

# THE CONSERVATION RESERVE PROGRAM AND ITS EFFECT ON FARMERS FILING BANKRUPTCY

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## I. INTRODUCTION

Concern about the environment has encouraged Congress to enact legislation providing protection for the nation's natural resources. In 1985, Congress enacted the Conservation Reserve Program (CRP). Since its inception, the program has been a success. Millions of farmers receive annual payments from the government for setting aside<sup>1</sup> their erodible farmland. Nevertheless, the receipt of these payments is no guarantee against financial distress, and highly leveraged farmers often find operating expenses can exhaust farm earnings. When these farmers seek relief through bankruptcy, disputes often arise over rights to their CRP payments. Because these payments represent a needed source of income for farmers, the outcome of these disputes is important to creditors and debtors alike.

Two distinct and irreconcilable lines of authority have been offered for resolving the dispute. It is well established that federal agencies have a right

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1. Setting aside means the landowner agrees not to use land enrolled in the CRP for crop production purposes and will implement conservation practices in return for yearly payment from the government. See *infra* text accompanying notes 35-44.

to set-off<sup>2</sup> independent of bankruptcy. The issue is usually whether the CRP payments in dispute arose out of a prepetition obligation or are a postpetition obligation that cannot be set-off.

The purpose of this Note is to provide the reader with both lines of authority. First, this Note gives an overview of the CRP. Second, it gives an in-depth discussion of the two competing lines of authority. This Note concludes by discussing the equity problems that necessarily arise in bankruptcy proceedings.

## II. AN OVERVIEW OF THE CONSERVATION RESERVE PROGRAM

### A. *The History of the Conservation Reserve Program*

In 1985, Congress enacted the CRP to create a program for long-term land retirement for marginally productive and erodible cropland.<sup>3</sup> When the CRP was enacted, Congress's goal was to retire forty-five million acres of marginal cropland from production.<sup>4</sup> Congress enacted the CRP believing a successful conservation program would "(1) reduce water and wind erosion, (2) protect [the nation's] long-term capability to produce food and fiber, (3) reduce sedimentation, (4) improve water quality, (5) create a better habitat for fish and wildlife through improved food and cover, (6) curb production of surplus commodities, and (7) provide needed income support for farmers."<sup>5</sup>

The CRP authorized the Secretary of Agriculture to contract with agricultural landowners for a retirement of up to forty-five million acres of highly erodible cropland for ten to fifteen years.<sup>6</sup> Under this program, eligible landowners can bid to retire their erodible cropland from production for ten years.<sup>7</sup> The CRP establishes an agreement between the landowner and the government in which the government agrees to provide substitute payments for income that otherwise would be realized from farmland, in return for the landowner's pledge to care for the land.<sup>8</sup> Thus, landowners who participate receive cost-sharing money to establish conservation practices and annual payments for effectively retiring the land.<sup>9</sup>

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2. A set-off is the equitable right to cancel or offset mutual debts. BLACK'S LAW DICTIONARY 1372 (6th ed. 1990).

3. Roger A. McEowen & Neil E. Harl, *A Look at the Conservation Reserve Program (CRP) and How It Affects Owners and Tenants of Marginal Land*, 12 J. AGRIC. TAX'N & L. 121, 122 (1990). The CRP was one of four programs enacted to address soil erosion problems. Neil D. Hamilton, *Legal Issues in Enforcing Federal Soil Conservation Programs: An Introduction and Preliminary Review*, 23 U.C. DAVIS L. REV. 637, 637 (1990). The other three programs included in the Food Security Act of 1985 are: (1) Sodbuster, (2) Swampbuster, and (3) Conservation Compliance. See Food Security Act of 1985, 16 U.S.C. §§ 3801-3845 (1988).

4. Neil D. Hamilton, *Securing Creditor Interests in Federal Farm Program Payments*, 33 S.D. L. REV. 1, 29 (1988).

5. 7 C.F.R. § 704.1(b) (1992).

6. 16 U.S.C. § 3831(e) (1988).

7. Hamilton, *supra* note 4, at 29.

8. McEowen & Harl, *supra* note 3, at 122.

9. Hamilton, *supra* note 4, at 29-30.

### B. The Role of the Agricultural Stabilization and Conservation Service

The CRP is one of several federal farm programs. The Agricultural Stabilization and Conservation Service (ASCS) administers all federal farm programs including the CRP.<sup>10</sup> County committees, comprised of three producers elected by program participants, determine initial and continuing eligibility in the CRP.<sup>11</sup> In addition, a state committee supervises each county committee.<sup>12</sup> All the various county and state committees are ultimately subject to the supervision of the ASCS Deputy Administrator, State and County Operations, and the ASCS Administrator.<sup>13</sup>

### C. CRP Participation Eligibility

#### 1. Land Eligibility

Highly erodible land that has been planted annually to produce any agricultural commodity in two of the crop years between 1986 and 1990, and is still available for crop production, is currently eligible for the CRP.<sup>14</sup> Highly erodible land is defined by statutes<sup>15</sup> and regulations.<sup>16</sup> Congress has set very distinct standards land must meet to qualify for the CRP. Cropland is

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10. Christopher R. Kelley & Susan A. Schneider, *Selected Issues of Federal Farm Program Payments in Bankruptcy*, 14 J. AGRIC. TAX'N & L. 99, 102 (1992). The ASCS is an agency created by the Secretary of Agriculture. *Id.* Its primary function is the administration of the federal government's farm income support programs. *Id.*

11. See 16 U.S.C. § 590h(b) (1988); 7 C.F.R. §§ 7.4-7.18, 7.21 (1992).

12. See 7 C.F.R. §§ 7.1, 7.4, 7.20 (1992).

13. See generally Christopher R. Kelley & John S. Harbison, *A Guide to the ASCS Administrative Appeal Process and to the Judicial Review of ASCS Decisions*, 36 S.D. L. REV. 14, 27 (1991).

