Beware of quota transfer pitfalls, farmers are told

QUOTA purchase is fraught with danger and farmers could be sitting on legal "time-bombs", warns Hugh Townsend of West Country agents Rendells.

"There are no problems when quota transfer involves a willing buyer and seller," says Mr Townsend. "But difficulties can arise if one of the farms changes hands, one of the farmers goes out of business or the seller decides to renege on the deal."

If transfer rules have not been followed to the letter, the seller or a third party could have a claim on the quota. A number of disputes have already occurred and many more could be on the cards.

Quota selling and buying has evolved by exploiting a curious loophole in quota regulations that has allowed transfers to take place.

Quota is tied to land used for dairy production. Using the loophole, the purchaser must occupy this dairy land for at least 10 months and use it for non-dairy production. After this the quota remains on the purchaser's holding and the land reverts to the seller.

"This has often been overlooked because of tedious practicalities," he says. "But this is a dangerous attitude and can leave the legality of the transfer open to challenge."

If the original seller of the quota sells the farm, the new owner could have a claim on the transferred quota if he can prove the transfer process was not followed to the letter. "This could be a big problem where farmers and quotas have been sold separately," says Mr Townsend.

There are also pitfalls if the seller goes bankrupt. A receiver is legally bound to maximise the value of assets, which could include transferred milk quota. "Farmers may think they have contractually bound up a deal but problems arise when a third party arrives who is not bound by the agreement."

Another problem could be sheer greed. Milk quotas first changed hands at about 13p/litre. But market prices have shot up to about 35p/litre today. "An incorrect transfer would allow an unscrupulous seller to claim the quota back which he could then sell again," says Mr Townsend. "Many farmers may be tempted to look back at these deals."

The change in occupation is now registered with the Milk Marketing Board using the TI/2 form. To overcome legal problems, Mr Townsend advises that a second form should be completed at the end of the period to show that the land has undergone a change of use.

Change in occupation forms must be submitted within 50 days or the transfer can be taken to arbitration. "The danger here is that a RICS-appointed arbitrator looks back at the problem of land use over the past five years and not just the transfer period," he adds.

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Transferring Milk Quotas

The Dangers of Permanently Transferring Milk Quota

Hugh Townsend of Townsend Chartered Surveyors' Quota Plan, Exeter

Identify the Quota

First, identify the quota, if it is part used evidence must be collected as to, not only the liquid percentage used but also the butterfat adjusted usage. Quite regularly production has been at a higher butterfat level than the butterfat base and this extra butterfat production transfers with the production to the purchaser. This increases his overall butterfat production and when translated into liquid litres (the MMB apply a particular formula translating butterfat points into liquid litres), this will increase the overall percentage used. (One has to assume butterfat is triggered)

There are now five different types of quota, being: wholesale, direct sale, SLOM wholesale and direct sale, SLOM II and EC Regulation 3880/89 wholesale quota. SLOM II as yet cannot be transferred permanently but otherwise the remaining types are very different and consequently have different values. The most commonly overlooked type is EC Regulation 3880/89.

Does the Vendor Have Good Title to the Quota?

Recent cases have raised the question of to what extent the selling agent should ensure that the vendor has the right to sell the quota. At the end of the day, if the vendor consistently lies and positively misleads an agent there is little an agent can do to check the vendor's right to sell the quota. The only comfort a purchaser can rely on is that the individual dealing with the vendor has the experience and the professional training to "catch out" or identify suspect vendors. It is only this close relationship with the vendor that reveals, in many cases, unintentionally hidden or unthought of problems.

Sometimes the Land Registry or Agricultural Credit Act search will reveal undeclared interested parties or indicate if the vendor is in financial trouble. If necessary, a solicitor's letter confirming the vendor's title to the freehold of the land should be obtained.

The "EC Holding" must be identified, not only on the date of change of occupation but also during the previous five years. It could well be that previous landlords have a claim to the quota, even though it does not form part of the "EC Holding" on the sale of the quota. Agreement with interested parties must be obtained so that they sign not only the first T1/2 transfer form but also the second transfer form at the end of the tenancy.

