COMMODITIES BULLETIN

MAY 2021

Welcome to the first edition of our relaunched Commodities bulletin.

In this edition, we first put the spotlight on supply chain financing. Next, consistent with our commitment to sustainability, we explore the demand for metals used in electric vehicle batteries. We then offer a perspective on trade restrictions imposed on various Australian goods, before considering whether a "Mickey Mouse" FOB vessel nomination justifies termination.

Please also see our schedule of upcoming events, including our participation in the FT Commodities Global Summit, the standout industry event, which we are proudly sponsoring this year. The Commodities world always presents unique challenges and opportunities, recently including the headwinds of Covid, failure and insolvency, price volatility, and political and legal challenges but also, in light of surging sector demand and prices, the hotly debated prospect of a supercycle.

Warm congratulations go to our newly promoted talent, several of whom – Ranjani, Caroline and Owen – feature in this first edition edited from London. For the second edition, we pass the baton to our Singapore office.

This bulletin has your business in mind. Please do share any comments or suggestions for future content – we will always respond to your feedback.

Wishing you a happy read.

Brian Perrott, Partner

RANJANI SUNDAR
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> "In the context of a turnaround, a business (be it seller or buyer) may consider implementing a supply chain financing arrangement due to the positive impact it has on its liquidity and the ability of the parties to negotiate extended payment terms."

SUPPLY CHAIN FINANCING AS A TURNAROUND STRATEGY

When used effectively, supply chain financing can help to improve the financial performance of a business and relationships with key counterparties on whom its success relies.

In the commodities sector, insolvencies have historically been the result of late payments or non-payments from a company's debtors and a lack of working capital over an extended period of time. Supply chain financing presents a unique opportunity for businesses in this sector to negotiate extended payment terms, maximise working capital and strengthen relationships with key counterparties.

Supply chain financing (also known as SCF, supplier finance and reverse factoring), is a commonly used arrangement for businesses with large supply chains and multiple trade creditors, to manage their cash flow management processes. Industry reports recognise that the principal reasons for implementing supply chain financing include:

- working capital optimisation
- supplier liquidity needs
- supplier relationship improvement
- supply chain stability improvement.

In a distressed scenario, these factors become all the more important as emphasis is placed on the ongoing liquidity of the company and its ability to negotiate with key creditors.

Supply chain financing arrangements can take many forms, depending on the context and market in which they are used. In the context of commodities, two companies enter into a contract pursuant to which the seller sells a commodity to the purchaser and invoices them in accordance with the payment terms (either on delivery or on performance). The invoice might also form the basis of a supply chain financing arrangement, whereby a financier purchases it from the seller for the value of the invoice, less an agreed discount. The financier will then own the invoice and, having provided notice of assignment to the purchaser, the purchaser is required to settle it with the financier on the due date, and on the terms of the invoice.

