Agricultural Leasing in Maryland

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Note: This publication is intended to provide general information about legal issues in agricultural leasing and should not be construed as providing legal advice. It should not be cited or relied upon as legal authority. State laws vary and no attempt is made to discuss laws of states other than Maryland. For advice about how the issues discussed here might apply to your individual situation, you should consult an attorney.

Introduction

According to USDA's National Agricultural Statistic Service (NASS), agricultural producers lease over 42 percent of all agricultural land in Maryland, or 865,692 acres in 2007 (Ag Census, 2007). Leases for agricultural real estate, equipment, and/or livestock take different forms to meet the needs of the landlord and the tenant. This guide provides an overview of various land leasing issues facing agricultural landowners and agricultural land tenants and raises issues important from both a landowner's and tenant farmer's perspective. Subjects discussed here include:

- The general legal enforceability of both oral and written leases;
- Common types of agricultural leases;
- The renewal and termination of leasing arrangements;
- Death of the landlord or tenant;
- The landlord's right of reentry onto leased premises during the leased period;
- The responsibility for repairs of the leased premises;
- Noxious weed control;
- Insurance issues;
- Failure to pay rent and how a landowner can protect himself;
- Bankruptcy of the landlord or tenant; and
- Lease language that parties should consider when a leased property is subject to multiple economic uses such as hunting, mineral development, or wind energy.

Executive Summary

Maryland farmers understand the importance of leases in their operations. From land to equipment, Maryland farmers use varying forms of agreements in their business operations. With the leasing of land, leases for a period of less than one year can be oral and there is no requirement the lease be in writing. Even if the lease can be oral, the landlord and tenant should still consider putting the lease in writing to provide both with a written record of the terms agreed to. Any lease longer than one year will be required to be in writing and signed by the parties involved. The tenant will be the one to request a renewal and a landlord can never force a tenant to renew a lease. Termination will depend on either the termination process in the lease or when the lease is silent on termination on state law which requires either the landlord or tenant to give at least 6 months' notice of the desire to terminate the lease. Unless specified in the lease, a landlord retains no right to reenter the property or to allow new tenants to enter the property to begin preparing fields for planting before the current lease terminates. The landlord can specifically request the right to reenter in the lease. Other issues to consider when negotiating a lease are how to split repair costs, which party will be responsible for noxious weed control, and when the tenant will be required to purchase crop insurance or how crop insurance costs will be split, depending on the type of lease the parties have. This publication will provide an overview of some issues to be considered by both landlords and tenants when negotiating lease agreements.

What is a Lease?

A lease is a legally enforceable contract that allows the owner of real property, equipment and/or livestock to convey the right to use that property to a person in exchange for rent. A lease will need four necessary elements to be considered valid:

1. A valid contract;
2. Payment provision or "how much rent is owed?"
3. The transfer of rights to use and possession, and control of the property to the tenant; and
4. Intent to transfer rights to use, possession, and control of property back to landlord when lease terminates.

A lease demonstrating these four elements will be considered valid.

The lease defines the rights between the parties and defines who is responsible for what over the term of the lease. For instance, the parties can define who is in charge of maintaining fences or other improvements on the property or can specify the types of farming practices that will take place. For example, the landlord can limit the tenant to certain conservation tillage practices on the leased property. Because the lease defines the rights of the two parties, the parties should negotiate clauses that will work best for them both.

Written versus Oral Leases

The typical farm lease is oral rather than written. The landowner and the tenant often view a verbal lease as showing trust in one another. Although an oral lease may convey trust, written leases actually record what the two parties have agreed to and as such can avoid misunderstandings. Most oral leases will be valid under Maryland law if they are for one year or less. Oral leases that violate the Maryland's Statute of Frauds will not be valid. The Statute of Frauds requires certain contracts to be in writing and signed by both parties. In Maryland, any lease with a set term longer than one year must be in writing and signed by both parties to be valid. If the landlord orally agrees to rent his farm to a Tenant for one year with an understanding that the lease can be renewed each year, the lease will be valid. This oral lease would be valid since the lease could be performed within one year. Even though the lease can be renewed at the end of the one year period, it does not mean it will be renewed. But if Landlord orally agreed to rent his farm to Tenant for 3 years, this lease *must* be in writing and signed by both parties to be valid and enforceable in a court of law.

