BUYING THE FARM: A DUE DILIGENCE PRIMER WHEN BUYING OR SELLING FARMING OPERATIONS AND OTHER AGRIBUSINESSES

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The sale of an agribusiness (a portmanteau of "agriculture" and "business" that includes a wide variety of commercial farming; processing; packing; manufacturing; and other livestock, dairy, or agricultural-focused operations) is more than a hybrid commercial real estate and corporate transaction. When negotiating the sale of an agribusiness, counsel for both the buyer and the seller must be prepared to grapple with issues that cross multiple practice areas including environmental, labor, tax, real estate, intellectual property, and corporate concerns. Each agribusiness transaction is as unique as the business itself, which can make for a fun, and sometimes challenging, experience for a deal lawyer. This article details a few key considerations to keep in mind when preparing for, and navigating through, the diligence for an acquisition or sale of an agribusiness, including: (1) important threshold considerations for the parties; (2) key terms and provisions in a purchase and sale agreement; and (3) the breadth of diligence work that may be required for a buyer in an agribusiness transaction.

IDENTIFYING THE THRESHOLD CONSIDERATIONS

What is at stake?

Before a buyer and seller execute a purchase and sale agreement, both parties should be clear as to the nature and scope of the agribusiness included in the transaction. Agribusinesses are multi-faceted enterprises, with various, often interrelated components.

Is the seller disposing of the business in its entirety, or will it retain certain operations? How will such a partition affect the functionality and profitability of the agribusiness as a whole? If the seller retains its grain elevator, for example, but offloads its farming and trucking operations, how will this affect both the buyer's and seller's ability to transport or store grain? Does either party contemplate a business relationship post-closing that would complement their operations? Will the seller continue certain operations in a way that could compete with the buyer's business that the buyer may want to address by negotiating a non-compete agreement? All of these items will affect the business terms, and therefore greatly impact the scope, timeline, process, and degree of due diligence activities.

How will the parties exchange information?

Depending on the size and complexity of the operation, the purchase or sale of an agribusiness may involve the seller's disclosure (and the buyer's review) of a significant amount of materials. Determining exactly how information will be shared between the parties is essential to a smooth transaction. For larger or more complex transactions, the parties may consider establishing an online data room to transfer diligence materials. The buyer may also need access to various documents from government or quasigovernment agencies during the diligence period. Due to privacy rules or agency regulations, many of those materials are accessible only by the seller. A letter of authority from the seller permitting the buyer access to the seller's files for an enumerated period of time is generally accepted by the United States Department of Agriculture Farm Service Agency (FSA) regional offices, thereby allowing the buyer access to FSA records as part of its diligence activities. [1]

NEGOTIATING THE PURCHASE AND SALE AGREEMENT

The purchase and sale agreement details the timing, essential terms and conditions, and the property and consideration that will change hands; further, it will describe the buyer's due diligence inspection rights. The parties will need to determine the scope of the buyer's inspection activities, timeline, and treatment of information discovered during the inspection period. A well-written purchase and sale agreement strikes the balance between specificity and flexibility needed to accommodate the expectations of both parties, and sets the stage for the diligence work to be completed.

Depending on the nature and complexity of the agribusiness, a long diligence period may be needed to accommodate the considerable diligence work required for more complex transactions. Conversely, the parties may try to time due diligence and closing based on the cultivation and harvest cycle of a given crop. Further, existing contracts, permits, or leases may dictate when the parties are able to conduct onsite diligence work, run inventory, or close the transaction.

The unique features of an agribusiness may present challenges to the tidy proration of costs and revenue at closing. For example, in farmland transactions, a seller and buyer will likely need to address whether the seller will receive a reimbursement for "cultural costs" (e.g., the costs for crop inputs and other cultivation efforts of the seller expended prior to closing that are necessary to prepare the crop for harvest). Further, unlike typical commercial rental agreements, farmland leases generally contemplate payment of base rent once or twice a year and not on a monthly cycle and may also include flex or hybrid rent payments (e.g., the property is leased to an operator and the landlord is entitled to "bonus" or "percentage" rent based on the yields returned from crop sales). Likewise, there may be a cost associated with yearly water rights that the buyer will need to confirm as part of its post-closing operating cost assumptions. Accordingly, a buyer will want to include these financial concerns as part of its due diligence review. Not only will this information be needed at closing, it is also relevant to the buyer's valuation of the asset.

CONDUCTING DUE DILIGENCE

The diligence process required for any agribusiness transaction will necessarily depend on the nature of the business itself. However, the following areas of review are likely to impact an agribusiness transaction.

Real Property

Real estate due diligence review in the agribusiness context requires more than a title search and survey review.

