

## District court interprets federal crop insurance arbitration clause

In a decision it characterized as one of first impression, a federal district court has interpreted the import and scope of the arbitration provision in federal crop insurance policies. *Nobles v. Rural Community Ins. Servs.*, No. CIV.A. 00-D-375-S, 2000 WL 1785089 (M.D. Ala. 2000) (pagination unavailable). At issue was whether losses to cotton on about 5,000 acres were covered under two multi-peril crop insurance policies. The policies, which were sold by a private insurance company, were reinsured by the Federal Crop Insurance Corporation (FCIC), and their provisions were consistent with the standards established by the USDA Risk Management Agency (RMA). After the cotton crop was lost, the insurance company refused to pay an indemnity. It based its refusal on its determination that the land had not been planted and harvested during one or more of the previous three crop years as required by the policy. In turn, the plaintiffs, invoking the federal court's diversity jurisdiction, brought suit against the company alleging breach of contract, misrepresentation, and other state law claims seeking compensatory and punitive damages.

The insurance company moved to compel arbitration. Its motion relied on a provision in the insurance contract that provided, in relevant part, as follows: "If you [the insured] and we [the insurer] fail to agree on any factual determination, the disagreement will be resolved in accordance with the rules of the American Arbitration Association.... No award determined by arbitration ... can exceed the amount of liability established or which should have been established under the policy." *Id.* (quoting policy ¶ 20(a), (b) published at 7 C.F.R. § 457.8). In their opposition to the motion, the plaintiffs contended that arbitration was optional. They supported their contention with another provision of the policy that provided, in part, as follows: "You [the insured] may not bring legal action against us [the insurer] unless you have complied with all the policy provisions." *Id.* (quoting policy ¶ 25(a) published at 7 C.F.R. § 457.8).

The court ruled that the arbitration of factual determinations was mandatory. It found nothing in the language of the policy's arbitration provision that suggested that arbitration was in any way optional. It also concluded that the right to sue contemplated by the policy was predicated on the insured first complying with all of the policy's provisions, including its arbitration provision. As to the question of whether plaintiffs' cotton crop was insured, the court ruled that this question was a factual determination subject to mandatory arbitration irrespective of whether the plaintiffs disputed the company's determination that a crop had not been planted and harvested in any of the three years previous or whether the crux of plaintiffs' claim was that they had relied in good faith on the representations of the company's agent that the crop was insured.

Having concluded the arbitration was mandatory, the court offered several observations about the arbitration contemplated by the policy. First, the court noted that the policy's arbitration provision required the arbitration to be conducted under the rules of the American Arbitration Association (AAA) but did not require the use of an AAA arbitrator. Second, it observed that the policy limits an arbitration award to the amount established or which should have been established under the policy, thus precluding the award of additional damages or attorney's fees. Third, the court noted that notwithstanding this limit an arbitrator could grant recovery for losses not covered by the policy if the insured could establish that he or she relied in good faith upon a misrepresentation of an insurance agent. Citing 7 C.F.R. § 457.6 and 56 Fed. Reg. 1345, 1347 (1991) for the proposition that the "FCIC has a long standing policy of honoring the misinformation provided by its agents to [an] insured as long as the statutory requirements of the Federal Crop Insurance Act are followed ...," the court opined that "even if the terms of Defendant's policy do not insure against losses on some 5,000 acres of Plaintiffs' cotton crop, the arbitrator may nevertheless award relief as if they do." *Id.*

The court also observed that state law claims against a private insurance company

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## INSIDE

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sion giving the equipment owner the right to use the equipment on demand.

The "substantive change rule" applies when the number of "persons" in a farming operation increases from the preceding crop year. The increase will be recognized only if there was a "bona fide and substantive" change in the farming operation. For example, a twenty-percent increase in total cropland is deemed to be such a change. The regulations list other changes that can qualify.<sup>59</sup> The change must take place by April 1 of the applicable program or fiscal year.<sup>60</sup>

The bulk of the substantive change rules are found in 1-PL (Rev. 1).<sup>61</sup> These rules are among the most imprecisely drafted directives in 1-PL (Rev. 1), but they must be consulted given the brevity of the regulation in comparison to the lengthy procedures found in 1-PL (Rev. 1).

The only payment limitation paperwork requirement expressly imposed by Congress is a notification requirement related to the "three entity rule." Under this requirement, an individual who has an interest in more than the number of

"permitted" entities must provide notification of the entities through which the individual will receive payments.<sup>62</sup> The FSA, however, imposes a significant paperwork requirement by conditioning the receipt of payments on the voluntary submission of various forms and supporting documentation. The basic payment limitation form is known as the "CCC Form 502." This form is styled as a "farm operating plan," and it must be completed before payments can be received. The form asks for information regarding the producer's contributions to the farming operation that generally correlates to the "actively engaged in farming" requirements. If the operation has not changed from the preceding year, producers may so certify on an abbreviated form.

The CCC Form 502 is submitted in the name of the farming operation, and the Form varies depending on whether an individual, general partnership, entity, trust, or estate is conducting the operation. For example, farming operations conducted by an individual complete a 502A while general partnerships complete a 502B.

