HEDGE-TO-ARRIVE CONTRACTS: THE SECOND CHAPTER OF THE FARM CRISIS

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I. INTRODUCTION

What *is* the new crisis? Currently, large amounts of grain, which do not exist, are being sold on the futures market. When it comes time to deliver this "phantom grain," problems naturally occur. As of July 18, 1996, six Iowa cooperatives had brought suit against fifty-nine member farmers for breach of contract.[1] Losses in Iowa alone have been estimated at $90 to $120 million.[2] One farmer was so

1. Anne Fitzgerald, *Grain Pact Disputes Taking Heavy Toll*, DES MOINES REG., July 18, 1996, at A1.

2. *Id.*

devastated by losses from his hedge-to-arrive (HTA) he hanged himself.[3]

A Minnesota cooperative was notified by 150 farmers that the farmers would not deliver the grain under their HTA contracts. Those farmers owe as much as 14 million bushels of corn. That cooperative could face as much as a $20 million dollar loss.[4] A Nebraska cooperative paid out $4.5 million because of HTA losses and was forced to sell out to a rival cooperative.[5] Indiana has gone so far as to pass a law requiring contracts to include a statement of risks for farmers.[6]

When farmers plant their land and wait for crops to mature, they attempt to receive the highest price possible for their crop. Some farmers achieve this by "playing" the markets. One way to play the market is hedging grain futures contracts. Hedge-to-arrive contracts (HTAs) allow the farmer three options: (1) sell corn and deliver it sometime in the future, thus fulfilling the contract; (2) store corn, and roll the futures position to another month (rather than deliver); or (3) sell corn on a cash market (to a different buyer) and roll the futures position (with the original buyer). If either of the last two options are chosen, then futures contracts are bought and sold for which no corn may exist.

Traditionally, the grain market has been predictable. Before the farm crisis of the 1980s, a stagnant market left few surprises in the selling-buying scheme, particularly concerning rising and falling in prices; simple supply-demand principles explained the falling market before and during the harvest, and the subsequent rise during the rest of the year. This environment made it difficult for many farmers to make money, and so they hoped to "cash in" on the recent peak in prices. The mid-1990s peak resulted chiefly from two factors: (1) fear of a "short" crop arising out of less than ideal growing conditions, and (2) a phenomenal world demand for our grain. It was assumed that this was just another infrequent peak and the market would go down again. So, farmers began to turn to HTAs as a hedge against that fall. It never came.

Hedge-to-arrive contracts make money for farmers on a falling market, and conversely, lose money on a rising market. Corn prices never went down. The trend continued through the 1995 harvest season and through the following winter. Although now tempered somewhat, this virtually unprecedented situation presently continues. Rather than making money from a falling market, which hedging farmers had been doing for years, they are now losing on a rising market. Generally, most farm economists predict this high demand is here to stay, at least through the 1996 crop. In other words, no relief is in sight.

This note discusses these complex contracts, known as HTAs, and how they work. It traces their development and the regulations that govern HTAs. Further, this note explores the legality of such contracts and touches on a few of the suits

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3. *Id.*

4. Karen Mills, *Farmers Pitted Against Cooperatives in Battle Over Corn Delivery*, FORT DODGE MESSENGER, June 26, 1996, at 11.

5. William Smith, *Grain Rally Takes A Toll on Business; Some Firms Suffer Losses Despite Highs*, CHI. SUN-TIMES, May 7, 1996, at 41.

6. Brian Williams, *Report Tries To Make Sense of Complex Grain Contracts*, COLUMBUS DISPATCH, June 16, 1996, at F2.

currently being adjudicated. Finally, this note attempts to offer helpful suggestions for the farmer, cooperative, and agencies which soon may regulate these contracts.

II. BACKGROUND

A. *Agricultural Contracts: Where the HTA fits in*

The National Grain and Feed Association (NGFA) organized a "Risk Evaluation Task Force on Hybrid Cash Contracts" to study HTAs.[7] In April 1996, this task force, comprised of experts in the grain industry, banking, accounting, and legal professionals, published a 95-page report known as the White Paper.[8] The task force surveyed 800 NGFA grain cooperative members.[9]

The White Paper divides agricultural contracts into four categories.[10] The first category, "Traditional Cash Contracts," includes fixed price contracts, basis contracts, and deferred price contracts. The second group, "Futures Based Hybrid Cash Contracts" includes HTAs (futures only), rolling HTAs, and multiple crop year HTAs. Then there are "Option Based Hybrid Cash Contracts," which include minimum price contracts, maximum price contracts, and min/max contracts. The last category, "Derivative Contracts," includes all swap contracts and revenue contracts.[11]

While each category and type of contract serves a different purpose, all were developed to fulfill a particular market need. The task force concluded that a standard hedge-to-arrive contract allows a farmer to fix a futures price (with the basis to be determined later, during delivery) and carries only a slightly higher risk for both cooperative and farmer than a traditional cash forward contract.[12] This unremarkable risk assessment is based upon a "normal" market not the current high demand market, in which a multiple-year HTA augments losses, rather than gaining or maintaining the status quo.

Another conclusion is that hybrid cash contracts are useful tools, but not appropriate in all situations. However, such a decision may be best left to the buyer and seller, as the appropriateness depends on the circumstances. Not all farmers are good candidates for these contracts because they are not willing to invest the time necessary to understand the details of risk profiles and management techniques.

The White Paper also provided recommendations for companies entering into

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7. *Futures Trading Laws, Hearings Before the Senate Comm. on Agric.*, 104th Cong. (May 15, 1996) [hereinafter *Futures Trading Laws*] (testimony of Kendal W. Keith, President, National Grain and Feed Association), *reprinted in* FEDERAL DOCUMENT CLEARING HOUSE CONGRESSIONAL TESTIMONY, May 15, 1996, *available in* LEXIS, Legis Library, Cngtst File.

8. *Id*. *NGFA Issues "White Paper" on Hybrid Cash Contracts*, FEEDSTUFFS, April 29, 1996, at 5 [hereinafter *NGFA*].

9. *Hybrid Cash Contracts Profitable, But Risky*, REUTERS LIMITED, April 24, 1996, *available in* LEXIS, News Library, Curnws File.

10. *Futures Trading Laws, supra* note 7 (testimony of Kendal W. Keith).

