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A GUIDE TO SWINE MARKETING CONTRACTS

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A Guide to Swine Marketing Contracts

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I.

Economics of Swine Marketing Contracts

1. Introduction

The most recent survey on packer procurement and pricing methods done by Glenn Grimes and Ron Plain (University of Missouri) for the National Pork Producers Council reports that as of January 1999, 64 percent of market hogs were procured under non-spot market conditions. The spot market is defined as a negotiated price at the specific exchange time for the hogs. This level of contracting has raised issues of the economic performance of market contracts as well as the legal aspects of market contracts. Following is a general overview of long-term contracts and their implications.

2. Why Have Marketing Contracts Emerged?

A. *Packer Motivations*

(1) Supply Assurance

The hog industry exhibits large supply variability. This is evidenced by the cyclical nature of swine production as well as seasonal variation in production. Large scale U.S. packing plants face high short-term fixed costs. These can include labor costs as well as traditional overhead costs of facilities, depreciation, and interest. In an attempt to reduce exposure to the risk of supply shortages or capacity shortages, packers have an incentive to coordinate supply via forward scheduling of hogs for slaughter. A means to accomplish this has been marketing contracts.

(2) Quality Assurance

An additional and related factor is the narrowing of demands of quality characteristics for hogs. So far, this quality distribution has been defined by the lean/fat characteristics of hogs, but increasingly will focus on meat quality attributes such as color, water holding capacity of pork products, taste and tenderness. Requirements that producers be PQA III certified is one manifestation of this desire. In an effort to further insure quality specifications, packers have an incentive to pre-source hogs. Particular quality specifications have the effect of narrowing the effective supply of hogs to hogs which meet the particular standard, so packers try to "capture" this particular supply through forward contracts. Quantity and quality incentives are closely related as the relevant market is defined by the quantity of hogs within a specific quality type.

(3) Price Risk Shifting

Price variation has adverse effects on packer profitability just as it does for producers. It can disrupt cash flows and credit acquisition or costs. Hence, contracts may have pricing mechanisms which seek to reduce price variation. This can be beneficial for both packers and producers, but may have the undesirable consequence of disproportionately shifting risk from one party to the other.

(4) Regional Supply Changes

Investment in packing capacity is long-term. The Midwest has traditionally had the greatest share of packing capacity. Since the late 1980's and continuing into the 1990's, hog supplies in the Midwest have declined while they have increased in the Southeastern and Southwestern regions - outside the procurement range of most Midwest packers. Midwestern meat packers will often cite their desire to assist producers in their region remain viable by offering risk protecting market contracts which helped stimulate investment and reduced short-term cash flow risk exposure. This strategy is in the self interest of packers to maintain supplies in regions where they have large fixed investments.

B. *Grower Motivations*

(1) Price Risk Shifting

Since most contracts reduce market risk when compared with traditional marketing alternatives, the growers= income tends to be more stable over time. Of course, such income stability may result in the grower losing some market flexibility and potential for increased income. Reduced market risk may also allow the grower greater access to capital or preferred interest rates.

(2) Market Assurance

Growers may face the risk of not having a buyer for delivery or more likely in scheduling delivery times consistent with their production system. The latter can be particularly risky for growers with all-in-all-out production systems where delivery is more likely dictated by time rather than market weights. A market contract provides assurance that a specified quality and quantity of hogs may be delivered at scheduled times.

(3) Reduced Marketing Management

With multi-year marketing contracts, it is likely that time contributed to marketing management will be reduced as compared to using other market risk management strategies such as the futures market or short-term forward contracts. This can free time for production or other financial management activities which may have higher returns.

3. What Are The Various Types of Marketing Contracts?

A. *Futures Hedge*

Use of a futures hedge does not require the involvement of a packer. In a simple hedge, a hog producer would simply sell the lean hog futures contract nearest the date the hogs are expected to be delivered. This does not eliminate all future price risk as there is still basis risk. Basis is the difference between the cash price and the futures price. In general, the net price received by the producer will be lower if the basis widens (the difference between the cash and the futures price increases). Using futures hedges does not address market access issues, since it does not involve the packer. In addition, producers must be aware of the potential for margin calls if the futures price moves against their position (in this case if the futures price rises). In such a situation, the hedge is likely also locking the producer out of profitable price increases. Futures hedges should only be undertaken with the aid of a trusted broker and with support of your lender.

B. *Options Hedge*

The options hedge again involves the use of the futures market. However, in this case instead of selling the actual futures contract, the producer would buy the *right* to sell the futures contract (lean hogs) at a certain price. This would be a put option and the purchase price of the put option is the premium. Put options can be expensive, but the main advantage is that they protect against price declines but do not limit the upside potential if prices rise in the future. In addition, the premium (plus brokerage commissions) is all the put option will ever cost - there are no margin calls or other financial requirements. Again, market access is not addressed.

C. *Fixed Price*

These agreements determine the actual price hogs will be delivered in the future. Typically, these will be very short-term e.g. 1-2 months because as the length of time to delivery increases the risk of establishing a fixed price becomes greater. The exchange price offered is likely related to the futures market which allows the packer to hedge the risk of fixing a price. While this assures short-term plant access, it does little to assure long-term access.

D. *Fixed Basis*

As the name implies, the basis price is offered rather than the actual exchange price. The expectation is that the producer can then fix a price relative to the futures market plus or minus the basis difference. The producer may be given the option of never establishing the price if delivery at the going market price is advantageous. To utilize these agreements, producers must have access to basis data to determine if the basis figures offered are reasonable and acceptable. Fixed basis contracts may be offered over the life of futures contracts so they may extend slightly over a year. Plant access is assured only over the life of the agreement.

E. *Formula Price*

Formula prices are used as a mechanism to establish prices when large quantities of hogs are forward contracted with a packer and there is some concern about the ability to establish a price. The formula price is based off a "price determining market": one where there are enough buyers and sellers to effectively establish a price). Formula prices for example will be calculated as Iowa/S. Minnesota 47-49% lean hogs, plus or minus a price differential or premium based on market differences such as location or overall quality of hogs. Formula prices do not provide price protection as they will fluctuate along with the market they're based on. Formula pricing may or may not provide market access, however, in most cases the formula price mechanism is a result of contracting for quantities.

F. *Cost-Plus*

This is a formula price based on feed costs which comprise the greatest single cost of production. However, this price is also used to set a minimum price level, so that it is a risk protection contract in addition to quantity assurance and market access. These contracts may have a balancing clause where payments made to producers when market prices are below the contract floor price must be paid back when the contract base price exceeds the cost-plus formula price of the contract. Lengths of these contracts range from 4 to 7 years. Terms and expected behavior of cost-plus contracts will be described in more detail later.

G. *Price Window*

These contracts are very similar to the cost-plus contract other than the pricing mechanism. In general a ceiling and floor price are set. When a predetermined market hog price falls within the ceiling and the floor, the hogs are exchanged at the market price. When the market price falls above the ceiling or below the floor price, the packer and producer split the difference between the two prices. Other terms are fairly similar.

H. *Price Floor*

As implied by the terminology a price floor contract sets a minimum price. To compensate the packer for this protection, the producer places a portion of the hog price above predetermined ceiling levels in an account to carry through the low price periods. Hence, the producer draws on this account during low price periods. The performance of these contracts will resemble a long-term put option.

Of these contracting alternatives, the long-term packer-producer marketing agreements are relatively new. Futures markets and short-term forward pricing arrangements have a long track record, and it is unlikely their use in itself results in changes in the fundamental behavior of the pork market. Therefore, the remainder of this paper will address issues raised by the long-term marketing contracts.

Each contract is different, therefore, it is difficult to say which contract will perform the best because it depends on the producer and packer situation. However, the following illustration of price performance is useful for illustrating the expected pricing behavior of long-term contracts and raising issues related to their use. These are not exact contract payments. Assumptions about prices used, the time periods the contracts are in effect, and delivery scheduling can dramatically affect the results, so all estimates should be viewed as approximations.

