



Legal fundamentals for the design of contract farming agreements¹

One of the main challenges to successful contract farming in a number of developing countries is the absence of strong legal systems that guarantee an adequate protection to the parties in their contractual relations. The general principles of contract law discussed in this brief, applicable to international commercial contracts, may serve as a model to help overcome this difficulty.

Purpose

The purpose of this brief is to highlight the main legal elements and principles to be considered in the design of farming contracts which are instruments that regulate contract farming operations. The legal elements and principles presented below are applicable to different national systems and may be employed in the contract when the parties have not chosen any specific law to govern it. This brief is a complement of other publications available on the FAO contract farming website (<http://www.fao.org/ag/ags/contract-farming/en/>).

Contract farming - definition

Contract farming can be defined as agricultural production carried out according to an agreement between a buyer and farmers, which establishes conditions for the production and marketing of a farm product or products. Typically, the farmer agrees to provide agreed quantities of a specific agricultural product. These should meet the quality standards of the purchaser and be supplied at the time determined by the purchaser. In turn, the buyer commits to purchase the product and, in some cases, to support production through, for example, the supply of farm inputs, land preparation and the provision of technical advice.

Legal elements to be considered

To be valid and enforceable, all contracts, including farming contracts, should comply with five necessary legal elements.

The first legal element for a valid farming contract is the **meeting of the minds** of farmer and buyer, i.e. the situation where farmers and buyers have a common understanding in the formation of the contract in the sense that they agree to the same matter and in the same sense. This must be based on an offer to contract from a party (i.e. the buyer) and the acceptance of the other (i.e. the farmer).

Secondly, farmer and buyer **consent** must be **free**, i.e. it should not be obtained by coercion, under influence, fraud or mistake.

In addition, for a valid farming contract farmer and buyer should have the **capacity to contract**, i.e. the ability, recognized by law, to assume obligations and enter into contracts (for example minors or people who are mentally incapacitated do not usually have the capacity to form contracts). Such agreement should be made for a licit good or service which constitutes the obligation of farmer and buyer, such as the sale of a designated crop by the farmer and the payment of money by the buyer. This is the **object of the contract** and the 4th element to be considered.

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The last requirement for the creation of a valid farming contract is the detail of the farmer and the buyer's duties and responsibilities including the price and the method of payment (**cause of the contract**).

General principles of contract law applicable to contract farming

To be valid and enforceable, all contracts, including farming contracts should respect the following general principles of contract law.

The freedom to contract

In contract farming the freedom to contract is the liberty of farmer and buyer to enter into contract and to determine its contents without any external interference. The freedom to contract gives farmers and buyers the right to decide freely to whom they will offer their goods and by whom they wish to be supplied. Parties may also provide in the contract clauses that prevent one party or both from entering into a similar contract with a third party (**exclusivity clauses**).

Good faith

With respect to the freedom to determine the contents of the contract, farmers and buyers should act in accordance with good faith, which is the good, honest intention to behave with fairness, without causing damage to each other.

Farmers and buyers should act in accordance with good faith not only during performance but also during the negotiation of the contract. The opposite of good faith is bad faith: an unlawful, malfeasant behaviour. An example of bad faith is **fraud**, which arises when one party has misled the other party as to the terms of the proposed agreement, either by misrepresenting the facts or by not disclosing those which should have been disclosed as an inducement to sign the contract. Besides, bad faith also occurs when a party has been forced to conclude the contract by means of **threat** of harm, e.g. threats against a person, a property or also threats affecting reputation and economic interests.

Moreover, bad faith behaviour arises in the case of **mistake**, i.e. when a party has an incorrect understanding of facts which are crucial for its consent to conclude the contract (such as the identity of the commodity) and the other party, being aware of such misunderstanding, takes advantage of it, leading his or her contract counterpart into error.

Finally, a bad faith conduct occurs when a party, at the time of the conclusion of the contract, was ignorant, inexperienced, lacked bargaining skills or was in economic distress or had urgent needs and the other party, who knew of this, took advantage of such situation taking an excessive benefit (**gross disparity**). This being said, the party who behaves against good faith should be liable to indemnify the aggrieved party for suffered damages.

Force majeure and hardship

After the conclusion of a contract, unforeseeable events beyond the control of farmer and buyer may arise. Such an exceptional situation is called *force majeure* and may constitute a production risk caused by climatic or human factors, among others. In contract farming, *force majeure* situations may arise, inter alia, from war, strikes, civil unrest, insect plagues and disease epidemics or natural disasters (the so-called *Acts of God*) such as drought, floods, hail, storms, cyclones and lightning. Because of this unforeseeable and exceptional situation, both farmer and buyer shall be considered exempted from liability for non-performance of their contractual duties and shall not be held in breach of contract.

