

The UNIDROIT/FAO/IFAD Legal Guide on Contract Farming

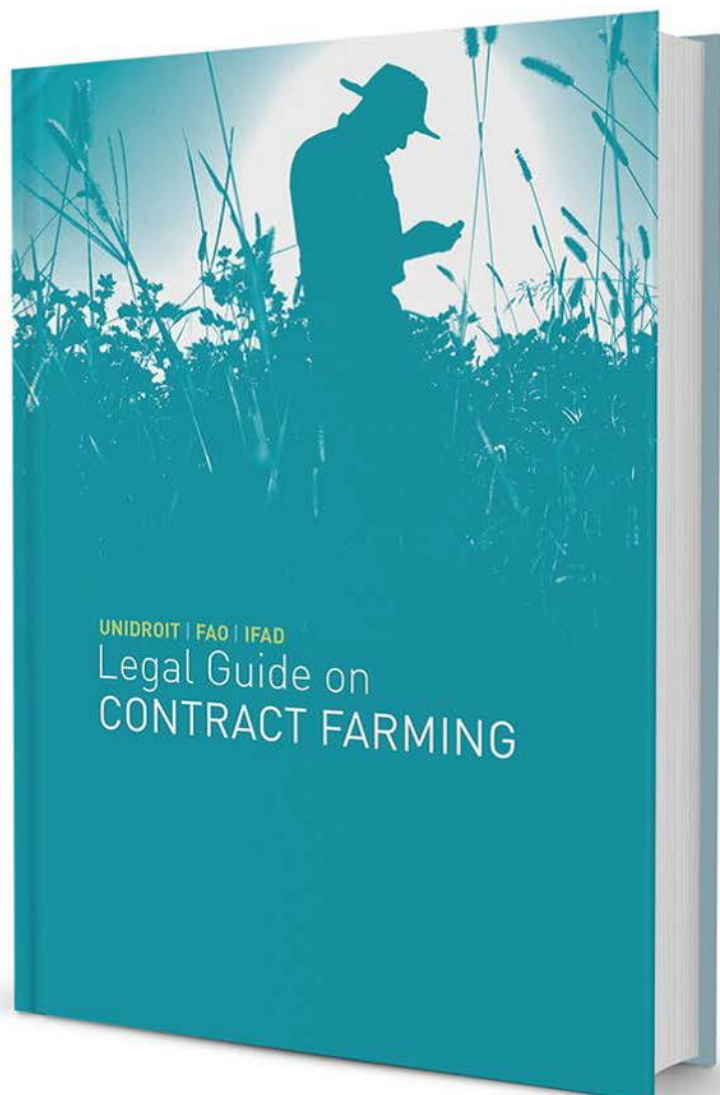
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What is contract farming?

Contract farming developed and became common in industrialised countries several decades ago, especially in the livestock production sector, and is now used for a broad array of agricultural commodities in many countries around the world. Contract farming has also recently spread very significantly in many developing countries, especially as a consequence of trade liberalisation and the opening up of these markets to foreign investment. As living standards rise and the demand for agricultural products increases, and with consumer markets growing ever more sophisticated, contract farming is expanding as a tool to organise and link production capacities and market needs, to increase and diversify the availability of products on local and global markets, and to improve value chain efficiency. Developing countries have considerable potential as suppliers of sought-after agricultural products at an attractive cost for export markets. They are also final consumer markets with a growing need for large quantities of products to feed their expanding populations, especially in urban areas. For small-scale producers, contract farming offers opportunities to access competitive markets based on the services provided by companies which help to modernise their production capacity.

Under contract farming arrangements entered into with agricultural producers, food processors and distributors secure a supply of a specified produce (vegetables, tree crops, grain, husbandry and dairy products, fish, etc.) in the required quantity and quality, at a future designated time and at a predetermined price. Depending on the type of agreement, the contractor very often provides inputs (seeds, fertilisers or young animals) and may also manage the production process by requiring the producer to apply designated technology and growing or raising methods. This enables the contractor to coordinate production and ensure efficiency gains without holding equity in the producer's activities and without bearing the financial and legal constraints that full vertical integration would entail. Independent entrepreneurs, medium-scale firms, and cooperatives may all participate as contractors. In general, major transnational corporations in the food processing and marketing industry play a prominent role either as direct contractors, or indirectly as the leading managing party in the supply chain.

