Crop Contract Considerations

Frayne Olson, PhD
Crops Economist/Marketing Specialist
NDSU Extension Service
Agribusiness & Applied Economics

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 many 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?

Frayne Olson
Dept. of Agribusiness & Applied Econ.
NDSU Dept. 7110
P.O. Box 6050
Fargo, ND 58108-6050
701-231-7377
frayne.olson@ndsu.edu