14. 7 C.F.R. § 1410.13 (a)(1)-(2) (1992). Producers who enrolled between 1986 and 1990 were required to have land that had been planted annually to produce any agricultural commodity other than orchards, vineyards, or ornamental plantings in two of the crop years between 1981 and 1985 and was still available to be planted in the year of contracting. *Id.* § 704.7(a)(1)-(2).

15. 16 U.S.C. § 3811 (1988). The statute defines "highly erodible land" as land:

(i) that is classified by the Soil Conservation Service as class IV, VI, VII, or VIII land under the land capability classification system in effect on December 23, 1985; or

(ii) that has, or that if used to produce an agricultural commodity, would have an excessive average annual rate of erosion in relation to the soil loss tolerance level, as established by the Secretary, and as determined by the Secretary through application of factors from the universal soil loss equation and the wind erosion equation, including factors for climate, soil erodibility, and field slope.

*Id.* § 3801(a)(7)(A).

16. The regulations define "highly erodible land" as "land that has an erodibility index of 8 or more." 7 C.F.R. § 12.2(a)(15) (1992).

eligible for the CRP if: (1) it is in capability classes II-V<sup>17</sup> and is eroding at more than two times the tolerance (T)<sup>18</sup> rate for the soil as specified by the Soil Conservation Service (SCS)<sup>19</sup> field office technical guides; or (2) the land is in a capability class of VI or higher.<sup>20</sup>

A particular field can be considered highly erodible only if two-thirds or more of the land in the field meets the requirements for erodibility.<sup>21</sup> The SCS uses soil maps to identify highly erodible land.<sup>22</sup> To determine soil erodibility, a particular plot's potential average annual rate of erosion is divided by the predetermined T value for the plot.<sup>23</sup> An on-site investigation finally determines erodibility.<sup>24</sup> If the SCS determines two-thirds of the field is highly erodible, then the entire field is eligible if the noneligible land cannot be separated.<sup>25</sup> If two-thirds of the field is not highly erodible, then the entire field must be redefined<sup>26</sup> to become eligible.<sup>27</sup>

Even land that does not meet the highly erodible test may be eligible for the CRP.<sup>28</sup> "The Secretary of Agriculture is authorized to include in the program land that is not highly erodible if it poses an off-farm environmental threat or, if continued in production, poses a threat of continued productivity decline due to high soil salinity."<sup>29</sup>

## 2. Person Eligibility

Any persons owning or operating eligible land may enter into a CRP contract<sup>30</sup> if they have owned the cropland for at least three years before seeking to enroll it<sup>31</sup> and have funds available to prepare the land for CRP

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17. An erodibility index is "a numerical value that expresses the potential erodibility of a soil in relation to its soil loss tolerance value without consideration of applied conservation practices or management." *Id.* § 12.2(a)(10).

18. "The T value represents the maximum annual rate of soil erosion that could occur without causing a decline in long-term productivity." *Id.* § 12.21(a).

19. The SCS is an agency within the United States Department of Agriculture that is responsible for "providing technical assistance in matters of soil and water conservation and for administering certain conservation programs of the Department." *Id.* § 12.2(a)(25).

20. *Id.* § 704.7(a)(3)(i)-(ii). Land was required to meet these standards to be eligible for enrollment in the CRP between 1986 and 1990. *Id.* To be eligible for enrollment today, land must only "be a predominantly highly erodible field." *Id.* § 1410.103(a)(3).

21. *Id.* § 704.7(c).

22. McEowen & Harl, *supra* note 3, at 123.

23. 7 C.F.R. §§ 704.8(a)(1)-(2), 704.8(a)(3)(b) (1992).

24. *Id.* § 704.8(c).

25. McEowen & Harl, *supra* note 3, at 123.

26. To "redefine" a field a landowner must reapportion the land so the portion sought to be enrolled in the CRP meets the erodible requirements. This can be done by removing land that is not highly erodible from the section and adding in land that is highly erodible.

27. McEowen & Harl, *supra* note 3, at 124.

28. *Id.*

29. *Id.*

30. 7 C.F.R. §§ 704.6, 1410.102 (1992).

31. *Id.* There are several exceptions to the three year requirement:

(1) The new owner acquired such cropland by will or succession as a result of the death of the previous owner;

participation.<sup>32</sup> In *In re Plihal*,<sup>33</sup> the court concluded a landowner was ineligible to participate in the CRP because he was unable to pay the expenses necessary for land preparation for CRP program participation.<sup>34</sup>

#### D. General Provisions of the CRP Contract

A qualified owner of eligible land may choose to enroll in the CRP. To enroll in the CRP an eligible owner must first submit an offer to participate at the local county ASCS office.<sup>35</sup> A producer enrolling in the CRP must sign a contract with the Commodity Credit Corporation (CCC).<sup>36</sup> This contract recites the producer's and government's primary obligations and incorporates, by reference, the program regulations.<sup>37</sup> The contract terms are dictated by the applicable statutes and regulations.<sup>38</sup> Generally, the CRP contract involves a lease agreement between the CCC and the landowner under which the CCC makes an annual payment to the landowner for a minimum of ten years.<sup>39</sup>

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(2) The only ownership change in the three year period occurred due to foreclosure on the land and the owner of the land, immediately before the foreclosure, exercises a timely right of redemption from the mortgage holder in accordance with state law;

(3) As determined by the Deputy Administrator, the circumstances of the requisition are such as present adequate assurances that the new owner of such cropland did not acquire such cropland for the purpose of placing it in the CRP.

