

THE ECONOMIC PERSPECTIVE OF THE UNIDROIT'S LEGAL GUIDE ON CONTRACT FARMING

Considerations from a demand for best practice standards in Contract Farming

KEYWORDS: Contract Farming; Unidroit; Law and Economics

1. INTRODUCTION: The main subject of this article is the Contract Farming, which is one of the alternatives of vertical coordination of the legal and economic relations in the agricultural sector. In a prima facie analysis, shall be noted that the Contract Farming is a continually evolving mechanism. In the international panorama – shaped by the globalization of the last decades – applications of Contract Farming have shown that the terms of the contract are shaped to match their own unique conditions and have varied from product to product, and that the experiences of each country differ from others.

2. RESEARCH PROBLEM AND OBJECTIVES: This article objective is to propose an analysis of the Guide based on law and economics fundamentals with the intention – or the criticism– to demonstrate that the application of the Guide incurs, preliminarily, in direct economic benefits such as reduction of specially the Transaction Costs Economics Economics and Informational Economic.

3. THEORETICAL APPROACH: To comply with the scope proposed in this article, it is necessary to observe some key relevant theoretical premises such as: (i) The UNIDROIT/FAO/IFAD Legal Guide on Contract Farming; (ii) The nature of Contract Farming; (iii) Benefits and Risks of Contract Farming; (iv) The applicable Private Law regime; and (v) The Law and Economics Approach, specially the Transaction Costs Economics and Informational Economic.

4. METHODOLOGY: The qualitative methodology will be used to analyze the texts that deal with the legal nature of Contract Farming and any practical issues that may arise from private relations. In the same methodological framework, the Guide will be analyzed. However, the Guide (as well as the consequent law and economics fundamentals to be presented) will be analyzed in an expository and critical way throughout the article, since most of the academic contribution of this article is to propose an economic analysis - albeit embryonic - about the Guide.

5. RESULTS ANALYSIS AND CONCLUSION: The nature of Contract Farming, concomitant with the content and notions exposed by the Guide, can be substantially understood as the system, involves an exchange of goods, services and finance, and aims at higher efficiency through better coordination, lower costs and chain alignment. In the economical point of view, the contracting parties, in the context of the application of the Guide under the vertical coordinated chain, will have a series of economic benefits as the reduction of Transaction Costs Economics and Informational Economic.

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1. INTRODUCTION

The agricultural sector involves a range of economics activities changing from farm input procurement to consumption. In general, the vertical coordinations between these activities change from open market transactions to vertical integration, resulting in controlled impersonal vertical coordination mechanisms such as organizing cooperatives, short and long-term contractual relationships, and ownership integration in the advanced and (agricultural) industrialized systems.

The main subject of this article is the Contract Farming, which is one of the alternatives of vertical coordination of the legal and economic relations in the agricultural sector. In a *prima facie analysis*, shall be noted that the Contract Farming is a continually evolving mechanism. In the international panorama – shaped by the globalization of the last decades – applications of Contract Farming have shown that the terms of the contract are shaped to match their own unique conditions and have varied from product to product, and that the experiences of each country differ from others.

The product characteristics – and the regional differences – have to be considered in all the process of analysis and evaluation. Basically, product characteristics of the agricultural commodities are the main determinants of the form of vertical coordination. While some products are handled in a fully coordinated contract system, some products such as grain are still subject to market transactions.

Considering the international nature of the Contract Farming institute (and also the necessity of observing the product characteristics and its application between the regional differences) the UNIDROIT/FAO/IFAD Legal Guide on Contract Farming (“Guide”) is addressed to promote better practices, under the Contract Farming relationship, based on a private international soft law form.

The Guide provides advice and guidance, from negotiation to conclusion, including performance and possible breach or termination of the contract. In the practical point of view, the Guide works by describing some sort of “*common structure*“ of the contract terms in the Contract Farming relation. Besides the discussion of legal issues that may arise under various practical situations, the Guide can be a helpful – or even a necessary – tool to coordinate the

international vertical relations that may arise from all the agricultural chain of production with clarity, security and foreseeability through the private relationships. In this context, the scope of this article is not only to appoint the legal nature of the Contract Farming, but also to suggest some concepts – or simply ideas – related to the economic effects of the application of the Guide in practical situations.

