one of the following must be true in order for the land to be eligible for special agricultural homestead.

1. The land must be actively farmed by the grantor, the grantor's spouse, or a qualifying relative either on that person's own behalf or on behalf of an authorized entity of which they are a qualified person. An authorized entity is any entity that complies with the Corporate Farm Act. The individual that is actively farming must be a Minnesota resident; or
2. The land is rented by an authorized entity of which the grantor or grantor's surviving spouse is a shareholder, member, or partner and a qualified person of the authorized entity that leases the property is actively farming the property on behalf of the authorized entity. The individual that is actively farming must be a Minnesota resident.

In addition, all of the following requirements must be met for the agricultural property to qualify for special agricultural homestead:

1. The agricultural property must be at least 40 acres, including government lots and correctional 40s;
2. Neither the grantor nor the grantor's spouse can claim another agricultural homestead in Minnesota; and
3. Neither the grantor nor the person who is actively farming can live farther than four cities or townships or a combination thereof from the agricultural property.

If all of the above requirements are met, then the property, even though held in trust, qualifies for special agricultural homestead.

Agricultural property classified as class 2a property owned by the same individual or entity can be linked together and classified as homestead. Even if the property is noncontinguous, it can be linked if it is classified as class 2a and located within four townships or cities or a combination thereof from the homestead. Married couples owning property in their names individually can link their property, even if not owned jointly and title is in their separate names. But if married couples own different parcels of agricultural property in two separate trusts, the property cannot be linked and placed together under the same agricultural homestead classification. Under the statute, the property is considered to be owned by two separate entities, rather than married individuals, so it cannot be linked. If all of the parcels are owned by one spouse's trust, then they can still be linked together if they are class 2a property and located within four townships or cities or a combination thereof from the homestead.

You should check with the county assessor if you have concerns about your homestead classification. Sometimes counties may interpret the laws differently, so it is important to ensure that you comply with their requirements for obtaining homestead status.

TRUSTS' EFFECTS ON CLAIMING THE QUALIFIED FARM PROPERTY DEDUCTION

The qualified farm property deduction is an estate tax deduction in the state of Minnesota that was passed during Minnesota's 2011 special session. There were many concerns about how the law may affect property held in trust in its first version, and the law was amended and clarified during the 2013 legislative session to quell these concerns and correct and clarify the law. One of the most important parts of the recent law corrections and clarifications deals with trusts that hold agricultural land and the eligibility of that land for the deduction.

The state of Minnesota has a $1.4 million state estate tax exemption in 2015, which is set to increase by $200,000 annually until the exemption reaches $2 million in 2018. For owners of agricultural land, this deduction can be increased to $5 million, if they own qualified farm property that meets specified requirements. Therefore, in 2015, an individual that qualifies for the qualified farm property deduction can pass an additional $3.6 million of assets to the next generation without incurring a Minnesota estate tax. In 2018, when the exemption has increased to $2 million, an estate can transfer an additional $3 million of assets to beneficiaries Minnesota estate tax free, for a total of $5 million being transferred with no transfer tax. This additional exemption is only available if the property passing subject to the additional deduction is qualified farm property.

In order to be considered qualified farm property, the agricultural property must meet the following requirements at the time of decedent's death:

1. The property's value must be included in the decedent's federal adjusted taxable estate.
2. The property must consist of agricultural land and must be owned by a person or entity that is either not subject to or is in compliance with Minn. Stat. Section 500.24.
3. The property must be classified for property tax purposes in the taxable year of death as agricultural homestead, agricultural relative homestead, or special agricultural homestead under Minn. Stat. 273.124.
4. The property was classified for property tax purposes in the taxable

year of death as class 2a property under Minn. Stat. 273.13, subdivision 23.

5. The decedent continuously owned the property for the three-year period ending at the decedent's death.

One of the requirements that can cause problems is the homestead requirement. As indicated in the above section, after transferring property from an individual's name into a trust, the property owner must ensure that the trust complies with the Corporate Farm Act and reapply for homestead. Agricultural property held by a trust is often eligible for some type of agricultural homestead, but the owner of the property must follow the steps to get the official homestead classification. If the property is not classified as agricultural homestead on decedent's date of death, the deduction is not available.

The other requirement that may cause concern is the requirement that the decedent has continuously owned the property for the three-year period ending at the decedent's date of death. Property held by a revocable trust of which the decedent was grantor will be considered owned by that person.

There are two additional requirements for the qualified farm property deduction. They are as follows:

1. A family member must maintain the 2a classification for the three years following the decedent's death.
2. The estate and qualified heir must agree to pay the recapture tax, if applicable.

In order to be a qualified heir, the recipient of the property must be a family member as defined by the statute. A family member is any one of the following: the decedent's ancestors (parent, grandparent, etc.), the decedent's spouse, a lineal descendant (child, grandchild, etc.) of the decedent, of the decedent's spouse or of the decedent's parents or a spouse of a lineal descendant, or a trust whose present beneficiaries are all family members. The permissible trust could be a family trust, which benefits the surviving spouse and the decedent's children during life. It could also be a trust for a child, which permits distributions to the child, the child's spouse, and the decedent's grandchildren.

If the property passes into a trust, the trustee of the trust has the responsibility to maintain the 2a classification to prevent the recapture tax, as well as file the required informational returns, whether the trustee is a family member or not. If these actions are not completed, the trust is responsible for paying the recapture tax.

CONCLUSION

Trusts have become an extremely important and effective estate planning tool for many people, and farmers in particular often utilize them for estate tax savings, probate avoidance, and privacy. Even though agricultural property is commonly placed in trusts, the follow-up required to comply with the Corporate Farm Act and ensure that owners retain agricultural homestead can sometimes be overlooked. It is important to understand that whenever ownership of your agricultural property is transferred from you to a trust, there are steps that must be taken to maintain tax benefits associated with that property today and in the future.

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