The purchase price for farmland may be calculated using a "per acre" figure based on the number of net, gross, tillable, irrigated, or dryland acres (or a combination thereof). Accordingly, the real property due diligence directly impacts the value of the property being conveyed.

Further, a real estate portfolio transaction may include numerous parcels (some owned, others leased) with various improvements—ranging from barns, silos, warehouses, and processing plants to greenhouses, irrigation systems, and even residential structures—all of which may be accompanied by permits, certificates of occupancy, and related documents. For agribusiness operations that own an assemblage of real property that was acquired over many years, or for longstanding family farms, it is possible that a title policy was never obtained when the seller initially acquired the property. Accordingly, a seller of such properties should consider ordering title prior to going to market to deal with any surprise title encumbrances or ownership issues in advance.

In addition to the typical examination of property tax records, security instruments, leases, title and zoning reports, and surveys and maps, special attention should be paid to water rights, ancillary uses of the property, and environmental issues.

If the agribusiness requires reliable access to uncontaminated water for crop irrigation, this will require examination of the water rights attached to the property, including:

- Groundwater and/or surface water permits;
- Water rights/sharing agreements and certificates;
- Water district records; and
- Maps of wells, pipelines, and other irrigation infrastructure.

If the transaction involves acquiring a processing facility, it is wise to assess the associated wastewater discharges and determine if the appropriate permits are in place. Depending on the location of the target property to the water source, a buyer may also need to review easements and/or licenses across adjacent land not owned by the seller. Also, it is not uncommon for large irrigation pivots to "walk" onto a neighbor's property, necessitating an easement or installation of pivot-stop technology; these items are typically discovered during the due diligence period since they require a survey or overhead aerial map to identify the encroachment.

Further, agricultural land often accommodates multiple simultaneous (and at times competing) uses, the rights to which may be held by unrelated third parties and may affect the buyer's future use of the property. These include:

- Mineral, oil, and gas leases;
- Fishing, hunting, and other recreational licenses; and
- Wind and solar energy agreements.

Accordingly, although these uses may not be central to the agribusiness operations, it is important for a buyer to confirm that ancillary uses (and the third-party user's rights associated therewith) align with the buyer's plans for the property.

Many agricultural properties include a shop, garage, fueling area, dump, or other area likely to have potential contamination, raising environmental issues. Because of the potential liabilities associated with environmental contamination and remediation, and to comply with "all appropriate inquiry" requirements of the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) [2], due diligence of such property should, at a minimum, include review of a Phase I environmental site assessment report dated within six months of close. These reports may also indicate whether the current occupant is properly storing fuel, fertilizer, pesticides, and other potentially hazardous substances. Similarly, given the potential for endangered species and wetland concerns relative to farming operations, a buyer should consider whether to obtain specialized review of these matters.

Personal Property

Agribusinesses are highly equipment-dependent, and this equipment may or may not be included in the transaction. So that both parties know exactly which items will be included in the sale, personal property diligence should involve:

- An examination of equipment lists, with one list of equipment to be excluded from the sale, and one list of included equipment (with a deemed "catch-all" for non-material equipment). This eliminates any confusion as to whether a valuable piece of equipment was inadvertently left out of the agreement or went missing prior to closing. Careful consideration should be paid to irrigation equipment, which may include movable components; these portions of the system may be personal property owned by a tenant or other third party (and therefore not part of the conveyance transaction). The list of equipment to be included in the sale should contain serial and/or VIN numbers, makes, models, and other details that will enable the buyer to accurately assess the value of the equipment. Because many farm operations lease equipment, it is important to confirm whether the buyer can assume those contracts or if lender consent is required.
- An inventory of other property related to the business—including crops, fertilizer, livestock, feed, and other incidental items—the quantities of which are not static and will inevitably change in the time period between diligence work and closing. To account for inventory fluctuations, the purchase and sale agreement should provide for an inventory "true-up" either immediately before or after closing, with an adjustment of the purchase price (based on the per-unit price contemplated under the agreement) if necessary. Also, consideration should be given to obsolete or tainted inventory: How will these items be identified, and who will take responsibility for disposal?
- If the transaction involves any commercial hauling activities, then the buyer should consider a specialized review of the applicable trucking regulations, as securing the necessary licenses and permits with respect to such operations may be a lead time item.

Intellectual Property

In addition to the general review of trademarks, copyrights, and patents of the agribusiness, there may be third-party agreements with respect to patented crops, seeds, or permanent plantings. Both sellers and buyers should be mindful of the terms and provisions of any third-party agreement and its impact on post-closing operations. Many third-party agreements with patent holders contain broad access rights (including the right to remove any existing plantings or crops), as well as the right of the third-party patent holder to obtain confidential information with respect to the property or the agribusiness. Finally, there may be assignment restrictions that affect the transfer of the seller's interest in a license to the buyer; consent can be a long lead item.

