
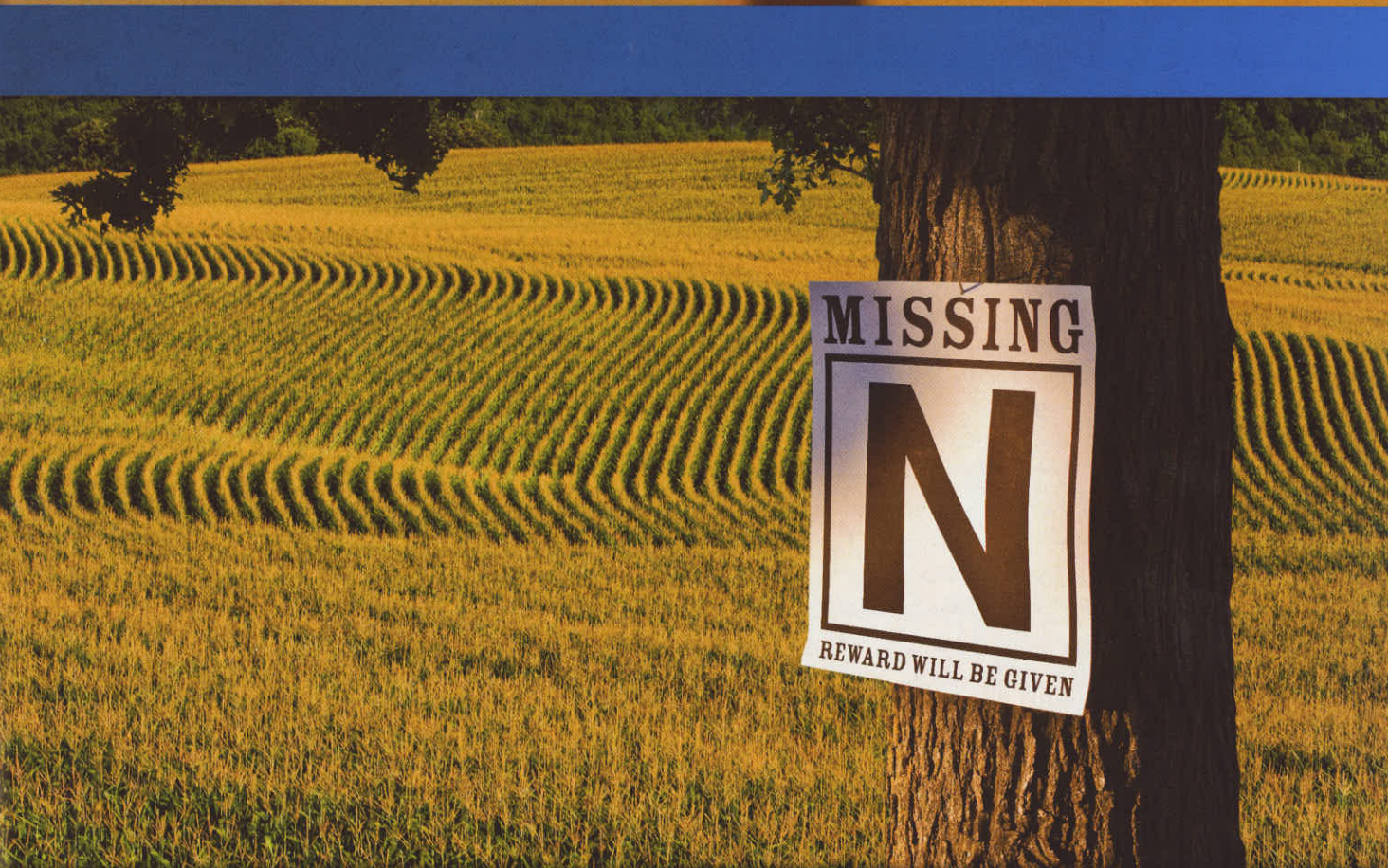


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AUGUST 2009

\$5.95 



FERTILIZER CONTRACTS AND COUNTERPARTY RISK

Retailers need to understand terminology and definitions before setting up contracts.

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The fertilizer industry has experienced significant price volatility over the past couple of years, with prices for certain fertilizers fluctuating by 50 percent or more between 2006 and 2009. Because fertilizer contracts are not traded on a common exchange and because fertilizer is a heavy, bulky commodity, local supply and demand issues can further lend to the volatility of prices.

Many agricultural contracts between retailers and farmers operate on handshake agreements, and fertilizer contracts are no exception. However, the fertilizer industry's recent price volatility has increased the retailer's risk of default by the farmer (who, in contract terms, is the "counterparty"), which in turn has increased the need for properly documenting contracts.

We are beginning with a short primer on some fundamental aspects of contract law and then discussing two key considerations that will enable retailers to maximize the enforceability and intent of fertilizer contracts—knowing the counterparty and properly documenting contracts of significance.

