



Contracting in Agriculture: Making the Right Decision

Information for Farmers from USDA

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Introduction

Contracting is changing the shape of American agriculture. In the future, you may consider signing a contract to raise a crop under detailed specifications or to care for livestock or poultry owned by someone else. USDA cannot tell you whether or not to sign a contract. Each farmer and every farm business is different and there are many different types of contracts available.

Making the important decision to produce and market your production under contract should only be made after you consider how contracting may affect the future of your farm business.

This guide is designed to help you understand contracts – and identify the questions you should consider as you decide whether contracting is right for you. At the end of this guide you will find a list of other sources of information about contracting, including the USDA web site, which may help you decide whether contracting makes sense for you and your business.

Production Contracts – A Different Type of Business Decision for

Farmers

Farming is a business. You already know this. Marketing what you raise on your farm involves entering into many types of business transactions. In many cases, these transactions involve people you know, who live nearby, and often deals may be done on a handshake. Deciding to sign a contract is also a business decision but it is much different than traditional marketing. So it's important to recognize and understand the differences. Most likely with a contract, you will deal with people you don't know and who don't live nearby. The agreement will not be a simple handshake but will require signing a binding legal agreement. You may be offered the deal on a "take it or leave it" basis with little opportunity to negotiate different terms.

A contract creates expectations and obligations between you and the contractor. You expect to be paid for what you do and that the contract will run for the agreed time period. The contractor expects you to meet the terms and deliver the quantity and quality of product promised, or to perform the services such as caring for livestock – in the manner described in the agreement.

Signing a contract is a business decision – one that brings opportunities and challenges.

Why Do Companies Want to Use Contracts?

Basically, an agricultural contract is an agreement – you agree to produce and market a specific agricultural commodity for the contractor, under the terms of a legal agreement that is signed before any seeds are planted or livestock are delivered. The contract might be a simple 1-page agreement or it may be many pages with detailed legal provisions. In any case the contract creates a unique relationship and requires you to follow its terms in the production and marketing of the commodity involved.

There are many reasons companies involved in agriculture use contracts:

Quality Control – Contracts can provide control over the genetic technology, production methods, and inputs used, and help ensure uniformity and quality of the commodity produced.

Assuring Adequate Supply – Contracts offer a way to manage the quantity acquired – to make sure an adequate supply is available.

Supply Management – Contracting can help lock in supplies for the contractor, but many contracts include terms that may limit the amount the contractor actually has to buy.

Marketing-Related Technology – Contracts can promote the use of related technologies, such as "packages" of seeds and chemicals. In other words, you agree to use both the seeds and the chemicals provided by the contractor to produce the final product.

Intellectual Property Protections – Contracts can control the release of the genetic technology by serving as a form of intellectual property protection.

Confidential Arrangements – Contracts offer a way to preserve the confidentiality of marketing arrangements and the identity of end-users or purchasers.

Pricing Confidentiality – Contracts often use non-public pricing which conceals the premium earned for any special trait. This can create higher profits for the contractor and may limit the ability of producers to bargain for more of the "added value."

Lower Risks and Higher Profits – Contracts offer companies a way to invest in technologies like plant breeding and extend their operations into the production process, but without having to own farmland or production facilities. This is important in those states with laws prohibiting corporate ownership of farmland.

Together these factors explain why many businesses, such as seed and chemical companies, grain merchandisers and meat and poultry processors, are now contracting with farmers to produce commodities. Contracting offers them stable financial returns and markets and reduces their risks.

What Are Your Benefits from Contracting?

The first question you might have is – why even consider entering into a contract? Most farmers consider signing a contract either to reduce their exposure to risk or to make more money. Indeed, some contracts can lead to higher returns and serve as a form of risk sharing. For example, contracts can insulate growers from some market price fluctuations. The following are some ways contracts may help you in your business operation:

Lower your financial risk – Contracts can reduce financial risks by providing a guaranteed source of cash flow while reducing your need for capital. For example, by raising hogs on contract, you will not need to purchase the animals but instead can use your labor and facilities to care for the contractor's animals. The contract will provide regular payments, and by not owning animals you are somewhat insulated from market price fluctuations.