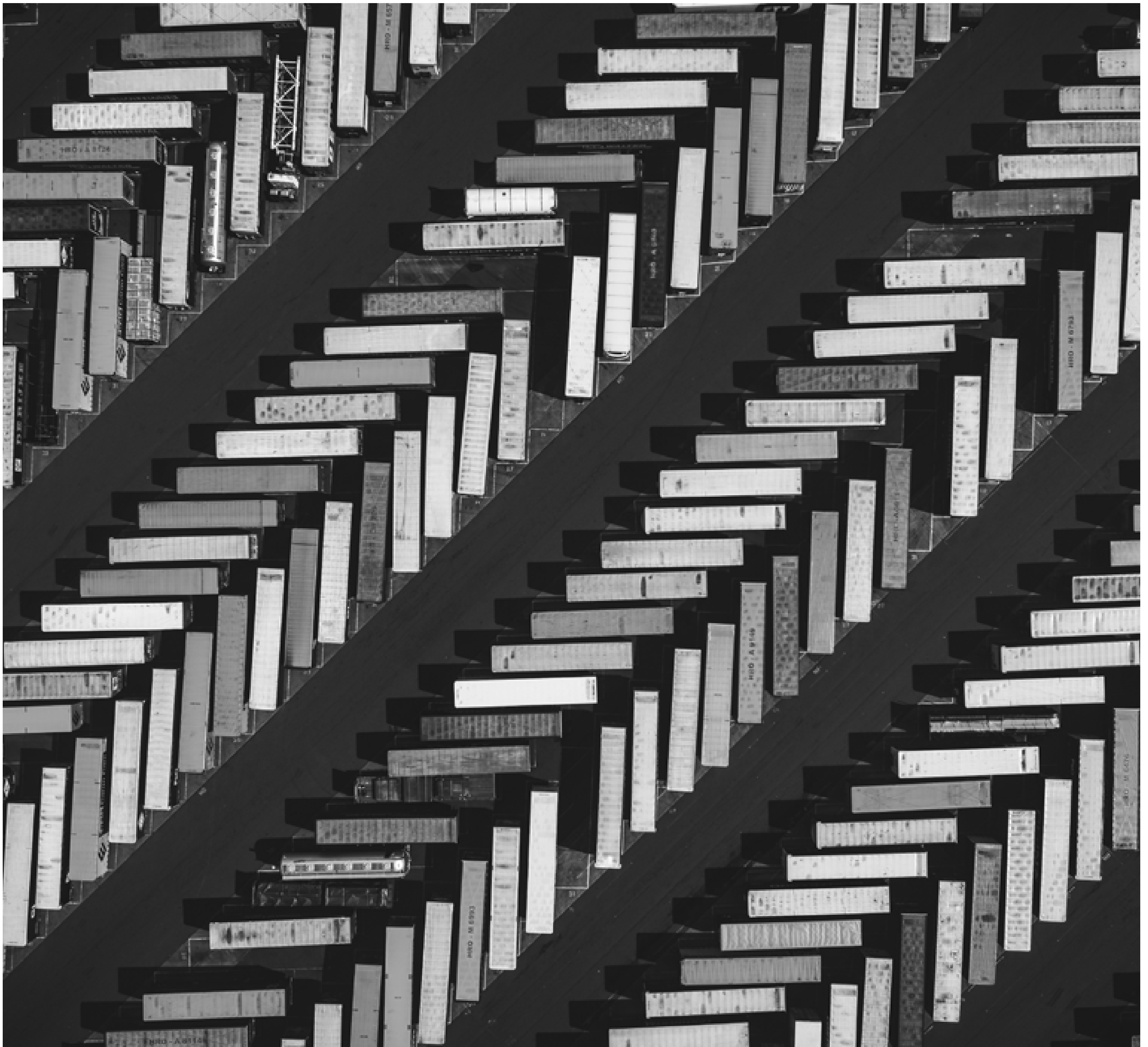
The benefit to the seller is that it receives immediate payment for the invoice from the financier, albeit at the agreed discount (to take into account the value of early payment).

From the perspective of the purchaser, it can negotiate extended payment terms with the seller in the knowledge that the seller will be paid by the financier, which is helpful in managing the purchaser's liquidity. Whereas historically, typical payment terms would be between 30 and 90 days, the growth of reverse factoring has resulted in payment terms of 180, 210 and even 364 days.

The financier benefits from the margin that it negotiates, being the difference between the discount negotiated with the seller and the amount received from the purchaser in settlement of the invoice.

In the context of a turnaround, a business (be it seller or buyer) may consider implementing a supply chain financing arrangement due to the positive impact it has on its liquidity and the ability of the parties to negotiate extended payment terms. Businesses considering such an arrangement should have regard to the following factors:

- The transactions are ordinarily non-recourse in respect of the seller. In the event of the purchaser being unable to settle the invoice, the financier's only recourse is against the purchaser, not the supplier.
- The transactions are ordinarily characterised as the purchase and sale of receivables. This is important for two reasons:
  - Firstly, in the event of non-payment by the purchaser, the financier will have a claim against the purchaser under the terms of the invoice purchased from the seller. Usually the financier cannot take security from the purchaser unless the terms of the invoice provide for this (and even still, the purchaser may not be able to provide security



if their other finance facilities contain a negative pledge).

– Secondly, the supply chain financing arrangement is usually given "off balance sheet" treatment (unless the purchaser incurs direct obligations in favour of the financier) due to it being characterised as a true sale, rather than incurring financial indebtedness. In other words, companies can account for the invoices under trade payables, boosting their cash flow forecast, instead of reporting the invoices as debts on their balance sheet. In a distressed scenario, whilst this may be positive for a distressed seller, prospective buyers should be aware when conducting due diligence that supply chain financing arrangements may appear "off balance sheet".

- Both financier and purchaser are bound by the terms and conditions in the invoice, rather than any supply chain financing arrangement. These will include the invoice's governing law and jurisdiction clause and could also include, for example, rights to set-off, rights to register security interests and retention of title clauses.
- Supply chain financing arrangements may operate in conjunction with other, more traditional, funding facilities which may require a negative pledge and/or first ranking security. Such an arrangement may be beneficial for businesses requiring immediate funding from various sources in order to manage cash-flow and existing debts.

