Module 4

Legal Considerations in Grain Contracting

Leisa R. Boley, Ohio State University
Neil E. Harl, Iowa State University

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Introduction

Media coverage of the recent hedge-to-arrive controversy has focused attention on the complex legal issues that can arise when marketing grain. While grain contracts have become more varied and sophisticated in recent years, the basic legal principles that govern the sale of grain are found in the contract and in state and federal law. Simply defined, a contract is a promise that the law will enforce. It is the goal of this segment to describe the basic legal principles that are applied when analyzing grain contracts so that the likelihood of a legal dispute arising is greatly reduced. A brief discussion of the income tax aspects of hedging and speculation is also included.

Commodity Futures Trading Commission

*(or go to **Topics**)*

Many common-law and statutory provisions apply to the marketing of grain. Of prime importance is the Commodity Futures Trading Commission (CFTC), a federal agency with statutory authority to regulate futures contracts. Cash forward contracts, however, are exempt from their oversight. Over the years, the courts and the regulators have struggled with the definitions of forward contract and futures contract.

A forward contract contemplates the actual sale of a commodity for delivery in the future. Title to the grain passes upon delivery of the grain to the buyer. A forward contract is a binding agreement on both parties who are commercial entities to make and take delivery, and delivery routinely occurs. The contracts must be individually negotiated, principal-to-principal, and are generally not assignable without the consent of the parties.

Futures contracts, on the other hand, are standardized agreements which obligate a party to deliver or take delivery at some designated time in the future. Futures contracts are entered into primarily for the purpose of assuming or shifting the risk of change of value of commodities while forward contracts are entered into for the purpose of establishing the components of the cash price and transferring ownership of the actual commodities. Establishing one or more of the components of the cash price also transfers risk from the producer to others.

Historically, there have been three basic forward contracts which have many names. One sets a fixed price; one fixes only the basis; and one fixes only the futures. Customarily, the part of the price which was not fixed by the contract could be set at any time and had to be determined at delivery. Some elevators have allowed both parts of the cash price to be fixed and unfixed multiple times in exchange for a fee during the life of the contract provided that the delivery remained firm. Some elevators have allowed for multiple or even third party delivery points or change of delivery points for a fee. Some elevators have allowed forward contracts to be rolled into a future crop year for a fee. Some elevators have allowed the open part of the contract to be fixed at some time following delivery.

All of these variations are currently being scrutinized, and each variation has its unique characteristic which needs to be analyzed and applied to existing law. Many of these variations have been in common use since the early 1990s, and many have been very profitable for farmers until the 1995-1996 crop year with its inverses.

The CFTC has been given statutory authority over "accounts, agreements ... and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market...." Federal law specifies that these "futures" contracts are illegal "off-exchange" contracts unless offered and sold on CFTC-designated boards of trade. Bona fide hedging transactions are specifically exempted from the legislation.

Cash forward contracts are excluded from the definition of futures contracts and thus are not subject to CFTC regulation. These are "any sale of any cash commodity for deferred shipment or delivery." The exclusion for cash forward contracts is predicated upon the fact that both parties to the contract contemplate future delivery of the actual commodity and intend that delivery of the actual commodity occur. The exclusion is not available to cover contracts of sale for commodities sold for speculative purposes and which are not based upon an expectation that delivery of the actual commodity by the seller would occur in the future.

The exclusion for cash forward contracts originated in the Futures Trading Act of 1921. Excessive speculation and price manipulation had been occurring on the grain futures markets. In an attempt to limit the observed abuses in the futures markets, Congress imposed a tax at prohibitive levels (20 cents per bushel) on all futures contracts with two exceptions. Under one exception, the 1921 legislation exempted from the tax future delivery contracts

entered into by owners and growers of grain, owners and renters of land on which the grain was produced and associations comprised of such persons. The legislation also exempted from the tax future delivery contracts made through (or by) members which had been designated as contract markets. As a result of objections raised on behalf of farmers and grain elevators, the Senate added language to the pending legislation excluding "any sale of cash grain for deferred shipment" from the term "future delivery." In the hearings, it was made clear that the additional language on cash forward contracts was premised on the fact that both parties to the contracts deal in and contemplate future delivery of the actual grain. The Futures Trading Act of 1921 was declared unconstitutional in 1922 as an impermissible attempt to regulate using the taxing power.

