

Crop Contract Considerations

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What is a Contract?

- All agreements to buy or sell, such as buying fertilizer or selling grain, are contracts.
- However, the transaction becomes more complicated if the agreement is created, the product is delivered, and the purchase price is paid at different times.

Key Functions of a Contract

- **Divide Value**
 - Price is only one element of value.
- **Divide Control Rights**
 - Who has authority to make decisions concerning actions which influence value?
- **Divide Risk and Uncertainty**
 - Who is exposed to the outcome(s) of various adverse events?

Economic Considerations

- Any transaction must be a (potential) “win-win” proposition.
- Considerations which are of greatest importance when the contract terms or transaction provisions are designed, agreed upon and executed.

Legal Considerations

- Considerations which are of greatest importance when the contract terms or transaction provisions must be verified by an independent third party and/or disputes must be resolved.

Dividing Value from Exchange

- Defines product or service to be exchanged.
- Defines quantity and quality.
- Assigns a price or pricing formula.
- Specifies time and location for exchange.
- Specifies timing of payments.
 - Lump sum
 - Sequential over time

Dividing Control or Decision Rights

- Who is responsible for making decisions which impact value?
- Crop Contract Examples:
 - Choice of seed varieties
 - Choice of pesticide use
 - Choice of deliver locations and timing

Dividing Risk & Uncertainty

- All contracts are *incomplete*.
- Contracting parties cannot anticipate all possible events.
- What does the contract specify?
- What do we do if something happens which is not included in the contract?

Dividing Risk & Uncertainty

- The longer the contract duration, the greater the uncertainty.
- Measurement of key quantity and quality characteristics can create challenges.
 - Objective Measurement vs. Subjective Measurement
 - Can measurement be verified by an independent third party?

Options for Unexpected Conditions

- Execute the contract.
- Renegotiate the contract.
- Utilize arbitration or mediation.
 - May be included in the contract.
- Bring into the court system.

Who writes the contract?

- Adhesion Contract:
 - Written by one entity and offered to all interested parties.
- “Boiler Plate” contract with modifications.
- Bi-lateral negotiation.
- All contracts are negotiable.

Assumptions for Remaining Discussion about crop contracts

- Contract is in writing, not oral.
 - Oral revisions have been confirmed in writing.
- Contract has been signed by competent parties.
- Contract has clearly stated terms.

General Classes of Crop Contracts

- Marketing Contract
- Production Contract

- Definitions are very broad and there is not a clean division between the two.

General Classes of Crop Contracts

- Marketing Contract
 - Focus is on establishing price, quantity, and quality for a specified commodity to be delivered in the future.
 - Producer/seller has wide discretion concerning production practices.

General Classes of Crop Contracts

- Production Contract
 - Establishes price for a specified commodity which is to be produced and delivered in the future.
 - *Buyer* includes provisions concerning appropriate production practices.

Key Contract Considerations

- Quantity:
 - All production on specified acres.
 - Fixed production on specified acres.
 - Example: Max. of 700 lbs./A.
 - What happens to over-run?
 - Specified number of bushels or pounds of production.

Key Contract Considerations

- Quantity:
 - If fixed quantity, how will production short-fall be covered?
 - Can you deliver another individual's (ex. neighbor's) production?
 - Are service fees charged if buyer must fill contract shortage?

Key Contract Considerations

- Act-of-God Clause:
 - Provides seller and buyer an exit provision due to drought, flood, fire, pests, etc.
 - Does not excuse poor management.
 - Seller usually required to deliver available production.
 - Must give notice to buyer in writing, usually within 10 days of event.

Key Contract Considerations

- Quality Specifications:
 - Min. standards should be detailed.
 - Objective measurement criteria recommended.
 - Be cautious of "visual inspections".
 - Act of God clause usually does not apply to quality issues.

Key Contract Considerations

- Quality Specifications:
 - Quality specifications for rejection or price adjustments.
 - Price adjustments (premiums and discounts) usually determined at time of delivery.
 - What happens if delivery is delayed?

