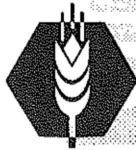

Arbitration Decision

National Grain and Feed Association

October 7, 1999

Arbitration Case Number 1839

Plaintiff: SunMark Ltd., Mansfield, Ohio

Defendant: Schumacher Farms Inc., *dba* Schumacher Grain, Shelby, Ohio

Statement of the Case

This case was initiated through a demand for arbitration filed on June 18, 1997 by SunMark Ltd. (SunMark)[1], Mansfield, Ohio, against Schumacher Farms Inc., *dba* Schumacher Grain (Schumacher)[2], Shelby, Ohio.

SunMark's allegations concerned numerous hedge-to-arrive (HTA) forward and basis contracts entered into between SunMark as buyer and Schumacher as seller. Schumacher, in turn, asserted various defenses and claims against SunMark.

Subsequent to submission by the parties of written arguments and materials[3], an oral hearing was conducted in Columbus, Ohio, on June 8, 1999, pursuant to Schumacher's request and in accordance with Section 8(f) of the NGFA Arbitration Rules.

SunMark's Claims. SunMark's claims were based upon the following:

- Twenty-three open hedge-to-arrive (HTA) corn contracts[4], totaling 705,000 bushels. Each of these contracts resulted in a "negative equity" position for Schumacher. Delivery dates were contractually provided for October/November 1995, January 1996 and October/November 1996.
- Two canceled HTA corn contracts[5], with open balances due, totaling 50,000 bushels. These contracts were for delivery during October/November 1996.
- Nine canceled HTA wheat contracts[6], with open balances due, totaling 50,000 bushels. These contracts were for delivery during July/August 1995 and July/August 1996.

SunMark alleged that Schumacher failed to perform on the 23 HTA corn contracts and failed to pay the amount due for market differences and cancellation fees on the two canceled HTA corn contracts and the nine canceled HTA wheat contracts entered into between January 1994 and February 1996. Although four of these contracts did not contain NGFA arbitration provisions, both parties, by agreement and pursuant to the order filed in the federal court litigation, agreed to submit these four contracts to this proceeding. SunMark

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[1] SunMark, an Ohio limited liability corporation, was and is a NGFA Active member.

[2] Schumacher, an Ohio corporation, is not a NGFA member.

[3] Schumacher initially failed to return the arbitration contract and an award of default was entered on Dec. 17, 1997, in favor of SunMark on part of its claims. The National Secretary, who administers the NGFA's Arbitration System, had found that four of the parties' contracts did not provide for NGFA arbitration. Prior to issuance of the default award, Schumacher had filed a lawsuit against SunMark in state court in Ohio, which was removed to federal court [*Schumacher Farms Inc. v. SunMark Ltd.*, Case No. 1:97CV-2945 (U.S. Dist. Ct., N.D. Ohio, Eastern Div.)]. The parties subsequently entered into an "agreed order" to stay the federal court action and to submit all claims to NGFA arbitration. Both parties stipulated in federal court that the initial default judgment should be set aside. The National Secretary did so based upon the parties' request. The case then proceeded on all of the claims asserted by both parties.

[4] Contract Nos. 1036, 1037, 1153, 1463, 2033, 2035, 2036, 2037, 2042, 2043, 2044, 2047, 2048, 2049, 2107, 2108, 2170, 2243, 2244, 453487, 462926, 455812 and 455815.

[5] Contract Nos. 1115 and 1250.

[6] Contract Nos. 870, 964, 1154, 1190, 1298, 1347, 1348, 2119 and 2571.

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alleged damages of $1,172,225 as a result of non-performance on all of the HTA contracts. SunMark acknowledged that Schumacher was entitled to a $221,897.01 reduction in the amount due, consisting of $171,897.01 that was owed to Shumacher by SunMark for 36 basis contracts (23 corn contracts[7] and 13 soybean[8] contracts) that were entered into and fulfilled between October 1996 and January 1997, as well as $50,000 that Schumacher paid against its "account" to SunMark in December 1996.

SunMark requested a net award of $950,327.99 for the market difference and cancellation fees associated with the 34 hedge-to-arrive contracts, plus interest at a rate of 10 percent, payable from Dec. 1, 1996. SunMark also requested all costs, expenses and attorney's fees associated with both the related court proceedings and this arbitration proceeding.

