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INSIDE

IN FUTURE ISSUES

- 1996 Farm Bill

Federal Farm Products Rule amended

For the first time since the Federal Farm Products Rule became law in December, 1986, Congress has amended the statute [7 U.S.C. section 1631]. The amendment permits secured parties to file effective financing statements (EFS's) electronically in state central notification systems (CNS's) created in response to section 1631. Congress accomplished this change by amending the definition of an EFS [section 1631(c)(4)] so that the definition now reads:

(4) The term "effective financing statement means a statement that"

(A) is an original or reproduced copy **of the statement, or, in the case of a State which (under the applicable State law provisions of the Uniform Commercial Code) allows the electronic filing of financing statements without the signature of the debtor, is an electronically reproduced copy of the statement;**

(B) **other than in the case of an electronically reproduced copy of the statement** is signed and filed with the Secretary of State of a State by a secured party;

(C) **other than in the case of an electronically reproduced copy of the statement** is signed by the debtor;

(D) [the remainder of the EFS definition remains the same as the present law.]

[The bold face type indicates the amending language.]

Congress adopted this amendment in section 662 of the Federal Agricultural Improvement and Reform Act of 1996 (FAIRA—the 1996 Farm Bill). The amendment became effective the day President Clinton signed the FAIRA into law—April 4, 1996. Two additional comments about this amendment seem worthwhile.

First, Congress did not require the secured party to show a debtor's signature on the electronic filing if the state UCC law does not require any electronic signature. This is important because electronic signatures (a type of graphics) use much greater computer storage space than straight text documents.

Second, many states (e.g., Texas, Kansas) already have begun or shortly will begin electronic filing for UCC financing statements. Over the next several years, electronic filing is likely to be a major development in the state UCC systems everywhere. By amending the law, Congress intended to make the state central notification systems electronically comparable to the state UCC systems.

—Drew L. Kershen, University of Oklahoma, Norman, OK

Tenth Circuit setoff decision withdrawn

In the October, 1995 issue of the *Agricultural Law Update*, the controversial decision in the case of *Turner v. Small Business Association (In re Turner)*, 59 F.3d 1041 (10th Cir. 1995) (hereinafter, *Turner I*) was reported. In Turner I, the court ruled that different agencies of the federal government failed to meet the mutuality requirement of section 553 of the Bankruptcy Code. The court subsequently voted to rehear the case en banc and vacated the panel judgment. On May 23, 1996, the panel decision was withdrawn, and a new decision was entered. *Turner v. Small Business Association (In re Turner)*, nos. 94-6191, 94-6208, 1996 WL 274388 (10th Cir. May 23, 1996) (hereinafter, *Turner II*).

The facts of the case were not in dispute. The debtors owed a substantial debt to the Small Business Association (SBA). Prior to bankruptcy, this debt was delinquent, had been accelerated, and was used as a setoff against farm program payments due to the debtors. The debtors did not challenge the legality of this setoff outside of bankruptcy and admitted that the SBA followed its regulations. Subsequent to the setoff, however, the debtors filed for relief in bankruptcy under Chapter 12 of the Bankruptcy Code. Because the setoff had occurred within ninety days of the filing, the debtors brought an adversary proceeding seeking turnover of the setoff funds as a

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voidable preference. The government argued that under section 553 of the Bankruptcy Code, setoff was allowed and avoidance was improper. The bankruptcy court held that the transfers were voidable preferences; the district court affirmed; and the government appealed to the Tenth Circuit. *Turner I*, 59 F.3d at 1043; *Turner II* at *1.

In its initial decision, the Tenth Circuit affirmed the lower courts, basing its ruling specifically on section 553. One of the requirements for setoff under section 553 is that the obligations between the debtor and the creditor be "mutual." 11 U.S.C. § 553(a). The court stated that "the obligations between debtor and creditor are mutual when both obligations are held by the same parties, in the same right or capacity." The court stated that setoff should be given a narrow application in a reorganization and that this is best accomplished by strictly construing the mutuality requirement. *Turner I*, 59 F.3d at 1043.

Applying this to the issue of two agencies of the federal government, the court in *Turner I* acknowledged that each agency drew from or contributed to the same federal Treasury. In the corporate context, however, the court noted that it was "well-established" that corporate subsidiaries do not meet the mutuality requirements of section 553, despite financial ties. To treat government agencies more favorably than their private sector counterparts would be contrary to the principle that all creditors be treated equally. The court further noted that government agencies frequently "squabble in court," and have "distinct budgets and interests." Moreover, bankruptcy law does not treat debts to the government as a single claim; and, in fact, some agency's claims may be given priority over others. For these reasons, the *Turner I* court held that mutuality was lacking between the SBA and ASCS. The administrative offset was found to be a voidable preference. *Id.* at 1046.

The Tenth Circuit court granted the government's request for a rehearing en banc to review the narrow issue of whether agencies of the federal government can be considered as one creditor for purposes of setoff. Reaching the opposite conclusion of the panel in *Turner I*, the court definitively held that "the United States is a unitary creditor in bankruptcy." *Turner II* at * 1.

