

## SOME LEGAL AND ECONOMIC ASPECTS OF FORWARD CONTRACTING

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*This fact sheet is not to advise you of the validity of your contracts. The purpose is to provide educational information. Specific legal questions should always be directed to your attorney.*

For several years, forward contracting of both crops and livestock has become more prevalent. One reason for this is that farm producers are seeking to eliminate some of the risk of falling prices. While this risk is eliminated, however, the opportunity of realizing a higher price is also foregone unless the contract provides a mechanism for sharing any market price increases. Recent crop years drove this point home to Texas farmers.

When market prices are substantially higher than the contract price, producers are interested in determining whether their contracts legally obligate them to deliver their crops or livestock. Likewise, when market prices are significantly below the contract price, the prospect of suffering substantial losses moves purchasers to seek advice as to whether a contract is legally binding on them.

The determination of whether a particular contract is binding and enforceable can be made only by your attorney. Small differences in the wording of contracts can cause significant differences in their interpretation and legal effect. Additionally, the legal meaning attached to specific words and phrases may vary substantially from the interpretation placed on them by laymen. For this reason,

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your attorney is the only person qualified to advise you of the precise terms and enforceability of your contract.

### Economic Components

Forward contracting may be thought of as either a marketing or a financial management tool. From the standpoint of the farm producer, it is quite often employed to remove or lessen the risk of fluctuations in market price. On the other hand, the purchaser may view a contract both as a risk decreasing mechanism and as a tool to assist in procuring a desired level of supply.

The following general advantages and disadvantages of forward contracting are relevant to either crop or livestock forward sale contracts which call for a single, specific price to be paid.

### Advantages

Forward contracting offers these advantages to farmers:

*Less financial risk.* Because the price of the product to farmers is fixed, buyers must bear the risk of decreases in market price.

*Greater financial leverage.* A guaranteed minimum price of at least part of the product may allow farmers to borrow more operating capital. Lending institutions often are more willing to extend loans to farmers who have a guaranteed price for their products. This factor becomes more important as the size of farming operations increases.

*Financial planning.* Producers who have part of their crops sold at a fixed price can use this information to plan the next year's capital expenditures.

## Disadvantages

Disadvantages of single price forward contracting must also be considered. They include:

*Limited profit.* Any increase in product market price above the contract price benefits purchasers rather than producers since the contract fixes the price.

*Quality may suffer.* Unless product quality standards are stated in the contract, farmers may concentrate on quantity produced rather than product quality improvement.

*Quantity stipulations.* Producers who sign contracts with a stipulated quantity (such as 400,000 pounds of sorghum) must deliver that quantity. If production is below the quantity contracted, sellers must arrange to purchase other grain to meet the contract arrangement or to pay any damages which their failure to deliver causes the purchaser. But if the market price is below the contract price, non-delivery has not damaged the seller. In addition, a farmer is free to sell elsewhere anything which he produces in excess of the stipulated quantity.

Some contracts do not provide for the delivery of a fixed quantity of crops or grain but rather for the entire production of a certain agricultural unit. Examples might be "all cotton produced on a certain 600-acre tract," or "all steer calves raised from a specific 1,000-cow herd." Here one need only deliver the entire production from the unit called for to avoid being held liable for breach of contract.

Thus, clearly there may be either advantages or disadvantages to signing a stipulated quantity contract, depending on how much one produces and the market price prevailing at sale.

## Legal Fees

Attorney fees for reviewing or writing contracts may be an added expense. However, legal advice for drafting a contract, or for helping you interpret a contract *prior* to signing it, may be money well spent. This is particularly true where such advice keeps you from obligating yourself to what would have been an undesirable or unfavorable contract.

## Other Considerations

There are other considerations which should be made before entering into forward sale contracts. For example, in order to eliminate the risk of a decrease in market price, are you willing to forego the opportunity of sharing in any increases above the stated market price? If you are not willing to

do so, you might consider negotiating with the buyer to establish a "floor price" contract. This type contract could guarantee you will receive a certain minimum price for your crops or livestock, and could also set forth a formula for *sharing* any increase in market price above the minimum guaranteed contract price. To illustrate, if the market price is \$3 per hundredweight above the contract price, the contract could be drafted to provide that each party should receive a certain percentage share of this \$3 differential.

If this approach is taken, the contract should carefully define what the "market price" means, and on what date the market price will be determined. For example, if 450-pound steers are involved, does market price mean the price which exists in the market at Amarillo, Omaha, Denver or some other location?

