

Rights of Farmers in Failed Grain Elevators

—Roger A. McEowen* and Neil E. Harl**

During the farm debt crisis of the 1980s,¹ grain elevator failures became a common occurrence in many rural communities. In recent years, elevator failures have occurred as a result of abuses with respect to hedge-to-arrive contracts and improper or unauthorized activity in futures markets. Presently, the severe decline in the farm economy has placed additional stress on elevators. With the recent news of the failure of the largest agricultural cooperative in the state of Kansas² the issue of grain elevator failures has received renewed attention along with its impact on grain depositors and on the agricultural community.

Upon the failure of a grain elevator the significant questions for those affected by the failure are their legal status and the probable amount and timing of any recovery.

Grain in Storage

Farmer position. A farmer who has grain in storage with an elevator that files bankruptcy is *not* a creditor of the elevator. Instead, grain in storage remains the property of the farmer who stored the grain, with ownership of the grain evidenced by warehouse receipts and scale tickets. The storing of the grain establishes a bailee-bailor relationship.³ The relationship is unaffected by the fact that the bailee will return to the bailor grain of like quality rather than the identical grain.⁴ While it is easier to prove ownership with a warehouse receipt, both warehouse receipts and scale tickets are prima facie evidence of ownership of the stored grain.

Commingled grain stored in an elevator is deemed to be owned in common by persons storing the grain.⁵ As a result, absent a grain shortage, a depositor can obtain his or her grain in accordance with their warehouse receipt and/or scale ticket. A trustee in bankruptcy is not entitled to retain farmer-stored grain in the bankrupt's estate so long as there is no shortage, because the trustee can only succeed to the rights that the bankrupt possessed, and stored grain is

* Associate Professor, Kansas State University, Manhattan, Kansas; Member of the Nebraska and Kansas Bars.

** Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University, Ames, Iowa; Member of the Iowa Bar.

not property of the elevator. Under 11 U.S.C. § 725, the trustee, *after notice and hearing*, is allowed to dispose of property in which an entity, other than the bankruptcy estate, has an interest.⁶ Clearly, once a farmer proves ownership and pays all storage and other costs, the farmer is entitled to their grain.

However, there is typically less grain in an elevator at the time of the bankruptcy filing than there are claims against the grain by holders of negotiated receipts and scale tickets. As a result, the holders of negotiated receipts and scale tickets share pro rata in the remaining grain. In the normal course of events, the bankruptcy trustee sells the grain remaining in storage and makes a pro rata distribution of the money received from the sale of the grain along with any bond money provided by the elevator's bonding company. A farmer who has not been fully compensated is a general, unsecured creditor of the elevator to the extent of any loss.

Bankruptcy priority. In 1984, the Congress authorized a limited priority for grain producers.⁷ Under the provision, unsecured claims of grain producers, up to \$4,300 per producer for grain or the proceeds of grain against a debtor owning or operating a grain storage facility (and unsecured claims of fisherman, up to \$4,300 per fisherman, against a debtor operating a fish produce or processing facility), are given a priority for purposes of distributions in bankruptcy of the grain storage facility.⁸ The priority is fifth in line after administration expenses in bankruptcy;⁹ unsecured claims arising after an involuntary petition is filed and before an order for relief is granted or a trustee is appointed;¹⁰ unsecured claims for wages, salaries and commissions up to \$4,300 per creditor earned within the earlier of 90 days before the filing of the petition or cessation of the debtor's business;¹¹ and unsecured claims for contributions to employee benefit plans up to \$4,300 per employee less any amount paid under the preceding priority.¹² The grain producer priority is ahead of the sixth priority claim (up to \$1,950 per claim of unsecured amounts for money deposited with the debtor for purchase, lease or rental of property or services that were not delivered or provided);¹³ the seventh priority claim for debts to a spouse, former spouse or child of the debtor and for alimony, maintenance or support payments to a spouse or child under a separation agreement or divorce decree, except to the extent the debt was assigned to a third party;¹⁴ and the eighth priority claim for unsecured claims for taxes.¹⁵