11. *Id.*

12. *Id.*

HTAs. Grain buyers and cooperatives should develop internal checklists to ensure management properly reviews a new contract strategy. As well, management should develop a customer checklist to evaluate the stability of engaging in a hybrid cash contract with a customer. The risk associated with the contract must then be disclosed to the customer. Additional recommendations include regular communication with the farmer to update him on his financial position.[13]

B. *HTA Basics*

HTAs, also known as IIHTA, Flex, HTA, and IIHTA Plus,[14] are private contracts that remain unregulated.[15] The President of the Chicago Board of Trade (CBOT) refers to the HTA as an "unregulated over the counter agricultural derivative."[16] These contracts allow farmers to hedge, or reduce the risk of price fluctuations early in the market season while continuing to hold their crop in an attempt to collect interest and storage costs.[17]

HTAs also allow farmers to gamble on several variables at once.[18] These contracts are not uniform or standard and are generally considered hybrid contracts or contracts containing aspects of grain futures and cash-forward or forward pricing contracts.

In a typical hedge, the farmer takes a futures position on the CBOT directly through a broker or through a cooperative, which takes a futures position through a broker on behalf of the farmer. The farmer sells a contract for a fixed quantity of grain for delivery in a certain month. In a cash-forward contract, the farmer promises to deliver a specified quantity of grain to the cooperative by a certain date, but at a price fixed at the time the contract is agreed to.[19] Therefore, a forward contract has a potential for greater risk than contracts for immediate delivery because the price may fluctuate. A hedge-to-arrive contract is a hybrid of these two types.

Traditional hedging contracts by farmers contained a promise to deliver grain

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13. *House Agriculture Risk Management and Specialty Crops Hedge to Arrive Contracts, Hearings Before the Subcomm. on General Farm Commodities* 104th Cong. (July 24, 1996) [hereinafter *House Agriculture*] (testimony of Joann Brouillette, Vice President, Demeter, Inc.), *reprinted in* FEDERAL DOCUMENT CLEARING HOUSE CONGRESSIONAL TESTIMONY, July 24, 1996, *available in* LEXIS, Legis Library, Cngtst File.

14. *The CFTC and Hedge-To-Arrive Contracts Before the Commodity Futures Trading Comm'n at the 58th Annual Summer Conference* (July 30, 1996) [hereinafter *CFTC*] (remarks of Joseph Dial), *reprinted in* FDCH FEDERAL DEPARTMENT AND AGENCY DOCUMENTS, July 30, 1996, *available in* LEXIS, News Library, Curnws File.

15. *Farm Bureau Tackles Hedge-to-Arrive Contracts*, IOWA FARMER TODAY, June 22, 1996, at 9 [hereinafter *Farm Bureau*].

16. George Anthan, *Experts*: *Farming Economy in Danger*, DES MOINES REG., May 16, 1996, at S7.

17. Heather Jones, *Hedge-to-Arrive Delivers Unexpected Problems*, WALLACES FARMER, June 1996, at 34, 34.

18. *Prairie Panic*; *Farmers Need Help in Grain Controversy,* STAR TRIB., July 3, 1996, at A22 [hereinafter *Prairie Panic*].

19. Fitzgerald, *supra* note 1, at A2.

in the future, backed by grain the seller (farmer) had stored or was expected to grow. HTAs are now more complicated because of their involvement in the futures market.[20] HTAs are like a normal hedge except (1) the buyer [cooperative] bears the cost of the margin calls, which eventually shift to the seller, and (2) the seller can benefit from the narrowing basis in the commodity.[21]

Thus, by using an HTA the farmer is able to lock in a price for grain ahead of delivery and to fix his delivery date and final price for the grain.[22] Common characteristics of an HTA contract include:

1. Cooperative and farmer enter into a contract, where the farmer is to deliver grain at a future date, at an agreed upon price, and the cooperative hedges the sale in the futures market;
2. Cooperative covers the required margin calls;
3. Farmer assumes responsibility for basis risk and any gains or losses generated; and
4. Farmer is in control of the position and rolling may be permitted by the agreement.[23]

These characteristics are more easily understood in the context of regulations on the farm economy. To achieve this, more background on the farm economy and its regulations is helpful.

C. *More on the Farm Economy*

Ten years ago, land values, grain prices, and exports were slumping.[24] Farmers traditionally have used contracts to hedge against the risk involved with bringing a crop to market;[25] they sell commodities on the spot market, and hedge on the futures market.[26]

Total economic activity for the agricultural sector in the United States represents about 14% of our nation's gross domestic product.[27] The marketing of a crop

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20. Anne Fitzgerald, *Fears Rise as CFTC Questions Contracts*, DES MOINES REG., May 18, 1996, at S11.

21. Neil Harl, *Hazards of Hedge-to-Arrive Contracts* 7 AGRIC. L. DIG., May 17, 1996 at 77, 77.

22. Anne Fitzgerald, *Farmers Urged To Settle*, DES MOINES REG., May 21, 1996, at S7.

23. *Futures Trading Laws, Hearings Before the Senate Comm. on Agric.*, 104th Cong. (May 15, 1996) [hereinafter *Futures Trading Laws*] (testimony of Roger G. Ginder, Professor of Economics, Iowa State Univ.), *reprinted in* FEDERAL DOCUMENT CLEARING HOUSE CONGRESSIONAL TESTIMONY, May 15, 1996, *available in* LEXIS, Legis Library, Cngtst File.

24. Fitzgerald, *supra* note 1, at A1.

25. *Prairie Panic*, *supra* note 18, at A22.

26. George Gunset, *Corn Contracts Penalize Farmers; Lawsuit Alleges That Full Risks Of Trading Devices Not Revealed*, CHI. TRIB., June 14, 1996, at 1.

27. U.S. Commodities Futures Trading Commission, *Division of Economic Analysis Statement of Policy in Connection With the Unwinding of Certain Existing Contracts for the Delivery of Grain and Statement of Guidance Regarding Certain Contracting Practices*, May 15, 1996, at 2. (This report may be obtained from the U.S. Commodity Futures Trading Commission at Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20561) (also on file with the DRAKE J. AGRIC. L.).

can begin as much as a year before harvest, and generally lasts until the end of the next crop year. The crop year is the twelve-month period which begins with the availability of newly harvested crops and concludes twelve months later.[28]

D. *Federal Regulations and Forward Contract Exemptions: The Beginnings of the Modern HTA*

Federal regulations for futures delivery contracts of agricultural commodities date back to the Futures Trading Act of 1921 (FTA).[29] Since 1921, contracts for futures delivery of commodities have always been required to be traded on federally designated exchanges. Any contracts occurring off-exchange were illegal.[30]

An exception to the exchange rule was made for forward contracts exempting them from the jurisdiction of the Commodity Futures Trading Commission (CFTC). A forward contract is a cash sale of physical commodities for deferred shipment or delivery.[31] Therefore, forwards could be traded off-exchange and were generally regulated by state law.[32] HTA contracts are generally variations on forward pricing contracts and thus remain unregulated.[33]

The goal of the FTA was to control problems of price manipulation and excess speculation.[34] The mechanism for controlling problems in the grain futures market was to tax all futures contracts, with two forward contract exceptions.[35] The first exemption was for all futures delivery contracts made by owners and growers of grain, while the second exempted futures delivery contracts made by or through members of boards of trade, designated by the Secretary of Agriculture.[36] The FTA also exempted from regulation all cash sales of grain for futures delivery.

