

CREDIT-SALE CONTRACT PROTECTION FOR FARMERS - BACKGROUND MEMORANDUM

House Concurrent Resolution No. 3045 (attached as an appendix) directs the Legislative Council to study grain credit-sale contracts to determine the need to provide protection for farmers against grain warehouse and grain buyer insolvency. This memorandum will review the protection provided for farmers before the 1999 legislative session, the protection provided to farmers subsequent to the 1999 legislative session while including the issues raised regarding protection during the session, and the potential solutions that may provide protection for farmers.

HISTORY

Before the 1999 legislative session, there were two groups licensed as to grain merchandising and storage--grain warehouses and roving grain buyers. North Dakota statutory provisions relating to grain warehousemen and roving grain buyers are found in North Dakota Century Code (NDCC) Chapters 60-02, 60-03, and 60-04.

Grain Warehouses

Grain warehouses are regulated by either federal or state law. The federal government regulates grain warehouses under the United States Warehouse Act, 7 U.S.C., 241-273, which is administered by the United States Department of Agriculture.

Licensing under the Act is voluntary and may be accomplished by applying and qualifying. Therefore, a grain warehouse can elect to be licensed by federal or state authorities. With respect to a grain warehouse licensed by federal authorities, matters regulated by the Act cannot be regulated by the state. A grain warehouse licensed under the federal Act must meet requirements for sound warehouse operations, i.e., furnish an acceptable bond, maintain a minimum net worth, and pay inspection and licensing fees. In lieu of a bond, a warehouse may file a certificate of participation in and coverage by an indemnity or insurance fund, approved by the Secretary of Agriculture, and established, maintained, and backed by the full faith and credit of the applicable state.

North Dakota Century Code Chapter 60-02 regulates grain and seed warehouses. Sections 60-02-02 and 60-02-03 set out duties and powers of the Public Service Commission in regulating grain and seed warehouses. In addition to other prescribed duties, the commission is to exercise general supervision of public warehouses. Section 60-02-09 contains bond requirements, which must be met before issuance of a public warehouseman's license. The bond must be

in a sum of not less than \$5,000 for any one warehouse (with the actual amount determined by the commission) and must be for the specific purposes of protecting holders of outstanding receipts and covering the costs incurred by the commission in the event of the licensee's insolvency. This section specifically exempts credit-sale contracts from bond coverage; however, under Section 60-02-19.1 specific terms and procedures are required to be used in a credit-sale contract.

North Dakota Administrative Code (NDAC) Section 69-07-02-02 provides the schedule for bond amounts required of public warehousemen. The amount of bond required ranges from \$50,000 for a warehouse with a capacity of 500,000 bushels to \$500,000 for a warehouse with a capacity between 475,001 and 500,000 bushels. For a warehouse with a capacity of more than 500,000 bushels, the bond amount is \$500,000 plus \$5,000 for each additional 25,000 bushels or fraction thereof. The commission may require additional bonds if necessary. Although the bond must be issued by a corporate surety company, the commission may accept bond substitutes in the form of cash, negotiable instruments, or a bond executed by personal sureties, if the bond substitute provides adequate protection to the holders of outstanding receipts.

Under NDCC Chapter 60-02, a license is required for the merchandising and storage of grain in a warehouse, including any warehouse licensed by the federal government under the United States Warehouse Act, as to its merchandising activities. Early in 1998, the United States Department of Agriculture informed the Public Service Commission that the commission cannot require federally licensed warehouses to obtain a state license for merchandising and warehousing grain. The United States Warehouse Act states that "the power, jurisdiction, and authority conferred upon the Secretary of State of Agriculture under this chapter shall be exclusive with respects to all persons securing a license hereunder so long as said license remains in effect." Courts have consistently held that federal law preempts state law and a federally licensed facility is not required to have a state license to conduct its warehousing activities. It is less clear whether federal law preempts state law in the merchandising functions of warehouses; however, there is no explicit court decision as to this matter. Unlike many states, North Dakota does not require grain warehousemen to obtain two licenses--one to govern merchandising and one to cover warehousing. Rather, North Dakota law requires that public grain warehousemen obtain only

one license. This license entitles them to conduct both merchandising and warehousing activities. Because of this combined license, it would appear Chapter 60-02 has been preempted by federal law as to federally licensed warehouses. In 1999 the Legislative Assembly changed the law so that this state is like many other states in having a dual licensing procedure.

