

Enabling a Better Marketplace

Proposing a New Approach to Enhancing Trading Practices and Financial Risk Mitigation in the Canadian Fresh Produce Sector

The Canada-U.S. Regulatory Cooperation Council action plan released on December 7, 2011, committed that: Agriculture and Agri-Food Canada (AAFC) and the U.S. Agricultural Marketing Service, “will establish comparable approaches to achieve the common goal of protecting Canadian and U.S. fruit and vegetable suppliers from buyers that default of their payment obligations.” After extensive consultations with Canadian and U.S. industry, the government of Canada announced its decision to address the current limitations to the Government’s existing licensing regime. In addition, the Canadian and US governments continue to explore additional financial risk mitigation options to address payment issues related to bankruptcy and insolvency within the fresh fruit and vegetable industry.

The government of Canada has made a commitment to examine the current licensing system to seek improvements on its provisions and operations. Currently, interprovincial and international dealers of fresh fruit and vegetables operating in Canada must be licenced by the Canadian Food Inspection Agency (CFIA) under the *Licensing and Arbitration Regulations*, unless they are a member of the Fruit and Vegetable Dispute Resolution Corporation (DRC). The DRC is a non-profit organization made of growers, shippers, wholesalers, retailers, foodservice distributors and brokers who handle fresh fruits and vegetables and over 90 percent of firms trading fresh produce in Canada are members of this organization. Although the two approaches have provisions to assist in financial risk mitigation for produce sellers, industry has identified that one unified system would be preferable.

This single dispute resolution body approach is a critical step towards achieving comparable approaches between Canada and the U.S. in terms of financial protection for sellers of fresh produce. The government of Canada is currently entering discussions with stakeholders on what could be included in a single unified licensing system, supported by government with industry providing the necessary tools for fair trading practices within the fresh fruit and vegetable industry. The goal is to:

- Ensure a unified system of strengthened, fair, ethical and effective trading rules for fresh fruit and vegetables,
- Provide harmonized standards, procedures and services to avoid and reduce commercial disputes in the produce sector,
- Permit requirements for posting of financial security where necessary, and
- Ensure improved industry education, counsel and support on fair trading rules and practices

with the objective to reduce instances of slow, partial and non-payment, and fraudulent activity within the fresh produce marketplace. **As noted, this does not, nor is it intended to address situations of bankruptcy or insolvency.**

Agriculture and Agri-Food Canada (AAFC) is seeking feedback from key industry stakeholders on a series of possible approaches to membership, contracting, arbitration, financial security and enforcement. The consultation document is a listing of ideas and approaches as summarized from discussions with stakeholders and including an analysis of the function of the current Licensing and Arbitration Regulations and the DRC rules and standards, and regulated practices for other Canadian agriculture commodities. **The document is presented for discussion, and does not represent an official position of the government of Canada or the specific stakeholders involved; it should not be interpreted as consensus as to their merit by government or stakeholders.**

We welcome your feedback and advice in this regard and on other related issues.

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**Proposing a New Approach to Enhancing Trading Practices
and Financial Risk Mitigation in the Canadian Fresh Produce
Sector**

PREPARED BY: Agriculture and Agri-Food Canada

Please note that this paper is being provided for discussion purposes only.

Introduction

For several years, both the Canadian and American fresh produce sector have expressed frustration with perceived deficiencies in the financial risk mitigation tools available in

Objective:

To develop the most effective approach to enhancing trading practices and financial risk mitigation in the Canadian fresh produce sector.

Canada to unpaid sellers of fresh produce. In this regard, industry and the Government of the United States have requested modifications to existing Canadian policies, legislation, and regulations that could potentially provide industry with a greater level of financial protection in instances of slow/partial/no pay as well as bankruptcy and insolvency. These requests have resulted in a number of different task forces, working groups, and other collaborative efforts, to study the overall impact of these issues and potential solutions. It is against this backdrop that the Government of Canada agreed to consider the establishment of a made in Canada solution that would offer comparable financial risk mitigation to sellers of fresh produce operating in Canada relative to what is offered in the United States. This was done in the context of identifying a specific action plan commitment as part of the Canada-United States Regulatory Cooperation Council announced in 2011.