In 1922, the United States Supreme Court held the FTA to be unconstitutional.[37] It was declared an improper use of congressional tax power.[38] Congress responded with the Grain Futures Act (GFA) in 1922. This Act prohibited the offer or sale of grain at a futures delivery date. The GFA did, however, carry on the forward contract exemption specified in the original FTA.[39] The GFA evolved into what is now the Commodity Exchange Act.

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28. *Id.* at 3.

29. *CFTC*, *supra* note 14 (remarks of Joseph Dial).

30. *Id.*

31. *Id.*

32. *Id.*

33. Roger McEowen, *Marketing Agricultural Commodities Through Use of Hedge-To-Arrive Contracts May Violate CFTC Rules*, AGRIC. L. UPDATE, May 1996, at 4, 4.

34. Commodity Future Trade Comm'n v. Petro Marketing, 680 F.2d 573, 577 (9th Cir. 1982).

35. *Id.*

36. *Id.*

37. Hill v. Wallace, 259 U.S. 44, 70 (1922).

38. *Id.* at 71-72.

39. As discussed below, the forward exclusion is unavailable as to contracts for sales of commodities sold for speculative purposes which are not based on delivery by the seller to the buyer. Commodity Future Trade Comm'n v. Petro Marketing, 680 F.2d 573, 578 (9th Cir. 1982).

The Commodity Exchange Act (CEA) does not regulate contracts involving physical delivery of commodities or deferred deliveries. The theory is that contracts that allow for actual physical delivery do not allow the same opportunity for speculation as those in which delivery is not required.[40] Thus, the determination of whether a contract meets the forward exemption depends upon whether both parties, and the terms of the contract, contemplate futures delivery. Such forward contracts usually establish a fixed price and delivery is required, but may be deferred for reasons of convenience and necessity. Therefore, forward contracts have a mutual binding obligation--delivery and acceptance, making them unregulated.[41]

In a forward contract, both parties perform (deliver or accept) and face the risk of loss from adverse price changes.[42] This is different from a deferred contract price. A deferred contract establishes a formula to determine the grain price rather than adhering to a pre-set, fixed price. Such a formula may specify a base price and a time period during which the producer may fix the final price.[43] Thus, rather than a pre-set price, a formula is used to determine the final price at the closing date.[44]

E. *The Rise of the HTA: A Fair-Weather Friend*

Because of an historically predictable lower grain market at harvest time, farmers developed a demand for a cash contract that could be optimized within a crop year, and stabilize revenue over time. At first, HTAs worked well for farmers. In 1994, an over-abundant corn harvest depressed grain prices, and farmers collected approximately 20 cents more per bushel sold through an HTA.[45] Yet no one noticed that HTAs, in eleven of the last seventeen years, lost an average of 5 cents per bushel.[46] HTAs were consistent in making money *collectively* only in 1992, 1993, and 1994 (this is not to say that individual farmers did not profit from their HTA in other years).[47] These contracts posted a minor loss in 1995; losses shot up to as much as 68 cents per bushel this year.[48] So what went wrong?

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40. McEowen, *supra* note 33, at 4..

41. *Id*. at 6.

42. *Id*.

43. *Id*.

44. Commodity Futures Trading Commission, 50 Fed. Reg. 39,656, 39,658, (1985) (citing Interpretive Statement of the Office of the General Counsel). For the rule and regulation of the Commodity Futures Trading Commission, see 17 C.F.R. pts. 1-199 (1996).

45. Fred Vogelstein, *Hedging Strategy Divides Farm Towns*, AGRIC. REV., July 2, 1996, at 4.

46. Paul Goodsell, *Failed Hedge-To-Arrive Contracts Spur Suits, Bankruptcy Fears*, OMAHA WORLD HERALD, July 31, 1996, at 20.

47. *Id.*

48. *Id.*

III. HOW HTAS WORK

A. *HTA: The Long and Shorts of It*

With an HTA, grain companies with a long position (holding futures contracts to buy grain) can demand the grain from those who are short (farmers who agreed to sell corn because they believed the price would fall), and they are obligated to deliver the corn.[49] Generally, futures contracts traded on the CBOT regulate prices and little grain changes hands.[50] This is because the grain companies with a long position normally sell back the contracts, canceling their obligation to buy.[51] Rarely is there a problem for the cooperative or grain company; but when there is, the problem can be devastating. Consider the following "March Wheat" example: On March 20th, a grain company with a short position needed to buy grain to cover its obligation to sell grain because of a contractual obligation under the futures contract.[52] This company was forced to bid up the price of wheat from $2.00 to $7.50 a bushel before a trader would sell. [53]

Perhaps the simplest way to explain how these contracts work is by example. A farmer enters an HTA contract with a cooperative. The farmer agrees to deliver corn based on a December 1995 futures price of $2.80 per bushel. In November, the price of corn is $3.30 per bushel. The farmer now has three options: (1) deliver the corn for $2.80 a bushel, completing his contract; (2) roll the futures position (extend the delivery date) another month and store the corn; (3) sell the corn for $3.30 on the market and roll the futures position.

If the farmer chooses the last option, the cooperative must now offset the $2.80 short position in December corn on the last day of November, at $3.30, creating a loss of 50 cents per bushel. The cooperative then re-establishes a short position in July 1996 corn at $3.34. As time passes, the farmer watches corn prices rise. While he has no corn, he either must buy enough corn to deliver on his contract or roll his position again. Once rolled, the price of the contract is changed by adding the old contract price to the current difference between the price of the newly referenced contract futures month and the old reference month at the time of the roll, minus any roll charges or fees listed in the contract.[54] This entails more risk to farmer and cooperative.[55] The HTA ends up as a short sale in the futures market, with the

49. George Gunsett, *Efforts Grow To Avoid Fireworks On Corn; Regulators, CBOT Seek July Harmony*, CHI. TRIB., July 5, 1996, at 1.

50. *Id.*

51. *Id.*

52. Charges were later brought against certain members of the Chicago Board of Trade; fewer than 10 people were found involved in any wrongdoing. The Board's disciplinary rule will be announced by the end of Dec. 1996. *Id.*

53. *Id.*

54. Christopher R. Kelley, *CFTC Issues "Hedge-to-Arrive" Contract Policy and Guidance Statements,* AGRIC. LAW UPDATE, June 1996, at 4, 5.