*Id.* §§ 704.6(b)(1)-(3), 1410.102(b)(1)-(3).

32. *In re Plihal*, 97 B.R. 561, 564 (Bankr. D. Neb. 1989).

33. *In re Plihal*, 97 B.R. 561 (Bankr. D. Neb. 1989).

34. *Id.* at 564. Part of the determination of personal eligibility is the ability to meet the initial costs. "For example, a participant must implement a conservation plan, establish temporary vegetative cover to control erosion until permanent cover can be established, and reduce the aggregate total of crop bases by the percentage of CRP land." McEowen & Harl, *supra* note 3, at 146.

35. 7 C.F.R. §§ 704.11(c), 1410.115(c)(1) (1992). This offer to enroll shall be irrevocable for "such period as is determined and announced by CCC." *Id.* § 1410.115(c)(2).

36. The CCC is "an agency and instrumentality of the United States, within the Department of Agriculture." 15 U.S.C. § 714 (1988). The Supreme Court described the CCC as "simply an administrative device established by Congress for the purpose of carrying out federal farm programs with public funds." *Rainwater v. United States*, 356 U.S. 590, 592 (1958). Producers who enrolled in the CRP program between 1986 and 1990 had to meet different requirements than producers who enrolled, or will enroll, in the CRP Program between 1991 and 1995. 7 C.F.R. §§ 704, 1410 (1992).

37. *See* 16 U.S.C. § 3834 (1988).

38. For producers enrolling in the CRP between 1986 and 1990, the Code states: "The CRP Contract will be comprised of: (1) The terms and conditions for participation in the CRP; (2) the offer of the applicant; and (3) the conservation plan." 7 C.F.R. § 704.11(b) (1992). For producers enrolling in the CRP between 1991 and 1995, the Code states: "The CRP contract will be comprised of: (1) The terms and conditions for participation in the CRP; (2) The conservation plan; and (3) Any other materials or agreements determined necessary by CCC." *Id.* § 1410.115(b).

39. 16 U.S.C. § 3831 (1988).

Annual payment is contingent on the participants' actions. CRP participants who abide by the CRP contract terms receive annual payments from the government. These payments may be made in cash, in kind, in commodity certificates, or in any combination the Secretary determines appropriate.<sup>40</sup> These payments are made as soon as practicable after October 1 of each year.<sup>41</sup> The total amount<sup>42</sup> of these payments may not exceed \$50,000 for any year.<sup>43</sup>

There are special rules concerning the assignment of CRP payments that are worth noting. These rules provide:

Any participant who may be entitled to any cash payment under this program may assign the right to receive such cash payment, in whole or in part, as provided in the regulations at 7 CFR part 709, Assignment of Payment, except that assignments may also be made to secure or pay pre-existing indebtedness.<sup>44</sup>

Significantly, assignments are restricted to the "cash" portion of the CRP payments; therefore, payments made in kind or in commodity certificates may not be assigned.

### III. THE CREDITOR'S RIGHT TO SET-OFF DEBTS OWED IN BANKRUPTCY WITH THE DEBTOR'S CRP PAYMENTS

#### A. *The Right to Set-Off Debts in Bankruptcy*

There are two possible ways a federal agency might obtain a set-off from the debtor. One way is by using the rules of the ASCS.<sup>45</sup> ASCS rules provide for set-offs when a producer owes money to any government agency.<sup>46</sup>

The right to set-off can also arise under the Bankruptcy Code. Bankruptcy law allows "parties who are mutually indebted to set off those debts against each other instead of exchanging mutual payment."<sup>47</sup> Originally, set-off arose as a practical tool to avoid unnecessary transactions when parties held mutual debts.<sup>48</sup>

Today, an independent right to set-off is not present in the Bankruptcy Code. The Bankruptcy Code does recognize, however, set-off rights arising under state or federal law.<sup>49</sup> Thus, "setoff rights created under state or fed-

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40. *Id.* § 3834(d)(2)(C).

41. *Id.* § 3834(a)(2)(A).

42. The annual payment amount is set by the Secretary. *Id.* § 3834(c)(1).

43. *Id.* § 3834(f)(1).

44. 7 C.F.R. § 704.18 (1992); see also *id.* § 1410.9.

45. *Id.* § 13.1.

46. *Id.*

47. Kelly & Schneider, *supra* note 10, at 105.

48. *In re Braniff Airways*, 42 B.R. 443, 448 (Bankr. N.D. Tex. 1984).

49. 11 U.S.C. § 553 (1988).

eral law may be exercised within a bankruptcy."<sup>50</sup> When a right to set-off is present under state or federal law, section 533 of the Bankruptcy Code restricts the rights that can be exercised in bankruptcy.<sup>51</sup>

Section 553 allows a creditor to "offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case . . . ."<sup>52</sup> This section of the Bankruptcy Code contains three requirements that must be met before a set-off is permissible.<sup>53</sup> "First, the creditor must owe a debt to the debtor that arose prior to the bankruptcy's commencement. Second, the creditor must have a claim against the debtor that arose prior to the bankruptcy. Third, the debt and the claim must be mutual obligations."<sup>54</sup>

Although the debt and the claim must be mutual, they do not have to arise out of the same transaction to be set-off.<sup>55</sup> "The basic test is mutuality, not similarity of obligation—something must be 'owed' by both sides."<sup>56</sup> Thus, even though debts and claims are not of the same character, they may be set-off if they are mutual and arise prepetition.<sup>57</sup>