Cost-Plus Contract Illustration

In this sample cost-plus method, the hog price is based on a formula including corn and soymeal prices plus a fixed payment, in this case $5/cwt. The formula price sets a minimum value paid, but if the market price of hogs is above the minimum price, the producer and the packer split the difference. Any carcass quality premiums are calculated in addition to the cost-plus formula price. In this particular case, the contract also includes a “ledger account.” As the cost-plus price paid exceeds the market price, the difference is accounted for and credited to the producer. As the market price exceeds the cost-plus price, the difference is credited to the packer. Expectations are that over the term of the contract and with the existence of hog cycles, the ledger account balance will be close to zero at the end of the 5-7 year contract term. It is intended to be a “self-liquidating” loan. In this particular contract, the account is not interest bearing. However, in other versions, interest may be charged or

accrued on the account balance. If either the packer or producer has a positive account balance at the end of the contract term, the provision is that the contract may be extended or the account balance can be repaid by the credited party. In addition to pricing provisions, market contracts will often include financial monitoring provisions, exclusive or right of first refusal on all the producer's hogs, quality specifications for hogs and possibly feeding and genetics programs. Figure 1 shows the price behavior assuming this contract were in place over the long run, with the price simulation beginning in 1984 and continuing to March 1, 1999. As shown by the average prices, the difference over this 13 plus year period is only $2.58/cwt. This shows, why expectations over the long run would be for there to be only a negligible ledger account. Also, simply looking at the variability of the cash and the contract price, it is clear that the contract smooths prices and reduces the likelihood of negative cash flows for the producer. The differences in prices can be thought of as the risk premium for reducing risk. Figure 2 shows the case where the contract was instigated January 1, 1995 and remains in effect until March 1, 1999. This represents an approximation of the time period many of the current contracts have been in effect. The contract payout and the cash payout are reversed from the longer-term illustration in Figure 1. The cash payout over this period is $2.26/cwt. lower than the contract payout. In this particular contract, the difference in payout will be maintained by the producer as a ledger account - it theoretically would be self- liquidating as cash prices rose in the future to compensate for the differential.

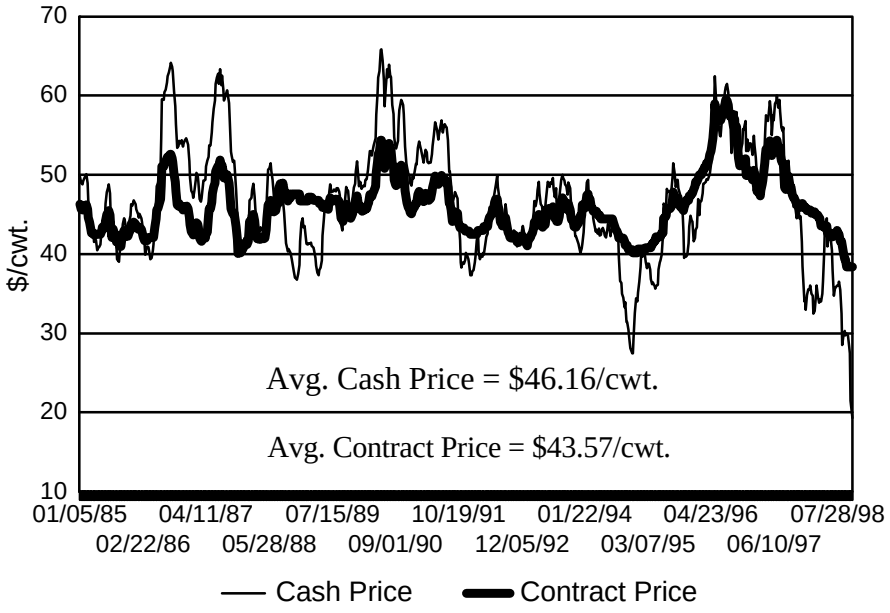

Figure 1. Long-Term Performance of Cost-Plus Contract

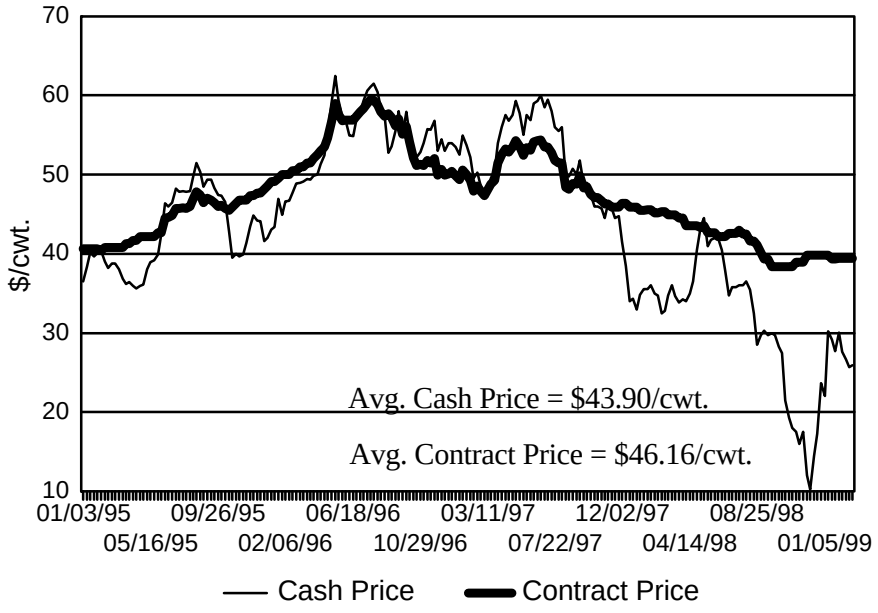

Figure 2. Cost-Plus Contract Performance, 1995 - March 1999.

Figure 3 shows the ledger account over the period 1995 - March 1, 1999. The value of the ledger account is in terms of dollars per hundred pounds sold in a particular week. As of the fourth quarter of 1997, the ledger account was zero. The ledger began to increase rapidly as hog markets collapsed in 1998 and into 1999. The total amount will depend on the number of head sold and the weight at which they are sold. A producer who markets 100 head per week would have a ledger balance of $703.25/cwt.* 2.5 cwt. * 100 head = $175,750. The way to interpret this level is to say "over the remaining term of the contract, the producer price received under the contract must sum to $703.25/cwt. lower than the market price." To simplify, this is saying that the market price would need to be $2/cwt. higher than the contracted price for 351 weeks for the ledger to be settled. If the same average contract price is assumed in the future (in other words crop prices remain relatively unchanged), market hog prices would need to average $50/cwt. for 201 consecutive weeks (almost 4 years) for the ledger to be settled.

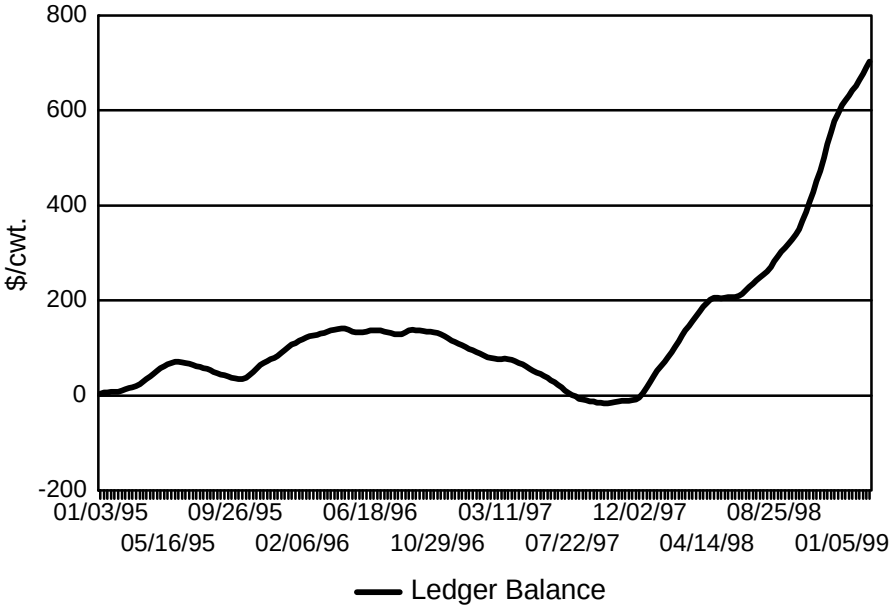

Figure 3. Cost-Plus Contract Ledger Account, 1995 - March 1999

Some contracts have specified credit limits, at which point the packer essentially begins paying the market price for hogs or the producer begins to pay down the account. The reason for the limit is clear considering what can happen to the packer in this situation. If a 12,000 head per day slaughter plant has 20 percent of their hogs contracted, then the amount the packer has outstanding would be (assuming a 5 day slaughter) 12,000 head * 20% * 5 days * $703.25/cwt. * cwt. =***$21,037,500***. This illustrates how the volumes contracted by the packer can quickly create a highly leveraged position for the plant. This would not necessarily mean the packer is unprofitable, depending on overall wholesale pork margins and operating costs. However, it represents a lost opportunity for profits and likely harms their relative competitiveness. If history is an indication, these large ledger accounts will be self-liquidating loans. However, if underlying market conditions change, it raises the possibility these loans will not self-liquidate.

