

Milk Purchase Agreement Guidance Notes



NFU/ NFU Scotland Approved Milk Contract Guidance Notes

Introduction

This document accompanies the NFU/ NFU Scotland approved milk contract. It provides an explanation of the aims and objectives of the contract and of the main clauses contained within it. **These notes are only intended to provide guidance on the NFU/NFU Scotland approved milk contract and not to be construed as contractual documents.**

Background

The approved milk purchase agreement (referred to as the Contract) has been developed by NFU and NFU Scotland to provide a template for an agreement that contains the terms and provisions that the 2 organisations believe should be contained in any given raw milk contract.

Since the NFU launched its 'Vision for the Dairy Industry' in 2005 there have been a number of positive developments in the types of contracts that are offered to milk producers. In particular, contracts have become much more closely tailored to end use. In spite of these developments, there remain some significant shortcomings in raw milk contracts, not least of which the lack of certainty with regard to the determination of milk prices.

Objectives

The purpose of the Contract is to:

1. Bring greater clarity and simplicity to raw milk contracts, both in the way they are structured and drafted.
2. Create a fairer balance in the rights and obligations that are established by a contract between the producer and the purchaser.
3. Be flexible. It is impossible to create a template that takes account of every single buying and selling situation in the industry. Therefore the Contract must be flexible and adaptable.
4. Help producers understand raw milk contracts and suggest ways in which they can be improved

Format

The Contract takes the form of a single document. Although this would not preclude separate supplementary or membership agreements, it suggests that the essential terms and conditions for milk purchasing can be accommodated in one document. The first part of the document includes the substantive and 'boilerplate' clauses of the contract. The second part consists of three Schedules which deal with pricing arrangements, sampling/ testing methods and milk quality requirements respectively.

The document covers the main aspects of the relationship inherent between the producer and purchaser as buyers and sellers. It does not reflect every market situation and is designed to allow additional clauses to be added into the Contract where necessary. In addition, a number of clauses contain provisions that have been left intentionally blank through the use of square brackets to allow the parties to enter provisions that suit their circumstances. Or, in some cases, a figure/ phrase has been inserted between square brackets to denote a suggestion.

This is a 'living document'. It is intended to spark debate about how contracts and relationships between buyers and sellers could operate. We hope that this debate will lead to a positive evolution in raw milk contracts and assist milk producers in scrutinizing the terms and conditions of the contracts that they sign.

As the Contract is intended to provoke debate and is designed to accommodate provisions relevant to different producers and purchasers, the NFU recommends that when using the Contract, producers take legal advice from their own professional advisers as to the suitability of the Contract for their own individual circumstances.



THE SUBSTANTIVE CLAUSES

The purchaser, producer and the farm

This section should clearly identify the purchaser and the producer who are the only parties to the Contract.

- For incorporated enterprises (companies, cooperatives and limited liability partnerships) it is recommended that the business name, registration number, place of incorporation and registered office be inserted;
- for sole traders it is recommended that the name and address of the individual be inserted;
- for partnerships it is recommended that the names and addresses of all partners (up to twenty), and the address of the business, are given.

Providing the full details of the purchaser makes it clear exactly who the producer is selling milk to. In addition, it allows the producer to obtain a credit check for any prospective purchaser if the producer believes that this is necessary or desirable. Credit searches will contain information from many sources and may include court judgments, although a satisfactory credit check is no guarantee that a purchaser will be able to pay in the future. It is good practice to obtain consent from the other party prior to obtaining credit checks from reputable credit rating services. This requirement to obtain consent to have a credit check carried out does not apply to searching the Companies House WebCheck service to confirm company details, and to obtain other records such as a company's latest accounts and annual returns.

The Contract also identifies the farm to which it applies. This requires the producer to fulfill their contractual obligations with milk produced on this particular farm, and it prevents the producer from buying in milk to supply to the purchaser. A producer with more than one farm would however be able to enter further contracts particular to those farms, or to include the other farms in the Contract by making reference to them.

