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Contracts in Agriculture

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Contractual relationships are nothing new for farmers. Contracts commonly used in agriculture include sales of land, equipment and grain; loans and mortgages; input purchases; land and equipment leases; and production and marketing contracts. Although these transactions occasionally take the form of oral agreements, written documents are increasingly being used to specify the terms of an intended transaction.

In fact, contracts have become so common that they are often overlooked. When installing a software program on a computer, users are asked if they accept the terms of the end user license agreement. Most people check "I agree" without reading the lengthy verbiage and not realizing that it is legally binding. While this method may be acceptable for some transactions, it is certainly not recommended for agribusiness contracts.

Some farmers have avoided written contracts, believing that they communicate lack of trust. A handshake and verbal agreement should be sufficient, some would argue. This perspective focuses on a potential offense of clearly writing out the terms of the agreement while overlooking the value of written contracts to clarify the agreement that is being entered into, and hence, preclude real offense. Depending on several factors, an oral agreement may not qualify to be called a contract and may have the effect of leaving one or both parties with absolutely no legal obligation.

A contract is a legally enforceable promise. It is an agreement that specifies the terms to which all parties associated with the contract agree. It is the result of one party making an offer that, if accepted by the other party, generally places on both parties the legal obligation to perform on their respective promises. More specifically, it often lays out the allocation of decision rights, value and risk among the parties either specifically or by inference.

A contract is a legally enforceable promise.

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The purpose of this guide is to provide an introduction to the legal foundation of contracts and an understanding of the role of contracts in business transactions. It provides information that will allow readers to understand several other guides dealing with specialized contracts being offered in agriculture. These specialized contracts involve activities such as carbon sequestration, conservation easements and long-term leases for wind energy turbines.

Contracts and legal considerations

A contract is different from an agreement. *Two* people can agree to trade an old truck for $3,000 and never have a contract. They can legally make the sale without the contract and, as long as neither party complains, no one will interfere. A contract, however, includes *three* entities — the two parties signing the contract and the court system. If you fulfill certain requirements in your agreement, the court system agrees to be a third party and step in when asked to correct any illegal or prohib-

Five requirements of a contract

1. Parties must be ***legally able*** to enter into a contract.
2. Contract must be for ***legal purposes***.
3. There must be an ***offer***.
4. There must be ***acceptance***.
5. ***Consideration*** must be given.

ited behavior or make a remedy available to an injured party.

For an agreement to become a contract and be legally enforceable, it must meet five requirements. The first two, although necessary for any legal contract, are usually not an issue in agribusiness agreements. First, the parties must be identifiable and legally able to be party to a contract. Second, the deal must not be for illegal purposes (you may not contract for someone to grow an illegal crop).

The last three requirements of a contract often create problems that significantly affect legal enforceability. Briefly stated, these three requirements are (1) there must be an offer, (2) there must be acceptance, and finally (3) there must be consideration given.

Offer: The offer involves a transfer of power from one party to the other to finalize the agreement. The offeror constructs a proposal in such a way that all that remains is for the other party to accept or reject the offer. If it is accepted, the offeror generally has no choice but to perform. He made the offer and gave the other person the full authority to form the contract.

Acceptance: When the party receiving a valid offer accepts that offer, what is otherwise an agreement becomes a legal contract if the last requirement, consideration, is met.

Consideration: To make the final step from an agreement to a contract both parties must provide some consideration to the other. Consideration is a legal term that means the parties must exchange something of value, a legal detriment to the parties giving consideration. "I promise to deliver 5000 bushels of corn that I currently own into your possession and ownership" is a legal detriment of the original owner of the corn. He did not have to give the corn away but offers to exchange it for money if the other party accepts and gives his consideration (the money), "I promise to pay you $15,000 for the 5,000 bushels of corn." He did not have to otherwise give the first person (offeror) the money — his legal detriment — but agrees to it if the other party delivers the corn.

When one business proposes to another business an agreement that may later become a contract, they will suggest terms that best meet their needs and interests. Without a careful understanding of the proposal by the other party, the resulting contact may only meet their interests by coincidence.

The offering business proposes the initial terms of the agreement; the accepting business must scrutinize the agreement to make sure that its interests are met. Acceptance of a contract means that the party being offered the contract believes that its needs or desires can be met within the terms of the contract. In other words, both parties should sign a contract only if it is expected to be a win-win situation.

The win-win situation is not necessarily one that was initially offered. The party that is offered the contract can tell the offeror that certain terms are unclear or unacceptable. The two parties can modify the agreement until the provisions more clearly meet the interests of both parties. The only time that this negotiation can safely occur is before the contract is completed, or signed.

