



## Tropentag 2011 University of Bonn, October 5 - 7, 2011

Conference on International Research on Food Security, Natural  
Resource Management and Rural Development

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### Transaction costs arising from breaches of legal contracts - The case of judicial breaches of contracts of anticipated sale contracts of soybeans in Brazil

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#### Introduction

This article aims to demonstrate the transaction costs arising from breach of legal contracts, specifically the anticipated sale contracts of agricultural commodities in Brazil. The future sales contracts represent a significant portion of the sale of Brazilian agribusiness, and are indispensable means for funding farmers during planting. For purposes of defining the object, will be specifically studied the anticipated sale contract of soybeans, popularly known in Brazil as "sale contract of green soybeans". We demonstrate that the contract breaches made in court greatly encumber the Brazilian agribusiness, imposing worst trading conditions for future operations to farmers, mainly due to the loss of confidence.

From the perspective of New Institutional Economics and Economic Analysis of Law and Organizations is important to analyze the institutional environment as a guarantor of legal certainty, especially with regard to the influence of the judiciary in the market.

Zylbersztajn and Sztajn (2005) argue that the Economic Analysis of Law and Organizations, from the theory of New Institutional Economics, based on theoretical studies provided by Ronald Coase, Douglas North and Oliver Williamson, adopts the concept of bounded rationality, turning more flexible the established hypothesis that institutions are always progressing efficiently and explains why property rights arise and ways to inefficient allocation of economic resources.

Ronald Coase is the first to break with the vision of the firm as a function of producing goods and services, going to treat her in his 1937 article *The Nature of the Firm* as a nexus of contracts that aim at minimizing transaction costs. Coase inaugurates new way of studying the firm, focusing on internal organizational aspects and in the relationship with customers and suppliers.

Williamson (1985) advanced the theory building, when considering the firm as a complex of contracts which has as most important variables, the sum of transaction and production costs, the performance of the product or service, the sociocultural context in which transactions occur and the role of institutions and organizations.

According to Williamson (1996), transaction costs lead to the emergence of alternative ways of organizing production, which he calls governance in an analytical institutional set. Transaction

costs are costs classified as *ex-ante* (before) to prepare, negotiate and secure a deal, and the costs *ex-post* (after) of the adjustments and adaptations that arise when the execution of a contract is affected by failures, errors, omissions and unexpected changes. These are the costs required to operate the economic system.

According to North (1990), the institutions, understood as rules of the game of society, are both informal constraints (customs and traditions) and formal (legal and constitutional norms, etc.). The purpose of the institutions would therefore ensure order and reduce uncertainty in exchange.

To Zylbersztajn (1995), opportunism comes from the actions of individuals in their search for self-interest. An individual who has inside information about the reality of another agent may, on that basis, act opportunistically, taking advantage of the situation to gain more than he would gain in the case he ignore this fact.

For Rezende (2007), in relation to the case of soybean producers who break their contracts, this was due to the rising price of the product. So, farmers gained more at that time, but they had their reputation damaged in the following relationships with potential economic losses.

There is, therefore, that for the New Institutional Economics, court rulings on the breach of contracts can generate impacts on organizational strategies. The institutional environment can affect the transaction costs of organizations, particularly in its ability to provide formal or informal contracts. If the rules of the game, quoted by North (1990), are not clear to the agents, institutional environment will generate uncertainty, increasing transaction costs in the following operations and also elevating the importance of contractual safeguards and economic sanctions.

The modern Contract Law passes undeniable evolutionary process that will gradually be reflected in the jurisprudence, in the sense that the contract does not admit a more individualistic approach and restrictive, they should be viewed by its various nuances of law, mainly, but also social, economic and political.

The focus of the contract is no longer available as the existing link between the parties and fell over them as individuals guided by their subjectivity and also third parties who suffer the effects of the contractual relationship. Is the notion of the social function of the contract

From a more purist framing the contract should remain unchanged in its rules, untouchable by mere unilateral will of one of the contractors. This fact would take place by application of a traditional principle of *pacta sunt servanda*. This requirement gives the obligatory power to the contract under which it is required.

However, the review and subsequent judicial intervention in contracts is justified when there is a supervening fact to the agreement, unforeseen and unpredictable, changing completely the situation in which the contracting parties were. It must not, however, bring the Theory of Unpredictability of contracts to the courts to undermine the principle of obligation of the conventions, with the risk to make the contract an instrument without faith, without security. The theory cannot serve as the mainstay of bad payers.