As support for its decision, the court first established that outside of bankruptcy, agencies of the federal government are treated as one unitary creditor, at least with respect to setoff. In *Cherry Cotton Mills v. United States*, 327 U.S. 536 (1946), the Supreme Court allowed the interagency setoff of Agricultural Adjustment Act payments against a debt owed to the Reconstruction Finance Corporation. Although setoff was not the primary issue before the Court, language in the opinion clearly indicates the Court's treatment of the different agencies as one for setoff purposes. Subsequent Supreme Court decisions have also allowed interagency setoff, and a federal statute and federal regulations expressly authorize this practice. Thus, under nonbankruptcy law, the United States is a unitary creditor for purposes of setoff. *Turner II* at *2.

The next question addressed by the court in *Turner II* was whether the intervention of bankruptcy law and procedure alters this result. The court held that it did not. The language of the Bankruptcy Code makes it clear that setoff has no special meaning in the bankruptcy context and that setoff rights are determined primarily according to nonbankruptcy law. *Turner II* at *3. As noted by the Supreme Court in *Citizens Bank of Maryland v. Strumpf*, ___ U.S. ___, 116 S.Ct. 286, 289 (1995), "[a]lthough no federal right of setoff is created by the Bankruptcy Code, 11 U.S.C. § 553(a) provides that, with certain exceptions, whatever right of setoff otherwise exists is preserved in bankruptcy." *Turner II* at *3.

The court cited *Luther v. United States*, 225 F.2d 495 (10th Cir. 1954) as further support for the treatment of separate agencies as one entity in allowing setoff. In *Luther*, a bankruptcy referee allowed an IRS refund to be offset against an amount the debtor owed to Commodity Credit Corporation. This holding was recently relied upon by the Ninth Circuit in *Doe v. United States*, 58 F.3d 494, 498 (9th Cir. 1995). The court rejected the debtors' attempts to distinguish *Luther* as a liquidation bankruptcy, noting that section 553 applies to liquidations and reorganizations alike. The court also cited a number of bankruptcy court opinions that have held that different agencies of the federal government act as a unitary creditor for purposes of setoff in bankruptcy. *See, e.g.*, *In re Kalenze*, 175 B.R. 35, 37 (Bankr. D.N.D. 1994). *Turner II* at *3-4.

The court in *Turner I* made its ruling solely on the issue of mutuality. The court in *Turner II* definitively reversed on that issue, holding that the separate agencies met the mutuality requirement for setoff under § 553. The *Turner II* court remanded the case to the panel for consideration of the remaining issues under § 553.

—*Susan A. Schneider, Hastings, MN*

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Conference Calendar

Drake Law School Summer Agricultural Law Institute 1996

June 10-13: Federal farm programs and the 1996 Farm Bill, Chris Kelley and Susan Schneider.

June 17-20: Legal aspects of livestock production and marketing, Prof. Jake Looney.

June 24-27: Farm and ranch estate and business planning, Prof. Roger McEowen.

July 8-11: Law of international trade in agricultural products, Prof. Donald E. Buckingham.

July 15-18: Law and the new agriculture: organic production, farmers' markets, CSA's, urban gardening, cooperatives, and farmland preservation, Prof. Neil Hamilton.

Sponsored by: Drake University Law School Agricultural Law Center.

For more information, call 515-271-2065.

State Roundup

MONTANA. *Question of CRP participation following purchase of real property.* In *Peuse v. Malkuch*, No. 95-388, 1995 WL 75626 (Mont. Feb. 22, 1996), the Montana Supreme Court heard an appeal in a suit for specific performance, necessitated by a dispute over a property's future participation in the CRP program.

In March 1990, Malkuch contracted to sell Peuse certain real property in Dawson County, Montana. Malkuch's land was enrolled in the Conservation Reserve Program (CRP). While the agreement addressed future CRP payments, it was silent as to whether the property would remain in the program after the sale. Concerned that he might incur penalties on payments already received, Malkuch sought guarantees that Peuse would keep the property in CRP. Peuse refused. Concerned over the property's future in the CRP program, Malkuch failed to close the sale.

After the closing date passed with no sale, Peuse filed suit for specific performance and moved for summary judgment. Malkuch asserted that Peuse's obligation to keep the property in CRP was implicit in the contract's reference to CRP payments. Thus, a question existed as to whether Peuse breached the agreement, precluding summary judgment. Unpersuaded, the district court granted partial summary judgment in favor of Peuse.

In a short opinion, the supreme court first noted that the sale agreement contained no provision requiring that the property remain in the CRP. The court then found that the dispute over the property's participation in CRP was not material to the main purpose of the agreement. Accordingly, specific performance could be enforced.

—*Scott D. Wegner, Lakeville, MN*

SOUTH DAKOTA. *Lack of personal jurisdiction over out-of-state cattle seller.* The South Dakota Supreme Cattle recently examined whether personal jurisdiction extended to a New Mexico rancher selling cattle to a South Dakota buyer. *Miller v. Weber*, 1996 SD 47, 1996 WL 196824 (S.D. Apr. 24, 1996).

