

2015 CGFA Annual Convention

The Monterey Plaza Hotel and Spa Monterey

Identifying and Managing Counterparty Risk

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April 23, 2015

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Identifying and Managing Counterparty Risk

Overview

- ▶ Commodity contract formation and enforcement primer
 - ▷ “Merchant – Farmer/user” purchases and sales
 - ▷ “Merchant – Merchant” transactions
 - ▶ Sorting through the fine print – “Battle of the Forms”
- ▶ Identifying Default
 - ▷ Failure to deliver or take delivery during contract window
 - ▷ Repudiation – breach before performance is due
- ▶ Cancellation and Determination of Damages
- ▶ Arbitration or Litigation

Contract formation – General Concepts

- ▶ UCC § 2-204(1) A contract for sale of goods may be made in any manner sufficient to show agreement, including conduct by both parties which recognizes the existence of such a contract.
- ▶ Issues of enforceability often arise in association with a grain contract dispute.
- ▶ Procedural deficiencies related to the enforceability of a grain contract are easily avoided.

Confirmation of an Oral Agreement – NGFA Grain Trade Rules

The NGFA Grain Trade Rules state the proper procedure for the entry into an oral agreement and the subsequent issuance of a written “confirmation” to form an enforceable contract.

Rule 3, NGFA Grain Trade Rules, states:

(A) Both the Buyer and Seller shall send a written confirmation, each to the other, not later than the close of the business day following the date of trade, or an agreed amendment, setting forth the specifications as agreed upon in the original articles of trade, or an agreed amendment. Upon receipt of said confirmation, the parties shall carefully check all specifications therein and, upon finding any material differences, shall immediately notify the other party to the contract, by telephone and confirm by written communication. In the case of minor differences, notification may be by either telephone or written communication.

(B) If either the Buyer or the Seller fails to send a confirmation, the confirmation sent by the other party will be binding upon both parties, unless the confirming party has been immediately notified by the non-confirming party, as described in Rule 3(A), of any disagreement with the confirmation received.

► Electronic confirmations are approved – NGFA Rule 5

Confirmation of an Oral Agreement – Uniform Commercial Code

NGFA Trade Rule 3 tracks the Uniform Commercial Code (UCC), which is generally applicable to grain contracts. Confirmations are specifically addressed in three sections of the UCC, namely Sections 2-201, 2-202, and 2-207.

Section 2-207 provides for the inclusion of additional terms in a confirmation as proposals for addition to the terms of the parties' contract (*e.g.*, standard terms and conditions stated on the reverse side of the confirmation).

Section 2-202 precludes the introduction of evidence contrary to terms set forth in writing between the parties (if the confirmation states a price of \$4.00, seller is prevented from introducing evidence of a promise to pay \$5.00).

Section 2-201 and the “Statute of Frauds”

The Statute of Frauds refers to the legal requirement that certain types of contracts be in writing to be enforceable. With respect to contracts for the sale of goods, which includes contracts for the sale of grain, California Commercial Code § 2201 provides:

A contract for the sale of goods for the price of five hundred dollars (\$500) or more is not enforceable by way of action or defense unless there is some record sufficient to indicate that a contract for sale has been made between the parties and signed by the party against which enforcement is sought or by his or her authorized agent or broker.

However, 2201 goes on to make a special provision for a certain category of buyer and seller, the merchant, stating:

Between merchants if within a reasonable time a record in confirmation of the contract and sufficient against the sender is received and the party receiving it has reason to know its contents, it satisfies the requirements of subsection (1) against the recipient unless notice of objection to its contents is given in a record within 10 days after it is received.

Electronic confirmations are acceptable in most states, including California.

Farmer as Merchant

“Merchant” means a person who deals in goods of the kind or otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction or to whom such knowledge or skill may be attributed by his employment of an agent or broker or other intermediary who by his occupation holds himself out as having such knowledge or skill.” California Commercial Code § 2104 (1).