Another item to resolve is whether you want to obligate yourself to deliver a stipulated quantity or the entire production from a given agricultural production unit. Another alternative is to contract for a stipulated quantity which is less than what you expect to produce.

A few other items to consider are:

*The buyer's financial strength.* Do you know if the buyer has the financial resources to meet his contractual obligation? Checking the buyer's credit may be necessary.

*Future price expectations.* Predicating prices for any product is difficult, but the long time span between contracting and delivery of a crop makes price predictions for forward contracting even more difficult. Chances for accuracy decrease as the time period increases. Keep this in mind during any negotiations over price.

*Producer's financial status.* Will entering into a forward contract allow you benefits of greater leverage and better financial planning? Some financially sound producers may not realize these advantages. Leverage and financial planning are discussed in greater detail in other Texas Agricultural Extension Service fact sheets.

## Legal Components

Legally, before a contract exists, five essential elements must be found. They are (1) competent parties (sane, 18 years of age), (2) legal or proper subject matter, (3) an offer, (4) acceptance of the offer and (5) consideration. Questions about these should be directed to your attorney. In this fact sheet, it will be assumed that these elements are



all present, and the procedure will be to discuss the effect of some general provisions commonly found in written forward price contracts.

*Description of the crop or livestock to be delivered.* A full description should be set out although minor omissions do not necessarily affect the validity of the contract. However, such omissions may require litigation (contesting by lawsuit) to determine precisely what must be delivered.

*Price and payment.* The price, or method of determining price, should be clearly stated in the contract. The method of payment should likewise be specified.

*Date of delivery.* A delivery date should be stated, such as on or before October 1, to avoid disputes. If no date is stated and litigation results, one possible ruling by the court could call for delivery at a date consistent with the custom in the community.

*Assignability.* Many contracts contain a clause stating it is not "assignable." This means you can not transfer the contractual obligations to someone else and let them take your place in the contract. The reason for inserting such a clause is that, while both parties reasonably expect a certain quality of performance from each other, there might be others in the community in whom they did not have such trust. From the standpoint of the farmer, this would prevent the buyer from transferring his contractual rights and obligations to someone of questionable resources who might not be able to live up to his obligations if prices were to fall significantly. From the standpoint of the buyer, it would assure him that the contract could not be transferred to a producer who has a reputation for being generally inefficient with respect to either production quantity or quality of the commodity involved.

*Clear title.* Contracts may contain a clause that the commodity involved shall be delivered "free of encumbrances." Here, when the seller promises to deliver free from the claim of his creditors, he becomes legally liable for any damages caused the buyer by his inability to so deliver.

*Total agreement.* Contracts may sometimes contain clauses stating that "this contract constitutes the total agreement between the parties." Actually, should litigation result, complicated rules of evidence determine whether agreements outside the written contract can modify the contract. If you

have an agreement in addition to the written contract, your attorney can determine whether it is effective.

Some contracts may contain clauses stating that "this contract can only be amended by an agreement which is in writing." Technically, such clauses are not always effective, because the parties can agree to change any clause in a contract, including this one.

*Arbitration.* The purpose for inserting an arbitration clause in a contract is to avoid the necessity of filing a lawsuit to resolve disputes. The simplest type of arbitration clause may provide that, in case of dispute, each party may select one person to arbitrate for him. The two arbitrators then agree on a person to serve as a third arbitrator, and a majority vote of these three arbitrators then resolves the dispute.

*Liquidated damages.* The purpose of liquidated damage clause is to provide a way for determining how damages shall be computed if the contract is breached. Occasionally these clauses contain unreasonable sums of money to be paid in case of breach (e.g., producer must pay \$100,000 damages if he fails to deliver 10,000 pounds of grain sorghum). If so, the courts will probably call this a "penalty" rather than "liquidated damages," and the clause will not be enforceable.

To be enforceable, this clause generally must represent an honest attempt by the parties to estimate the damages likely to occur in case the contract is broken. So long as this honest attempt is made, the clause will likely serve its intended purpose of avoiding litigation.

In some contracts, language may be inserted stating in essence: "This is a liquidated damages clause and not a penalty clause." This language does not make an unreasonable sum for damages enforceable. The reasonableness of the attempt to assess damages determines this.

### **Concluding Comments**

This fact sheet summarizes some general economic and legal components of forward price contracting. For additional information and assistance in regard to the economic issues raised, contact your county agricultural Extension agent, area economist-management or Extension marketing specialist. If you have specific legal questions, they should be directed to your attorney.

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