By Diana Klemme

Farm Marketing Recommendations: Risk or Reward for You?

Most elevators view buying grain as a competitive transaction with a farmer customer, not an advisory duty. Not everyone agrees. Address your basic business practices — avoiding disputes is the cheapest solution.

March 24, 2003 brought good news and bad news to the grain industry. A federal appellate court ruling that day on a Hedge to Arrive case could change the way you deal with farmers, continuing the fallout from 1996. (HTAs are cash grain contracts where a base futures reference price is fixed in the original contract but basis is set later.)

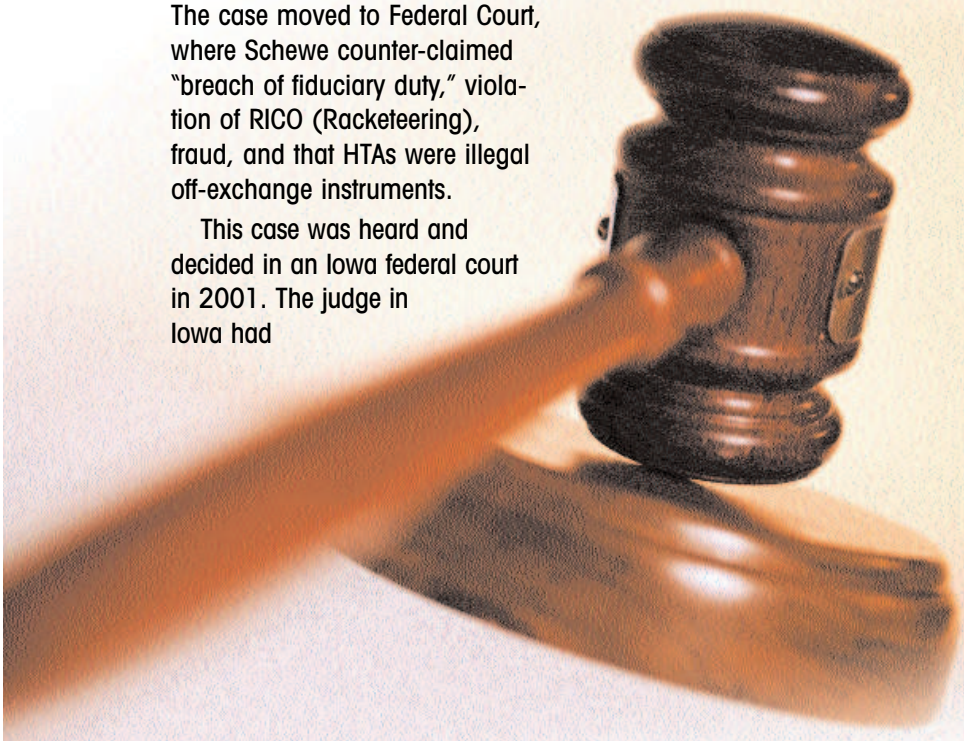
Case background:

Top of Iowa Cooperative filed suit in Iowa court in August 1996 against Farmer Schewe, alleging breach of contract of HTAs and seeking market-loss damages. The case moved to Federal Court, where Schewe counter-claimed "breach of fiduciary duty," violation of RICO (Racketeering), fraud, and that HTAs were illegal off-exchange instruments.

This case was heard and decided in an Iowa federal court in 2001. The judge in Iowa had ruled pretrial the HTAs in this case were valid cash-forward contracts. The jury subsequently ruled the farmer breached the contracts, and awarded $60,400 damages to the co-op. But the jury also ruled that Top of Iowa had a fiduciary duty to the farmer, and that Top of Iowa had breached fiduciary duty in dealing with Farmer Schewe, awarding Schewe $3,400. The case was appealed to the Eighth Circuit U.S. Court of Appeals.

The issue

The good news was that the Eighth Circuit appellate court affirmed in this case the farmer's duty to fulfill his HTA contracts. The damages for contract market loss were upheld for the elevator. Courts have generally upheld HTA contracts, so this part of the appellate ruling wasn't newsworthy.



The bad news was the appellate court upheld that the elevator was guilty of breach of fiduciary duty in dealing with the farmer and upheld the damages against the co-op.

Somewhat-good news was that the appellate court decision stated, *"While the district court admits it would have reached a different verdict on this issue (fiduciary duty), the district court did find a sufficient evidentiary basis for the jury's verdict."* The appellate judges also stated, *"and the district court was reluctant, as we are, to 'invade the jury's rightful province.'"* This seems to infer the courts simply couldn't find legal grounds to overturn the jury rather than agreeing the elevator had a fiduciary duty.

The appellate ruling stated the Top of Iowa jury heard about the experience and knowledge of the elevator manager and merchandiser but not whether the farmer matched that sophistication. The jury did hear that Top of Iowa *"was privy to more information*

about the volatility of the corn market and the risks of rolling HTAs." It is worth noting also that producers are considered merchants in Iowa, with the assumption they are in the business of selling grain and inferring a level of knowledge.

