



Contract farming and the law: What do regulators need to know?

What is contract farming?

At the heart of contract farming is an agreement between farmers and buyers: both partners agree in advance on the terms and conditions for the production and marketing of farm products. These conditions usually specify the price to be paid to the farmer, the quantity and quality of the product demanded by the buyer, and the date for delivery to buyers. The contract may also include more detailed information on how the production will be carried out or if any inputs such as seeds, fertilizers and technical advice will be provided by the buyer.

Purpose of this brief

This brief aims to help regulators and policy-makers to achieve a correct understanding of the legal aspects of contract farming (CF). It is based on information extracted from the *Legal Guide on Contract Farming* (UNIDROIT/FAO/IFAD, 2015), and from field experience in the implementation of contract farming projects by the Food and Agriculture Organization of the United Nations (FAO).

PART 1

WHY IS THE REGULATORY FRAMEWORK IMPORTANT FOR CONTRACT FARMING?

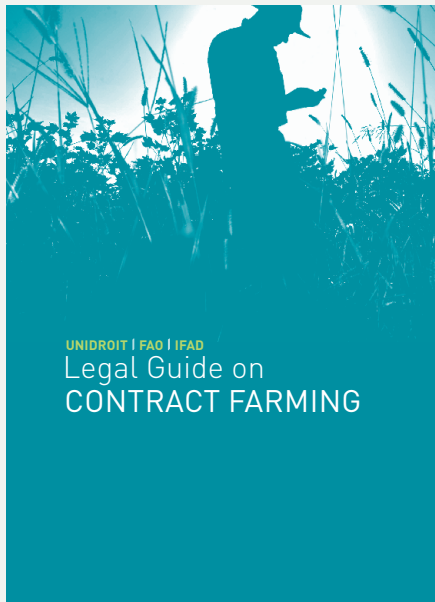
Appropriate regulatory frameworks are instrumental for clear and balanced CF operations. Legislation recognizes people's rights and protects those rights. It gives security to contractual relations and clarifies the mechanisms available to facilitate agreed solutions.

From a public policy viewpoint, legislation brings stability to agricultural policies, because laws – by the nature of their creation process – are difficult to change. For the parties involved in CF, this sustainability and enforceability of rights provides legal security. They know that their legal rights and obligations will be respected and that they will remain constant in the future. This can give them the peace of mind they need in order to enter into an agricultural production contract.

There are different possibilities for regulating CF. Some countries regulate CF through general contract or agricultural legislation, whereas others introduce CF provisions in commodity based legislation, or enact specific CF legislation. Contractual practices might also be governed by other sources, including legal principles, customary rules, usages and practices.

There is no one best regulatory solution to facilitate CF. The most appropriate regulatory and policy framework will depend on the national policy and regulatory objectives, the existing legislation and legal tradition.

BOX 1

The Legal Guide
on Contract Farming

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) collaborated to develop the UNIDROIT/FAO/IFAD Legal Guide on Contract Farming (the Legal Guide). The Legal Guide provides guidance on the elements that should be incorporated into an agricultural production contract. It analyses all the elements of the contract throughout the contract life cycle and thus helps to build trust between the parties and support mutually beneficial relationships. It is a useful tool and reference point for a broad range of users involved in CF practice, policy design, legal research and capacity-building. The Guide is freely available on the websites of FAO, UNIDROIT and IFAD.

Source: UNIDROIT/FAO/IFAD, 2017.

PART 2

CONTENT OF THE LEGAL GUIDE

1. Regulatory frameworks for contract farming

To help understand CF, the Legal Guide discusses the international and national legislation that may have an effect on the CF relationship.

A) The applicable private law regime

Contracts will normally specify the national legislation which governs them, an issue that may be particularly relevant in an international context. In these cases, the Legal Guide suggests that the **law of the country where the production takes place commonly serves everyone's interests the best**. It generally best takes into account the national circumstances and is also the most familiar for the producer. In addition to national legislation, countries may find relevant regulatory frameworks in regional harmonization initiatives, such as the legal framework of the Organization for the Harmonization of Business Law in Africa (OHADA), in Box 2.

