

Guide to Financing the Community Supported Farm

*Ways for Farms
to Acquire Capital
Within Communities*





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INTRODUCTION

by Ben Waterman, New Farmer Project, University of Vermont Extension Center for Sustainable Agriculture

Increasing numbers of farmers are exploring creative ways to acquire capital for farm operations.¹

The following pages detail options and considerations for crafting unconventional financial arrangements that have been used in other sectors of the economy, but might be new to the agricultural sector. We guide the reader through basic legal issues relevant to farmers and community members when pursuing these arrangements. We highlight several mechanisms that allow for creativity and customization of financial transactions at the neighbor-to-farmer or farmer-to-community-member level:

- the promissory note
- the owner-financed land sale,
- equity financing
- revenue-based financing
- the “multi-year” CSA
- share leases

Four farmers who have tested these and other alternative ways to source capital for farm operations have written case studies included throughout this guide.



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This guide defines *Community Supported Farm* as a farm whose financial and social support comes from individuals or entities in surrounding communities. Like-minded individuals with common interests make up communities; they are not necessarily geographically-based. For purposes of this guide, **Community Financing** is financial capital exchanged directly between farmers, food processors and people or other entities within their communities. **Community Capital** includes human, environmental and financial capital.² While this guide focuses on financing mechanisms, its premise is that all forms of capital are equally important to sustainable and flourishing communities.

This guide outlines ways in which community financing can be transferred, often with flexible terms that enable farmers to acquire capital for farm operations. This might include capital assets such as food processing equipment and energy-efficient infrastructure. Other uses of community financing might include securing short-term operating cash; making improvements to product quality; enhancing soil and water quality, preserving working landscapes; hosting social events; and providing other benefits. Community financing’s fundamental purpose is to enable the creation of products and services for the benefit of the community. In a sense, the equation can come full circle. **Where there is a Community Supported Farm, there also can be a Farm Supported Community.**

Farm, there also can be a Farm Supported Community.

This guide is designed to address questions that farmers might have, but anyone hoping to become more engaged in building community capital will find it informative. It provides case studies and replicable models of innovative farmers who have utilized community financing. It outlines key talking points for communicating possibilities, negotiating, and developing sensible community financing agreements.

This publication covers important legal issues relevant to crafting customized financing arrangements. It is by

1. Anecdotally evident, since the financial crisis of 2008, by the private sector taking interest in farms and food ventures as potential investment vehicles, and farmers seeking investors through various avenues, such as through “Entrepreneurial Showcases” at investor conferences and gatherings (example: “Slow Money National Gathering”).

2. Iowa State University Department of Sociology researchers Cornelia and Jan Flora along with Susan Fey developed the Community Capitals Framework, first presented in their 2004 book, *Rural Communities: Legacy and Change* (2nd ed.). Boulder, CO: Westview. Press. Descriptions of the seven capitals: human, social, natural, financial, built, cultural, political can also be found at: <http://www.soc.iastate.edu/staff/cflora/nccrd/capitals.html> or at http://edev.byu.edu/ellsymposium/documents/community_capital.pdf.



no means intended as a substitute for the counsel of qualified tax accountants and attorneys. In fact, these services may become essential when developing unique, customized community financing arrangements. This guide’s purpose is to empower farmers and community members with knowledge of pertinent issues and potential options. In turn, it might be possible to reduce legal and accounting costs by calling on the service of outside experts only when it is most appropriate.

The interest in community financing at the time of this writing is expanding.³ While there is much work to be done, this guide does not explore policy level considerations, such as towns setting aside common land for community farms. ***The purpose of this work is to provide easy-to-read, timely and relevant information outlining options and considerations for exploring and crafting creative financing arrangements for community supported farms. While the following pages contain many references to ways in which parties to an agreement can reduce liability risk, again it cannot be overemphasized: The information provided is for educational purposes only, and is not a substitute for sound legal representation from a qualified attorney.***



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Finally, financing mechanisms presented in the following pages are highlighted as “complementary” rather than “alternatives” to traditional debt financing. This guide does not contain information on bank loans, USDA Farm Service Agency (FSA), institutional agricultural credit programs, or other forms of traditional debt financing. Farmers are encouraged to contact agricultural lenders for more information on existing loan programs. Many local avenues of traditional debt financing can, in fact be considered “community financing” as defined in this guide. Local agricultural finance experts can provide valuable technical assistance with farm business management planning and help farmers develop appropriate farm finance strategies. They are a tremendous resource that should not be overlooked.

The financing models in this guide might be new to the agricultural sector, but they have been time tested through decades of use in other sectors of the economy as innovative ways to fund business start-up and early growth stages. In the same manner farmers have refined pioneering practices in production systems, it might only be a matter of time before they adopt practical innovations in financing.

For more background information on community financing, see Appendix 1 of this guide: Community Financing



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Theory: the Role of Patient Capital in Sustainable Agriculture and Rethinking Profit and Return on Investment. The following chapters detail practical options and considerations for community financing of farms. Topics include:

- Securities regulations and why they are important
- Acquiring land through owner-financed sales and land contracts
- Talking points for dealing with farmland investors
- The promissory note
- Equity financing
- Revenue-based financing
- The multi-year CSA share
- The share lease
- A comparison of business structure in terms of raising capital

Four case studies are also included throughout this guide. They are written by farmers who have utilized various forms of community financing or who are exploring these kinds of arrangements.

³ Anecdotal evidence based on the author’s numerous conversations in 2010-2011 with Cooperative Extension agricultural educators and other agricultural service providers.



PREFACE: Matching Financing with Appropriate Use

By Mark Cannella, Farm Business Management Specialist, University of Vermont Extension

Farms may arrive at alternative community financing opportunities for a variety of reasons. Before seeking credit or finance from other sources it is important to consider the basic reasoning why a business needs capital and what is required for such a relationship to exist. Farm owners will need to identify their annual operating expenses and proposed multi-year capital investments separately in order to evaluate the best financing option. There is a difference between seeking operating capital versus investment capital.

Farms need cash to pay for annual operating expenses before cash receipts from products sales are received. Farms may need a large amount of borrowed cash for the first year of operation and they will likely require a certain amount of cash every year at the beginning of the season. Operating expenses include everyday expenses to purchase the inputs that keep the business running over the course of the year. This includes items like advertising, seeds, fertilizer, fuel, labor payroll, broiler chicks (to be sold within the year), insurance and utilities. A business strives to pay off its annual operating expenses within the year before it begins to accrue expenses for the next year. Ideally, all bills are paid off and any sources of credit/finance for operations have been paid off from farm income received that period.

Farms will also need finance options to make capital investments or acquire assets that keep the farm running. These investments, by definition, will have a multi-year life span and include items like: machinery, breeding livestock, conservation improvements, buildings and land. Finance options for investments are structured to reflect the cost, the lifespan and income generating potential of asset. For example, a tractor or construction improvement has a shorter useful lifespan and lower cost than a large tract of farmland. A tractor loan would commonly be paid back over two to seven years, while investments in real estate would be expected to be paid down over many more years. Real estate mortgages, for instance, may range from 20-35 years.

Each source of capital comes with certain obligations, relationships and maintenance. The level of obligation, type of relationship and amount of maintenance will vary among different sources. Business owners will decide which sources match their preferences or requirements. This guide provides examples of many benefits to community finance options. Owners should consider that there are costs, however, associated with alternative finance options that may not be apparent at the onset. Two significant costs can include the time required to organize the agreement and the likely need for professional services (legal or tax accounting) to establish, verify or properly report on the agreement. These costs may or may not outweigh the benefits of a community finance option. Owners should consider these costs when engaging in community finance relationships to make sure they have the time and resources to properly execute and administer the process from start to finish.



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“Shiitake Mushroom Log Laying Yard.” Image used with permission of Ben Waterman.



Chapter 1

Federal Securities Laws

*by Kenneth Miller, Esq.
Co-founder of Law for Food, LLC*



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This guide presents several financing options for farmers who intend to acquire capital from their existing customer base, neighbors, friends, family or others within their communities. Chapters 1 and 2 cover basic legal issues to consider before going too far down the road of choosing the right option(s), advertising the need for funding and crafting agreements with community capital partners. By becoming familiar with these issues, parties to financial transaction(s) might take steps to avoid the risk of expensive court actions from regulatory bodies, or prevent unnecessary litigation brought on by unsatisfied parties. The information provided is for educational purposes only, and does not substitute the need for representation by a qualified attorney.

The Securities Act of 1933 and the Securities Exchange Act of 1934 regulate the selling and trading of “securities” across state lines. The definition of “security” is broad and encompasses a variety of instruments and transactions. The term “security” in common parlance indicates stock, notes or bonds; but legally and theoretically, anything can be a security: stocks, promissory notes, distribution rights, chinchillas, whiskey warehouse receipts, and beavers. Anything that resembles an “investment contract” will be regulated as a security. **Many transactions and financial arrangements used to finance the Community Supported Farm could be considered securities, depending on how they are structured. It is therefore important for farmers to have an understanding of the laws in order to determine what steps to take to reduce legal liability potentiated by any given arrangement.**

In determining whether an instrument is a security, courts look beyond the name of the instrument. **The test is whether there is an investment of money in a common enterprise with profits to come solely from the efforts of others.**¹ The courts will look to the substance of the instrument, and apply what is referred to as the “economic reality” test. Merely labeling something a security or investment contract means less than how the instrument is actually used. Also relevant in determining if certain financing amounts to a security, the farm operation must consider the investor’s overall participation. The instrument will less likely be considered a security if the investor has any level of managerial capacity in the business enterprise generating the returns. The decisive factor here is the investors’ actual power to exercise managerial control, rather than their legal right to exercise their ability to be repaid. For example, general partnership interests, or active members and managers of a Limited Liability Company (LLC) carry the right to participate in management. They differ significantly from limited, investor partners, or passive members of an LLC, whose interests are more likely to be considered securities. The more active a limited partner in the operation, the less the chance their business transactions with the entity will meet the legal definition of security.

Securities laws were intended to regulate transactions where marketing efforts and promotion attract otherwise passive investors, who rely on the expertise of the promoters or managers of the venture seeking investment.² Financial deals among a limited number of individuals, all with expertise in the field of the business, on the other hand, may be less likely to be characterized as securities transactions.

The general intent of federal securities regulation is to protect ordinary individuals from fraudulent investment claims. The regulations serve to:

- Identify certain investment transactions (“securities”) in which the returns on investment to the investor depend on how others manage a business venture;
- Require that these types of transactions or “securities” be registered with the federal Securities and Exchange Commission (SEC). The registration process is designed to ensure that investors are provided full disclosure about the nature of the transaction or investment;
- Identify types of financial offerings that are exempt from the requirement to file registration with the SEC or appropriate state agencies; and
- Provide anti-fraud provisions that further protect investors.

What’s a “No-Action Letter”?

For a \$250 filing fee, the securities division responds to a written request to determine whether the actions or transactions described amount to a security, or are otherwise compliant with the relevant securities laws. A No-Action Letter will be issued if the described activities do not amount to a violation of securities regulations. The letter provides that no action will be taken against the particular party in connection with the facts described in the written request. Reliance on the No-Action Letter may justify only the actions of the particular party addressed, and only insofar as the facts described in the request sufficiently describe the action taken.

1 S.E.C. v. W. J. Howey Co., 328 U.S. 293 (1946). This case established a four-point test to determine whether a transaction qualifies as a security as defined by the Federal Securities and Exchange Act of 1933. According to the “Howey Test,” a security is any interest that involves (1) an investment of money, (2) in a common enterprise, (3) with the expectation of profits, (4) that come solely from the efforts of others. “Investment” in this test means any instance in which money or capital has been expended or contributed. “Common enterprise” has been defined by courts in various ways, but generally means that the fate of the investor’s return is linked to the fate of the business enterprise responsible for generating the returns.

2 Parker v. Broom, 820 F.2d 966 (8th Cir. 1987).



Offers or sales of financial transactions that meet the definition of “securities” must be registered with the SEC unless the transaction is exempt from the requirement to register according to Federal law.³ For more information on the exemptions, see the section in Chapter 2 entitled, “Securities Registration Exemptions Most Applicable to the Small Farm.”

Are CSA Membership Shares “Securities”?

Where Community Supported Agriculture (CSA) shares serve as prepayment for goods and services as opposed to a vehicle for earning the shareholder profit, they would typically not be considered securities. CSA’s are common means through which farmers raise cash to cover operating expenses of furnishing products or services to the CSA membership. The farmer might also put the cash towards some capital expenses (e.g., fencing, barns or greenhouses) that are necessary for producing food. CSA membership fees used to cover these expenses enable “consumer consumption,” which generally falls outside the umbrella of federal and state securities regulations.⁴

The most commonly used legal test for determining whether any type of transaction is a “security” is known as the *Howey* test.⁵ It presents four criteria for making the determination. Courts examine whether there is a clear:

- 1) Investment of money
- 2) in a common enterprise,
- 3) with an expectation of profits, and
- 4) these profits derive solely from the promoter of the investment or another third party (in other words, from the efforts of someone other than the investor).

All four of the *Howey* test criteria must be met in order for the transaction to be defined as a security. “Investment” in this test means any instance in which money or capital has been expended or contributed.⁶ “Common enterprise” has been defined by courts in various ways, but generally means that the fate of the investor’s return is linked to the fate of the business enterprise responsible for generating the returns.⁷ For example, in a “common enterprise,” if the business does poorly, the investor does not receive as much as would otherwise be available if the business performed well.

It is clear that there are scenarios in which CSA shares could meet the criteria of the *Howey* test and trigger securities regulation. For example, if the agreement between the farmer and CSA member stated that the community member “invests” his or her money in the farm enterprise or there is a potential for “profit” above the share price in the form of food produced by the farmer’s efforts, courts might deem the purchase of the CSA membership to be a security transaction. Even if the CSA share was found to be a security, there is a chance that the transaction is exempt from registration requirements (see Chapter 2: “Securities Registration Exemptions Applicable to Farms”), and the farmer could avoid the time and expense involved in registration or penalty fees for not following SEC or state securities requirements for registration. Nonetheless, making sure that any kind of CSA membership agreement clearly disclaims any sort of profit expectation and clearly affirms that the money is used for pre-purchase of goods and services might further reduce legal risk.

Another less frequently used legal test for determining whether a transaction meets the definition of security is the *Risk Capital* test.⁸ This test has only been adopted by courts at the state level, and its statutory use is mandated in only a few states.⁹ No courts in the Northeast have used the test, but could conceivably do so in the future. Hence it is worth mentioning here. The test is whether or not one party is putting capital **at significant risk for the “development” or start-up of the business** of another. The test was first used by the California Supreme Court, who found country club memberships to meet the SEC definition of securities because there was insufficient infrastructure in place to be able to provide the membership benefits, thereby putting the “member’s” capital at enough risk to warrant the protections intended by SEC regulations. Theoretically, CSA memberships used to finance farm start-up could be treated similarly if courts were to use the *Risk Capital* test.

To summarize, to reduce the likelihood that a CSA share, membership or subscription will be viewed as a security, the farmer can emphasize that proceeds from the CSA will not be used to finance start-up costs, there is an opportunity for customers to pre-purchase food or services and **not invest in or loan to the farm business** (see Chapter 5 for a summary of the difference between a CSA and a loan).

³ Registration should involve a legal expert. Following is a general list of filing requirements. Registration statements for federal securities generally are filed at the Security Exchange Commission’s main office in Washington, D.C. The registration fee is 1/29th of one percent of the maximum aggregate price at which the securities are offered, but not less than \$100, payable the time the registration statement is filed. In addition to payment of the registration fee, there are particular requirements as to the proper form of the statement. To ensure proper form of your particular statement, a professional opinion should be sought. But, before any of this, be sure what you have is a security.

⁴ JA Blomberg and HE Forcier, 2005. But Is It a Security? Business Law Today, American Bar Association Business Law Section’s Online Resource. Volume 14, number 5. Accessed online 1/10/2012 at: <http://apps.americanbar.org/buslaw/blt/2005-05-06/forcier.shtml>.

⁵ S.E.C. v. W. J. Howey Co., 328 U.S. 293 (1946).

⁶ CJ Russ, 2010. What is a Security? Online newsletter, Business Law Section of the North Carolina Bar Association. Accessed online 1/10/2012 at <http://businesslaw.ncbar.org/newsletters/nbinov2010/security.aspx>.

⁷ R Borneman, 2005. Why the Common Enterprise Test Lacks a Common Definition: A Look Into the Supreme Court’s Decision of SEC v. Edwards 5 U.C. Davis Business Law Journal 16. Accessed online 1/10/2012 at: <http://bjl.ucdavis.edu/archives/vol-5-no-2/Why-the-Common-Enterprise-Test.html>.

⁸ The California Supreme Court in its 1961 case, Silver Hills Country Club v. Sobieski, is noted for creating the “risk capital” test.

⁹ According to Steinberg, author of Securities Regulation: Liabilities and Remedies (2005, American Lawyer Media, Inc., Law Journal Press, New York, New York), at least six states have adopted the “risk capital” test by statute: Alaska, Georgia, Michigan, North Dakota, Oklahoma and Washington; and at least four states have adopted the test by regulatory rule: New Mexico, North Carolina, Wisconsin, Wyoming.



When a CSA is structured as a pre-purchase, the customer pays an agreed on price up front that will be applied to later purchases. In a sense, the pre-paid CSA share acts as a *gift certificate* to purchase future farm produce.

In certain situations the farmer may wish to provide a “bonus” or “incentive” to the pre-purchaser. To lessen the likelihood that this triggers securities laws, the bonus can be offered as a predetermined or specified amount rather than an open-ended potential for profit or gain. The bonus should be tied directly to the pre-purchase. For example, a farmer may provide a customer who buys a CSA share before May 1 a \$50 bonus to apply to the customer’s purchase. The pre-purchase price and any bonus credit are put towards the purchase of the farmer’s produce, meats, etc., for the duration of the specified CSA share period.

There have been no court cases to date that call into question whether a farm CSA membership in particular situations should be treated as a security. When in doubt about how to interpret the laws, consult a qualified securities law attorney. For more information, including considerations for reducing risk when crafting CSA arrangements, see Chapter 9: “Multi-year CSA.”



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Chapter 2

State Securities Laws

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Registration: Vermont as a Case Study

Those seeking alternative capital should consider state securities laws, in addition to federal laws. Where all acts essential to a sale or transfer of securities takes place within state borders, the transactions are exempt from federal regulations. **However, in these “intrastate offerings,” state regulations still apply.** In Vermont, the Vermont Securities Act governs transactions that are administered by the Securities Division of the Department of Banking, Insurance, and Health Care (“Securities Division”). State statutes enacted to regulate and control the traffic in securities are commonly referred to as “Blue Sky Laws.”¹⁰

An essential consideration for intrastate offerings exempted from federal registration requirements is whether or not registration is required under the Vermont’s Securities Act. **Under the Vermont Securities Act, securities must be registered, although registration exemptions apply to financial offerings or transactions that meet certain criteria** (See below, “Securities Registration Exemptions Applicable to Farms”). The term “securities” includes a wide range of instruments, such as notes, stocks, bonds and investment contracts. As with federal law, Vermont’s definition of investment contracts functions as a catch-all.

Under Vermont law, unless exempt, a security must be registered with the Securities Division of the Vermont Department of Banking, Insurance, Securities and Health Care Administration. There are several methods of registration. Registration by notification applies only to federal covered securities, such as investment companies.¹¹ Registration by coordination is available for securities registered under federal securities law.¹² Registration by qualification is the most common form of registration for businesses offering or selling securities within Vermont.