55. *Id.*

cooperative as the intermediate party.[56] Because of the roll, the cooperative has no grain to deliver, and thus has no collateral to pledge against its margin call. The cooperative's liabilities may now be significantly greater than its assets in terms of that transaction.[57]

Many farmers forward price their grain with the cooperative directly, rather than through the CBOT, because the price they receive for their grain from the cooperative is lower than the cost to replace the sale with a buy (long position) on the CBOT. Freight, interest on investment, storage cost, and local demand are all built into a forward contract price. This reluctance to do business with the CBOT is most likely one of the reasons HTAs were developed.

In the current market, losses on HTAs are unpredictable. The absolute losses in most cases are not fixed until the positions are closed out. These losses will grow or lessen by the daily moves in the market.[58] The result is the traditional predictability of the grain market has vanished for the time being.

B. *Pricing, Basis, and Margins: Where Did the Money Go?*

The pricing formula, mentioned above, refers to a futures price and month. On the futures price the farmer sets his basis of the grain contract. Basis is the difference between the futures price and the local cash price.[59] The farmer is allowed the opportunity to determine the basis at some point in the future before delivery.[60] The farmer has time to lock in his basis; it is usually no more than 30 cents per bushel [61] In other words, the price paid with an HTA contract is based on a formula (contract's cash price or futures price plus basis[62]) where the basis is established in the future.[63] Sellers (farmers) use HTAs to lock in futures prices assuming the futures price will decline and the basis will improve or become positive.[64] Until the recent change in the market, HTAs worked exactly as hoped.

With so much at stake, one might imagine the actual contracts as quite complete and complex. Yet, many of these contracts fill only a single page. The standard form contracts contain blanks for the quantity to be delivered, the futures

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56. *Hybrid Cash Contracts Causing Financial Stress,* 59 DOANE'S AGRIC. REP., May 3, 1996, at 18-5.

57. *Hedge-to-Arrive Grain Contracts and Regulatory Compliance, reprinted in* FDCH FEDERAL DEPARTMENT AND AGENCY DOCUMENTS, Aug. 3, 1996, *available in* LEXIS, News Library, Curnws File [hereinafter *Hedge-to-Arrive*].

58. Roger G. Ginder, *Key Dates for the July Contract for HTA Holders*, June 6, 1996, at *2*. (This report was prepared by Roger G. Ginder, Professor of Economics, Iowa State University, Ames, IA) (on file with the DRAKE J. AGRIC. L.).

59. *NGFA*, *supra* note 8, at 5.

60. *Id*.

61. George Gunset, *Corn Contracts Penalize Farmers; Lawsuit Alleges That Full Risks of Trading Devices Not Revealed,* CHI. TRIB. June 14, 1996, at 1.

62. Kelley, *supra* note 54, at 4.

63. *Id*.

64. *Id*.

month and price for delivery, the grade and type of grain, and a place for the farmer to sign. When the grain market shot up in 1995, the farmers then used the high 1995 futures price as a new basis.[65] Yet, in 1996 the corn prices doubled and delivery would have caused the farmers to incur huge losses. Therefore, the farmers kept rolling.[66]

To perform a roll, the cooperative buys back the futures position and sells a later futures contract. If the cooperative suffered a loss on the first position (like the farmer) the loss was charged to the farmer's account. These losses, at $2.40 to $3.00 per bushel, are now even larger because of record high corn prices in 1996.[67] When the farmer and cooperative roll this position, they end up with a spread position. The spread is the difference between the exit price of the near-by futures and the next futures contract. Slippage is loss in the spread as the HTA is rolled forward.[68] When the spread goes a different direction than expected (record highs in this case), losses are compounded.

Cooperatives sold futures contracts on the Chicago Board of Trade covering hundreds of millions of bushels of corn.[69] The cooperatives, which sold these contracts at $2.70 per bushel for delivery in June 1996, must now pay twice that to buy back the contracts. The losses kept adding up because no one sold the positions. Cooperatives believed they could deduct the costs from the farmers' receipts for the grain; this tended to keep the farmers in the market beyond their financial ability to cover the losses, hoping the market would come back down and thus reduce or erase these losses. Completely unexpected were the huge price patterns of the first four months of 1996.[70]

For everyone to make money from HTAs, cooperatives need volume, farmers need money, and the brokers need fees. HTAs were supposed to protect farmers from falling prices. Many HTAs were entered into when corn was selling at $2.70 to $3.00 per bushel last year.[71] No one could have expected corn to reach $5.00 per bushel this year. Normally, the corn price goes down as harvest approaches. Yet the exportation of grain and supply concerns have increased, practically doubling the price of corn from a year ago.[72]

One of the hardest hit areas has been north central Iowa.[73] A class action suit has been filed in Chicago on behalf of some farmers who feel they were mislead

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65. Fitzgerald, *supra* note 1, at A1.

66. *Id.*

67. John Otte, *Hedging-to-Arrive: Understand You Have a Short Futures Position*, WALLACES FARMER, May 1996, at 8.

68. *Weekly Outlook: Pricing Corn,* UPI, Dec. 6, 1995, *available in* LEXIS, Nexis Library, UPI File.

69. Vogelstein, *supra* note 45, at 4.

70. Harl, *supra* note 21, at 77.

71. *Farm Bureau*, *supra* note 15, at 9.

72. Scott Kilman, *Hedge Row, As Corn Prices Soar, A Futures Tactic Brings Rancor to Rural Towns, Grain Cooperatives and Farmers Split Over Responsibility for Losses, Margin Calls, Some Co-ops Might Fold,* WALL ST. J., July 2, 1996, at A1.

73. *Farm Bureau*, *supra* note 15, at 9.

about the risks of HTAs.[74] Some estimate that more than 50 million bushels of corn could be involved in Iowa alone.[75] Other estimates have placed losses at $800 million to $1 billion nationwide.[76] Four hundred million bushels of corn may have been sold for which no corn exists.[77] Most of these futures contracts were sold by cooperatives on the Chicago Board of Trade.[78] Normally, the cooperative would buy back these contract futures as the delivery date approached. So why did the cooperatives fail to get out of the market? First, they cannot sell the futures even when the price is rising because the producer (farmer) not the merchandiser (cooperative) is in charge of the decision.[79] Second, rising prices made it costly to close out these positions.[80]

As the spread between the fixed price of the contract and the current futures price increased, the amount of money necessary to cover the contract also increased. Therefore, cooperatives began to face margin calls on their own futures contracts. The cooperatives are unable to deliver the corn because farmers have sold their crop and rolled over their contract for another year.[81] Farmers would experience huge losses if they were forced to deliver corn now, and cooperatives would face bankruptcy if they were unable to cover their positions on the futures market.[82] Farmers also pay a charge each time they roll the contract.[83]

