



Legal Issues Involving Cash Forward Grain Contracts

Curriculum Guide

I. Goals and Objectives

- A. Learn about the merchant's confirmatory memo rule.
- B. Learn about issues related to crop casualty caused by the weather.
- C. Understand the rights of farmers when the buyer fails to meet financial obligation.

II. Description/Highlights

General Approach

- A. The use of cash forward grain contracts can be a useful tool for the marketing of grain. However, the unwary grain seller can inadvertently create legal problems. A primary issue involves the ability of a seller to refuse to deliver the crop in accordance with an oral conversation with the buyer after the buyer sends the seller a confirmatory memo of the oral conversation to which the seller does not object. Another concern is weather damage or destruction to a forward contracted crop before harvest and delivery. The problems with hedge-to-arrive contracts are also mentioned with guidance given on how to determine whether a hedge-to-arrive contract is an illegal contract or a legal cash forward contract.

Supplemental Information

- B. *Merchant's confirmatory memo rule.* Contracts for the sale of goods worth \$500 or more must be in writing to be enforceable. This requirement is known as the "statute of frauds". However, as between merchants, a written confirmation of an oral contract is enforceable unless objected to within ten days. Thus, if a farmer sells grain in accordance with a cash forward contract, and had received a written confirmation of the initial oral conversation with the seller, the farmer is bound by the terms of the oral conversation as outlined in the written confirmation unless the farmer had objected to the written confirmation within ten days. This is particularly a problem when the market price at harvest is higher than the forward contract price. If the farmer is a merchant, the farmer must deliver under the contract and cannot raise the statute of frauds as a defense. This is the merchant's confirmatory memo rule. However, if the farmer is not a merchant, the farmer is not bound by the contract and can sell the grain on the open market. In this situation, the statute of frauds can be raised as a defense to non-delivery.
- C. *Commercial impracticability.* Another significant problem that can arise with a cash forward grain contract is casualty to the crop caused by weather. If a farmer enters into a cash forward grain contract with a buyer and weather damages or destroys the crop before the specified delivery date, the farmer is not excused from delivering the

contracted amount unless the contract specified where the crop was to be grown, the crop was grown at that location. However, this provision is in cash forward grain contracts. The contract may contain an “act of God” clause excusing performance in the event of casualty to the crop, but this type of clause is also rare.

- D. *Rights of farmer in failure of elevator.* Another concern is that a seller pursuant to a cash forward grain contract is an unsecured creditor of the buyer after the contract is entered into and before delivery is made. Thus, if the buyer fails financially before delivery is made, the seller will likely receive nothing under the contract. State indemnity and bonding programs are typically insufficient to cover such a loss. In bankruptcy, unsecured claims of grain producers, up to \$2,000 per producer are allowed for grain or the proceeds of grain against a debtor owning or operating a grain storage facility.
- E. Under the UCC, a farmer who is not paid or who is given an insufficient funds check may reclaim the goods upon demand made within ten days after receipt. The ten-day provision is waived if the buyer misrepresented its solvency to the seller within three months before delivery. Unfortunately, when an elevator fails, there usually is less grain stored in the elevator than there are claims for grain. In this situation, the holders of negotiated receipts and scale tickets share pro rata in the remaining grain.
- F. *Hedge-to-arrive contracts.* In early 1998, the CFTC created a pilot program that would allow trading of off-exchange agricultural options. Legislation has been proposed that would completely eliminate the restriction on trading off-exchange options.

III. Potential Speakers

- A. Local Attorney
- B. Extension Tax and Law specialist

IV. Review Questions

- A. Describe the statute of frauds.

Answer: The statute of frauds says that a contract for the sale of goods worth \$500 or more must be in writing to be enforceable. If the sale is between merchants, a written confirmation of an oral contract is enforceable unless objected to within 10 days.

- B. Why might a farmer whose crop was destroyed by the weather be excused from delivering on a forward contract?

Answer: A farmer may be excused in this situation if: (1)the contract specified an exact location for the crop to be produced, or (2)if the contract contained an “act of God clause.”

V. For More Details

None available at this time

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! Merchant's confirmatory memo rule

- ☞ Worth more than \$500, unless
- ☞ Written confirmation of an oral contract objected to within 10 days
- ☞ Harvest price greater than contract price

! Commercial impracticability

- ☞ Casualty to the crop caused by bad weather
- ☞ Farmer still responsible for delivery, unless
- ☞ Contract specifies where the crop was to be grown and destruction occurred at that location
- ☞ Contract may contain an "act of God" clause excusing performance but this is very rare

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! Rights of farmer in failure of elevator

- ☞ Concern of seller to a cash forward grain contract is an unsecured creditor

- ☞ If buyer fails financially before delivery, seller will likely receive nothing

- ☞ State indemnity and bonding programs typically don't cover loss

- ☞ In bankruptcy, unsecured claims up to \$2,000 per producer are allowed for grain or proceeds of grain against a debtor owning or operating a grain elevator

- ☞ If the farmer is not paid or is given an insufficient funds check they may reclaim goods within 10 days of receipt

- ☞ Ten day provisions are waived if buyer gives 3 month notice of misrepresentation of solvency

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! Hedge-to-Arrive

- ☞ Early 1998, CFTC created pilot program to allow trading of off-exchange agriculture options
- ☞ Legislation has been proposed to eliminate the restriction on trading of off-exchange options