

- **Marketing (or sales) contracts** – These contracts involve a firm agreement to accept or deliver a specified quantity of grain or soybeans with a minimum content of a specified physical trait or chemical trait, or which have been produced using a specified set of practices. Pricing may be established prior to production or pegged to commodity markets with a premium.
- **Bailment production contracts** – These contracts generally involve the contractor (buyer) providing some critical genetic trait or traits through the seed input. Title in the growing crop and the finished product remains in the hands of the contractor/bailor. The producer in this case is a temporary holder for the genetic seed input that remains the property of the contractor.
- **Personal service contracts** – These contracts generally involve the contractor providing most of the non-land production inputs. These fee contracts sometimes involve more management decision-making from the contractor as well. In essence the contractor provides compensation to the producer for the use of land, labor and machinery.
- **Pool contracts with a closed cooperative** – This involves delivery by the producer to a closed “*new generation*” cooperative facility jointly owned and operated by a group of producers for the purpose of adding value to the raw product they produce. Such cooperatives typically require the purchase of equity instruments by each producer in direct proportion to that producer’s rights and commitment to deliver under the contract.

These contracts are generally sales contracts. However they may be treated differently than under warehouse regulations, grain dealers laws, farm programs and other types of governmental institutions because the member producers are contracting with an organization they own and control.

Contracting affects other relationships

There are at least six entities in the market channel that could be affected by contracting arrangements. In addition to the farmer and contractor, landlords, suppliers, lenders and custom operators may be affected. While these same agents are also present in the open market bulk commodity marketing channel, the existence of a contractual agreement will in many cases change the traditional relationships among them.

In many cases, the new risks associated with contract production are more manageable by the producer and can be dealt with in a more proactive way.

New relationships are forged when a contractor (buyer) executes a contract agreement with a grower. This is especially true where rights and interests in the crop are concerned. These new relationships can be a source of different kinds of risk than those existing in the traditional commodity marketing channel. In many cases, the new risks associated with contract production are more manageable by the producer and can be dealt with in a more proactive way. But it is critical that producers understand that old relationships may have changed.

Several critical areas where the traditional relationships may be altered by production contracts are:

- Title to the crop
- Eligibility for federal crop insurance and farm program provisions
- Rights in the event of a contract breach
- Requirements and rights under seed producer, grain dealer, and grain warehouse laws
- Assumption of physical and quality risks during production and after harvest
- Security interests in the crop produced
- Rights of landlords under crop share and cash rent leases

Yield penalties and basis for compensation

Some specialty grains may have yield penalties or involve greater production risks than the standard hybrids or varieties. The grower should be aware of these risks and make sure they are adequately covered in the compensation schedule.

If the contract is a marketing contract, the producer should make sure the premiums paid are large enough to compensate for the likely differences in yield. The contract should be evaluated under “*worst case*” scenario outcomes as well as expected outcomes. The contractor’s responsibility and the producer’s responsibility for such losses can be clearly stated in advance. An alternative approach to the yield risks is to write the contract on an area or acre basis so the crop produced on a specific area is contracted rather than a specified number of bushels.

Grower obligations for quantity

The producer’s obligation to deliver quantity may also be a source of risk and uncertainty. Some specialty crops may not be insurable. A clear understanding of how shortfalls and excess production are to be handled should be incorporated in the contract. Heavy penalties or reductions in the rate of payment for a shortfall could represent a potential loss of not only the specialty premium but also reduce returns below levels available in the commodity market.

Quantity-based contracts that require the producer to locate substitute product may represent a significant risk - especially if the producer assumes production risks due to “*Acts of God*” beyond his or her direct control.

Risks of weather delays could also result in failure to meet quantity obligations. Unlike forward contracts for commodity grain, which are usually not made for the full yield expected, many production contracts are for full expected yield. Hence, there should be “*triggers*” in these contracts that specify when planting is no longer a viable option.

