Assisting Lawyers in Reviewing Production Contracts

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Introduction:

Increasingly, Iowa farmers are entering into production contracts rather than independent production of agricultural commodities. An agricultural production contract is an agreement where a farmer producer agrees to produce a specific crop, or feed and care for livestock, for a contractor and the producer will be paid according to a previously agreed upon price for the commodity. Production contracts differ from marketing contracts, such as cash forward contracts, futures contracts, or cooperative marketing agreements. Under marketing contracts, the farmer retains ownership of the commodity and the farmer retains control of the manner in which the crop is grown or the livestock is fed and cared for. Under production contracts, generally the contractor retains the ownership of the commodity and the contractor directs the manner in which the crop is grown or the livestock fed and cared for. The producer is expected to produce crops or care for livestock according to the terms of the production contract and the producer will be paid a set amount according to the contract with possible premiums or deductions for quality or performance.

Production contracts are attractive to farmers because they offer income stability, improved efficiency of production, and risk management. Production contracts are attractive to contractors because they offer control of input supply, improved response to consumer demand through a more uniform product, and increased volume of business operations. Although the use of production contracts is most noticeable in livestock production, there has also been an increased use of production contracts for crop production. Seed corn has been produced for many years under production contracts and with the increased market for specialty grains and organically produced crops; the potential exists for increased use of production contracts for grain farmers.

Essential Contract Terms and Considerations:

All production contracts should be written contracts executed by both parties. The following is a summary of some of the essential contract terms and some considerations of each.

Production and Delivery Requirements: The production requirements must be clearly stated in the production contract. Producers need to be aware of the specified quantity requirements in the contract and any penalties for inability to fulfill the quantity. The quantity of production under a grain production contract may be defined by either total bushels produced or total number of acres in production. Likewise, the quantity of livestock raised may be defined by a total of animals actually raised or the use of the producer's animal spaces at the producer's facilities. Additionally, the contract should provide for quality requirements measured by objective standards, which are understood by both parities.

The contract should define the delivery terms. Under a crop production contract, the producer is frequently required to deliver the grain to the elevator and bears the cost of transportation. Livestock production contracts may require the producer to have additional help available for the arrival and load out of livestock.

Price terms: The contract should clearly define the method of price determination. Compensation systems for grain contracts may be either flat price per bushel or acre or a base price plus premium based upon the quality of the crop delivered. Some grain production contracts allow the producer to choose a future date on which the base price is set based upon the pricing of the commodity on the futures market. Compensation systems for livestock may involve calculations based upon animal units produced, days on feed and feed efficiency, with deductions for death loss or poor performance or carcass quality. Alternatively, a livestock production contract may include a flat rate per animal unit space with adjustments made for performance.

The timing of payment should be set forth in the production contract. Often payment is not made until the commodity is delivered and marketed. With longer-term livestock production contracts, the payments may be made more frequently. It is often advantageous for the producer to time the payments to coincide with the producer's obligations. The producer should also be advised to perfect his security interest in the commodity to protect his right to payment.

Risk of Loss and Insurance: The contract should contain a provision to determine which party bears the risk of loss of the crop or livestock and whether the producer is required to obtain insurance on the crop or livestock. Some production contracts place the risk of loss on the producer until delivery is made even though the contractor claims title to the commodity. The livestock production contract should address which party bears the risk of loss due to diseased livestock and which party is responsible for the expense of veterinary care. Frequently, livestock production contracts restrict the placement of other animals at a producer's facilities to minimize disease risk. The contractor will generally retain a right to enter producer's facilities to inspect and care for livestock. A force majeure clause may also provide both parties with an excuse for non-performance due to circumstances beyond their control.

Term of Contract and Termination Provisions: The length of the contract should be specified. If the production contract requires a significant investment by the producer, the term of the contract should be long enough to allow the producer to recapture the investment. Often the producer's lender will require a longer contract to match the term of the note for improvements or specialty equipment needed by the producer to comply with the production contract.

The contract should define the conditions under which the contract may be terminated by either the producer or the contractor. The form and time of notice of termination should be stated. Rights of the parties after termination should be covered as well. Additionally, some contracts include provisions for liquidated damages and payment of attorneys' fees in the event of breach of the contract.

Facility and Equipment Requirements: Prior to entering into a production contract, the farmer producer should consider whether the production contract will require the producer to construct new facilities or purchase new equipment. An additional consideration would be cost of repair and maintenance of facilities and equipment.

Environmental Concerns: In livestock production contracts, the producer is often required to comply with all environmental regulations regarding the disposal of manure from production. The producer should be prepared to submit necessary manure management plans and permit applications, if required. Environmental concerns exist to a lesser extent with grain production crops; however, producers should be aware of applicable regulations concerning pesticide and herbicide use and soil conservation management.

Governmental Approval and Regulation: The producer should understand any special certification requirements of the contract. With crop production, the producer must be aware of and have the ability to comply with any pest management practices, field isolation requirements and other special production practices, which are required to certify the crop. Special care must be taken regarding producer's guarantees on the genetic quality of grain. Some contracts contain a blanket "Non-GMO" certification statement, which would leave a producer liable for practices over which the producer has no control. For example the guarantee that "the grain has no GMO germplasm" is a certification, which is not entirely within the producer's control as the contractor provided the seed and the producer has no control over the grain after it left the farm.

Additionally, prior to entering into the production contract, the grain producer should consult with the Farm Service Agency to determine if the crop grown is eligible for farm programs and whether the farmer's participation in the production contract may affect eligibility for payments on other crops not subject to the contract.

With livestock production, the producer must be prepared to comply with the applicable governmental regulations concerning the construction of confinement feeding operations and disposal of manure. If the operation requires special permits from the government, these should be obtained prior to entering into a production contract or the contract should contain a provision, which would void the contract if necessary permits are not obtained.

Choice of Law and Forum, Dispute Resolution: Many production contracts include a choice of law and forum provision. When representing an Iowa producer, this provision should be reviewed. Many of the larger contractors include a choice of law and forum provision to the home state of the contractor as the place for litigation of any dispute under the agreement. Additionally, some contracts provide for additional rules of interpretation. For example a grain-industry contract may provide that the contract is subject to the National Grain and Feed Association Rules.

Frequently, contracts are requiring alternative dispute resolution rather than traditional district court action to resolve disputes under the contract. Arbitration provisions are frequently included in contracts, which may result in a binding arbitration decision concerning the dispute and precluding district court action. It should be noted that regardless of the contract provisions regarding dispute resolutions, Iowa Code Chapter 654B does require that producers and contractors involved in an livestock production contract are required to participate in mediation prior to the filing of a lawsuit in Iowa District Court.

Integration Clause/ Oral Agreements: Most production contracts include an integration clause which states that the agreement constitutes the entire agreement between the parties and no alteration of the contract will be made unless the modification is in writing and signed by both parties. This term is included to prevent the enforcement of oral communications and oral modifications from affecting the written terms of the contract. Producers should be aware of this provision and understand that any additional provisions that the producer feels have been represented by the contractor regarding the production contract should be in writing and included in the contract. The producer should obtain future modifications in writing as well.

References and Other Sources of Information:

Hamilton, Neil D., A Farmer's Legal Guide to Production Contracts, Farm Journal, Inc., Philidelphia, Penn., 1995 (Available through Drake University Agricultural Law Center).

Iowa State University Extension Publications, Custom Cattle Feeding in Iowa , 1987, (Available through ISU Extension (515) 294-5247)

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