2. RESEARCH PROBLEM AND OBJECTIVES

First, the premise that legal and economic relations in agriculture undergoes constant evolution in a highly technological and globalized context should be noted. Naturally, legal instruments cannot (and even cannot) keep up with this evolution. In addition to the temporal mismatch between private relations and the legal instrument, it is absolutely necessary to emphasize that the internationalization of agriculture is a dominant factor in this scenario.

Thus, with the diversity and complexity of private relationships that can arise in the context of the vertical coordination of modern agriculture, the Contract Farming regime consequently becomes diverse and complex. Although, at first glance, this statement seems to be some kind of "*legal pleonasm*", it should be noted that, by definition, Contract Farming is intended to enable the coordination of vertical transactions in an organized manner, behaving as an essential mechanism for evolution in the agricultural chain in the aforementioned context.

However, despite the fact that Contract Farming is a contractual mechanism of vertical coordination widely known in the practice of international agriculture, it is noted that there is no pattern whatsoever in this contractual structure. The main problem that shall be confronted along the chapters of this article is based by the fact that there is no set of common denominators or standards that establish a notion of the best practices of Contract Farming.

In the described panorama, the Guide appears as a useful tool for offering a general standard of contractual structure based on the private sense in contractual relations, confronting the problem addressed in this article on its very nature. Thus, the purpose of this article is to stimulate a debate based on an analysis that is not only linked to the literality of the provisions of the Guide, nor to the pragmatism of the traditional (and non-internationalized) Contract Farming regime, but also an analysis through fundamentals of law and economics in the sense of encouraging the adoption of a contractual structure standard in the international practice of Contract Farming.

In most accurate words, this article objective is to propose an analysis of the Guide based on law and economics fundamentals with the intention – or the criticism– to demonstrate

that the application of the Guide incurs, preliminarily, in direct economic benefits such as reduction of negative economic phenomenon's such as Transaction Costs Economics and Informational Economic.

3. THEORETICAL APPROACH

To comply with the scope proposed in this article, it is necessary to observe some the theoretical premises. Such as theoretical premises are provided in the chapters below in a merely expository manner, and, under no feasible hypothesis, the themes exposed below are enough to suppress the possibilities and appease the potential conflicts in the vertical relationships to be coordinated by Contract Farming.

3.1. The UNIDROIT/FAO/IFAD Legal Guide on Contract Farming

Foremost, before the theoretical approach of the premises regarding Contract Farming and the law and economics fundamentals, it seems necessary to highlight some guidelines about the Guide. Thus, the nature of Contract Farming shall be demonstrated under the conceptual guidelines of the Guide. Since the concept of Contract Farming can be very broad, the Guide does not intend to cover all possible agricultural contracts nor all of the contract varieties that could join under the umbrella of contract farming (GABRIEL, 2018, pp. 270-281).

The Guide has the scope focused essentially on the bilateral relationship between producer and buyer. Certain characteristic features distinguish the agricultural production contract from other contract structures or types which may already be known and well defined under domestic settings. One of the most important advantages of the Guide is that it does not interfere with mandatory domestic rules; nor does it intend to provide a model for, or encourage the adoption of, special legislation. The Guide simply has the goal to identify problems on agricultural matters and highlights possible workable and fair solutions based on the best practices in the private law applicated.

Under the Guide, the Contract Farming may be seen under an economic approach as describing a supply chain management system which potentially includes several stages, from production through processing and marketing to final consumption. Contract farming, as a system, involves an exchange of goods, services and finance, and aims at higher efficiency through better coordination, lower costs and chain alignment.

Besides its expressive and long-term objectives, the Guide also deals with a wide range of agricultural production contracts, from straightforward transactions between a buyer and an individual producer or group of producers to more complex transactions with direct or indirect involvement of third parties, such as government agencies, development aid and certification schemes. The Guide works focused on the private bilateral relationship between the agricultural producer and the buyer seeking to obtain a designated product, based on an “agricultural production contract”. Under such a contract, the producer undertakes to produce and deliver agricultural commodities in accordance with the buyer’s specifications.