In 1987, Buddy Major, a New Mexico rancher, decided to liquidate his 600-head cattle herd. Culbertson, a New Mexico resident, obtained an option to buy Major's cattle at $470 per head. Thereafter, Jeff Weber of South Dakota and Culbertson reached an oral agreement for Weber to purchase the cattle at $505 per head. Weber subsequently brokered the cattle to Eugene Miller of Isabel, South Dakota. Successful brucellosis testing was a condition of the agreement.

Blood tests revealed several cattle were either brucellosis "suspects" or "reactors." (A "reactor" has a high probability of being infected with brucellosis, commonly known as Bangs disease. A "suspect" can neither be classified as a reactor or nonreactor.) Shipment was delayed in the hope that the cattle would later test negative. In April, 1987, at Major's initiative, the cattle were given health certificates for shipment to Nebraska. The livestock arrived in poor health and many died in route. (A New Mexico veterinarian was later disciplined for failure to properly inspect the cattle.)

Following the move, Miller contracted to sell the herd to Ducheneaux, a South Dakota rancher. However, given the herd's health history, Ducheneaux could not move the cattle to South Dakota and was forced to sell the herd for slaughter. Ducheneaux sued Miller, alleging breach of contract, breach of warranty, and fraudulent misrepresentation. *See Ducheneaux v. Miller*, 488 N.W.2d 902 (S.D. 1992)(trial court's award of actual and punitive damages and prejudgment interest to Ducheneaux upheld.)

In this case, Miller brought an action against, *inter alia*, Buddy Major. Major was served in New Mexico, but on advice of counsel, ignored the pleadings. Consequently, default judgments were entered against him in South Dakota. A South Dakota circuit court later granted Major's motion to set aside the judgments and dismissed the case against Major for lack of personal jurisdiction.

On appeal, the South Dakota Supreme Court set forth the standards for determining whether sufficient contacts exist to support personal jurisdiction. "First, the defendant must purposefully avail himself of the privilege of acting in the forum state, thus invoking the benefits and protections of its law. Second, the cause of the action must arise from defendant's activities directed at the forum state. Finally, the acts of defendants must have a substantial connection with the forum state to make the exercise of jurisdiction over defendant a reasonable one."

Miller relied on *Opp v. Nieuwsma*, 458 N.W.2d 352 (S.D. 1990), where the court upheld personal jurisdiction over an Iowa cattle buyer, and on South Dakota's long arm statute. S.D. Codified Laws Ann. § 15-7-2. However, the supreme court distinguished *Opp*, observing that the Iowa cattle seller knew the livestock were destined for South Dakota; sent fraudulent health documents to South Dakota; arranged to have the cattle shipped to South Dakota; received a check drawn on a South Dakota bank; placed telephone calls to South Dakota; and had post-sale negotiations with the South Dakota buyer.

In contrast, Major's agreement was with Culbertson, a New Mexico resident. Further, Major never solicited Miller or Weber to purchase the cattle. Major did not negotiate or make contact with anyone in South Dakota. Finally Major's efforts to get the cattle health certified were for purposes of shipment to Nebraska, not to South Dakota. Lacking a substantial connection with South Dakota, the supreme court affirmed the dismissal for lack of personal jurisdiction.

—*Scott D. Wegner, Lakeville, MN*

State Round-Up/*Continued on page 7*

Federal Register *in brief*

The following is a selection of items that were published in the *Federal Register* from April 18 to May 17, 1996.

1. APHIS; Importation of animals and animal products; shipping containers and other means of conveyance; inspection requirements; proposed rule; comments due 7/17/96. 61 Fed. Reg. 16978.

2. Farm Credit Insurance Corporation; Policy statement concerning stand-alone assistance; effective date 3/28/96. 61 Fed. Reg. 17299.

3. Foreign Agricultural Service; Regulations governing the financing of commercial sales of agricultural commodities; final rule; effective date 5/23/96. 61 Fed. Reg. 17823.

4. Farm Service Agency; Dairy Indemnity Payment Program; final rule; effective date 4/26/96. 61 Fed. Reg. 18485.

5. Farm Credit Administration; Accounting and reporting requirements; high risk assets; final rule; effective date 12/15/94. 61 Fed. Reg. 18235.

6. Farm Credit Administration; Notice of effective date on loan information disclosure; effective date 5/3/96. 61 Fed. Reg. 20125.

7. Farm Credit Administration; Policy statement on mergers of unlike associations; effective date 4/23/96. 61 Fed. Reg. 19938.

8. Farm Credit Administration; Funding and discount relationship between FCS banks and other financing institutions; final rule; effective date 7/16/96 61 Fed. Reg. 24907.

9. Agricultural Marketing Service; Amendment of general regulations for marketing orders; adding stipulation procedures; final rule; effective date 5/9/96. 61 Fed. Reg. 20717.

