National Grain and Feed Association

Arbitration Decision

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March 24, 2011

Arbitration Case Number 2247

Plaintiff: **Schell and Kampeter Inc. d/b/a Diamond Pet Foods, Meta, Mo.**

Defendant: **Performance AG, LLC/Palmetto Grain Brokerage Inc. n/k/a Woods Holdings Inc., Ridgeland, S.C.**
Peoples Grain Company Inc., Hemingway, S.C.
Simpson Farms LLC, Manning, S.C.

Statement of the Case

On Dec. 16, 2005, Schell and Kampeter Inc. d/b/a Diamond Pet Foods ("Diamond") began receiving phone calls from veterinarians regarding dogs in ill health, which allegedly had been fed dog food originating from Diamond's plant in Gaston, South Carolina. Diamond estimated that the time frame of production of the pet food that potentially could have caused the illnesses was in the period from Sept. 1 through Dec. 12, 2005, and Diamond began recalling finished feed manufactured during that period. Subsequently, Diamond established a call center staffed with experts to attend to matters surrounding the recall.

Retained samples of pet food manufactured during the foregoing period were sent by Diamond to a third-party laboratory for analysis; the laboratory detected the presence of aflatoxin in the samples. In the process of locating the dog food and corn retained samples, Diamond stated it discovered that several retained samples were missing for various truckloads of corn received between Sept. 1 and Nov. 30, 2005.

A subsequent U.S. Food and Drug Administration ("FDA")/ South Carolina Department of Agriculture ("SCDA") investigation was performed on Dec. 21, 2005 to ascertain where the contaminant entered the pet food system. The outcome of this government investigation revealed that Diamond's quality control system had multiple process breakdowns that permitted aflatoxin to enter the pet food production stream. Following the investigation, there was one retained sample of corn identified with abnormally high levels of aflatoxin – 1,851 parts per billion (p.p.b.) – which resulted in Diamond taking action against its sole corn supplier, Performance Ag. During the interim period, Diamond, in conjunction with its insurance carrier, settled a class-action lawsuit with pet owners for dogs affected by the contaminated dog food and their consequential property losses.

The case of the plaintiff, Diamond, against the defendants, ("Performance Ag, et.al") entered into the South Carolina Court system on March 21, 2008, at which time the presiding judge, the Hon. Joseph F. Anderson, Jr., of the U.S. District Court for South Carolina, transferred all claims of the plaintiff against the defendants to binding arbitration before the National Grain and Feed Association ("NGFA"), and dismissed the U.S. District Court case based upon the consent of all parties to the action to transfer all claims between them to binding arbitration. Further, the Court ordered that the parties retained the right to present any claim they had made or could have made in the district court to the NGFA, and would be entitled to all rights and remedies that would be available in the district court and pursuant to South Carolina law in their case before the NGFA. The Court retained jurisdiction only "for all matters relating to this action after binding arbitration, including enforcement of any NGFA arbitration judgment rendered." Subsequent to issuance of the Court order, the parties each properly executed the NGFA Contract for Arbitration Services and agreed to comply with all NGFA Arbitration Rules. The only NGFA member involved in this case was the broker, Palmetto Grain ("Palmetto"). Performance Ag and Palmetto are controlled by the same principal.

The plaintiff's requested award in the district court case was "in an amount not to exceed $25,000,000," plus discretionary costs, court costs and any other costs associated with the case. In the arbitration proceedings that followed, the plaintiff requested damages of $16,225,000. In response, the defendants claimed the plaintiff was not entitled to recover any amount, and that the plaintiff was liable for expenses associated with the arbitration case, including attorneys' fees and other costs. In

addition, the parties agreed that Simpson Farms, LLC ("Simpson") would pay no more than $7,500 in arbitration fees, with payments to be made in reasonable periodic installments.

Diamond contended that corn delivered to its Gaston manufacturing plant by Performance Ag was the source of the aflatoxin in the dog food. It was noted that Performance Ag was the sole corn supplier to Diamond and that during the relationship between the parties, Performance Ag shipped approximately 1.9 million bushels of corn to Diamond. Diamond's practice was to use a sole supplier and to verbally contract grain without use of written confirmations. Diamond used the Performance Ag confirmation to generate a purchase order for its internal accounting system.

