Nonconformity with Delivery Obligations Under NGFA Trade Rules

Tips to help avoid being long on disappointment

By Todd Langel

As anyone involved in the grain or feed ingredient business knows, managing the flow of commodities between producers, handlers and end users requires constant attention to ensure that the timing and quality of commodity deliveries meets customer expectations. Market volatility, thin margins, high working capital requirements, and constant efforts to reduce transaction costs translate into a system in which a single failed delivery can have devastating impacts on overall profitability. Properly managing these breakdowns can spell the difference between a bump in the road and a sizable financial blow.

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Types of failures

In plain terms, the failure of a party to perform its obligations in accordance with a contract is a breach. Quality and timing issues are likely two of the most common problems that cause breaches to arise in grain

and feed ingredient transactions. As in much of agriculture, market participants are often at the mercy of Mother Nature. Quality issues arising in the field, such as aflatoxin contamination or grain going out of condition while in storage or in transit can be compounded as truckloads are commingled to become unit trains or eventually barges. As the volume of batches or lots increase, so do transportation costs and the challenge and expense of locating replacement deliveries. Timing issues can wreak just as much havoc on both buyers and sellers, especially when receiving parties are short on inventory or have immediate plans to remarket the products to another buyer. Often these can result from harvest delays, weather challenges, rail and maritime transportation delays or the like.

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Breach by sellers or buyers under NGFA Grain Trade Rule 28

The Grain Trade Rules of the National Grain and Feed Association (NGFA) govern a large percentage of grain and feed ingredient contracts. NGFA Grain Trade Rule 28 sets forth specific provisions that govern nonperformance by Buyers and Sellers. Part 28(A) (titled "Seller's Non-Performance") imposes a duty on a breaching Seller to provide notice to the Buyer upon learning they cannot perform in accordance with the contract:

"If the Seller finds that he will not be able to complete a contract within the contract specifications, it shall be his duty at once to give notice of such fact to the Buyer by telephone and confirmed in writing. The Buyer shall then, at once elect to:

1) agree with the Seller upon an extension of the contract; or 2) buy in for the account of the Seller using due diligence, the defaulted portion

of the contract; or 3) cancel the defaulted portion of the contract at fair market value based on the close of the market the next business day."

This provision and others like it promotes a breaching party to inform its counterparty of the issue, and forces the nonbreaching party to quickly elect how it plans to handle the problem. The goal of the forced election to agree to extend, buy in or cancel at market is to help avoid situations where tough decisions aren't timely made, which can cause the unresolved issues to languish, subjecting both parties to undue burden and expense. Shortly after the notice is given, damages or cancellation charges can become a known quantity, hopefully avoiding a situation where a train or barge sits idle while the parties decide how to resolve the nonconformity.

If the breaching Seller fails to give notice that it will be unable to perform in accordance with the contract, that Seller remains at the mercy of the market until the contract is either performed or the Buyer becomes aware that the Seller will be unable to perform. Depending on the length of the contract, several months can elapse before a Buyer learns that his/her seller cannot perform. During that time, since the Seller did not give notice, the Seller is subject to adverse market price movements that can drastically increase the measure of damages. Once the buyer learns of the seller's inability to perform (which in legal terms is considered a repudiation, or a breach before the obligation is due), a duty arises on the part of the Buyer to elect one of the same three remedies: extend, buy in or cancel.

Breaches by buyers operate similarly, and the corresponding Grain Trade Rule 28(B) (titled "Buyer's Non-Performance") mirrors 28(A).

Avoiding mixed signals

Once a decision is made to declare a breach and choose a remedy under Rule 28, it is important that a non-breaching party's words and actions proceed in accordance with that remedy, and doesn't confuse them with other remedies. In other words, after giving notice of a breach and an election to cancel a contract at market value, a party should avoid discussions or communications that that party may agree to accept a later, damaged or otherwise nonconforming delivery. Occasionally, a party will send correspondence intending to declare a breach and cancelling a contract at

the close of the next day's market; shortly followed by another email seeking confirmation from the other party as to whether a cancellation is acceptable. These types of discussions, often over email, look less like elections of contract remedies, and more like invitations to bargain. In other words, actions that convey uncertainty following a "declaration" can undo any positive effects the declaration had. It is often advisable to determine the best response, make the declaration, and stick with it.

Acceptance of nonconformity, such as agreeing to load a late vessel or agreeing to a discount schedule in order to account for damaged grain, may extinguish the legal claims related to the failed performance. Acceptance "under protest," such as when a party declares it will "unload the train and seek damages for nonperformance later" has limited effectiveness here, absent an agreement by the parties that they will truly take up their issues later, because Grain Trade Rule 28 doesn't allow a combination of remedies. Further, attempts to tack on extra damages following delivery and payment are rarely enforced. Such efforts may be considered to be unilateral modifications of contract terms, which are prohibited by most contracts — one party cannot change the pricing term after the fact.

Having a plan in place

The best approach to managing a counterparty's less-than-stellar performance of a contract obligation depends greatly on your position in the trade and the type of nonperformance. Regardless of which side of a default you are on, the most valuable asset in managing default is flexibility. Being able to quickly divert nonconforming grain to an alternate market, or to quickly procure replacement grain from a trusted source can help to avoid costly rerouting of trains, trucks and barges.

As complications arise, it is advisable to involve your legal counsel in discussions at an early stage. The decisions you make upon learning of the breach may thwart your later efforts to collect damages for another party's failure to comply with a contract, or may bind you to damages if you are the breaching party. Strategic advice from counsel may also help address situations where a nonbreaching counterparty overreaches or seeks to gain an undue advantage as a result of the nonconformity. ▮