In most states, the status of a farmer as a merchant is a question for the trier of fact. The trier of fact may consider evidence regarding:

1. The length of time the farmer has been engaged in the practice of selling his product to the marketers of his product;
2. The degree of business acumen shown by the farmer in his dealings with other parties;
3. The farmer's awareness of the operation and existence of farm markets; and
4. The farmer's past experience with or knowledge of the customs and practices which are unique to the particular marketing of the product which he sells.

Farmer as Merchant: Case Law Examples

- Iowa: Annual sales by a farmer of his own crops will not alone give rise to a finding that a farmer is a merchant. *Sand Seed Service, Inc. v. Poeckes*, 249 N.W.2d 663 (Iowa, 1977).
- Nebraska: “experienced grain producers who regularly grow and market grain on the open market as the principal means of providing for their livelihood . . . possess knowledge or skill peculiar to the practices and operations of grain marketing, are merchants” *Agrex, Inc. v. Schrant*, 379 N.W.2d 751, 754 (Neb. 1986).
- Tennessee: “In considering the questions at issue, the Court notes that cases which hold that the farmer is [a] merchant reflect on the fact that today's farmers are involved in far more than simply planting and harvesting crops... the Court is persuaded that today's Tennessee farmer possess an extensive knowledge and sophistication regarding the purchase and sale of crops. *Brooks Cotton Co., v. Williams*, 381 SW 3d 414 (Tenn. 2012).
- California: Sellers of animal feed and hay exports to customers in Korea, and commodity merchandiser specializing in cottonseed were all considered to be Merchants under Cal. U. Com. Code § 2104. *Apex LLC v. Sharing World, Inc.* 206 Cal. App. 4th 999 (California 2012).

Farmer as Merchant: Hypotheticals

- ▶ Ma & Pa Dairy have day jobs and 25 cows and rely primarily on feed and supplements from their local farm store. Pa decides to forward contract for 3-months' worth of DDG's from a local ethanol plant.
 - ▷ Is Pa a merchant?
- ▶ ABC Dairy Farm, LLC, has for the last 20 years operated a 2,000-head dairy operation. ABC buys custom-manufactured pellets from XYZ Feed Mill, LLC, but periodically makes forward contract purchases of bulk commodity ingredients through XYZ for risk management purposes.
 - ▷ Is ABC a merchant?
 - ▷ What if ABC forward contracts for 100 tons of canola meal pellets, but has never purchased canola meal pellets before?
 - ▷ What if ABC engages the services of a broker for the transaction?

(1) "Merchant" means a person who deals in goods of the kind or otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction or to whom such knowledge or skill may be attributed by his employment of an agent or broker or other intermediary who by his occupation holds himself out as having such knowledge or skill.

Best practices for transactions with Non-Merchants

- ▶ Properly identify the party. Seek formation documents if it is an entity. Consider requiring personal guarantees.
- ▶ Sign, issue and insist that farmers sign your confirmations. Follow up to make sure they do.
- ▶ Consider underwriting procedures, financial review, crop history references, etc. Take steps to avoid contracting into an oversold/overbought situation.
- ▶ Consider a master agreement setting forth the rules for underlying individual trades. (examples available)
- ▶ Join NGFA and utilize NGFA Trade Rules and Arbitration wherever possible.
- ▶ Documents win disputes. Keep phone notes, calendars, emails, etc.



Considerations for Merchant-to-Merchant Transactions

Considerations for Commercial (Merchant to Merchant) Transactions

- ▶ Timeline of a typical merchant to merchant transaction:
 - ▷ Inquiry: please quote price and delivery
 - ▷ Quote: (may or may not be an offer)
 - ▷ If an agreement is reached the parties often swap hedge positions
 - ▷ Buyer sends Seller a confirmation with boilerplate T&C's
 - ▷ Seller sends Buyer a confirmation with boilerplate T&C's
 - ▷ Contract exists on the papers under U.C.C. 2-207 if the boilerplate doesn't prevent it
 - ▷ Delivery & Acceptance
 - ▷ If problems arise, so begins THE BATTLE OF THE FORMS

U.C.C. 2-207 Addresses the impact of conflicting terms

2-207. Additional Terms in Acceptance or Confirmation.