All agreed upon contract clauses need to be written to be effective. Unwritten agreements made before execution of the contract are likely to have no legal effect. In other words, if one of the parties to a contract does not do something they agreed to orally but did not write into the contract, the second party probably has no legal recourse. This principle comes from the Parol Evidence Rule of the Uniform Commercial Code, which may govern the enforceability of the contract.

For some novel contracts, *bailment* is an important term to understand. Bailment is the transfer of possession (not ownership) of something from one person to another for some temporary purpose (e.g., repair or storage) after which the property is either returned to the original person or otherwise disposed of in accordance with the contract of bailment. Examples of bailment in novel contracts include wind turbines owned by an electric company and placed on property owned by a farmer, livestock owned by one business but raised in a building owned and managed by another business, and a farmer growing seed corn or pharmaceutical crops for a business that retains full ownership of the genetic material in the crops.

An important distinction is the idea of conducting a transaction and developing an entity. Many contracts involve merely a transaction where the two parties agree to trade goods or services. Some contracts create another business entity such as a partnership or corporation. The assignment of rights, responsibilities, rewards and risk differs depending on whether the contract is creating a new business entity or merely facilitating the trading of goods and services.

Many contracts contain confidentiality clauses. These clauses are designed to keep the contracts out of the public domain. They do not negate the right of each party to obtain competent legal and financial counsel about the contract.

Contracts and economic transactions

At least three business decisions are involved in every business transaction: (1) the allocation of decision rights; (2) the allocation of reward, or value, and (3) the allocation of risk and uncertainty. These three elements along with the relationship between output and input should be reflected in the amount of detail in the contract.

Allocation of decision rights

An allocation of decision rights occurs when one party receives rights from another party. A simple transfer of title for any good is a transfer of decision rights; the buyer acquires the ownership rights from the seller. But the transfer of rights does not have to be as exhaustive as a complete transfer of ownership rights. Decision rights might involve the right to use or access property (e.g., mineral rights), the right to conduct business (e.g., a lease) or the right to make a decision that is binding upon another at some point in the future (e.g., putting a water well on a piece of property).

An important decision right that is normally specified in contracts is how disputes that might arise later will be resolved. While having a contract means that the court system will step in when asked to correct any dispute, it does not mean that the court will always assist in dispute resolution that may be possible before the case gets to court. The contract may specifically state that disputes are to be resolved by mediation or by arbitration. Mediation is when the two parties to the contract enter into negotiation in the presence of a neutral third party. Arbitration is when a neutral third party evaluates the contested issues and renders a decision, usually binding on each party.

This illustration of how decision rights are specified in the contract indicates how important it is to understand what decision rights each party has in a contractual relationship. Each party should be fully confident that they can successfully accomplish their work within the constraints specified in the contract. Each party should also be comfortable with the rights given to the other party. For example, the other party may be given the right to enter your property, send a representative into your premises or view your records to ensure compliance with the contract.

Allocation of reward

As discussed above, a contract must, by definition, include *consideration from both parties*. The allocation of reward or value identifies who will receive what valuable consideration. The simplest allocation of value is the transfer of money for a good or service. While a seller receives monetary value from the buyer, a buyer receives value from the service provided or from the control of a product.

A perfectly legal and enforceable contract can be formed by two parties even if the resulting deal is a bad decision economically for one of the parties. In other words the "valuable consideration" is not judged by a standard of whether the consideration offered was a good business decision, but rather that the consideration leaves one party deprived of a legal right to ownership or control he would otherwise have. The courts will avoid injecting themselves into whether one or both parties got a "good deal." Rather, they want to make sure the deal was legal. Two people can agree that one would buy the brand new car belonging to the other for $500, and it may be a perfectly enforceable contract. Of course, the person giving up the car may have second thoughts and want out of the deal. This is where the third party (the court system) comes into the deal. If the five elements of a valid contract are met, the contract is probably formed and disputes may now be litigated in court.

Risk can rarely be eliminated, but it can be allocated between the parties to a contract.

Because reward is the benefit most people naturally seek in a contract, a contract attempts to specify how rewards will be distributed. Pertinent payment issues include (1) how payment is calculated, including details related to bonuses, premiums and penalties, (2) when payment is to be made, and (3) how payment should be delivered. The value offered (consideration) does not have to be monetary. A buyer receives value, but no money, in the good or service obtained through the contractual arrangement. Another nonmonetary value might be in the form of a decision right. When a business pays to receive the right to make a decision in the future, it is referred to as a real option. Several novel contracts contain real options. Carbon sequestration contracts contain real options when they specify that the contract becomes effective only when the price reaches a certain level. Wind energy development contracts contain real options when they specify that the company has the right to erect wind energy turbines if a wind study indicates sufficient wind to run the turbines.

