

PRODUCER PAYMENT SECURITY ISSUES

*Hal Harris**

In February 1991, Finevest Foods, Inc. filed for Chapter 11 bankruptcy in Jacksonville, FL. Included among subsidiary companies were Land O'Sun Dairies, Inc., distributors of the nationally recognized Pet brand, and several other dairy processing firms. The largest dairy processor in the Southeast, Land O'Sun operated nine plants in seven states. At the time of the bankruptcy, Land O'Sun independent and cooperative milk suppliers were owed for most of February's milk shipments plus the final settlement for January. An estimated \$13.7 million was owed producers. At least six cooperatives and over 500 independent producers were affected. As unsecured creditors under the bankruptcy laws, Land O'Sun's milk suppliers have not yet been paid. It now appears that their final settlement may amount to between 5 and 10 cents on the dollar—to be paid in installments over a two-year period.

Only a year after the Finevest bankruptcy, another large fluid milk processor, Hawthorn-Mellody, located in Whitewater, WI filed under Chapter 11. Its milk supplier, the Morning Glory division of Associated Milk Producers, Inc. stands to lose \$12.9 million from the tragedy. Even more recently, Cumberland Farms, a major northeastern processor, filed for bankruptcy, again under Chapter 11. Cooperative and independent suppliers of Cumberland's four milk plants are owed \$3-4 million in this latest incident. So, in just over a year, three major processors declared bankruptcy, leaving producers with \$30 million in unpaid milk checks or checks that failed to clear.

The Land O'Sun, Hawthorn-Mellody and Cumberland Farms events are nothing new. In recent years other well-known firms such as Knudsen have folded. The Knudsen bankruptcy cost California and Southwestern producers even more than may be lost in any of the three most recent cases. Scores of smaller dairy operations have ceased operations in the past few years—often leaving producers holding the bag.

Each time such a disaster has struck, there has been an outcry in the national dairy press and a flurry of political activity to enact producer protection measures at the national or state level, or to strengthen existing state laws. The Land

O'Sun, Hawthorn-Melody and Cumberland Farms incidents have once again served to bring dairy producer payment security issues to the forefront.

These recent bankruptcies reveal some glaring contrasts. For example, while Land O'Sun's milk suppliers lost millions of dollars, fruit and vegetable suppliers of another Finevest subsidiary, Southeast Frozen Foods, were protected by a 1984 amendment to the Perishable Agricultural Commodities Act. This law in essence categorizes fruit and vegetable suppliers as secured creditors. Wisconsin's dairy producer security law helped alert its supplier about the shaky financial condition of Hawthorn-Mellody, but the cooperative chose to take the risk rather than possibly forcing the firm into insolvency. In the Cumberland Farms case, producers in some states will get paid because of state producer security laws, while those located in other states may be big losers.

The Problem

When a producer, or his/her cooperative delivers milk to a processor, title transfers to the buyer. However, payment for the milk is made on a delayed basis. Under most Federal orders, producers are required to be paid twice monthly. A partial payment (often the misnomer "advance" is used) for deliveries during the first 15 days of the month is due several days following the Market Administrator's announcement of the partial payment rate per hundredweight. The final settlement for the month's deliveries is due several days after the MA's announcement of the blend price. The producer's exposure in terms of milk for which he/she is unpaid, ranges from about two weeks to over a month. To an extent, producer payment security problems are an outgrowth of the classified pricing structure used in fluid milk markets, which requires after-the-fact accounting of milk disposition by plants—resulting in significant delays in producer payment.

In the event of insolvency, the situation where a firm's liabilities exceed its assets, or other situations where a firm cannot meet its cash obligations, the legal remedy is found in the U.S. bankruptcy courts. In most cases, Chapter 7 of the bankruptcy statutes is used. Under Chapter 7 cases, the court simply supervises the division of the insolvent firm's assets.

*The author is a professor in the Department of Agricultural and Applied Economics at Clemson University.