For mutuality to exist, debts must "be in the same right and between the same parties, standing in the same capacity."<sup>58</sup> Thus, there is no mutuality when "the debts to be set off arose between parties acting in different capacities."<sup>59</sup>

"The right of setoff is permissive, not mandatory. Allowance of a setoff is within the discretion of the court—which must exercise that discretion consistent with general principles of equity."<sup>60</sup> Therefore, a set-off does not necessarily follow even when the creditor can satisfy the requirements of section 553.<sup>61</sup>

### B. CRP Payments as Prepetition Obligations

To be eligible for set-off, the debt owed by both sides must be a prepetition obligation. CRP participants argue the CRP payment is a postpetition obligation because participants must adhere to CRP contract terms to receive annual payments.<sup>62</sup> Participants argue an annual payment is contingent on their actions.

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50. Kelly & Schneider, *supra* note 10, at 106.

51. *Id.*

52. 11 U.S.C. § 553(a) (1988).

53. Kelly & Schneider, *supra* note 10, at 106.

54. *Id.*

55. *Id.*

56. 4 LAWRENCE P. KING, COLLIER ON BANKRUPTCY ¶ 553.04[1] (1989).

57. McEowen & Harl, *supra* note 3, at 135.

58. 4 KING, *supra* note 56, ¶ 553.04[2].

59. *Id.*

60. *In re Nielson*, 90 B.R. 172, 174 (Bankr. W.D.N.C. 1988).

61. Kelley & Schneider, *supra* note 10, at 106.

62. *In re Allen*, 135 B.R. 856, 860 (Bankr. N.D. Iowa 1992).

The government argues the annual CRP payment is a prepetition obligation because the obligation to pay arises when the contract is signed.<sup>63</sup> The majority of the reported decisions addressing the issue of whether the CRP payments in dispute were prepetition obligations have held in the affirmative, although their rationale for doing so varies.

1. *In re Greseth*<sup>64</sup>

Six months before filing Chapter 12 bankruptcy, the debtors in *In re Greseth*<sup>65</sup> enrolled in the CRP.<sup>66</sup> Also before filing, the debtors became indebted to the ASCS for various deficiency payments.<sup>67</sup> Thus, the ASCS was affected by the bankruptcy proceeding. In their original reorganization plan, the debtors listed ASCS as an unsecured creditor.<sup>68</sup> Furthermore, the debtors' plan provided receipt from the ASCS of all CRP payments owed them, without set-off.<sup>69</sup>

The bankruptcy court denied confirmation of the debtors' plan, holding "ASCS was entitled to a setoff."<sup>70</sup> The court also ordered the ASCS be treated as a secured creditor in the amount of the set-off.<sup>71</sup> The debtors appealed the court's decision denying confirmation.<sup>72</sup>

The debtors argued that because their CRP contract required strict compliance with its terms for ten years in order to receive payments, the right to receive payments arose postpetition.<sup>73</sup> The debtors also asserted failure at any time to comply with the CRP contract requirements would require them to refund all payments received.<sup>74</sup> The debtors argued that because the payments did not relate to a prepetition claim they could not be set-off by the ASCS.<sup>75</sup>

The court agreed, however, with the ASCS's reasoning that the benefits of the CRP contract accrued to the debtors when they entered into the contract.<sup>76</sup> The court stated that once the CRP contract was made, prepetition

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63. See Kelly & Schneider, *supra* note 10, at 107.

64. *In re Greseth*, 78 B.R. 936 (Bankr. D. Minn. 1987).

65. *Id.*

66. *Id.* at 941.

67. *Id.*

68. *Id.*

69. McEowen & Harl, *supra* note 3, at 135.

70. *In re Greseth*, 78 B.R. 936, 941 (Bankr. D. Minn. 1987).

71. *Id.*

72. *Id.*

73. *Id.*

74. *Id.*

75. *Id.*

76. *Id.* at 941-42. The court based its decision on the ruling in *In re Matthieson v. United States Agric. Stabilization & Conservation Serv.*, 63 B.R. 56 (Bankr. D. Minn. 1986). *In re Greseth*, 78 B.R. at 942. *Matthieson* is the seminal case holding government payments were a prepetition obligation even when certain acts triggering payment had not yet been performed. *In re Matthieson v. United States Agric. Stabilization & Conservation Serv.*, 63 B.R. at 60. The reasoning the *Matthieson* court used is representative of the reasoning adopted by most courts when determining whether CRP payments may be set-off.



mutual obligations were acquired by both the ASCS and the debtors.<sup>77</sup> The court held because the debts owed to the ASCS by the debtors and the CRP payments owed to the debtors by the ASCS were mutual prepetition debts, the ASCS was entitled to set-off its payments.<sup>78</sup>

## 2. *In re Lundell Farms*<sup>79</sup>

*In re Lundell Farms*<sup>80</sup> involved five contracts existing between the debtor and the CCC when the debtor filed for bankruptcy.<sup>81</sup> Two were CRP contracts.<sup>82</sup> At the time of filing, the debtor also owed a sizable prepetition debt for a grain storage loss.<sup>83</sup> The CCC sought to set-off the CRP payments owed to the debtor against the grain storage loss debt the debtor owed them.<sup>84</sup> The debtor claimed the mutuality requirement was not satisfied because the actual amount of the CRP payment was not ascertainable prepetition.<sup>85</sup> The CCC, on the other hand, contended although the amount was not fixed, the obligation to pay was fixed prepetition.<sup>86</sup> Thus, the mutuality requirement was satisfied.