1. A definite and seasonable expression of acceptance or a written confirmation which is sent within a reasonable time operates as an acceptance even though it states terms additional to or different from those offered or agreed upon, unless acceptance is expressly made conditional on assent to the additional or different terms.
2. The additional terms are to be construed as proposals for addition to the contract. Between merchants such terms become part of the contract unless:
 - a) the offer expressly limits acceptance to the terms of the offer;
 - b) they materially alter it; or
 - c) notification of objection to them has already been given or is given within a reasonable time after notice of them is received.
3. Conduct by both parties which recognizes the existence of a contract is sufficient to establish a contract for sale although the writings of the parties do not otherwise establish a contract. In such case the terms of the particular contract consist of those terms on which the writings of the parties agree, together with any supplementary terms incorporated under any other provisions of this Act.

Conflicting terms: Actual Examples

► Buyer's Confirmation terms:

Seller warrants that the Commodities are merchantable and fit for sale to domestic and foreign customers, and that all Commodities were grown in the continental United States.

Seller warrants that no Commodity shall be adulterated or misbranded within the meaning of the Federal Food, Drug and Cosmetic Act, as amended, and regulations, or include any article or commodity which may not, under the provisions of such act, be introduced into interstate commerce.

Seller guarantees that all Commodities meet the minimum standards prescribed by the United States Food and Drug Administration, including a maximum aflatoxin level of 20 parts per billion, and that all Commodities have been free at all times of crotolaria, or any other contamination or adulteration. Furthermore, Seller guarantees that the Commodities will not pose any food safety or quarantine risk to the Buyer and that the Commodities have not been shipped from any area quarantined by the United States Department of Agriculture – Animal and Plant Health Inspection Service (“APHIS”).

► Seller's Confirmation terms:

SELLER MAKES NO WARRANTIES, GUARANTEES, OR REPRESENTATIONS, EXPRESS OR IMPLIED, THAT EXTEND BEYOND THE DESCRIPTION ON THE FACE OF THIS CONTRACT. WITHOUT LIMITING THE PRECEEDING, SELLER EXPLICITLY DISCLAIMS ALL WARRANTIES, GUARANTEES, OR REPRESENTATIONS OF ANY KIND TO BUYER, EITHER EXPRESS OR IMPLIED, OR BY USAGE OR TRADE, STATUTORY OR OTHERWISE, WITH REGARD TO THE GOODS SOLD, INCLUDING, BUT NOT LIMITED TO ALL WARRANTIES OF MERCHANTABILITY, FITNESS FOR A PARTICULAR PUPOSE, USE AND ELIGIBILITY OF THE PRODUCT FOR ANY PARTICULAR TRADE USAGE.

Battle of the Forms

When a contract exists on the writings consistent with 2-207(2):

- ▶ Terms are those that agree between the exchanged forms
 - ▷ “Additional” terms that are not material come in if not contradicted
 - ▷ “Material alterations” are not accepted
- ▶ Contradictory terms are “knocked-out”
- ▶ Seller’s protective terms typically do not become part of the contract
- ▶ Buyer wins the battle of the forms

Battle of the Forms

When there is no contract on the writings 2-207(3):

- ▶ Such as when Seller expressly conditions its acceptance on Buyer's acceptance of Seller's T&C's
- ▶ Parties still perform. Seller ships and Buyer accepts shipment. (Very common)
 - ▷ The writings do not evidence the formation of a contract. But there is a contract by conduct under 2-207(3). What terms apply?
 - ▷ "Dickered" terms and terms that don't clash remain (price, delivery, etc.)
 - ▷ Remaining terms are pro-Buyer UCC "gap fillers"

Implied warranties of merchantability and fitness	4 year statute of limitations
No limitations on liabilities	Typical Buyer remedies
Consequential damages	

- ▶ Buyer wins the battle of the forms

Battle of the Forms

- ▶ Material Alterations – Will Not Become Part of the Contract by Operation of 2-207(2):
 - ▷ Any change to price, quantity, quality, delivery
 - ▷ Warranty disclaimers
 - ▷ Limitations on liability
 - ▷ Dispute resolution
 - ▷ Arbitration
 - ▷ Choice of law
 - ▷ Forum selection
 - ▷ Attorneys' fees provisions
- ▶ Impact: Most of a Seller's fine print often will not become part of the contract

So the Buyer wins. What is a Seller to Do?