In the Land O'Sun, Hawthorn-Mellody and Cumberland Farms cases, Chapter 11 bankruptcy was filed. Under this chapter, the judge may approve a financial reorganization plan allowing the bankrupt firm to continue to operate, and calling for supervised scheduled payments to creditors. Under both Chapter 7 and Chapter 11, "secured" creditors (those who have liens on the property of the bankrupt firm) generally go to the top of the list to receive payment. These usually include banks, equipment dealers, truck dealers, etc. who require collateral for debts outstanding. If any money remains after these debts are satisfied in full, the unsecured creditors (milk producers, paper and plastic container suppliers, and other "open accounts") divide the remaining assets if any exist. Often the latter category comes up short. Sometimes no assets remain for the unsecured accounts, and in any event, it may take years for bankruptcy cases to be settled.

The risk of a dairy farmer becoming an unsecured creditor in a bankruptcy appears to be increasing. There is a great deal of excess processing capacity in the industry. Many plants are technically obsolete or too small in scale to compete over the long haul. In some parts of the country such as Minnesota and Wisconsin, short supplies have forced processors to bid producer prices up to ensure a source of supply—resulting in negative profit margins for many firms. The increased volatility of dairy product prices, particularly cheese, has created additional financial headaches for milk processors. Suffice it to say that the main cause of bankruptcy in any industry—poor management—also exists in some dairy plants. The bottom line is this. In the months and years ahead plants will close, firms will fail to survive; and some of these exits from the industry will be forced. The problem is not going away and may indeed worsen.¹

Current Status of Producer Protection Laws

Shortly after the Knudsen failure in the mid 1980s, the Milk Stabilization Branch of the California Department of Food and Agriculture conducted a national survey in the process of strengthening its producer payment security measure. It revealed that 19 states had producer security provisions on the books. At hearings during July 1992 before the Subcommittee on Livestock, Dairy and Poultry of the U.S. House of Representatives, the National Cheese Institute reported that at least 23 states had some form of producer security law, based on a survey by the Institute. Among the major dairy states with such laws are California, Michigan, Minnesota, New York, Ohio, Pennsylvania, and Wisconsin. At least one state (Georgia) has passed a new law since the Land O'Sun case and a number of other state legislatures are debating producer security issues.

There is no national dairy producer security program. However, there is precedent in the form of producer protec-

tion afforded livestock and poultry sold by farmers to meat packers under the Packers and Stockyards Act; and to growers of fresh and frozen vegetables under the Perishable Agricultural Commodities Act. Congressman Gunderson of Wisconsin introduced a bill in the 102nd Congress that would amend the P&S Act to cover milk producers. As mentioned above, the House recently held a 1992 public hearing on the producer security issue and hearings are likely in 1993.

Key Issues

Prospective solutions to the problem are clouded by three key questions. First, what level of government should have the authority to effectively institute and carry out producer security measures? Second, who should pay and how much? The third and perhaps most fundamental question is: is producer security a public issue or a private issue?

State or Federal Legislation? Laws dealing with producer payment security can and have been adopted on an individual state basis. A somewhat broader set of options is available at the Federal level, because any law superseding the Federal Bankruptcy Code would have to be national in scope. There are pros and cons to regulation at both the state and federal level.

It is far easier to obtain consensus and deal with the issue legislatively on a state basis. For example, Georgia passed a producer security law within a few months of the Land O'Sun bankruptcy. The issue is how effective state laws may be. A big question is whether states can constitutionally enforce their programs effectively across state lines.

A high and growing proportion of bulk milk and finished dairy products now moves in interstate commerce. Can the state of Georgia require a Florida plant to purchase a surety bond, submit to financial audits, or contribute to a producer indemnity fund because it is buying milk from Georgia producers or from a Georgia cooperative? Or can it put the requirement on Georgia plants who are buying milk from Tennessee farmers? Under the Interstate Commerce Clause of the U.S. Constitution it is questionable. Apparently, Florida firms think so too, as it is reported that they have refused to purchase the bond required by the new Georgia law. Placing the requirement on Georgia firms alone puts them at a disadvantage in the marketplace where they compete with handlers from other states. Thus, many believe the ultimate answer may have to be national in scope.

Another related question has to do with national uniformity. Companies which deal in more than one state, as is common today, have an obvious preference for playing with one set of rules. This does not necessarily imply support for a federal law, but faced with a choice between a quilt of state laws and a uniform federal approach, the latter would be preferable to many.

¹ It is ironic that in view of these circumstances, Chapter 11 reorganizations may in fact perpetuate the conditions that led to producer payment problems in the first place.

