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Selling Grain in Texas: What are the Risks?

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No one questions whether farming is a risky business—erratic weather, volatile commodity markets, pests and plant disease, equipment breakdowns, political and regulatory changes—all of these and more combine to make crop production uncertain with significant financial consequences. And that is just on the production side. What about the risks farmers face as grain sellers?

A common practice in production agriculture is to deliver all of your production to one facility and sell to a single buyer. What happens to your grain if the elevator declares bankruptcy? What if you sold grain on a deferred contract (and no longer hold title to the grain), have not been paid, and the buyer goes out of business?

In 2016, Texas corn, grain sorghum, wheat, and soybean farmers produced 514 million bushels valued at over $1.7 billion. In a time when grain markets and the economy are volatile, farmers need to know their rights and responsibilities when selling grain.

When is a Farmer a Grain Merchant?

A contract is a written or oral agreement between two or more parties to result in commitment to do or refrain from doing something. In the case of selling grain, the most common form of marketing contract is forward sale of a growing crop where the contract provides for later delivery of a specified quantity at an established a price.

In This Issue. . . .
a discussion of counterparty risk in grain marketing contracts and rules of thumb when entering such agreements.

Forward contracts fall under the jurisdiction of commercial law known as the Uniform Commercial Code or UCC. In the UCC is a requirement that contracts for the sale of goods in excess of $500 be in writing. By law, in the event of a dispute, a contract for the sale of goods of $500 or more is not enforceable unless it is in writing and signed by the party against whom enforcement is sought. Regardless of this requirement, it is always recommended that contractual agreements be in writing.

However, contracts between 'merchants' are often made orally. In the case of a grain contract, two merchants agree to price, quantity, and delivery details and one merchant sends the other merchant a letter of confirmation or preprinted form contract within a reasonable time. This confirmation is signed by the merchant who sent it and gives the other merchant 10 days to object in writing. If the merchant who receives the confirmation fails to object within 10 days, the "merchant's confirmatory rule" allows the writing between merchants to be an enforceable contract.

Of particular importance to the enforceability of a written agreement from a grain merchant is whether

a farmer is considered a "merchant" under this UCC provision. Factors used to determine whether a particular farmer is a merchant include the length of time the farmer has been engaged in marketing products on the farm, the degree of business skill demonstrated in previous transactions with other parties, awareness of the operation and existence of farm markets, and past experience with or knowledge of the custom and practices unique to the marketing of the product sold.

The Texas Supreme Court has ruled that a 1,200 acre wheat and cotton farmer was a merchant. The farmer sold all the production for each of the previous five years and daily kept abreast of current market prices and conditions by talking to grain dealers and listening to the radio.

What about Grain Licensing and Bond Protection?

The Texas Department of Agriculture's Grain Warehouse Program helps protect Texas grain producers by licensing grain elevators and conducting audits and inspections of warehouse facilities. The program requires that any entity that stores grain for the public be licensed. Each warehouse must be insured for loss of grain stocks for its full market value (bonded). The operator of a public warehouse must maintain current records of all agricultural commodities stored, conditioned, handled, or shipped by the facility.

When a grain elevator declares bankruptcy, a farmer with grain in storage is not a creditor of the elevator. Grain in storage is still the property of the farmer and ownership verified by warehouse receipts and scale tickets. It does not matter if the grain has been commingled. Comingled grain is held in common by persons storing grain. If a farmer proves ownership with warehouse receipts and scale tickets and pays all storage and other charges, farmers are entitled to their grain.

What is the Difference between a Scale Ticket and Warehouse Receipt?

A scale ticket is a document that shows the grain was delivered to a warehouse. It is a document of title (evidence of ownership) but it is non-negotiable. A warehouse receipt is a negotiable document that shows the owner has clear title to the grain in storage. When endorsed, it can be transferred to someone else.

What about Storage Rates and Handling Fees?

