Agricultural Production and Marketing Contracts

(Part 1)

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Editor's Note: The following article is based upon a presentation made at the ABA Agricultural Bankers Conference in November 1998. It involves two parts, the second of which will appear in the Spring 1999 issue of the Journal of Agricultural Lending. *That installment will cover "Issues for the Lender to the Producer," "Issues for the Lender to the Processor" and Case Studies.*

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The last 30 years have seen significant changes in the marketing and sale of agricultural commodities. It has been said that American agriculture is in "the last phase of industrialization – the integration of every step in the food production process"[1]. The ongoing changes in agricultural production and marketing contracts provide current evidence of that transition.

According to the USDA, in 1993, 11 percent of all farms entered into production or marketing contracts, and those contracts resulted in 32 percent of U.S. commodity production. This reflected nearly a doubling of such contract use by farms since the 1960s[2]. The use of the contracts continues to increase.[3]

Production and marketing contracts are prevalent in the sale of livestock (nearly 89 percent of poultry farmers reported using marketing or production contracts in 1993).[4] In addition, production contracts are used with increasing frequency for grains and other crops as well.

Setting the Framework

Production contracts come in varying types, including traditional marketing contracts that set a price or a pricing mechanism, prior to the time it is ready to be marketed and delivered.[5]

[1] Thomas N. Urban, "Agricultural Industrialization: It's Inevitable," Choices, 4th Q. 1991

[2] USDA, "Farmers' Use of Marketing and Production Contracts," Ag. Econ. Rpt. No. 747, P. 5 (1996) (hereinafter cited as "USDA").

[3] Associated Press Interview with Stu Ellis, Marketing Specialist, Illinois Farm Bureau, Sept. 1, 1998.

[4] USDA, p. 6

[5] USDA, p. 3

[6] *Id.* at p. 4

In these contracts, title to the commodity and management decisions concerning production of the commodity generally remain with the producers until delivery, with the producer assuming all or most of the risks of production.

Perhaps more exotic, yet becoming more commonplace, are "Production Contracts" which specify what the producer is to grow, how to grow, how to care for the crops or livestock, the types of inputs or feed, and the compensation to the producer.[6] These types of contracts may involve production seed, specialty crops, genetic based livestock and identity-preserved grains. In either the case of "traditional" forward contracts or the new "production contracts," the effect is to shift marketing from public markets to private markets.

This article will focus on both the legal and credit issues for the lenders to the producer/seller and the processor/buyer. It is important to note that the specific legal and credit issues are derived from the specific production contract.

Specific Contract Provisions

Although marketing and production contracts are as numerous and varied as the commodities to which they pertain, some kinds of provisions are found in many.

Bailment, Title, Risk of Loss and Related Provisions

One of the most noticeable trends in the development of marketing and production contracts is the change in the legal relationship between the producer and buyer. In a typical, simple contract for the sale of goods, title to the goods does not pass to the buyer until "delivery" is accomplished – either to the buyer or to the buyer's agent, bailee or warehouseman.[7] This arrangement allows, among other things, the producer to pledge the crops or livestock as collateral. It may also mean that the loss of the crop or livestock prior to delivery is a loss that must be absorbed by the producer.[8]

However, in many of the newer production contracts, title to the crop or livestock may begin with and remain with the non-producing party throughout the term of the contract.[9] In these cases, the "producer" may in fact be just a "bailee"[10] whose job it is to grow, feed and care for the crops or livestock.

In bailment contracts, the producer may not be free to pledge the growing crop or the livestock as collateral to a lender. In addition, the producer may not be able to obtain conventional crop insurance.[11] And, in the event the buyer becomes insolvent, the producer may not be able to stop delivery to the buyer, or reclaim delivered goods, even though the producer is owed money.[12]

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[7] The Uniform Commercial Code will allocate the risk of loss if the parties, by agreement, do not. See UCC § 2-303, 2-509 and 2-510.

[8] The most significant legal consequence of bearing the risk of loss is that the one who bears it may not be able to look to the other party for contractual performance if the goods are destroyed.