Some exceptions to the Statute of Frauds apply which may render an otherwise invalid oral lease enforceable. One exception is when one of the parties has partially performed in reliance of the oral lease. For instance, Maryland courts ruled in some cases that an otherwise invalid oral agreement will be upheld where a tenant has made payments of rent or has made improvements to the property (*Schluderberg*, 1929). For example, say the Landlord and Tenant have an oral lease to rent Landlord's farm for three years. Ordinarily, this would be an invalid agreement because it is not in writing. But if Tenant takes over the farm, pays rent on time, and improves the pasture portion of the farm, he has partially performed by paying rents and improving the property. As such the landlord would not be able to argue the oral lease is invalid under the Statute of Frauds. However, a written agreement provides both landlord and tenant greater legal certainty especially when the term exceeds one year.

Getting a court to enforce an oral lease requires a party in court to present evidence as to what constituted the oral agreement—a potentially difficult matter of evidence. All parties present at the time the oral lease was made could be called to testify. The credibility of each witness to the oral lease will need to be established. A court will take the testimony of the witnesses and each witness's credibility into consideration when determining the enforceable terms of an oral lease.

Given the evidentiary difficulties for proving the terms of oral leases and the costs and uncertainties of the court system, written leases can have many obvious advantages over oral leases. Written leases remove the need for the parties to prove the existence of each term in an oral lease. Parties should consider a written lease as a necessity similar to obtaining receipts from input suppliers and other documents to provide parties with a record of other farming transactions. Reducing negotiations to a written document can allow parties to determine the issues that will be driving their leasing relationship. As will be discussed later, parties can define who is responsible for what repairs, how a lease is to be terminated, the types of farming practices to be employed, the crops to be grown, and rights to any growing crops after the formal termination of the lease, etc.

In addition to giving parties to a lease greater legal certainty, in some cases written leases may be required for other reasons. For instance, lenders may require written leases as proof or verification that a tenant farmer actually does have the acreage he/she claims. Federal and state conservation programs may require a written lease to prove that the tenant has control of the land where conservation practices are to be installed.

Types of Leases

Landlords and tenants have a variety of lease types from which to choose depending on their various goals. The following discussion is an overview of four common arrangements between landlords and tenants: the ***cash lease***, the ***flex lease***, the ***crop-share lease***, and the ***custom farming contract***. Parties will want to pick the best leasing arrangement that works for their needs.

Under a ***cash lease*** or a ***fixed cash lease,*** the tenant pays the landlord a cash sum per acre or lump sum for the rights to use the land and other farm resources. For a landlord, a cash rent lease represents a fixed income per year with little involvement in the management of the agricultural operation. Landowners need not concern themselves over the types of crops grown or amount of production costs, nor about price and yield fluctuations. For a tenant, a cash lease allows the tenant to make all the management decisions, provides an incentive for the tenant to reap the highest yields possible, and allows the tenant to retain windfall profits from yield or price increases.[1]

Cash leases face the challenge of determining the right per acre rental rate that should be charged. The two parties can agree to use the current cash rental rate in the area, but cash rental rates can also be set using a variety of factors and the current rate may just be a starting point. Factors in calculating the cash rent rate may include: 1) the amount of federal and state farm program "payment acres;" 2) expected crop returns; 3) improvements on the land and whether or not those improvements (e.g. barn, lots, irrigation, or other fixtures) could be used by the tenant during the lease term; 4) the size of the farm; 5) location of the farm; 6) land quality; and 7) the reputations of the two parties. These factors provide some examples of items that could drive the cash rental rate for the land but others might exist and if so, should be incorporated. Worksheets are available through organizations, such as AgLease101.org, to aid the parties in calculating a fair rental rate.[2]

With cash rent leases, tenant will pay the crop insurance premiums, because the landlord has no interest in crops grown. The tenant will also receive 100 percent of all federal and state farm program payments that may come from the rented farmland. Federal and state farm program regulations require that a party actively participate and take some risk to be eligible for program payments. Under a cash rent lease, a landlord does not meet these requirements.