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In *Matthieson*, the debtors had enrolled in the Federal Crop Deficiency Program for the 1984 growing season. *Id.* at 58. The Federal Crop Deficiency Program provided payments to the debtors based on end-of-the-year market prices in exchange for the debtors' promise to refrain from planting crops on certain acreage and to maintain soil conservation practices on unused acreage. *Id.* The debtors owed the government a prepetition debt, and the ASCS moved to set-off the deficiency payment. *Id.*

The question before the court was whether the payments owed debtors under the federal program presented a prepetition claim subject to government offset. *Id.* The ASCS contended because its obligation to pay arose when the debtors enrolled in the program, the payments were prepetition obligations and could therefore be used to set-off the debtors' obligations. *Id.* The debtors argued that because they had to satisfy several conditions postpetition in order to receive payments, and because the amount of payment could not be determined prepetition, the government's obligation occurred postpetition and therefore could not be set-off. *Id.*

The court ruled the federal payments represented a prepetition obligation allowing for set-off. *Id.* at 60. The court held mutual obligations were created prepetition when the contract was formed and the fact debtors could be assessed liquidated damages for failing to fulfill contractual obligations postpetition did not prevent setoff. *Id.*

77. *In re Greseth*, 78 B.R. 936, 942 (Bankr. D. Minn. 1987).

78. *Id.*

79. *In re Lundell Farms*, 86 B.R. 582 (Bankr. W.D. Wis. 1988).

80. *Id.*

81. *Id.* at 583.

82. *Id.* Lundell Farms was a partnership comprised of Howard Lundell, John Lundell, Dennis Lundell, Debra Lundell, and Elna Lundell. *Id.* Both of the CRP contracts were between the CCC and Howard, Elna, Dennis, and Debra. *Id.*

83. *Id.* Debra and Elna were not listed as general partners on the grain storage agreement. *Id.* Also, the exact date of the loss was unclear. *Id.* The CCC claimed the loss arose in July 1983, although the debtors claimed 1984. *Id.* Both sides agreed, however, the debt arose well before October 1987. *Id.*

84. *Id.*

85. *Id.*

86. *Id.*

The court wrote, "The overwhelming majority of courts faced with similar arguments regarding ASCS contracts have concluded that a final prepetition determination of the deficiency amount is unnecessary."<sup>87</sup> The court also noted a majority of courts have adopted the rationale that "the obligations are created at the inception of the contract."<sup>88</sup> The court held there was no need to determine the amount of the CRP payments prepetition because the CCC's obligation to pay, the debtor's right to receive CRP payments, and the grain storage loss had all occurred prepetition.<sup>89</sup> The court reasoned that as long as debts are of the same kind or quality, mutuality of debt is present.<sup>90</sup> Because the mutuality requirement was satisfied, the court held the CCC was entitled to set-off its grain storage debt against the debtor's CRP payments.<sup>91</sup>

### 3. In re Allen<sup>92</sup>

In *In re Allen*,<sup>93</sup> the debtors signed a CRP agreement with the CCC three months before filing Chapter 12 Bankruptcy.<sup>94</sup> On the date of filing, the debtor owed the CCC money from shortfalls on corn placed in storage.<sup>95</sup> The CCC wanted to set-off the money owed to it by the Allens in the bankruptcy proceeding.<sup>96</sup> The CCC proposed to set-off the yearly rental payments it owed the debtors for the CRP contract against the money the Allens owed the CCC.<sup>97</sup> The CCC then moved for relief from the automatic stay to exercise a right to set-off.<sup>98</sup>

The debtor argued the CRP contract was an executory contract<sup>99</sup> and therefore a postpetition contract that defeated both the requisite prepetition

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87. *Id.*; see *In re Buske*, 75 B.R. 213, 216 (Bankr. N.D. Tex. 1987); *In re Pinkert*, 75 B.R. 218, 221 (Bankr. N.D. Tex. 1987); *In re Parrish*, 75 B.R. 14, 16 (N.D. Tex. 1987).

88. *In re Lundell Farms*, 86 B.R. 582, 585 (Bankr. W.D. Wis. 1988).

89. *Id.* at 588.

90. *Id.* at 586.

91. *Id.* at 588.

92. *In re Allen*, 135 B.R. 856 (Bankr. N.D. Iowa 1992).

93. *Id.*

94. *Id.* at 858-59. In 1986, Congress passed the Family Farmer Bankruptcy Act as Chapter 12 of the Bankruptcy Code. 11 U.S.C. §§ 1201-08, 1221-31 (1988). Chapter 12 reduces some obstacles farmers encounter under other chapters of the bankruptcy code and offers provisions specifically designed for the family farmer in bankruptcy. See *id.* For this reason, many farmers filing bankruptcy file Chapter 12 Bankruptcy.

95. *In re Allen*, 135 B.R. at 860.

