

The Risks and Rewards of Agricultural Contracting

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The Risks and Rewards of Agricultural Contracting

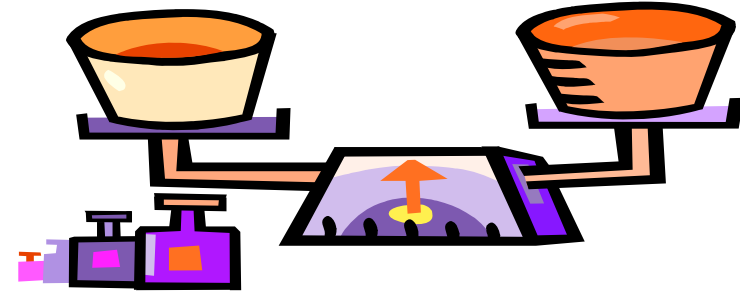
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Our Program Today

The Rewards of
Production Contracting

The Risks
(hey, I thought that was
what we were eliminating)



The Questions Every Producer Should
Ask about Their Proposed Contract.

Why It's an Issue

- Agricultural producers are entering into more contractual arrangements
- Many different types of contracts

The Rewards of Production Contracting

Contracts Pertaining To Pricing

- Historically, farmers perceived price risk to be their greatest source of risk
- Prior to 2007 that perception was in contrast to reality (other risks have been shown to be more important than price risk)
- More recently, it is hard to argue that price risk is not near the top of the list



Era of Higher Price Risk

- Output price risk
- Input price risk
- Many advisors are encouraging broader use of tools to “lock in the margin” (more than historically)
 - Way to mitigate “price” risk
- More common for producers to contract for
 - Fuel, fertilizer, machinery usage, etc.



Contracting production

- Historically, many producers have been somewhat reluctant to forward contract output ahead of harvest
 - Not the topic of today to either support or refute the merits of pre-harvest selling
 - Simply note that it is an increasing practice, along with contracting input purchases



Now Less Risky

- Still not widely understood (at least where I work) that revenue insurance products offer a much higher degree of comfort in pre-harvest contracting
 - Not completely covered, still have basis risk
- As the level of understanding of this concept increases, and because of more interest in other types of contractual arrangement, there is a need for increased awareness of the legal aspects



The Risks (Hey, I Thought That Was What We Were Eliminating)

Production risk

- What are the penalties for non-compliance with contract specifications?
- Are you penalized if you were not able to meet production specifications due to factors beyond your control?
- Who bears the extra costs incurred to achieve specifications (like extra drying)?
- What about “Acts of God” or “*force majeure?*”

The Big Picture

- Tradeoff: give up a considerable amount of control / flexibility in exchange for assurances provided by contract (guaranteed market, price if specifications are met).
- May lock in price, but may also introduce other risks – legal risk, risk of failing to meet contract specifications, risk of losing investment in specialized equipment if contract is terminated, etc.
- Majority of risks often left on producer.

Title and Risk of Loss

- Who holds title to the crop?
- Risk often follows title, but not always.
 - Can be modified by the language of the agreement.
 - Risk often gets shifted away from the contractor and towards the producer.



Why Does Title Matter???

CCC Eligibility

- CCC eligibility hinges on producer holding a “beneficial interest.”
- 7 C.F.R. § 1421.6(a) : The term “beneficial interest” refers to a determination by CCC that a person has the requisite title to and control of the commodity that is tendered to CCC as collateral



Why Does Title Matter???

“Insurable interest” for Federal Crop Insurance Corporation

- 7 U.S.C. § 400.651: *Insurable Interest*: The value of the producer’s interest in the crop that is at risk from an insurable cause of loss during the insurance period. The maximum indemnity payable to the producer may not exceed the indemnity due on the producer’s insurable interest at the time of loss.



Why Does Title Matter???

Marketing Assistance Loans

7 C.F.R. § 1421.6 Requirements -

- Be the producer of the commodity;
 - landowner, landlord, tenant, or sharecropper.
- Have had ownership of the commodity from the time it was planted through the earlier the date the loan was repaid or the maturity date of the loan.
- Have control of the commodity from the time of planting through the maturity date of the loan.
 - Complete decision-making authority regarding whether the commodity will be tendered as collateral for a loan..
- Not have received any payment from any party with respect to the commodity; and
- If the commodity has been physically delivered to a location other than a location owned or under the total control of the producer, have delivered the commodity to a “warehouse”



Why Does Title Matter???

Loan Deficiency Payments

7 C.F.R. § 1421.6

- Be the producer of the commodity;
 - landowner, landlord, tenant, or sharecropper.
- Have had ownership of the commodity from the time it was planted through the date the producer has elected to determine the loan deficiency payment rate;
- Have control of the commodity.
 - For control such person must have complete decisionmaking authority regarding whether a loan deficiency payment will be requested with respect to the commodity...
- Not have received any payment from any party with respect to the commodity; and
- If the commodity has been physically delivered to a location other than a location owned or under the total control of the producer, have delivered the commodity to a warehouse.