Commencement, term and termination (clauses 2 and 5)

The Contract includes a choice of:

1. Clause 2A: The basic model which is of indefinite duration until terminated by notice (i.e. a so-called 'evergreen' contract), or;
2. Clause 2B: A rolling agreement (of, for example, one year) requiring the written notice to terminate.

The indefinite duration option (clause 2A) reflects usual current practice and is recommended for most producers as it will continue indefinitely until express action is taken to end the contractual relations. The rolling contract (clause 2B) will require written notice to terminate, which may be served, for example, within a period of 6 weeks before the end of the contract duration (e.g. one year). A further alternative might be a fixed term contract requiring the agreement of both parties to ensure an ongoing contractual relationship. The difficulty with this type of arrangement is that if this step (i.e. agreement to continue the contract) were accidentally missed, a producer could end up with the Contract automatically expiring and he could be left without a buyer for his milk.

Both Contract types are also subject to particular clauses to deal with variation, termination for breach, assignment and force majeure.

The ability to vary milk contracts at short notice, particularly in relation to price, composition and seasonality schedules, has become very controversial in recent years. Many contracts give the right to the purchaser to make adjustments to these and other aspects of the contract whilst the producer must continue to supply milk, usually for some time, as the notice periods to terminate can be lengthy. In part this issue arises from the long term business relationship between producer and purchaser - neither party wants to go into the market on a daily basis. However, the long notice provision acts together with the exclusivity clause to lock the producer in to a contract and the ease of the price variation provisions enable the purchasers to pass on the commercial risk inherent in their milk buying and processing operations through the chain to the producer.

The termination periods should be carefully negotiated with this end in mind, and this should dovetail with the restricted variation provisions to restore balance to the business relationship. In principle, while the Contract does not specify a standard or minimum notice period, the overwhelming opinion of those who have been involved in preparing the Contract is a desire to foster long-term, stable relationships and contracts.



Entire output of milk, exclusivity, and defined volume (clause 3)

The Contract contains two options for milk supply to the purchaser. Milk producers should consider the implications of these two alternatives very carefully.

1. 'Entire output' clause (3A). The usual milk contract at present requires the producer to sell his entire output of milk to the purchaser often with a narrow exemption for milk that is used or processed directly by the producer. This ties the producer to exclusively selling to one purchaser. This can restrict the development of new market opportunities and can, when coupled to certain payment schedules, prevent producers from seeking the best market outlet for milk that might be produced in excess of their profile. However, the usual exclusivity clause is balanced by the obligation on the purchaser to take all the milk produced by the producer. These currently allow milk producers to expand production without major impediment and ensure a high degree of flexibility where milk supply falls outside of forecast volumes/ profile for example.
2. 'Defined volume' clause (3B). A contract for a defined volume of milk would mean that the producer would be responsible for supplying a determined quantity of milk to a buyer. The producer and purchaser may arrange a separate agreement for the collection of any additional volumes but the producer could also sell milk produced outside of the defined volume to another purchaser.

The determined volume should be entered in Schedule 1 of the Agreement. This could be set annually or monthly and could be determined based on past production (in line with some existing profile schemes) or some other factor (such as forecast demand).

Because the purchaser is no longer obliged to take the entire output, the parties should also consider whether the agreed volume should be subject to a tolerance for short or excess supply as is usual in many other agricultural contracts for a defined quantity. The period of calculation of tolerance should also be considered – it might be based on each collection, but could include monthly cumulative volumes.

A weakness with a defined volume clause is that the purchaser is not obliged to take milk over the defined volume, something that is presently taken for granted. Secondly, in practice the ability of a producer to sell to more than one purchaser is limited by practical (collection costs or availability of another buyer) and commercial (allowing the same producer to supply a competitor) considerations.