A hybrid cash rent lease is a ***flexible cash rent lease*** or a ***flex lease***. A flex lease is similar to a cash lease in that the landlord charges the tenant an amount per acre. Unlike a cash rent lease, rent under a flex rent lease can fluctuate up or down depending on crop yield, market price, or a combination of both.[3] A flex lease allows the landlord to gain when market prices or crop yields increase during the crop year. But in return for the possible increase in rental payments, a landlord also loses when market prices or crop yields decrease. Under a flex

[1] For a more detailed review of the advantages and disadvantages of a cash lease for either party, see North Central Farm Management Extension Committee, *Fixed and Flexible Cash Rental Agreements For Your Farm* (Dec. 2011), available at http://aglease101.org/DocLib/docs/NCFMEC-01.pdf.

[2] See North Central Farm Management Extension Committee, *Fixed and Flexible Cash Rental Agreements For Your Farm* (Dec. 2011), available at http://aglease101.org/DocLib/docs/NCFMEC-01.pdf.

[3] For information on how to set a flexible rental rate, see North Central Farm Management Extension Committee, *Fixed and Flexible Cash Rental Agreements For Your Farm* (Dec. 2011), available at http://aglease101.org/DocLib/docs/NCFMEC-01.pdf.

lease, the tenant benefits from the possibility of lower rent payments during low yield or low price years. However the tenant also has to share his gains during high yield or high prices years through higher rental payments.

Under a ***crop share lease,*** a tenant pays the landowner a certain percentage of harvested crops. In return, a landlord agrees to allow the tenant to use the land and may pay a percentage of certain input costs. The percentage of crops and the percentage of selected expenses are usually based on local custom. For example, Tenant agrees to crop share rent Landlord's farm for corn production. Terms of such a lease might require Tenant to give Landlord 25 percent of the corn crop produced on Landlord's farm in exchange for the use of the farm and Landlord paying 25 percent of the drying and herbicide costs.

With a crop share lease, both the tenant and landlord would pay crop insurance premiums based on the share of the crop each owns. Federal farm program payments could also be divided based on the crop share, as long as the landlord meets the eligibility requirements. Typically, the landlord and tenant agree upon the division of federal and state farm program payments prior to the current crop year.

Landlords will need to consider the tax implications of each type of lease. Rent paid to a landlord under the terms of a cash rent lease or flexible lease will be reported as income on a landlord's 1040 Form. Similarly, the income from the sale of crops paid to the landlord under a crop share rental arrangement could be taxed on the landlord's 1040 Form if the landowner had not materially participated. Landlords collecting only his share of the crops and paying his share of expenses—but who is not significantly involved in the operation—will likely not be found to be materially participating in the operation.

Alternatively, the income for the sale of the landowner's share of the crop could be considered self-employment earnings if the landlord materially participates in the farming operation. The IRS considers a landlord to have materially participated in the operation when the landlord meets any of the following four tests:

A. Any three of the following:

   1. Pay, using cash or credit, toward at least half the direct costs of producing the crop or livestock

   2. Furnish at least half the tools, equipment, and livestock used in the production activities

   3. Advise or consult with the tenant

B. Inspect the production activities periodically

C. Work 100 hours or more spread over a period of 5 weeks or more in activities connected with agricultural production.

D. Do things that considered in their totality, show you are materially and significantly involved in the production of the farm commodities (IRS, 2011).

