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Legal aspects of contract farming agreements

Synthesis of the UNIDROIT/FAO/IFAD
Legal Guide on Contract Farming

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Preface

This document is primarily a synthesis of the *UNIDROIT/FAO/IFAD Legal Guide on Contract Farming* (hereafter referred to as the “Guide”) (UNIDROIT, FAO and IFAD, 2015). It was prepared by FAO and reviewed by UNIDROIT and IFAD. The work was financed through an IFAD grant.

The Guide is a comprehensive document that considers contract farming from the viewpoint of private law. It adopts a worldwide perspective, drawing on experiences from contract farming in many countries, both developed and developing. The present publication aims to extract and synthesize the most important issues covered in the Guide. However, although the resulting document tries to remain faithful to the original, it aims to place greater focus on issues of relevance to developing countries and the realities in these countries. It also includes observations and lessons learned from FAO’s previous experience with contract farming to illustrate the findings from the Guide when appropriate (FAO, 2001; 2005; 2012; 2013a). Thus, the publication may be seen as a tool for the dissemination and practical implementation of the Guide, particularly in developing country contexts.

It is hoped that the publication will give commercial organizations, lawyers, policy-makers, farmer representatives and others a useful summary of the many legal issues related to contract farming. Nevertheless, for legal professionals and for those planning to draft contracts, it is not intended to be a substitute for consulting the original Guide, which is highly recommended.

The document seeks to provide guidance concerning the design and implementation of sound contracts, thereby generally contributing to building a conducive environment for contract farming. Neither it nor the Guide consider in detail legislation that governments may wish to use to regulate contract farming agreements. Legislation can be used to create an environment in which parties can benefit from informed decision-making and the protection of rights. Such regulation should aim to enhance the freedom of parties to develop contracts in a way that is mutually advantageous.

The publication does not intend to cover all possible agricultural contracts. Its scope is limited to the bilateral relationship between producer(s) and a contractor through contract farming. This involves parties entering into a contract that could be established for a fixed term, for one production cycle, for several or many cycles or years, or for an indefinite period. The document aims, first and foremost, to provide advice to promote harmonious relations among all parties involved in contracts and those advising them. In general, contract farming has been found to be a very workable way of organizing production and marketing relations and this publication, far from wishing to challenge that idea, aims solely to inform the parties involved in contract farming operations of approaches to address some of the ongoing difficulties.

A specific difference between contract farming in developed and developing countries is that producers in developed countries tend to be medium- or large-

scale commercial farmers, whereas in most developing countries they are usually smallholders, often in a comparatively weaker bargaining position. Although this document discusses the potential resolution of disputes in state courts, it should be recognized that this is not effective in those judicial systems where the cost of litigation is greater than its potential benefits (FAO, 2005). However, this does not mean that contracts are not required. Legally valid contracts are in all circumstances an important way of enhancing understanding between contractors and producers, specifying their respective responsibilities and facilitating the development of trust. They are also essential if the parties want to resort to mediation or arbitration in cases of dispute.

Acknowledgements

The present document has been drafted on the basis of the longer document *UNIDROIT/FAO/IFAD Legal Guide on Contract Farming*, published in 2015 by the International Institute for the Unification of Private Law (UNIDROIT), the Food and Agriculture Organization of the United Nations (FAO) and the International Fund for Agricultural Development (IFAD). A full list of those involved in preparing the previous guide is given on pages v to vii of that document.

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Finally, Roberta Mitchell is thanked for editing, Simone Morini for layout and design and Caterina Pultrone for proofreading.

Acronyms

FPIC	Free, prior and informed consent
IFAD	International Fund for Agricultural Development
IPR	Intellectual property right
NGO	Non-governmental Organization
UNIDROIT	International Institute for the Unification of Private Law

Introduction

The subject of contract farming has been widely discussed in various FAO publications and the reader is referred to these for detailed descriptions of the system, its benefits and potential problems (FAO, 2001; 2005; 2012; 2013a). In addition, FAO's Contract Farming Resource Centre makes available a wide range of reports on the topic, together with many examples of actual contracts. Given the wealth of information already available on the subject, this document simply provides a brief description of contract farming, in order to clarify the exact nature of the contractual arrangements under discussion.

WHAT IS CONTRACT FARMING?

Contract farming can be defined as agricultural production carried out according to a (contract farming) agreement between a buyer and farmers, which establishes conditions for the production and marketing of a farm product or products (FAO's Contract Farming Resource Centre). This publication focuses on contract farming agreements between producers and a contractor,¹ which are usually drawn up before production begins. Contractual specifications can be more or less detailed, covering provisions regarding production technology, prices, risk sharing and quality, among many others. The producer undertakes to produce and deliver agricultural commodities in accordance with the contractor's specifications. The contractor, in turn, agrees to purchase the product for a specified price and generally has some involvement in production activities through, for example, the supply of inputs and provision of technical advice. Contracts may specify the desired processes for crop production or livestock rearing. This is often, in part, to comply with domestic or international quality and safety standards.

Virtually any commodity may be produced under contract, but the nature of the commodity invariably has important implications for the content and type of the agreement. For example, commodities have different production cycles. Some require only a few weeks to grow, while others may take several years, as is typical for many tree crops, forestry production and some livestock. Among other aspects, the growth cycle will generally determine the duration of the contract, and may influence other elements such as delivery arrangements. Long-term relationships are essential when long-term investments are made but may not always be needed for short-term crops.

BENEFITS AND RISKS OF CONTRACT FARMING

Contract farming has opened up important opportunities for economic and social development in developing countries. It can link smallholder producers

¹ In this document, the word "contractor" is used to refer to any individual, company or other organization that works with farmers in order to carry out contract farming. To avoid confusion, the contractor is referred to throughout as "it".

to supply chains that guarantee a consistent market for their products. Knowing in advance when and to whom to sell their production can help to reduce the inherent unpredictability of agriculture and allow producers to plan production better. Contractors also usually give technical assistance and inputs to producers. Access to knowledge on more modern agricultural practices through the technical assistance and access to modern technology provided by contractors is a major incentive for producers to participate in contract farming, as it can lead to significantly increased yields and profits.

However, in addition to the risks associated with all agricultural ventures, this type of farming clearly involves specific risks for both parties. For example, the downside of easy access to credit is the possibility of incurring mounting debts that the producer may struggle to repay, should the market price fall unexpectedly below a profitable level. Moreover, switching from subsistence farming to cash crops may cause a loss in biodiversity and even a threat to the producer's own food security.

Further risks are that increased labour requirements may place an additional workload on the producer's family or workers. Gender relations may be affected. Women may not benefit sufficiently from the potential advantages – they may lose access to land traditionally allocated to food production; incur an increased workload; and have little access to payment for the contracted crops.

On the other hand, contracts should enable the parties to reduce risks effectively. Contractors can use the products from contract farming to optimize the capacity of processing facilities, management of stocks and delivery to customers. They can theoretically ensure that the product meets the designated quality standards. In return, producers may get a more predictable income, based upon the contractor's commitment to purchase the product. Market price fluctuations, which are often a major source of risk for agricultural production, may be avoided. Contract farming can also create opportunities for producers to grow marketable commodities that are new to a particular area.

Producers not working under contract have to bear the entire risk of crop failures and other natural disasters, and/or market collapse. Contract farming can sometimes lead to risk sharing with the contractor, usually in a better position to absorb risk without endangering its own viability. Shifting even minor risks from contractor to producer may lead to smallholders being unable to shoulder the added burden. It is thus important for a contract to take into account how risks can be reduced and how they should be allocated.

A major benefit of contract farming is its role in providing credit. Contractors often provide inputs or services (such as land preparation, planting, harvesting and transportation of produce) and repayment is usually deducted from the value of the product on delivery. As a result, a producer can start production without facing any advance payment. This is almost essential for smallholders, who are often unable to obtain credit because of the lack of banking facilities in their area or, where they exist, they offer financial products that are often characterized by high interest rates and/or an inadequate design in terms of agricultural cash flow patterns and collateral requirements (FAO, 2013b).

Contract farming can have wider societal benefits. It generally sustains family farming by enabling producers to continue working on their own land. It can also encourage the creation of producer organizations and thus increase the bargaining

power and efficiency of smallholder producers. Furthermore, it can contribute to resolving environmental concerns by including the environmental standards of global supply chains.

SCOPE OF THIS DOCUMENT

The structure of this document closely follows that of the Guide. Chapter 1 introduces the legal environment within which contract farming operates. Building on this basis, Chapter 2 presents the key characteristics of the parties involved in contract farming – the producer and the contractor – as well as those of the contract itself. Chapter 3 is dedicated to the obligations of the parties, as well as to the ways in which contract farming can be used to allocate risks. Since such obligations cannot always be fulfilled, Chapter 4 looks at acceptable legal excuses that the party unable to perform may use. Where non-performance cannot be excused, the aggrieved party has to rely on certain remedies. The most common remedies used in contract farming are highlighted in Chapter 5. Chapter 6 covers issues related to the duration, renewal and termination of the contract. Chapter 7 contemplates the role of dispute resolution in contract farming, particularly alternative dispute resolution such as mediation and arbitration.

Chapter 1

Legal framework for contract farming

Parties involved in contract farming should generally be free to draft their contracts as they see fit, based on the widely recognized principle of freedom of contract. However, this freedom may be limited, as domestic contract law usually includes mandatory rules from which the parties cannot deviate. Additionally, the law is likely to offer default rules that provide solutions when matters are not specifically addressed in the contract. More important, legislation safeguards the rights of parties involved in a contractual relationship, which is especially relevant in cases of uneven balance of power among partners. Understanding how a contract is regulated by law will help the parties consider mandatory and default rules, and enable them to draft better terms for their contract. It will also help them when trying to resolve disputes.

1.1 LEGAL RULES GOVERNING CONTRACT FARMING AGREEMENTS

Applicable private law regime

The rules of the country where production takes place should usually apply to both the contract farming agreement itself and to the relationships between those signing the contract and third parties, such as credit, input or service providers. Even when the contractor is part of a multinational group, it generally conducts its operations through a local subsidiary, which is a separate legal entity.

Contract farming may be affected by many laws. Some regulations are found in special provisions in general contract law, while others are enacted through stand-alone contract farming legislation or commodity-specific legislation. Within laws concerning agriculture, land, tax, labour, corporate relations, commerce and competition, special provisions may address the relationships between producers and buyers. Relevant provisions are sometimes included in a general statute on agricultural sector development that also covers aspects such as investment, finance, land tenure and producer organizations.

Specific regulations on contract farming may contain requirements regarding the structure and content of a contract as well as its negotiation process. Specific legislation also often deals with dispute resolution, generally by favouring alternative dispute resolution. The aim of specific regulations is generally to balance the relationship between the parties.

Not all legal systems treat contract farming agreements as a special contractual category. Even those that do so may not regulate them in great detail. Therefore, default rules are often drawn from rules governing traditional types of contract. For example, in many contract farming arrangements, the producer has ownership over the product throughout the production cycle. When the product is ready for sale, the producer transfers it to the contractor and receives payment, minus any advances and other costs. Legislation on transactions that involve a transfer of ownership, such as sales contracts, can provide default rules for these kinds of contract farming arrangements. However, in other contract farming agreements, particularly for livestock, no transfer of ownership takes place. This is a common

practice in poultry production, where the contractor entrusts day-old chicks to the care of the producer, while retaining the title to them. At the end of the production cycle, producers return the chickens to the contractors, and are paid for their performance. Legislation governing transactions that do not involve a transfer of ownership could provide default rules for these kinds of arrangements.

Other domestic legal sources

General principles of law may provide further guidance to the parties. More or less widely recognized principles include: principles of good faith; principle of reasonableness; preference for preserving the contract and its efficacy whenever possible, in accordance with its purpose and the original will of the parties; loyalty and fair dealing (often considered as consequences of the principles of good faith); behaving in a consistent manner; and the duty of information, transparency and cooperation among the parties. The content and authority of the principles may change greatly in different legal systems.

