

Managing Contract and Counter-Party Risk in a Volatile Market

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Webinar Topics

Tactics to address counterparty risk in an era of price volatility.

Questions to ask, and actions to take, if a counterparty files a bankruptcy case.

Key provisions to include in grain and feed contracts to manage counterparty risk and reduce legal costs.

Importance of understanding a counterparty's organizational structure and limited liability companies.

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Current Contracting Challenges

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- **Price Volatility** = greater counterparty risk/bankruptcy
- **Changing legal structure of producer businesses**
- **Contract formation and contract performance**
- **Dispute Resolution/Contract enforcement**



Counterparty Risk

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- Risk of contract performance by other party,
- and
- Risk of collecting damages if other party unable or unwilling to perform.

Price Volatility

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- Need to know more about counterparty's legal and financial situation
- Price volatility = sudden death overtime for some counterparties



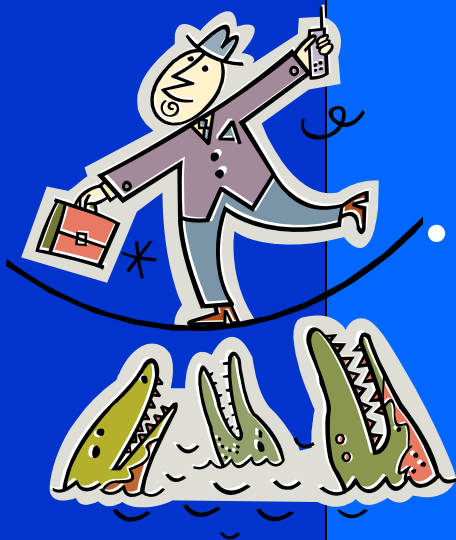
WATCH OUT: Increased use of limited liability companies (LLCs) by producers and others

Counterparty Bankruptcy

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- Risk of not getting paid for pre-bankruptcy deliveries
- Risk of paying back what you already have been paid for pre-bankruptcy deliveries
- Risk of not getting paid for post-bankruptcy deliveries to reorganizing parties

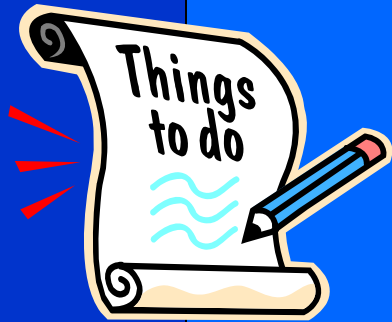


Bankruptcy Primer

- **Chapter 7 = Liquidation by Trustee**
- **Chapter 11 = Reorganization by business or individual: many turn into liquidations**
- **Chapter 12 = Family Farm Reorganization (debt limits)**
- **Chapter 13 = Individual Consumer Reorganization (debt limits)**

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Bankruptcy Counterparty Issues

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1. Did you receive payments from the debtor during the 90-day period prior to the bankruptcy filing?
2. Did you deliver grain to the debtor within 20 days of the bankruptcy filing?
3. Does the debtor owe you money?

Bankruptcy Preferences

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- Theory = prevent unequal treatment of creditors (*i.e.*, creditor is receiving more than it would in Chapter 7 liquidation)
- Presumption that payments received from the debtor within 90 days (one year to insiders) of bankruptcy filing are preferential transfers

Defenses to Preference Claims

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- **Not an antecedent debt**
- **New value given to the debtor**
- **Substantially contemporaneous exchange of new value**
- **Ordinary course of business**

More Defenses to Preference Claims

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- **Affixing of statutory lien**
- **Transfer involved “forward contract” as defined by Bankruptcy Code**
- **Amount sought is less than \$5,850**
- **Other defenses**

Preference Claim Extortion

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- Debtor may file bankruptcy in a distant jurisdiction (*e.g.*, U.S. Bankruptcy Court for District of Delaware)
- Incentive to pay something on preference claim even if you may have defenses because of cost of litigation
- If preference claim is less than \$11,725, you can force Trustee to sue in your jurisdiction

20-Day Claims

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- Goods delivered within 20 days of bankruptcy filing are eligible for allowance and payment as administrative claims
- Administrative claims get paid before any payments to general unsecured creditors
- Usually need to file motion for allowance as administrative claim (different than proof of claim)