Access to Capital – If you need to borrow, contracts may make you a more attractive borrower. In fact, some lenders may require contracts as a condition for a loan. By providing a steady source of income and reducing marketing risks, a contract may make banks more willing to lend you money to construct facilities. Some contractors even offer direct financing for producers if new buildings are required.

Access to New Technologies – Contracts can provide you with access to new technologies such as biotech grain. Entering into a contract may be the only way to acquire some technologies. By contracting you may get not only the

technology but also support and advice from the company.

Access to New Markets and Higher Prices – Contracts can provide an opportunity to sell for higher prices or to receive price premiums for raising new crops or using certain production methods. It may be easier to raise a specialty crop by contracting with a processor.

What Do You Give Up in Contracting?

Every business decision has pros and cons associated with it, and the decision to enter into an agricultural contract is no different. While contracts may be a way to reduce your risk, in some cases contracts may create new risks. In addition, you may lose some of the independence you have as the sole decision-maker in your business.

As you evaluate the terms of a contract, a good rule to keep in mind is that if you expect higher returns or to gain a benefit under a contract, it will be in exchange for something you do. In contract law this is known as the "consideration." Depending on the commodity involved and the contract terms, the required action – your "consideration" – can take several forms:

- You might have higher production costs in order to comply with contract terms, for example, because you must use higher priced inputs or special equipment;
- You might invest large amounts in special-purpose buildings or equipment of little use without the contract;
- You may have less flexibility in how you farm;
- You may have less control over pricing and marketing decisions;
- The crop under contract may have lower yields than your traditional crop; although your contract may state a higher potential price per unit (e.g. bushel) your overall yield may result in lower total revenue for the contract crop;
- You might receive less for the product you market if it does not meet quality standards specified by your contract. Remember, not all of your crop may be eligible for the premium or contract price;
- There is a risk you will end up financing the contractor for a time until you are paid for your crop or services.

The key to evaluating the economics of any agricultural contract opportunity is to pencil out the costs and expected returns and then determine if the extra effort is worth it.

Pencil It Out and Compare

To determine if a contract is a good economic opportunity, you should take these three steps. First, you need to "pencil it out." Try to figure what your economic return will be under the contract. Be honest with yourself. Don't just use the highest yield or the best performance, or the highest price and premiums you could earn. Of course it could happen, but you should also figure the return based on average performance. Above all, know what your breakeven price is, and evaluate the contract in that context.



You should also estimate the worst case situation – if something really bad should happen, such as a storm destroying the crop or the animals getting sick. Once you have determined your range of possible returns, you should consider any other costs or risks associated with the contract, such as any lengthy delays in

payment or the cost of complying with necessary environmental requirements. The final step is to compare the returns possible under the contract to your alternative marketing and production options. For example you might consider working with other farmers to form a cooperative, rather than enter into a contract. The point is – don't consider the contract in a vacuum. Compare it to current markets for the commodity you produce and to your current costs of production and returns. If it will be a new business, consider the alternative returns you could earn on money you will invest or borrow under the contract.

Contracting Can Create New Risks

Only by considering the terms of the contract, the legal obligations, and the relation the contract creates between you and the contractor, can you decide if the contract is a good risk for you. Consider these examples of how contracts can result in new risks for producers:

A long-term investment but a short-term contract – Most livestock contracts require you to build one or more new facilities to the company's specifications, which may require borrowing money and mortgaging your land. However, some contracts may be for a shorter period than the term of the loan. This can create a serious risk if your contract ends before the building is paid off. This risk is especially serious if the contractor is the only company contracting for livestock or poultry in your area.

Similarly, many specialty crops are produced under 1-year contracts and may require access to expensive harvesting equipment. If you buy equipment expecting to continue raising the crop long enough to pay it off, serious problems can arise if the contract isn't renewed.

