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# Realizing Value and Creating Protection: A Practical Approach to Monetizing the Value of a Racehorse While Retaining Control Over Future Interests

Brad Butler  
*University of Kentucky*

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# REALIZING VALUE AND CREATING PROTECTION: A PRACTICAL APPROACH TO MONETIZING THE VALUE OF A RACEHORSE WHILE RETAINING CONTROL OVER FUTURE INTERESTS

*Brad Butler\**

## I. INTRODUCTION

People perceive the intrinsic value of a horse in a multitude of ways. Some believe horses serve a purely recreational function. Others view horses as purely financial investments. However, at the core of either perspective is the concept of value and, like any investment, the owner must eventually capture that value. Certain methods of harvesting the investment, such as selling to breeding farms abroad, while potentially lucrative, might have been avoided due to the prevalence of worldwide horse slaughter in recent years. Horse owners need a method of realizing the horse's value while retaining control over its future ownership.

During 2012, over 160,000 American horses were sent abroad and slaughtered for consumption by either dogs or humans.<sup>1</sup> The United States banned horse slaughterhouses in 2007; consequently, horse dealers began shipping horses to Mexico and Canada, where they were either slaughtered or sold to slaughterhouses in other countries.<sup>2</sup> Over 120,000 horses were sent to slaughter in Canada and Mexico during 2010 alone.<sup>3</sup> A limited number of breeders and horse farms deal directly with the slaughterhouses, but licensed dealers, commonly referred to as "kill buyers," facilitate the bulk of slaughterhouse equine sales.<sup>4</sup> Since most breeders refuse to sell their horses to kill buyers directly, the buyers will typically purchase horses at auction and then sell them to slaughterhouses abroad.<sup>5</sup>

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\* Notes Editor, KY. J. EQUINE AGRIC. & NAT. RESOURCES L., 2014-2015; B.B.A. 2011, University of Miami (FL); J.D. expected May 2015, University of Kentucky.

<sup>1</sup> *The Facts About Horse Slaughter*, THE HUMANE SOCY (Mar. 17, 2014), [http://www.humanesociety.org/issues/horse\\_slaughter/facts/facts\\_horse\\_slaughter.html](http://www.humanesociety.org/issues/horse_slaughter/facts/facts_horse_slaughter.html).

<sup>2</sup> *Horse Slaughter*, THE HORSE FUND, <http://www.horsefund.org/horse-slaughter-faq.php> (last visited Jan. 18, 2014).

<sup>3</sup> *Id.*

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

One possible reason for breeders' unwillingness to sell to international slaughterhouses is the facilities' particularly barbaric slaughtering method. In the United States, slaughter procedures were strictly regulated and theoretically protected the horses as much as possible. Federal law required that horses be rendered unconscious by using a captive bolt gun, which propels a nail directly into the horse's brain before the slaughter.<sup>6</sup> The horse would then be slaughtered.<sup>7</sup> Unfortunately, these efforts did not always render a horse unconscious.<sup>8</sup> Slaughter procedures in Mexico are far more primitive; in some instances, those responsible for the slaughter sever the horse's spinal cord by repeatedly stabbing its neck with a puntilla knife.<sup>9</sup> Severing the spinal cord merely paralyzes the horse; it does nothing to numb the pain during the subsequent slaughter.<sup>10</sup>

Notwithstanding a few outliers, such as Mexico, the worldwide method for slaughter generally parallels the United States' former standard. For example, in Australia, Great Britain, and Canada, either a captive bolt gun or a rifle is required to render the horse unconscious prior to slaughter.<sup>11</sup> Despite such horse slaughter laws, many horse skulls recovered from Canadian slaughterhouses show no evidence that either a captive bolt gun or a rifle was used.<sup>12</sup> While their slaughter methods are sloppy and disorganized, the international slaughterhouses do have precision when selecting their horses for slaughter. Eighty percent of the horses slaughtered abroad are Thoroughbreds, the most common type of racehorse.<sup>13</sup>

Every year, hundreds of Thoroughbreds from the United States are sold to stables in Japan, but not necessarily for immediate slaughter.<sup>14</sup> Ninety percent of those Thoroughbreds, however, will eventually be slaughtered despite their pedigree.<sup>15</sup> Ferdinand, a Thoroughbred that was

<sup>6</sup> *Id.*

<sup>7</sup> See *Transport to Slaughter*, THE HUMAN SOCIETY (Mar. 18, 2013), [http://humanesociety.org/issues/horse\\_slaughter/facts/transport\\_to\\_slaughter\\_092909.html](http://humanesociety.org/issues/horse_slaughter/facts/transport_to_slaughter_092909.html).

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

<sup>10</sup> *Horse Slaughter*, *supra* note 3.

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> *PETA's Investigation Inside Japanese Slaughterhouse*, PETA, <https://secure.peta.org/site/Advocacy.jsessionid=CAB372C46BDCEC064E99F1B4B4DAF574.app338a?cmd=display&page=UserAction&cid=2103> (last visited Jan. 18, 2014).

<sup>15</sup> *Id.*

purchased by a Japanese breeding farm, was sent to slaughter in late 2002.<sup>16</sup> Ferdinand was not an average Thoroughbred horse, though; he was the 1986 Kentucky Derby winner.<sup>17</sup> He also won the 1987 Breeders' Cup Classic and even received the 1987 Eclipse Award for Horse of the Year.<sup>18</sup> Overall, he won eight of his twenty-nine starts and earned over \$3,700,000 in purse proceeds during his career.<sup>19</sup> After retirement in 1989, he was sent to Claiborne Farms near Paris, Kentucky to begin breeding with female horses.<sup>20</sup>

In stark contrast to his racing career, Ferdinand achieved little success as a stud and was soon sold to a Japanese farm in the fall of 1994, a time when Japanese investors aggressively purchased American Thoroughbreds.<sup>21</sup> From 1995 through 2000, Ferdinand lived at Arrow Stud Farms, located on the Japanese island of Hokkaido.<sup>22</sup> Unfortunately, Ferdinand's popularity faded, and he was sold to a Japanese equine dealer.<sup>23</sup> There was no attempt to contact his original owners prior to the sale because the original owners created no system of safeguards to protect the horse, which led the horse dealer to dispose of Ferdinand by selling him to a slaughterhouse.<sup>24</sup> This cautionary tale gains traction when considering that Kentucky Derby and Preakness winners, Charismatic and War Emblem, currently reside on Japanese breeding farms.<sup>25</sup> This history of racehorse slaughter in Japan presents disturbing questions regarding these other champions' fates once their current owners deem them worthless. This note does not intend to argue that Japan is the only place posing a legitimate danger to racehorses. For example, Exceller, an English champion, won fifteen of his thirty-three

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<sup>16</sup> Ray Paulick, *Death of a Derby Winner: Slaughterhouse Likely Fate For Ferdinand*, THE BLOOD-HORSE (July 25, 2003, 8:19 AM), <http://www.bloodhorse.com/horse-racing/articles/17051/death-of-a-derby-winner-slaughterhouse-likely-fate-for-ferdinand>.