Many countries recognize legal pluralism, where the right of certain regions or communities to be regulated by specific rules is applicable on the grounds of legal tradition or personal, ethnic, territorial or religious criteria. Awareness of such issues by contractors is particularly important when tenants are contracted to farm on customary land. Customary rules often derive from practices and traditions, are rarely written down, and may deal with matters such as family relationships, inheritance, governance of land and other natural resources, as well as rights over livestock. They may include rules on contract formation, risk allocation and dispute resolution. Rights may be collective and apply to a whole group or community, with internal enforcement and dispute resolution mechanisms often being in place. In these cases, local culture and private institutions may prevail over other laws.

Besides laws and customary rules, usages that refer to common practices and terms in transactions taking place in a particular trade or industry should be taken into account, so long as they are not contrary to the law or express terms of the contract.

To assist contractors and producers in developing reliable contracts, voluntary or mandatory standard contracts could be drafted by both governments and private entities such as trade associations, professional organizations, Non-governmental Organizations (NGOs) or individual commercial firms. This drafting process should preferably involve a wide range of actors, representing producers, contractors and possibly third parties. Where there is no suitable multistakeholder association or similar to do this, the parties may advocate that one be developed (FAO, 2009). Standard contracts may also originate from public entities (such as international organizations or government agencies, or bodies formed by stakeholders from various sectors). Compliance with such standard contracts is usually monitored by an internal or external body, which may also serve as an enforcement authority, especially when the contractual standards are mandatory.

1.2 ROLE OF THE REGULATORY ENVIRONMENT

Food safety

Food safety is becoming more important when drafting agreements. Consumer health protection is usually enforced under domestic legislation and, for exports, by the importing country. In the case of livestock, for example, production is governed by animal health and production legislation.

Farm inputs

Legislation governing agricultural inputs affects the manner in which a contract is carried out, because contract farming frequently specifies adherence to prescribed production methods, as well as the direct provision of agricultural inputs by the contractor. Contractual arrangements for access to and use of seeds may be subject to seed legislation, which ensures that seeds are of a high quality and remain available and accessible to producers. Both parties to a contract are bound by domestic seed legislation. Access to seeds and seedlings may also depend on domestic legislation governing biosafety. For example, certain countries have banned the import of genetically modified seeds. Countries also provide legal protection for new plant varieties to encourage commercial plant breeders to invest in varietal improvement.

Laws governing access to and use of pesticides and fertilizers may also influence contracts. Legislation normally includes a general prohibition against producing, purchasing and using these products if they are not authorized or registered by the competent authorities. Producers are bound to use only authorized products and to respect regulations related to their use and disposal. With livestock production, parties also need to pay attention to legislation governing feed and veterinary pharmaceuticals.

Agricultural sector legislation

Governments around the world have, to varying degrees, implemented policies and enacted legislation designed to support their domestic agricultural sectors. These efforts may be very broad or focus on one or several commodities. They may also have a range of effects on the contract itself and the producer's or contractor's relations with third parties.

Human rights

International human rights obligations may influence how governments regulate contract farming. Businesses have a responsibility to respect human rights, independently of any legislation or other form of state action on the subject. Without fair and creditable management practices, contracts will collapse and it is thus in the long-term interests of the contractor to observe all aspects of human rights. Participation, accountability, empowerment, non-discrimination, transparency, human dignity and respect for the rule of law are some of the relevant principles. Although women are the main producers of many commodities, they are often excluded from decision-making and, in most cases, yield to men for contract signature. Culturally, this may be difficult to circumvent. However, contractors need to be aware of such issues, avoid exacerbating gender inequalities and, where possible, ensure that contracts are made with those who actually do the work.

One of the human rights most central to contract farming is the right to food. The core contents of the right to adequate food include the availability of food in a quantity and quality sufficient to satisfy the dietary needs of individuals, free from adverse substances, and acceptable within a given culture; and the production of such food in ways that are sustainable and do not interfere with the enjoyment of other human rights. Issues that may arise include the need to ensure that contract farming does not result in a total monoculture that denies producers the opportunity to produce their own food, or that production practices used do not result in land degradation, water pollution or loss of soil nutrients.

Labour law

This may play an important role if producers recruit workers to assist them in producing the quantities and qualities specified in the contract. In such cases, producers will need to follow the relevant domestic labour legislation. Failure to do this may also have repercussions for the contractor. In some cases, contractors choose to limit this risk by issuing production quotas based on the work capacity of the family to deliver the required quantities without employing additional labour. Labour law may have an impact on contract farming operations in cases where the contract could be seen as a labour relationship rather than as a relationship between two independent parties. It is often up to the courts to draw the distinction.

Natural resources

Contract farming may touch upon issues of access to land, water, forest resources or wild products. In many contracts, accessibility to land is the most essential component for production. For contractors engaging in contract farming with indigenous producers, the concept of free, prior and informed consent (FPIC) is extremely important (FAO, 2014; IFAD, 2014). FPIC stresses the collective right of indigenous peoples to make decisions through their own freely chosen representatives and to give or withhold their consent to any project that may affect the lands, territories and resources that they customarily own, occupy or otherwise use. The issues that arise are often extremely complex and some contractors have therefore been less likely to contract with indigenous people.

Finally, public land management law can impose restrictions on the kinds of commodities that may be grown or raised, in addition to specifying environmental requirements. Countries may regulate access to other natural resources that are fundamental for agricultural development, including water resources, forests and fisheries.

Chapter recap: Legal environment

1. Contractors should familiarize themselves with all relevant laws governing contract farming agreements and make these known to farmers or their representatives.
2. Relevant laws may be found in legislation on, among others:
 - contract laws;
 - agriculture;
 - land;
 - tax;
 - corporate relations and competition.
3. Other legislation likely to affect the operation of contracts includes that on:
 - food safety;
 - farm inputs;
 - human rights;
 - labour;
 - natural resources.
4. Both managers and farmer representatives have a responsibility to ensure that contract negotiations are carried out in good faith. Legal principles dictate that acting in bad faith, abusing rights, failing to declare relevant information and exploiting a stronger bargaining position are unacceptable.

Chapter 2

The contract

Contracts are generally not subject to any requirement regarding form or content. However, mandatory requirements may be applicable in certain legal systems. There is sometimes a concern that contracts are drafted in the stronger party's favour. Producers should be able to form an opinion about a contract on the basis of having received all information necessary to enable them to arrive at a decision as to whether the agreement is in their interests or not.

2.1 PARTIES TO THE CONTRACT

Contract farming usually involves a producer and a contractor engaged in a bilateral relationship, but sometimes others may participate, creating a multiparty contract or a separate but linked contract.

Agricultural producer

It is assumed that the producer carries out agricultural production on an independent basis, whether individually, as part of a group or as a company. Employees therefore fall outside this definition.

An agricultural activity typically takes place on an area of land or by using infrastructure that is under the producer's control. The producer does not have to own the land but may lease it. Additionally, in many developing countries, individuals or communities often live on land under traditional or customary forms of tenure. Whatever the type of tenure, producers who can rely on secure tenure rights can engage safely in production and can contract on a sound basis. Ensuring that the producer has security of land tenure for the duration of the contract before contracts are finalized would be mutually beneficial for both parties.

Individual producers generally operate through relatively small production structures in terms of capital, number of workers employed, if any, and volumes of production. In most parts of the world, farming businesses are not required to incorporate under a specific legal form.² However, registration is often necessary to obtain permits or licences to operate. In some countries, simple registration procedures have been implemented to provide producers with legal recognition that may, for example, facilitate access to credit and to government support.

In an undertaking owned and operated by one producer, or in a partnership of two or more producers, personal assets and those used for agricultural production form one single entity, to which creditors may have access when debts are not paid. Although the danger may be less in the case of contract farming, agricultural production can still lead to the producer, as well as the producer's family, being

² Legal forms for businesses include limited liability companies, partnerships, sole traders and cooperatives.

exposed to substantial risks. However, depending on the country law, certain items of household property, or the land itself, may be protected in debt-recovery proceedings.

Agricultural producers may create organizations (such as associations or cooperatives) for production and marketing. By doing this they are able, as a group, to seek commercial financing, conclude insurance contracts, hire labour, own shares in other legal entities and take various other steps to build, strengthen and increase their production capacity. Legal formalization of an organization creates an independent legal entity, separating the owners' personal assets from those of the company and limiting the owners' liability for the company's debts, although creditors may still expect a personal guarantee for loans to the cooperative. Certain countries also recognize a legal personality for customary bodies or traditional communities. A community could function as a producer organization, with members having their own assets and the head of the community being authorized to enter into contracts. Members could also have common ownership over community property.

Different types of organizations may have an important advocacy role. Under the generally recognized principle of freedom of association, contractors should not restrict producers' rights to join or contract with a producer association. Similarly, they should not engage in retaliatory or discriminatory practices towards producers exercising such rights.

Producers may join together informally. However, when one person (often known as a "lead farmer") deals with a contractor on behalf of a group of producers, for example by aggregating production, delivering the inputs supplied by the contractor and then making payment to the other producers, the person's role and responsibilities should be clearly defined, particularly in the case of default by one member or by the whole group.

Contractor

The contractor is the party commissioning production from the producer – typically a commercial food processor, trader, distributor or other purchaser of the product – and providing a certain degree of guidance (such as the supply of inputs, services, finance and control over the production process). Contractors vary widely in size, business format and ownership. They may be small businesses dealing with limited numbers of producers and supplying buyers in the local market, but they could just as well be a transnational or foreign company.

A cooperative may act as a contractor. Depending on domestic law, relations between members and the cooperative are either regulated by special cooperative law or general contract law subject to certain adaptations reflecting cooperative principles. When a cooperative deals with non-members, it does so as a contractor based on general contract law or the applicable specific legislation.

Although less common, public entities may act as a contractor in a relationship for the procurement of agricultural products for the delivery of a public service to hospitals, schools, etc. When a public entity enters into a direct contract with producers, many countries apply special rules to the procurement process, including competitive bidding proceedings to select the contracting party. More often, however, the public entity contracts through a private partner.

Other parties

Those carrying out contract farming may be linked in many different ways to other supply chain participants or interested bodies, referred to commonly as “third parties”. A contract farming contract cannot usually modify or otherwise affect third parties’ rights. However, it is in the interest of both producer and contractor to ensure clarity regarding their respective rights in relation to others.

Examples of third parties are providers of goods (e.g. seeds) or services (such as land preparation, harvesting or transport) needed to support the producer. Non-performance or defective performance of third-party responsibilities may cause non-performance under the main contract, such as when an input supplier fails to have sufficient quantities of inputs in stock for use at the time specified in the contract.

A contract could serve as a means for producers and contractors to obtain finance from financial institutions, which can also be considered as third parties.³ For example, when a bank is a part of the contract, if the producer receives advances from it with repayment based on revenues to be generated under the contract, the contractor could make direct payments to the bank after delivery of the product. A contract could also be used as collateral to obtain financing, even if the creditor is not a party to the contract, by providing evidence that the producer has a guaranteed buyer for its products.

Insurers may also be interested parties. Insurance can play an important role in mitigating many of the risks involved, be they hazards such as theft or natural calamities, or risks to the life or health of the main actors in the contract. However, insurance coverage is not always available and, when it is, premiums may be unaffordable for many smallholders, particularly when they seek to insure a growing crop. Some systemic risks, such as a hurricane affecting the entire country, are by definition non-insurable.

The parties may rely on third-party verification to ensure the quality of both the product and the process. This provides them with an independent and expert assessment of conformity with the terms stipulated in the contract for products delivered by the producer, the production method or inputs supplied by the contractor. Additionally, third-party verification will be needed for certification schemes (e.g. certified organic) when conformity with the required standard is built into the contract. In this case, certification by an accredited third party will be necessary. The parties may also resort to third-party verification following disagreements about product conformity.

Government extension services aim to strengthen producers’ capacities by supporting the development of agronomic and management skills. They may also support contractors by helping to identify potential producers for them to work with, and assist in negotiating their contracts. During production, the extension services may support better compliance and provide assistance when disagreements arise. According to FAO and IFAD field experience, public and private extension services complement each other in terms of geographic and thematic coverage.