Now, out of necessity, cooperatives are demanding that farmers meet margin calls; but farmers are claiming they did not know they could be held responsible for the margin calls.[84] The margin call requires additional money to maintain the position on the market. When the market price exceeds the price set in the futures contract, more money must be added to the account with the futures broker.[85] For example, an investor pays $6,000 to purchase $10,000 worth of stock (100 shares at $100 per share).[86] The investor then borrows the remaining $4,000 from the broker.[87] The initial percentage margin is 60%, or $6,000 divided by $10,000.[88] If the price of the stock falls from $100 to $70 per share, the equity in the account also falls establishing a new percentage margin of 43% or $3,000 divided by $7,000.[89]

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74. *Id.*
75. Fitzgerald, *supra* note 20, at 511.
76. Goodsell, *supra* note 46, at 20.
77. Jones, *supra* note 17, at 34.
78. Kilman, *supra* note 72, at A1.
79. *Id.*
80. *Id.*
81. *Farm Bureau*, *supra* note 15, at 9.
82. *Id.*
83. *Hedge-to-Arrive*, *supra* note 57.
84. Kilman, *supra* note 72, at A1.
85. *NFGA*, *supra* note 8, at 5.
86. ZVI BODIE ET AL., INVESTMENTS 97 (2d ed. 1989).
87. *Id.*
88. *Id.*
89. *Id.* at 98.

If, in the above example, the value of the stock was to fall below $4,000, the equity becomes negative, or the value of the stock is now insufficient collateral to secure the loan from the broker.[90] Once the stock falls below this point, known as the maintenance margin, the broker issues a margin call which requires the investor to supply new cash or security to the account.[91] If the investor fails to meet the margin call, the broker sells enough of the security to pay off the loan.[92]

The money paid to cover the margin calls goes to the Board of Trade and is not refunded unless the market moves with the holder's position. In other words, the price must fall for the farmers and cooperatives to make money.[93] It has been estimated that cooperatives have spent millions of dollars just covering margin calls on HTAs.[94] Because of the high margin calls, cooperatives began pressuring farmers to execute promissory notes or settle their accounts.[95] This is where the "phantom grain" comes into the equation. Some cooperatives are unable to sell the futures contract at a profit because they cannot count on the farmer to have the grain.[96]

C. *Farmer vs. Cooperative: Is This the End of the Handshake Deal?*

Predictably, farmers are turning against one another. Those who never entered into an HTA are worried their investment in the local cooperative might be lost because of HTA trading losses.[97] Those fears are justified. Several cooperatives are in financial trouble. One small Iowa cooperative, plagued by HTAs, finally buckled under the strain. The Ledyard Elevator in Ledyard, Iowa, is now strongly considering a buy-out offer by a larger northern Iowa cooperative.[98]

Failed cooperatives will not disappear, but merely will be purchased by another cooperative and hence farmers will still be able to haul their grain to the closest elevator and do business there. However, because of the enormous debt caused by the HTAs its members will have lost their equity in the company. Some equity is repaid in the form of cash dividends, but much of a member's share of the profits (probably as much as 80%) is deferred for a number of years, and so would be lost. As fall approaches, cooperatives require the most amount of working capital in order

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90 *Id.*

91. *Id.*

92. *Id.*

93. Fitzgerald, *supra* note 1, at A1.

94 Anne Fitzgerald, *Co-ops Suing Farmers for HTAs;the Lawsuits Heighten the Battle Over Who Will Bear the Recent Losses Tied to Hedge-to-Arrive Contracts,* DES MOINES REG., July 11, 1996, at 8.

95. Fitzgerald, *supra* note 20, at S11.

96. Anthan, *supra* note 16, at S7.

97. Kilman, *supra* note 72, at A1.

98. Anne Fitzgerald, *More Grain Elevators to Merge After Losses; Hedge-to-Arrive Contracts Gone Sour Have Led to Some of the Co-op Buyouts.* DES MOINES REG., August 18, 1996, at 1 (Farm Country section).

to buy grain.[99] Because of the losses of HTAs, some cooperatives may not be able to buy grain and will need to restructure.[100] This could mean mergers or recapitalization.[101]

While the HTA contract was designed to protect farmers from falls in the market, these positions turned into huge losses as grain prices skyrocketed.[102] Certainly, cooperative members will lose much, if not all, of their investment when a cooperative fails. The critical question becomes who will absorb the rest of these huge losses, which as noted, are currently estimated at $800 million to $1 billion nationwide?

Cooperatives are beginning to wrestle with another issue: what about farmers who have HTAs with several elevators for hundreds of thousands of dollars each, or who have defaulted on HTAs with another cooperative, and are now seeking membership? Some farmers keep hedges hidden by contracting with up to three cooperatives.[103] Cooperatives are trying to increase volume in a highly competitive market and in many cases do not verify whether the farmer can deliver the grain.[104]

Cooperatives will want to know if they can deny membership to a farmer who has multiple hedges with other elevators, or who has defaulted on HTAs in the past. Even if membership can or should be denied on this basis, cooperatives first must have the means to discover this information. The records kept by cooperatives regarding its members contain sensitive information about farmers' finances. No exchange of records is currently taking place. Is an exchange of such information among cooperatives legal? Is it morally proper? Perhaps the best a cooperative can do is require a disclosure statement before granting membership.

IV. THE ULTIMATE QUESTION

A. *Are HTA Contracts Legal?*

First, it is important to realize that not all HTAs will be challenged. Members of the Iowa Risk Management Task Force opined, in a June 18, 1996, meeting in West Des Moines, that some HTAs are clearly enforceable.[105] The task force was most likely referring to the standard HTAs with specified delivery dates and which

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99. Fitzgerald, *supra* note 1, at A1.

100. *Id.*

101. *Id.*

102. Kilman, *supra* note 72, at A1.

103. Ann Toner, *Farmers, Officials Wrestle Over Hedging Pacts*, OMAHA WORLD HERALD, May 31, 1996, at 20.

104. *Hedge to Arrive Contracts*, *Hearing Before the House Subcomm. on Risk Management and Specialty Crops; and Subcomm. on General Farm Commodities*, 104th Cong. (July 24, 1996) [hereinafter *Hedge-to-Arrive*] (testimony of Larry J. Adams, Assistant Director for the Ohio Department of Agriculture), *reprinted in* FEDERAL DOCUMENT CLEARING HOUSE CONGRESSIONAL TESTIMONY, July 24, 1996, *available in* LEXIS, Legis Library, Cngtst File.

105. *Some Hedge-to-Arrive Contracts are Enforceable, Task Force Says,* IOWA FARM BUREAU SPOKESMAN, June 29, 1996, at 20.

have no unlimited rolling provisions as previously discussed. The task force is comprised of farmers, cooperative managers, grain merchandisers, bankers, accountants, regulators, and farm advisors.[106] Their view of enforceability is reinforced by the successful use of HTAs in the soybean markets. Experts conclude it is the unexpected market conditions in the corn market that have caused the problems, rather than the nature of the contracts themselves.[107]

Yet, some HTAs may be found to be illegal. These may be the contracts that are speculative. One common characteristic of speculative HTA contracts is a provision for the farmer to produce more than could possibly be produced within a year.[108] In addition, many contracts might be speculative if they extend more than two years into the future.[109] Finally, an element of speculation exists if the farmer is allowed to roll the delivery outside of the current crop year.[110] A requirement that the actual grain be delivered may help make these contracts legal.[111]

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.[112] 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 also may assert that unpredictable events such as weather or pest infestation may make rolling beyond the current crop year speculative.

