

Chapter 7

Contract Law

This chapter considers some of the basic elements of contract law and highlights legal issues addressed in the Uniform Commercial Code. The chapter concludes by looking at a sample contract and identifying general questions that apply in most sales situations.

In the context of producer marketing associations, buyers are often an organization in which producers are members, such as a cooperative, LLC, or some other type of grower network. While you might assume because you are already a stakeholder in the group you do not need to worry about protecting your own personal interests, this is not true. This sense of security means producers often enter into marketing agreements with their organizations without much concern over the terms of the contract. Unfortunately, this may be the wrong thing to do because the contracts establish enforceable rights and obligations for both parties.

Your sales relationship with the group results in you having two different roles with the organization. In one sense, you are concerned with the success of the group and are willing to contribute toward this goal. It is reasonable to expect you may even need to make some occasional sacrifices for the organization. In another sense, however, if the organization is having difficulty, your interests may no longer align with the group's. You may be left with unpaid bills or a crop you cannot market. Desperate times call for desperate measures, and although the association may not want to take advantage of a provision in a contract that is against your interests, it may have no choice. On the other side of the coin, you may assume because you are a member you do not need to be concerned about meeting all of the requirements of a contract. You should not make this assumption. The organization is counting on you to supply a certain type of product to meet its own obligations with buyers. If the organization suffers losses because you breached the agreement, it may have little choice but to try to shift those losses to you.

Depending on how your group is organized, the people who run the business have a duty to do what is best for the organization, even if that means it might injure some of its members. This is not to suggest you should shy away from working with a joint producer association. Rather, you should enter into any agreements with your eyes

wide open and recognize what real risks and responsibilities you have in relation to the organization.

To understand the risks and responsibilities involved in the buyer-seller relationship, you need to know the rules of the game. This chapter looks at some of the law that affects the business sales relationship between farmers and buyers. It examines basic contract law and the Uniform Commercial Code. Other types of contracts, such as loan documents and insurance policies have already been addressed in other chapters.

CONTRACT LAW

Black's Law Dictionary defines a contract as "[a]n agreement between two or more parties creating obligations that are enforceable or otherwise recognizable at law." For purposes of this chapter, we are concerned with agreements to buy and sell some type of agricultural product.

Contracts 101

You should be concerned about contract law because it determines how parties to the contract will need to keep the promises they make. Although very few contracts ever end up in court, if the parties to a contract disagree on something and are unable to resolve the disagreement, they may have to resort to the judicial process. This means that as the parties negotiate a contract, they need to consider how a judge might ultimately interpret it.

For a contract to be enforceable, it must involve:

1. **Competent parties.** A court will not uphold a contract entered into by parties the law does not believe have the capacity to take on such a legal responsibility, such as minors or people who are mentally incapacitated.
2. **A legal subject matter.** A court will not uphold a contract requiring anyone to do something illegal.
3. **An offer.** An offer occurs when a party communicates the intention of doing something if the other party does another specific thing. Either the buyer or seller can initiate an offer so it could occur when you approach a cranberry cooperative with an offer to sell your cranberries for a certain price, or if they approach you with a form contract to sign.
4. **Acceptance.** Acceptance occurs when a party communicates a willingness to be bound by the proposed agreement. When dealing with a written contract, this usually means when the offeree signs the contract.
5. **Consideration.** Each party to the contract must provide consideration for the contract to be binding. Consideration is something of value or a promise to do, or not to do, a certain act in the future. In a contract between a producer and an LLC that processes and sells honey, the producer's consideration could be the promise to deliver a certain amount of honey while the LLC's consideration could be the promise to pay a certain amount per pound.

The Drake Agricultural Law Center has published an entire book on this subject by Professor Neil Hamilton titled *A Farmer's Guide to Production Contracts*. The

book broadly discusses all of the issues involved with agricultural sales and service contracts--everything from entering into the contract, performing under the contract, getting paid, and resolving disputes. The book analyzes a number of different types of contracts involving vegetables, livestock, and grain.

In a section on the basics of contracting, Professor Hamilton provides twelve rules to consider when entering into a contract. The following list is taken from those rules and is slightly modified with some of the special issues involved with joint producer relationships.

