

DEPARTMENT OF AGRICULTURAL ECONOMICS

Legal Issues Involving Cash Forward Grain Contracts

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Overview

This publication addresses contract and sale transactions common to farmers involving cash forward grain contracts. Many contract issues involve aspects of commercial law. Commercial law issues are generally governed by laws that are the same across all jurisdictions. These uniform laws have developed as a result of the increased complexity of business transactions and the conduct of those transactions across state lines. The Uniform Commercial Code (UCC) has been developed and enacted, with some modifications, in every jurisdiction in the United States (though Louisiana has enacted only parts of the UCC). Article 2 of the UCC governs sales transactions.

Application of UCC Article 2 to Contracts

Scope of Article 2. UCC Article 2 pertains to the sale of goods. “Goods” includes all things that are movable, as well as timber, minerals or the like and permanent type buildings if the seller severs them from the land. If the buyer is to sever such items, they are classified as interests in land. These transactions are handled as if the land is being sold, and Article 2 does not apply. Growing crops, temporary or movable buildings and other items that can be moved without harming the realty are also considered goods under the UCC as are animal products while still on or in the animal, and the unborn young of animals. Article 2 also applies to contracts involving goods that are provided along with services or real estate if the goods are a predominant factor of the contract.

Requirement That Contracts be in Writing

In the United States, nearly every state has adopted, and retained, a statute of frauds. Typically, these laws require a writing for certain types of contracts. The

writing requirement for sales of goods, adopted by most states, is applicable only when the goods have a price of \$500 or more. In addition, under another provision of the UCC, there is an overall statute of frauds for every contract involving a contract for the sale of personal property having a value in excess of \$5,000. Thus, for personal property except goods, a contract is not enforceable

beyond \$5,000 unless there is some writing signed by the party against whom enforcement is sought.

Merchant’s confirmatory memo rule. As indicated above, a contract for the sale of goods of \$500 or more is generally not enforceable unless there is some writing signed by the party against whom enforcement is sought sufficient to indicate that the contract had been made between the parties. For contracts between merchants, it is common for one merchant to send the other merchant a letter of confirmation, or a preprinted form contract. This confirmation will be signed by the party who sent it, thus leaving one party at the other party’s mercy. The UCC remedies the situation by providing that unwritten contracts between merchants are enforceable if a writing and confirmation of the contract is received within a reasonable time unless written notice of objection to the contents of the writing is given within 10 days. Thus, the effect of this merchants exception is to take away from a merchant who receives a writing in confirmation of a contract the statute of frauds defense if the merchant does not object to the confirmation.

In any event, the sender of the written confirmation must still be able to persuade a jury that a contract was, in fact, made orally, to which the written confirmation applies. The merchant’s confirmatory memo rule is of particular importance with respect to cash forward grain contracts.

Example 1:

In December of 1997, Albert Black, a Kansas wheat farmer, telephoned his local elevator for a price quote. During their telephone conversation, Albert and the elevator agreed that Albert would sell the elevator 25,000 bushels of Grade #1 wheat (60# test weight) at the December price next July, with performance to be completed no later than July 31, 1998. The elevator sent Albert a written confirmation asking that it be signed and returned within ten days. Albert did not sign the written confirmation. Because of poor growing conditions and a resulting small wheat crop, the July 1998 wheat price was substantially higher than the December 1997 price. Albert refused to perform in accordance with the forward contract, preferring instead to sell his wheat crop at the higher current market price. The elevator sued to enforce the forward contract. As a defense, Albert asserted the UCC statute of frauds.

If Albert is a merchant with respect to the kind of goods contemplated in the forward contract (wheat), Albert will be bound by the oral contract entered into over the telephone with the elevator in December of 1997. If it is determined that Albert is not a merchant, the elevator might be able to recover if it can establish that it changed its position in reliance on Albert's conduct, that Albert knew or reasonably should have known the elevator would sell the forward contract, or can demonstrate that nonperformance by Albert was based on Albert's desire to benefit from a higher market price.