Contract Documentation

On or about Sept. 20 through Oct. 3, 2005, Performance Ag said it received a call from Diamond placing an order for 40,000 bushels of corn to be brokered by Palmetto. Consistent with prior transactions between the parties, Diamond did not send any written documentation to Performance Ag. Performance Ag could not produce the contract confirmation either; however, the broker, Palmetto, produced confirmation number 43817 dated Oct. 3, 2005. This confirmation stated:

- #2 Yellow Corn
- Destination Weights and Grades
- Maximum 20 PPB Aflatoxin
- Southeastern Scale of Discounts
- Maximum 15.5% Moisture
- No Live Insects

Also stated in this brokerage confirmation was the phrase, "SUBJECT TO THE TRADE RULES OF THE NATIONAL GRAIN AND FEED ASSOCIATION; ALL DISPUTES ARISING HEREUNDER ARE SUBJECT TO ARBITRATION BY THE NGFA PURSUANT TO THE NGFA'S ARBITRATION RULES" [Emphasis in original].

Performance Ag contracted the corn with People's Grain Co. ("People's") using Palmetto as the broker. Performance Ag used a confirmation of purchase #312 with People's. There was no confirmation available from People's to Performance Ag. Palmetto produced a confirmation #43522 between Performance Ag as the buyer and People's as the seller. The same verbiage as noted above on confirmation #43817 was present on confirmation #43522. People's shipped corn to Diamond from Simpson. No confirmation of the transaction between People's and Simpson was produced.

According to NGFA Grain Trade Rule 3(C):

> **Rule 3. Confirmation of Contracts**
>
> (C) When a trade is made through a broker, it shall be the duty of the broker to send a written confirmation not later than the close of the business day following the date of trade to each of the principals setting forth the specifications of the trade. Upon receipt of said confirmation, the parties shall carefully check all specifications therein, and upon finding any differences, shall immediately give notice to the other party to the contract and to the broker. **If either party fails to give such notice, the terms and specifications contained in the confirmation issued by the broker shall govern the contract.** *[Emphasis added.]*

The following table provides a matrix of the contract transactions for the incident:

Document	Buyer	Seller	Broker	Contract Date	Commodity	Bu Amt	Terms
Perf Ag Confirmation of Purchase #312	Performance Ag	People's Grain Co.	Palmetto	09/20/05	corn	50,000	NGFA Trade Rules to apply Destination Weights and Grades to Apply
Palmetto Brokerage Agreement #43522	Performance Ag	People's Grain Co.	Palmetto	09/20/05	#2 yc	50,000	Destination Weights & Grades Maximum 20 PBB Aflatoxin Southeastern Scale of Discounts Maximum 15.5% Moisture No Live Insects Seller's Option to Price NGFA Trade Rules and Arbitration Rules to apply
Palmetto Brokerage Agreement #43817	Diamond Pet Food PO#4797	Performance Ag	Palmetto	10/03/05	#2 yc	40,000	Destination Weights & Grades Maximum 20 PBB Aflatoxin Southeastern Scale of Discounts Maximum 15.5% Moisture No Live Insects Seller's Option to Price NGFA Trade Rules and Arbitration Rules to apply
Verbal Contract	People's Grain Co	Simpson Farms LL	none	n/a	corn	n/a	

Since neither Performance Ag nor Diamond could produce a written contract confirmation, the arbitrators concluded that the broker confirmation shall govern in this transaction. In addition, the arbitrators found that neither the plaintiff nor defendants had adequate controls present for the distribution or receipt of contract confirmation documentation. There was no evidence presented to the arbitrators that written documents were sent and/or received by either party. The plaintiff could not produce a purchase contract, and the defendants could not produce a sales contract. Therefore, pursuant to NGFA Grain Trade Rule 3(C), the arbitrators determined that the broker's confirmation shall govern.

Destination Weights and Grades

The broker's confirmation of the trade between Diamond and Performance Ag stated the terms of the contract as follows:

Destination Weights & Grades
Maximum 20 PBB Aflatoxin
Southeastern Scale of Discounts
Maximum 15.5% Moisture
No Live Insects
Seller's Option to Price
NGFA Trade Rules and Arbitration Rules to apply

Throughout this case, the interpretation of the term "destination weights and grades" was at issue between the plaintiff and defendants.

The corn was sold "destination weights and grades." In the testimony presented during written arguments and the oral hearing in this case, Diamond also stated that it retained the right to sample and test the corn at destination and could/would reject corn that did not meet Diamond's specifications or quality requirements. With respect to this matter, Diamond accepted the corn and subsequently manufactured pet food that was found to contain aflatoxin. The FDA investigated and found serious quality control deficiencies at the Gaston plant, with four of the incoming corn samples that the plant did retain from the recall period showing aflatoxin levels greater than 20 p.p.b., all of which had receiving paperwork marked as "negative" after the Afla-Cup test as shown in the following table:

Date Received	P.P.B. Aflatoxin
Sept. 16, 2005:	90
Oct. 10, 2005:	1,851
Oct. 31, 2005:	111
Nov. 21, 2005:	123