Evolutionary Changes in Cost-Plus Contracts

Original cost-plus contracts were first observed in 1994. Since that time, modifications have emerged, both from within firms and across firms. Including interest costs on ledger accounts was largely a feature of second generation contracts. Similarly, as ledger accounts have increased in total value contracts have sought to create secured interest in the producers'

operations and the payment terms have also been restructured. Figure 4 provides an illustration of the payment terms of a descendent of the above contract.

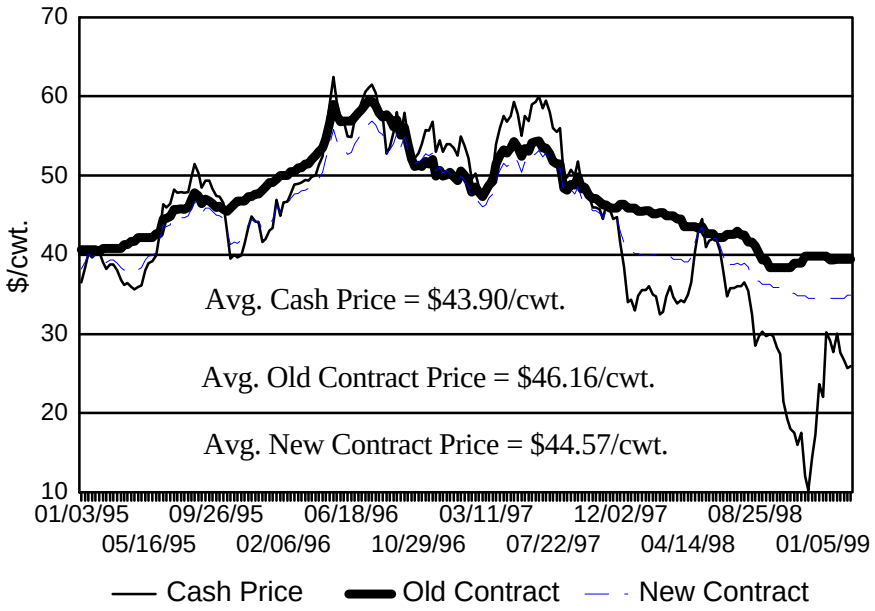

Figure 4. Illustration of Cost-Plus Contract Evolution.

In this case, the price paid under the new contract is lower than the original contract price. This improves the chances that the ledger account will be recovered over the life of the new contract. However, it's interesting to note that it is still above the recent historical cash market hog price. Producer's under the old contract may or may not have the option to renew under the new payment.

Window Contract Illustration

The window pricing method relies solely on a hog market price rather than the cost matrix to set its exchange price. It sets an upper and lower bound (window) for the price and if the market price is within the bounds, that's the price at which the hogs are exchanged; if the price is outside the bounds, the packer and producer split the difference between the nearest bound and the market price. In this case the upper price bound was $47/cwt. and the lower price level was $41/cwt. and there was no ledger account - the producer or packer simply accepts the losses or gains. Figure 5 shows the simulated results only for the 1995 through March 1, 1999 period rather than historically. For the period analyzed the market and contract price have tracked each other closely, as expected. This contract does not offer as

much protection as does the cost-plus contract, but still mitigates some of the market price fluctuations.

Floor Price Contract Illustration

This particular contract sets a guaranteed floor price of $40/cwt. to be paid to the producer. However, a producer must put $0.50/cwt. into an account with the packer when market prices go above $45/cwt and must put $1/cwt. into an account with the packer when the market price exceeds $48/cwt. Thus, the packer is essentially maintaining a savings account which the producer draws on when prices are low. The balance in the account may be positive in which case the packer owes the producer, or negative in which case the producer owes the packer. The contract length is five years and is renewable if the balance remains. Figure 6 illustrates the behavior of this contract over the period January 1995 through March 1999. This contract has also paid out well relative to market conditions because of recently very low hog prices. However, recently the ledger account has turned negative (Figure 7) so that the packer is essentially loaning money to the producer. This situation is very similar to what has happened with the ledger account for the cost-plus contract.

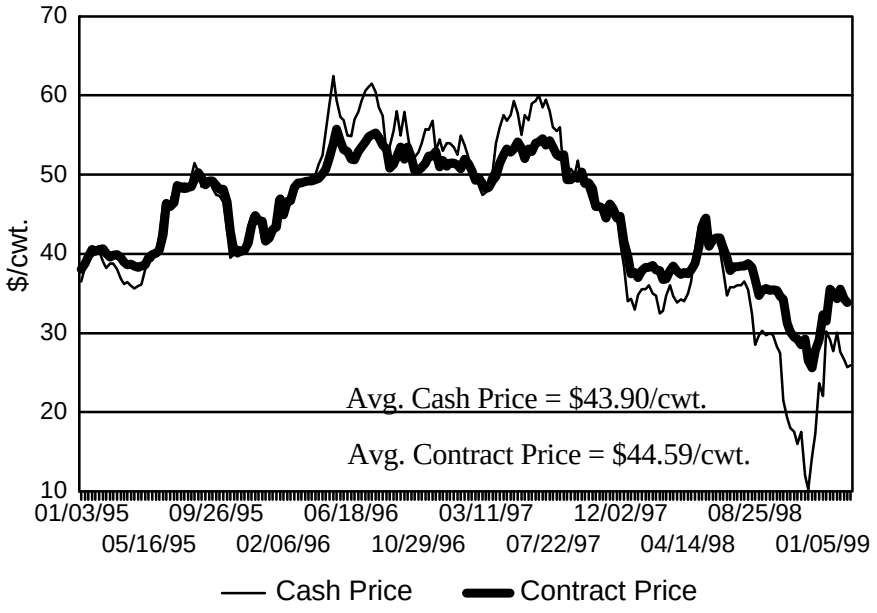

Figure 5. Window Contract Illustration, 1995 - March 1999

Figure 6. Floor Contract Illustration, 1995 - March 1999

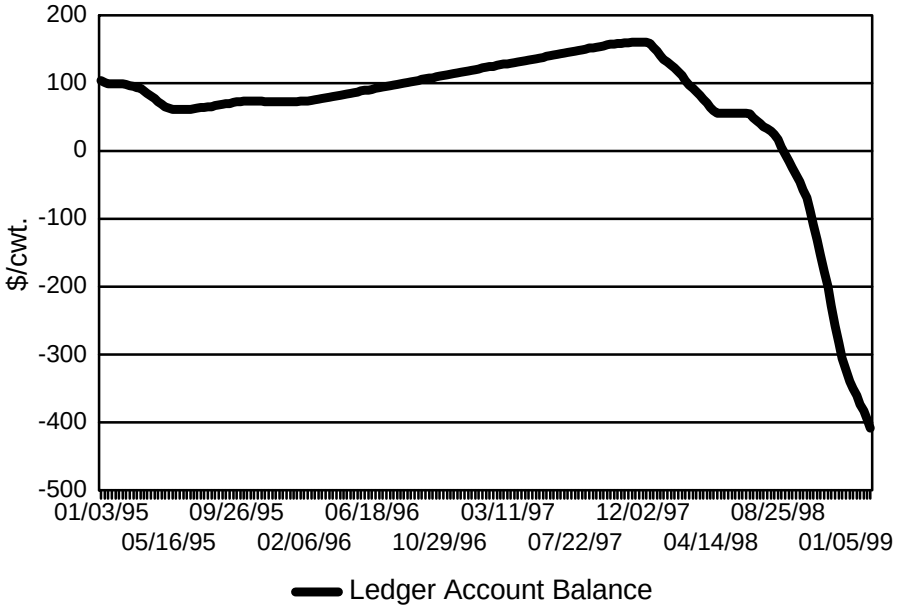

Figure 7. Floor Contract Ledger Account, 1995 - March 1999

Summary of Long-Term Contract Performance

Although each of the long-term contracts is different in its mechanism, they all essentially reduce price risk for producers. With the ledger accounts, it's clear that the intention is to achieve a long-term price level near the market average. However, in the short run there can be significant risk shifting and balances accrued. All market contracts closely track market prices which means the main advantage is that they will amount to cash flow assistance — smoothing out the highs and the lows of hog prices. However, producers could achieve this themselves through other mechanisms such as the futures market. It is clear that, from an incentive standpoint, producers enter these contracts for market access considerations as well.