<sup>17</sup> *Id.*

<sup>18</sup> *Id.*

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> *Id.*

<sup>22</sup> Paulick, *supra* note 17.

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> PETA, *supra* note 15.

starts and earned over \$1,600,000 in purse money.<sup>26</sup> Nevertheless, this legendary horse met its demise inside a Swedish slaughterhouse in 1997.<sup>27</sup>

All countries that permit equine slaughterhouses or consider horse as a delicacy pose a serious threat to horses. Many horse breeders and original owners do not wish to see their former horses meet such barbaric ends.<sup>28</sup> Clearly, the problem is not a domestic issue since there are no slaughterhouses in the United States. Rather, the problem lies in direct agreements with international purchasers that have no significant ties to the United States and agreements indirectly providing a future sale to a foreign party. The issue therefore is how to best realize the horse's value while maintaining the requisite degree of control over future ownership to prevent horse slaughter. However, retaining control over future interests requires restrictions to be placed on the property and restricted property will result in a lower demand for the property, thereby generating a lower selling price. Essentially, this note will determine the most profitable way to sell the horse and still retain control over the future of the horse.

Part I of this note will discuss the problem with international equine slaughterhouses and explain the tension between capitalizing on a horse's value in the short run while retaining some control over future interests, which will prevent inhumane death. Part II will provide a brief overview of the equine breeding industry, including the common roles played by parties involved in equine transactions, the breeding cycles for Thoroughbreds, and the revenue cycles underlying the farm operation. Part III will examine the current buying models for horses, including auction and direct private sales. Part IV will propose three potential methods of realizing the value of the horse while retaining some control over future interests, examining each proposed method, and analyzing how two of the methods can be achieved through either an auction or a direct sale. Finally, Part V will argue in favor of using a right of first refusal contractual provision, which is in the best interest of all parties involved.

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<sup>26</sup> Rick Maese, *'Washed Up' Thoroughbreds Often Land At Slaughterhouse*, THE ORLANDO SENTINEL (May 28, 2004), <http://www.rense.com/general53/unspeakable.htm>.

<sup>27</sup> *Id.*

<sup>28</sup> See Steve Zorn, *What to Do With All Those Horses?*, N.Y. TIMES (May 14, 2008, 4:27 PM), [http://therail.blogs.nytimes.com/2008/05/14/what-to-do-with-all-those-horses/?\\_r=0](http://therail.blogs.nytimes.com/2008/05/14/what-to-do-with-all-those-horses/?_r=0).

## II. A BRIEF OVERVIEW OF THE EQUINE BREEDING INDUSTRY

Lawyers who are unfamiliar with the equine industry should have a general understanding of it before attempting to structure a transaction involving an interest in a horse. People can achieve a basic understanding by considering three perspectives: the basic terminology and the types of people involved in the industry, the life cycle and the breeding cycle of a horse, and the financial aspects of a breeding farm's operations.

### *A. Relevant Parties and Horse Terminology*

The foundational aspect of the breeding industry is the horse. A familiarity with horse terminology helps understand the breeding farm revenue cycles.<sup>29</sup> A male horse older than age four is known as a "stallion"; however, castrated male horses are known as "geldings." Male horses age four and younger are known as "colts." Female horses older than age four are known as "mares." Females used for breeding are known as "broodmares." Female horses age four and younger are known as "fillies." Horses are known as "foals" from the time they are born until they are weaned from their mother. At that point, the foals are known as "weanlings" until they reach the age of one, when they are given the name "yearlings."

One important party to the horse transaction is the breeder. A breeder is the person who owned or leased the mare at the time of breeding and may or may not own the horse farm where the mare is impregnated. Another critical party is the investor or ownership group. The investor can either be a sole proprietor, a partnership, a corporation, or, in some cases, a syndicate. These investors purchase mares, stallions, foals, and even horse farms. The advantages and disadvantages of various business structures for the investor groups are beyond the scope of this Note, as are the securities implications of group ownership.

The Jockey Club is the final party to consider in these transactions. The Jockey Club was incorporated in New York on February 9, 1894 with

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<sup>29</sup> See Cheryl Souter, *Basic Horse Terminology*, EQUUSITE.COM (Apr. 1997) (providing a basic understanding of horse terminology), <http://www.equusite.com/articles/basics/basicsTerminology.shtml>.

the purpose of promulgating rules for breeding and racing.<sup>30</sup> The Jockey Club maintains a breeding registry and the Club's primary responsibility is the maintenance of *The American Stud Book*.<sup>31</sup> The "Principal Rules and Requirements of the American Stud Book" are colloquially known as "The Jockey Club Rules."<sup>32</sup> The Jockey Club Rules detail regulations regarding breeding and registering ownership.

### B. Life Cycles and Breeding Cycles

A domesticated horse will typically live between twenty-five and thirty years.<sup>33</sup> The majority of Thoroughbreds have a racing career that last less than two years.<sup>34</sup> Therefore, a horse is forced into a second career relatively quickly. Secondary careers include breeding, hunting, riding, polo, and police work.

The breeding cycle for horses is fairly uniform across the country as a result of tradition, practicality, and necessity. Owners begin to breed their mares in mid-February and continue until early July because horses have an 11-month gestation period and the owners want the foal to be born as close to January 1 as possible.<sup>35</sup> For the purposes of determining the age of a Thoroughbred, the Jockey Club Rules set the date of birth for every horse as January 1st of the year that the horse was born to simplify the issue.<sup>36</sup> Accordingly, the foaling season typically begins between mid-January and ends in late May.<sup>37</sup> There is usually a small sale during the summer focused on yearlings, but most transactions occur during September sales.<sup>38</sup>

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<sup>30</sup> *History of The Jockey Club*, THE JOCKEY CLUB, <http://www.jockeyclub.com/Default.asp?section=About&area=0> (last visited Jan. 19, 2014).