³ These arrangements are usually known as “tripartite agreements” among producers, contractors and financial institutions.

Landowners can be important third parties. If the producer's tenure rights are challenged, the producer may not be able to perform under the contract. If the producer has leased the land, the landowner may need to authorize the particular crop to be grown, cultivation practices to be used and any facilities built to carry out the production or comply with certification requirements. A landowner may have a claim on the crop, such as a lien for unpaid rent. Agricultural production contracts thus often include a clause concerning the producer's title to the land, and sometimes the landowner may be asked to sign the contract.

The rights of the contractor's creditors may affect the producer's rights. This may occur, for example, in the case of a contractor's insolvency, when the producer's rights to payment for the production may rank second to a third-party creditor's rights. Some domestic laws, however, provide special protection to producers by giving them a priority claim.

2.2 CONTRACT FORMATION

Offer and acceptance

A contract farming agreement sets out the parties' legal obligations. The concepts of offer and acceptance have traditionally been used to determine whether and when the parties have reached an agreement, a contract being concluded when an offer is accepted. The process of developing the contract is extremely important for building the relationship because it shapes the obligations over the duration of the agreement.

As a common best practice, the whole contract formation process should be carried out in a fair and transparent manner and in good faith. To achieve transparency, some form of pre-contract document may be useful, for example providing information on the contractor, rights and obligations of the parties, costs of production and any environmental responsibilities. In certain countries, legislation requires the contractor to disclose the risks for the producer. Lack of awareness of such risks, in particular regarding profitability, could be considered to represent a lack of informed consent. For instance, a key issue to be defined is the adequate estimation of the yields that smallholder producers may achieve compared with the more controlled environment of a research station.

The offer containing the prospective terms of the agreement usually comes from the contractor. It should preferably be presented in writing in advance, so that producers may review the proposed conditions thoroughly and, if necessary, consult with their advisors. In certain legislations, a written offer may be obligatory. The offer should be sufficiently descriptive and definite. Vagueness and uncertainty with respect to any essential terms of the agreement may render the contract unenforceable. As a general rule, price, payment terms, quantity, quality and duration must be stated in such a way that the obligations of each party are clarified sufficiently.

Under general contract law, accepting an offer is enough to create a contract, whether by a statement or by conduct, such as by starting to prepare the land. Parties to the contract should be aware that the applicable law may impose additional requirements for the contract form, as discussed in section 2.3.

When working with a large number of farmers, particularly those with no representative organization, carrying out meaningful negotiations can be burdensome. The tendency, therefore, is for the contractor to draft a contract and present

it to producers. This presentation can be done in a public meeting at which farmers are present and are represented by a third party with the competence to translate what is presented and advise the farmers. Negotiations may take place in an informal context that takes note of cultural differences, customs and other circumstances.

Capacity and consent

For a contract to be valid and enforceable, the parties must have the legal capacity to enter into the contract and give valid consent at the time of formation of the contract. One potentially sensitive issue is whether the producer has a sufficient understanding of the implications of the contract. Lack of understanding can be later interpreted as a defect in the consent, making the contract avoidable, i.e. giving a possibility for the party with insufficient consent to cancel the contract and be released from its obligations, or allowing other remedies. Similarly, if the contract is induced by fraud, mistake or threat, it may also be avoidable. The circumstances of the negotiations and the producer's individual situation will determine whether informed consent was indeed present.

Facilitators

Facilitators, such as public authorities, NGOs and farmer associations, may play an important role in assisting the parties to set mutually advantageous contract conditions, in particular by providing support and advice to producers before and at the time the contract is concluded and by building trust between contractors and producers so that they fully understand the terms of the agreement. This applies particularly when a contractor is entering a new business or a new area. A producer organization negotiating a contract on behalf of its individual members is likely to have a higher bargaining power than individuals. Facilitators may have a mandate to represent producers in negotiating with the other party and signing the contract.

2.3 CONTRACT FORM

In most cases, the contract takes the form of a written agreement. It should be in a language understandable to both parties. When one party has limited literacy, an oral explanation may accompany the agreement. On occasions, because of industry usages, local practices, the parties' desires or other circumstances, the contract may be an oral or "handshake" agreement. Oral agreements can be concluded without any documentation and ideally, but not necessarily, in front of an independent third party. However, under specific contract farming legislation or as a matter of good practice, contracts should normally be written in a straightforward and simple manner, with care taken to reduce complexity where possible. Technical terms should be avoided unless they are clearly understood by the producer.

The fundamental principle of freedom of contract provides that parties are free to enter into a contract and to determine its specific content. To reduce costs when dealing with numerous small farmers, contractors often make an offer on standard forms, using standard terms. Producers may appreciate standardized contracts, especially if they know that other producers have entered into the same arrangements. However, this does not negate the need to explain the terms fully to all producers prior to signature.

2.4 CONTRACT CONTENT

Apart from requiring sufficient identification of the parties and the object of the agreement, general contract law does not usually set detailed content requirements. However, some rules may impose additional requirements on contract farming agreements, in order to achieve transparency and balance possible unequal access to information, among other aims.

It is always in the parties' interest to address the relevant elements of their contractual relationship in a complete and detailed manner. Although contracts may take many forms, several important components are present in most written arrangements. They are summarized here and discussed in more detail in this and later sections, as specified below.⁴

Parties to the contract (section 2.1)

A contract usually starts with the names and contact details of the producer and contractor and any third parties signing the contract.

Purpose

This succinctly outlines the reason for the contract (e.g. "Agreement to grow tomatoes"). The purpose of the contract is often expressed in a preamble.

Identification of production site

Contracts typically identify the production site. The particular size and location of the contracted land (determined from land registries, where available) may determine the obligations of the parties (for example when the delivery and purchase obligations refer to the whole production from the designated plot).

Obligations of contracting parties (Chapter 3)

Most of the content of a contract consists of statements about the parties' obligations. Common producer obligations specified may include production and handling requirements, use of specific inputs to meet market requirements, location and timing of delivery, quality standards and whether the contract is volume (i.e. quantity) or area based. Contractor obligations specified often include production inputs to be provided, technical assistance services, production oversight and delivery acceptance.

Provision of inputs (section 3.3)

The agreement may identify the inputs to be used. For physical inputs, it is common to refer to inputs by technical specifications or commercial brands. Inputs are an essential component of the agreement if they are to be provided by the contractor or if the producer is to use only those approved by the contractor. They must be described with enough specificity to allow enforceability. The price of inputs or their method of calculation should be clearly explained in the contract. Because payment to the producer for produce often takes place after deduction of the cost of inputs, a well-drafted agreement should connect the description and pricing of inputs with overall payment terms.

⁴ See also FAO, 2012.

Price and payment (section 3.5)

A contract usually stipulates the price to be paid or describes, in a clear and transparent way, how this will be calculated. Other provisions include specifications on when and in what form the contractor will transfer payment to the producer.

Excuses (Chapter 4)

This legal term covers the defence given for failing to comply with the contract. Agricultural production contracts are particularly vulnerable to occurrences that make performance impossible or significantly more difficult than foreseen at the time of entering into the contract. The contract may specify the risk of *force majeure* loss or changes in circumstances and responsibility for taking out insurance, where available.

Remedies (Chapter 5)

The contract may include designated remedies in the event that one party fails to meet its obligations, for example when a contractor fails to supply inputs on a timely basis or a producer fails to deliver all its contracted production. Parties may design different remedies depending on the nature of the problem, but they should be aware that the law may limit the use of some of these. Regular meetings between contractors and farmers may be used to identify the possibility of failure to meet obligations.

Duration (section 6.1)

The duration of the contract may vary, depending on the production cycle and the applicable law. For example, a contract to grow maize – an annual crop – is implicitly limited to a single year. On the other hand, contracts requiring a substantial financial investment by one party (such as investment by a producer in chicken-rearing facilities or investment in a large processing facility by a contractor) may imply a more durable relationship and an expectation of renewal. The duration has significant implications for the type of contract used.

Renewal (section 6.2)

Renewal may result from a separate agreement to extend the duration of the existing contract, from an automatic provision in the initial contract, or simply – and quite commonly – because the parties continue to behave in accordance with the contract even after the fixed term expires.

Termination (section 6.3)

Contract termination may happen automatically, by mutual agreement or as a result of one party's non-performance. To increase clarity and certainty, contracts should specify the situations and requirements for termination (such as a notice period).

Dispute resolution (Chapter 7)

Any contractual relationship may give rise to disputes. Accordingly, contracts should incorporate, at the outset, methods for dispute resolution. It is best that disputes be resolved at meetings between contractors and producers, but where this proves impossible other common forms include amicable procedures such as mediation or conciliation, arbitration or judicial proceedings.

Signature

In written contracts, there should be a distinct section that, in addition to the parties' signature, includes the date and place of contract formation. As good practice, the parties should sign in the presence of witnesses and include their signatures on the document. Witnesses could be leaders of the farming community and/or farmer representatives.

Finally, it should be noted that if the applicable law puts requirements on the form or the content of the contract, it should also give the consequences of non-compliance with these requirements.

Chapter recap: Form and content of contracts

1. Contracts should normally be written, and presented in an unambiguous and simple way, using terms that are understood by all. Where illiteracy is a problem, farmers should be given an oral explanation.
2. It is in the interest of all parties to ensure that contracts are complete and detailed. Important components are the following.
 - *The parties.* Names and addresses of the signatories.
 - *The purpose.* Reason for the contract.
 - *The production site.* Size and location of the farming area, specified in as much detail as possible. Where land is leased or rented, confirmation of tenure arrangements and, sometimes, of the owner's approval may be required.
 - *Obligations of the parties.* What and how the farmer is expected to produce and deliver and what support the contractor is required to provide.
 - *Price and payment.* Price to be paid or how it will be calculated. When and where payment will take place.
 - *Input provision.* Specific description of inputs and when and where they will be provided. How repayment by the producer will be calculated and made.
 - *Third parties.* Relationships with others that may contribute to the success of the contract, such as input suppliers and financial institutions.
 - *Excuses.* Acceptable justification for failing to comply with the contract, such as *force majeure*.
 - *Remedies.* Ways in which one party can be compensated for the failure of the other to meet its obligations.
 - *Duration, renewal and termination.* How long the contract is for, arrangements for extension or renewal, and how and why it can be ended.
 - *Dispute resolution.* Ways of addressing potential disputes.
 - *Signatures.* Parties should ideally sign in the presence of witnesses.
3. The process of developing a contract is important to build up a harmonious relationship between the parties. Contractors should consider providing producers with advance information about the contractor, what is expected from the contract, possible risks, and the rights and obligations of the producer.
4. Prior to making a formal offer for acceptance by the producer, contractors should ensure that:
 - there is no vagueness or uncertainty in the proposed agreement;
 - farmers have been consulted and fully understand what they are being asked to agree to;
 - smallholder farmers are represented by suitable third-party negotiators, such as farmer association officers, in all negotiations.

Chapter 3

Obligations of contracting parties

This chapter discusses the obligations of parties carrying out contract farming that derive from the contract. The producer's main obligation is, of course, to produce and deliver goods to the contractor in accordance with the contract specifications, often using inputs and financing received from the contractor. The contractor, in turn, undertakes to purchase the product and will normally have the right to coordinate cultivation and harvesting practices and offer technical advice through its extension staff.

Several obligations are directly concerned with the physical characteristics of the goods to be produced, such as their quality, quantity and delivery time or the corresponding remuneration (price, time of payment). These can be described as "product-related" obligations. Other obligations are concerned with the process through which the goods are produced (method of production, technology used). Some may be aimed at achieving the desired physical characteristics of the goods (time and method for seeding, quantity and manner of using fertilizers) or meeting safety standards (use of pesticides, hygienic conditions). Others may be related to factors such as compliance with specific quality, environmental and sustainability standards, or to addressing gender or child labour prevention concerns. These obligations can be described as "process-related" obligations.

