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INSIDE

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IN FUTURE ISSUES

Constraints on PCA challenge to state taxation

The U.S. Supreme Court recently addressed the significance of the "United States instrumentality" status granted entities in the Farm Credit System. The Court held in *Arkansas v. Farm Credit Services of Central Arkansas*, ___U.S.___, 117 S.Ct. 1776, ___L.Ed.2d___ (1997), *reversing*, 76 F.3d 961 (8th Cir. 1996), that Production Credit Associations' (PCAs') status as instrumentalities of the United States does not exempt them from Tax Injunction Act constraints. 28 U.S.C.§ 1341. The Tax Injunction Act provides that district courts cannot enjoin assessment or collection of taxes imposed by state law. A judicially created exception removes that constraint when the United States sues to protect itself or its instrumentalities from state taxation. *Department of Employment v. United States*, 385 U.S. 355, 87 S.Ct. 464, 17 L.Ed.2d 414 (1966).

The Farm Credit Act of 1971 exempts PCAs from state taxes on their "notes, debentures, and other obligations" (12 U.S.C. § 2077) and designates PCAs "instrumentalit[ies] of the United States." (12 U.S.C. § 2071(b)(7)). Farm Credit Services argued that PCAs should be immune from Arkansas sales and income taxes as well. It sought declaratory judgment and injunctive relief in a federal district court.

The Supreme Court held that although PCAs are defined as United States instrumentalities, they are not the kind of instrumentalities that can, without joining the United States as co-plaintiff, avoid the jurisdictional restrictions of the Tax Injunction Act. Important consequences flow from instrumentality status but such entities can "enjoy the benefit and immunities conferred by explicit statutes... without the further inference that the instrumentality has all the rights and privileges of the National Government." PCAs resemble private entities distinguishable from government agencies that have regulatory or other powers associated with governmental authority. "[PCAs'] interests are not coterminous with those of the Government any more than most commercial interests."

Because PCAs do not fit within the judicially created exception to the Tax Injunction Act, the district court lacked jurisdiction to enjoin Arkansas from applying its sales and income tax laws to PCAs. The Court did not reach the immunity issues raised by the PCA.

—James R. Baarda, The Ackerson Group, Washington, D.C.

A fresh approach to putting new farmers on the land

This past week we had house guests—Louis Lorvellec, a French agricultural law professor and his wife Soizic, a legal scholar. Louis directs a graduate program on food and agribusiness law at the University of Nantes in the west of France. Each summer for six years I have taught a course to his students on American agricultural law and policy and almost every year he comes to Drake [University, Des Moines] to teach our students about European law. This summer his class examined the relation between the World Trade Organization and agricultural trade.

One of the many pleasures of visiting France is being in a society which appreciates high quality locally produced food and which understands the importance of supporting a diverse farm economy. France is very concerned about preserving rural life as part of its national identity and has implemented various programs to help do so. While some of their approaches may have limited application here— for example we will probably not see labels of origin for soybeans raised in Adams county (though we might see Muscatine melons)—other French concepts have potential application.

One of the most intriguing French legal institutions—both because of the power of the concept and what it says about the commitment to people—is SAFER or *les*

Continued on page 2

societes d'amenagement foncier et d'etablissement rural—roughly translated as the society for rural planning and resettling farms. The institution, now owned and financed as a non-governmental cooperative, was created in 1960 under President de Gualle with start-up funding from the national government (a history not unlike our farm credit system). In simplest terms, SAFER functions as a potential purchaser whenever farmland is put up for sale anywhere in the nation. The purpose of SAFER is to help new farmers buy land and to assist people already farming—such small farmers—acquire additional land to be successful. French agriculture faces many of the same problems as American agriculture. The farm population is aging and for each new farm started, five farmers retire. Our challenges are similar—how to give young people with little money access to land and help retiring farmers pass on their farms, all while limiting conversion of farmland to non-agricultural uses.

SAFER helps France meet these challenges in a fairly simple and direct manner. Whenever owners of farmland want to sell, under national law they must notify the local agency of SAFER. It then has sixty days to decide whether to purchase the land at the price the owner is asking. The frequency of SAFER purchases varies by region and depends on whether there are new farmers waiting to buy. Most sales to SAFER are voluntary but by law it can decide to pre-empt a sale for seven reasons. The first is to resettle new farmers while the second is to bring a neighboring farm up to the size set hy local agricultural development authorities. Another objective is to prevent the separation of farmland from the buildings and houses. [Under French law tenants, family members, and workers have a right to buy the land even before SAFER!] If the SAFER does not exercise its option then the sale can go through. If SAFER does buy a farm but has not sold it within five years the former owners can sue to annul the purchase. After 35 years in existence SAFER has been involved in the sale of about 2% of all the farmland in France.