In moving forward on this action plan commitment, the Government of Canada has indicated its willingness consider a new approach to managing the trading practices in the fresh produce industry as a means of helping to address the financial risks facing the sector, in addition to other considerations. Key to the proposed changes is the mandatory membership in a third party dispute resolution body of buyers and sellers of fresh produce who are trading these products interprovincially or internationally. This paper is being presented in the context of soliciting input on the development of this proposal to inform its further refinement.

Background and Context

Trading Practices in the Fresh Produce Sector

While the fresh produce business historically involved local sales, the nature of the industry has changed in the past 20 years. International trade is now essential to the success of the fresh produce industry and to consumers who are demanding an ever-increasing variety of fresh produce year-round. This has led to changes in the fresh produce industry resulting in increasingly integrated, interdependent and complex value chains.

Given the perishable nature of fresh produce, sellers are motivated to move their product quickly while attempting to obtain a reasonable rate of return. This places them at a disadvantage when seeking to negotiate the sale of their product. Often product has to move before payments are made leaving sellers financially reliant on buyers honouring contractual arrangements. Buyers in Canada range in size from large retail outlets that purchase directly from producers and growers/packers to those that operate on a much smaller scale. Wholesalers can also act as buyers. Fewer firms and larger financial transactions have become the norm and this places greater risk on the fresh produce industry should a large buying entity fail.

A non-payment, partial or slow-payment situation, whether it involves a solvent or insolvent buyer, is never completely unexpected but comes as a shock given the tight margins facing industry players and their dependence on an uninterrupted cash flow.

Any failure in meeting contractual arrangements along the chain, whether deliberate, accidental or by design, can disrupt normal operations and negatively affect the business of multiple industry

players. A domino effect can occur, especially if a medium or large sized buyer with multiple suppliers becomes insolvent. Many produce sellers rely exclusively on a single buyer to purchase their entire crop and can instantly be left with no income and in a desperate financial situation, should a buyer default on their payment obligations. This can then significantly impact other suppliers linked to a seller facing difficulties.

Current System for the Canadian Fresh Produce Sector

Federal Jurisdiction

The Canadian Food Inspection Agency is the federal agency responsible for regulating fair and equitable trade practices in the Canadian fresh fruit and vegetable sector. Its authority is derived from the *Licensing and Arbitration Regulations* made pursuant to the *Canada Agricultural Products Act*. The *Canada Agricultural Products Act* and *Licensing and Arbitration Regulations* contain the authority to regulate the interprovincial and international marketing of fresh produce (and all agricultural products). The regulatory framework is intended to promote fair and ethical trading practices in the fresh produce sector by establishing trading standards, rules, and a language of commerce by which transactions must be conducted.

Specifically, the *Licensing and Arbitration Regulations* are intended to enable the Canadian Food Inspection Agency to:

- demand financial security (bonds) from dealers;
- license fresh produce dealers;
- enforce payment obligations through the suspension and cancellation of these licenses under certain conditions.

Third Party Dispute Resolution Body

The Fruit and Vegetable Dispute Resolution Corporation was established in February of 2000, pursuant to Article 707 of the North American Free Trade Agreement (NAFTA) as a private commercial dispute resolution body for trade in agricultural commodities. Anticipating an increase in the number of commercial trade disputes, industry stakeholders and governments of the three countries recognized the need to establish an international mechanism to resolve disputes effectively and efficiently among fresh produce firms operating in Canada, Mexico and the United States. To facilitate the operation of the Dispute Resolution Corporation, the *Licensing and Arbitration Regulations* were amended to exempt members of the Dispute Resolution Corporation from Canadian Food Inspection Agency licensing requirements.

This industry-led organization's membership base includes growers, packers, shippers, produce brokers, wholesalers, fresh processors, food service distributors, retailers, transportation brokers, freight contractors, and carriers in North America. The Dispute Resolution Corporation is tasked with promoting fair and ethical trading practices within the NAFTA region and to resolving commercial disputes that arise between member companies in a cost-effective and timely manner. Over 90% of Canadian fresh produce buyers required to hold a federal produce license have chosen membership with the Dispute Resolution Corporation over being licensed under the *Licensing and Arbitration Regulations*. Dispute Resolution Corporation members agree not only to abide by Dispute Resolution Corporation's trading standards and membership by-laws, but also to a binding arbitration process. The Dispute Resolution Corporation can also demand financial security and enforce payment conditions on buyers of fresh produce.

Limitations of the Current System

Canadian law requires buyers of fresh produce who want to trade interprovincially or internationally to be licenced by the Canadian Food Inspection Agency. An exemption to these regulations is given to those who choose to become members of the Dispute Resolution Corporation, which the vast majority do. However, this creates a dual system with two similar yet distinct sets of trading rules.