The farming operation must be in existence as of the "status date" for each program year, which is either April 1 of the crop year or the fiscal year, depending on the program.<sup>63</sup> The number of "persons" on a farming operation may not be increased after the status date. The number of "persons" may be decreased, however, based on the farming operation's "status" on or before the date of the last program crop harvested.<sup>64</sup>

The FSA conducts "end-of-year reviews" of selected producers to determine whether they followed their respective farm operating plans. These reviews usually require those producers to provide nearly all of their operation's records for that crop year. On occasion, the USDA Office of Inspector General (OIG or IG) conducts audits of farming operations either on its own initiative or at the request of the FSA.

The payment limitation and eligibility statute prohibits "schemes or devices" having the "purpose" of evading the payment limitation rules.<sup>65</sup> The regulations significantly expand this prohibition by prohibiting such actions that have the "effect" of evading the rules.<sup>66</sup> A person who adopts or participates in a prohibited "scheme or device" is ineligible for payments in that year and the following year.<sup>67</sup> Although the regulations appear to require a "scheme or device" to involve intentionally fraudulent or deceitful conduct,<sup>68</sup> the meaning of the phrase is the subject of disagreement.

False statements made in seeking farm program benefits can also lead to civil or criminal liability under the False Claims Act<sup>69</sup> and criminal prosecution for mail

fraud<sup>70</sup> and other offenses.

<sup>1</sup> ~~The most recent changes, minor ones relating to the limit for Environmental Quality Incentives Program payments, the submission of required forms, and FSA compliance reviews of farming operations, do not appear in the 2000 edition of the Code of Federal Regulations. They can be found at 65 Fed. Reg. 36,550, 36,561 (2000) (to be codified at 7 C.F.R. §§ 1400.1(g), 1400.2(e), (h)).~~

<sup>2</sup> See 7 C.F.R. § 1400.2(f).

<sup>3</sup> See, e.g., *Jones v. Esby*, No. 90-2831-LFO, 1993 WL 102641 (D.D.C. Mar. 17, 1993) (unreported decision). The APA's rulemaking procedures require publication of the proposed and final rules in the Federal Register and an opportunity for public comment. See 5 U.S.C. § 553.

<sup>4</sup> 120 S. Ct. 1655 (2000) (ruling that unpublished agency interpretations of an ambiguous federal statute were only entitled to deference commensurate with their "power to persuade," a standard articulated in *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944)).

<sup>5</sup> 113 S. Ct. 1913 (1993) (ruling that an agency's interpretation of its own legislative regulations is binding on the courts unless the interpretive rule is inconsistent with the legislative rule, violates the Constitution or a federal statute, or is plainly erroneous).

<sup>6</sup> The funding for the production flexibility contract program included sums from the refund of unearned deficiency payments from previous years and forfeited production contract payments. 7 U.S.C. § 7213(c)(1), (2). Production flexibility contract payments made from these funds are subject to a \$50,000 limit extending for the seven-year term of the production flexibility contracts. 7 U.S.C. § 7213(e).

<sup>7</sup> Beginning with the 2000 crop year and at the participant's option, marketing assistance loan gains can be realized without limitation through the use of commodity certificates. See Agriculture, Rural Development, Food and Drug Administration, and Related Agencies Appropriations Act, 2000, Pub. L. No. 106-78, tit. VIII, § 812, 113 Stat. 1135, 1181; FSA Notice LP-1723 (Feb. 15, 2000).

<sup>8</sup> For the 1999 and 2000 crop years only, this limit was increased to \$150,000. Agriculture, Rural Development, Food and Drug Administration, and Related Agencies Appropriations Act, 2000, Pub. L. No. 106-78, tit. VIII, § 813(a), 113 Stat. 1135, 1182; Agriculture, Rural Development, Food and Drug Administration, and Related Agencies Appropriations Act, 2001, Pub. L. No. 106-387, tit. VIII, § 837, 114 Stat. 1549, 1549A-155.

<sup>9</sup> Farmer A cannot have more than a 50% interest in either LLC. If he does, the LLC(s) in which he has more than a 50% interest will be "combined" into him. See

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PAYMENT LIMITATION/Cont. from p. 7  
7 C.F.R. § 1400.101(a). Also, Farmer A needs to be sure that neither LLC is organized in a manner that will result in a "combination" under 7 C.F.R. § 1400.101(b). This is why the members of the LLCs are "AB" and "AC," respectively. Neither "B" nor "C" can be Farmer A's spouse, minor child, or trust for the benefit of Farmer A's minor children. Otherwise, a "combination" will result under 7 C.F.R. § 1400.101(a).

<sup>10</sup> Individual B in this example could be completely "passive" with respect to the farming operation if the "significant contribution" of capital, equipment, or land was made by the partnership and individual A made a "significant contribution" of "active personal labor" or "active personal management" as an individual and as a 50% member of the LLC. See 7 C.F.R. §§ 1400.203(b), 1400.204(b). In other words, assuming the land and production of the farming operation will generate the payments, A can receive up to 150% of a single limit simply by finding a "warm body" to participate as an equal member in the LLC.

<sup>11</sup> But see *supra* note 23 (providing an example in which an individual retains complete control over a farming operation in which another individual receives payments indirectly as a member of an LLC).

<sup>12</sup> See 7 C.F.R. § 1400.3 (defining "Person").