Contingencies of Long-Term Market Agreements

As part of assessing any contractual agreement it is useful to consider contingencies and how they're handled as part of the contract. These "what if?" exercises are valuable for trying to understand whether they are acceptable for the intended objective. Following is a series of brief considerations in long-term agreements.

What if the Packer's Quality Premium Schedule Changes? In the contracts reviewed, this has no direct bearing on the actual base price performance of the contract. Carcass quality premiums are added to the contracted payout which is independent of the quality premium. However, producers in Minnesota have several packers to choose from. Since a producer entering a contract is obligated to deliver hogs over the term of the contract, an unfavorable quality premium change by the packer the producer contracts with would make it more appealing to deliver to other packers who have not changed their quality premium. So, by locking in with a particular packer, it does limit the producer's marketing options and ability to make changes as appropriate.

What if the Packer's Base Price Changes? This will directly affect the underlying price paid under the contract and will also likely affect the value of the ledger account. This possibility is written into some of the contracts as an option of the packer. However, in some cases, the base price increased while the quality premium grid declined. Hence, the net price received may not have changed. As in all circumstances it is very difficult to determine prices paid without actually marketing hogs under alternative pricing systems. Again, with captive producers under contract, it limits their ability to market to other packers if these underlying pricing elements change.

What if the Packer or Producer Ceases Operations? In most cases, the contract itself provides for this eventuality and the contract is void. It is not clear from the contracts reviewed that the same circumstance holds for producers who cease operation. In particular, it is sometimes not clear what would happen if the producer had a disease outbreak and were unable to deliver. Although "Acts of God" will not incur liability, disease may be a special

case because it is at least partially related to managerial practices and presents a moral hazard problem. That is, if the contract were not performing to a producers satisfaction, the producer may be more careless about biosecurity and other health practices, resulting in or contributing to a disease outbreak.

What are the Implications of Large Ledger Accounts? A commonly asked question recently has been: "Aren't these contracts hazardous because producers are accruing large debts to packers?" The immediate response is: "aren't $20/cwt. hog prices equally as hazardous?" There is no clear fundamental reason why the accounts themselves create any more problems than the low prices they mitigate for producers. The accounts are clearly a transfer from the packer to the producer with the intention of settlement in the future and on a schedule that coincides with high market prices. One concern is that packers may have the right to call in the loans which does not appear to be the case. The main problem is that packers may find themselves overextended with relatively low quality loans in the sense that they may be secured only by future hog production and not secured assets. One contract had clauses specifically addressing the need to collateralize the ledger accounts if the account became large enough, but this was left to the discretion of the packer. In extreme situations, packers finding themselves overextended may find it necessary to renegotiate their contracts or risk facing serious financial and competitive disadvantages. From a producer's perspective, the prudent action is to treat the ledger balance as a liability, although the temptation is to assume it will be paid back in the future on higher prices.

What are specific delivery requirements? Clearly the contract provides for access to a particular packer. However, it should also be very specific on delivery times (dates and times) and delivery location. Several packers own multiple plants and may attempt to schedule and allocate pigs among the plants if warranted. The contract should stipulate who pays freight, shrink and other costs associated with delivering the hogs to a plant further away than the primary plant specified in the contract. Delivery times and dates are clearly important for production systems utilizing all-in-all-out methods. The contract should specify payment of compensation if delivery dates are postponed either by the packer or producer.

4. What are the Implications of Contracts on the Spot Market For Hogs?

A. *Market Thinning*

On any given day, fewer hogs will be available on the open market when contracts exist. If the market is competitive (there are no physical capacity constraints, there are still a large number of buyers and sellers, all hogs (contracted and uncontracted) are essentially the same), there would be little or no effect. However, given market imperfections in meat packing (few buyers, short-run capacity constraints, quality differentials in hogs, high entry barriers) there is the possibility that spot prices will tend to be more variable. Another aspect of market thinning or differential pricing is that since contracted hog

prices have less flexibility, that packers will seek to purchase spot market hogs at a lower price in order to lower the average cost of procurement.

B. *Quality Distribution Changes*

One of the incentives for packers to contract is to secure supplies of high quality hogs. Naturally, if the high quality hogs are contracted, the spot market will be comprised of the remaining lower quality hogs. In all likelihood, spot prices will reflect this lower quality by being lower priced. This is often observed when comparing the market for source verified weaner pigs to feeder pigs sold in an auction market.

C. *Impacts on Contracts*

If spot markets are compromised, this ultimately also has an effect on contracts since contracts are often also formula priced based on spot market prices. Hence, this can become a circular problem -- more contracts to avoid less reliable spot prices further erode spot prices which provides more incentives for contracting.

D. *Integration*

If both contracting and determining or discovering spot market prices become ineffectual for meeting the objectives of packers and producers, an alternative option is integration, where there is no external transaction price, but merely a transfer price within the vertically aligned firm. It is highly unlikely that an entire market will become integrated as the capital costs and management resources become extraordinary. As we currently observe, the market will likely be comprised of a mixture of spot market, contractual and integrated procurement and ownership strategies.

II.

Legal Considerations in Swine Marketing Contracts

1. Introduction

Traditional agricultural financing is generally composed of three components: (i) long-term credit to finance the purchase or improvement of real estate; (ii) intermediate-term credit to finance the purchase of equipment and breeding livestock; and (iii) short-term production credit to cover current operating costs, including annual crop production expenses. However, capital and labor are now frequently provided by different persons, especially in the pork industry.

Very often this is accomplished by contractual arrangements. Such contracts may be either (i) production contracts or (ii) marketing contracts. It is important to distinguish between the two types contracts. A "production contract" is an agreement between a processor (or contractor) and a grower (or producer) that usually specifies in detail the production inputs supplied by the processor, the quality and quantity of hogs to be delivered and the compensation to be paid to the grower. A "marketing contract" is an agreement between a processor and a grower establishing an outlet and price, often based upon a formula for determining the price, for the hogs to be delivered under the contract.

It is important to distinguish between production and marketing contracts in the pork industry since they serve different functions. Marketing contracts provide the packer with a stable source of hogs at a price which is established by the contract. Such contracts typically include a delivery schedule and method for determining price. They are often for a term of four to seven years. In contrast, hog production contracts are often used by large-scale growers and/or processors to provide for specialized facilities and services for the purpose of feeding and fattening hogs (e.g, farrowing contracts, nursery contracts and finishing contracts). In some cases, a grower under a marketing contract may be the contractor under a production contract, providing management inputs as well as compensation for a grower which provides such specialized facilities and services.

2. Basic Principles of Contract Law

Before one can begin to analyze the various risks presented by swine marketing contracts, it is helpful to become familiar with several basic legal concepts relating to contracts in general. Each contractual dispute involves unique contractual provisions as well as unique facts. As a result, any discussion of contract principles is necessarily very general. However, several basic principles of contract law are noteworthy.

A. *Definition*

Most business transactions involved contracts. The Minnesota courts have never provided a succinct definition of the term "contract." However, in practice, a contract is a legally enforceable agreement between two or more persons which creates an obligation to do or not to do a particular thing. It is a promise or a set of promises for the breach of which the law gives a remedy or for the performance of which the law recognizes a duty. Not all contracts must be in writing. Conversely, the existence of a written agreement does not necessarily mean a contract has been formed. For example, a written agreement, even though complete in its terms, does not become a binding contract until the parties express an intention that it be so.

B. *Sources of Contract Law*

The law governing contracts is found in several places. Article 2 of the Uniform Commercial Code governs contracts for the sale of goods over $500. In addition, the Minnesota Agricultural Contracts Act will apply to such contracts. Finally, apart from those areas which are expressly governed by legislation, the Minnesota case law of contracts will govern the creation, enforcement and interpretation of Minnesota contracts.

A swine marketing contract is a contract for the sale of goods which is governed by Article 2 of the Uniform Commercial Code. As with the case of contracts in general, the provisions of the U.C.C. may generally be varied by the agreement of the parties. However, should the agreement not address certain issues, the U.C.C. and the Minnesota Agricultural Contracts Act will operate so as to supplement the contract between the parties. In addition, certain other provisions of federal or state law may affect the validity of certain contractual provisions.

C. *Freedom of Contract*

Contracts may generally be made for any lawful purpose. While a contract which violates the law is "illegal," the burden of establishing that a contract is illegal is on the party making such an assertion. Courts will generally construe contracts to be enforceable in an effort to preserve each party's freedom to enter into contracts of their choosing. Thus, the law presumes a contract to be valid.