For purposes of the fifth priority position of claims by grain producers, "grain" is defined broadly to include wheat, corn, flax seed, grain sorghum, barley, oats, rye, soybeans, other dry edible beans, and rice.¹⁶ "Grain storage facility" is defined as a site or physical structure used to

store grain for producers or to store grain acquired from producers for resale.¹⁷ “Producer” means an entity which engages in the growing of grain.¹⁸

Unfortunately, the \$4,300 priority is of only limited benefit to most affected producers, and is not available if the grain producer has transferred title to the elevator.¹⁹ However, the Bankruptcy Court for the District of Kansas has held that the priority provision also accords priority status above even *secured* creditors as to grain held by the elevator which is owned by the producers.²⁰ The result was that the elevator’s financier was not entitled to participate in the pro rata distribution of the elevator’s remaining grain along with the producers that had grain on storage at the time the elevator filed bankruptcy.²¹ Although the court did not cite any specific statutory language for the holding, the court cited the Senate Report to S.R. 445:

“The bill would require the court to distribute grain assets or the proceeds of such assets first to producers who have merely stored their grain in such a facility upon a contract of bailment.”²²

Technically, the only priorities specifically granted by the bankruptcy act amendments of 1984 is a fifth priority for unsecured claims of grain producers to the extent of \$4,300.²³ Thus, it appears that the case represents an extension of the statute. The case was affirmed on appeal,²⁴ but the court did not discuss the priority of grain depositors as against an elevator’s secured creditors under bankruptcy law. The court relied instead on a state statute²⁵ that gives grain depositors priority over a warehouse owner and the owner’s creditors in the grain stored in the elevator.

Expedited procedure. The bankruptcy code authorizes an expedited procedure for determining ownership of the available grain. A bankruptcy court may, notwithstanding any of the bankruptcy code provisions concerning adequate protection, use of estate property, assumption of contracts and leases or abandonments of bankruptcy estate property, expedite the procedures for determining interests in and disposition of grain and grain proceeds held by a debtor in a grain storage facility by shortening otherwise explicable time periods so that the entire procedure takes no more than 120 days.²⁶ A bankruptcy court must, upon the request of a grain producer who is a creditor of a bankruptcy storage facility, expedite the determination of the interests in the disposition of the grain held by the facility.²⁷

Several features of the expedited procedure should be noted:

- The expedited procedure can be requested by the trustee or by any person claiming an interest in the grain.²⁸
- The extent to which a court shortens the time period is dependent upon a number of factors including the market for the grain, the conditions under which the grain is stored, the expense of storage and the need of an interested party for a prompt determination.²⁹
- The court may extend the period for final disposition of grain or grain proceeds beyond 120 days if justice so requires because of the complexity of the case and claimants entitled to the grain will not be materially injured by the additional delay.³⁰
- Unless an order establishing an expected procedure is stayed depending an appeal, reversal or modification of the order on appeal does not affect the validity of any disposition of the grain occurring before the reversal or modification and any proceedings in the case where the order is issued cannot be delayed.³¹
- The trustee can recover from the grain, or the proceeds from the grain, the reasonable and necessary costs for preserving or disposing of the grain or the proceeds of the grain.³²
- If a debtor operating a grain storage facility has more than 10,000 bushels of a specific type of grain, which is usually the case, the trustee must sell the grain and distribute the proceeds as determined by the court.³³

Grain Sold on Contract

Undelivered grain. For grain that has been sold on contract to an elevator that files bankruptcy after the time the contract was entered into, but before the time a specified for delivery of the grain, the grain seller is entitled to refuse delivery if the buyer is insolvent unless payment can be made in cash.³⁴ Under a separate provision, an insecure party may request adequate assurance from the other party to the contract.³⁵ Both the request for and the granting of adequate assurance must be commercially reasonable.³⁶