20-Day Claims

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- **Reorganizing debtor will often agree to pay 20-day claims soon after filing in exchange for agreement to continue supplying goods to debtor post-petition**
- **Be careful when making deals with debtor to provide post-petition goods on credit – negotiate the deal and limit exposure**

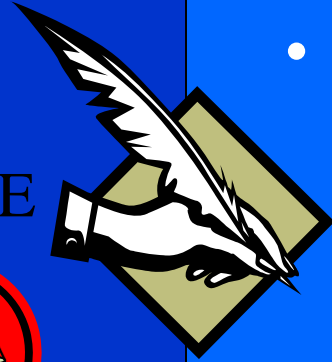
Reclamation Rights

- Seller has right to reclaim goods sold to the debtor while insolvent, within 45 days of the bankruptcy filing, if seller demands in writing reclamation of such goods –

(A) not later than **45** days after the date of receipt of such goods by the debtor; or

(B) not later than **20** days after the date of commencement of the case, if the 45-day period expires after the commencement of the case.

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Proofs of Claim

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- **General Rule = you need to file a proof of claim to get paid in a bankruptcy case**
- **Creditors who fail to file proofs of claim increase the percentage payout to those creditors who file proofs of claim**
- **Comply with court deadlines for filing proof of claim**

Bankruptcy Shark Repellant



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- Special Bankruptcy Code provision permits a “forward contract merchant” to make offsets against forward contracts – contract should contain provisions reserving these rights.
- This special right is available only to “forward contract merchants.”

Sample Grain Buyer Clause

The parties agree that Buyer shall have the right to cause liquidation, termination or acceleration of any or all Contracts because of (a) the insolvency or financial condition of the Seller, (b) the commencement of a case under Title 11 of the United States Code, (c) the appointment of or taking of possession by a trustee in a case under Title 11 of the United States Code or by a receiver or custodian before such commencement, (d) any and all other defaults of the terms and conditions specified herein either directly or by reference thereof. It is expressly agreed that each and every Contract entered into with Seller is subject to the Buyer's right to setoff any mutual debts and claims against Seller under or in connection with this Agreement, as well as any and all other grain contracts or forward contracts between the parties, as provided in 11 United States Code §§ 362(b)(6) and 556, and pursuant to any other contractual, common law or legal right of setoff available to Buyer.

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Commodity Contracts

Oral Agreement of the Parties



Written Evidence of Parties' Agreement

Industry Trade Rules (*e.g.*, NGFA)

Uniform Commercial Code

Other State or Federal Law

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Commodity Contracts

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- **Cooperatives = member agreements, bylaws, etc.**
- **Master Trading Agreements**



Enforceable Agreement

An enforceable contract is an agreement that a court or arbitration committee will enforce.

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Arbitration is Binding

“The standard for reviewing an arbitration award is one of the narrowest standards in all of American Jurisprudence.”

Farmers Crop Ins. Alliance v. Laux, 2006
U.S. Dist. LEXIS 14936 (S.D. Ohio March
31, 2006).

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NGFA® SAMPLE ARBITRATION CLAUSE

NGFA® ARBITRATION OF DISPUTES. The parties agree that the sole remedy for resolution of any and all disagreements or disputes arising under or related to this contract (including, but not limited to, any statutory or tort claims arising from the relationship between the parties) shall be through arbitration proceedings before the National Grain and Feed Association (NGFA) pursuant to the NGFA® Arbitration Rules. The decision and award determined through such arbitration shall be final and binding upon the parties. Judgment upon the arbitration award may be entered and enforced in any court having jurisdiction thereof. (Copies of the NGFA® Arbitration Rules are available from the National Grain and Feed Association, 1250 Eye Street, N.W., Suite 1003, Washington, D.C. 20005; Telephone: 202-289-0873; Website: <http://www.ngfa.org>). The parties agree that any arbitration conducted hereunder shall be governed by the Federal Arbitration Act, 9 United States Code §§ 1-16, as now existing or hereinafter amended.

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Arbitrate Everything

The parties agree that the sole remedy for resolution of any and all disagreements or disputes arising under or related to this contract (including, but not limited to, any statutory or tort claims arising from the relationship between the parties) shall be through arbitration proceedings before the National Grain and Feed Association (NGFA) pursuant to the NGFA® Arbitration Rules.