The Congress then enacted the Grain Futures Act of 1922 which regulated grain futures trading under the Commerce Clause of the U.S. Constitution. The cash forward contract exclusion was included in the 1922 legislation. The exclusion was reworded in the Commodity Exchange Act of 1936 to except "any cash commodity for deferred shipment or delivery." The 1936 legislation also deleted the express exemption for owners and growers of grain, owners and renters of land and associations of such persons. That move was justified on the grounds that the legislation excluded cash commodity contracts for deferred shipment or delivery; the specific exemption was, therefore, not needed.

The language excluding cash commodities for deferred shipment or delivery has been continued to the present. The 1974 amendments to the legislation reaffirmed that, in a cash forward contract, the parties contemplate transfer of the actual commodity. As the courts have noted, nothing in the legislative history suggests that Congress intended for the exclusion to embrace agreements for the future delivery of commodities sold for purposes of speculation.

An important question is whether the so-called "hedge-to-arrive" contracts are considered to be cash forward contracts and, therefore, within the statutory exception. For such contracts extending two to three years into the future, with rollovers permitted to later contract months, and with no expectation of delivery, it would seem that such contracts might not come within the exception. That outcome seems indeed likely if the seller does not have sufficient commodity on hand or expected to be produced in the current production cycle to cover the amount specified in the contract. Thus, it would appear that at least some of the contracts may be "off-exchange" contracts which, as noted above, may be illegal. A contract involving an off-exchange futures contract or trade option runs the risk of being held unenforceable by federal and state courts.

Ordinary cash forward contracts clearly contemplating delivery appear to be well within the exception in the regulations for "cash forward contracts" and, therefore, are not "off exchange contracts."

An unresolved issue is whether a multi-year contract is enforceable to the extent the farmer had crop in storage that was sold in a cash sale rather than being delivered against the contract. Also, it's not clear whether a multi-year contract would be enforceable to the extent of production expected in the current production cycle.

State Uniform Commercial Code *(or go to* ***Topics****)*

As forward contracts are exempt from CFTC regulation, the governing body of law that applies is state law, typically the law of the state in which the contract is made. The contract, however, can stipulate which state's law will apply.

All states have adopted a form of the Uniform Commercial Code (U.C.C.). The U.C.C. was developed so that commerce would function in a uniform manner throughout the country. The sale of grain is ordinarily governed by the U.C.C. While there are some variations in the U.C.C. from state to state, the following discussion generally applies. It is, however, important to have a working knowledge of the current U.C.C. in any state in which you enter into business transactions.

Elements of Contract

(or go to Topics)

All valid contracts are comprised of five elements: (1) offer; (2) acceptance; (3) consideration (an exchange of value); (4) competent parties; and (5) valid subject matter. In a common example, the elevator makes an offer by posting prices based on the market.

The farmer accepts when a verbal commitment is made to enter into a contract based on the posted price. Conduct by both parties which recognizes the existence of an agreement is sufficient to establish a contract of sale. The consideration requirement is met by the parties exchanging something of value or promising something of value to each other.

To be a legally competent party, the contract participant must be of the age of majority, eighteen years of age in most states, and have sufficient mental capacity to understand the significance of the contract. Deficient mental capacity can arise from mental illness or intoxication.

A contract may lack proper subject matter if the agreement involves illegal activity. For example, an elevator cannot offer contracts, such as off-exchange trade options, which are clearly contrary to CFTC regulations.

Contract Provisions *(or go to Topics)*

Normally, the parties to a sales agreement specify clearly the essential details such as price, quantity sold, time and place of delivery and product warranties. However, under the U.C.C., all terms except quantity may be implied. A statement of quantity is essential.

Quantity may be stated in specific terms such as bushels of corn or head of cattle, or in terms of the seller's total output or buyer's requirements. Three conditions are imposed if quantity is stated with respect to the output of a seller or the requirements of a buyer to prevent one party from taking unfair advantage of price changes: (1) the quantity must be such as would occur in good faith; (2) the quantity must not be unreasonably disproportionate to an estimate, if stated; and (3) the quantity must not be unreasonably disproportionate to any normal output or requirement of the recent past in the absence of an estimate.

Price may be specified or may be left for determination at a later time. In such instances, the buyer is required to pay a "reasonable" price which is determined in accordance with the circumstances.

The place of delivery is the seller's place of business (or the location of the goods if different from the place of business) unless otherwise specified in the contract. If the contract specifies F.O.B. (free on board) the place of shipment, the seller must bear the risk and expense of placing the goods in possession of the carrier for shipment to the buyer. If the contract specifies F.O.B. the place of destination, the seller is under duty to transport the goods to that place at the seller's own risk and expense and there deliver the goods to the buyer.