<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> *Interesting Horse Facts*, THE HORSE LOVER'S CORRAL (Jan. 19, 2014), <http://www.angelfire.com/tx2/horsecorral/facts.html>.

<sup>34</sup> See Clarissa G. Brown-Douglas, Joe D. Pagan, & Arnold J. Stromberg, *Thoroughbred Growth and Future Racing Performance*, IV ADVANCES IN EQUINE NUTRITION 125, 129 (2009), [http://www.ker.com/library/Proceedings/06/12\\_TB\\_GrowthFuturePerf\\_p125.pdf](http://www.ker.com/library/Proceedings/06/12_TB_GrowthFuturePerf_p125.pdf).

<sup>35</sup> JAMES H. NEWBERRY, JR., UK/CLE LEGAL ASPECTS OF HORSE FARM OPERATIONS, § 2.9 (Timothy S. Chase ed., Univ. of Ky. Coll. of Law Office of Continuing Legal Educ., 3rd ed. 2004).

<sup>36</sup> See *The American Stud Book Principal Rules and Requirements: Glossary of Terms*, THE JOCKEY CLUB REGISTRY,

<http://www.registry.jockeyclub.com/registry.cfm?Page=tjcRuleBook> (last visited Sept. 19, 2014).

<sup>37</sup> NEWBERRY, *supra* note 36, at § 2.10.

<sup>38</sup> *Id.* § 2.11-12.

### C. *Financial Model of Equine Operations*

Understanding when equine transactions occur is essential for effectively drafting a deal to realize the value of a racehorse while retaining some control over future interests. The best way to understand the transactional timing is to consider the unique revenue and expense cycles within the equine industry.

#### 1. *Common Sources of Income*

In the typical equine breeding operation, the main sources of income are the yearling sales, weanling sales, broodmare sales, boarding fees, and occasionally racing income. Most revenues are generated during the yearling sales.<sup>39</sup> Every year, breeding farms attract some interest during the July and August summer sales, but the majority of yearling sales occur during sales in September.<sup>40</sup> The buyers are generally investors who intend to race the horse within the next few years, but there are some investors who plan to hold the horse for a year and then sell it at one of the many established two-year old sales.<sup>41</sup> These types of investors are known as “pinhookers.”<sup>42</sup>

Second, revenues may also be generated through the sale of weanlings.<sup>43</sup> Farms occasionally sell their weanlings during November of the year the foal was born.<sup>44</sup> However, there is a much lower market demand for weanlings, meaning they typically sell for less than yearlings.<sup>45</sup>

Third, a potential source of revenue is the sale of broodmares.<sup>46</sup> For various reasons, every breeding operation must occasionally reduce the number of broodmares on the farm.<sup>47</sup> While this may produce a small source of revenue for the majority of equine breeding operations, there are

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<sup>39</sup> *Id.* § 2.17.

<sup>40</sup> *Id.* § 2.11-12.

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> NEWBERRY, *supra* note 36, at § 2.18.

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

<sup>46</sup> *Id.* § 2.20.

<sup>47</sup> *Id.*



farms that focus specifically on purchasing mares to breed and sell each year.<sup>48</sup> The value of the mare greatly appreciates when their ability to breed is confirmed. Operations such as these would not likely be concerned with retaining control over future interests, as mares can theoretically breed for the entire length of their lives. Therefore, the broodmare always has economic value, unlike a racehorse that becomes worthless once it is no longer an attractive stud in the market.

Fourth, using excess space to board other owners' horses presents a common source of revenue.<sup>49</sup> The other owners may not own their own farms or may simply need their mare in a particular state so that it can breed with a specific stallion.<sup>50</sup> Just as there are specific breeding farms with a focus on purchasing and selling broodmares, there are farms that exist specifically to board other horses.

Finally, a fifth source of revenue comes from racing the horses.<sup>51</sup> Typically, equine breeding farms do not engage in the racing side of the industry.<sup>52</sup> If buyers in the market know that the farm engages in horseracing, then they may assume that those horses sent to auction are not the farm's best.<sup>53</sup> A perception such as this may suppress selling price, which would unlikely be offset by the income generated through horse racing. However, some horses do not sell and there simply is nothing else to do with them.<sup>54</sup>

## 2. Common Types of Expenses

While revenues are typically generated in clusters, expenses are year-round considerations for which a precise budget must be carefully constructed. For a typical equine breeding operation, some of the common expenses are wages, stud fees, insurance, interest paid on capital assets, maintenance, horse nutrition, sales company commissions, and veterinarian expenses. Breeding operations are extremely labor-intensive because of the

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<sup>48</sup> *Id.*

<sup>49</sup> NEWBERRY, *supra* note 36, at § 2.22.

<sup>50</sup> *Id.*

<sup>51</sup> *Id.* § 2.24.

<sup>52</sup> *See id.*

<sup>53</sup> *Id.*

<sup>54</sup> *Id.*

level of care needed to maintain the horses and the facilities.<sup>55</sup> Consequently, wages paid to farm employees are usually one of the farm's largest expenses.<sup>56</sup> Stud fees also constitute extremely large expenses with the average stud fee, as of 2012 projections, at \$21,098.<sup>57</sup> However, stud fees can climb as high as \$150,000 depending on the horse's pedigree and performance on the racetrack.<sup>58</sup>

Based on the size of the average horse farm, insurance is another major expense.<sup>59</sup> The average Thoroughbred farm in Kentucky is 369 acres with 59 horses.<sup>60</sup> According to the Fayette Alliance, "[t]wo-thirds of the farms each had fewer than 50 horses," while "only one-third of the farms had more than 50 horses each".<sup>61</sup> A capital-intensive business, such as an equine breeding operation, usually requires a large amount of debt financing. Large loans lead to large interest payments, which is a factor that farm owners must consider when engaging in the financial planning of their business.<sup>62</sup>

Another large expense is the cost of physically maintaining the horses and safely maintaining the farm facilities.<sup>63</sup> Injured horses have little to no value and the public's perception of the facilities may affect the market's perception of the farm's quality when it is time for auction. Providing the horse with hay and feed is another large expense.<sup>64</sup> With the cost of keeping nutritionists on staff at feed mills, the cost of the feed has grown much larger over the past few years than the average person may expect.<sup>65</sup> Additionally, since horses are the main product produced by an equine breeding operation, veterinarian care is extremely important and exceptionally expensive.<sup>66</sup>

<sup>55</sup> NEWBERRY, *supra* note 36, at § 2.26.

