

Evaluating Production Contracts

No one is anxious for the telephone to ring in the middle of the night. It usually means a traumatic event, which weighs heavily on human emotions, such as a death or injury to a loved one. The same is true for a farmer who is producing a value-added commodity. A surprise in the middle of the contract term may mean not only the loss of the premium, but potential default on the contract.

A wise specialty crop producer will thoroughly evaluate a production contract to determine if it fits his or her operation, if it is economically sound, and if the risks to be taken are manageable. This exercise will require line-by-line and word-by-word study of the contract, questions asked of contractor representatives, and potential evaluation of the contract by the producer's attorney.

To assist the evaluation process, a template has been developed with the assistance of the Iowa Attorney General's Office to provide a producer with the type of questions he or she needs to research.

Check List of Important Considerations for Specialty Grain Contract Production

Production Issues

Facilities and Equipment:

1. Does the contract require you to make investments in equipment or facilities?
2. Is special drying, storage, irrigation, or other handling equipment needed? Does this equipment require extra management, fuel, utilities, or repair?
3. Is the duration of the contract adequate to recover your investment?
4. Does the contract require your facilities or equipment to be approved or certified? Is special calibration needed?
5. If identity-preserved grains are involved, will you need special storage facilities?

Production costs:

1. Do you know your costs of production for the crop involved? If not, then you should consult University of Illinois Extension or others for estimated costs of production.
2. Do the requirements of the contract increase the production costs above those normally expected?
3. Are you required to use inputs or techniques that are more expensive than normal?
4. Are you required to buy inputs from a certain source?

Yield/production penalty:

1. What is the expected yield of the crop involved?
2. If specialty grains are involved, then is the projected yield less than one would normally expect?
3. Do you receive compensation for this yield reduction?

Growing obligations:

1. Are you able to comply with the growing obligations in the contract? Are you willing to comply with these obligations and give up certain decision-making freedom on how, when, and where to grow crops?

2. Is a specific pest control program required?
3. Is the hybrid involved herbicide susceptible or resistant? Is the hybrid involved insecticide susceptible or resistant?
4. Is a particular fertility program required?
5. Do you need to maintain a distance from other crops to prevent cross-pollination or other adverse effects?
6. How much crop residue is left from this crop and how does that impact your conservation compliance plan?
7. What authority does the contractor have to enforce growing obligations? Can the contractor enter your land and do work on the crops? If so, who is responsible for any damage?

Payment and delivery issues

Payment terms:

1. How are you being paid? Are the terms of the payment clear?
2. If you are being paid on the price of the grain, then how is that price established? Is it established basis Chicago Board of Trade or is there a different pricing method?
3. When is the grain priced? Can the grain be forward priced?
4. Who, in fact, markets the grain?
5. Are check-off funds collected on the grain?
6. Is the schedule of payments firmly set? Does this schedule satisfy your cash flow?

Premiums/bonuses:

1. If there are premiums or bonuses involved, then how are they calculated and when are they paid?
2. Can you examine the calculations used to determine these premiums or bonuses?

Condition of the crop:

1. What does the contract require as to the condition of the grain such as moisture, foreign material, test weight, oil content, protein content, etc.?
2. Has the Federal Grain Inspection Service established quality standards for this grain and these factors? If not, then what standards are used? Can you achieve those standards?
3. Is there a concern about aflatoxin and other mycotoxins? Is this grain mycotoxin susceptible or resistant? What are the mycotoxin limits under the contract?
4. Who conducts the quality tests and when?
5. If you disagree with the test results, can you get a third party to independently test the grain? How are conflicting test result disputes resolved?
6. What are the penalties for quality non-compliance? How is the amount of the penalty determined? Is it set in the contract language itself, or is it determined at time of harvest?
7. Are you penalized for poor quality if it was caused by adverse weather conditions or other factors out of your control?
8. Who bears extra costs incurred to achieve quality compliance, such as extra drying to achieve test weight?
9. Does quality non-compliance on a portion of the crop result in penalties on all of the crop involved in the contract?
10. If the grain is rejected as a specialty grain, then can it be sold on the open market as a conventional commodity grain?

Amount of production:

1. Are you required to deliver a set amount of grain under the contract?
2. What is the penalty for failing to deliver this amount?

3. Do you have to find substitute supplies to fulfill the contract if you have a shortfall?
4. Are you responsible if the shortfall is due to an "Act of God." such as weather, insects, or plant disease?
5. If the weather prevents planting, then can you make adjustments in the number or location of acres? Are there trigger dates for these adjustments?
6. Are you responsible if the shortfall is due to production decisions you did not make, such as fertility or pest programs?
7. Does the contract list the fields on which the crops are to be grown, without chance of changing that cropping pattern?

Delivery site/delivery date:

1. Where is the crop to be delivered?
2. Are there any special handling procedures?
3. Who pays for the delivery to the site?
4. When is the crop to be delivered?
5. Is the date set in the contract? If not, then who sets the date?
6. What is the penalty for late delivery? What is the penalty for early delivery?
7. Are you penalized if late delivery is due to circumstances beyond your control?