Seller's Options

- ▶ Knowing that Seller will likely lose the Battle of the Forms, what can the savvy Seller do to protect itself?
 - ▷ If Seller has leverage, force Buyer to accept and sign Seller's standard T&C's
 - ▷ If Buyer has some power too, try and negotiate a "frame agreement" that incorporates both parties' key T&C's
 - ▷ For Seller, the key protections are:
 - ▶ Payment provisions
 - ▶ Disclaimer of implied warranties
 - ▶ Limitation on remedy to repair/replace at Seller's option
 - ▶ Limit on total liability to a % of the contract price
 - ▶ Disclaimer of all consequential damages
 - ▶ Dispute resolution (venue, choice of law)

Best Practices for Merchant-to-Merchant Transactions

- ▶ Always send a confirmation, regardless of whether you are buyer or seller, or if there is a broker involved; try to be the first party to send a confirmation
- ▶ Consider T&C's that limit acceptance to counterparty accepting your T&C's
- ▶ If practicable, sign your own confirmations; not those of your counterparties
- ▶ Review your counterparty's confirmations and object within 10 days
- ▶ Engage in-house and external legal counsel to evaluate contracting protocol; involve counsel early in disputes
- ▶ Documents win disputes. Keep phone notes, calendars, emails, etc.



Identifying Default and Determining Damages

Identifying Default (Repudiation)

When a party, without warning, fails to deliver/accept delivery during the term set forth in a contract, the fixing of damages is straightforward; damages are generally established as of the close of the delivery period. Generally a party may offset hedges and fix damages as a matter of right.

When a party “repudiates” a contract, however, damages can be more difficult to ascertain. Repudiation typically occurs when a contracting party notifies the other party prior to the period of performance that it will not perform pursuant to the terms of a contract.

Because damages are fixed as of the time of the repudiation, identifying a party’s repudiation of a contract is critical to determining the measure of damages.

When to Fix Damages – Repudiation Under the UCC

The UCC allows a non-breaching buyer to recover damages from a breaching seller based upon either the cost to “cover” (UCC 2-712) or the market price/contract price difference at the time of the default (UCC 2-713).

UCC 2-713 states that “the measure of damages for repudiation by the seller is the difference between the market price at the expiration of a commercially reasonable time after the buyer learned of the repudiation . . .”

- ▶ A Repudiation in this context is a breach occurring before performance is due.