Quality of the output is set by the contractor—Contracts often contain detailed terms for the quality of the crop or the methods of production desired. In most cases the contractor alone decides whether the crop or performance satisfies the standard in the contract. Experience shows market conditions can influence how strictly such provisions are applied. Many court cases on contracts have involved claims that the farmer's crops did not meet the contract standards. Courts have often found the products to be in compliance, but the real disagreement arose because the market price had fallen and according to the contract, the contractor was obliged to pay a price that was higher than the current market price. Of course, these disputes can happen both ways. In some court cases farmers have refused to deliver commodities produced under contracts when market prices were higher. It is important to recognize that one of the purposes of a contract is to fix the price or premium to be paid. As a result, contracting reduces the flexibility the parties have to take advantage of price changes in the market.

Risk of not being paid— Production contracts are a form of marketing commodities or services – and producers depend on contractors to pay under the agreements. If a contract provides for a significant delay in payment after the crop is delivered or the service is rendered, you are at risk. Until you are paid, you are an unsecured creditor financing the contractor. When poultry, livestock, or grain are sold in normal marketing channels to a warehouse or dealer, you are protected by Federal and state laws which regulate buyers and which protect your right to be paid for the crops delivered. But under most contracts you will have no such protection.

"Know Your Risk: Read the Contract"

When an Iowa seed company experienced financial difficulty and filed bankruptcy, many farmers who had grown and delivered soybeans to the company under contract were surprised to learn they weren't going to be paid. Worse yet, when the producers applied for payments from the Iowa grain bonding and indemnity funds, they were not eligible for several reasons. The contractor had never purchased a grain dealer's license as required. Further, because the production contract delayed payment until well after delivery, the state ruled the sales were "deferred pricing" arrangements not covered by law under the indemnity fund. This news came as a surprise to the growers but if they had read the contract closely, it shouldn't have. Right at the bottom of the second page was the following statement in bold print: "Notice to Seller of Financial Risk. This Contract Constitutes a Voluntary Extension of Credit. This Contract is Not Covered by Any Grain Buyer's Bond." This situation illustrates how contracting can introduce new risks of payment

and how the financial health of your contractor can affect you. It also shows how important it is to read and understand the contract

Risk of loss because you don't own the livestock or crop – Under many common forms of contracts, you do not have any legal title to the crop or animals being raised. This protects the contractor from claims by your creditors. But a contract may also state that the risk of loss of the crop, such as by weather or disease, is yours. In other words, if you raise a crop, the contractor owns it; but if the crop is lost or the animals die, you own them and no compensation is earned.

Ten Legal Rules About Production Contracts for Farmers To Consider

Most farmers are not lawyers – although sometimes you may feel like you need to be. To read and sign a contract you don't need to be a lawyer but you do need to understand how the law might apply to your contract. It is always a good idea to get your lawyer's advice on major business decisions you make on your farm – and signing a contract is no exception. Even if you decide not to consult your attorney – there are certain basic rules of contract law you should understand.

Here are 10 important rules to keep in mind -- before and after you sign the contract:

1. **Remember the first rule of contracts: whoever writes the contract benefits most.** Don't assume a contract protects you. It might but you shouldn't assume so. The contractor who wrote the contract protected its interests. You have to protect your own. Contracts are "arms-length" transactions in which both sides try to maximize their advantages. The less bargaining power you have, the less "advantage" you have.
2. **Read and understand a contract before signing it.** Contract terms determine your rights and responsibilities. Once you sign a contract it creates binding legal obligations. That is why it is critical to understand what you are agreeing to do.
3. **If you do not understand the contract, ask questions and obtain legal advice.** This is especially important if the investment or action involved is significant or if the contract creates a long-term relation.
4. **Fulfilling the terms of the contract will be required before you are paid.** You sign a contract to obtain an economic advantage. Before you can receive the benefits, you will have to perform your required obligations. You should not expect to be paid if you do not meet the terms of the contract.
5. **Never assume breaking an agreement will be excused.** Some contract terms may be more important than others but all have legal effect. If something happens so you can not fulfill the contract – like bad weather or illness – the contractor might excuse your failure but not always. In some situations, like a crop failure due to weather, state law may even provide an excuse. But if the failure to perform is your fault, the contractor might choose to enforce the contract. If you believe you

may have to default on a contract, consider alerting the other side and negotiating a resolution.

