Livestock Production Contracts:
Information for Pennsylvania Farmers

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The use of livestock production contracts, particularly in the poultry and swine industries, has gained a strong foothold in Pennsylvania. These contracts have opened many new and possibly lucrative opportunities for Pennsylvania farmers. Livestock production contracts offer the potential for substantial benefits not only for farmers and processors, but also consumers. However, farmers must understand how contract agriculture works so that they can weigh the risks of entering these contracts and can better protect themselves in contract negotiations.

Part One: Introduction
Livestock production contracts have enormous potential to benefit producers, processors and, ultimately, consumers. Processors control production methods, giving them access to an assured adequate supply of livestock with certain characteristics and qualities. This quality control feature of production contracts can boost sales to consumers. Farmers, or "producers," have the potential to gain a reliable flow of income that reduces the financial uncertainty of entering into or expanding their operations. They may also gain access to necessary or larger amounts of capital as a result of the reliable income stream that will be generated by the contract. While a producer's potential for profit is capped by the payment terms of the contract, the potential for loss is greatly decreased because a producer will be paid according to the predetermined terms of the contract despite fluctuations in the market. Placing much of the production risk on large processors promotes economic efficiency in agriculture, and therefore reduces production costs, providing consumers with higher quality, lower cost products.

Despite the potential benefits for all parties, farmers should carefully consider the nature of this relationship before deciding to enter into a production contract. Because of the rapid trend toward consolidation in agriculture, production contracts raise two major concerns:

1. Processors are much larger, more sophisticated, and more knowledgeable about the markets. Consequently, processors might have the power to take unfair advantage of producers by drafting one-sided contracts.
2. Strict confidentiality provisions are required by many processors. These clauses in the contract limit the producer's ability to compare contracts with other
producers, which is the primary way that the producer can gain important information that will assist the producer in negotiating a fair deal.

Farmers contemplating entering into a livestock production contract should be aware of the inherent risks, as well as the potential benefits, and take the appropriate measures to protect themselves. This article highlights and summarizes some important issues that every Pennsylvania farmer should consider before entering into a livestock production contract.

Part Two: The Contract
The decision to enter into a livestock production contract has financial and practical considerations that farmers must weigh before deciding whether to go forward. Farmers should not make the decision to enter into a production contract without fully understanding their obligations under the contract and the possible consequences.

A good rule of thumb to remember is that the party who wrote the contract wrote it with his interests in mind. Processors often offer farmers a typed contract on a "take-it-or-leave-it" basis, offering little or no opportunity to negotiate the terms. Producers should not automatically assume that a contract presented to them by a processor will fairly protect the producer's interests. The allocation of risks can be buried in the fine print or in "lawyer talk" that is difficult to understand. Before signing, a farmer should talk with an attorney or financial advisor, and, if possible, an established producer. Farmers cannot make an intelligent decision about entering a contract before they understand the terms of the contract, their risks, and the potential for profit. Processors should also want to make sure that farmers understand these contracts prior to signing in order to prevent misunderstandings and disagreements in the future.

There are many important issues that should be covered in a production contract, including the following:

1. Capital Investment. Livestock production contracts often require a substantial capital investment on the part of the producer. As a result of this investment, producers often must make payments on a mortgage for many years after signing the contract. Most producers will rely predominantly on the income stream from the production contract to meet these payments. Although livestock production contracts can significantly reduce the risk of loss due to market price fluctuations and offer a steady stream of income, there are still substantial risks involved for each producer.

Structures to house livestock are costly to build. Therefore, farmers must determine the size of the facility required, how much it will cost to build and whether the income stream from the contract will be sufficient to meet the mortgage and other overhead expenses, such as increased electric bills, property taxes and insurance. If the facility requires changes or modifications over the duration of the contract, a producer should determine who is responsible for
making and paying for the changes. Producers should ask: Am I solely responsible for the cost of any changes? Is there any limit to the extent of those changes? When and how often will such changes be necessary? Will payments I receive under the contract be increased to reflect additional investments in the future?