96. *Id.*

97. *Id.*

98. *Id.*

99. An executory contract is a contract that has not been fully performed. BLACK'S LAW DICTIONARY 570 (6th ed. 1990). It is a contract that has an obligation of performance in the future. *Wagstaff v. Peters*, 453 P.2d 120, 124 (Kan. 1969). In the context of bankruptcy, an executory contract is a contract under which an obligation of both the bankrupt party and the other party to the contract are so far unperformed that failure of either to complete performance would constitute material breach excusing performance of either. *In re Knutson*, 563 F.2d 916, 917 (8th Cir. 1977).

character of the debt as well as the mutuality of obligation.<sup>100</sup> The CCC, on the other hand, contended all of the statutory elements necessary for set-off<sup>101</sup> were satisfied.<sup>102</sup> The court found the CCC had a right to relief from a court stay in order to perfect its right to a set-off.<sup>103</sup>

The court looked to Iowa law to determine whether the CRP contract was a contract of mutual promises.<sup>104</sup> The court found Iowa law recognizes a difference between a contract for mutual binding promises and one subject to conditions precedent.<sup>105</sup> It further found a contract without conditions is based on mutual promises and is binding and enforceable at the time the parties enter the contract.<sup>106</sup> "Hence, a contract based on conditions precedent does not give rise to obligations under the contract until the conditions are satisfied whereas a contract based on binding, mutual promises gives rise to the obligations at the time the parties make the agreement."<sup>107</sup> Using the Iowa contract law as a guideline, the court found the CRP contract to be a contract for mutual promises, not a contract based on conditions precedent.<sup>108</sup> The court therefore found the CCC's debt arose prepetition.<sup>109</sup>

Although the debtor claimed the requirement of mutuality was destroyed when he assumed the CRP contract under his plan of reorganization, the court did not agree.<sup>110</sup> The court found no difference between the debtor and the debtor-in-possession.<sup>111</sup> The court concluded the mutuality requirement dealt with the prepetition time frame only and was therefore satisfied.<sup>112</sup> Having found all three requirements of section 553 met, the court allowed the CCC's set-off.<sup>113</sup>

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100. *In re Allen*, 135 B.R. 856, 860 (Bankr. N.D. Iowa 1992).

101. 11 U.S.C. § 553(a) states to establish a right to set-off the creditor must demonstrate:

1. A debt exists from the creditor to the debtor and that debt arose prior to the commencement of the bankruptcy case,
2. The creditor has a claim against the debtor which arose prior to the commencement of the bankruptcy case, and
3. The debt and the claim are mutual obligations.

McEowen & Harl, *supra* note 3, at 135.

102. *In re Allen*, 135 B.R. at 860.

103. *Id.* at 871.

104. *Id.* at 864.

105. *Id.*

106. *Id.* at 865.

107. *Id.*

108. *Id.* at 866.

109. *Id.* at 867.

110. *Id.*

111. *Id.* at 868.

112. *Id.* at 869.

113. *Id.* at 871.

4. *In re Mohar*<sup>114</sup>

In *In re Mohar*,<sup>115</sup> the court considered two CRP contracts the debtor entered into in February 1989.<sup>116</sup> Under the debtor's CRP contracts, the CCC owed the debtor forty dollars per acre, payable October 1 of each year for ten years.<sup>117</sup> On October 15, 1992, the debtor filed Chapter 12 Bankruptcy.<sup>118</sup> The CCC sought to set-off the CRP payments against the debt due to it for a loan.<sup>119</sup> The debtor argued mutuality did not exist and the CRP contracts were executory; thus, no set-off should be allowed.

The debtor first argued against mutuality because the CRP contracts were executory and "upon assumption becomes, not a prepetition debt, but a postpetition obligation."<sup>120</sup> The court did not agree with the debtor's arguments, and instead followed the reasoning of *In re Allen*.<sup>121</sup> The court held the assumption of a CRP contract does not give rise to a postpetition obligation destroying mutuality.<sup>122</sup> Furthermore, the court rejected the debtor's argument that mutuality was lacking.<sup>123</sup> The court accordingly found the CCC had a right to set-off.<sup>124</sup>

5. *In re Gerth*<sup>125</sup>

In *In re Gerth*,<sup>126</sup> the debtor was indebted to the CCC for unpaid cash collateral arising from the debtor's previous bankruptcy proceeding.<sup>127</sup> In July 1989, the debtor entered into a CRP contract.<sup>128</sup> In January 1991, the debtor filed for Chapter 12 Bankruptcy.<sup>129</sup> The bankruptcy court considered whether the ASCS should be allowed to set-off its claim against the postpetition payments from the debtor's CRP contract.<sup>130</sup> The bankruptcy court agreed with the reasoning of *In re Gore*, stating the three elements of section 553 must be satisfied in order to establish a right to set-off.<sup>131</sup>

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114. *In re Mohar*, 140 B.R. 273 (Bankr. D. Mont. 1992).

115. *Id.*

116. *Id.* at 275.

117. *Id.*

118. *Id.*

119. *Id.*

120. *Id.* at 277.

121. *Id.*

122. *Id.* at 278.

123. *Id.* at 279.

124. *Id.*

125. *In re Gerth*, 136 B.R. 241 (Bankr. D.S.D. 1991).

126. *Id.*

127. *Id.* at 242. The debtor filed Chapter 11 Bankruptcy in April 1985. *In re Gerth*, 116 B.R. 167, 168 (Bankr. D.S.D. 1989). The debtor's bankruptcy plan was confirmed in October, 1986. *Id.*

128. *In re Gerth*, 136 B.R. at 242.

129. *Id.*

130. *Id.* at 243.