Credit Risk: Unsecured Creditors and Bankruptcy

- If contracting party accepts payment at some later date than delivery, they become an “unsecured creditor.”
 - “Farmers must be aware that their rights as creditors may change, reduce, or vanish...”
 - Unsecured creditors risk getting erased in bankruptcy, but secured creditors stand a better chance – must file and perfect the lien.
- When a farmer receives a notice of a bankruptcy, they need to submit proof of their claim (DO NOT IGNORE THESE NOTICES).



Credit Risks and Storage

Seller agrees to store the soybeans at Seller's expense until Buyer has called for full or partial delivery hereunder. The Contract need not be priced for Buyer to take delivery; provided however, that where required by law or Buyer's procedures, this Contract will be replaced by a credit sale contract if Buyer has received shipments not priced or not paid.



Credit Risk: Unsecured Creditors and Bankruptcy

- Proof of claim:
 - A written statement of the claim,
 - A copy of the contract, and
 - Proof that his security interest has been perfected.



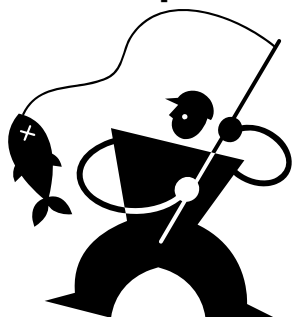
“Executory Contracts” in Bankruptcy

- A contract that has not expired and still has existing, unfulfilled obligations by both parties is an executory contract, and can be either assumed or rejected by the trustee.
- If the trustee assumes the contract, the debtor's obligations under the contract become obligations of the bankruptcy estate.
 - But if they don't, well, tough cookies...
- If an assumed contract is subsequently breached, the farmer is entitled to an “administrative expense” priority – the front of the line in claims.



Preferential Transfers in Bankruptcy: Reeling it Back In

- Whatever assets a debtor transfers during the ninety-day time period prior to filing bankruptcy may be recoverable by the trustee as a preferential transfer.



Preferential Transfers in Bankruptcy A payment can be recovered if it was:

- Made to a creditor; AND
- Made for a debt owed by the debtor before such transfer was made; AND
- Made while the debtor was insolvent; AND
- Made on or within 90 days before the date of the filing of the petition; AND
- If the payment allowed the creditor to receive more than such creditor would receive if—
 - (A) the case were a case under chapter 7 of this title (liquidation);
 - (B) the transfer had not been made; and
 - (C) the creditor was paid according to the bankruptcy plan.



Indemnification Risks

Producer shall indemnify and hold Company harmless against any losses, claims or lawsuits caused by said default or breach.

No claim of any kind, whether or not based on negligence, shall be greater in amount than the value of commercial seed in a quantity comparable to that quantity of seed subject to this agreement. Neither party shall be liable for special, consequential, punitive, exemplary, or indirect damages and the measure of damages shall be without regard to the cause relative thereto and whether or not caused by or resulting from the negligence of such party.



The Questions Every Producer Should Ask about Their Proposed Contract.

How will required production practices affect your costs and revenues?

- Will any investment in new equipment be required?
 - Will the contract provide an assured cash flow adequate to cover the capital needs of the equipment?
 - Is the length of the contract long enough to recover your investment?
 - Can the contract be terminated before you recover your investment?
- Are you willing and able to adopt the production practices specified in the contract?



How will required production practices affect your costs and revenues?

- Are you willing and able to adopt the production practices specified in the contract?
 - Are specific herbicide / insecticide programs required?
 - What about fertility programs?
 - Can the contractor enter the land to inspect and/or perform production operations? Is notice of such visits required?



How will required production practices affect your costs and revenues?

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What about GMOs?

- Does the contract require you to plant GMO seed?
- Has the GMO seed identified in the contract been approved for use in foreign markets, including the EU?
- If your delivery point is a local elevator, what is that elevator's policy with regard to GMO products?
- If you are instead required to avoid GMOs, what lengths will you have to go to?
 - Does anyone raise GMOs nearby? Pollens can carry for several miles.
 - Are there tolerances? Research has shown it is difficult to achieve levels below 3% of GMO if there are other GMO growers nearby.
- Watch out for PVPA and other genetic protection issues.



What's Everybody's Background Here?

- Are you willing (and able) to give the contractor a financial statement and references that can speak to your financial stability and management abilities?
- Is the contractor willing to do the same?
- Research and understand the background of the person or company with which you are signing the contract.



Who needs to be at the table?

- Your attorney
- Your accountant or other financial professional
- FSA
- Crop insurance professionals
- Are you prevented from discussing the contract with others?
 - Other producers?
 - Landlords?
 - Lenders?



How Do I Know if I am Even Complying with the Contract?

Seller hereby represents and warrants that all grain delivered will be in compliance with the provisions of the California Safe Drinking and Toxic Enforcement Act of 1986 (proposition 65);⁵⁷ and that it will not be adulterated or misbranded within the meaning of the Federal Food, Drug, and Cosmetic Act,⁵⁸ nor be a grain which may not, under the provisions of section 404 and 505 of the Act, be introduced into interstate commerce.