Grower obligations for quality

Quality obligations are also a potential source of risk. In most cases, the commodity quality standards for moisture, foreign matter, test weight and condition must be met along with the specialized traits in the grain. Quality is determined by a combination of the producer’s practices, the genetics, and “*Acts of God*” which are beyond the control of either the producer or the contractor. In some cases such as moisture or foreign matter, there may be extra costs associated with correcting quality problems when they do develop.

Managing these risks is best accomplished through the contract terms. If responsibilities and contingencies are clearly specified for both the producer and the contractor, these can be shared fairly and managed properly. As with quantity problems, “*trigger*” points or threshold points can be specified for “*Act of God*” contingencies. Penalties can be established for quality problems which are under the producer’s direct control. The responsibility for insurance and other quality maintenance expenses should also be specified and covered during both the growing season and post harvest period.

Pricing of grain

Methods of pricing specialty grains may vary a great deal from one contract to another. Payments under marketing contracts for specialty grains may closely resemble the cash forward contracts used for commodity grains. The major difference is the presence of special traits and a premium. If prices are tied to cash market prices for commodity grain, then price risk management steps similar to commodity grain may be appropriate.

If the contract turns possession of the grain over to the contractor and it is not priced until later, then the risks associated with a standard price later contract must be assessed. One risk is that these types of contracts are not covered by Iowa’s grain indemnity fund. In general, these arrangements are credit sales contracts and the producer is unsecured whether specialty grain or commodity grain is involved.

Other bailment contracts or personal service contracts may involve fixed payments to the producer. Here the producer incurs less price risk but must be sure that the payment covers all costs for the inputs he or she has provided.

Payment risks

As stated earlier, some marketing and “*bailment-like*” contracts may technically be credit sales contracts that leave the producer in the position of an unsecured creditor if the contractor is unable to pay. In these cases, the same precautions that must be used by producers of commodity grains are appropriate. Like price later or deferred payment contracts for commodity grain, the seller is in essence making an unsecured loan to the buyer for the value of the crop. In this situation, it is important to deal with reputable buyers and to avoid buyers who may not be capable of paying for the grain.

Payment risks may also exist for personal service contracts where a flat payment is made to the producer. These risks can be minimized by dealing with reputable and financially sound contractors.

Transfer of Ownership

Where title to the grain is held by the producer, ownership risks are present at least during the production period and sometimes during part of the storage period. It is desirable to clearly designate when actual ownership is transferred and when this risk is terminated. Ownership risk can be especially troublesome where there are stringent provisions in the contract and storage risk is assumed.

Risk of contract termination

Termination of a contract can generate serious losses. This is especially true when the grower has incurred high production expenses. Where bailment contracts or personal service contracts are used, the conditions for terminating by the contractor can be viewed as a risk factor. These risks can best be managed by clearly specifying in the contract:

- about what constitutes a breach,
- the notice required before termination,
- the producer’s right to correct a problem,
- who has residual rights to the crop after termination, and

- events that may “*trigger*” termination, such as death, disability and financial emergency.

It might also be useful to specify conditions that must be met before the grower can terminate the contract.

Managing these risks can best be accomplished through complete and clearly stated contract terms that take into account production risks beyond the direct control of the producer and contractor.

Financial and tax concerns

Two areas where producers using contracts may encounter increased risks are financing and taxes. For example, if a marketing or bailment contract is assignable, unexpected tax consequences can occur. Likewise, if the producer has entered into some type of personal service contract, there may be unintended credit consequences for the producer if liens cannot be granted in the crop. These types of risks can be managed by carefully evaluating the terms of the contract with legal tax and financial experts prior to entering it.

Conclusions

The production of specialty grains brings about some different kinds of risk management needs. Production or marketing contracts that clearly define the responsibilities of the buyer and the producer can be of great value in managing these risks.

There are several very different kinds of contractual arrangements. Executing a contract changes some of the traditional relationships between buyers, sellers and others in the market channel. Much of the “*traditional*” knowledge about marketing and risk management needs to be re-evaluated when a contract is used. It is absolutely essential that producers who produce grain under contract seek advice from an attorney and fully understand the terms before signing an agreement.