<sup>13</sup> Corporations, limited liability companies, and limited partnerships have the advantage over general partnerships of being able to compensate their shareholders or members for their "significant contribution" of "active personal labor" or "active personal management." See 7 C.F.R. § 1400.204(b). Members of general partnerships cannot receive a salary or other guaranteed payment for these services to the farming operation. They can only be entitled to receive their respective distributive share of the partnerships net earnings.

<sup>14</sup> See 7 C.F.R. § 1400.3 (definition of "Person").

<sup>15</sup> See 7 C.F.R. § 1400.101(a).

<sup>16</sup> Corporations and similar limited liability entities are subject to two combination rules. See 7 C.F.R. § 1400.101(a), (b).

<sup>17</sup> See 7 C.F.R. § 1400.103. The payment limitation and eligibility rules specifically define an "irrevocable trust." 7 C.F.R. § 1400.3 (defining "Irrevocable trust"). Not every trust that is an "irrevocable trust" under state law will satisfy this definition.

<sup>18</sup> See 7 C.F.R. § 1400.104.

<sup>19</sup> See 7 C.F.R. § 1400.105.

<sup>20</sup> See 7 C.F.R. § 1400.106.

<sup>21</sup> See 7 C.F.R. § 1400.107.

<sup>22</sup> See 7 C.F.R. § 1400.108.

<sup>23</sup> Women Involved in Farm Economics

v. U.S. Dep't of Agric., 876 F.2d 994 (D.C. Cir. 1989), cert. denied, 493 U.S. 1019 (1990). This case is sometimes referred to as the "WIFE case," a reference to the plaintiff's acronym.

<sup>24</sup> 7 C.F.R. § 1400.105(a).

<sup>25</sup> 7 C.F.R. § 1400.105(a)(1).

<sup>26</sup> See 7 C.F.R. § 1400.3 (defining "Substantial beneficial interest").

<sup>27</sup> See 7 C.F.R. § 1400.105(a)(2).

<sup>28</sup> See 7 C.F.R. § 1400.201.

<sup>29</sup> See 7 C.F.R. § 1400.203(b).

<sup>30</sup> See 7 C.F.R. § 1400.204(a).

<sup>31</sup> See 7 C.F.R. §§ 1400.205(a) (Trusts), 1400.206(a) (Estates).

<sup>32</sup> See 7 C.F.R. § 1400.207.

<sup>33</sup> See 7 C.F.R. § 1400.204(b).

<sup>34</sup> See 7 C.F.R. § 1400.205(b).

<sup>35</sup> See 7 C.F.R. § 1400.206(a).

<sup>36</sup> See 7 C.F.R. § 1400.3 (defining "Active personal labor" and "Active personal management").

<sup>37</sup> See 7 C.F.R. § 1400.204(b).

<sup>38</sup> See 7 C.F.R. § 1400.3 (defining "Active personal management").

<sup>39</sup> Also, under the "landowner" rule discussed in the text below, a "person" can be deemed to be "actively engaged in farming" merely by contributing land to the farming operation. See 7 C.F.R. § 1400.207. Thus, a New York City resident who owns a farm in Alabama and share-leases the farm is "actively engaged in farming."

<sup>40</sup> See 7 C.F.R. § 1400.3 (defining "Significant contribution").

<sup>41</sup> See 7 C.F.R. § 1400.3 (defining "Active personal management").

<sup>42</sup> See 7 C.F.R. § 1400.3 (defining "Capital," "Equipment," and "Land").

<sup>43</sup> See 7 C.F.R. § 1400.3 (defining "Interest in a farming operation").

<sup>44</sup> See 7 C.F.R. § 1400.3 (defining "Capital," "Equipment," and "Land").

<sup>45</sup> See 7 C.F.R. § 1400.3 (defining "Capital," "Equipment," and "Land").

<sup>46</sup> See 7 C.F.R. § 1400.2 (defining "Interest in a farming operation"). 1-PL (Rev. 1) has a more complete definition of "interest in a farming operation." For example, unlike the regulation, 1-PL (Rev. 1) provides that shareholders in a corporation do not have an interest in the farming operation of the corporation. 1-PL (Rev. 1) ¶ 91(B).

<sup>47</sup> The FSA Handbook permits all of the members of a joint operation to guarantee a loan to the joint operation without violating a "financing rule." See, e.g., 1-PL (Rev. 1), ¶ 296(C). Since this is not permitted by the regulations, reliance on the Handbook directive is potentially perilous.

<sup>48</sup> This is an entirely unrealistic assumption because the dollar values of the land, equipment, and capital will almost always significantly exceed the monetary value of the contributed labor and management. Nonetheless, for simplicity in illustrating the importance of the

"commensurateness" requirement, the assumption must be made. Otherwise, the required mathematics might devour the points this example illustrates.

<sup>49</sup> In the "real world," depending on the relative value of the contributions, the spouses might be able to qualify for equal shares.

<sup>50</sup> See 7 C.F.R. § 1400.207.

<sup>51</sup> See 7 C.F.R. § 1400.208.

<sup>52</sup> See 7 C.F.R. § 1400.209.

<sup>53</sup> See 7 C.F.R. § 1400.207.