Cash forward, deferred payment and deferred price contracts. Except for the limited priority in bankruptcy, unsecured creditors typically do not fare well in an elevator failure. Grain producers who have sold and delivered grain to the elevator before the elevator failed under forward or deferred payment or deferred pricing contracts are unsecured creditors in the event of elevator failure and usually do not participate in state indemnity funds³⁷ or elevator bonding protection.³⁸

Once grain has been delivered under a contract to an elevator, title passes to the elevator, and the seller becomes a general creditor with no right to reclaim the delivered grain. However, under the bankruptcy rules, a limited possibility for reclaiming delivered grain may be present.³⁹ Under the provision, a seller may reclaim goods upon written demand within ten days after the insolvent debtor receives the goods.⁴⁰ If the ten-day period expires after commencement of the case, the seller can reclaim the goods within 20 days after the debtor receives the goods.⁴¹ While the right of reclamation is generally subject to the automatic stay,⁴² a demand for redelivery is specifically made not subject to the automatic stay.⁴³

Equity Holders

The equity holders of a bankrupt grain facility that is an agricultural cooperative have limited liability protection much like a shareholders in a corporation.

Potential Legislative Remedy

Under the Packers and Stockyards Act⁴⁴ provision is made for failure to make prompt and full payment for livestock. Under the provision, before the close of the next business day following the purchase of the livestock, the packer, market agency or dealer must deliver a check or wire funds to the seller. This provision was added in 1976 and, when the Bankruptcy Act of 1978 was amended in 1987, the provision was exempted from the Bankruptcy Act so even though a packer goes into bankruptcy, the proceeds of livestock sales are held in trust out of bankruptcy away from the creditors to assure payment to the seller of the livestock. Written notice must be given to the purchaser and the USDA if payment is not made or an instrument of payment is dishonored. Unpaid cash sellers of livestock have priority over holders of perfected security interests of the purchaser as to the purchaser's assets.⁴⁵ Nothing but "an express agreement in writing" can operate as a waiver of the seller's right to next-day cash payment for livestock. Proof of delay or a course of dealing is not sufficient to constitute a waiver. However, with a

written agreement to defer the payment or pricing of livestock, there is a danger of waiving the right to prompt, next-day payment and becoming no more than an unsecured creditor.

Arguably, a similar provision to the PSA provision for unpaid sellers of livestock should be created for unpaid sellers of grain.

Other Remedies

Farmers adversely affected by an elevator failure whose claims are not made whole may consider other forms of legal relief. While directors are generally not personally liable for individual debts of the organization, they are subject to fiduciary duties of obedience, loyalty and care. Co-op directors have the same fiduciary duties that corporate directors have.⁴⁶ Directors can become personally liable to a creditor either by statute or by any conduct that creates privity of contract or results in tortious injury to the creditor.⁴⁷ A breach of the fiduciary duty of loyalty may be present, for example, when a director fails to disclose information concerning the co-op in an open and fair manner to the co-op's stockholders and patrons, or acts on inside information for personal benefit that is detrimental to stockholders and/or patrons.

Liability exposure upon failure of an elevator may also lie with employees of state and federal agencies responsible for monitoring the operation of licensed elevators. Such lawsuits, however, frequently fight an uphill battle against federal and state tort claims acts.⁴⁸

¹ See Harl, *Farm Debt Crisis of the 1980s*, Iowa State University Press, 1990.

² See "Elevator owner files for bankruptcy," Topeka Capital-Journal, September 28, 2000, p. B-1.

³ U.C.C. § 7-102 (1)(a) defines "a bailee" to be the person who by a warehouse receipt...or other document of title acknowledges possession of goods and contracts to deliver them.

⁴ See 54 A.L.R. 1166 (1928).

