Agricultural Law Update

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AMERICAN AGRICULTURAL LAW ASSOCIATION

INSIDE

Solicitation of articles: All AALA members are invited to submit articles to the Update. Please include copies of decisions and legislation with the article. To avoid duplication of effort, please notify the Editor of your proposed article.

IN FUTURE ISSUES:

- Orderly marketing of agricultural products in Ontario, Canada

IRS issues proposed regulations concerning shareholder loans to S corporations

When a "sub-chapter S" election is made, a corporation is treated taxwise as an individual. That means all of the corporate income, loss, deduction and other tax items flow through the corporation to the individual shareholder's tax return. So, for example, if the corporation has a loss, that loss is deductible by the shareholders on their personal tax returns. But, the loss is limited by the shareholders' tax basis in their stock. Stock basis is determined by the shareholder's original investment in the corporation's stock plus certain debt basis. Also, the manner in which the shareholder acquires the stock influences basis (e.g., whether it was received as a gift, a purchase, as compensation, or through an estate).

Basis is increased by the shareholder's share of corporate taxable income and any capital contributions the shareholder makes. Basis is decreased by the shareholder's share of corporate losses and any S corporation distributions to the shareholder.

So, a deductible loss reduces the shareholder's basis in the stock at the close of the year. Basis cannot be reduced below zero, and any loss that is not deductible due to the basis limitation is carried forward to the next tax year. It does not expire and may be deducted when the shareholder gains sufficient basis to absorb it.

A shareholder can loan money to their S corporation and increase their stock basis by the amount of the loan. But care must be taken. Basis is increased for debts only if there is an actual economic outlay by the shareholder and the S corporation is obligated to pay off the debt. In essence, the loan must have substance and the taxpayer must be "at risk." For example, the U.S. Court of Appeals for the Eighth Circuit, in 2004, affirmed a Tax Court opinion on this issue in a case that involved the owner of a trucking company. The owner had multiple S corporations and borrowed money from one corporation and loaned it to another S corporation with tax losses so he would have basis to deduct the loss on his personal return. The second corporation sent the money immediately back to the first corporation in another loan. The court did not have any trouble holding that the loan did not have any substance and was not

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AALA—A fresh look

AMERICAN AGRICULTURAL LAW ASSOCIATION

AALA has a new look! With this edition of the *Agricultural Law Update*, AALA is premiering a new logo. Based on the voting by members at the 2006 annual conference and a second round of voting via the AALA website, the Board adopted the new logo. The new logo will soon appear on the AALA website with some updating on the website appearance, will be on the 2007 conference brochure and AALA letterheads. We hope you like our new look.

This fresh look symbolizes our need to constantly refresh the organization to best serve the membership in a rapidly changing professional world. We have an ecellent Executive Director, a dedicated membership, and our finances are in good shape. A special committee is examining our operating procedures to make sure they provide the stability and flexibility we need for the future. With the help of the Membership Committee, we are preparing a series of short member surveys. With your input, we can develop better products and services for you. It has become increasingly difficult to find volunteers to write for the *Agricultural Law Update*. The Communications Committee will be exploring ways we can continue the excellent tradition of this publication in new ways that best serve you.

We welcome your comments and suggestions. This association has been built by thoughtful and energetic members. If you have an idea or concern, please contact me or Robert Achenbach.

–Steve A. Halbrook, President AALA, steve@farmfoundation.org

"at risk." The result was that the shareholder was not able to deduct losses in the amount of approximately $14 million. *Oren v. Comr.*, 357 F.3d 854 (8th Cir. 2004).

An Iowa farmer also learned this lesson the hard way in 1999. He borrowed money from a family member that he farmed with (and who was also a shareholder), paid off the corporate debt, and then contributed the balance to the corporation as a loan. The Tax Court held that the taxpayer's share of corporate losses was disallowed because they were not "at risk." Had he simply borrowed the funds personally and then loaned them to the corporation, he would have been able to increase his stock basis and deduct the losses. *Van Wyk v. Comr.*, 113 T.C. 440 (1999).

The Tax Court again dealt with this issue in 2005. In that case, the shareholders had no basis remaining in their shares. So, to be able to claim corporate losses on their individual returns, the shareholders each advanced funds (via two separate loans) to the corporation near year's end. They withdrew the cash contributions near the beginning of the next year, and then loaned the funds back to the corporation to enable them to take more losses.

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The Tax Court said this procedure worked because only the debt balances at year-end were what mattered. The withdrawal of funds during the year was immaterial. The court held that the multiple advances by the shareholders and repayments by the corporation constituted open account indebtedness.That meant that they were treated as a single indebtedness rather than separate indebtedness. The basis of the indebtedness was, therefore, determined at the end of the year by netting the advances and repayments during the year. By restoring the basis in their debts, the advances that the shareholders made to the S corporation shielded them from realizing gain on debt repayments made during the years at issue. *Brooks v. Comr.*, T.C. Memo. 2005-204.

IRS did not like the Tax Court's decision, but they had little room to complain because their own regulation provides that advances and repayments of open account debt are treated as a single indebtedness for the purpose of making debt basis adjustments and defines open account debt as "shareholder advances not evidenced by separate written instruments and repayments on the advances." Treas. Reg. §1.1367-2(a). That meant that the only date of significance in measuring the basis of the advances is December 31. So, in accordance with the IRS regulation, the Tax Court held that the corporate owners got to take the whole loss, and they did not have taxable gain on the loan repayment early the next year.

