



# COMMODITIES BULLETIN

## Enforcing arbitration awards in the cotton trading world

The International Cotton Association (ICA) is the world's leading cotton trade association and arbitral body, with over sixty per cent of the global cotton trade conducted under its terms, the ICA Bylaws and Rules. The Bylaws contain some notable and innovative procedures aimed at dealing with parties who default on their obligations, either under the original contract of sale, or in arbitration awards obtained against them. Given that many cotton producers are found in jurisdictions where successful enforcement of an award is challenging, the ICA's procedures are particularly apposite.

The centrepiece of the ICA's enforcement regime is the Default List. This document, publicly accessible on the ICA website, lists all entities against whom there are unfulfilled ICA arbitration awards. The purpose is twofold. First, as ICA members are liable for penalties up to and including expulsion from the ICA should they trade with a listed defaulter, the list serves

to warn them away from trading with parties named. Secondly, because the list is public, it is a way to "name and shame" defaulters. The purpose behind this is not merely punitive: it allows investors and underwriters in the wider market to make appropriate and informed risk assessment decisions.

Listing particular defaulters cannot address the risk that, in a world of complex, sometimes informal corporate structures, where different entities can be utilised to conduct the business of the same ultimate owner, law-abiding parties may unwittingly trade with counterparties who may in fact be serial defaulters. To counter this, the ICA has a system of Advisory Notices. These are circulated to ICA Members reporting all entities the ICA believes to be related to, or utilised by, listed defaulters. Linked to this, it is a disciplinary offence (again punishable by expulsion) for ICA members to be party to a trade with the intention of circumventing the Default List.

The ICA Bylaws also contain a fixed mechanism for non-performance, which results in the

contract being closed out by being invoiced back to the seller. The idea is to create a straightforward and efficient way of dealing with non-performance, even if it does effectively leave the issue of liability to one side. Whilst contracts made on ICA terms must include the invoicing back procedure, it is possible for parties to make provision for breaches of contract or events such as counterparty insolvency in clauses tailored so as to be consistent with invoicing back. This was explored in more detail in HFW's Cotton Briefing, August 2011 (<http://www.hfw.com/publications/client-briefings/no-blame-game-at-a-price>).

The ICA's regime cannot eradicate the problem. Cotton traders, like participants in all global commodity markets, are still faced with the challenges of enforcing obligations and awards against parties in far-flung jurisdictions. With key cotton producers found in jurisdictions such as India, China and Vietnam, enforcing arbitration awards can prove difficult. The number of parties appearing on the ICA Default List bears this out. Cotton traders therefore need to ensure first that their contract terms provide robust protection against a counterparty's default. In the event that they reach the stage of enforcing an arbitration award, they should consider using all available legal tools. This includes the possibility of obtaining a freezing order from the English Commercial Court. These orders can prevent a defaulter from dissipating its assets held anywhere in the world, in the face of an unpaid award. Obtaining a freezing order is more straightforward for ICA-governed disputes as the relevant contracts and arbitrations are governed by English law. Freezing orders should therefore

be considered as a potentially valuable means of making award defaulters pay up.

For more information, please contact **Brian Perrott**, Partner, on +44 (0)20 7264 8184 or [brian.perrott@hfw.com](mailto:brian.perrott@hfw.com) or your usual contact at HFW.