Below is some of the information required for registration by qualification, in addition to payment of a \$600 filing fee:

- The name, address and form of organization of the person selling the security, including the state in which the business was established.
- The date it was established, and the general character of the business.
- Basic information for each person playing a significant role in the business, the number of securities they hold, and a description of transactions between the business offering the security and any of its owners.
- The aggregate amount paid to the persons playing a significant role in the business, and a description of how the business is capitalized, whether through equity or long-term debt.¹³

Offerings are reviewed to ensure they are fair to investors. Small Corporate Offering Registration is a streamlined form of registration for small businesses which is submitted to the Securities Division for merit review.

Securities Registration Exemptions Applicable to Farms

The Vermont Securities Act exempts particular securities and transactions from the registration requirement. Exempting a security means a particular type of security or instrument will always be exempt from security registration. These would include those transactions that would occur within the state or intrastate, and also those securities that are offered to a limited number of investors. Both of these are explained further below. Exempt transactions are slightly different from exempt securities. They pertain only to one transaction between an investor and the business offering the security. Whereas a particular security that is exempt will always be exempt as long as that security is involved, an exempt transaction is not such a blanket exemption. The exemption of a particular security remains with that security as long as the security exists, whereas the exemption of a transaction applies only to the qualifying transaction and does not automatically apply to any secondary distribution.

Common Question: *“This is all seems pretty complicated. Is there any way I can avoid or cut down on legal fees?”*

Consultation with an attorney is an indispensable part of reducing risk of liability when it comes to interpretation of the legal implications of securities transactions. Determining whether you have a security, and then if you qualify for an exemption, and what must be done to comply with the terms of a particular exemption should be done with the assistance of an attorney. You can, however, reduce the number of hours necessarily spent on your case. One way is by contacting the state securities divisions or equivalent agencies. Depending on the circumstances, it may be better to make this call anonymously.

The state securities division may provide information that gives you some idea as to what you need to do. Alternating between the securities division and the attorney may allow you to get a better grasp of the situation in the eyes of the securities laws. While this should not be in the place of legal advice, a better understanding of the case may in some cases allow for streamlining and economizing of legal services.

¹⁰ Such legislation is called “Blue Sky Laws” because it tends to stop the sale of stock that represents nothing but blue sky, nothing terrestrial or tangible. It pertains to speculative schemes which have no more basis than so many feet of blue sky. Its violators became so barefaced that it was stated that they would sell building lots in the blue sky in fee simple. Cal.—People v. Yant, 26 Cal. App. 2d 725, 80 P.2d 506 (2d Dist. 1938).

¹¹ 15 USCS § 77r (b) (2). Certain “covered securities” are regulated exclusively by the federal government. They are exempt from state regulations. These include securities issued by investment companies registered under the Investment Company Act of 1940.

¹² 9 V.S.A. § 5303.

¹³ See 9 V.S.A. § 5304 and 5305 for all the required information.



It is often within the best interests of a farm engaged in community financing to stay within the bounds of the exemption criteria, as securities registration can be expensive and time consuming. The following are the most common exemptions available in Vermont:

The following requirements must be present for the **Limited Offering Exemption**¹⁴ to apply:

- The security is sold to no more than 25 persons in Vermont in a 12-month period. Investors/lenders of money would be limited to residing within state borders, otherwise the transaction might be regulated by Federal securities laws.
- The buyers purchase the security for investment purposes with no intent to distribute the security. For example, the investor or lender does not transfer the investment to other parties after the security is purchased.
- General advertising is not made in connection with the security. For example, a farmer would not be able to put an advertisement in a newspaper asking members of the general public to invest or loan money to the farm operation.
- Nobody was paid to solicit prospective buyers, with a few exceptions.

Vermont's Small Business Offering Exemption ("VSBOE") allows you to raise \$500,000 in an offering to 50 or fewer purchasers. Requirements of this exemption are:

- The seller's principal place of business and the majority of its employees must be in Vermont.
- General solicitation is permitted but you must submit the advertising material to the Securities Division.
- Each prospective investor must receive an investment brochure containing specified material, and a notice has to be filed with the state Securities Division.

"O.K., I'm a farmer and I'm pretty sure my fundraising effort amounts to transacting a security. But I'm also pretty sure the transaction would meet the criteria for allowing me to be exempt from registration with the state securities division. Is there anything further to take into consideration?"

It is important to take the next step and consult an attorney, even if one believes he/she qualifies for an exemption. Qualifying for an exemption may free the farmer from registering the security, but there remain a number of key considerations. Each exemption has its own set of criteria. It is necessary to know what exemption applies in order to keep appropriate records that demonstrate your compliance. Documentary support for each condition needed to qualify under an exemption can be time consuming, but it is well worth the effort should suspicion or contention ever arise. Among the details to include in your records are the name and residence of each individual investor or funder, the amount of each individual financial exchange, and the total of all of the investments combined. Exactly what details to include depends on the exemption applicable to your specific circumstances.

Regardless of whether or not the offering is exempt from registration, if it is a security, it remains subject to the antifraud provisions of the Securities laws. To stay in compliance with these provisions, it is generally prudent to keep documents that disclose the description of the business, specific risks related to the investment, and any other material terms or limitations associated with the offering. Disclosure documents that are provided to each funder will considerably reduce the risk of adverse claims.

The Uniform Limited Offering Exemption¹⁵ applies to businesses that meet the following requirements:

- The business may raise \$5,000,000 from 35 non-accredited investors, and an unlimited amount from those purchasers deemed "accredited" investors.¹⁶
- This exemption requires filing of a Form D with the federal Securities and Exchange Commission as well as filing of a copy of the Form D with the state Securities Division.
- To take advantage of this exemption, issuers must provide an offering document to investors setting forth considerable information about the company.

The Vermont Securities Division now permits an unlimited number of sales to accredited investors under the Vermont **Accredited Investor Exemption**. Accredited investors include banks, 501(c)(3) non-profits and natural persons whose net worth, or joint net worth exceeds \$1,000,000, among others. General announcements are allowed in a prescribed format. No registration of the offering is required, but the issuer must file a notice of transaction with the Securities Division. The information required to be submitted includes name, address, and telephone number of the business or person selling the securities; brief description of the security being offered; and, a brief description of the business. Further basic information is necessary.

Another exemption applies to an isolated non-issuer transaction. The "isolated transaction" exemption requires several features. Sales are not repeated and successive, separate sales are not made within such a period of time that they appear connected. Multiple sales will disqualify one from this exemption if they are for the same general purpose.

Any doubt as to the availability of a particular exemption should be taken seriously, and, in most instances, you may present the facts and your particular circumstances to the Securities Division for an informal administrative interpretation. The Securities Division then reviews the facts as provided and gives an opinion based upon the information supplied. Unfortunately, this determination does not represent a conclusion of law and the Securities Division is not bound by it.

¹⁴ 9 V.S.A. § 5202 (14) – This is the Vermont statute authorizing the Limited Offering Exemption.

¹⁵ The Uniform Limited Offering Exemption follows the federal exemption under Regulation D of the Securities Act of 1933.

¹⁶ Accredited investors are purchasers who meet certain income or net worth standards prescribed by federal law.



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Chapter 3

Owner- Financed Sales and Land Contracts

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This section explores two options—owner-financed sales and installment contracts—that farmers should be aware of when they seek to buy or sell farmland without relying solely (or at all) on traditional lenders like banks. By cutting out the “middle man,” owner-financed sales and installment contracts can enable buyers and sellers to be more creative in setting terms tailored to the realities of a farm start-up, lowering hurdles for new farmers and potentially increasing a seller’s overall gain. A brief explanation of the basics of buying and selling land illustrates how these two options differ from the traditional mortgage scenarios, and should help you understand whether one of them might be right for you.

In the normal property sale, the average buyer cannot, on the date of sale (known as the “closing”), pay the seller’s full asking price for the property. Instead, the parties contract for the sale with a “purchase and sales agreement” pursuant to which the buyer typically makes a down-payment toward the overall sale price and takes out a mortgage loan from the bank for the rest using the property as loan collateral. The bank then pays the seller a lump sum on behalf of the buyer who took out the mortgage. In exchange, the seller signs over a deed to the buyer conveying ownership of the property. At the same time, the bank requires the buyer to sign a promissory note, a contract reflecting the buyer’s promise to repay the loan, and a mortgage deed creating a lien on the property. The mortgage entitles the bank to take the property from the buyer, through foreclosure, in the event that the buyer defaults on the loan. The bank records the mortgage in the land records giving notice to all of its interests in the property.

There are several reasons why a new farmer seeking to buy land and a seller seeking to help a new farmer get started may not have the desire or the ability to work with a traditional lender. A bank typically requires the buyer to “qualify” for the loan by demonstrating good credit history and a steady source of existing income that is sufficient to cover repayment of the loan principal with interest. Yet for someone just starting up in farming, it may be difficult to convince a loan officer that future revenues from the start-up farm operation will meet a bank’s rigid income requirements, especially if the future farmer’s credit score is not high enough.

The Risk of Foreclosure

Just like in a traditional bank mortgage, farmer-buyers should understand that if they are not able to keep up with mortgage payments owed to the seller, the seller then has the legal right to foreclose and repossess the property. After receiving a foreclosure notice, the buyer typically has a six-month redemption period during which the buyer can avoid foreclosure by making good on delinquent payments (and in some cases repaying the seller’s costs of foreclosure).

Foreclosure is no picnic for the seller. During the redemption period an owner-seller could have a buyer living on his “sold” property for half a year where the owner-seller neither can use the property, nor be paid by the buyer. Unlike a bank, however, a seller offering owner financing may be willing to seek a creative resolution to avoid foreclosure. Even though both parties hope that the buyer will pay the loan on time without problems, it is best for the parties to discuss and agree upon these creative alternatives up front and to include them in the agreements they make.

A buyer’s up-front and overall costs in a bank loan scenario may be increased by administrative fees that banks charge for processing the loan. Banks set interest rates at a level necessary to help recoup overhead for bank operations while also earning a profit for the bank. Time is money, too, and your deal may be one of many that a bank is working on, thus the process can move slower than the buyer and seller would like.

The Basic Owner-Financed Farm Sale

With an owner-financed sale, the process of transferring ownership (purchase and sales agreement, promissory note, mortgage deed) is the same, but there is no third-party lender involved. Instead, the buyer and seller directly negotiate the amount of time—the loan term—that the buyer will have to pay the seller the full sale price and the interest rate that the buyer will pay on the outstanding balance over that time.¹⁷ Thus, on the closing date, instead of getting a lump sum for the entire sale price from the bank the buyer is borrowing from, the seller signs the deed over to the buyer in exchange for a promissory note and mortgage that the seller then records in the land records. Before entering any deal, a buyer needs to be sure that the seller actually owns the property and that it is not subject to another mortgage already. An attorney can provide this information to the buyer by conducting a title search in the land records where the property is located.

¹⁷ IRS regulations classify owner-financed situations as “installment sales” and require that the seller charge the buyer some amount of interest in an owner-financed sale, though the actual interest rate remains subject to negotiation between the buyer and seller. See IRS “Tax Topic 705: Installment Sales” for basic information or IRS Publication 537 for full details about accounting for installment sales. If you do not state interest, the IRS will state it for you, based on the rules outlined in Publication 537. State law sets a maximum limitation on the interest rate that an owner-financer may charge. In Vermont, those limitations are set forth at 9 V.S.A. § 41a.



In an owner-financed sale, the buyer and the seller have tremendous flexibility when it comes to key elements of the deal. The parties can tailor their financing plan; for example, owner-financing arrangements are often set as “balloon payments,” where the farmer-buyer makes payments according to a 30-year amortization schedule and is required to hand over a lump sum of the remaining balance balloon payment at some point prior to the full thirty year term (often at the five-year mark). This assumes that the buyer will build up enough equity in the property, good credit, and a solid income stream from farm operations to attract a conventional lender to step in and enable the farmer-buyer to pay off the owner-seller in full. In this scenario, the owner-seller would not have to worry about collecting payments for the entire 30 years.

Other lower-risk strategies an owner seller might want to use include an above-market interest rate or a hefty down payment. A seller can require an offer of personal liability from the buyer, a third-party guarantee or co-signature on the agreement. Depending on a seller’s individual circumstances, the heightened risk to the seller may be offset by the tax advantages the seller could realize. In an owner-financed sale, the seller pays capital gains on the principal and income tax on the interest over time as the seller receives annual installments from the buyer, rather than having all state and federal taxes taken in one big chunk in the

year of the closing—as is the case in a traditional sale.

Is the Land Encumbered?

Real estate is encumbered when a legal claim exists against a property that restricts its transferability. Any farmer entering into an installment contract (conventional owner-financed sale or land contract) should make sure to ask the all-important question: is the seller’s land or farm encumbered in any way? In Vermont, buyers can access public records at the town office to research whether or not any mortgages or liens have been recorded specific to the property in question. The buyer should also consult with his/her attorney reviewing the agreement to confirm that the owner-seller will be able to transfer free and clear title to the buyer at the end of the payment period. Buyers should also be aware if the owner-seller is using the installment contract as a “wrap-around” to pay off a mortgage from another lender while seller is slowly selling to the buyer under the installment contract (which can be a dicey situation for both owner-seller and farmer-buyer).

making sure that the parties clearly spell out any special terms like this to avoid misunderstandings after the deal is done. The parties should be able to negotiate without the aid of lawyers, but once you come to terms, it is wise for each party to consult a lawyer with experience in real estate to ensure that the terms of the final agreement are enforceable and clearly reflected in writing.

Sellers can either be the primary financier or they can team up with another lender to offer financing that enables the farmer-buyer to meet the total purchase price. This can be especially beneficial to new farmers in cases where conventional lenders are willing to write a loan for only a portion of the purchase price. The owner-seller provides financing for the balance, based on terms that are defined by the owner-seller and the farmer-buyer. The farmer-buyer makes two separate regular loan repayments; one to the conventional lender and the other to the owner-seller, each of which would record a mortgage lien on the property.¹⁸

Tax Implications of Owner-Financed Sales

Owner-financed sales can involve complicated tax ramifications, and it is advisable to consult with a qualified tax accountant to understand clearly how the IRS will interpret the terms of the arrangement. For example, in many cases, unless the arrangement falls under specific exemptions, the IRS expects that some portion of the loan will be paid back in interest and taxed accordingly. If interest is not stated in the agreement, it will be imputed or implied according to IRS regulations and the going IRS’ Applicable Federal Rate (AFR). Read IRS Publication 537, “Installment Sales,” for more information on the AFR and tax treatment of owner-financed sales. AFR rates are based on federal short, medium and long-term interest rates, and are published monthly in the Internal Revenue Bulletins (IRBs), available at local IRS offices or online at <http://www.IRS.gov>. The rules for including interest hold true even when sympathetic sellers desire to make zero or low-interest loans. For tax purposes, if these transactions are to be considered loans (vs. taxable gifts or capital contributions), they must follow IRS “Below-market Loan Rules.” For more information about below-market loans, see IRS Publication 550, “Investment Income,” available online at <http://www.IRS.gov>.

¹⁸ Farmers can also get creative to finance land where the property is not entirely owner or bank-financed. For example, farms can finance part of their land by partnering with their future customers through the various financing mechanisms outlined in this guide. Farmers can consider giving several seasons’ worth of CSA shares (see Chapter 9: The Multi-year CSA) or specifying an amount of food to be used to pay back part of the principal and/or interest on a loan from a community member over several years (see Chapter 5: The Promissory Note). Farmers should be aware of the implications of the financing arrangement for triggering securities regulations (see Chapters 1 and 2, Federal Securities Laws and State Securities Laws), especially in cases where the farmer solicits financing for the land purchase from the general public.



An owner-seller will not generally need a license from the state to sell and finance the property as long as the loan is primarily for an agricultural property, and personal, family, or household use does not supersede agricultural use (e.g., a hobby farm where the buyer is purchasing the land to serve primarily as a residence). Otherwise, the seller may need a mortgage loan originator license.¹⁹



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Another Variation of an Owner-Financed Farm Sale: The Land Contract

In cases where a seller is reluctant to fully finance a start-up farmer with a low credit score and/or little track record in the business of farming, a land contract with what amounts to a lease-to-own arrangement, aka an “installment contract”²⁰ may provide the seller with more comfort in taking a risk. Unlike an owner-financed sale, the seller in a land contract does not give the buyer a deed conveying an ownership interest in the property to the buyer until the full price is paid. Thus, unless the land contract agreement specifies otherwise, the buyer will not be allowed to borrow against the property by taking out a second mortgage to finance farm operations, and the buyer will not be able to sell the property to a third party. Owner-sellers might feel more comfortable knowing that they retain legal ownership while the land is “under contract” and the buyer is making payments.

Land contracts allow for a great deal of flexibility and creativity in setting the terms of payment. They allow both the farmer-buyer and owner-seller to avoid the hassle and expense of most closing costs common in conventional mortgage transactions. As noted above, land contracts give sellers more control than normal owner-financed sales. For all these reasons, land contracts are often the preferred mechanism for transferring ownership of agricultural property from senior to junior generation within the farm family.

Land contracts can be considered as conventional purchase and sales agreements with a greatly extended time period before closing—instead of signing a purchase and sales contract and then taking 30-45 days to close the deal, land contract deals can take as long as 30 years. Five to ten years is a more common time frame, with a regular payment schedule concluded by a balloon payment. The assumption is that in five to ten years, the farmer-buyer will have enough time to improve his/her balance sheet and credit to come up with traditional financing to make the lump-sum payment that finishes the deal with the seller.

Lower risk for the seller, in some cases, means higher risk for the buyer. In traditional land contract arrangements, when a buyer defaults, there is typically a forfeiture provision whereby the buyer loses the property and all the payments they have made. He or she is not likely to be entitled to the legal protections of the foreclosure process. If the buyer resides on the premises, the seller will have to use eviction procedures pursuant to state law. If the buyer does not reside at the premises, the seller can likely pursue an ejection action against the tenant. The seller can take back the property without going through the foreclosure process because there is no mortgage involved, and under the terms of the contract, the buyer loses possession of the property. A buyer generally cannot recover principal paid to the seller, unless the contract specifies otherwise. Instead, the buyer may forfeit past principal payments upon breach of the contract (essentially, those past payments may be viewed

¹⁹ 8 V.S.A. § 2201(a)(3) describes these licenses, and subpart (e) of the same section outlines exemptions for the license requirement. A Vermont Superior Court case in 2011 elucidated the terminology of “in the business of.” Based on the statute and the recent case, it would be rare for an owner-seller to need a lender license when selling to a farmer-buyer, assuming the seller is not involved with money-lending aside from the owner-financed deal.

²⁰ The USDA Farm Service Agency’s definition of a land contract is “an installment contract drawn between a buyer and a seller for the sale of real property, in which complete fee title ownership of the property is not transferred until all payments under the contract have been made.” From the January 2012 FSA Fact Sheet on the Land Contract Guarantee Program. Accessed online 2/14/12 at http://www.fsa.usda.gov/Internet/FSA_File/lc_guarantee_program.pdf.



Image used with permission of Steve Mease.

as lease payments compensating the owner for the buyer's past use of the property as a farm and residence).²¹ Here again, it is up to the parties to anticipate these possibilities and to tailor the agreement to their expectations and needs before signing on the dotted line.

Farmer-buyers often intend to make changes or improvements to the property as the farm gets up and running, before making all the required payments under an owner-financed sale or a land contract. It is important for the parties to determine the fate of these improvements in case the agreement goes sour, either from the buyer's default or the seller's breach of contract. For example, the contract can include a formula that indicates how much the owner-seller should pay the buyer for improvements made prior to default. In other cases, the seller might not want to be responsible for compensating the buyer for improvements, justification being that the seller assumes risk by permitting the farmer to access and alter the land while the seller still owns it, still pays the taxes, still is ultimately responsible for environmental laws breached, etc. In any case, it is common practice in crafting land contract agreements for parties to agree that the buyer must seek the seller's permission before making any major improvements to the land or buildings on the property during the contract period. Remember: the buyer does not actually own the property until the seller receives all payments required under the land contract!