IRS has now proposed new regulations that would, in essence, wipe out the Tax Court's opinion. In essence, the proposed regulations mirror the approach that IRS took in the case and define open account debt as shareholder advances not evidenced by separate written instruments for which the principal amount of the aggregate advances, net of repayments on the advances, does not exceed $10,000 at the close of any day during the S corporation's tax year. That definition includes separate advances under a line of credit agreement not evidenced by a separate written instrument. The rules split open account debt into multiple loans if the balance of the open account debt exceeded $10,000 during the year. The open account debt on the books would be treated as a loan under a note at the time it went over $10,000, and any additional advances would be treated as a separate loan. That means that open account debt would be measured separately for each advance, on a first-in, first-out basis.

So, how would the proposed rules have impacted the 2005 case had they been in effect at that time? The shareholders still would have been able to deduct the losses in full, but they would also have had a significant capital gain on the repayment of the "deemed" separate debt that they paid off early the next year. That is because the rules would have resulted in two loans instead of a single loan with the balance measured at the end of the year. The rules essentially trigger a "recapture" of the loss claimed in the prior year by virtue of the year-end loan. They also change dramatically the basis in the open account debt.

If the rules become final (which is likely), S corporation shareholders will have to determine whether their advances and repayments exceed the $10,000 aggregate principal threshold. Probably the best way to do that is to maintain a running balance of those advances and repayments and the principal amount of the open account debt.

IRS is taking comments on the proposed regulations by July 10, and a public hearing is set for July 31, 2007. Section 1367 Regarding Open Account Debt, 72 Fed. Reg. 18417 (to be codified at 26 C.F.R. pt. 1)(proposed Apr. 12, 2007).

–Roger McEowen, Director of the ISU Center for Agricultural Law and Taxation.

Fed. Reg. : 5/5-6/15/07

CROP INSURANCE. The FCIC has issued proposed regulations which amend the common crop insurance regulations by removing the quota tobacco crop insurance provisions, revising the guaranteed tobacco crop insurance provisions, and changing the title of the guaranteed tobacco crop insurance provisions to Contracted Tobacco Crop Insurance Provisions. 72 Fed. Reg. 28895 (May 23, 2007).

CROP INSURANCE. The FCIC has issued proposed regulations which add cultivated wild rice to the common crop insurance policy basic provisions. The proposed regulations convert the cultivated wild rice pilot crop insurance program to a permanent insurance program for the 2009 and succeeding crop years. 72 Fed. Reg. 31196 (June 6, 2007).

FARM LABOR. The National Agricultural Statistics Service has issued farm employment figures as of May 18, 2007. There were 961,000 hired workers on the nation's farms and ranches the week of April 8-14, 2007, unchanged from a year ago. Of these hired workers, 720,000 workers were hired directly by farm operators. Agricultural service employees on farms and ranches made up the remaining 241,000 workers. Farm operators paid their hired workers an average wage of $10.17 per hour during the April 2007 reference week, up 39 cents from a year earlier. Field workers received an average of $9.35 per hour, up 40 cents from April 2006, while livestock workers earned $9.55 per hour compared with $9.31 a year earlier. The field and livestock worker combined wage rate, at $9.41 per hour, was up 35 cents from last year. The number of hours worked averaged 40.6 hours for hired workers during the survey week, down fractionally from a year ago. All NASS reports are available free of charge on the internet. For access, go to the NASS Home Page at: http:/www.usda.gov/nass/ . Sp Sy 8 (5-07).

FOOD SAFETY. The FSIS has issued a notice to articulate its position on the slaughter for human food of hogs and chickens from farms identified as having purchased or otherwise received pet food scraps that contain melamine and melamine-related compounds. The contaminated pet food scraps were used to supplement animal feed on farms in several states. The FSIS

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Scope of cooperative antitrust exemption

The first federal antitrust law was enacted in 1890. Additional antitrust legislation was put in place in the early 1900s. This early legislation contained a general exemption from antitrust restrictions for agricultural organizations, but it came to be viewed as too limited and not applicable to cooperative marketing activities. As a result, the Capper-Volstead Act was enacted in 1922. That law specifies that "persons engaged in the production of agricultural products as farmers, planters, ranchmen, dairymen, nut or fruit growers, may act together in associations, corporate or otherwise, with or without capital stock, in collectively processing, preparing for market, handling, and marketing in interstate and foreign commerce, such products of persons so engaged."

So, agricultural cooperatives that satisfy two requirements are not subject to antitrust restrictions that apply to other businesses. What are those requirements? First, the organization must be involved in the "processing, preparing for market, handling, or marketing of the agricultural products of its members." Second, the organization must be comprised of "members" that are "producers of agricultural products" or cooperatives comprised of such producers. That means an association consisting in part of persons engaged in "production" and in part of persons not so engaged does not get the exemption. That was the issue in this case.

The Eastern Mushroom Marketing Cooperative (EMCC) is the largest mushroom cooperative in the U.S., controlling more than 60 percent of all Agaricus mushrooms grown in the U.S. and about 90 percent of all Agaricus mushrooms grown in the eastern U.S. EMCC is comprised of entities that grow, buy, package and ship mushrooms to retail and food service outlets across the U.S.

EMCC sets and regularly publishes the minimum prices at which its members sell their mushrooms to customers in various regions of the U.S. In *In re Mushroom Direct Purchaser Antitrust Litigation*, No. 06-0620 (E.D. Pa. Apr. 25, 2007), the plaintiff, a group of mushroom growers, packagers, sellers, distributors and other related entities sued, alleging that EMCC schemed to inflate the average prices for mushrooms by setting the price at which mushrooms would be sold in the various geographic regions. Then, the plaintiff claimed, EMCC launched a "supply control" campaign by using membership funds to acquire and dismantle non-EMCC mushroom-growing operations.

