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Managing Counterparty Risk

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INTRODUCTION

Agricultural producers operate in a risky environment, whether such risks are due to weather, markets, global economic performance, human factors or changes in technology. Effective risk management involves anticipating risks which may materialize and adversely affect production. Producers must constantly be assessing the probability such risks will materialize and the adverse consequences should they occur. Such planning does not eliminate all risk, but may reduce the adverse consequences which may result.

Not all producers are the same when assessing or assuming risk. Managing risk involves setting goals and objectives, identifying potential risks, and determining, valuating, selecting and implementing alternatives. Some producers are more willing to tolerate or withstand adverse conditions. Others are extremely cautious, avoiding as much risk as they can avoid. Risk management strategies are also affected by a producer's ability to bear risk. Risk bearing is, to a large degree, directly related to the solvency or liquidity of the producer's financial position.

While there are a host of risks faced by agricultural producers on a daily basis, the purpose of this fact sheet is to address counterparty risks and the potential ways in which agricultural producers can attempt to limit such risk and address nonperformance by the other parties to their contracts. "Counterparty risk" is the risk that the party on the other side of a contract will not perform the contract as agreed.

Losses from this risk may come without warning. And they may be significant. For example, Eastern Livestock Company was one of the largest cattle dealers in the United States before an involuntary bankruptcy petition was filed against it in December, 2010, resulting in millions of dollars of losses for cattle sellers, buyers and livestock dealers with which Eastern Livestock did business. The Eastern Livestock case clearly demonstrates how important it is to manage counterparty risk and how catastrophic the losses may be if not managed appropriately.

COUNTERPARTY RISK FOR AGRICULTURAL PRODUCERS

There are several types of risk that a producer should keep in mind when considering any contract. The nature of the risk may be somewhat different, however, depending upon the type of contract under consideration and the commodities to be produced or marketed under such contracts.

Agricultural producers are often a party to various supply or service agreements. Crop producers may enter into a supply contract for seed, fertilizer and chemicals in advance of the growing season. Livestock producers may enter into supply agreements for feed, or service agreements for veterinary services.

Producers may choose to sell their output on the spot market, or enter into forward contracts, or long-term marketing agreements. Each carries with it differing risks of nonperformance on the part of the counterparty. For a more extensive discussion of agricultural marketing agreements, see the fact sheet, *Agricultural Marketing Contracts*.

Producers may also be parties to agricultural production contracts either as a grower or as a processor/contractor. The counterparty risks associated with agricultural production contracts are different, depending upon which side of the contract the producer is situated. For a more extensive discussion of agricultural production contracts, see the fact sheet, *Agricultural Production Contracts*.

Counterparty risk will also be affected by the commodity which is the subject of the contact. For example, if perishable commodities are involved, the seller of such commodities may be provided protection by the Perishable Agricultural Commodities Act ("PACA"). If a contract relates to the production or sale of livestock, the Packers & Stockyards Act ("PSA") may be applicable. The Minnesota Wholesale Producers Dealers Act ("MWHPDA") law provides limited protection for the seller of perishable commodities, including milk and eggs.

IDENTIFYING AND MANAGING COUNTERPARTY RISKS

Supply/Service Contracts

The principal risk for producers raised by supply or service agreements is the risk the counterparty will not perform as agreed. The feed supplier may not deliver necessary feed as scheduled. Crop inputs may not be delivered in a timely manner. A supplier of services such as a veterinarian, electrician or other service provider may not perform under the contract.

If the contract is a supply contract for the purchase of goods by the producer, Minnesota law provides various remedies for the producer. The producer may be able to cancel the contract as a result of the seller's failure to perform. The producer may also be able to seek recovery of any excess costs incurred by obtaining a substitute supplier, subject to any provisions in the contract which limit the amount of such damages. The buyer will not likely be able to recover lost profits, however.

If the contract is a service contract, the remedies available to the producer will generally be determined by the terms of the contract.

In order to limit the potential impact of the failure of a supplier to perform, it is important for producers to do due diligence on all significant suppliers of goods and services. Comparing experiences with other producers may be helpful. Monitoring a supplier's performance is perhaps the best way to stay on top of its ability and willingness to perform in the future. If the producer reasonably feels there are potential issues with the supplier's ability to perform, it may be possible to demand adequate assurances of due performance of the contract. If the supplier does not provide such assurances, the buyer of goods from the supplier will be excused from performing under the contract. Finally, it may be possible to secure alternative or multiple sources of supply. Of course, this may carry with it increased costs if a single supplier cannot supply all of a producer's requirements for seed, fertilizer, chemical, feed, etc.

Marketing Agreements

In general, the risks presented by sales agreements in which payment is due at the time of delivery, or shortly thereafter, are significantly less than those presented by delayed payment or forward contracts. However, even cash sales present some risk. A buyer's check may be dishonored. A buyer may file bankruptcy before issuing a check. PACA, PSA and MWHPDA may provide some protection for cash sellers. All three statutes provide for a nonsegregated trust on the assets of covered persons to secure nonpayment of covered commodities. However, these protections are only available under PACA and MWHPDA for licensed dealers in the covered commodities. And the packer trust provided by PSA is only available for cash sales to packers. Sales to livestock dealers and brokers are not covered by the packer trust.

