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Agricultural Contract Clauses for Supplying Energy Crops to the Biofuels Industry: Part II

As important as technology advancement and biorefinery business formation are to the future of the biofuels industry, success is also wholly dependent on enormous quantities of biomass being produced by America's farmers. The purpose of this article is to further thinking and discussion on the essential terms of biomass supply arrangements among all parties – farmers, biorefinery owners, seed suppliers, feedstock supply companies, bankers, lawyers and public officials. Many interests must be balanced:

- Contracts for energy crop supply must be competitive and fair to farmers in the short- and long-term to attract the required quantities and quality of switchgrass, miscanthus, sorghum, agricultural residues and other energy crops.
- Biomass conversion facilities are dependent on reliable and uniform feedstock, and supply arrangements

must address those requirements over the life of the facility.

- Bankers and investors providing biomass conversion project financing demand assurance of feedstock supply for the life of the project, and agricultural contract arrangements must provide confidence in the availability of feedstock for the long-term.
- Mother Nature dictates requirements and introduces uncontrollable variables into all parties' contract expectations. Supply contracts will fail unless they: take account of drought, storm or other acts of God; are adapted to realistic agricultural, capital and labor input cycles, as well as requirements for planting, cultivating and harvesting; and fit the particulars of the specified crop.¹

Traditional agricultural contracts include agreements between farmers and those that purchase or market the farmers' crops, agreements between

producers and suppliers, and agreements concerning land use. Two common forms of agricultural contracts, elements of each, common contractual clauses, and state statute considerations are summarized below.

Cooperative Marketing Contracts

Agricultural cooperatives are a method by which farmers and purchasers work together to accomplish their respective goals. To meet these goals, a cooperative may enter into marketing contracts requiring its member-farmers to sell a specified portion of the member's crop or a specified crop produced from identified acreage exclusively to the cooperative. Marketing contracts under a cooperative structure may, in some cases, be limited in duration by state statute. For example, Tennessee mandates that marketing contracts under a cooperative structure may not exceed ten year terms.²

Under a cooperative marketing contract, the member retains title to the crop until delivery, at which point title passes to the cooperative.³ Therefore, the member has control of production decisions and assumes production-

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related risks. The cooperative may see this lack of control as a disadvantage; however, the contract between the member and the cooperative may alleviate some of the cooperative's concern by specifying the quality of crop that will be accepted by the cooperative under the agreement.

Successful performance of marketing contracts is the "life-blood" of a cooperative.⁴ Because of the dependent relationship between members and cooperatives, courts are more willing to order specific performance in the event of breach by a member, even when there are ascertainable money damages or the contract contains a liquidated damages clause.⁵ The courts reason that the breach by one member undoubtedly affects all members, including the members' ability to carry on business, and the general credibility of the cooperative. The availability of specific performance is an advantage for a biomass supply contractor to a cellulosic ethanol plant because there is less concern that the steady stream of biomass feedstock will be hindered by a member's breach of his or her marketing contract.

Cooperatives may prove to be extremely valuable in biomass production because of the close relationship between the cooperative and its members, which in turn fosters a reliable source for a large quantity of biomass feedstock.

Leases of Farmland

The farmland lease is both a contract and a conveyance of an interest in real property.⁶ The tenant, as grantee of a leasehold estate, has the right of exclusive possession and control of the land for the term of the lease.⁷ There are two major categories of farmland leases: the crop share and the cash rent lease.

Under a crop share lease, the landlord receives a specified share of crop proceeds in return for providing the land and a share of input expenses.⁸ The

tenant provides labor, management and the remaining input costs.⁹ This type of lease gives the landlord an enhanced return if production or market value of the crop increases; however, the landlord also shares with the tenant the risk of crop failure and declining market prices. Provisions commonly found in crop share leases include: method of crop splits, responsibility for payment of input expenses, and responsibility for storage of the crop.¹¹ Because rent is paid by collecting a share of the crop proceeds, the landlord will typically perfect a security interest in the crop.¹² The tenant will be required, by the terms of the lease, to grant to the landlord a security interest in the crop, and the landlord will perfect its interest by filing a financing statement.

Under a cash rent lease, the landlord receives payment for use of the land. The landlord typically pays real estate taxes and for major repairs on the premises, but pays no portion of input costs. The tenant pays for all input costs, retains the entire harvested crop, and provides the labor and management. In this arrangement, the landlord has a fixed return and assumes no risk as to crop yield or market price fluctuation. The landlord does, however, carry the risk of non-payment as well as the risk that the tenant will use farming practices or grow a crop that damages the leased land. Cash rent leases, like crop share leases, usually require that the tenant grant the landlord a security interest in all crops to ensure payment of rent.

Clauses commonly found in both crop share and cash rent leases include: rights of entry after termination of the lease, land use obligations, upkeep of the leased property, type of crop permitted, actions of the tenant that require consent of the landlord and general maintenance duties.¹⁴

It is common for farmland leases to be year-to-year leases that automatically renew unless one party terminates the agreement as specified in the lease documents. However, with respect to biomass, the contractor supplying

feedstock to the biorefinery owner will likely want, or be required by the project owner, banker, or investor, to enter into relatively long-term leases. The character of biomass feedstock will often require leases for ten years or more in order to realize the full benefits of the crop. With this in mind, if the landowner is already leasing his or her farmland, the decision to grow biomass instead may be chiefly a financial one, based on the return offered by the contractor compared to available alternatives.

The discussion of appropriate terms to include when contracting for biomass is one that must be continued among farmers, feedstock suppliers, bankers and biomass conversion facility owners as the industry progresses, to eventually find a middle ground on which all parties can agree. **P**

1 For example, whether a particular crop is an annual or a perennial, or grows from a seed or a rhizome.

2 Tenn. Code Ann. § 43-16-133. Note that this statute does not specifically prohibit an auto-renew contract. In fact, in 2004, the "Tennessee Processing Cooperative Law" was enacted, which specifies that five-year auto-renew terms are permitted. Tenn. Code Ann. § 43-38-114.

3 Some state statutes may provide caveats to this general rule. For example, in Tennessee, "title to crops is transferred to the cooperative upon delivery unless the contract expressly provides for transfer at another time." Tenn. Code Ann. § 43-38-114.

4 Donald B. Peterson & Keith G. Meyer, *Agricultural Law in a Nutshell* 285 (1995).

5 *Id.*

6 Donald B. Peterson & Keith G. Meyer, *Agricultural Law in a Nutshell* 95 (1995).

7 *Id.* at 96.

8 The share of proceeds will likely depend on local custom and the landlord's total input contribution. Shares generally range from a quarter to a half of all crop proceeds.

9 Input costs refer to seed, fertilizer, chemicals, pesticides, fuel, machinery, and the like.

10 Peterson & Meyer, *supra* at 97.

11 *Id.* at 103.

12 A security interest will only be appropriate if the tenant retains title to the entire harvested crop until delivery to the landlord of its share.

13 Peterson & Meyer, *supra* at 103.

14 Certain crops are more invasive than others (e.g., switchgrass) and may require contracts to be more specific as to liability for damage to farmland and obligations of the tenant to return farmland to its original condition upon termination of the contract.