EMCC moved to have the case dismissed, at least in part, on the basis that their anti-competitive conduct was exempt from antitrust law under the Capper-Volstead Act. The court disagreed, noting that other courts have held that where an agricultural cooperative acts in concert or enters into an agreement with persons or entities not engaged in agricultural production, the Capper-Volstead exemption does not apply. So, if non-producers participate as members in an agricultural cooperative, that cooperative is not entitled to use the Capper-Volstead exemption. Because the plaintiff's complaint alleged that some of the defendants were members of EMCC, but were not engaged in agricultural production, and that the EMCC entered into multiple agreements with persons or entities not engaged in agricultural production, the court refused to dismiss the case. The court also noted that the plaintiff sufficiently alleged an antitrust injury, and refused to dismiss the case on the argument that EMCC is a single entity. However, the court did dismiss a claim related to alleged monopolization and attempted monopolization.

–Roger McEowen, Director of the ISU Center for Agricultural Law and Taxation.

Federal courts disapprove APHIS approval procedures

In August 2006, the U.S. District Court for the District of Hawaii considered allegations that the U.S. Department of Agriculture had violated the National Environmental Policy Act (NEPA) and the Endangered Species Act (ESA) by granting permits for limited field tests of genetically engineered (GE) corn and sugarcane. The judge decided that the USDA's Animal and Plant Health Inspection Service (APHIS) had violated the ESA by failing to obtain information about any endangered species and critical habitats in the regions of the proposed tests. Turning to the alleged NEPA violations, the judge said that his review of APHIS' records revealed no evidence of an Environmental Assessment, an Environmental Impact Statement, or an explanation as to why neither study had been required before granting the permits. The judge granted the plaintiffs summary judgment on claims that APHIS' approval of the permits had violated the ESA and NEPA.

Following the court's verdict, a spokesperson for APHIS announced that the agency was devising a comprehensive programmatic environmental impact statement to address concerns about its oversight of GE crops. In two cases decided this year, federal court judges prodded the agency to accelerate an overhaul of procedures.

Bentgrass approval gets mowed

On February 5, Judge Henry H. Kennedy, Jr., of the U.S. District Court for the District of Columbia concluded ruminations about the regulation of GE creeping bentgrass. The bentgrass had been engineered to tolerate glyphosate, the active ingredient in the herbicide Roundup®. GE bentgrass could be used for lawns, athletic fields, and on golf courses. Over the years, efforts to develop Roundup Ready grasses have inspired concern that the gene conferring glyphosate tolerance might spread through reproduction with sexually compatible wild relatives and then persist in the environment.

The plaintiffs alleged that APHIS had acted arbitrarily and capriciously when it denied their petition to list GE bentgrass and glyphosate-tolerant Kentucky bluegrass as noxious weeds pursuant to the Plant Protection Act. APHIS had concluded that no biological basis existed for treating glyphosate-resistant strains of bentgrass and bluegrass differently from their non-resistant counterparts. APHIS then determined whether the plant species warranted quarantine pest status, because the plant is either "new or not known to be widely prevalent." Since neither Kentucky bluegrass nor creeping bentgrass fits this criterion, APHIS concluded that listing was not warranted.

The judge agreed with plaintiffs that the "new or not known to be widely prevalent" standard—borrowed from international agreements—is not a required consideration for the view of a noxious weed petition. APHIS' insistence on this criterion, the judge decided, was arbitrary and capricious.

The judge vacated the denial of the noxious weed petition and sent the petition back to APHIS. "Congress's intent in passing the Plant Protection Act (PPA)," the judge wrote, "was plainly to provide for regulation of all dangerous noxious weeds, whether new or old, or whether prevalent or not." The judge also cautioned that APHIS cannot supply its decision without providing a reasoned explanation, informed by sound science.

In a second allegation, plaintiffs claimed that APHIS had failed to comply with its own regulations when it granted field test permits for GE bentgrass. They argued that the agency had approved the GE bentgrass field trials without considering evidence that the plant is a weed in the areas of proposed release, and the agency had failed to make any type of localized weediness determination.

APHIS countered that it had complied with its regulations, which include a state-agency notification process for field trials. If local or state authorities consider the plant to be a weed, then APHIS does as well. If state authorities do not consider the plant to be a weed, then APHIS does not either.

Although the judge voiced concern that "APHIS has essentially ceded to state authorities the task of considering whether

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Producer's liens follow the money in California

By Sharlene Roberts-Caudle

The laws of several states, including California, include so-called secret liens for producers of agricultural products. These "producer's liens" provide for liens on agriculture products as security for the unpaid agricultural producer. A recent decision of the California Appellate Court clarified the law in that state and established that a producer's lien under California law cannot be characterized strictly as a "possessory lien" that terminates upon sale of the product. The "jural correlative" analysis used by the court may be helpful in other states to argue that the rights of growers to enforce their liens in agriculture products continue in the proceeds even where the products have been sold and conveyed to a third party and the proceeds turned over to another secured creditor of the processor.

Last year California's Fifth District Court of Appeal took the evolution of the interpretation of state producer's liens another step in *Frazier Nuts, Inc., v. American Ag Credit*, 141 Cal. App.4th 1263 (2006). The court ruled that the nut growers *did* have the right to enforce their producer's liens in an action against the bank that received the funds pursuant to a security interest in the processor's inventory.

California producer's liens[1] arise automatically upon delivery of agriculture products and secure the full amount owed to the producer. The lien attaches and is given priority upon the delivery to the processor, and no further steps are necessary to perfect the lien. Under the statute, it is illegal for a processor to remove beyond its control any agricultural products subject to the lien unless those products are in excess of what is needed to satisfy the liens.