Roving Grain Buyers

North Dakota Century Code Chapter 60-03 applies to roving grain or hay buyers. Under Section 60-03-01(6), a roving grain or hay buyer is a person, other than a public warehouseman governed by Chapter 60-02, who is in the business of buying grain or hay for resell or processing, or is a person who markets grain or hay on behalf of the owner. In addition to other requirements set forth in the chapter, Section 60-03-03 provides that roving grain or hay buyers are subject to the laws governing public warehouses, insofar as they apply. Licenses for roving grain or hay buyers are issued on an annual basis and may be revoked or suspended for cause. The license of a roving grain or hay buyer is automatically suspended for failure to have or maintain the required bond.

Under Section 60-03-04, a licensee is required to be bonded in an amount set by the commission. Generally, the amount of bond may not be less than \$100,000 unless at least 90 percent cash is paid at delivery and any remainder is paid within 24 hours of delivery, and then the bond may not be less than \$50,000. This section specifically exempts credit-sale contracts from bond coverage; however, under Section 60-03-04.1, a separate bond is required for credit-sale contracts. This bond may not be less than \$100,000. In addition, this section also provides for specific terms and procedures to be used in a credit-sale contract.

Insolvency Proceedings

North Dakota Century Code Chapter 60-04 pertains to insolvent grain warehousemen. The chapter establishes a procedure for the appointment of the Public Service Commission as trustee for an insolvent warehouseman, the establishment of a trust fund containing the assets of the insolvent warehouseman, and the marshalling and distribution of the assets of the warehouseman to receiptholders. Receiptholders, within 45 days of the last publication of notice or a longer period if prescribed by the commission, must file claims against the warehouseman. Failure to file a claim within the prescribed time may bar the receiptholder from participation in the distribution of the trust fund. Additionally, receiptholders are barred from bringing separate claims for relief against the warehouseman's bond, insurance proceeds, and other trust assets. However, the receiptholder may seek an action against the

warehouseman for the whole amount owed or any deficiency.

Credit-Sale Contracts

A credit-sale contract is a sale in which the selling price is to be paid more than 30 days after the grain is delivered or released for sale. There are two main types of credit-sale contracts--delayed price and deferred payment. Under a delayed price contract, no price is established at the time of transfer of title of the grain from the farmer to the elevator. The farmer has the option to price the grain as per the market during a period of time contained in the contract. The typical length of this time is 100 to 240 days; however, it could be any period of time. Under a deferred payment contract, title to grain passes from the farmer to the elevator and the price is set; however, the elevator does not pay for the grain immediately. Generally, a deferred payment contract is used for income tax planning purposes. The deferred payment would be paid in the following tax year.

According to the Public Service Commission, there has been a substantial increase in the use of credit-sale instruments in recent years. Although a formal survey has not been completed, it is assumed that credit-sale contracts have risen from less than 10 percent of the industry's sales volume to between 40 and 60 percent. Much of this increase is related to the rail transportation system. Warehouses need to hold title to grain so that they can have grain on hand to make use of rail transportation that has been purchased up to six months in advance under car auction programs. Whatever the reason for the increase in popularity of credit-sale contracts, the increase has increased the risk to farmers who sell their grain to a warehouse on a credit-sale contract. Because there is no bond protection for a credit-sale contract, the farmer is not afforded any protection in the insolvency proceeding and is treated as an unsecured creditor if the warehouse becomes insolvent.