- 1. Remember the first rule of contracts – whoever wrote the contract took care of himself.** Although you might be a member of the group with whom you are contracting, you still need to make sure the terms are fair and your interests are protected. The people representing the organization will take care of the interests of the group; it is your job to take care of your own interests.
- 2. Read and understand any contract before signing it.** Because the words in the contract will be enforceable in the future, you need to understand what you are promising to do and what you can and cannot hold the other party responsible for. If the contract is relatively large or involves a long duration, you should consider having your attorney go through the contract with you to make sure you understand all of the provisions.
- 3. Know that complying with contract terms is required before you have performed under the contract.** To receive a premium for raising organic vegetables, you will need to certify they are organic. If you are unable to deliver the amount or type of product you promised, you may need to go out into the market to find replacement products, otherwise, you might open yourself up to a lawsuit for breach of contract. Because of this, you will want to make sure you are able to live up to the promises you make in the contract or be willing to pay the consequences.
- 4. Never assume your failure to perform a contract will be excused.** If the buyer is damaged by your failure to perform under the contract, assume you will have to make amends. If you think you will not be able to fully meet your obligations under the contract, it is usually best to let the buyer know so both of you can deal with the situation. For instance, before planting, you promised to deliver 1000 pounds of blue potatoes to your cooperative but your crop was wiped out because of a late freeze. You should inform the coop that you will not be able to deliver the potatoes. The buyer might know about a good substitute source for the potatoes and be able to acquire the product for much less cost than you would be able to. You may still have to pay for any cost difference for the substitute potatoes, but you will not have to pay as much.
- 5. Know the other party's financial situation and performance history.** This is especially important when you are not paid immediately for your product because in this case you become a creditor for the buyer. If the buyer experiences serious

financial problems after you deliver the product, you may never get paid. This situation is partially dealt with for livestock with the statutory trust in the Packers and Stockyards Act and for fruits and vegetables with the PACA trust in the Perishable Agricultural Commodities Act, both of which are discussed in Chapter Eight.

6. **Weigh the advantages of the contract in terms of higher prices against any increased costs or risks.** This suggestion is especially important in niche and specialty markets. Although you usually receive a higher price for the products, you will usually face greater costs or risks as well.
7. **Remember proposed contracts are always subject to negotiations.** Many contracts dealing with the purchase of agricultural goods appear to use fixed “boilerplate” language. But all contracts are negotiable before signing; nothing forces you to sign the contract until you are satisfied with the deal. An important thing to keep in mind is you have much greater power to negotiate changes in the agreement before the contract is signed than after, so make sure you are satisfied with the agreement before signing.
8. **Make sure any changes to the contract are made in writing.** Although it can be difficult to change a contract after it is signed, shifting conditions can persuade both parties it is in their best interest. To ensure the changes are enforceable, the new terms need to be in writing and signed or initialed by both parties.
9. **Do not rely on oral communications made by the buyer, either before the contract is signed or during the contract performance.** If your agreement ever has to be interpreted in court, the court will most likely rely only on the written language in the contract itself. Courts usually refuse to accept evidence of oral agreements that goes against the contract language, and most contracts include a similar restriction. Because of this, you will want to get in writing any agreements important to you. If you are unable to do this, then make sure to keep copies of any documents, such as letters, payments sheets, and checks you can use to show what was agreed to.
10. **Keep good records of your performance.** You never know when you will need to prove you have lived up to your end of the bargain. Keeping good records is the only way to do this. This is especially true when a crucial part of the contract requires you to raise your product in a certain way. Whether this means not using antibiotics, raising organic tomatoes, or treating your animals in a certain way, if you have records indicating you have done what you promised, you can avoid headaches in the future.
11. **Do not hesitate to ask questions when you do not understand what is happening.** The best time to ask questions about what you are promising to do is before you promise to do it. For example, if your contract with a wholesaler requires you to certify your operation with a third party certifier, make sure you understand what this will entail. To make sure you understand the terms of the

contract, you can ask questions of the buyer or your advisors. To make sure you understand the concepts in the contract, ask other people such as extension officers or others who are growing products under similar contracts.

- 12. Stay in touch with the other party to the contract.** Regular communication with the buyer will help prevent misunderstandings about the contract or about what is required to satisfy the contract requirements. Open lines of communication will help both parties make sure that each is doing what the other party understood they would do.

THE UNIFORM COMMERCIAL CODE

The rules governing contracts traditionally came from common law, meaning the law that is produced on an ad hoc basis by courts. When the courts came up against a novel problem, they look at what they have done with somewhat similar issues in the past and craft a new rule for the new problem. From then on, when the same set of circumstance arise, the court will follow its precedent. Because different courts and jurisdictions evolved in various directions, different states handle the exact same issue in various ways. This can lead to confusion for people who do business with firms in other states. To avoid this confusion, policy makers in the U.S. decided to create a set of common rules for commercial law. The result was the Uniform Commercial Code (UCC).