As illustrated above, a significant consideration is whether a particular farmer or rancher is a merchant. A merchant is defined as one who deals in goods of the kind being sold, or one who by occupation holds himself or herself out as having knowledge or skill peculiar to either the goods involved or the practice of buying and selling such goods. Courts are divided on the issue of whether a farmer or rancher is a merchant, with the outcome depending on the jurisdiction and the facts of the particular case. Unfortunately, in many instances, farmers and ranchers cannot know with certainty whether they are merchants without becoming involved in legal action.

Courts consider several factors in determining whether a particular farmer is a merchant. These factors include (1) the length of time the farmer has been engaged in marketing products on the farm; (2) the degree of business skill demonstrated in transactions with other parties; (3) awareness of the operation and existence of farm markets; and (4) past experience with or knowledge of the customs and practices unique to the marketing of the product sold.

In one of the better known cases, the Texas Supreme Court ruled that a farmer who sold cotton and wheat produced on a 1,200-acre farm was a merchant. The farmer sold all of the production for each of the previous five years and daily kept abreast of current market prices and conditions by talking to grain dealers and listening to the radio. In another significant case, the South Dakota Supreme Court concluded that "the average farmer...with no particular knowledge or experience in selling, buying or dealing in future commodity transactions, and who sells only the crops he raises to local elevators for cash or who places his grain in storage under one of the federal loan programs is not a 'merchant.'" The Wisconsin Court of Appeals has held that a person who did not own a farm and who had sold grain in small quantities on only three previous occasions was not a merchant. Similarly, the Alabama Supreme Court has held that a farmer who made only occasional sales of corn and did not perform additional marketing activities was not a merchant.

Cash Forward Grain Contracts and the Delivery Requirement

If a contract fails to state a time for the delivery of goods, a reasonable time is assumed. In recent years, the use of fixed price forward contracts has gained popularity among grain producers. Forward contracts are of several types, but one of the most often used varieties is a sale agreement that binds the farmer to deliver a specified quantity of grain at a future date. The farmer takes the risk that the commodity price will not rise before delivery is required under the contract. This is usually the case as commodity prices tend to decline during harvest months as new crops come on to the market. The buyer usually covers the price risk by selling an identical amount of the commodity to a third party or by the use of hedges in the futures market. Forward contracting can be a sound marketing tool provided that the amount of the crop forward contracted is limited, in general, to a modest proportion of a normal crop above crop insurance carried.

In the event growing conditions lead to smaller than expected crop yields, a particular producer could be in a position of having hedged more than can be harvested with a resulting inability to deliver against the contract. The buyer in this situation is allowed to "cover" by purchasing substitute goods and charging the extra cost back to the seller. Another concern is the tendency of some producers to use a provision in the so-called "hedge-to-arrive" (HTA) contract that allows the

transaction to be rolled forward several months when prices are expected to be lower. If the market continues to climb during this period, some buyers (elevators) may experience a severely weakened liquidity position and may exhaust their line of credit for margin calls.

A potentially serious problem with the continuous forward roll of HTA contracts is that they often make the delivery requirement unclear and may be illegal under Commodity Future Trading Commission (CFTC) regulations that ban trade options (an off-exchange derivative) on agricultural commodities. This has been a major issue since 1996 and the run-up in grain prices that occurred during that time. Several cases have been decided by courts and other disputes have been settled by arbitrators. The result of each dispute has heavily depended upon the particular facts involved, with some courts and arbitrators upholding the HTA contract and requiring the farmer to deliver, while other courts and arbitrators have determined the contracts to be illegal under the CFTC ban. In general, HTA contracts will be upheld as cash-forward contracts if a court or arbitrator can determine that the contracts clearly contemplated actual physical delivery of a specified amount of grain to a specified location at a specified price during a specified period of time. If a particular contract was entered into between a seller engaged in the business of producing grain and a buyer engaged in the business of buying grain, then it is likely that the contract will be upheld as a cash-forward contract not subject to the CFTC ban on off-exchange derivatives in agricultural futures.

