



# NGFA

# Newsletter<sup>®</sup>

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## NGFA Trade Rules and the 2012 Drought – Contracting and Delivery Issues –

The NGFA is receiving a high-volume of inquiries from the trade arising from concerns that prospective sellers who have entered into forward contracts may not produce sufficient quantities to meet delivery obligations.

In some cases, sellers may have contracted – or are considering contracting – to sell quantities of new crop corn or other commodities beyond what they know they will be able to deliver as a result of this year's drought. It also is being reported that in some situations, sellers are being encouraged to do so by unidentified "advisers." Allegedly, the anticipated theory of recovery is that when the sellers subsequently are unable to deliver, the sellers will be able to "buy-out" of the contract and collect the monetary difference from the buyers – based upon the assumption that market prices are lower than the contracted prices.

**CFTC Implications:** Parties engaging in transactions of this nature have reason to be concerned that they may be in violation of the Commodity Exchange Act. The Commodity Futures Trading Commission (CFTC) successfully has pursued court action against parties for entering into forward grain contracts for quantities that they lacked the ability to produce or otherwise did not intend to actually deliver upon. These CFTC actions have included instances where grain prices decreased, resulting in corresponding gains in short futures positions by grain buyers. That subsequently was followed by demands from sellers that buyers share their hedging grains with the sellers. In litigation of this type, the CFTC may seek return of the "ill-gotten gains, and impose" civil monetary penalties and permanent injunctions prohibiting the defendants from engaging in any commodity-related activity and from further trading, among other sanctions. *Parties with suspicions related to such potentially illegal off-exchange transactions are well-advised to consult with competent legal counsel.*

**NGFA Trade Rules:** In response to questions from the trade regarding how these issues might relate to contracting under the NGFA Trade Rules, it may be instructive to provide a reminder that these questions have been addressed to some extent by the NGFA through its various industry committees and rulemaking bodies.

- ▶ The situation of when a party breaches (e.g., fails to deliver upon) a contract – and then claims damages under the contract (presumably based upon shifts in market prices) against a non-breaching party – was specifically presented to the NGFA Trade Rules Committee in 2006. *[Under NGFA's Bylaws, the Trade Rules Committee is charged expressly with the duty to consider the Trade Rules, as well as proposals for changes or additions to the Trade Rules, and to report its recommendations to the NGFA Board of Directors and general membership for approval.]* When it considered the issue in 2006, the Trade Rules Committee determined that a defaulting party whose contract is canceled and closed out "in-the-money" was not entitled to claim any net monetary benefit from the cancellation under the NGFA Trade Rules. The committee also at that time determined that the rules' intent was sufficiently ascertainable as-is, so no changes to the rules were recommended at that time.
- ▶ However, the question continued to resurface over the ensuing years under various situations. For example, in 2008-09 the trade experienced a particular influx of claims against grain companies by sellers who had defaulted on contracts and subsequently claimed that, because market prices had declined, payment was due to the defaulting seller based upon buy-in and cancellation provisions in the NGFA Trade Rules.
- ▶ Consequently, in 2009 the Trade Rules Committee revisited the issue. It confirmed that the rules do not anticipate that a defaulting party retains the right to pursue claims for damages under the NGFA rules. But this time – based upon significant feedback and requests for clarification from the trade – the committee decided that clarification in the rules was warranted – with the NGFA's Country Elevator Committee, NGFA's Legal Council and others weighing in.
- ▶ The NGFA then appointed a special broad-based task force to review the issue further, including consideration of implications for the Trade Rules and Arbitration System. Participating in the various meetings, conference calls, and other communications that ensued

*(Continued on page 2)*



# From the Bench

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("Trade Rules" continued from page 1)

through 2010 were Trade Rules Committee members, in-house legal counsel and others representing more than a dozen NGFA-member companies. These discussions resulted in amendments to provisions of the Trade Rules that refer to liability and damages for contract defaults by buyers and sellers – NGFA Grain Trade Rule 28 [Failure to Perform] and the comparable provisions of the Feed Trade Rules, Barge Freight Trading Rules and Secondary Rail Freight Trading Rules – to clarify that these rules are **not** intended to provide for damages for the defaulting party to a contract. The pertinent section of each of these rules reads: *"This rule does not permit compensation to the defaulting party to a contract."*

► In formulating these amendments, the NGFA's task force and the various subcommittees assigned to each subset of the rules:

- Reviewed applicable trade practices, and confirmed that the proposed amendments were clarifications – not changes – to what already was considered to be trade custom and what was intended in the existing rules.
- Recognized potential confusion from the practice of canceling and *washing out* contracts without regard to fault by either party, but concluded that the proposed clarifications would not affect this practice and that parties could continue to mutually resolve the cancellation of contracts in any form they wished (i.e., that the rule clarification refers simply to the situation where the party in default is pursuing damages based upon the particular trade rule implicated, such as by filing an arbitration claim based upon Grain Trade Rule 28).
- Considered comparable rules-based approaches taken elsewhere, including other grain-based industry trade associations and the Uniform Commercial Code.

► **Importantly, the Trade Rules Committee and the specially-assigned task force also considered legal implications, noting that if a transactional framework provides that a party can default on delivery obligations and nonetheless recover gains based on market positions, it risks resembling an illegal off-exchange futures transaction.**

► The NGFA Board then voted unanimously to approve these amendments to NGFA's Trade Rules in March 2010. The amendments subsequently were ratified by the NGFA's membership during the annual business meeting in March 2011.

Importantly, the NGFA does not purport to advise or dictate to its members or others about application of the Trade Rules to their individual contractual arrangements. To the contrary, as expressly stated in the preamble of each subset of NGFA's Trade Rules: *"All Active members and other parties using these rules are free to agree upon any contractual provisions, which they deem appropriate, and these rules apply only to the extent that the parties to a contract have not altered the terms of these rules, or the contract is silent as to a matter dealt with by the pertinent rule."* Therefore, contracting parties are free to preclude or alter application of any or all of the provisions in NGFA's Trade Rules.

Further, the Trade Rules do not automatically apply in all situations. For example, as explained in NGFA Arbitration Rule 3(c), while the Trade Rules may be deemed to apply in transactions between NGFA members, they may be excluded or nullified by the express terms of the contract. Arbitration Rule 3(c) also provides the Trade Rules do not expressly govern in transactions between a NGFA member and a non-member unless the contract so stipulates.

The preceding information is provided simply to respond to the question of how the NGFA – through its committees and rulemaking bodies – have addressed this issue in the context of the NGFA Trade Rules.