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Agricultural Marketing Contracts

Phillip L. Kunkel, Jeffrey A. Peterson
Attorneys, Gray Plant Mooty

INTRODUCTION

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

A long-term marketing contract is an agreement of a fixed term, entered before production begins, under which a producer either agrees to sell or deliver all of a specifically designated crop raised on identified acres in a manner established in the agreement or to sell specific quantities of livestock to the contractor. Under such contracts, the producer is paid according to the payment terms set forth in the contract.

REGULATION OF MARKETING CONTRACTS

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

Federal Regulation

An unpaid cash seller of livestock and perishable agricultural commodities may be able to assert a priority claim against the assets of a buyer which fails to pay for such farm products (under the statutory trust provisions of the Packers and Stockyards Act (PSA) nor the Perishable Agricultural Commodities Act (PACA). In 2008, Congress also revised the PSA to include: (a) the producer the right to discuss with certain individuals (regardless of any restrictions in the contract) the terms of a marketing contract that is for a period of one or more years, (b) that the venue for an contractual dispute shall be the federal judicial district in which the contract was performed and the choice of law shall be governed by the state in which the dispute arose (unless otherwise prohibited by the law of the state in which the contract was being performed), and (c) the right of the producer to reject an arbitration provision in the contract. However, this legislation only relates to poultry and swine marketing contracts.

State Regulation

Recent federal laws overlap, to some extent, with laws already enacted in the State of Minnesota. The Minnesota Agricultural Contracts Act contains several provisions designed to protect producers who enter into marketing contracts. Under these provision: (a) any contract for an agricultural commodity must contain a provision calling for either mediation or arbitration of any contract disputes; (b) parent companies of subsidiaries licensed to purchase agricultural commodities are liable to a seller for any unpaid purchase price or any claim based upon a contract if the contractor fails to perform; and (c) all agricultural contracts must be in plain language, contain risk disclosures and provide for a right of rescission. A producer must be aware of the applicable state restrictions and limitations on the use of such contracts.

OTHER LEGAL ISSUES

Several legal issues may be raised by long-term marketing contracts. As in the case of any contract, the terms of the contract at issue will often be determinative in resolving any contractual dispute. However, there are several important considerations for sellers which are raised by such contracts.

Quantity of Crops/Livestock Subject to Contract

An initial issue to consider when assessing a long-term marketing contract is the quantity of crops or livestock which are to be subject to the contract. Some contracts require specific numbers of animals to be provided each month or week. Such contracts sometimes grant the buyer a first option to purchase any additional marketable production of the seller. Other contracts involve a promise by the seller to sell all his production to the buyer. Contracts which cover all of the seller's production result in an inability on the part of the seller to sell its production on the spot market in the event market prices are in excess of the contract price. Conversely, however, if the contract price is substantially in excess of the market price, such contracts provide the seller with a more attractive marketing outlet for his production.

Determination of Price

A long-term marketing contract will typically set forth in some detail the manner of computing the amount due the producer. For example, some contracts establish the price to be tied to a cost matrix based on costs of inputs. Other contracts are based upon a market price index. Producers must understand the basis for payment set forth in the contract. In addition to understanding the formula, however, both parties must evaluate whether the contract will likely allow for a profit under existing market conditions. For example, if the marketing contract is based upon a market price index, and the cost of inputs increases substantially, the producer may incur significant lose if the market price does not immediately reflect the increased price of the inputs.

Conditions of Payment

A marketing contract will also generally establish various conditions of payment. The quantity of farm products required to be delivered as well as the grade, weight or condition under such a contract will often be carefully defined. Compliance with the buyer's production requirements will generally be required. Premiums or merit adjustments may be provided for crops or livestock which exceed such minimum requirements. These conditions must be understood by both the producer and its lender.

Amounts to be Paid to Seller

Some marketing contracts, particularly in the swine industry, provide for guaranteed minimum prices to be paid the seller regardless of the market price of the hogs at the time of delivery. While the details of such contracts are unique, depending upon the terms of each such contract, there are several common characteristics of such "ledger contracts." Such contracts generally establish a minimum price for the livestock. The price paid the seller may be greater than the minimum price if the "market price" of the livestock is higher than the minimum price at the time of delivery. The exact amount to be paid the seller in such a case will be determined based upon a formula set forth in the contract. A portion of any amount by which the market price exceeds the minimum price may be accounted for by crediting a reserve account established by the buyer for the seller. Interest may, or may not, accrue on any such amounts owed the seller. However, if the market price for comparable livestock at the time of delivery is lower than the minimum price, the seller will be paid the minimum price. In such a case, the buyer will account for such payments by debiting a reserve account in the name of the seller. Any amounts owed the buyer by the seller on account of such payments may bear interest. Such amounts may be repaid when, and if, the market price again exceeds the minimum price provided in the contract out of the excess via credits to the reserve account.

