

# Farm Lease Letter

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Letter No. 6

LEASE COMPARISONS

July 2000

Each type of farm lease has characteristics, which make it more suitable for use in some situations than in others. Selection of the lease type best suited to a given situation is a matter of comparing the characteristics of the alternatives with the particular needs, interests, and abilities of the landlord and tenant.

- What are the management requirements?
- What are the operating capital requirements?
- Who bears the risk of reduced prices, reduced yields, and increased operating costs?
- What is the financial condition of the tenant? Landlord?
- How do the returns compare with alternative lease types?
- What are the estate planning goals of the landlord?

This will provide a comparison of the various lease types.

## MANAGEMENT REQUIREMENTS

Management requirements on the part of the landlord are generally greater under sharing type leases than under cash leases.

The level of rent received by the share rent landlord is directly affected by the level of production and the production efficiency of the tenant. Under the livestock share lease, this involves both the livestock and the crop production. It involves only the crop production under the crop share lease. The ability to select a capable tenant and to work effectively with him is extremely important under the share type leases. The landlord's ability to market his share of the production is also important to the level of rent achieved.

Under a share lease, the landlord is often involved in production decisions.

Cash leases require less management input from the landlord than the sharing leases.

It is important that the landlord and tenant understand soil erosion hazards and suitable cropping patterns and tillage practices for keeping soil loss within acceptable limits regardless of the type of lease.

Leases on highly eroded land may restrict land use to acceptable cropping programs where necessary because of the erosion hazards, which exist on the farm. On the other hand, undue crop restrictions may reduce the income potential.

Successful operation of a farm requires a high level of management on the part of the operator. The operator generally expects more assistance from the landlord under sharing leases than under cash leases, however.

### **CAPITAL REQUIREMENTS**

Operating capital required of the landlord varies by the type of lease. Under sharing leases, the landlord provides a portion of the operating capital for crop production under the crop share lease, and for crop and livestock production under livestock share leases.

Under cash leases, the landlord does not provide operating capital.

The tenant's operating capital requirements are less under the share type leases, because the landlord provides part of the operating capital. This may be particularly important to the beginning or otherwise capital limited tenant. The tenant provides all of the operating capital under cash leases. On 500 acres of corn operating capital for the tenant increases from approximately \$74,000 (under a 50-50 crop share) to \$166,500 (under a cash lease).

### **RISK**

Three kinds of risk are of primary importance. These are the risks of price decline, reduced yields and increased costs.

The amount of risk varies from one farming operation to another. Risk bearing ability of landlords and tenants also varies. Thus, this factor should be carefully considered when selecting the type of lease to be used.

Under share leases, the landlord and tenant share the price, yield and much of the operating cost risk.

Under the straight cash lease, all of these risks are borne by the tenant with the hope that above average returns to the tenant in some years will balance out the below average returns in other years

The tenant with limited ability to withstand the low-income years may find the straight cash lease less well suited to his needs than some other types.

Under a flexible cash lease, the landlord shares part of the risk. Some flexible cash leases share price and yield risk between landlord and tenant. Other types of flexible cash leases only share the risk of price decline between landlord and tenant.

*To fully share the risk of income variability, the landlord and tenant must share the risk of price, yield, and production cost changes. If only a portion of these factors is reflected in the level of rent, risk may increase rather than decrease.*

For example to the extent that the crop price level fails to reflect the income resulting from the crop due to reduced yields or unanticipated costs, risk is increased.

### **LEVEL OF INCOME**

If the terms of a rental agreement place more risk on one of the parties, then it should also give a higher long term potential return to the party with the increased risk. Consistent with the above, over a period of years, the farm rented to a capable tenant should yield the highest average rent with a share type lease. The straight cash lease would be expected to yield the lowest average rent and the flexible cash lease should fall in between.

Rent to the share type landlord will be more variable from year to year than to the straight cash landlord. On the other hand, income to the fixed cash rent tenant will be more variable from year to year than under a crop share or flexible cash lease.

**LANDLORD’S LIENS**

The Iowa Code authorizes a landlord’s lien to secure the payment of rent on leased property. The landlord’s lien secures the payment of cash rent as well as rent under share leases. In Iowa, the landlord’s lien may be asserted against “all crops grown on the leased premises and upon any other personal property of the tenant which has been used or kept on the leased premises which is not exempt from execution.”