10. PSA; Livestock care and handling guidelines; proposed rule; comments due 7/16/96. 61 Fed. Reg. 24916.

—*Linda Grim McCormick, Alvin, TX*

CFTC issues "hedge-to-arrive" contract policy and guidance statements

By Christopher R. Kelley

Concerns over "hedge-to-arrive" contracts are mounting in the Corn Belt. *See, e.g.*, Fred Vogelstein & Scott Kilman, *Some Grain Accords Leave Farmers in Bushels of Debt*, Wall St. J., May 20, 1996, at C1. Ironically, the concerns stem from this year's record high grain prices. Under hedge-to-arrive contracts made last year or earlier, many farmers are obligated to sell grain at prices sometimes more than two dollars under current prices. These farmers face substantial losses, particularly those who must purchase grain to meet their obligations. Buyers also face losses. Many hedged their positions under their hedge-to-arrive contracts. As futures prices have risen, the equity in their hedges has declined, leaving them exposed to margin calls on hedges for grain that has not been delivered and may never be delivered. With potential total losses estimated at $500 to $700 million, the "hedge-to-arrive problem" has been described as "blossoming into one of the biggest trade debacles to ever sock the Farm Belt." *Id. See also* Suzanne McGee, *Farmers May Be Next Victims of Derivatives*, Wall St. J., Dec. 11, 1995, at C1. For many on both sides of these contracts, the question now is how to limit or offset their losses.

In attempting to answer this question, some discovered that information and guidance was difficult to obtain. That situation improved last month. On May 15, the Commodity Futures Trading Commission's (CFTC) Division of Economic Analysis issued policy and guidance statements on hedge-to-arrive contracts, the same day on which the Senate Agriculture Committee held hearings on such contracts. Both actions were preceded by the National Grain and Feed Association's (NGFA) publication of a "white paper" on hybrid cash grain contracts. The then-pending publication of that study was noted in Roger A. McEowen, *In Depth: Marketing Agricultural Commodities Through Use of Hedge-to-Arrive Contracts May Violate CFTC Rules*, Agric. L. Update, May 1996, at 4 [hereinafter McEowen].

The hedge-to-arrive contract

Although categorically combined as if they were all alike, hedge-to-arrive contracts are not all alike. Some offer alternatives that others do not. Some are well-conceived and drafted, others are not. Properly drafted and performed, the hedge-to-arrive contract is a recent variant of the more familiar fixed-price contract for deferred delivery. *See generally* Richard A. Malm, *Contracts for Future Delivery of Grain: An Overview of Common Legal Problems,* 2 Agric. L.J. 485 (1980-81) (discussing traditional deferred delivery contracts). Both are forward contracts under which delivery is deferred. However, unlike a fixed-price contract where the price is a flat price established at the contract's inception, the price paid under a hedge-to-arrive contract is based on a formula in which a major determinant, the "basis," is established in the future.

In a basic hedge-to-arrive contract, the parties establish at the contract's inception a per-unit price based on a board of trade "futures" contract price for a month within the crop's marketing year. This price is sometimes called the "reference price" or "futures price." Later, but usually before delivery of the contracted commodity, the seller establishes the "basis." The "basis" is typically defined as the sum representing the difference between the buyer's per-unit cash price on that date and the futures price for a designated futures contract month. The contract's cash price is its futures price plus its basis. Under this formula, a negative basis results in a final cash price that is lower than the contract's futures price. For example, if the futures or reference price is $2.50 and the basis is a negative twenty-five cents (-.25), the final cash price is $2.25. The seller has the obligation to deliver the commodity, and the buyer has the obligation to accept delivery within the marketing year, subject to the contract's *force majeure* provision.

Sellers use hedge-to-arrive contracts to "lock-in" a futures price on the prediction that futures prices will decline and the basis will improve by becoming more positive. They thus assume the "basis risk" because market conditions can cause a contract's potential basis to change over time. *See generally* Susan K. Davis, *Hedged-to-Arrive Arrives*, Top Producer, Aug. 1992 at 8. Buyers, on the other hand, often use such contracts to remain competitive by giving their customers a greater variety of marketing options. As the counterparty to the seller, the buyer assumes the "futures risk."

Buyers typically hedge their "futures risk" by making a "short" or selling hedge on a board of trade. Such hedges require deposits in margin accounts that must be increased as the equity in the hedge declines. Chicago Board of Trade, *Commodity Markets* 12 (1983). Margin obligations can be costly to buyers when futures prices rise, as they have recently.

Potentially troublesome for both parties is the opportunity offered under some types of hedge-to-arrive contracts to "roll" the contract to another futures month, thereby postponing delivery of the grain. *See generally* Larry Stalcup, *Give It a Roll*, Top Producer, Feb. 1995, at A-8; Pam Henderson, *Cash Contract Crackdown: Grain Elevators Tighten Policies To Protect Against Farmer Default*, Top Producer, Mid-Feb. 1996, at 17. "Rolling" also may have undesirable consequences for sellers if per-bushel and "spread" costs are significant. Statement of Dr. J. William Uhrig before the Senate Committee on Agriculture, Nutrition and Forestry, May 15, 1996, at 7. Moreover, "rolling" to another crop year introduces a high degree of speculation into the contract because new-crop prices often behave independently of old-crop prices. *See, e.g.*, Linda H. Smith, *Lessons Learned: The 1995-Crop Rally Was a Tough Teacher for Both Farmers and Elevator Managers*, Top Producer, Apr. 1996 at 22, 23. For some sellers and buyers, therefore, the most attractive alternative may be to terminate or "unwind" the contract on agreed-upon terms.