Corn from weight ticket G20213, dated Oct. 10, 2005, was tested by an independent laboratory and found to contain 1,851 p.p.b. aflatoxin. The foregoing retained sample had been under the complete control of Diamond for approximately 2½ months when the investigation began. The next day, dog food was manufactured at the facility that contained nearly 30 percent corn. The dog food that was manufactured had aflatoxin levels of 376 p.p.b. and 280 p.p.b., or roughly 30 percent of 1,851 p.p.b. Expert witnesses did not deny that aflatoxin could increase in storage, including in retention samples and grain stored in grain bins. At Diamond's Gaston plant, corn storage bins had two to three years of old moldy corn (5 to 6 truckloads) in the bottom. Further, Diamond added untested pet food fines (screenings) back into its pet food production, which may have resulted in additional aflatoxin being introduced. In addition, retained samples were not held in a controlled environment.

The arbitrators concluded that Diamond had complete control over the corn from the time Diamond accepted the corn at its facility and through production of the finished pet food product, including the opportunity for further testing of the product to detect aflatoxin during storage, production, packaging and otherwise prior to distribution. The arbitrators noted that written procedures were not followed; testing equipment either was not maintained or not properly utilized; testing procedures were not completed pursuant to specifications; documentation and sampling was either missing or it had not been conducted; and employees evidently were not supervised appropriately. These conditions existed because of Diamond's own actions and/or inaction.

Diamond claimed a specification sheet used for its sole supplier at a different Diamond plant in Meta, Mo., was sent to Performance Ag in 2002, when Diamond first contacted Performance Ag requesting that it be the sole corn supplier for the Gaston plant. Diamond, however, could not produce a document that specified Performance Ag as the supplier nor any proof this document was sent. Performance Ag contended it never received such a document, and corn specifications were provided verbally.

The term "destination weights and grades" as commonly and customarily used within the grain trade means that the seller is not entitled to payment until it delivers grain that the buyer accepts as conforming to the contract. The buyer has the obligation and absolute right to test, pursuant to its means and methods, for conformance of the grain to all quality and other specifications in the contract. In relevant part, NGFA Grain Trade Rule 6 states that, "Title, as well as risk of loss and/or damage, passes to the Buyer as follows….On delivered contracts: … By truck, upon arrival at the Buyer's final destination." Once the buyer accepts delivery, all risk of loss and responsibility for quality passes to the buyer. The buyer then assumes all ownership and risk after it accepts the goods received. Specifically, NGFA Grain Trade Rule 6, in relevant part, provides as follows:

> **Rule 6. Passing of Title as Well as Risk of Loss and/or Damage**
>
> Title, as well as risk of loss and/or damage, passes to the Buyer as follows: …
> (B) On delivered contracts:
> (1) By rail, when the conveyance is constructively placed or otherwise made available at the Buyer's original destination.

(2) By truck, upon arrival at the Buyer's final destination. *[Emphasis added.]*

Diamond contended that it had no knowledge it was trading based upon "destination weights and grades" and that it did not know what those terms meant. However, Diamond demanded the sole right of inspection and rejection in all of its contracts with grain suppliers. In fact, Diamond provided testimony that it had discussed Diamond's absolute right to reject and not pay for goods that did not meet Diamond's specifications with Performance Ag. Therefore, the arbitrators concluded that pursuant to both NGFA Grain Trade Rule 6(B)(2) and trade custom, Diamond retained absolute right to accept or reject any truckloads of corn, and perform whatever testing it deemed necessary.

Consideration of South Carolina Law

Diamond's contention, based upon expert testimony, was that there are no NGFA rules which address merchantability, product liability or warranty legal theories. It was also Diamond's contention that the NGFA should renounce jurisdiction, decline to hear the case and send it back to the South Carolina court because the issues presented were not provided for in the NGFA Trade Rules.

Contrary to Diamond's contention, the arbitrators found that this case was subject to NGFA Arbitration pursuant to the specific contract terms between the parties, the March 21, 2008 Order Dismissing Action and Transferring Claims to Arbitration issued by the U.S. District Court for the District of South Carolina ("Order"), and the consent of all parties to the transfer of all claims between the parties to binding arbitration before NGFA as reflected in that Order. It is important to note that NGFA Arbitration is not limited solely to disputes specifically involving the NGFA Trade Rules. As expressly provided in the NGFA Arbitration Rules, even in cases where NGFA Arbitration jurisdiction is deemed to apply – without having been established expressly by contract or court order as it was in this case – NGFA arbitration includes any dispute "involving the warehousing, processing, manufacturing, merchandising, financing, transportation, or distribution of grain or feed, or feed ingredients within or between the United States, Mexico or Canada…." (NGFA Arbitration Rule 3(a)(1)).