All of the states have adopted a version of the UCC. The laws can differ from state to state, but states generally do not vary from the major themes in the UCC. The UCC deals with a number of subjects related to commerce, such as leases (Article 2A), warehouse receipts (Article 7), and secured transactions where a lender obtains a security interest in goods (Article 9). This section will focus on the UCC article that covers sales: Article 2.

Applicability. Article Two deals only with sales and does not deal with contracts for services, such as production contract that pays a farmer for raising livestock or vegetables owned by someone else.

Statute of Frauds. To prevent people from lying about non-existent contracts (that is, committing fraud), the UCC has adopted the statute of frauds to encourage people to write down their agreement. Under the UCC, a contract for the sale of goods for a value of \$500 or more needs to be in writing to be enforceable. The writing, however, does not need to be a formal contract and it only needs to be signed by the person against whom enforcement is sought.

A contract can also be reached if the agreement is between merchants (see text box for a discussion on whether a farmer is a merchant) and one of the merchants sends a writing confirming the agreement and the other merchant does not object in writing within ten days. For example, assume a sugar beet LLC contacted you in the spring about purchasing your entire crop of beets in the fall. You agreed to the price and other terms over the phone. Within a few days, you receive a letter from the LLC

When is a farmer a merchant?

In general, a farmer is a merchant for purposes of Article 2 when the farmer is familiar with the marketing practices in the industry. To determine whether a farmer is “merchant” for these purposes, a court might look to the length of time the farmer has been engaged in the sale of the particular goods, the degree of business acumen shown by the farmer, and the farmer’s awareness of farm markets. At any rate, whether a farmer is a merchant depends on the particular facts, and states are split on the question. *Colorado-Kansas Grain Co. v. Reifschneider*, 817 P.2d 637, 640 (Colo. Ct. App. 1991).

that outlines the details of your agreement. If you are a merchant, this can be enforced against you as a contract, although you never actually signed the document. If you do not agree with the terms as written, then you have ten days to send a written response to the LLC. If you are not a merchant, then the letter could not be enforced against you as a contract.

Warranty of merchantability and warranty of fitness for a particular purpose. The UCC assumes or “implies” two types of warranties in sales contracts. The first deals with a warranty of merchantability which means the goods should be “fit for the ordinary purposes” for which the goods were intended. This implied warranty applies only if the seller is a merchant. Importantly for those who prepare food, the implied warranty

of merchantability applies to food sold for consumption on or off the premises. (UCC § 314). If someone is injured by consuming the food, the question is whether the food “was not reasonably fit for eating” and whether the injured person can prove the defect caused the injury. The second type of implied warranty is the warranty that the product is fit for a particular purpose. (UCC § 315). This warranty arises where the “seller at the time of contracting has reason to know the particular purpose for which the goods are required” and that the buyer is relying on the special skill or knowledge of the seller to supply these goods. For example, if you are selling apples to a group you know produces organic apple cider and the group is relying on your knowledge as an organic apple grower, you will probably breach your warranty if you deliver apples that are not organic or have significant traces of insecticide.

Consumers have a responsibility to prepare food appropriately

A woman in New Jersey bought raw pork chops in a supermarket. After preparing the pork and serving it to her family, the woman and her children became ill from what was revealed to be trichinosis, a parasitic infection that was more common in pork in the 1970’s. The woman sued the supermarket for, among other things, a breach in the warranty of merchantability. In essence, the woman was arguing the supermarket breached its promise to sell pork that was fit for its ordinary purpose. The supermarket, however, argued the pork was fit for its ordinary purpose, which was for someone to take home and cook thoroughly before serving in a meal. Such thorough cooking would have eliminated the trichinosis. The court agreed with the supermarket and found the supermarket was not liable to the woman. *Hollinger v. Shoppers Paradise of New Jersey, Inc.*, 340 A.2d 687 (N.J. Super 1975).

Remedies related to a breach. The UCC provides a number of possibilities for a party to a contract who incurs costs because of a breach. If a seller breaches a contract, the buyer can cancel the contract and keep what has already been paid. The buyer can also seek substitute products and sue the seller for the extra costs incurred. If the product involved is hard to replace, then the contract may provide liquidated damages, which are fixed damages of a reasonable amount in relation to the actual harm caused by the breach.