For farmers, contract farming offers the opportunity of a more stable revenue stream through guaranteed market access, in particular to specialised segments which offer the opportunity of higher prices. Generally, contracts work as a credit vehicle when inputs are provided by the firm or the contract proceeds may serve as collateral to obtain funding from a financial institution. Higher yields and better quality derive from the extension services and technology supplied by the contractor. Sustainable contracts enable farmers to share production risks, promote stable relationships and contribute to improving capacities. Producers that are parties to a contract farming arrangement may vary widely as to economic power and legal structure, from independent producers to cooperatives, and from smallholder farmers and producer organisations to medium-scale agricultural companies.

The advantages of contract farming are generally widely recognised, given its potential to sustain and develop the production sector by contributing to capital formation, technology transfer, increased agricultural production and yield, and economic and social development. Final consumers may also draw substantial benefits from varied and stable sources of supply and well functioning processing and marketing chains. Governments are increasingly mindful of the role that contract farming can play in agricultural development and enabling policies are put in place to attract private sector investors and to coordinate ventures with local producers, sometimes under public-private partnerships.

The importance of the legal framework

Contract farming arrangements reflect multiple commercial practices and their success depends on many elements. One key element is the capacity of the parties to build stable, commercially sound and fair relationships, based on clear commitments and mutual compliance. For both parties, major interests are at stake in ensuring a mutually beneficial relationship based on collaboration and trust.

Ensuring fair relationships is all the more important in view of the imbalance of economic power between the parties which generally characterises agricultural contracts. Typically, large processing or marketing companies with sophisticated management capabilities deal with large numbers of small or medium-scale producers, thereby spreading their risks of loss, while producers engage in an exclusive relationship with the firm and may have little or no opportunity to contract with another potential party if the contract fails or is not renewed. Producers are largely dependent upon natural factors and financial constraints, and may generally lack the skills or information needed to operate in the larger economic or business environment; for example, market data may have direct implications for the contract terms, in particular the price.

The cornerstone of the relationship is the agreement. When the contract is concluded, ensuring clear and fair allocation of risks, liabilities and economic returns, and predictable conditions regarding both performance of the contract and possible non-performance events is essential to sustainable relationships and enhances financial benefits in the long term. How the parties organise the many aspects involved in their future dealings plays a crucial role in their ability and willingness to meet their commitments and to find solutions when performance is hindered. In this respect, the legal framework is essential to give legal effect to the parties' stipulations and to supplement them, as the case may be. Depending on each legal system, legal provisions may apply to certain aspects of the contractual relationship, excluding the parties' ability to derogate from such provisions. The legal framework regulates a vast number of aspects relevant to the contract farming relationship, such as the legal capacity of the parties, third party rights, tort liability, regulatory prescriptions regarding, for example, labour and food safety matters, etc.

Understanding the interplay between the terms and practical implementation of the contract and the applicable legal provisions certainly increases the security of the parties by making them aware of possibly critical issues regarding their rights and remedies throughout the life of the contract. However, in view of the particular nature of the relationship involved in agricultural production, contracts where parties are linked through a variety of reciprocal obligations which may be seen as falling under different legal categories, determining the legal regime applicable to one or another aspect of the relation or to the contract as a whole may not be straightforward. Different approaches would apply depending on the legal system and what types of contract are available under domestic law. In some countries, ad hoc legislation has been enacted to create a special type of contract and applies specifically designed provisions to certain aspects of the relationship. Although different in scope, such legislation generally imposes minimum requirements as to contract form and content, essentially to ensure that producers are fully informed of their future obligations, and establishes dispute resolution mechanisms intended to provide adequate enforcement of contracts and enhance voluntary compliance.