Payment of property taxes and insurance are key considerations for both parties. The buyer will want to be sure that the seller is not behind on taxes. A buyer can obtain tax status information at the town office where the property is located. Insurance is another important issue; the farmer-buyer should ask the owner-seller or his/her agent about the seller's insurance policies on the property. This information will give the farmer-buyer a sense of what kinds of prominent risks might exist in owning the property and how and at what cost insurance might mitigate these risks. The parties will also want to agree on who will pay insurance and taxes during the payment period of the installment contract.

There are many templates found and sold online for developing installment sale agreements. While the parties can do much of the preliminary work on their own, including negotiating key terms, there is no substitute for the expertise of an attorney or an accountant familiar with these types of transactions.

Buyers and sellers have been using owner-financed sales and land contract sales to transfer property without third-party lenders for decades. With creativity, careful attention, and timely assistance of professionals such as attorneys and accountants, these alternative financing agreements can help a start-up farmer clear the biggest barrier to entry in agriculture: access to farmland.²²

²¹ Some courts have imposed a more equitable parting of the ways, and have ordered the return of some of the buyers payments. *Dow, Heikkila v. Carver*, [378 N.W.2d 214](#) (S.D.1985), and *Prentice v. Classen*, [355 N.W.2d 352](#) (S.D.1984).

²² USDA FSA opened nationally in 2012 the Land Contract Guarantee Program. According to FSA, "guarantees will be offered to the owner of a farm who wishes to sell real estate through a land contract to a beginning farmer or a farmer who is a member of a socially disadvantaged group." For more information, contact your local USDA service center FSA office or see the FSA one-page fact sheet on the program online at: http://www.fsa.usda.gov/Internet/FSA_File/lc_guarantee_program.pdf Accessed online 1/26/2012.

Farm Case Study



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Bloomfield Farm Charlotte, Vermont Highlighting Cohousing and Cooperative Land Ownership

by Matthew Burke, Farmer



Since 2006, my wife, Tanya, and I have been growing for farmers markets, restaurant and grocery sales, and for a small CSA, on land owned in common by a group of cohousing residents. Our farm, Bloomfield Farm, is a small, diversified farm, producing organic vegetables, herbs, flowers, and eggs.

In the early 2000's, the founding members of Champlain Valley Cohousing Development Company sought a property to create a residential farming village. While no one of the original group intended to make their living from farming, they offered land and included two affordable housing units in the project for potential farmers. The members intended to attract a farm enterprise, by combining resources to enable farmers to access land with a degree of affordability in an otherwise costly land market.

Tanya and I are the sole partners and farmers in our farm, a Limited Liability Company. Common Pastures Cohousing is organized as a Homeowners Association (HOA). As we own a household in the HOA, we are also members of the HOA, but the farm and the HOA are independent entities.

The entire land use agreement process was handled internally among the residents. The outcome of the original work included the lease to Bloomfield Farm, and a general Land Use Agreement document that could apply to any later requests for use of land. The Bloomfield Farm lease, (as well as any other land use agreement), is monitored annually by a small member committee tasked with the overall management of commonly-owned farm and forest land. We drafted an agreement, as well as a template used subsequently by others, and presented it to the committee where, upon discussion, modifications were made, agreement was reached, and the proposal was approved by a committee on behalf of the HOA. At that point the agreement was signed by the farmers and the HOA representative, as a formal land lease.

Combining assets such as land or capital among multiple owners offers both strengths and challenges that need to be considered carefully. Advantages for us have included:

- Several households sharing the cost of the land purchase.
- Sharing of capital/overhead and possibly operating expenses, such as utilities.
- Providing assurance of tenure for lessees. May allow no- or low-cost lease, or even payments for land management services.
- No rent or mortgage for farm land.
- Coordinating multiple uses and users of property, over time and space.
- Inspiring other enterprises to complement existing. Option to create part-time or seasonal work among non-farming residents.
- Allowing for agreed baseline management practices, in this case, organic standards, although not necessarily certified.
- Allowing for another set of eyes to review land use, look out for problems (e.g., electrical issue in an old barn) within infrastructure and business plan, to offer suggestions for success.

Some potential challenges can be:

- Agreement on land use requires some clearly defined process for making group decisions, and providing ongoing oversight and a venue for hearing grievances.
- Group process takes time, especially early on. It requires careful communication and patience.
- The process of drafting and approving proposals may deter some activity, although this has gone smoothly in our experience.
- There is a need to have the agreement in writing, for reference and to update.
- It's critical to give ample notice, and allow for feedback and modification to accommodate diverse perspectives.
- Issues of dividing utilities and coordinating competing uses. Where land is owned in common, space and resource base limitations can be an issue.

Related Models Defined: Cohousing

Cohousing is a type of collaborative housing in which residents actively participate in the design and operation of their own neighborhoods. We farm and live at Champlain Valley Cohousing. Also in Vermont, Cobb Hill Cohousing has a number of independent enterprises, as livelihoods and hobbies, with a high percentage of residents participating in some farming enterprise, in some cases multi-family, and multi-generational. The community founders acquired the property with the clear intention of supporting active farming, combining two former farm properties with existing infrastructure. For more info: <http://www.cohousing.org>, <http://www.champlainvalleycohousing.org>, <http://www.cobhill.org>.

Related Models Defined: Cooperative Land Management

Cooperative Land Management is the voluntary enrollment of a portion of one's land into a program that would collectively manage sections of neighboring parcels, with the purpose of creating a larger parcel suitable for farming (e.g., sheep grazing or vegetable production). Landowners retain ownership of their individual parcels and the specifics of the land management agreement between all parties must fit the unique nature of landowner preferences and available land resources. The actual hands-on management of the land may or may not include landowner. Erickson, D. L., et al. 2011. Landowner willingness to embed production agriculture and other land use options in residential areas of Chittenden County, Vermont. Landscape Urban Plan.



Here are some lessons we have learned, when working on commonly-owned land:

- Allow for periodic (annual) review, updates and modifications of the land use agreement. It is important to be able to revisit this in order to make necessary modifications to maximize the arrangement's success.
- Identify clearly who has authority to approve agreement, and create a written agreement.
- It's best for land owners to speak as one voice, through a smaller group, with identifiable person or legal entity with authority. Smaller committees make sense for discussions between the farm entity and the land owner.
- Both the farm entity and the land owner need insurance.
- Common infrastructure helps share investment and maintenance costs, and maximize benefit of use.
- Separate the farm enterprise from the community or landholding entity. Financially and legally this may simplify the arrangement and reduce risk.
- Decision making must explicitly address security of tenure for farmers.
- Include a commitment to sustainability.
- Prioritize livelihoods over hobbies.
- Bring in outside help as needed.
- Give preference to owners and residents to use land first.
- There is a balance between allowing inspiration and initiative, and following process.
- Terms of transfer and termination of the enterprise must be clear.
- First come-first served. Respect existing enterprises.
- Find land with existing infrastructure to inspire multiple and adaptive uses.
- Be as clear with friends and family as you would be with a new group.

In addition to commonly owned land, a new farmer or landowner may pursue several related opportunities, including commonly-owned capital assets, complementary enterprises among several farms, producer cooperatives, public or private institutional support, public lands and infrastructure, and working with landowners to share the benefit from enrollment in the Vermont Use Value Appraisal (Current Use) program.

Fixed costs such as use of land or capital could be granted at no or low cost. Owning some built capital, such as barns, wells or fencing gives cooperating land owners the potential to continue operation should enterprises change or fail. Collective or common²³ ownership of infrastructure helps defray overhead for the farmer. Labor costs could still be covered by farm, as a variable cost of operation.

Integrating enterprises, seasonally or in adjoining locations, may also allow for shared capital among enterprises, without involving the land owner. A cooperative is a formal business structure recognized in many states. A group of farmers may organize themselves as a producer cooperative in order to pool resources such as land, financial or built capital, or equipment, or may cooperatively market or distribute goods.

Schools, hospitals, senior living centers, and other institutions may offer land, capital resources, and other support. This may serve to meet the goals of the institution while supporting a farming enterprise that could be managed independently or within the structure of the organization.

Towns may offer public land or infrastructure, such as storage or slaughter facilities, for farming and forestry, as a public common, or through a low-cost lease to an independent farm. A common farm, using community land, may serve as an important asset to the community, by providing food to those in need, allowing public participation and education, or by simply putting unused or under-valued community land to productive use.

Related Models Defined: Shareholder CSA

To start a shareholder CSA, a core group of people, mostly non-farmers (Community) pool resources to hire (Supported) a producer or farmer (Agriculture). The core group of non-farmers is responsible for covering production costs of the farm (including the farmers' income needs) and may even invest in and own the capital assets. This core group cooperatively manages the marketing, membership, distribution, share costs, etc., while the farmer focuses on growing a high quality and quantity of produce for distribution according to the manner the members determine. In this sense, the non-farmers are not consumers strictly, but rather, they are active members of a farming cooperative which pays a farmers to farm. Importantly, the cost of membership is not related to the value of the food received, but rather the costs of the farming operation. The Temple-Wilton Community Farm in Wilton, New Hampshire is the longest-running shareholder model in the USA.

²³ Collective or common ownership can be governed by various types of legal agreements. A cooperative is one example created by state law that operates under specific principles and specialized taxation rules. The farm in this case study is not structured as a cooperative.



In cases where the farm operation enables the land to qualify for property tax benefits, the land owner entity can reinvest these savings in whole or in part into common infrastructure, or other mutually beneficial expenditures, such as cover cropping to build soil fertility, and reduce fixed or operating costs to farm.

References:

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"Community Supported Agriculture: An Introduction to CSA". *Biodynamic Farming and Gardening Association*. 2009. <http://www.biodynamics.com/csa.html#howworks>

Temple-Wilton Community Farm, "A Brief History of the Farm". <http://www.templewiltoncommunityfarm.com/a-brief-history-of-the-farm/>

The case studies included in this guide are provided as examples of how farmers have used or are exploring various financing mechanisms and are not an endorsement by UVM or UVM Extension of the business practices outlined. This guide is for educational purposes only, and does not constitute legal advice. Individuals remain fully responsible for their own management decisions and for compliance with all applicable laws and regulations, and are encouraged to consult independent legal and business counsel.



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Chapter 4

Considerations in Dealing with Farmland Investors

*by Ben Waterman,
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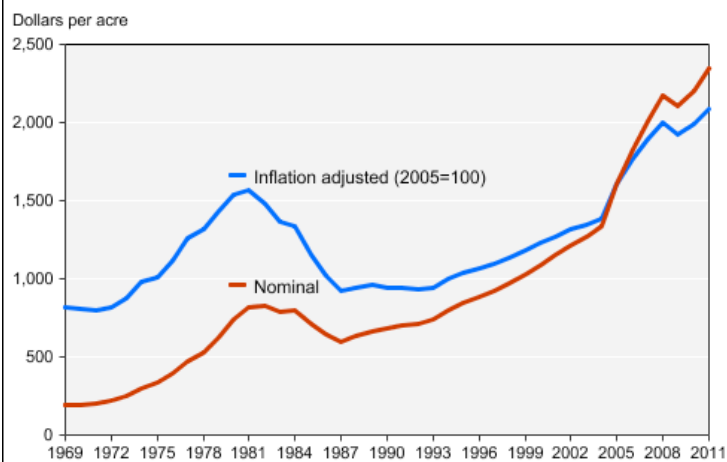
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Increasing numbers of investors are taking serious interest in purchasing farmland as an investment. There are at least three fundamental reasons:

1. Land values continue to trend upwards.
2. Returns from stocks and other investments seem increasingly unpredictable.
3. Land is a tangible asset, and historically it has been a hedge against inflation.

Average U.S. farm real estate value, nominal and real (inflation adjusted), 1969-2011



Note: The GDP chain-type price index is used to convert NASS current-dollar statistics to 2005=100 equivalents (Bureau of Economic Analysis, Dept. of Commerce).
Source: USDA-NASS.

U.S. Farm real estate has retained its value over the past decade, despite the housing market's tumble. In fact, the average value of land and buildings on farms has steadily increased since the late 1980s, as the chart on this page shows. Market value for land and buildings on farms is currently at an all-time high, with national average prices reported at \$2,350 per acre for the year 2011.* In New England (NE), average values tend to be more than double the national average. The average cited by a 2010 NE Agricultural statistics report was \$4,931. One reason for the discrepancy between NE and the U.S. is parcels tend to be subdivided and smaller in NE, meaning housing and other buildings inflate the per acre value of the real estate. Another reason could be higher population density; suburban sprawl, and development pressure all put upward pressure on prices of land throughout the region.

*USDA NASS Land Values, 2011 Summary.

The Midwest has seen a recent explosion of interest and speculation from investors.²⁴ Rental rates and revenues from larger annual commodity crop plantings are easier to predict in the midwest relative to other regions.²⁵ Although the movement has not yet spread beyond the Midwest in noticeable proportions, many analysts predict that farmland investing is on the horizon in the Northeast. The potential opportunity is to channel private investment into farmland and open space preservation, buffering suburban sprawl and keeping farmers at work. The potential drawback is that land is still controlled by “those who do not work it and worked by those who do not own it.”²⁶ Annette Higby points out in “The Legal Guide to the Business of Farming in Vermont”:

This land tenure pattern—which is even more extreme in other parts of the U.S.—has consequences. It affects the way land is used, the care it is given, and even extends into the quality of community of life. Rural sociologists report that communities with high rates of farm tenancy have weaker social institutions than communities characterized by farm ownership.

Financial returns for the investor in farmland can come from two main sources, rental or share-lease income from a farmer, and/or the appreciation of the real estate itself. There are several models or options for partnering with investors in farmland that might be appropriate for the community supported farm. In order to craft arrangements that reduce the risk of compromising community values, neglecting land stewardship and setting false expectations, both farmers and investors will benefit most by having clear, informed communication which includes open sharing of goals and vision during the initial stages of pursuing an agreement—*before any formal commitment is made from either party.*

24 Recently TIAA-CREF, one of the largest pension funds and money managers in the world, took a controlling interest in Westchester Group Inc., controlling \$1 billion worth of agricultural assets and 320,000 acres of farmland as investments. TIAA-CREF also recently met with several other large international investment firms to adopt the “The Principles for Responsible Investing in Farmland: 1. Promoting environmental sustainability, 2. Respecting labor and human rights, 3. Respecting existing land and resource rights, 4. Upholding high business and ethical standards, and 5. Reporting on activities and progress towards implementing the Principles and promoting the Principles.”
http://www.tiaa-cref.org/public/about/press/about_us/releases/pressrelease396.html. Accessed online 2/14/2012.

25 Various reasons for rental rate and farm revenue predictability include government commodity program payments and the economies of scale of large-scale cropping systems.

26 Higby, Annette. “Chapter III, Farmland Tenure and Leasing.” In *The Legal Guide to the Business of Farming in Vermont*. University of Vermont Center for Sustainable Agriculture, university of Vermont Extension, 2006.



Five early-stage talking points with considerations are detailed below. They are:

1. What is the investor's motivation for purchasing the farmland and seeking partnership with the farmer?
2. What is the farmer's motivation for seeking partnership with the farmland investor?
3. What kind of management rights and responsibilities will result from the farmer-investor partnership?
4. Who else can assist in developing the arrangement?
5. What type of agreement will be used?

TALKING POINT #1: *What is the investor's motivation for purchasing the farmland and seeking partnership with the farmer?*

In the traditional model, the investor purchases the land and pays all associated ownership costs. The farmer leases the land and pays cash rent to the landowner. There are many variations of this model, depending on the motivation of the investor. It is useful to uncover and articulate motivations in order to clarify expectations. Clarifying expectations saves time and energy from avoiding unproductive relationships and arrangements, and/or enables agreement terms to be set to preempt situations from unexpectedly turning sour in the future.

Three types of farmland investors are described below. Keep in mind, a person will likely have multiple motivations, and span across each of these three descriptions:

A) An investor motivated by the prospect of short to medium term financial gain will focus on the cash rent (dollars per acre per year) in terms of how it factors into the “capitalization rate”²⁷ or percentage of the original purchase price the landowner will get as a financial return. A really serious investor might compare this capitalization rate to other investments. If a farmer hopes to partner with this type of investor, it is important to be up front about the cash rent that can be paid per acre per year, or what portion of the landowners ownership costs can be covered by the farmer. The farmer should be realistic about what the farm business can handle, and anticipate the landowner to be particularly interested in talking through the numbers.

Yearly income: Total real estate value=
Capitalization Rate or “Cap” rate:

Some investors recognize that investments can have social or environmental impact and these investments can generate superior financial returns. This is exemplified by the trend in investing in organic farmland. Investment partnerships have been launched recently that specialize in the purchase of land, converting it to certified organic land, and leasing it to organic farmers.²⁸

B) Another type of investor is motivated by the prospect of long-term capital appreciation from reselling the land in the distant future. Year-to-year potential returns from cash rent from a farmer are secondary concern. This investor will usually take the most hands-off approach to any other described here. The motivation is often to purchase land as a long-term investment for the kids or family. Having a farmer on the land is desirable, and in many states will enable the landowner to benefit from a significant reduction in property taxes; but the desire to host a farm business is secondary to finding the right piece of land to purchase and hold onto. There is usually little prospect of the farmer gaining a chance to acquire these types of farms via a later purchase or lease-to-own scenario.

C) Finally, there is the investor who is motivated, at least in part, by the desire to have a beneficial impact on local agricultural development. This type of investor might not consider themselves to be an “investor” in the traditional sense. Among primary purposes for seeking farmers are to provide opportunities for land access or local agricultural economic development, and to enjoy having a farm on or near their property. This type of investor has good intentions, but can frequently be the most “hands-on” of the three types described here. Farmers might underestimate the amount of time spent familiarizing the investor with plans for farming and with how farms operate in general. The advantage is that there can be opportunities to partner with this type of investor beyond strictly renting the land. The investor can provide capital through flexible and patient mechanisms outlined in this guide. The arrangement might enable the farmer to significantly

²⁷ Capitalization rate, or cap rate is defined by investopedia.com as “A rate of return on a real estate investment property based on the expected income that the property will generate. Capitalization rate is used to estimate the investor's potential return on his or her investment. This is done by dividing the income the property will generate (after fixed costs and variable costs) by the total value of the property” <http://www.investopedia.com>. Accessed online 12/2/2011.

For more information about capitalization rates: <http://www.investopedia.com/terms/c/capitalizationrate.asp#ixzz1fPjsg1xW>.

²⁸ Farmland LP, based in California, is one such investor partnership. From their website, <http://www.farmlandlp.com> (accessed online 1/13/12): “Farmland LP acquires conventional farmland and converts it into certified organic, sustainable farmland. Our investors benefit from the security of owning farmland while participating in the growth and profitability of the organic market.”



build a base of equity and capital that stays with the farmer wherever he/she ends up down the road. The investor can be a welcome presence at or around the farm. Depending on personalities or characters, these arrangements can be assets or obstacles in the eyes of a farmer.

The most common way these types of relationships fail is when the farmer and non-farming partner find themselves years into the arrangement and have a fallout about an “improvement” or alteration to the land. It is especially important to have mutually understood boundaries and clearly communicated expectations for what all parties plan or want to see happen on the land. (See Farm Case Study, Bloomfield Farm, for lessons learned in communication). Keep in mind that the non-farming investor/landowner will likely be in the process of increasing their understanding of how agricultural systems and economies work. They will be looking to the farmer as a patient teacher. What might be common knowledge to the farmer might be foreign to the farmland investor (and visa versa).

