

# **Risk Management Education**

## **Peanut Marketing Train-the-Trainer Workshops**

### **FARMERS GUIDE TO PEANUT CONTRACTING**

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## **INTRODUCTION**

Traditionally, independent farm operators have exercised nearly complete control over their production and marketing decisions. Each farmer decided what kind of seed, fertilizer, pesticide, or breeding stock to use. When crops and livestock were ready for market, they were sold to the highest bidder at a local market. Due to changes in the peanut program brought about by the Farm Security and Rural Investment Act of 2002, peanut marketing has changed dramatically. More and different production and marketing agreements are being devised and implemented. These agreements are commonly called contracts.

## **WHY SHOULD I CONTRACT MY PEANUTS?**

Any person who engages in business should have a firm handle on why they are in that particular business. Reasons for being in a business should be specific enough that they can be defined and driven by strategic plans that accomplish financial and personal goals and objectives. Historical and lifestyle reasons for the existence of the business are certainly valid, but cannot not be the only reasons that the business continues. Those who can afford to live a chosen lifestyle are usually those who first took care of business.

Producer reasons for contracting peanut production are the same as for other contracted agricultural products: 1) market security, 2) income stability, 3) access to capital, and

4) improved efficiency. Contractor reasons for contracting are: 1) assurance of product supply, 2) standardization of product qualities, 3) market demand responsiveness, and 4) protection of patented technology. All are excellent justifications for using a risk management tool such as a contract. In most ventures, the risk/reward relationship is such that higher risk is associated with greater potential for return. If a producer wants to avoid the risk potential of low prices, he/she might consider some kind of contractual arrangement that provides a risk-sharing arrangement between the producer and a contractor.

## **WHAT IS A CONTRACT?**

A contract is a legal document defining a written or oral agreement between two or more parties, and involving enforceable commitments to do or refrain from doing something in exchange for some form of compensation. Two types of contracts that are important to crop and livestock producers are production contracts and marketing contracts.

## **Production Contracts**

Production contracts are made between a producer and a contracting firm such as a feed mill or a livestock processor. Production contracts usually specify the quantity and quality of production inputs provided by the contracting firm, acceptable quantity and quality of the delivered product, and the compensation that the grower will

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receive. Such contracts specify varying elements of control over a farmer’s production decisions, depending on the type and nature of the contract. Production contracts also tend to move management returns (associated with either profit or loss) from producer to buyer in exchange for a certain payment. The following is a definition of a production contract which covers a majority of agricultural production agreements.

*“An agricultural production contract is a legally binding agreement of a fixed term, entered before production begins, under which a producer either: agrees to sell or deliver all of a specifically designated crop raised on identified acres in a manner set in the agreement to the contractor, and is paid according to a price or payment method, and at a time, determined in advance; or agrees to feed and care for livestock or poultry owned by the contractor until such time as the animals are removed, in exchange for a payment based on the performance of the animals.”*

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The factors below are typical elements of a production contract:

1. The agreement is for a fixed term, either one crop year or for many production cycles.
2. The agreement is made or signed before production begins.
3. The contract calls for either the production of a crop or the care and feeding of animals on land owned or controlled by the producer.
4. A specified quantity (usually all) the animals or the crop from a designated number of acres or specific acreage, of at least the designated quality, will be delivered to the contractor.
5. The crops or livestock must be produced or cared for according to the terms of the agreement.
6. The producer will be paid according to the agreed schedule and terms, and at the specified price, which may include premiums or deductions for quality or performance.
7. If livestock or crop seed are delivered to the producer by the contractor, the producer often has no legal title to the crop or livestock.

8. The producer is defined as an independent contractor rather than as an employee, partner, or joint venturer with the contractor.
9. The agreement specifies enforceability terms for non-compliance with contract terms, typically only for producer non-compliance.

### Marketing Contracts

Marketing contracts are also made between a producer and a contracting firm, although the contracting firm in this case is typically a sheller, processor, or retailer. Marketing contracts either set a price or establish a price-setting mechanism, and establish a market outlet before harvest or before the product is to be marketed. In large part, production management control remains with the producer, because ownership is retained at least through harvest. The producer bears all production risk under the contract, while the contractor and producer share the price risk. Typical elements of a marketing contract are:

1. The agreement is for a fixed term, usually for one or a few production cycles.
2. The agreement can be entered into at any time, but is usually entered into after planting and before harvest.
3. The contract calls for delivery of either crops or livestock, usually produced on land or in facilities owned or controlled by the producer.
4. All the animals or the entire crop from a designated number of acres may be delivered or sold to the contractor.
5. The producer will be paid according to a specified price or price formula, which may include premiums or discounts for quality or other factors, according to the agreed schedule or terms.
6. The producer is described as an independent contractor rather than an employee, partner or joint venturer with the contractor.
7. The producer retains ownership to the product, and bears all the risk, until the product is delivered to the contractor under terms of the agreement.
8. The agreement specifies enforceability terms for non-compliance with contract terms, typically only for producer non-compliance.