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COMMUNICATE

- **Clearly provide for NGFA arbitration of disputes in agreements and confirmations.**
- **Make NGFA rules available to producers:**
 - *Hard copies of NGFA rules at business locations**
 - *Links to NGFA rules on websites**

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Contracting &

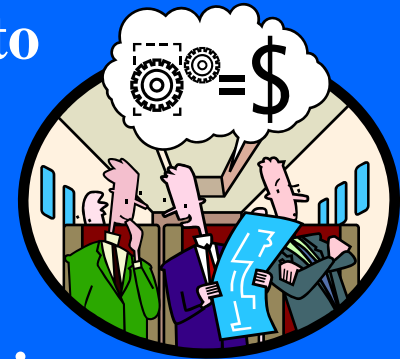
Contract Performance

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1. Have a **PLAN** for identifying with whom you do business and for monitoring those with whom you do business.

2. Have a **PLAN** for how you enter into contracts and how you monitor performance.



3. Have a **PLAN** for what you include in your contractual documents.



Who is your customer?

Know how the customer's business is organized:

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- **Sole Proprietor(s) -- husband and/or wife?**
- **Limited Liability Company? – who are members?**
- **Corporation?**
- **Partnership? – who are partners?**
- **Limited Partnership?**
- **Trust?**



WHO HAS AUTHORITY TO BIND CUSTOMER?

- **First, you have to know how counterparty's business is organized.**
- **Make sure you are contracting with the right entity and that you have clear evidence of the contact person's authority to enter into contracts, etc.**

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Limited Liability Companies

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- Hybrid entity – combines limited liability of corporations, but flexibility on how it is taxed (most elect partnership taxation treatment).
- Name of entity may include “LLC,” “Limited,” or “Ltd.”
- Owners are called members.

Limited Liability Companies

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- VERY IMPORTANT: Operating Agreement sets forth rights and obligations of members.
- Management of LLC can be exercised by members or by “managers” who act for entity.
- LLC could have officers, but does not have to have officers.

LLC IS DIFFERENT

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LLC Members

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- **Authority of members may be limited if “member-managed.”**
- **Less than all members may not be able to confess judgment against LLC.**
- **Less than all members may not be able to submit a claim or liability of the entity to arbitration.**

LLC Dangers

- **Members exceeding authority.**
- **Fraud on part of individual claiming to be sole member or claiming to have authority.**
- **LLCs are not corporations.**
- **The citizenship of an LLC is determined by the citizenship of its members and not the state of organization of the LLC.**

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FUNDAMENTALS

- You need to see the operating agreement.
- You need to know who is a member of the LLC.
- You need to know who has authority to act on behalf of the LLC.
- Do managers have full authority to bind the LLC to contracts?

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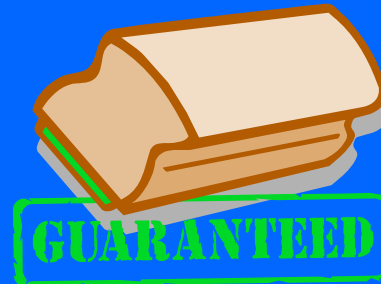


FUNDAMENTALS

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- Who are the managing members?
- You may want guarantees of an LLC's obligations from all of the members.



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LLC

- **You may want to see tax return of LLC – all multiple-member LLCs are required to file a tax return.**
- **You may want to require all LLCs and their members to execute a master agreement before engaging in business with you.**

LLC CERTIFICATE

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- **BEFORE DOING BUSINESS:** You may want to obtain certificate of action by members and/or managers of LLC authorizing the business relationship with you.

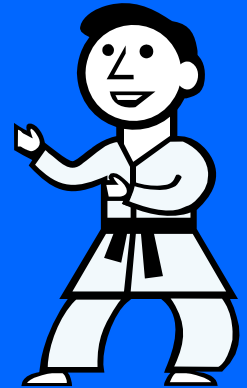
Creditors of LLC Member

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- **Judgment creditor of a member of a limited liability company has only the rights of an assignee of the membership interest.**
- **Assignee does not have right to become or to exercise any rights of a member.**
- **Assignee can only receive distributions when LLC decides to make distributions.**

Master Trading Agreement



- Document signed by customer before you enter into forward contracts – you make all later dealings subject to this signed agreement.
- Customer acknowledges that he/she/it is a “merchant” and bound by unsigned confirmations.
- Customer acknowledges that NGFA arbitration applies to dispute resolution.