<sup>56</sup> *Id.*

<sup>57</sup> Joe Nevillis, *Stud Fees for 2013 Indicate Market is Stabilizing*, DAILY RACING FORM (Nov. 30, 2012, 5:33 PM), <http://www.drj.com/news/stud-fees-2013-indicate-market-stabilizing>.

<sup>58</sup> *See id.*

<sup>59</sup> NEWBERRY, *supra* note 36, at § 2.28.

<sup>60</sup> PERRY NUTT ET AL., LEGIS. RESEARCH COMM'N, KY., THOROUGHBRED BREEDING INDUSTRY & STATE PROGRAMS THAT ASSIST THE EQUINE INDUSTRY at 3 (Nov. 10, 2011), available at <http://fayettealliance.com/wp/wp-content/uploads/2011/11/The-KY-Thoroughbred-Breeding-Industry-Study.pdf>.

<sup>61</sup> *Id.* at 4.

<sup>62</sup> NEWBERRY, *supra* note 36, at § 2.29.

<sup>63</sup> *See id.* § 2.30.

<sup>64</sup> *See id.* § 2.31.

<sup>65</sup> *Id.*

<sup>66</sup> *Id.* § 2.33.

Finally, the last expense can vary greatly but is also likely the one horse owners are the most happy to incur. This final expense, which can be very large, is the commission paid to the sales company on the successful auction of a horse,<sup>67</sup> where “[t]he standard fee is five percent of the sales price.”<sup>68</sup>

### III. CURRENT BUYING MODELS

Horse transactions will occur by means of one of two sales models: public auctions or private direct sales. The type of seller usually determines the type of sales method. Typically, the initial sale of a horse from a horse farm will be done through an auction and subsequent sales will be direct.

#### *A. Public Auctions*

Every year “hundreds of millions of dollars of Thoroughbreds are sold at public auction in Kentucky alone.”<sup>69</sup> A reasonable person might think that lawyers would be heavily involved in such high volume sales; however, lawyers are actually relatively uninvolved in the process as a result of the industry’s traditions and customs.<sup>70</sup> The process has essentially evolved into a mere filing of the proper forms in a fairly streamlined manner that begins with the auction.

The auction begins with the consignment contract between the seller and the sales company.<sup>71</sup> Once the contract has been finalized, the sales company transports the horse from the farm to the location of the auction.<sup>72</sup> The sales company then distributes sales catalogues to potential bidders containing pedigree information and the conditions of sale, which later become the terms of the contract between the successful bidder and the seller.<sup>73</sup> The next step is the public auction itself, where the successful bidder must sign an acknowledgment of purchase, which contains the

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<sup>67</sup> *Id.* § 2.32.

<sup>68</sup> NEWBERRY, *supra* note 36, at § 2.32.

<sup>69</sup> *Id.* § 7.2.

<sup>70</sup> *Id.*

<sup>71</sup> *Id.* § 7.3.

<sup>72</sup> *Id.*

<sup>73</sup> *Id.*

conditions of sales laid out in the sales catalogue.<sup>74</sup> At this time, there will be full payment or the arrangement of credit through a neutral-party, third-party, or the breeder.<sup>75</sup> After the sales company has received payment, the purchaser is issued a “stable release form” and the purchaser may take the horse and leave.<sup>76</sup>

The importance of the conditions of sale found in the catalogue cannot be underemphasized. In *Cohen v. North Ridge Farms, Inc.*, the court’s decision not to rescind a contract formed by way of auction turned upon the existence of specific conditions in the preliminary sales catalogue.<sup>77</sup> The facts of the case were straightforward. The plaintiff, through his agents, purchased a colt at auction for \$575,000 on July 18, 1988.<sup>78</sup> Prior to the sale, North Ridge Farms consigned the horse to Keeneland racetrack to sell at auction<sup>79</sup>

On July 19, 1988, Cohen had the horse examined by a veterinarian and the veterinarian discovered that the horse suffered from a flaccid epiglottis.<sup>80</sup> This condition can lead to a soft palate, which can affect the horse’s respiratory function and potentially impair its racing ability.<sup>81</sup> After discovering the horse’s medical condition, Cohen wrote a letter to Keeneland demanding his money back.<sup>82</sup> However, counsel for North Ridge Farms sent a response demanding that Cohen take possession of the horse and that payment be made immediately.<sup>83</sup>

Cohen brought suit to rescind the contract, alleging failure of consideration, mutual mistake, unilateral mistake, violation of the Kentucky Consumer Protection Act, misrepresentation, fraud, and a breach of fiduciary duty.<sup>84</sup> The court began its opinion by discussing the conditions of sale that were made available in the sales catalogue.<sup>85</sup> Among other things,

<sup>74</sup> NEWBERRY, *supra* note 36, at § 2.29.

<sup>75</sup> *Id.*

<sup>76</sup> *Id.*

<sup>77</sup> *Cohen v. N. Ridge Farms, Inc.* 712 F. Supp. 1265, 1269 (E.D. Ky. 1989).

<sup>78</sup> *Id.* at 1266.

<sup>79</sup> *Id.*

<sup>80</sup> *Id.* at 1266-67.

<sup>81</sup> *Id.* at 1267.

<sup>82</sup> *Id.*

<sup>83</sup> *Cohen*, 712 F.Supp. at 1267.

<sup>84</sup> *Id.* at 1268.