In mid-1997, the CFTC indicated that it was considering lifting the long-standing ban on off-exchange agricultural trade options. If made available, farmers would be able to make an agreement with an elevator “for the right, but not the obligation, to sell a specific amount of grain at a preset price. If prices rose by the delivery date, the farmer would pay a premium to get out of the agreement and sell his crop elsewhere.” If these type of options are permitted, a remaining question is whether they should be regulated. Indeed, the CFTC would retain the authority to investigate allegations of fraud or unlawful representations. Rules concerning disclosures, education and eligibility to buy and sell could also be created. However, difficulties with oversight and enforcement can be expected.

Contract Performance

Commercial Impracticability. A seller is excused from timely delivery of goods if performance becomes commercially impracticable because of unforeseen

circumstances. However, if a farmer fails to deliver a crop because drought, hail or other weather has destroyed it, the farmer is generally not excused from performance unless the contract called for the crop to be grown on a specified geographic area (such as a 160-acre tract) and weather damage reduces the amount available for delivery. In one significant case, the farmer forward contracted to sell 300,000 bushels of corn to a buyer. Before the specified time of delivery, a hailstorm destroyed most of the crop. The farmer claimed that he was excused from delivery because of casualty to the crop. The court disagreed, noting instead that the contract did not specify the tract of land on which the crop was to be grown. Likewise, another court reached a similar conclusion in a case involving the future delivery of corn as rental payment for a farm lease.

Adequate assurance. A sales contract imposes an obligation on both the seller and the buyer that each party’s expectation of receiving performance will not be impaired. When reasonable grounds for insecurity arise with respect to the performance of either the seller or the buyer, the insecure party may, by written demand, seek adequate assurance of due performance of the other party. Until adequate assurance is received, the insecure party may, if commercially reasonable, suspend any performance for which the insecure party has not already received the agreed upon return. If the contract involves merchants, the reasonableness of grounds for insecurity and the adequacy of any assurance offered is determined in accordance with commercial standards. A demand for adequate assurance must be commercially reasonable. This issue is of particular importance with respect to cash forward grain contracts and the typical time span between when the contract is entered into and delivery of the grain.

Remedies Upon Breach of Contract

Right to “cover.” The traditional measure of damages for a seller’s total breach of contract is the difference between the market price and the contract price. The UCC retains this rule, but also allows an aggrieved buyer to “cover” by making a good faith purchase or a contract to purchase substitute goods without unreasonable delay. The buyer that covers is entitled to recover from the seller the difference between the cost of cover and the contract price.

Example 2:

Assume the same facts as set forth in Example 1 except that Albert Black signed and returned within ten days of receipt the written confirmation sent by the

elevator. Assume that the December 1997 price for wheat was \$5.50 per bushel. Because of poor growing conditions, Albert's wheat crop only yielded 17,500 bushels which Albert delivered to the elevator pursuant to the forward contract. Will Albert be excused from delivery of the additional 7,500 bushels of wheat as required under the forward contract? Likewise, what, if any, is the elevator's remedy? Assume the July 1998 market wheat price is \$6.45 per bushel.

Albert will be excused from delivery of the additional 7,500 bushels of wheat as required under the forward contract only if the forward contract legally described the land on which the crop was to be grown and it was clear that Albert was selling the output of that tract. However, even if the contract does specifi-

cally describe the acres where the crop is to be grown, Albert will be required to deliver whatever he produces. He will only be relieved from the shortfall. As for the elevator's remedy, the elevator will be able to "cover" by taking the difference between the July 1998 market wheat price and the December 1997 price times the number of bushels of shortfall ($7,500 \times \$0.95 = \$7,125$). That amount can be charged to the seller.

Most of the agricultural cases concerning "covering" focus on the difference between the goods purchased as cover and the goods called for in the contract (cover goods must be like-kind substitutes), and the time frame within which cover was carried out (there must be no unreasonable delay).

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