6. **Know the financial situation of whoever the contract says will pay you.** The biggest risk with contracting is not being paid once you have performed. You can minimize the risk by investigating the contractor's finances, by requesting financial guarantees, and by selling only to those covered by public laws ensuring that farmers get paid for crops or services.
7. **Remember, any proposed contract is subject to negotiation.** Even though most contracts are printed, they can still be amended, if the



parties agree. If you don't like a certain term, ask that it be changed. Remember – you will never have more bargaining power in a contract than just before you sign. The reverse is also true – once you sign, it will be difficult, though

not impossible, to alter a contract. In addition, once you enter into a production contract relation – and invest substantial sums, such as for buildings – you may have even less bargaining ability in future negotiations.

8. **Be sure any changes to a contract are in writing. Do not rely on oral communications to amend an agreement.** Just because you believe a contract was changed by a conversation with the contractor or its representative, doesn't make it true. If you and the other party agree to amend the terms of a contract, get the new terms in writing and have the other party sign them. Be sure to determine whether the person has legal authority to make the change. Most contracts provide that only written terms are binding and "oral modifications" are not allowed -- unless in writing. That is why you must get changes in writing. It is also important to keep letters or other documents showing what was agreed to. Courts may allow oral testimony to alter contracts, but the burden of proof will be on you to prove the changes were made.
9. **Keep good records of your performance under the contract.** It is very helpful to keep records and documents concerning your performance -- such as amounts you delivered and when payments were made. Also, keep notes about any communications with the contractor. If a dispute arises, your records may provide the answers a court will need in order to resolve it.
10. **Stay in touch with the other party.** Good communication between parties to a contract is important for resolving uncertainties and preventing problems. Do not hesitate to ask questions if you don't understand what is happening, such as why a payment is late. The other party may be unaware of the problem. Good communication is especially

important when conditions such as price changes or weather make upholding the contract difficult.

Critical Issues in Contracting – and the Questions To Consider

When you sign a contract – everything in it is part of your agreement. But experience shows some issues are more critical to the success of a contract. Below is a list of the most critical issues in contracting and a checklist of questions to consider about your contract.



Getting paid – *The most important reason you sign an agreement is to gain an economic advantage.*

- Do you understand how your payment will be calculated?
- Do you know when you will be paid and who will pay you?
- Are there special rules relating to bankruptcy, or for filing a security interest to protect your right to be paid if the contractor experiences financial difficulty?
- Are there payment options which might be better for you and which have less potential for disputes?

"How Will You Be Paid?"

As growers and contractors have more experience with contracting and each other, the business arrangements will evolve and improve. For example, in recent years many contractors involved in swine feeding have adopted contracts making payments based on pig space and paying bonuses for better performance. Payments under these arrangements are easier to calculate and understand than payments based on performance factors relating to feed conversion, death loss, and animal health. Experience shows that the most serious disputes between contractors and producers often relate to distrust over how performance and payments are determined. In the broiler industry, the inability of growers to measure their performance and predict their payments creates tension and has led to litigation between growers and contractors. Because performance is often tied to factors beyond growers' control – such

as feed quality, accuracy of weights, and the health of the animals when delivered – payments based on building space or other objective and predictable measures are less likely to lead to misunderstandings.

Understanding the your obligations – Every contract involves an agreement for you to perform some action. It is important to consider the risks that might arise in satisfying the contract terms and how you are affected by those risks:

- What are the risks associated with the crop you are agreeing to produce? In other words, in the event of sick or dead animals, bad feed, or poor weather, how are you affected?
- Do you know what you are agreeing to do? For example, does your contract provide for delivery of a fixed quantity of the crop produced on identified acres? Under an acres contract you are selling production from certain fields, but under a bushels contract the agreement is to deliver a certain quantity regardless of where it is produced.
- Does the contract create open-ended obligations that let the contractor require new investments or impose conditions you didn't anticipate or feel are unnecessary?
- Who sets the standards for how your actions are evaluated, and are the standards and expectations clear?

