

UNDERSTANDING & EVALUATING CARBON CONTRACTS

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Carbon contracts have been a popular topic of conversation for farmers and ranchers around the country. As with any agreement, several legal and economic issues arise and should be carefully considered by producers before entering into a carbon contract. A critical consideration is that producers and landowners should never rely on verbal representations made by anyone related to a contract; assume only the written contractual terms will be enforceable. Remember, this is new territory, and many unknowns still exist about the carbon market and these carbon agreements. It is recommended to engage an attorney to review any carbon contract prior to signing.

KEY CONCEPTS

When reviewing a carbon contract, producers and landowners may notice it seems to speak a different language than most agricultural contracts. Understanding some of the basic concepts related to carbon contracts is an essential starting place. Importantly, each contract will likely have specific definitions of these terms. It is critical for landowners and producers to carefully review the definitions in any contract before signing.

Additionality – The concept of additionality refers to some companies only paying for new carbon-sequestering practices. If additionality is required, the farmer or rancher would have to undertake a new practice to qualify, such as converting from conventional farming to no-till farming, for example. A producer who has already adopted carbon-sequestering practices would need to seek a contract that pays for these previously adopted practices or allows for a look-back period and does not have an additionality requirement.

Carbon market – Currently, most carbon markets are voluntary programs where brokers essentially serve as intermediaries between companies seeking carbon

credits and farmers and ranchers willing to generate these credits. A producer agrees to undertake certain practices which sequester carbon or reduce carbon emissions; the company then pays the producer and claims the carbon credit generated by the producer helps to offset the company's carbon footprint.

Carbon practices – These are farming or ranching practices that can reduce carbon emissions and/or sequester carbon. The most common carbon practices include no-till farming, planting cover crops, crop rotation, planting buffer strips, and regenerative grazing.

Carbon credit – A carbon credit is a frequently used measurement unit to quantify carbon. Typically, one carbon credit is equal to one metric ton of carbon or carbon equivalent that is sequestered.



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Carbon emissions – The release of carbon into the atmosphere.

Carbon sequestration – The process of capturing carbon from the atmosphere.

Permanence – The length of time a carbon reduction lasts. Some contracts may require a producer to abstain from certain activities for an extended period of time to ensure the continuation of storing sequestered carbon.

Stacking – The concept of stacking refers to one producer enrolling the same land in more than one program or contract. Many contracts prohibit stacking, meaning the producer may enter into only one carbon contract for a specific piece of property. The breadth of a stacking prohibition can vary greatly by contract, with some prohibiting only other carbon contracts, while others may prohibit participation in any government programs.

Verification – The process of confirming carbon reduction or sequestration.

KEY CONTRACT TERMS TO CONSIDER

Control of land – Brokers or companies seeking carbon agreements will likely require some proof that the party entering into the contract either owns or controls the land. This may include a copy of a written lease agreement, for example. Some companies or brokers may require both the tenant and the landowner to sign any contractual agreement. This is particularly true if the lease in place is for a shorter timeframe than the carbon contract.

Data ownership – Data collection is a requirement for any carbon contract, and a carbon agreement should address issues related to the ownership and use of such data. Issues like who will be given access to the data, how the data may be used, and who has ownership rights in the data should all be addressed.



Indemnification – Indemnification clauses essentially shift potential liability and costs from one party in the contract to another. These clauses are an agreement to reimburse another party for damages they sustained as a result of the indemnifying party's actions. It is critical to analyze the breadth of an indemnity clause. First, indemnification clauses should be mutual, meaning each party agrees to indemnify the other. Second, some provisions may be so broadly written as to require a landowner to indemnify the company for any damages or injury which are not a result of the developer's contract, including actions taken by third parties over whom the landowner has no control.

Impact on energy production – Producers should carefully consider what impact a carbon contract may have on energy production on the land. Depending on the mineral ownership or the potential energy production activities, this may require identifying carve-out areas where oil or gas wells, or potentially even wind turbines or solar panels, can be placed.

Land title implications – Producers should be careful to determine if there are contractual provisions that may impact their ability to sell or otherwise transfer ownership of the land. For example, contracts may allow the purchaser to place a restrictive covenant or a lien on the property or require the landowner to enter into a conservation easement for the term of the contract. Certainly, these types of limitations could impact the marketability and potential sales price for the land.

Negotiation costs – Some companies and brokers offer to pay a certain portion of a producer's legal fees associated with negotiating a carbon contract. This would likely be an agreement separate from the contract itself but might be worth producers requesting from the company or broker. Regardless, a producer should consider using an attorney to assist with reviewing or drafting any carbon contract.

Other allowable uses – Producers may wish to make other uses of the property at issue in a carbon contract. Many farms and ranches have added various agritourism activities to diversify income. For example, many producers may wish to reserve the right to hunt or fish on the land. The contract should address any desired allowable uses for the producer to ensure both parties are on the same page.

Payment – The payment provisions of the contract are extremely important for the producer. There are several different potential payment methods that could be included in an agreement. There could be a per-acre payment for adopting certain carbon practices or a payment per metric ton of carbon as measured and verified. Another option could be a payment based on the carbon market at an identified time.



