

Issue Report

Production Contracts

How this risk-management tool is being used is being reshaped by consolidation within many sectors of the food industry, impacting supply chains and rural communities.

Every sector of agriculture is being reshaped today by consolidations within the industry, strong consumer interests and influences of the global marketplace. This evolutionary process also is reshaping the industry's risk-management tools, including production contracts.

Agriculture has used production contracts for decades. The earliest form probably was sharecropping—farming a parcel of land owned by another person in return for a predetermined percentage of the crop. In the early 1900s, production contracts were used to market vegetables to grocery chains. But since the 1960s, agriculture has increasingly used contracts as a means to clarify relationships and responsibilities between commodity and livestock farmer-producers and the entities that buy their goods—merchants, processors or end users.

In some sectors of agriculture, production contracts have seen rapid

adoption. Contracts became widespread in poultry production in the 1950s; hog contracting began to increase a decade later. In 1969, only 6% of all farms used production or marketing contracts, amounting to 12% of the total value of all U.S. agricultural production. By 2001, 10% of all farms used contracts to raise 36% of the total value of agricultural production.

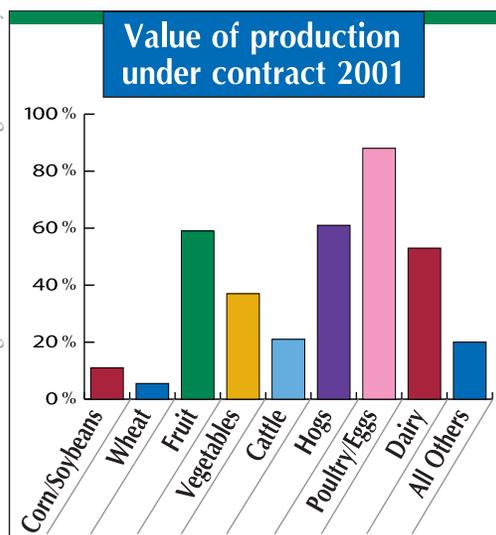
Issues Under Debate

A number of factors are combining to encourage and foster growth in the use of contracts to define relationships and address risk. These include: specialization, consolidation and globalization in the food sector; increased consumer demand for food safety; increased use of patent-protected inputs; and more attention to the environmental and natural resource impacts of agricultural practices. These factors have contributed to greater use of contract production and resulted in more control of the production relationship being given to or taken by the purchaser/contractor.

Increased specialization and consolidation of the food processing, distribution and marketing sectors have resulted in larger retail, distribution and processing firms. Fewer independent farmer-producers are directly involved in the marketplace. Increased use of patent-protected inputs also has caused an increase in the use of contracts as a means of controlling production.

Contractors see an increasing need to maintain high levels of quality and consistency in product inputs. Product identification requires higher levels of

Source: USDA 2001 Agricultural Resource Management Survey





- Retention of too much risk by the producer, including environmental risk; and
- Decline in positive relationships between the producer and the companies with which they contract.

control of the day-to-day activities of production units. Contracts also are seen as improving the ability to incorporate new technology and skills at a more rapid pace within the production system. Increasing awareness of and concern about food safety have put more emphasis on controlling food products from farm to table.

However, some farmer-producers contend contractors are shifting costs to them, reducing already tight margins. Charges have also been made of unfair treatment and market manipulation by contractors. Some farmer-producers contend they have made substantial capital investment based on contract specifications, only to have the contracts changed or withdrawn.

Large firms using contracts may bypass local participants in the food marketing chain. The result is reduced economic activity in the local community.

Issues in the public debate about the use of contracts to define agricultural relationships, as identified at a Farm Foundation workshop on the topic (see box, page 4), include the:

- Potential for exploitation of a company's market power;
- High levels of producer indebtedness tied to production contracts that involve sophisticated and rapidly evolving technological requirements;
- Inability of the weaker party (the producer) to negotiate all elements of the contract (unequal bargaining power);

A recent development is the move to establish, as a matter of state law, that producers involved in contract relationships are in fact employees of their contractors and not independent contractors, a status contracted to by the parties. Production contracts traditionally have contained provisions recognizing the producer's status as an independent contractor. As such, producers are responsible for tax and insurance liabilities, liabilities related to third parties and, most importantly, environmental liability that might arise in connection with the production activity. If the producer were an employee of the contractor, a chain of liability to the contractor could be established.

Regulatory and public concern about the impact agricultural practices may have on water quality has brought an increasing number of court challenges regarding the relationship between the producer and the contractor. Emerging issues related to food safety and public health will undoubtedly yield similar debate on the independence of these relationships.