⁵ U.C.C. § 7-207(2) states, "Fungible goods so commingled are owned in common by the persons entitled thereto and the warehouseman is severally liable to each owner for that owner's share. Where, because of overissue, a mass of fungible goods is insufficient to meet all the receipts which the warehouse has issued against it, the persons entitled include all holders to whom overissued receipts have been duly negotiated." See also, *United States v. Luther*, 225 F.2d 499 (10th Cir. 1955).

⁶ Indeed, the legislative history of 11 U.S.C § 725 suggests that it was intended to cover bailments.

⁷ 11 U.S.C. § 507(a)(5).

⁸ *Id.*

⁹ 11 U.S.C. § 507(a)(1).

¹⁰ 11 U.S.C. § 507(a)(2).

¹¹ 11 U.S.C. § 507(a)(3).

¹² 11 U.S.C. § 507(a)(4).

¹³ 11 U.S.C. § 507(a)(6).

¹⁴ 11 U.S.C. § 507(a)(7).

¹⁵ 11 U.S.C. § 507(a)(8).

¹⁶ 11 U.S.C. § 557(b)(1).

¹⁷ 11 U.S.C. § 557(b)(2).

¹⁸ 11 U.S.C. § 557(b)(3).

¹⁹ See, e.g., *In re Mickelson*, 205 B.R. 516 (Bankr. D. N.D. 1996).

²⁰ *In re Esbon Grain Co.*, 55 B.R. 308 (Bankr. D. Kan. 1985).

²¹ *Id.*

²² S. Rep. 98-65, 98th Cong., 1st Sess. 26 (1983).

²³ See 11 U.S.C. § 507(a)(5).

²⁴ *First National Bank v. Nugent*, 72 B.R. 528 (D. Kan. 1987).

²⁵ Kan. Stat. Ann § 34-2,107.

²⁶ 11 U.S.C. § 557.

²⁷ 11 U.S.C. § 557(c).

²⁸ 11 U.S.C. § 557(c)(1).

²⁹ 11 U.S.C. § 557(c)(2).

³⁰ 11 U.S.C. § 557(f).

³¹ 11 U.S.C. § 557(g).

³² 11 U.S.C. § 557(h).

³³ 11 U.S.C. § 557(i).

³⁴ U.C.C. § 2-702.

³⁵ U.C.C. 2-609.

³⁶ See, e.g., *Farmers Cooperative Elevator v. Heyes*, No. 23493 (Dist. Ct. for Kossuth County, Iowa, Dec. 23, 1997); *Land O' Lakes v. Hanig*, 610 N.W.2d 518 (Iowa 2000). See also Harl, "Adequate Assurance in Contracts," 9 *Agric. L. Dig.* 41 (1998).

³⁷ See, e.g., Iowa Code Chapter 203D (1999).

³⁸ See *In re Woods Farmers Co-op Elevator Co.*, 107 B.R. 678 (Bankr. Dist. N.D. 1989) (contract seller of grain to elevator who had not received payment held only liens as to any proceeds remaining and was unsecured creditor).

³⁹ 11 U.S.C. § 546(c)(1)(A).

⁴⁰ *Id.*

⁴¹ 11 U.S.C. § 546(c)(1)(B).

⁴² 11 U.S.C § 362(a)(3) provides that “any act to obtain possession of property of the estate or of property from the estate [is stayed].”

⁴³ 11 U.S.C. § 362(b).

⁴⁴ 7 U.S.C. § 181 et. seq.

⁴⁵ A “cash sale” is defined in the PSA as a sale in which the seller does not expressly extend credit to the buyer. Mailing a check is not an extension of credit.

⁴⁶ See McEowen and Harl, *Principles of Agricultural Law*, §10.06 (2000).

⁴⁷ See, e.g., *Merriman v. Smith*, 599 S.W.2d 548 (Tenn. App. 1979).

⁴⁸ See, e.g., *Hicks v. Williams*, 104 Ill. App.3d 172, 432 N.E.2d 1278(1982).