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FARM LEGAL SERIES

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 him 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.

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, the FSA offers 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.*

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 Programs — 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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