

Opinion

How to protect your forward price

By DAVID A. DOMINA

If the early pains of the new economic era teach producers nothing else, surely they have learned price protection means nothing if the buyer can't pay!

Right now, only farmers sell, deliver and lose control of indistinguishable commodity products before they are paid. What could be more dangerous than to drop a load of dollar bills into a big pile and hope yours will reappear someday?

The pain is already an all-too-familiar refrain. Corn is forward contracted, and the buyer is in bankruptcy in Delaware. The farmer learns a Delaware judge can force him to deliver at market price, not the protected price.

A cattle feeder hedges both corn and critters to protect price, but the banker is nervous when one moves against the other. Suddenly there is no money to meet a margin call.

A hog producer contracts feeder pigs from Canada, and the packer refuses them because the country of origin is in doubt.

Now what? How can the pain be avoided the next time? These are the questions that usher in the lawyers. So what can a producer do to provide some protection?

Assure payment?

Let's start with grain. Forward contracting or selling on the Chicago Board of Trade are classic hedges. Sell less than you have but sell enough to be sure you can pay the bills and feed the family. Sounds sensible. It takes care of the cash market's uncertainty. But what about the new risk of delayed sale — a risk absent from cash market transactions? Will the grain buyer be able to pay at delivery time?

Recent events brought reality to producers holding stamped out hedge positions. "Price protection" sales ignored the risk that the buyer would be insolvent and not perform. The producer suddenly realizes his "sale" was really an unsecured loan to the failed buyer. Unsecured loans are seldom worth much in bankruptcy.

Every farmer knows bankers won't make huge unsecured loans. Grain buyers know this, too. So, why not take a play from the banker's book? Why not make the buyer collateralize the promise to pay for the producer's grain?

Collateralize the promise

Every responsible purchaser of grain sold forward sells the grain on the board the same day it is purchased from the producer. This is the grain buyer's price protection strategy — to buy from the

producer and immediately sell on the board. Simple.

So, why doesn't the producer require the grain buyer to post collateral for the promise to pay? Doing so would be simple. The buyer can pledge proceeds of the board position to the producer. The grain buyer's position remains intact, its performance is assured and the producer is protected by collateral and knowledge that cash is coming to pay for the hedged crop.

Is there an impediment? The buyer's bank shouldn't object. It will know its customer's position is safe. The grain buyer isn't harmed since the profits (or losses) still come to pass from the transaction. Lenders for both producer and buyer avoid potential disaster if either the buyer or seller fail. Crop production is the risk; this is how it should be. The transaction does not have to involve the board beyond collateral notification. This occurs commonly between the grain buyer and the board now. Securities are routinely pledged as collateral. Why not commodities contracts?

Initially, grain buyers might resist. They may say, "We have a strong financial statement and are trustworthy. This is not necessary." But it is necessary. Not too long ago, similar words would have been expected from AIG, Farmer

Mac or Fannie May. The days of "trust me, I am rich and will be kind to you" are surely over!

Steps to protection?

The steps required to protect the sale price of grain and assure the buyer will pay the price upon delivery will vary. Generally, they will include:

- a written contract to deliver a quantity of grain, at a delivery time and price, with payment due on delivery

- a contract to sell the grain on the board by the grain buyer

- a security agreement, accompanied by confirmation of the grain buyer's sale order, containing an assignment of the sale position for collateral purposes and an agreement that the grain buyer will retain all benefits or detriments of margin requirements but keep the producer informed of compliance

- Uniform Commercial Code filing to protect the producer's rights, just as any creditor protects its rights where credit is extended through advances of funds or other value, including grain sale commitments

Producers who forward sell grain "loan" its value to the buyer. They must lock in price and protect the right to be paid. Bankers do. So must farmers.

Domina is an Omaha attorney who focuses his practice on agricultural issues.



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