Payment date:

1. When are you entitled to receive payment?
2. If payment is to be made after delivery, then what guarantee of payment do you have?

Ownership of crop/risk of loss:

1. Who owns the crop?
2. Usually the party with title of ownership bears the risk of loss. Does the contract modify this rule?
3. Who bears the risk of loss of the crop in the field, in storage, or in transport?

Grain dealer status/Grain insurance fund:

1. Illinois law establishes an indemnity fund to compensate unpaid sellers of grain if: (a) the buyer was a licensed grain dealer, and (b) the transaction was considered a sale of grain. Are you covered by this fund?
2. Is the contractor a licensed grain dealer?
3. Is the contract a sale of grain? Is the contract only paying you for services?
4. Is payment for unpriced grain to be made 30 days or more after delivery?

Liens:

1. Does the contract prohibit you from granting liens or security interests on the crop to a third party, such as a landlord, lender, or supplier?
2. Will you as a producer be able to obtain a lien in the crop, which is superior to all other liens?

Contractor credentials:

1. If you have concerns about getting paid under the contract, then will the contractor provide you with a financial statement? Will the contractor provide you with a list of producers used in past years?
2. Is the contractor bonded for this type of obligation?
3. Does it appear that the contractor is committed to contracting in the region? Has the contractor made investments in fixed assets or relocated management to the region? Is contracting the contractor's core business?

Your credentials:

1. If the contractor has questions about your ability to perform the contract, then are you willing and able to give the contractor a financial statement and names of individuals who will verify your financial stability and management abilities?

Parent company responsibility:

1. If the contractor is a subsidiary company, then does the contract make the parent company responsible for payment if the contractor defaults?

Other legal issues

Dispute resolution:

1. Does the contract provide for alternative dispute resolution such as mediation or arbitration before the parties can take the dispute to court?
2. Is a mediator a neutral party?
3. Is the arbitrator a neutral party? Are you willing to accept the binding arbitration settlement?

Termination of contract:

1. Under what conditions can the contractor terminate the contract?
2. Who determines whether those conditions are met? Are there objective standards, or is it the discretion of the contractor? For example, can the contractor terminate the contract if the contractor determines you have not complied with the quality provision? Or, does the contractor have to verify the quality problems with independent testing?
3. Can the contractor terminate the contract for minor breaches of the contract?
4. How much notice does the contractor have to give prior to termination?
5. Are you given an opportunity to cure a problem before termination? How much time are you given for this?
6. What are your rights after termination by a contractor?
7. Can you sell or use the crop not purchased under the contract?
8. Under what conditions may you terminate the contract?
9. What if you get sick, disabled, or die? What if you go bankrupt?

Renewal of contract:

1. Under what conditions can the contract be renewed?
2. Again, are there standards, or is it up to the contractor?

Legal relationship of parties:

1. What legal relationship does the contract create between you and the contractor? Is it a landlord/tenant relationship, employer/employee relationship, independent contractor, partnership, joint venture, agency?
2. Does the contract refer to a bailment?
3. Does the legal relationship impact your tax situation?

Approval of others/assignment:

1. Do other parties have to approve the contract, such as your landlord, lender, or spouse?
2. Can the contract be assigned or transferred by you or by the contractor to other parties, which may have important tax consequences?

Farm programs:

1. How will the contract affect your eligibility for farm program payments?
2. Will the contract jeopardize your "beneficial interest" in the crop being produced for purposes of government loan or deficiency payments?
3. Is the crop considered a program crop for purposes of payment or base retention? How will this affect your established farm yield?

Insurance:

1. Are you required to buy multi-peril, hail, or other crop insurance? Are you required to buy liability insurance to cover pesticide drift and other problems?
2. Can you get Federal Crop insurance on the crops involved? If so, then can you use your actual production history or will other yield determinations be used?

Protection of intellectual property:

1. Are you required to take any special steps to protect the contractor's property interests in the grain's germplasm (genetic material)?
2. Are you responsible for security of the germplasm?
3. Who owns the germplasm? Does the contract limit your ability to save seed to plant on your own farm in the future?

Choice of law/venue/change of law:

1. If the contractor is from another state, then does the contract specify the state law that governs? Is this choice of law fair to you?
2. Does the contract set a venue (location) for any lawsuit that might be filed? Is this location fair to you?
3. Does the contract permit renegotiation or nullification of the contract if the laws governing production contracts are changed?

Duration of offer:

1. How long do you have to accept the contract? Is there an expiration date for signing?

Put it in writing:

1. Are all agreements, promises, interpretations of the contract in written language? Are there any oral agreements that may not be valid in a court?

If you cannot answer these questions, consider asking or having your attorney ask a company representative for answers. If you still have concerns, you may not want to enter into the contract. In any case you should always consider having your attorney review any legal document before you sign it.