

UNITED STATES BANKRUPTCY COURT

DISTRICT OF SOUTH DAKOTA

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225 SOUTH PIERRE STREET

PIERRE, SOUTH DAKOTA 57501-2463

IRVIN N. HOYT
BANKRUPTCY JUDGE

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May 3, 2000

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Subject: *Community First National Bank v. Elkhorn
Farm, Inc., (In re Elkhorn Farm, Inc.),
Adversary Proceeding No. 00-5004;
Chapter 11; Bankr. No. 99-50553*

Dear Counsel:

The matter before the Court is Plaintiff Community First National Bank's motion for summary judgment and Defendant-Debtor's response. This is a core proceeding under 28 U.S.C. § 157(b)(2). This letter decision and accompanying order shall constitute the Court's findings and conclusions under F.R.Bankr.P. 7052. As set forth below, the Court concludes that the Bank has a security interest in \$161,169.16 of post-petition government farm program payments received by Debtor. However, a hearing will be held to determine whether the Bank's post-petition security interest should be cut off based on the "equities of the case" as provided by 11 U.S.C. § 552(b)(1).

SUMMARY. Elkhorn Farm, Inc. ("Debtor") filed a Chapter 11 petition on November 19, 1999. Since that date, Debtor has continued to receive various payments under government farm programs. These payments have included, through February 18, 2000:

\$40,000 (maximum allowed) under the Ag Marketing Transition Act's Production Flexibility Contract for crop year 2000. The Ag Marketing Transition Act is an ongoing program that began with a general contract between Debtor and the government in July 1996. The program continues through 2002 dependent annually on the number of Debtor's "base" acres and Debtor's compliance with certain soil

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conservation and weed control measures. The earliest Debtor could have requested his Production Flexibility Contract payment for 2000 was after November 1, 1999. Debtor filed his payment request form on November 31, 1999 for payment in December 1999. Debtor received the funds in late January 2000. All of that year's funds would have been automatically disbursed in September if no request had been made for an earlier payment of one-half the allowed amount;

\$108,438.16 under the Ag Marketing Transition Act's loan deficiency program involving Debtor's 1999 sunflower crop. The funds became available for 1999 crops as prices fell below the applicable county loan rate. Debtor could have made application for funds under this program anytime after the 1999 harvest through May 2000. The sum includes a small interest penalty because the government was late in issuing the check after Debtor made application. Debtor had to have a Production Flexibility Contract on file to participate in this loan deficiency payment program; and

\$12,731.00 as a 35% advance on Debtor's projected 1999 crop disaster payment. This program was initiated by Congress in 1999 or early 2000 and producers could begin applying to participate in January 2000. The balance of the disaster payment will be paid pro rata with other producers' claims later in 2000. Debtor did not have to have a Production Flexibility Contract on file to participate in this program.

Community First National Bank, which has a secured interest in Debtor's real property (second position) and in Debtor's equipment, machinery, crops, farm products, contract rights, and general intangibles (first position), claims a post-petition security interest in these post-petition farm program payments. The Bank commenced this adversary proceeding for a declaration to that effect. Debtor disputed the Bank's post-petition security interest in the post-petition farm program payments that are the result of a post-petition occurrence or occurrences. Debtor also affirmatively argued that the Bank's post-petition security interest failed because the Bank had not obtained an assignment of the payments in compliance with regulations of the Farm Service Agency. Debtor also argued that its security agreements with the Bank are not as broad as the UCC financing statements that were filed. Finally, Debtor argued that a broad security interest as defined by the financing statements would frustrate Debtor's reorganization effort and that the Bank had previously acquiesced

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to Debtor's use of these funds.

The Bank filed a motion for summary judgment on March 7, 2000 stating no material facts were in dispute. Debtor responded on March 15, 2000. Debtor disputed the Bank's legal conclusions regarding whether the Bank had a post-petition security interest in the farm program payments. Debtor also asked that evidence be received on the issue of whether any post-petition security interest that the Bank had in these payments should nonetheless be cut off under 11 U.S.C. § 552 based on the equities of the case.

EXTENT OF THE BANK'S PRE-PETITION SECURITY INTEREST.