ACTION BY THE 56TH LEGISLATIVE ASSEMBLY

During the 1999 legislative session, two bills passed which relate to grain buyers and public warehousemen--House Bill No. 1156 and Senate Bill No. 2153.

House Bill No. 1156

House Bill No. 1156 provides that if required for United States Department of Agriculture approval of the Public Service Commission's warehouse inspection program, the commission may require an applicant for a public warehouse license to submit a current financial statement. The bill requires a warehouseman to publish and post in a conspicuous place the fees that will be assessed for receiving, storing,

processing, or redelivering grain and provides that information regarding the volume of grain handled is a confidential trade secret and is not a public record. As introduced, the bill would have provided for a bonding requirement for a warehouseman purchasing grain by credit-sale contract. The bond was to be set by the commission as it deemed necessary.

Senate Bill No. 2153

Senate Bill No. 2153 removes public warehouses licensed under the United States Warehouse Act from the licensing requirements under NDCC Chapter 60-02. The bill creates Chapter 60-02.1 which is similar to Chapter 60-02. Chapter 60-02.1 creates a merchandising license for facility-based grain buyers which may include the merchandising activities of federally licensed warehouses. The bill removes the roving grain buyer license provisions from Chapter 60-03 and places them in this new chapter. As of the effective date of this bill, Chapter 60-03 relates solely to the licensing of hay buyers.

Chapter 60-02.1 requires a licensee to be bonded for the purposes of insolvency in a sum of at least \$5,000 and in an amount as deemed necessary by the commission. The bond does not cover credit-sale contracts. The bill contains required credit-sale contract provisions and procedures much as is done in Sections 60-02-19.1 and 60-03-04.1 for public warehousemen and hay buyers; however, the bill removes credit-sale contract bonding requirements for roving grain buyers. Under Section 60-02.1-14, as created by Senate Bill No. 2153, credit-sale contracts must meet the following conditions:

60-02.1-14. Credit-sale contracts. A grain buyer may not purchase grain by a credit-sale contract except as provided in this section. All credit-sale contracts must be in writing and must be consecutively numbered at the time of printing the contract. The grain buyer shall maintain an accurate record of all credit-sale contract numbers including the disposition of each numbered form, whether by execution, destruction, or otherwise. Each credit-sale contract must contain or provide for all of the following:

1. The seller's name and address.
2. The conditions of delivery.
3. The amount and kind of grain delivered.
4. The price per unit or basis of value.
5. The date payment is to be made.
6. The duration of the credit-sale contract.
7. Notice in a clear and prominent manner that the sale is not protected by the bond coverage provided for in section 60-02.1-08. However, if the grain buyer has obtained bond coverage in addition to that required by section 60-02.1-15 and the coverage extends to the benefit of credit-sale contracts, the grain buyer

may state that fact in the credit-sale contract along with the extent of such coverage.

The contract must be signed by both parties and executed in duplicate. One copy must be retained by the grain buyer and one copy must be delivered to the seller. Upon revocation, termination, or cancellation of a grain buyer's license, the payment date for all credit-sale contracts, at the seller's option, must be advanced to a date not later than thirty days after the effective date of the revocation, termination, or cancellation, and the purchase price for all unpriced grain must be determined as of the effective date of revocation, termination, or cancellation in accordance with all other provisions of the contract. However, if the license of the grain buyer is transferred to another grain buyer or licensed warehouseman, credit-sale contracts, if so agreed by the seller and transferee, may be assigned to the transferee.

POSSIBLE SOLUTIONS

There are at least three methods to address the issue of farmers not being protected in credit-sale transactions. One is to require warehouses to be bonded for credit-sale transactions. A second is to create a state indemnity fund to cover losses in cases of insolvency. The third is to consider the provisions presently in law as adequate. These provisions provide for certain contract provisions and procedures in credit-sale contracts.