Default (Repudiation) - NGFA Grain Trade Rules

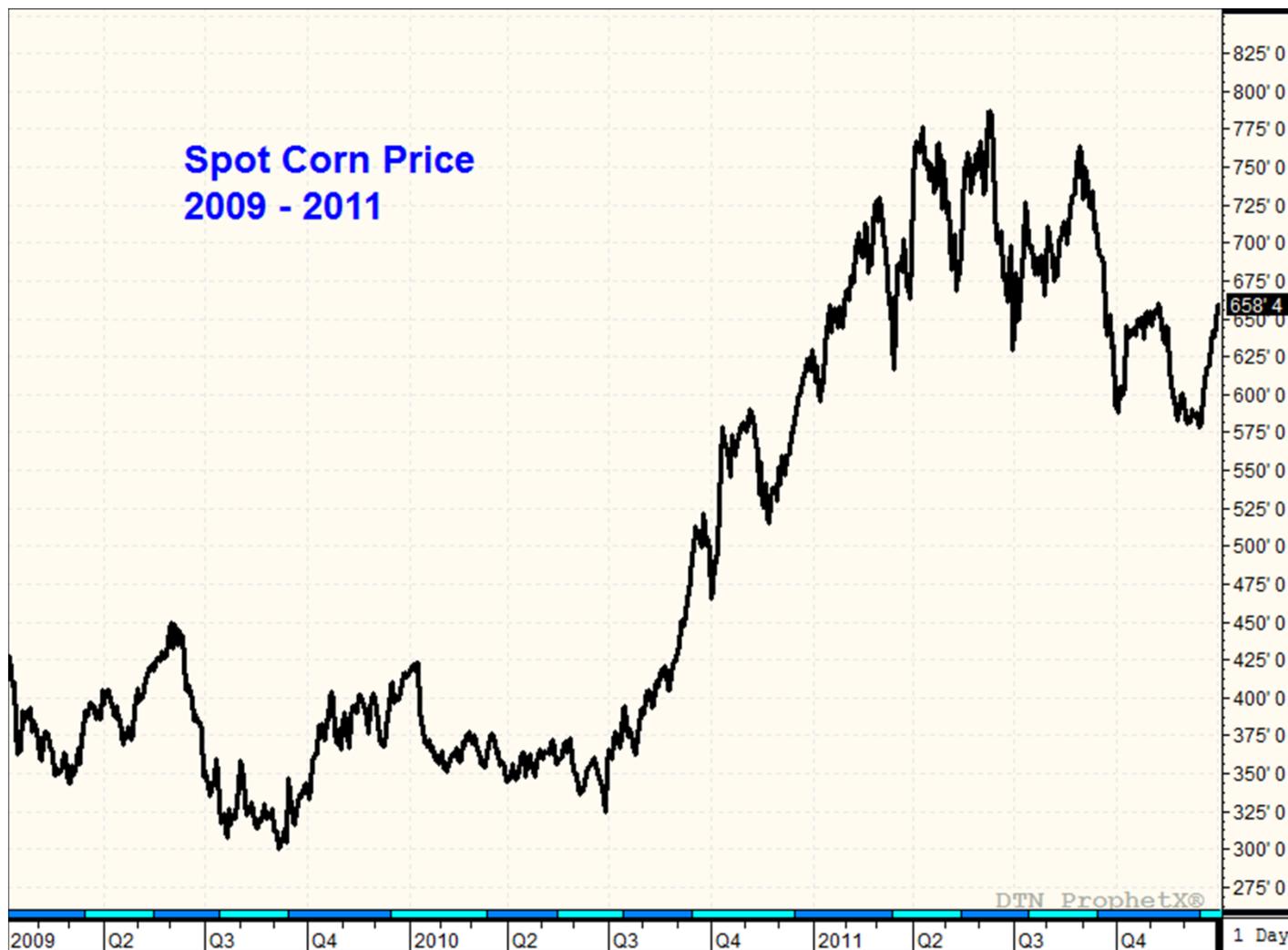
With respect to a default (including repudiation) by a seller, Rule 28 states:

If the Seller fails to notify the Buyer of his inability to complete his contract, as provided above, the liability of the Seller shall continue until the Buyer, by the exercise of due diligence, can determine whether the Seller has defaulted. In such case, it shall then be the duty of the Buyer, after giving notice to the Seller to complete the contract, at once to:

- (1) Agree with the Seller upon an extension of the contract; or
- (2) Buy-in for the account of the Seller, using due diligence, the defaulted portion of the contract; or
- (3) Cancel the defaulted portion of the contract at fair market value based on the close of the market the next business day.

See Rule 28, Grain Trade Rules (emphasis added).

When to Fix Damages – It Matters!



What should you do if the other party to a contract indicates it may not perform?

- ▶ Document the statements/actions giving rise to your concern, and consider appropriateness of a demand for assurance pursuant to UCC 2-609.
- ▶ If assurance of performance is not provided, terminate the contract, close-out hedge positions related to the contract, and proceed with settlement discussions/an action for damages against the breaching party.

Right to Adequate Assurance of Performance

If a ground for insecurity exists, a party should demand assurances pursuant to UCC 2-609, which states:

(1) A contract for sale imposes an obligation on each party that the other's expectation of receiving due performance will not be impaired. When reasonable grounds for insecurity arise with respect to the performance of either party, the other may in writing demand adequate assurance of due performance and, until he receives such assurance, may if commercially reasonable suspend any performance for which he has not already received the agreed return.