<sup>54</sup> See, e.g., 7 C.F.R. § 1412.303(a)(3).

<sup>55</sup> See 7 C.F.R. § 1400.211.

<sup>56</sup> See, e.g., 7 C.F.R. § 1412.303(a)(2).

<sup>57</sup> See 7 C.F.R. § 1400.401(a).

<sup>58</sup> See 7 C.F.R. § 1400.401(a).

<sup>59</sup> See 7 C.F.R. § 1400.109.

<sup>60</sup> See 7 C.F.R. § 1400.100(b).

<sup>61</sup> See 1-PL (Rev. 1) ¶¶ 93-97.

<sup>62</sup> See 7 U.S.C. § 1308-1(a).

<sup>63</sup> See 7 C.F.R. § 1400.100(a).

<sup>64</sup> See 7 C.F.R. § 1400.100(b).

<sup>65</sup> See 7 U.S.C. § 1308-2.

<sup>66</sup> See 7 C.F.R. § 1400.5(a).

<sup>67</sup> See 7 C.F.R. § 1400.5(b).

<sup>68</sup> The regulation provides that examples of a scheme or device include "[c]oncealing information . . . , [s]ubmitting false or erroneous information, or [c]reating fictitious entities for the purpose of concealing the interest of a person in a farming operation." 7 C.F.R. § 1400.5(a).

<sup>69</sup> 31 U.S.C. §§ 3729-31 (civil); 18 U.S.C. §§ 286-87 (criminal).

<sup>70</sup> See 18 U.S.C. § 1341.

ARBITRATION CLAUSE/Cont. from p. 3  
are not preempted by the Federal Crop Insurance Act or its implementing regulations. *Id.* (citing *Williams Farms of Homestead, Inc., v. Rain & Hail Ins. Serv., Inc.*, 121 F.3d 630 (11th Cir. 1997), and other authority). It noted that an arbitrator's findings are subject to judicial review and enforcement under the Federal Arbitration Act, specifically, 9 U.S.C. §§ 9, 10. Therefore, according to the court, state law claims might still be heard by a court following arbitration but only to the extent that such claims were not precluded by the arbitrator's findings. In this case, however, the court declined to rule on which, if any, of the plaintiffs' state law claims might remain justiciable after arbitration because the issue was not before it. Nevertheless, it declined to "rule out the likelihood that, under the doctrine of claim preclusion, at least some of the arbitrator's findings can serve as the basis for Plaintiff's common law claims raised against Defendant in court." *Id.* at n.6.

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# The basics of federal farm program payment limitation and eligibility law

By Christopher R. Kelley

This article provides an overview of the federal farm program payment limitation and eligibility rules. Because all or some of these rules govern eligibility for the most economically significant commodity programs, they are an important part of federal farm program law. This overview, however, is not intended to serve as a substitute for a close study of the rules or competent advice and assistance with respect to compliance with them.

The payment limitation and eligibility statutes are codified at 7 U.S.C. §§ 1308-1308-5. Some program payment limits, however, are contained in separate statutes. For example, the \$50,000 limit for Conservation Reserve Program (CRP) payments is found at 16 U.S.C. § 3834(f)(1).

The payment limitation and eligibility regulations are found at 7 C.F.R. Part 1400. Except for some relatively minor changes,<sup>1</sup> these regulations have been in effect since the 1989 crop year. They were codified at 7 C.F.R. Part 1497 until 1996.

The payment limitation and eligibility rules are administered by the USDA Farm Service Agency (FSA). Most payment limitation and eligibility determinations are initially made by county or area FSA committees. However, determinations involving farming operations conducted by general partnerships or joint ventures having more than five members are made at the state FSA committee level.<sup>2</sup>

The county, area, and state FSA committees have been instructed to follow the directives contained in the *FSA Handbook*, the agency's internal procedures manual. The *Handbook* volume containing the payment limitation and payment eligibility directives is known by its "short-reference," which is "1-PL (Rev. 1)."

Because the county, area, and state FSA committees and their staff use 1-PL (Rev. 1) in making their determinations, 1-PL (Rev. 1) is an important reference. Most FSA offices will permit program participants or their representatives to review their copy. A copy can also be obtained without cost from the FSA's Information Office in Washington. Since 1-PL (Rev. 1) is amended frequently, maintaining a current copy requires periodic requests for the most recent amend-

ments. Recent notices relating to 1-PL (Rev. 1), which often are later incorporated into amendments, can be found on the FSA site on the USDA's web page, <http://www.usda.gov>.

The federal courts have consistently ruled that the *Handbook's* directives do not have the force and effect of law because they are not promulgated as legislative rules under the Administrative Procedure Act (APA).<sup>3</sup> Nonetheless, the FSA historically has treated the *Handbook's* directives as if they were legally binding rules. This does not present serious problems when the particular directive being treated as a legally binding rule is consistent with the statute and regulations. Not all of the directives are consistent, however.

To the extent that the directives are inconsistent with these statutes and regulations, a court is not likely to enforce them. Otherwise, if they can be fairly deemed to interpret ambiguous or incomplete provisions in the statutes and regulations, there is the possibility that a court may defer to them under one or the other of the deference doctrines announced in *Christensen v. Harris County*<sup>4</sup> and *Stinson v. United States*.<sup>5</sup>

In the broadest sense, payment limitation and payment eligibility law serves the three basic functions of limiting (a) the dollar amount of certain farm program payments a "person" can receive in a crop or fiscal year; (b) the number of "entities" through which an individual may receive payments; and (c) payment eligibility to "persons" who are "actively engaged in farming."