The contracting party can later give away its rights under the contract, but cannot transfer its obligations without the consent of the other party. For example, even if the contract says that the contractor should receive the product, the contractor can allow the production to be delivered to a third party of its choice. However, the contractor still has the obligation to pay the producer, as required by the contract.

3.1 RISK ALLOCATION

The parties' obligations under the contract are clearly related to how the parties intend to allocate and compensate risks. The main risks to which the parties are exposed during the life of the contract are divided into two broad categories: production risks and marketing risks.

Production risks

There may be risks of production loss or shortfall because of a disruptive event during production, such as poor weather. The owner of the produce – which during production may be either the producer or the contractor, depending on contract and form of production (see section 1.1) – usually carries the production risks. Applicable legislation or the contract itself may allocate risks differently.

Commercial risks

The actual market value of the produce upon delivery or marketing may be lower or higher than the price anticipated by the parties when they set the price or

formula for its calculation. These risks may impact the parties' ability to recoup their investment and compromise the project's financial viability. Commercial risks are largely controlled and mitigated through the price mechanism established in the contract (see section 3.5).

One way of controlling both production and commercial risks is by requiring exclusivity, i.e. that the producer undertakes to deal with only one particular contractor. The producer, however, must be aware of the risks that may be involved in granting a monopoly over its whole production to a single contract partner, such as loss of economic independence.

3.2 THE PRODUCT

Quantity

The contractor often agrees to pay for the producer's "whole" production. This may mean several different things, and should be clearly specified. It may refer to all output produced from a specific plot of land agreed upon by the contractor and producer, or to the crop grown from the inputs provided by the contractor. In either case, the term is likely to exclude production not conforming to quality requirements. Similarly, in animal husbandry contracts that require the contractor to supply the animals, the normal expectation is that the whole production refers to all the animals. This, of course, should be plainly stated in the contract.

The producer's obligation to deliver the whole crop to the contractor implies exclusivity. In such cases, unless authorized by the contractor, any type of side-selling (selling the promised produce to a third party instead of the contractor) amounts to a breach of an obligation, triggering the use of remedies (see Chapter 5).

Other contracts may provide for the purchase of a specified quantity, a minimum quantity, a quota or a variable quantity. Some contracts state that the quantity will be determined during production on the basis of field tests conducted as the crop grows. Similar arrangements can be found in contracts dealing with animal husbandry.

Regardless of the exact method, a specific quantity allows both parties to know in advance what quantity is required under the contract, although it places the risk of underproduction on the producer. To avoid this risk, the contract can provide a quantity within the potential yield of the producer. From experience, yields can be forecast based on the producer's previous performance and available family labour. In principle, the producer is free to sell the quantities produced above the contractual amount to a buyer of its choosing.

Whatever the method used to determine the quantities to be delivered, contracts often stipulate that the produce must come from the producer's own production. Purchasing from third parties to be able to reach the required quantity is normally not allowed, since the goods must have been produced at the agreed location, using the inputs and methods provided for in the contract. However, where this is permitted, it should be clearly stated in the contract.

Quality

Under a contract, producers must meet the quality standards provided for in the contract, and in any applicable public regulations or certification programmes. Quality characteristics may include all physical characteristics (e.g. colour, size, shape); contents (e.g. low-fat milk, seedless grapes); fitness for a purpose (e.g.

seeds that are resistant to a certain virus, green beans that are free from chemicals prohibited by the target market); together with any process requirements.

Quality standards may be set out in the contract. The contractor should ensure that the producer understands all the specifications. Where possible, appropriate explanations of these specifications should be given at the time of negotiation. Unfortunately, contracts are often imprecise about quality and merely use terms such as “good quality”, “the highest quality”, “merchantable” or “exportable quality”. The vagueness of these terms is likely to be a source of difficulty in a dispute. Better contracts give precise and objective quality requirements, such as “maximum moisture content 6.5 percent”. When working with smallholders, it may be desirable to keep the number of different grades to a strict minimum, thus reducing the likelihood of dispute. The contract can also provide a list of faults that justify refusal of the goods by the contractor and the contractor’s extension staff can work with producers to avoid such faults.

Depending on the law and on industry requirements, both producers and contractors may have obligations related to product safety, such as ensuring traceability, avoiding or limiting the use of certain pesticides or ensuring the hygienic conditions of livestock. Safety is related to quality and has long been a part of the evaluation as to whether a product conforms to a standard. Furthermore, producers under contract are increasingly required to become certified under one or more specific quality schemes (see paragraphs on production methods, compliance and control in the following section [p. 17]).⁵

3.3 PRODUCTION PROCESS

Provision and use of inputs

Contracts normally set forth obligations as to how the production process should be carried out, in particular for the producer, but also for the contractor. Use of inputs, including all physical items such as seeds or animal feeds, as well as intangible elements such as technical assistance or training, is invariably central to the process.

The supply of inputs by the contractor allows poorer producers to produce without having to finance the cost of the inputs. The contractor is often in a better position to guarantee input availability, quality and prices. Economies of scale available to the contractor can keep costs low and such savings can be passed on to producers. The contractor may also have ready access to mechanization and transportation facilities that would not otherwise be available to the producer.

When using the contractor’s inputs, the producer may have to comply with certain obligations. The first is to verify that the inputs are as specified in the contract and notify the contractor of any apparent defects. Second, the producer may need to take care of the inputs. This could be a far-reaching obligation, especially when there is a danger of theft or other loss, against which producers in some countries may be required to obtain insurance. Third, the producer may have to use the inputs according to the contractor’s instructions. This may include observing necessary precautions when using chemicals; applying fertilizers correctly; keeping

⁵ There are numerous certification programmes. Examples include Rainforest Alliance, fairtrade, organic and GlobalG.A.P.

records; and not diverting inputs by selling them or using them for other purposes, such as food production.

It would be in the parties' best interest to have a price mechanism for inputs that promotes clarity. Price indications for inputs in the contract can be flexible in order to reflect market price changes. However, a way of specifying the price to be used should be made clear (such as "supplier's list price plus 15 percent for transport and handling"). Despite this, in some cases the producer may become locked into obtaining inputs from the contractor that reflect neither the best price nor the best quality available. This may call the contract's enforceability into question.

Inputs provided by the contractor may turn out to be defective (e.g. poor-quality plants, infected seeds), thus preventing the producer from meeting the contractual quality or quantity requirements. Certification of input quality by an independent entity is sometimes advisable, if this can be obtained. Problems may also arise when the contractor is late in delivering the promised inputs, thereby endangering the production process and the producer's ability to meet its obligations.

Inputs may be provided by third parties. If these third parties fail to provide the inputs, it may cause product non-conformity or a breach of process-related obligations. The party responsible under the applicable law for the actions of the third party, usually the contractor, could then also be responsible for the non-conformity or the breach. Contracts may include a clause assigning this responsibility. Applicable law, where it exists, may provide default rules on the assignment of responsibilities over third parties.

Land, facilities and equipment. In most contracts, producers farm on land that they own, are lessees of land owned by a third party, or benefit from other forms of land-use rights. The land on which the production takes place may be one of the product's most important attributes (e.g. when denomination of origin is relevant or when the land has to be certified as organic). If the producer leases the land, an important issue is the duration of the production contract in relation to the lease. If the lease ends during the contract, producers may not be able to carry out their obligations. Therefore, it may sometimes be crucial to clarify land tenure before a contract is signed.

Some contracts require the producer to build or improve a facility, such as for poultry rearing. These obligations are often accepted by the producer on the assumption that the contract is going to be of a sufficient duration to make the investment profitable.

Physical inputs. The contractor can either provide the inputs itself or require the producer to procure certain inputs from third parties. The contractor has the obligation to deliver inputs that conform to specifications – failure to do this will incur a liability for breach of contract. If the contract specifies how the inputs supplied by the contractor are to be used, the contractor generally has the obligation to supply information about proper usage. The time of input delivery typically affects the producer's ability to meet production requirements. It is therefore advisable to provide terms in the agreement for the time and place of input delivery, although there should be some flexibility to account for unforeseen events.

Financing. Advance payments are often essential for the producer to cover costs incurred in production. The contractor is likely to require that advances be used specifically for contracted production (rather than for personal or household use), although some contractors may also provide inputs for the farmer's

household food production. Advances may be made after the contract has been concluded, in order to finance the whole production process, but they may also be more limited and be paid a few days before harvest, in order to finance the labour required for harvesting. They may account for a large part of the eventual amount payable upon product delivery and, if they are uncontrolled, producer indebtedness may increase to unsustainable levels. The contractor has a moral obligation and may even have a legal obligation, to ensure that the producer has a reasonable likelihood of paying off such loans.

Financing usually involves interest payments (in countries where interest is recognized). The contractor generally deducts the principal and interest from the final price owing to the producer for the products. The contract should clearly spell out the interest rates and other possible costs associated with financing. In FAO and IFAD field experience, it is considered good practice to treat the provision of finance as a means of facilitating production for purchase by the contractor and not as a profitable activity in itself; thus, the interest rates charged reflect the rate that the contractor would have to pay for the money, together, perhaps, with an allowance for the costs incurred in distributing loans to the producers.

Services. The contractor may provide services to the producer on potentially every production aspect. In doing so, the contractor is subject to standards of performance that may be specified in the contract. A contractor may seek to disclaim liability in the contract for production loss caused by its poor advice, although not all legal systems permit such a waiver of liability.

Intellectual property rights. Contracting parties are well advised to consider possible obligations related to intellectual property rights (IPRs). These may be held by the contractor or by third parties. If the inputs are protected by, for example, plant variety rights or patents, producers are usually excluded from a variety of actions, such as producing, offering for sale or selling the products, without the rights holder's consent. In addition to these obligations, the parties may have to perform certain duties even after termination of the contract. For example, the duty to keep trade secrets confidential may continue to exist. In general, IPRs are an aspect of the contractual relationship where the contractor is well aware of its rights but that the producer may not understand very well. Such a situation may impose an obligation on the contractor to ensure that the producer is fully aware of the issues.

Production methods, compliance and control

Contracts usually specify the obligation to comply with specific methods during the production process, including mandatory regulations (e.g. traceability) and private standards where applicable. The food industry has developed a wealth of private standards regarding particular attributes, qualities or geographical origin of a product or the process of its production. There are now so many that some exporters selling to a range of buyers may have to comply with 20 or more different standards. Compliance with standards generally involves substantially higher costs, but may be an opportunity to achieve higher prices. Obtaining a licence or certification is in some cases now becoming a prerequisite to selling on specific markets, rather than a source of a premium (Kuit and Waarts, 2014). Traceability is an increasingly used component of certification. Producers are often required to facilitate the identification of products as being from their farm or even from just one part of their land.

Specified production methods. Most contracts require the producer to follow the methods laid down by the contractor, in addition to any mandatory obligations to comply with safety or environmental legislation. These obligations may be either expressed or implied with the contractor's detailed requirements for the production process, or they may be implied obligations stemming from either the contract, good practices, codes of conduct, practice between parties or requirements of good faith, fair dealing or reasonableness. The producer's obligations are either to deliver a particular result or apply its skills, diligence and best efforts to that end.

The contract may require the producer to cooperate with the contractor to ensure compliance with the production method and avoid incidents. The obligation for the producer to comply with the contractor's instructions is sometimes only expressed as a general statement in the contract. This may expose producers to responsibilities that they have not had the opportunity to discuss and fully understand. A more acceptable approach is to list the different aspects where the contractor's instructions have to be followed. However, even this leaves much uncertainty and the contractor's requirements should ideally be discussed with and fully understood by producers prior to the signing of the contract.

The requirements for specific production methods can cover a wide field. Contracts commonly include clauses on the use of fertilizers and pesticides, procedures to be followed when harvesting, production methods for livestock and poultry, together with clauses on labour and hygiene.