Hedge-to-arrive contracts and the Commodity Exchange Act

"Unwinding" a hedge-to-arrive contract on terms not calling for delivery of the commodity initially appeared to raise a potentially thorny issue under the Commodity Exchange Act (CEA). As ably discussed in Professor McEowen's article, a potential question regarding an individual hedge-to-arrive contract is whether the contract violates the CEA. The CEA regulates "futures" trading, confining the offering and sale of contracts for the "future delivery" of any commodity, except onions, to designated contract markets. 7 U.S.C. §§ 6(a), 13-1 (1994). *See generally* John H. Stassen, *The Commodity Exchange Act In Perspective: A Short and Not-So-Reverent History of Futures Trading Legislation in the United States*, 39 Wash. & Lee L. Rev. 825 (1982) (explaining, *inter alia*, the "onion exception"). Such

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"futures contracts" are within the jurisdiction of the CFTC. *See* 7 U.S.C. § 4a (1994). While the CEA does not define a "futures contract," it exempts from the term "future delivery" the "sale of any cash commodity for deferred shipment or delivery." 7 U.S.C. § 1a(11) (1994). This exemption is variously called the "forward contract exclusion" or the "cash commodity exclusion." It has been a part of federal futures regulation since 1921 and is generally intended to place the sale or purchase of actual commodities outside of the CEA's scope.

Violations of the CEA can result in stiff civil and criminal penalties. 7 U.S.C. §§ 13a-1, 13 (1994). Thus, grain buyers issuing hedge-to-arrive contracts want their contracts to come within the forward contract exclusion. Yet, despite the seeming simplicity of the exclusion's language and purpose, drawing the distinction between a futures contract and an exempted forward contract can be extremely difficult. Glenn Willett Clark, *Genealogy and Genetics of "Contract of Sale of a Commodity for Future Delivery" in the Commodity Exchange Act*, 27 Emory L.J. 1175, 1178 (1978) (noting that "considerable confusion is associated with the conceptual line of demarcation between the two"). *See generally* Committee on Commodities Regulation of the Ass'n of the Bar of the City of New York, *Section Report: The Forward Contract Exclusion: An Analysis of Off-Exchange Commodity-Based Instruments*, 41 Bus. Law. 853 (1986) (collecting CFTC and court decisions).

"[N]o litmus paper test" distinguishes a futures contract from an exempted forward contract. *In re First Nat'l Monetary Corp.*, [1984-1985 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶22,698, 1985 LEXIS 289 at *13 (CFTC 1985). Instead, "[t]he transaction must be viewed as a whole with a critical eye toward its underlying purpose." *CFTC v. CoPetro Marketing Group, Inc.*, 680 F.2d 573, 581 (9th Cir. 1982)). Although "it is the underlying economic reality of the transaction ... that determines legality, *Precious Metals Associates, Inc. v. CFTC*, 620 F.2d 900, 908 (1st Cir. 1980), the CFTC and the courts have identified and applied a variety of factors for making the distinction. *See, e.g., In re Stovall,* [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941, 1979 CFTC LEXIS 10 (CFTC 1979); *CFTC v. CoPetro Marketing Group, Inc.*, 680 F.2d at 579-81.

One of the factors used to distinguish a futures contract from a forward contract is whether the contract results in the delivery of the commodity. Delivery is a traditional hallmark of a forward contract. *See, e.g., NRT Metals, Inc. v. Manhattan (Non-Ferrous) Metals Ltd.*, 576 F. Supp. 1046, 1050 (S.D.N.Y. 1983). A contract might not be an exempted forward contract if, by its terms or for reasons other than a *force majeure*, it does not result in the actual delivery of the commodity. Thus, the CFTC's recent Statement of Policy addressing the "unwinding" of hedge-to-arrive contracts under terms that excuse the delivery of the commodity has special significance.

"Unwinding" hedge-to-arrive contracts

The Statement of Policy recognized the significance of delivery. That recognition, however, was coupled with an acknowledgement that the courts and the CFTC have acted "cautiously in weighing the potential disruption that could be caused to vital commercial markets" where the forward contract exclusion was at issue. CFTC, *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 7 n.10 [hereinafter *CFTC Statement*]. Also acknowledging the "unprecedented nature of current market conditions in certain commodities," the Statement announced that "the failure to deliver on an individual contract alone would not require the Division to conclude that the contract did not qualify for the forward contract exclusion." *Id.* at 7. It then amplified that position by announcing:

> As a matter of policy, the Division of Economic Analysis will not determine the status of any such 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.

Id. at 8.