The original allocation of SLOM 1 quota must be fully investigated to ensure that the quota was properly claimed.

The Change of Occupation

As yet there seems to be no authoritative precedent set as to whether a written tenancy agreement in itself constitutes a change of occupation or whether the tenant/ purchaser of the quota must physically take occupation himself.

The greatest danger is that the selling agent looses control of what is going on. Most problems have arisen where a tenancy has been granted over the land and the purchaser, sometimes at the other end of the country, has been left to his own devices to occupy the land. This practice has only encouraged unscrupulous vendors to take advantage of unsuspecting purchasers. Many unreported disputes have arisen and been settled where the vendor has extracted further payment for the quota as the purchaser has been totally at the mercy of the vendor. It is vital that agents commit both parties to the change of occupation and ensure that the vendor provides and co-operates in supplying evidence to that effect. The advantage of the second T1/2 transfer form is that this also commits some, if not all, of the interested parties.

The Second T1/2 Transfer Form

The use of a second T1/2 transfer form has now been accepted as a worthwhile "belt and braces" by the Ministry and leading firms of solicitors and surveyors. Unfortunately, agents have succumbed to the temptation of over-simplifying sales of quota. This perhaps is quite understandable, due to the farmers' aversion to red tape and particularly EC red tape. There is, thankfully, less and less resistance to dealing with the complications of milk quota which the farming community must now either digest with relish or go out of business following the recent CAP reforms.

Mechanics of Transfer

Vendors must be made aware, as must purchasers, that the transfer of the full 8,000 litres per acre should only be the last resort compared with transferring at a more realistic apportionment, in most cases nearer 3,500 litres per acre.

Invoicing of contract farming arrangements should not be carried out at the beginning of the tenancy. This practice is a totally unrealistic proposition which will not convince any arbitrator or judge that occupation was carried out under a "commercial and arm's length arrangement". Similarly, contract farming arrangements which ensure there is no chance of profit or loss to either party, must be considered with some suspicion.

Whilst professionally one must adopt a wary and suspicious approach, the level of risk involved when buying milk quota, if handled with care, is probably no greater than any other commercial undertaking in which a business is involved on a day to day basis.

Changes of occupation for milk quota transfers

Hugh Townsend reports on the latest requirements for a change of occupation to transfer milk quota with land

Farm business

MILK QUOTA LEGISLATION and its interpretation is no different from the rest of the law. It is nearly impossible at any one time to say categorically what the law means.

There are arbitrations, there are court cases and (in respect of milk quota) there is regularly new EU and UK legislation. Understanding of milk-quota law is continually changing as new precedents are set interpreting existing and changing legislation. So great care should be taken when relying on any existing precedents or the current 'perceived wisdom'.

This caution now particularly applies to what constitutes a change of occupation under regulation 7 of the Dairy Produce Quotas Regulations 1994. More and more questions have been answered over the years, following various court rulings and arbitrations.

What is the next weak link to be challenged?

The most dangerous issue, which has probably always been the most dangerous, is whether the purchaser of the milk quota has taken up occupation of the leased land. The market in milk quota has increasingly become a national one, encouraged by the possibility now of trading across the border with Scotland, Wales and Northern Ireland. How can a purchaser of quota from Derrygonnelly on the banks of Lough Erne be expected to farm land on the North Downs in Kent!

As it has become more widely known that granting a lease does not, without occupation being taken up, effect a transfer, various contract farming arrangements have developed. These range from the most sophisticated five-page contract farming agreements, to the two-sentence letter. The question about all of them is: will they be considered a 'sham'.

Until a recent arbitration, the only guidance available was to ensure the contract farming arrangement was a commercial one, that is, where the purchaser of quota, by renting the land and farming it through a contractor, had the opportunity to make a profit (as one would expect of most people running a business or renting land). It was also important that the arrangement was, as far as possible, at 'arms length'.

Hugh Townsend: The market in quota has increasingly become a national one

Likewise, the arrangement must not have predetermined that there was no chance of making a loss.