Another value provided by contracts may be access to a market. This is common in marketing contracts but can also be true of novel contracts. For example, the investment needed to purchase and operate a wind electricity turbine is prohibitive for most people. But producers leasing their land to companies that specialize in wind energy can obtain a contract that allows them to benefit from energy price increases.

Allocation of risk

All transactions contain uncertainty. Uncertainty is increased when long-term contracts are used because the further into the future that a business relationship exists, the more uncertain each party is of the financial and production conditions that will exist when the contract is executed. Risk is uncertainty that has the potential to cause a negative effect for one or both parties of the contract.

Risk can be reduced but rarely eliminated. It is merely assigned to one party who accepts responsibility for managing the uncertainty. Each party should clearly understand what risks they are accepting and which ones they are transferring in the contract. An allocation of risk arises from a situation in which the future value of some element in the contract is not known at the time of the contract signing.

For example, when grain is delivered for that day's market price, there is little uncertainty involved in the transaction. But if the contract specifies the quantity of grain to be delivered or the price to be paid at some time in the future, risk increases. Production conditions may not have been sufficient for the full quantity of grain to be produced. If the price goes up, the provider of the grain may want to choose not to deliver at the agreed upon price. Conversely, if the price declines, the purchaser of the grain may want to cancel the delivery.

The problem of price risk within contracts can be illustrated by the bankruptcy filing of VeraSun Ethanol. VeraSun Ethanol filed for bankruptcy protection on October 31, 2008. The result was that farmers and elevators that had contracts to deliver grain to VeraSun Ethanol at specified prices were left with few good choices. The courts decided that corn already delivered but not paid for would be treated as an unsecured credit that would be paid from the assets of the company if there are any remaining. Corn still to be delivered would not be paid the contract price but the lower of the contract price or the current market price.

Because contacts contain legal clauses and definitions of words, the allocation of risk can be unclear to a person not familiar with contracts. For example, is grain that has been delivered but not yet paid for the property of the producer who put it in storage, or has ownership been transferred to the business controlling the storage? The case of VeraSun not paying full contract price for already delivered grain is an issue of bailment, discussed above. Bailment issues assign risk to different parties. These peculiar allocations of risk may require legal counsel to be discovered and understood.

In production contracts, price uncertainty to the producer is frequently reduced because producers are raising livestock for a set fee, regardless of how the price of the livestock changes. Grain production contracts can also reduce uncertainty by specifying a set price or a price formula.

Some risk occurs just because of the contractual relationship each business has to the other. Risk of the other party defaulting on their responsibilities can be evaluated by (1) reviewing their current business, including how long they have been involved in the business, what fixed investments they have made, determining any bonding they have for this type of business, and reviewing their financial statements, and (2) obtaining references from other persons who have contracts with them.

Because contracts can affect the riskiness of a business, lending institutions have a vested interest in new contracts being considered and often desire to review them before they are signed.

Characteristics of contracts

Input- or outcome-based performance

Satisfactory performance of a contract can be judged by monitoring either the inputs used or the outcomes achieved. If outcomes are closely correlated with effort, then designing a system based on observable outcomes might be an efficient allocation of value and risk. In such a case, producers would have significant operational independence because their incentives are closely aligned with the buyer's incentives.

Output-based contracts determine whether the terms of the contract have been met by testing the quality of the output. For example, high oil corn contracts pay based on the percent oil in the corn. Producers have great latitude in how they raise the corn, knowing that the final price will be determined not by the activities done during production but by the measurable traits in the output. The company purchasing the product may specify certain minimum inputs (e.g., seed planted, number of acres, etc.) to guarantee an adequate supply, but generally leaves operational decisions to the producer.

Input-based contracts can be used when the quality of the outcome can be controlled by specifying what steps should be taken in the production process. An example of an input-based contract is organic farming, where the organic label is determined not by any measurement of the final product's characteristics such as calories or protein level. Rather an organic label is granted to products that have been produced by following certain input practices. Because the final product is not tested for particular traits, monitoring of input practices is used to verify individual performance. Such contracts specify many tasks related to production inputs, such as seed planted, location of production, records to show that no chemicals were used, and inspections during growing season.

The Chicago Climate Exchange (CCX) offers soil carbon sequestration contracts in which it assumes that 0.6 ton of carbon dioxide is sequestered by no-till practices in specific regions of the United States. This is an input-based contract. The CCX specifies what activities can and cannot be done on land enrolled in a carbon sequestration contract. Basing payment on observable input (no-till management) is an efficient allocation of risk and value because trying to measure outcome (actual sequestered carbon) on all acres would be prohibitive. The cost of monitoring production practices is very low in relation to the cost of testing soils.