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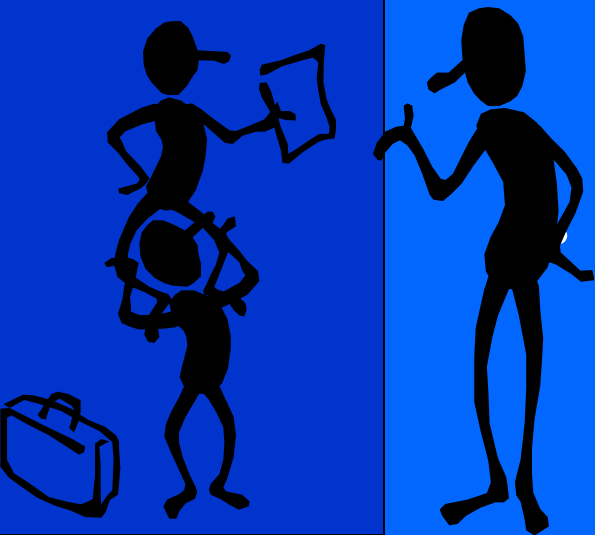
Master Trading Agreement

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- Counterparty discloses how business is organized and who has authority for the business.
- Counterparty agrees that you can demand assurances of performance and security if demanded.

Counterparty agrees to other terms that will govern all transactions such as offsets, etc.



Master Trading Agreement

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- Can require counterparty to provide financial information including financial statements.
- Can require guarantors of contract performance if uncertain about finances of counterparty.



Internal Risks

- **Contract Execution, Monitoring and Performance**
- **Hedging Costs, Margin Calls, Interest Expense**
- **More Likely That More Personnel Will Be Involved Between Start and End of Long-Term Contracts**
- **???**

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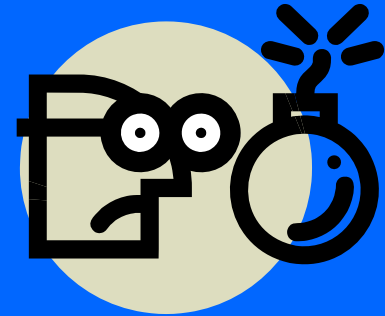


Contract Performance Issues

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Key is knowing when to pull the plug.



NGFA Grain Trade Rule 28 and NGFA Feed Trade Rule 19.

Both parties have duty to communicate.

DEFAULT can occur prior to shipment or delivery period.



Default

NGFA Trade Rules



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- **Exercise of due diligence required by both parties.**
- **Non-defaulting party required to notify the other party to complete the contract before taking action such as buy-in or cancellation.**

Performance Issues

Contract Terms – Do your contracts require counterparty to give assurances of performance?

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Example: Company may demand payment from Customer up to an amount equal to the difference between the contract price and the then prevailing market price for the contracted commodity. Customer shall provide such adequate assurance within 48 hours of the receipt of a demand from the Company.



Adequate Assurance of Performance Issues



When reasonable grounds for insecurity arise with respect to the performance of either party, the other may in writing demand adequate assurance of due performance and until he receives such assurance may if commercially reasonable suspend any performance for which he has not already received the agreed return.

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Repudiation

After receipt of a justified demand failure to provide within a reasonable time not exceeding thirty days such assurance of due performance as is adequate under the circumstances of the particular case is a repudiation of the contract.

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Performance Issues

NGFA Grain Trade Rule 28(A) = Seller's Failure to Perform

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Buyer has duty to act “at once” when it knows Seller is not going to perform on contract



Buyer's Choices on Default



Agree with Seller upon extension of the contract; or

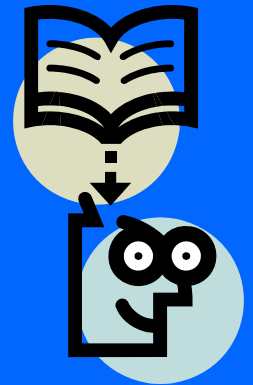
Buy-in for the account of the Seller, using due diligence, the defaulted portion of the contract; or

Cancel the defaulted portion of the contract at fair market value based on the close of the market the next business day.



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FOR MORE INFORMATION, CONTACT:

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