<sup>85</sup> *Id.*

there was a provision expressly disclaiming all express and implied warranties.<sup>86</sup> The court then noted that the conditions of sale function as a contract between the parties.<sup>87</sup> The court then dismissed each of the plaintiff's claims by allowing the conditions of the sale to govern, thereby removing all implied warranties, including the implied warranty of fitness and the implied warranty of merchantability present in all sales of goods.<sup>88</sup>

### *B. Private Direct Sales*

Private direct sales are the opposite of public auctions. In auctions, the seller has no direct input regarding the identity of the buyer. Whereas, in private direct sales, the seller can select to whom he sells the horse and the seller will be forced to negotiate the terms of the contract with the buyer. At a minimum there are two relevant bodies of law that must be considered because the buyer's nationality can determine which body of law applies. For contracts with domestic buyers, a lawyer drafting the contract must be aware of the governing state's adopted version of the Uniform Commercial Code ("UCC"). For contracts with international buyers, a lawyer must carefully consider and examine the United Nations Convention on Contracts for the International Sale of Goods ("CISG"). A practitioner must research these issues before contracting for the sale of a horse. From a practical standpoint, the UCC and the CISG are very similar, but there are a few significant differences worth discussing at this time.

#### *1. UCC*

According to the UCC, a good is anything that is "movable at the time of identification to the contract for sale other than the money in which the price is to be paid, investment securities (Article 9), and things in action."<sup>89</sup> A horse, therefore, is a "good" as defined by the UCC. Since the UCC does not specify the elements required to establish the existence of a contract, the common law requirements of a valid offer, valid acceptance, and

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<sup>86</sup> *Id.*

<sup>87</sup> *Id.* at 1269 (citing *Keck v. Wacker*, 413 F. Supp. 1377, 1381 (E.D. Ky. 1976)).

<sup>88</sup> *Id.*

<sup>89</sup> U.C.C. § 2-105(1) (2014).

consideration remain the standard.<sup>90</sup> However, the UCC does expressly mention the statute of frauds, which is the provision that requires a contract be in writing to be enforceable. It states:

[A] contract for the sale of goods for the price of \$500 or more is not enforceable by way of action or defense unless there is some writing sufficient to indicate that a contract for sale has been made between the parties and signed by the party against whom enforcement is sought.<sup>91</sup>

The statute of frauds contains several exceptions that are important to know when engaging in the sale of horses. First, when the transactions involve merchants there is an extended period of time for a writing to be created and the writing does not need to be signed.<sup>92</sup> Second, if the goods are “specifically manufactured for the buyer and are not suitable for sale to others in the ordinary course of the seller’s business,” then there is no need for a writing to prove the existence of the contract.<sup>93</sup> Third, there is no need to present evidence of a writing when the party against whom enforcement is sought testifies that the contract exists before a tribunal.<sup>94</sup> Fourth, if there is partial payment or partial performance, then there is no need for a writing to prove the existence of the contract.<sup>95</sup> The exceptions to the statute of frauds are important to understand because horse sales must technically be memorialized. This runs counter to the industry’s traditions and customs surrounding handshake deals, but noncompliance with the statute of frauds could lead to an unenforceable agreement.

It is also important to consider the types of remedies available to the respective contractual parties in the event of a breach. When the buyer breaches the contract, the seller may withhold the delivery of goods, cancel the contract, and recover damages for non-acceptance.<sup>96</sup> When the seller breaches the contract, the buyer may seek damages and specific

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<sup>90</sup> See *Collins v. Ky. Lottery Corp.*, 399 S.W.3d 449, 455 (Ky. Ct. App. 2012).

<sup>91</sup> U.C.C. § 2-201(1) (2014).

<sup>92</sup> *Id.* § 2-201(2).

<sup>93</sup> *Id.* § 2-201(3)(a).

<sup>94</sup> *Id.* § 2-201(3)(b).

<sup>95</sup> *Id.* § 2-201(3)(c).

<sup>96</sup> *Id.* § 2-703.

performance in certain situations.<sup>97</sup> Specifically, the buyer may seek specific performance where the goods are unique or when the situation warrants it.<sup>98</sup>

## 2. CISG

Contracts for the International Sale of Goods (CISG) is a treaty that was developed by the United Nations that serves as a uniform international sales law. The CISG came into force on January 1, 1988 after being ratified by eleven countries.<sup>99</sup> Its purpose is to allow exporters to avoid choice of law issues since the CISG offers “accepted substantive rules on which contracting parties may rely.”<sup>100</sup> It is also important to note that contracting parties may opt-out of any of the CISG requirements.

While the CISG resembles the UCC in most regards, there are a few subtle but significant differences. First, acceptance is effective only when received by the offeror under the CISG, which is contrary to the “mailbox rule”<sup>101</sup> in the United States.<sup>102</sup> Second, an acceptance of the offer with a modification and/or additional terms is considered a rejection and a counteroffer, which is contrary to the UCC’s § 2-207.<sup>103</sup> Third, both buyer and seller have the right to seek damages or specific performance, which is contrary to only the buyer having the right to specific performance in a few limited situations under the UCC.<sup>104</sup> Finally, there is no writing requirement to establish the existence of a contract under the CISG.<sup>105</sup>

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<sup>97</sup> U.C.C. § 2-711 (2014).

<sup>98</sup> *Id.* § 2-716(1).

<sup>99</sup> United Nations Convention on Contracts for the International Sale of Goods, opened for signature Apr. 11, 1980, S. Treaty Doc. No. 98-9 (1983), 1489 U.N.T.S. 3 (entered into force Jan. 1, 1988) [hereinafter CISG], available at: <http://www.uncitral.org/pdf/english/texts/sales/cisg/V1056997-CISG-e-book.pdf>.

<sup>100</sup> *Id.*

<sup>101</sup> *Mailbox Rule*, LEGAL INFO. INST., [http://www.law.cornell.edu/wex/mailbox\\_rule](http://www.law.cornell.edu/wex/mailbox_rule) (last visited Nov. 10, 2014) (defining the rule as “the default rule under [contract] law for determining the time at which an [offer] is accepted, that states that an offer is considered accepted at the time that the [acceptance] is mailed”).

<sup>102</sup> CISG, *supra* note 100, art. 18(2).

<sup>103</sup> *Id.* art. 19; U.C.C. § 2-207 (2013).

<sup>104</sup> CISG, *supra* note 100, arts. 46, 62.

<sup>105</sup> *Id.* art. 11.