The CCX also offers a methane destruction contract where livestock facilities that capture and destroy methane are paid for the reduction of greenhouse gases. This is an output-based contract. The outcome, amount of gas captured and destroyed, is measured and payment is based on the actual output.

Asset specificity

To fulfill the obligations of a contract, assets may need to be purchased that are specific to the product being delivered. For example, a grain bin might be necessary to hold grain until the time that it is to be delivered. The grain bin is an asset with a specific, often narrow or restricted use. Because it cannot easily be used to store anything except grain, it has *asset specificity*. This introduces risk into the transaction by causing an investment in something that may have little other use in the future. Should the purchaser of the grain stop purchasing, the need for the grain bin would diminish and yet the asset (and its financial impact on the business) would remain.

The amount of risk introduced into a business activity from asset specificity depends on how specific the asset is to one use. The grain bin has asset specificity because it can be used for little else of value. However, the specificity of the asset is not dependent on the current contract that might have justified the investment. If the farmer ceases to store grain for one company, the grain bin can be used to store it for another company. The amount of risk is reduced if the asset can be used to satisfy business activity with other businesses.

In novel contracts, highly specific assets might be employed. For example, a lagoon cover and electric generator may be purchased if methane is captured and burned to generate electricity. Should a smaller quantity of methane than expected be captured or the value of green electricity be reduced, the lagoon cover and generator are still expenses that can be used for little else. Risk is high with this type of asset specificity.

Asset specificity can also be a positive feature for some business transactions. When companies are looking for places to locate wind electric turbines, they seek specific locations that have good wind characteristics. Frequently a high ridge of land in an otherwise flat location has more value than the surrounding land. This gives increased value to the ridge that may be of no other benefit than for wind turbines. In such a case, the ridge of land has high value relative to its next-best use.

Contractual incompleteness

While a contract attempts to specify the rules of the game, it is difficult to fully specify all of the rights and responsibilities of both parties in every situation. From this perspective, contracts involve what is called incompleteness. This incompleteness creates loopholes, an ambiguity that might allow one party an opportunity to take advantage of the other party.

While loopholes can be frustrating, attempting to close all loopholes can be costly and result in long, detailed contracts or later litigation. If a contract has substantial possibility of leaving these loopholes open, an attorney should definitely be involved to protect your interests.

Contracts that are fairly common should have fewer problems with incompleteness because experience acquired over time has revealed many of the loopholes or the number of contracts written reduces the cost of closing the loopholes. These loopholes can be lessened in future contracts as they become evident in existing contracts. For example, hundreds of producers have entered into carbon sequestration contracts over the last few years. Because so many contracts have been written for the same transaction, the cost of outlining the rights and responsibilities for various cir-

cumstances is fairly low. On the other hand, long-term options to place wind energy turbines on land are fairly new, and there are relatively few existing contracts on which to model new contracts. Incompleteness is likely to be more of a problem with wind energy contracts than with soil carbon sequestration contracts.

Contractual incompleteness is worsened by "information asymmetry," when one party has information that the other party does not have. If one party has better information about something such as price or quantity, they are able to use that information to write a contract that allows them to take advantage of their information. For example, the market for "green energy" is currently developing and, as yet, is quite flexible. Companies that enter into contracts with producers who supply some input (e.g., biomass or land leases for wind energy generation) may have better information about the governmental policies and markets that surround green energy. Such contracts might specify how energy is currently marketed but not give insight into developing energy value that can be captured (and shared) with all the parties involved in the energy production.

Having all contracts reviewed by an attorney is another way to reduce the problem of contractual incompleteness. Competent counselors should be able to alert producers to situations that have led to undesired consequences and give advice on how to avoid the problem.

Another key to understanding contract incompleteness is to become familiar with the activities involved in any contractual arrangement you are considering. Learn about the market that you are entering with a novel contract. Appropriate counsel might include not just an attorney or financial counselors but also a professional in the activity being conducted on your land. For example, many of the novel contracts offered in agriculture deal with green energy or global climate change legislation. Being familiar with the range of legislation being considered will give insight into the possible circumstances that could affect your participation and your potential gain by participating.

Anything that was discussed between the two parties should be committed to writing. If an agreement, or some part of it, is not in writing, it may not be binding on either party and therefore may not be enforceable.

Acknowledgment: This guide summarizes information from a research article titled *Contract Structure and Design in Identity-Preserved Soybean Production,* by Sykuta and Parcell.

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