3.2. The nature of Contract Farming

The Contract Farming is commonly related with recent transformations in agricultural systems which make it increasingly difficult to meet consumer demands under more traditional, open market-based procurement strategies (EATON; SHEPHERD, 2001, pp. 12-34). It’s must be noted that demographic changes and rising living standards have been substantially linked to the increased demand for food quantities. Such increase in demand has led to scientific and technological developments, which in turn have significantly contributed to changes in market demand, the operation of supply chains and the production of raw commodities (GLOVER; KUSTERER, 2016, pp. 127-155).

In this social and economic context, the use of Contract Farming is expanding in developing countries, opening relevant opportunities for development by providing local producers with access to markets and support in the form of technology transfer and credit facilities.

Contract Farming is a potential tool to reduce poverty, contribute to rural development and employment, and increase food security. In emerging and developing countries, certain market features there may reflect some of the most advanced models of contract farming present in industrialized countries. These features sometimes coexist with traditional forms of production involving small producers. On the other hand, the use of Contract Farming has intensified following agricultural industrialization in the second half of the twentieth century all over the advanced economies (UNIDROIT; FAO; IFAD, 2015, p. 2)

In economic terms, Contract Farming generally refers to “*a particular form of supply chain governance adopted by firms to secure access to agricultural products, raw materials and supplies meeting desired quality, quantity, location and timing specifications*”.

(UNIDROIT Working Group for the preparation of a Legal Guide on Contract Farming First Meeting, Rome, 28 – 31 January 2013).

In the ideal structure of Contract Farming, the specifications can be more or less detailed, covering provisions regarding production technology, price discovery, risk sharing and other product and transaction attributes. With such nature, Contract Farming shall be understood as an intermediate mode of coordination, whereby the conditions of exchange are specifically set among transaction partners by some form of legally enforceable, binding agreement.

Accessibly adapting the concept of Contract Farming to the reality of international practice, the Guide's concept of Contract Farming is built on the coordination between the different parts of a supply chain, involving various participants and contract modalities. However, in legal terms, Contract Farming is different from direct sales between producers and buyers through open market spot transactions where the product is delivered immediately against a price (UNIDROIT; FAO; IFAD, 2015, pp. 2-15).

In fact, the common practice provides that Contract Farming relies on agreements that are made either during production or, more often, before it begins, thus providing certainty for the future delivery and supply of the product. For example, should be noted the successful case of the Brazilian agricultural market, where economic transactions occur in the pre-contractual phase.

Contract Farming is mechanism that have developed to meet the changing needs of the economic environment. To illustrate such structure, Erkan Rehber (REHBER, 2007, p. 130) defines the Contract Farming mechanism through the following chart:

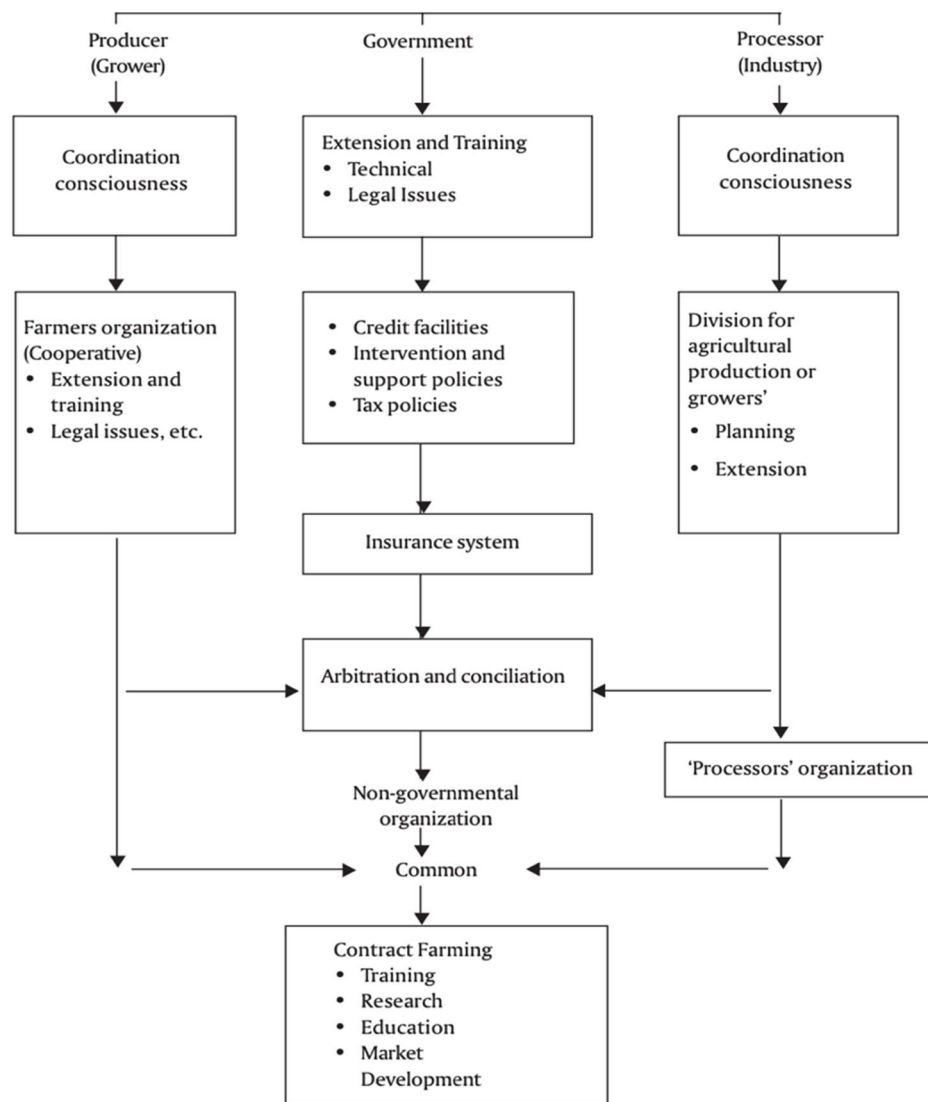


Figure 1: Rehber, E. (2007). Contract farming: Theory and practice (No. 1114-2017-1691) p.130.

Without necessarily opposing the organizational chart model proposed by Rehber, the Guide held a model of agricultural production based on an agreement between a producer and another party – typically an agribusiness company. Under this agreement (agricultural production contract), the producer undertakes to produce and deliver agricultural commodities in accordance with the buyer specifications. The buyer, by its turn, undertakes to acquire the product for a price and generally has some degree of involvement in production activities through, for example, the supply of inputs and provision of technical advice (REHBER, 2007, p. 131).

With the structure addressed by the Guide, the adoption of a specific rules for Contract Farming shall provide a useful – and even better in terms of efficiency – framework for the formation and execution of contracts and, subsequently, for their application by the local and

international courts, arbitrators and the parties (WATANABE; ZYLBERSZTAJN, 2014, pp. 459-478). In general, the Guide does not interfere with mandatory domestic standards, nor is it intended to provide a model or encourage the adoption of special legislation.

Through a structural analysis of the Guide, it is possible to identify an extremely pleasant similarity with well-known figures in the international trade in agricultural commodities, such as the Unidroit Principles of International Commercial Contracts and the United Nations Convention on Contracts for the International Sale of Goods (CISG). However, the nature of Contract Farming, under the scope defined by this article is not to revisit traditional legal instruments in international trade in agricultural commodities, such as "risk allocation", "force majeure", "hardship clauses" or "change of circumstances", nor to discuss the appropriate remedies to breach of contract. These traditional legal instruments are well represented in the Guide and matured by the practice of domestic and arbitral courts.

What is proposed under the scope proposed by this article is some sort of modern concept of Contract Farming which can be analyzed as a mechanism of vertical coordination substantially related to the idea of agribusiness as a nexus of contracts in the agricultural chain. Because of its very nature, the concept of Contract Farming proposed by the Guide imply into a series of economic benefits to the parties, among them; (i) the reduction of Transaction Costs Economics, since the relations between producers and potential buyers must become more clear and prosperous as a result of the adherence of an international soft law in accordance with the domestic rules of each contract party; (ii) the reduction of Informational Economic, since both parties have access to the most relevant information that regulates the contract; (iii) the allocation of risks since the Guide's clear provisions are helpful to coordinate agricultural transactions in order to allowing the producer and the buyer to allocate resources to other tasks.

