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Grain Elevator Credit Sales Contracts and Alternatives to Reduce Their Misuse

Abstract
Credit sales contracts for grain have been widely used as a marketing tool by farmers and elevators. For farmers, they represent a method (accepted by the IRS) to delay the recognition of grain income until a later tax period. During periods when storage capacity is short these contracts move grain into the market channel earlier than might otherwise be the case. Farmers can relinquish title at harvest or later delivery and still maintain pricing flexibility later in the year when prices may be stronger.

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GRAIN ELEVATOR CREDIT SALES CONTRACTS AND ALTERNATIVES TO REDUCE THEIR MISUSE

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Credit sales contracts for grain have been widely used as a marketing tool by farmers and elevators. For farmers, they represent a method (accepted by the IRS) to delay the recognition of grain income until a later tax period. During periods when storage capacity is short these contracts move grain into the market channel earlier than might otherwise be the case. Farmers can relinquish title at harvest or later delivery and still maintain pricing flexibility later in the year when prices may be stronger.

Other marketing advantages to the contracts arise from time to time. Such advantages vary depending on availability of transportation, the need to rotate farm-stored grain and similar factors. In times of excess commercial storage capacity, some elevators have used this form of transaction as a competitive device to gain possession of grain early in the season and to take advantage of merchandising opportunities. These marketing advantages accrue to both farmers and grain merchants and have caused the contracts to become more popular during the past several years.

Still there are some serious problems associated with credit sale contracts.

**INTERRUPTION OF DEBTOR CREDITOR RELATIONSHIPS**

The contracts interrupt some of the accepted title and risk management relationships among farmers, elevators, and their lenders. It is the interruption of these relationships that the concerns are focused upon.

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*Prepared by Roger G. Ginder, Professor, Economics Department, Iowa State University, February 15, 1991.*
established debtor-creditor relationships that may create a problem. In most cases where the elevator is financially sound, has adequate cash, and does not default on unsecured loans, the contracts do not create a serious problem. However, when an elevator begins to encounter financial difficulty there is a serious potential for abuse. Issuing more credit sale contracts as a means of borrowing needed cash becomes a nearly irresistible temptation when the best alternatives involve issuing bad checks for grain and losing the license, filing for protection under Chapter 11 bankruptcy, or liquidating under Chapter 7 bankruptcy.

A somewhat predictable pattern is followed when financial difficulty arises. The first symptom is a shortage of working capital and difficulty in obtaining cash to meet current obligations and payables. This condition may arise because an operating loss has drained cash from the business. It may occur because a speculative position in the commodities market has resulted in a precipitous loss. It may occur because the business has attempted to grow more rapidly than its capital base will permit. It may occur because a large receivable cannot be converted to cash. Mismanagement, fraud, grain quality loss, inadequate financial accounting and other factors may also be causes for the problem.

Whatever the reason for the cash problem there is an acute need to generate additional liquid funds quickly. This may be done through short term borrowing or issuing additional equity. But if lenders balk and new investors cannot be found to purchase equity the problem remains. At this point the business would be forced to cease operations unless additional cash can be injected. Furthermore, the possibility exists that secured lenders may initiate proceedings leading to involuntary bankruptcy.
For a firm operating in the grain business the credit sale contract offers another alternative. New credit sales contracts permit the elevator to take possession of the grain and convert it to cash. Furthermore there is little or no outside review or limit placed on how much cash is raised in this way. The elevator may raise a great deal of cash if necessary. The documents are typically written so that payment cannot be made prior to some future date. Whether it is done to delay recognition of taxable income to the farmer or to allow the producer to take advantage of market movements, the payment is not due immediately.

Clearly the intent of such a transaction is not to make a loan from the farmer to the elevator. Nonetheless it fulfills the major purpose of a short term loan for an elevator in this cash short position. In particular, it reduces the need for ready cash at the time the grain is purchased and it buys additional time for the elevator to locate additional cash.

In fact the producer is supplying high risk capital to the elevator with no explicit interest return on that capital and no security position if the elevator fails. Only the savings in storage expenses and the possibility of price improvements offer a potential return for the action. Treatment of this capital in past bankruptcy and liquidation cases has established it as being in a very high risk position for the seller. Thus the seller should carefully evaluate the financial position of the elevator before entering into such a contract if this risk is to be minimized or even held to an acceptable level.

**MISUSE OF CONTRACTS CAN AFFECT OTHERS NOT SIGNING THEM**

While the majority of credit sales contracts are executed in good faith by all
parties and can provide the benefits described at the beginning of this paper, their misuse can have widespread disastrous effects. Misuse can create serious problems for sellers to the elevator, the seller's lenders, the elevator's lenders, and those responsible for the regulation and licensing of firms in the grain industry. Even third parties who buy from or sell to the elevator using cash or forward cash contracts (rather than credit sale contracts) can be put at risk when credit sales contracts are misused. Nonsufficient funds checks or repudiation of cash forward contract are both possible side effects. Beyond that external effects on other businesses in the community are often observed as a result of large dollar losses concentrated in a relatively small geographic area.