Grain delivered under this Agreement shall be of merchantable quality, unadulterated and unrestricted from movement in interstate commerce within the meaning of the Federal Food, Drug, and Cosmetic Act, Environmental Protection Agency tolerances, the United [States] Grain Standards Act⁵⁹ and applicable state law.



Um, Can I Get That In Writing?

- Get everything in writing. This includes any spoken assurances or changes in the contract.
- Read and understand the contract before signing. If you have any questions, seek legal advice.
- Recognize that you most likely will be bound by the terms of the contract – that you are not likely to get out of the contract if you later find that you do not like it.



Um, Can I Get That In Writing?

- Watch for “integration clauses” [like “this writing represents the complete and total understanding of the parties...] – that means evidence of any other discussions will not be allowed.
- UCC may REQUIRE the contract be in writing to be enforceable.
- NEVER rely upon spoken communications from the company’s representatives , either before or after the contract is signed.



Are We Partners Here or What?

- Most agreements will specify that no partnership or joint venture is to be created by virtue of the agreement.
 - Partnerships can mean that liabilities of one party become the liabilities of the other.
- Language regarding partnership is important, but also important is how the parties act.
 - How is the producer paid?
 - How are resources shared?



Forget Partners – Am I This Guy’s Employee? Employees vs. Independent Contractors

- An independent contractor is one who engages to perform a certain service for another, according to his own method and manner, free from control and direction of his employer in all matters connected with the performance of the service, except as to the result thereof. *Miller Constr. Co. v. Wenthold*, 458 P.2d 637 (Okla. 1969).
- An employer may specify and control the manner in which an employee performs the actual work itself. *Bouziden v. Alfalfa Elec. Coop., Inc.*, 16 P.3d 450, 459 (Okla. 2000).
- paid based largely on performance, rather than receiving a wage or salary, which is indicative of an employment relationship, *Mistletoe Express Serv., Inc. v. Culp*, 353 P.2d 9, 12 (Okla. 1959).
- Courts have held that provision of one’s own equipment and the right to engage employees are factors which militate in favor of finding that the person in question is an independent contractor. *Cook Constr. Co. v. Longcrier*, 405 P.2d 165, 169 (Okla. 1965) (Williams, J., dissenting).



Delivery issues

- Where is the crop to be delivered (and how will that affect transportation costs compared to what you are used to?)
- If the delivery location changes, who is going to be responsible for the additional costs?



Is the Contractor a “Grain Dealer?”

- Is the contractor a licensed grain dealer/warehouse?
- What protections are available as a result of that status?
- Under the contract terms, will the producer be able to take advantage of that status?



How will payment be handled?

- How will the payment price be objectively determined?
- If there are premiums or deductions, how will they be determined (and can they be appealed)?
- Do you understand the production specifications and do you have a way to independently determine that they have been met?
- When will your payment be due (will you be paid upon delivery or will you be a creditor until payment is made)?



How (or will) the Contract be Renewed?

- Can the contract be renewed by the contractor?
 - If so, under what conditions?
 - Will notice be provided?
 - Will the producer be able to opt out of renewal without penalty?



What are the Risks that This Thing Gets Yanked Out from Under Me?

Either party to this Contract may terminate this Contract at any time, for any reason at all by giving the other party ten (10) days written notice of that party's intention to terminate.





- Can the contractor terminate the contract for minor breaches?
- Are you given an opportunity to cure a problem before termination? What are the provisions for “notice and cure?”
- Under what conditions can YOU terminate the contract?
- What happens if you get sick, disabled, die, or go bankrupt?
 - Powers of attorney are CRITICAL.



Do I Even Get to Go to Court?

The parties agree that the sole remedy for resolution of all disagreements or disputes between the parties arising under this Contract shall be arbitration proceedings under the trade association identified in this Contract.



Arbitration May Not Be All its Cracked Up to Be...

- Parties may have to pay for the arbitration panel (and most contracts specify “loser pays”).
- The rules of evidence may be different.
- Heck, a lot of the rules may be different.
- Watch for “choice of law” clauses.
 - Most state’s choice of law rules would state that the home court of the producer is where the case should be tried.
- If you have a disagreement with the other party do NOT cash the check. Cashing the check may be deemed by the court as settlement of the dispute.



Other Considerations

- Your questions may be satisfactorily answered before you sign a contract but not afterward. Understand all aspects of the contract before signing.
- Don’t sign a contract you do not like hoping to negotiate better terms later.
- Document everything you do.



Closing Thoughts

- Remember what Rodney said – it is only recently that price risk has become the biggest risk to producers.
- The other risks are still substantial, use contracting if it will HELP you deal with those risks.
 - Be the best manager you can.
 - Keep costs down.
 - Spend as much time with a pencil or computer as you spend with a tractor.