Could we benefit by having a law like SAFER to give local authorities the right to purchase and resell land to new farmers? No doubt the reaction by many to this idea will be "It's a socialist intervention in the free market and violates our American ideal of the free alienability of land." But we already place restrictions on who can buy farmland—for example a 1980's reform of mortgage foreclosure law gives some former owners the right to repurchase their land if it is resold and under Iowa's anti-corporate farming law certain businesses cannot own farmland. Several state programs assist people buying farms—most notably the agricultural development authority's "aggie bond" program and "Farm-On," which matches retiring farmers with young people. Innovative private efforts such as "AG Connect" are helping people make these connections. All the French have done is tie their effort to put new people on the land with an effective legal device to insure that when farms come on the market, society has some ability to shape the future of rural life. At a 1995 national SAFER conference in Le Mans, Christine Lambert, President of the National Young Farmers, said her members "want more neighbors not more acres." One reason we will probably never adopt more active approaches to shape rural society, such as SAFER, is because most American farmers (and landowners) would answer that question the other way.

—Neil D. Hamilton, Director,
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Letters and editorial contributions are welcome and should be directed to Linda Grim McCormick, Editor, Rt. 2, Box 292A, 2816 C.R. 163, Alvin, TX 77511.

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An Analysis of Off-Exchange Commodity-Based Instruments, 41 Bus. Law. 853 (1986).

[45] Cole, supra note 22, at 254.

[46] Report to Congressional Committees, supra note 35, at 20.

[47] 959 F. Supp. 428 (W.D. Mich. 1997).

[48] 18 U.S.C. §§ 1962(a), 1962(c)(1994).

[49] [1997] Comm. Fut. L. Rep. (CCH) ¶26,691 (CFTC May 15, 1996).

[50] For an analysis of this guidance letter based on the work of task force of the National Grain and Feed Association (NGFA), see Barrett, supra note 32, at 169-74.

[51] Christopher R. Kelley, CFTC issues "hedge-to-arrive" contract policy and guidance statements, 13 Agric. L. Update 4 (June, 1996).

[52] Susan A. Schneider, Hedge to arrive contracts in Chapter 12 bankruptcy, 13 Agric. L. Update 4 (Oct. 1996)(includes discussion of HTA contracts as executory contracts).

[53] Remedies for shorted bailors (warehouse operation) and unpaid sellers (grain dealer operation) in elevator bankruptcies are discussed at Pedersen and Meyer, Agricultural Law in a Nutshell 217-25 (West 1995).

[54] Cole, supra note 22, at 253-54.

[55] Trade Options on the Enumerated Agricultural Commodities 62 Fed. Reg. 31,375 (1997)(advance notice proposed rulemaking for 17 C.F.R. pt. 32); See CFTC seeks comments on ag trade options, 69 Feedstuffs 3 (June 16, 1997). Note that off-exchange trade options on most nonagricultural commodities are permitted. Notice of Public Meetings, 62 Fed. Reg. 33,379 (1997)(on CFTC/Div. Econ. Analysis Study Policy Alternatives Relating to Agric. Trade Options and Other Agric. Risk Shifting Contracts. http://www.cftc.gov/ag8.htm.)

[56] CFTC: ag trade options plan in works, Ill. AgriNews A10 (June 6, 1997).

[57] See Heather Jones, CFTC suggests regulatory options for lifting ban on ag trade options, 69 Feedstuffs ___ (June 9, 1997).

[58] For an argument in favor of lifting the ban on ag trade options, see Barrett, supra note 32 at 177-79.

[59] Jean Caspers-Simmet, FB offers new 'safety net' for Iowa crops. AgriNews A1 (Dec. 12, 1996).

[60] In 1997, the Indiana legislature amended an existing grain statute to require all contracts after 6-30-97 for the purchase of grain from producers, except flat price contracts, to include a cautionary notice about risks of future payments to maintain the contract, a lower sales price, unspecified risks and other matters. Ind. HEA 1915, Sec. 19, Pamph. 2C, Burns 1997 Advance Leg. Ser.

Cooperative tax decision suggests re-assessment

A simple transaction between a cooperative and its patrons has yielded a judicial decision that casts some doubt on the "single tax" principle running throughout the cooperative-patron relationship. The single tax principle usually associated with cooperatives' patronage refund systems may not be as clearly defined as once thought, at least in the Eleventh Circuit.

Subchapter T (I.R.C. §§ 1381-88) allows a cooperative to deduct patronage refunds allocated and paid to patrons on a patronage basis generated from business done with or for those patrons. This same principle applies when part of the patronage refund is paid in the form of cooperative equity with "qualified written notices of allocation" rather than cash. One condition for this treatment is that the patron consent to take the entire amount of the patronage refund into account for tax purposes whether received in cash or as cooperative equity. The cooperative's subsequent redemption of the equity (payment of cash for the equity) brings no tax adjustments to either the cooperative or the patron.

If the cooperative notifies the patron holding such an equity interest that redemption is in an amount less than the face value taken into account by the patron when issued, the patron recognizes a loss. The cooperative, on the other hand, had originally deducted the entire amount because it was paid to the patron as a patronage refund. When equity is redeemed at less than face value, the cooperative has not "followed through" on the patronage refund process upon which the deduction and single tax system is based. The IRS argues that the problem is solved by applying the tax benefit rule to the cooperative. This requires the cooperative to recognize as taxable income the difference between the amount for which it claimed patronage refund deduction and the amount actually paid to patrons either as original cash payment or as cash redemption of qualified written notices of allocation.

In a recent decision the Court of Appeals for the Eleventh Circuit treated patronage refund and redemption as separate transactions and refused to apply the tax benefit rule to connect the two. *Gold Kist, Inc. v. Comm'r*, 110 F.3d 769 (11th Cir. 1997).