Courts also will consider past practice. Courts are not likely to overlook the fact that many farmers, who are now challenging these HTA contracts, honored them for years prior to the recent rise in market prices. Whether the contract brings profits or losses to one party does not, in the law of contracts, affect its validity.[113] The courts may decide that farmers have a legal obligation to honor contracts entered into in good faith and with an intent to perform.

B. *Option or Forward Contract: The Problem of Delivering Phantom Grain*

An HTA contract is a trade option if it has the following three characteristics: 1) Does the purchaser have the right to make or take delivery of the commodity? If the right does not exist, then it is an option; 2) Is the initial charge for the option a non-refundable premium? Such requirements will appear to make the contract an

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106. *Id.*

107. *House Agriculture*, *supra* note 13 (testimony of Joan Brouilette).

108. Kelly, *supra* note 54, at 4.

109. *Id.*

110. *Id.*

111. Farm Division, Iowa Office of Attorney General Tom Miller, *Hedge-to-Arrive Legal Packet*, Mar. 21, 1996 (this two-page packet is available from the Iowa Attorney General Office, Farm Division) (on file with the DRAKE J. AGRIC. L.).

112. Kelly, *supra* note 54, at 4.

113. E. ALLEN FARNSWORTH, CONTRACTS, § 9.6 n.24 (2d ed. 1990) (citing Neal-Cooper Grain Co. v. Texas Gulf Sulfur Co., 508 F.2d 283 (7th Cir. 1974)).

option; and 3) Are the losses limited to the principal? If these characteristics are met, then a trade option, rather than an enforceable HTA, is in effect.[114]

While some HTAs meet the definition of a classical forward contract, other forms of these "agricultural derivatives" are more like futures or options and raise the same legal, jurisdictional, and policy issues as swaps or off-exchange instruments.[115] Therefore, a forward contract cannot replicate a futures or option contract.[116] The futures and options contracts fall under the regulations of the CEA.

Trade options are generally off-exchange and hence illegal.[117] These options are different than a forward contract, where both parties perform and face the full risk.[118] The law has banned agricultural trade options for the last sixty years.[119] In 1983, Congress mandated the authority for the CFTC to lift the ban on agricultural options traded on or off-exchange.[120] While the CFTC allows exchange options, it has failed to act on off-exchange options.[121]

Regulated exchanges require full disclosure and capital to back up losses.[122] In addition, they maintain price integrity and allow for centralized markets. Consequently, daily margining and clearinghouse guarantees are provided, as well as a proven self- regulatory mechanism and compliance programs with market surveillance.[123] Therefore, exchange markets generally are safer than over-the-counter markets. While off-exchange contracts lack these and other protections built into the exchange markets, commodity exchange officials have testified before the Senate Agricultural Committee that there is no need for new legislation to allow exchanges to deal with newer and innovative contracts.[124]

As previously noted, many farmers are contracting to sell more grain than they can physically produce. The amount of grain specified in the HTA is important because, when the courts or the CFTC determine whether a contract is an option or

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114. Commodities Futures Trading Commission, *supra* note 44.

115. *Hearing Before the Senate Comm. on Agriculture, Nutrition and Forestry*, (June 5, 1996) (testimony of Patrick H. Arbor, Chairman Chicago Board of Trade), *reprinted in* FEDERAL NEWS SERVICE, June 5, 1996, *available in* LEXIS, Legis Library, Cngtst File.

116. *Id.*

117. Commodities Futures Trading Commission, *supra* note 44.

118. *Id.*

119. *Hearings Before the Senate Comm. on Agriculture, Nutrition, and Forestry,* (June 5, 1996) (testimony of Lawrence N. Neumann, Chairman and CEO Benson-Quinn Co.), *reprinted in* FEDERAL NEWS SERVICE, July 24, 1996, *available in* LEXIS, Legis Library, Cngtst File.

120. *Id.*

121. *Id.*

122. *Prairie Panic*, *supra* note 18, at A22.

123. *Hearings Before the Risk Management and Specialty Crops and General Farm Commodities Subcomm's of the House Agric. Comm.*, (July 24, 1996) [hereinafter *Risk Management*] (testimony of David Lehman, Agric. Economist at the Chicago Board of Trade), *reprinted in* FEDERAL DOCUMENT CLEARING HOUSE CONGRESSIONAL TESTIMONY, July 24, 1996, *available in*. LEXIS, Legis Library, Cngtst File.

124. Monte Sesker, *Headaches Grow From $5 Corn*, WALLACES FARMER, July 1996, at 12, 12.

forward contract they look to the economic reality of the contract.[125] If the farmer lacks the ability to produce enough grain to fulfill the contract, the contract is probably illegal.

HTAs with unclear delivery dates might also violate CFTC regulations prohibiting trade options or options on certain agricultural commodities.[126] While off-exchange trade options are permissible and outside of CFTC regulations, they are unavailable for options on domestic agricultural commodities.[127]

A trade option is defined as a commodity option offered to a producer, commercial user, or merchant handling the commodity, and is subject to an option transaction "which is entered into solely for business purposes."[128] HTAs in which the marketing of grain is not the primary purpose of the contract are likely to be illegal. They usually will have nonexistent, ignored, or indefinite delivery requirements.

Some argue that HTAs are agreements between two parties to deliver grain and, therefore, do not fall under federal futures regulations.[129] Yet, the CFTC holds the position that HTAs allow grain delivery to be deferred and thus equal a futures contract.[130]

To be considered a hedge, the futures transaction must reduce the price (or interest rate) risk. The courts have used two tests to determine if a commodity futures transaction is a hedge or speculative contract.[131] The first is the Insurance Test, which requires gains to offset losses (or losses to be set off by gains) on the futures transaction.[132] If this happens, the commodity purchaser sells the contract on the futures market. The purchaser later buys back the contract to offset the gains or losses on the first contract.[133] The second test, the Direct Relation Test, requires a reasonable relationship between the amount traded on the futures market and the amount produced.[134] The Direct Relation Test would appear to be most applicable to the production requirements of the HTA contracts mentioned above because if the farmer cannot possibly produce the number of bushels of corn promised, then the reasonable relationship between amount traded and produced cannot be met.