"Rolling" hedge-to-arrive contracts

The CFTC Division of Economic Analysis also provided guidance on "rolling" provisions in hedge-to-arrive contracts. While disclaiming any position on the validity or legality of any individual contract, its Statement of Guidance addressed the provisions found in some hedge-to-arrive contracts that allow sellers to delay delivery and final pricing by selecting, or "rolling over" to, a new futures price. When "rolled," "the price of the contract is adjusted by adding to the old contract price[ ] the current difference between the price of the newly-referenced contract futures month and the old reference month at the time of the roll, less any 'roll charges' or fees specified in the contract." *Id.* at 8-9. Of particular concern were those contracts where the price referenced a contract month that expires before the crop-year in which harvest was anticipated. *Id.* at 9. *See generally* Keith Schap, *Commodity Marketing* 188 (1993) (defining "crop (marketing) year" as "[t]he time span from harvest to harvest," as specifically designated by a contract market, i.e, an exchange, for the crop).

Such "rolls," according to the Division, create risks that are unrelated to the value of the contract commodity because "it is not uncommon for the new crop-price to behave quite independently from old crop prices." *CFTC Statement, supra*, at 9 n.11. Hence, they are "inconsistent with the principles of prudent risk-reduction and create[ ] significant additional risks." *Id.* at 9 (footnote omitted).

In the Division's view, "the reference month used to establish the price of the commodity should be one that will reflect the commercial value of the commodity at the time of delivery." *Id.* at 10 n.13. Accordingly, "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 a prudent risk-reduction practice." *Id.* at 10.

Tying the traditional forward contract hallmark of delivery with its guidance on "rolling" and other concerns, the Statement of Guidance offered the following guidelines regarding hedge-to-arrive contracts:

> The Division of Economic Analysis concludes that prudent risk-reduction requires that such contracts:
>
> 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 within 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 merchandising and at a location whereby delivery can be made by the producer under normal merchandising 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

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within which the grain is, or will be, harvested, to reflect the production and inventory-carrying nature of the cash position....

Contracts which adhere to, and do not materially deviate from, the above Guidance regarding prudent risk-reduction, would be construed by the Division of Economic Analysis to fall within the forward contract exclusion of section 1a(11) of the Commodity Exchange Act.

Id. at Attachment 2-3 (omitted is a table listing the first and last sequential futures reference months and corresponding transition months for certain commodities).

Lingering questions

While the CFTC may have resolved doubts about excusing delivery in the "unwinding" of a hedge-to-arrive contract, its Statements leave questions unanswered. The ultimate question for many sellers and buyers is whether their contracts are exempted forward contracts. Parties to hedge-to-arrive contracts that are not exempted could conclude their contracts are unenforceable. While the CFTC disclaimed a position on any individual contract, its Statements may have some bearing on the question of a particular contract's legality.

The hedge-to-arrive contracts likely to receive the most scrutiny are those in which the marketing of grain does not appear to be the parties' primary purpose. Such contracts are likely to be characterized by nonexistent, indefinite, or ignored delivery requirements; unlimited "rolling" provisions; and other attributes suggesting that they were intended to serve, or served, as substitutes for on-exchange futures contracts.

In this regard, the CFTC Statements underscored the significance of the actual commodity's delivery as a hallmark of an exempted forward contract. The Statement of Policy discussed delivery in the context of contract terminations in which delivery was excused in an agreement *separate* from the hedge-to-arrive contract. The Statement of Guidance began with the proposition that hedge-to-arrive contracts should "require mandatory delivery." In both respects, the Statements serve as reminders that delivery is the "starting point" for analyzing a particular transaction. *In re Stovall,* 1979 CFTC LEXIS at *10.

As explained by the CFTC in *Stovall*:

the "cash commodity" exclusion was intended to cover only contracts for sale which are entered into with the expectation that delivery of the actual commodity will eventually occur through performance of the contracts. The seller would necessarily have the ability to deliver and the buyer would have the ability to accept delivery in fulfillment of the contract. Although the desire to acquire or dispose of a physical commodity is the underlying motivation for entering such a contract, delivery may be deferred for purposes of convenience or necessity....

Thus, a major difference between an excluded cash commodity-deferred delivery contract and contracts for sale of a commodity for future delivery is that the former entails not only the legal obligation to perform, but also the generally fulfilled expectation that the contract will lead to the exchange of commodities for money. In contrast, parties to a futures contract do not usually expect delivery and it rarely occurs.

Id. at *9-10. This passage implicitly recognizes that delivery cannot serve as a litmus paper test because futures contracts can be satisfied or liquidated by delivery. Less than one percent, however, are discharged in that manner. *Cargill, Inc. v. Hardin*, 452 F.2d 1154, 1156 n.2 (8th Cir. 1971), *cert. denied*, 406 U.S. 932 (1972). Instead, most are discharged by the trader taking "an opposite and offsetting transaction in the same future prior to the expiration of trading in that future...." *Id.* at 1156.

The significance of delivery is also reflected in a 1985 interpretative statement by the CFTC Office of General Counsel discussing the characteristics distinguishing cash and forward contracts and "trade" options. There, after explaining the forward contract exclusion's legislative history, the Office of General Counsel began its discussion of factors that bring a contract within that exclusion by emphasizing delivery:

First, the contract must be a binding agreement on both parties to the contract: one must agree to make delivery and the other to take delivery of the commodity. Second, because forward contracts are commercial, merchandizing transactions which result in delivery, the courts and the Commission have looked for evidence of the transactions' use in commerce. Thus, the courts and the Commission have examined whether the parties to the contracts are commercial entities that have the capacity to make or take delivery and whether delivery, in fact, routinely occurs under such contracts.