The per-person dollar limits are program-specific. The following table sets forth the current limits for the most economically significant programs:

Program Payments	Limit
Production flexibility contract payments	\$40,000 <sup>6</sup>
Marketing assistance loan gains <sup>7</sup> and loan deficiency payments	\$75,000 <sup>8</sup>
1998 & Multi-Year Crop Loss Assistance Program	\$80,000
1999 & 2000 Crop Loss Assistance Program	\$80,000
Non-Insured Crop Disaster Assistance Program (NAP)	\$100,000
Conservation Reserve Program (CRP)	\$50,000

In addition to imposing per-"person" dollar limits on payments, payment limitation and eligibility law restricts the

number of "entities," such as corporations and limited liability companies, through which an individual may receive program payments. As discussed below, the rule imposing this limit is commonly called the "three entity rule." This rule is controversial because it permits the doubling of the payment limits.

Payment limitation and eligibility law also defines who may receive certain program payments. In other words, it imposes eligibility requirements. The general purpose of these requirements, particularly the rules limiting eligibility to individuals and entities "actively engaged in farming," is to prevent "passive" investors from receiving program payments. The "person" and "actively engaged in farming" rules are a central, but complex, feature of payment limitation law.

As a general rule, payment eligibility is limited to "persons" who are "actively engaged in farming." There are exceptions, however. The following table indicates which programs are subject to the "person" and "actively engaged in farming" rules:

Program	Applicable Rules
Production flexibility contracts	"Person" and "actively engaged in farming"
Marketing assistance loans (no gain)	Not applicable
Marketing assistance loan gains	"Person" and "actively engaged in farming"
Loan deficiency payments	"Person" and "actively engaged in farming"
1988 & 1999 crop loss assistance	"Person" only
Non-Insured Crop Loss Assistance	"Person" only
Conservation Reserve Program	"Person" and "actively engaged in farming"

The "person" and "actively engaged in farming" rules do not directly limit the number of "persons" who can qualify for payments from a single farming operation. To the contrary, they encourage farming by multiple-member general partnerships. Farming through a general partnership is the most effective way for multiple "persons" to receive payments from a single farming operation. In addition, the rules permit an individual to receive payments from up to three "entities."

Under the so-called "three entity rule," an individual who receives payments as

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an individual cannot receive program payments from more than two entities. An individual who does not receive payments as an individual may receive program payments from up to three entities, hence the name, "three entity rule."

The three entity rule allows the payment limits to be doubled. For example, assume that Farmer A farms as an individual. In addition, he holds a 50% interest in two limited liability companies, AB LLC and AC LLC.<sup>9</sup> Each of these LLCs has a farming operation that is separate from the other LLC's farming operation and from Farmer A's farming operation. Also assume that in his individual capacity Farmer A will receive the full limit of \$40,000 in production flexibility contract payments and the full combined limit of \$75,000 in marketing loan gains and loan deficiency payments. Each of the LLCs will also receive these amounts through their respective farming operations. Because Farmer A's distributive share is 50% of each LLC's payments, he will receive \$77,500 (\$20,000 + \$37,500) from each LLC. As a result, the \$115,000 he receives directly as an individual will be doubled by the amount he receives indirectly as a member of the two LLCs. The result would be the same for Farmer A if, instead of farming separately, Farmer A, AB LLC, and AC LLC farmed as a general partnership.

The three entity rule is not always used to double an individual's effective limit. To the contrary, it is most often used to capture a payment amount somewhere between the single limit amount and the doubled limit amount. For example, in a farming general partnership consisting of A, an individual, and AB LLC, a limited liability company equally owned by individuals A and B, A would be relying on the three entity rule to be eligible for payments up to 150% of a single limit.<sup>10</sup> Likewise, if the general partnership consisted of individual A, individual B, and AB LLC, both A and B would be using the three entity rule to receive payments directly as individual partners and indirectly through AB LLC.

The three entity rule does not limit the number of "persons" in a farming operation who are eligible to receive payments. In theory, a hundred-member general partnership could conduct a farming operation in which all of its members were "persons" who were "actively engaged in farming." Thus, the number of "persons" in a farming operation is primarily constrained by the practical difficulties associated with operating a farm with multiple "persons." These difficulties include coordinating farm program planning with tax, estate, and general business planning. Other difficulties include the problems that can arise from ceding control of the farming operation to others.<sup>11</sup> Nevertheless, farming operations

can be structured so that more "persons" receive payments than are in true control of the operation. Elaborate methods for doing this often use trusts as shareholders in multiple corporations which, in turn, form a general partnership to conduct the farming operation. In such a farming operation, the trustees (or the person who selected them), who are fewer in number than the number of "persons" in the farming operation, essentially control the farming operation.

For payment limitation and eligibility purposes, a "person" is separately entitled to receive payments up to the applicable limit. Thus, the terms "person" and "separate person" are sometimes used interchangeably. In the payment limitation and eligibility regulations, for example, the term "person" is usually synonymous with "separate person."

