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CFTC COMPLAINT UPHeld

— by Neil E. Harl*

The hedge-to-arrive saga¹ took another turn on November 6, 1998, with release of the Agricultural Law Judge's opinion in the Grain Land Coop case.² The hedge-to-arrive controversy arose in 1995-96 when grain and soybean prices rose sharply and caught many producers with multi-year contracts hedged on a nearby futures contract month.³ The old crop-new crop spread between the 1995 and 1996 crops widened to unprecedented proportions in the early summer of 1996 and caused huge losses to elevators which were holding the futures obligation.⁴ Litigation since that time has endeavored to ascertain who would ultimately bear the losses from margin calls, roll charges and other costs associated with the contracts.⁵

The Grain Land Case

The Commodity Futures Trading Commission case against Grain Land Cooperative commenced with a CFTC complaint filed on November 12, 1996.⁶ The one-count complaint alleged that Grain Land had violated the Commodity Exchange Act⁷ by entering into off-exchange futures contracts outside the cash forward contract exception.⁸ The cooperative argued that the issue of whether the contracts in question were illegal, off-exchange contracts had already been decided by the Federal District Court in Minnesota⁹ and had been found to be cash forward contracts.¹⁰ The ALJ rejected that argument, holding that CFTC was not collaterally estopped from pursuing the matter in an administrative proceeding and was not bound by the judgment rendered by the federal court.¹¹

Grain Land had entered into more than 2,000 "Flex HTA" contracts¹² and had in excess of 21 million bushels of grain under such contracts.¹⁵ Although the exact amount remained in dispute, less than 25 percent of the grain was actually delivered.¹⁴

The "Flex HTA" contract used by Grain Land was developed by taking an ordinary hedge-to-arrive contract and adding "flexible privileges" which included a rolling provision and a cancellation provision.¹⁶ The rolling provision allowed producers to roll the contract obligation forward by closing out the nearby futures contract position and establishing a similar position in a more distant futures contract month. For example, producers whose grain was hedged on the March, 1996, corn futures could roll the obligation by closing out that obligation and establishing a position in the July, 1996, or December, 1996, corn futures.

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ALJ Decision

The Administrative Law Judge, Judge George Painter, held the contracts in question to be illegal, off-exchange contracts in violation of the Commodity Exchange Act.¹⁷ The ALJ issued a cease and desist order but declined to approve the proposed civil penalty of \$110,000.¹⁸ The ALJ noted that Grain Land had failed and did not benefit from the contracts.¹⁹

The ALJ made much of the fact that the contracts involved provisions allowing the producer to cancel the contract at any time and "cash out" of the obligation by paying all roll charges and other costs that had accrued.²⁰ The producer could pay the amounts by check or by executing a multi-year promissory note.²¹ More than 45 producers cancelled at least one of their Flex HTA contracts.²² Between March and May of 1996 alone, at least 846,000 bushels of grain contracted under Flex HTA contracts were cancelled.²³

For a time, Grain Land had paid gains on cancellation of the contracts but had stopped that practice when the cooperative realized that it was not a licensed broker.²⁴ Thereafter, Grain Land paid the gains by allowing other costs incurred by the producer to be paid from the account containing the gains.²⁵ As the ALJ noted, the producers were "directly accessing the futures market, and accruing gains and losses—albeit with Grain Land as the middleman."²⁶ The ALJ found the contract to be "futures contracts" and thus in violation of the Commodity Exchange Act.²⁷

The hearing produced evidence that Grain Land's brochures stated that producers could use the contracts to "lock in price for 1-3 years production" but there was evidence that some had obligations running through the year 2005, nine years beyond the time of contracting.²⁸

Grain Land told the producers that they had the option, when the cash price was higher than their price under the Flex HTA contract, to sell their grain for cash and roll the Flex HTA contract forward.²⁹ Some producers took advantage of this option.³⁰

Further appeals

The decision is subject to review by the CFTC and by the United States Court of Appeals. It is likely that the decision will be appealed through those channels. A final decision is several months away.

Breadth of decision

One highly important issue is the breadth of the decision. Clearly, the cancellation provision figured prominently in the ALJ's analysis. It is not clear whether a multi-year contract without a cancellation provision would be deemed an illegal, off-exchange contract where producers were, nonetheless, allowed to cash out. Likewise, it is not clear whether multi-year contracts without a cancellation provision and without evidence that producers were allowed to cash out might be deemed outside the cash forward contract exception. Those questions remain for another day.

FOOTNOTES

- ¹ See Harl, "Hazards of Hedge-to-Arrive Contracts," 7 *Agric. L. Dig.* 77 (1996); Harl, "Reporting HTA Losses," 7 *Agric. L. Dig.* 183 (1996); Harl, "Hedge-to-Arrive Contracts: Two Federal Court Cases," 8 *Agric. L. Dig.* 153 (1997). See generally 10 Harl, *Agricultural Law* § 74.04 (1998); Harl, *Agricultural Law Manual* § 13.11 (1998).
- ² See, In the Matter of Grain Land Coop., C.F.T.C. Docket No. 97-1 (Nov. 6, 1998).
- ³ See Harl, "Hazards of Hedge-to-Arrive Contracts," 7 *Agric. L. Dig.* 77 (1996).
- ⁴ *Id.*
- ⁵ See, e.g., Harl, "Hedge-to-Arrive Contracts: Two Federal Court Cases," 8 *Agric. L. Dig.* 153 (1997).
- ⁶ In the Matter of Grain Land Coop., CFTC Docket No. 97-1 (Nov. 12, 1996).
- ⁷ 7 U.S.C. § 6.
- ⁸ For a discussion of the cash forward contract exception and the history of the Commodity Exchange Act, see 10 Harl, *supra* n. 1.
- ⁹ In re Grain Land Coop Cases, 978 F. Supp. 1267, 1280 (D. Minn. 1997).
- ¹⁰ *Id.*
- ¹¹ In the Matter of Grain Land Coop., C.F.T.C. Docket 97-1 (Nov. 6, 1998).
- ¹² *Id.*
- ¹³ *Id.*
- ¹⁴ *Id.*
- ¹⁵ *Id.*
- ¹⁶ *Id.*
- ¹⁷ 7 U.S.C. § 6.
- ¹⁸ *Id.*
- ¹⁹ In September, 1996, Grain Land was unable to continue operations and transferred a "substantial portion" of its fixed assets to a limited liability company which was "based, managed and operated" by Wantonwan Farm Service Company. In the Matter of Grain Land Coop., C.F.T.C. Docket 97-1 (Nov. 6, 1998).
- ²⁰ *Id.*
- ²¹ *Id.*
- ²² *Id.*
- ²³ *Id.*
- ²⁴ *Id.*
- ²⁵ *Id.*
- ²⁶ *Id.*
- ²⁷ 7 U.S.C. § 6.
- ²⁸ *Id.*
- ²⁹ *Id.*
- ³⁰ *Id.*