50 Fed. Reg. 39,656, 39,657-58 (1985) (footnotes omitted).

Even the context in which factors other than delivery are discussed by the CFTC and the courts underscores the importance of the actual delivery of the commodity. For example, standardized terms are characteristic of a futures contract. Except for price, futures contracts contain standardized terms that make them "fungible." "The fungible nature of these contracts facilitates offsetting transactions by which purchasers or sellers can liquidate their positions by forming opposite contracts." *CFTC v. CoPetro Marketing Group, Inc.*, 680 F.2d at 579 (citation omitted). Because forward contracts are discharged by delivery, not offsetting transactions, their terms need not be standardized, and they often vary in respects other than price.

In addition, although margin deposits and commissions may seem unrelated to delivery, the relationship may exist. Parties to a futures contract must make an initial payment when they purchase or sell the contract. The minimum amount that must be deposited and maintained is set by the exchange on which the contract is traded. Chicago Board of Trade, *Commodity Markets* 12 (1983). "Such margin requirements are a recognized characteristic of futures contracts." *In re First Nat'l Monetary Corp.*, [1984-1985 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶22,698, 1985 LEXIS 289, *18 (CFTC 1985). Also, "[c]ommissions are generally charged by brokers dealing in futures contracts." *NRT Metals, Inc. v. Manhattan Metals (Non-Ferrous) Ltd*, 576 F. Supp. at 1052 (citation omitted). In *NRT Metals*, the court concluded that "[t]he payment to plaintiff of a commission and the use of the term 'margin' to depict certain payments made by defendants to plaintiff also strengthen[ed] the improbability that physical trades were the intended arrangement between the parties." *Id.* at 1051.

Similarly, the sale of the contracts to the general public is a factor linked to delivery. The courts and the CFTC focus on the degree to which contract purchasers are members of the general public and thus need the CEA's regulatory protection. A contract that is marketed to the general public invites scrutiny to see whether the commodity has any "inherent value" to its purchasers or whether the transaction is only a speculative venture. *See, e.g., CFTC v. CoPetro Marketing Associates, Inc.*, 680 F.2d at 578-79. *See also CFTC v. U.S. Metals Depository Co.*, 468 F. Supp. 1149 (S.D.N.Y. 1979) (focusing on the suitability of the investment for unsophisticated members of the general public). This factor has resulted in the application of a "commercial-use" test, an inquiry that examines whether the customer has a commercial use for the commodity. If the purchasers of the product have no use for the underlying commodity and are unsophisticated, the need for their protection becomes a significant consideration. *See CFTC v. CoPetro Marketing Associates, Inc.*, 680 F.2d at 578-79.

Finally, courts generally agree that using a contract for speculative purposes indicates the instrument is a futures contract. *See, e.g., Precious Metals Associates, Inc. v. CFTC*, 620 F.2d at 905. The

STATE ROUNDUP/*Continued from page 3*

NEW HAMPSHIRE. *Claim that pesticides killed horses.* In *O'Donnell v. Moose Hill Orchards, Inc.*, No. 94-107, 1996 WL 2105 (N.H. Jan. 31, 1996), the New Hampshire Supreme Court considered a claim that pesticides sprayed on orchards resulted in the illness and death of horses.

O'Donnell owns a thoroughbred horse farm which abuts Moose Hill's apple orchards. During the spring of 1983, twenty-two horses at the O'Donnell farm experienced colic, and eight horses later died. O'Donnell filed suit, alleging that pesticide spraying in Moose Hill's orchards caused the illness and death of the horses. A jury returned a verdict in favor of Moose Hill.

At trial, Moose Hill called Dr. Eaton, an entomologist from the University of New Hampshire as an expert witness. Dr. Eaton testified concerning LD-50, the best available measure of a pesticide's toxicity. The LD-50 is the number of milligrams of pesticide that are required for every kilogram of body weight in order to achieve a fifty percent kill of a target population. Dr. Eaton calculated the LD-50 of Dithane, a chemical sprayed on the orchards, for a thoroughbred horse. Dr. Eaton also determined and testified as to the amount of contaminated hay a horse would have to eat to ingest a lethal quantity of pesticide.

On appeal, O'Donnell contended that Dr. Eaton was not qualified as an expert on LD-50's, toxicology, or the toxic effects of pesticides on horses. Accordingly O'Donnell argued that the trial court erred in allowing the testimony. The supreme court made short work of O'Donnell's claims, noting that Dr. Eaton is the statewide integrated pest management coordinator, author of numerous articles, and an editor and participating author of the New England Pesticide Control Guide. The court also cited with approval the trial court's comment that "there is no suggestion by either counsel that there is a better way of measuring toxicity other than the recognized LD-50 process." Further, the supreme court observed that the proper method of testing an expert's opinion is by cross-examination. The decision of the trial court was affirmed.