...

(4) After receipt of a justified demand, failure to provide within a reasonable time not exceeding thirty days such assurance of due performance as is adequate under the circumstances of the particular case is a repudiation of the contract.

What are “reasonable grounds for insecurity”?

- ▶ White & Summers § 6-2: “Whether a party has reasonable grounds for insecurity depends upon many factors including the seller's exact words or actions, the course of dealing or performance between the particular parties and the nature of the industry.” (emphasis added).
- ▶ *Top of Iowa Coop. v. Sime Farms, Inc.*, 608 N.W.2d 454 (Iowa 2000): Buyer of corn demanded adequate assurances from seller of corn based on two grounds for insecurity due to conditions in the market that did not specifically relate to the seller. The Iowa Supreme Court held that the existing market conditions and negative publicity in the industry could support a jury finding that the buyer had reasonable grounds for insecurity. Does this mean all buyers can demand adequate assurance at every market hiccup?



Arbitration/Litigation: Where to Enforce a Contract

Options for Enforcement

- ▶ State Court
- ▶ Federal Court
- ▶ Arbitration
 - ▷ Trade Association - Administered
 - ▶ NGFA (National Grain and Feed Association)
 - ▶ USA Rice Miller's Association
 - ▶ GAFTA (Grain and Feed Trade Association)
 - ▶ FOSFA (Federation of Oils, Seeds and Fats Associations Ltd)
 - ▷ Administered (AAA, JAMS, etc.)
 - ▶ AFOA (American Fats and Oils Association)
 - ▶ NOPA (National Oilseeds Processors Association)



- ▶ State Court:

- ▷ Typical for residents of the same state
- ▷ Wide variations across jurisdictions
- ▷ County-wide jury
- ▷ Unpredictable outcomes
- ▷ Appeal rights

- ▶ Federal Court

- ▷ Diversity jurisdiction required (citizens of different states and >\$75,000 at issue)
- ▷ The President appoints judges with the "advice and consent" of the Senate.
- ▷ Wider jury pool (not necessarily better or worse, just different)
- ▷ Well-developed case law, generally a preferred jurisdiction for corporate parties
- ▷ Appeal rights

NGFA Arbitration

- ▶ Formally established in 1901, the NGFA's Arbitration System has operated in some form since the formation of the Association on November 9, 1896. It is believed to be North America's oldest industry-based arbitration system.
- ▶ Compulsory for resolution of disputes between Active members under the NGFA's Bylaws
- ▶ Arbitration Committee comprised of three persons selected by the NGFA secretary and approved by the NGFA chairman.
 - ▷ Employees, active partners, principals, officers, or directors of Active and Associate/Trading members from different geographical areas.
 - ▷ Arbitrators selected based upon their personal experience in the type of trade practices or questions involved in the case. Arbitrators cannot have a commercial interest in the case.

NGFA Arbitration (continued)

- ▶ Typically decided by the Arbitration Committee based upon written submissions
- ▶ Small percentage of cases involve oral hearings; usually taking one day or less.
- ▶ Limited appeal rights following decision by the Arbitration Committee
 - ▷ Appeals heard by a 5-person Arbitration Appeals Committee
 - ▷ Requires deposit of prior award, if any.
- ▶ Enforcement of award by local state or Federal court. Usually by motion/application to confirm.

Compelling Arbitration

If a party refuses to participate in arbitration, or if the party initiates litigation regarding a contract subject to arbitration, that party can be compelled to participate in arbitration.

Proceedings to compel arbitration can be initiated in either state or federal court. If conducted in federal court, the court will typically apply the substantive law of the state in which it is seated.

In order to compel arbitration, the compelling party must establish that an agreement to arbitrate before the NGFA exists and is enforceable.

If the confirmation is unsigned (and no master agreement exists between the parties), discovery and an evidentiary hearing may be required to determine if the respondent (a farmer) is a “merchant.”

Proceedings to compel arbitration add a layer of cost and litigation risk that can be completely avoided by adherence to proper contracting procedures.

Questions?

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