The security agreements provide, in relevant part, that the Bank has a security interest in

All inventory, chattel paper, **accounts**, equipment, **general intangibles**, **crops**, farm products, livestock, farm equipment and fixtures, together with the following specifically described property: ALL FARM PRODUCTS INCLUDING, BUT NOT LIMITED TO LIVESTOCK, **CROPS**, AND SUPPLIES USED OR PRODUCED IN FARMING AND FEEDING OPERATION, AND ALL EQUIPMENT, VEHICLES, **CONTRACT RIGHTS AND ACCOUNTS, NOW OWNED OR HEREAFTER ACQUIRED; AND ALL GENERAL INTANGIBLES.**

In addition, the word "Collateral" includes all the following, whether now owned or hereafter acquired, whether now existing or hereafter arising, and wherever located:

(a) All attachments, accessions, accessories, tools, parts, supplies, increases, and additions to and all **replacements of and substitutions for any property described above.**

(b) All products and produce of any of the property described in this Collateral section.

(c) **All accounts, general intangibles, instruments, rents, monies, payments, and all other rights, arising out of a sale, lease, or other disposition of any of the property described in this Collateral section or appurtenant to any of the lands or operations of Grantor, or held in gross, whether in cash, farm products, or otherwise, and whether from or through any federal or**

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state government agency or program or otherwise, including without limitation, all easements, profits, rights of storage, trailing and grazing, and irrigation and water rights; all entitlements, rights to payment, and payments, in whatever form received, including but not limited to, payments under any governmental agricultural diversion programs, governmental agricultural assistance programs, the Farm Services Agency Wheat Feed Grain Program, and any other such program of the United States Department of Agriculture, warehouse receipts, chemicals and fertilizers, documents, letters of entitlement, and storage payments.

(d) All proceeds (including insurance proceeds) from the sale, destruction, loss, or other disposition of any of the property described in this Collateral section.

....
(f) All crops and crop products, whether stored, planted, growing or to be grown by Grantor or to be acquired from third parties, including crops hereafter grown, owned or acquired, and all supplies, including without limitation all seed, fertilizer, fungicides, and pesticides...[emphasis added].

If there had not been an intervening bankruptcy, it is clear that the Bank's security interest, based on the expansive collateral description in the security agreements, included all payments Debtor would receive under the Production Flexibility Contract, the loan deficiency program, or the disaster program. See *Drewes v. Lesmeister (In re Lesmeister)*, 242 B.R. 920, 923-25 (Bankr. N.D. 1999) (creditor's secured interest in the debtor's rights under the federal 1998 Crop Loss Disaster Assistance Program attached when the program became effective); *In re Sauer*, 223 B.R. 715, 718-19 n.3, 725 & n.4 (Bankr. N.D. 1998) (the debtor's interest in a Production Flexibility Contract arose pre-petition when contract signed although contract was subject to certain post-petition events). The security agreements between the Bank and Debtor specifically encompassed all farm program payments paid or to be paid to Debtor through the direct provision "payments, in whatever form received, . . . from the Department of Agriculture [emphasis added]."

As to the Production Flexibility Contract in particular, that Debtor's base acres could change over the term of the original contract and that any changes could be documented in an updated

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contract does not diminish Debtor's continuing right to payments under the contract beginning when the contract was signed in 1996, nor diminish the Bank's continuing, pre-petition security interest in those payments. All events giving rise to Debtor's right to payment under that contract occurred in 1996. See *Lesmeister*, 242 B.R. at 926 (if the debtor has a legally enforceable right to an asset, a creditor has sufficient rights under the U.C.C. for a security interest to attach); *Sauer*, 223 B.R. at 718-19 n.3 (the debtor's right to payment under Production Flexibility Contract came into existence when the contract was signed and they were promised payments under it). Moreover, the security agreements encompassed any substitutions of collateral, under which any updated Production Flexibility Contracts would fall.