Gold Kist is a corporation operating on a cooperative basis subject to Subchapter T. In prior years, it paid patronage refunds in equity form as qualified written notices of allocation, claiming a deduction for the face amount. Patrons agreed to take that amount into account for income tax purposes. Under certain defined circumstances, Gold Kist subsequently redeemed the equity at a discount based upon expected time to redemption, defined discount rates and other factors. The difference between the patronage-based equity's face value and the amount paid in redemption was transferred from the patrons' allocated account and placed in unallocated cooperative "retained earnings."

The IRS contended that the tax benefit rule requires Gold Kist to include in its gross income the difference between the stated value of the written notices of allocation qualified under I.R.C. § 1388(c)(1)(B) and deductible under I.R.C. § 1382(b)) and the amount actually paid out to patrons. Gold Kist claimed that its original deduction was conditioned only on the patrons' agreement to account for the refund for tax purposes and that later discounting is not inconsistent with that premise. Gold Kist in fact contended that nothing requires any amount at all ever be paid out to the patron to support its original deduction. [Gold Kist also claimed that I.R.C. § 311(a) providing for non-recognition of income upon a corporation's redemption of stock for cash applied. The Tax Court (104 T.C. 696) had rejected that argument; the Circuit Court did not reach the issue.]

The judicially-created tax benefit rule is designed to correct transactional inequities created by annual accounting systems. According to the rule as detailed in *Hillsboro Nat'l Bank v. Comm'r*, 460 U.S. 370, 103 S.Ct. 1134, 75 L.Ed.2d 130 (1983), an initial tax reporting method can be corrected subsequently when an apparently completed transaction re-opens unexpectedly in a subsequent tax year that makes the initial tax reporting method fundamentally inconsistent with the premise upon which the deduction was originally based.

The court in Gold Kist held that the patronage refund transaction was completed upon the refund's payment and recognition by the recipient patron. "The statutory scheme created by Congress does not require the cooperative to guarantee that written notices of allocation qualified by consent pursuant to § 1388(c)(1)(B) will be redeemed at a certain time or at a certain amount." The transaction is complete, not to be reopened in subsequent years. The court added that when patronage refunds are paid in equity interests, the interests involved are no longer patronage refunds but are reinvestments in the cooperative. The court further noted that redemption at discounted value is not fundamentally inconsistent with the single tax principle because the time value of money undermines the equivalence of redemption at face value for twenty-year-old equity interests.

This ruling may have fundamental implications for the present generally-understood cooperative tax scheme as well as to the integrity of the Subchapter T single-tax doctrine's application to non-cash patronage refund payments. For example, a cooperative may pay patronage refunds in qualified written notices of allocation in year one and take a deduction for the full face value. Patrons consent to recognize the full amount of the refund for tax purposes, and the cooperative's books reflect an allocated equity account for each patron. In year two, the cooperative declares that the equity will never be redeemed, issues a qualified notice to that effect to equity-holders, eliminates the patron's allocated account and transfers the full amount to a retained earnings account. The patron recognizes a loss for the full amount of the equity not redeemed. The final result is that the cooperative retains the amount that would have gone to the patrons as patronage refunds through the redemption process, pays no tax on the patronage refund originally declared, and has a tax-free addition to its retained earnings account. Patrons recognize none of the income on the patronage refund received in equity because they claim a loss upon receiving the notice that the equity which they previously declared for income tax purposes will not be redeemed.

—James R. Baarda, The Ackerson Group, Washington, D.C.

Federal Register *in brief*

The following is a selection of items that were published in the *Federal Register* from July 24 to August 7, 1997.

1. Farm Service Agency; Disaster set-aside program—second installment set-aside; interim rule with request for comments; comments due 9/30/97. 62 Fed. Reg. 41,251.

2. Farm Service Agency; Handling payments from FSA to delinquent FSA Farm Loan Program borrowers; interim rule with request for comments; comments due 9/30/97. 62 Fed. Reg. 41,794.

3. FCIC; Ineligibility for programs under the Federal Crop Insurance Act; final rule; effective date 9/4/97. 62 Fed. Reg. 42,037.

—Linda Grim McCormick, Alvin, TX

Hedge-to-arrive contracts in the courts—part II©

By Donald B. Pedersen

NOTE: Part I of this article appeared in 14 Agricultural Law Update 1 (Aug. 1997) and included sections entitled: Troubled times; What are HTA contracts?; and Jurisdiction. Endnote numbering continues in this part II with number 20, and there are important references herein to the example of an HTA contract set forth in part I.

Legal theories

Much is at stake in the HTA contract litigation. Losses in the Corn Belt may exceed $1 billion—traceable in the final analysis to margin calls. Neil Harl has written that the "saga of hedge-to-arrive contracts promises to be the most traumatic phenomenon to hit the agricultural sector since the farm debt crisis of the 1980s."[20] Neil Hamilton is critical of elevators and farmers alike whose "greed," he suggests, has been a major factor in the "overuse and misuse" of "gimmicky" HTA contracts.[21] Others see the HTA crisis as one where many well-intentioned people, grain dealers and farmers alike, were simply trying to allocate economic risks in a legitimate commercial manner and got caught in a rare market swing. Whatever one's view, the financial future of many individual farmers is now in question. The solvency of an unknown number of grain dealers is threatened,and, in the case of certain cooperative elevators, equities of members are at risk.[22] And, some agricultural lenders face losses. How will the grain dealer against farmer cases play out substantively?

