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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 or rent regardless of the crop yields or prices. The farmer-tenant had 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 law 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 transfer 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 county recorder's office 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*.

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 more a more detailed discussion see fact sheets: *Security 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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