Other provisions of the security agreements also encompassed some of the farm program payments received by Debtor. The security agreements specifically covered "existing or hereafter acquired" "accounts," "general intangibles," and "contract rights." *Bank of Cresbard v. Lindhorst Farms, Inc.*, 78 B.R. 1002, 1005 (D.S.D. 1987). In this District, government farm diversion or deficiency payments have previously been defined under the Uniform Commercial Code as either an account or general intangible, *In re Sunberg*, 729 F.2d 561, 562-63 (8th Cir. 1984) (cited in *In re Kingsley*, 865 F.2d 975, 981 (8th Cir. 1989)); see also *Bank of North Arkansas v. Owens*, 884 F.2d 330, 333-34 (8th Cir. 1989), or a contract right. *Lindhorst Farms*, 78 B.R. at 1004-05 (referencing S.D.C.L. §§ 57A-9-106). Here, it appears that by their nature Debtor's interest in both the Production Flexibility Contract program and the loan deficiency payment program are either an account, general intangible, or contract right as those terms are defined by state law.

Debtor's disaster program payments are also covered by other provisions of the security agreements. The security agreements included crops and the proceeds from the sale, destruction, loss or other disposition of crops. Since the disaster payments were made upon the loss of all or part of Debtor's 1999 sunflower crop, the security agreements covered that payment as a proceed from a loss of a crop. See *Kelley v. Ring (In re Ring)*, 169 B.R. 73, 75-77 (Bankr. M.D. Ga. 1993).

The same is not true of farm program payments in the nature of a deficiency or diversion payment. In this Circuit, they are not proceeds of a crop. *Kingsley*, 865 F.2d at 979-81 (farm diversion and deficiency payments are not proceeds under the U.C.C. definition); *Bank of North Arkansas v. Owens*, 884 F.2d 330, 333-34 (8th Cir. 1989) (payments under government dairy termination program

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were not proceeds of the debtor's dairy cattle). Accordingly, the payments Debtor has received under the Production Flexibility Contract and the loan deficiency program, like the deficiency and diversion payments discussed in *Kingsley* are not a proceed of a crop. Neither type of payment was "received upon the sale, lease, exchange, collection or other disposition" of collateral or proceeds." Hence, they were not a proceed, as defined by S.D.C.L. § 57A-9-306(1).

EXTENT OF POST-PETITION SECURITY INTEREST UNDER § 552(A).

Section 552 governs the effect of a creditor's security interest in property acquired by a debtor after a bankruptcy case is commenced. *Smith v. Dairyman, Inc.*, 790 F.2d 1107, 1111 (4th Cir. 1986). The general rule, provided by § 522(a), is that a creditor's security interest does not extend to property the debtor obtains post-petition. *Id.* When § 552(a) is applied to the security agreements between Debtor and the Bank, the parties do not dispute that the Bank's security interest in all post-petition government farm program payments terminated on the petition date. Compare *In re Connelly*, 41 B.R. 217, 221 (Bankr. Minn. 1984). Thus, the first question then is whether the post-petition payments fell under the exception at § 552(b)(1).

There are three conditions to the exception: (1) the debtor and creditor must have a valid, pre-petition security agreement that exists on the petition date; (2) the security agreement by its terms must extend the creditor's security interest to the subject pre-petition property and the proceeds, product, offspring, or profits of the subject property;¹ and (3) applicable non bankruptcy

¹ There is some debate about whether state or federal law should define the terms "proceeds, product, offspring, or profits." Compare *Financial Security Assurance, Inc. v. Tollman-Hundley Dalton, L.P.*, 74 F.3d 1120, 1124 (11th Cir. 1996) (the reference to "nonbankruptcy law" in § 552 does not suggest that state law defines the terms of § 552; the subject terms should be broadly construed as Congress intended), *In re De Cespedes*, 241 B.R. 260, 262-63 (Bankr. S.D. Fla. 1999), and *In re Megamarket of Lexington, Inc.*, 207 B.R. 527, 532 (Bankr. E.D. Ky. 1997), with *Unsecured Creditors Committee v. Marepcon Financial Corp. (In re Bumper Sales, Inc.)*, 907 F.2d 1430, 1437 (4th Cir. 1990) (non bankruptcy law defines terms), *In re Patio & Porch Systems, Inc.*, 194 B.R. 569, 574 (Bankr. D. Md. 1996), *In re Mintz*, 192 B.R. 313, 318-19 (Bankr. D. Mass. 1996), and *In re Rumker*, 184 B.R. 621, 624 (Bankr.