BOX 2

CF under the legal framework of the Organization for the
Harmonization of Business Law in Africa OHADA

OHADA is an international entity currently comprising of 17 member states in Central Africa, West Africa, and the Indian Ocean. OHADA aims to ensure legal security for economic activities and to stimulate investment.

OHADA has enacted nine uniform acts, some of which cover aspects of CF. The legal structure of parties is determined by OHADA law. The pledge of farming products to a food industry in exchange for financing will be covered by the OHADA uniform act on securities. The transportation of farming products by road will be covered by the provisions of OHADA uniform acts. Disputes arising from CF can be submitted to official courts and, in that case, the common court of justice and arbitration – the common Supreme Court for the 17 member states in matters related to the application and interpretation of OHADA law – may intervene. For arbitration, OHADA has a uniform act on arbitration and also a specific arbitration system located in the common court of justice and arbitration.

OHADA is heading towards a more extended coverage of CF. Work currently under development is focusing on several aspects relevant for CF, including an instrument on commercial mediation, work on developing leasing, private public partnership contracts, and joint venture.

Source: UNIDROIT, 2014.

B) The role of the regulatory environment

Besides legislation directly regulating the agricultural production contract, many **other laws and regulations will influence its formation and implementation.** Competition laws, labour laws, and legislation on agricultural inputs, intellectual property rights or food safety and quality, among other areas, may condition the content and implementation of agricultural production contracts.

CF relationships can also be influenced by international **human rights obligations**, which are relevant not only for states but also for businesses. Participation, accountability, empowerment, non-discrimination, transparency, human dignity, and the rule of law are some of the most important general principles in relation to CF. The Human Right to Food has an especially important role, as does the protection of women and other vulnerable parties.

- » CF operations are commonly governed by the law of the country where the production takes place.
- » Besides rules directly applicable to CF, also the wider legal framework may also have an effect on CF operations. Human rights obligations, for instance, must be respected by both the state and the parties.

2. Parties, formation and form

Contract farming is a mechanism that creates mutual benefits for the parties – the producers and the buyer. The formation and the form of the contract have a great impact on the future of the CF relationship.

A) Parties to the contract

CF normally occurs between two main parties: the producer and the buyer. To participate in CF, **producers** may group together in producer organizations, but they can also participate independently. **Producer organizations** (cooperatives, associations, etc.) can greatly increase producers' bargaining power, achieve economies of scale, and have a strong advocacy role. This could also bridge the power imbalance between producers and buyers. See Box 3 for an example of a successful business model using agricultural production contracts with cooperatives from the Philippines.

The **buyer** is the party commissioning the production, often providing inputs, guidance, and control. The buyer might be a private business or a public entity.

Third parties may participate in the contract. They can provide loans and services and play other supporting roles.

B) Contract formation

As with all contracts, the agricultural production contract is made up of an **offer and an acceptance.** The offer should preferably be submitted in writing and in clear language, and generally comes from the buyer during contract negotiations. It may be beneficial to allow third parties, especially producer organizations, to participate in the negotiations to balance contractual power.

The parties must know what they are signing. Lack of **informed consent** may render the contract void, so it is very important to ensure that the producer understands the contract.

BOX 3

Cooperatives and inclusive agribusiness models in the Philippines

Through its inclusive policies, Unifrutti, a private company exporting, processing and producing pineapple and banana in the Mindanao Region, has managed to make positive changes in the livelihoods of the rural communities involved, while simultaneously being profitable.

Four lessons of good practices for inclusive CF schemes can be identified from the experience. First, rural communities may need assistance to take part in the venture. Second, producers' associations are fundamental both for engaging more efficiently and on a more level playing field with buyers, and to generate additional benefits for the communities involved. Third, open dialogue and timely communication during contract negotiation and implementation can develop a high degree of trust, which is essential for a mutually successful relationship. Finally, both producers and buyers should share risks unique to their roles, and mutually support each other.

Source: FAO, 2015a.

When all stages of formation are conducted fairly, in a transparent manner, and in good faith, a foundation of trust is created for the CF relationship.

C) Contract form

In many jurisdictions, contracts are not subject to any requirements concerning form or content. Oral contractual arrangements can be admitted in legislation. Nevertheless, **written contracts** with easily understandable language are recommended as they improve

clarity, completeness, enforceability and effectiveness.