Importantly, under the current federal system, while the Canadian Food Inspection Agency may take compliance action against a licensee in the form of bonding, suspension or cancellation actions, remittance of outstanding funds is not guaranteed to sellers. It is important to note that any financial security held by Canadian Food Inspection Agency and subsequently forfeited due to payment issue is limited to an amount sufficient to cover legal and other Government of Canada costs that are associated with pursuing payment related actions and is not distributed to the affected sellers.

The DRC can require the posting of financial security that is commensurate with the level of potential risk of a buyer, however, under the current system, these firms have always had the choice of simply choosing to be licensed under the *Licensing and Arbitration Regulations* rather than comply with this or any other membership requirement.

Provincial Jurisdiction

While it is clear that provincial governments have a clear role in enhancing trading practices and financial risk mitigation in the fresh produce sector, this consultation process is limited to those aspects of legislation, regulations, and policies which govern interprovincial and international trade and fall under federal jurisdiction.

Why are changes to the existing system being proposed?

The Government of Canada is proposing that the fresh produce sector should gain access to a more efficient and effective approach for managing industry trading practices. The overall intent of this undertaking is to address the limitations of the current system by ensuring that:

1. **all** market participants in the fresh produce sector are subject to a **single set** of fair trading practice **requirements** while seeking to **prevent** payment-related issues from occurring in the fresh produce marketplace before other risk mitigation measures become necessary;
2. there are **more consistent periods for payment and delivery** obligations for Canadian buyers of fresh produce;
3. there is more **timely resolution** of payment issues between buyers and sellers when they do arise;
4. there is a more **predictable** and **transparent** producer payment protection model; and that
5. the system enables the **orderly marketing** of fresh produce by **reducing** instances of fraud and other unscrupulous financial transactions.

Moving Forward

The Government of Canada is now prepared to consider a new approach which would involve the repeal of the *Licensing and Arbitration Regulations* and the parallel enabling of a third party Single Entity for the oversight of fair trading practices in the fresh produce sector. We are utilizing this paper to initiate public consultations on what this new system would look like; what the membership requirements would be; and how this new system would be implemented. Moving in this direction will allow the Government of Canada to address limitations associated with the current system.

What would this new approach look like?

(1) Coverage

The intent of Canada's new approach would be to enable the management of trading practices in the Canadian fresh produce industry with the three main goals of:

- Ensuring sellers have access to better training and more comprehensive, real-time information so they are able to make the best business decisions possible.
- Promoting and enforcing fair and ethical trading practices with payments made commensurate with contractual obligations.
- Having sufficient capacity to deter and penalize those firms who are unable or refuse to meet their payment obligations and the ability to prevent them from inflicting further damage to the fresh produce marketplace in the future.

Buyers

Proposal 1.1.1: That all dealers engaged in interprovincial and international trade of fresh produce become a member of a designated third party Single Entity.

Rationale: To ensure fair and ethical trading of fresh produce and eliminate the current option of being a licence holder under the *Licensing and Arbitration Regulations*, all buyers would comply with the membership requirements of the Single Entity.

Proposal 1.1.2: No exemption that permits dealers who purchase all agricultural products within the province where their business is located to sell interprovincially or internationally without a membership. These firms would now need to become and maintain a membership in good standing in the Single Entity.

Rationale: Ensures that virtually all buyers who sell interprovincially and internationally are subject to the same rules thereby contributing to orderly marketing and enabling greater oversight of these types of financial transactions where purchases are made only from intraprovincial sources.

Proposal 1.1.3: Reduction of exemption (currently in *Licensing and Arbitration Regulations*) that permits dealers to market agricultural products directly to consumers without a membership if the total invoice value of the products is less than \$230,000 in a given year. This limit would be reduced to an appropriate amount (to be determined) that would capture a greater number of market participants.

Rationale: Ensures that virtually all buyers who sell interprovincially and internationally are subject to the same rules thereby contributing to orderly marketing. Also diminishes opportunity for dealers/companies created on an annual basis with the sole intent of maintaining sales below \$230,000 so as avoid payment obligations or commit fraudulent activities.