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Purpose of the Guide

The UNIDROIT/FAO/IFAD Legal Guide on Contract Farming is primarily addressed to the parties to a contract farming relationship, *i.e.* producers and contractors. It provides advice and guidance on the entire relationship, from negotiation to conclusion, including performance and possible breach or termination of the contract. In so doing, the Guide aims to promote a better understanding of the legal implications of contract terms and practices. It intends to promote more stable and balanced relationships and to assist parties in designing and implementing sound contracts, thereby generally contributing to building a conducive environment for contract farming.

While not intending to provide a model for, or encourage the adoption of, special legislation, the Guide could, however, provide useful information for legislators and public authorities dealing directly or indirectly at a public policy level with contract farming. The Guide could be recognised as a reference for good practice by reflecting a minimum internationally accepted standard of practice in contract dealing in this area.

The Guide intends to provide practical guidance to international organisations and bilateral cooperation agencies, as well as non-Governmental organisations and farmers' organisations, engaged in strategies and capacity building programmes in support of contract farming, especially in developing countries. The Guide could also be useful for professional organisations, judges, arbitrators, legislators, and perhaps even most importantly, for mediators, because it promotes amicable dispute resolution.

The UNIDROIT/FAO/IFAD Legal Guide on Contract Farming is aligned with the *Principles for Responsible Investments in Agriculture and Food Systems* (RAI Principles) approved in October 2014 by the Committee on World Food Security. The Guide also shares with the RAI Principles the goal of providing a framework that stakeholders can use when developing domestic policies, regulatory frameworks, corporate social responsibility programmes, individual agreements and contracts, all of which in responsible and inclusive ways.

Content of the Guide

The Guide is composed of an Introduction and seven chapters dealing with the various conceptual stages of the contract farming relationship. The chapters provide a description of common contract terms and a discussion of legal issues and critical problems that may arise under various practical situations.

The **Introduction** describes the basics of contract farming, the variety of contract farming operations in practice, and the benefits and risks of contract farming as a tool which may serve different purposes: risk-mitigation, access to credit, technology transfer, and economic, social and environmental development. The Introduction also describes the Guide's scope *i.e.* an "agricultural production contract" intended as a contract whereby the producer undertakes to produce and deliver agricultural commodities in accordance with the contractor's specifications, and the contractor, in turn, undertakes to acquire the product for a price and generally has some degree of involvement in production activities.

Chapter 1 discusses the legal framework applicable to agricultural production contracts. Under the applicable private law regime, agricultural production contracts may be governed as special contract types or under rules applicable to traditional contract forms. Other domestic legal sources are presented, *i.e.* rules and principles of law, customary rules and usages, trade usages and practices, standard contract terms, technical standards and soft law. In particular circumstances, an international element may be involved, which may entail the application of a foreign law. The role of the regulatory environment is addressed with respect to the following areas: agri-food trade, production inputs, agricultural finance and support, competition and antitrust, Human rights, labour law, and access to natural resources.

Chapter 2 addresses the parties to the contract, and the contract formation, form and content. The main parties in the contract are the agricultural producer (either an individual or a collective entity) and the contractor (generally a food processor, a distributor or an exporter), but other parties may have an interest in the agricultural production contract. The chapter then describes the process of contract formation and discusses in particular the issue of consent, and the role of other parties in contract negotiation. Finally, issues of the contract's form (including the writing requirement) and content (with the typical elements in the contract) are discussed.

Chapter 3 concentrates on the obligations of the parties. It first introduces key aspects of risk allocation between the parties (relating both to production and commercial risks) and the related issue of exclusivity of dealings. The main body of the chapter analyses the core obligations of the parties, which are most often interlinked and span over a period of time. The obligations may relate to the product (especially as regards the quantity and quality), but also very often to the production process (with aspects related to inputs and production methods), the delivery of the final product and the price and payment for the product. Finally additional obligations are discussed, alongside with the transfer of obligations.

Chapter 4 focuses on excuses for non-performance, which derive from the occurrence of certain events. It first introduces the basic underlying legal issues raised by such occurrences, *i.e.* the concepts of force majeure and change of circumstances and discusses issues of allocation of risks. It then outlines how different supervening events may be characterised by contracts and the applicable law. Lastly, it explores the consequences of such events on parties' obligations (such as excuse from non-performance, suspension of performance, compensation) and on the contract as a whole (with termination, renegotiation, and judicial adaptation of the contract).