D. *Extent of Contractual Obligations*

Each party to a contract is presumed to have knowledge of the terms and conditions of a contract which he has signed. As a result , a person cannot escape being bound by the terms of a written contract merely by asserting that he did not read the contract. In contrast, if both parties to a contract make a material mistake which goes to the basic assumptions behind the contract, the contract may be voidable by the party adversely affected. However, such a mistake must go to facts as they exist at the time of the making of the contract.

In interpreting a contract, the language used in the contract will usually be given its plain and ordinary meaning. A court asked to construe a contract will consider the contract as a whole and will attempt to read all of the contractual provisions consistently. The goal of a court in such a case is to determine the parties' intent. Only if a contract is ambiguous will a court consider evidence outside the contract itself.

Some contracts or contractual provisions may be so one-sided as to be "unconscionable." In such a case, the contract or contractual provision may be disregarded by a court.

However, should a contract be challenged as being unconscionable, a court will generally consider the commercial setting and purpose of the contract in evaluating such a challenge. The mere fact the parties to the contract did not hold equal bargaining power or that the contract was a preprinted form is not sufficient to render the contract unconscionable.

E. *Implied Duty of Good Faith*

Every contract includes an implied covenant of good faith and fair dealing requiring that one party not unjustifiably hinder the other party's performance of the contract. For example, without an implied covenant of good faith, an agreement granting one party complete discretion under a contract to terminate the contract would be illusory. Under the provisions of the U.C.C. governing the purchase and sale of goods, "good faith" in the case of a merchant such as a packer means "honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade."

F. *Changed Circumstances*

Should some event occur which was not contemplated at the time the contract was made, the affected party to a contract may be relieved from performance. For example, if a contract is made for the delivery of a specific crop to a buyer, the destruction of the crop by hail before it is harvested may excuse the farmer from performing under the sales contract. However, should the market price for the crop increase significantly from the date of the contract until the prescribed delivery date, the farmer will generally be required to perform. Mere changes in market prices, without more, will not allow a party to escape performance of his contract.

G. *Remedies for Breach*

Should a party to a contract not perform, the other party to the contract may seek one of several remedies. Generally, a non-breaching party will be entitled to damages for the loss resulting from the breach of the contract. Sometimes contracts contain provisions which predetermine the amount of damages to be recovered by a party in the event of a breach. Such "liquidated damage" provisions will generally be recognized so long as the amount is fixed and the damages are a reasonable forecast of just compensation for the harm caused by the breaching party. In addition, for such a provision to be enforceable, the harm must of a kind which is difficult to estimate.

Courts may, in certain circumstances, award remedies of specific performance or injunctive relief in lieu of or in combination with money damages. Specific performance is an order by the court that a contract be fully performed according to its terms. Injunctive relief usually consists of an order by the court forbidding one party from taking certain actions that may be inconsistent with the contract. Usually, these remedies are

available only if money damages will not adequately compensate the non-breaching party for the harm suffered.

3. Legal Issues Raised by Swine Marketing Contracts

Several legal issues may be raised by swine marketing contracts. As in the case of any contract, the terms of the contract at issue will often be determinative in resolving any contractual dispute. However, there are several important considerations for sellers and their lenders which are raised by such contracts.

A. *Quantity of Livestock Subject to Contract*

An initial issue to consider when assessing a long-term marketing contract is the quantity of hogs which are to be subject to the contract. Some contracts require specific numbers of hogs to be provided each month or week. Such contracts sometimes grant the buyer a first option to purchase any additional marketable hogs produced by the seller. Other contracts involve a promise by the seller to sell all his production to the buyer.

Contracts which cover all of the seller's production result in an inability on the part of the seller to sell marketable hogs on the spot market in the event market prices are in excess of the contract price. Conversely, however, if the contract price is substantially in excess of the market price, such contracts provide the seller with a more attractive marketing outlet for his production. Under the U.C.C., a contract which provides for exclusive dealing in the goods covered by a contract (such as in the case of a marketing contract covering all of the seller's hog production) requires both parties to perform the contract in good faith. Such contracts require the purchaser to use reasonable effort and due diligence to utilize all of the seller's production.

B. *Determination of Price*

A long-term marketing contract will typically set forth in some detail the manner of computing the amount due the grower. For example, some contracts establish the price to be tied to a cost matrix based on costs of corn and soymeal. Other contracts are based upon a market price index.

The U.C.C. recognizes that a contract can be legally enforceable even if the price term is not fixed in the contract. The law specifically allows a contract to establish the price term by a future agreement between the seller and buyer or to be based upon a formula, market or index. So long as the buyer and seller intend to enter into a binding contract, the agreement will be recognized even though the price is not firmly established at the time the contract is signed. If a contract provides the price is to be determined at a later date by either the seller or the buyer, the U.C.C. provides that he must do so in good faith.

In short, a grower should carefully review a marketing contract to ensure that he understands the basis for payment set forth in the contract. In addition to understanding the formula, however, the grower should carefully evaluate whether the contract will likely allow him to make a profit.

C. *Conditions of Payment*

A marketing contract will also generally establish various conditions of payment. The quantity of livestock required to be delivered as well as the grade, weight or condition of the livestock to be provided under such a contract will often be carefully defined. Compliance with the buyer's nutritional and genetics program may be required. The contract may provide the buyer with access to the seller's facilities to observe and verity the seller's compliance with such programs.

Premiums or merit adjustments may be provided for livestock which exceeds such minimum requirements. Generally such contracts provide that the determination of quality is left to the buyer. Some contracts incorporate the standards to be employed by the buyer in making such determinations into the contract. Other contracts are silent with respect to such terms. Some contracts provide access to the buyer's facilities by sellers to observe and/or verify the buyer's determination of quantity and quality of the livestock delivered under the contract. Absent a provision in a contract controlling such determinations, the U.C.C. requires the buyer to act in good faith in making such determinations.

D. *Amounts to Be Paid Seller*

Some swine marketing contracts provide for guaranteed minimum prices to be paid the seller regardless of the market price of the hogs at the time of delivery. While the details of such contracts are unique, depending upon the terms of each such contract, there are several common characteristics of such "ledger contracts."

Such contracts generally establish a minimum price for the livestock. The price paid the seller may be greater than the minimum price if the "market price"of the livestock is higher than the minimum price at the time of delivery. The exact amount to be paid the seller in such a case will be determined based upon a formula set forth in the contract. A portion of any amount by which the market price exceeds the minimum price may be accounted for by crediting a reserve account established by the buyer for the seller. Interest may, or may not, accrue on any such amounts owed the seller.

However, if the market price for comparable livestock at the time of delivery is lower than the minimum price, the seller will be paid the minimum price. In such a case, the buyer will account for such payments by debiting a reserve account in the name of the seller. Any amounts owed the buyer by the seller on account of such payments may bear interest.

Such amounts may be repaid when, and if, the market price for hogs again exceeds the minimum price provided in the contract out of the excess via credits to the reserve account.

Any amounts owed under such contracts, regardless of which party to the contract is owed funds by the other, legally constitute an extension of credit to the other party. If the seller owes the buyer substantial sums as a result of such a contract, it may affect the ability of the seller to obtain continued financing from his lender. Such amounts may trigger defaults under the seller's loan agreements. In addition, some contracts provide that the seller will provide the buyer with a security agreement granting the buyer a security interest in the seller's assets to secure all amounts owed the buyer by the seller. If the seller grants a security interest in his assets to the buyer pursuant to such a contractual provision, the legal relationship between the parties is transformed from that of buyer and seller to that of borrower and secured lender. Depending upon the provisions of the security agreement, the buyer may obtain a security interest in the seller's machinery, equipment, crops and livestock.

Conversely, if the buyer owes the seller pursuant to such a contract, the seller has provided unsecured financing to the buyer. In some cases, this may violate the terms and conditions of the seller's loan agreements. In addition, the sellers remedies in the event of nonpayment by the buyer will be affected by such contracts. The seller will not be able to reclaim any livestock which has been delivered to the buyer under such a contract based upon the nonpayment of any amounts owed the buyer. In addition, it is not clear whether the trust provisions of PASA would apply to the nonpayment of any deferred amounts owed a seller under a ledger contract.