The question of the scope of producer's liens arises frequently in bankruptcy cases where the courts have struggled with the tension inherent between the rights of producer's lien holders and bankruptcy's fundamental law of equitable distribution of the debtor's assets.[2] A U.C.C. state court case, *Bank of Stockton v. Diamond Walnut Growers, Inc.*, 199 Cal. App.3d 144 (1988), decided the priority as to competing security interests of a bank and an agricultural marketing cooperative. Although the bank had the only valid secured claim on the walnut *crop*, the court held that the bank's security interest was extinguished upon the sale of the walnuts by the cooperative. Both the bank and the cooperative had valid security interests in the *member proceeds* generated by the sale, but the cooperative's security interest was filed earlier in time and so had priority.

Subsequent bankruptcy court rulings have been consistent with the holding in *Bank of Stockton*. In *Richardson v. Wells Fargo Bank, et al., (In re Churchill Nut Company)*, 251 B.R. 143 (Bkrtcy. N.D. Cal. 2000), a grower found itself in a Catch-22 situation where the grower sued to enforce its lien on a walnut crop, and the crop was seized by the sheriff within 90 days of the processor's bankruptcy filing, the "preference period." In order to improve its position, the grower had to argue that the seizure interrupted the processor's possession of the crop, thus extinguishing the producer liens of the other growers in the seized crop. However, if the seizure resulted in a transfer, it was preferential and thus avoidable by the trustee.[3]

In *Loretto Winery Ltd. v. Valley Farm Management, Inc.*, 898 F.2d 715 (9th Cir. 1990), the court held that the grape grower's producer's lien was good against a bona fide purchaser *without possession* of the agricultural product. In that case, the crop had already been sold at the time the bankruptcy was filed. The trustee was allowed to argue that it would stand in the shoes of the bona fide purchaser, but the court refused to allow the hypothetical bona fide purchaser to obtain hypothetical possession of the grapes. The court held that the lien remains on the grapes only so long as the processor retains possession. Subsequently *Loretto Winery* has been cited for the proposition that, for California producer's lien holders, "[T]he lien lives or dies based on possession."[4]

In the bankruptcy case, *U.S. Bank v. Deseret Farms of Cal., Inc.*, 219 B.R. 880 (E.D. Cal., 1998), the court dealt directly with the question of whether the producer's lien continued in the proceeds of the sale of the walnuts. At the relevant time, the debtor no longer held any walnut inventory. A bank held a perfected security interest in, *inter alia*, proceeds held by the debtor from the sale of inventory. The court held that the bank had a superior right to the funds because the walnut growers' producer liens depended upon the debtor's possession of the walnuts. The court distinguished the case from *Loretto Winery*, where the debtor still maintained possession of the sold grapes.

The *Deseret* court compared California's livestock lien law, which expressly *does not* depend on possession, with the producer's lien. That court analogized the producer's lien to possessory liens such as the lien of one who performs services on personal property where, "If possession is given up, the service provider loses the lien." The court considered it unimportant that in the latter case it is not the secured party that is in possession of the property.[5]

The California Fifth District Court of Appeal charted a new course in its decision in *Frazier Nuts, Inc., v. American Ag Credit*, 141 Cal.App.4th 1263. In *Frazier Nuts* the court settled two issues: (1) whether the producer's lien right attaches to the proceeds of the security interest; (2) and whether the producer's lien is superior to prior liens. In holding in the affirmative on both questions, the court reversed the lower court's decision and allowed nut growers to proceed against the bank that had received the proceeds from sale of grower's nuts.

In *Frazier Nuts,* numerous almond growers had delivered nuts to Central Valley Processing, the debtor in the underlying bankruptcy case ("Central Valley"), during the 2002-2003 harvest year. Beginning in 2000, Central Valley began a lending relationship with a production credit association (PCA). Central Valley's credit line with the PCA was secured by Central Valley's inventory, accounts receivable, the equipment at the facility, and by the personal guarantees of five of Central Valley's shareholders. When Central Valley experienced difficulties and did not pay its four million dollar balance down to zero in April 2002 as it had agreed, the PCA renewed Central Valley's line of credit and established a new maturity date set seven months out. When Central Valley did not pay down the debt by the new due date, the PCA sent a letter stating that payment as agreed was "imperative". Two months later, Central Valley filed a Chapter 11 bankruptcy petition, which was converted to Chapter 7 eleven months later.

Between the time of renewal of the credit line and the bankruptcy filing, Central Valley paid the PCA approximately $400,000. Central Valley did not use the proceeds of sales to pay the producers. Subsequently, through a series of cash collateral orders, Central Valley sold all of its almond inventory.[6] The growers filed complaints against the PCA, which were consolidated. The growers asserted claims based on five legal theories: (1) intentional interference with economic relations, (2) money had and received, (3) conversion, (4) unjust enrichment, and (5) unfair business practice. The PCA demurred, and the superior court entered judgments in favor of the PCA.