- » Producers can participate in CF either individually or as a group, for example through producer organizations.
- » Producer organizations can be instrumental in improving a contractual relationship between the producers and buyers.
- » A producer's acceptance of a buyer's offer is enough to create a binding contract.
- » Written contracts facilitate clarity, completeness, enforceability and effectiveness.

3. Obligations of the parties

The Legal Guide discusses the obligations of the parties and offers best practices on ways to organize them. Particular attention is paid to the kinds of obligations which are likely to cause disputes and may require the national regulator's attention.

A) Quantity and quality of the product

CF can contribute to **better quality of agricultural products**, especially when the buyer provides quality inputs. Product quality can be improved through a producer's obligation to meet requirements as specified in the contract. Third party certification of the product or the production process can help to ensure that these requisites are met.

The parties can contract either for the producer's **entire production or a part of the same**, depending on their needs and preferences. Contracting for the total production reduces market uncertainty for the producer, while contract-

ing for a part of it allows both parties some degree of autonomy in marketing decisions, without breaching their contractual obligations.

B) Production process

i) Production methods, compliance and control

Cooperation between the parties is important to make CF successful. Cooperation requires fair behaviour and timely and diligent action to support, communicate, and provide advice for the other party. This is especially important when the buyer has a great level of control over the producer's agricultural production processes.

Compliance with **specific standards or procedures** during the production process is connected to compliance with quality obligations at delivery. The contract may require specific quality characteristics in the final product, or the use of special production methods, such as fair trade or organic production. In the case of organic products, for instance, producers will need to have their farms certified. Certification can be done by a third party organization or under alternative arrangements, such as participatory guarantee systems.

ii) Inputs

Inputs are often provided by the buyer and can be physical, such as seeds and pesticides, or non-physical, such as technical assistance and know-how. An example of the non-physical inputs

are the various services provided by the buyer, such as tilling the producer's land. Another form of input is the financing provided directly by the buyer, for example in the form of advance payments. The contract typically has requirements on how the inputs are to be used. **The producer generally must pay for the inputs** by having their price deduced from the final contract price.

C) Delivery

Delivery is a key moment in the performance of the contract. The buyer's obligation to take delivery of the goods and the producer's obligation to deliver them are basic obligations in any CF relationship. With delivery, the ownership and the associated risks for the product generally pass from the producer to the buyer. Delivery also triggers the buyer's obligation to pay the price.

The buyer may have an **obligation to inspect the product** at delivery. If the buyer does not inspect, he or she might lose the right to remedies for any apparent defects. To guarantee trust in the inspection, the producer or a third party should be allowed to be present when the products are inspected.

D) Price

Price is a crucial element in any agricultural production contract.

There are different **methods to calculate the price**. Some of the most common ones are fixed prices, or variable prices depend-

BOX 4

Pricing strategy for rubber in Ghana

Ghana Rubber Estates Limited (GREL) uses CF to source rubber. The CF scheme currently includes 5 450 farmers with a total plantation area of about 21 500 hectares. The agreement between the producers and GREL includes an innovative price mechanism.

Producers' representatives engage in annual price negotiations with GREL. The price is indexed on the Singapore Commodity Exchange and set at 64 percent of the prevailing monthly average price. A second payment is foreseen at the end of the year, based on the real rubber the producers deliver. GREL deduces fees for extension services and transport, for loan repayment, for Rubber Outgrowers and Agents Association's annual membership fee, and 4 percent as savings for capital accumulation on behalf of the farmers, which is refunded to them at the end of the year.

The pricing formula represents a good practice. As it is linked to international rubber prices, it protects producers against falling prices, and allows them to repay their loans more quickly when prices rise. Open dialogue and transparency in price setting enables producers to understand the price structure and to recognize that the price depends on what the market are willing to pay.

Source: FAO, 2013a.

- » *In CF, the parties' obligations are interlinked – one party's performance depends on the other party's compliance.*
- » *The producer's main obligation is to produce following the specifications agreed upon in the contract and to deliver the product to the buyer.*
- » *The buyer's main obligation is to take delivery and pay the price.*

ing on market changes or performance measurements. Fixed prices do not necessarily have to be a set monetary amount, but they may also refer to the market price at the time of delivery, or to other objective indicators. Ultimately, it is up to the parties to choose the price setting method that best suits their needs. Box 4 provides an example of a price-setting mechanism for rubber in Ghana, which can be considered as good practice.