The statutory landlord’s lien does not need to be recorded and arises by operation of law automatically without any action on the part of the landowner other than the execution of the lease. In addition, a contractual landlord’s lien may be included in a written lease. To be effective against third parties, however, the contractual lease must be recorded. A written lease can be recorded at the County Recorder’s office if it is notarized by an authorized notary public. It is possible to have both a statutory and a contractual lien involved in the same lease.

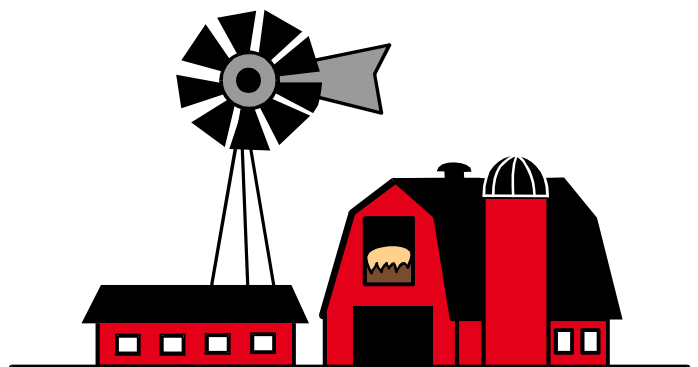
Purchasers of farm products are generally subject to the landlord’s lien, thus putting the landowner in a position to collect rents out of commodities even though they are sold. It is important that landowners be careful not to waive their landlord’s lien by failure to exercise their rights.

Lenders and other creditors file security interest in collateral such as farm products to insure payment of debts under Article 9 of the Uniform Commercial Code. Under this statute, it would appear that UCC Article 9 rules do not apply to landlord’s liens. To date, the Iowa Supreme Court has no reported decision stating whether the landlord’s lien prevails over a properly perfected security interest under UCC Article 9. However, several court cases have

held that under Iowa law, a statutory landlord’s lien was superior to a perfected security interest in a tenant’s crop. These cases are persuasive, but not the final word on the issue. Until the Iowa Supreme Court rules, no definitive answer can be given as to priority. When a cash rent lease is involved, it may be important that the landlord create a “perfected” security interest against the tenant.

The filing of a security interest may also help to avoid the problems of a trustee in bankruptcy being able to void the landlord’s interest completely--the landlord has a security interest, not just a statutory landlord’s lien. Note, however, that the landlord may not be in first position because of a prior filing by a lender or other creditor. A security agreement and financing statement can be utilized whether a cash rent or crop share lease is involved.

In the 1985 Farm Bill, the Congress included a provision, the Federal Farm Products Rule, concerning protection of buyers of farm products subject to perfected security interest. In the bill, Congress included language that may affect the priority rules of landlord’s liens as compared to perfected security interests in farm products. It is important that landowners check with their attorneys regarding the possible impact of this section.



Landlord's liens are subject to many questions of priority as compared to other secured interests. The following suggestions may help provide some certainty of interest for the landowner and tenant in a farm lease.

- A landowner can acquire a security interest under UCC Article 9 in the farm products raised by the tenant. The tenant can sign a security agreement describing the collateral, giving a description of the land on which the crops are to be grown, stating the value that has been given and that the tenant/debtor has rights in the collateral. To perfect the landowner's security interest, it is necessary to file a financing statement with the Secretary of State's Office in Des Moines. The priority of security interest is based on time of filing.
- The lease can require that all the rent be paid at the beginning of the lease. It is important to realize that this may place a cash flow hardship on the tenant, however. The level of rent may also be reduced to compensate the tenant for additional interest incurred by early payment of the rent.
- Before entering into a lease a landowner may wish to conduct a lien search to determine the extent of prior liens. If there are prior liens, it is suggested that the landowner seek a subordination of the prior lien-holder's interest.

- One of the safest vehicles to protect the landowner is an irrevocable letter of credit issued by a lender in behalf of the tenant insuring payment of the rent.
- When a tenant is sealing grain with the Commodity Credit Corporation, the landowner may request that his or her name be included as a payee on the check for sealed grain. Having the check include the landowner's name will give the landowner leverage in dealing with all parties concerned as the landowner must endorse the check before it can be negotiated.

### IN CONCLUSION

Development of a lease that will provide a satisfactory situation for the parties involved is a complex undertaking. Your Extension Farm Management specialist is knowledgeable about leases and local leasing situations. Feel free to contact him or her for additional information.

Questions of rental of building and facilities often arise. For information on this topic, a copy of Rental Agreements for Farm Machinery, Equipment and Buildings, NCR 214, or Farm Building Rental, FM-1798 may be obtained from your County Extension Office.