Ultimately, of course, the balances owed under such contracts must be reconciled. Under some contracts, whichever party is in a negative position at the end of the initial term of the marketing agreement may extend the contract in order to liquidate the negative balance owed in the reserve account. Other contracts provide that the amount owed in the reserve account, regardless of which party is the obligor, is payable at the expiration of the term of the agreement. The manner in which any such reserve account is reconciled should be carefully analyzed and understood by both parties to any such contract.

E. *Nonpayment By Buyer*

As is true with any contract, a seller of livestock is always subject to the risk of nonpayment or other nonperformance by the purchaser. If the buyer breaches the marketing contract, the terms of the contract may affect the seller=s remedies. However, both federal and state law may provide an unpaid seller of livestock additional remedies in the case of such a default on the part of the buyer.

(1) Refuse to Deliver Additional Livestock

When a seller of goods learns that a buyer of goods is insolvent or fails to pay for such livestock when required by the contract, the U.C.C. gives him the right to refuse to deliver any additional goods except for cash and to stop delivery of any goods that are in transit. Thus, should a buyer fail to pay for livestock delivered, the seller may be able to legally refuse to make future deliveries to the buyer. Of course, in such a case, the seller will have lost the benefits of a long-term marketing agreement.

(2) Terminate Contract

In addition to refusing to deliver additional livestock, a seller which has not been paid may terminate the contract.

(3) Reclaim Delivered Livestock

The U.C.C. also gives an unpaid seller the right to reclaim recently delivered goods for up to ten days after receipt of the goods. Such rights may be subject to the rights of a secured lender which holds a security interest in the buyer's assets. In addition, should the livestock have been slaughtered prior to the seller asserting its rights, such rights may be lost. If a bankruptcy case is filed by the buyer during this period, the Bankruptcy Code provides that the right of a seller to reclaim the goods may be recognized. However, the issues surrounding reclamation in bankruptcy become substantially more complex.

(4) Seek Money Judgment

A unpaid seller may simply seek a money judgment against the buyer based upon the terms of the contract. In order to do so, the seller must begin a lawsuit against the buyer. Once a judgment is obtained, the seller may attempt to satisfy its judgment from the assets of the buyer, subject to the claims of the buyer's secured creditors which will have priority over the unpaid seller.

(5) Assert Agricultural Producer's Lien

Minnesota law may provide a seller with a lien on the livestock delivered to a buyer under a marketing contract provided the seller takes the appropriate steps to perfect such a lien. The Minnesota agricultural producer's lien grants an unpaid seller of agricultural commodities, including livestock, with a lien against the commodities delivered to a purchaser and the proceeds of such commodities for the contract price of the commodities. There are two major limitations on the use of this statutory lien. In order to successfully assert such a lien, it will be necessary for the seller to perfect the lien by filing a lien statement with the appropriate filing office within 20 days of

delivery of the livestock to the buyer. If a lien statement is timely filed, the lien will have priority over all other liens in the commodities and their proceeds. However, the agricultural producer's lien will not be available if the buyer obtained the commodities free of all security interests and liens as provided by federal law. Inasmuch as livestock delivered under a long-term marketing agreement will, in all likelihood, be free of such security interests, the agricultural producer's lien may not provide unpaid sellers substantial protection.

(6) Assert Statutory Trust Under PASA

A unpaid seller of livestock may be entitled to assert a secured claim based upon the Packers and Stockyards Act (PASA). PASA specifically creates a statutory trust for the benefit of all unpaid cash sellers. Under the trust provisions of PASA, an unpaid cash seller is entitled to have its claim satisfied from a defaulting packer's assets, composed of the livestock purchased via cash sales, and all receivables and proceeds from meat, meat products and livestock products. If a packer has average annual purchases which do not exceed $500,000, it is exempt from the trust provisions of the Act.

Only unpaid cash sellers of livestock have standing to assert the PASA trust. For purposes of the trust provisions of PASA, a cash sale is any sale in which the seller does not "expressly" extend credit to the buyer. Nothing but an express agreement in writing can operate as a waiver of the seller's right to prompt payment for livestock.

To preserve a trust claim against a packer, the unpaid cash seller must give notice to the Secretary within 30 days of the final date for making payment or within 15 business days of being notified that the payment of a promptly presented check was dishonored. Failure to comply with the notice provisions will be fatal to a trust claim under PASA.

Under the Act, a cash seller is entitled to "full payment" including the sales price, prejudgment interest on the sales price from the date of delivery and costs incurred in seeking to enforce their rights. An unpaid seller who seeks to recover under the PASA trust is not required to specifically trace or identify inventories or proceeds attributable to his sale of livestock. He need only show a balance due from the packer and the existence of a floating pool of commingled inventories of livestock products, accounts receivable and proceeds derived from cash and credit livestock sales. If such assets are transferred to a creditor of the packer, they may not lose their status as trust assets. Unpaid cash sellers will have priority over a secured creditor of a defaulting packer.

Assets subject to a PASA trust are not property of the packer's bankruptcy estate. As a result, an unpaid livestock seller which has protected its trust claim may be entitled to be satisfied from the buyer's assets even if the buyer files bankruptcy.

F. *Assignment of Marketing Contracts*

In a time of consolidation in all industries, including agriculture, an important consideration of any seller considering a long-term marketing contract is whether the contract may be assigned by the buyer. Generally, a contractual right can be assigned unless the substitution of a new party to the contract would materially change the duty of the party which owes an obligation to perform, materially increase the burden or risk under the contract, or materially impair or reduce the value of the contract for the nonassigning party. In addition, the assignment of a contract may be precluded by the contract.

As a result, long-term marketing contracts may contain provisions addressing the ability of either party to assign the contract. Some contracts provide that the contract may not be assigned without the consent of the other party. Other contracts prohibit an assignment of the contract by the seller. Still others attempt to restrict the ability of the seller to transfer the facilities in which the livestock operations are conducted without also assigning the marketing contract to the buyer of those facilities.

Should the livestock buyer merge or be acquired by another packer, an issue may arise as to whether the surviving entity or purchaser will be required to perform under the marketing contract. Generally, if the assets of a company are sold, the buyer of the assets will not be liable for any of the obligations of the seller, including executory contracts, unless such obligations are expressly assumed by the buyer. Thus, if a livestock buyers sells its facilities and equipment to another livestock buyer, the new owner may not be required to honor existing marketing agreements. This may not be the case if a livestock buyer merges with another livestock buyer. In such a case, the obligations of the target corporation may become the legal obligations of the acquiring corporation.

G. *Confidentiality Agreements*

Oftentimes, long-term marketing contracts contain provisions which prohibit the disclosure of the terms of the contract, including the prices to be paid under the contract by the buyer. Generally, as with any other contractual term, the parties to a contract are free to agree to such a provision. However, on September 10, 1998, the United States Department of Agriculture has issued a notice of rulemaking proposing that such confidentiality agreements be made illegal under PASA. In its notice, the USDA noted that "conditioning the purchase or sale of livestock on nonreporting of prices may be an unfair trade practice in violation of PASA." It is interesting to note that it is currently illegal for a packer to disclose information to its competitors "for the purpose of

restricting or limiting competition [or] manipulating livestock prices" to furnish competitors information concerning "proposed" prices to be paid.

The 1999 Minnesota legislature passed an amendment to the Minnesota Packers and Stockyards Act which requires packers to report daily all prices paid for livestock "under contract" and through "cash market sales." Such reports must be filed with the Minnesota Department of Agriculture (the "MDA") and the USDA. In addition to price reporting, the Minnesota law requires packers who acquire livestock under contract to provide the MDA with copies of each type of marketing agreement used by the packer to obtain livestock from producers.

H. *Buyer's Bankruptcy*

Should a buyer file bankruptcy, the rights and remedies of a seller under a long-term marketing contract will be affected. A marketing contract is an "executory contract" under the Bankruptcy Code. Characterization as an executory contract carries with it several legal consequences.

Under the Bankruptcy Code, an executory contract may not be terminated or canceled by the nondebtor party because of the debtor's bankruptcy filing. As a result, even if a buyer should file bankruptcy, the seller is not automatically relieved of its obligations to deliver livestock under the marketing contract. However, should the debtor have defaulted in its performance of the marketing contract prior to filing bankruptcy, the debtor will not be able to assume the contract without curing such defaults or providing the seller with adequate assurances that it will be able to cure such defaults. This means the buyer may not be able to require the seller to continue to deliver livestock under the terms of a marketing agreement over an extended period of time.