As the market continues to grow, company directors, stakeholders and financiers may wish to consider supply chain financing as a valuable funding solution, particularly in the context of a turnaround strategy.

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"This year promises to be an exciting one for the development of electric vehicles and consequently for the market in metals used in batteries such as lithium, cobalt and nickel."

GREEN MACHINE: THE DEMAND FOR METALS USED IN BATTERY PRODUCTION FOR ELECTRIC VEHICLES

2021 will be an exciting year for the electric vehicle industry as many major manufacturers make new commitments to produce electric cars. This industry shift has already caused a surge in demand for metals used in battery production, such as lithium, cobalt and nickel.

At the time of writing, the published LME price for cobalt was in excess of USD46,000 per tonne – a substantial increase on December 2020 prices.[1] Economists largely attribute this trend to increased demand from the electric vehicle industry.

Some analysts predict that the scarcity of cobalt could be a restricting factor in the cost effective development of electric vehicles. Cobalt is mined in a limited number of locations around the world, with the biggest share being found in the Democratic Republic of Congo.

Whilst new projects are expected to bring increased supply to the market, lead times for developing new mine sites are considerable. With these challenges in mind, some companies are reported to be exploring alternative battery technologies utilising less cobalt in their design.

A further issue for vehicle manufacturers, affecting all raw materials for battery production, is developing a transparent supply chain whereby material is ethically sourced. Last year, we reported that the LME has introduced responsible sourcing requirements for all brands listed for good delivery on the LME against physically settled contracts. Broadly, all LME brands will be required to check their supply chains for certain 'red flags' – for example, minerals originating from conflict-affected and high-risk areas. Parties are increasingly including responsible sourcing clauses in their contracts in order to help ensure compliance with these requirements.

In volatile market conditions, any traders hoping to explore opportunities by entering into new sale and purchase agreements should draft contract terms carefully. Unlike the oil industry where certain general terms and conditions are widely used across the market, typically, metals like lithium, cobalt and nickel are traded on a variety of terms.

When negotiating long-term or spot contracts, traders should consider the following:

Price

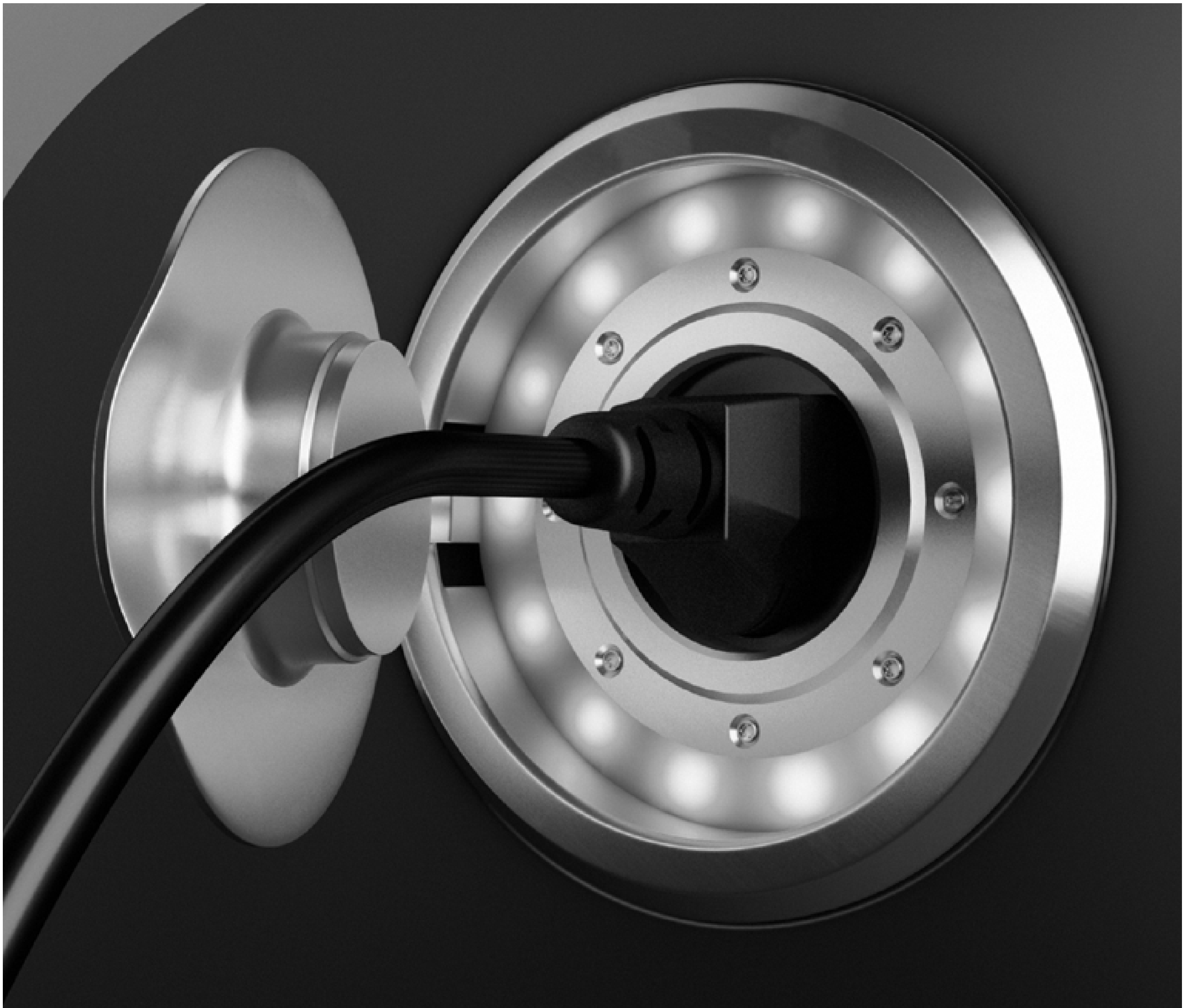
Often contracts provide for the price to be determined by a formula with reference to a published pricing index, plus a premium or less a discount. To avoid disputes, the appropriate quotation period should be carefully specified. In a long-term supply contract, some parties may insist on a price review clause. These clauses should be carefully drafted so that, if the parties are unable to reach agreement within a specified time, a final determination can be reached (for example by an independent expert) or the contract terminated. Clauses which are open-ended "agreements to agree" and which do not set a clear mechanism, risk rendering the contract too uncertain to be enforceable.

Quantity and Quantity

To avoid disputes, quality and quantity specifications must be clear. Parties should note that, where English law governs a contract, certain implied terms under the Sale of Goods Act 1979 apply, unless expressly excluded.

Agreements must specify a clear mechanism for quality and quantity determination. This is particularly important in metals contracts that provide for provisional pricing followed by a final price fixed by reference to the quality of the delivered material. In the event that the quality and quantity is to be determined by an independent inspector or lab, the identity of that inspector or lab must be clear.

1 https://www.lme.com/en-GB/Metals/Minor-metals/Cobalt#tabIndex=2



Force Majeure

Force majeure clauses can limit a party's liability when certain specified events hinder or prevent performance of contractual obligations. Following the disruption caused by COVID-19, many traders are reviewing their standard clauses to ensure they continue to meet their needs.

Termination

Clauses providing a contractual right to terminate should be drafted with care. In particular, parties should resist copy and pasting terms used in spot contracts into long-term agreements without first subjecting the terms to scrutiny.

Governing Law and Dispute Resolution

Parties must remember to specify expressly the governing law of the contract and the forum for resolving any disputes. When concluding a metals supply contract with a state entity, it would be advisable to include a waiver of state immunity.

This year promises to be an exciting one for the development of electric vehicles and consequently for the market in metals used in batteries such as lithium, cobalt and nickel. It will be interesting to see how the industry responds to increased demand. For commodities traders, careful contract drafting will be essential to avoid uncertainty in a potentially volatile market.

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"While a number of tariffs have now been lifted, the diplomatic situation remains tense, raising the prospect of further trade restrictions in the near future."

VOLATILITY – WHO BEARS THE COST? A FOCUS ON GEO-POLITICS IN THE INDO-PACIFIC REGION.

In the midst of a volatile period, another challenge for commodities traders and carriers has emerged in the form of worsening geopolitical tensions in the Indo-Pacific region. Diplomatic disputes between China and Australia have led to, among other things, the Chinese government introducing trade controls on various Australian goods.