On appeal the growers argued they were "entitled 'to recover the wrongfully diverted proceeds of the sale of their almonds,'" pursuant to contract and under the producer's lien statute.[7] The PCA contended that the growers had no lien or right at any time in the *proceeds* of the almond sales. The Court in *Frazier Nuts* reduced the case to two specific issues. "First, did Growers have any rights to the *proceeds* from the almond sales? Second, if

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Growers had rights to the proceeds, are those rights *superior to a [contractual] security interest*?"[8]

In its analysis, the court wrote that the only relevant section of the law was the last sentence of the California Food and Agriculture Code § 55638:

> It is unlawful for any processor to remove, from this state or beyond his ownership or control, any farm product which is delivered to him, or any processed form of the farm product, to which any of the liens provided for in this chapter has attached, except for any of such product or processed product as may be in excess of a quantity on hand which is of a value that is sufficient to satisfy all existing liens. Furthermore, this section shall not prohibit the sale of any farm product or processed form of the product to which such a lien has attached, so long as the *total proceeds of the sale* are used to satisfy obligations to producers which are secured by a lien established pursuant to this chapter. (Italics original.)[9]

The court iterated the legislative history of the producer's lien statute and explained the purpose of the law and amendments concluding, "[T]he main objective of the 1979 amendments [to the law] was to see that producers would be paid for their product. Consistent with this objective, the legislative history identifies only one use for proceeds generated by the sale of farm product subject to a producer's lien–the payment of producers who hold the lien."[10] The court could not identify any authority that implied "that the proceeds generated by the sale of farm products subject to a producer's lien are part of the collateral available to lenders with security interests."[11] The court held that the producer's right to be paid from the proceeds of the sale of its goods is a legal relationship expressly created by the California Food and Agriculture Code through the "*jural correlative*" of the legal obligation expressed in the statute.[12]

The court explained that the producer-processor relationship with the proceeds could be described either, "(1) as the duty of the processor to apply the proceeds from the sale of farm product to pay the producer or, correlatively, (2) as the right of a producer to be paid by the processor from the proceeds generated by the processor's sale of farm product. Language that creates the duty necessarily creates the right." Since the statute specified the *processor's duty*, the "jural correlative" of that duty was the *rights of producers*. "Because the duty is expressed plainly and the concept of jural correlatives is a fundamental, well-established principle of jurisprudence, recognition of the duty's jural correlative is nothing more than an application of the rule that statutory language must be given its 'plain and commonsense meaning.'"[13]

The court next addressed the competing rights of the secured parties. The court defined the right of the producers under the statute as literally a 'producer's lien" on the proceeds. The court examined the language used and the consequences of the competing interpretations advocated by the parties to decide if those interpretations promoted or frustrated the legislative purpose of the statute.[14] The court concluded that "a construction that treats a producer's claim to the proceeds as a 'producer's lien' entitled to priority under [the statute] promotes the general purposes of the producer's lien statute, while the PCA's interpretation "would frustrate the statutory purpose of the 1979 amendments and create an anomaly."[15]

The court explained the distinction between the law creating the California livestock lien, which expressly does *not* depend upon possession by the entity with the obligation, and the producer's lien, which is silent on that point. The court explained that the difference in language used in the two lien statutes was due, in part, to the process leading to their enactment. The livestock lien statute "was enacted as a single, integrated piece of legislation in 1979," while "[T]he sentence in the producers lien statute that addresses proceeds was added as part of a revision of a bill that proposed amending the producer's lien statute and so was the result of a political compromise rather than the work of a single drafter writing an entire article on a blank slate. Thus, it is an unrealistic view of the legislative process to expect (much less, to require) the use of parallel language to define the relationship between the producer and processor as it concerns sale proceeds."[16]

Finally, the court reminded the PCA that, first,

> The prudent banker should rely on product in a processor's inventory only to the extent that product is 'free and clear of such lien.' Second, a bank that relies on proceeds from inventory subject to a producer's lien is betting that (1) the producers will not enforce their lien on the product itself before it is sold and generates proceeds and (2) the processor will violate the directive in the statute that the proceeds are to be used to pay producers.

This result, the court stated, "adds merely a slight increment to the risk taken by lenders that chose the already risky course of relying on *proceeds* generated by product inventory that was subject to a producer's lien.[17] The court reversed and remanded and granted costs to the growers.[18]

What does this mean for producers, processors, and lenders? At least one commentator disagrees with the result in *Frazier Nuts*. Prof. Dan Schechter of Loyola Law School, Los Angeles, believes the *Frazier Nuts* court wrongly interpreted the statute to extend to products that have left the possession of the processor and believes that lenders will routinely demand lien releases or subordination agreements from each grower.[19] Reliance on the enforcement of such agreements by courts is very risky, however. [20]

Prior to the *Frazier Nuts* case, a producer's only remedy was a court order enjoining the processor from selling the products. The holding in *Frazier Nuts* is relevant to bankruptcy cases in preference and in actions by the trustee as well as in determination of priority of security interests and substantially improved the position of agricultural producers.

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[1] Cal. Food & Agric. Code Ann. §§55631-55653 (West 2001).

[2] See Riley C. Walter, *A Case for Avoidance of Secret Farmer Liens: The California Producers Lien*, 4 San Joaquin L. Rev. 37 (1994), where the producer's lien is discussed in connection with the avoiding powers of the bankruptcy trustee.

[3] *Richardson v. Wells Fargo Bank, et al., (In re Churchill Nut Company)*, 251 B.R. 143, 150.

[4] *Loretto Winery Ltd. v. Valley Farm Management, Inc.*, 898 F.2d 715, 721. In its analysis the *Loretto Winery* court seemed to confuse the fact that, while the producer's lien is a possesory lien without any further need for perfection, it is distinguishable from other possessory liens such as the lien of an automotive shop on the automobile it has repaired and that it maintains possession of. In the case of the producer's lien, the product is in possession of the party with the obligation. The producer with the right of payment has little control over surrender of possession.

[5] *U.S. Bank v. Deseret Farms of Cal., Inc.*, 219 B.R. 880, 886.