2. **Renewal Terms.** Closely related to terms covering necessary capital investment is the duration of the contract. The length of the contract, as well as the terms for renewal and termination are extremely important terms. Most contracts will contain clauses detailing when and why a contract may be terminated or renewed.

Producers should be aware of all of the terms and conditions upon which a processor may rely to terminate a contract. The termination clause in an agricultural production contract will set forth the circumstances for termination, such as who can terminate the contract, at what time and for what reasons. Producers should carefully read and understand this clause to make sure that a processor cannot terminate the contract for little or not reason. A processor's interests in termination and renewal can be quite different from those of a producer's.

Processors have a legitimate interest in being able to respond flexibly to market fluctuations and to ensure that the producers with whom they have contracted maintain a certain level of performance. Therefore, processors have an interest in offering contracts with a short duration and more flexible renewal and termination terms. Conversely, any investment made by a producer pursuant to a production contract will likely be long term. Therefore it is necessary that the contract, or the option to renew, be long enough to allow producers to recoup their investment. Obviously, a farmer does not want to build a structure and then have a production contract that lasts only for one year before not being renewed.

Producers are even more vulnerable when it is time to renew the contract. After having made a substantial investment, producers may feel compelled to agree to contract terms that are disadvantageous or even adverse to their interests because they need to make sure that the contract is renewed. This is particularly a problem in areas where a single processor has gained regional dominance. Producers may have no choice but to renew their contracts even if the new terms are disadvantageous or even harmful because no other options are available. It is important to note that while some processors use these types of unfair practices, it does not necessarily mean that every processor uses such tactics. **It is wise, however, to be aware of the potential risks associated with this type of contracting by focusing on the renewal terms of the original contract.** One should always ask: Assuming I perform my end of the bargain competently and correctly, will this contract be renewed? On what terms? For how long?

3. **Payment Terms.** Payment and price terms vary from contract to contract. Before entering into the contract, farmers should determine how their payments will be calculated under the contract. Usually, payment will be made as a flat fee, or may
be adjusted based on factors such as feed efficiency, rate of gain or weight, and death loss. Payment terms can be complicated and pose a real risk of misunderstandings and disputes over the amounts earned. Producers who do not fully understand their payment terms might believe that the processors are "fixing the books," leading to disputes that benefit neither party.

The producer should also understand whether he will get paid if the processor goes out of business. A producer should carefully review the production contract to see if it includes a provision on how the producer's claim for payment under the contract will be handled if the processor goes out of business. Will a producer be paid what is owed to him under the contract, or must that producer become a creditor of the processor and wait his turn for payment like any other creditor? It is likely that a producer will be one among many creditors with a lien or claim for payment from the assets of a processor that has gone out of business. If a producer will be treated the same as other creditors he may suffer a significant loss and it may take a considerable amount of time to recoup his money. There is also the possibility that the processor will not have enough money or assets to pay all of its creditors and that some creditors will receive nothing. If the contract deals with this issue, it is important to understand exactly what rights this contract provision gives a producer, whether the contract term requires that the producer be paid immediately and if payment is to be delayed, whether payment to a producer is given priority over payment to the processors other creditors.

A farmer should always ask: How will my payments be calculated? Who assumes the risk of loss for animals that die? Will I be paid for animals that are of lesser quality? How will that be determined? If the processor goes out of business, will I be paid?

