

**FARM LEGAL SERIES****June 2015**

# Agricultural Production Contracts

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## INTRODUCTION

Contracts are an increasingly important aspect of agricultural production and marketing. Such contracts may take the form of leases, contracts for deed, production contracts, or marketing contracts. Some of the legal issues surrounding such contracts are discussed in other fact sheets in this series, including *Agricultural Marketing Contracts, Contracts, Note and Guarantees, Mortgages and Contracts for Deed, and Farm Leases*. This fact sheet deals with the legal considerations involved in agricultural production contracts.

An *agricultural production contract* is a contract by which a producer (sometimes called a “grower”) agrees to (i) sell or deliver all of a designated crop raised in a manner set forth in the agreement to a contractor (sometimes called a “processor”) and is paid according to a formula established in the contract; or (ii) agrees to feed and care for livestock or poultry owned by the contractor until such time as the animals are removed, in exchange for a payment based on a formula typically tied to the performance of the animals. A production contract usually specifies in detail the production inputs to be supplied by the contractor, the quality and quantity of the particular commodity involved, the production practices to be used, and the manner in which compensation is to be paid to the producer.

While significant attention has recently been focused on production contracts with large, corporate agricultural processors, farmers, themselves, can be contractors. For example, a dairy farmer may contract with a neighbor for the raising and/or breeding of heifers. A swine farmer may simply operate a farrowing business for surrounding farmers.

Agricultural production contracts are not new. Seed contracts, vegetable contracts and even hog contracts have been used in agriculture for several years. However, contracting has been a growing part of U.S. agriculture since at least 1960. According to estimates of the United States Department of Agriculture, agricultural contracts covered 41 percent of the value of U.S. agricultural production in 2005, up from 39 percent in 2003, 36 percent in 2001, 28 percent in 1991, and 11 percent in 1969. Contracts cover some commodities much more than others. Taken together, hogs and poultry (including broilers, turkeys, and eggs) account for nearly 40 percent of all contract production.

## Advantages of Production Contracts

There are several potential advantages for producers who may consider a production contract. Such contracts may provide for a more stable income for the producer by reducing traditional marketing risks. Such contracts may allow a producer to benefit from technical advice, managerial expertise and access to technological advances provided by the contractor. An agricultural production contract may provide the

producer with a guaranteed market, provided that the commodities are produced in accordance with the contract. Finally, such contracts may allow a producer to increase the volume of his business with limited capital since the contractor may often supply the necessary production inputs. However, by entering into a production contract which establishes a formula for compensation, the producer may lose the potential for increased profits due to market conditions. In addition, since such contracts are often very specific in their requirements and in limiting the producer's interest in the commodities produced, the producer may become a mere provider of production services for a fee.

From the contractor's perspective, production contracts may provide an orderly flow of uniform commodities so as to allow the contractor to control production costs. And such contracts may allow contractors to better respond to changing market conditions. The use of such contracts may allow a contractor to protect its investment in genetics and other intellectual property associated with a particular commodity.

### ALTERNATIVE LEGAL RELATIONSHIPS

Agricultural production contracts take various forms, depending upon the commodities to be produced, the economics of the transaction and local custom. The manner in which such contracts are structured will affect the legal relationship between producer and contractor.

#### Personal Service Contract

A production contract may be considered a *personal service contract*. Such contracts generally provide that the producer is to provide services, rather than commodities, to the contractor. Under such contracts, the producer will not typically "own" any of the commodities which are the subject of the contract. Rather, he will be providing services

and management to the contractor. The Uniform Commercial Code (UCC) provisions relating to sales of commodities will not be applicable to a personal sales contract.

#### Bailment

Some production contracts, especially those involving seed and vegetables, may be *bailments*. A bailment is the legal relationship which exists when someone else is entrusted with the possession of property, but has no ownership interest in it. A classic example of a bailment is a grain storage contract. The elevator which stores a farmer's grain does not have an ownership interest in the stored grain. Rather, it merely holds the grain for the farmer. Crop production contracts which are structured as bailments provide the contractor with additional protection against the unauthorized distribution of seeds and crops which may be the result of extensive genetic inputs by the contractor. Under such contracts, the contractor retains full ownership to the seed and crop to be produced.

#### Lease

Finally, some production contracts may be *leases* of facilities, especially if the contracts relate to the production of livestock.

Regardless of the legal relationship created by a production contract, most contracts will contain provisions which specify that the producer is an independent contractor and not an employee or agent of the contractor. Such provisions are designed to limit the liability of the contractor for the actions or omissions of the producer. Similarly, such contracts typically declare that no joint venture or partnership between the producer and contractor is intended.

## RISKS ASSOCIATED WITH PRODUCTION CONTRACTS

Before a producer enters into any production contract, he should carefully assess the risks associated with such a contract. There are several risks which must be considered.

### Long-term Capital Investment

Frequently, such contracts may require substantial long-term capital investments. For example, if a producer is entertaining a proposal to raise hogs under contract, a significant improvement to existing facilities may be necessary to comply with the contract. This may mean a long term obligation to a lender to finance the costs of such improvements. Certain crops may similarly require specialized equipment in order to raise and harvest the crop. Before entering into any such contract, the producer should pay especially close attention to the provisions of the contract specifying the term of the agreement and the ability of the contractor to terminate the agreement. If a substantial investment is required in order to perform the contract, the producer should ensure that the contract provides sufficient safeguards to allow him to recover his investment. As discussed below, Minnesota law has addressed these concerns.