To ensure that both parties trust that the prices paid have been fairly established, the producer or a third party should be allowed to verify all information used in the calculations performed.

Regardless of how the price is calculated, a **contract should clearly state the price to be paid, or describe in a clear and transparent way how it will be calculated**. This will benefit both parties by fostering trust and creating certainty.

4. Excuses for non-performance

The CF relationship can be disrupted by an event outside the parties' control, or the circumstances surrounding the contract can drastically change. Force majeure and change of circumstances are possible legal responses for these events and changes.

Force majeure and change of circumstances

Excuses are legal responses provided by law or by the contract, which can justify a party's failure to fulfil its contractual obligation.

Intervening events – such as floods, riots, or strikes – may have an effect on the parties' ability to perform. When these events are **unpredictable, inevitable and beyond the reasonable control of the parties**, the parties may be able to rely on legal concepts such as *force majeure*.

During the life of the contract, the circumstances surrounding the contract may also change in a way that goes beyond the risks contemplated by the parties at the time of entering into the contract. If this makes one party's performance significantly more difficult, the affected party may be able to rely on the legal concept of "**change of circumstances**".

When an intervening event happens or circumstances change dramatically, it is often beneficial for the survival of the CF relationship that the **affected party gives notice** to the other party. To the extent of its capacity and acting in good faith, the affected party may also be required to **minimize damages**.

Force majeure and change of circumstances have different consequences. The basic difference is that *force majeure* allows the affected party not to perform the affected obligation, while change of circumstances generally leads to renegotiations.

- » Natural events, such as floods or draughts, may prevent the producer from doing what the contract requires.
- » Force majeure events normally excuses the affected party from its obligation.
- » Change of circumstances provides for renegotiation of the contract.

5. Remedies for breach

Sometimes the parties breach their obligations under a contract. To preserve cooperation, the parties may opt to use remedies that allow the relationship to overcome the breach and continue the relationship.

A) Overview of remedies

Remedies are **legal measures** provided by law or by contract that protect the interest of one party against the failure of another party to perform properly. **Cooperative remedies** correct or adjust the effects resulting from the breach and aim to preserve the relationship.

Remedies for breaches of an agricultural production contract can be divided into three categories: **remedies in kind, remedies providing monetary value, and remedies ending the relationship (termination)**. Remedies in kind aim to provide the aggrieved party with the same or

similar benefit as was originally expected. This would be the case if, for example, a buyer requires the producer to further dry grain that was delivered in accordance with the agreed delivery schedule but does not meet the minimum moisture content specified in the contract. In-kind remedies are often the most suitable remedies to address a breach in CF. Remedies providing monetary value require the party in breach to pay damages or adjust the price to be paid, as the example from El Salvador in Box 5 shows. Termination releases the parties from their obligations and ends the relationship. Sometimes the aggrieved party may have either taken actions that have contributed to the failure of the other party to comply with the contract, or may have failed to minimize the negative consequences of a breach. In these cases, the aggrieved party's selection of remedies might be limited. For example, if the buyer fails to provide the promised inputs, it may not be possible to terminate the contract based on an insufficient quantity delivered, as this can be shown to be partly caused by the original lack of inputs.

B) Buyer's remedies for producer's breach

A producer's breach of contract is often related to the quantity or quality of the final product, non-compliance with the technical specifications, or non-compliance with the agreed delivery. The applicable remedies will vary depending on the type of breach. **Cooperative remedies** – remedies that aim first and foremost to allow the relationship to survive the contract breach – are nearly always preferable.

BOX 5

Remedies in sugar production in El Salvador

Sugar production in El Salvador is governed by the Law on the Production, Processing and Marketing of the Sugar Agribusiness. The law, among other aims, regulates the contractual relationship between the sugar mills and the producers of sugar cane.