TALKING POINT #2: *What is the farmer’s motivation for seeking some form of partnership with the farmland investor?*

Farmers should be clear on what their goals are, both short- and long-term. They should articulate these goals in conversations with potential capital partners. Is a goal to access land for the long haul? Is it to provide an area for short-term expansion and enterprise growth? Is the goal to provide somewhere to reside and settle down for an extended period? **In many cases, owning a farm or tract of land via partnerships with farmland investors is not an option.** It is more typical for arrangements to be crafted with farmland investors to allow the farmer to lease the land on a short term basis, i.e., one to five years. This might be perfectly acceptable, especially in cases where the farm’s “home base” of operations is already established and the farm is looking to expand onto more land for production. Either way, partnering with an investor can provide opportunities for avoiding or sharing the high up-front costs of land ownership, enabling farmers to build equity in other business assets.

Farmers can communicate openly and clearly about their motivations. After talking with the investor, the farmer should be able to determine whether ownership of land or operating with the security of a long-term tenure arrangement is an option. If it is not, the farmer who is motivated by the prospect of long term secure tenure acquisition, either through purchase or long-term lease, might want to explore other land access options.²⁹

In cases where acquisition will take place by the farmer by purchasing back real estate from the investor, for example in a “lease-to-own” arrangement, clear terms need to be set on how to determine when and in what manner the purchase will be “triggered.” These types of arrangements tend to fail when, although there is a mutual understanding that the farmer will work towards acquisition and build equity during the lease process, there is no specified manner at the outset of the arrangement in which transfer of ownership will start to take place. On the other hand, there can be a real potential for success when both parties work together to iron out a timeline for the farmer to acquire ownership of assets, and detail the process by which transfer of ownership will take place.

Both farmers and the investor (in this sense, a “land holder”) should be realistic about the time horizon in which the farmer can buy back land from the investor. Both family needs and realistic projections for the business need to be taken into account. In general, it is advisable, if not necessary, to consult with tax accountants and attorneys when developing any type of “lease-to-own” arrangement. For more information on mechanisms for farm transfer and transitions, such as a Lease-

The Land Buyback Model

This model is most appropriate for the investor motivated by having a beneficial impact on agricultural development as described in these pages. The investor essentially acts as a “holding company,” purchasing a tract of farmland or farm, for example 100 acres. The investor covers all closing costs and acquires full ownership title in fee simple. The investor identifies a farmer who is willing and able to purchase a large portion or the entirety of the 100 acres at a later date. The investor has the initial intention or willingness to subdivide the parcel to sell some of the land or sell all of the land to the farmer at a later date. For example, the investor and farmer would enter into a lease-option agreement, where the farmer would have the legal option to enter into a purchase and sales agreement with the investor any time before five years has elapsed. The purchase price of the acreage and other critical terms would be specified in the lease-option agreement.

The main advantage of this model for the farmer is it provides a clear path to accessing long-term and secure farmland tenure at a point when the farmer still needs to build equity and can’t yet afford full farm purchase. The disadvantage might be that the future purchase price for the farmer might be higher in order to help the investor cover the initial transaction and closing costs or the cost of subdividing the tract. One disadvantage of the model for the investor is that these costs for owning, subdividing and closing on transactions might exist. Advantages are that the model provides a clear opportunity to support the local food system by preserving farmland, enabling farmers to access land and steward it productively and sustainably, and payback the original investment in the land at the same time.

²⁹ Many non-profit government and other organizations throughout the Northeast offer consulting and assistance to farmers in comparing the pros and cons of various farm access options. Contact your local Cooperative Extension office, state Department of Agriculture, or other non-profit agency, such as Land for Good (<http://www.landforgood.org>) for more information on who can meet with you or services available to assist you navigate through farm tenure and business partnership options.



option agreement, or any other variation of a “lease-to-own” agreement, contact Cooperative Extension, local agricultural non-profit service providers, or attorneys and tax accountants with familiarity with real estate and tax law.³⁰ One particular model, the “Land Buyback Model” is described in greater detail the sidebar above.

TALKING POINT #3: *What kind of management rights and responsibilities will result from the farmer-investor partnership?*

There can be a very clear distinction, legally speaking, between owning an asset and managing it. In farm partnerships it is common for one party to own an asset, such as land, but not have the right or responsibility to manage it. This is commonly known as a limited partnership. For example, one partner’s rights might be “limited” to owning land but not having the authority to engage in business transactions or decide how the land is used for production. In order to hold up in court, the limited authority must be documented in the original partnership agreement in the “statement of partnership authority,” which is filed at the Secretary of State’s office.³¹

Lease agreements also have provisions that specify permitted and prohibited uses of the land. This can serve a similar purpose as a “statement of partnership authority” to clarify and place on record what the landowner and farmer-tenant have agreed to be reasonable practices that the farmer can implement without the ongoing consent of the landowner. Often the lease contains additional provisions that detail a process in which the tenant can obtain written permission from the landowner to implement a practice that was unforeseen or originally questionable at the time of crafting the original agreement.

It is safe to expect at the outset of any type of partnership (legal or informal) that parties will encounter differences in opinion down the road. **“Farmscapes” can change significantly over time as buildings and infrastructure are put in place to accommodate growth in the operation. Even the most well-intentioned partnership can encounter rough spots when parties disagree on the degree and manner in which changes are implemented.** It is therefore critical in early stages of developing arrangements to converse as openly, transparently and specifically as possible about the short-, medium- and long-term visions of all parties involved, regardless of their legal status. Documentation of the nature of management rights and responsibilities is highly recommended, but the success of the arrangement ultimately hinges upon open communication between parties that develops trust and confidence that intentions are clear, and when issues arise they can be resolved diplomatically.



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TALKING POINT #4: *Who else can assist in developing the arrangement?*

1. State Cooperative Extension agencies have farm business management specialists on staff who are experienced in explaining the nuts and bolts of different types of partnership or lease arrangements. Extension educators’ role is to serve communities by being non-biased, and by providing relevant research-based information. Extension staff are often trained facilitators. They will sometimes have the capacity to travel to the farm to assist in meetings. Otherwise, Extension can provide you with free educational materials or point you to other resources that might meet your needs.³²

2. Other non-profits, such as land trusts, exist with the missions of preserving states’ rural heritage, keeping farm landscapes open and productive, and assisting new or relocating farmers’ with land access or farm tenure arrangements. These organizations offer a “cafeteria” menu of support services. While dealing with farm investors is a relatively new program area, these non-profits might have educational resources on the topic of partnering with investors. They might be in touch with investors who share their missions, and might be able to connect farmers directly with these investors when appropriate. Some non-profits in the midwest have this explicit purpose, to serve as the facilitator of farmer-investor relations.

³⁰ Id.

³¹ For more information, see the section, “Farm Partnership,” in Chapter I of the Legal Guide to the Business of Farming in Vermont. Accessed online 1/6/12 at <http://www.uvm.edu/farmtransfer/LegalGuide1.pdf>

³² An example of an Extension publication routinely used in early negotiating stages to develop partnership agreements is the General Partnership for Agricultural Producers Agreement Worksheet. The PDF is a seven-page publication from Michigan State University Extension. It includes questions and blank lines for farmers to use before going to a lawyer when considering a business arrangement. Questions include: Contributions of each partner; distribution of salary and profits; management and dissolution, the exit strategy. Accessed online on 1/6/12 at <http://web2.msue.msu.edu/bulletins/Bulletin/PDF/E2119A.pdf>.



3. **Investment firms or private money managers** will be interested to talk with farmers who are actively seeking investment. Some of these firms’ investor clients might desire to diversify their portfolios and support local food systems, or might be open to the idea of investing in farmland for the prospects of financial gain alone. Either way, farmers should recognize this is a new sector or topic area, and investment managers might not look favorably on the amount of risk involved. On the other hand, if the farmer is prepared to present a convincing business plan or idea, and has a thoroughly-researched strategy for expanding into markets with high-demand, the broker or financial adviser might be intrigued.

4. **Accountants and attorneys** should be consulted to discuss tax and legal implications of any agreement, at the very least towards the later stages of developing an agreement. Some accountants and attorneys might offer free consultations or services on a sliding payment scale to help farmers determine where the biggest areas of risk are or how they might assist as the arrangement is developed. The farmer and investor can do as much homework as possible before paying accounting or legal fees by accessing educational resources of Cooperative Extension or other organizations. Accountants and attorneys will appreciate this, as it might make their work more efficient (thereby lessening their time involved and the total cost of services).

TALKING POINT #5: *What type of agreement will be used?*

A written agreement serves many purposes. The professionals mentioned above (in talking point #4) can assist farmers and investors choose the most appropriate one. All types of agreements should have the basic elements of a contract. It is important for both the farmer and investor to understand the value of a contract. A thorough contract can help avoid any potential problems, and can offer solutions if problems do arise. Crafting an effective contract can involve a significant amount of time and relatively high upfront costs, but having a written agreement in place can avoid many potentially time-consuming and costly legal problems in the future.

The following types of agreements might be applicable for farmers and farmland investors:

- Purchase and Sales Agreement
- Lease-Option Agreement
- Land Contract (See Chapter 3: Owner-Financed Sales and Land Contracts)
- Owner-financed Sale Agreement (See Chapter 3: Owner-Financed Sales and Land Contracts)
- Share Lease
- Farmland Lease Agreement
- Partnership Agreement (There are many different types, including General and Limited Partnerships.)
- Ground Lease (This is an arrangement where the tenant owns and can resell buildings but does not own the land.)



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Templates and samples can be found online all over the Internet, but the reader is cautioned that these samples might not factor in all considerations applicable to specific circumstances. A separate qualified attorney should represent each party to any legal agreement, and review the agreement before it is finalized. Parties should also consult with a tax accountant before the agreement is finalized to fully understand tax implications.



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Chapter 5

The Promissory Note

*by Kenneth Miller, Esq.
Co-founder of Law for Food, LLC*



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A promissory note is a formal contract between parties. It is a written, signed, unconditional promise to pay a certain amount of money on demand at a specified time or over a period of time. A promissory note is used to memorialize a promise to pay a sum of money by a future date in exchange for a loan or various financing at present. The individual who promises to pay is the *maker*, and the person to whom payment is promised is called the *payee* or *holder*. For example, if two people enter into a promissory note, the maker and holder each have legal obligations to perform certain duties under the contract. Typically, the maker will borrow money from the holder, and will have a payment schedule detailed within a promissory note to return the lent money to the holder at a later date.³³

A promissory note can be either secured or unsecured. A secured promissory note is one that specifies collateral securing the amount loaned to the note maker (the borrower). This means that the holder (lender) protects his interest in the borrowed money by loaning money to the maker against the maker's collateral. For example, if the maker (borrower) owns a piece of property, the holder (lender) can loan the maker money and, in addition to the promissory note, require the maker (borrower) to grant the holder (lender) an interest in the property until the promissory note is satisfied (i.e., the maker fully paid his debt with the holder). If the maker fails to pay according to the terms of the promissory note, the holder can foreclose on the property that secured the note, thereby recovering the unpaid principal of the note, interest, fees and expenses.

An unsecured promissory note is one that is not secured by any collateral. With this type of promissory note, the maker borrows money from the holder without relinquishing any interest in his property. The holder's recourse in the event of non-payment will be through the debt collection process.

A promissory note may contain other terms such as the right of the holder to order payment be made to another person, penalties for late payments, a provision for attorney's fees and costs if there is a legal action to collect, the right to collect payment in full if the note is secured by real property and the property is sold ("due on sale" clause), and whether the note is secured by a mortgage or deed of trust or a financing statement (a filed security agreement for personal collateral).

To avoid potential liability, it is important to consider whether the loan transaction falls within federal or state securities regulations (see Chapters 1 and 2, Federal and State Securities Regulations). Whether a promissory note is a security is a complicated legal question. The answer will involve an assessment of the investment scheme of which the promissory note is a part. When seeking investments or loans in the form of promissory notes, businesses should consult legal counsel to be sure that their plan either would not be considered a security or whether an appropriate exemption from federal or state rules would apply.

Generally, promissory notes are presumed to be securities, especially when they are not secured with collateral. Remember, the general intent of securities regulation is to provide anti-fraud protections for members of the public contributing capital.

Promissory Note vs. the CSA: Can a farmer pay back a loan in food?

It is generally not advisable to structure a loan with a payback in food, because of the complexity of tax implications involved and the risk that the IRS might interpret this kind of arrangement as tax avoidance. Remember, principal payments are not deductible by the borrower and not reported as income to the lender. Interest paid is a deductible expense for a business. Interest received by the lender is taxable income. If a community lender wants both food and money in return, it can be easier to use two separate agreements: A CSA or other farm goods purchase contract, distinct from a loan contract that involves a payback in cash principal and interest.

CSAs might seem like loans because in a sense they provide the farmer with operating capital to produce a certain quantity of product. Loans that are paid back in food may seem similar to the CSA concept. However, the comparison below illustrates that the typical CSA membership is completely different from a promissory note in a legal and accounting sense. Here is a general comparison:

CSA: Food or services are prepurchased.

LOAN: Food is neither bought nor sold.

CSA: There are no principal or interest payments.

LOAN: Involves principal and stated and/or unstated interest payments.

CSA: The farmer pays taxes on net income from the operation.

LOAN: The farmer does not pay tax on the loan proceeds (principal), and does not deduct principal payments as an expense. The lender pays income taxes only on interest payments received from the loan.

CSA: Is a simple consumer transaction, attorney oversight is unusual.

LOAN: Requires a more detailed contract, with accountant and attorney assistance more common.

If you are thinking of considering structuring a CSA share to function like a loan, it is highly advisable to consult with a qualified tax accountant and/or attorney for clarification on how the IRS or courts might likely interpret the arrangement.

Keep in mind that any transaction format that hints of tax avoidance will draw close scrutiny of the IRS. Remember the duck test: If it looks or sounds like a duck (or a plan to avoid tax), it's likely a duck (a tax avoidance plan)!

³³ Title 9A Article 3 of the Vermont Code Annotated.



Courts may be more likely to view a holder of a note without collateral more vulnerable to fraud than a holder of a note with collateral. The conservative view is that a promissory note with a maturity of more than nine months is a security.³⁴

Promissory notes, while not relevant to *all* types of “community financing” as defined in this guide, are considered indispensable in *many* community financing agreements because they provide ample room for creativity in setting the repayment terms of the loan. Repayment schedule, interest payments, the nature of these payments and other variables can be based on the needs of the community—represented by the holder and maker of the note who are both members of the community. As long as the core elements of the legal contract are in place (see Appendix 3: Contract Basics), other clearly articulated terms within the promissory note should be legally legitimate. When in doubt, consult with a licensed attorney who can review the final draft of the contract. The way in which principal and interest payments are set will also have tax implications, so a certified accountant should also be consulted to better understand these effects.

Two sample promissory notes are provided in Appendix 4 of this guide.

Gift versus Loan

A loan constitutes indebtedness or an obligation to repay, whereas a gift is made according to the IRS, “without expecting to receive something of at least equal value in return.” A gift has distinctly different tax consequences from a loan. The donor is generally responsible for paying a gift tax on the value of the taxable gift, unless the value is less than the IRS “annual gift tax exclusion.” At the time of this writing the exclusion was \$13,000 per year, meaning one generally could give gifts valued up to \$13,000 per person, to any number of people, and none of the gifts will be taxable. For more information, see IRS Publication 950: Introduction to Estate and Gift Taxes.

The IRS is very suspect of any financial transaction that might resemble avoidance of the gift tax. Loans can be suspect, because in a loan, a large amount of proceeds or principal can be transacted back and forth between a lender and borrower without being taxed. Documentation of the loan, such as a promissory note, must be present to prove that the transaction is not a gift. However, the IRS points out, “If you make an interest-free or reduced-interest loan, you may be making a gift” (from IRS Publication 950). **It is not always easy to distinguish between a “gift” versus a “loan.” Hence the IRS has set guidelines for tax treatment of “below-market loans” and “gift loans.” (see below, “What about a zero-interest loan?”)** These guidelines can be complicated, and a tax adviser should be consulted when crafting promissory notes for creative community financing arrangements.

What about a Zero Interest Loan?

In the eyes of the IRS, “zero-interest loan” is an oxymoron. The U.S. Tax Code (section 7872) sets requirements for how loans with below-market interest rates are treated for tax purposes. An interest rate is generally “below-market” if it is below the “Applicable Federal Rate” (AFR), set monthly and made publicly available online or at IRS offices. The general rule is that interest will be “imputed” or implied by the IRS, when it is not stated by a lender and borrower in their loan contract, or it is stated by the loan agreement to be less than the AFR.

A “gift loan” is the closest thing to a zero-interest loan that the IRS recognizes. According to Section 7872, the term, “gift loan” means any below-market loan where the forgoing of interest is in the nature of a gift.” A gift loan, as in other types of below-market loans, involves imputed interest. The consequence for the lender is he/she can be taxed even when there is no interest income that was received! The borrower might be able to deduct the implied interest payment even if there was no real payment made! These rules are complicated and might not make sense. **This is all the more reason to seek the assistance of a Certified Public Accountant or other tax adviser.**

There are exceptions within the below-market loan rules to the requirement to impute interest. There is the \$10,000 exception and the \$100,000 exception, both applicable to loans made directly between individuals. For loans totaling less than \$10,000 in value, the loan meets the exception if the proceeds are not used to purchase income-producing assets. This would disqualify most farms crafting community financing agreements to provide start-up or operating capital for farm operations. The second exception, the \$100,000 exception, does not contain disqualifiers about income-producing assets, and thus *would* likely be relevant to farms. As long as the loan amount is less than \$100,000, and the borrower’s annual investment income (interest and dividends reported on his/her tax returns) is below \$1,000, then interest is not required to be imputed in the deal. If the borrower’s investment income is greater than \$1,000 then the amount of imputed interest is capped at the amount of the borrower’s investment income.

Again, these rules might not make sense to the average person who is not familiar with the U.S. tax code. The above is only an introduction to the IRS below-market loan rules. For these reasons, when crafting debt instruments that integrate “patient” or creative financing terms, it is highly advisable to enlist the assistance of a qualified tax attorney and/or a Certified Public Accountant or other tax adviser.

³⁴ However, some courts have used the “family resemblance test” (See *Reves*, 494 U.S. 56, at 67 (1990)) to scrutinize whether a promissory note is a security. A note with a term of more than nine months is presumed to be a security, but this presumption may be rebutted if the instrument strongly resembles an instrument that has been excluded from the reach of securities laws, or a note that ought to be excluded based on the “family resemblance” test. For example, these might not be securities: A note delivered in consumer financing, an example of which would be a note that may accompany the purchase of a consumer good (e.g., large appliances); a note secured by a mortgage on a home; a short-term note secured by a lien on a small business and/or its assets; a note from a bank, or other financial institution; a short-term note secured by an assignment of accounts receivable. For example, checks coming in from customers/clients are assigned to the lender; a note formalizing an open account debt, incurred in the ordinary course of business (an open account/credit at a supplier); a business loan from a commercial bank, or one that is in the business of making money on loans (the interest).

Farm Case Study



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Fair Food Farm East Calais, Vermont Highlighting Creative Use of Promissory Notes

by Emily Curtis-Murphy, Farmer



Fair Food Farm was conceived during a winter that my husband and I both spent unemployed with our first baby in remote North Troy, Vt. We had each been laid off from our jobs, and wanted to work for ourselves, as it seemed unreliable to expect a steady job or a living wage working as a farmhand. We love the idea of our children growing up on a farm, and we dreamed of a livelihood we'd love everyday. We planned to feed all of our neighbors (and especially low-income families) through a farm store based Community Supported Agriculture program that would provide healthy whole foods at a lower price than local big box supermarkets. Our rotation of livestock pastures, forage crops and vegetables would build healthy soils to nourish our new community in Calais, Vt.

