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Briefing on the Agribusiness Enabling Environment

AgCLIR LESSONS FROM THE FIELD: ENFORCING CONTRACTS

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The business of agriculture occupies a critical space in most economies. Distinct and special among industries, agriculture is the dominant source of employment for a large share, even a majority, of the population in developing nations.

Accordingly, governments treat the regulation of agriculture and food differently than any other sector. Unlike the output of other sectors, many agricultural products are basic necessities: agriculture provides the food, fiber, fuel, and construction materials necessary to sustain human existence. Governments everywhere assume responsibility for assuring that the distribution of agricultural commodities is great enough and equitable enough to provide a reasonable quality of life for its citizens.

Agriculture and Agribusiness: Enforcing Contracts is a briefer that mirrors the analytical framework used by the World Bank Group's *Doing Business* series (www.doingbusiness.com) and adopted by *USAID's Business Climate Legal and Institutional Reform Project* (www.bizclir.com). Divided into four sections (Legal Framework, Implementing Institutions, Supporting Institutions, and Social Dynamics), this briefer highlights the specific issues that must be addressed in local legal, regulatory, and institutional environments if agribusiness is to be economically productive, contribute to environmental sustainability, and assure a safe and reliable food supply.

ENFORCING CONTRACTS: KEY CONCEPTS

Contracts are legally recognized and enforceable agreements between two or more parties for the exchange of goods or services for something of value in return—"consideration." Consideration is typically money or other assets but can consist of almost anything, even a promise not to do something. The more informal an agricultural enterprise, the more likely contracts will be unwritten (oral) and/or enforced by social and community norms and processes. Nonetheless, even the simplest informal agribusiness, by its nature, necessarily involves a contract (agreement). The larger scale and more formal an agribusiness, the more likely contracts will be written by lawyers or specialized contract managers, international in scale, and enforced by both local and international law. The range of possible forms of agreement between these two extremes is broad.

A maxim in the globalizing world is that the ability to enter into contracts without face-to-face contact facilitates more widely dispersed trading patterns and market efficiency, but also requires sophisticated systems for informed, calculated allocation of risk that do not usually exist in settings where oral agreements between merchants are the norm.

Contracts are important to agribusinesses for key purposes: securing labor and other inputs; selling products, especially across borders where other business laws may apply; and managing business processes over time (for example, "forward" contracts that commit buyers to purchase crops still to be produced).

Technology agreements associated with the purchase of transgenic seeds are a specialized form of contract, committing the purchaser to their use in only one season. The provision of supplier credit in the form of in-kind production inputs is another form of contract;

the recipient of the input contracts to deliver a specific amount of product at some time in the future. Leasing arrangements (e.g., rental of land, equipment) also fall into the area of contracting, and typically require a specialized legal regime.

Established grades and standards for defined products and services are fundamental to the contracting process in the agricultural sector. When a contract is made to deliver "Number 2 hard red wheat" with a specific degree of moisture content, all parties have to agree on exactly what that product is and have a way of verifying it at time of shipment and/or delivery. The lack of such standards is a key barrier to effective use of contracts and agricultural market development in many developing countries. Technical barriers to producers' abilities to meet such standards reliably compound the problem.

Non-performance on contracts is normally subject to penalties that should be understood by both parties entering into the contract. In some cases, e.g., for late delivery, for lower quality, these penalties are written into the contract itself. When contracts are poorly written or are established verbally, there is great scope for disagreement between the parties as to the quality or timeliness of the contract's fulfillment. Adjudication and other dispute resolution services are thus integral to the maintenance of a system of contracting. In fact, it is the efficiency of the judicial system in resolving commercial disputes that forms the core of the World Bank Group's *Doing Business* analysis of enforcing contracts.

For local contracts, traditional courts or mediators might be sufficient to resolve disputes between contracting parties. For more complex contracts, formal legal entities following codes of civil procedure or other court regulations are likely to be involved, though the dispute may be resolved through private or semi-private sector arbitration/mediation structures that comply with mandatory legal provisions. Small claims may be easily reimbursed, but non-performance on international contracts, e.g., the export of raspberries from Guatemala to a Whole Foods in Florida, may be significantly more complex.

Work on the evolution of supermarkets as key players in the food business in both developing and developed countries has highlighted the importance of contracting in agribusiness. Small agricultural enterprises and cooperatives need training and technical assistance to enable them to move from local, verbal contracting processes to the kinds of contracts that underpin the global horticulture business, for example. Penalties for non-compliance with sanitary-phytosanitary standards (SPS) can be severe. Rejection of an entire shipment of green onions for SPS reasons at a U.S. port of entry may mean the loss of an entire season's work and significant capital investment, a critical blow for an exporting cooperative.