At present the quantity of milk produced by the producer is regulated by the milk quota system. The administrative requirements of the quota regime encourage the use of exclusivity clauses in contracts. It is expected that the milk quota regime will end in 2015 and in anticipation of this, milk purchasers will increasingly seek to manage milk intake through contractual arrangements. The Contract is intended to work both within the present quota system, and after its repeal. The Contract currently contains a clause on quota, which means that if UK wholesale milk quota were exceeded, and the purchaser were required to pay superlevy, that the purchaser could recover the cost of this from producers who had exceeded their milk quota. This is in common with existing practice.

Variation (clause 6)

As it stands the Contract may only be varied with the consent of both parties. At first glance this is somewhat blunt for a Contract evidencing a business relationship which may last for many years. The intent of the Contract is to allow negotiated changes to take place whilst preventing unilateral and immediate changes in the exclusive discretion of the purchaser, whilst the producer is locked into supplying milk due to a long termination period.

Realistically, it is foreseeable that elements of a contract based on the NFU/NFUS Milk Contract will require variation to reflect changes in market circumstances or legal requirements. The purpose of this clause is to allow variation with agreement, and to make sure that the purchaser is unable to vary the terms of the contract at its discretion as is usual in many current milk supply contracts.

The Contract provides a strict timetable for conducting negotiations to vary the Schedules of the Contract. If agreement to a variation of the Schedules cannot be reached during a given period (suggested 8 weeks), then either party can terminate the Contract with immediate effect.

So, the terms of the Contract can only be changed by a written agreement signed by both parties. As for the Schedules, these can also only be changed by written agreement, but if a proposal to change the Schedules is put forward and the parties cannot reach agreement, then either party can terminate the Contract after a limited period of time (e.g. 8 weeks). With this procedure it is easier to change the Schedules than the main contract, but the use of this procedure is inherently very risky.



The intention with this clause is to drive the parties to negotiate variations to the agreement responsibly, with the risk of the Contract being terminated if a variation to the Schedules cannot be agreed. Producers should be aware that if the purchaser proposes a variation to the Schedules which is not agreed, the Contract could be terminated.

There is also a risk that an unreasonable party could use the clause to trigger termination of the Contract (by proposing an unreasonable variation to the Schedules), therefore, were this type of clause to be used in raw milk contracts, consideration would need to be given as to how any proposal to vary the Schedules could be limited to those that could be deemed reasonable.

There are substantial practical difficulties in milk producers individually seeking or negotiating a variation to a contract (e.g. to seek a higher milk price). To make best use of this fulcrum in negotiations, producers will in most circumstances find it advantageous to develop a representative group to facilitate the necessary negotiations. The Contract does not prescribe how a representative group should be formed; to do this would be exceedingly complex and is beyond the scope of this agreement. But it is designed to be compatible with the use and formation of Representative Groups that may be empowered to make deals with the purchaser, which bind the producer members of the representative group. A simple representative group should be able to propose variations on behalf of its members or consider variations proposed by purchasers.

It should be pointed out at this stage that the creation of a representative group and the concept of negotiation on the Contract is much less applicable where the purchaser is owned by the producers supplying it (as in the context of a milk co-operative). In the case of a milk co-op, the democratic structure of the company should already provide for the election of member councils and a board that are responsible for taking decisions on behalf of the members in respect of milk pricing issues and so on.

The whole point of the Contract however is to be flexible and to suggest the types of provisions that could be contained in raw milk supply contracts where they are deemed applicable.

Price and payment (Schedule 1 and clause 4)

This Contract is designed to require both parties' agreement to a variation of Schedule 1 (milk price) – neither party can unilaterally vary this Schedule without the other party's agreement. On the other hand, the reality is that the price of raw milk will need to change from time to time to reflect changing market conditions.

The Contract leaves it open for the parties to negotiate how the price should be specified and it is inherently recognised that the formulation of the milk price will vary with different purchasers. The important principle is that the price is fixed in the Contract and may only be changed by agreed variation. In this way, the price formulation is legally defined and certain.