Key Contract Considerations

- Quality Specifications:
 - Is quality averaged across all deliveries or applied to each load?
 - How long does buyer save samples after delivery for re-testing?
 - Should you save samples?
 - Can you deliver production from another individual (ex. neighbor)?

Key Contract Considerations

- Quality Specifications:
 - Buyer's options for dealing with quality variability:
 - Blend
 - Clean or Sort
 - Segregate
 - Reject

Key Contract Considerations

- Time of Delivery
 - “At Harvest” – When does harvest begin and end?
 - General period – “First half October”
 - “Buyer Call” – at buyer's discretion; seller usually provided with delivery window.

Key Contract Considerations

- Delivery Location (FOB)
 - The local elevator.
 - The processor's facility.
 - Designated receiving site.
- Will this impact harvesting efficiency or conflict with other farm operations?

Key Contract Considerations

- Time of Payment
 - After contract is fulfilled and all deliveries have been made.
 - Can be different from delivery dates.
 - May be split or sequential payments.
 - *By accepting payment, you are agreeing that contract is fulfilled.*

Key Contract Considerations

- Counter Party Risk
 - What happens if one of the parties cannot fulfill all of their contract commitments?
- It depends upon the cause:
 - Examples:
 - Breakdown in sequential sales
 - Insolvency and Bankruptcy
 - Purchased by another company

What happens if the buyer
(seller) can't fulfill their
commitments?

If Grain Buyer files Bankruptcy

- Has contracted grain been delivered?
- If company is sold, the new grain company may or may not honor existing contracts.
- If grain has been delivered and is in storage, but title has not transferred:
 - Seller still owns grain and can request redelivery if bankruptcy is filed.

If Grain Buyer files Bankruptcy

- If title has transferred, was payment to be made within 30 days of delivery or release?
 - If yes, it is a noncredit-sale contract under North Dakota law.
 - If no, it is a credit-sale contract under North Dakota law.

If *Noncredit-Sale Contract*

- **Company Sale:**
 - Sales agreement usually covers payment
- **Bankruptcy:**
 - Seller is unsecured creditor!!
 - In case of a noncredit-sale contract, grain dealers bond may cover portion of unpaid portion.

Noncredit-Sale Contract and the Grain Dealers Bond

- Amount of bond coverage is based upon physical size of facility and amount of grain the buyer handles.
- This is not a guarantee that a farmer will be fully reimbursed if buyer becomes insolvent.

Noncredit-Sale Contract and the Grain Dealers Bond

- In some cases, the grain in inventory plus bond coverage may not be large enough to cover all grain claims.
- In this case, proceeds are distributed on a prorated basis.
- Public Service Commission has list of licensed dealers and bond coverage.

Credit-Sale Contract

- The bond **may not** be available to cover credit-sale contracts; that is, agreements where the selling price will be paid more than 30 days after the delivery or release of the grain.
- Credit-Sale Contracts can include:
 - Delayed Price Contracts
 - Deferred Payment Contracts
 - No-Price-Established (NPE) Contracts

Credit-Sale Contracts

- But credit-sale contracts are partially covered by North Dakota Indemnity Fund.
- Covers 80% of the unpaid credit-sale contract, up to a maximum payout of \$280,000 per person.
- NOT available for credit-sale contracts with un-licensed buyers.

Credit-Sale Contracts

- Amount is prorated among farmers with credit-sale contracts if the indemnity fund is not large enough to cover loss.
- Current fund is \$6.0 Mill.
- EC-1194 “Selling Grain? Know Your Rights and Your Responsibilities”

Summary

- Crop Contracting can be an effective tool for managing risk and locking in margins.
- One needs include all of the potential benefits and costs of contracting, and look beyond just price.

Summary

- Be sure to read and understand the contract's provisions.
- Know what your rights and responsibilities are before you sign a contract.
- Get any contract changes in writing. This helps protect both parties.

Questions & Comments?

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