Timing is often crucial as well. In the example of a rejected shipment for contract non-compliance, getting the right kind of third-party inspection and setting in motion the process for legal redress must be done within hours of notification of non-compliance. While a shipment of steel can sit in a warehouse without damage for weeks, the green onions must be reinspected almost immediately. This not only requires that the sellers have contract representation on the spot but also places a premium on communications facilities. In these cases, contract management can incur considerable costs.

LEGAL FRAMEWORK

Statutes and regulations regarding contract formation and performance are a standard part of the commercial law in most countries. The *Doing Business* assessment process, therefore, does not rate the law itself, but the efficiency of the judicial process in resolving a commercial dispute over a contract.

It is often a country's constitution that establishes the court system and its jurisdictions. In countries following the civil law tradition, various codes address specific aspects of dispute resolution. In common law jurisdictions, there is a greater reliance on case law. Contract laws are supplemented with laws regarding reliance on information, capacity, and bargaining positions. "For example, the integrity of contractual exchange relies on fraud law to punish those who have positively misled their contracting partners into a contractual relationship and to deter others from doing so in the future."[1]

Carefully drafted law with regard to agricultural products and services and the ability of a variety of institutions, not just the courts, are required for the satisfactory resolution of contract disputes, especially when time is of the essence.

Three legal components are particularly critical to agribusiness.

Provisions regarding grades and standards. Mechanisms to establish such grades and standards and to inspect products for their compliance with these standards are critical for developing country agriculture. Increasingly, such grades and standards, e.g., for sustainably harvested sawn wood or "fair trade" coffee, are so complex that third-party inspectors are required as part of the contracting process.

Provisions on expeditiousness of the adjudication process. For many agricultural products, a drawn-out court process is not satisfactory. Mechanisms to establish evidence regarding the contract in dispute and preserve it for legal proceedings must reflect the fact that many agricultural products are highly susceptible to spoilage, contamination, or loss in a very short period of time. Attaching a shipment of "sustainably harvested wood" is more feasible than attaching a container load of "contaminated raspberries."

Provisions on transgenics. This will be particularly important as Bt cotton and Bt soy production expands in the developing world. While seeds from first generation Bt cotton can be planted for a second year, contracts with seed suppliers prohibit such planting.

IMPLEMENTING INSTITUTIONS

While the negotiation, drafting, and performance of an agreement may be a rather private affair between two or more parties, the resolution of disputes arising out of agreements typically requires more institutional involvement. Resolution of disputes without some kind of fair and predictable institutional intervention is undesirable and usually against public policy. Whether the intervention comes from a public sector institution or from a private/semi-private institution is a different matter.

The mechanisms for enforcement of contracts originate both in the public sector and in civil society. In fact, both contracting (agreeing) and the enforcement of such agreements are rooted

1 USAID and Booz Allen Hamilton (BAH), *Commercial Law & Microeconomic Reform: A Practical Guide to Program Implementation* (March 2007), at 92. This publication can be found at www.bizlawreform.com/CLIRTechPub-r2b.pdf.

in the customs and traditions of a social unit. More complex systems and structures for enforcement developed as the distances (both geographic and relational) between traders became larger. When distances were small (between blood relatives or townspeople only), the traditional systems were typically some variation of arbitration or mediation.[2] As the public sector became more deeply involved at the policy level, and the contracting relationships became more tenuous and complex, official judicial systems were adapted to provide law-based resolutions. Much more recently, because of the drawbacks to adjudication,[3] arbitration and mediation have found new popularity.

Judicial institutions (i.e., lawyers, courts, court-appointed bailiffs/repossessors) are critical as the default institutions for contract disputes as well as for enforcement of awards given in disputes resolved outside the court system. As the *Doing Business* analysis points out, countries that provide better and faster services in enforcing contracts are those that have established specialized commercial courts and have systems that do not involve excessive costs.

Traditional dispute resolution systems are often sufficient for resolving local contract issues—performance on a labor contract, payment for a good or service. These are typically in the nature of arbitration or mediation and can be quite formalized, but are usually simplistic to the point that they can only accommodate limited types of disputes and only parties from the same town or region.

More complex transactions do not necessarily require increased formality (indeed, arbitration is typically less formal than adjudication) but do need a dispute resolution system in which the arbitrators/mediators understand the issues and parties not from the same area can still feel they are being treated fairly.

Alternative dispute resolution can also involve third-party inspection or certification and provide more timely and satisfactory conclusions to some contract disputes. A number of relevant "third parties" exist for key agricultural commodities, e.g., the Forest Stewardship Council.

