Food and Agriculture Organization
of the United Nations

Legal considerations on contractual design and enforcement

DEFINITION

Contract farming can be defined as agricultural production carried out according to an agreement between farmers and a buyer which establishes conditions for the production and marketing of a farm product. To be binding and enforceable, such agreements depend not only on good contractual design, but also on the existence of an adequate legal framework. This brief aims to illustrate some of the legal issues involved in the design, negotiation and enforcement of farming contracts.

Contract design

While a sound design does not by itself guarantee the success of a contractual relationship, the opposite is often true: non observance of basic contract principles creates risks for the contractual relationship. The following principles are usually recommended to be followed in contract design.

1. The contract should be written to be binding. If the agreement between framers and firms is verbal only, it will invariably make them legally unbinding for the two parties.
2. It should be written to be enforceable in a court of law.
3. It should define the parties (seller-buyer, producer-processor, and supplier-purchaser).
4. It should clearly specify the product under consideration (quality and quantity).
5. It should state the time of delivery.
6. It should clearly establish prices, payment obligations and other financial issues. The parties should determine the price to be paid for the product transacted or establish the rules for its determination, including price adjustments for variation of quantity, quality and timing of payment where applicable.
7. It should indicate the mutual obligations, specifying the responsibilities of both parties.
8. It should have an indication of its duration.
9. It should establish a legal instance to govern the contract (provincial state, country, etc,). If the two parties are located in different provincial states in one country, only one law should be chosen to be applied. It can simplify a dispute if it arises.
10. Refer to a dispute settlement mechanism or to an arbitrator to resolve dispute.
11. It should have a signature clause.

BOX 1: CONTRACT LAWS IN UGANDA

Under the laws of Uganda, for a contract to be recognised as valid, the following conditions have to be met:

1. There must be an offer and a following acceptance made by parties.
2. The parties must have the intention to be legally bound and must freely agree to be legally bound.
3. The buyer must provide money and the seller goods.
4. A contract is not valid if it involves the use of force or fraud.
5. Both parties must be entitled to sign contracts (legal capacity).
6. Businessmen dealing with Farmers' Associations which are registered as a Community Based Organisations but not recognised as corporate bodies under the Laws of Uganda must bear in mind that those individuals do not act as a group but as single entity.

The legal framework

A contract may be defined as a mutual assent between two parties, usually manifested by an offer and an acceptance upon a legal consideration to meet some commitments or to abstain from doing some acts. The exchange process between the buyer and the seller is not always easy. That is why it may require a facilitating process, that is to say a "ruling" contract to eliminate or minimize transaction risks. Moreover, if disagreement over the performance of the contract arises, disputes may ensue. The rules or principles for dispute resolution must thus be agreed upon.

Contracts should be designed and enforced under an adequate legal framework. The rule of law is essential for an agreement to work properly. In some countries, contracts will be governed by non specific general contract law. In these cases, on one hand there might be a need to reconcile the general laws with the ones that might regulate agriculture production and agricultural marketing. On the other, there might be the necessity to set up which country law has to be applied when stipulating a contract. When there is no specific regulatory framework, a contract is covered under the contract laws which belong to the civil law systems, as part of a general law of obligations.

The US Uniform Commercial Code, for instance, has been promulgated to regulate commercial transactions. Sale is an integral part of commercial activity. It could be argued that it is the cornerstone of business. The common law describes the circumstances under which the law will recognise the existence of rights, privilege or power arising out of an agreement. The United Nations Convention on Contracts for the International Sale of Goods (CISG), ratified in 1980, may be referred to by ratifying countries for sale agreements.

BOX 2: THE LEGAL FRAMEWORK FOR CONTRACT FARMING IN HONDURAS

An example of the application of the domestic law regulating contract farming is the Honduran case, where both general and ad hoc legislations are used to govern international contracting agreements.

At the domestic level, the Civil Law passed in 1906 and the Commercial Law passed in 1950 are the main bodies of legislation regulating contractual relations between parties entering a commercial relationship. In addition, special legislations and international agreements, following a constitutional hierarchy, are used as the basis to enforce mutual obligations arising from contracts.

The special legislation affecting contract farming are:

1. The law on agrarian reform
2. The law on agrarian modernization

Arbitrage and conciliation are very much used to solve dispute as an alternative to the Court system.

At regional level, all Countries in Central America have their own judicial structure with their own laws regulating contracts' obligations. In addition, the regional international Court, the Court of Justice of Central America, plays the role of arbitrator.