3.3. Benefits and Risks of Contract Farming

As duly addressed by the Guide, Contract Farming is generally recognized for its potential to sustain and develop the production sector by contributing to capital formation, technology transfer, increased agricultural production and yields, economic and social development and environmental sustainability. The consumers, as well as all participants in the supply chain, may also draw substantial benefits from varied and stable sources of raw material supply, and efficient processing and marketing systems (GABRIEL, 2018, pp. 270-281).

However, Contract Farming may also involve risks and have adverse effects. Improper use of the credit provided by the buyer might lead to unsustainable levels of indebtedness for

the producer. In the international perspective, labor issues are also likely to have sensitive implications, especially when the local regulatory framework is weak and does not provide adequate protection to the producer or the community. Also, switching from subsistence farming to cash crops might cause problems related to monoculture production such as loss of biodiversity and even a threat to the producer's own food security. (UNIDROIT; FAO; IFAD, 2015, pp. 6-8)

In matter of risks and disadvantages, shall be noted that judicial dispute resolution is rarely used in the contract farming context in developing countries as disputes often relate to factual issues arising from lasting relationships that involve relatively low financial amounts. On this basis, obtaining redress from a judge is generally very lengthy, can be costly, and thus is often avoided by parties. (UNIDROIT; FAO; IFAD, 2015, p. 11)

3.4. The applicable private law regime

Among the consequences of the risks to Contract Farming, the risk of eventual judicialization stands out, as well the risks related to the applicable law in the worst-case scenario. In general, most agricultural production contracts establish purely domestic legal relationships, meaning that all contractual elements are located in or produce effects in a single country (UNIDROIT; FAO; IFAD, 2015, pp. 17-20).

Typically, agricultural production contracts have strong ties to the producer's country of domicile or residence. The producer may be a national of that country, and the essential obligation under the contract, namely producing the designated commodity, takes place on the land or installations owned or controlled by the producer. Several other elements forming part of, or related to, the contract is likely to take place in or be linked to that country. This applies, for example, to the contractor's place of incorporation or registration. Based on the strictly domestic character of the contract, the rules of the producer's domestic legal system will usually apply, including both mandatory and default provisions. This will be true not only when the parties have expressly referred to the domestic law, but also – as is most often the case – when the contract is silent in this regard.

It must be noted that there would normally be no advantage for the parties to choose or seek the application of a foreign law to regulate their contract, and in some jurisdictions, they would not even be authorized to do so. The choice of the domestic legal system, by express provision or by default, may generally foster the parties' access to justice and procedural

protection, both during dispute resolution procedures and at the enforcement stage (UNIDROIT; FAO; IFAD, 2015, pp. 20-22).

The domestic legal system is also likely to apply to most legal situations involving parties other than the producer and the contractor. This includes parties participating in production contract performance based on the same agreement, or under separate contracts. The domestic legal system is also likely to apply to agreements for the provision of credit, inputs or services. Furthermore, third parties may potentially have a liability claim against the buyer or the producer as a result of the agricultural production contract's performance.

3.5. Law and Economics Fundamentals: Contract Farming as coordination instrument and the Coase's concept of nexus-of-contracts

The agricultural sector – as its vertical coordinated chains – is formed by economics activities exploited with the risks and expectations of producers and buyers even before becoming an organized production chain. In order to evolve an economic activity into an *organized production chain*, an infinity of managerial, legal and economic factors is necessary.

Therefore, it is appropriate to highlight on of the main factor in the evolution of agribusiness: Contracts. In general, contracts are used to organize – and also do coordinate – the economic activity in order to mitigate the risks and enabling the expectations of the parties and even generating new business in the sector. Given the legal and economic importance of contracts – and specially Contract Farming – in agricultural relations, it is worth mentioning Ronald Coase's analysis (COASE, 1937, pp. 386-405) seem extremely pertinent in the idea that the (agricultural) company – or producer – is also a *nexus-of-contracts*. Although the agricultural activity is not a necessary synonymous of commercial activity, it is feasible to understand agricultural activity as substantial economic activity under the concept of the *nexus-of-contracts* as well, especially with the purpose to fulfill the organization of production chains and the *social function* determined by public interest over the agricultural activity (BRATTON JR, 1989, pp. 407 -408).