Producers should ensure the contract sets forth the exact details about how payment will be calculated. For any contracts based on actual carbon sequestered, producers should investigate the amount of carbon likely to be sequestered in their particular area. For example, agronomists report the amount of carbon likely to be sequestered in the Texas Panhandle and South Plains to be far less than the 1 ton of carbon per year it takes to create a carbon credit. Also important is to determine what costs or expenses may be deducted from the producer's payment. Ensure the provision also addresses when and how payments will be made.

Parties – A producer should certainly do his or her homework to investigate any party with whom they will enter into a carbon agreement. Understand the party's position in the market. Many contracts are being offered by brokers or aggregators, but there are also agricultural retailers offering these types of contracts. Try to speak to other producers who have entered into contracts with the company to ask about their experience.

Penalties – All contracts contain penalties if certain conditions are not met. It is important to understand these penalties and the risk associated with them. For example, if a party agrees to undertake a certain practice but an external reason such as weather prevents them from doing so for an amount of time, there could be a specific penalty for that. Some contracts may require a certain increase in the amount of carbon in the soil and include a penalty if that amount is not realized or is released during the term of the contract. Carefully review the contract to understand under which circumstances a producer could potentially be liable if this occurs. Contracts will likely also contain early termination penalties if the producer is unable to comply with the contractual requirements for the term of the contract.

Required practices – An agreement will set forth the required practices a producer agrees to undertake as part of the contract. Again, this differs by contract and must be carefully reviewed. Some contracts may list very specific requirements, while others may contain a more general description, such as conservation practices. Producers should be careful to analyze the additional costs that may come with adopting a required practice as compared to the potential carbon contract payment they would receive. Finally, producers should pay attention to whether the required practices are set throughout the entire contract or whether they may change from year to year.

Stacking prohibition – Often, carbon contracts will include a prohibition on stacking—meaning a producer may not enroll the same land in multiple carbon contracts or programs. It is important to carefully review any stacking prohibitions in a contract, as some may be worded broadly enough to prohibit participation in other government programs, such as the Environmental Quality Incentives Program (EQIP) or Carbon Reduction Program (CRP), for example.

Standard legal clauses – There are several standard legal clauses that are common in most contracts.

- ▶ **Attorney's fee provision** – Generally, regardless of the outcome, parties in a lawsuit pay their own attorney's fees. One way to modify this approach is if parties to a contract agree, the prevailing party may recover his or her reasonable attorney's fees.
- ▶ **Choice of law** – A choice of law provision is an agreement between the parties to a contract as to which state's law will govern the agreement. For example, if a farmer in Texas signs a contract with a broker in California, they could agree on either Texas or California law applying to the contract.



- ▶ **Dispute resolution** – Many contracts include a dispute resolution clause. Frequently, this is an agreement to participate in either mediation or arbitration. Mediation allows the parties to meet with a third-party mediator in an attempt to resolve their dispute. If no agreement is reached between the parties, then either party may proceed to file a lawsuit in court. Arbitration, typically, is agreeing to have a dispute heard before an arbitrator rather than in court. Both approaches are designed to be more efficient than a trial to resolve disputes, but each has different pros and cons to consider.
- ▶ **Insurance** – The producer likely wants to ensure the purchaser has an insurance policy and seeks to be added as an “additional insured” on this policy. Additionally, the producer may seek a waiver of subrogation, which essentially is a clause stating that the purchaser’s insurance company will not seek recovery from the landowner for negligence.
- ▶ **Venue** – A venue clause states where any legal dispute over the contract must be filed. For example, a farmer could request that any legal dispute be filed in his or her home county.

Term of the agreement – It is important to understand the length of the contractual agreement. An agreement will likely set forth a given number of years practices must be undertaken. Keep in mind that lengthy contracts may have estate planning implications as well. Some agreements may require the continuation of identified practices even once the term of the agreement ends to ensure permanence. Also, watch for any opt-out provisions that allow parties to terminate the contract prior to the end date if certain requirements are met. Some contracts allow either party to cancel merely by giving notice. Others may require certain conditions to be met. On the other hand, there could be provisions allowing for extensions to be granted, so watch for those provisions as well.

Verification – Provisions regarding measurement and verification are some of the most important in a carbon agreement. As an initial matter, the contract should set forth exactly what is being included in the measurements. For example, will the verifier simply measure the carbon in the soil, or will the entire system be looked at, including the impacts of livestock on the property or the impacts of using nitrogen fertilizer? Understanding exactly what will be measured is critical.

Next, parties should agree upon who will conduct any testing and verification, what methodology will be used to do so, and when and where such data collection will occur. Some contracts may offer payments based on modeling, while others will take actual measurements.

Measurements may be done in a number of ways, including algorithmically by taking actual physical soil samples and using satellites. The manner in which samples are taken can impact the results, and considerations related to the time of year (and even time of day), location in the field, and soil depth are all important to consider and understand. Parties should consider who will bear the costs of the data collection and verification. Generally, these costs fall to the purchaser. Finally, the producer may want to ensure there is a provision allowing an audit of the data and payments to ensure requirements are being followed and a process for how a producer can challenge or appeal determinations they believe are inaccurate.

