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Management Considerations in Agricultural Contracting

The purpose of this factsheet series is to help producers and processors understand the key elements needed to manage a business. The factsheets also discuss some of the essential components used to develop a business plan and assess the profitability of a business venture.

Contracts (in agriculture) are enforceable agreements between farmers and companies, or farmers and other farmers that include specific conditions for the purchase, production or marketing of agricultural inputs or products. Hiring a custom operator, purchasing a new machine, forward pricing a commodity and arranging for a future delivery will all involve an agreement between parties.

Contracts create unique relationships between the parties. The existence of a contract means that each party has certain legal rights and duties under the agreement. An important point to keep in mind is that there is no such thing as a standard contract. Therefore, determining whether a contract provides a benefit or adds risk to a business depends on the relationship established by the contract, the language of the contract, and the terms and conditions specified in the contract.

Every contract must be assessed individually. The purpose of the publication is to provide agricultural managers with a framework for assessing the obligations and performance required by a contract. This organized approach, assesses the business, economic and legal implications of agricultural contracts. It is an important step in developing contracts that contribute to the success of the farm business.

Management Considerations in Contracting

It is important to keep a management perspective when considering, negotiating or developing a contract arrangement. The key management issue to be considered is how a contract contributes to the short-term and long-term goals of the farm business. The specific management factors to be considered are:

- the purpose of the contract
- the economic implications of the contract
- financial considerations in contracts
- the benefits and risks of the contract
- the impact of the contract on other business relationships

The Purpose of a Contract

Contracts are developed to address or resolve key business issues. Generally, the two most common types of contracts used in agriculture are:

- purchase, production or marketing of agricultural products
- business arrangements such as leasing or custom work

Producers enter into contract agreements for the following reasons:

- Producers want to secure income security. Contracts enable producers to share production and marketing risk with other producers or with a processor. Therefore, the income received by producers using contracts tends to be more stable over time.
- Producers want to gain access to technology.
- Producers want access to management expertise.
- Contracts can provide improved access to capital.
- A contract can set a price, pricing mechanism or market outlet for a commodity before it is ready to be marketed. It can also ensure producers have access to markets, providing grades and standards are met.

Economic Considerations in Contracts

The economic motive behind contracting is to form relationships with other parties in order to gain an economic advantage that might not otherwise be available. To determine the economic benefit gained through a particular contract, managers must be able to assess the return for the resources contributed to the contractual arrangement.

Important factors for managers to consider when assessing the economic implications of a contractual agreement include:

- knowing and understanding the costs of production for the product or item that is the subject of the agreement
- knowing how the requirements of the contract will impact on cost of production
- understanding input restriction: determining whether the contract requires that inputs are bought from a certain source
- understanding input cost: determining whether the production inputs or techniques required by the contract are more expensive than what is currently being used
- realizing that whoever contributes the resource (contributed to a contractual relationship) should receive the returns as the payment received under a contract should provide a reasonable return to the resources contributed to the arrangement
- receiving a reasonable return as rent or interest for capital, wages or salary for labour and management, or profit for risk bearing
- receiving a share in the profits (and losses) that reflects the share of the total risk being carried by the individual

Financial Considerations in Contracts

Cash flow budgets can be used to assess the financial feasibility of a contract arrangement. An arrangement is considered feasible when the it produces sufficient cash inflows to meet all costs, service debt and provide a fair return to the labour contributed to the project.

Benefits and Risks of Using Contracts

Contracts may be developed so that they are favourable to all parties involved in the agreement. However, many contracts are developed in an adversarial environment. As a result, many parties involved in negotiating contracts set out to benefit at the expense of the other party. Therefore, individual managers must be skilled in assessing the benefits and the risks of a particular contract.

Generally, the motivation behind contract arrangements is that each party wants to gain some economic advantage beyond the resources they currently manage. For example, parties with limited capital may be seeking arrangements that give them access to additional land, facilities or equipment that they could not (limited capital) or would not (financial risk) acquire on their own. In other situations, individuals may seek arrangements that provide access to a market, a reliable supply or an acceptable price. In these cases, a producer is able to share some of the risk (production, financial or price) associated with the production and marketing of an agricultural commodity.

Agricultural managers must be prepared to assess whether the benefits of a particular contract offset the risks of that contract. An important consideration for many agricultural managers is the loss of management freedom that results in many contracts. In particular, production contracts lay out the production practices, the inputs to be used and the scheduling of production activities. Rather than be entrepreneurs, producers may be providers of management services.