If a debtor has failed to make payments to a seller prior to filing bankruptcy, the claim of the seller for such amounts will generally be an unsecured claim against the debtor unless (i) the seller has preserved its PASA trust rights; (ii) perfected a statutory lien against the livestock delivered to the debtor or (iii) promptly exercised its reclamation rights. However, the claim arising out of the delivery of livestock to a buyer *after* the filing of the bankruptcy case may be entitled to a higher priority in the debtor's bankruptcy case as an administrative expense.

Any executory contract to which a debtor is a party is subject to rejection by the debtor or the debtor's trustee in a bankruptcy case. Rejection of an executory contract allows a debtor to avoid performing under the contract. For example, if a buyer entered into a long-term marketing contract in which the price to be paid for livestock was substantially in excess of the market price for such livestock, the debtor would be able to elect to not perform under the contract. Following rejection of the marketing contract by the debtor, the seller will be entitled to an unsecured claim in the contractor=s bankruptcy case for

the damage caused by the rejection of the contract. However, the seller will lose the market for his livestock.

I. *Termination of Contract*

Virtually all long-term marketing contracts will contain provisions relating to the termination of the contract. A grower should always carefully consider the termination provisions of a contract. Generally, neither party will be allowed to terminate the contract absent a default in the performance of the other party's obligations under the contract. However, contracts will often contain provisions which allow a party an opportunity to cure any defaults under the contract and requiring the nonbreaching party to provide notice of any such defaults before termination is effective. It will generally be necessary for the nonbreaching party to comply with such provisions to legally terminate the agreement.

J. *Alternative Remedies*

In addition to termination of the contract, marketing agreements may contain provisions which allow the buyer to offset any claims which it may have against the seller against amounts due the seller under the contract. Such a provision is known as a "setoff" provision. Generally, the parties to a contract are entitled to such setoff rights (also known as "recoupment") even if the contract does not expressly so provide. No court action is required for a party to a contract to exercise such rights. Nor is prior notice generally required. As a result, a seller which is dependent upon payments from a contract to provide ongoing cash flow, such setoff remedies by the buyer pose potentially significant problems.

K. *Financing Considerations*

A lender which provides production or facilities financing to a hog producer will likely be very interested in the provisions of the producer's long-term marketing contract. If the lender holds a security interest in the hogs, the buyer may acquire the hogs free of the lender's security interest. As a result, the lender's true collateral for its loan will be the obligations of the buyer to purchase the seller's hogs. Accordingly, a lender which is considering the financing of a swine producer will carefully consider the financial strength of the purchaser and the ability of the purchaser to utilize the seller's production in addition to the seller's collateral in underwriting any such loan. In addition, the terms of the marketing contract, including the setoff rights of the buyer, the payment terms, the pricing formula, the ability of the buyer to alter the terms of the contract, and the risk of poor feeding performance will all be critical to the lender. Finally, any such lender may require a collateral assignment of the marketing contract in order to obtain direct payment of the proceeds of the contract from the buyer.

L. *Recovery of Capital Investment*

The performance of long-term swine contract requires the grower to have specialized facilities and equipment available for the production of the hogs which are the subject of the contract. Some marketing contracts require the buyer to approve the grower's facilities. Such facilities and equipment are expensive. However, such facilities and equipment must be available to the grower before the grower can contemplate entering into a swine marketing contract. And, should the grower plan to construct such facilities in order to obtain a marketing contract, the grower's lender may require a long-term marketing contract before it agrees to finance a portion of the facilities and equipment cost.

A critical consideration for a grower and his lender is the relationship between the length of the marketing contract and the ability of the grower to provide for meaningful income to service the indebtedness incurred in order to provide for such facilities and equipment and to allow the grower to recover his investment. The Minnesota Agricultural Contracts Act attempts to address this potential problem for the grower. Minn. Stat. § 17.92, subd. 1 provides as follows:

"A contractor must not terminate or cancel a contract that requires a producer of agricultural commodities to make a capital investment in buildings or equipment that cost $100,000 or more and have a useful life of five or more years until:

(1) the producer has been given written notice of the intention to terminate or cancel the contract at least 180 days before the effective date of the termination or cancellation or as provided in subdivision 3; and

(2) the producer has been reimbursed for damages incurred by an investment in buildings or equipment that was made for the purpose of meeting minimum requirements of the contract."

Should the grower breach the marketing contract, the contractor is required to give "written notice with all the reasons for the termination or cancellation at least 90 days before termination or cancellation" and the grower is entitled to "correct the reasons stated for termination or cancellation" within 60 days of receipt of the notice. In the case of "voluntary abandonment of the contract" or "conviction of the producer of an offense directly related to the business conducted under the contract" the termination of a regulated contract may be accomplished immediately.

While the purpose of the statute is clear, it may not provide the protection which it seeks to offer. Few, if any, marketing contracts expressly "require" the grower to make a capital investment in facilities or equipment. Rather, such contracts generally assume that the grower has access to such facilities. In such a case, the statute is not clear as to

whether it provides any protection for a grower who already owns specialized facilities or equipment prior to entering into the contract.

4. Regulation of Contracting

A. *Federal Regulation*

(1) Packers and Stockyards Act (PASA)

The Packers and Stockyards Act is comprehensive federal regulatory statute for the meatpacking industry. In the words of the Congress, the purpose of the PASA is "to assure fair competition and fair trade practices, to safeguard farmers and ranchers...to protect consumers...and to protect members of the livestock, meat, and poultry industries from unfair, deceptive, unjustly discriminatory and monopolistic practices."PASA was prompted by Federal Trade Commission investigation into the amount of control exercised by the Nation's five largest meat packing and livestock and meat marketing firms and was enacted August 15, 1921 to assure effective competition and integrity in the marketing of livestock, meat, and poultry. PASA has been updated several times to keep pace with changes in the industry.

PASA provides payment protection for sellers of livestock by requiring prompt payment, bonding, packer and poultry trusts, and market agency custodial accounts. It addresses unlawful acts such as unfair, deceptive, discriminatory, or monopolistic practices in the marketing of livestock, meat, and poultry. Enforcement of PASA is the responsibility of the administrator of the Grain Inspection, Packers and Stockyards Administration (“GIPSA”) of the USDA.

Those engaged in the business of marketing livestock, meat, and poultry in commerce are subject to PASA. Stockyards, commission firms, livestock auctions, order buyers, dealers, meat packers, meat brokers, meat wholesalers, and distributors, and live poultry dealers are included. Farmers and ranchers are not subject to the P&S Act when buying livestock for their own stocking or feeding purposes, or when marketing their own livestock.

Several provisions of PASA address protection of the right of livestock sellers to obtain payment for their production:

(a) Bonds

Commission firms, auction markets, dealers, and order buyers must maintain a bond as a measure of protection for livestock sellers. The size of the bond is based on the volume of business, generally an average two days' business with a

minimum of $10,000 bond. Packers whose annual livestock purchases exceed $500,000 are also required to be bonded.

(b) Prompt Payment Rules

Commission firms, auction markets, dealers, order buyers, and packers are required to pay promptly for livestock, usually by the close of business on the day after transfer of possession. For livestock sold on a grade-and-yield basis, it is the end of the next business day after the final purchase price is determined. Any credit agreement must be in writing, with prior approval from the seller. Live poultry dealers must pay before the close of the next business day for live poultry obtained in a cash sale. Live poultry obtained under a poultry growing arrangement must be paid for by the close of the 15th day following the week in which the poultry is slaughtered. Payment for meat and meat food products must be made according to contract terms.

(c) Custodial (Trust) Accounts

Commission firms and auction markets must maintain a separate bank account for custodial funds. This is a special trust account designed to ensure payment to consignors.

(d) Packer and Poultry Trusts

As outlined above, if a meat packer fails to pay for livestock or a live poultry dealer for live poultry, the receivables, inventories, and proceeds derived from such purchases in cash sales or by poultry growing arrangement become trust assets by operation of law. These assets are to be held by the meat packer or live poultry dealer for the benefit of all unpaid cash sellers and/or poultry growers. Such cash sellers and poultry growers will enjoy a priority payment position in bankruptcy or in claims against trust assets in the event of a business failure.

(e) Solvency

Commission firms, auction markets, dealers, and order buyers must maintain a solvent financial condition to remain in business. Insolvent packers may be required to pay for livestock under specified conditions.