SUPPORTING INSTITUTIONS

Though trade/business/professional associations may be blossoming in a growth-oriented economy, and there may be significant interest in the possibilities for alternative dispute resolution (ADR), often virtually nothing will have been done to develop it. This seeming ambivalence may be the result of public sector inertia, a paucity of lawyers trained in ADR, or the lack of organizations that provide assistance in the area. ADR should be, and often is, one of the highest priorities for the development community.

Trade associations and chambers of commerce often have interests in establishing ADR mechanisms: they provide a service to the membership, income and prestige to the association, and allow the association to have input in the way specific disputes are handled.

Many contract forms are standard, specifying such things as the grades and standards expected, the timing of receipts and payments, and terms of delivery. Identifying the grades and standards, however, can require considerable work, especially when regional markets involving contracting for future delivery are being developed for the first time and there is little homogeneity in the way people produce and trade. Serious consultation with academic analysts, research institutes capable of analyzing quality, and market actors is required to come up with a system that works across a region.

SOCIAL DYNAMICS

Contract specialists (who are sometimes lawyers) can help agribusinesses reduce their risks of contract non-compliance. Knowledge of the culture(s) within which the contract is being negotiated can help to reduce surprises and the risk of non-compliance and dispute. This includes knowledge of the trade usages/business customs in effect in the place in which the contract is to be performed.

Given the importance of supplier credit for financing commercial agriculture, remedies for contract non-compliance (i.e., side-selling) in this area have been of some concern to the supplier industries—seed companies, fertilizer companies, and processors (milk, textiles, etc.). Government extension services and NGOs providing farmer organization and education services have been helpful in sensitizing farmers to their responsibilities regarding contractual obligations and performance.[4]

There are some who feel that contract terms offered by buyers to cooperatives and their member-farmers have been extortionate and have relied upon farmers' not understanding exactly what the expected grades and standards are or having the capacity to certify that they are being delivered. If this is the case, attention also needs to be paid to protecting farmers from having to accept non-competitive terms due to actual or perceived quality deficiencies. Donor-funded projects promoting agricultural exports and "aid for trade" have directed some attention to this issue, making sure that expected grades/standards as well as delivery terms are well understood and fair.[5]

It is, by now, well established that a business climate is made more effective, productive, and efficient if commercial ADR, especially arbitration, is promoted, facilitated, and made available to businesspeople. There are a number of reasons for this, some of them perhaps a bit surprising unless commercial ADR is thought of as a *structure* that underlays the entire *process* of business—from negotiating a deal to drafting an agreement to performing the obligations to resolving disputes if necessary and to maintaining a long-term, multi-agreement relationship between the parties. Through the provision, promotion, and facilitation of a *system* of arbitration, a culture of contract and allocation of risk—in other words, e*ducated contracting*—can be developed.

The notion of ADR as an after-the-breach method for referring disputes to an organization outside an inefficient judicial system is only the tip of the iceberg. The true value of an ADR system is in its ability, if it is structured properly, to provoke the careful preparation of agreements so disputes are never suffered, and if they are, the burden is minimal.

2 For the purposes of this briefer, arbitration may be defined as a dispute resolution mechanism that exists outside the official judicial system and offers binding resolution of a dispute based on applicable or chosen laws/rules. Mediation refers to resolution that is attempted through non-binding third-party facilitation. Various combinations of the two mechanisms may also be available.

3 Advantages to an alternative dispute resolution mechanism include, among others, that it can be quicker and less expensive than litigation, that it can be kept confidential, that arbitral centers may be specialized in complex matters, and that arbitral awards are often enforceable abroad, where the losing party may have assets.

4 Heifer International, for example, has worked with Kenyan dairy producers and cooperatives on honoring contracts with a buyer. Land O'Lakes is working more broadly with the dairy industry in East Africa to strengthen fair competition. And RATES, among others, has analyzed the issue of side-selling in Zambia. See http://www.cottonafrica.com/downloads/Zambia_Cotton_VCA.pdf.

5 See www.pfid.msu.edu.

About AgCLIR:

AgCLIR is a unique agribusiness enabling environment diagnostic that provides a comprehensive method to diagnose the root causes and inefficiencies of an underperforming agricultural sector. AgCLIR is one of a series of sector specific diagnostics produced under the USAID BizCLIR project. BizCLIR, or the Business Climate Legal & Institutional Reform Project, is a multi-year initiative of the United States Agency for International Development (USAID) with the goal of improving the business enabling environments through sound analysis and strategic interventions. This series, Briefings on the Agribusiness Enabling Environment is intended to shed light on some of the most important, and least understood, components at the intersection of agribusiness and commercial law and institutional reform. All issues are available at www.bizclir.com.

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