[6] The Bankruptcy Court accomplished by order the same result which *Frazier* held was correct: post petition proceeds were sequestered with producers' liens allowed.

[7] *Frazier Nuts, Inc., v. American Ag Credit*, 141 Cal.App.4th 1263, 1269.

[8] *Id*. 1270.

[9] *Id*. at p. 1272-72.

[10] *Id*. at 1274.

[11] *Id*. The court cited *Loretto Winery* but declined to follow its reasoning. *Loretto Winery* was decided on different grounds.

[12] *Frazier Nuts, Inc.*, at 1275.

[13] *Id*. at 1276, citations omitted.

[14] *Id*. at1274.

[15] Id. at 1278.

[16] *Id*. at 1280.

[17] *Id*. at 1281-82, emphasis original.

[18] The court remanded the matter to the superior court with directions to vacate its order sustaining the demurrer as to the third and fifth causes of action and enter an order overruling the demurrer in its entirety; and to enter an order granting

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APHIS/ cont. from p. 3
a given organism is a weed in the area of release," courts must give great deference to an agency's interpretation of its rules. The judge granted summary judgment in favor of defendants.

The plaintiffs also claimed that APHIS had violated NEPA when it failed to determine whether the GE bentgrass field trials qualified as exempt from the agency's obligation to conduct an Environmental Assessment (EA) or an Environmental Impact Statement (EIS). The judge said that the record contained no findings that the field trails fell under this exemption. Yet such findings were unecesssary. Any field test of GE organisms permitted by APHIS pursuant to the Plant Protection Act inherently falls under the "confined field release" NEPA exemption.

Falling within an exemption does not end the story, however. Even when APHIS has determined that an action falls under one of the NEPA exemptions, it still must determine whether an exception to the exemption applies. APHIS must prepare an EA or EIS if a confined field release of GE organisms has the potential to significantly affect the quality of the human environment. For example, the confined release may involve a new species or organism, or novel modifications of an organism that raise new issues. The judge could not find any evidence in the record that APHIS had considered these aspects of the proposed GE bentgrass field tests.

Judge Kennedy found substantial evidence that the field tests may have had the potential to significantly affect the quality of the human environment, and that the tests may have involved, at the least, novel modifications or new organisms that raised new environmental issues. APHIS' apparent failure to consider these possibilities, Judge Kennedy decided, manifested arbitrary and capricious agency action and violates NEPA.

The judge granted summary judgment in plaintiffs' favor, and he enjoined APHIS from processing any permit for a plant pest or potential plant pest without inquiring whether the NEPA exception applies to the permit and whether an environmental assessment should be prepared.

No happy days for APHIS' FONSI

On February 13, Charles R. Breyer, a judge in the US District Court for the Northern District of California, decided another case that focused on APHIS' procedures. This time, APHIS had taken the step of drafting an Environmental Assessment.

In May 2003, Monsanto Company submitted a petition that requested nonregulated status for GE Roundy Ready alfalfa. APHIS prepared an Environmental Assessment and accepted comments from the public about the EA and Monsanto's petition for deregulation.

Many objected to deregulation of the GE plant. One of the main objections focused on the possibility that bee pollination could spread the glysphosate tolerance gene from GE alfalfa to conventional alfalfa, organically-grown alfalfa, or wild populations of alfalfa. Genetic contamination would affect US markets for organic and conventional products, as well as foreign markets. Seventy-five percent of exported US alfalfa heads to Japan, a country that bans the import of glyphosate tolerant alfalfa. Commentators also objected that deregulation of the GE alfalfa with the affiliated increase in Roundup use could boost the developent of glyphosate-resistant weeds.

In June 2005, APHIS issued a Finding of No Significant Impact (FONSI) and approved Monsanto's deregulation petition. APHIS concluded that it would be "up the individual organic seed or hay grower to institute those procedures that will assure" that their crops will not include any GE alfalfa. By using reasonable quality control, the agency decided,"it is highly unlikely that the level of glyphosate tolerant alfalfa will exceed 1% in conventional alfalfa hay." This level of contamination would not bar the product from Japan.

While APHIS agreed that the deregulation of the GE alfalfa could lead to the development of additional glyphosate-resistant weeds, the agency did not see this impact as significant. After all, weed species have developed resistance to every widely used herbicide. Alternate herbicides and good stewardship could afford a defense against this potential problem, the agency assured.

Alfalfa growers, the Sierra Club, and other farmer and consumer associations alleged that the USDA's deregulation of GE alfalfa violated NEPA. They contended that the introduction of the GE alfalfa would pass on the glyphosate tolerance gene to natural alfalfa, a significant environmental impact.

In the judge's view, APHIS had effectively concluded that, whatever the likelihood of gene transmission, the impact would be insignificant, because organic and conventional farmers bore the responsibility to ensure that such contamination did not occur. Judge Breyer could find no evidence that APHIS had investigated whether farmers could actually protect their crops from genetic contamination.

APHIS could have approved the petition with a geographic limitation to isolate GE alfalfa, but it did not. "APHIS's rejection of this option," the judge wrote, "without making any inquiry into the extent of likely gene transmission from genetically engineered seed crops to non-engineered seed crops is arbitrary and capricious."

The judge did not care for APHIS' conclusion about the effect of GE alfalfa on exports. He could find no support in the EA or the FONSI for APHIS' conclusion that gene transmission is highly unlikely to occur with the application of reasonable quality control. Judge Breyer also decided that the plaintiffs had raised substantial questions about the extent to which the GE alfalfa would contribute to the development of Roundup-resistant weeds, and about methods farmers use to control the resistant weeds.