Chapter 5 deals with the remedies for breach. It begins with an overview and a description of remedies, encompassing remedies in kind, withholding performance, price reduction, termination, restitution, damages and payment of interests. The chapter highlights the relevance of the aggrieved party's conduct on the use of remedies, the breaching party's right to cure, and the renegotiation of the contract after a breach. The chapter then moves on to identify and analyse the applicability of remedies both for the producer's and contractor's breach, underlining the different interests of the parties and the different natures of the various breaches and their relevance for the choice of remedy.

Chapter 6 examines the duration, renewal, and termination of the contract. The chapter recognizes the differences between "short-term" and "long-term" contracts and takes into account possible durations imposed by law. The renewal of the contract can happen either by an express agreement, tacitly or automatically, or at the option of one party, each with their own consequences. Finally, the chapter discusses termination of the contract, emphasising the importance of a well drafted termination clause and of the inclusion of a notice requirement, before moving on to the grounds for termination and ending with a discussion on the effects and consequences of termination.

Chapter 7 discusses dispute resolution in the context of agricultural production contracts. After an overview of the various dispute resolution methods available for the parties, the chapter describes the various aspects involved in each dispute resolution method, *i.e.* mediation, arbitration and judicial proceedings. The chapter concludes with a discussion on the enforcement of settlements or decisions resolving a dispute.

Project History

The Guide is the result of a collaborative drafting process lead by the International Institute for the Unification of Private Law (UNIDROIT) in partnership with the Food and Agriculture Organization of the United Nations (FAO) and the International Fund for Agricultural Development (IFAD). The primary drafting was completed by a Working Group over four meetings held in Rome between January 2013 and November 2014, which brought together internationally-recognised legal scholars, multilateral organisations and representatives of the farming community and agribusiness.

The preparation of the Guide also depended upon the invaluable input from discussions held at consultation events during 2014. Regional consultations on "Promoting Good Contract Practices between Producers and Buyers in Contract Farming Operations" were held in Buenos Aires (Argentina), Bangkok (Thailand) and Addis Ababa (Ethiopia), and a meeting held in Rome (Italy) focused on issues and concerns specific to the private agribusiness sector. In addition, prior to the Working Group's final meeting, the Guide was made available publicly on UNIDROIT website for one month to solicit comments from a broader range of interested stakeholders.

At the end of a two-year process of development, the UNIDROIT Governing Council considered and adopted the Guide at its 94th session, held in May 2015.

The UNIDROIT/FAO/IFAD Legal Guide on Contract Farming was released in paper and electronic form on 28 July 2015 and is accessible on line on the websites of UNIDROIT, FAO and IFAD. The Guide will serve as a basis for the preparation of knowledge and implementation tools to be used in training and development programmes.

<http://www.unidroit.org/work-in-progress-studies/current-studies/contract-farming>

Project Partners

UNIDROIT is an intergovernmental, Rome-based organisation specialising in the harmonisation and modernisation of private law rules at the global level, through international treaties and soft law instruments in several areas. UNIDROIT has earned widespread recognition for its activities in the area of contract law, in particular with the UNIDROIT Principles of International Commercial Contracts, 2010 which are widely used in commercial practice and arbitration and as a reference in domestic legislative reforms (www.unidroit.org)

FAO promotes responsible contract farming by implementing domestic and regional development and capacity building programmes, issuing publications and maintaining a Contract Farming Resource Centre on the FAO website which gives access to bibliographical references, contract samples and general legal documents (www.fao.org/ag/ags/contract-farming/index-cf/en/).

IFAD – Based on its mandate to mobilise and deploy resources to alleviate rural poverty, and in furtherance of its priority objectives to promote the inclusion of smallholder farmers in agricultural value chains and to facilitate access to markets, IFAD actively supported the work to prepare the Guide since the outset. IFAD provided a grant that was instrumental in organising and implementing consultations on the draft Guide in 2014 (www.ifad.org)

(Updated September 2015)