The procedural posture of litigants varies significantly in cases reported to date. In *North Central, F.S., Inc. v. Brown*[23],for example, the North Central elevator has sued for declaratory judgment to have its HTAs declared valid (exempt from regulation under the Commodity Exchange Act (CEA)), to declare farmers obligated to deliver corn, to win damages for repudiation and for lost revenues, to impose a constructive trust on corn, to correct unjust enrichment, and for other relief. Farmers have counterclaimed for declaratory judgment that the HTAs are illegal futures and void, for damages and rescission based on fraud under 7 U.S.C. § 6b, for rescission and actual and punitive damages for common law fraud, for actual and punitive damages for negligence, and alternatively for damages for breach of contract. In other cases, the farmers are plaintiffs, but the causes of action are essentially the same. In yet other cases,there may be allegations by grain dealers of contract rights to recover margin call payments, or allegations by farmers of grain dealer RICO violations, or wrongs by commodity brokers.[24] Some cases are being handled in arbitration, but with many of the same issues.[25] Certain cases are being pursued by farmers as reparations claims.[26] What follows is a brief look at some of the primary legal theories in these cases, often pleaded in the alternative.

Misrepresentation

In some instances, farmers, in defending against specific performance and damage claims brought against them, are basing their defense on alleged misrepresentations by the plaintiff grain dealer. Affirmative farmer claims for damages are also being so based. Such claims are very fact specific and require precise pleading. Actionable misrepresentations under state law may exist if there is proof that representatives of the grain dealer induced farmers to enter into HTA contracts, particularly those with roll-over features, by stating to farmers that "this is a way to enter the futures market without have to meet margin calls," or "the 2 cent roll-over fee covers any margin calls," or "it is perfectly safe to HTA contract for more than your production," or "your only risk is in the basis," or "you have no risk on the CBOT," or "multiple year HTAs are safe and excellent plans," or "if the cash market is higher than the HTA price you can sell in the cash market and there will be no problem," or "if you have the corn to cover your contract you have no real risk." Typically under state law, a claim of fraud or misrepresentation requires proof of a material representation, that such representation was false, that it was known to be false or made recklessly without knowledge of truth or falsity, made with the intent the hearer would act on it, and was so relied upon with resulting injury.[27] Remedies sought include rescission or cancellation of the HTA and actual and possibly punitive damages. As explained hereinafter, such claims could also be pursued under the CEA if the particular HTAs are not exempt as forward contracts.

Consider an argument based on the hypothetical facts drawn from the Agricultural Outlook article as set forth in Part I, of this article at 14 Agric. L. Update 2 (Aug. 1997). In Dec. 1995 when the farmer did his first roll-over, the grain dealer met the first margin call of .51 cents a bu. and rehedged (July 1996 contact). Had the farmer physically delivered in July 1996 rather than then rolling-over a second time, he would have gotten $2.61 per bu., but at a time when the local spot market was about $3.14. The second margin call, met by the grain dealer in July 1996, cost it $2.04 a bu. And the spread went against the farmer when the grain dealer rehedged in July 1996 (as happened in the real world). If the farmer had physically delivered for .91 cents in December 1996, this is the result. Assuming no further margin calls, the grain dealer, to come out of this whole, needed to recover .51 cents (first margin call), plus $2.04 (second margin call), plus its .21 cent basis, for a total of $2.76. In the physical transaction the grain dealer made about $2.80 by selling in the terminal market for an assumed $3.71 ($3.71 minus .91 paid farmer = 2.80). This assumes—for simplicity—that the grain dealer sold Dec. 1996 futures at $3.71 and bought back at $3.71. As demonstrated, the grain dealer ended up with $2.80 from the physical transaction which covered its two margin calls, its basis, and its twice-assessed .02 cent roll-over fee (.51 + 2.04 + .21 + .04 = 2.80).

Who had the ultimate risk of the margin calls when the HTA contract played out according to its terms after the second roll-over. As the facts just recited demonstrate, a strong argument can be made that the farmer always had that risk. Thus, any of the hypothetical *representations* enumerated above, if actually made by a grain dealer to a farmer who relied upon them, arguably could have been actionable misrepresentations. The grain dealer's response might be that since the farmer was never long or short in the futures market (e.g. CBOT), at least the statements that the farmer would not have to meet margin calls and would not be exposed on the CBOT were not false. Technically this may be so, but if the economic risks imposed on farmers in HTAs were based on price movements and spreads tied to CBOT, such representations arguably were misleading in terms of critical economic realities.

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Grain dealers in some cases will seek to prove that the litigant farmer had prior experience hedging in futures markets, had executed other HTA contracts, or both. Thus, the argument will be that such farmers knew and understood the mechanisms of HTAs and either knew or with a few minutes of calculations could have illustrated for themselves the risks that became reality. In such cases, the essential element of farmer reliance on grain dealer representations may be found to be missing. Feigned ignorance would be an inappropriate and dangerous litigation tactic for such farmers.