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law, usually the governing state's version of the Uniform Commercial Code, must permit a security interest to extend to such after-acquired property. *Smith*, 790 F.2d at 1111-12.

The application of the exception is easiest with Debtor's post-petition disaster payments. Those are a proceed of pre-petition collateral -- crops -- that is referenced in the security agreements. Thus, the disaster payments are covered by the exception. The Court is not concerned whether the disaster program had been adopted or implemented by the petition date nor whether Debtor had filed any necessary applications by the petition date. See *Ring*, 169 B.R. at 77. The key is that the disaster payments are the proceed upon the loss of pre-petition crop. See *In re Lemos*, 243 B.R. 96, 101 (Bankr. D. Idaho 1999) (post-petition Crop Loss Disaster Assistance Program payment was a proceed of the debtor's pre-petition crop for purpose of determining whether payment was property of the estate under § 541(a)(6)). Accordingly, the Bank maintains its security interest in them post-petition under the § 552(b)(1) exception.

We turn next to the post-petition Production Flexibility Contract payments and the post-petition loan deficiency program payments. Are they a proceed, product, offspring, or profit of collateral and are these proceeds, product, offspring, or profit of such collateral covered in the security agreements as required by § 552(b)(1)? "Offspring" is not included in the security agreement and these farm program payments do not meet an accepted definition of "products." See, e.g., *In re Mintz*, 192 B.R. 313, 320 (Bankr. D. Mass. 1996). Hence, we move to the remaining terms under § 552(b)(1) exceptions, "proceeds" and "profits," and whether they cover these post-petition farm program payments.

The security agreements encompass "proceeds" from the sale, destruction, loss or other disposition of any described collateral. For the same reasons discussed in *Kingsley*, however, this Court cannot conclude that Debtor's rights under the loan deficiency program or Production Flexibility Contract were sold, destroyed, lost, or otherwise disposed of, to enable Debtor to receive the post-petition payments. *Kingsley*, 865 F.2d at 979-81. Debtors'

S.D. Ga. 1995). However, whichever definitional law is used, it does not appear that the result would change in this case. See *In re Package Design & Supply Co.*, 217 B.R. 422, 424 (Bankr. W.D.N.Y. 1998) (while the court first applies state law's strict definition of proceeds, § 552(b) provides considerable flexibility when the equities of the case are considered; the flexibility comes from the statute itself, not legislative history).

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post-petition payments under the Production Flexibility Contract and the loan deficiency program resulted solely from "contract rights having origin in the statutory and regulatory fabric of the farm support program, rather than upon marketing the crop" or another collateral. *Id.* at 980. Compare *Carlson v. W.J. Menefee Construction Co. (In re Grassridge Industries, Inc.)*, 78 B.R. 978, 979-81 (Bankr. W.D. Mo. 1987) ("proceeds" reference in security agreement broader).

The security agreements encompass "profits" in paragraph (c) of the collateral description section. Making sense of all the commas, prepositions, conjunctions, and semicolons in paragraph (c) is a memorable task. Paragraph (c) contains two parts separated by a semi-colon. "Profits" are included in the first part and refer to profits from all accounts and general intangibles and include profits from any federal agency or federal program. Further, the introductory statement to the sequence of paragraphs that included (c) incorporates "now owned" and "hereafter acquired" profits. So the question becomes, are the post-petition Production Flexibility Contract payments and the loan deficiency payments a "profit" from these programs?

The term "profits" is not defined by § 552(b)(1), state law, or the security agreements. Case law based on state law is not helpful. Other courts have applied the term broadly.² See *Mintz*, 192 B.R. at 320 (profits include gain or net proceeds from a business transaction but not distribution rights from a partnership), and *Great-West Life & Annuity Assurance Co.*, 177 B.R. 843, 853-55 (Bankr. N.D. Ohio 1994) (equated profits with revenues). Under either a broad or common use definition, this Court is satisfied that "profits" include those Production Flexibility Contract payments and loan deficiency payments that Debtor received post-petition. According to the county Farm Service Agency officer, payments under the Production Flexibility Contract and the loan deficiency program were both premised upon Debtor's pre-petition Production Flexibility Contract. Thus, the payments are a profit from that contract. Since profits from general intangibles and accounts, which include the Production Flexibility Contract, are included in the security agreements, the Bank's security interest in the payments continues post-petition under the § 552(b)(1) exception.