Therefore, particular caution is required if a contract farming arrangement clearly documents and pre-determines that the purchaser of the quota will neither make a profit nor a loss out of renting the land, the contract farming arrangement and the sale of the hay, silage or arable crop. It must be safer not to have an agreement as follows:

a = rental for land
b = value of crop
c = contracting charges
(b - c) = a

In the above example, there is no change either of a profit or a loss, and it is difficult to believe that any party is in a position to predict the exact cost of contracting charges and the resulting crop 10 months in advance.

The purchaser must have control over what happens on the land. For instance, if he has no choice of which contractor to use or is not allowed to take the option of farming the land himself, this suggests that he does not have control over his occupation of the leased land.

With an 'arms-length' arrangement, the purchaser will continue to have the option to occupy the land himself throughout the term of the lease.

Should he employ a contractor, the charges and invoicing should be realistic, billing the purchaser after the work has been done, detailing and itemising the operations and charging a realistic amount. Details should also be provided by the contractor as to the areas over which he carried out the operations and the period during which these were completed. In case there is any query in the future, this is important evidence that the purchaser must retain as proof of his occupation.

Obviously, in most circumstances a profit will be made after paying the contractor and having sold the crop to either the contractor, a third party or the vendor, for non-dairy production. As would normally be expected with any farming operation, payment of such profit would take place at the end of the season when everything had been calculated. One would expect monies to be paid and to change hands.

The recent *Llandolfi* v *Tolley* arbitration, where the arbitrator ruled that the transfers to nine purchasers were ineffective, illustrates well the type of problems to watch out for and the most common mistakes made. One cannot be too careful.

To avoid these problems, the obvious answer is to sell quota without land or make sure the purchaser farms the land himself. Unfortunately both options have inherent problems of their own, which still leaves a high percentage of sales using land and contract farming arrangements.

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DEVELOPMENTS IN MILK QUOTA LAW

"A Surveyor's View"

by Hugh Townsend

As with any UK legislation, the interpretation of milk quota legislation and its practical application is still developing. New court and arbitration awards are still setting precedents which subsequently can dramatically affect everyday situations. Although it has been over 10 years since milk quotas were first introduced, fundamental issues are still being sorted out.

Agricultural Holdings Act
Rent reviews and the apportionment of milk quota

In 1993, the *Marshall v Hughes* county court case set out the first principle of considering milk quota at a rent review. Arbitrators are obliged to ascertain what makes up the subject holding in the way of land, property, fixed equipment, and now milk quota, before setting a new rent.

The arbitrator can only take account of what milk quota is apportioned on the holding at the review date, in accordance with the Dairy Produce Quotas Regulations. At each review, a five-year analysis of what area has been used by the registered milk producer for dairy production is carried out. This involves the parties presenting field-by-field evidence of stocking and cropping, on all land farmed by the registered milk producer whether or not this is the tenant on his own or a partnership or company. The arbitrator would be ill-advised to carry out a review without satisfying himself that this statutory procedure had been carried out.

It should be remembered that while an arbitrator can only consider the evidence brought before him he does have the ability to direct that certain information is brought before him following the precedent set in the Court of Appeal *Chilvers v Ankers*. His priority is to fulfil his statutory obligation and is subsequently different from a contactually instigated arbitration where the priority is to settle a dispute between two parties.

Tenant leasing out quota

The Dairy Produce Quotas Regulations 1993 and further EC legislation have weakened the tenant's defence against rent increases. There is now no query as to whether quotas will last for the three-year review period. Milk quota is here until the year 2000.

A precedent was set in 1994 with the *Trustees of RB Nelder deceased v W J Pope* arbitration. In this case, the tenant was not obliged to run a dairy herd, had ceased production and was leasing out the quota. The review was with effect from September 29, 1993 when leasing prices were still 5.5p per litre. The landlord argued that 84% of the leasing income should be paid to the landlord in the form of a Section 12 rental. The arbitrator accepted the landlord's argument that the tenant had little input compared with the landlord, who had in effect provided the quota in order to produce the income. The award gave the landlord 60% of the net leasing income.