## IV. PROPOSED METHODS OF CONSTRUCTING A DEAL TO REALIZE VALUE AND TO CREATE PROTECTION

*A. Borrowing Against the Horse's Future Earnings*

The first proposed method of realizing the value of the horse while retaining control is to borrow against the horse's future earnings. This method may seem simple but it involves the most risk. Borrowing against the future earnings of the horse will enable the owner to keep the horse and to obtain the present value of projected future revenue streams. This means that the bank would project all future earnings of the horse, and then calculate the present value of those revenue streams by applying a discount rate that it believes accurately reflects the risk of the loan. Consequently, there are two things to consider. First, the owner would need to race the horse to generate fees because the present value sum given by the bank would be predicated on these projected numbers. Second, the loan from the bank would likely be made in exchange for a security interest in the horse,<sup>106</sup> and the debt would probably be a recourse obligation.<sup>107</sup>

The advantages and disadvantages of this method are fairly clear. The primary advantage of borrowing against future earnings is that the horse owner never has to relinquish ownership. Therefore, there is no immediate chance of the horse being sent to slaughter. The primary disadvantage of borrowing against future earnings is that the owner of the horse is burdened with the risks of the transaction. If the owner of the horse is unable to make payments on the debt to the bank, then the bank can repossess the horse and sell it to satisfy the outstanding balance of the obligation.<sup>108</sup> The recourse nature of the obligation means that the owner of the horse would be personally liable for any deficiency after the sale of the horse. Therefore, the owner runs the risk of losing the horse and facing personal bankruptcy. An additional disadvantage of this method would be the impact that racing

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<sup>106</sup> BLACK'S LAW DICTIONARY 1562 (10th ed. 2014) (defining "security interest" as "[a] property interest created by agreement or by operation of law to secure performance of an obligation").

<sup>107</sup> BLACK'S LAW DICTIONARY 1466 (10th ed. 2014) (defining "recourse" as "[t]he right of a holder of a negotiable instrument to demand payment from the drawer or indorser if the instrument is dishonored").

<sup>108</sup> See U.C.C. § 9-609 (2013).



the horses would have on the farm's auction of other horses. As was previously noted, when potential buyers at auction know that a particular horse farm engages in racing as well as breeding, they may believe that the horse farm is keeping the best horses for themselves and selling less superior products. A belief like this would undoubtedly lead to a reduction in the sales price of all other horses from the farm. Therefore, the owner of the horse faces the potential of destroying the brand equity associated with the farm itself.

Some of the risks of default, however, are mitigated through Article 9 of the Uniform Commercial Code or could be through the use of contractual provisions within the security agreement. Under Article 9, the debtor has the right to redeem the collateral in the event of a default.<sup>109</sup> Redemption is when the debtor pays the underlying obligation secured by the collateral in full.<sup>110</sup> However, this may be an unreasonable course of action for the owner of the horse because he would likely be incapable of satisfying the entire debt since he was unable to even make a payment. Accordingly, the logical method would be to incorporate specific contractual provisions into the security agreement.

There are certain provisions that can be found in almost every equine security agreement.<sup>111</sup> These provisions relate to the parties and to the collateral. The document must provide: the precise name of the borrower, the address of the borrower, the name of the lender, the address of the lender, a description of the events leading up to the creation of the security interest, a clause granting a security interest in the collateral, a detailed description of the collateral, a list of the obligations secured by the collateral, and a provision for the collateral to secured future advances from the lender.<sup>112</sup>

Furthermore, the equine security agreement should contain representations by the borrower regarding the collateral, including: title, the borrower's commitment not to sell or encumber the property, the location of the collateral, and the events that lead to a default, the rights of the

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<sup>109</sup> *Id.* at § 9-623.

<sup>110</sup> *Id.*

<sup>111</sup> NEWBERRY, *supra* note 36, at § 7.24.

<sup>112</sup> *Id.*

lender in the event of default, insurance requirements, provisions regarding where notice must be given, authorization to notify the Jockey Club of the security interest, and a choice of laws provision among a few other small things.<sup>113</sup>

For the horse owner to attempt to mitigate the harsh requirements of redemption under Article 9, he should try to negotiate an extended period of time to redeem the collateral or try to include a provision that would extend the loan for a longer period of time with a slightly higher interest rate. Doing this would allow the creditor to remain secured while also enhancing the likelihood that the lender gets paid in full and the borrower retains ownership of the horse.

The implementation of this method is simple in theory but difficult in practice—the owner of the horse must find a lender willing to provide the present value of a stream of revenues that do not currently exist. Since this method does not involve selling the horse to another person, there is no need to discuss the consequences of the different buying models.

In conclusion, the owner of a horse using this method will retain ownership of the horse but will also carry all risks at a business and a personal level. Furthermore, the owner must keep in mind the fact that if the lender does repossess the collateral, then the owner will have no say regarding where the horse is subsequently sold.

### *B. Creating a Trust*

The second proposed method of realizing the value of the horse while retaining control is to place the horse in trust and sell either the equitable title or a portion of the legal title to a purchaser. This method is complex, but it can result in realizing most of the horse's value while retaining complete control over subsequent sales of the horse. A brief discussion of the roles of parties to a trust, the elements of a trust, and the types of trusts available elucidates this concept.

A "trust" is an intentionally created fiduciary relationship with regard to property in which the legal title is in the trustee, but the benefit of

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<sup>113</sup> *Id.*

ownership is in a beneficiary.<sup>114</sup> There are several different classifications for trusts, and the best type for a particular use is determined by the desired consequence by the settlor. The “settlor,” also known as the “trustor,” is the party who creates the fiduciary relationship by placing the horse into trust.<sup>115</sup> The “trustee” holds the legal title to the property,<sup>116</sup> and the beneficiary holds the equitable title to the property.<sup>117</sup> The property in the trust is known as the “trust res.”<sup>118</sup> A trustee is typically free from control by the settlor and the beneficiary, although some power can be retained through the terms of the trust instrument. Generally, the transfer of the res by the settlor to the trustee for the benefit of the beneficiary creates a trust.<sup>119</sup> A trust is therefore comprised of five elements: the settlor, the res, the transfer, the trustee, and the beneficiary.

The first element is the settlor. The settlor must be the owner of the property placed in trust or at least have the right to place the property in trust, must have the capacity to make the transfer, form the intent to create a trust, and must manifest an intention to make a trust.<sup>120</sup> The settlor may be a trustee or a beneficiary, but cannot be both the sole trustee and the sole beneficiary.<sup>121</sup> Also, the settlor can retain certain powers over the trust assets that were not allowed concerning common law gifts.<sup>122</sup>

The second and third elements are the res and the transfer. The res may be any interest in any type of property, so long as it is not unlawful or against public policy.<sup>123</sup> Therefore, the res may be real or personal, tangible or intangible, so long as it is in existence, separated, and assignable. The

<sup>114</sup> See ROBERT L. MENNELL & SHERRI L. BURR, *WILLS AND TRUSTS IN A NUTSHELL* 176 (4th ed. 2012).