Individuals and certain common forms of business organization such as corporations, limited liability companies, limited partnerships, and trusts may be "persons." General partnerships, joint ventures, and cooperative marketing associations, however, are not eligible for "person" status. In addition, trusts, estates, charitable organizations, and states and their agencies may be "persons."<sup>12</sup>

General partnerships and joint ventures are called "joint operations" in the payment limitation and payment eligibility regulations. Joint operations may not be "persons." However, their individual members may be "persons." As a general rule, general partnerships and joint ventures are more advantageous for payment limitation and eligibility purposes than corporations, limited liability companies, and limited partnerships. While a corporation, limited liability company, or limited partnership will be only one "person" irrespective of the number of its shareholders or members, each of the partnership's or joint venture's members may be a separate "person" unless there is a "combination" of "persons" under one of the so-called "combination rules." Therefore, more "persons" are potentially available to a farming operation conducted by a general partnership than to a farming operation conducted by a corporation, limited liability company, or limited partnership.<sup>13</sup> Of course, one trade-off is that all of the members of a general partnership that conducts a farming operation will be jointly and severally liable for the partnership's liabilities under state law. This disadvantage can be mitigated to some degree by forming a partnership of single-member limited liability companies in lieu of individuals if state law permits single-member limited liability companies.

A separate "person" must (1) have a separate and distinct interest in the land or the crop involved; (2) exercise separate responsibility for such interest; and (3)

maintain funds or accounts separate from that of any other individual or entity for such interest.<sup>14</sup> General partnerships and joint ventures may satisfy these requirements on behalf of their members. Although these requirements are tersely worded, they are very important for their violation leads to payment ineligibility. If, for example, the personal funds of a general partner are commingled with the funds of the farming general partnership or vice versa, the partner will be denied "person" status.

Under a collection of payment limitation rules known as the "combination rules," some individuals are deemed to be too economically interdependent with other individuals or entities to be separate "persons." These combination rules deny separate "person" status to "persons" who would otherwise be eligible for a separate limit.

For example, a corporation and its shareholders are generally considered to be separate "persons." Thus, a corporation may receive program payments based on its fulfillment of the "person" and "actively engaged in farming" requirements, and its individual shareholders may receive program payments from separate operations in which they are "persons" who are "actively engaged in farming." So long as none of the shareholders holds more than a fifty percent interest in the corporation, the corporation's and each shareholder's payments will be separately limited. If, however, one of the corporation's shareholders holds more than a fifty percent interest in the corporation, one of the "combination" rules will "combine" the corporation with the majority shareholder.<sup>15</sup> When this combination occurs, the corporation is subject to the same limit as the majority shareholder. If the majority shareholder has already reached his or her payment limit, the corporation will not be eligible to receive payments. For this reason, farming operations seeking to "maximize" program payments must pay careful attention to the combination rules.

One or more combination rules apply to corporations and similar limited liability entities,<sup>16</sup> trusts,<sup>17</sup> estates,<sup>18</sup> spouses,<sup>19</sup> minor children,<sup>20</sup> governmental bodies,<sup>21</sup> and charitable organizations.<sup>22</sup> These rules must be carefully considered in farm program planning. On occasion, a farming operation might be structured in a manner that will result in one or more combinations because the loss of payments to the resulting combined person(c) will be offset by other gains.

Of all the combination rules, the general rule combining spouses has produced the most controversy, including litigation in which the combination of

*Continued on p. 6*

PAYMENT LIMITATION/Cont. from p. 5 spouses was upheld.<sup>23</sup> The general rule is that spouses are one "person."<sup>24</sup> There are two exceptions. The first and more longstanding exception applies to spouses who farmed separately before their marriage and who continue to farm separately after their marriage.<sup>25</sup> Very few spouses can satisfy the requirements of this exception.

The second exception was authorized by the 1990 farm bill, and it took effect in the 1991 crop year. Under this exception, a husband and wife may each be deemed to be separate "persons" if

(a) neither spouse has a "substantial beneficial interest"<sup>26</sup> (usually, but not necessarily, 10 percent or more) in another entity receiving farm program payments, and

(b) each spouse is a "person" who is "actively engaged in farming."<sup>27</sup>

This second exception limits the spouses to one payment limit each, and it precludes either of them from using the three entity rule. In other words, if each spouse is participating in a federal farm program they each must receive their respective payments directly, not indirectly, to avoid their combination into one "person." Thus, if H and W each farm separately or as partners, neither can have a "substantial" interest in a farming entity that participates in a farm program through which he or she receives payments indirectly.

Spouses who seek separate "person" status typically farm in a general partnership or a joint venture either as co-partners or in partnership with others. Depending on how they conduct their operation, they may be able to claim equal shares in the partnership or joint venture.

As a general rule, only "persons" who are "actively engaged in farming" are eligible for program payments.<sup>28</sup> The "actively engaged in farming" requirement is intended to distinguish "active" participants in a farming operation from those who are merely "passive" investors.