If the HTAs in a particular case are alleged to be illegal off-exchange futures, farmers could choose to base their fraud and misrepresentation claims on the CEA, or plead in the alternative under the CEA. The remedy under CEA for losses sustained as a result of fraud is money damages.[28] While rescission of the HTAs is not a remedy under the fraud section of CEA, it is an available remedy pursuant to the federal Declaratory Judgment Act.[29] This strategy is being pursued in the counterclaims of farmers in the *North Central F.S., Inc.* litigation.[30]

Would it make a difference if the grain dealer making the representations was a cooperative and arguably owed a fiduciary duty to member patrons? This, of course, suggests a distinct, though farm from well-recognized, cause of action.[31]

Absence of delivery term

In some instances, farmers may argue, based solely on state law, that they have no contractual obligation to deliver under particular HTA contracts. Several scenarios are theoretically possible: the HTA contract is so sketchy as to lack enforceable language[32]; the HTA contract is for more quantity than farmer could possibly produce during the crop year thus undercutting any suggesting of an intent of the parties that there be mandatory physical delivery; or the contract contemplates indefinite roll-overs. If there is no contractual obligation on the farmer to deliver physical commodities, the farmer has an obvious defense to an action for specific performance or for damages for breach for failure to deliver. In this context, resolving whether or not the particular HTA contracts are illegal off-exchange futures contracts would not be essential to the farmers' case. But, within these suggested fact patterns are hints of illegal agricultural options.

If the contract is silent on time of delivery or has no apparent limits on roll-overs, there is a good chance that the grain dealer will nevertheless seek to enforce physical delivery on one of a number of theories: implied reasonable time to perform; "good faith" requirement; or past course of dealing of the parties. What becomes interesting at this point is whether a court will go along with any of these arguments—if otherwise available in the law of the jurisdiction—if the particular HTA is found to be an illegal off-exchange futures contract, as explained in the following section of this article.[33]

Some HTAs have specific clauses allowing farmers to cancel rather than do physical delivery. Such clauses typically have a per bu. cancellation fee, perhaps 5 cents, and a requirement that the farmer cover losses to the grain dealer resulting from rolling, less rolling fees. Even if the HTA is found not to be an unenforceable illegal off-exchange futures or option contract, there is a potential repudiation of contract issue if the grain dealer refuses to accept further roll-overs and demands a cash settlement—absent a specific contract right to do so.[34]

The fact patterns in these cases vary significantly, in part because there is little consistency in terms in HTA contracts and in part because the actual conduct of the parties often varies markedly from their written contracts. Thus, outcomes cannot be predicted just because there is an initial determination that an HTA is involved.

Illegal off-exchange futures contracts

If certain HTA contracts are found to be illegal off-exchange futures contracts, what are the ramifications? Since 1921, contracts for "future" delivery of commodities have been required to be traded on designated exchanges overseen by the Commodity Futures Trading Commission (CFTC) and self-regulated by the exchanges themselves. Off-exchange trading of futures is illegal unless the CFTC has used its statutory exemptive authority.[35]

From the perspective of the grain dealer and others who may have promoted illegal off-exchange futures contracts, there can be problems with the CFTC Division of Enforcement, which may administratively seek cease and desist orders and the assessment of civil and criminal penalties.[36] From the perspective of farmers caught in demands to deliver under HTA contracts, the strategy might be to argue that the cash forward contract exclusion in the CEA is inapplicable and that the particular HTAs, as illegal off-exchange futures contracts, should be avoided and not enforced as a matter of public policy. As David Barrett points out in his article: "...it is a general rule of contract law that agreements involving promises that are otherwise illegal or immoral are not enforceable."[37] Of course, illegality does not always equal unenforceability, particularly under the Restatement view.[38] The challenging issue is whether the public policy concerns will be deemed strong enough to let a farmer who up front fully understood the risks of rolling over an HTA (assumed here to be an illegal futures contract) will simply get to walk away from the deal he initiated and let the financial loss fall totally on the grain dealer.

Some HTA contracts may fall within the definition of cash forward contracts and thus be exempt from federal regulation. The CEA provides that "[t]he term 'future delivery' as used herein shall not include any sale of any cash commodity for deferred shipment or delivery."[39] The CFTC in 1979 in *In re Stovall* set out factors it will consider in distinguishing cash forwards from futures.[40] Futures contracts are those "entered into primarily for the purpose of assuming or shifting the risk of change of value of commodities."[41] Cash forward contracts serve the purpose of "transferring ownership of the actual commodities."[42] Norm Thorson points out in the context of *Stovall* that "[f]actors which might result in a purported cash forward contract being denominated a future include the identity of parties to the contract, whether or not the contract terms are standardized, and whether delivery obligations are generally performed or whether offset is the rule."[43] However, as one court has put it, "no bright-line definition or list of characterizing elements is determinative."[44]

As to HTA contracts, the applicability of the exclusion will have to resolved case-by-case. If no delivery obligation is found to have been imposed on the farmer, the probability is strong that the contract is an off-exchange futures contract or option, not a cash forward contract. The more interesting issue is whether flex-HTAs that allow roll-overs into the succeeding crop year or years, but that require eventual physical delivery, could nevertheless be illegal off-exchange futures contracts.