Agricultural managers must also be able to assess how risks are allocated by the terms of a contract. A particular concern is that a contract does not shift an unacceptable level of risk onto the business. Specific risks to be considered when entering a contractual arrangement include:

- the contract being terminated, particularly if the contract is terminated before an asset (acquired to complete the contract) is completely paid for

- the loss in management control (ability to manage production practices and production losses) that may be part of the contract
- the possibility of not being paid or not receiving the performance that was contracted
- a reduction in the risk of price variability that can reduce returns, but also has a cost associated with reducing risk

Individual managers must take steps to identify and evaluate both the benefits and the risks of a particular contract. Once again, the form of the contract as well as the specific terms and conditions laid out in the contract are the key factors to consider when assessing risk.

The Impact of Contracts on Other Business Relationships

Business relationships with landlords, suppliers, lenders and custom operators may be affected by a contractual arrangement. Critical issues to consider when entering a contract agreement are:

- the rights of landlords under crop share and cash rent leases
- the credit consequences if security interests cannot be given in the crop or livestock that are being produced under contract
- eligibility for farm program payments
- the tax consequences that could arise due to a contractual relationship

Basic Legal Considerations in Contracting

Contracts can provide individual managers with legal protection, as well as exposure to legal risks. The degree of legal protection an individual achieves in a contract is largely determined by their awareness of the legal rights that are available. For an individual, the degree of legal protection achieved in a contractual arrangement is determined by their understanding of the general principles of law and their ability to identify potential legal problems when developing the contract.

The following outline presents the general principles of law that govern the performance of contracts. This outline is not intended to serve as a substitute for legal advise on a specific contractual problem.[1]

Essential Elements of a Contract

A contract is a legal agreement between two or more parties in which both parties are legally obligated to fulfil specific duties and for which either party can seek legal remedies if the other party does not meet its legal obligations.

A contract must include certain key legal elements in order for it to be enforceable in law. If any of these factors is missing, the agreement does not constitute a legal agreement and neither party is obligated to carry out the terms of the contract. The key elements are:

- **Capacity** - An individual must be able to understand the nature of the business agreement being entered into before they can be legally bound to their contractual obligations. The law recognizes that a person may lack this capacity in the case of :
  - minors
  - mentally incompetent people

  A party who lacks the maturity or mental capacity to exercise good judgement will not be bound to the terms of the contract. Legally, no enforceable contract ever existed because one of the essential elements (capacity) was missing.
- **Legality** - The purpose of a contract must be neither criminal nor against public policy. A contract will be considered illegal if it:
  - is meant to bring out a result that breaks the law
  - violates public interest or is against the common sense or morality of society

  Contracts against public policy would include contracts in restraint of trade or those that limit an individuals ability to earn a living.
- **Offer** - An offer is an invitation by one party to another to enter into a contract. Important legal considerations concerning offers include:
  - Has an offer actually been made? Of particular note is whether a proposal is an invitation to treat or an offer.
  - When is an offer communicated? The person receiving the offer must be aware that an offer has been made in order to accept.
  - Has there been a counter-offer? A counter-offer is made when a person receiving an offer attempts to qualify or add a condition to an offer. A counter-offer destroys the original offer.

[1] For an overview of the general principles of law that apply to contracts see; *An Introduction to Contract law*, Prepared by Duncan & Craig; for Agricultural Business Management Branch, Alberta Agriculture, Food and Rural Development.

- Has an offer lapsed? An offer can expire if it is not accepted in a set amount of time (indicated in the offer) or if it has not been accepted in a reasonable amount of time (as determined by the circumstances).
- Has an offer been revoked? An offer that is withdrawn or revoked can no longer be accepted. To be effective the revocation must become known to the person to whom the offer was made.