The "actively engaged in farming" requirement is grounded on the notion that "real farmers" contribute land, capital, or equipment *and* labor or management to their farming operation. It also incorporates the notion that a "real farmer" will make contributions to the farming operation in proportion to his or her share of the operation's profits and losses and that these contributions will be subject to farming's economic risks. Accordingly, the generally applicable "actively engaged in farming" requirement has three constituent elements:

To be "actively engaged in farming," a "person" must directly make to the par-

ticular farming operation

1. a "significant contribution" of (a) land, capital, equipment, or a combination thereof, *and* (b) "active personal labor," "active personal management," or a combination thereof; *and*
2. the "significant contributions," together with other qualifying contributions, must be "commensurate" with the individual's claimed share of the profits and losses of the farming operation; *and*
3. the contributions must be "at risk."

An individual who farms as an individual (i.e., as a sole proprietor) usually has to satisfy all three of these contribution requirements. However, members of a general partnership or joint venture do not have to make individual "significant contributions" of land, capital, equipment, or a combination thereof. Instead, the general partnership or joint venture may make the contribution for each of them.<sup>29</sup> Otherwise, any member seeking to be deemed "actively engaged in farming" must contribute the requisite quantity of the qualifying input(s) to the partnership's or joint venture' farming operation.

With respect to corporations and other limited liability entities, the entity must make the "significant contribution" or one or more of the qualifying inputs.<sup>30</sup> The same is true for trusts and estates.<sup>31</sup>

Subject to the landowner exception,<sup>32</sup> individuals who seek to be deemed "actively engaged in farming" must make a "significant contribution" of "active personal labor," "active personal management," or a combination thereof. Likewise, individual members of a general partnership or a joint venture must personally make such a contribution.

"Entities," on the other hand, are incapable of contributing personal services. Therefore, corporations, limited liability companies, and limited partnerships seeking to be deemed to be "actively engaged in farming" must have one or more of their shareholders or members having a single or combined interest of at least fifty percent make the requisite quantity of the qualifying services.<sup>33</sup> A similar rule applies for trusts with respect to the income beneficiaries.<sup>34</sup> With respect to estates, either the personal representative or the heirs must collectively "activate" the estate by contributing the requisite labor and/or management.<sup>35</sup>

"Active personal labor" and "active personal management" are defined to include hired services.<sup>36</sup> Shareholders in a corporation or members of a limited liability company or limited partnership, however, may be paid for their labor and management without disqualifying their services from being considered as a "sig-

nificant contribution" of "active personal labor" or "active personal management."<sup>37</sup> On the other hand, partners cannot receive a guaranteed wage or salary by the partnership for their labor or management. If they are paid, none of their labor or management will qualify as a "significant contribution" of "active personal labor" or "active personal management." Partners must be compensated only through their partnership "draws" or distributive shares.

"Active personal management" need not be performed on the farm.<sup>38</sup> Thus, a person can contribute "active personal management" while residing on New York City's Fifth Avenue.<sup>39</sup>

In general, a "significant contribution" of land, capital, or equipment is a contribution equal in rental value (land and equipment) or cash value (capital) to fifty percent of the contributor's commensurate share of the total value of those respective inputs necessary to conduct the farming operation. When these inputs are contributed in combination, the applicable percentage is thirty percent.<sup>40</sup>

A "significant contribution" of "active personal labor" is 1,000 hours (one-half of a year's worth of 40-hour workweeks) or at least fifty percent of the hours necessary to conduct a farm comparable in size to the individual's share of the farming operation. A "significant contribution" of "active personal management" is a contribution that is "critical to the profitability of the farming operation, taking into account the individual's or entity's commensurate share in the farming operation." A somewhat similar standard applies when labor and management are contributed in combination.<sup>41</sup>

"Significant contributions" of land and equipment can include owned or leased land or equipment, and owned or borrowed capital.<sup>42</sup> However, if the land, equipment, or capital was acquired through a loan made, guaranteed, or secured by an individual or entity with an "interest in the farming operation"<sup>43</sup> its contribution cannot qualify as a "significant contribution."<sup>44</sup> Nonetheless, such contributions may be included in the "commensurate" contribution calculation if certain requirements are met.<sup>45</sup>

The so-called "financing rules" that prohibit contributions of capital, equipment, or land from being deemed "significant contributions" if they were acquired through a loan made, guaranteed, or secured by someone with an "interest in the farming operation" often present difficulties. For example, assume individuals A and B farm as a general partnership. By virtue of the definition of "interest in a farming operation," they each have an interest in the partnership's farming operation.<sup>46</sup> Also assume that the partnership will borrow, in its name, all of the capital needed to fund its fam-

ing operation, including the funds required to lease the necessary equipment and land. If either A or B guarantee the loan to the partnership or secure it with their personal assets, the partnership's contributions of capital, equipment, and land would not qualify as "significant contributions."<sup>47</sup>

Although the so-called "financing rules" often present difficulties, there are various ways to work through these difficulties. The best solution is to avoid a problem with a financing rule altogether by making sure that no one with an "interest in [the] farming operation" is involved in the financing leading to the acquisition of the input. If this cannot be done, an alternative is to satisfy the "significant contribution" of capital, equipment, or land with the contribution of an input whose acquisition is not "tainted" by a financing rule violation. For example, if a lender insists on personal guarantees by the members of a general partnership for a loan to the partnership, the partnership's contribution of this capital will not qualify as a "significant contribution." However, the partnership may still be able to make the requisite "significant contribution" of an input or a combination of inputs by contributing equipment or land or a combination of both whose acquisition was not funded by the "tainted" capital borrowed from the lender. Another option is to persuade the lender to make two loans to the farming operation, one of which was not guaranteed by the partnership's individual members. So long as the loan that was not guaranteed results in a contribution of at least fifty percent of the capital needed by the partnership for the year's farming operation, this contribution of capital would qualify as a "significant contribution" of capital.