4. **Operations.** There are numerous issues relating to the day-to-day operation and care of the animals. Contracts usually require the processor to supply the animals, food, medicine, and managerial assistance. The producer usually furnishes adequate facilities to house the animals, related equipment, water, and the labor and management necessary to properly care for them. Beyond these basics, however, there are many other related issues that must also be resolved. For example, the delivery of the livestock raises a number of questions. A farmer should always ask: Who pays for the trucking? Who decides the schedule for delivery? Who bears the risk of death loss while the livestock are being shipped in or out? There are a variety of practical issues that should be addressed in the contract, some of which are listed below.

   a. Producers should know who is responsible for all managerial decisions and for record and bookkeeping
   b. Producers should know who decides whether and when livestock require veterinary care.
   c. Producers should know who is responsible if livestock die while in your care due to natural disasters, and who bears the cost of poor performance due to unhealthy or low-quality livestock. Additionally, if producers are
responsible for the disposal of dead livestock they must take into account how they will dispose of the animals and the costs involved.

d. If the number of livestock at the facility increases over a certain number, special environmental regulations may apply. Producers should know who owns the manure and who is responsible for its disposal. Failure to properly dispose of manure could lead to civil lawsuits or even criminal penalties.

Producers will be better able to protect their interests if they have adequate knowledge about their obligations and potential liabilities. Therefore, they should carefully consider how the contract addresses these and other issues before entering into a contract. The potential risks to a producer can be as significant as the potential benefits.

Part Three: The Law

Currently, Pennsylvania has no law that specifically regulates the contractual relationship between producers and processors. If either party fails to meet the required obligations, producers and processors must turn to traditional contract law for recourse. As a general rule, courts will enforce the terms of the contract as written, even if the terms appear to be harsh when applied to the producer. Unless the contract contains an arbitration clause, the producer will need to bring a lawsuit if the processor doesn't comply with the contract. A lawsuit does have the potential to compensate a producer for his losses, however, the process is time-consuming and expensive. In reality any money recouped by the producer may go to pay court costs and attorneys fees rather than into the pocket of the producer. Therefore, in many circumstances, taking the case to court will not be a practical alternative for producers lacking the resources or the stamina for protracted litigation.

Legislative Proposals

In an attempt to balance the disparity of bargaining power and information between producers and processors, some states have passed specialized statutes to address these contracts. The Producer Protection Act has been proposed in sixteen farm and ranch states to protect contract growers and producers. It has not been introduced in Pennsylvania. This Act was drafted in response to the concern that farmers would not get a "fair shake" from processors as agriculture become more concentrated and consolidated. The premise is that contracting often results in an unfair shifting of economic risks to farmers and ranchers, especially those required to make large capital investments in buildings and equipment. Proponents of the Producer Protection Act believe that its protections are necessary because of the market dominance of processors and the inherent disadvantage this causes producers when negotiating contracts.

This Act is meant to protect farmers without overly burdening processors. Generally, the Producer Protection Act:
1. Requires contracts to be in plain language and contain disclosures of material risks.
2. Provides contract producers with a three-day right to review production contracts. This provision helps maintain the "market transparency" that historically has been available to farmers and ranchers who have access to complete information through auctions and terminal and futures markets.
3. Prohibits confidentiality clauses in contracts.
4. Provides producers with a first-priority lien for payments due under a contract. This protects producers in case the processor goes out of business.
5. Protects producers from having contracts terminated arbitrarily or as a form of retribution if farmers have already made a sizable capital investment required by the contracts.
6. Makes it an unfair practice to retaliate against or discriminate against a producer who exercises rights under the Act, including the right to join producer organizations.

Although each state will customize the Act as it is passed by their legislatures, each will consider the model statute an important starting point. No state has passed the Act in its entirety, although segments of it are already law in several states.

**Federal Legislation**

Legislation has been introduced at the Federal level that closely resembles the proposed Producer Protection Act. One of the goals of the states' model legislation was to implement a uniform framework for the regulation of contracting to avoid placing a harsh burden on processors who must comply with each state's individual regulatory scheme. The proposed federal legislation has two important components.

1. The legislation will strengthen producers' ability to bargain by accrediting voluntary producer associations and authorizing them to bargain with large processors, contractors, and cooperatives. Mutual obligations of good faith bargaining are imposed on both parties. This legislation strengthens the ability of producers to organize associations without fearing coercion, intimidation, or discrimination by large agribusinesses as a result.
2. The Federal Legislation will not invalidate state laws dealing with producer bargaining.