Two years in, we've been struggling to service our debt and keep up with daily expenses, and found we need to overhaul the business plan we thought would lead to profitability by now. Those farmhand jobs glow brighter in the receding autumn light on this farm where we don't have enough money to do things efficiently; where things don't happen on time because we try to do too much; where we can't afford our plans, needs, and obligations; and where I awake in the night more frequently than our newborn son wondering how long we can keep operating at a loss, and what happens if we can't.

In the spring of 2010, we hiked into our new home - a one-room rented cabin with no hot water on a farm six miles from our freshly plowed 10-acre leased field. We had a borrowed tractor for two months, two old trucks and some borrowed implements. We found a historic grist mill to lease as a farm store, and we were off and farming!

In June we were approved for a start-up business loan from the Vermont Agricultural Credit Corporation, but we only had enough collateral for a \$9,000 loan. Our business plan required at least \$15,000 to get going, so we went looking for more money. Selling shares in the business was too complicated for us. We worried about maintaining control of decisionmaking, legal costs and potential tangles with the SEC. We needed loans with affordable interest rates to cover our operating expenses, and with all of our meager collateral committed to our start-up loan we had limited options. I got the idea to approach individuals from reading the socially responsible investing periodicals that my mom sends me.

There are increasing numbers of investors interested in putting their money to work for positive change.[1] Some people want to see a monetary return on their investment, others are more interested in building "social capital." This could mean facilitating the growth of a rural economy, supporting sustainable agriculture, improving access to fresh food, or educating local youth about the joys of farm work. There are few ways to have a more immediate impact than loaning money to an entrepreneur, and by doing so directly they avoid the fees associated with supporting the administrative functions of a fund. The lendee also benefits from a lower interest rate because they don't need to pay for these services either. But direct loans can be risky for the lender. While Vermont did have the second lowest rate of business failures in the U.S. in 2010[2], start-up businesses are tenuous, with under 50% surviving longer than 5 years[3].

Loan seekers should expect some degree of due diligence desired by the lender. There are options for investors that provide more safety checks than a direct investment or loan to a small business; organizations put resources into preforming "due diligence." Their experts evaluate a loan application or investment opportunity by checking references, reviewing the business plan, and looking over financial reports and projections to verify accuracy. Private individuals, however, may not have the in depth knowledge of agricultural businesses required to understand the details of the plan you provide. Some lenders might not even ask to see your financial data and projections, but will give a loan based on your perceived good character.

I attended the Slow Money National Gathering in Shelburne, Vt. in June 2010 to learn more about who is interested in the Slow Money³⁵ concept, and how I might take advantage of this interest in "investing as though food, farms, and fertility mattered,"[4] to garner more capital for our nascent farm business. At lunch I talked with a bank executive interested in our project. She agreed to loan us \$6,000, and I offered to write the promissory note. After I read a number of samples on the Internet, and checked out the Uniform Commercial Code that governs this form of contract on the websites of the Cornell University Law School Legal Information Institute (<http://www.law.cornell.edu/>) and the Vermont State Legislature (<http://www.leg.state.vt.us/>), I adapted a promissory note prototype to our needs. The lender and I discussed payment details, and we signed and sent it. Easy! And much quicker than the process we submitted to for our VACC loan.

I did not have a lawyer check over any of our promissory notes, but I suggest that would be prudent. I decided to keep it simple, and omitted anything draconian sounding to make it favorable to us in the sad case we make late payments or default. Punitive fees and climbing interest rates fall in this category, as do acceleration clauses such as this example: "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." [5] We removed such ideas from our contract. If you must include a penalty, I suggest a clause such as "If payment is 15 days late, a surcharge of \$10 will be incurred." Another fee to look out for is an early repayment fee, because one may want to refinance higher interest rate debt, or pay it off early. The

³⁵ Slow Money is a non-profit alliance hosting regional and national gatherings, providing financial products and services and promoting the "Slow Money Principles: new ways of thinking about the relationship between food, money and soil." For more information, visit <http://www.slowmoney.org>.



amounts and method of payment should be clearly laid out. It is usually cheapest to pay by check. Bank transfers incur hefty fees, and PayPal makes good use of money passing through, holding it for as long as possible in its own coffers.

I now know that we should have looked for more money at the beginning; we have had expensive cash flow problems from the beginning, we don't have equipment that we need, and many things keep breaking. More promissory note loans for operating expenses have kept our cash flow limping along. In the past year and a half we have secured two more short-term operating loans for which we used promissory notes. I wrote one, and a neighbor-lender wrote the other. We have also taken a loan from another farmer and from family members for which we only have verbal agreements.

It takes a lot of talking to people and asking to come up with loans from individuals; I feel like I really earned each one. I need to spend more time soliciting interest in supporting our farm business, and am planning on applying for loans for 2012 from a number of institutional sources as we adapt our business plan to meet the greater demand of different markets than we originally planned to serve. But I love the connection of a personal loan, and we will continue to seek them out as we work out ways to grow our farm towards profitability. Small lenders are simpler to negotiate a favorable agreement with, will not report late payments automatically to a credit agency, and may be willing to work with you on repayment terms if you experience hardship.

What we learned the hard way:

- We bought some equipment with short-term loans. This was a mistake, because it is harder to pay back loans when you haven't put all the money to work to make more money.
- You won't get it unless you ask. Small loans take as much time to procure as big loans, so ask for more.
- Things will probably go worse than you expect once you start farming, and you don't want to end up in a situation where you are trying to work without a vehicle that you can't afford to fix. So give yourself a cushion.
- Not having enough money is really REALLY expensive.

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The case studies included in this guide are provided as examples of how farmers have used or are exploring various financing mechanisms and are not an endorsement by UVM or UVM Extension of the business practices outlined. This guide is for educational purposes only, and does not constitute legal advice. Individuals remain fully responsible for their own management decisions and for compliance with all applicable laws and regulations, and are encouraged to consult independent legal and business counsel.



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Chapter 6

Demystifying Equity Financing

*by James Macon, Principal,
Barbour Alliance L3C*



Above images used with the permission of Ben Waterman.



The Equity Model

Equity is a representation of ownership in an enterprise allocated to individuals or other entities in the form of ownership units (or shares). Equity can be used as a financing tool by for-profit businesses in exchange for ownership (control) and an expected return to investors. Unlike many debt financing tools, equity typically does not require collateral, but is based on the potential for creation of value through the growth of the enterprise. Equity investors may not require ongoing interest payments, however, the future return expectations are higher than debt, ranging from 8% to more than 25% per year over the life of the investment. The primary considerations for any enterprise considering equity are 1) the level of ownership and thus control the founders are willing to relinquish in their enterprise; and 2) the ability to deliver the level of return expected by the equity investors.

The two primary categories of equity are “common” shares (typically for founders and employees) and “preferred” shares (typically for investors). Preferred shares include special features or “terms” to sweeten and protect the investment. Such features include liquidation preference (right to redeem their allocation of proceeds from a sale of the business before common shareholders), anti-dilution protection (protecting the value of preferred equity units at the expense of common shareholders should the value of the enterprise decline), and redemption rights (the right to sell shares at a given price in a certain timeframe). Equity investors may require a seat on the Board of Directors (either an active voting Board seat or an observer seat) for greater control over the enterprise to protect their investment.

When equity investors make an investment in an enterprise, they are purchasing shares of the enterprise. The price per share is determined by the total enterprise value divided by the total number of shares outstanding. For newly-formed enterprises with little to no value, however, that share price will be very low and typically set at an arbitrary value around a penny, focusing investors on the *percentage* of the enterprise they intend to acquire. The idea is that over time as the enterprise grows and new capital is brought in, value will be created and the price per share will therefore increase. Many equity investors experience gains from their investment by an increase in the value of the enterprise from the time of investment to some future “liquidity event” where returns are actually realized. Such events include a sale to another enterprise (“acquisition”), to the general public via an initial public offering (“IPO”) or to the management team of the enterprise (“management buy-out”). Equity investors may also be entitled to distributions of earnings as well prior to any liquidity event.

Words of Caution:

Farmers who seek outside capital through any process should consider carefully structuring the agreement to maintain management control. Farmers should also consider carefully limiting the capacity of investors to withdraw capital before the business can withstand a withdrawal of capital. Farmers in an equity agreement might want to consider including provisions to “buy out” the investor by allowing future repurchase of equity. In cases where the investor has the option to sell their shares to another investor, the farmer should consider restricting transfers of equity to other investors without the farmer’s approval.

Investor Types & Expectations

During the early venture design and development phase (“seed” stage), **friends and family** are often the source of equity financing. This group suits enterprises in the seed stage because the individuals are known entities, close to the entrepreneur and want to support his/her mission in the venture. Friends and family with the means to invest are often hands-off in the operations of the business (though there are obviously exceptions). When the senior generation steps in to provide capital for the junior generation, they are typically less demanding on the terms of the investment, what return they expect, how much equity they receive and how their investment is protected. Accepting money from friends and family does have potential challenges as they are meaningful personal relationships that may be impacted by the performance of the enterprise and ability to deliver a return.

Once an enterprise reaches a point where additional capital is required to reach the commercialization phase (when you can start generating revenue), other individual investors may be approached. These individuals, known as “**angel**” investors are accredited (meaning they have the net worth to legally qualify for making investments in high risk enterprises), and may invest independently and/or within investment groups called “**angel groups**.” Angel investors are typically more sophisticated and experienced investors that will demand more from their investment than friends and family. These demands are reflected in the terms they attach to their investment, often similar (though less demanding) than those used by institutional venture capital funds.

A new breed of angel investor has emerged over the past 20 years, building a new investment field known as **patient capital**. Although still fragmented, patient capital investors have emerged to capitalize upon lower or slower yielding investment opportunities, yet still require high-quality enterprises with balanced risk/return profiles. To generate returns, patient capital investors may look to creative or less common strategies mimicking debt via dividend requirements plus an eventual re-purchase of shares from the management to manufacture a liquidity event. Many of these investors are driven by social and environmental missions that take a holistic view of the investment beyond just the economic return.



Venture capital (“VC”) funds are professional intermediary financial institutions that manage risk capital for large institutions (pension funds, endowments, mutual funds, etc.), foundations, family offices and accredited investors. VCs invest capital in start-up enterprises from seed stage through later-stage growth. VC fund entities typically have a life term of ten years and are responsible for realizing gains for their investors within the ten year period. VCs realize returns predominantly through acquisition of portfolio companies by larger market enterprises or private equity firms and less commonly via an initial public offering of portfolio company stock. Because VC funds are typically multi-million dollar pools of capital, the VC managers need to deploy large amounts of capital to put the money to work. VCs seek an annual 25% return over the life of the fund - on a cash basis, this means VC money is targeting 10 times their investment within 3-7 years – a formidable task for entrepreneurs.

The VC model is built to anticipate failures, many flat investments, some modest return investments and one or two high-return investments within a portfolio; however, investments are assessed and made only in enterprises VCs believe have the ability to achieve or exceed their return requirements. Most VC funds are focused on technology-based enterprises with a particular competitive advantage (e.g., intellectual property), within large and growing markets and with an ability to rapidly scale and exit. The typical community farm enterprise model does not qualify for institutional venture capital investment primarily due to the small target markets and thus the inability to rapidly scale with a resulting liquidity event.

Equity Financing Process

Seeking equity investors can be very time consuming and drain significant resources and energy. The first step is to determine if equity financing is appropriate for your enterprise based on control tolerance and return potential. Successful fund raisings stem from finding the right individual investor with a passion for the space, a clear fit within their portfolio of companies and at the right time in their investment cycle (investing capital or liquidating investments?). To increase the odds of success, entrepreneurs must have some key business elements and documentation in place when first approaching prospective investors including:

- Full business plan (including an executive summary and financials)
- Historical and projected financials (5-year projections, monthly for the first year)
- Use of proceeds (how you will deploy the invested capital and over what period)
- Capitalization table (showing equity holders, their % ownership and investment if any)

The time to close on equity financing can take anywhere from a few weeks to more than a year, depending on how prepared the entrepreneur is and the ability of the investor to focus on the investment analysis and structuring. The process generally includes:

1. Identification and qualification of prospective investors
2. Initial outreach (with executive summary)
3. Provide business plan with full financials
4. Initial meeting (“pitch”)
5. Investor due diligence (deep dive into the business to validate assumptions, get to know management team and determine return potential)
6. Investment terms (negotiation, usually initiated by a “term sheet” highlighting key terms)
7. Closing (money is moved to the entrepreneur’s account)

Building a Framework for Financing Considerations

Any entrepreneur assessing what financing is appropriate for his/her enterprise should begin by assessing the fundamental drivers behind his/her enterprise. These drivers can provide early direction on the kind of appropriate financing strategies. Answers to the following questions can reveal some of these drivers and provide a basic framework for financing considerations:

- Why am I personally starting or growing this enterprise (what you want out of the business)?
- How large do I want this enterprise to be (customers, revenue, earnings, employees, # products, etc.)?
- What are my expectations with this enterprise (ongoing concern, multi-generation, eventual sale)?
- What is my target market and who are the competitors in that market?
- What assets do I have now (partners, staff, equipment, facilities, existing capital)?
- What level of control do I want and can I tolerate giving up (100%, investor partial ownership, employee ownership)?

For the community farm, equity may play a role in the overall capitalization; however, it should be viewed as just one of many layers of financing in the overall capital structure of the enterprise. For community farm enterprises with the potential to meet return expectations and with a tolerance for giving up some ownership and control, some friends, family, and patient capital investors may be well-aligned to provide a layer of equity-based capital to support the business growth.



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Chapter 7

Revenue- Based Financing

*by Kristina Michelsen, Esq.,
Attorney-at-Law*



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When considering how to involve community members in financing a small agriculture based business, a revenue-based financing agreement (also known as revenue-participation or royalty financing) may be a good model to explore in conjunction with other options.

What is Revenue-based financing?

Revenue-based financing is debt financing with a twist. It is a loan with a promissory note where repayment of the loan is tied to a percentage of the company's revenue. Instead of repayment being measured in a fixed interest percentage of the loan amount, the return amount is negotiated and that amount is paid through the agreed-upon percentage of revenue.

While revenue-based or royalty financing seems a relatively new financing model, it has historically been used in the oil, gas and mineral industries. Speculators invested in oil, gas or mineral extraction companies in exchange for a percentage of earnings from successful operations. More recently, this financing format has been used in the pharmaceutical and bio-tech industries. Read "Drug Royalty Financing Thrives in a Difficult Market," Reuters (8/20/08); the article notes that the biotech industry was facing a paucity of financing options where venture capital was drying up and banks were reluctant to make traditional loans. Royalty financing filled a need and is a thriving method of financing these companies.

The situation for small businesses, including small agriculture businesses, is similar. There is not a ready source of venture capital available and banks are reluctant to loan money to new or small businesses without financial history or collateral. There are organizations providing loans to small agriculture businesses; however, they tend to provide more traditional financing which include requirements of collateral and personal guarantees. Even if some financing can be obtained by more traditional methods, revenue-based financing is an option that

should be considered in an agriculture business plan that includes a community financing component. A revenue-based agreement can provide the kind of flexibility or "patient capital" designed to help the farmer maintain cash flow during seasonal fluctuations or mitigate risk during down periods.³⁶

There is no one royalty or revenue-based financing agreement. As with most loans, these agreements can be tailored to the needs of the business and the investors. Instead of a fixed interest rate of return and fixed monthly payment, the parties agree to a total repayment amount above the original loan to be paid over time pursuant to the agreed-upon percentage of revenues. An example could look as follows: \$10,000 loan to be repaid with 3% of gross annual revenue³⁷ until lender is repaid \$15,000.

Profit Margin:

Net proceeds or profit as a percentage of gross revenue.

Traditional Financing Options

1. **Equity financing** is when an investor invests money in a company in exchange for an ownership interest. The investor's return depends on dividends and more likely a percentage of the sale price of the business based on the investor's percentage of ownership. Equity financing is a significant component of capital for fast-growth companies that are likely to be sold.

Equity financing presents challenges to a small farm operation. The owners may not want to dilute their ownership interest by selling equity in the business. Further, the agricultural company may be difficult to value and investors may be less interested in equity positions in situations where a sale of the company is not in the business plan.

2. **Debt financing** is the commonly used bank or institutional loan. It will often require putting up collateral and giving a personal guarantee among other requirements of any particular lender. Debt financing can also involve secured or unsecured loans with promissory notes to individuals.

While ordinary debt from financial institutions or community loan funds should be considered as part of an overall financing plan, such loans might be hard to secure because of a farm's lack of financial history or collateral. In these situations, considering a royalty financing arrangement with members of the community may be an appropriate option for both the company and the investor.

CAUTION!

It is very important when assessing whether to explore revenue-based financing to understand your company's profit margins. Gross margin can be expressed as a percentage: The revenue minus cost to produce the goods sold as a percentage of total revenue. Finance experts generally suggest that company should have gross profit margins of at least 15 - 25%. The higher the profit margin, the more appropriate it may be to enter into a revenue-based financing deal. A detailed financial analysis of the business should be in place to project cash flow for any revenue-based financing scenario.

³⁶ If structured carefully, the arrangement can include provisions to mitigate the farmer's risk to the downside. However, the nature of the obligation can be such that it might only be appropriate for farmers who have high profit margins or value-added product lines with predictable sales revenue. Other ways to acquire capital might be more appropriate for farmers with low profit margins or unpredictable sales of products year-to-year.

³⁷ Revenue-based financing agreements typically set payback terms based on gross revenue. However, there is nothing that would preclude parties from agreeing to use net income as the index upon which to base the payment. Gross sales revenue is usually much easier to define than net income, and that is one reason gross is more commonly used. If net income is to be used, the financing agreement should clearly specify the definition of net income and the process by which the parties to the agreement will derive the payment amount. For example, parties could use the farmer's income and expense accounting as documented with the annually-filed IRS tax form Schedule F: Profit or Loss from Farming, and calculate the revenue-based payment at the time this form is officially filed with the IRS each year. Or the parties could specify which expenses can be deducted from gross income for purposes of determining net income and then calculate the revenue based payment amount based on that figure.



The most obvious advantage to this kind of financing is that the repayment of the loan is tied to revenues, which gives the business a reprieve in the event it experiences a sales slow-down or period of no revenue. This may benefit a seasonal operation, such as a farm. There is an upside potential for the lender as well when there is a revenue-based payment involved. The lender will be repaid faster and thus have a higher annual return on the loan when the business does better. Use the example above with the \$10,000 loan to be repaid 3% of gross revenue until the lender is repaid \$15,000. The annual 3% of gross revenue could amount to \$5,000 or it could amount to zero dollars, depending on how the business does that

year. If it turned out to be \$5,000 there would be a 50% return on investment, not bad for one year's time! But the lender has also assumed the risk of the annual or monthly (depending on the terms) revenue-based payment being much lower.

It will be important for an agriculture business that is considering royalty financing to understand their profit margins. Generally, this method of financing is most appropriate where a business has a large enough profit margin such that it can sustain a loss of a percentage of revenue over time, and still be able to cover the revenue-based payment and all business expenses.

Securities Law

While there appears to be some disagreement among experts about whether a royalty financing agreement is a security subject to regulation by federal and state securities laws, revenue-based financing agreements as described above are likely securities, and businesses choosing to use this tool should take steps to comply with those rules. As with other types of securities offerings, there are exemptions from registration that a small farm entering into revenue-based financing agreements with community members will likely be able to use. It is important to note that even if an exemption applies, any sale of securities is still covered by the anti-fraud provisions of the securities laws.

One interesting revenue-based financing agreement that might be considered outside securities regulation³⁸ is described in the book "Locavesting: The Revolution of Local Investing and How to Profit From It."³⁹ In the example, the lender receives repayment of the full loan amount but the revenue sharing portion of the loan repayment (i.e., the interest or royalty amount) is given to charity instead of to the lender. This could be a particularly creative way to encourage local community members to contribute to the financing of a small agricultural enterprise. In this agricultural space, an obvious choice for a local charity would be a local food bank for purchase of local agricultural products. Such a model would keep local money in the local food system as well as provide resources for local food banks to acquire and distribute local food products.