There is also an exception to the exception. The Court, after notice and hearing, may determine that the creditor's post-petition security interest in proceeds, product, offspring, or profits of

² See *supra* note 1.

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property secured pre-petition may be discontinued if "the equities of the case" so warrant. 11 U.S.C. § 522(b)(1). There is surprising little case law on this exception to the exception. In one farm reorganization case where the court was asked to balance the equities, the court considered whether the debtors were continuing to invest time, labor, and money into the farm operation, whether the subject creditor was oversecured, and whether the creditor could receive a replacement lien or other adequate protection to the extent that the debtor used the post-petition collateral. *In re Lawrence*, 56 B.R. 727, (D. Minn. 1984).³ See *Wilke Truck Service, Inc. v. Wiegmann (In re Wiegmann)*, 95 B.R. 90, 93-94 (Bankr. S.D. Ill. 1989) (discussion of similar factors to consider). With this information, the Court can determine whether the creditor's post-petition security interest should be cut off so that assets otherwise available for unsecured creditors are not being used by the debtor to increase the collateral of the secured creditor and so that the debtor's reorganization effort is assisted. *Wiegmann*, 95 B.R. at 93. A case by case decision must be made. *Id.* at 94.

Debtor has contended that the exception to the exception in § 552(b) should be applied in this case and that the Bank's secured interest in all post-petition farm program payments should be cut off based on the equities of the case. A hearing, based on the considerations set forth in *Lawrence* and *Wiegmann*, will thus be necessary.

NECESSITY OF AN ASSIGNMENT. An assignment under Farm Service Agency rules was not necessary for the Bank to have a perfected security interest in these farm program payments. An assignment of the payments under Farm Service Agency rules would only govern to whom the government issued the check; it would not pre-empt the application of the state's Uniform Commercial Code once the farm program payments are in Debtor's hands. *Sunberg*, 729 F.2d at 563 (federal regulation regulating assignment of PIK benefits does not prevent a debtor from pledging the benefits as security on loan properly made under state law); *In re Endicott*, 239 B.R. 529, 531

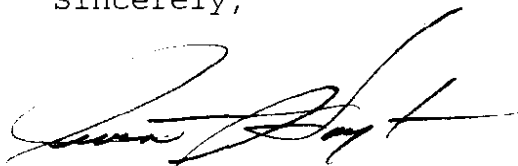
³ The District Court reviewing the Bankruptcy Court's decision in *Lawrence* smartly avoided the tougher question of whether a post-petition security interest existed. It said that the Bankruptcy Court properly concluded that the equities of the case cut off any post-petition security interest that the creditor held. Thus, the court found no need to determine whether a post-petition security interest actually existed under the § 552(b)(1) exception. *Lawrence*, 56 B.R. at 728.

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(Bankr. E.D. Ark. 1999)(cites therein); see *Rolling Plains Production Credit Association v. Cook (In re Cook)*, 169 F.3d 271, 275-77 (5th Cir. 1999); *In re Rees*, 216 B.R. 551, 555 (Bankr. N.D. Tex. 1998); *Armstrong v. Dakota Western Bank of Bowman (In re Arithson)*, 175 B.R. 313, 320-21 (Bankr. N.D. 1994). Compare *United States v. Landmark Park & Assocs.*, 795 F.2d 683, 684-86 (8th Cir. 1986)(federal law governed perfection of government lender's security interest in rental income under rent assignment provision in loan documents).

Since a hearing is needed to determine whether the "exception to the exception" in § 552(b)(1) should be applied in this case to cut off the Bank's post-petition security interest in post-petition Production Flexibility Contract payments, crop disaster payments, and loan deficiency payments, the Bank's summary judgment motion must be denied. The Court will enter an appropriate order

Sincerely,



Irvin N. Hoyt
Bankruptcy Judge

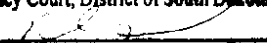
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