These potential problems have led to a number of suggestions to reduce the risks created by credit sales contracts. Each has advantages and disadvantages. Among suggested solutions are the following:

1. Totally eliminate the use of credit sales contracts as a legal means of selling grain.
2. Regulate the use of the contracts more strictly by placing limits on the dollar amount of contract that may be issued based on financial position.
3. Require more complete financial disclosure to farmers before they sign credit sales contracts.
4. Require some type of escrow account when grain is moved.
5. Require a letter of credit from the elevator's lender for credit sale contracts.
TOTALLY ELIMINATE CREDIT SALES CONTRACTS

It is tempting to approach the problem by simply eliminating credit sale contracts altogether. The producer would not be permitted to relinquish title to the elevator without the safeguards provided in the warehouse law to protect producers -- including indemnity fund protection. There is no potential for abuse once the contracts have been eliminated. Although some have questioned whether such a measure would violate constitutional rights to contract, other disadvantages would accompany a total ban as well.

This approach would create several kinds of marketing problems for producers and competitive problems for some elevators. First, when storage is in short supply it would remove one of the main incentives to move grain further into the market channel. Producers would not be able to move excess grain into elevators without either pricing it or placing it under warehouse receipt. Once the available storage at the warehouse has been exhausted, the producer would be forced to price the grain at the time of delivery before the elevator could move it into commercial channels. This would lock the farmer into the position of selling at a seasonal low or accepting an abnormally wide basis in most years.

A second disadvantage in this approach is the problem it creates for farmers who wish to delay recognition of taxable income into the next calendar year. Such producers would be forced to store the grain at harvest and carry it into the next year. The current practice of selling grain at harvest to be priced in the next calendar year would be eliminated. Unless the farmer was willing to accept current price and receive the income
at the time of sale the grain could not be marketed.

Finally (and perhaps most problematic) the banning of credit sale contracts would put Iowa out of step with the grain industry in the midwest. Availability of credit sales contracts from elevators in surrounding states would create a situation where Iowa elevators would lose the business of many producers who want to defer income into a later tax year. It is not unreasonable to expect that significant volumes of grain within 50 miles of the border would move across state lines to elevators offering credit sales contracts with "reduced" or "free" storage provisions and income or price deferrals programs.

The net effect of forcing the credit sale to out of state elevators is undesirable in several respects: (1) It increases the cost to Iowa producers who wish to obtain the benefits of income deferral and the marketing flexibility offered by the contract; (2) it places Iowa elevators at a competitive disadvantage to elevators in other states; (3) it forces Iowa producers wanting to use credit sales contracts to do business with elevators not operating under the regulatory protection of the Iowa warehouse and grain dealer laws.

PLACE LIMITS ON THE DOLLAR AMOUNT OF CONTRACTS ISSUED BY INDIVIDUAL FIRMS

Some have suggested that an upper limit (based on equity) be placed on the amount of credit sales any firm can issue. This approach has been employed by the CCC and USDA warehouse authorities as a means of limiting uniform storage agreements and licensed storage capacity. While it will not totally prevent losses in the event of elevator failure it provides a rip-stop to limit the magnitude of losses in two ways. First, as an
elevator approaches insolvency, fewer and fewer contracts can be legally issued. Second, if an insolvency should occur, it is more probable that at least some equity will be available to cover unsecured creditors holding credit sales contracts. A major advantage to this approach is that the credit sales contract activity is geared to solvency rather than being open ended.

There may be several problems with this approach. There is a possibility of financial deterioration following the establishment of the equity limit. For example, a severe operating loss or a commodity speculation loss (accompanied by a reduction in equity) may occur at any time. Such a loss may occur shortly after the allowable level of credit sales contracts for an elevator has been established. It would be difficult to ensure that the intent of the law was being accomplished under these circumstances.

A second problem with the use of equity based programs is the accuracy of the asset valuation. Overstatement of fixed or current asset values would result in overstated equities. Fair and equitable application of an equity based limit on credit sales contracts would require the use of CPA audits to provide a minimal level of assurance that assets and liabilities are properly stated.

**REQUIRE AN ESCROW ACCOUNT TO BE MAINTAINED TO COVER ANY CREDIT SALES CONTRACTS.**

The suggestion has been made that an escrow account be set up for any grain that is sold under credit sale contract. The idea behind such accounts would be to assure that sufficient cash would be available to the seller in the event of insolvency and at the same time preserve the income deferral characteristics of credit sales contracts.

There is little doubt that escrow provisions could accomplish one or the other of
these objectives very effectively. However, there may be serious difficulties in achieving both at the same time. That is the escrow accounts may be set up so that the buyer of the grain has so little control over the balance that a bankruptcy trustee could not pull these assets into a bankruptcy proceeding. However such an insulation of the proceeds from the sale of grain may imply that constructive receipt of the proceeds by the producer has occurred. This would prevent the producer from deferring income into a later tax year. Action of this kind should not be taken until the legal and tax ramifications of both these issues can be better understood. Research is underway on both the bankruptcy and taxation aspects of this option.