Any amounts owed under such contracts, regardless of which party to the contract is owed funds by the other, will likely constitute an extension of credit to the other party. If the seller owes the buyer substantial sums as a result of such a contract, it may affect the ability of the seller to obtain continued financing from his lender. Such amounts may trigger defaults under the seller's loan agreements. In addition, some contracts provide that the seller will provide the buyer with a security agreement granting the buyer a security interest in the seller's assets to secure all amounts owed the buyer by the seller. If the seller grants a security interest in his assets to the buyer pursuant to such a contractual provision, the legal relationship between the parties is transformed from that of buyer and seller to that of borrower and secured lender. Depending upon the provisions of the security agreement, the buyer may obtain a security interest in the seller's machinery, equipment, crops and livestock.

Conversely, if the buyer owes the seller pursuant to such a contract, the seller has provided unsecured financing to the buyer. In some cases, this may violate the terms and conditions of the seller's loan agreements. In addition, the seller's remedies in the event of nonpayment by the buyer will be affected by such contracts. The seller will not be able to reclaim any livestock which has been delivered to the buyer under such a contract based upon the nonpayment of any amounts owed the buyer. In addition, it is not clear whether the trust provisions of PSA would apply to the nonpayment of any deferred amounts owed a seller under a ledger contract.

Ultimately, of course, the balances owed under such contracts must be reconciled. Under some contracts, whichever party is in a negative position at the end of the initial term of the marketing agreement may extend the contract in order to liquidate the negative balance owed in the reserve account. Other contracts provide that the amount owed in the reserve account, regardless of which party is the obligor, is payable at the expiration of the term of the agreement. The manner in which any such reserve account is reconciled should be carefully analyzed and understood by both parties to any such contract.

Modification of Terms

Most long-term marketing contracts contain provisions which allow the economic terms of the contract to be modified. While this is necessary inasmuch as such contracts are long-term arrangements, it is critical the producer understands that the economics of such contracts may be subject to change. Producers should consider not only how pricing terms may be modified by the packer, but how often, under what circumstances and to what extent such modifications will be permitted.

Impossibility

An important provision in any long-term marketing contract is the force majeure term. This essentially frees both parties from liability or obligation when an extraordinary event or circumstance beyond the control of the parties occurs. The production of farm products carries significant production risks. If the contract relates to the production of crops, crop failure due to weather conditions, disease, etc. is not uncommon. Livestock is susceptible to disease problems which can significantly affect the ability of a producer to comply with a marketing contract. Producers and their lenders should be conscious of the impact of such production risks in assessing any marketing contract.

Nonpayment by Buyer

As is true with any contract, a seller of farm products under a marketing contract is always subject to the risk of nonpayment or other nonperformance by the purchaser. Federal and state law may provide an unpaid seller of livestock additional remedies in the case of such a default on the part of the buyer. Minnesota law grants an unpaid seller of agricultural commodities, other than grain and raw milk, with a lien against the commodities delivered to a purchaser and the proceeds of such commodities for the contract price of the commodities. Furthermore, an unpaid seller of livestock may be entitled to assert a secured claim based upon the PSA, which specifically creates a statutory trust for the benefit of all unpaid cash sellers.

Contractors/Buyer's Bankruptcy

Should a buyer file bankruptcy, the rights and remedies of a seller under a long-term marketing contract will be affected. As an executory contract, the marketing contract is subject to rejection by the debtor under Bankruptcy Code §365. If a debtor has failed to make payments to a seller prior to filing bankruptcy, the claim of the unpaid seller for such amounts will generally be an unsecured claim against the bankruptcy estate unless (i) the seller has preserved its PSA or PACA trust rights, if any; (ii) perfected a statutory lien against the livestock delivered to the debtor or (iii) promptly exercised its reclamation rights.

CONCLUSION

Marketing contracts have become an integral part of production agricultural. Due to this increased use (and the extensive use of contracts to bind producer to less than favorable contract terms), the Federal government and the State of Minnesota have adopted laws that are intended to provide additional rights to producers. Being aware of these rights is critical to any producer who is intending to enter into a contract or who is a party to a marketing contract.

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