With marketing contracts, the parties share much more management control and risks than do more traditional marketing tools. As a result, failure to understand contract provisions could place one of the parties in a perilous financial situation. Every person who is considering a contract agreement should know and understand each element of the contract before signing. If the language contains too much “legalese” for the producer, it is advisable to consult with a trusted third party who understands and can explain such language. Above all, it is in the interests of both parties to have everything clarified in writing, and to use common sense when considering a contract arrangement of any kind.

Characteristics of both production and marketing contracts include obligation disclaimers. From the perspective of the contractor, such disclaimers are deemed necessary as a risk management mechanism used to place a ceiling on potential risk of unforeseen market events. Such clauses are usually a function of the contractor’s perspective of and ability to handle business risk exposure.

While many contracts are offered on a take-it-or-leave-it basis, amendment of contract terms is always possible if both parties agree. If changes are negotiated, the written contract should be modified and the modifications themselves signed by the company representative. Oral assurances are harder to prove if disputes occur later. Most contracts specifically provide that only terms in writing are enforceable. To be effective in developing a mutually beneficial business relationship, contract negotiators should practice “Principled Negotiation.” Everything is always negotiable. The following table from Fisher and Ury’s *Getting to Yes* provides an excellent resource for finding a win/win situation in any negotiated environment.

**Hard / Soft vs. Principled Negotiation**<sup>1</sup>

<b>PROBLEM:</b>		<b>SOLUTION:</b>
Positional Bargaining: Which Game should you Play?		Change the Game – Negotiate on the Merits.
<b>Soft</b>	<b>Hard</b>	<b>Principled</b>
Participants are <u>Friends</u> . The goal is <i>Agreement</i> .	Participants are <u>Adversaries</u> . The goal is <i>Victory</i> .	<b>Participants are <u>problem-solvers</u>. The goal is <i>wise outcome reached efficiently and amicably</i>.</b>
Make concessions to cultivate the relationship.	Demand concessions as a condition of the relationship.	<b>Separate the people from the problem.</b>
Be soft on the people and the problem.	Be hard on the problem and the people.	<b>Be soft on the people and hard on the problem.</b>
Trust others.	Distrust others.	<b>Proceed independently of trust.</b>
Change your position easily.	Dig into your position.	<b>Focus on interests, not positions.</b>
Make offers.	Make threats.	<b>Explore interests.</b>
Disclose your bottom line.	Mislead as to your bottom line.	<b>Avoid having a bottom line.</b>
Accept one-sided losses to reach agreement.	Demand one-sided gains as the price of agreement.	<b>Invent options for mutual gain.</b>
Search for the single answer: the one <i>they</i> will accept.	Search for the single answer: the one <i>you</i> will accept.	<b>Develop multiple options to choose from: decide later.</b>
Insist on agreement.	Insist on your position.	<b>Insist on using objective criteria.</b>
Try to avoid a contest of the will.	Try to win a contest of the will.	<b>Try to reach a result based on standards independent of will.</b>
Yield to pressure.	Apply pressure.	<b>Reason and be open to reason; yield to principle, not pressure.</b>

<sup>1</sup> Fisher, Roger and William Ury. *Getting to Yes*, New York: Penguin, 1991 2<sup>nd</sup> edition, p. 13.

## **WHAT IS A PEANUT MARKETING CONTRACT?**

A peanut marketing contract is a legal agreement (written or oral) under which a peanut producer agrees to deliver a defined quantity and quality of peanuts to a peanut contractor, usually a sheller or processor. Terms of the contract will most likely include delivery and storage specifications, pricing and compensation terms, and contractor obligation disclaimers.

The general provisions state that the producer promises to deliver a quantity of Segregation I Farmer Stock peanuts with no freeze damage at a time and place specified in the contract. In return, the producer receives payments according to the contract terms. The contract may require that peanuts be placed under the USDA Marketing Assistance Loan Program, and may indicate how any gains/losses from such payments are to be divided.

Some peanut contracts are “marketing option contracts.” The producer, in return for some compensation, grants the contractor an exclusive option to purchase a quantity of peanuts. With such an option contract, the contractor is not promising to purchase the peanuts, but is buying the right to purchase the product under terms of the contract. If not exercised, when the contract expires or is otherwise terminated by consent of the parties, then the producer retains ownership of the peanuts. Timing of ownership transfer is very carefully spelled out in the contract.