The argument for a "yes" (illegal—cash forward exclusion inapplicable) answer might proceed like this. When roll-overs actually occur, the "hedge" transaction that is closed out by the grain dealer actually turns into a speculative transaction because there is no physical transaction associated with it. Thus, the margin call, if one there be, results in speculative losses that, as in the hypothetical HTA contract from Agricultural Outlook (Part I, *supra*), are eventually passed on to the farmer—though disguised in the spread. It is only in the physical transaction resulting after the final roll-over (second roll-over in the hypothetical) that the true characteristics of a cash forward

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contract are present. When physical delivery ultimately results, the argument goes, the overriding effect of the entire HTA will not have been to give the farmer up front assurance of a price, but to allow the farmer the option to indirectly win (or lose) in speculative transactions. The fact that the parties to the HTA may not have so characterized their contract cannot erase the fact that futures markets are not predictable and that an up-front analysis of different market scenarios at the time of HTA contract formation would have revealed the speculative risk associated with roll-overs. Neither party, the argument continues, expected delivery if the spot market was unexpectedly high at the point of choice between physical delivery and roll-over, and it is exactly in this setting that the decision to roll-over exposed the farmer to speculative risk. That being the case, the argument is that the contract falls outside the "narrow reading" of the cash forward exclusion and falls into the category of transactions where the Congressional missions of the CEA come into play—to authorize markets, to require full disclosures, and to require timely margin calls directed to the party at risk. Put another way, even if an eventual binding delivery obligation existed in an HTA, the losses sustained in connection with individual roll-overs arguably are essentially the same as had there been no delivery obligation.

The argument for a "no" answer (not an illegal off-exchange futures) under the same hypothetical would focus heavily on the physical delivery requirement; the chance for the farmer to benefit under most HTAs from a narrowing basis; evidence that the parties were capable of making and taking physical delivery; the nonstandard nature of the contracts; the reality that the farmer could have elected never to roll-over to a new crop year and could have made physical delivery as in any standard cash forward contract; the reality that once the farmer decided to roll-over, the farmer typically profits in the cash spot market and simply has a new cash forward obligation with a recalculated price; and the fact that the farmer is never forced into a recalculated price but so opts knowing that price as well as the immediate benefit of a sale of the commodity in the spot market. The "no" (not illegal) answer might be bolstered if the evidence in the particular case shows the farmers intended to roll-over *only* and in fact rolled-over *only* when the basis had failed to narrow as expected or anticipated production fell short. It might further be bolstered if the HTA contained no contractual right in the farmer to offset, as opposed to making eventual actual delivery. And the "no" (not illegal) argument might get a strong boost if it is demonstrated that under the contract between the parties, roll-overs could take place only if requested by the farmer and individually agreed to by the grain dealer on a case-by-case basis. However, the "no" argument could fall apart if prior to committing to roll-over, the farmer is not informed of the recalculated HTA contract price.

In his article, Matthew Cole has summed up as follows: "Even contracts with a rolling provision may be legal as long as actual delivery of grain is specified; however, some long rolling provisions may be illegal regardless of delivery. According to some, even rolling into the next crop year is speculative because crop years act independently of each other. Others feel that the market can be predicted one or two years ahead, and hence only the longer rolling periods are speculative. A speculative HTA usually will have such faults with delivery or rolling. Courts may assert that unpredictable events such as weather or pest infestation may make rolling beyond the current crop year speculative."[45]

The GAO has concluded: "CFTC or a court could find some hedge-to-arrive contracts or other variations on agricultural forwards to be futures or agricultural trade options. Either finding could make them illegal and unenforceable, provided the contracts did not qualify for the swaps exemption."[46] Swaps are private contracts that require counterparties to make payments to each other based on certain calculations over a specified period. The CFTC swaps exemption allows exempted swaps to trade legally outside regulated exchanges, subject however to certain antifraud provisions. Exempted swaps require among other things eligible participants, and it is doubtful that most farmers who entered into HTAs so qualify.

RICO

In *Eby v. Producers Co-op, Inc.*[47] farmers allege that grain dealer engaged in mail fraud and wire fraud, "predicate acts" for RICO claims.[48] Farmers claim that grain dealer sent the HTA and roll-overs through the mail and confirmed futures contracts the same way. It also is alleged that telephone lines were used to effectuate HTA contracts as well as futures transactions on the Chicago Board of Trade. These claims were dismissed by the district judge under Rule 12(b)(6) because mail and wire fraud had not been pleaded with sufficient particularity—the what, when, and how of each act were not set forth, just legal conclusions.

The judge in *Eby* also noted that to establish an 18 U.S.C. § 1962(c) RICO violation, a civil plaintiff must prove conduct of an enterprise through a pattern of racketeering activity. Farmers failed to sufficiently allege that the grain dealer participated in the farmers' production operations. The judge also noted that farmers had not stated a viable § 1962(a) claim because they did not plead a separate and traceable injury stemming directly from the grain dealer's alleged use or investment of the illegally obtained income from the alleged RICO enterprise. Whether RICO will work for any farmers in HTA cases remains to be seen—but farmers who fully performed at great loss under rolled over HTAs might try very detailed RICO pleadings as a possible avenue into federal court.