[9] Hamilton, "Why Own the Farm," *supra* p. 19.

[10] To refresh your memory, a bailee is defined as a person to whom goods are entrusted. Black's Law Dictionary 141 (6th Ed. 1990).

[11] *Farmers Approach Contracts with Caution*, Associated Press story quoting Steve Moline, Office of the Iowa Attorney General, Aug. 22, 1998; Neil D. Hamilton, A Farmer's Legal Guide to Production Contracts, Farm Journal Inc. 109 (1995).

Where a producer is asked to sign a contract in which title to the crop is to rest with the other contracting party from the outset, the producer should, at a minimum, consider two issues: 1) whether being precluded from pledging that crop may interfere with contemplated bank financing or crop insurance, and 2) whether the buyer of the commodity is sufficiently capitalized in order to make the required payments.

Arbitration and Mediation Clauses

Some production contracts include mandatory arbitration or mediation clauses. In addition, some state laws, such as the Minnesota Agricultural Contracts Statute,[13] require that agricultural production contracts include mediation or arbitration provisions.

Formulas for Determining Grower Compensation; Remedies for Contract Breach

1. Importance of Having an Understandable Formula.

Critical to both marketing and production contracts are the provisions which deal with how the producer is compensated. These provisions not only determine what revenues the producer can expect, but they are also pertinent to the issue of damages in the event of breach. Some contracts require certain amounts of crop or livestock to be delivered and guarantee a price. Others calculate price on a "cost-plus" basis. Still others base it on the market for a specified date or period of time. For the contract to be advantageous to the producer, the producer must understand the formulation, and he must be able to predict with an acceptable degree of accuracy whether the contract will likely allow him to make a profit. Parties that sign a contract whose compensation formula is complicated or ambiguous invite disputes. The parties should take extra care to strive for simplicity and clarity in this portion of the contract.

Some production contracts involve a promise by the producer to sell "all his production" from a certain amount of acreage. In those contracts, the producer's revenue from the contract will not be ascertainable until the amount of the production is finally determined. And, the buyer is only entitled to the amount of the commodity produced, unless the contract guarantees a certain amount.[14]

In contracts for the sale of crops to be grown on designated land, the producer may be excused from performance by an unexpected casualty, such as a hail storm or a fire.[15] But care must be taken to determine whether a particular contract allows such an excuse.

In a recent case involving the sale

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[12] The UCC allows a "seller" of goods to stop delivery or reclaim goods already delivered under certain circumstances when the seller learns of the buyer's insolvency. But where title has already passed to the "buyer," the grower may no longer be considered a "seller." The UCC defines a seller as a person who sells or contracts to sell goods. If title to the seed and growing crop remains with the contractor, then arguably the grower is not a seller at all, but instead just a contract laborer or bailee, raising a commodity he does not own.

[13] Minn. Stat. Ann. § 17.90 *et seq.*

[14] For a case involving a true production contract of this nature, *see Tennell v. Esteve Cotton Co.*, 546 S.W.2d 346 (Tex. 1977).

[15] Section 2-613 of the UCC deals with casualty to goods which are identified to the contract (*see* Section 2-501) and Section 2-615 deals with contracts where performance has been rendered impracticable by the occurrence of some unexpected event.

of corn, a farming partnership apparently thought they had entered into such a contract, but found out that instead they had agreed to deliver a set number of bushels from whatever source they might find them. In the case of *Conagra, Inc. v. Bartlett Partnership*,[16] a hailstorm wiped out most of the corn crop, and the farmers hoped that the law would excuse them from having to deliver all of the corn under contract. The court held that the contracts they had with Conagra were to sell to Conagra 300,000 bushels of corn — no matter whether their farm was able to produce it or not. The result was the farmers owed Conagra for the undelivered bushels, even though those bushels were destroyed in the storm — a seemingly harsh result, but one that is consistent with contract law and the Uniform Commercial Code.