Bond Requirement

During hearings on House Bill No. 1156 (1999), the standing House Agriculture Committee was made aware of two shortcomings of requiring credit-sale bond coverage. First, not all grain warehousemen would be able to qualify for coverage through bonding companies. Unable to lawfully obtain a license, these warehousemen would be given the choice of operating illegally or losing a substantial portion of their business. Secondly, the cost of bonding would result in an extremely expensive form of insurance. The cost of coverage at the same rate as current warehouse bonds, at \$1 per bushel on the first 500,000 bushels and 20 cents per bushel thereafter, would be approximately 1.8 cents per bushel on a 500,000 bushel volume. A five million bushel volume would result in a cost of .504 cents per bushel.

Indemnity Fund

During the 1987-88 interim, the Legislative Council's Agriculture Committee studied the feasibility and desirability of establishing a state bonding fund for those persons who are required by state law to be bonded in order to engage in business activities. By directive, the Legislative Council limited the study to grain warehousemen and livestock auction markets.

The study was proposed to consider the establishment of a state bonding fund to address problems created by the escalating costs of obtaining bonds and the decreasing number of companies willing to provide bond coverage. Although the committee made no recommendation concerning the establishment of a state indemnity trust fund or a grain insurance fund, the committee received testimony on action in other states with a focus on Illinois.

Illinois has a program that operates through the use of two separate but interrelated funds: (1) the grain indemnity trust fund, and (2) the Illinois grain insurance fund. All grain assets of failed grain warehouses are placed in the grain indemnity trust fund and all claims are paid from the fund. The Illinois grain insurance fund consists of assessments made against elevators, in lieu of requiring elevators to have bonds. The insurance fund is intended as a supplementary means of payment when the amount of the grain indemnity trust fund is insufficient to pay all claims. The grain insurance fund is financed by an assessment on each licensed grain dealer and grain warehouseman for a period of three years and then as needed to maintain a fund balance of \$3 million. Each state-licensed grain dealer and grain warehouseman is required to participate in the program. Federally licensed warehouses may participate in the program through the use of a cooperative agreement. The fees assessed against the grain dealers and grain warehousemen are consistent with the current cost of bonds that are required in the grain industry on an annual basis. To generate sufficient initial funding, the assessments were doubled for the first year and for the initial year of each subsequent participant. Any claimant who has suffered a financial loss due to the use of a credit-sale contract is entitled to compensation for 85 percent of the balance claimed up to a maximum of \$100,000 from the fund. A claimant who has a financial loss other than through the use of a credit-sale contract is entitled to compensation for 100 percent of a valid claim.

During the 1987-88 interim, a representative from the Illinois Department of Agriculture testified no assessments have been paid since 1985. This cost-savings has been passed down to the producer and has decreased costs to elevators. Lending institutions whose debts are covered by warehouse receipts can recover from the insurance fund. This feature has aided elevators in obtaining financing because lenders no longer have to rely on the surety bond as protection for losses on loans. Producers are more willing to take their grain to a warehouse that participates in the fund because if the elevator goes insolvent, the producers will recover 100 percent of their claims. The creation of the fund has shortened the time period in which payments are made to those in the farming community from one year to 90 days.

Representatives of the North Dakota Stockmen's Association, North Dakota Grain Dealers Association,

and Public Service Commission opposed the establishment of an indemnity trust fund and insurance fund. They testified that any person or company that is having difficulty obtaining a bond is probably having financial difficulty. They argued that if the state established an indemnity fund and an insurance fund, the state would be required to assume the responsibilities of the surety bond companies with regard to screening applicants to determine whether they have adequate financial capabilities to operate a business. Surety companies will not bond those companies that do not have the necessary financial strength required to operate. Although it would be easier and less expensive for companies to obtain bonds if the bonding requirements were lowered, doing so would decrease the financial protection afforded to producers. Because bond costs are based on risk, healthy companies pay less than a company in financially poor shape. In addition, opposition was expressed because all companies would have been required to pay the same assessment, thus penalizing financially healthy companies.