Conclusion

Revenue-based financing is one creative way for a small farm or agriculture business to raise money from members of the community. It is a flexible instrument that can reduce the burden of repayment obligation in periods of lower revenue. This is particularly well suited to an agriculture business with seasonal fluctuations in sales. However, revenue-based repayment terms are typically based on gross sales revenue, not net income, and the model might not be suitable for farms with lower profit margins.

Is revenue-based financing appropriate for businesses in start-up stages?

The answer to this depends on the terms of the agreement specified by the community member and the business owner. **But generally, start-ups should be very cautious about committing to making monthly or annual revenue-based payments as part of a financing agreement. The revenue-based financing model has been typically used by mature businesses with predictable sales and profit margins.** Start-ups, on the other hand, are generally known for having less predictable revenue flows and lower profit margins. Start-ups might be hard pressed to carry on with operations normally with the burden of regular revenue-based payments. Another primary reason for caution is that start-ups are typically in debt or investing heavily in capital improvements during this stage. Revenue-based payments could detract from the start-ups ability to pay down principal on loans or make investments in farm infrastructure in a timely manner. As in any type of financing agreement, it is important for the farmer to have a detailed historical financial statements and realistic projections in place to confirm that the terms of the agreement match the ability of the business to meet the requirements of the obligation.

Local Loan Funds Using Royalty or Revenue-Based Financing

Vermont Sustainable Jobs Fund: <http://www.vsjf.org/what-we-do/flexible-capital-fund/financing-options>

New Hampshire Community Loan Fund - Vested for Growth: <http://www.vestedforgrowth.com/financing-options/deal-scenarios.aspx>

³⁸ There may be other ways to tailor specific royalty financing deals that would not implicate securities laws, however, an experienced attorney should be consulted prior to entering into any such agreement.

³⁹ "Locavesting The Revolution in Local Investing And How To Profit From It" Amy Cortese, John Wiley & Sons, Inc. (2011).

Farm Case Study



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SILO SESSIONS CONCERT SERIES
BREAD AND BUTTER FARM






→ **SATURDAY, DECEMBER 17TH**
BREAD AND BONES
Bread and Bones perform award-winning original music with traditional roots. They are Richard Ruane on vocals, guitar, fiddle, and 5 string banjo, mandolin and ukulele, Beth Duquette on vocals and Mitch Barnes on fiddle, fretted and upright basses and looat.

→ **SATURDAY, JANUARY 14TH**
BOW THAYER AND THE HOLY PLOUGH
Bow Thayer and The Holy Plow combines the talents of three of Vermont's most unique musical acts. In the acoustic, blues, songwriting and rockier blue fover Thayer has provided his provocative and dynamic original music for reinterpretation through the lens of guitarist/producer Kristina Styler and the northeast kingdom's fiddler par excellence, Patrick Ross.

→ **SATURDAY, FEBRUARY 11TH**
POSSUMHAW
Possumhaw is a dynamic, original, authentic bluegrass and folk quartet from Burlington, Vermont. Originally formed in 2004, the band has evolved to combine award-winning, executive songwriting and singing with top-notch bluegrass instrumentation. On the stage, Possumhaw offers a genuine, energetic, and highly entertaining performance without gimmicks.

→ **SATURDAY, FEBRUARY 25TH**
SETH GLIER
Despite his relatively young age, Seth Glier is a seasoned troubadour traveling all over the United States and performing over 200 dates a year. In 2010 he opened for Edwyn McCain and The Verve Pipe, appeared with his idol James Taylor and performed on main stages of the prestigious Falcon Ridge and Kenilworth Folk Festivals, with rave reviews and a constantly expanding fan base following him every step of the way.

All ages. Doors at 7pm. Visit www.breadandbutterfarm.com for ticket information.
Sponsored by 910 Music of Bread and Butter Farm - 200 Lecus Farm Road Shelburne, VT

Bread & Butter Farm
Shelburne, Vermont

Highlighting Purchasing the Farm
and Community Financial Support

by Corie Pierce, Farmer



Background

Bread and Butter Farm is co-owned by Corie Pierce and Adam Wilson and was purchased in 2009. We opened for business in May 2010. The farm is located in Chittenden County, Vt. in the towns of Shelburne and So. Burlington – straddling the town line. We are a diversified farm operating a micro raw milk dairy, grass-fed beef, vegetables (focusing on winter greens production), wood-fired oven bakery, and pastured pork. We have a farm store and we attend two local farmers markets. We also sell our bread, greens, and beef wholesale to local accounts. We do on-farm events, most notably our seasonal, weekly Friday night “Burger Nights” where we sell our own burgers and salads. We are considering developing educational programs for children and also hosting other community events at our farm

Acquiring the Farm – Vermont Land Trust Conserved Farm – Proximity to Population Centers

We purchased the farm in September 2009 from the Leduc Family who had owned and operated the farm for the previous 180+ years. Being in Chittenden County, the farm value was over \$2.2 million. The Leduc Family worked with the Vermont Land Trust who facilitated the purchase of the development rights⁴⁰ with the Shelburne and So. Burlington Land Trusts, Vermont Housing and Conservation Board, and many private land owners near the farm. We were then able to purchase the land at a more reasonable price of \$225K.

The proximity of the farm to several populated towns (Burlington, So. Burlington, Shelburne, Williston, etc.) has proven to be a key to the early success of the farm. We envisioned a community farm and we have structured much of our planning and marketing to get as many people as possible to come to the farm. Again, the location has been critical to our success.

For farmers looking for land, working with private landowners to consider conservation is a highly encouraged route to go. It's slower, but worth it for access to more affordable land. Proximity to populated towns is also a critical consideration. We wanted to do most of our business from the farm and through direct marketing channels with as few deliveries as possible. We also wanted to create a community farm engaging customers directly with the land, plants, animals and farmers, so we wanted to find land close to a relatively high population. Purchasing land with the development rights sold to the Land Trust was the only way we could have afforded land in Chittenden County. Farmers looking at cheaper land in more remote areas should be realistic about their potential markets and the need to travel more for farmers' markets and deliveries.

With all this being said, we have operated on a very tight budget in our first two and a half years and it will continue to be tight for a while. Our combined 15 years of farming and business management experience has been critical in our ability to raise needed capital, develop a sound business plan, and manage the business to operate in our start up years. For new farmers who need to invest a large percentage of their savings into land and all the associated costs, this leaves little for other needed capital investments so the business has to be large enough and economically viable to make it all work. We will continue to work long, hard hours to figure this out to make it work, but we are committed to it and are hopeful it can happen in today's world!

Community Supported Farm – Grass Roots Raising Capital – Initial “Getting off the Ground”

When we decided to apply to purchase the farm, we knew we would need some operating and start-up capital right away, in addition to the money for the land purchase. We knew that to support two families, and to grow, raise and produce enough to be economically viable we had to invest in infrastructure early on and quickly. Within the first year we wanted to build our bakery, update the dairy barn, build our first greenhouse, and put in perimeter fencing for their dairy herd and growing beef herd. Adam had an existing bakery (he had built an oven on a friend's property) and had been bringing his bread to the Burlington Farmers' Market for a full season. He had built a loyal customer base so we tapped into this group of supporters to see if any of them could help the farm to launch. We offered “memberships” where individuals could purchase a membership that came with a 10% discount on future food purchases from the farm. For example, a \$1000 membership was valued at \$1100 worth of farm product. Members could use their “declining balance account” to shop for all farm products at the farm and at the farmers' market. We raised \$60K in memberships to put towards capital start-up costs. These ranged from \$500-\$10,000 per membership share, most were in the \$500-\$1000 range with a few larger memberships with some unique terms we developed with each individual and a lawyer. The shares were paid back with long-term “discounts” given to the member, not interest paid back.

In addition to the financial support, this also built in a loyal customer base that then helped to spread the word. Adam had about 10 of his customers become members. We then began doing openhouses at the farm every month that attracted an additional 15 members to have 25 initial members.

40 The “purchase of development rights” refers to the legal process in which land trusts secure a conservation easement on the property, restricting any future building development on the land that is not allowed by the easement. Some land trusts work with beginning farmers to secure the easement at the time of property ownership transfer. In effect, this can significantly lower the purchase price. The beginning farmer pays the “agricultural value” portion of the land purchase price, the land trust pays the “development value” portion, and the seller takes away full fair market value.



First Two Years – Diversity of Funding Sources

In addition to the memberships, we knew we needed additional capital in the first year and a half. Without 3 years of proven business experience or collateral, we were hard pressed to get a traditional bank loan. We looked for a diversity of sources and secured several loans, both traditional and non-traditional.

One loan was a family loan with a 4.5% interest rate. Additionally we secured two microloans from the Carrot Project⁴¹ and NOFA-VT⁴² - \$15K each with about 4.5% interest rate. All of those loans were secured in 2010. In 2011 we brought on one more loan through FSA.⁴³ Additionally we worked with the local USDA/NRCS office to apply for programs applicable to their farming models and received grants for fencing, laneways for stream protection, stream restoration, and a season extension greenhouse.

In the fall of 2011, we launched the second round of memberships, this time targeting smaller amounts (\$300) but building our customer base especially for the slower winter months. This push for membership in November has helped to create a buffer going into the lower cash flow season.

Burger Nights – Added Value Through Agritourism

“Burger Nights” started in June 2010. Every Friday evening we serve our own burgers and salads from the gardens. The mood is festive with live music each week. The event is great for all ages and the food is simple and delicious. This idea to bring people to the farm started with the idea of getting more folks to the farm store and has turned into a community- and farm-building event. Burger Nights are not only a good potential money maker but also great marketing. It is a weekly event that allows us to bring people to the farm. Burger Nights are an opportunity for us to showcase the farm and mingle with farm supporters.

The success of our first year of this event took us by surprise and is an exciting opportunity for us to have a higher margin venture on our farm. There are a lot of details to manage, more inherent risk (having 300+ people on your farm regularly has a lot of associated risks), and has challenges with weather, consistency, staffing, etc. However, if we can manage it well, the up sides are tremendous so we are using our less-busy season to figure out the details to make it all work. Will we do Burger Night forever? We aren’t sure yet, but it seems like a great event for us for our first several early years



Image used with the permission of Jarrett Frankel

Financing in the Future – From Years 1+2 to 5 Years and Beyond

The farm has been able to get a fast start that has brought immediate business to the local economy. We have been able to employ between two and six people at any given time in year two and are looking to grow after year three. We have been able to give farm tours and field trips for many local schools and love to share their farm with kids and adults of all types.

We’re in the midst of planning out the next five years. The goal is to not take on more debt for two to three more years and to pay back the loans initially taken out. We’re in the midst of building initial production areas focusing mostly on building the vegetable and beef operations. We’re currently enrolled in the state program “Farm Viability”⁴⁴ to work with an advisor to create a five-year business plan. With the experience of using diverse financing strategies, we are in good shape for accessing needed capital in the future from a variety of sources.

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41. The Carrot Project Microloan program operates in Maine, Massachusetts and Vermont. For more information, visit <http://www.thecarrotproject.org> or contact info@thecarrotproject.org or call (617) 674-2371.

42. Northeast Organic Farming Association of Vermont has a revolving loan fund program. For more information, visit <http://nofavt.org/programs/farm-financial-resources/revolving-loan-fund> or contact NOFA-VT at (802) 434-4122 or info@nofavt.org.

43. USDA Farm Service Agency (FSA) has farm ownership and farm operating loan programs. Contact your local FSA office for more information. To find the nearest office, visit FSA’s website at <http://www.fsa.usda.gov>.

44. The Vermont Housing and Conservation Board (VHCB) coordinates the Farm Viability Enhancement Program, with a team of professional business management consultants across the state who meet with farmers to develop customized business plans. For more information, visit <http://www.vhcb.org/viability.html> or contact VHCB at (802) 828-2117.



Chapter 8

The “Multi-Year CSA” Financing Model

*by Kristina Michelsen, Esq.,
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For purposes of this guide, a “multi-year CSA share” is any Community Supported Agriculture membership share or subscription that enables the purchaser or customer to pre-buy food produced during more than one growing seasons. These shares can be bought for a substantial amount of money, for example one thousand to ten thousand dollars or more, simply due to the extended timeframe for producing these shares’ worth of food and the fact that the volume of food purchased can be much higher than one would consume in a single three-month growing season.

Multi-year CSA shares can be construed as “investments” or securities, and farmers need to be careful when offering these kinds of CSA memberships. To lessen the risk of the transaction being classified as a security and, in turn, avoid the requirements for registering with state and federal authorities, the farmer should make clear that the CSA share is being sold as a method for pre-buying and selling food and/or services, and **not a method for investing in the farm operation for purposes of the investor gaining a profit. See the text box in Chapter 1 entitled, “Are CSA Shares Securities,” for more information on what factors might make it likely for the transaction of CSA shares to be considered by the federal or state securities regulators as a securities transaction.**

Here are some other considerations for selling multi-year CSA shares to customers:

- To entice customers to buy larger CSA shares or those with more extended time frames, farmers might offer bonuses of food when these types of shares are purchased. To lessen the possibility for the transaction to be considered a security, the farmer can refrain from offering “returns” or “gains” or “profits” on top of the money used by the customer to purchase the share. Instead, emphasize that a **discount** will be given on food pre-purchased. Similarly, a **bonus** can be given, as long as its amount is fixed, predefined and will be given in the form of a product or service.
- Farmers often underestimate the amount of time it takes to converse with purchasers of multi-year CSA shares. These customers feel like they are taking a stake in the operation, and they are in a sense. This can be beneficial for all involved, but the farmer should expect questions that are not ordinarily fielded. One idea is to have a special “openhouse” for those interested in purchasing multi-year CSA shares to address common concerns and brainstorm about positive ideas.
- When uncertain about the way in which an “offering” or solicitation to potential multi-year CSA shares should be written, consult the advice of a qualified licensed attorney. A small amount of cash to do this might save a much larger hassle down the road.
- Special benefits can be offered to coincide with the purchase of multi-year CSA shares. For example, these shareholders might get first dibs on a specialty crop or first chance to place orders for bacon once the farm animals are processed. Members can be offered discounts on other on-farm events, such as music or barbeques. Offering these benefits as services purchased with membership fees will not likely trigger securities registration.⁴⁵ For more information, see the section entitled, “Are CSA Membership Shares Securities?” in Chapter 1 of this guide.
- Is there a refund policy? In a multi-year CSA, it is much more likely that a customer will need to terminate their membership or subscription, for example due to a sudden move out of town or change of other circumstances. One option for the farmer is to offer a total refund on demand, or there can be a policy set in place that does not allow a refund unless the customer notifies the farmer before a specified date prior to the start of each growing season. Another variation would be to prorate the refund depending on when it was requested during the year. The farmer can charge a cancellation fee equal to production costs in cases where goods have already been produced and these costs need to be covered. There are many options with varying appeal to the customer, but the farmer needs to choose a refund policy that meets both the farmer’s and customers’ needs.

Memberships

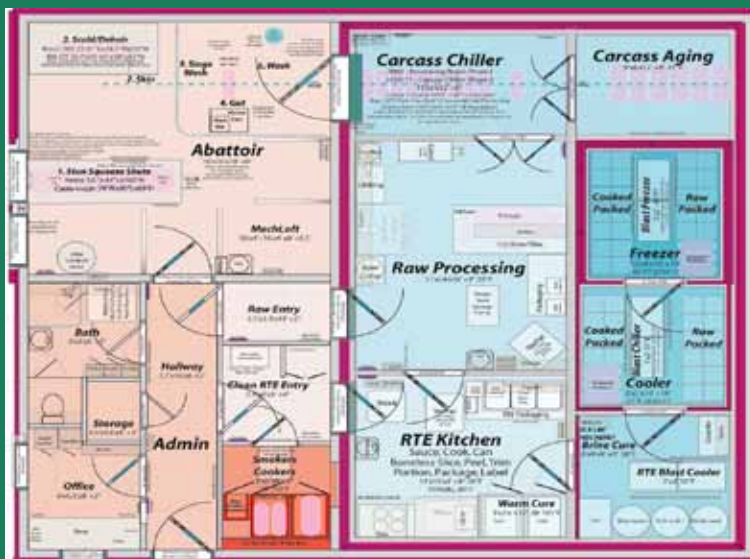
In terms of reducing the likelihood securities laws and regulations will apply, another way to think about and structure multi-year CSAs is to create “memberships” or “subscriptions” in the farm or agricultural business. These would be structured like a club membership as opposed to owner memberships. The farm could create different levels of membership or subscription with different benefits. One level could be a three-year membership that entitled the member to a certain amount of food product per month, like a regular CSA. Another level of membership could add discounts for farm social events or specialty product. This could be flexible by benefit and /or number of years allowing for accumulation of capital for the farm and an extended period of time for exercising the membership benefits.

In order for a membership structure to avoid the likelihood of being characterized as a security, the farm or agricultural business entity would need clear membership documentation that specifies:

- 1) the benefits of membership;
- 2) that the member should not expect any profit, financial gain or appreciation from their membership over time;
- 3) that the memberships are not transferable or tradable in any open market;
- 4) that the members are not entitled to ownership or voting rights;
- 5) that the membership is intended to provide the member with the use of consumable product, services provided by the farm or food business and/or other social benefits; and
- 6) that the membership fees are not going to be used primarily for investment in the start-up of the business.

⁴⁵ JA Blomberg and HE Forcier, 2005. But is it a security? Business Law Today, Volume 14, Number 5. <http://apps.americanbar.org/buslaw/blt/2005-05-06/forcier.shtml>. Accessed online 1/10/12.

Farm Case Study



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Sugar Mountain Farm West Topsham, Vermont

Highlighting Bootstrapping, Vendor Financing, Pre-buys and the Quest to Build On-Farm Slaughter Infrastructure

by Walter Jeffries, Farmer



In April of 2008 the owner USDA slaughterhouse and butcher shop we had been working with announced to us that he wanted to get out of meat processing. He was tired of the employee problems, the equipment failing and the general hassles of an aging plant that was getting further and further run down. He asked us if we wanted to buy it. It was an hour from us and we knew of the problems - no, we didn't want them.

However, I had been researching since 2004 about building our own on-farm USDA meat processing facility. My plan had been to start construction in 2014. The butcher's announcement was a wake-up call to us. We immediately met with the state agency of agriculture and then the USDA about what would it take to setup our own facility.



They were encouraging but warned that it was very expensive and the permitting was very difficult.

We have several advantages that would keep the costs down, such as I'm the engineer and architect, our family is the construction crew, we already have the land and being on-farm doing only our own livestock simplified some issues. Over the course of the following year I researched options, worked up a business plan, rough engineering plans, got all of my permits and we saved our pennies. Having an idea, a plan and a goal is great but without money we can't buy concrete, wood, steel or equipment. In fact, it takes money to save money - our existing meat processing uses 36% to 50% of what we earn on every animal that goes to slaughter.

What has not worked for us:

Banks:

- Would not lend to us despite us having excellent credit, a great deal of collateral, high net equity, decades of borrowing and repayment history, business and farming experience and a solid business plan, etc:
- Told us "Not lending at this time to new or expanding businesses." We heard these exact same words from many a banker!
- Were hesitant to lend to farms.
- Were hesitant to lend to self-employed people.
- Were hesitant to lend if we're doing the construction even though we're experienced.

Government grants:

- We were told there were none for building on-farm slaughter infrastructure, despite later finding out they had given grants to others.
- We were told we were not qualified since only doing processing for our own farm despite the fact that what we are doing is helping other farmers by freeing up processing slots, and we're sharing how we did it so others can do it themselves.