Determinations of employment status historically have hinged on such criteria as instructions given to workers, training provided by the business, financial control, permanency of the relationship, extent of the worker's investment in the business, how payment is made, and freedom of the worker to engage elsewhere in the marketplace. Ultimately, the issue hinges on control.

Should the courts rule that the relationship of the producer to the contractor is that of an employee, rather than independent contractor, the ramifications include:

- *Tax liability* – loss of tax deductions and tax status; changes in tax treatment of on- and off-farm income; changes in expense treatment for the farming enterprise.
- *Benefits* – entitlement to unemployment compensation, workers' compensation and retirement benefits from the company.
- *Labor* – coverage under the Fair Labor Standards Act; issues of supervision of employees, formerly independent contractors.
- *Tort liability* – treatment under federal and state anti-discrimination laws; issues related to termination at will or for cause; employment status and its effect on property ownership and liabilities associated with property ownership.
- *Participation in federal farm programs and financial implications* – liens on employment contracts; collateral; producers (now employees) no longer seen as "actively engaged" in farming; eligibility for federal technical and financial assistance programs.
- *Management* – the ability of producers to manage all or a portion of their operation.

Environmental liability has been the driving force behind cases seeking judicial interpretation of current contract relationships. New precedent is being sought that would impose on the contractor the full range of environmental liability for soil, water and air quality impacts that may be caused by agricultural production. Potential policy impacts could go beyond environmental problems, creating unintended consequences. These could be avoided with a more comprehensive understanding of policy ramifications.

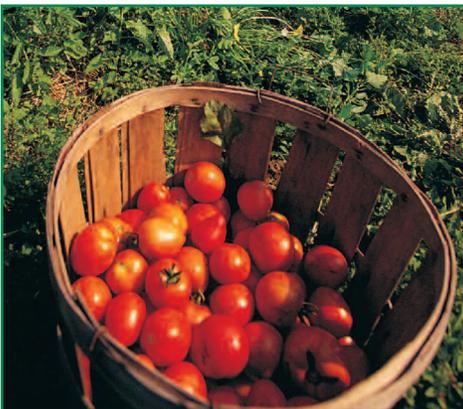
Current Federal, State Policies

No comprehensive federal agricultural contracting policy exists today. Some states have enacted agricultural contracting regulations, but inconsistencies are present state to state.

In debate prior to passage of the Farm Security and Rural Investment Act, several proposals that addressed contracting issues were introduced. These generally centered on fairness in the contracting relationships or food sector concentration concerns. Only one was included in the final legislation: a provision that farmers who contract have the right to discuss the contract with their lawyer, financial adviser or family member.

While comprehensive federal agricultural contracting legislation remains under debate, states are taking actions to create or enhance existing policies. The states' approaches include:

- Clear disclosure to the producer of all risks of the contract;
- Prohibition of confidentiality clauses;
- Prohibition of binding arbitration in contracts;
- Recapture of capital investment protection by allowing cancellation of contracts only after notice and an opportunity to cure problems; and
- Identification and banning as an unfair trade practice use of the tournament pay system, or ranking system, to determine payment under production contracts.



Additional provisions are contained in a model Producer Protection Act, drafted by the Iowa attorney general and endorsed by more than one-third of the state attorneys general. Details of this model legislation are available at www.iowaattorneygeneral.org/AGContractingIowarelease.htm.

Policy Alternatives and Consequences

Participants in the Farm Foundation workshop identified two policy approaches that could be used to address the issues surrounding contract production: 1) Do nothing at the federal or state policy level; or 2) Enact a comprehensive federal policy or encourage passage of comprehensive state policies. The consequences of each option are summarized below.

Policy Alternative 1: Do nothing at the federal or state policy level. This would likely mean contract disagreements and disagreements on liability questions would be decided by the court system. This policy option allows for problem resolution at the state and local level fashioned around particular local precedent.

Consequences for farmers: Courts will continue to entertain piecemeal approaches to farmers' concerns. Inconsistencies in interpretations, as well as unintended and unexplored consequences, may occur.

Consequences for agribusiness: Courts will continue a piecemeal approach to addressing such issues as environmental liability to third parties, and relationship issues between producers and contractors. Agribusinesses would be unable to manage effectively for risks because of the broad range of possible outcomes within each state or jurisdiction.

Consequences for consumers: Food prices, percentage of income spent on food, food safety and nutrition could be negatively impacted through absorption of damage awards associated with

Producers historically have been involved in open local or regional spot markets as a first line of market involvement. The agricultural production and marketing system has been grounded on the principle of maximum independence for the individual producer. But contracts are changing the way business is done.

A contract is a legally binding agreement between two or more parties involving an enforceable promise to do something or to refrain from doing something. Contracts usually relate to the supply of goods or services and price, but they can vary widely in scope, complexity and terms or conditions. Contracts are one tool to reduce risk, stabilize quality, protect against price fluctuation, and describe the rights and responsibilities of the parties in the transaction or relationship.