- **Acceptance** - Acceptance of an offer forms a binding contract and ends any negotiation over the terms of the contract. Important legal considerations with respect to acceptance are:
  - acceptance must be communicated to the person making the offer
  - acceptance must be in the manner set out in the offer
  - if there is no prescribed manner of acceptance set out, then acceptance can be implied by conduct
  - acceptance to an offer must correspond to the offer
  - standard form agreements have the terms of the agreement set out in print and these terms may or may not be negotiable
  - conditional contracts include certain conditions that must be fulfiled before the contract takes place
- **Intention** - Both parties (to a contract) must intend to create a legally enforceable agreement. An important issue is whether there is a meeting of the minds to enter into a legal relationship. Key issues to be considered with respect to intention are:
  - the tests used by courts
  - family and social agreements
  - exaggeration
  - parties can state they do not intend to be legally bound
  - written contracts
  - fine print
  - oral contracts
  - implied contracts
- **Consideration**- The promises exchanged in the offer and acceptance must have some value in the eyes of the law. Therefore, to be binding a contract must show consideration in that each party exchanges something of value. Some issues relating to consideration include:
  - agreements under seal may displace the need for consideration
  - a promise to perform an existing obligation is not adequate consideration for the formation of a contract
  - past consideration is not considered consideration for a promise and thus a promise given with respect to past consideration is not legally binding

The Terms of a Contract

The terms of a contract define rights and obligations of each party. In order for a contract to be binding, certain fundamental terms must be identifiable. If terms are missing that are significant to the deal, then there is no valid contract.

In contracts with missing or uncertain terms, courts will imply terms to give effect to a contract, but will not make new terms for the contract or imply terms that are contrary to the agreement.

Individual managers need to ensure that a contract agreement covers all the items that it is supposed to and that the terms in the contract are clearly understood. Parties to a contract must be satisfied with the specific terms relating to:

- contract length
- conditions for contract renewal
- pricing arrangements
- payment schedules
- delivery and marketing terms
- production requirements
- facility requirements
- management requirements
- default provisions
- conflict resolution

Enforcing the Contract

A breach of contract occurs when one party fails to live up to its obligations or duties in the contract. When a contract has been breached, the innocent party has the right to sue for damages arising from the breach and the obligation to mitigate its damages arising from the breach.

Since it takes time and money to bring about a lawsuit and prove damages, many contracts stipulate an alternative method for resolving a dispute.

Mediation is a system of resolving disputes. It requires the parties to meet and discuss their differences with a trained mediator. The mediator's role is to facilitate communication between the parties and to assist them in resolving their differences, without having to go to court.

The mediator does not have the authority to order the parties to take certain actions or to agree to a certain course of action.

In an arbitration process, the parties to the dispute present the facts to an arbitrator and make their legal arguments. Generally, the decision of the arbitrator is final and enforced by law.

(See Appendix A for a checklist of contract issues.)

Assessing the other party

Before entering a contract, each party should make a careful assessment of the other party and its ability to fulfil the commitment given in the terms of the contract.

Proper assessment of the following factors is essential when assessing the risk of a party being able to perform the contract being considered.

- The first factor is the financial position of the party. Long-term commitments generally require solid financial resources. The most appropriate approach to obtaining this information is to work with the other party in order to find out about its financial strength without compromising its right to privacy. As well, individuals have to be able to assess the other party's financial ability to manage the debt load of the proposed project.
- A long-term strategic commitment to a contract can be indicated by reputation, historical commitment to contract relationships and investment in the community.
- Identify evidence of clear business goals and long-term planning.
- References of past performance in contract arrangements is valuable.
- Does the party have the ability to manage the production process? Of particular note is the individual's ability to recruit, train, motivate and retain high quality workers.

A Management Framework For Assessing a Contract

The purpose of the following framework is to assist managers in assessing the business and legal implications of contracts and to spot potential legal problems.

Basic issues to assess when negotiating or reviewing a contract

- Has the contract been assessed in terms of how it fits into the long-term goals set for the farm business and the family? Are the financial consequences of the contract fully understood?
- Have you considered the profitability and financial feasibility of the contract arrangement under a wide range of possible prices and volumes?
- Have you considered the importance of a written contract? It is a good business practice to ensure all contracts are written. A written contract, with all terms clearly set out, ensures the enforce ability of the contract and reduce any misunderstandings about the rights and obligations of the contract.
- Is the contract written in plain language and does it include?
  - the date of the agreement
  - identification of the two parties, including any agents
  - a description of the goods or services
  - the price or other consideration
  - specification of when title passes from one party to the other
  - the signatures of the parties involved
- Does the written contract spell out all of the issues that could arise during the implementation of the contract?
  - Do all the terms that have been agreed to appear in the contract?
  - Are any changes to the written contract made in writing and initialed by all parties?
  - Has a lawyer been consulted about any legal terms in a contract or any legal consequences that are not understood?