This case sets the precedent that milk quota leasing income should be dealt with on a different basis to that of the rest of the farm income. What we do not know is whether a 60% split is enough. There is no doubt that there will be continued arbitrations, where large quantities of milk quota are involved, on the question of whether the landlord should receive a higher percentage.

Under the Section 12 rent formula it is difficult to see how arbitrators will be able to resist such arguments in the future.

Tenant not leasing out quota

In 1995, the *Mortimer v Mortimer* arbitration set a further precedent. In this case a tenant was renting some bare land adjoining another dairy holding where he milked the cows. Some quota was apportioned on the bare land in accordance with the *Marshall v Hughes* principle and while the tenant was not leasing out the milk quota but using it for his adjoining holding, again 60% of the hypothetical leasing income was awarded by consent as a Section 12 rental.

This touches on the question of marriage value and also the issue which is yet to be tested as to whether a Section 12 rental can be based on a hypothetical leasing out of milk quota where the tenant is still milking. With the requirement for better fixed equipment, the economies of scale and the problems with pollution control where holdings have profitable alternative uses, ie. where the land is also registered for arable area payments, there could be an argument in certain circumstances that the rent should be based on the tenant leasing out the milk quota and going out of dairy production.

It should be remembered that the rent formula takes no account of the landlord/tenant split of quota under the Agricultural Act 1986 which occurs at the end of the tenancy. The tenant received his compensation at this time, not during the life of the tenancy when the landlord can collect a rent in respect of all the quota.

The same, of course, applies in that the tenant can lease out all the milk quota including that proportion for which he would not receive compensation at the end of the tenancy. It should not be forgotten that the basis of the rent formula is fundamentally what would the holding let for on the open market with the quota available to a prospective tenant. This is the starting point of any rental calculation.

Marriage value

Following the Court of Appeal ruling this summer on *Chilvers v Anker* an arbitrator must take into account any marriage value the subject holding may have with any other land farmed by the "class of hypothetical prospective tenants within the locality."

A further precedent has been set following the first arbitration award to identify and quantify a marriage value. This could have far reaching implications not only in respect of excess cottages, farm buildings, the "business centre" farmhouse and economy of scale arguments, but also in respect of milk quota.

Farm Business Tenancies and milk quota.

The traditional clauses in pre-September 1995 tenancies are now no longer sufficient to protect a tenant's interest in milk quota apportioned to the holding at the end of such a tenancy. It is not considered to be a "routine improvement" and so prior consent is required from the landlord should the tenant wish to have any rights to the quota.

It should be remembered that there is no right to compensation, as under the Agriculture Act 1986, and one cannot contract out the Dairy Produce Quotas Regulations apportioning milk quota at the end of the tenancy. As before it will not avail a tenant to state merely that the landlord will not claim any of the milk quota that will be left on the holding at the end of the tenancy. As milk quota is not a "routine improvement" there is not the opportunity to obtain retrospective consent from an arbitrator.

Farm Business Tenancies, however, have made it easier to use arable land to transfer quota with land as only a 10-month tenancy is now required. Also it makes it easier for vendors to retain their right to claim the arable area payments.

Legal development

Concern has always been expressed as to what constitutes a change of occupation under Regulation 7 of the DPQR 1994. More and more queries have been answered over the years following various court rulings and arbitrations.

Initially, there was the issue of whether a grazing licence was sufficient and then what length of lease was required. This query resulted in a change to the DPQRs and introduced the 10-month rule.

As illustrated in *Llandolfi v Tolley* transfers can fail when the change of occupation is deemed to be less than 10 months. In this case nearly all of the transfers challenged failed on this elementary point. There was certainly an intention to grant leases for more than 10 months. Due to the documentation method used this was not the case.

Then there still remained the query as to whether a *"Gladstone v Bower"* should be used for granting a lease. This debate has been superceded following the introduction of Farm Business Tenancies.

What's next?

In an increasingly litigious environment one can guarantee that given long enough someone, somewhere, with

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some solicitor, will challenge any weakness that can be found in the mechanism used for transferring quota.

There remains the oldest chesnut: whether the system adopted by the UK is in contravention of EC Regulations. Are the DPQRs and resulting transfer of land illegal under EC law?