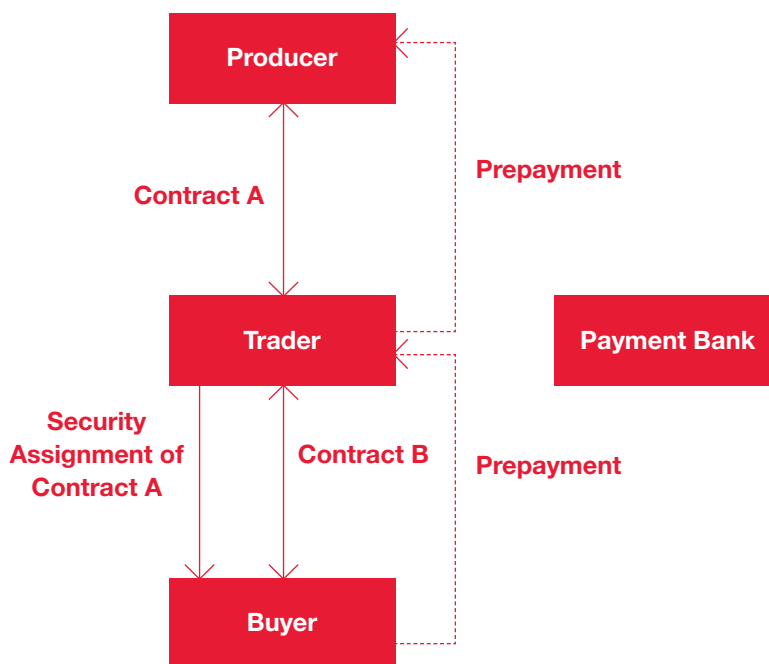
### Trade finance: different sources

The trade finance market is adapting to the liquidity squeeze caused by reduced US Dollar availability, the various sovereign debt crises and additional, expensive market regulation imposed by the Basel III regime. Traditional routes to finance, involving bank provided debt facilities, are being replaced by alternative structures. These structures are not new, but they have not previously had such a prominent role in world trade. They include prepayment arrangements, Export Credit Agency (ECA) support and ownership

structures, such as Forfaiting and Repo. Additionally, trading houses are playing a greater role in the provision of finance.

### Prepayment arrangements

The structure below sets out a basic prepayment arrangement, whereby the Buyer pays for part, or the whole, of the cost of the goods, as an upfront prepayment. In this structure, the Buyer makes an initial prepayment under Contract B which the Trader passes up the chain to the Producer under Contract A. The security package offered to the Buyer comprises a security assignment of the Trader's rights under Contract A. It might also involve an irrevocable direct payment instruction via a third party bank, so that funds are routed through the bank and are certain to find their way to the Producer. This mitigates the risk of dealing with the Trader. Additional security may be taken over the goods in transit, depending on the efficacy of this under local law.



## ECA support

ECA backed financings are well-established. Traditionally, they have been deployed to assist with financing infrastructure projects, ships, trains and aircraft. The ECA may issue a guarantee, or an indemnity for the debtor's obligations, or may act as a direct lender for all or part of the project.

Recent months have seen an increase in activity from Asian ECAs (in Japan, China and South Korea, in particular). Figures from Dealogic suggest increases in ECA financings from 2007/2008, when market size was approximately US\$35 billion for the whole year, to 2011, when it was US\$28.5 billion in the first six months alone. 2012 figures are approximately US\$60.3 billion for the first half of the year.

The emergence of US Ex-Im backed bonds in the aviation sector is an interesting development. This

involves the ECA issuing a bond and applying the resulting funds towards the project. This encourages investment, by shifting the credit risk away from the asset sector and specific transaction to the ECA itself, hopefully releasing liquidity. It provides additional advantages through provision of a fixed interest rate, rather than the more standard floating rate traditionally associated with ECA loans.

It is anticipated that this increase in ECA activity and interest in pursuing alternative structures will filter through to other types of trade finance.

## Ownership structures (forfaiting/ repo)

Forfaiting is another well-used structure that is finding favour in the current economic climate. In essence, it involves a Trader selling goods to a financial institution and buying them back at a premium at a future date, before on-selling to an end buyer:

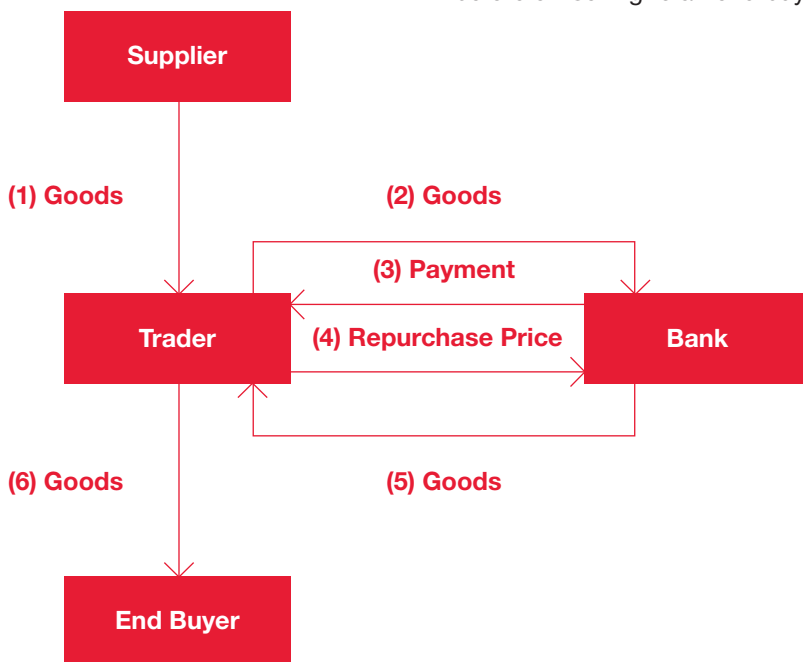
The repurchase price may be fixed or based on the market index price at the time of repurchase, with the time elected by the Trader. This structure provides a form of quasi-security for the bank, because it takes ownership of the goods until the finance is repaid. These transactions also assist with off balance sheet treatment for the Purchaser, although issues regarding the true sale nature of the financing and possible re-characterisation of the transaction as a loan need to be considered carefully.

## Provision of finance by trading houses

Trading houses are becoming more directly involved with financings. Payment is made to the Supplier by the trading house on behalf of the Trader, who takes delivery of the goods and sells them to the end

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**“These transactions also assist with off balance sheet treatment for the purchaser, although issues regarding the true sale nature of the financing and possible re-characterisation of the transaction as a loan need to be considered carefully.”**



Buyer. The trading house realises a profit by receiving a promissory note, or discounted bill of exchange of greater value than the amount paid to the Supplier. The trading house will take security over the goods in transit and be named on the insurances as a loss payee.

### Conclusion

While the prevailing economic climate presents difficulties, the trade finance

market is adapting by favouring the use of alternative sources of finance. With the role of the ECA and trading houses becoming more prominent, there are signs of greater liquidity ahead.

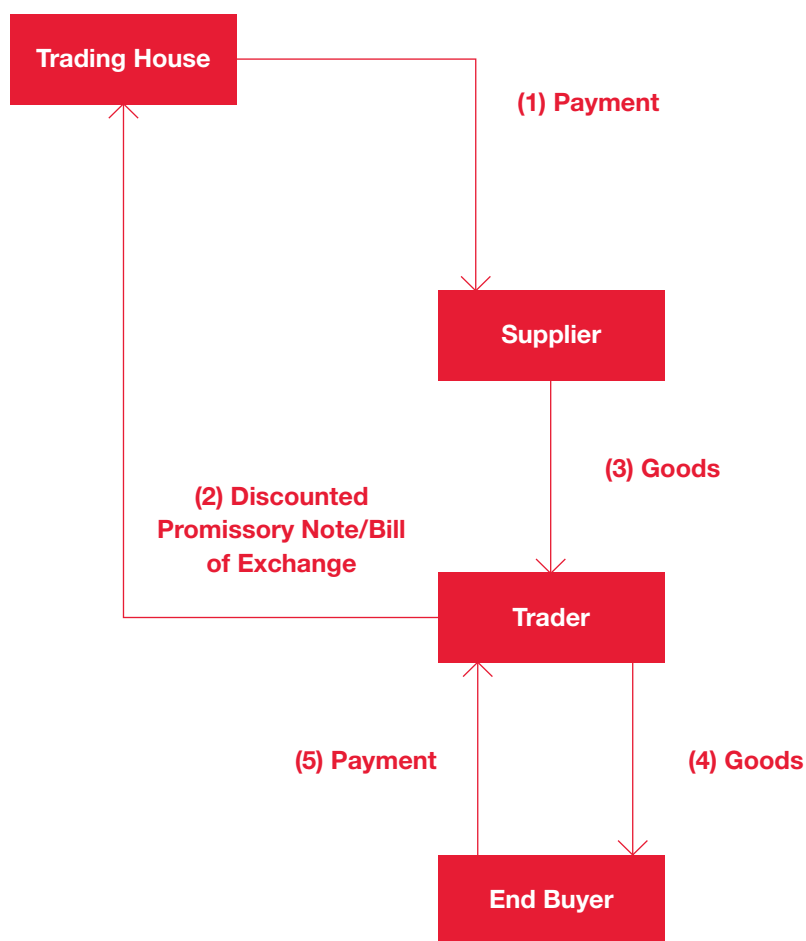
For more information, please contact **Spencer Gold**, Associate, on +44 (0)20 7264 8177, or [spencer.gold@hfw.com](mailto:spencer.gold@hfw.com), or your usual contact at HFW.