- What legal relationship is established between the parties to a contract?
  - What impact does this legal relationship have on rights, responsibilities, credit consequences and tax consequences?
  - Do other parties (such as landlords, lenders or spouses) have to approve the contract?
  - Can the contract be assigned or transferred to other parties?
  - Does the contract clearly state that the contract is not intended to give rise to a partnership agreement?

Assessing the General Terms and Conditions of a Contract

Each party to a contract has a duty to perform their part of the contract and a right to expect the other parties to perform fully. The extent of these duties and rights will depend on the terms and conditions of the contract.

A **term** is a provision of the contract that states or makes explicit an obligation or set of obligations imposed on one or more of the parties. Terms can be expressed or implied. Failure to fulfil a term of a contract gives rise to a breach of the contract.

A **condition** is a contractual term. If breached, it gives the injured party the right to rescind the contract and claim damages.

A **warranty** is contractual term. If breached, it only gives the injured party the right to sue for damages.

Contract terms spell out the responsibilities of all parties to a contract. They need to be reviewed in order to ensure that all financial and legal obligations are understood. Required terms to be included in a contract and to be carefully assessed are:

- the contract length
- contract termination
  - Under what conditions can the contract can be renewed?
  - Under what conditions can the contract be terminated?
  - How much notice is required before termination?
  - What are the rights of parties after termination?
- dispute resolution
  - Does the contract specify a procedure to follow to resolve disputes?
  - How will damages be determined?
  - What happens if the contract cannot be fulfiled?
- contract renewal
  - Under what conditions can the contract be renewed?

Assessing Terms Concerning Performance and Responsibilities

The roles and responsibilities of the parties must be clearly defined in order to avoid misunderstandings and to eliminate surprises. Contracts must clearly define:

- who owns the product
- who holds the risk of loss
- when ownership of the commodity passes from one party to the other

Assessing Pricing Terms

Compensation issues that need to be clearly understood and evaluated include:

- knowing how prices are to be established
  - Fixed prices guarantee a certain price and the contract fixes this price on a certain amount of a commodity.
  - Are prices based on a base payment plus a bonus?
  - Are prices to be established at some point in the future?
  - What are the calculations to be used to calculate a price that is to be determined at some point in the future?
  - Are there discounts and premiums that will be applied to prices?
- knowing how the net price per unit will be determined under all circumstances

Assessing Payment Terms

Payment terms need to clarify the following issues.

- How are payments to be made?
- Is there a schedule of payments?
- At what point is the party entitled to payment?
- Are there penalties for late payments?
- Can payments be assigned to a lender?
- Will payments be made before delivery?
- Are there incentive payments and how are they determined?
- What are the computations used to arrive at incentive payments?
- Are there provisions for minimum or maximum payments?
- Does the Goods and Services Tax apply?

Assessing Delivery and Marketing Terms

There are numerous delivery and marketing issues to consider. They include the following questions.

- Where is the product or performance to be delivered?
- Are there special handling procedures to be employed in the delivery, such as health precautions?
- Who pays for delivery to the specified site?
- When is delivery to take place?
- If there is no schedule set for delivery, who decides when delivery is to take place?
- If the delivery date is not established in the contract, who sets the date?
- What is the penalty for late delivery?
- Is there a penalty if late delivery is due to circumstances beyond the control of the party?
- Does the receiving party have the right to refuse delivery?
- On what basis may the receiver refuse delivery?
- Is there a minimum number or amount that can be delivered at one time?
- How are grade and quality standards to be determined?

Assessing Production Issues

A contract may include a section dealing with production issues such as facility requirements, equipment requirements, production practices and production requirements.

- Facilities and Equipment.
  - Does the contract require an investment in equipment or facilities?
  - Does the contract require specialized equipment, additional labour or additional management?
  - Is the duration of the contract adequate to recover the investment in facilities?
  - Can the contract be terminated before the investment is fully recovered?
  - Does the contract require facilities or equipment that requires approval or certification?
  - Are there any exclusivity of use attached to the facilities?
  - Are buildings and facilities required to be standardized?
- Production requirements
  - Are there special health care practices or procedures to be followed?
  - What is the cost sharing arrangement for health care?
  - Are there standards of husbandry practices to be followed?
  - Are there limitations placed on an operators management control?
  - Who provides the labour to the production process?
  - Are production records required and who is responsible for keeping these records?
  - Who determines feed requirements, rations, sourcing, pricing, processing and handling of feed?
  - Who bears the risk of a loss in production?
  - Who pays for liability and other types of insurance?