The judge decided that APHIS had failed to take a "hard look" at the potential environmental impacts of its deregulation decision, as required by NEPA. He granted plaintiffs' motion for summary judgment on its NEPA claim that APHIS must prepare an EIS.

Judge Breyer ordered the parties to submit a proposed remedy by the end of February. This did not happen. On March 2, the plaintiffs filed a request for permanent injunction against deregulation of the GE alfalfa before APHIS performed an environmental review in an EIS.

—Phill Jones, reprinted from ISB News Report, April 2007, pp. 4-6.

Fed. Reg./Cont. from page 2
reported that the results of an interim safety/risk assessment indicate that, based on currently available data and information, the consumption of pork, poultry, eggs, and domestic fish products from animals inadvertently fed animal feed contaminated with melamine and melamine-related compounds is very unlikely to pose a human health risk. Based on the findings of the interim safety/risk assessment, as well as the results of validated testing for melamine concentration that has been conducted on tissue samples of hogs and chickens exposed to the adulterated feed, FSIS has determined that pork and poultry products from all animals identified as having been fed animal feed containing contaminated pet food scraps are "not adulterated" and are thus eligible to receive the mark of inspection. All such animals that were being held on farms have been released and may be offered for slaughter for human food. 72 Fed. Reg. 29945 (May 30, 2007).

ORGANIC FOODS. The AMS has issued proposed regulations which amend the Department of Agriculture's National List of Allowed and Prohibited Substances regulations to enact recommendations submitted to the Secretary of Agriculture by the National Organic Standards Board (NOSB) during public meetings held May 6-8, 2002, in Austin, Texas, and March 27-29, 2007, in Washington, DC. Consistent with the NOSB recommendations, the proposed regulations add 38 substances, along with any restrictive annotations, to the National List regulations. 72 Fed. Reg. 27252 (May 15, 2007).

–Robert P. Achenbach, Jr., AALA Executive Director

California/Cont. from page 5
summary adjudication as to the first cause of action, which was labeled "intentional interference with economic relations."

[19] Dan Schechter, *Secret Automatic Superpriority Nonpossessory Producers' Lien Trumps Valid Article 9 Security Interest in Proceeds of Agricultural Products*, 2006 Comm.Fin.News 59.

[20] *In re T.H Richards Processing Co.*, 910 F.2d 639 (9th Cir. 1990), where the court held a subordination agreement invalid against a producer.

Damages for replanting saved seed from biotech crops

While the practice of savings seeds after a harvest to plant the next season is as old as farming itself, farmers have found that patent laws count in the end.

In *Monsanto Co v. Homan McFarling*, 2007 U.S. App. LEXIS 12099 (Fed. Cir. 2007), Monsanto went after the farmer for breaching a technology agreement over genetically modified crops that resist glyphosphate herbicide. Upon planting such crops, farmers can spray glyphosphate herbicide over their fields to kill weeds while sparing the resistant crops. Monsanto sells the glyphosphate herbicide under the trade name Roundup® and sells seeds of the genetically modified crops, in this case soybeans, under the trade name Roundup Ready.

Monsanto's U.S. Patent No. 5,633,435 claims a plant cell containing a DNA molecule that encodes a genetically modified enzyme. That enzyme allows plants to survive exposure to glyphosphate herbicide. Monsanto's U.S. Patent No. 5,352,605 claims a a plant cell containing a genetic promoter sequence that facilitates a plant's production of the modified enzyme.

Monsanto distributed the patented seeds by authorizing various companies to produce the seeds and sell them to farmers. Monsanto required those seed companies to obtain a signed "Technology Agreement" from purchasers. The Technology Agreement licensed the '435 and '605 patents to farmers on several conditions and required that farmers promise not to violate those conditions—specifically, the farmers promised not to replant seeds that were produced from the purchased seeds or to supply those seeds to others for replanting.

The purchasers also paid a fee to Monsanto for the license. For the time periods relevant here, Monsanto charged a license fee of $6.50 per 50-pound bag of Roundup Ready soybean seed. Mr. McFarling also would have had to pay a seed company between $19 and $22 for each bag of the seed that he purchased.

In 1998, McFarling purchased Roundup Ready soybean seeds and signed the Technology Agreement for that year and paid the required fees. However, he saved 1500 bushels of seeds from his 1998 soybean crop and planted those seeds in 1999. He did the same thing the next year, saving soybeans from his 1999 crop and planting them in 2000.

The saved seeds contained the patented genetic traits, but McFarling did not pay the license fee for the 1999 or 2000 growing seasons. Hence, Monsanto sued him, asserting that he had breached the technology Agreement and infringed the '435 and '605 patents.

McFarling raised various defenses, including patent misuse and preemption by the Plant Variety Protection Act. The district court rejected those defenses and granted Monsanto's motion in full except as it concerned damages for breach of contract and infringement of the '605 patent.

On appeal, the CAFC affirmed the dismissal of McFarling's antitrust counterclaim and the rejection of his defenses of patent misuse and preemption by the Plant Variety Protection Act.

The jury returned a damages verdict of $40 per bag of saved seed, well in excess of the $6.50 per bag for which Mr. McFarling had argued, but substantially less than the $80.65 per bag (for 1999) and $73.20 per bag (for 2000) urged by Monsanto based on the analysis of its expert. Mr. McFarling again moved to limit the damages award to what he contended was Monsanto's $6.50 per bag established royalty for use of its patented technology. The district court denied the motion, adopted the jury's verdict, and awarded Monsanto approximately $375.000 in damages.