With all these leases, the landlord will be able to deduct expenses for repairs to keep the property in working condition, depreciation on the property, uncollected rents, and operating expenses. For landlords collecting Social Security benefits, rental income will not adversely affect Social Security benefits.An alternative to leasing is a ***custom farming contract*** where a landowner contracts with a custom operator to perform all the machine operations on the landowner's land. The landowner takes all the risks involved in the operation and pays the custom operator a set fee for performing the work. The landlord will receive all profits, incur all production costs, pay all crop insurance premiums, and collect 100 percent of eligible federal and state farm program payments. Income earned on the farm will be reported on the landowner's Schedule F. This type of arrangement works well for landowners who still want to control the operation but may not have the time or ability to do the work required. This type of arrangement is also attractive for custom operators—those who wish to earn extra income from the equipment they currently lease or own.

One special note on types of lease agreements: the type of leasing agreement can have federal estate tax implications specifically Internal Revenue Code § 2032A. Landlords looking to qualifying for this federal estate tax provision need to discuss the implications of various leasing arrangements with an estate tax planning specialist. Current federal estate tax law allows for qualifying agricultural lands' value to be reduced below the fair market value if the land continues in agriculture under a qualifying family member. IRS currently views farms operating under a cash lease as ineligible for this reduction in the land's fair market value. For more information see University of Maryland Extension Factsheet entitled "Estate Planning for Farm Families."

Lease Renewal and Termination

Renewal and termination of a lease depends on the type of tenancy—the type of legal relationship between landlord and tenant—the lease creates. Certain types of tenancies may allow the lease to automatically renew, unless the parties give proper notice of termination. Renewing a lease will always be the responsibility of a tenant. Tenants should be the ones to request a renewal. By contrast, a landlord has the option of either agreeing to the renewal or giving the tenant the proper notice that the lease will terminate at the end of a lease term. Contract provisions may be written to govern the rights of the tenant to renew the lease or the method by which the landlord may exercise her right of termination.

A ***periodic tenancy*** has a set period of time such as month-to-month or year-to-year. The periodic tenancy will be classified based on when rent payments are made. For example, if you pay rent once a year, you have a ***year-to-year periodic tenancy***. If you pay rent once a month, you would have a month-to-month tenancy. The typical oral farm lease would be a year-to-year periodic tenancy. Periodic tenancies renew automatically at the end of lease period unless the landlord or tenant gives proper notice of termination. In Maryland, agricultural leases require *at least 6 months'*

notice to terminate a year-to-year tenancy (Md. Code Real Prop. Section 8-402(b)(4) (2013)). Notice of termination can be given orally or in writing by the landlord to the tenant or by the tenant to the landlord, even with a written lease, unless the lease says it must be in writing (Md. Code Real Prop. Section 8-402(b)(3)-(4) (2013)). Unless proper notice is given, a periodic tenancy will automatically renew at the end of the term. This also means the terms of the original lease will continue to apply until the parties agree to terminate the original terms or the parties agree to a new lease.

Under a ***tenancy for a term of years,*** the landlord and tenant agree the lease will end after a certain period of time. For example, Tenant and Landlord sign a lease stating "the lease will run for 4 years from March 1, 2011." This lease will end on February 28, 2015. A lease for a term of years requires the landowner to give written notice one month before the end of the lease that the landlord desires to repossess the property (Md. Code Real Prop. Section 8-402(b)(1)(i) (2013)). Once the landlord gives notice, the tenant must surrender the property back to the landlord at the end of the term. The tenant can also decide to terminate the lease once the term has expired, but—unlike the landlord—is not required to give notice under Maryland law unless the terms of the written lease require the tenant to do so.

When a tenancy for a term of years renews automatically at the end of its period, the lease typically becomes a periodic tenancy. For example, a lease could state that "the term shall extend from June 1, 2010 to May 31, 2011 or if no written notice is given then the lease will extend as a year-to-year tenancy until properly terminated." In these situations, the tenant and the landlord will be bound by the same duties and rights as stated in the original lease. In other cases, a lease could contain language that only allows renewal if a ***lease extension***, a written document stating the intention to continue the lease, is signed by both parties. If an extension is signed, a landlord's and tenant's rights and duties under the extended lease will be dictated by the terms of the extension.