Australian barley, beef, lamb, wine, cotton, timber, coal and lobsters have all been subject to prohibitive import tariffs, with shipments either delayed at origin or, in a number of instances, afloat. In May last year, the Chinese Ministry of Commerce imposed a combined 80.5% tariff on Australian barley, following an 18-month investigation into alleged anti-dumping breaches. In late 2020, more than 60 Australian coal-carrying vessels were stuck off the Chinese coast, a number that had hardly improved (to around 40) by March of this year.

The imposition of trade restrictions after contracting, and even in the period between cargo shipment and discharge, can have significant financial consequences for both traders and carriers. In some instances, although the goods have already been paid for and title to the goods afloat may have already passed to the buyer, the buyer may be unable or unwilling to receive them because in so doing, they will become responsible for payment of local tariffs.

In that scenario, vessels can be stranded at sea, without a clear solution. The carrier will be bound to deliver the goods to the bill of lading holder and, unless the cargo is abandoned, may be forced to sit and wait until the importer obtains customs clearance and the receiver finally takes the goods. Of course, the costs of delay will be passed on through the charterparty chain in the form of hire or demurrage. This is a situation made more difficult, both practically and legally, by the crew change restrictions that have been widely adopted due to Covid-19.

At the same time, commodity producers who have entered into fixed take or pay arrangements with ports and rail providers may be forced to continue shipping product in the absence of Chinese buyers, and therefore forced to compete in new markets.

While a number of tariffs have now been lifted, the diplomatic situation remains tense, raising the prospect of further trade restrictions in the near future. It is almost always the case that an importer will be contractually responsible for the payment of local customs duties, but the response to the recent Chinese tariffs shows that in practice, risk is borne by all parties involved in the trade. As ever, volatility can mean opportunity, but traders and carriers should be aware of their potential exposures and ensure that their agreements contain protections suitable for this ever-changing world.

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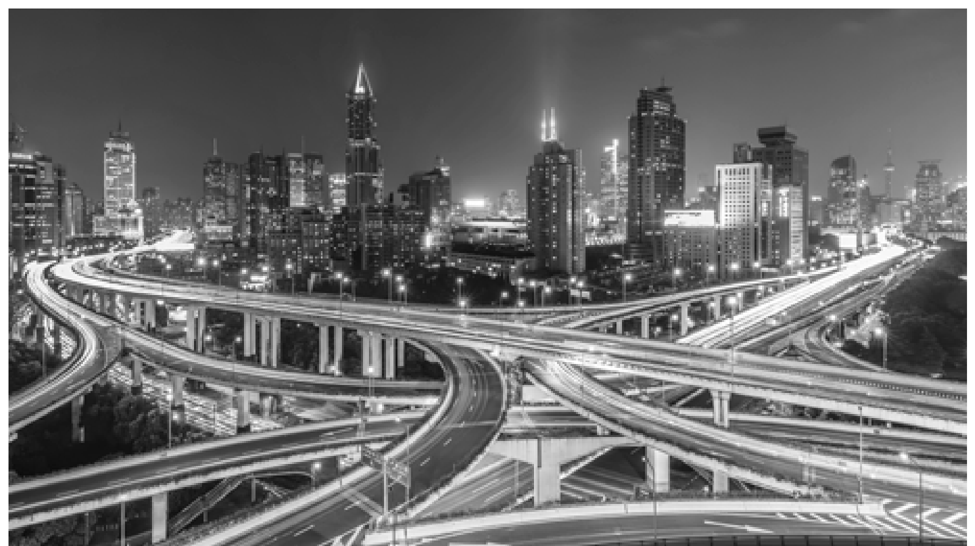

FANCIFUL FOB VESSEL NOMINATIONS – CAN THE SELLER TERMINATE?

The High Court has held [1] that a FOB buyer who made a "fanciful" vessel nomination was not in breach of a condition, and the seller who subsequently jumped to terminate the contract was not entitled to do so.

Under an FOB contract for the sale of Ukrainian feed corn, the buyer nominated a vessel. The seller became aware that the vessel was already committed on another voyage and alleged the buyer was in repudiatory breach of contract for making a "fanciful" nomination. The seller purported to terminate the contract by accepting the alleged breach. There was still time in the delivery window and so the buyer proceeded to make a valid substitute vessel nomination, but the seller refused to accept it.

It is also relevant to note there was a clause in the sale contract that required the buyer to furnish a copy of the vessel's charterparty at the seller's first request. On the first nomination, the seller requested a copy of the charterparty. The buyers advised they would pass the request down to their sub-buyers, but ultimately did not provide one.