C. *An Early Look at the Courts' View*

The first ruling regarding HTAs came down from a federal court in

125. McEowen, *supra* note 33, at 5.
126. *Id*. at 4.
127. *Id*.
128. *Id*.
129. Anthan, *supra* note 16, at S8.
130. *Id*.
131. Harl, *supra* note 21, at 82.
132. *Id*.
133. *Id*. at 81.
134. *Id*. at 82.

Wisconsin.[135] The plaintiff claimed the contract was invalid because it involved speculation. The crop production was for the 1995/1996 year. The judge ordered the cooperative to pay $2.00 per bushel as reimbursement, and allowed the farmer until Friday to deliver 180,000 of the one million bushels of grain sold under the contract.[136]

Many HTA suits will contain federal and state claims. The class action suit in Chicago provides an example of the type of arguments to be expected. The suit was filed in the United States District Court for the Northern District of Illinois, Eastern Division. The pleadings allege violations of the Commodity Exchange Act (CEA), Racketeer Influenced and Corrupt Organizations laws (RICO), common law fraud, breach of fiduciary duty, breach of contract, recession, and negligence. Similar claims exist in other suits. In *Nagel v. ADM Investor Services, Inc.,*[137] the same claims are asserted, along with the addition of emotional distress.

D. *An Early Look at the Consequences of This Crisis*

Farmers once blindly followed the advice of agricultural advisors and failed to understand the contracts or the implications of an inverted or rising market.[138] Many farmers are being more critical and careful in following agricultural advisor's recommendations this crop year.[139] The current situation is changing the relationship between farmer and cooperative. A lack of trust has damaged the once close relationship between some farmers and cooperatives. One commentator believes farmers will now seek market information from other sources.[140] This could affect the cooperative because their members are drawn from a relatively small geographical area, and a strong relationship must be maintained with the customer.[141]

On the other hand, cooperatives may no longer feel farmers can be trusted to honor their contracts and revoke the memberships of those farmers. This could affect the farmer because some cooperatives cover large geographical areas; Once denied membership in the local cooperative, a farmer may have to haul his grain impossibly long distances, effectively driving the farmer out of business. However, some improvements have come out of this situation. Current HTAs are written so the cooperatives will not be confronted with this financial crisis again.

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135. Anne Fitzgerald, *Iowans Watch HTA Ruling in Wisconsin*, DES MOINES REGISTER, Aug. 7, 1996, at S9.

136. Anne Fitzgerald, *Tension on the Land as Harvest Nears: High Prices, Tight Supply and Uncertainty Over Contracts Have Farmers and Handlers Sizing Each Other Up*, DES MOINES REG., Aug. 11, 1996, at 1 (Farm Country section).

137. Nagel v. ADM Investors Services, Inc., No. 96C-2675 (E.D. Ill. filed May 3, 1996).

138. *Hedge-to-Arrive*, *supra* note 104 (testimony of Larry J. Adams).

139. Matt Kelley, *Farmers Wary After Wild Swings in Futures Market*, FORT DODGE MESSENGER, July 5, 1996, at 3.

140. Emily Kaiser, *Free Market Raises Risk For U.S. Farmers*, REUTERS LIMITED, May 8, 1996, *available in* LEXIS, News Library, Curnws File.

141. *House Agriculture*, *supra* note 13 (testimony of Joan Brouillette).

The CEA has led to a regulatory structure comprised of three agencies: the Exchanges, the National Futures Association, and the CFTC. So what are these agencies doing with regards to HTAs?

E. *Commodity Futures Trading Commission Action*

The CFTC has acknowledged HTAs have created a gray area in the law.[142] They are investigating whether (1) these agreements are illegal because they are off-exchange futures, (2) whether participants are required to be registered with the CFTC, and (3) whether fraud has occurred in the marketing of HTAs.[143]

The Commission also has issued a Statement of Policy and a Statement of Guidance to assist in settling HTA disputes and to set out what it considers to be legal and acceptable practices with regard to HTA contracts.[144] The Statement of Policy deals with questions involving delivery. The crux of the Statement was to help further settlements. The CFTC feared farmers would think a cash settlement, instead of delivery, would prove the HTA contract was an illegal off-exchange futures contract.[145] The goal of the Statement of Policy was to make clear that cash settlements are allowed as a means to unwind or restructure HTA contracts without creating a violation of the Commodities Exchange Act. The Statement reads:

> The Division of Economic Analysis will not determine the status of any such [HTA] contracts existing as of May 15, 1996, under the forward contract exclusion of Section 1a(11) of the Commodity Exchange Act based on the ground that the parties mutually agree by a separately- negotiated settlement, entered into subsequent to entry into the original contract, to unwind, arrange a work-out, or restructure the original transaction through cash payments, wholly or in part. [146]

The Statement of Guidance provides guidelines to farmers and cooperatives who continue to use HTAs in the futures. This Statement provides four elements for prudent risk reduction. First, the contract requires mandatory delivery.[147] Second, the quantity to be delivered must rationally relate to the producer's annual production.[148] Third, the contract should specify a delivery date and futures contract month reference price which coincides with the crop year when the grain will be

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142. *Prairie Panic*, *supra* note 18, at A22.

143. *Hedge-to-Arrive*, *supra* note 57.

144. *CFTC*, *supra* note 14 (remarks of Joseph Dial).

145. *Id.*

146. Commodity Futures Trading Commission, *CFTC's Division of Economic Analysis Issues Statements of Policy and Guidance Relating to "Hedge-to-Arrive" Contracts*, (Press Release #3911-96) May 15, 1996, at 1. (This report may be obtained from the U.S. Commodity Futures Trading Commission, Office of Public Affairs) (on file with the DRAKE J. AGRIC. L.).

147. *CFTC*, *supra* note 14 (remarks of Joseph Dial).

148. *Id.*

harvested.[149] Finally, the rolling of the reference price can only occur in the same crop year.[150] The Statement of Guidance refers to reducing the risk implications of common features and practices associated with HTAs. The Statement reads:

> Only the sequential rolling of the reference price between months which are clearly within the same crop year during which the commodity is, or will be, in a deliverable state would be prudent risk reduction practice. In addition, general prudence requires that the quantity to be delivered and the delivery location reflect normal merchandising practice.[151]

F. *National Grain and Feed Association (NGFA)*

The NGFA is attempting to educate cooperatives and producers about the potential risks of HTA contracts.[152] The members of the NGFA include more than one thousand grain, feed, processing, exporting, and other grain related companies nationwide, along with thirty-seven state and regional grain and feed associations.[153]

The NGFA views the rapid escalation of markets to their current high level as the cause of the financial strains on the farmers and cooperatives. This strain would occur with or without the use of HTAs.[154] The financial pressure is the natural result of the short supply of grain and its equally high demand. The NGFA noted that the added flexibility of the HTAs are advantageous to the farmers who understand the contracts and caution the government not to overreact to the current situation.[155]

V. SUGGESTIONS FOR THE FUTURE

A. *For the Cooperative*

In the future, the contracts must be more complete. Oral agreements as to terms and delivery no longer will be safe. A thorough written contract must exist. Cooperatives may consider adding a severance clause to these contracts. Such contract clauses provide that, if one portion of a contract is invalid it is severed and the rest of the contract is valid. The seller's obligation to deliver must be unconditional, and a signature of the farmer's understanding of the risks needs to be included. The farmer needs to be aware he is ultimately responsible for damages if delivery is not met.