CONTRACT LAW BASICS

A first step in understanding proper contracting procedures is to develop a basic understanding of laws applicable to contracts. The primary source of contract law in the context of fertilizer sales is the Uniform Commercial Code (UCC), which has been adopted, with some variation, in all 50 states. A person can typically find the UCC, as adopted in his or her home state, on the Web site of the state legislature.

In addition to understanding what the applicable law is, it is important to understand the legal terminology associated with contracts. The agreement generally refers to the terms of the transaction that the parties expressly agreed to, either through their oral discussions or writings or through their mutual understanding of the transaction, as reflected by the usage of trade, course of performance or course of dealing. The

parties' contract includes the terms of the parties' agreement and goes further, incorporating terms by operation of law, such as terms regarding delivery and timing if those terms are not specifically addressed by the parties' agreement. Following entry into an oral agreement, one or both parties may send a confirmation.

KNOWING THE COUNTERPARTY

"Know your customer" may be one of the oldest clichés in business, but it is still one of the most important. In this context, knowing the counterparty to a contract means knowing:

- The party's full legal name and, if the party is an entity, the identity of the individuals with the power to bind the entity.
- The nature and scope of the person's/entity's business operations.

Retailer comfort, after a reasonable inquiry and assessment, with the risk of doing business with the person/entity, is key.

Understanding the counterparty's business organization, properly identifying the counterparty and conducting a financial assessment of the counterparty are essential.

BUSINESS ORGANIZATION OPTIONS

The first step in knowing your customer is to understand what types of business organization options are available to potential counterparties. Although the options vary by state, the primary entities are as follows:

- A sole proprietorship is a business that is owned and managed by one person. Sole proprietorships are often referred to as "doing business as" or "d/b/a." The owner is inseparable from the business, and the owner is personally liable for the debts of the business.
- A general partnership is an association of two or more persons to carry on as co-owners of a business for profit. A general partnership is a legal entity but does not require filing with the secretary of state. General partners have unlimited liability for debts of partnership,

regardless of which partner incurred the liability.

- A corporation is a legal entity with powers and liabilities independent of its stockholders (the owners). The corporation owns the corporate property, owes the corporate debt and is the debtor that gets sued or the creditor who sues. A corporation must file with the secretary of state and observe other formalities, such as having a board of directors and officers and conducting annual meetings.
- A limited partnership is an entity having one or more general partners and one or more limited partners. Limited partnerships must file with the secretary of state. The general partner(s) has unlimited liability for the debts of the limited partnership, but the limited partner(s) is not liable for the debts of the limited partnership.
- A limited liability company (LLC) is an unincorporated association having one or more members. The LLC form combines elements of both a corporation and a partnership. Like a corporation, owners of an LLC are not liable for the obligations of the business. Like a partnership, income and losses of the company flow through the company to the owners, avoiding double taxation. This type of entity is becoming increasingly popular because LLC members are not liable for debts and obligations incurred by the LLC.
- The limited liability partnership arose in response to laws authorizing the creation of the LLC. In a general partnership, individual partners are liable for the partnership's debts

and obligations, whereas the partners in a limited liability partnership are statutorily provided full-shield protection from partnership liabilities, debts and obligations.

IDENTIFYING AND FINANCIAL ASSESSMENT

Although it may seem obvious, it is important to clearly identify the counterparty to the contract. For example, if a retailer enters into a contract with Bob Smith, is it contracting with Bob Smith, Inc., Bob Smith individually, or Bob Smith Farms, LLC? The answer to this question is important because, as discussed above, it bears directly on who the retailer can look to for recovery if the counterparty defaults.

Where feasible, it is good practice to develop a master agreement for each customer that establishes the identity of the contracting party and the other terms of the parties' relationship. If no master agreement exists, it is advisable to be precise as to the legal name of the contracting parties when preparing contract documentation for each separate transaction.

Another important step in knowing your customer is assessing the financial condition of the counterparty and whether the counterparty can perform the contract. Based on the risk assessment, it may be advisable to consider other contracting practices, including obtaining personal guarantees for limited liability entities and obtaining financial information for contracts beyond a certain size.

PROPERLY DOCUMENTING THE CONTRACT

Many people incorrectly assume that for a contract to exist it must be in writing and be signed by both parties. In fact, a contract may be either written or oral. With respect to oral contracts, however, certain conditions must be met in order for the contract to be enforceable, and, in certain circumstances, it may be difficult to prove the existence of an oral contract without the existence of a written confirmation.

Written confirmations are common in fertilizer contracts among manufacturers, distributors and retailers, but it can sometimes be difficult for a retailer to determine when to obtain a written confirmation for a fertilizer contract with a grower. A starting point in making that determination is evaluating what sort of exposure the retailer can tolerate—that is, the dollar figure at which the retailer determines that it cannot withstand the loss. When the retailer enters into an oral fertilizer contract for an amount that exceeds that exposure, it would be advisable for the retailer to send a written confirmation to memorialize the deal.

Doing business on a handshake can be dangerous in the current environment. The considerations outlined should assist retailers in minimizing defaults or, if defaults occur, minimizing the impact of defaults on retailer businesses. **AG**

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