When a buyer refuses to purchase the products as promised under the contract, the typical remedy is for the seller to find another buyer for the product and charge the original buyer the difference between the contract price and the price actually received. With some specialty or niche products, finding a suitable buyer in a timely manner might be almost impossible. Nevertheless, in general the seller has a responsibility to make a good faith effort to limit the amount of damages.

EXAMPLE CONTRACT

When someone sells something on the spot or cash market, the seller attempts to seek bids from a number of buyers to receive the highest market price possible. When someone is using a more formal contract to market goods, they should also determine whether they can receive a better deal. This means comparing the contract with other similar contracts. This simple idea can be a challenge for farmers raising specialty crops or commodities because similar contracts may not exist. For those who raise commodities, some contracts include confidentiality clauses that prohibit people from sharing the contents. Some states, such as Iowa, prohibit these types of clauses in livestock contracts, but most states allow the provisions.

Can a warranty be waived?

Either type of warranty can be waived if the waiver is in writing and is reasonably conspicuous. In a case involving a farmer who purchased chickens for the purposes of laying eggs and in which the farmer relied on the expertise of the seller to furnish healthy chickens, most of the chickens became ill soon after delivery and many of them died. The farmer sued the seller for, among other things, breach of both the implied warranty of merchantability and the implied warranty of fitness for a particular purpose. The seller pointed to language on the receipts the farmer signed that stated that “no warranties, express or implied, have been made by the Seller or Grower as to the quality or condition of the pullets” and that the farmer accept them in “as is” condition. While persuading the farmer to purchase the chickens, the seller repeated that they would be good chickens. A lower court dismissed the suit because it found the language in the receipt waived any warranties. A higher court, however, ruled the case should have gone to the jury because there was a question whether the representation of the seller was an express warranty. Furthermore, the higher court questioned whether the language in the receipt was conspicuous enough to draw the farmer’s attention given that it was in normal type in the middle of the document.

Woodruff v. Clarke Co. Farm Bureau Cooperative Assoc., 286 N.E.2d 188 (Ind. App. 1972).

Swine contract library

In 1998, Congress required USDA to implement a swine contract library. The Grain Inspection Packers and Stockyards Administration implements this web-based library designed to provide a catalogue of the different types of marketing agreements that have been offered or entered into and provides regional and monthly reports on swine marketing contracts. The website is: scl.gipsa.usda.gov/.

Even in states where confidentiality clauses are prohibited, there usually is not a formal clearinghouse to provide farmers an idea of what contracts have been offered and accepted. This means that the market for contracts may not be very transparent.

This lack of transparency can be an even bigger problem in specialty and niche contracts because no similar contracts may exist. When considering entering into a contract in this type of market, you may need to be creative in determining what types of provisions the contract should

include. Contracts can be simple one-page documents setting out the most basic provisions of the agreement, or they may go on for pages attempting to consider every possible issue that might arise in the sales arrangement.

State law prohibits confidentiality clauses

Iowa Code chapters 202 and 202A prohibit the use of confidentiality clauses in livestock production and marketing contracts. Iowa Code section 202.4 states:

A packer shall not include a provision in a contract executed on or after the effective date of this section for the purchase of livestock providing that information contained in the contract is confidential.

Set out below is an example of a shorter contract that considers most of the essentials of a contract for the sale of a specialty or niche product. It is presented not as a form contract to be used, but simply as a way of raising issues you should consider when drafting or entering into your own contract.

SUPPLY AGREEMENT

This agreement is between Bernard's Best, a dairy processing plant and marketing operation located in Bernard, Iowa, hereinafter know as BB,

AND _____ an individual dairy milk producer supplying raw milk to BB hereinafter known as the producer.

BB and the producer agree to the following terms:

Article I. Regarding purchase of the raw milk supplied to BB by the producer:

Section 1.01 BB will purchase from the producer and producer will sell to BB any and all milk that meets the certification requirements discussed in Article II.

Section 1.02 BB agrees to provide in writing the testing specifications from Section 1.01.

Section 1.03 The base price of the raw milk will be \$__ per hundredweight.

Section 1.04 BB will provide transportation of the raw milk to the BB plant at no cost to the producer.

Section 1.05 BB will pay a combined rate of ten percent of after tax profits at the end of each fiscal year to all producers that have signed this agreement on an individual basis. The ten percent will be apportioned to individual producers based on the percentage of the total milk supplied to and used by BB.

Section 1.06 BB will maintain accurate records of producer’s volume and pricing with records to be made available to the producer upon written request.

Article II. Certification Requirements.