Livestock sellers have specific responsibilities to be eligible for protection under PASA's payment protection provisions. The requirements for asserting the PASA trust are outlined above. In order to assert a bond claim, the seller must file a written claim with GIPSA within 60 days of the transaction in which he or she failed to receive payment. Persons who feel they have been financially harmed may file claims

for reparations against stockyards operators, commission firms, auction markets, dealers, and order buyers. To do so, injured parties must file a claim with GIPSA in writing within 90 days of the transaction date, or in the case of fraud, within 90 days of the date of discovery. Once a claim is filed, an administrative proceeding will determine the damages, if any, to be awarded the claimant. However, there are no reparation provisions against packers and live poultry dealers under the PASA.

In addition to providing for payment protection for cash sellers of livestock and poultry, pursuant to PASA, GIPSA investigates and analyzes the structure and performance of the livestock, meat, and poultry industries to ensure fair and open competitive conditions. Such investigations may relate to monopolies, apportioning of trade territories or supplies, and the manipulation or control of prices, predatory pricing, boycotting, and other restraints on competition, including pricing agreements, agreements not to compete, and intimidation of potential competitors and conflicts of interest.

Finally, GIPSA is charged with attempting to counter unfair, deceptive, and fraudulent practices in the livestock and poultry industry. Such practices may include conspiracies; diversion of packer and poultry trusts; false weighing of livestock, meat, and poultry and use of inaccurate scales; weight or price manipulations; bankruptcy fraud; check kiting; and unfair business-getting tactics such as free trucking and commission rebates.

GIPSA may enforce PASA through a variety of means including cease and desist orders, suspension of business operations, civil penalties up to a maximum of $20,000 per violation for poultry payment and trust infractions and up to a maximum of $10,000 per violation of all other infractions of PASA, and permanent injunctions, fines, and jail sentences for actions taken through the Justice Department.

(2) Agricultural Fair Practices Act (“AFPA”)

The Agricultural Fair Practices Act is designed to protect the right of growers to join associations of producers in order to enhance their bargaining power with purchasers of agricultural commodities. The statute prohibits Ahandlers@ (i.e., contractors) from knowingly taking a variety of actions against individual growers or associations of growers because of their membership in a growers association. Under the AFPA handlers cannot coerce producers to join or refrain from joining an association, discriminate against producers who do join an association, or reward producers who refuse to join an association. However, the AFPA does not prohibit a contractor from selecting its customers or suppliers for any reason other than a grower=s membership or contract with a growers= association. As a result, the AFPA has not been utilized by many producers in litigation arising out of contract disputes with processors. Several attempts have been made to strengthen the protection afforded producers

under AFPA in recent years. However, to date, such attempts have been unsuccessful.

B. *State Regulation*

(1) Minnesota Corporate Farming Act

The Minnesota corporate farming act prohibits corporations or other business entities other than family controlled entities from engaging in farming or owning agricultural real property. The Minnesota law is similar to laws enacted in several other Midwestern states. Such statutes have been recognized as contributing to the development of long-term marketing contracts and production contracts as a means for purchasers of agricultural commodities to control production.

(2) Minnesota Agricultural Contracts Act

The Minnesota Agricultural Contracts Act contains several provisions applicable to Agricultural contracts:@

- Any contract for an agricultural commodity must contain a provision calling for either mediation or arbitration of any contract disputes.

- All agricultural contracts must be interpreted to include an implied statutory promise of good faith. If a court finds there has been a violation of the implied promise of good faith, the court may allow the party to recover damages, costs and attorney fees.

- When a grower is Arequired@ to make a capital investment in buildings or equipment that cost $100,000 or more and have a useful life of five or more years, the contractor may not cancel or terminate the contract until (i) the grower has been given written notice of termination at least 180 days prior to the termination date and (ii) the grower has been reimbursed for damages incurred by such capital investment.

- If a grower breaches a production contract which required the specified capital investment, the contractor must give the grower 90 days notice before terminating the contract and must give the grower 60 days to cure the breach.

- Parent companies of subsidiaries licensed to purchase agricultural commodities are liable to a seller for any unpaid purchase price or any claim based upon a contract if the contractor fails to perform.

(3) Minnesota Packers & Stockyards Act

The Minnesota Packers and Stockyards Act ("MPASA") provides limited payment protection for unpaid sellers of livestock and disclosure of certain information by packers, stockyard owners, market agencies and dealers. Under MPASA each regulated business is required to provide by MDA with an annual report disclosing its maximum packing capacity and each contract the packer has entered into with a livestock producer. MPASA contains prompt payment rules and bank account rules similar to PASA. Should a packer not be able to fulfill its commitments under contracts within 30 days of the delivery date, the MDA may seek to revoke or suspend its license. Finally, as noted above, a recent amendment to MPASA requires daily and quarterly reporting of both contract and cash market prices as well as copies of all agreements relating to the acquisition of livestock by packers.

(4) Minnesota Agricultural Marketing and Bargaining Act

The Minnesota Agricultural Marketing and Bargaining Act ("MAMBA") is a state counterpart to the AFPA. The MAMBA covers producers of "agricultural commodities" which is defined to include all "materials produced for but not limited to use in or as food, feed, seed, or fiber, and includes but is not limited to crops for fiber, food, oil seeds, seeds, livestock, livestock products, poultry, poultry products, and other products or by-products of the farm products produced for the same or similar use."

The statute sets forth requirements for accreditation of marketing associations. Once accredited, the association "shall act as exclusive sales agents for the bargaining unit area in negotiations with handlers."

Under MAMBA, it is an unfair practice for a processor to: (i) coerce a producer in the exercise of his right to join an association or to refrain from belonging to an association; (ii) discriminate against a producer because of his membership in an association; (iii) coerce or intimidate a producer to breach a membership agreement; (iv) give anything of value as an inducement to producer for refusing to join or terminating membership; (v) make or circulate unsubstantiated reports regarding an association; and (vi) refuse to bargain with an association.

At any time prior to 15 days before the first day of the marketing year in dispute, either party may "opt out" of negotiations. The processor may elect to not purchase any commodities, directly or indirectly, from the association. The association may elect to not sell any commodities to processor.

The marketing year is set by rule to be February 2-February 1. If either party makes the "opt out" election, the other party is not under an obligation to continue bargaining with the electing party.

The statute also sets forth procedures by which the Minnesota Department of Agriculture can become involved to mediate contract negotiations and provides detailed factors to be considered in mediation and bargaining.

An issue may arise as to whether the AFPA preempts the MAMBA. The United States Supreme Court has held that certain provisions of a Michigan statute similar to MAMBA was preempted by the AFPA. Under the United States Constitution, if a federal law and a state law conflict, the federal law will generally control. This general rule is subject to several limitations and qualifications. The law surrounding preemption is extremely complex. However, if compliance with both the AFPA and the MAMBA is possible, then it is likely that state law is not preempted. On the other hand, if compliance with both acts is not possible, the federal act will prevail.

(5) Minnesota Cooperative Act

Minnesota law contains special provisions which regulate marketing agreements between a cooperative and its members or patrons. Such provisions generally operate to encourage the use of a cooperative by growers. Among the provisions are the following:

- Marketing agreements between a cooperative and its members may not exceed a term of five years, but may be self-renewing, subject to the right of either party to the agreement to terminate it at the end of the initial term.

- Liquidated damages to be paid by the grower for breach of the marketing agreement are made expressly enforceable.

- If there is a threatened breach of a marketing contract, the cooperative is entitled to an injunction to prevent further breaches of the contract and to specific performance of the contract. In other words, the cooperative may obtain a court order which directs the grower to perform under the marketing agreement.

- A person who induces or attempts to induce a cooperative member to breach a marketing contract or who maliciously and knowingly spreads false reports about the finances or management of a cooperative may be guilty of a misdemeanor.

Summary

Swine marketing contracts have emerged from a combination of incentives including a desire to better coordinate supplies between producers and packers, a desire to share or reduce price risk exposure and an attempt to assure quality of supply prior to delivery. Market contracts exhibit elements of long-term price discovery as they evolve over time in response to changing market conditions as well as performance of previous contracts.

Producers seeking to enter contracts should carefully consider their motivations for entering contract production. If there motive is purely one of price risk protection, the futures market and options on futures contracts offer an alternative to achieve price risk management objectives. Alternatively, if market access is of strategic importance, the long-term marketing contracts may be a more appropriate option. Currently, as more packers seek to either vertically integrate into swine production or contract and pre-source hogs for slaughter, the issue of market access will become greater.

Contract performance provisions will be as critical as the payout mechanisms in determining how well the contract performs for any given circumstance. Producers should always carefully read and understand both the pricing structures to be used and other performance clauses. In most cases, contracts should be reviewed with an attorney and lender before a commitment is made.