Unless otherwise agreed upon, the time of delivery is to be within a reasonable time.

The Statute of Frauds *(or go to **Topics**)*

The Statute of Frauds, which is codified as a part of the U.C.C. in most states, requires that contracts in excess of $500 and contracts which cannot be completed within one year of formation be in writing. Because of the nature of the industry, frequently a contract for sale of grain is entered into orally, often over the telephone.

Farmers need to be aware that they are considered merchants in about half of the states. In considering whether a farmer is a merchant, the courts generally look to whether the farmer regularly deals in goods of the type involved or is familiar with the practice of buying and selling such goods. Between merchants, the U.C.C. has special provisions for satisfying this writing requirement. After a verbal agreement has been reached between a farmer and an elevator, the elevator promptly confirms in writing by ordinary mail and requests a signed confirmation to be returned. Typically, the elevator has a specific time by which this written confirmation must be sent, often ten (10) days. Upon receipt, the farmer, as merchant, then has ten (10) days to provide a written objection to the confirmation of contract. If the farmer does nothing, a fairly common occurrence, the contract is valid ten days after receipt of the written confirmation, absent a written objection. The elevator need only provide evidentiary proof of receipt, should the farmer claim he or she never received the written confirmation.

Warranties *(or go to **Topics**)*

Contracts contain certain promises or "warranties" to the buyer. Express warranties are based upon explicit statements made by the seller or seller's representatives about the nature or quality of the goods being sold. Implied warranties of merchantability are imposed on all goods sold by merchants and are based on generally accepted practices in the trade (for example, that a load of grain must run of "fair average quality" through the load). An implied warranty of fitness is imposed if the seller has reason to know the purpose for which the goods are being acquired and the buyer is relying on the seller's skill and judgment in providing the goods.

Implied warranties of merchantability can be avoided or "disclaimed" orally or in writing in language that mentions merchantability. An implied warranty of fitness can be avoided or disclaimed only by conspicuous written provisions in the contract.

Promissory Estoppel *(or go to **Topics**)*

In addition to the statutory U.C.C., all states have case precedents and equitable principles that apply. It has been effectively argued that once the farmer verbally commits to a grain

contract, and the elevator then takes a resulting action in the market, promissory estoppel applies. This is an equitable doctrine that "estops" or prevents a party from arguing that there was no valid contract in existence because the other party has relied on the breaching party's verbal commitment to their detriment. While this legal principle is not as weighty as statutory U.C.C., it is wise to not make verbal contractual promises that others are likely to rely on to their detriment unless you are committed to fulfilling your obligation.

The Parol Evidence Rule *(or go to **Topics**)*

The Parol Evidence Rule is also a part of the U.C.C. in most states. Parol Evidence merely means that if an agreement is reduced to writing, that writing is the agreement and constitutes the best evidence of it. Evidence of prior or contemporaneous agreements or negotiations is not admissible to contradict a term of the writing. While there are some exceptions to this rule, such as if there is uncertainty or ambiguity in the written contract's terms or a dispute about the meaning of those terms, these exceptions are rare and expensive to litigate. The Parol Evidence Rule means that oral statements or promises that are made during the contract negotiations carry no weight unless these statements are incorporated into the written document. Regarding any grain contracts, it is imperative that the signed document constitute the entire agreement that the parties reached. Unless a term or condition is included in the final confirmation, it is difficult to establish that the missing term was in fact contemplated by the parties at the time the agreement was made. Read the written document closely and verify that all terms and conditions are precisely the deal that was reached.

Use of an Agent in Marketing Decisions

*(or go to **Topics**)*

Should a farmer opt to seek marketing advice from a market analyst or advisor, the farmer should be clear about the legal arrangement with the advisor. If the farmer enables the advisor to operate as agent regarding grain marketing transactions, the agent may be able legally to bind the farmer to contracts, if it is within the scope of the agency.

While market experts can provide valuable insight and direction, it is unwise to enable anyone other than the producer to legally commit you to a contract. The best alternative is to obtain marketing advice and direction from the advisor or analyst but reserve the right to actually enter into legally binding commitments.

Contract Liability *(or go to **Topics**)*

Once a party enters into a contract a legal obligation to perform has been assumed. Unless all details and consequences of this commitment are fully understood and potential consequences contemplated, the contract commitment should never be made.