Section 2.01 Producer must obtain and maintain certification from Food Alliance Midwest. This certification includes both the Whole Farm certification and the product specific certification for dairy.

Section 2.02 Producer must obtain and maintain certification as an organic dairy operation as specified under the USDA National Organic Program. BB recommends the State of Iowa as the Organic Certifier. However, the producer may choose another certifier, provided the certifier is part of USDA’s National Organic Program (NOP).

Section 2.03 Producer will be responsible for the costs associated with any certifications related to this agreement.

Section 2.04 Producer will maintain records required for the certification programs and will provide them to BB upon request.

Section 2.05 BB will provide the producer a comprehensive listing of the certification standards required by this agreement upon request.

Article III. Additional agreements by BB and/or the producer

Section 3.01 Each party has a right to terminate this agreement with 180 days notice.

Section 3.02 BB may immediately terminate the agreement if the producer fails to maintain a certification required under this agreement.

Agreed to this _____ day of _____, 2005.

The following section uses this sample contract to raise specific questions you should consider when entering into a contract:

- 1. Quantity.** Section 1.01. Is the contract an exclusive contract? Will you be able to sell some of your products to other sellers? Many farmers like to have this option to make sure the buyer is grading their products fairly and to maintain options should the buyer no longer be in the market in the future. Buyers, on the other hand, want to lock in as much supply as they can and do not want to work with the seller to improve the seller's operation just so the seller can market to other operations.
- 2. Price.** Section 1.03. Is the price set in the contract or does it rely on another market as the base price? For instance, most marketing agreements for hogs look to USDA reported prices for the spot market as a base price.
- 3. Duration.** Section 3.01. What is the duration of the contract? If it is open ended, what type of notice must the parties give to terminate the contract? If there is a set duration, is there an opportunity to renew the contract?
- 4. Delivery.** Section 1.04. Who has responsibility and pays for shipping the goods? Will the buyer pick them up at your place or do you need to deliver the goods to a particular place? Is there a specific time when the goods need to be delivered?
- 5. Profit sharing.** Section 1.05. Is there any sharing of profits? The idea of profit sharing is inherent in the cooperative model, but a number of LLC's also look for ways to share profits with producers.
- 6. Recordkeeping.** Sections 1.05 and 2.04. What are the recordkeeping requirements and who has a right to see the records? Records can be especially important when trying to prove you adhered to certain standards for raising a crop or livestock.
- 7. Certification requirements.** Article II. Are there certification requirements? Who is the certifier? Is there a chance these requirements will change over time? Who pays the costs of certification? What happens if the seller is not able to maintain the required certification?
- 8. Dispute resolution.** What happens if disagreements occur? Is there a particular process, such as mediation or arbitration, the parties must follow if disagreements occur?

CONCLUSION

This chapter introduces the general legal framework of contract law. If you enter into contracts with a producer marketing association, these rules will apply just as if you were dealing with an outside party. By becoming familiar with how contracts are interpreted and enforced, you can help ensure a smoother relationship between members and the association.

Additional Internet Resources for Contract Law

Contracts 101 –The following links provide a general overview of the basic legal concepts surrounding contractual arrangements.

[Business Contracts and Arrangements](#) (Ag Marketing and Resource Center)

[Contract Law: The Basics](#) (FindLaw.com)

[Five Questions to Ask Before Signing a Contract](#) (Entrepreneur Magazine)

[Plain English Guide to Contracts](#) (www.business.gov)

The Uniform Commercial Code (UCC)

[Overview of Sales Under the UCC](#) (Cornell's Legal Information Institute)

[UCC as Adopted by Specific States](#) (Cornell's Legal Information Institute)

Contracts in Agriculture

Overview

[Agricultural Production Contracts](#) (University of Minnesota Extension Services)

[An Introduction to Agricultural Production and Marketing Contracts](#)

(University of Nebraska Cooperative Extension)

[Contracting in Agriculture: Making the Right Decision](#) (USDA-AMS)

Contract Libraries

[Production Contract Library](#) (Iowa Attorney General's Farm Division)

[Swine Contract Library](#) (USDA – GIPSA)

Contract Evaluation Checklists

[Grain Production Contracts](#) (Iowa Attorney General's Farm Division)

[Livestock Production Contracts](#) (Iowa Attorney General's Farm Division)

[Vegetable Production Contracts](#) (Illinois' Value Project)

National Agricultural Law Center ([website](#))

[Commercial Transactions Reading Room](#)

[Production Contracts Reading Room](#)

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