### Manner of Payment

The manner in which the producer is to be paid should be clearly understood. Often, production contracts include formulas which base such payments upon a comparison of the performance of the livestock which are the subject of the contract to other similar livestock. Such a formula should be analyzed carefully before a contract is signed. Other contracts are based upon the capacity of facilities owned by the producer. Regardless of the basis for payment, the producer should clearly understand the basis for compensation under any contract.

### Assumed Risks

The risks assigned to the producer under the contract should similarly be understood. The extent to which the producer must bear the risk of casualty losses, crop failure, disease, or adverse weather conditions should be considered by the producer. The contract should clearly set forth the risks which are to be assumed by the contractor and absorbed by the producer.

### Risk of Non-payment

As in any contractual relationship, a producer will always be subject to the risk of nonpayment by the contractor. While state law may provide for a limited bond for grain purchasers, there may be no similar protection for a producer who raises certain crops or livestock under contract. Rather, in the event the contractor's business fails, the producer may be an unsecured creditor of the contractor. The rights of unsecured creditors are discussed in another fact sheet in this series, *Rights of Unsecured Creditors*. Should the contractor's business completely fail, a producer who has acquired facilities or equipment in order to perform under a contract may lose any meaningful ability to generate sufficient income to pay for such facilities or equipment.

The best way for a producer to address the risk of nonpayment is to contract with financially responsible contractors. However, state or federal law may provide some relief, depending upon the nature of the contract and the commodity produced. For example, a producer who custom feeds livestock may be provided with a lien by Minnesota law. Generally, any person who keeps, feeds, pastures or otherwise cares for domestic animals is entitled to a lien on the animals for all charges associated with such care. This lien may have priority over the security interest of another party. A producer who delivers perishable fresh fruits and

vegetables, milk and cream, or poultry or poultry products may be protected, at least in part, by a bond which must be posted by dealers in wholesale produce. Finally, an agricultural producer may be entitled to a lien for the contract price or the fair market value of the commodities delivered to a buyer. However, such a lien is not available if federal law allows the buyer of such commodities to acquire them free of any such lien.

## REGULATION OF PRODUCTION CONTRACTS

Production contracts are regulated by both the Federal government and by the State of Minnesota; to provide the producer some additional protections when entering into and operating under a marketing contract.

### Federal Regulation

Until recently neither the Packers and Stockyards Act (PSA) nor the Perishable Agricultural Commodities Act (PACA), would generally affect the contractual relationship between a contractor and producer under a production contract except as may be available through the enforcement of the acts by the USDA. In 2008, Congress revised and expanded the PSA to incorporate protections already enacted by many Midwestern states (and as discussed below), including: (a) the right to discuss with certain individuals (regardless of any restrictions in the contract) the terms of a production contract, (b) the right of contract producers to cancel production contracts within three (3) business days of the production contract being executed, (c) the requirement that the production contract provides a written disclosure that the contractor may require additional capital investments of the producer during the term of the production contract, (d) that the venue for a contractual dispute shall be the federal judicial district in which the contract was performed and the

choice of law shall be governed by the state in which the dispute arose (unless otherwise prohibited by the law of the state in which the contract was being performed), and (e) the right of the contract producer to reject an arbitration provision in the production contract. In addition, Congress has directed the USDA to set promulgate additional regulations to further advance the regulation of production contracts. These new provisions only relate to poultry and swine production contracts.

### State Regulation

Recent federal laws overlap, to some extent, laws already enacted in the State of Minnesota. The Minnesota Agricultural Contracts Act contains several provisions designed to protect producers, including laws which require: (a) any contract for an agricultural commodity must contain a provision calling for either mediation or arbitration of any contract disputes; (b) when a producer is "required" 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's ability to terminate or cancel the contract is restricted; (c) 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; and (d) all agricultural contracts must be in plain language, contain risk disclosures and provide for a right of rescission. A producer must be aware of the applicable state restrictions and limitations on the use of such contracts.

Minnesota has also enacted legislation directed specifically at purchasers of perishable fresh fruits and vegetables, milk and milk products and poultry and poultry products. Such purchasers must provide a bond to protect producers of such

commodities. Such a bond is required even if the “purchaser” is the owner of the commodity which is produced by another. Thus, a vegetable processor which obtains raw product through bailment contracts is subject to the bonding requirements of this law. However, any person claiming to be damaged by a breach of a contract must submit a claim to the Commissioner of Agriculture within 40 days after the due date in order to assert a claim against the bond. The purchasers of such products are also subject to civil and criminal penalties for violations of the law.

In addition to state regulation, the federal Packers and Stockyards Act (PASA) and Perishable Agricultural Commodities Act (PACA) may provide additional protection for producers. PACA, in particular, provides significant protection for unpaid producers.

Under PACA, a buyer of commodities subject to the act (generally fresh fruits and vegetables) must hold all inventories, receivables or proceeds received from the sale of the perishable commodities in trust for the benefit of unpaid sellers (i.e., producers) until full payment is made.

## **CONCLUSION**

The decision by a producer to enter into a production contract should be carefully considered. While such a contract may provide the producer with several advantages, the terms of the contract and the underlying economics of the contract should be carefully assessed. State and federal laws may provide limited protection to producers. However, the law does not provide complete protection.

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