131. *Id.* This court, however, viewed § 553 slightly differently from the court in *In re Gore*. See *infra* notes 144-163 and accompanying text. The *Gerth* court stated:

Because payment to the debtor was conditioned on future performance of certain duties, the bankruptcy court found the contract was executory.<sup>132</sup> The bankruptcy court stated executory contracts may be accepted or rejected by the debtor-in-possession.<sup>133</sup> Thus, the bankruptcy court held any executory contracts accepted by the debtor-in-possession are postpetition contracts and are not eligible for set-off.<sup>134</sup> Therefore, the bankruptcy court did not allow the ASCS to set-off its debt because the debt did not arise prepetition.<sup>135</sup>

The Eighth Circuit Court of Appeals, however, disagreed with the bankruptcy court's reasoning.<sup>136</sup> The court first found Gerth's obligations arose under the executory contract as the parties agreed.<sup>137</sup> Next, the court found the ten year contract terms, combined with the dependency on a postpetition event, did not create a postpetition obligation.<sup>138</sup> Rather, the court found the "debt was absolutely owed and arose prepetition, satisfying the first requirement for setoff . . . ."<sup>139</sup>

On the issue of mutuality, which was one of first impression for the Eighth Circuit, the court held "when a debtor-in-possession assumes an executory contract, the debtor and the debtor-in-possession are the same entity for purposes of mutuality . . . ."<sup>140</sup> The court found both the debt to and the claim against Gerth "arose prepetition and were mutual obligations."<sup>141</sup>

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First, the debtor must have a prepetition claim against the creditor. Second, the creditor must have a prepetition claim against the debtor. Third, the obligations must be mutual; that is, the debts in question must be in the same right and between the same parties, standing in the same capacity.

*In re Gerth*, 136 B.R. 241, 243-44 (Bankr. D.S.D. 1991).

132. *Id.* at 245. The court considered the CRP contract provision calling for payments by the CCC for a period of 10 years. *Id.* It also considered the CRP participant's required yearly report of the acreage, land use, and other requirements to remain eligible for continued payments under the program. *Id.* See generally 7 C.F.R. § 704.12 (1992).

133. *In re Gerth*, 136 B.R. at 243-44.

134. *Id.*

135. *Id.* at 246.

136. *In re Gerth*, 991 F.2d 1428 (8th Cir. 1993).

137. *Id.* at 1432.

138. *Id.* at 1433.

139. *Id.* at 1434.

140. *Id.* at 1435.

141. *Id.* at 1436.

### C. CRP Payments as Postpetition Obligations

Cases that have not allowed the government to set-off against CRP payments have essentially followed a line of authority developed in *In re Walat Farms*.<sup>142</sup> *In re Gore* is one of these cases.<sup>143</sup>

In *In re Gore*, the Gores entered into a ten-year contract with the government under the CRP shortly before they filed Chapter 12 Bankruptcy.<sup>144</sup> Under their CRP contract, the Gores would receive approximately \$5250 per year, if they properly set aside 105 acres of their land.<sup>145</sup> The Gores received CRP payments in 1988 and 1989.<sup>146</sup> The Gores included the annual CRP payment in the cash flow analysis for their Chapter 12 plan.<sup>147</sup> They also intended to use the future payments to operate their farm.<sup>148</sup>

Because the Gores owed money to the Small Business Administration (SBA), the government asserted it was entitled to set-off the Gores' debt against any future CRP payments the Gores would receive.<sup>149</sup> The Gores, however, argued the mutuality requirement of section 553 was not met because the obligations under the CRP contract arose year to year.<sup>150</sup> The court held all three requirements of section 553 had to be satisfied.<sup>151</sup>

The court found the first requirement, a prepetition claim of the creditor against the debtor, was satisfied because it was undisputed the Gores owed the government, through the SBA, an identifiable sum of money before the bankruptcy petition was filed.<sup>152</sup> The court found, however, the second and third requirements were not met.<sup>153</sup>

The court stated, "For a contract to be executory, material performance must remain due on both sides, and the contract is no longer executory if performance on one side is completed."<sup>154</sup> The court also stated the failure of either party to complete an executory contract's performance would consti-

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142. *In re Walat Farms*, 69 B.R. 529 (Bankr. E.D. Mich. 1987). The court in *In re Walat Farms* found a CRP contract is an executory contract which the debtor-in-possession can assume postpetition. *Id.* at 531. The court concluded such postpetition assumptions make the contractual obligations arise postpetition. *Id.* Consequently, mutuality does not exist and setoff is disallowed. *Id.*

143. *In re Gore*, 124 B.R. 75 (Bankr. E.D. Ark. 1990).

144. *Id.* at 76.

145. *Id.*

146. *Id.*

147. *Id.*

148. *Id.*

149. *Id.*

150. *Id.* at 77.

151. *Id.* The three requirements for a set-off under § 553 were:

(1) the creditor owes a debt to the debtor which arose prior to the commencement of a bankruptcy case; (2) the creditor has a claim against the debtor which arose prior to the commencement of the bankruptcy case; and (3) the debt and the claim are mutual obligations.

*Id.* (citing *In re Cloverleaf Farmer's Co-op.*, 114 B.R. 1010, 1016 (Bankr. D.S.D. 1990)).

152. *Id.*

153. *Id.*

154. *Id.*

tute a material breach, and therefore excuse the performance of the other party.<sup>155</sup> The court noted CRP participants are obligated to carry out the terms of the CRP contract for a period of ten years,<sup>156</sup> and the government may terminate the contract if the participant fails to carry out the conditions of the CRP contract.<sup>157</sup> Thus, the court reasoned an executory contract existed and was therefore a postpetition contract under which the Gores were obligated to perform because at the time of filing the Chapter 12, petition performance was due from both parties.<sup>158</sup> Accordingly, the court held the postpetition CRP payments could not be set-off against the Gores' prepetition debt to the SBA.<sup>159</sup>

The court also found the third requirement lacking. The court reasoned that mutuality requires debts to be in the same right and between the same parties standing in the same capacity.<sup>160</sup> The court found that for bankruptcy purposes the SBA and ASCS stood in the same capacity as federal agencies.<sup>161</sup> The court made a distinction, however, between a prepetition debtor and a debtor-in-possession and stated, "A postpetition debtor-in-possession does not stand in the same shoes as a prepetition debtor for off-set purposes."<sup>162</sup> Therefore, the court held mutuality of obligations had been destroyed.<sup>163</sup>

#### IV. IS SET-OFF OF CRP PAYMENTS CONSISTENT WITH EQUITY PRINCIPLES?

Allowance of a set-off is within the discretion of the court. Even if all the requirements for a set-off are met, set-off is an equitable remedy a court may grant or deny. This concept offers debtors one last alternative for avoiding a CRP payment set-off. Several courts have discussed this and reached different outcomes.