Brazilian agriculture has reached its greatest period of growth with the formation of the National Rural Credit System (SNCR), starting in 1965. In subsequent years, grants have been made with great ease, allowing the producers and agribusinesses greater capitalization and integration. However, since the late '70s, this system has shown several problems of operationalization. Belik and Paulillo (2001) claim that a huge imbalance between the sources of fundraising and the demands raised by interested parties emerged at that time. Moreover, even from a productivist perspective, it was possible to prove the ineffectiveness of high amounts of resources to finance production. Not to speak of land and social distortions that were caused by discriminatory use of rural credit.

In 1980, total credit granted by SNCR has been reduced to an amount five times smaller than what had been consolidated in the previous decade. As a consequence, parallel and exclusive lines of funding began to be built around agricultural production chains. Since then, funding for several of these chains has come from parallel public agencies, sometimes exclusive, that offer linked resources.

In the 1990s, adopting a posture of liberal economic character, and in order to obtain the much desired economic stability, several mechanisms have been implemented with the goal of cleaning up the public accounts. Therefore, public funding, mainly for agriculture, they were meager and replaced gradually by private credit, originated from the market. Better organized sectors, such as soybeans, have succeeded in constructing support and financing mechanisms independently from public sector. The main alternative arrangement for the segment has become precisely the anticipated purchase of production through processing industries or traders, through anticipated sale contracts, where part of the production to be harvested in the next crop is purchased by a preset price fixed in advance, allowing the capitalization required for planting and maintenance of the crop.

## **Material and Methods**

In a first step, a profound literature review was carried out, linking law and economics. The second step was an analysis of judicial decisions regarding breaches of anticipated sale contracts of soybeans in Brazil. The main data about the monetary value involved in the breaches of anticipated sale contracts of soybeans in the seasons 2003/2004 and 2004/2005 was obtained from Rezende (2007).

## **Results and Discussion**

In the 2003/2004 season the Brazilian soybean producers sold their products in advance, via contract, an average of US\$ 10.00 per bag of 60 kg. However, at the time of product delivery, prices reached US\$ 17.00, corresponding to the time, to R\$ 54.00.

The significant variation between the value of contracts for future sales of soybeans and the price of the commodity upon delivery of the product created an opportunity for opportunist actions of several producers, who sought the support of the Judiciary for the breaking of contracts, thus relieved of the obligation assumed with buyers can sell their produce at better prices.

The producers' argument for contractual breaches was very similar: climate variation, such as excessive rainfall, pests (primarily rust) in the field, change the price of inputs applied at planting and lack of delivery of supplies in case of advance payment the buyer of inputs.

In the largest soybean-producing states of Brazil, such as Mato Grosso, Parana and Goiás State Courts of Justice as early as 2004, gave support to the farmers at first, allowing the breaks. From 2008, the Superior Court of Justice reformed such decisions, saying the reasons given by producers would not justify breaches. However, decisions of the superior court did not have major practical effects, because the breaks allowed by the state courts were now accomplished, leaving only the buyers the possibility of demanding compensation for damages resulting from breach of contracts.

The avalanche of lawsuits generated economic effects in the soybean market in subsequent years. In the year 2004 was noticed a significant reduction in the advances of funding, indicating an increase in transaction costs because of contractual breaches (MENDONÇA DE BARROS ET AL. APUD REZENDE, 2007).

Quantitative research carried out with soybean producers by Rezende (2007) demonstrated that it was perceived a 44% reduction in price-fixing agreements between 2003/2004 and 2004/2005.

The researcher advises that it is not possible to say whether the reduction in contract pricing is directly related to the contract breaches, but said there were indications that, given that the production of soy in Goiás, for example, rose 13.6% in those harvests.

In the same survey the farmers surveyed stated that since the 2004/2005 harvest, there was greater demand for guarantees for loans and expenses, of which 46% of them said that negotiations with the company became more difficult and 30% signed fewer anticipated sale contracts.

The data presented point to an influence of favorable decisions to contract breaches in the agribusiness market. Economic costs appeared or were increased in view of the uncertain environment created by the courts. Companies now had no more certainty about the application of the "game rules" and had even prevented the signing of new contracts. Considering that was maintained the need for funding of the producers, they were obliged to make use of more expensive sources of funds such as bank loans, which led to rising production costs and, finally, to loss of competitiveness of Brazilian agribusiness.

## **Conclusions and Outlook**

Brazil's agribusiness is one of the economic sectors most susceptible to the effects of judicial decisions, because it is also highly regulated in comparison to other areas like trade and services.

Due to the dwindling supply of public credit in recent decades, the agricultural sector was forced to create alternative sources of funding. One of the best options were the contracts arising from anticipated sale, especially for soybeans. It happens that opportunistic behavior of producers put the credibility of this type of business under question.

The breach of contract of anticipated sales of agricultural commodities permitted by the courts have created new transaction costs for these contracts, and still others that were already increased, which ultimately lead to an enhancement of production and a consequent loss of competitiveness of Brazilian agribusiness .

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