Control and independence issues – By entering into a contract you agree to meet the obligations set by the other party. This means you agree to give up some independence in how you produce or market your crop. Some contracts are more detailed in specifying expected performance:

- How much independence or flexibility in decision making will be left to you?
- Do you have any right to appeal if you don't agree with a decision or action by the contractor? For example, can you have third parties do inspections or weighing?

Length and termination of the contract (and protection of investments) – Most contracts run for a length of time specified in the agreement. The length of the contract determines how long you will have access to the contract opportunity and how long you will be bound by the obligations:

- How long does the agreement run and can it be renewed?
- What are the conditions for terminating a contract and who can terminate the contract?

- If the contract is terminated early, what happens to any long-term investments you make in buildings or equipment?
- If the contract runs for a given time, does it mean you will actually be earning income? For example, can your feeding facility stand empty for long periods with no payments?

Default and problems in performance -- *People sign contracts expecting everything to go as planned. State contract law generally requires parties to contracts to act in good faith. But experience and human nature show this doesn't always happen. The contract will probably contain a provision relating to "default" or what happens if either party breaks the agreement. Defaulting on a contract, which can give rise to a claim for damages by the other side, raises the following questions:*

- Who decides when the contract has been broken? Does it go to a court or does the contractor reserve the right to make this decision?
- What happens if something goes wrong such as a crop failure? Are you excused if forces beyond your control prevent you from performing?

"Read the Terms Carefully!"

When drought cut his white corn crop in half, a Kentucky farmer assumed he would be excused by delivering the 18,000 bushels he raised instead of the 35,000 bushels called for in the contract. But the drought had pushed the price of white corn up from the contract price of \$3.70 to over \$5.50 a bushel. When the company sued for damages based on what it had to pay to replace his corn, the farmer argued the drought was an "Act of God" that made it impossible to deliver the amount he had promised. But the court ruled the contract did not specify the grain had to come from his farm and held the farmer liable for replacing the full amount at the higher price. The case was an expensive lesson in the difference between an acre contract – which is tied to production from specific land and generally includes an excuse for nonperformance due to crop failure – and a bushel contract that does not.

Liability and responsibility – *A production contract involves a promise to produce a crop or care for animals but it may also establish other responsibilities you must meet. Contracts to raise livestock require growers to dispose of manure and dead animals pursuant to state and local laws. Production contracts typically provide that growers are "independent contractors," meaning the contractor has no liability for your actions. Identifying the other potential liabilities in a contract raises these questions:*

- What legal exposure or possible liability does the contract create?

- Does the contract require you to obtain insurance to meet your responsibilities?
- Does the contract provide that you are an "independent contractor"?

Legal protections – *The increasing use of contracts has led several states to enact laws protecting rights of farmers. Some Federal and state marketing protection laws also apply to contracting:*

- Is your contract subject to state or Federal rules establishing additional rights or protections for you?
- Does state or Federal law require that certain terms be disclosed or included in your contract?

Legal issues – *Most production contracts contain provisions relating to the rules of law governing the agreements. These provisions determine which state law applies and the procedures to follow if disputes arise. These "choice of law" provisions raise the following questions:*

- Which state law applies to your contract? (It may not be the state where you reside!)
- Where will any disputes be resolved and how? For example, is alternative dispute resolution, such as mediation, required or allowed? Does the contract require you to use arbitration rather than mediation?
- Do any special "trade" rules apply, such as those established for members of the grain industry? If special rules apply, do you know what these rules mean for your rights and obligations?

How Do You Recognize a Good Contract?

The success of any contract depends on the people involved as well as the agreement used. Contracts are written to address varying circumstances and as a result need to have some flexibility in the terms. Certain contract provisions can create more balance between the parties; however, other terms can create uncertainty. For example, when you see phrases such as: "At all reasonable times"; "Any other actions as required"; or "Reserve the right to ... at the producers' expense," you should ask how those terms might be applied to alter your expected obligations.

Because contracts are written for individual situations, it is hard to predict if a contract will turn out to be a good deal. But there are basic rules to keep in mind. Remember the old saying, "if it sounds too good to be true then it probably is" when thinking about a contract. You should be realistic -- both about the financial opportunities and about why someone wants you to sign a contract.