Monitoring and control. Contracts often provide that the contractor's representatives or authorized third parties, such as a certifying agent, have access to the production site to give direct advice and supervise how the prescribed methods are implemented. Many contracts have detailed terms to ensure free access (for instance specifying that the rights of inspection extend not only to crops, but also to harvesting equipment, transportation vehicles and storage facilities, or to the food and medicine to be given to animals). It is common to provide for arrangements for visits (such as frequency, hours and advance notice to be given). The contractor may have an obligation to see that its representative is present at the due date, since harvesting and other operations cannot be delayed.

3.4 DELIVERY

The contractor's obligation to take delivery of the goods and the producer's obligation to deliver them are, of course, basic to any contract. In the absence of an agreement to the contrary, producer delivery is necessary for the contractor to pay. Delivery may trigger a change of ownership and transfer of risks from producer to contractor. Additionally, the contractor may lose its right to exercise remedies for apparent defects, not including defects that may become apparent much later, if it does not make appropriate reservations upon delivery. Given the numerous factors that often accompany delivery (such as inspection before or after delivery, quality certification, weighing, grading and packaging), it is a matter of good practice to organize delivery through appropriate provisions in the contract. Clarity is essential and it is desirable to avoid clauses that allow one party to determine delivery arrangements unilaterally after the contract has been signed.

Time and place

Setting the time for delivery can consist of specifying in the contract a provisional date, the last possible date, a time, a series of dates or a period. If a definite delivery date is not set, the contract should provide a method for setting the delivery date or to stipulate that the delivery date is subject to variation, either on one party's initiative or, preferably, by mutual agreement. The contract may also specify the time of day for delivery in order, for example, to minimize post-harvest damage from high temperatures or exposure to the sun.

Although the contractor may tolerate minor delays, delay in delivery by the producer can be considered a form of breach of contract. Compliance with a delivery schedule is extremely important in the case of goods that deteriorate rapidly, although it may be of lesser importance in the case of certain livestock or of logs, for example. Similarly, failure of the contractor to provide agreed transport or its inability to receive products because of congestion or other problems can have major repercussions for the producer.

The contract should indicate the place of delivery. It may require the producer to deliver the goods at the contractor's premises or at another location. In some cases, the contractor may wish to take delivery at the producer's premises, which in many cases (such as with livestock) may be a preferable option for the producer, as it shifts to the contractor the risk of loss during transport. The contract often specifies which party is responsible for transporting the goods and which party will bear the costs. If the produce needs to be stored before delivery, the contract should specify the conditions of storage. Some contracts contain other directions about post-harvest practices, such as cleaning of the produce prior to delivery.

Acceptance

The contract may require the contractor to inspect delivered products promptly. This is particularly important for commodities that deteriorate rapidly. Any delay in taking delivery will cause a delay in inspection, resulting in loss of income through product deterioration for which the producer should not suffer financial or other consequences.

The establishment of quality during inspection can often cause substantial logistical problems. Large contractors may be buying from hundreds or thousands of producers over a few days. Fair and accurate quality decisions need to be made quickly and these can be assisted by the use of simple and uncomplicated grades wherever possible.

It is usually advisable to provide for either the producer or a trusted third party, such as a farmer representative, to monitor the weighing and inspection. Field experience indicates that if the contractor's relevant extension officer is present when farmers deliver, disputes can often be minimized. It is also common to include contractual terms specifying that when the crop or livestock is weighed or examined, the producer should be able to view the weighing or examination and that any weighing should use certified scales. Weighing receipts may also be provided.

When not present or represented at delivery, it is in the producer's interest to be informed without undue delay that the goods have been accepted (or that problems have been detected). It is sometimes agreed that, shortly after delivery, the contractor will provide the producer with a document giving its final quality evaluation of the goods, based on the relevant criteria.

Refusal to accept delivery of goods stated by the contractor to be “non-conforming” is unacceptable and an intentional breach of contract if inspection is carried out unfairly or fraudulently. The consequences of such an action normally include liability for unforeseeable damages, which include damages from non-performance that the parties could not foresee at the time of the signing of the contract and, ultimately, if the breach is considered fundamental, termination of the contract.

3.5 PRICE AND PAYMENT

Price

The contractor’s main obligation is to pay the agreed price in return for the goods or services delivered by the producer. Price is an essential component of any contract, and failure to set the price or set a basis for determining it according to a formula may render the agreement legally unenforceable. The producer should understand the price and be able to assess the expected payment. Price terms in contracts should always be transparent and clear. Poorly drafted terms contribute to disputes, litigation, delays and costs and may also lead to contract breaches and manipulation. Where a formula is followed, and this is stated in the contract, it is good practice to allow the producer or a third party to verify the calculation.

The price term may provide a fixed amount, a variable amount or a combination of both. Fixed prices are generally set to reflect production costs and the producer’s performance or alternatively be tied to market prices at the time of delivery. In the first case, both parties can maximize the certainty of the price to be paid or received, but changes in market prices might render the contract unattractive and prompt side-selling. Using market prices accurately reflects the value of the products at the markets, and may thus lower the incentive to side-sell, but leaves the parties at the mercy of price volatility.

For some commodities, the price varies based upon different performance measures, or “price scales”. Price scales can take into account variations in quantity and quality and, in some cases, efficiency and application of diligence standards related to production, safety and social and environmental issues. They may be designed either as incentives or penalties. Well-functioning price scales provides producers with incentives to create high-quality goods, whereas complex price scales may lead to confusion and manipulation. FAO’s field experience shows that where the price is to be calculated at harvest, it seems preferable to calculate a price at the time of the first deliveries and use that throughout the season. Daily price calculations seem to cause confusion among producers and leave them wondering why they are all getting different prices. Where a price formula is used under a long-term contract, e.g. for oil palm, the price could be recalculated at fixed intervals, such as every quarter.

Payment

The contract should specify the time and method of payment (for both goods and inputs). Late payment or payment through a different method may negatively affect the producer’s ability to meet expenses or repay loans from third parties. Slow payment or payment delays are a major cause of loss of trust between the parties. Clearly expressed provisions in the agreement regarding to

whom, when and how payment is to be made promote certainty and reduce the possibility of disputes.

If the price is based on a market price, it is important to specify how and when this price is to be decided. It is also important to consider, when relevant, the producer's obligation to pay back any advances provided by the contractor and how these will be deducted, possibly over successive deliveries. There may also be an obligation on the contractor to make it clear to the producer how the payment has been calculated. A written document specifying dates of delivery, quantities, grades and applicable prices may be provided and specified in the contract.

Payment terms vary widely depending on both the contract type and the parties' private arrangements. Some contracts provide for immediate on-the-spot cash payments, while others provide for staggered payments based on further deliveries, inspections and processing. As payment usually takes place after delivery, the producer is exposed to the risk of not being paid if the contractor becomes insolvent. In some jurisdictions, the law provides for guarantee funds through public financial institutions, insurance schemes or payment guarantees to protect producers against contractor insolvency. These are mandatory obligations on the contractor that cannot be waived in the contract.

Payment may depend upon certain actions that have to be undertaken by the producer. For instance, the producer may have to request payment, provide an invoice, or provide certain certifications. In some cases, it may have to wait until after inspection, cleaning or other quality verification, including potential laboratory testing, before requesting payment. Such conditions, however, cannot be commercially unreasonable and are more likely to apply to contract farming involving large producers than smallholders.

3.6 ADDITIONAL OBLIGATIONS

The parties sometimes agree on additional obligations beyond the core obligations of production, delivery and price. These will differ from contract to contract and are best discussed at meetings between the contractor and potential producers prior to finalizing the contract.

Although many contracts contain no provisions for insurance, because of its lack of affordable availability in most developing countries, some contracts may require it. In such cases, the contract should specify which party has the obligation to obtain insurance, and indicate which type of insurance should be purchased. It should describe in sufficient detail the coverage's minimum features, such as risks to be insured and the amount to be covered. Merely obliging a party to take out insurance, with no further clarification, is a recipe for confusion.

Certain administrative obligations are often imposed on producers. For example, they may be required to open a bank account to receive payments from the contractor. Some contracts also deal with the treatment of confidential information. These clauses should not prevent the producers from discussing contract terms with third parties in order to enhance informed consent and favour competition. Finally, many contracts require that the producer attend training sessions organized by the contractor's extension staff and provide the contractor with information on events that affect production. For example, a producer may be liable if it fails to inform the contractor of an infestation.

Chapter recap: Parties' obligation

1. The contracting parties have obligations relating to the product, the process by which it is produced, delivery of the product, and price and payment arrangements.
2. Product-related obligations to be addressed in a contract include the following.
 - *Quantity.* The amount the producer undertakes to deliver and the contractor undertakes to purchase should be clearly specified either as an agreed weight or number, or with reference to the area of production, a quota established following agreed procedures or some other agreed arrangement. Minimum and maximum quantities are sometimes specified.
 - *Quality.* It is important that the contract specifies quality requirements in a clear way and that these are understood by farmers, with support from the contractor's extension staff.
 - *Source of supply.* To guarantee that quality requirements are met, the contract should specify that all products must be produced by the producer, following agreed procedures. This is to avoid producers purchasing non-conforming products from a third party.
3. Process-related obligations include the following.
 - *Inputs.* Producers are obliged to handle and use inputs as specified by the contractor, according to the instructions provided. The prices charged by the contractor for inputs, or their method of calculation, should be clearly indicated. The time and place for input delivery should be identified and the consequence of late delivery or of the supply of defective inputs clearly spelled out.
 - *Advances.* In most cases, the contract should specify that financial advances be used for contracted production and not for any other purpose. Interest rates and other charges for financial advances and inputs should be specified, as well as repayment arrangements.
 - *Services and advice provided by the contractor.* The contractor may require the producer to follow prescribed production methods. Specific details about what should be done must be given in the contract to avoid confusion. Consequences of failure to follow the contractor's requirements must be specified, as must consequences for the contractor of providing faulty advice or other services.
 - *Access to the production area.* If the contractor wishes its staff to visit farmers' fields (which is desirable), this should be specified, together with times for such visits. There are obligations on both producer and contractor to comply with such agreed times.
 - *Other process-related obligations may include the following.*
 - Compliance with standards, certification and traceability;
 - Avoidance of use of child labour;
 - Hygiene requirements;
 - IPRs.
4. Delivery-related obligations are important, particularly for perishable products. They should be included in the contract to avoid arbitrary arrangements being made at a later stage and should cover the following.
 - *Place.* Where the products are to be delivered or whether the contractor is responsible for collection.
 - *Period.* The period when delivery will be accepted (although this should be flexible, given the vagaries of agricultural production).
 - *Time.* The time of day for harvesting and delivery to the contractor.
 - *Transport.* Who is responsible for transport and who meets the costs.
 - *Weighing and quality assessment.* Arrangements for carrying this out need to be specified in detail. The opportunity for the producer to attend or be represented also needs to be covered here.

Parties' obligation (continued)

5. Price and payment obligations are an essential component of any contract and failure to include them may make the contract unenforceable. Clauses in the contract should cover the following.
 - *Price calculation.* If the contract does not specify the price to be paid, it is important to indicate how it will be calculated. This should be easy to understand by farmers or, if not, by their representatives.
 - *Deductions for advances.* When advances are paid to farmers or inputs are supplied on credit, the loans have to be repaid. In addition to interest and other charges, the method whereby the loans will be repaid through deductions needs to be specified.
 - *Payment arrangements.* Arrangements for paying the producer should be stated, including how long after delivery this will take place. Where certain steps need to be taken by the producer, such as opening a bank account, they should be indicated.

Chapter 4

Excuses for non-performance and *force majeure*

In contract farming, the performance of either party may be affected by certain external events. Although this may happen for all types of contracts, it is more likely when agricultural production is involved because of its dependence on natural phenomena. Furthermore, events affecting either party's ability to perform will almost invariably affect the other party's performance. This chapter reviews failure to perform when circumstances are beyond the control of the parties and discusses how this can be treated in contracts.

In practice, contractors should exercise a great deal of common sense when drafting contracts, recognizing that there are circumstances when producers, particularly smallholders, are unable to comply with the contract through no fault of their own. The aim should be, where possible, to ensure the continuation of the contract.