Sellers

Proposal 1.2.1: Sellers would be required to obtain a membership in the Single Entity in order to trade or sell interprovincially or internationally and commit to perform due diligence in their business practices including partaking in relevant education and awareness activities. There would be a much different set of requirements compared with buyer memberships and the cost would be significantly lower (e.g. 50%), given the reduced cost of administration. Requirements would also include obtaining sufficient business history/credit information on potential buyers before agreeing to transactions. Expanded access to this data will now be provided by the Single Entity.

Rationale: To encourage sellers to become more proactive in mitigating the financial risks to their operations through greater due diligence. The Single Entity would provide enhanced access to resources such as training and education, buyer information sharing, anonymous electronic reporting capacity, database of credit-worthy buyers, greater due diligence activities, etc. Prevention of payment-related issues before they cause significant harm to sellers would be the primary goal of this new system and not just waiting to deal with these problems once they have occurred.

(2) Contract Requirements

Much emphasis would need to be put on ensuring that a legal basis is obtained to enable binding decisions in favour of unpaid sellers. However, these systems would fail if the necessary factual and evidentiary basis for claims cannot first be established. Attention must therefore also be paid to reinforcing diligent practices by the industry and individuals.

By building an industry which routinely uses effective transactional practices, the impact on the individual seller would be reduced and his or her ability to collect would be enhanced. These practices are largely preventative in nature and should lead to the promotion of greater due diligence (reducing the possibility of entering into a contract with a delinquent buyer in the first place) and the development of the evidentiary basis for a claim before an adjudicative body (standardized contracts and documented industry standards through a single membership system).

Proposal 2.1: Provision of a default contract for all Single Entity members. This would come into effect when a dispute occurs and there is no written contract in place.

Rationale: Enables the application of consistent periods for payment and delivery obligations for Canadian buyers of fresh produce while ensuring timely resolution of payment issues between buyers and sellers when they do arise. As many transactions in the Canadian fresh produce market are completed through verbal or other very informal unwritten contracting mechanism, a default contract is needed to ensure that both buyers and sellers are protected.

(3) Arbitration Process

Having a system that includes mandatory arbitration should other mechanisms of dispute resolution fail is an important component of the proposed approach. Under the proposed system, the parties would agree to submit any unresolved dispute to mediation and arbitration by the Single Entity. Any such arbitration decision would be final and enforceable in court if the need arises. It is expected that most arbitration awards would be paid willingly by the party against whom an award is made, but in some instances it may become necessary to have the award enforced through a Court.

Proposal 3.1: The Single Entity becomes the sole arbitrator in the resolution of payment conflicts that arise between buyers and sellers of fresh produce in Canada. When the parties are unable to come to an agreement, an arbitration process would be undertaken by the Single Entity between members to provide a court-enforceable, binding decision. This process may be initiated regardless of the amount of the claim and is similar to the current dispute resolution process established under the by-laws and rules of the Dispute Resolution Corporation.

Rationale: Ensures that formal arbitration becomes an important tool available to all firms in the fresh produce sector in the same way that it is currently a mandatory membership requirement in the Dispute Resolution Corporation. Arbitration can often resolve many payment-related disputes even if the outcome is not 100% of what was agreed to prior to the original transaction between buyer and seller. A compromised solution is certainly better than no solution at all and this may also keep certain firms from slipping into insolvency.

(4) Requirements of Financial Security from Buyers

Financial security requirements obliging a sufficient posting in line with the risk profile of the firm would be key components of obtaining and maintaining buyer memberships in the new third party Single Entity.

Ensuring that fresh produce buyers provide financial security is a crucial element in:

- ensuring timely payments and reducing financial losses due to payment related issues
- termination of memberships of those firms who break the rules or become financially insolvent;
- preventing bad actors from entering the fresh produce market who have malicious intent.

Financial security requirements must not be so onerous or burdensome as to prevent new or existing firms from entering or remaining in the fresh produce market and thereby creating economic harm to the sector. There is a large amount of flexibility in the different mechanisms by which this security can be obtained (e.g. bonds, cash, letters of credit, insurance, etc.). The key here is trying to prevent large financial losses from occurring in the fresh produce market whether it is unintended or fraudulent.

Also, transparency related to the formulas for determining the amount of financial security that must be posted shall be provided to all Single Entity members.