McFarling argued that the damages should have been limited to the "established royalty" for Roundup Ready seeds, i.e., the "Technology Fee" of $6.50 per bag that Monsanto charged licensees who purchased Roundup Ready seeds under its Technology Agreement.

By statute, damages for patent infringement are to be "adequate to compensate for the infringement, but in no event less than a reasonable royalty for the use made of the invention by the infringer, together with interest and costs as fixed by the court." 35 U.S.C. section 284.

Monsanto agreed to let other soybean farmers use the patented traits in planting and growing soybean crops and to let them sell the harvested seeds as a commodity. In exchange, farmers agreed to pay Monsanto a Technology Fee and to refrain from planting Roundup Ready seed saved from a previous season's crop and from selling Roundup Ready seed from their crop to others for planting.

The parties agreed that the amount of the Technology Fee was $6.50 per 50-pound bag of Roundup Ready soybean seed for the pertinent years, 1999 and 2000. Because that fee does not take into account the added obligation imposed on all authorized licensees under the Technology Agreement—to purchase seed from an authorized seed store—the CAFC held that the trial court was correct to refuse to treat the $6.50 Technology Fee as the established royalty for a license comparableto the infringing conduct.

The CAFC did not take kindly to McFarling being an infringer trying to get a sweet deal. Specifically, the court stated that:

Picking $6.50 as the upper limit for the reasonable royalty would create a windfall for infringers like McFarling. Such infringers would have a huge advantage over other farmers who took the standard Monsanto license and were required to comply with the provisions of the license, including the purchase-of-seed and non-replanting provisions. The evidence at trial showed that Monsanto would not agree to an unconditional license in exchange for a payment of $6.50, and the explanation—that Monsanto would lose all the benefits it gets from having the cooperation of seed companies in promoting Monsanto's product and controlling its distribution—is a reasonable commercial strategy.

By insisting that the established royalty is $6.50 per bag, Mr. McFarling does not acknowledge the significance of the requirement that licensees not only pay the $6.50, but also purchase the genetically modified seeds from a seed company rather than replanting saved seed. He does not argue, even in the alternative, that the court should have limited the reasonable royalty to the total amount paid by licensed farmers for patent-protected seeds.

Monsanto's experts testified that the no-saving-seed requirement (1) decreased the risk of under-reporting and the consequent reputation harm to Monsanto with farmers, (2) ensured Monsanto's knowledge of the quality of seed planted each year, and (3) provided a bargaining chip for signing up new seed companies. It is difficult to assign a dollar vlaue to those benefits, but the benefits nonetheless justify the jury's finding that a reasonable royalty for a license to engage in conduct like Mr. McFarling's would exceed the amount of the payments made by farmers who participated in the licensing program.

In determining the amount of a reasonable royalty, it was proper for the jury to consider not only the benefits of the licensing program to Monsanto, but also the benefits that Monsanto's technology conferred on farmers such as Mr. McFarling.

In this case, we hold that the jury's verdict was supported by evidence and was not grossly excessive, particularly in light of the evidence of the savings Mr. McFarling achieved by his infringement, the benefits to Monsanto from requiring farmers to adhere to the terms of its standard licensing agrement, and the benefits conferred by the patented technology over the use of conventional seeds.

In the end, McFarland reaped what he had sown.

—Stephen Albainy-Jenei, reprinted with permission from Patent Baristas, June 4, 2007

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Ethics fact patterns requested

Prof. Drew Kerhen, University of Oklahoma, is the presenter for the one-hour of ethics at the San Diego conference. Professor Kershen desires to build his presentation upon ethical issues that have arisen in the practice of AALA members. Prof. Kershen requests that AALA members send him fact patterns from your individual practice that gave rise to difficult, refuddling, worrying ethical issues related to your agricultural law practice. Prof. Kershen will use fact patterns submitted (without attribution or identification) to organize his presentation. As Prof. Kershen has fifty minutes for his presentation, he will be able to use, at maximum, no more than four or five fact patterns.Prof. Kershen thanks you for your assistance in making the San Diego ethics presentation as relevant, helpful, and practical as possible to the membership of AALA. Please submit your fact patterns to dkershen@ou.edu.

AALA Board Election

The AALA Board Nominations Committee has selected an excellent slate of candidates for the 2008-2010 seats on the board of directors and new president-elect. The ballots will be sent the first week of July and need to be returned to the AALA office by August 15, 2007.

2007 Annual Conference.

President-elect Roger McEowen has completed the planning of an excellent program for the 2007 Annual Agricultural Law Symposium at the Westin San Diego Hotel (formerly a Wyndham hotel) in sunny downtown San Diego, CA, October 19-20, 2007. Mark your calendars and plan a trip to enjoy the sights (Gaslight District), sounds (sea gulls and trolley bells), animals (San Diego Zoo and Seaworld) and sunshine. The program has been posted on the AALA web site with a registration form for those who want to get the registration fee in early. Conference brochures are at the printers and will be mailed soon. If you would like extra copies to distribute in your area, please let me know by e-mail.

Special note: A full block of rooms has been reserved at the conference rate for Thursday and Friday evenings. However, there are only a small number of rooms available at the conference rate on Wednesday and Saturday night. So if you come early or stay late, you may not be able to get the conference rate for all days. If you are prevented from getting the conference rate on Wednesday or Saturday, please let me know and I will increase the room blocks for these days for future conferences. If you seek a reservation that includes these early/late days, the hotel may tell you that the conference rate is not available because the block is full for just one or more of these early/late days. The conference rate may still be available for the regular conference nights (i.e. Thursday and Friday). Room blocks are limited because the association is severely penalized financially if the room blocks are not filled.

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