Another potential disadvantage of the escrow approach is the fact that funds which could be legitimately used by the financially sound elevator are moved to a separate escrow account. This means that financially sound elevators must substitute other capital (either internal or borrowed) to replace what has been escrowed. An opportunity cost to the elevator and in many cases additional costs to all producers using the elevator would result. Although procedures may exist to allow elevator access to the escrowed funds for use in operations the producer's access to the funds in bankruptcy may be lost when this is done.

REQUIRE MORE COMPLETE FINANCIAL DISCLOSURE TO FARMERS PRIOR TO EXECUTING A CONTRACT

Those who wish to avoid intervention as much as possible have suggested an approach where the producer decides which elevators are financially sound enough to justify assuming the risks associated with selling under credit sales contract. They favor a system where producers are given access to adequate financial information on the
elevator and allowed to decide for themselves whether it is prudent to write a credit sales contract with the elevator. The producer would then assume full responsibility for the consequences if the elevator failed.

To make this approach work the elevator would need to provide accurate financial statements (including a balance sheet and statement of cash flows) to the producer prior to execution of a contract. In order to prevent misrepresentation of assets and liabilities an unqualified opinion audit from a CPA would be necessary. The farmer would then make a "yes" or "no" decision based on informed knowledge of the elevator's condition.

Several problems exist in this approach. While farmers now make such decisions without the financial information, many would not possess the specialized skills necessary to evaluate the information if it were available. Even where the producer has the necessary experience and background to evaluate a complex financial statement there is no way for a producer to determine how many additional credit sales contracts might be issued to other producers. The elevator may be in sound condition when the producer sells using a credit sales contract but issue too many contracts to other farmers after that point. Nor is there knowledge of other adverse events that may have lessened the financial strength of the elevator since the disclosed information was compiled.

Beyond these problems many firms in the industry would resist disclosure. A significant number of the elevators in Iowa are not publicly held corporations. As a consequence, they are not required to provide financial statements to outsiders. Many sole proprietorships, partnerships and closely held corporations would consider making
financial information available to potential credit sales contract customers to be an
invasion of their privacy.

**PROVIDE AN IRREVOCABLE NONTRANSFERABLE LETTER OF CREDIT TO THE PRODUCER**

It has been suggested that producers could be protected by a nonnegotiable
irrevocable letter of credit payable after a specified future date to the Iowa Department
of Agriculture and Land Stewardship to be held for the benefit of producers who sold
grain under credit sales contracts. In this way the producer would be paid even though
the elevator had failed. One advantage of this kind of approach is the maintenance of
the secured lender’s position in determining the gross amount of credit available to the
borrowing elevator. It would, therefore, be less disruptive to the normal debtor-creditor
relationships established for other types of transactions.

In many ways it is similar to the type of lending that occurs when company-owned
grain is purchased by the elevator and stored for sale at a later time. The elevator
typically establishes a line of short term credit with a lender for the purchase of grain as
farmers wish to sell. This credit is drawn upon as the company-owned inventory is built
and repaid later after the inventory has been liquidated.

The line of credit is extended by a lender who has presumably determined a
prudent level of borrowing given the elevator’s assets, other liabilities, available security,
and, in most cases, its history of profitability. Lenders usually monitor financial position
and profitability of the elevator closely through monthly reporting.

The credit sale contract short-circuits this external discipline by the lender. It
allows the elevator to increase the level of operating credit without direct lender
knowledge or any restraint based on financial condition.

Backing credit sales contracts with a letter of credit from the secured lender would reinstitute this kind of discipline on the elevator. At the same time the elevator would have access to the liquid assets from credit sales contracts in much the same way it now does. The elevator would be expected to arrange a line of credit with the lender to cover expected credit sale contract grain purchases before the lender would issue a letter of credit. The lender would make a judgment about the credit-worthiness of the elevator in establishing this level. The elevator would then be free to write any level credit sales contracts less than the line of credit and provide the bank with a security interest in the inventories or proceeds from sale of grain.

As the elevator's credit sales contracts are liquidated, the letter of credit may be cancelled if the elevator is capable of making payment to producer. If not, the lender makes payment on the letters of credit and moves against the security interest it holds in the elevator's assets. In this situation, the credit risk assumed by the producer-seller shifts from the financial viability of the elevator to the financial viability of the financial institution issuing the letter of credit. However, two entities regulated by different agencies would have to fail before the producer would lose.

There may be several disadvantages to this approach. Some lenders are not accustomed to the use of letters of credit. This could create problems in operating under such a system for clients of those lenders. The standing of the letters of credit in bankruptcy and their treatment by the IRS could also be a potential problem. Additional legal analysis would be desirable before concrete action is taken.
Finally, there is an additional transaction cost as a result of issuing the letters of credit. While the actual and opportunity cost is much less than the alternatives of escrowing or banning the contracts, it would be somewhat higher than taking no action.