SunMark asserted that all of the hedge-to-arrive contracts entered into with Schumacher were valid and enforceable, and contained specific bushel requirements and specific delivery dates. SunMark[9] claimed that it entered into many different types of contracts over the years with Schumacher (including hedge-to-arrive contracts) and fully anticipated that Schumacher would fulfill its commitments. All of the contracts involved in this dispute, including the basis contracts that Schumacher delivered on, were at some time during the life of the contract rolled from one Chicago Board of Trade option month to another. Many of the contracts were rolled from one marketing year to the next. However, none of the contracts made specific reference to how many times they could be rolled. Most of the contracts had multiple options purchased and sold against them; some contracts had as many as 15 options trades attached to them over the life of the contract. Each contract change was documented and a copy was sent to Schumacher. An officer of Schumacher signed and returned to SunMark almost all of these changes, including all of the contract cancellations.

Schumacher's Claims. Schumacher asserted that its principals and officers thought the farming corporation was selling flat-price forward contracts and not HTA contracts – which they said they did not fully understand – and that the futures price referenced on the contract was the final contract price. It was Schumacher's position that it did not understand the contracts or the contract changes that SunMark sent out. Schumacher also asserted that it did not, at any time prior to receiving a bill from SunMark in January 1997, ever have any understanding of the negative equity position that it had accumulated.

Schumacher further asserted that SunMark breached its contractual obligation by refusing to continue rolling these HTA contracts to a deferred delivery position, which it alleged SunMark orally had promised to do. Schumacher asserted that this made the contracts null and void. Schumacher stated that many of these contracts were the result of exercised options that had been sold against other contracts. This resulted in HTA contracts far in excess of Schumacher's annual production of 200,000 bushels of corn. Consequently, Schumacher contended that the contracts were not legal excluded forward contracts under the Commodity Exchange Act because no risk disclosure was provided when the parties entered into the contracts. Thus, Schumacher argued that all of the HTA contracts that resulted from exercised options were null and void.

It was Schumacher's position that the payment of $50,000 made to SunMark in December 1996 was made to demonstrate Schumacher's "good faith," while Schumacher tried to convince SunMark that it was obligated to continue rolling these contracts forward as originally agreed to by both parties.

Schumacher sought an award of $221,879.01, plus interest and attorneys fees associated with these proceedings. This sum represented the $50,000 "good-faith" payment made to SunMark and the $171,897.01 that SunMark withheld for delivery of corn and soybeans against basis contracts between October 1996 and January 1997.

The Decision

The arbitrators concluded that the parties had entered into these contracts willingly and agreed upon the original terms and conditions. Thus, the arbitrators ruled that both parties were responsible for their respective contractual obligations. It was clear that all contracts entered into (except the four cited previously) clearly called for NGFA arbitration as the sole remedy for any and all disputes arising between the parties. The parties' subsequent agreement entered into as part of the federal court case provided the arbitrators with jurisdiction under Section 3(a)(2) of the NGFA Arbitration Rules to resolve all claims arising from the contracts at issue.

Through evaluation of the evidence provided by the parties, it was clear to the arbitrators that Schumacher was an ongoing business concern engaged in the production and sale of corn, soybeans and wheat as its main sources of revenue. The testimony of both parties firmly established that Schumacher had a long – up to 15-year – history of selling cash grain to SunMark. During most years, 90 percent or more of Schumacher's total production was sold to SunMark or its predecessor. Thus, the arbitrators found there was no reason for SunMark to believe that Schumacher would be entering into a contract for any purpose other than to deliver cash grain to SunMark's elevator.

It was apparent from the testimony that Schumacher was experienced in using many different types of grain contracts over the years, and had previously entered into and fulfilled

[7] Corn Contract Nos. 3302, 3303, 3304, 3305, 3306, 3307, 3308, 3309, 3312, 3313, 3314, 3315, 3316, 3317, 3318, 3319, 3320, 3321, 3322, 3323, 3324, 3441 and 3442. These contracts totaled 100,000 bushels.

[8] Soybean Contract Nos. 3241, 3269, 3270, 3271, 3272, 3273, 3274, 3275, 3276, 3277, 3278, 3281 and 3282. These contracts totaled 29,500 bushels.

[9] The evidence showed that SunMark was formed in September 1994 to operate an existing grain elevator facility operated by Countrymark Co-op. Schumacher was a Countrymark customer and continued to do business with SunMark when it began operating the facility.

HTA contracts with SunMark. The arbitrators also concluded from the evidence presented that Schumacher and its principals understood the practice and mechanics of "rolling" futures and basis contracts from one CBOT option month to the other. The basis contracts that Schumacher delivered on, and sought payment for, in this case all were rolled at least one time beyond the option month stated on the original contract and included confirmation of each and every change (roll). Schumacher also had used both forward cash contracts, as well as minimum price contracts, in previous years for grain that was delivered to SunMark.