At least 10 states have indemnity funds. These states include Idaho, Illinois, Indiana, Iowa, Kentucky, New York, Ohio, Oklahoma, South Carolina, and Tennessee. There are a number of issues that need to be addressed when creating an indemnity fund. These issues include the size and method of payment, the funding level, the level of coverage, any limitation on claims, penalties for failure to contribute to the fund, and the procedures for the administration of the fund.

The states listed use a variety of ways of funding indemnity funds. Some use a checkoff system collecting various amounts, including one-half cent per bushel, one-tenth of one percent of the value of the commodity, and various amounts per bushel for different crops. Some states base the money collected on the grain purchased and storage capacity. Kentucky has a checkoff system in which contributions are voluntary. Some states have a maximum and minimum amount that must be maintained in the fund, some states only have a maximum amount, and some states have no amount limits. The minimum amounts range from \$500,000 to \$5 million, and the maximum amounts vary between \$3 million and \$10 million. The minimum amount is usually the amount at which collections resume if the fund reaches that level.

Claims are usually covered from 80 to 100 percent. Iowa provides that all claims are covered at a rate of 90 percent up to a maximum of \$150,000. Ohio provides that delayed price credit sales are covered at the level of 100 percent for the first \$10,000 and 80 percent thereafter. Most states provide for a time after which claims are no longer allowed. These time limitations range from 30 days to one year.

The different penalties among the states for the failure to contribute or remit moneys collected to the fund include a loss of license, a Class A misdemeanor, fines, and other penalties. The administration of the fund is sometimes covered by a portion of the interest earned from the fund. Generally, the administration of the fund is covered through general appropriations.

Contract Provisions

A review of the adequacy of present provisions of law governing the contract can only be evaluated by a study of whether farmers understand the risks involved with credit-sale contracts and deliberately assume those risks. The actual risk can be measured by the number of warehouse insolvencies. According to the Public Service Commission, in the last 10 years there have been fewer than three formal insolvencies, but five or six informal insolvencies. An informal

insolvency is when the Public Service Commission works with the warehouse, farmer, and bonding company to provide relief for the farmer without a formal insolvency proceeding. These are also useful figures in determining the need for other forms of protection.

SUGGESTED STUDY APPROACH

A suggested study approach is to follow the general organization of this memorandum with a focus on the suggested solutions. Depending on the solution being studied, it would be useful to receive testimony from the Public Service Commission, the North Dakota Grain Dealers Association, the North Dakota Agriculture Department, farmer groups including the Farmers Union and the Farm Bureau, bonding companies, and producers.

ATTACH:1

Fifty-sixth Legislative Assembly, State of North Dakota, begun in the Capitol in the City of Bismarck, on Tuesday, the fifth day of January, one thousand nine hundred and ninety-nine

HOUSE CONCURRENT RESOLUTION NO. 3045

(Representatives Mueller, Pollert, Renner)

(Senators O'Connell, Urlacher, Wanzek)

A concurrent resolution directing the Legislative Council to study grain credit-sale contracts to determine the need to provide protection for farmers against grain warehouse and grain buyer insolvency.

WHEREAS, state law does not require bond coverage to protect farmers in grain warehouse and grain buyer insolvency proceedings if the grain was sold via credit-sale; and

WHEREAS, the use of various forms of credit-sale contracts has risen dramatically in recent years; and

WHEREAS, this situation has greatly increased the risk exposure of farmers;

NOW, THEREFORE, BE IT RESOLVED BY THE HOUSE OF REPRESENTATIVES OF NORTH DAKOTA, THE SENATE CONCURRING THEREIN:

That the Legislative Council study grain credit-sale contracts to determine the need to provide protection for farmers against grain warehouse and grain buyer insolvency; and

BE IT FURTHER RESOLVED, that the Legislative Council report its findings and recommendations, together with any legislation required to implement the recommendations, to the Fifty-seventh Legislative Assembly.

Filed March 23, 1999