<sup>115</sup> BLACK'S LAW DICTIONARY 1582 (10th ed. 2014) (defining “settlor” as “[a] person who makes a settlement of property; esp., one who sets up a trust”).

<sup>116</sup> BLACK'S LAW DICTIONARY 1748 (10th ed. 2014) (defining “trustee” as “[o]ne who stands in a fiduciary or confidential relation to another; esp., one who, having legal title to property, holds it in trust for the benefit of another and owes a fiduciary duty to that beneficiary”).

<sup>117</sup> BLACK'S LAW DICTIONARY 186 (10th ed. 2014) (defining “beneficiary” as “[a] person for whose benefit property is held in trust; esp., one designated to benefit from an appointment, disposition, or assignment (as in a will, insurance policy, etc.), or to receive something as a result of a legal arrangement or instrument”).

<sup>118</sup> BLACK'S LAW DICTIONARY 419 (10th ed. 2014) (defining “corpus” as “[t]he property for which a trustee is responsible; the trust principal . . . [a]lso termed . . . *trust res*”).

<sup>119</sup> See RESTATEMENT (THIRD) OF TRUSTS § 10 (2003).

<sup>120</sup> MENNELL & BURR, *supra* note 115, at 204.

<sup>121</sup> UNIF. TRUST CODE § 402(a)(5) (2010); see also MENNELL & BURR, *supra* note 115, at 204.

<sup>122</sup> MENNELL & BURR, *supra* note 115, at 205.

<sup>123</sup> RESTATEMENT (THIRD) OF TRUSTS § 40 (2003).

transfer can happen in one of two ways—by contract during the settlor’s lifetime or through a will at the time of settlor’s death.<sup>124</sup>

The fourth and fifth elements are the trustee and the beneficiary. The trustee can be any person or entity capable of taking or conveying legal title.<sup>125</sup> A trust can have more than one trustee, in which case the trustees are referred to as co-trustees. Co-trustees typically have full responsibility of the trust; however, the settlor may divide up the tasks and powers among the co-trustees at the time of trust creation.<sup>126</sup> The beneficiary can be any person or entity with the capacity to take and hold legal title to the trust property.<sup>127</sup> Usually, a person who lacks capacity to hold legal title to property may not be a trust beneficiary.<sup>128</sup>

Now that the roles of parties related to a trust are well defined, an overview of the different classifications for trusts is needed. A trust can be classified in several different ways. The first consideration with regard to a trust is whether it will be active or passive.<sup>129</sup> A passive trust is one in which the trustee has no duty except to transfer the property to the beneficiary.<sup>130</sup> An active trust is one in which the trustee must manage the trust based on the provisions of the trust instrument.<sup>131</sup> The next consideration is the degree of voluntariness behind the creation of the trust: implied, constructive, or express.<sup>132</sup> An express trust is one that is unequivocally and intentionally created and is what is needed in this Note. The third consideration is the method of creation. A trust can be created through a contract during the lifetime of the settlor, called an “inter vivos trust,” which also contains provisions regarding its revocability.<sup>133</sup> In the absence of a provision regarding the revocability, the trust is deemed revocable.<sup>134</sup> Also,

<sup>124</sup> UNIF. TRUST CODE § 401(a)(1) (2010).

<sup>125</sup> See RESTATEMENT (THIRD) OF TRUSTS §§ 32-33 (2003).

<sup>126</sup> See UNIF. TRUST CODE § 703 (2010); MENNELL & BURR, *supra* note 115, at 209-10.

<sup>127</sup> See RESTATEMENT (THIRD) OF TRUSTS § 43 (2003).

<sup>128</sup> *Id.*

<sup>129</sup> See UNIF. TRUST CODE § 402(a)(4) cmt. at 60 (2010); RESTATEMENT (THIRD) OF TRUSTS § 6(1)-(2) (2003).

<sup>130</sup> See RESTATEMENT (THIRD) OF TRUSTS § 6(1)-(2) (2003).

<sup>131</sup> See UNIF. TRUST CODE § 402(a)(4) cmt. at 60 (2010); RESTATEMENT (THIRD) OF TRUSTS § 6(1)-(2) (2003).

<sup>132</sup> MENNELL & BURR, *supra* note 115, at 239.

<sup>133</sup> *Id.* at 242.

<sup>134</sup> UNIF. TRUST CODE § 602(a) (2010).

“an inter vivos trust remains private and free from public scrutiny.”<sup>135</sup> A trust created through a will at the time of the settlor’s death is called a “testamentary trust.”<sup>136</sup> Unlike inter vivos trusts, testamentary trusts are not revocable and are a matter of public record.<sup>137</sup>

Having considered the parties to a trust, the elements of a trust, and the types of trusts, considering the duties and powers of the trustee is also vital. Typically, the trust instrument will define the powers, responsibilities, and limitations of the trustee.<sup>138</sup> However, there are Uniform Trust Code provisions dealing with both the general and specific powers in greater depth. Generally, a trustee may exercise the powers that a person usually has over their own property except when the powers are limited by the trust instrument.<sup>139</sup> Specifically, a trustee may acquire or sell property for cash or credit at public or private sale, unless prevented from doing so in the trust instrument.<sup>140</sup>

The best design for a trust that allows the owner of the horse to realize the value of the horse while retaining control over specific aspects of ownership is clear. An attorney for the owner of the horse should create an inter vivos trust by drafting a contract identifying the horse as the res, the future buyer as the sole beneficiary and a co-trustee, and the current owner of the horse as the settlor and a co-trustee. From there, the attorney should include a provision which delegates all duties and responsibilities of the trustee to the buyer except for the right to sell or lease the property, which would remain with the owner of the horse as a co-trustee. However, the attorney must be careful to not allow the settlor to retain so much control that it appears that he is shifting income to the beneficiary because then all income taxes may be assessed against him.

Using this method would have several distinct advantages and disadvantages. The primary advantage is that the horse owner would retain complete control over future sales of the horse, which would prevent the horse from being sold to a slaughterhouse. The primary disadvantage is that

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<sup>135</sup> MENNELL & BURR, *supra* note 115, at 242.