In addition to having experience with the pricing formulas contained in such cash contracts, testimony by Schumacher's witnesses also revealed that the farm corporation had its own futures account and had sold calls before on the Chicago Mercantile Exchange. The arbitrators concluded that this evidence demonstrated that Schumacher and its principals possessed both knowledge and experience as to how the futures markets operate, and attested to Schumacher's own ability to trade options. Given these facts, the arbitrators found that Schumacher's contention that it did not understand the pricing formulas in the cash contracts was objectively unreasonable.

Next, the arbitrators determined that both parties voluntarily entered into the subject contracts with the sole intent of delivering/receiving the underlying physical commodity specified in each individual contract. The "TERMS AND CONDITIONS" of the parties' contracts also expressly provided[10] that "[t]he rules and regulations of the National Grain and Feed Association shall govern except as modified or limited herein, and both parties agree to bound thereby." Any discrepancy that may have existed between the parties on any single contract should have been addressed at the time pursuant to NGFA Grain Trade Rule 6(a), which provides as follows:

*"(a) **Confirmation**: It shall be the duty of both the Buyer and Seller, not later than the close of the business day following the date of the trade, to send a written confirmation, each to the other (the Buyer a confirmation of purchase, and the Seller a confirmation of sale), setting forth the specifications as agreed upon in the original articles of trade. Upon receipt of said confirmation, the parties thereto shall carefully check all specifications named therein and upon finding any differences, shall immediately notify the other party to the contract, by telephone and confirm by written communication, except in the case of differences of minor character, in which event, notice by written communication will suffice."*

When either party entering into a contract fails to comply with NGFA Grain Trade Rule 6(a), then the following provisions contained in Rule 6(c) control the outcome. This rule states as follows:

"(c) If either Buyer or Seller fails to send out confirmation, the confirmation sent out by the other party will be binding upon both in case of any dispute, unless confirming party has been immediately notified by nonconfirming party, as described in 6(a), of any disagreement with the confirmation received."

The ability to roll each HTA and the number of times each HTA could be rolled was not specifically addressed in any of the contracts. Therefore, any discrepancy that Schumacher had with the original contracts should have been addressed pursuant to the procedures set forth in NGFA Grain Trade Rule 6. Subsequent contract changes and/or amendments[11] generally are made pursuant to NGFA Grain Trade Rule 41, which provides that:

*"**Alteration of Contract:** The specifications of a contract cannot be altered or amended without the expressed consent of both the Buyer and the Seller. Any alteration mutually agreed upon between Buyer and Seller must be immediately confirmed by both in writing."*

Therefore, SunMark was bound only by the terms and conditions in the written contracts that Schumacher had agreed to, and was not bound by any oral agreements (real or otherwise) not stipulated in the contracts.

Nevertheless, the arbitrators did consider certain facts surrounding these contracts and the parties' past relationship as relevant to other matters discussed in further detail below.

The NGFA Trade Rules, if followed, generally assist parties in avoiding disputes of this magnitude between buyers and sellers. There were multiple opportunities for either party to these contracts to raise a dispute if they were not in agreement with the terms and conditions set forth. There were multiple changes to all of the contracts in this case and none of the changes were disputed by either party at the time they were made. If Schumacher had not understood any of the contracts or contract changes that its officers were signing and returning, sound business practice would have dictated that the contracts or contract changes be disputed at that time. At a minimum, Schumacher should have asked for a full explanation from SunMark of contractual matters and positions it allegedly misunderstood.

The excesses that were brought forward in this case in the written and oral testimony were very troubling to the arbitrators. It was clear that there had been a long-standing business relationship between these two entities. That relationship, until January 1997, appeared to have been mutually beneficial. It was unclear to the arbitrators why either party involved in this arbitration would choose to assume the magnitude of financial and counterparty risk that was involved in these contracts. The arbitrators, of course, have the advantage of

[10] While four of the contracts did not reference the NGFA rules, it is well established that the NGFA Trade Rules generally reflect recognized trade practices. Likewise, both parties agreed to submit those four additional contracts to NGFA arbitration. Thus, the arbitrators found that it was appropriate to apply the NGFA Trade Rules to all of the contracts.

[11] The arbitrators distinguished contract amendments from those situations arising under formula-based contracts that require further action. For example, a contract formula that requires "basis" to be set by a certain date obviously contemplates action by one or both parties to do so. Thus, an instruction (oral or written) or confirmation that sets the "basis" ordinarily would not be a contract amendment covered by Rule 41.

hindsight. The parties are left with the experience and consequences of the contractual bargains they made.