Further, NGFA Arbitration Rule 3(c) describes the circumstances under which the NGFA Trade Rules may or may not apply in a particular case depending upon the contract terms; this rule, cited below, demonstrates how it is not a prerequisite for NGFA Arbitration that the dispute be resolvable exclusively with reference to the NGFA Trade Rules:

> (c) **Rules of Contract Interpretation:** The following general rules of contract interpretation shall apply in NGFA arbitration cases:
> (1) In cases between NGFA Active members, the NGFA Trade Rules shall be deemed to apply unless expressly excluded or inconsistent with the express contractual terms governing a transaction;
> (2) Where the parties to a transaction have expressly provided for the trade rules of another association or group to apply to a transaction in lieu of the NGFA Trade Rules, then such terms shall be used to decide the case;
> (3) If a contract between a member and nonmember references NGFA Arbitration but does not also reference the NGFA Trade Rules, the NGFA Trade Rules do not expressly govern the transaction but they may reflect general customs and practices of the trade.
> (4) A general reference to NGFA rules shall be deemed to incorporate all rules of this Association including the Trade Rules and Arbitration Rules.

Diamond claimed that it was due contribution because Performance Ag supplied defective corn that did not conform to industry standards. By contrast, Performance Ag's claim was that if a reasonable inspection would have revealed the defect, then no recovery was available to Diamond. Pursuant to NGFA Grain Trade Rule 6(B)(2) and obligations arising out of trade custom and practice in conjunction with the term "destination weights and grades," the arbitrators concluded that the defect (aflatoxin) was detectable by Diamond with proper sampling and testing and, thus, Diamond alone was responsible for the defect.

Diamond also claimed recovery under strict liability and negligence. However, Diamond had the ability, control, experience and sophistication – as well as the obligation – to avoid its damages and to protect itself in the contract for this risk of loss in the purchase of the corn. Therefore, its remedy would be in contract, not in strict liability or negligence.

Diamond also claimed recovery as it allegedly was supplied a defective or adulterated product. The South Carolina Food and Cosmetic act contemplates good manufacturing processes as it relates to the use of raw agricultural commodities. This implies that Diamond had the responsibility as the manufacturer to ensure good quality products were being received and utilized, and Diamond's control of testing of inbound ingredients should have followed good manufacturing practices.

Finally, Diamond claimed recovery under the Uniform Commercial Code's implied warranty of merchantability. The arbitrators decided that this was not a valid claim, as the terms of the contract expressly excluded implied warranties when considered within the commercial context of the grain brokerage industry. When title and risk passed to Diamond, all warranties were excluded as outlined in NGFA Grain Trade Rule 6(B)(2).

The arbitrators complied with the Court's Order to consider application of claims based upon state law (including warranties, contribution among tortfeasors, property damage and personal injury), and provided the parties with the opportunity to present any and all claims and defenses. Further, the arbitrators did not deny to the parties availability of any rights or remedies.

The Decision

It was clear to the arbitrators that Diamond failed to consistently test for aflatoxin levels that may have been present in incoming corn it received; that it commingled incoming corn; used untested fines (screenings) for making pet food; and in general acted contrary to good manufacturing practices in the production of pet food.

Diamond could not prove the corn was the source of the aflatoxin levels in the finished dog food product or that the high aflatoxin levels were not the result of improper storage, preparation, packaging and/or other unsanitary conditions that clearly existed at its Gaston facility.

With regard to contract documentation, it was evident that Diamond and Performance Ag were negligent, and did not adequately prepare and distribute contract documents. However, per trade custom, a destination-weights-and-grades transaction shifts risk to the buyer after delivery and acceptance, and Diamond bore sole responsibility for the breakdown of its quality-control processes and system that may have averted use of the contaminated corn.

The arbitrators decided it important to note for the industry as a whole the importance of following proper contracting and documentation procedures, the absence of which may put individual companies at risk.

The Award

Therefore, it was ordered that:

No award be granted to Diamond.

Performance Ag shall pay to its Co-Defendants – Palmetto, People's and Simpson – the documented costs related to the progression of this case through the South Carolina courts and NGFA Arbitration, with total cost payment not to exceed $100,000 to each party individually and $300,000 in the aggregate.

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

Sharon Clark, *Chair*
Vice President
Perdue AgriBusiness Incorporated
Salisbury, Md.

John Augspurger
Manager, Feed Ingredient Merchandising
DeBruce Feed Ingredients
Kansas City, Mo.

Jack Smit
President
Furst-McNess Company
Ingersoll, Ontario, Canada