While parties can specify how the lease will be terminated, both parties must have the same period of time to give notice; one party cannot be given a longer notice period than the other party (Md. Code Real Prop. Section 8-501 (2013)). If the contract specifies how a lease is to be terminated, the exact procedure must be followed; courts are traditionally not forgiving of parties that do not follow the proper notice termination procedures. For example, if the lease states notice should be given "in writing and delivered by certified mail within 6 months before the lease terminates", then notice must be given within 6 months of the end of the lease.

When a lease is for a term of years and the tenant knows when the lease will expire, a tenant will not be able to harvest crops maturing after the lease expires. This rule has long been settled by Maryland courts (*Carmine*, 1906). Tenants should exercise good judgment before planting crops they know they cannot harvest before the lease expires. The one exception to this rule is when custom and practice in an area allows for harvest after termination or there is an agreement between landlord and tenant to allow the harvest after termination. For example, Tenant plants a fall crop knowing the lease expires before the fall crop will be ready to harvest; the tenant must ask the landlord if tenant can harvest the crop after the termination of the lease. If the landlord does not reply or says nothing, tenant should be entitled to harvest the crops, the landowner's lack of response could be viewed as agreeing.

A tenant terminating the lease would want to consider setting the termination date with enough time to harvest any growing crops. For example, Tenant has a year-to-year tenancy with Landlord for the past 10 years. Tenant has decided to scale back his operation and sends written notice to the landlord that tenant plans to terminate the lease on May 31. Because a portion of the leased farmland would have crops ready to harvest after May 31, tenant reserves in the termination letter that "termination for the portion of the above described farm with growing fall-seeded crops which was prepared in conformity with normal growing practices in the county, termination will deemed to be the day after following the last day of harvest or August 1, whichever comes first."

Lease Consideration

Improvement/Fixtures

A ***fixture*** is personal property attached to the land that is regarded as a non-moveable part of the real property. An example of a fixture would include a shed, cattle lots, diesel and oil storage tanks, etc. In Maryland, unless the lease contract specifies otherwise, tenants would have the right to remove any fixtures he has erected on the property once the lease terminates (Md. Code Real Prop. Section 8-114 (2013)). Of course, a tenant does not have the right to remove fixtures which the landlord has placed on the property.

Good Husbandry Practices

Many state courts and commentators view an agricultural lease as carrying the implied duties that the tenant use good husbandry or good agricultural practices on the leased property (Hamilton, 1990). Good husbandry practices conserve the fertility, usefulness, and value of the soil (Hamilton, 1990). For example, Tenant is using the leased property for cattle and constantly over grazes the leased property damaging the pasture and promoting soil erosion. This agricultural practice would not meet the duty to use good husbandry practices. But if Tenant is properly grazing the leased property and not damaging the property then Tenant would be meeting the duty to use good husbandry practices.

Death of Tenant/Landlord

The death of a landlord or a tenant does not terminate the lease. If the landlord dies, the tenant's lease continues for the lease term until the lease is properly terminated. The tenant must pay rent to the landlord's estate as it becomes due and the landlord's estate will include any rent payments on its 1040 Form. The executor of the landlord's estate or the heir to the property can decide whether or not to allow the lease to renew or to properly terminate the lease.

Right of Reentry

By law or by custom, a landlord has no right to enter onto leased property during the lease period. In fact, unless the landlord reserves a right of reentry in the terms of the lease agreement, the landlord could be charged with trespassing for entering the leased premises. Those landlords considering new tenants after the current lease expires or those landlords expecting to prepare the property for a new crop after the expiration of the current lease should reserve a right of reentry in the lease agreement. If a right to reentry has not been reserved in a lease, a tenant has the option to forbid the landlord or new tenants to enter the property to begin tillage operations. Reentry provisions are also important for those landlords wishing to make repairs, improvements, or inspections on the leased property.