Other types of peanut marketing agreements have to do with peanut production not covered by contracts with a sheller or processor. These contracts provide further marketing services for the producer. A producer may become a member of a Cooperative Marketing Association (CMA), and in so doing agree to all rules and regulations governing such a body. The producer gives the CMA the exclusive right to market delivered peanuts. The CMA typically has a marketing manager that manages storage and marketing of the peanuts. This type of contract is similar to pre-2002 agreements

between regional marketing associations and producers to cooperatively sell “additional” peanuts not covered by a peanut marketing contract between a producer and a contractor.

In a CMA, the producer agrees:

1. **to give title** to the peanuts to the CMA when delivered;
2. **to deliver** peanuts when the CMA makes agreements to sell peanuts that the producer is storing on the farm;
3. **to give authority** to the CMA to obtain loans, to pledge, and to give liens on any peanuts delivered to the Commodity Credit Corporation (CCC) as security for any amounts loaned by CCC to the CMA;
4. **to give the sole right** to the CMA to redeem any peanuts held as collateral by the CCC;
5. **to not hold** the CMA liable for payments of any amount in excess of the government loan value until the peanuts are sold and patronage dividends (if any) have been determined and officially declared;
6. **to give the right** to the CMA to forfeit on the USDA marketing assistance loan covering the peanuts;
7. upon any notification of payments by the CMA, **to include such payments** on his/her taxable income for the year in which a notice is received;
8. **to give the right** to pursue damages for any breach of the contract by the producer; and
9. **to pay** court costs for any legal action the CMA may bring against the producer for breach of contract.

In return, the CMA will:

1. **make an advance** to the producer based on the marketing assistance loan value applicable on the date of the transfer less any fees determined by a Board of Directors and/or and fees charged by FSA to make the marketing assistance loan;
2. **provide marketing options** with respect to handling of the peanuts;
3. **provide and account to producers** for the proceeds from the sale of peanuts; and

4. **return any proceeds** including marketing gains to the producer upon completion of pool sales of peanuts.

## WHAT SHOULD be CONSIDERED BEFORE SIGNING a CONTRACT?

The decision to grow peanuts under contract is ultimately up to the producer. As with every business decision to produce or provide a service in exchange for compensation, all pertinent issues should be considered. Contract relationships should be approached with common sense and with a principled basis for decision making. **Before consideration of any marketing alternative, the producer's accurate knowledge of his/her cost of production is fundamental.** Such information can then be compared with the compensation offered by the contract. If production must be optimal in order to be profitable, then all options should be considered before committing resources under the contract.

The variable costs of producing a 3,200 pound yield of peanuts in Virginia are estimated to be approximately \$520 per acre in 2004. If fixed costs are considered as well, total costs per acre **with no return on investment** are approximately \$640 per acre. At this yield and cost of production, the producer will have to average \$400 per ton in gross returns in order to break even on the direct costs of production. Additional returns would be necessary to generate reinvestment capital and to permit continued economic viability.

Other risk management factors that should be taken into consideration before agreeing to any marketing contractual relationship are: 1) Cash flow requirements, 2) Profitability of alternative opportunities, 3) Crop and revenue insurance risk management tools, and 4) Indebtedness and access to capital.

Producers should remember these tips when considering a contract:

1. *Know* your cost of production
2. *Carefully examine* all alternative income opportunities.
3. *Consult* an expert.
4. *Negotiate* in a principled manner.
5. *Remember* that unless otherwise negotiated, contract terms are usually written to protect the author of the contract.
6. *Read and understand* all contract provisions before signing.
7. *Look* for vaguely defined fees and costs.
8. *Ask* questions and demand clearly stated answers if you don't understand a term.
9. *Be certain* that all verbal promises are written in the contract.
10. *Know* that contract compliance is required by law. Unless stated in the contract, unforeseen circumstances do not release the producer from his/her obligations and liability for penalties for noncompliance. Such penalties may be severe.
11. *Keep* good records of your *contract* performance.
12. *Maintain* good communication channels with the contractor to resolve uncertainty and prevent misunderstandings.

Remember, contracts are about relationships. As in all business relationships, those that remain fair and principled throughout usually result in good outcomes. Contractual relationships that are forced, unfair, or exist in a veil of mistrust and coercion often end badly. Both parties should use any contractual relationship to their advantage in developing win/win situations. This is the only way to foster long-term business environments that are profitable and mutually beneficial.

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