Determination of Requirements for Financial Security to be Posted by Buyers

Proposal 4.1: Financial security requirements for all fresh produce buyers would include:

- Provision and maintenance of a valid Dunn and Bradstreet (D&B) number and registration in the Blue Book for the purposes of credit history evaluation. The formulas used to determine risk/credit worthiness would be listed for all Single Entity members to review.
- Credit checks, provision of business information (e.g., past business history, size of company, nature of transactions), an average perishability profile of the main commodities being traded (e.g. apples vs. lettuce), and other factors could be used in the determination of financial security.
- A sufficient percentage (to be determined) of the accounts receivable due to fresh produce sales over a 6 month period need to be provided as financial security. This amount would be established on the basis of the level of risk of the buyer as determined by the Single Entity and could increase or decrease over time.

Rationale: the requirement of financial security provides a significant disincentive to the buyer to default on a contract to purchase or to ever enter into an agreement with this intent. It also plays a significant role ensuring that timely payments are made and reducing financial losses due to payment related issues when used by the Single Entity to distribute to unpaid sellers.

Pay outs

Proposal 4.2: The financial security required by the Single Entity of a member would be used to payout liabilities to sellers when an arbitral decision is awarded.

Rationale: Ensures buyers adhere to the Single Entity membership rules and contributes to orderly marketing. The temptation for a nefarious dealer to enter the market place with the intent of defrauding sellers of fresh fruits and vegetables by defaulting on their payment would be greatly reduced if they were required to put up a sufficient amount of financial security to become a member. The cases of unintentional losses through bankruptcies or otherwise could at least be partially addressed through this process as well. This requirement therefore acts both as a deterrent to unethical trading practices by buyers and a tool for financial risk mitigation for sellers.

These enhanced requirements would also ensure that more resources are available to compensate the sellers for their losses in the event of non-payment including fraud.

(5) Enforcement and Penalties

Enforcement of trading practices and financial protection measures are likely to be enhanced if overseen by a Single Entity as in part, it removes the ability for parties who have had their memberships revoked or questioned to simply transfer to the licensing provided under the *Licensing and Arbitration Regulations* and continue to undertake questionable, unethical, or even fraudulent practices before they are caught again. It also provides consistent requirements for all buyers and sellers and the ability to impose effective consequences in cases of non-compliance. However, the resources and infrastructure available for enforcement (including that provided by government) must be commensurate with the implementation requirements of the new approach, if it is to be effective.

Proposal 5.1: Conditions for disciplinary action would be specified including the range of penalties (monetary fines, suspension, revocation of membership, etc.). The penalties for slow and partial payment may differ from that of non-payment. The conditions to regain membership revoked as a result of disciplinary actions would be specified and may include the posting of further financial securities. Continued interprovincial and/or international trading of fresh produce without a valid Single Entity membership number would be considered to be in contravention of federal

regulations and would be expected to be enforced by the appropriate Government of Canada authorities.

Rationale: The consequences for non-compliance with arbitrarial awards relating to payment issues or other membership requirements could result in the permanent loss of ability to conduct business in Canada. This is likely to be a significant deterrent to those who intend to engage in unethical trading practices as these firms would no longer be able to trade produce interprovincially and internationally without an active and valid membership number and/or they would be required to put up a cost-prohibitive amount of financial security in order to regain their membership once suspended/revoked.

Proposal 5.2: A more robust system for real-time information sharing between the new Single Entity and government bodies should be established to help prevent those firms who have lost their membership rights from continuing to trade fresh produce internationally. This system should include instant updates of Single Entity memberships that are no longer valid and allow shipments to be stopped at the border or other point-of-entry.

Rationale: This investment would be necessary to ensure that companies who are not complying with Single Entity membership rules are not able to do further damage to the fresh produce marketplace therefore minimizing further losses to their suppliers.

Proposal 5.3: A formal appeal process and body should be provided for members who disagree with the decisions made by the Single Entity regarding membership including requirements, by-laws, financial security requirements, suspensions, terminations, etc.

Rationale: The appeal process is necessary in order to ensure fair treatment for all buyers who would now be mandated to be members of the Single Entity if they want to trade internationally or inter-provincially It provides greater legitimacy to the Single Entity by permitting recourse by members and ensures that the Single Entity is providing the best possible service to the fresh produce industry.

Questions for Consideration

- 1. What are the most critical elements of a third party Single Entity that would help in slow, no or partial pay situations?**
- 2. What do you see as the benefits and challenges of each of the proposals?**
- 3. What do individual buyers and sellers require to help them in undertaking due diligence before entering into transactions?**
- 4. Are there any potential downsides to the approach proposed in this paper?**