While storage and handling fees are not regulated by state law, all public grain warehouse license holders must post a copy of all storage rates charged by the warehouse at the main office. Farmers should not confuse storage or in-and-out fees with other contract or marketing fees associated with grain contracts or price risk management tools. Be sure you understand all costs and obligations of your marketing contract and discuss any questions you might have with your elevator manager or other grain buyer or, if need be, an attorney.

What about the Licensing Requirements of Grain Buyers?

The state of Texas does not require grain buyers to be licensed. The aforementioned licensing and bonding requirement is for the warehousing of grain, not for the buying of grain. When a public warehouse acts as a grain buyer, they do have a bond, but this bond protects grain depositors for storage. Bond protection does not apply to forward contracts or other grain purchasing activities.

Additionally, non-warehouse buyers such as grain processors and livestock feeders are not regulated by TDA's Warehouse Program and are not subject to its rules and requirements, and the customers of these businesses are not under its protection. Feedlots, dairies, and feed mills are often referred to as turn row buyers and do not have to have a public warehouse license. They may be required to have other licensing from other agencies. If grain is sold to an unlicensed buyer, and if the buyer does not pay for the grain, there is no bond coverage available to help pay the seller. Disputes in this area are handled in civil courts and only civil penalties apply.

Counter party risk, the risk that the other party in an agreement will default, must be recognized when entering a grain marketing contract. This is especially important for credit-sale contracts for grain, in which the title to the grain has been transferred to the buyer but payment has not yet been made. When previously contracted grain is delivered to the elevator, title passes to the elevator

and the seller is now a general creditor with no right to reclaim delivered grain in the case of default. In Texas, credit-sale contracts do not have the same financial safeguards available for storage under warehouse receipts. Even in those cases where the buyer is licensed and bonded, there is no guarantee farmers will be fully reimbursed if a buyer becomes insolvent.

What if the Farmer Fails to Meet His or Her Contract Obligations?

A sales contract imposes obligations on both the buyer and the seller. Each contract contains specific language outlining these requirements and should be carefully reviewed prior to execution. If a farmer fails to deliver a crop because drought, hail, or other conditions have made it undeliverable, he or she generally is not excused from performance unless the contract called for the crop to be grown in a specified geographic area (often called an acre contract).

The traditional measure of damages for a seller's breach of contract is the difference between the market price and the contract price. The UCC also allows the legally injured buyer to 'cover' by making a good faith purchase or to contract to purchase substitute goods. In this case, the buyer is entitled to recover from the seller the difference between the cost of cover and the contract price.

What about Grading Disputes?

Grain grading is the starting point for describing quality and assigning value. Minimal standards are often specified in grain forward contracts with corresponding premiums and discounts to apply. In the event that a farmer disputes the in-house grade assigned by the elevator, there are a number of remedial steps that may be taken. First is to have the elevator re-grade the sample or draw another sample for grading. If the result is still not satisfactory, the farmer may ask that the sample be sent to a Federal Grain Inspection Service (FGIS) field office for official grading. This would allow for an 'official' grade to be given for that sample but for that sample alone. There is no implied certification that the sample submitted is representative of the entire truck or load from which the sample was drawn. Grading charges for this process are minimal. For an official grade to be given for an entire load an FGIS employee would be required to personally draw the sample on sight or the load of grain would need to be taken to an official grain inspection office, either being a cost prohibitive process in most cases.

Rules of Thumb for Contracting Grain

Grain contracts can be an important tool in price risk management. The effectiveness of this tool and overall success of this price risk management strategy can be enhanced by following a few basic rules:

1. Have a complete understanding of how the contract works and get it in writing. Know the kind of risk the contract is designed to control and the areas of risk that remain after the contract is signed. If in doubt, don't sign. Consider having an attorney review contracts prior to execution.

2. Know your customer. Counter party risk can never be eliminated, but knowledge of your customer's business reputation and ability to perform obligations may reduce this risk. Be sure the other party can explain to your satisfaction how the contract works under all market situations. Be comfortable, after reasonable inquiry and assessment, with the risk of doing business with that entity.

3. Maintain open communication with the other party before signing and throughout the life of the contract.

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