In addition to the perception of the *nexus-of-contracts*, other scholars also contribute by defining the contract as a way of coordinating transactions (O'KELLY, 2001, p.1247) and all relationships that create interdependent links between two or more subjects (FORGIONI, 2019, pp. 24-28). Without the proper coordination of agricultural transactions, there is no way to continue global-scale agricultural production.

3.5.1. Law and Economics Fundamentals: general considerations of the Contract Farming application in the international scale

In some sort of pragmatical observation, the fundamentals of law and economics primarily proposed in this article have the substantial intention to encouraging the adoption of general contractual structure standard in the international practice of Contract Farming.

The proposal – which can be also conclude in the structural interpretation of the Guide – is that an analysis of the Guide based on law and economics fundamentals provides that the Guide incurs, preliminarily, in direct economic benefits such as reduction of negative economic phenomenon's such as Transaction Costs Economics, since the parties are aware of the "*rules of the game*", as the Guide is an easily accessible international soft law and is essentially designed to contribute to the clarity and consistency of economic relations and not interfere with domestic legal relations. In this way, especially in an internationalized context, the Guide is a reducer of Transaction Costs Economics, since the negotiation between producer and buyer is facilitated through the general terms of the practice of international agriculture (COOTER; ULEN, 1988, pp. 28-72).

In the same perspective, any Informational Economics within the verticalized contractual context can also be pulverized with the fulcrum in the adoption of the practices foreseen by the Guide. In addition to the ease in negotiating contracts, which incurs in the reduction of Transaction Costs Economics, the Guide also makes it easier for the producer and the buyer to have more access to information on the chain based on a standard of treatment, and also through mitigation mechanisms of risks mentioned above (RUBINFIELD, 1987, pp. 375-394)

4. METHODOLOGY

To honor the scope of this article, the qualitative methodology will be used to analyze the texts that deal with the legal nature of Contract Farming and any practical issues that may arise from private relations. In the same methodological framework, the Guide will be analyzed. However, the Guide (as well as the consequent law and economics fundamentals to be presented) will be analyzed in an expository and critical way throughout the article, since most of the academic contribution of this article is to propose an economic analysis - albeit embryonic - about the Guide.

In addition to the scientific methodology indicated in this chapter, it should be noted that this article did not intend to address an empirical case study. For the purposes of the proposed analysis, it should be noted that the criticism is part of the Guide's exposition together with an accurate bibliographical review.

5. RESULTS ANALYSIS AND CONCLUSION

With the exposition of the theoretical premises regarding the Guide, it is concluded that The Guide has the scope focused essentially on the bilateral relationship between producer and buyer and one of the most important advantages of the Guide is that it does not interfere with mandatory domestic rules; nor does it intend to provide a model for, or encourage the adoption of, special legislation. Under the Guide, the Contract Farming may be seen under an economic approach as describing a supply chain management system which potentially includes several stages.

The nature of Contract Farming, concomitant with the content and notions exposed by the Guide, can be substantially understood as the system, involves an exchange of goods, services and finance, and aims at higher efficiency through better coordination, lower costs and chain alignment. The Contract Farming is a particular form of supply chain governance adopted by firms to secure access to agricultural products, raw materials and supplies meeting desired quality, quantity, location and timing specifications.

Even considering the benefits, risks and the applicable legislation regime, an analysis of the economic rationality of the Guide incurs, preliminarily, in the reduction of Transaction Costs Economics and the reduction of Informational Economic.

Considering that agribusiness can be understood economically as a *nexus-of-contracts*, there is a great demand for efficient legal mechanism. In this sense, the proposal of this article was in order to apply Guide's soft law to Contract Farming matters, with provisions similar to those used in the practice of international trade. For that, there is the Guide.

In the economical point of view, the contracting parties, in the context of the application of the Guide under the vertical coordinated chain, will have a series of economic benefits as (i) the reduction of Transaction Costs Economics, (ii) the reduction of Informational Economics, and the (iii) increase in the quality of the substantive content of the contracts, allowing the producer and buyer to allocate resources for other tasks.

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