4.1 FORCE MAJEURE

Generally, domestic laws only provide for relief in the case of events that are unpredictable, unavoidable, beyond the parties' reasonable control and objectively prevent one or both of them from performing. An example might be an exceptional flood that destroys all the crops being grown under a contract on a specified plot of land. Although each legal system may employ its own terminology, *force majeure* is widely used to describe such events.

It should be stressed that *force majeure* can mainly excuse producers from their obligation to deliver the product. In almost all contract farming arrangements, a crop remains the property of the producer until delivery; damage to that crop is at the risk of the producer. Thus, *force majeure* does not necessarily entitle the producer to receive any compensation and, in most cases, would not excuse the producer from repaying any loans, as discussed below. However, when dealing with uninsured small farmers, contractors need to recognize that some risk sharing could be desirable in order to maintain the contractual relationship and, in some cases, ensure the continued viability of the contractor's business.

Contract signatories are generally free to agree on a specific provision on *force majeure* rather than rely upon default rules provided by the law. Agreements often contain at least a minimum reference to *force majeure*. However, this issue seems to receive surprisingly less attention than might be expected, given the possibility of unforeseen events.

Inserting a *force majeure* clause into a contract does not necessarily make any applicable national law irrelevant. General clauses referring to *force majeure* without further specifications will be interpreted in accordance with the law. Lists of relevant *force majeure* events included in contracts may be construed in different ways depending on the court. The parties can make it clear that such a

list is not exhaustive by using expressions such as “including, but not limited to”, or by adding a cover-all final description. Those wishing to include such lists in their contract should expressly clarify whether specific events are excluded and whether there are different consequences from different events.

4.2 EVENTS QUALIFYING AS *FORCE MAJEURE*

In those countries where the notion of *force majeure* is part of the general law, contracting parties can rely on its usual interpretation by domestic courts. Some contracts may also use the terms “adverse factors” or “adverse events”, with or without additional language, such as “beyond the control of the parties”.

An important element to be considered is the extent to which the *force majeure* event has to affect the parties’ performance before the clause comes into effect. For example, an infestation may be only partial, enabling some crops to be produced. The ground may be waterlogged but not flooded. Sometimes contracts require that the obligation be impossible to perform in order for *force majeure* to apply.

Legal systems all share a few common factors in their interpretation of *force majeure*. First, is consideration of whether, in practice, the event is within the party’s “typical sphere of risk” (e.g. connected to its performance under the contract). Second, courts tend to interpret narrowly events excusing a party from honouring its contract. It may therefore be difficult for the producer to prove that the event was outside its normal sphere of control, at least when the destruction of part of the crops sold under contract was caused by bad (or even exceptionally bad) weather conditions.

The paramount example of an event that may affect the producer’s performance is a natural catastrophe destroying the crops to be produced and delivered, or killing the flock of animals to be raised, in whole or in part.

Epidemics and pests also raise particular legal issues because most contracts require the producer to take precautions to guard against them and to comply with the contractor’s instructions. They are not generally mentioned in the lists of events contained in *force majeure* clauses. Accordingly, it is crucial for producers to be aware of their contractual obligations and their exposure to such risks.

While natural catastrophes are usually the cause of the producer’s inability to perform, acts by government and others can also impede the parties’ ability to fulfil their obligations. An example could be an export ban that results in the contractor being unable to sell the products. Among other non-natural events affecting performance, strikes or other labour union actions or resolutions are often expressly mentioned. Mobs, riots and other social disturbances are additional events that appear in *force majeure* clauses, as well as wars, insurrections and revolutions. Generally speaking, an employee strike affecting either party rarely qualifies because it is not considered outside the employer’s control. Interruption of services such as transportation or communication, on the other hand, would fall more easily under a general *force majeure* clause or be recognized by domestic laws as excusing the obligation to perform. Changes in market conditions are not generally considered to be *force majeure* or adverse events, nor are they specifically listed in *force majeure* clauses.

Issues of evidence are frequently overlooked by contracting parties, but they may well determine the outcome of a legal dispute regarding *force majeure*. The type of reliable, compelling evidence to demonstrate such a link between the

inability to perform and an external unavoidable event (such as having unbiased observers visit the fields and document the situation, taking pictures and making detailed notes of the extent of the losses or damage, collecting newspaper articles, etc.) may only become apparent after a conflict has arisen. For storms or other climatic events, the contract may require a certification by a meteorological station. Similarly, when dealing with pests, a certification of the existence and severity of the infestation could be procured from a competent authority. In practice, smallholders in developing countries may not be able to do this and they will have to rely on the contractor's willingness to accept both that the described events have occurred and that they have impacted on the producers' ability to perform.

4.3 CONSEQUENCES OF THE RECOGNITION OF *FORCE MAJEURE*

Force majeure traditionally exonerates a party from performing the obligation affected by the event, or at least prevents the affected party from raising a claim for damages. This is based on the assumption that it would be unfair to hold a party liable for a performance that has become impossible.

It is not uncommon for contracts to require that the producer is still liable to pay for inputs received or to pay back any loans to the contractor if production is affected by *force majeure*. In most developing countries, contractors' insistence on such immediate repayments would probably result in the end of the relationship. An alternative, practical approach would be to share such costs between the contractor and producer or defer repayment until the subsequent harvest.

Some contracts treat the obligation as suspended for the duration of the period when the *force majeure* event affects the ability to perform. Suspension cannot be indefinite, and the contract must stipulate whether, after the suspension, the obligation may be excused, the contract terminated or the parties obliged to renegotiate the terms.

Contracts or, less frequently, domestic laws may grant to either one or both parties the right to terminate the contract based on *force majeure*. The right may be immediately available or arise only after the period in which the performance has been suspended has expired.

Some agricultural production contracts, and a majority of international instruments, expressly provide for notice of a *force majeure* event to be provided formally, while domestic laws rarely do so. The contract may require, for example, that after the occurrence of the relevant event the affected party provide further notices to the other party, fully describing the event and its cause, providing information relating to the efforts made to avoid or mitigate its effects and estimating the time in which the affected party reasonably expects to be unable to carry out its obligations.

Parties may wish to continue their relationship even when unforeseen circumstances have severely restricted their performance. To achieve such continuation, a clause of the initial agreement could provide a right or a duty to renegotiate its terms following a *force majeure* event.

4.4 CHANGE IN CIRCUMSTANCES

A related concept to *force majeure* is a change in circumstances, also known as hardship in some legal systems. A change in circumstances can arise from similar events as *force majeure*. Similarly, as in *force majeure*, the event should be exceptional,

unforeseeable, unavoidable and beyond the parties' control. The difference between the two concepts relates to the level of disruption that occurs. A change in circumstances would not have to prevent performance, but would have to change the balance of the relationship fundamentally, making performance far more difficult.

As an example, suppose that a producer has agreed to obtain a specific brand of pesticide to be used in the production of the contracted crops. After the producer has signed the contract, but before buying the pesticide, the government makes an unforeseeable change to its subsidy policies. As a result, the specific brand of pesticide has become significantly more expensive, while still remaining available on the market. Although it is not impossible for the producer still to procure the specified pesticide, doing so could endanger the economic viability of the contract, and therefore the balance of the relationship has fundamentally changed. Consequently, the producer may be allowed to rely on a change in circumstances, either to avoid using that particular pesticide or to renegotiate the price to be paid.

A change in circumstances does not excuse the parties from performance either in contracts or in applicable law. More often, they provide for renegotiation, either as a right or as a duty, with a possibility of terminating the contract should renegotiations fail. Although a rare occurrence, some legal systems may even allow one of the parties to petition a court to adapt the contract to the new circumstances.

Chapter recap: Excuses for non-performance

1. Contracts should recognize that performance by producers may sometimes be impossible through no fault of their own, as a result of *force majeure* events or change in circumstances. They should specify how such failure will be treated. Less frequently, contractors' performances may also be subject to *force majeure* or change in circumstances.
2. A contract may envisage *force majeure* in a number of ways.
 - It may excuse the producer from delivery because of *force majeure*.
 - It may indicate how repayment of advances will be treated.
 - It should clarify the extent of damage necessary for *force majeure* to apply.
 - It may address situations where delivery is possible but quality does not meet requirements.
 - It may consider how to share the potential risks. In many cases it will be in the contractor's interest to continue the relationship with the producer after a *force majeure* event. However, this is likely to require some cost sharing by the contractor.
3. Renegotiation is often the solution of choice for a contractually defined change in circumstances.
4. If *force majeure* or change in circumstances is included in a contract, it is desirable to specify in detail all events that could qualify. This would normally exclude events where the producer's negligence has contributed to the loss, e.g. by failing to use appropriate pest control methods during an infestation. Similarly, events considered within the contractor's control, such as strikes by its employees, would be excluded.
5. Changes in market conditions, such as major price falls, are not considered *force majeure*.

Chapter 5

Remedies for breach of contract

A “remedy” refers to any legal measure provided by law or by contract to protect the interest of one party against the failure of another party to perform properly. This chapter covers remedies provided against a breach of contract that does not qualify as *force majeure* or other similar legal excuse. Contracting parties are generally free to select remedies, to define the sequence in which the remedies will be implemented and to limit them in different ways. However, the first aim of any contract should be to maximize communication between contractor and producer so that remedies are the result of mutual agreement rather than being imposed by one party or the other. The legal sources of remedies can be found primarily in the contract itself, in framework contracts as well as in the applicable law.

Remedies used should reflect the seriousness of the breach. Some legal systems limit the use of the most severe remedies (such as contract termination) to cases in which the breach of contract substantially deprives the aggrieved party of what it was entitled to expect, the breach is intentional or reckless, or where there is no reason to believe that the non-performing party will be able to perform in the future.

5.1 OVERVIEW OF REMEDIES

Types of remedies are briefly discussed below. The extent to which each remedy may be used and the way legal systems prioritize remedies or provide for a sequence of remedies depending on a party’s response to a breach may differ greatly from one legal system to another and across markets.

Renegotiation

In general, the Guide promotes *cooperation* between the parties after a breach of contract. One way of achieving this cooperation is through renegotiations between parties after a breach. For example, a contract may provide that a breach of a specific obligation (e.g. failure to obtain certification for a given input, process or output) can cause immediate termination. In fact, parties may agree that such a failure is only temporary and that termination would be undesirable, thus preserving the relationship and continuing to enjoy its benefits.

In-kind remedies

These include the right for the aggrieved party to insist that the party that has failed to perform should rectify this failure by carrying out the activities specified in the law or in the contract, by replacing faulty products or by undertaking corrective actions relating to the production process and the final product. A request for in-kind remedies may be made directly between the parties or through a dispute resolution mechanism, such as arbitration (see Chapter 7). The applicable law may restrict the use of this remedy when it is not physically possible, is unreasonably burdensome or because the aggrieved party’s request has not been timely.

Withholding performance

The remedy of withholding performance may be used when one party breaches the contract before the aggrieved party has still to perform, or when circumstances make it apparent that there will be a fundamental breach, i.e. an extremely serious breach. Thus, when the contractor commits to making an advance, failure to provide it may justify the producer in refraining from growing the crop for which advance payments were to have been made. In the same way, delivery of inputs may be withheld by the contractor when the producer has failed to carry out the required land preparation.

Price reduction

This is a common remedy when the producer fails to provide the contracted quality or quantity. Its function is to preserve the exchange and restore the balance of the transaction. Both in the case of products that do not conform to required standards and where there is only partial delivery, the law may give the producer the opportunity to resolve performance difficulties before the contractor is entitled to reduce the price. The criteria for price reduction would benefit from being specified in the contract.

Termination

Termination is the most severe remedy against any party's breach. It acknowledges that there is no further potential for cooperation. At the same time, the threat of termination may provide powerful incentives to negotiate when breaches occur. For example, within a long-term relationship in which the producer has made significant investments and the contractor is among the few able to purchase the entire production, the producer will want to make every effort to comply with the agreed standards.