<sup>136</sup> *Id.*

<sup>137</sup> *Id.*

<sup>138</sup> UNIF. TRUST CODE § 103(18)-(19) (2010).

<sup>139</sup> UNIF. TRUST CODE § 815(2)(A) (2010).

<sup>140</sup> *See* UNIF. TRUST CODE § 815 (2010).

the encumbrance placed upon the horse through the trust instrument would make the horse a less desirable product in the market place. A lack of demand would reduce the selling price, thus preventing the horse owner from realizing the maximum value of the horse.

The implementation of this method is straightforward. If the horse were to be sold at auction, then the terms of the trust would be placed in the conditions of sale section of the pre-auction catalogue. The terms could then be placed in the acknowledgement of sale document signed by the buyer after the auction. An increased degree of flexibility could be achieved by stating that the terms in the conditions of sale section are not exhaustive and that the horse owner is willing to negotiate other unmentioned provisions. If the horse were to be sold through a direct sale, then the terms of the contract would simply need to be negotiated, as they would be in a normal contract. The only problem with this is that the buyer and the buyer's attorney would be aware of the most important concern of the owner of the horse and this would give them a stronger negotiating position and would result in a lower price. At auction, the market demand could still potentially drive the price up beyond what a direct sale purchaser is willing to pay.

### *C. Contracting for the Right of First Refusal*

The final proposed method of realizing the value of the horse while retaining control is to simply incorporate a contractual right of first refusal into the contracts generally used through the auctions or direct sales. This method is very simple and allows for maximum realization of value while retaining initial control over to whom the horse is subsequently sold. A right of first refusal simply means that the party who has the right of first refusal has the right to match any offer made to the other party, and if matched the other party must accept the party with the power's offer.<sup>141</sup> Typically, ownership groups use this type of provision when jointly purchasing a horse so that if any co-owner receives an offer for his share, then the other co-owners have a chance to purchase it.

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<sup>141</sup> BLACK'S LAW DICTIONARY 1521 (10th ed. 2014) (defining right of "first refusal" as "[a] potential buyer's contractual right to meet the terms of a third party's higher offer").

As with the other proposed methods, there are distinct advantages and disadvantages of this method. The primary advantage is that the owner does not have to encumber the asset to the point that it would become an unattractive product in the market place, thus allowing the seller to maximize the realization of the horse's value. Another advantage is that the original owner of the horse would have the opportunity to match any offer for the horse received by the initial buyer. The primary disadvantage is that the original owner would not retain ultimate control over the disposition because the offer may be too high for the party to match. Another disadvantage is that the provision would be extremely difficult to enforce against international purchasers who have no significant ties to the United States and therefore are essentially judgment proof.

The implementation of this method would be fairly simple. In event of an auction, an attorney would simply need place the provision into the conditions of sale in the pre-auction catalogue. The provision should look something like this:

The buyer shall not sell all or any portion of his interest in the horse except in compliance with this provision. In the event that the buyer receives an offer to purchase an interest in the horse which the buyer is willing to accept, the buyer shall notify the seller in writing, stating the name and address of the proposed purchaser, the complete terms of the offer, and shall attach to the notice a fully executed copy of a bill of sale, purchase and sale agreement or other written document evidencing a binding contract with the complete terms of the offer. The notice shall constitute an offer to the buyer to exercise the right of first refusal hereby granted on the same terms and conditions as are in the offer. The seller shall have ten days from receipt of the notice to notify buyer of the intent to exercise the right of first refusal. If the offer is accepted, the buyers shall sell the offered interest upon the terms and conditions contained in the offer. If the offer is not accepted by the seller, the buyer

desiring to sell may sell upon the terms and conditions contained in the offer.

In the event of a direct sale, the same clause should simply be incorporated into the written contract.

## V. CONCLUSION

Twelve years ago, Ferdinand, a Kentucky Derby champion, was sent to a slaughterhouse in Japan and had his life brutally taken from him. He was sent there because Ferdinand's owner no longer saw value in the horse. So, he tried to liquidate Ferdinand's remaining value anyway that he could. There was no attempt to contact Ferdinand's original owners before doing so, even though they may have been willing to match the slaughterhouse's offer and Ferdinand could live out his days on their farm.

The story of Ferdinand illustrates an important issue in the equine industry that usually goes without mention: the owner wants to capitalize on the value of the horse while maintaining a personal sense of security that the horse will be taken care of and will not be sent to slaughter. There are three proposed methods that would allow for the horse owner to accomplish this goal: borrowing against future earnings, creating a trust, and contracting for the right of first refusal at the time of sale. Each method has its own advantages and disadvantages, but there is one method that rises above the rest.

The best method to achieve the goal of realizing the value of and retaining control over the future interests of the horse would be to use a right of first refusal contractual provision. This method allows the original owner to maximize the value received for the horse at the initial sale because there is no significant encumbrance causing a reduction in the selling price. This method also allows the original owner to retain the opportunity to match any offer made to the current owner of the horse. The disadvantage to this method is that there is not complete control over who purchases the horse because the offer may be too high for the original owner to match. This method would also be difficult to enforce against



international purchasers who do not act in good faith. However, if the actual goal of the owner is to merely prevent the horse from being sent to slaughterhouses abroad, then a regulatory system could accomplish this. If there is legislation in place, then the original owner would gain the benefits of the contractual provision while avoiding the aforementioned disadvantages.

The regulatory system would not need to be complicated and could effectively accomplish the goal of keeping the horse from slaughter by instituting a permit system for international buyers and by implanting a global positioning satellite ("G.P.S.") chip into the horse. Using the G.P.S. chip would allow the original owner to monitor the location of the horse and its vital statistics. As for the permit system, any international citizen who seeks to purchase a horse in the United States would need to apply for a permit prior to buying the horse. If the G.P.S. indicates that the horse was killed or was living on a different farm from the purchaser, then the purchaser's right to obtain a permit would be suspended until he pays the contractual damages. After breaching once, a subsequent breach would result in a permanent loss of right to obtain the permit.

In conclusion, the best way for the owner of a horse to realize the value of the horse is through a contractual provision granting the owner the right of first refusal. This method would allow for the owner to maximize the selling price of the horse while creating a safeguard against the horse being sold directly to an international slaughterhouse.