Both the first tier Tribunal and the GAFTA Appeal Board found in favour of the buyer, holding that irrespective of the first nomination being invalid, the subsequent nomination was valid and the seller was in breach for refusing to accept it. The seller appealed to the High Court on five questions of law, three of which we consider further below.

Q1: Was making a false vessel nomination a breach of condition?

Where a contract of sale requires a buyer to nominate a vessel by a particular date, it is a condition that the buyer provides a valid nomination by that date. The mere giving of an invalid nomination is not in itself a breach of condition, provided the buyer makes a subsequent valid and timely nomination.

The Court distinguished between a nomination made (i) not in good faith and of a vessel which could obviously not reach the loadport in time (coined a "Mickey Mouse" nomination) and (ii), in good faith but without reasonable grounds. Whilst a Mickey Mouse nomination may evince an intention not to perform and entitle a seller to treat the contract as a whole as discharged, the latter type of nomination will not lead to the same consequences.

Here, the buyer was acting in good faith in making the nomination but due to the vessel's position and predicted congestion delays, the vessel would not have made it to the loadport in time and therefore the buyer's nomination was without reasonable grounds. Although the buyer made an invalid nomination and was in breach of contract, it was not in breach of a condition *"provided, always, that a valid nomination is ultimately given in accordance with the contractual timetable."*

Q2: Was the buyer obliged to nominate a vessel that had been chartered (at the date of nomination)?

This question of law was held to be immaterial, as the Board had concluded (in their award) that there was insufficient evidence to determine whether the vessel had been fixed or not.

However for completeness, the Court considered the question. At the time of nomination, the seller's critical need was for the buyer to give a valid and timely nomination, and for that nominated vessel to arrive on time to load the cargo. To make that happen, the buyer was obliged to take the necessary steps to secure a vessel to arrive on time. The judge concluded, *"I do not consider it possible to infer that the parties intended to go further by requiring, as a condition of the contract, that the charterparty actually be fixed at the time of the nomination."*

Q3: Was the obligation on the buyer to provide a copy of the charterparty a condition?

The Court recognised that in commercial chain transactions, it is reasonable to expect there may be delays in passing documents down the chain. As such, the Court *"very much doubt[ed] that commercial*

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"The mere giving of an invalid nomination is not in itself a breach of condition, provided the buyer makes a subsequent valid and timely nomination."

1 A v B [2021] EWHC 793 (Comm)

parties would have intended any such delay to render the contract liable to immediate termination" and held that the buyer's failure to provide a copy of the charterparty *immediately* on the seller's request was not a breach of condition.

Commentary

This is a classic tale of a party unsure of its contractual rights and terminating too soon. It is a reminder that not all breaches of contract will entitle a party to terminate.

The Court made clear that an initial invalid vessel nomination (made in good faith) may not be sufficient to allow termination, and a party may be able to make a subsequent, valid nomination within the relevant time.

It is important to consult with your legal advisors to ensure you are legally entitled to terminate a contract before you take steps to do so. A party pulling the plug too early could itself be in repudiatory breach, allowing its counterparty to claim damages.

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WHERE YOU CAN MEET THE TEAM NEXT

3 June 2021
ASIFMA ESG & Sustainable Finance Week
Speaker: Peter Zaman

3 June 2021
Softs Webinar
Speakers: Sarah Hunt, Michael Buisset, Brian Perrott, Caroline West, Emma Bud, Patrick Myers

15-16 June 2021
FT Commodities Global Summit
Speaker: Brian Perrott

21 June 2021
HFW Commodity Webinar Series
Speakers: Damian Honey, Matthew Cox

OTHER TEAM NEWS

A warm welcome to **Matthew Cox** who specialises in structured trade and commodity finance. Matthew joined us on 6 April 2021. You can find out more details about Matthew's arrival **here**.

Dan Perera has been named as one of three lawyers listed in the Commodities section of the Singapore 2022 edition of **Best Lawyers**. He joins **Richard Crump**, **Siri Wennevik**, **Paul Aston** and **Alistair Duffield** as ranked individuals from our Singapore office.

Congratulations to **Ranjani Sundar** (Sydney) who has been promoted to Partner, to **Owen Webb** (Melbourne) who has been promoted to Special Counsel, to **Edward Beeley** (Hong Kong) and **Caroline West** (Geneva), who have been promoted to Senior Associates.

HFW has over 600 lawyers working in offices across the Americas, Europe, the Middle East and Asia Pacific. For further information about our commodities capabilities, please visit hfw.com/Commodities

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