There must be a limit placed on the forward roll that only allows a roll within the same crop year. It must specify what options are available to the farmer if he has

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149. *Id.*
150. *Id.*
151. Commodity Futures Trading Commission, *supra* note 146, at 2.
152. *Risk Management*, *supra* note 123 (testimony of David Lehman).
153. *House Agriculture*, *supra* note 13 (testimony of Joann Brouillette).
154. *Futures Trading Laws*, *supra* note 7 (testimony of Kendal W. Keith).
155. *Id.*

a bad crop year. For example, the farmer may buy grain to fulfill delivery. If a liquidated damages clause exists, it must be reasonable and spelled out completely in the contract. Cooperatives should attempt to ascertain whether members have only hedged with one cooperative. If other hedges exist, their exact amounts should be determined. This determination depends upon the legality and propriety of exchanging records with other cooperatives. An accounting method that does not hide the risk should be implemented. Current accounting for HTAs comply with Generally Accepted Accounting Principles (GAAP). GAAP accounting hides some of the risk associated with an HTA contract because it classifies the risk as it would a standard forward cash delivery contract. Cooperatives should consider implementing some type of internal checklist that asks if the cooperative has inspected state laws recently and regulations affecting the contracts and if the risks and market scenarios have been disclosed to the farmer before the contract is executed. Farmers also should be asked to provide a disclosure statement detailing their past and current HTA contracts including any defaults thereon. Placement of credit limits on HTAs that are available to the farmer, as well as the limitation of the overall risk or exposure of the cooperative, also may be a good idea. Finally, providing updates to the buyer regarding the market value of the contract and any margin calls should be considered.

B. *For the Farmer*

The farmer must first realize an HTA is a cash contract and not a trading vehicle. Then, to fully understand HTAs, the farmer needs to know the current price of the futures contract the buyer is selling. Next, the farmer needs to project what the basis will be at the time of delivery. Subtracting the projected basis from the futures price will set the expected cash price. The farmer then evaluates how the net cash price will fit with the position if the futures rise or fall.[156]

If the futures contract price rises after sale on an HTA contract, the cooperative incurs a loss on the sale because it has to buy back the futures at a higher price. The cash grain price received by the farmer will equal equally the amount of the loss on the futures for the cooperative and vice versa.[157]

Farmers who are holding HTA contracts that are causing losses may want to consider mediation rather than refusing to honor the obligation and risk being sued by the cooperative. Along with such a lawsuit may come revocation of membership in the cooperative and its attendant problems. This is especially true if the HTAs do not have long rolling provisions or if they have specified delivery dates, which would give a court less reason to find the contracts illegal.

We are entering a new era for farming.[158] The government safety net is

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156. Otte, *supra* note 67, at 8.

157. *Id.*

158. *Remarks Before the Commodity Club of Washington*, (July 23, 1996) (remarks by Joseph Dial), *reprinted in* FDCH FEDERAL DEPARTMENT AND AGENCY DOCUMENTS, July 23, 1996, *available in* LEXIS, News Library, Curnws File.

phasing out and farmers will be farming for the market and not the government.[159] The international trade tariffs and non tariff trade barriers are falling thanks to the General Agreement on Tariffs and Trade (GATT) and the North American Free Trade Agreement (NAFTA).[160] Markets now will be driven more by supply and demand and less by government intervention.[161] Many farmers will need to modify their attitudes toward change. They will have to acquire business savvy and become business specialists in agriculture.[162] That means understanding new marketing techniques and how to use them.

C. *For the Agencies*

Agencies under whose jurisdiction HTA might fall should convince Congress to lift the agricultural trade option ban to enable the development of new and innovative risk management tools. These new tools will be needed to secure the farmer's profit as government farm subsidies are cut.[163] State agencies may wish to provide better education and training on how to audit the books of cooperatives. These agencies lacked the knowledge necessary to discover and evaluate the risks associated with HTAs.[164]

D. *Mediation*

Iowa Attorney General Tom Miller stated at an informational meeting in Mason City that there is no time to litigate these contracts in court. Mediation should be pursued. While mediation is probably the best option, some of the higher price multi-year hedge contracts will be litigated.

But some multi-year hedge contracts can be mediated and worked out depending on (1) the total number of bushels sold, (2) the number of producers who have a claim to the bushels, (3) the financial strength of the farmer, (4) the financial strength of the cooperatives, (5) the provisions of the contract, and (6) the will of the parties to reach a solution.[165] If the total number of bushels is small, or large but distributed over multiple cooperatives or farmers, then the problem is minor. Therefore, the more complete the contract, the easier it will be to work out the problem.[166]

In cases where larger losses will occur there appears to be only one solution offered to date. That is to have the cooperatives give the farmers a loan at a reduced

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159. *Id.*

160. *Id.*

161. *Id.*

162. *Id.*

163. Eddie Evans, *Lifting Option Ban Seen Cutting Farmers' Risk*, REUTERS EUR. BUS. REP., Dec. 29, 1995, *available in* LEXIS News Library, Curnws File.

164. Kilman, *supra* note 72, at A1.

165. *Futures Trading Laws*, *supra* note 23 (testimony of Roger G. Ginder).

166. *Id.*

interest rate to pay off their debt.[167] This way the cooperative is paid over time and collects some interest. As a result, the loss to the farmer and cooperative can be reduced to a certain extent.

VI. CONCLUSION

Even with the problems, HTAs will not disappear.[168] HTAs are a valuable tool, and they work in the grain and soybean markets. Not all HTAs will be found illegal. They will only be illegal if they are futures or options, and thus would be considered an off-exchange contract. Some HTAs also will be determined illegal if they are found to be speculative. Speculative HTAs will allow multi-year rolls, for the delivery requirement to exceed production, and no delivery date. Courts also may consider a farmer's original intent to perform and history of honoring these contracts until they became unprofitable. HTAs should remain in use, but the contracts must be more thorough. They must require delivery and may have to limit the roll to the current crop year. The terms must be spelled out. Sadly, handshake agreements must cease.

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167. *Id.*

168. Anne Fitzgerald, *Confusion over Hedge Contracts, Federal Regulators Not Much Comfort, Grain Handlers Say*, DES MOINES REG., May 22, 1996, at S8.