The formulation could be by way of a fixed base price with bonuses for additional standards, or through an automatic price formula. The advantage of the latter is that as well as ensuring a high degree of price transparency, it would allow milk prices to adjust automatically according to the relevant market conditions and avoid frequent recourse to a variation process. The formula could be based on input costs, a market index, or combination of factors. Familiar price indexes in the dairy sector include Actual Milk Price Equivalent (AMPE), and the MDC Milk for Cheese Value Equivalent (MCVE). Other indexes include the Retail Price Index (RPI), Consumer Price Index (CPI), and for labour costs the National Minimum Wage (NMW) and the Agricultural Wages Orders (AWOs).

The difficulty with the use of a tracking formula is the break with recent commercial practices it represents. It is currently usual for purchasers to vary the price as they see fit. As such, a certain price formula requiring both parties' consent may represent a loss of flexibility and negotiating power for purchasers. On the other hand, this measure would go partway to restoring normal market conditions and provide producers with the confidence to build stable business relationships with purchasers.

Composition, seasonality (Schedule 1)

The requirements of the Contract in relation to milk compositional specification, and volume/seasonality/ profile where applicable should also be entered into Schedule 1. These sections have been left intentionally blank to allow the parties to set out suitable arrangements depending on the market requirements. Basic minimal norms that are deemed appropriate (such as minimum butterfat content) or are set out in legislation should be set out in Schedule 3 (milk quality requirements).

The reason for grouping these issues under the same Schedule is to improve the simplicity of the Contract. In addition as these aspects are normally explicitly linked to the price paid for the raw milk, it is appropriate to group them under the same Schedule.



Sampling (Schedule 2 and clause 9)

The Contract seeks to create a greater degree of certainty as to the process by which sampling for hygienic or milk quality reasons is undertaken and the tests that are used by the purchaser to verify that the milk is free from extraneous water or antibiotics.

The Contract allows the producer to request that dilutions are performed on a sample that has failed an antibiotic test in order to ascertain whether the presence of antibiotics was below the MRL. The Contract also allows the producer to request independent verification of the results of a milk sample that has tested positive for antibiotics.

Milk Quality Requirements (clause 12 and Schedule 3)

Milk Quality Requirements are referred to in the contract at Clause 14 and defined in detail in Schedule 3. This covers temperature, extraneous water hygiene quality requirements and other quality criteria. The Contract reflects usual industry practice in leaving the milk storage temperature to be agreed by the parties in Schedule 3. The minimum legal requirements are set at <8°C for milk collected every day and at <6°C for every other day collection. However, in practice this it is normal for milk buyers to require milk to be cooled to a temperature below 4.5 - 5.0°C, in order to ensure the highest quality of the raw milk that is collected.

THE BOILERPLATE CLAUSES

Measurement of milk collected (clause 10.2)

The Contract requires that any flow meter or other measuring device used to calculate the quantity of milk supplied by the producer be regularly calibrated by the purchaser to ensure that milk payments are accurate.

Indemnities, insurance and limitation of liability (clauses 13 and 14)

The producer will pay to the purchaser the appropriate proportion of any levy incurred in the event of the purchaser incurring a levy liability as a result of insufficient quota being held by the producer. Although wholesale superlevy has not been payable in recent years, in the past, standard practice has been for the purchaser to deduct the costs of levy from the milk payment.

In this section, the producer also agrees to pay the purchaser for any direct costs caused by the producer failing to meet the necessary milk quality requirements set by the Contract when the milk of the producer has been mixed with milk from other producers.

Clause 14 makes it clear that the producer should arrange for product and third part liability insurance and the purchaser may demand evidence that this cover is in place. This is to protect the producer's position in the event of, for example, the costs of a major product recall resulting from the presence of contaminants in milk.

There is a need for a much larger debate about the extent of the liabilities that are potentially held by producers in respect of raw milk contracts both in the light of some recent food safety scares and the risks of ever greater litigation. In considering liability, distinctions may be drawn between foreseeable and unforeseeable risks. In either event contractual liability for death and personal injury cannot be excluded except as far as the restriction is reasonable. However, whilst the risk of milk causing injury or death going unnoticed through the supply chain is highly unlikely, a more realistic risk is of the costs of a recall and damage to the brand image of a processor. Again, in considering allocating liability for these risks reasonableness is a necessity if the terms are set in a standard form contract which is not individually negotiated.