2. *Remedies for Breach — Buyer and Seller.*

Remedies for breach of a production or livestock marketing contract where a true sale is involved are most often governed by the Uniform Commercial Code, which pertains to the "sales" of goods. However, if the contract is a true "bailment" contract, where the producer only agrees to, for example, feed and care for livestock which are owned by the other contracting party, then the Uniform Commercial Code might not apply, and the body of state common law relating to contract breaches would govern.

When the seller breaches a contract for the sale of agricultural goods, the UCC affords the buyer several possible remedies:

- The buyer can cancel the contract, and recover any money he has already paid pursuant to it. If that remedy does not make him "whole" he can also either procure similar ("substitute") goods in the market and recover the price differential,[17] or seek damages for non-delivery.[18]
- If the seller breaches by failing to deliver the goods, or rejecting the contract, the buyer can recover the goods themselves, if they have been "identified to the contract."[19]

The remedy the buyer chooses may depend on the particular circumstances of the case, market fluctuations, and perhaps on the terms of his contract with the seller. For example, if the market price of the goods has increased substantially since the contract was entered into, the buyer may not want to "cover" (that is, purchase substitute goods) because of the increased cash outlay it would require, or because the goods are not available elsewhere. The buyer might instead decide to try to recover the goods themselves or settle for the damages set forth in Section 2-713.[20]

When the buyer breaches, the

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[16] 248 Neb. 933, 540 N.W.2d 333 (1995).

[17] UCC Section 2-712 (1). This is referred to as "cover." *See*, for example, *Kanzmeier v. McCoppin*, 398 N.W.2d 826 (Ia. 1987) in which seller failed to deliver cattle pursuant to an oral sales contract. The buyer tried to "cover" by purchasing other cattle, but a dispute developed over whether the other cattle were similar enough to those contracted for to constitute "cover."

[18] UCC Section 2-713.

[19] UCC Section 2-711 (2)(a). In the case of "unique" goods, specific performance may be available. UCC Section 2-711 (2)(b).

[20] *See*, for example, *Tongish v. Thomas*, 251 Kan. 728, 840 P.2d 471 (1992,) which is a case involving the seller's breach of a contract to sell sunflower seeds to a co-op. In that case, the buyer recovered damages for the difference in the market price and the contract price.

seller can resell the goods and recover the price differential if he lost money on the contract plus, in some cases, incidental damages.[21] Or, he can sue the buyer for the full price of the goods if they were delivered and not paid for.[22] Once again, fluctuations in market price may impact upon the seller's remedies.

Take for example the Kansas case of *Desbien v. Penokee Farmers Union Cooperative.*[23] There, the buyer, a farm cooperative, defaulted in the purchase of wheat pursuant to marketing contracts with some of its members. When it came time for delivery, the co-op lacked the funds with which to purchase the wheat. However, at the time the co-op breached the contract, the market price had nearly doubled over the contract price. The court held that the sellers actually benefited from the breach of contract by the co-op and should have immediately resold the wheat at a higher price when the co-op refused to pay them.[24]

Cancellation and Release Provisions

Some marketing or production contracts include provisions which allow the buyer to be excused from his purchase obligation if certain events occur — for example, if the commodity being purchased becomes diseased, weed-infested, if the buyer decides that the crop was improperly planted or fertilized or if the crop does not meet quality standards, e.g., high oil requirements.

Implications to the Producer when the Buyer Files Bankruptcy

The filing of an insolvency proceeding affects all those who have contractual or other legal relationships to the debtor. If the processor/buyer files a bankruptcy case, the processor can reject the production contract leaving the producer without a market for the product. **jal**

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[21] UCC Sections 2-706 and 2-708.

[22] UCC Section 2-709.

[23] 552 P.2d 917, 220 Kan. 358, 20 UCC Rep. 102 (1976).

[24] *Id.* The court relied on UCC § 2-708, which states that the measure of damages for nonacceptance or repudiation by the buyer is the difference between the market price "at the time and place for tender and the unpaid contract price ..." Here, that difference was a negative number, and thus the buyers could not recover. *See also Burk v. Emmick*, 637 F.2D 1172 (8th Cir. 1980).