Contracts more likely to result in problems often have these features:

Little detail – The contract is written in very general terms that may allow the contractor to impose or avoid obligations as it feels necessary.

Delays in payment – Anytime a contract allows a significant delay in when you are paid, it raises the risk of never being paid and adds to your costs.

Lack of clear language explaining how your pay will be determined -- Many contracts use a variety of "performance" factors to determine how much you will earn. Many of the evaluations will be based on factors over which you have no control, such as the health or weight of the animals or the quality of the feed provided. While these factors may provide a way to evaluate your work, they make it difficult to predict whether a contract will be a good economic opportunity.

Confidentiality provisions – Some contracts contain provisions prohibiting farmers from revealing the contract terms to anyone. Some pricing terms may be market sensitive, but no one should be able to stop you from getting advice about a contract. In fact, some States (e.g. Iowa and Minnesota), make such confidentiality provisions illegal.

Contracts that give you little authority to make decisions – If the contract says you can only act on direct orders of the contractor, then you will have little flexibility in managing your farm.

Provisions shifting risks to you -- Contracts are often used to shift responsibility between parties. If your contract appears to make you responsible for anything that might go wrong – for example, bad weather, sick pigs, environmental problems, worker protections – and does not provide any compensation to you for taking these risks, you should be concerned.

Provisions that make it hard to seek relief – Contracts with provisions giving courts in far-away states jurisdiction over your dispute or which apply special trade rules may make it difficult or impossible for you to seek relief.

Contracts that are more likely to operate smoothly often have terms the opposite of those that are included in poorly written agreements. Good contracts typically feature:

Clear payment terms that make it easier to predict how much you will earn or which set a minimum payment, and terms which make it possible to verify the accuracy of payments you receive.

Understandable legal obligations which make it possible to know what is required.

The opportunity to



appeal decisions which impose costs on you or reduce your pay.

The ability to use third parties to supervise or review actions such as weighing or quality determinations.

Jurisdiction in the local courts and under the laws of your state.

The contract runs for a sufficient period to provide a return on your investments.

If You Have Concerns

After you have considered this information and asked yourself these questions, you are in a better position to make an informed decision about whether signing a production contract is the right business choice for you. If you still have questions or doubts about the contract, consider the following steps:

Slow down -- Don't be in a hurry to sign a contract, this is a major decision and no one should pressure you into signing until all your concerns are addressed, and you fully understand all of the terms of the contract.

Ask questions of the person offering the contract -- The contractor should be able to answer your questions and if they won't or can't, this is reason for caution.

Talk with your attorney -- Have your attorney review the contract and get advice about its legal effect and tax implications. Remember, contracts are always negotiable and you will never have more bargaining power than just before you sign.

Talk with other producers -- Visit with other farmers who have experience with production contracts, especially producers who have worked with the contractor you are considering, and ask about their experience and whether they would do it again.

Talk with other advisors -- Visit with your banker or others who have experience with contracting and see what they think about the contract you are reviewing.

Pencil it out -- Work through the checklist of issues and do the calculations to see if the contract will benefit your farm.

Visit the web sites of the Agricultural Marketing Service (AMS) and the Grain Inspection, Packers and Stockyards Administration (GIPSA) in USDA -- Learn more about contracting and compare your contract to other agreements by visiting USDA's contracting web sites (see addresses below). Use the glossary of terms located on the web site to understand what your contract means.

Talk with officials from USDA or your local Extension agent – More and more people within Federal and state agencies are gaining experience with agricultural contracts. Contact them for advice.

Consider your options – For some commodities contracts are increasingly necessary, but for other crops there are many options for production and marketing. For example, it may be possible to join with other producers in a cooperative or bargaining association to do the same thing. Determining which option works best for your farm is the key.

Remember no one can force you to sign -- You must decide whether or not to sign a contract, but remember once you do so, you have accepted binding legal and financial obligations and risks which may run for many years.

For More Information

Check out the web sites that are evolving to address contracting issues at AMS and GIPSA in USDA: <http://www.ams.usda.gov/> and <http://www.usda.gov/gipsa/>.