Termination for breach (clause 15)

This clause sets out the circumstances under which the contract may be terminated on notice following a breach of the Contract:

1. If the purchaser has properly rejected the producer's milk three times within a one month period, the purchaser may terminate the Contract by giving one month's written notice.
2. Either party may terminate the Contract if they have given the other party 14 days' notice to put right a serious breach and that has not been done after the 14 days.
3. Either party can terminate the Contract immediately if the other party closes or threatens to close its business or a substantial part of it, or becomes insolvent.



Assignment (clause 16)

Generally, the rights under this Contract are personal to the parties; that is, only the parties to the Contract may perform it, and they may not transfer the Contract to someone else.

However, it is recognised that were this to be applied rigorously it would be too inflexible as often farm businesses are family partnerships with changing participation by family members, and purchasers can be involved in mergers and takeovers (although it is only where the legal entity that entered into the Contract changes that an assignment is needed). Consequently, if a party to the Contract wants to assign their interest in the Contract to a successor in title, they should give the other party notice of this in writing. The other party to the Contract may then object to the assignment within 60 days of receiving the notice, or if they fail to object then the Contract can be assigned. Should a party object to the assignment, then either party may terminate the Contract on 3 months' notice unless the other party withdraws the assignment.

For example, if the purchaser merges with another purchaser to become a new legal entity, it should write to the producer and inform them of the change. If the producer does not want to supply the new entity they can write back and reject the assignment and serve 3 months' notice to terminate. The same rule would apply with a producer in the form of a family partnership, when the family members involved change, notice may need to be sent to the purchaser who then has 60 days to object if the purchaser does not want to continue to do business with the farm partnership now that it is being run by different family members. If the other party does object to the assignment, then either party may terminate the Contract on 3 months' notice – this would allow a party unable to re-structure their business to get out of the Contract on 3 months' notice.

Severability (clause 19)

This clause is to explain that should a court find one part of the Contract void, that so far as possible the rest of the contract shall continue.

Waiver (clause 20)

The failure or delay of a party to the Contract to insist upon their rights shall not be taken to mean that they have agreed to suspend their rights under the Contract.

Force majeure (clause 21)

If it is impossible for a party to perform their obligations under the Contract for reasons beyond their control, they will not be in breach of the Contract. If a party delays the performance of its obligations under the Contract for more than 14 days due to reasons beyond its control, then either party may terminate the Contract with immediate effect on serving notice. If either party is unable to perform its obligations 3 times in a [6] month period, then either party may terminate the Contract on giving [3] months' notice.

Entire agreement (clause 22)

The Contract and its Schedules contain all the terms that have been agreed between the parties. Oral representations and other documents do not form part of the Contract.

Governing law and jurisdiction (clause 23)

The intent of the Contract is to have the applicable law to be the law of the country the farm is situated in, be this Scotland, or England and Wales. Likewise, it is intended that the appropriate court to hear disputes which are not resolved by alternative forms of dispute resolution will be the courts of the country where the farm is situated, be that the Scotland or England and Wales.

Dispute resolution (clause 24)

In recent years arbitration which previously has been seen as simple, quick and inexpensive in comparison to litigation in court, has in some cases become as lengthy and expensive as going to court, and has developed its own complex rules of procedure. Consequently, in this Contract the parties are reminded to consider an appropriate form of alternative dispute resolution before commencing court proceedings. Consequently, the Contract is not prescriptive, and the parties may consider the use of mediation or arbitration, but have not been excluded from commencing court proceedings.



NFU, Agriculture House
Stoneleigh Park, Stoneleigh, Warwickshire CV8 2TZ
Tel: 024 7685 8500 Fax: 024 7685 8501
www.nfuonline.com

NFU Scotland, Rural Centre - West Mains
Ingliston, Midlothian EH28 8LT
Tel: 0131 472 4000 Fax: 0131 472 4010
www.nfus.org.uk