Critics of the Producer Protection Act argue that extending special protections to farmers entering into this type of contractual relationship is unnecessary and that existing laws provide adequate protection. Critics charge that the Act may have certain unintended consequences. For example, unnecessary regulation may prompt processors to own their own production facilities rather than forming contracts with individual producers. Additionally, opponents are concerned that increased regulation may encourage processors to take their business to other states.
However, laws providing similar protections have been successfully implemented in other contexts without such unintended consequences. Franchise Law provides an example of legislation offering protections similar to those offered by the Producer Protection Act. Franchising typically involves an agreement between a large company [the franchisor] and an individual or small business [the franchisee]. The franchisee pays the franchisor an initial franchise fee plus royalties and promises to follow certain guidelines set out by the franchisor. Often the franchisors possess superior bargaining power and market knowledge that can put franchisees at a disadvantage during the initial negotiations for the franchise and when the franchise agreement is renewed. Similar to production contracts, franchise agreements are almost always drawn up by the franchisor and presented to dealers without negotiation over terms. Recognizing the potential for abuse by franchisors, state and federal legislation has been enacted to protect franchisees.

The Petroleum Marketing Practices Act is another example of this type of protective legislation. The Act provides petroleum dealers some protection against the utilization of unfair practices by oil companies. These protections include limitations on the rights of franchisors not to renew a franchise agreement unless certain enumerated requirements have been met and a federal civil cause of action for franchisees against franchisors who have not complied with the requirements of the Act. In addition many states impose registration and disclosure obligations on franchisors and some even regulate the ongoing relationship. While not a perfect equalizer, these statutes attempt to counter-balance the advantage that franchisors have over franchisees, to better allow the franchisee an opportunity to negotiate a fair deal.

As stated above, Congress has enacted no legislation, nor has the Producer Protection Act been enacted in Pennsylvania. Nevertheless, the Model Act can provide a good checklist of important issues for producers and their lawyers to address in their contract. Additionally, producers can look to franchise statutes and similar protective legislation to find examples of language designed to ensure a fair contract. Although these statutes do not deal with every important issue, producers might request that processors adopt these "neutral" terms in their contract to address fairly some of the most important issues.

Part Four: Conclusion
Stop, look, and listen. This has always been good advice, but it is absolutely necessary in connection with production contracts. Making the decision to enter into a livestock production contract is an important crossroads, and the farmer's choice has far reaching consequences. Before choosing which path to take, farmers should stop, look carefully at the contract and consider all of the options, and listen to those around them. Remember that knowledge is power. The more knowledge a farmer has, the more likely that farmer is to be able to negotiate a fair deal that serves the interests of the farmer.

IN CONCLUSION, A FARMER SHOULD USE THE FOLLOWING CHECKLIST AS A STARTING POINT WHEN CONSIDERING ENTERING A PRODUCTION CONTRACT:
A contract contains legal rights and responsibilities, so it is important that you:

- Read the contract thoroughly and make sure you understand the entire document.
- Consult with a legal advisor before signing any contract.
- Consult with other producers who have dealt with this processor.
- Realize that you will be expected to fully perform all of the obligations required by the contact. Legal and financial consequences may follow if you fail to fully perform.
- Know the nature and the extent of any required capital investment. (Construction costs for a new facility, the cost of improvements on an existing facility or the purchase of additional equipment.)
- Know when and how you will be paid.
- Know how long the contract lasts and the terms and conditions for renewal.
- Determine the specifics of the day-to-day operation. Resolve any issues you may have before signing the contract. If you make any changes to the agreement, make sure they are in writing and a processor's representative signs that writing.
- Check to see if the proposed contract contains a confidentiality clause. You should try to ensure that you are free to discuss contract terms and experiences with other producers.
- Keep good records. Those records will be helpful and necessary if a dispute should arise concerning your performance or your compliance with the terms of the contract.
- Assess your long-range goals and make sure that a livestock production and the long-term obligations associated with the contract are compatible with those goals.
- Ask questions and stay informed.

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