Contractual clauses often place termination at the end of a sequence, after other remedies have been tried and failed. In many legal systems, domestic law requires a breach to be fundamental before an aggrieved party may terminate and often limits parties' ability to terminate contracts when significant investments have been made by one or the other party. Contract termination generally releases parties from the obligations arising from the contract but not from post-contractual obligations. If performance has been executed, restitution is due. When based on a breach, termination does not normally preclude any claim for damages. Termination can also be partial, in which case only performances affected by termination need to be compensated.

Restitution

This implies that persons not entitled by contract or by law to retain goods or money in their possession must return them to the owner. With contract farming, the real possibility of providing restitution in kind may be rather limited. Physical inputs, in principle, should be returned to the contractor if the producer fails to produce. However, they may have already been used. In this case, the producer may be requested to pay the contractor for the value of the inputs used, although in a smallholder context the cost to the contractor of obtaining such a judgement may well exceed any benefit. When the contractor has provided services such as agronomy or training, restitution in kind is obviously not possible and, if allowed

by applicable law, could be substituted by restitution in money if the services have given effective value to the recipient.

Damages

Damages may be sought on their own or in combination with other remedies. In a court of law, the aggrieved party generally has to prove the contract breach, the harm suffered and the causal connection between the breach and the harm. However, some legal systems reverse the burden of proof so that all the aggrieved party has to do is prove the breach, and the breaching party must then prove that no harm has been caused or that it was not caused by the breach. Parties to a contract are normally entitled to determine the type and amount of recoverable damages through contractual clauses.

In order to assess the level of damages caused by a breach, legal systems use several criteria. Some of the most common include the concept of full compensation (that damages include any loss incurred and gains deprived); foreseeability (the party in breach is only liable for damages as a result of non-performance that was either foreseeable or should have been reasonably foreseeable at the time of conclusion of the contract); and certainty (that the harm is established with a reasonable degree of certainty).

Interest and late payments

When allowed by the applicable law, interest is often provided by contract law for delay of payment of monetary obligations. Right to interest thus arises whenever the party demands a delayed payment. The payment of interest does not generally require evidence of loss, nor does it reduce the right to claim damages.

Role of aggrieved party's conduct

Depending on the applicable law, the behaviour of the aggrieved party may influence access to specific remedies, deny certain remedies or reduce the scope of remedies. These effects can come into play when the aggrieved party has either contributed to the breach or has failed to mitigate its negative consequences. For example, if the aggrieved party contributed to the breach, such as when a contractor gives poor technical advice on farming methods that leads to a lower quantity than required, it may not be able to seek termination or may be required to bear part of the breaching party's additional costs.

Right to cure

Legal systems often give the party in breach some right to attempt to fix the breach before the application of remedies. Sometimes this is allowed even after the time for performance has passed. Where recognized, this right to cure normally suspends the aggrieved party's right to resort to remedies other than withholding performance and claiming damages.

5.2 CONTRACTOR'S REMEDIES FOR A PRODUCER'S BREACH

Producers can breach their contract in many ways. The main areas in which failures to comply can occur concern the production process, input use, product quality and quantities delivered. The remedies available to contractors are briefly discussed below. In practical terms, remedies in developing country smallholder

contracts are likely to be limited. Again, the need for cooperation between the parties cannot be stressed too strongly.

Production process

Remedies for breach of process-related obligations, whether or not these breaches appear as defects in the final product, can preserve the relationship but often require the aggrieved party's cooperation. As such, in-kind remedies can be particularly important. With these remedies, the contractor can, for example, either request the producer to perform specific activities or take corrective measures, without having to wait until delivery to take action. Damages can often be used to complement in-kind remedies, especially where the breach of process-related obligations results in a lowered value of the final product. In practice, termination is a rarely used remedy for breaches of process-related obligations, as it effectively ends the relationship.

If the producer fails to carry out land preparation or other necessary activities, the contractor may withhold performance by refusing to comply with its contractual obligations, such as delivery of inputs, when they are supposed to happen after the producer's performance. This enables the contractor to limit risks from the producer's failure. Establishing in the contract a clear schedule of activities that specifies the sequence in which each agreed activity should be carried out is therefore essential.

Input use

Producers may fail to use the required inputs or may use substandard inputs not specified in the contract. When the contractor identifies a problem, it does not have to wait until delivery of the resulting inadequate crops or animals to take action. The contractor may opt to require the input to be repaired or replaced or require changes in the production process through a corrective action. Clauses that link prices paid to farmers to productive performance standards such as yields or feed conversion rates are used in some contracts to ensure that incentives for proper utilization of inputs are in place.

Product quality

Quality problems may emerge not only before or at the time of delivery, but even long after delivery, during the processing, transportation and storage stages or even at the time of consumption. Remedies for poor performance may therefore differ, depending on when the problem is detected. Early detection may permit correction, whereas detection at the time of delivery or later may make corrective measures impossible to implement, leading the contractor in some cases to seek termination. When non-conformity is detected at the time of delivery, the contractor may, of course, reject the product. In some cases, it is possible to "repair" products, such as when further drying is done by the contractor, at the producer's expense.

The contractor may also rely on damages, either as a stand-alone remedy or in combination with in-kind remedies or termination. Price reduction can often be used when product quality does not meet requirements.

Delivery of contracted quantities

Examples of failure to deliver the product include total lack of delivery, delayed delivery and partial delivery. In all these cases, the contractor may have an interest

in requesting a performance, i.e. delivery. In most contracts, payment will follow the delivery of the goods and their accompanying inspection. This makes withholding payment a natural remedy against the producer's failure to deliver the right quality and quantity at the right time and place. Once the contractor has accepted the goods and taken delivery, payment can no longer be withheld.

Partial delivery may not be considered sufficiently serious to warrant termination unless it has a major impact on the contractor's economic activity. Thus, failure to deliver tomatoes for processing on a particular day may not be considered a breach, whereas failure to deliver fresh vegetables for export shipment the same evening may be considered so, because the contractor could risk losing its contract on the export market. Total lack of delivery, especially if caused by side-selling by the producer, is likely to be considered a fundamental breach, leading to termination.

When delivery is late, partial or arrives in the wrong place, damages may cover the lost value or profits of such breach. If the contract is terminated for an insufficient delivery quantity, the contractor may have to buy similar goods from the open market to fulfil its needs, and the producer may have to pay the difference between the contract price and the price that the contractor paid for these substitute goods.

5.3 PRODUCER'S REMEDIES FOR A CONTRACTOR'S BREACH

Breach of contract by the contractor is, of course, also possible. The main areas of failures to comply with the contract are input supply, delivery of services, acceptance of delivery and payment. The remedies available to producers in these circumstances are discussed below. However, legal action by smallholders is improbable and smallholders and their advisors should thus aim for a cooperative approach in addressing a contractor's breach as soon as it becomes apparent.

Input supply

When a contractor fails to deliver, or delivers non-conforming inputs, the use of remedies by the producer depends upon when the breach can be detected. If the breach is detected at input delivery, or after input delivery but before delivery of the final product to the contractor, the producer can provide notice to the contractor and request instructions. The producer may also require the contractor to provide conforming inputs, or procure similar inputs itself from the open market and have the contractor cover the costs.

When the input non-conformity emerges only after delivery to the contractor, and because it is likely that input non-conformity will translate into non-conforming products, the main question is coordination of remedies between the parties. For example, the contractor should not reduce the price to be paid for the final production because of lower quality, if the lower quality was caused by the poor quality of the inputs. Producers may try to induce the contractor to honour its contractual commitments by withholding their own performance. In the case of the contractor's failure to provide inputs, for example, the impact of withholding production would represent a significant risk to the contractor. However, while producers may be able to stop activities prior to planting, their possibility of withholding performance is reduced as the crop grows. Harvests cannot be delayed and alternative markets may not exist.

Delivery and payment

Taking delivery as specified in the contract is particularly important in cases where commodities are subject to rapid deterioration (such as highly perishable crops), a high risk of contamination (certain livestock) or high costs of storage. Producers normally have the right to demand that the contractor take delivery of the goods.

In the event of taking late delivery or taking delivery at the wrong place, the contract normally permits the producer to claim all the costs connected with storage, preservation and transportation of the goods, if needed to facilitate changes required by the contractor. Taking late delivery may result in a loss of quality, for which the producer may be compensated. In the case of an express refusal to accept delivery or a significant delay in taking delivery, the producer may seek termination in order, where possible, to resell the goods on the open market in order to avoid losses.

Where payment is not made as specified in the contract, a formal request will normally be enough to enforce the producer's right to that payment. However, if the claim remains unsatisfied, the producer may have to obtain a court judgement that can then be enforced by seizing the contractor's goods. If the more cooperative measures fail, and the breach of payment obligation is severe enough, the producer may seek termination as a remedy of last resort.

Chapter recap: Remedies for breach of contract

1. Contracts should include clauses relating to remedies that could be applied when one party fails to perform for any reason other than *force majeure*. Emphasis should be on arriving at mutually acceptable, cooperative solutions.
2. Remedies can take a range of forms, including correction of the problem, withholding of subsequent performance by the aggrieved party, reducing the price payable, restitution of loans and advances, payments of damages and, as a last resort, termination. Where the possibility of such remedies is envisaged, they should be included in the contract but national laws are also likely to be relevant.
3. Potential breaches of contract by producers that may lead to the application of remedies include the following.
 - Failure to carry out required land preparation.
 - Failure to use inputs as specified in the contract.
 - Delivery of products that do not meet agreed quality standards.
 - Failure to deliver all or part of the contracted quantities.
4. Potential breaches of contract by the contractor can include the following.
 - Failure to deliver inputs on time or inputs of the agreed type or quality.
 - Failure to take delivery at the time and location specified and in the agreed quantities and qualities.
 - Failure to pay.
5. To avoid confusion concerning responsibilities, it is a good idea to include an annex in the contract setting out all contractual activities in the sequence in which they are to be carried out. Furthermore, the need for remedies to be implemented can usually be reduced by ensuring maximum communication, so that both parties are aware of emerging problems at an early stage.

Chapter 6

Contract duration, renewal and termination

The issues of contract duration, renewal and termination are of great importance. It is essential for the parties to know from the outset when their contractual relationship begins and ends. Equally important is whether and how the relationship may be terminated before its expiry date, and how the contract can be renewed when it comes to an end.

Duration, renewal and termination are largely interrelated. For instance, the shorter the duration of the contract, the greater the need to provide expressly for its possible renewal. On the other hand, the longer the duration, the greater the need to provide for the right of either party to terminate the contract prematurely.

6.1 DURATION

Providing expressly for duration in a contract is a common practice and may even be imposed by law. In determining the duration, the production cycle of the products involved has to be taken into account, together with the parties' financial obligations. These are particularly relevant where the producer has to make long-term investments such as the purchase of specific equipment or the construction of new facilities, so that the producer can get a return on investment. In some legal systems, contract farming agreements are subject to minimum and maximum durations.

Contracts may be short, usually expressed in months or with reference to a crop season, or last for several years. In some cases, an end date is not even specified, as in the case of tree crops that may bear for many years. Contracts for short-term crops, such as vegetables, are usually concluded on an annual or seasonal basis, whereas crops such as tea, coffee, cocoa, sugar cane and oil palm involve longer durations and invariably require much higher levels of capital investment. Livestock contracts may last for a fairly long period. Parties are likely to prefer a longer contract duration when they are interested in a solid and lasting relationship. However, for crops such as vegetables grown for both domestic and export markets the ability of the contractor to commit to a long-term relationship will, in turn, depend on its own contractual relationship with its buyers.

6.2 RENEWAL

On expiry of a fixed-term agreement, the parties may be interested in its continuation. They are advised to make provision in the contract as to how it may be renewed, which may also be required by applicable law. While a contract will normally be renewed under the same terms as the "old" one, the parties may occasionally decide to revise some of its terms.

A clause in the contract may permit it to be renewed automatically. This can even be possible when there is no such clause since the parties simply continue

to behave as if the contract were still in existence even though the expiry date has passed. In a short-term contract, the parties frequently stipulate that it should be automatically renewed for additional periods of the same or a different duration. Automatic renewal can be limited to a specified number of occasions.