CFTC 1996 Interpretive Letter

This discussion would not be complete without mention of CFTC Interpretive Letter No. 96.41.[49] Dated May 15, 1996, it recognizes the existence of disputes over many HTA contracts and seeks to encourage settlements by "provid[ing] certainty to producers and elevators that cash payments may be used, in whole or in part, to unwind, or in connection with a work-out or the restructuring of, certain existing contracts for the delivery of grain, where the parties have mutually agreed to do so through a separately-negotiated settlement, entered into subsequent to entry into the original contract." In other words, the status under federal law of HTA contracts in existence as of May 15, 1996 will not be determined *by CFTC* using the failure to make physical delivery and the ensuing settlement by the parties as evidence of illegal off-exchange futures.

The same Letter includes a Statement of Guidance from the CFTC Division of Economic Analysis indicating that contracts that adhere to and do not materially deviate from stated principles should in its opinion be construed to fall within the forward contract exclusion of the CEA: (1) require mandatory delivery, absent an intervening event such as a crop failure, of a specified quantity and grade of grain at a specified location and reference price by a specified date with the crop-year during which the crop is harvested; (2) be for a quantity to be delivered which is reasonably related to the producer's annual production, not committed elsewhere and normally available for merchandizing and at a location whereby delivery can be made by the producer under normal merchandizing practices; (3) specify a delivery date and futures contract month reference price which coincides with the crop-year during which the grain will be harvested; and (4) permit, where such contracts include provisions allowing the "rolling" of reference prices, that reference prices only be rolled sequentially from a nearby to a more deferred futures contract month in the same crop-year within which the grain is, or will be harvested, to reflect the production and inventory-carrying na-

ture of the cash position.[50]

The CFTC Statement then sets out reference months by crop years for various commodities. Caveat. It must be observed that these tests are not going to have an impact on HTA litigation involving contracts made prior to May 15, 1996. The Statement is an after-the-fact declaration, not tied to any specific set of facts, and interpretive only. For a helpful legal commentary on the entire Interpretive Letter, see Chris Kelley's in depth article in the June 1996, Agricultural Law Update.[51]

Legal side effects of the HTA crisis

Legal side-effects of the HTA crisis are already being felt, but it is beyond the scope of this article to explore them. How shall HTA contracts be handled in farmer bankruptcies? Susan Schneider has written about this in the October 1996 issue of *Agricultural Law Update*.[52] How many elevator failures will occur—resulting in take-overs or complex bankruptcies?[53] Is the refusal of a farmer to perform under an HTA or to amicably settle claims grounds for expulsion when the grain dealer is a cooperative? Can cooperatives deny membership to farmers who have defaulted on HTAs with other elevators? Cole has alluded to the latter issue in his article.[54] The questions just raised probably are but the "tip of the iceberg" as to the fallout from the HTA crisis.

Ag trade options

On June 9, 1997, the CFTC issued an advance notice of proposed rulemaking on the possibility of its lifting the long-standing ban on off-exchange agricultural trade options.[55] If made available, farmers would be able to make an agreement with an elevator "for the right, but not the obligation, to sell a specific amount of grain at a pre-set price. If prices rose by the delivery date, the farmer would pay a premium to get out of the agreement and sell his crop elsewhere."[56] Some suggest that the past availability of such options might have headed off the use of HTAs and the considerable risk associated with the so-called "old-crop-new-crop spread." Whether such options, if permitted, should somehow be regulated is a pressing issue. At a minimum the CFTC would have the authority to investigate allegations of fraud or unlawful representations. Rules as to disclosures, education and eligibility to buy and sell could be promulgated.[38] But, potential difficulties with oversight and enforcement have been suggested. Clearly, in an era without income supports, grain producers are looking for ways to take advantage of rising prices rather than being locked into traditional devices such as cash forward contracts, and so the pressure is on to lift the ban on these options.[58]

Conclusion

Expect several years of litigation to sort out HTAs entered into in recent years. Given the vast differences in fact patterns, be prepared for farmers to win some cases and grain dealers others. And, many of the issues raised in this article should soon get clarification as opinions discussing substantive, not just procedural, issues emerge from the courts.

New HTA contracts that follow the 1996 CFTC Guidelines are not totally risk free and are not somehow immune from challenge in the courts. Other marketing strategies, while more conservative, may be the best in terms of legal advice. The traditional cash forward contract, when properly handled, can protect a farmer against a falling market with minimum risk. Price later or deferred pricing contracts (within the marketing year) can be used by farmers but have their own set of risks—falling prices, widening basis, and grain dealer insolvency. Agricultural trade options, if sanctioned by the CFTC, may be attractive, but premium risks in wildly fluctuating markets need to be carefully assessed up front. New forms of revenue protection insurance are interesting, not to capture rising markets, but to bring income stability to farmers.[59]

The crisis with HTAs should at least generate new thinking about the future of grain marketing and instill a measure of caution in all concerned for some years to come. *Disclosure of risks* should be the theme of the day for any marketing program, whether required by specific statute or regulation, or simply by the general law of fraud and misrepresentation.[60]

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[20] Neil E. Harl, *Hedge-to-Arrive Contracts*, 38 Agri Finance 28, 30 (June/July 1996).