If a farmer fails to perform under a contract, the elevator may sue alleging breach of contract. As the main purpose of the elevator is to obtain delivery of the commodity, specific performance of an open contract is often sought as a resolution. Courts have required specific performance despite a farmer's defense of impossibility due to crop failure. In so ruling, the Courts relied on the concept that grain is fungible, and the farmer could have purchased the shortfall from others or "covered" to complete performance. Typically, damages are calculated by determining the cost of cover which is the difference between the

contract futures reference price and the current futures market price. Farmers have been excused from performance where the output that was sold from a specific tract or geographic area and drought reduced the amount available for delivery. Otherwise the producer who oversells is obligated to deliver the quantity of grain or answer by paying the costs of covering the contract.

Statute of Limitations *(or go to* ***Topics****)*

Depending upon state law, actions founded on written contracts are barred if not brought within a specified period (10 years in many states). Actions based on oral contracts must be brought within a shorter time period (often five years).

Hedge-to-Arrive Contracts

*(or go to **Topics**)*

Hedge-to-arrive contracts, many of which are still in litigation or arbitration, provided farmers an opportunity to lock in a referenced futures price and allow for possible basis appreciation. Unfortunately for many participants in 1995-1996, a large inverted old crop-new crop corn market proved devastating to their marketing plans. The Commodity Futures Trading Commission (CFTC) released a Statement of Guidance regarding the H-T-A that includes the following list of prudent risk reduction practices:

1. Delivery of the contract is mandatory, absent an intervening event such as crop failure, of a specified quantity and grade of grain at a specified location and reference price by a specified date within the crop-year during which the crop is harvested.

2. The quantity to be delivered should be reasonably related to the producer's annual production, not committed elsewhere and normally available for merchandising and at a location where delivery can be made by the producer under normal merchandising practices.

3. The contract should specify a delivery date and futures contract month reference price which coincides with the crop-year during which the grain will be harvested.

4. If the contract allows the "rolling" of reference prices, that reference price can only be rolled sequentially from a nearby to a more deferred futures contract month in the same crop-year within which the grain is, or will be harvested, to reflect production and the inventory-carrying nature of the cash position. This should allow the producer to store the grain into a more deferred month within the crop year to capture either favorable carry in the futures market and/or basis improvement in the cash market.

Based on a May 15, 1996 release by the CFTC, H-T-A contracts which adhere to these prudent risk-reduction practices would be considered forward contracts and exempt from CFTC regulation. The CFTC did not take a position on the validity or legality of any contracts whose terms differ from the prudent risk-reduction practices previously described and in existence prior to May 15, 1996. CFTC did, however, state that parties to a disputed H-T-A in effect as of May 15, 1996, could enter into a negotiated settlement in lieu of delivery without losing the forward contract exclusion.

Subsequent to this issuance, the CFTC has filed three administrative complaints against three cooperative elevators, and in one of the complaints has included a market adviser and one of his pools.

Each of the cooperative elevators is also involved in suits with farmers. There are also numerous other suits filed by farmers against elevators, elevators against farmers, and, also, some elevators and farmers have filed for bankruptcy. A few cases have been decided.

In some of these suits, federal district courts have ordered the parties to arbitrate under the Arbitration Rules of the NGFA. These cases are moving forward at present.

Although there is some conflict among the courts, it is pertinent to H-T-A and similar cases that there is precedent for such cases to be stayed under the doctrine of primary jurisdiction to allow the CFTC to resolve issues which, under its regulatory scheme, have been placed within its special competence.

Director Liability *(or go to **Topics**)*

As many farmers also serve as directors of agricultural cooperatives and corporations that engage in grain marketing, it is important to be aware of additional legal implications. A director has three duties to the members or shareholders: (1) obedience of all applicable laws; (2) loyalty to the members or shareholders; (3) due diligence in business duties as a director.

The director, in this role, must serve the members of the cooperative or the shareholders of the corporation by establishing policies, including grain marketing guidelines, for the management to administer. This means that the director must objectively, using sound business judgment, believe that the grain marketing program of the elevator is legal and economically reasonable. All directors of businesses engaged in grain marketing should routinely review their practices to verify compliance with CFTC regulations and relevant state law.

A director learning of any inconsistencies or concerns regarding the elevator's grain marketing program has a duty to investigate the problems alleged and seek outside expert review if the director does not have the expertise to assess the situation. So long as the director reasonably investigates and is assured that no appropriate marketing and management practices are occurring, no individual liability should be incurred. Most states' laws, however, do not allow a director to "play ostrich" or ignore the director's role by not attending meetings.