A similar circumstance to force majeure is hardship, which is another exceptional situation beyond the control of farmers and buyers, which may arise after the conclusion of the contract, when the duty of the performing party (for instance, the farmer) becomes extremely expensive or too difficult to fulfil, so that the latter is prevented from meeting his or her obligations. Such a situation may be due, for instance, to a substantial increase in the cost for the farmer of performing its obligation, because of a dramatic rise in the price of the raw materials necessary for the production of the goods, or also to a decrease or total loss of any value of the performance received by the farmer due to the drastic change in market conditions, such as the effect of a dramatic increase in inflation on a contractually agreed price.

In such cases, the farmer or the buyer should be entitled to request the contracting partner to enter into renegotiation of the original terms of the contract, with the view to adapting them to the changed circumstances.

As we may remark, in the circumstance of *force majeure* non-performance is excused and the farming contract is frustrated, whilst in case of *hardship*, the terms of the contract may be renegotiated so as to allow the contract to be kept alive although on revised terms.

Performance

Farmers and buyers are bound to fulfil commitments according to the stipulated terms.

The performance of a farming contract is the execution of its terms, by which farmers and buyers are automatically discharged of their contractual obligations. It is advisable that they provide in the contract terms regarding the quality specifications and standards of the goods that should be supplied.

Performance payments shall be made in any form that is usual at the place for payment (e.g. in cash, by cheque or credit card)

The place where obligations are to be performed is often determined by an express clause of the farming contract or is determinable from it.

However, when a farming contract is silent on the matter and circumstances do not indicate where performance should take place, farmer and buyer should refer to the general rule of contract law according to which the *debtor is to perform its obligations at its own place of business whilst monetary obligations are to be performed at the creditor's place of business*. Also, with a view to determine when a contractual obligation is to be performed, normally a farming contract fixes a precise time for performance and in such case a party has to fulfil its obligations at that time. If the contract does not specify a precise moment for performing, performance should be due within a reasonable time.

Non-performance

The non-performance of a contract is the failure to meet the obligations under contract. It includes complete failure to perform, as well as defective and late performance in cases where time of performance is considered essential.

Sometimes parties may include in the contract the so called **exemption clauses**, i.e. terms which directly limit or exclude the nonperforming party from liability in the event of non-performance. Exemption clauses are normally suggested by the strongest party (such as the buyer) who in this process may take advantage of the weaker bargaining power of the other party (e.g. the farmer).

In application of the doctrine of freedom of contract, exemption clauses are in principle valid. However, a party may not invoke in a contract such clauses if it would be grossly unfair to do so. This may be the case where the term is inherently unfair and its application would lead to an evident imbalance between the performance of the parties. Accordingly, where a buyer establishes an unfair exemption clause, such clause will not be valid and the farmer may obtain full compensation for the non-performance of the buyer.

Damages

Any non-performance of contract farming obligations gives the aggrieved party the right to compensation for damages, except where the non-performance may be excused (for instance in case of force majeure or hardship).

The non-performing party shall be liable to indemnify the aggrieved party in respect not only of the loss which it has suffered, but also of any gain of which it has been deprived as a consequence of the non-performance.

In addition, it shall also be liable to compensate the non-pecuniary harm. This may be pain and suffering, loss of certain amenities of life, aesthetic prejudice, etc. as well as harm resulting from attacks on honour or reputation.

The parties may provide in the contract a so-called **penalty clause**, i.e. a term that establishes to pay a specified penalty sum to the aggrieved party in case of non-performance.

Where non-performance is in part due to the conduct of the aggrieved party, the right to damages is limited to the extent that the aggrieved party has in part contributed to the harm. It would indeed be unjust for such a party to obtain full compensation for harm for which it has itself been partly responsible. The contribution of the aggrieved party to the harm may consist either in its own conduct, which may take the form of an act (e.g. the buyer gave to the farmer a mistaken address for the delivery of the goods) or an omission (the buyer failed to give to the farmer all the necessary instructions for the crop).

Termination

Termination of a farming contract takes place when farmer and buyer are released from their contractual obligations.

A farming contract may be terminated **by performance** of farmer and buyer's obligations. Discharge of the contract in this way takes place when performance of the contract is complete and exact, with reference to the terms of the contract.

A farming contract may also be terminated **by agreement** where farmer and buyer provide for the event. In addition, termination may occur in case of **force majeure and hardship**, where farmer and buyer may be excused from their obligations to perform as a result of exceptional and unforeseen events arising after the contract has been entered.

Finally, termination may arise in case of **breach of contract**. Breach of contract takes place when a party does not perform its obligations or where its performance is defective or late.

The aggrieved party may terminate the contract only if the non-performance of the other party is material and not merely of minor importance and it must give notice of termination to the other party within a reasonable time.

Dispute settlement methods

Farmers and buyers should include in the contract a reference to the dispute settlement methods in case of contractual disputes (court, arbitration, mediation). It is advisable that, before resorting to court, parties agree on mediation, whereby they request a third party to assist them in their attempt to reach an amicable settlement of their dispute.

It is also important that, in the dispute settlement clause, parties provide for the place to settle their dispute as well as the language to be used in the agreed proceedings.

Finally, the law applicable to the contract envisaged by the parties may give some responses such as what to do in case of contingency, breach of contract or new elements that obstacle or modify the conditions on which a contract was conclude.

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