In agriculture, the traditional use of contracts has included agreements between farmers and the companies that purchase or market the commodities farmers produce, agreements between producers and suppliers, and agreements concerning land-use arrangements.

Historically, two major types of contracts have been used in agriculture: marketing and production. Marketing contracts, which can be verbal or written, usually set a price for established quality grades and identify delivery procedures for the harvested product. Under typical marketing contracts, the individual producer makes most, if not all, management decisions and owns the commodity until its delivery to the specified market, thus bearing all the risk for its production, delivery to market and conformity to contracts. Marketing contracts can be in the form of forward sales contracts, pre-harvest pooling arrangements or contracts setting price after delivery.

Agricultural production contracts usually involve a shift in management authority from the farmer-producer to the contractor—a processor, mid-chain purchaser or end user. Contracts may require producers to comply with production conditions. Contracts also may specify acceptable inputs and management requirements, as well as quality and quantity requirements. Producers may be paid a specified price identified in the contract. Purchasers may supply producers with inputs and technical production guidance. Purchasers may assume some production risk and may retain ownership of the contracted crop or animal throughout the production relationship.

litigation regarding third-party liability and producer/contractor relationships.

Consequences for taxpayers: It is uncertain what the taxpayer cost would be if no action is taken.

Consequences for the environment: The cost of environmental impacts to current and future generations is uncertain. Proponents of the shift to employer/employee status argue that environmental liability will be passed to the corporate partner in the relationship, which arguably has access to greater resources to address environmental impacts of agricultural operations. If no action is taken and the employer/employee proponents are correct, the potential for environmental impacts will be prolonged during lengthy potential court battles and may only be passed to the contractor on a piecemeal basis.

Policy Alternative 2: Enact comprehensive federal or state policies addressing the full range of contract arrangement impacts, including oversight and enforcement capabilities.

Consequences for farmers: Possible alleviation of relationship problems in the current contracting system might occur. Independent third-party entities



The Source

At the September 2003 workshop, *Truth or Consequences: The Future of Contracts in Agriculture*, Farm Foundation brought together producer and commodity groups, agribusiness leaders, community activists and legal experts to identify policy options concerning production contracts. Collaborating with Farm Foundation were the University of Arkansas Division of Agriculture,

the National Association of State Departments of Agriculture, American Farm Bureau Federation and Arkansas Farm Bureau. Conference presentations are at www.farmfoundation.org/projects/03-30ContractsinAgpresentations.htm. Contributing authors were Janie Hipp and H.L. Goodwin, both of the University of Arkansas.

could be created to provide ongoing guidance to and oversight of the relationships. Passage of state legislation only could still result in a piecemeal approach if states adopt conflicting or dissimilar policy instruments.

If the courts deem producers to be employees of the contractor, a comprehensive examination of unintended consequences and potential ramifications of this precedent is needed to fully determine the impact on producers' income, distribution of benefits, land prices, efficiency, farm structure and product prices to the consumer.

Consequences for agribusiness: There may be potential costs associated with changing to a new producer/contractor relationship system. There may be positive consequences for agribusiness in relation to the ultimate consumer.

Consequences for consumers: The impact on consumers is uncertain. Consequences for taxpayers: There could be a cost to the taxpayer in increased governmental regulation of the agricultural contract relationship.

Consequences for the environment: If comprehensive federal and/or state policies that address the changing nature of

contracting relationships were adopted, the strain on natural resources would arguably not be as great over time. Studies to analyze this outcome are needed.

Consequences for rural people and communities: Rural communities have been under tremendous strain as they attempt to walk the narrow line between encouraging economic development by involvement in the changing nature of a global agricultural system, while balancing support for fair treatment of citizens and the stewardship of natural resources. Policy options that encourage clarification of the needs of rural communities, and clarification of policy regarding use of natural resources and employment/contracting, could assist rural areas.

Summary

As agriculture continues to evolve, the nature of contracting relationships of parties within the system will change. We are currently in the midst of social debate about which direction these relationships will turn. Changes will occur—either in the marketplace, the courts or the legislative arena. Analysis of the consequences of potential policy changes is critical.

Farm Foundation's mission is to improve the economic and social well-being of U.S. agriculture, the food system and rural communities by serving as a catalyst to assist private and public sector decision makers in identifying and understanding forces that will shape the future.

Farm Foundation

1211 West 22nd Street • Oak Brook, IL 60523
Tel (630) 571-9393 • Fax (630) 571-9580
www.farmfoundation.org

This publication is intended to be a vehicle for discussion and debate of challenges in agriculture and rural America.