Income Tax Treatment *(or go to **Topics**)*

Hedges produce ordinary gains and ordinary losses and are not subject to the loss deferral rules and the "mark-to-market" provisions that are applicable to speculative transactions. Indeed, gains and losses from hedge transactions are treated like gains and losses from transactions involving the actual commodities. Losses from hedge transactions can be used to offset ordinary income from grain sales and from sales of livestock held for sale in the ordinary course of business.

In general, a hedge transaction requires that the futures trade be structured to offset price changes in actual commodities. Pre-hedges, where the futures position is established before actual commodities are acquired, have been treated as hedges if the acquisition of the actuals is an integral part of the taxpayer's business. It is not clear whether that concept can be used to cover futures transactions several months or years before production of the actual commodities but it appears doubtful that a pre-hedge could cover more time than the current production cycle. It would seem at least that contracts are not hedges that involve positions beyond the months for which futures positions can be established.

Speculative transactions are treated differently. Gains from speculative transactions are treated as capital gains; losses are reported as capital losses. In general, positions in regulated futures contracts are subject to the "mark-to-market" rules and are treated as if sold on the last day of the year. Gains or losses arising under those calculations are treated as if they were 60 percent long-term and 40 percent short-term without regard to the actual holding period. Hedging transactions are exempt from these rules.

Long-term capital losses can be used to offset long-term capital gains and, for individuals, up to $3,000 of ordinary income each year. Excess capital losses can be carried forward indefinitely for individuals and for up to five years for corporate taxpayers. Losses from regulated futures contracts can be carried back by individuals to the three prior years. The maximum loss that may be carried back to any carryback year is the regulated futures gain in that year (without regard to regulated futures losses) that is the lesser of the net capital gain for the year, taking into account only gains and losses from regulated futures contracts or the net capital gain income for the tax year.

To be considered a hedge, the futures transaction must have the effect of reducing price (or interest rate) risk, as noted above. Courts have emphasized two tests in evaluating commodity futures transactions as hedges or speculative ventures.

If futures trading is used to offset price changes in actual commodities (the "actuals"), the transactions should be viewed as hedges. This is the insurance test. That means gains on the actual commodities should be offset by losses on the futures trade. Similarly, losses on the actual commodities should be offset by gains on the futures transactions.

Typically, to create a hedge transaction someone purchasing a commodity would sell a contract on the futures market in order to avoid price risk. When the commodity is sold, the futures contract is repurchased. Gains on one offset losses on the other. Thus, hedges usually involve ownership of actual commodities.

Under the direct relation test, there must be a reasonable relationship between the amount of actuals involved and the amount of the trading in the futures market. In cases where the volume of futures trading greatly exceeded the amount of actuals, the transactions have been held to be speculative in nature.

Final regulations were issued in late 1994 providing guidance on reporting hedging and speculative transactions involving futures. Taxpayers other than farmers and other small businesses are required to take gains and losses from hedges into account in the same period as the income, deductions and gains or losses on the item hedged. However, for farm and small business taxpayers on the cash method of accounting, the simpler methods used

previously and allowing the reporting of gains and losses on a cash accounting basis can continue to govern the reporting of hedge transactions if the taxpayer has no more than $5,000,000 of gross receipts.

Taxpayers are required to identify hedges when entered into, along with the item or items hedged. To receive loss treatment, taxpayers must identify hedges when entered into along with the item or items hedged. Hedging transactions must be identified as such. The identification must be made and retained on the taxpayer's books and records and must specify the hedging transaction and what is being hedged.

The consequences of failure to identify properly are relatively severe. If a taxpayer identifies a transaction as a hedging transaction and it is not a hedge, gains are ordinary but losses may be capital. If a transaction satisfies the definition of a hedge, but it is not identified as a hedge, gains are ordinary and losses are capital. Thus, the regulations have been made the exclusive way to receive treatment as a hedge.

Until further guidance is received, it is suggested that hedge-to-arrive contracts entered into with one or more elevators involving commodities in storage plus the amount expected to be produced in the current production cycle be generally considered a hedge if the requirements for a hedge are otherwise met. Amounts in excess of the amount of commodity in storage plus the amount expected to be produced in the current production cycle may be considered speculative unless the facts and circumstances of the situation support a characterization as a hedge. Note that even hedge-to-arrive contracts involving crops in storage plus expected production in the current production cycle could be speculative if the same commodity was sold to more than one elevator.

End of Module *(or go back to **Topics**)*

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