Other Legal Issues, Penalties and Obligations

- Are the division of expenses clearly spelled out for both production and marketing of a commodity?
- Who bears the extra costs associated with bringing the commodity to the required standards?
- Is adequate insurance provided for and maintained?
- Is the determination of grade and other quality factors clearly spelled out and agreed to?
- Does one party have the right to declare the contract null and void if any of the terms of the contract are not fulfiled?
- Are there liquidated damages, specifying the amount of damages that may be claimed in case of non performance?
- Who bears responsibility for the product at various stages in production and marketing?
- Does a party to a contract have the right to enter onto the other parties land and inspect the commodity being produced?

Assessing Specific Types of Contracts

Various types of specific contracts require specific and detailed assessment. The following is a brief description of various types of contracts and key issues associated with them.

- **Production contracts** are legally binding agreements entered into before production begins to either:
  - sell a designated crop on identified acres
  - feed and care for livestock in exchange for a payment based on performance of the livestock
- Since contractors control the level of production and the production processes they tend to dominate these types of contracts.
  - There are cattle feeding agreements in which the owner of the cattle pays the feeder an agreed amount per pound of weight gained by the cattle. Weight gain is established by subtracting the beginning weight of the cattle from the weight at the end of the feeding period. An important factor to be resolved in these agreements is how shrink is to be applied when weighing the cattle.
  - There are cattle feeding agreements in which the owner of the cattle pays the feeder on the basis of feed fed to the cattle plus a yardage charge.
  - There are farrowing contracts that generally pay producers on the basis of each weaned animal, plus bonuses for achieving high production standards.
  - There are finishing contracts that pay producers for each market hog produced. Specific issues to be resolved include quality and grade standards for the market hogs and the method of compensation.
- **Marketing contracts** which set a price, pricing mechanism or market outlet for a commodity before it is ready to be marketed. Marketing contracts take several different forms.
  - **Forward sales contracts** provide for delivery at some time in the future. The price is either set in the contract or through provisions established in the contract.
  - **Pricing contracts** set the price after delivery, based on provisions contained in the agreement.
  - **Pooled price** agreements see the price based on the net receipts for the particular pool and the quantity sold.
- **Technology use agreements** have producers agree to pay a per acre fee to technology companies and buy seed each year. The cost of development is not recovered through the price of the seed, but through the technology use agreement.
- **Personal services contracts** see an individual agree to perform specified duties, in a specified time frame, at an agreed rate ($/hour/week/month).
- **Financing contracts** are simple contracts with terms varying from 12 to 84 months. The producer is the owner of the equipment and the finance company retains a secured interest in it until the contract is paid off. Monthly payments are fixed for the term of the contract. The contract may also be structured so that the payments start 30 to 90 days after the equipment is delivered and installed. This type of contract is ideal when you want to own the equipment for a longer period of time and want to match a monthly payment to your budget.

Appendix "A" – Key factors to be Considered in Agricultural Contracts

- Does the contract require higher priced inputs, intensive production practices, investment in equipment and facilities, increased handling costs or increased storage costs?
- What is the potential variation in production levels under the contract arrangement?
- If investment in specialized equipment is required, does the length of the contract relationship match the repayment period required to finance the investment?
- How financially sound is the other party to the contract?
- How ethical is the other party to the contract?
- In a production contract, is the contract for a specified quantity of commodity or for the production from a specified number of acres?
- What penalties would apply if the producer does not produce sufficient quantity to fulfil the contracts?
- Is there an "Act of God" clause that excuses weather or other problems related to production?
- How is payment to be made?
- What is the legal relationship being established between the parties to the contract?
- What is the potential liability as a result of the contract?
- When does title to the commodity change hands?
- When is payment to be made?
- What contract terms must be completed before performance is completed?
- What records must be kept as part of performance?
- How will any disputes be resolved?
- Does the contract allow for changes in the contract terms after the agreement has been entered into?
- What is the basis for termination of the contract?
- What is the basis for renewal of the contract?
- Can the contract be assigned to another party? If so, what approvals are necessary?
- Are the delivery points required in a contract convenient?
- What grading or standards must be met?
- When inputs must be acquired from a particular source, are there terms to ensure timely delivery and reasonable prices?
- Are there restrictions on the sale or use of a crop that is contracted, but not sold under the contract?
- Does the purchaser of contracted production have the right to not purchase production if it meets the specifications set out in the contract?

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