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155. *Id.*

156. Mr. Gore testified that under the program he was required "to make reports to the Government each year regarding the set-aside acreage, to maintain the acreage, and to pay taxes on the acreage." *Id.* at 76.

157. *Id.* at 77. "The regulations provide that if a CRP participant fails to carry out the conditions of the CRP contract, the Government may terminate the contract, and the participant 'shall forfeit all rights to further payments under the CRP contract, refund all payments received together with interest thereon . . . and pay liquidated damages to [the Government] in such amount and under such conditions as are specified in the CRP contract.'" *Id.* (quoting 7 C.F.R. § 704.22(a)(1)-(2) (1990)).

158. *Id.* at 77-78.

159. *Id.* at 78.

160. *Id.*

161. *Id.*

162. *Id.* (citing *In re Evatt*, 112 B.R. 405, 414 (Bankr. W.D. Okla. 1989), *aff'd*, 112 B.R. 417 (W.D. Okla. 1990)).

163. *Id.*

A. *In re Allen*<sup>164</sup>

As discussed above,<sup>165</sup> the court in *In re Allen*<sup>166</sup> held the creditor had a right to set-off the debt owed to him.<sup>167</sup> The court "flatly rejected a blanket denial of set-offs as inconsistent with the purposes of Chapter 12 Bankruptcy, arguing that each case must be determined on an individual basis."<sup>168</sup> The court also stated set-off should be deferred rather than denied when the debtor can prove the set-off will hurt his ability to reorganize.<sup>169</sup>

The court found the debtor had not shown evidence that a set-off would harm the debtor's chances to reorganize.<sup>170</sup> Therefore, the court did not grant the debtor's request to disallow the set-off on equitable grounds.<sup>171</sup>

B. *In re Mohar*<sup>172</sup>

As previously discussed,<sup>173</sup> the court in *In re Mohar*<sup>174</sup> held mutuality was not lacking and, therefore, the creditor had a right to set-off.<sup>175</sup> The debtors urged the court to prohibit set-off because it would significantly harm or destroy their ability to reorganize.<sup>176</sup> The court concluded the funds that could be set-off were necessary for effective reorganization and held the CCC would be required to pay the annual amount due to the debtors.<sup>177</sup>

The court held the CRP payments were to be treated as secured claims.<sup>178</sup> The court classified that case as one in which "the creditor is denied the immediate right of setoff, but the setoff claim is treated as a secured claim as provided by the Bankruptcy Code Section 506(a)."<sup>179</sup> When this is the case, "[t]he creditor's setoff rights are . . . deferred but preserved."<sup>180</sup>

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164. *In re Allen*, 135 B.R. 856 (Bankr. N.D. Iowa 1992).

165. See *supra* notes 93-113.

166. *In re Allen*, 135 B.R. 856 (Bankr. N.D. Iowa 1992).

167. See *supra* note 113.

168. Kelly & Schneider, *supra* note 10, at 114.

169. *In re Allen*, 135 B.R. at 870.

170. *Id.*

171. *Id.* The court did indicate, however, the debtor could submit factual evidence to support the claim by a subsequent motion. *Id.*

172. *In re Mohar*, 140 B.R. 273 (Bankr. D. Mont. 1992).

173. See *supra* notes 115-124.

174. *In re Mohar*, 140 B.R. 273 (Bankr. D. Mont. 1992).

175. See *supra* note 124.

176. *In re Mohar*, 140 B.R. at 279.

177. *Id.* at 279-80.

178. *Id.* at 280. The court reaffirmed its opinion that when CRP payments are necessary for effective reorganization the creditor must pay the annual amount due to the debtor in *In re Lincoln*, 144 B.R. 498, 502-03 (Bankr. D. Mont. 1992).

179. *In re Mohar*, 140 B.R. 273, 279 (Bankr. D. Mont. 1992) (quoting *In re Blanton*, 105 B.R. 321, 327 (Bankr. E.D. Va. 1989)).

180. *Id.*



## V. CONCLUSION

The CRP is a program that is vital both for the environment and the landowners who participate. Environmental Protection Agency studies have shown good conservation practices can reduce sediment pollution from fifty to ninety percent.<sup>181</sup> Landowners benefit from improving the quality of their land and receiving payments from the government for doing so. At the same time, society benefits by preserving highly erodible land. When a farmer must declare bankruptcy, however, the determination of whether he will continue to receive CRP payments depends on the jurisdiction in which he files for bankruptcy. Because only one federal court of appeals has ruled on the issue of CRP payment set-offs, bankruptcy courts in the other circuits may choose their own line of reasoning.

The majority of courts have held CRP payments are prepetition obligations that can be set-off. In most situations, this substantially hinders a landowner's ability to reorganize. Therefore, several courts have acknowledged that although a set-off is permitted, it need not be granted. Several courts have exercised their discretion by refusing to allow the set-off to aid the farmer in his reorganization.

A minority of courts deciding CRP set-off cases in bankruptcy have held the CRP contract to be an executory contract. Thus, in most cases farmers are not receiving a needed source of income. Because CRP payments represent a needed source of income for farmers, more courts should adopt the equitable stance that set-off need not always be granted.

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