Who Pays? Even though the aggregate costs of any of the producer security measures discussed in this leaflet are paltry when compared to most of the other policy issues dealt with in this series, the question of who pays has repeatedly snuffed out passage of national and state legislation. Should processors have to pay to protect producers? Should financially healthy processors have to pay to help ensure that their less sound competitors are able to get a milk supply? Should producers pay to protect their neighbors who insist on selling to a fiscally unsound buyer?

Is Producer Security a Public or a Private Issue? We all feel great sympathy for the Land O'Sun, Hawthorn-Mellody and Cumberland Farms milk suppliers who have suffered a terrible financial loss, as with earlier occasions where producers failed to get paid. Nevertheless, the question must be asked as to how heavy the government's role should be. Cooperatives have been the traditional institution that dairy-men have turned to for market security. One of the foremost responsibilities of co-op managers should be to protect the market security of their members.

To the extent that co-ops have multiple customers, the risk of buyer insolvency is reduced. Any loss is shared among all members of the cooperative, not just the members whose milk was shipped to the defunct processor. Single customer cooperatives have all their eggs in one basket. They and independents were hurt worst in the three recent cases. There are usually numerous tip-offs as to when a processor is in financial trouble. Astute cooperative managers are paid to sniff out such dangers. Merger, integration into processing, diversification of customers, seeking alternative markets, and putting customers on accelerated payment schedules are alternatives that co-ops have pursued for security of payment.

Market security comes at a cost, whether public or private. Privately, the cooperative sector has borne that cost. Do "free riding" independents, who may have been avoiding this cost, deserve protection under producer security laws? It has been argued that governmental producer security measures are anti-cooperative; because they eliminate or reduce the risk-reducing and risk-sharing benefits that cooperatives would otherwise have to offer. These are some tough questions to answer, but the industry will have to debate them in pursuit of a solution to the payment security problem.

Alternatives

There are a number of alternatives that would address the producer security problem. All raise questions of effectiveness, equity and cost. As mentioned above, some state programs may raise the additional question of constitutionality.

Speed Up Producer Payment. An alternative that has been proposed under the Federal order program has been to speed up producer payment dates. There have been proposals for three monthly payments instead of one or two. While aimed more at processors "operating on producer's pocket-books," such measures would reduce the number of days of deliveries exposed to loss. At best, speeding up payment would be only a partial solution, and even this simple measure would cost some money.²

Indemnity Fund or Special Pool. A solution used in some states for milk and other farm commodities, would be to accumulate an insurance type fund to be used in the event of failure of a milk processor to pay. The funds would initially come from mandatory checkoffs from producers, processors, or both. Interest on the fund balance would enhance the size of the fund. The fund would be capped at a specified level. Ideally that level would be sufficient to pay off the largest potential failure. Checkoffs would then cease unless disbursements were required. Such funds are often operated by state Departments of Agriculture. Similarly, a special contingency pool could be operated under the federal order system. One problem with such funds has been in handling nonpayments that occur prior to a sufficient balance being accumulated. Another has been an insufficient cap to the fund amount. This is often the situation in cases of laws dating back to when milk processors were much smaller and milk prices were lower.

Financial Disclosure or Audits. Just as most dairy plants are routinely audited for milk purchases and disposition by federal and state price regulatory agencies, they could be made subject to financial audits. Such is the case with the banking, and savings and loan industries—perhaps a discouraging fact for proponents of this alternative. Firms not meeting requisite financial health standards would be barred from purchasing milk, or could be required to purchase a surety bond sufficient to cover monthly milk purchases. Costs of conducting audits could come from tax revenues or from checkoff funds.

The California survey found that 11 states had producer security measures that fall somewhat short of audits. Each requires the filing of a financial statement, often certified, prepared by, or audited by a CPA. Problems with audits and financial disclosure include timeliness (a firm's balance sheet can deteriorate quickly), and verification of accuracy. Processors also raise the issue of potential disclosure of highly confidential information.