—*Scott D. Wegner, Lakeville, MN*

Rep. Minge seeks AALA members' input

As the U.S. moves towards the year 2000, American agriculture sits at a crossroads. With the recent passage of the 1996 farm bill, several decades-old federal farm programs are gone, replaced by annual transition payments. Although the new farm bill advances flexibility, it has no vision and may not even address the changing needs of American agriculture over the next seven years.

The small and medium-sized family farms which have dotted rural America re increasingly giving way to larger farm-ing operations and corporations. Farmers are also forming cooperatives and entering into contract production agreements with other producers or with processors. These changes will naturally have far-reaching consequences. Some farmers are choosing to maintain moderate-sized operations and are promoting "sustainable" and "low-input" agriculture.

I would like to open an avenue of discussion between legislators and critical thinkers about government policies which will assure open markets, a level playing field, and opportunities for American farmers, including those who wish to maintain moderate-sized operations. What tools do farmers need to manage risks? How important are crop and revenue insurance; marketing loans; rules for a level playing field; and minimum standards for national and international production contracts? What role can or should the government play in creating those tools? I would also like to explore whether minimum till, low input agricultural practices can be economically viable in contemporary agriculture and whether we can have a policy that is neutral or even supportive of such practices. It is also important to consider how we can advance environmental and conservation practices without over-regulating or overspending and without paying for practices which ought to be standard operating procedures.

I recognize that readers of this journal have experience and knowledge which is crucial to the development of sound national policy. I hope that you will join me in the search for ideas and methods that will enable farmers to maintain their current farming operations in a profitable manner. To take part in this discussion, please contact me at (202) 225-2331.

—*Rep. David Minge, Washington, D.C.*

HEDGE TO ARRIVE/*continued from page 6*

absence of a delivery requirement or expectation may reveal such a purpose. For example, the Ninth Circuit in *CFTC v. CoPetro Marketing Group, Inc.*, held that the forward contract exclusion "is unavailable to contracts for sale for commodities which are sold merely for speculative purposes and which are not predicated upon the expectation that delivery of the actual commodity by the seller to the original contracting buyer will occur in the future." 680 F.2d at 579.

The CEA and its predecessors were enacted because of "the inherent speculativeness of commodity trading, and the absence of government regulation spawned a breeding ground for unscrupulous tactics, manipulation, and irresponsible trading." *Precious Metals Associates, Inc. v. CFTC*, 620 F.2d at 905 (citation omitted). Congress wanted to place speculative activity in a controlled environment and leave farmers and those to whom they sold their commodities unburdened by that environment's restrictions.

When individual hedge-to-arrive contracts go beyond the basic format and introduce a high degree of speculation into the transaction, a fair question is whether such contracts are exempt forward contracts. Implicit in the CFTC Statement of Guidance is the requirement that exempted forward contracts provide "prudent" risk-management. Whether the CFTC intended its Statement of Guidance to be understood as saying that a hedge-to-arrive contract that failed to follow such "a prudent risk-reduction practice" is a futures contract is not clear. As with the other factors used by the CFTC and the courts, "speculative risk" is but one of several factors considered in distinguishing between futures and forward contracts. Nonetheless, items 2 through 4 in the Statement's listing of "prudent risk-reduction" requirements all relate, directly or indirectly, to the risks attendant to hedge-to-arrive contracts that allow "rolling" into later marketing years. Because "rolls" defer delivery, contracts that allow unlimited rolling may be something other than exempted forward contracts.

How the CFTC and the courts will evaluate delivery and rolling issues under the forward contract exclusion as the "hedge-to-arrive problem" unfolds is a question that will have many waiting for the answer. For now, the text of the Division's Statements is available through the Internet at http://www.cftc.gov. Also available, but by mail, is the NFGA's "white paper," *Hybrid Cash Grain Contracts: Assessing, Managing and Controlling Risk*. The cost to non-NGFA members is $38.00, payable to the National Grain and Feed Association, 1201 New York Avenue, N.W., Suite 830, Washington, D.C. 20005-3917. Both are highly recommended.

Editor's note: The National Grain and Feed Association has prepared an analysis of the CFTC guidance statement, which appears in the May 23, 1996 NGFA Newsletter. David Barret, counsel for the NGFA and an AALA member, has offered to share his analysis with AALA members. He can be reached at 202-289-0873.

Agricultural Law Update
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ADDRESS
CORRECTION REQUESTED

American Agricultural Law Association News

American Agricultural Law Association "Distinguished Service Award"

In addition to nominations for Awards for Excellence in Scholarship, the Awards Committee is accepting nominations for the Association's "Distinguished Service Award" (DSA). The DSA is conferred in recognition of distinguished contributions to agricultural law. Achievements may be in the field of practice, research, teaching, extension, administration or business.

Any member of the Association may nominate another member for selection by submitting the name to the Chair of the Awards Committee. A nominee must be a current member of the Association. Any member making a nomination may be requested to submit biographical information in support of the nominee. Nominations must be received by August 15, 1996 to be considered. Submit nominations to:

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We are beginning the editing stage for the new membership directory. If you have not sent in your data sheet or have changes to any information previously submitted, please let us know soon.

Law Review Symposium Issue

If you have not as yet received your Symposium issue, published by the University of Oklahoma, let us know and we will send you a copy.