Minnesota law provides a seller of grain with a limited remedy for the breach of a cash grain sales contract by a buyer. Minnesota law provides a limited bond in the case of such sales. PACA, PSA and MWHPDA also provide for such bonds. However, the amounts of such bonds are often not sufficient to cover all loses sustained by producers when a buyer of agricultural commodities fails.

Should a buyer file bankruptcy shortly after receiving delivery of agricultural commodities, the Bankruptcy Code may provide some relief for a producer. A seller of goods who delivers such goods to a buyer in the ordinary course of the buyer's business within 20 days of the buyer's bankruptcy may be entitled to an administrative expense claim, ahead of unsecured creditors, for the value of the goods delivered. There are several issues raised by this provision, including when payment for such goods must be made. However, in general, the priority granted by the Bankruptcy Code for such creditors provides at least some protection for agricultural producers who meet the requirements.

If a longer term marketing agreement, deferred pricing agreement or forward contract is involved, the risks of nonpayment for the buyer are increased significantly. The trust provisions of PACA, PSA and MWHPDA will not protect a seller of goods who agrees to provide financing to its buyer by deferring the payment for such goods under the terms of such a contract. The bond provided by Minnesota law for sellers of grain will not cover voluntary extensions of credit. And the Bankruptcy Code provision for sellers of goods does not apply to any goods delivered more than 20 days prior to the filing of the bankruptcy petition.

It is also important to note that, once a buyer of goods acquires rights in the goods (generally upon delivery), any security interest granted by the buyer to its lender will likely attach to those goods. As a result, an unpaid seller of goods will not likely be able to assert a successful claim to the goods previously delivered to the buyer in order to recoup its losses.

Should a seller begin to reasonably believe that its buyer is experiencing financial stress, Minnesota law permits the seller to demand adequate assurances of future performance from the buyer. If the buyer cannot, or will not, provide such assurances, the seller is excused from performing under the contract. In addition, should a buyer fail to pay for one installment under the contract, the seller may be excused from making future deliveries and may even be entitled to stop goods in transit to the buyer.

Production Contracts

Counterparty risks for parties to production contracts depend upon which side of the contract a person is on. For growers, the most significant counterparty risk is the risk of nonpayment by the owner of the commodities. If a grower has made significant capital improvements (e.g., poultry barns or swine finishing facilities), an additional risk is that the owner of the animals will not keep the facilities fully occupied. For animal owners, the principal risk is that the grower in whose care the owners' animals have been placed is unable to continue to provide necessary and appropriate care. Because production contracts are generally not subject to extensive regulation by either the State of Minnesota or the federal government, the responsibilities and remedies for breaches of such contracts will generally be controlled by the terms of the contract.

The risks associated with nonpayment by a livestock owner for a contract grower have been largely addressed by Minnesota law. Under the law in Minnesota, contract growers are entitled to a "feeder's lien" which, if perfected by the filing of a financing statement, will have priority over that of the livestock owner's lender. Some contracts contain provisions which would subordinate this lien to that of the lender. The feeder's lien does not, however, provide protection for feed suppliers.

For livestock owners concerned about their growers' continued performance, it is important that the contract provide access to the grower's facilities, the right to inspect the facilities and animals on a regular basis, and provisions to address animal welfare, health and environmental issues on an expedited basis. Without such provisions, it may be necessary to obtain a court order to obtain access, causing delay which could be disastrous for the livestock owner. The contract should also permit the owner to terminate the contract upon short notice for such breaches.

COMMON RESPONSES TO COUNTERPARTY RISK

Regardless of the type of contract and the commodities produced under such contracts, there are several common approaches to managing counterparty risk.

Due Diligence

It is important that agricultural producers undertake due diligence before entering into a contract with someone other than their usual providers. Once a contract has been agreed upon, carefully monitor the counterparty's performance. Are they timely? Are they truthful? Do they follow through with their promises to take action? Do they try to "cut corners"?

Written Contracts

A written contract will always provide more certainty as to the terms of the relationship. Contracts should include the volume anticipated under the contract, price, payment terms, time of delivery, and any specific provisions to address risk. In addition, a well-drawn contract should include insurance requirements, a provision for notice of claims, any limitations on damages, and, if agreed upon, alternative dispute resolution measures.

Contract Enhancements

In the case of some contracts, it may be possible to obtain contract enhancements such as guaranties, letters of credit, or a bond. Such provisions are not common in most agricultural contracts, but may be used in the appropriate case.

Diversification

It is always a good idea to consider multiple sources of supply, services and outlets for your production. It is never good to concentrate all of your efforts or net worth with a single party.

Avoid Middlemen

If possible, it is advisable to avoid brokers, dealers and other middlemen. Adding additional parties to the chain of title or possession of agricultural commodities increases risks.

Accelerate Payment

If possible, sellers of agricultural commodities may want to seek to accelerate payments under the contract via wire transfers or ACH transactions.

Legal Remedies

All parties should be aware of their legal remedies in the event a counterparty to one of their contracts does not perform its obligations under the contract. It is often necessary to move very quickly to effectively exercise these remedies. As a result, it is important agricultural producers monitor counterparty performance and seek appropriate legal advice promptly when necessary to protect their rights.

For more information:
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