The weakest link

We consider that the most dangerous aspect is still whether the purchaser of the milk quota has taken up occupation of the leased land. The market in milk quota has increasingly become a national one, encouraged with trading now possible across the border with Scotland, Wales and Northern Ireland.

How can a purchaser of quota from Derrygonnelly on the banks of Lough Erne be expected to: farm land on the North Downs in Kent? As it has become more widely known that granting a lease does not, without occupation being taken up effect a transfer, various systems of contract farming arrangements have developed. These range from the most sophisticated five-page contract farming agreements, to the two-sentence letter.

The problem with all of them is whether they are considered a "sham". There are few Irishmen that rent land in Kent on a short term basis in order to farm it for a profit. Indeed, it is probably fair to say that only a handful of permanent transfers of milk quota in one year can be argued to have any other commercial consideration other than for the sole purpose of transferring quota. This has not been fully tested.

Commercial and at "arm's length"

Up until a recent arbitration, the only guidance available was to ensure the contract farming arrangement was a commercial one, ie, where the purchaser of quota, by renting the land and farming it through a contractor had the opportunity to make a profit as one would expect from the majority of people running a business or renting land. It was also important that the arrangement was as far as possible at "arm's length". Likewise, the arrangement must not have pre-determined there was no chance of making a loss.

Particular caution is required if a contract farming arrangement clearly documents and pre-determines that the purchaser of the quota will neither make a profit nor a loss out of renting the land, the contract farming arrangement and the sale of the hay, silage or arable crop. It must be safer not to have an agreement as follows:

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"Control"

The purchaser must have control over what happens on the land. For instance, if he has no choice of which contractor to use or is not allowed to take the option of farming the land himself, this suggests that he does not have control over his occupation of the leased land. With an "arm's length" arrangement, the purchaser will continue to have the option to occupy the land himself throughout the term of the lease.

The contractor

Should he employ a contractor the charges and invoicing should be realistic, billing the purchaser after the work has been done, detailing and itemising the operations and charging a realistic amount. Details should also be provided by the contractor about the areas and the period over which he carried out the operations.

In case there is any query in the future, this is important evidence that the purchaser must retain as proof of his occupation. Obviously, in most circumstances a profit will be made after paying the contractor and selling the crop to either the contractor, a third party or the vendor, for non-dairy production. As would be normally expected with any farming operation payment of such profit would take place at the end of the season when everything had been calculated. One would expect monies to be paid and to change hands.

Keeping records

The vendor's and purchaser's IACS return in respect of claims for arable area payment and forage area calculation should record the lease, and that the purchaser has been in occupation claiming, if appropriate, as much commercial benefit as possible from the subsidies available. June Census returns likewise should record the lease as should all diaries and farm records.

Zero apportionment MQ1

As set out in the Intervention Board explanatory notes for transfers with land, paragraph 8, the option of submitting a zero apportionment MQ1 transfer form should be taken up. "Where land is transferred which forms part of a holding to which quota is attached, producers may wish to submit a quota transfer form (MQ1) recording the formal agreement of all parties to the zero apportionment."

Hugh Townsend, of Townsend Chartered Surveyors in Exeter, already known for milk quota agency, is now making a name for himself as an arbitration advocate, having recently become a fellow of the Chartered Institute of Arbitrators.

Llandolfi v Tolley

This case involved a vendor selling land and milk quota simultaneously to two different parties. The purchaser of the land instigated an arbitration which has ruled that the milk quota was not effectively sold to the nine purchasers and is still apportioned to the land and thus should be registered with the new owner of the land. While this case is still under judicial review there are fundamental lessons to learn:

1. Solicitors and agents involved in the sale of land should properly consider farm quota clauses.
2. Vendors selling quota through more than one agent should ensure that quota is not sold from the same piece of land twice.
3. Milk quota sales with land require a 10-month lease and change of occupation. Even if the documentation says it is a 10-month lease, it will not always in practice be the case.
4. Proper arrangements should be set up whereby the purchaser either himself or through a contractor can farm and subsequently occupy the land and control its use.
5. Use of second/zero apportionment MQ1 forms can prevent such problems.