The two components of the "significant contribution" requirement are often called the "left-hand side" (the physical inputs of land, capital, or equipment) and the "right-hand side" (the human services of labor or management). When the farming operation is conducted through a general partnership, the partnership may make the left-hand side contributions on behalf of the partnership's members. When it does, the contributions are attributed proportionally to each member for "commensurate" contribution purposes. When the farming operation is conducted by a corporation or similar entity, the corporation or similar entity makes the left-hand side contributions, and the shareholders or members with at least a fifty percent interest in the corporation "activate" the corporation by making the "active personal labor" or "active personal management" contributions.

To illustrate how the "actively engaged in farming" requirements apply in an

artificially simple hypothetical, consider the case of a husband and wife who farm as a general partnership. They began farming together after their marriage, and they participate in the production flexibility contract program. Neither spouse has an interest in any other farming operation that receives farm program payments.

All of the land farmed by the partnership is owned by the partnership. The same is true for the needed equipment, and all of the necessary capital is borrowed by the partnership. The husband contributes 100 percent of the labor and fifty percent of the management. The wife contributes fifty percent of the management. Finally, for purposes of this example, assume that all of the respective contributions of land, equipment, capital, labor, and management have an equal per-unit rental or other value, as applicable to the input or service.<sup>48</sup>

In this example, both spouses have satisfied both "sides" of the "significant contribution" requirement. The partnership satisfied the "left-hand side" for each of them, and they individually satisfied the "right-hand side."

Can the husband and wife claim equal shares in the farming operation? No. Their respective commensurate shares of the contributed land, capital, and equipment are equal because these inputs were contributed at the partnership level and thus are deemed to have been made equally between them. However, their respective contributions of labor and management are not equal. If the wife claims more than twenty-five percent of the farming operation's profits and losses, her contributions will not be "commensurate" with her claimed share of the profits of the partnership because she has only contributed twenty-five percent of the total contributions of labor and management to the farming operation. Consequently, she will be denied all farm program payments, and her husband will not be entitled to receive what would have been her share.

Assuming that their respective contributions are "at risk," both the husband and wife will be "actively engaged in farming" if he claims a seventy-five percent interest in the partnership, and she claims a twenty-five percent interest. As a result, assuming that their farm will produce exactly \$80,000 in production flexibility contract payments, they will be leaving \$20,000 "on the table" because the husband's partnership distributive share right to \$60,000 of those payments will be capped at \$40,000 by the production flexibility contract payment limit. As a couple, they will receive \$60,000: she will receive \$20,000, and he will receive \$40,000. This result is still a gain of \$20,000 over what their farming op-

eration would have received if they had been "combined" under the general combination rule for husbands and wives.<sup>49</sup>

Among other things, this example illustrates that each partner's "actively engaged in farming" status is separately determined. The problem this couple encountered with the "commensurate" contribution requirement would be compounded if only one spouse, instead of the couple's partnership, owned or leased the land or equipment. In that case, the other spouse would have to acquire and contribute an equal amount of land or equipment if they wanted to have seventy-five percent/twenty-five percent shares based on the contributions of labor and management assumed in this example.

The "actively engaged in farming" requirements are relaxed for landowners,<sup>50</sup> family members,<sup>51</sup> and sharecroppers.<sup>52</sup> Under the "landowner rule," a person who owns an interest in land and who receives rent or income for the use of that land based on the land's production or the farming operation's operating results is automatically deemed to be "actively engaged in farming."<sup>53</sup> Such an arrangement is usually called a crop share lease.<sup>54</sup> The use of custom farming services may also qualify a person as a "landowner."

"Landlords," on the other hand, may never be deemed to be "actively engaged in farming."<sup>55</sup> A "landlord" is a person who receives a guaranteed return on the land's use, whether payable in cash or in a fixed quantity of the crops. Such an arrangement is usually called a cash lease.<sup>56</sup>

On the other hand, cash rent tenants can receive payments. Cash rent tenants are persons who rent land for cash or for a crop share guaranteed in amount.<sup>57</sup> To be "actively engaged in farming," a cash rent tenant must make a "significant contribution" of (1) land, capital, or equipment and active personal labor; or (2) equipment and active personal management. If the cash rent tenant seeks to qualify under option 2 and the equipment is leased from the landlord, the lease must reflect payment of the equipment's fair market value. If the equipment is leased from the person who is providing labor to the farming operation, the equipment lease and the labor fees must be based on fair market values, and the cash rent tenant must exercise complete control over a significant amount of the equipment during the crop year.<sup>58</sup> In some instances, program participants who believed they were qualifying under option 2 above, and who leased equipment from the same individual who provided hired labor, have been denied payments because their attorneys drafted equipment leases that included a provi-

*Cont. on p.2*