BOX 3: LEGAL FRAMEWORK FOR CONTRACT FARMING IN HARYANA STATE, INDIA

Contract farming arrangements are rapidly emerging in India since the governmenment decided to promote private sector participation in agricultural marketing. A law on contract farming in Haryana, an agrarian state in the north of the country, was on the anvil in 2003. In general, all Indian states are set to amend the Agricultural Produce Marketing Act (APMC). The "amended bill" was still on anvil in 2006. This was mainly to protect the interest of farmers and companies entering contract farming and to provide an effective dispute resolution system (The Tribune India, 2003).

The proposed Bill has the following characteristics:

1. It defines contract farming as an agreement by a producer (farmer) and a sponsor (contractor, firm, company) saying that the latter would purchase the produce of the former as specified in the agreement.
2. The Bill provides an institutional arrangement for registration of sponsoring and recording of the Contract Farming Agreement, indemnity to farmers' land.
3. The Bill will be set up to take a decision in the case of disputes arising out of the contract farming agreement. The regulatory authority will resolve the dispute within 30 days after giving the parties a reasonable amount of time to be heard.
4. If the party is not pleased with the decision of the regulatory body, an appeal can be made within 30 days from the day of the decision. The appellate authority's decision will be treated as a decree of the civil court.
5. The proposed Bill's draft points out that disputes arising out of contract farming cannot be brought before any civil court.

Enforcement and dispute settlement mechanisms

The enforcement of contracts is an important pre-condition for efficient exchange and investments in economic activities in general and in agrifood in particular. Legally, a party's failure to comply with the contract's mutual obligations is known as a breach of the contract. When a breach of contract happens, one or both the parties might wish to enforce the agreement on its terms.

In developing countries enforcement institutions are often weak or absent. Government interventions to address such a shortcoming are needed as a pre-condition for the development of a conducive climate for business investments. Enforcement mechanisms may include private sanctions such as the termination of the contract or of the relationship, with a consequent damage to the party's reputation, as well as legal action in a court of law.[1] Alternatively, the parties can agree to have a mediator to settle a contract dispute. Although they may not be bound by the mediator's decision, they may be convinced to accept it so as to avoid lengthy and costly court disputes. Binding arbitration of a contract dispute may also be agreed upon by the contracting partners.

BOX 4: US DOMESTIC CONTRACT LAW

The Perishable Agricultural Commodity Act (PACA) was passed in 1930 to promote fruit and vegetables fair trade. PACA is managed by The US Department of Agriculture (USDA).

Furthermore, the Dispute Resolution Corporation for fruit and vegetables (DRC) may act both as a mediator and as a arbitrage if a dispute arises.

The more complex the nature of the farming production governed by a contract, the higher the potential for disagreement to arise. Clauses electing a dispute settlement resolution system are thus important to safeguard parties in the case of disagreements.

[1] If an informal resolution method fails, the party can resolve the dispute through the Court system

Balance of power and flexibility

In several contracts there is no legal obligation for firms to share with growers the risk associated with the vagaries of weather or the incidence of pests and diseases. That is why, often, growers alone must absorb the cost of agricultural production insurance. In these cases, it can be argued that the sharing of risks is uneven, unfairly penalizing the weakest player in the contractual transaction.

A flexible contract may allow renegotiations and thus enable parties to adjust the contract to changes in the environment. Ex post discretionary adjustments and/or renegotiations may work to implement and improve the contract, especially when they are considered "incomplete". The advantage is that parties can remove ex post inefficiencies through renegotiation. The disadvantage is that renegotiation reduces commitment and may lead to opportunistic behaviour. If the parties know that the contract can be renegotiated they may not care about the incentives in the initial design, but just about the incentives they expect to receive in the renegotiated contract. Hence, while desirable in principle, renegotiation can lead to *ex ante* inefficiencies (Olesen, 2001).

Conclusions

The success of any contract farming scheme depends primarily on the degree of trust that is developed among the contracting partners. When trust is present, contracts can be very simple, including only those clauses that establish the general conditions under which the commercial relationship is to be developed. When trust is not present, contractual complexity is likely to grow, as more and more clauses tend to be added to safeguard the parties. In any case, it is always desirable that a legally binding instrument exists to govern the commercial relationship. It is also desirable that this instrument is backed by an appropriate legislative framework that ensures its validity and enforcement.

More than simply protecting the transaction parties, a binding contract can bring additional benefits to those engaged in it. A case in point is the growing role of value chain financing mechanisms, whereby contracts are accepted as "de facto" collateral by lending institutions: the contract is seen as evidence that the parties belong to a value chain and for this reason they have their credit worthiness improved.

REFERENCES

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TO KNOW MORE

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