### The Bribery Act and market practice

The media spotlight may have moved away from the United Kingdom's Bribery Act, but the Act remains high on the agenda of the Serious Fraud Office and other regulators. While we have not yet seen a corporate prosecution for breaching the Act, it seems likely that various investigations are underway, and that there will be a prosecution within the next 12-18 months. Given the heavy criminal penalties for breaching the Act, which include imprisonment and unlimited fines, businesses worldwide should continue to consider the implications of the Act for their operations.

Companies involved in vessel chartering and trading commodities face particular challenges because of the nature of those businesses, including the use of agents, the involvement of foreign public officials, and political and cultural circumstances in producing countries. Companies involved in trading energy commodities are at particular risk, since several of the main producing countries, such as Russia, Ukraine and Nigeria, have been identified as high risk countries in the annual Corruption Perceptions Index. In addition, because vessels and cargoes are high-value assets, corrupt public officials may rely on the cost of any delay to put pressure on companies to make payments which they might prefer not to make.

Where companies are dependent on a licence from a producing country, they need to understand the application process and criteria for the award of that licence, so that they can satisfy themselves that all





of the indirect and direct payments they make as part of the process are legitimate. Payments made by third parties on their behalf should be carefully scrutinised, as should requests for hospitality and other expenditure.

Where companies are appointing agents and paying agents' fees and disbursements, they should satisfy themselves that the activities of the agents do not expose the principal under the Act. Appropriate due diligence and proper contract terms offer protection in this area. Agents could also be required to comply with the company's code of conduct, and there should be clear rules on invoicing and payments.

Companies must have clear policies on facilitation payments. They should be particularly wary of charges that are described as payments for expedited services (unless it is a genuine charge for a genuine fast-track process), cash payments (e.g. for unnecessary certificates and clearances), gifts in kind (e.g. whisky and cigarettes), or fines which are not supported with genuine penalty notices.

All companies involved in vessel chartering and trading commodities should have the following in place:

- Robust (but proportionate) policies and procedures that prohibit bribery and actively seek to prevent it where it might arise.
- A published policy of zero tolerance of bribery.
- A commitment to an anti-bribery programme and to compliance in all jurisdictions.

- Communication of that programme to all relevant employees, subsidiaries, agents and business partners, with a requirement that they comply with the programme (or their own equivalent).
- Due diligence and vetting of agents and counterparties.
- Appropriate terms and conditions of appointment for agents.
- Ongoing monitoring and review of the programme.

For more information, please contact **Daniel Martin** (pictured below), Associate, on +44 (0)20 7264 8189 or [daniel.martin@hfw.com](mailto:daniel.martin@hfw.com), or your usual contact at HFW.



**“Companies must have clear policies on facilitation payments.”**

## Conferences & Events

### International Cotton Association Conference

Hong Kong  
(1-2 November 2012)  
Brian Perrott and Peter Murphy

### C5's 3rd EU OTC Derivatives & Clearing Conference

London  
(6-7 November 2012)  
Robert Finney

### Global Grain

Geneva  
(13-15 November 2012)

### Sugar Association of London Seminar

London  
(29 November 2012)  
Judith Prior

### HFW Seminar: Trade Finance and Basel II/III

Geneva  
(29 November 2012)  
Matthew Parish, Janet Butterworth,  
Jeremy Davies, Paul Wordley,  
Robert Finney, Géraldine Piechaud,  
Ian Chung and Vitaliy Kozachenko

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