Bonding Requirements. Almost all existing state laws require processors to post a surety bond or similar form of security instrument sufficient to pay all, or a portion of,

²Nationally the implicit interest savings that would be shifted from processors to producers from three monthly payments rather than two would amount to about \$12.5 million per year, plus additional accounting and transaction costs. But the actual figure begs the issue, as plants would ultimately pass the additional costs on to consumers or back to farmers in a different manner.

producer obligations. In some cases, every processor is required to participate. Alternatively, only firms failing to meet certain financial standards or failing to report their financial conditions (as many firms are reluctant to do), are required to buy a bond. Wisconsin's producer security law, for example, operates along these lines. Some states exempt co-ops; others do not.

Surety bonds are expensive, and cost more per dollar of coverage for firms in weak financial condition. Some argue that firms who cannot afford to post such a bond have no business in today's dairy industry. Others argue that a bonding requirement could drive out firms, thus reducing price competition for producer milk and/or resulting in less competitive product prices. As with the indemnity fund alternative, a big problem with laws requiring posting of security has been the insufficient amount of funds mandated. For example, in a worst case outcome in the Cumberland Farms bankruptcy—no restitution for producers—New York suppliers would be pretty much fully compensated by that state's security fund. By contrast, New Jersey requires only a minimal \$100,000 bond, which would pay only a small percentage of producer claims. Nor will the law provide any protection at all to the out-of-state producers shipping to Cumberland's New Jersey plant.

Laws Superseding Order of Payment to Creditors, P&S/PACA Trust Provisions. It has been suggested that the bankruptcy statutes are unfair, giving protection to the "haves" and punishing the "have nots" such as farmers. The Bankruptcy code has been amended over time, but changes placing producers higher or highest in the ranking of creditors would face opposition from the banking sector. However, in two commodity groups, farmers have been given special status in the hierarchy of payments.

Producers of cattle and hogs are afforded payment security by the Packers and Stockyards Act, enacted in 1921. Sales of live poultry to dealers were covered in a 1987 amendment. Among a number of other provisions, the Packers and Stockyards Administration assures prompt and full payment by using its power to revoke licenses, post bonds and maintain custodial bank accounts. Most important, since 1976, P&S has provided for establishment of a "trust" composed of meat packers' inventory, accounts receivable, and proceeds from sales to be used to pay producers in the event of bankruptcy, thus effectively giving producers payment priority over secured creditors.

Fresh and frozen fruit and vegetable buyers and sellers have been regulated by the Perishable Agricultural Com-

modities Act since 1930. In 1984 a similar trust amendment was added to PACA. As with P&S, trust assets include raw and processed product inventory and all receivables or proceeds from the sale of products. To be eligible for trust protection, contracts must provide for payment within a maximum of 30 days after receipt and acceptance by the buyer, and when a written notice of intent to preserve trust benefits is delivered to both the buyer and USDA within 30 days after payment is due. Transactions between marketing cooperatives and its members are exempt from trust requirements under PACA, but transactions between cooperatives and buyers are covered.

In the 102nd Congress, Congressman Gunderson of Wisconsin introduced a bill, H.R. 3131, that would establish such a trust for dairymen. The law would amend the Packers and Stockyards Act to cover milk producers. It would require that milk handlers "hold in trust" all inventories of milk and milk products, and all receivables or proceeds from the sale of milk or milk products for the benefit of milk producers. In the event of bankruptcy, the interests of unpaid milk producers and handlers "shall be superior in rank to any and all statutory and common law liens" with respect to the bankrupt company's assets.

A consequence of such a measure would be to make obtaining credit somewhat easier for producers, but it would make financing more difficult and/or more expensive for processors. In a 1991 letter sent to all members of Congress, the Milk Industry Foundation based its opposition to H.R. 3131 in large part to this impact. MIF claimed the loss of assets for collateral would amount to 16 percent of total industry assets and 34 percent of equity. While these figures are arguable; the amount would nonetheless be quite significant.

Concluding Thoughts

A number of states have developed producer payment security programs over the years. The recent flurry of plant bankruptcies has prompted other states to consider such measures, and others to consider strengthening existing laws. Some states feel that they have extremely adequate and effective producer security laws. On the other hand, many feel that a national program is the ultimate answer. However, producer security legislation should not be viewed as a substitute for sound, prudent business practices by individual producers, cooperatives and processors. Producers, cooperatives, and processors who use sound everyday market security and business practices can legitimately question programs that cause them to subsidize those who do not.