If renewed frequently, a contract may *de facto* create a long-term relationship. This is quite a common practice, as seasonal contracts are often allowed to “roll over”, with minor changes made to the pricing structure and specifications. Nevertheless, after a series of renewals, the contractor may decide to terminate the contract by providing notice only a short time in advance, acting on the basis that the renewed contracts, like the original one, are short, fixed-term contracts. However, continued renewal over many years may lead the producer to believe, quite reasonably, that the relationship has become a long-term one. As a result, in some countries, according to the general principles of good faith, the contractor may have to give notice of termination at a reasonable time before the renewal date.

6.3 TERMINATION

“Termination” covers various situations, ranging from automatic termination of the contract upon fulfilment by the parties of all their obligations, to termination by either of the parties on the basis of the contract or the law. Some domestic legislation recommends that contracts include provisions specifying when and how the contract is to be terminated. Indeed, the more precisely the parties regulate the possibility of termination, the more stable and predictable their relationship is likely to be.

A party intending to terminate a contract is normally required to give notice of its intention to do so in writing. Advance notice is also generally required, but how long in advance depends on the circumstances. The longer the contract duration, the longer the period of advance notice needed.

As a rule, fixed-term contracts end automatically on their stipulated expiry date, without any advance notice. Alternatively, parties may provide for automatic termination upon fulfilment of their contractual obligations, i.e. when products have been delivered and all payments made. Mutual agreement between the parties is another way to end the relationship, although this is sometimes not written in contracts because the parties take it for granted that they may terminate their relationship in this way.

Contracts are sometimes drafted to give one of the parties – usually the contractor – the right to terminate unilaterally at any time. Such clauses may be legally unenforceable, on the grounds that they give one party an unfair advantage over the other and parties are advised to provide some restrictions on early unilateral termination. Although rare, some domestic laws provide special protection for the producer, such as requiring the contractor to give notice a sufficient time before the effective date of termination or reimburse the producer for any damages incurred as a result of early termination.

At the time of termination, the parties are usually released from their obligations to perform. However, any rights or liabilities, such as the right to claim damages for non-performance, continue to exist, as do provisions for the settlement of disputes or any other terms that are to operate after termination. Finally, when producers have prematurely terminated the contract and have received financing from the contractor, they are still obliged to repay advances and loans.

Chapter recap: Contract duration, renewal and termination

1. Contracts should clearly state the planned duration, which is likely to be related to the production cycle of the product as well as to the level of investment required from the producer.
2. Renewal of contracts is common and may be done automatically through a clause in the contract or by mutual agreement. Otherwise, the contract should indicate how renewal will be organized.
3. With long-term contracts, one or other of the parties may, at some stage, wish to terminate the agreement. Ways of doing this need to be specified in the contract.
 - Giving formal notice should be required. Generally, the longer the contract the longer the period of notice to be given.
 - Clauses giving the contractor the right to terminate unilaterally are not recommended, as they could result in substantial losses for the producer and may be illegal.
 - Termination does not exclude the parties from existing liabilities for non-performance or from repayment of any debts.

Chapter 7

Dispute resolution

Certain areas of agricultural production, such as quality and quantity, are particularly prone to controversy. Ideally, contractual problems should be resolved through mutual collaboration. However, when entering into a contract, the parties should assume that disagreements may arise that they will not be able to solve on their own through regular meetings between contractor and producer. They should therefore plan how to deal with possible disputes. In addition, contracts are often drawn up rather vaguely and include terms that may be open to conflicting interpretation.

There are a number of dispute resolution methods that can be used. First, through mediation, the parties seek assistance of a third party. Second, under arbitration, the parties appoint one or more arbitrator(s) and are bound to comply with the decisions made. Third, under a judicial process, parties are subject to the authority of the courts. The decisions under both arbitration and judicial proceedings are binding and enforceable.

Certain types of disputes are often excluded from mediation or arbitration. This may be the case when public or governmental parties are involved, making the dispute fall under the mandatory jurisdiction of courts or other public entities.

The fairness of the dispute resolution mechanism depends on the mediators or adjudicators acting independently and impartially. The proceedings must guarantee that both parties have the same opportunities to present their case, with particular attention to the protection of the weaker party. It is essential for smallholder producers to be adequately advised and represented. Producer organizations or associations with advocacy functions can play an important role in providing this assistance.

7.1 NON-JUDICIAL DISPUTE RESOLUTION METHODS

Unlike court proceedings, recourse to mediation – also known as conciliation – and to arbitration are based on both parties' initial consent. To consent to these methods, the parties may either include a term in their contract or conclude a separate agreement, usually after the dispute has arisen.

The choice of which mechanism to adopt can be based on the nature of the dispute. For example, resolving quality disputes might call for rapid expert adjudication, whereas more legal disputes might require a different mechanism, such as arbitration. Another important factor is the intended outcome. Mediation could be more conducive to maintaining trust and preserving the relationship between the parties. It may also provide a solution to the impracticability of using normal court procedures.

Mediation

Under mediation, the mediator assists the parties in settling their dispute, but does not have the authority to impose a solution. Mediation is generally simple to

organize, allowing parties to deal with conflicts at an early stage. Furthermore, it generally takes place over a short period, has lower costs and can be used for disagreements that the parties would prefer not to bring before the public or a court.

Mediation encourages dialogue between the parties with a view to finding a mutually acceptable solution. Agreements resulting from mediation are likely to be complied with because the decision to seek mediation requires both parties' consent in the first place. A high proportion of contracts does provide for the use of mediation. In some legal systems it may be mandatory to include a clause to that effect, making it clear that mediation will take place prior to arbitration or state court litigation.

Clauses covering mediation are advised to be as specific as possible. The contract may provide for a particular institution to mediate or for ways to appoint the mediator when a dispute arises, although parties are advised against naming a particular person, as this may lead to problems if the person is not available. Some countries' laws allow parties to choose an ad hoc mediation procedure, while others require use of a particular institution that has authority for such settlements.

When contracts are concluded with a large number of producers, such as those in indigenous communities, special kinds of mediators may play an important role. Respected individuals, who, although not necessarily neutral, are perceived as being fair, may act as mediators. It is also vital to remember that traditional dispute resolution mechanisms may exist, parallel to the official ones.

Among other issues, the mediator and the parties need to establish the scope of the dispute covered by the mediation; the way the proceedings will be carried out; the rules for giving evidence; disclosure and confidentiality issues; drafting and enforceability of the settlement agreement; allocation of costs; and any right to initiate subsequently arbitration or judicial proceedings. Mediation proceedings may be kept confidential, to foster a climate of trust between the parties and confidence in the mediator.

When there is a legal or contractual obligation to resort to mediation, the parties are bound to undertake it. Although the parties do not make a commitment to reach an agreement, should an agreement be reached it becomes contractually binding. The parties are advised to sign a settlement agreement to confirm this.

Arbitration

Under arbitration, the parties refer their dispute to a neutral third party whose decision will be binding and enforceable under the law. Disputes settled under arbitration cannot normally be subject to further review, although most legal systems do provide some limited bases on which a decision can be challenged. Arbitration is attracting increasing interest as a way of solving civil and commercial disputes because it is seen as combining expeditious proceedings with the reliability of a judicial decision. In some countries, laws governing contract farming encourage the parties to use arbitration when available.

Parties to the contract have significant autonomy to agree on the way the arbitration will be carried out and to choose the arbitrator. However, because arbitration is intended to produce the same binding effects as a judicial decision, it is governed by mandatory domestic legislation. The arbitrator must address the dispute with reference to the law, as well as to the principles of justice and fairness when the parties have so agreed and the law allows it.

The request for arbitration should generally be put in writing to ensure consent. The parties should pay special attention to the drafting of the arbitration clause. An unclear clause, providing for both arbitration and the use of domestic courts, could be declared unenforceable. Instead, language that demonstrates a clear intention to arbitrate should be used in the contract. Model arbitration clauses, drafted by arbitration institutions, are sometimes available and should be followed where feasible. If used, the contract or arbitration agreement should clearly state the institution to which the dispute is to be submitted.

In order to protect its rights, one party may wish to request interim relief pending the arbitration proceedings. Typically, interim relief takes the form of a court order directed at preserving the value of production. For example, producers may be authorized to take immediate action to sell perishable goods that the contractor is unable or unwilling to buy. Most arbitration laws recognize that seeking interim relief before domestic courts does not mean that a party is waiving its agreement to arbitrate.

7.2 JUDICIAL DISPUTE RESOLUTION

If the parties choose not to pursue arbitration, they may resort to the law courts. Every legal system should guarantee free and fair access to justice and enable private parties to settle their dispute before independent judges. In judicial proceedings, the parties may be required to have legal representation. Although professional representation should help the parties to present their case adequately, it generally involves significant costs, which may not be recoverable by the winning party.

Public justice may involve complex, lengthy and repeated proceedings that can go on for several years. This, together with the cost, generally deters parties from relying on the judicial system to obtain redress, particularly for the time-sensitive issues that arise with contract farming. However, some judicial proceedings provide for a preliminary mediation stage in order to seek fast and amicable settlement and a number of countries are trying to improve the settlement of small claims through flexible and simplified proceedings.

Chapter recap: Dispute resolution

1. Ideally, contracts should be self-regulating through mutual collaboration. However, disagreements do occur and their possibility should be assumed when contracts are drafted. Avoiding vaguely worded contracts is an important way of minimizing disputes. When drafting contracts, the parties should familiarize themselves fully with available dispute resolution mechanisms in their country.
2. Contracts should propose a sequential approach to dispute resolution. First, the parties should attempt to resolve difficulties on their own. If this does not work, mediation should be tried. Failure in mediation could then lead to arbitration or the national courts.

continued

Dispute resolution (continued)

3. Mediation involves a mediator who tries to help the parties resolve their difficulties. The parties willingly agree to participate but make no commitment to accept the results unless they reach agreement, when that agreement becomes contractually binding. Most contracts include reference to mediation and in some countries it may be a legal requirement.
4. Arbitration is governed by domestic legislation. Participation in arbitration is voluntary but its inclusion in the contract indicates that consent to arbitrate if required has been given. It is carried out by a neutral third party whose decision is legally binding. Unlike mediation, the arbitrator must consider the dispute with reference to the law so that contracts should clearly specify the institution that will be called upon to carry out the arbitration.
5. Arbitration is often a preferable alternative to law courts. Only rarely do the courts consider cases that have already gone through arbitration. Courts can be costly and time consuming and are not normally appropriate for resolving contract farming disputes.

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Legal aspects of contract farming agreements

Synthesis of the UNIDROIT/FAO/IFAD
Legal Guide on Contract Farming

Contract farming, broadly understood as agricultural production and marketing carried out under a previous agreement between producers and their buyers, supports the production of a wide range of commodities and its use is growing in many countries.

In 2015, mindful of the importance of enhancing knowledge and awareness of the legal regime applicable to contract farming operations, the International Institute for the Unification of Private Law (UNIDROIT), the Food and Agriculture Organization of the United Nations (FAO) and the International Fund for Agricultural Development (IFAD) released the UNIDROIT/FAO/IFAD Legal Guide on Contract Farming. This Guide is a comprehensive reference document that considers contract farming from the perspective of private law with the aim to promote a better understanding of the legal implications of contract terms and practices.

The synthesis of this Guide has been developed to further disseminate the important content of the Legal Guide to a broader audience of non-technical actors interested in contract farming including farmer representatives, extension agents, cooperatives, farmer associations, small and medium agrifood businesses and government regulators. It synthesizes the most important issues covered in the Guide while placing greater focus on legal issues of relevance to developing countries. It also includes observations and lessons learned from FAO's previous experience with contract farming in the field to illustrate the findings from the Guide. As such, it provides a useful summary of the many legal issues related to contract farming and offers guidance concerning the design and implementation of sound contracts, thereby contributing to building a conducive environment for contract farming.



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