It appeared that both parties were obsessed with "beating" the market by using option premiums to enhance the price of grain that was sold. When market conditions turned against the position that had been established, the parties mutually accelerated this options strategy in an effort to improve a situation that was getting worse by the day. Moreover, the arbitrators concluded that **both parties** were in agreement and had a full understanding of each and every contract change that was made. Both parties undoubtedly were not fully cognizant of how the contractual bargain would in reality play out. Indeed, it appeared that both parties at times acted like two ostriches with their heads buried deep in the sand while a storm continued to swirl around them.

While there has been much controversy surrounding the use of a short call position in conjunction with cash forward contracts, the arbitrators concluded that the contracts presented in this dispute were legitimate cash forward contracts[12]. Both of the parties involved were well aware of commitments to deliver the physical commodity specified in the underlying contracts and the options' components of the transactions were inseparable from Schumacher's delivery obligations. The evidence showed that Schumacher recognized its commitments when it signed contract confirmations for the newly written HTA contracts.

The premiums received for selling the original call options were used to increase the sale price of Schumacher's original contracts. Since Schumacher received the benefit of selling the options, it also contractually bore the burden of delivering the cash grain associated with the exercise of these options. If Schumacher was not in agreement with the HTA contracts arising from the original options' position, it should have immediately addressed the issue with SunMark pursuant to NGFA Grain Trade Rule 6(a).

When SunMark entered into contracts of this volume with Schumacher, the grain company was acknowledging that it was willing to take delivery over an extended period of time. Testimony during this proceeding clearly showed that SunMark's representatives were in fact very familiar with the Schumacher farming enterprise. Therefore, SunMark knew that it could not expect delivery of grain in this volume within a time frame of two production years. SunMark should have expected to bear the costs associated with maintaining this type of position for an adequate amount of time to allow for the physical delivery of all contracted bushels.

Evidence presented in this case demonstrated that the time required for Schumacher to produce the amount of grain contracted would have been four production years. Thus, **both** SunMark and Schumacher should not have expected Schumacher to complete delivery of these contracts within the original delivery periods.

Therefore, the arbitrators found that both parties were at fault for their handling of these contracts. In doing so, the arbitrators were cognizant that the seller traditionally assumes the entire risk of delivering – within the stated period(s) – all of a commodity that has been contracted. The arbitrators did not disturb that assumption, but concluded that the evidence presented in this case justified taking into account the totality of the circumstances.

Consequently, the arbitrators concluded that SunMark should **not** be awarded prejudgment interest on its claim[13]. Nor should SunMark be entitled to any award of costs or attorney fees.

All of the claims and arguments of the parties were thoroughly reviewed and considered by the arbitrators, even if not addressed expressly in this written decision. Thus, this decision was intended to resolve all issues between the parties on the transactions at issue in this case.

The Award

Therefore, it was ordered that:

- SunMark Ltd. is awarded judgment against Schumacher Farms Inc., *dba* Schumacher Grain, in the amount of $950,327.99.
- Compound interest shall accrue on the judgment at the rate of 8 percent per annum from Oct. 1, 1999 until paid in full, **except that no interest shall be due if the judgment is satisfied in full on or before Jan. 1, 2000**.
- Costs for the oral hearing are set at $7,500, and are assessed against Schumacher, the party requesting the oral hearing. Schumacher is credited with the $7,500 deposit it previously paid.
- Each party is to pay its own costs and attorneys' fees.
- All other claims asserted or assertable by the parties in connection with the subject contracts are denied.

Submitted with the unanimous consent of the arbitrators, whose names are listed below:

Eric Perry, *Chairman*
Assistant Director of Ingredient Procurement
Murphy Family Farms
Rose Hill, N.C.

Rodney Christianson
Chief Executive Officer
South Dakota Soybean Processors
Volga, S.D.

James Whitaker
Vice President,
Grain Marketing Division
Southern States Cooperative
Richmond, Va.

[12] Schumacher, during the oral hearing, attempted to introduce additional evidence regarding contracts between SunMark and an entity – SchuFox – apparently also operated by Schumacher's principals. The arbitrators concluded that it was unnecessary to decide whether those contracts were admissible or enforceable because the record contained ample evidence that Schumacher subsequently entered into written contracts with SunMark for all of the contracts in dispute in this case. Thus, even if some of the ShuFox transactions addressed the same or similar contracts or issues, Schumacher and SunMark substituted the new contracts at issue in this case for the old ones involving ShuFox.

[13] This is a significant penalty to SunMark and a corresponding benefit to Schumacher. SunMark sought an award of interest at the rate of 10 percent per annum from Dec. 1, 1996. The prior default judgment award of $950,350 entered by the National Secretary would have accrued interest from June 18, 1997.