Government loans - direct or guaranteed:

- Wouldn't lend to us since we're doing our own construction. We were told we should hire out consultants to do business plan (we already have an excellent plan), architecture (I do it), engineering (I do it), labor of construction (we do it), etc.
- Hiring contractors would make the project cost so much (1.5 to 4.5 million) that it would become unfeasible. The government and bank's requirements to hire everything out seemed to be designed to stimulate the economy, but for us it would produce a debt-dependent business.
- Wouldn't lend to us because we're too small. They wanted projects of \$250K or more, preferably over \$1M.

Since our budget is significantly lower than that, they weren't interested in our project. So we are doing it without government or bank support.

So what has worked?

Savings - We had saved up about \$30,000 for building a greenhouse when this hit us. We diverted that all to building the butcher shop. That bought our initial concrete, wood for form building, electrical installation, etc.

Cash flow - Every penny we can spare goes into our project. We're still dealing with the fact that meat processing uses up 36% to 50% of our gross income. If we were already doing the processing that would be available. Catch-22.

Generous small donations from a number of friends, customers and blog readers.

Local businesses and Farmers who have given us extended terms on supplies (e.g., lumber, steel, hay, electric, equipment, etc) which meant money was freed up to buy hard stuff like concrete.

CSA Pre-Buys ranging from quarter pigs to decades of pork. See <http://SugarMtnFarm.com/csa>

Small to larger loans from individuals - family, friends, customers and a visionary angel who read about our project in the newspaper.

Benefits of not working with the government and banks have been:

- We pay significantly lower interest rates.
- People who loan to us earn significantly higher interest rates than they get at banks.
- Spreading out the cost between many people rather than putting it all in the hands of one lender.
- We know our lenders personally and they know us - their farmer, relative, and friend.
- Keeping it all more tightly tied locally.
- Less paperwork.

- Because we were not forced to do it the "Big Way" of hiring consultants and such for everything the project came in at about the budget I had originally projected with a small increase for inflation in the past three and a half years. We will probably be able to open for cutting meat within 15% of my original projection three years ago which is very good. Today we have spent only about \$100K of the \$150K that I originally projected.

- Because we're working on a tight budget we kept things simple. This means less debt load which means lower interest payments and the project is viable instead of being an impossible burden as it would be if we had spent a million dollars or more.

In the end, commercial lenders were of no use in the funding of our project. We fell back on our own resources and those of our local community. This makes our project truly Community Supported Agriculture.

The case studies included in this guide are provided as examples of how farmers have used or are exploring various financing mechanisms and are not an endorsement by UVM or UVM Extension of the business practices outlined. This guide is for educational purposes only, and does not constitute legal advice. Individuals remain fully responsible for their own management decisions and for compliance with all applicable laws and regulations, and are encouraged to consult independent legal and business counsel.



"Butcher Shop Under Construction." Image used with permission of Walter Jeffries. ©2012 Walter Jeffries, SugarMtnFarm.com



Image used with permission of Rachel Schattman

Chapter 9

The Share Lease Agreement

*by Ben Waterman,
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The share lease is a lease agreement that allows the landowner to have material participation in the farm operation on their owned land, but not be affiliated as a legal partner in the farm business entity. In a sense, it is a hybrid between a conventional farm lease agreement and a revenue-based financing agreement. It is not a loan, but a lease agreement that specifies what percentage of the costs will be shared by farmer and landowner, and what types of production costs will be covered by each party. The agreement details what percentage of revenues gained from farming will go to the landowner as a “share lease fee” and what percentage of revenues the farmer will keep.

The advantage of using the share lease agreement is that new business entities do not need to be formed in order for the landowner to act as “investor” and share in the farm business revenues. Attorneys are generally very familiar with a conventional lease agreement, and the share lease is a variation. The primary disadvantage for a farmer in using the share lease versus a promissory note or straight cash lease with a fixed payback term is that, in a good year, the farmer might pay a substantial amount of money as the share lease fee. On the other hand, in a bad year, the landowner assumes some risk, and the required share lease payment in bad years might be less than what would ordinarily be paid in a fixed cash lease or loan situation.

There are significant tax implications for pursuing a share lease, depending on whether or not the landowner meets the criteria for “material participation” in the farm enterprise, and recognizes the income as self-employment income. Consult with a qualified accountant before signing any share lease agreement to discuss tax consequences. Listed below are resources from Cooperative Extension Agencies across the country that cover considerations and options for landowners and farmers in crafting sound crop share lease arrangements:

Resources for Crafting a Share Lease Agreement:

“Developing Share Lease Agreements for Farmland.” Oklahoma Cooperative Extension Service. This workbook goes through detailed considerations in pursuing a share lease, and includes worksheets for determining costs and revenue sharing. Available online at: <http://pods.dasn.okstate.edu/docshare/dsweb/Get/Document-1778/AGEC-215web.pdf>. Accessed online 2/15/2012.

A Sharemilking agreement is specific to dairying, and is a share lease that is focused on sharing dairy infrastructure and building equity for the tenant farmer through partial ownership of the herd or other assets. The University of Missouri Pasture-based Dairy Program has comprehensive resources on share-milking agreements for livestock operations. They are available online at: <http://agebb.missouri.edu/dairy/grazing/sharemilking/>. Accessed online 2/15/2012.

“Crop Share Rental Arrangements for Your Farm.” North Central Farm Management Extension Committee. This publication covers advantages and disadvantages of crop share arrangements, guiding principles used for developing equitable arrangements, and different approaches used for developing a functional arrangement. Available online at: <http://www.aglease101.org/DocLib/docs/NCFMEC-02.pdf>. Accessed online 2/15/2012.



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Appendix 1: Community Financing Theory

By Ben Waterman, New Farmer Project, University of Vermont Extension Center for Sustainable Agriculture

The Role of Patient Capital in Sustainable Agriculture

Many farmers in the Northeast aspire to expand or establish new business segments that, by nature of the start-up period involved, don't generate *immediate* cash flow. Take, for example, a livestock farmer reclaiming exhausted fallow land for grazing beef cattle. She needs to contribute capital towards considerable investments in soil rehabilitation, pasture establishment, and fencing installation. These practices are critical to the enterprise's long-term success, but might not produce positive cash flow for the first three years.⁴⁶

Take another small fruits grower, for example, who is expanding into apple orchards at the request of u-pick customers in the community. He needs to make significant capital outlays in order to create soil and water conserving terraces for the orchard, complete the planting, install irrigation, and care for the trees in early stages of growth. For this enterprise, he won't see a penny in sales for at least the first five years. Taking out a conventional loan during this period might significantly detract from his family's quality of life, assuming the grower will have to reduce his pay to finance the debt. It might require that profits from other farm enterprises be devoted to service the debt, thereby decreasing whole-farm short-term profitability.

The farmer might not want to take on debt without the capacity of the particular business segment to immediately fund its own repayment. However, in the above example, the community would garner a benefit from the presence of U-pick expansion. This particular farmer may not have had plans on making more investment into the property or he may not be in a financial position to finance this expansion with conventional debt finance options, but this is a perfect case where community investors may decide to provide capital on more favorable terms to the business to facilitate a project that community members would benefit from. Overall, a community financing arrangement might speed up the orchard's potential for becoming a thriving hallmark of the community.

Agricultural service providers in the Northeast generally agree that there is no shortage of financing for agricultural development.⁴⁷ What is needed, however, is for financing to be more aligned with the longer-term nature of many types of farm enterprises. What is needed is *patient capital*, money that can be invested or loaned to the business owner, when appropriate, on terms allowing for deferred repayment of principal. **Terms to deploy and repay patient capital can be customized according to the capacity of the farm enterprise to generate cash flow for repayment of the obligation, or to provide other benefits to the lender and community.**⁴⁸

Typically, lending institutions are inherently limited in their ability to provide the farmer with patient financing for improvements that don't generate immediate cash flow. They are also limited to making loans that are based on collateral and credit history. But, in many cases, the farmer does not have the required collateral, matching equity, or credit history. Although alternative lending institutions such as Municipal Loan Funds and Community Development Financial Institutions (CDFIs) have less stringent credit and collateral requirements, they still maintain certain minimum requirements for securing each loan. In some cases, agricultural lenders, such as FSA or Farm Credit, are flexible and can provide interest-only repayment periods or loans that take an honest look at the farmer's character, but for the most part, they are not in a financial position to take on the risk necessary to provide "patient" financial products. For the time being, community financing for farms can fill this gap.

The role of patient capital in sustainable agriculture can support the "three-legged stool of sustainability," providing economic resources, as well as environmental and social support. Community members can often provide flexible financing and payback arrangements, such as deferred principal repayment, revenue-based repayment or lower interest rates that provide a financial cushion for the farmer to implement environmental conservation or soil fertility building practices as first order of business.⁴⁹ "Repayment" can be specified to include certain social and environmental improvements as "returns" (see below, "Rethinking Profit and Return on Investment"); **theoretically, patient capital (by nature) waits for these longer-term social or environmental improvements to "pay back" an investment over time.**

46 While this example is not specific to new farmers, it is common to many new farmers (using the USDA definition of "new farmer" as an operator with between zero and ten years of experience managing their own enterprise(s)). Many new farm operations are under-capitalized, and new farmers often do not possess the equity position to finance start-up or use as collateral to obtain loans. Various community financing mechanisms detailed in this guide might be appropriate for farmers who do not have the credit history or collateral to source capital through other means.

47 Anecdotal evidence based on the author's numerous conversations in 2010-2011 with Cooperative Extension agricultural educators and other agricultural service providers.

48 Historically, farm families have employed various mechanisms for the transfer of "patient capital" from the senior to junior generations. For more information and resources on farm transfer planning and family farm succession, visit <http://www.uvm.edu/farmtransfer/>.

49 It is important to note that historically and currently, USDA NRCS (using taxpayer dollars) has been the primary "investor" in environmental conservation on farms across the United States. Farmers should contact local NRCS offices for more information on programs that share the costs for farmers to implement environmentally sound practices. Theoretically, community financing can be used to complement existing NRCS conservation funding or in cases when farmers are not eligible for enrollment in NRCS programs for various reasons.



Economists studying the “multiplier effect” know that money spent locally stays local, and recirculating exchange of local capital spreads the benefits of any one sale. The same holds true for money invested locally. Currency circulating through local economies has a human face, amplifying values of the community.⁵⁰

Rethinking Profit and Return on Investment

This guide provides options and considerations for crafting funding agreements with flexible terms. In the process, it might also challenge readers to expand their understanding of several core concepts in economics and financing: profit and return on investment.

Profit

What do you think of first when you think of profit?

The Merriam-Webster⁵¹ online dictionary defines profit as:

1. a valuable return or gain
2. the excess of returns over expenditure in a transaction or series of transactions; especially: the excess of the selling price of goods over their cost

The first definition of profit, according to this dictionary, does not include any specific mention of financial gain. It is more broadly defined as something, or anything that represents a benefit or gain. The second definition pertains strictly to economics and finance.

Community financing begs the question: If profit is considered any “valuable return or gain,” and not just financial gains, do environmental/social costs and gains deserve line items in farm enterprise budgets? Do positive environmental and social impacts improve a farmer’s bottom line? Can they be considered returns for a community investor?

Needless to say, accounting for non-cash profits or gains can get a bit complicated. Imagine if “income” line items in the enterprise budget included “% soil organic matter increased” or “tons of carbon offset” or “number of smiles put on customers’ faces.” Or if capital asset line items in the balance sheet included “topsoil that is X inches deep” or “pasture that sequestered X tons/acre of carbon last year” or “farm workers who are acquiring X number of new skills and abilities per year.” Yet along with economic contributions, these are the types of community capital that farms have the potential to build.

The fact is that farm-supported community members might share returns from community supported farms in some way or another, and communities will naturally want to preserve this ability to benefit moving forward. It can be useful for farmers to engage in social and environmental accounting, in order to justify both private and public support. Anyone with a vested interest in building community capital will seek to identify farms as key partners in cases where they do not expend significant social and environmental resources, but actually preserve or improve them through production practices. Can farmers or other research institutions measure the beneficial impacts that result from socially and environmentally-conscious agricultural practices? Yes, if they use measures that anyone can understand. Once community members discover businesses that enhance the community’s social, environmental and financial bottom lines, they might voice recognition with their wallets, with customer loyalty, or with other support for these businesses in times of unique need.

Return on Investment

The Two-dimensional Analysis: Risk and Return

The traditional debt and equity financing paradigm is a cash-in, cash-out equation. Risks are weighed against financial rewards. A loan or investment is made by tying up money; financial returns are expected to outweigh the risk of losing money, and to offset the inflation of currencies as time passes.

The Vermont Sustainable Jobs Fund, in its Vermont Farm to Plate Investment Program Strategic Plan⁵², describes a “Capital Continuum,” in which ways to finance agricultural and food businesses are categorized along a spectrum of low risk

Farm Financial Statements

In typical farm business management planning exercises, farmers are encouraged to produce enterprise budgets that detail income and expenses for a particular segment of the farm operation. Cash flow is projected, based on production expenses and sales history during different times of year. Lenders look at these income and cash flow projections along with other financial statements, such as balance sheets to assess a farm’s track record and future potential. Financial statement line items contain dollar number (\$) figures.

⁵⁰ At the time of this writing, crowdfunding was emerging as a new approach to raising capital for local business start-ups, creative projects, and more. Rather than reaching out to a few sources of capital for relatively large sums of money as in traditional fundraising, crowdfunding works by pooling small amounts of capital from a relatively large number of sources. In so doing, the entrepreneur or project owner not only have their capital needs met, but they also build a supportive community around their initiative. Online crowdfunding platforms such as kickstarter.com, kiva.com and crowdcube.com have been emerging around the world. Some platforms wholly dedicated to farm and food businesses are being developed. Crowdfunding in some forms has raised legal issues. At the time of this writing, several bills were being considered in congress to make it easier for some forms of crowdfunding to be recognized as exempt from securities regulations.

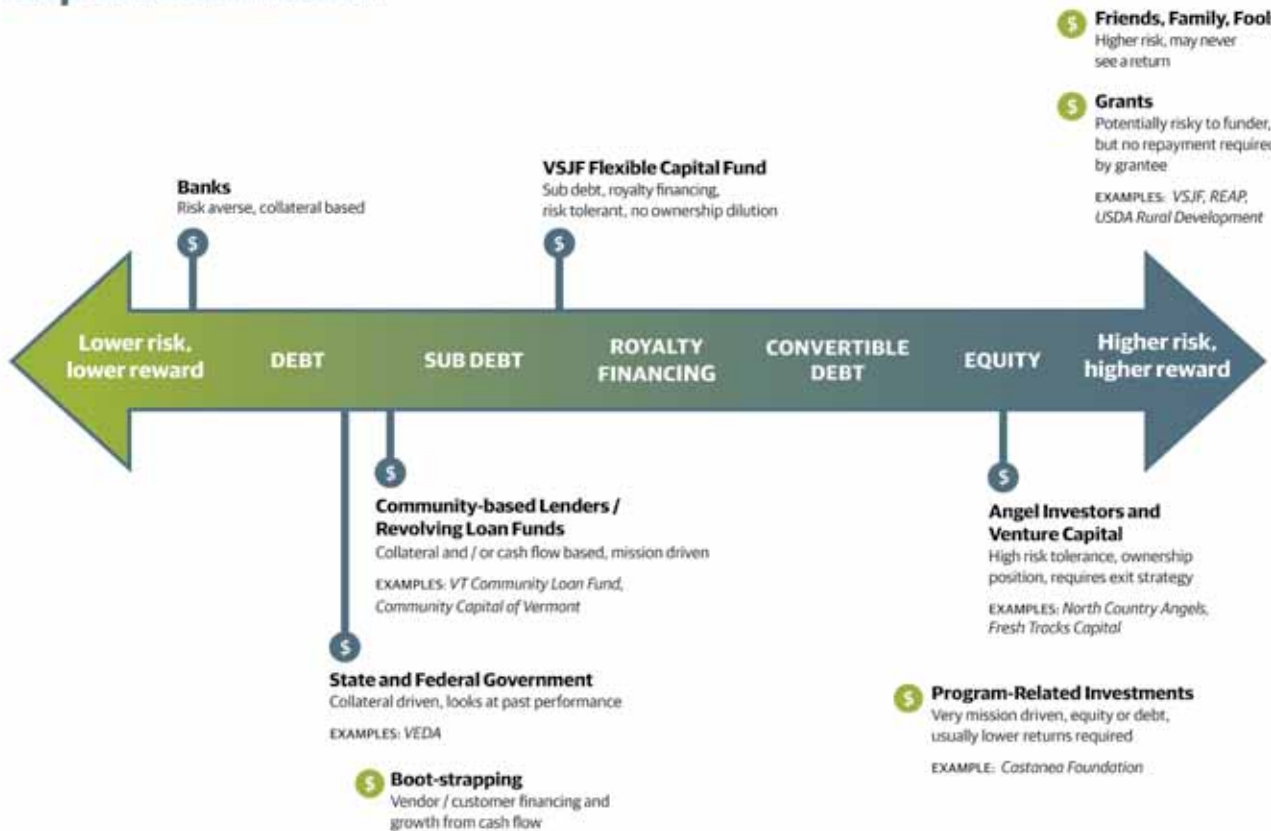
⁵¹ The Merriam-Webster online dictionary can be found at <http://www.merriam-webster.com/>. (accessed online on 1/5/12)

⁵² 10 Vermont Statutes Annotated §330. In 2009 the State of Vermont passed into law the creation of the Vermont Farm-to-Plate investment Program, appropriating initially \$100,000 to fulfill the goals of increasing economic development in Vermont’s food and farm sector, creating jobs in the food and farm economy, and improving access to healthy local foods. As part of the program, the Vermont Sustainable Jobs Fund was tasked with facilitating the creation of a ten-year strategic plan for agricultural economic development. For more information, visit www.vsjf.org.



to high risk. Rewards or returns are usually proportionate to the level of risk involved in the deal (granted, unique combinations of risk and reward exist). A low-risk bank loan, for example, would typically have limited returns for the lender, while a higher-risk equity investment might have the potential to generate double or triple-digit percentage returns. The analysis typically factors in risk and return from a financial point of view.

Capital Continuum



The many faces of finance along the spectrum from low risk/return to high risk/return. Image used with permission of the Vermont Sustainable Jobs Fund. From Chapter 4.5, "Financing the Food System" of the Vermont Farm to Plate Investment Program Strategic Plan. The full strategic plan can be accessed online at <http://www.usjf.org>.

The Three Dimensional Analysis: Risk, Return and Impact

Brian Dunn, Founder and CEO of Growth Capital Services, Inc., in his 2006 presentation to investors entitled, "Modern Portfolio Theory With a Twist,"⁵³ explained a framework for adding a third dimension, "impact" to the basic variables in investment theory, risk and return. Dunn describes impact as "the benefits one can receive when investing in the social good."

Community financing arrangements can be crafted based on the concept that impact is factored into return on investment. In other words, returns can be generated in the form of dollars and cents in the same manner as they can be generated in fresh and nutritious food, open space conservation, water quality improvements, recreational opportunities, wildlife enhancement, soil fertility improvements, carbon sequestration or other ecosystem services, rural economic development, enhanced community relations, improved quality of family life, and other social and environmental benefits, etc.