The law provides specific remedies applicable to sugar cane production. Sugar cane loses its sucrose in about three days after harvesting. To take this into account, the law requires the buyer to receive the delivery within seventy-two hours of harvest. If the buyer breaches its obligation to take the delivery, it is liable to compensate the producer for the total or partial loss incurred. The producer has a similar obligation to deliver, enforced by a similar penalty. The law specifically identifies *force majeure* as a potential excuse for non-performance.

Source: Decreto Legislativo N° 490.

C) Producer's remedies for buyer's breach

A buyer's breach of contract is frequently related to the delay or failure in payment, the non-conformity of inputs, and the buyer's failure to take delivery. Similarly with the buyer's remedies, the use of **cooperative remedies** as the parties' first option will often ensure the survival of the relationship. These remedies could be remedies in-kind, such as when the producer requires the buyer to replace faulty inputs.

- » Remedies promoting cooperation are particularly suitable for CF, as they aim to preserve the mutually beneficial relationship.
- » Cooperation after a breach is an integral part of a trust-based relationship.
- » Using a sequence of remedies, starting with in-kind remedies and ending in termination, allows the parties time to overcome the breach and continue their relationship.

6. Duration, renewal and termination

The Legal Guide discusses the interlinked issues of duration, renewal and termination.

The **duration** of the contract is based on the free will of the parties and is frequently connected to the commodity in question. Duration should ideally be long enough to allow the parties to cover their investments.

After the contract's duration has ended, the parties may want to renew their contract. Optimally, **renewal** would be the result of a **common decision** to continue

a profitable relationship. Other modalities for renewal are also possible and can be elaborated in the contract.

Besides being a remedy for breach, **termination** is a way to bring the contract to an end. Termination releases the parties from their obligations to perform and accept performance, but does not affect their rights and liabilities. Prior to termination, the party wanting to end the relationship is normally required to provide a notice to the other party. This allows the other party to prepare for the end of the relationship.

- » The contract's duration may take into account the parties' need to cover their investments.
- » The contract's duration, renewal and termination are interrelated issues.
- » The longer the duration of the contract, the more important it is to provide for termination.
- » The shorter the duration of the contract, the more important it is to provide for renewal.

7. Dispute resolution

The Legal Guide discusses different forms of dispute resolution: (i) alternative dispute resolution mechanisms, specifically mediation and arbitration; and (ii) judicial dispute resolution. Alternative dispute resolution mechanisms may be particularly suitable for disputes arising from CF.

Disputes and dispute resolution in agricultural production contracts

Besides traditional dispute resolution in state courts, the parties may have access to **alternative dispute resolution**, such as mediation and arbitration. In mediation, the parties try to reach a solution with the help of a neutral mediator, and decisions are not binding on the parties. In arbitration, parties submit the dispute to a neutral arbitrator whose decision is binding.

The alternative dispute resolution mechanisms are often faster, cheaper and more flexible than traditional judicial dispute resolution. Therefore, they are often a **good solution to expedite conflict resolution**. Box 6 shows how established relationships can be used to enforce contracts, without the need for courts to intervene.

BOX 6

Importance of trust in contract farming: experience from India

Enforcement of contracts does not necessarily have to include court proceedings. In fact, buyers in India tend to view court-based enforcement as detrimental to farm-firm relationships in a way that undermines the handshake ethic. Instead of going to court, the buyers can use their relationship of trust to leverage producers into compliance. Active participation in the everyday life of the community, such as by donating to schools or conducting medical camps, can go a long way towards establishing the required trust. Additionally, buyers often choose to overlook certain levels of breach, in order to keep the relationship alive.

Source: Narayanan, 2012.

Multiple dispute resolution methods can also be **used in a sequence**. Following a breach of contract, the parties can try to resolve their difficulties through discussion and re-negotiation. If direct talks do not succeed, parties may rely on mediation and subsequently, if an agreement is not reached, on arbitration or law courts. This may allow the parties to resolve their differences first through less formal methods, potentially saving money and time.

- » *Alternative dispute resolution mechanisms are particularly suitable for disputes arising from CF.*
- » *Using a sequence of dispute resolution mechanisms (from negotiation to mediation and if no agreement is reached, arbitration) gives the parties time to overcome the dispute and continue their relationship.*

References and resources

FAO, UNIDROIT and IFAD have all created material on contract farming. Some of these, as well as other notable resources, are indicated below.

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