[21] Neil D. Hamilton, *Plowing New Ground: Emerging Policy Issues in a Changing Agriculture*, 2 Drake J. Agric. L. 181, 183 (1997).

[22] See Matthew J. Cole, *Hedge-To-Arrive Contracts: The Second Chapter of the Farm Crisis*, 1 Drake J. Agric. L. 243, 253-54 (1996).

[23] *North Central F.S., Inc. v. Brown*, 951 F. Supp. 1383 (N.D. Iowa 1996).

[24] *See Harter v. Iowa Grain Co.*, [1997] Comm. Fut. L. Rep. (CCH) ¶ 27.015 (N.D. Ill. 1997)(FRCP 11 sanctions issues under facts in attempting to bring in broker).

[25] Arbitrator Richard G. Lareau decided on April 8, 1997 for three Minnesota farmers against the Farmers Elevator Co. and awarded damages of $99,200 and fees. Lareau found no fraud, but did conclude that Elevator had inadequately informed farmers about how HTAs work and the potential risks. The elevator grain department manager had assisted farmers in their planning and "[w]hile this is not exactly an estoppel situation, it is very close to an assurance that if they followed his [elevator's] guidance they would achieve their desired price without appreciable downside risk." Arbitrator's Dec. and Award, *Hoffman v. Farmers Elevator Co.*, Am. Arb. Ass'n. Comm. Arb. Tribunal case no. 56 181 459 96.

[26] *Schaefer v. Cargill, Inc.*, [1997] Comm. Fut. L. Rep. (CCH) ¶ 26,962 (CFTC Feb. 27, 1997)(motion to dismiss reparations proceedings denied).

[27] *See, e.g., Baker v. Arbor Drugs, Inc.*, 215 Mich. App. 198, 544 N.W.2d 727 (1996).

[28] 7 U.S.C. § 25(c)(1994).

[29] 28 U.S.C. § 2201(a), § 2202 (1994).

[30] *North Central F.S., Inc. v. Brown*, 951 F. Supp. 1383 (N.D. Iowa 1996).

[31] See Barbara Hoekstra, *The Fiduciary Duty Owed by the Farm Credit System to Their Member-Borrowers*, 13 J. Agric. Tax'n & L. 3 (1991)(cases on fiduciary duty of cooperatives). Christopher A. Kelley, in a letter of 7-28-97 to your author, suggests that the duty at the very least ought to apply to the manner in which a coop settles its HTA disputes with members—unless there is a reasonable basis for making distinctions, all settlements ought to be under the same basic terms and conditions.

[32] For a discussion of U.C.C. gap filler provisions as to time and place of delivery, see David C. Barrett, Jr., *Hedge-to-Arrive Contracts*, 2 Drake J. Agric. L. 153, 164-65 (1997).

[33] Courts seek lawful interpretations of contracts. Restatement (Second) Contracts § 203(a)(ALI 1981).

[34] Id. at § 250; farmer could suspend performance under U.C.C. § 2-610(3).

[35] Futures Trading Practices Act of 1992. CFTC in 1993 used its authority to exempt swaps and certain other OTC derivatives from most CEA provisions. Of course, the requirement that a futures contract be traded on an exchange is what makes the contract legal, not what makes it a futures contract. Report to Congressional Committees, The Commodity Exchange Act: Legal and Regulatory Issues Remain 6 (GAO/GGD-97-50 Apr. 1997).

[36] *See, e.g.*, Complaint and Notice of Hearing, In the Matter of Grain Land Cooperative, CFTC Docket No. 97-1 (Nov. 13, 1996), available at http://www.cftc.gov/opa/grain-fnl.html; In the Matter of Roger J. Wright et al., CFTC Docket No. 97-2, and In the Matter of Southern Thumb Co-op, Inc., CFTC Docket 97-3, are available at http://www.cftc.gov/opa/adcmplnt.html and http://www.cftc.gov/opa/stcorp.html.

[37] Barrett, *supra* note 32 at 174 [citing E. Allen Farnsworth, Contracts, section 5.1 n. 10 (2d ed. 1990)(citing Crichfield v. Bermudez Paving Co., 51 N.E. 552 (Ill. 1898)].

[38] Restatement (Second) Contracts §§ 178, 179, 181 (ALI 1981).

[39] Commodity Exchange Act § 2(a)(1), 7 U.S.C. § 2 (1994).

[40] In re Stovall, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941 (CFTC Dec. 6, 1979).

[41] Id.

[42] Id.

[43] Norman W. Thorson, *Commodities Futures Contracts*, in 1 Agricultural Law § 5.02 (Davidson, ed. 1981 & 1989 Supp.); see also CFTC v. Noble Metals Intern., 67 F.3d 766 (9th Cir. 1995).

[44] CFTC v. Co Petro, 680 F.2d 573, 581 (9th Cir. 1982); see also Barrett, *supra* note 32, at 167-69 for a discussion of CFTC staff guidance letters and CFTC General Counsel's 1985 opinion at 50 Fed. Reg. 39,660 (1985); Report of Committee on Commodities Regulation of the Assoc. of the Bar of the City of New York, *The Forward Contract Exclusion:*

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Because of the lateness in mailing the ballots, the deadline for voting is extended one week. Please mail your ballots in as soon as possible.