To conclude, lenders or investors might be more willing to transfer capital or creatively rearrange repayment terms if there is a clear potential for positive impact beyond financial rewards.⁵⁴ Two loans with the same risk/reward profile can be, in fact, different when impact is factored into the mix. In cases where they are measurable and meaningful, projections for

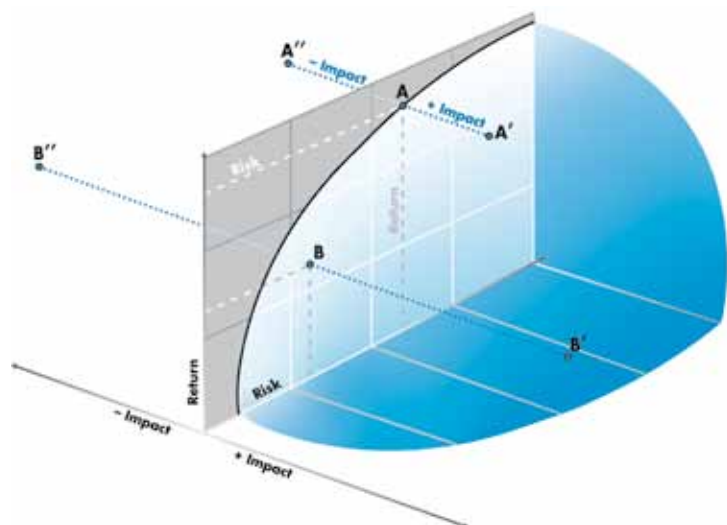
⁵³ "Modern Portfolio Theory with a Twist, The New Efficient Frontier." White paper, by Brian Dunn, 2006. Accessed online 2/10/10, at <http://www.americansforcommunitydevelopment.org/downloads/NewEfficientFrontier.pdf>

⁵⁴ Both public and private entities can invest in education. While it might be challenging to model how financial investments result in quantifiable environmental or beneficial "ecosystem services," another solution is to invest in education and information on sustainable farming methods. This can often provide the most environmental benefit for the least amount of financial investment, while building human and social capital at the same time.



positive impact can come in handy as background for crafting arrangements with lenders or investors.⁵⁵ Even from a purely financial point of view, “socially responsible investing” has historically outperformed major indexes, as sustainability practices are linked to sound management, robust and long lasting business models.⁵⁶

The inner workings of how to craft creative community financing arrangements are covered in the preceding chapters of this guide.



This three-dimensional view incorporates “impact” into the basis for making potential investment decisions. As the image implies, investments with similar financial risk vs. reward profiles can be different when “impact” is considered. While they are difficult to quantify, examples of impact could be social ramifications or environmental effects of the investment. Image used with the permission of Brian Dunn, Growth Capital Services, Inc.



Image used with permission of Corie Pierce

55 Measuring external benefits of agricultural activity is not easy, which is why it is often left out of the equation or left to economists, agencies, governments and research institutions to sort out. It may be too much to ask of the individual farmer or community member to measure “externalities” or positive/negative impacts of agricultural practices.

56 Strategies for “Socially Responsible Investing” (SRI) include screening out companies that promote addictive substances (alcohol, tobacco, gambling) or targeting companies that promote clean energy or other environmentally-sound practices. According to the investor association, the Forum for Sustainable and Responsible Investment, “The longest-running SRI index, the FTSE KLD 400, was started in 1990. Since that time, it has continued to perform competitively — the FTSE KLD 400 with returns of 9.51 percent from inception through December 31, 2009, compared with 8.66 percent for the S&P 500 over the same period.” (For more information visit <http://ussif.org/resources/performance.cfm>. Accessed online 1/23/2012. Other studies have found there is “a positive association between corporate social performance and corporate financial performance.” See Orlitzky, Marc, Frank L. Schmidt, and Sara L. Rynes. “Corporate social and financial performance: A meta-analysis.” *Organization Studies*, 24, 2003.



Appendix 2: Profit vs. Non-Profit and Different Ways of Raising Capital

By Erin Roche, Research Specialist, University of Vermont Center for Rural Studies

Following this short essay, the author has included a full detailed comparison of business structures. There are many considerations to take into account when structuring a business, and the entity's ability to raise capital should not be the only one. Set-up costs, liability, number and involvement of owners, typical duration of the entity, taxes, raising capital, distributing profits, accountability and reporting are all axis on which organizational structure differs. Refer to the chart following "Profit vs. Non-Profit" for more information on these differences.

The following addresses a common question posed by farmers exploring community financing and ways in which businesses can be structured to raise capital.

"Profit or non-profit?" that is the question.

Actually, the first question should be "What is the primary goal of my business or organization?" If the answer is "Making money," then you want to operate under a for-profit model. If your answer is "To do 'good' in the world," then a non-profit might be what you want. This is a broad generalization; there are many different business entities and governance structures along the spectrum between profit and non-profit, and **there are many more factors to consider when choosing a business entity.**⁵⁷ For detailed explanations of considerations in choosing a business entity, see Chapter 1 in the Legal Guide to the Business of Farming in Vermont.⁵⁸

You can make a living operating a non-profit, but your salary, goals, purchases, mission, etc. are all determined and controlled by a Board of Directors; even if you are the founder and executive director of the non-profit, you do not have full control over it. With a non-profit comes access to certain types of funding and capital not available to for-profit companies, such as donations and grants. In addition, so long as you keep to the identified mission, a non-profit pays little to no tax. There are no owners or shareholders of a non-profit.

On the other hand, a for-profit structure affords the owner or partners direct control over most aspects of the business – what to do with the profits, how much to charge for a product or service, what markets to go after, etc.⁵⁹ A for-profit company also has access to certain types of funding not readily available to non-profits – venture capital, bank loans, stocks, etc. Which type of for-profit structure used will determine the type and level of taxes owed.

So what happens if you want to make money and do good? Can you start a for-profit business and spin-off a non-profit entity? The simple answer is "Yes." But a more relevant question is "Why?" Occasionally, non-profits spin-off a for-profit company for certain legal and tax reasons, and use the profits generated to fund the non-profit. Similarly, large corporations will create non-profit foundations in order to create a non-profit entity. But neither of these examples is typical. In all cases, the non-profit and the for-profit are distinctly separate entities, with contracts being the primary means of determining how the two entities do business with one another.

If you currently operate under for-profit business structure and are considering creating a non-profit entity, you need to be clear on your motivation. One thing to seriously consider is there can be significant costs associated with setting up and maintaining a non-profit with 501(c)(3) tax status. Legally and for tax/accounting purposes, the non-profit and for-profit will function independently. You may also consider bringing in other like-minded businesses and people to jointly create the new non-profit in order to expand its reach and goals. Or you might find an existing non-profit with similar interests and consider donating time, money or resources – either as a business or individual.

⁵⁷ There are many different business entities and governance structures along the spectrum between profit and non-profit. The L3C, Cooperatives, B-Corps, Stewardship Councils are examples. See Appendix 1: Comparison of Business Structure, in this guide for a comparison of the characteristics of various traditional and emerging agricultural business ownership structures. The author acknowledges that the comparison of profit with non-profit is by no means all-inclusive, and other business structures might be better aligned with the enterprise.

⁵⁸ Higby, Annette. Legal Guide to the Business of Farming in Vermont. UVM Center for Sustainable Agriculture, University of Vermont Extension, 2006. Available online at <http://www.uvm.edu/farmtransfer/?Page=legalguide.html>. Accessed online 2/15/12.

⁵⁹ Depending on the type of for-profit entity, execution of plan and strategy is in the control of the management, but the "Board" can be the group with control over the plan approval and hiring/firing executives, and functions to represent the best interests of the shareholders.



Traditional Agricultural Ownership Structures

	Sole Proprietor	General Partnership (GP)	Corporation (General, S or C)
Set up costs	Least expensive	Requires agreement b/w partners, otherwise like sole proprietor	Filing fees; more expensive than other forms of organization
Ongoing costs	Cost of employee benefits not deductible from business income	Agreement needs updating/amending or it could expire	More expensive than other orgs
Duration	Owner's life or until sold or closed	5 years	Unlimited
Liability	Unlimited liability, personally responsible for all debts	Liability shared by partners according to agreement	Shareholders (owners) have limited liability
Tax	Form 1040, etc. - profits are only taxed as owner's income	Form 1040, etc. for all partners, profits are taxed as each partner's income, profits can be distributed according to partner agreement	S & C have different tax structures; Corporations can deduct cost of employee benefits from taxes; taxed as separate entity; may result in higher taxes
Ownership	Complete control by single owner	Owned by all partners according to agreement, good for 5 years but can be amended	Stockholders
Raising capital	Limited to personal funds, some loans	Limited as w/ sole proprietor, though add'l partners could mean add'l investors	Can raise additional funds through sale of shares of the company; S corp not ideal for raising VC or angel money; C-corp. is probably necessary if getting money from institutional investors (like VCs)
Flexibility	Very flexible for owner, but not to change owners, raise capital, etc.	Not flexible unless agreement is amended, but agreements are easy to change	S-corp more flexible (like partnership)
Reporting and Auditing	Profits flow directly to owner's income, informal	Partnership agreement: name of partnership, names/contact for all partners, registered agent, signatures, notarized, Profits flow directly to partner's income	Monitored by federal, state, local agencies - often more compliance paperwork; annual reports
Structure	Easiest to start & end	Similar to sole proprietor except everything is shared by more than 1 owner	Individual entity created via statute and law.



Emerging Agricultural Enterprise Ownership Structures

	Limited Liability Partnership or Limited Partnership (LLP or LP)	Limited Liability Company (LLC)	Low-profit Limited Liability Company (L3C)	Cooperative	Not for profit
Set up costs	determined by statute; registration form filing fee.	Filing fees, amendments, agent requirements	Same as LLC	Filing fees	Filing fees, amendments, agent requirements
Ongoing costs	lowest ongoing costs; taxes determined by statute, annual report filing fees	Taxes determined by statute, annual report filing fees	Same as LLC	Annual report filing fees, taxes, annual dividends distributed to shareholders.	biennial report fees
Duration	Determined in filing	Determined in filing	Same as LLC	Determined in filing	Ongoing unless failure to comply with regulations occurs
Liability	General partner is liable as with partnership, while limited partner is only limited to amount invested in enterprise	Liability as corporation	Same as LLC	Managerial members can be liable if their practices are questionable but liability is protected for all under normal circumstances.	Board of Directors can be liable if their practices are questionable
Tax	Taxed as a separate entity	Same as partnership; may have to file corporation papers if displays more than 2 of the 4 corp characteristics	Does not qualify for 501(c)3 tax status	Taxed only on income kept within the co-op for investment or reserve purposes. Members responsible for taxes on dividends paid to them.	501(c)(3) are tax exempt. 501(c)(4) may be exempt depending on the organization's mission. Contributions to (c)(4)'s are not deductible.
Ownership	At least 1 general partner and 1 limited partner – Created by statute and can override a partnership agreement	Owners = members; this structure works well for limited number of owners, but S Corp better for unlimited owners	Same as LLC	Co-op members	Not "owned." Nonprofit corporation is considered to be a "person" and decisions to buy property, manage bank accounts, and pay wages are made by the board of directors.
Raising capital	Frequently used as vehicle for raising capital	Frequently used as vehicle for raising capital	L3C status may make foundations or other charitable donors more amendable to investment	Membership fees, fund raising, sale of goods/services,	Donations, grants, fund-raising
Flexibility	Typically for "project-driven" organizations	Same as partnership; formation is more complex and formal than GP, though	Can't have political/legislative purpose; can't produce income or appreciate property; must further charitable or educational purpose	Based on the charter	Non-profit must be solely dedicated to its exempt purposes. Control through Board of Trustees; all assets and profits belong to the non-profit and must be used for or funneled back into the exempt purpose. 501(c)(3)'s are prohibited from political activities.
Reporting and Auditing	Must obtain the business licenses and permits. No state filing is required.	Annual report filing; more complex & formal than partnership	Similar to LLC	Annual report to members	IRS Form 990; Overseen by State AG Office
Structure	Can offer shares to more limited partners w/o them needing to invest capital or take liability	No more than 2 of 4 of: limited liability (extent of assets), continuity of life, central management, or free transfer of ownership interest. Will be treated as corporation if exceeds more than 2 of 4	Cross between non-profit and corporation - low profit with charitable or educational goals - same as LLC but foundations and donors may be more willing to make program related investments	Membership with Board of Trustees	Does not mean "no profits"; pursue public benefit purposes; must have mission which is primarily not for profit; no person can own shares in the company; profits, income never distributed to owners but are invested in the organization's mission and activities

APPENDIX 3: Contract Basics

By Anthony Iarrapino, Staff Attorney, Conservation Law Foundation

The Basics of a Contract

A contract is simply an enforceable agreement between two or more persons. Contracts can cover everything from delivery of an animal to buying or selling machinery to employing workers.

The basic contract elements are straightforward. They can be expressed as this simple equation:

Offer + Acceptance + Consideration = Contract

An **Offer** is simply words or conduct that a reasonable person would view as intention to enter into a contract. To determine whether there is an offer, it is helpful to look at whether the words or conduct involved are those of commitment.

An **Acceptance** is an agreement to the terms of the offer. A contract may not be created if the acceptance does not agree to the exact terms of the offer, instead a counteroffer may be created. In other words, there must be a “meeting of the minds” on all terms of the contract before it can be created.

Contracts also require **Consideration**. Consideration in a contract is created when the parties exchange something of value, including goods or services. For example, when two parties agree to exchange cash for the purchase of a tractor both the cash and the tractor are valuable consideration. If only one party receives something of value in the exchange it is not a contract, but rather a gift. For example, if your uncle promises to give you money but requires nothing of you in return then there is no enforceable contract.

An oral agreement between the parties involved can form a contract. In certain situations, however, contracts need to be in writing and signed by both parties. Some contracts that must be in writing include: transfers of interest in real estate, sale of goods (tangible objects like machinery) for \$500 or more, lease of goods for \$1,000 or more, and a guarantee to pay for another person’s debts if that person cannot pay.

A final point about contracts: if you spend more than five minutes questioning whether you need a contract, then from a legal standpoint you probably do!



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APPENDIX 4: Sample Promissory Notes

Sample Promissory Note #1

This document is to be used as a guideline for educational purposes only. Samples are not to be construed as legal advice.

Borrower Information:	
Name:	Date:
Street Address:	Date of Birth:
City:	Area code/Telephone number:
State:	Driver's License Number:
Zip:	Social Security Number:

Lender Information:	
Name:	Area code/Telephone number:
Street Address:	If paying by check, make check payable to: Send payments to:
City:	
State:	
Zip:	

Loan Information:	
Loan Amount:	Loan Period:
Interest Rate:	Payment Schedule:



1. **Promise to Pay.** For value received, _____ (Borrower) promises to pay _____ (Lender) \$ _____ and interest at the yearly rate of _____% on the unpaid balance as specified below.

2. **Installments.**

Borrower will pay _____ payments of \$ _____ each at monthly/yearly/ _____ intervals on the _____ day of the month.

Borrower will pay one lump payment on _____ date.

Borrower will pay _____ payments of \$ _____ each at monthly/yearly/ _____ intervals with a final balloon payment of _____ at the end of the loan term on _____ date.

3. **Application of Payments.** Payments will be applied first to interest and then to principal.

4. **Prepayment.** Borrower may prepay all or any part of the principal without penalty.

5. **Loan Acceleration.** If Borrower is more than _____ days late in making any payment, Lender may declare that the entire balance of unpaid principal is due immediately, together with the interest that has accrued.

7. **Security**

This is an unsecured note.

Borrower agrees that until the principal and interest owed under this promissory note are paid in full, this note will be secured by a security agreement and Uniform Commercial Code Financing statement giving Lender a security interest in the equipment, fixtures, inventory and accounts receivable of the business known as _____.

Borrower agrees that until the principal and interest owed under this promissory note are paid in full, this note will be secured by the

mortgage

deed of trust covering the real estate commonly known as _____ and more fully described as follows: _____

8. **Collection Costs.** If Lender prevails in a lawsuit to collect on this note, Borrower will pay Lender's costs and lawyer's fees in an amount the court finds to be reasonable.

The undersigned and all other parties to this note, whether as endorsers, guarantors or sureties, agree to remain fully bound until this note shall be fully paid and waive demand, presentment and protest and all notices hereto and further agree to remain bound notwithstanding any extension, modification, waiver, or other



indulgence or discharge or release of any obligor hereunder or exchange, substitution, or release of any collateral granted as security for this note. No modification or indulgence by any holder hereof shall be binding unless in writing; and any indulgence on any one occasion shall not be an indulgence for any other or future occasion. Any modification or change in terms, hereunder granted by any holder hereof, shall be valid and binding upon each of the undersigned, notwithstanding the acknowledgement of any of the undersigned, and each of the undersigned does hereby irrevocably grant to each of the others a power of attorney to enter into any such modification on their behalf. The rights of any holder hereof shall be cumulative and not necessarily successive. This note shall take effect as a sealed instrument and shall be construed, governed and enforced in accordance with the laws of the State of _____.

Borrower: _____ Date: _____
 _____ (print name)

Lender: _____ Date: _____
 _____ (print name)

Witnessed: _____ Date: _____
 _____ (print name)

Witnessed: _____ Date: _____
 _____ (print name)



Sample Promissory Note #2

This document is to be used as a guideline for educational purposes only. Samples are not to be construed as legal advice.

PROMISSORY NOTE

Principal Amount \$ _____
_____(Town), _____(State) _____(Date) , 20__

For value received the undersigned (hereinafter "Maker") promises to pay to the order of _____ (hereinafter "Holder"), the principal sum of _____ Dollars (\$ _____), together with interest from the date hereof until paid on all sums which are and which may become owing hereon from time to time, all as hereinafter provided and upon the following terms and conditions:

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Interest. Unless there shall be a default, interest shall accrue from the date hereof and be paid at the rate of ___ percent (___%) per annum; provided, however, that in the event of any default, as hereinafter defined, all sums then and thereafter owing hereon, at the option of the Holder, shall bear interest at the rate of percent (___%) per annum (the "Default Rate").

Payments. Maker shall pay this note in _____ equal installments on or before the _____ day of _____ (month) until it has been paid in full. Each payment made on this note shall be applied first to interest accrued to date of payment and then to principal.

Late Payment Charge. If any installment is not paid within _____ (___) days after it becomes due, then the Maker agrees to pay a late charge equal to ___ percent (___%) of the delinquent installment to cover the extra expense involved in handling delinquent payments. This is in addition to and not in lieu of any other rights or remedies the Holder may have by virtue of any breach or default.

The Deed of Trust. This Note and the sums evidenced hereby are secured by a deed of trust (the "Deed of Trust") of even date herewith, executed and delivered by, or caused to be executed and delivered by the Maker to the original Holder hereof. The Maker agrees to perform and comply with, or to cause to be performed and complied with, all of the terms and conditions of the Deed of Trust.

Default; Attorneys' Fees and Other Costs and Expenses. In the event of any default, all sums owing and to become owing hereon, at the option of the Holder, shall become immediately due and payable and shall bear interest thereafter at the Default Rate per annum. The Maker agrees to pay all costs and expenses which the Holder may incur by reason of any default, including without limitation reasonable attorneys' fees with respect to legal services relating to any default or to a determination of any rights or remedies of the Holder under this Note and reasonable attorneys' fees relating to any actions or proceedings which the Holder may institute or in which the Holder may appear or participate and in any appeals therefrom. Any judgment recovered by the Holder hereof shall bear interest at the Default Rate per annum, not to exceed however the highest rate then permitted by law on such judgment. The venue of any action hereon may be laid in the _____ Judicial District, State of _____, at the option of the Holder.

Liability. The Maker hereby waives demand, presentment for payment, protest, and notice of protest and of nonpayment.



Maximum Interest. Notwithstanding any other provision of this Note or of the Deed of Trust of interest, fees and charges payable by reason of the indebtedness evidenced hereby shall not exceed the maximum, if any, permitted by any governing law.

Applicable Law. This Note shall be construed according to the laws of the State of _____.

(Signature of Maker)

(Date)

(Printed Name of Maker)

(Address of Maker)

(Signature of Holder)

(Date)

(Printed Name of Holder)

(Address of Maker)

(Signature of Witness)

(Date)

(Printed Name of Witness)