Production History

Depending on the type of crop (permanent or annual) and the time of year (pre- or postharvest), the parties will need to confirm whether to include or exclude the current season crops as part of the transaction. Separately, a tenant or other third party may have rights to the growing crops. Regardless of the ownership of the crops, a buyer's due diligence should include review of crop health, soil conditions, disease and blight conditions, and other factors relevant to the production history of the property. Closely related is a review of pump tests and other water quantity factors (separate and apart from the water rights due diligence mentioned above).

Contracts, Permits, and Licenses

The type and quantity of the existing contracts, permits, and licenses required for the normal operation of the agribusiness will vary considerably based on the nature of the enterprise. It is essential to examine all contracts, permits, and licenses as soon as possible in the diligence process, as the reissuance or transfer of permits (especially by government agencies) may take some time. Contracts and licenses may contain limits on their transfer or assignment to new entities, so the parties should plan accordingly by applying or seeking approval for such transfers as early as possible. In the event that all permits needed for the continued operation of the agribusiness will not be available by closing, the buyer should consider contracting for the seller to continue operations under its existing permits and licenses until the necessary permits are obtained by the buyer. Because the availability of required permits and licenses can significantly impact the viability of the business, the buyer may make approval of such permits a condition to closing.

Further, if the agribusiness has any supply-chain contracts, it is important to carefully review and assess the relative risk arising out of these contracts. Are there broad, sweeping indemnitees that could negatively affect the valuation of the agribusiness? Are there appropriate records to verify the seller's compliance with applicable law including food safety, trucking, and transportation issues? Depending on the underlying operations at issue, a buyer may want to review the seller's product recall procedures and prior recall history.

Labor and Employment

Agribusinesses are labor-intensive operations, and the success or failure of a business may depend, in part, on securing the right employees. Depending on the nature of the company, the buyer may wish to ensure that certain key managers or operators remain on for a designated period of time after the closing; further, the buyer may desire to hire all of the seller's current workforce. This will require communication between the buyer, seller, and employees prior to closing, and the parties will want to jointly agree on timing and messaging to the affected employees.

If the seller will be retaining a portion of the business post-closing, the buyer may want assurances that the seller will not solicit key employees for hire. Accordingly, the buyer may ask the seller to sign a non-solicitation agreement. Alternatively, if the seller happens to be one of the key employees, the parties may negotiate an employment agreement with respect to post-closing operations. If the transaction is to occur during harvest, consider how the parties will handle a transition of seasonal labor. Additional employment diligence includes the review of documents regarding:

- Employees' salaries and benefits;
- Human resources policies and handbooks, as well as ongoing and/or potential employee disputes, claims, or litigation;
- Employment verification practices including immigration status, visas/work permits, and background checks;
- Agreements with farm labor contractors, unions, and other organizations; and
- Housing arrangements for seasonal farm laborers.

Compliance and Other Regulatory Oversight

Certain agriculture-focused federal statutes may be implicated in an agribusiness transaction. For example, if the buyer or seller of the real property is not a U.S. citizen, certain filing requirements under the Agricultural Foreign Investment Disclosure Act may apply. [3] Similarly, the applicable agribusiness may have rights or liabilities arising under the Perishable Agricultural Commodities Act [4] or compliance obligations under the Food Safety Modernization Act. [5] Often, states have analogous laws that likewise could affect the parties or the subject business. Finally, organic and other specialty crops have their own regulatory regime; the parties need to be aware of fees, timing, and filing obligations required for applicable regulations.

AGRIBUSINESS: A LEGAL CORNUCOPIA

Agribusiness transactions differ widely depending on the sophistication of the parties, the location of the real property involved, and the type of operation at hand. The transaction will need to address certain industry-specific due diligence matters affecting the rights and obligations of both the buyer and the seller. In the end, there is no one-size-fits-all answer, but one thing is certain: legal work in this sector requires skills and expertise from a variety of practice areas.

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NOTES

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[1] Certain Farm Service Agency offices will only share information if the seller signs a Form-2004; other Farm

Service Agency offices will accept a simple letter of direction from the seller.
[2] 42 U.S.C. § 9601 et seq. (2018).
[3] 7 U.S.C. § 3501 et seq. (1978). See also, Bocci, Larson & Wu, Acquisition and Dispositions of U.S. Agricultural Land by Foreign Investors: Federal and State Legislative Restrictions, Limitations, and Disclosure Requirements, Drake Journal of Agricultural Law, Volume 23.1.
[4] 7 U.S.C. § 499a et seq. (1995). See also Sargent & Larson, PACA and Real Property: Follow the Fruit, New Developments in Real Property (WSBA CLE August 2018).
[5] Food Safety Modernization Act of 2011, Pub. L. No. 111-353, 124 Stat. 3885 (2011).

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