The Top of Iowa jury was instructed, *"It is a breach of fiduciary duty to fail to perform the duty to disclose all material facts in dealing with the other party to permit the other party to make an intelligent, knowing decision in such dealings."* The jury interpreted the evidence and the jury instructions and placed a fiduciary duty on the elevator. Apparently the co-op should have known what the corn market could or would do in 1996.

This is the first apparent appellate ruling upholding that an elevator has such a duty to producers, and it leaves the grain industry in a quandary.

The critical issue becomes how elevators should deal with farmers after this Eighth Circuit ruling. Elevators have traditionally viewed that despite elevator emphasis on customer service, buying grain is a competitive transaction with a farmer customer, not an advisory duty.

The fact that Top of Iowa only has to pay $3,400 in punitive damages is important; the co-op is not going to appeal the ruling due to the legal cost relative to the financial damages. But now the precedent stands and puts an undefined burden on elevators for dealings with farmers.

There is another case pending on appeal in the U.S. Eighth Circuit Court; however, that addresses the same issue. This case (ASA Brandt, Inc., vs. Farmers Coop, Wesley) involves nine farmers and another Iowa cooperative. In July 2001, the Brandt jury awarded these farmers *almost $1,250,000 in punitive damages for the co-op's breach of fiduciary duty*, but in this case the jury also awarded over $700,000 in punitive damages *to the farmers* on contract claims.

The appeal on the Brandt case is important because upholding for the farmers would strengthen the elevator's apparent fiduciary duty to producers. Overturning the jury's ruling in Brandt would potentially mean the elevator does not have a fiduciary duty, and would leave the industry with opposing rulings on the issue.

Background of the HTA litigation

Younger grain merchandisers and managers may have little background of the Hedge to Arrive disputes from the '90s. Battles arose across the country in 1996, primarily in the Midwest, over certain Hedge to Arrive cash grain contracts. A lot of farm meetings and producer magazine articles talked about HTAs and the strategy's value for farmers.

Corn futures rallied sharply in the late summer and fall of 1995 to over $3.00, a price farmers hadn't seen in years. Futures prices inverted, with Dec 1996 futures 40¢ to 70¢ below '95 crop futures. Interest soared in selling not only 1995 crop, but 1996 crop and beyond using HTAs based on nearby 1995 crop futures. The typical plan was to roll the HTA reference price forward later, expecting the inverses would have lessened or disappeared. Professional farm advisers, some elevator personnel, and even some university professors discussed how the 'average' old-crop/new-crop corn spread made such roll-over strategies attractive to the farmer.

But the fates were cruel that year. Demand continued strong, corn futures prices rose throughout the fall and winter, peaking in the summer of 1996 at over $5.00 July '96 futures. The inverses increased dramatically, both within old-crop and to December 1996 futures.

Farmers who rolled HTAs saw their earlier projected roll-over contract prices decline as corn futures soared and the inverses increased, fueling their frustration.

By May 1996, many farmers were voluntarily rolling to December 1996 or being pressed to do so by elevators eager to get out from under the staggering margin calls. (Some farmers had priced several years' crops at the lower prices.)

When the HTA situation peaked in the spring and summer of 1996, a lot of farmers repudiated their contracts and contacted lawyers.

Some elevators found their banks would no longer fund margin calls against the short futures hedges. Some farmers acknowledged their obligations and worked out long-term settlements. Some farmers insisted they were misled — that nobody told them of the rollover risks; some

simply repudiated the contracts, calling them "illegal off-exchange futures contracts." Other farmers hung on, betting the inverses would eventually break and their final roll-over price would improve. They were wrong.

A number of elevators were forced to merge or sell out; some only suffered huge financial losses through settlements. Some managers and merchandisers were dismissed and the grain industry learned bitter lessons.

Implications & suggestions

Top of Iowa sets a serious precedent and raises questions: "How can you work with farmers? What can you do and say? Worse, could you possibly be accused of breach of duty if you don't try to talk an unsophisticated farmer out of selling grain or out of using a particular strategy?"

Elevators have long worked informally with farm customers on grain marketing, through:

- farmer meetings,
- newsletters,
- one on one discussions, or
- casual conversations.

As a result of the Top of Iowa ruling, managers need to reassess how they originate grain.

Review basic practices

Customer service is still important, and I doubt anyone seriously expects managers and merchandisers will quit talking with farmers. But address your basic business practices:

- Review contract language; use clear understandable terms and phrases and include risk disclosure where appropriate. Avoiding disputes is the cheapest solution.
- Consider using a Master Agreement form that farmers review and sign, outlining terms, conditions, and risks, reducing the need for complete terms on each contract.
- Adhere to all Trade Rules if your contracts are subject to such rules.
- Provide grain marketing training for employees who talk with or buy grain from farmers.
- Document all materials used at farmer meetings or in mailings.
- Evaluate how you talk with farmers. Even casually speaking in absolutes could be misconstrued. *("Oh, this market's going lower for sure . . .")*
- Know your customer!

One key point from the Top of Iowa case is that a jury years from now may have to scrutinize the things you say and do today. Logic doesn't always rule in their deliberations, but think how a juror who is unfamiliar with grain trading might view the way you deal with farmers.

Second, being careful can be as important as being right. Lengthy litigation is extremely expensive, draining, and generates bitter feelings with your customers. ■