ReedSmith

Avoiding the pitfalls in an under-supplied and rising market

4 September 2012

Authors: Diane Galloway , Vassia Payiataki , Philippa Rowe

The commodities world is experiencing its third price spike in five years. Countries all over the globe – from India, Australia and China to the United States and parts of Europe - have suffered poor rainfall and the resultant droughts have lowered crop yields and raised concerns about poor quality of the crops that have grown.

GAFTA reports on agricultural harvests so far show that both Ukrainian and Russian harvest yields are lower than last year. The drought in the United States, which grows approximately a third of the world's corn and soybean, has devastated these crops and it is expected that many livestock farmers will turn to wheat as an alternative animal feed, increasing demand.

As a result, agricultural prices are rising. It has been reported that U.S. corn prices have risen by a massive 41% since mid-June, soybean by 25% and European wheat by 50% in the same period. As the harvest continues and actual yields are discovered, it appears that supply is dwindling, bringing with it increases in demand and in prices.

Volatility in the agricultural market is not new. Each price rise and dip brings with it its own problems and challenges for traders and lawyers alike. What, therefore, can parties selling and buying on a rising market expect to encounter and how can these potential issues be minimised? This client alert examines some of the most common consequences of a rising market.

(1) As prices rise, so do defaults…·

The most obvious impact of a rising market is that a seller is able to – and will want to - obtain a much higher spot price than it may be due to be paid under its existing contract. In such circumstances, a seller may do everything it can to get out of its low-priced contract.

A buyer, on the other hand, needs to perform the contract precisely to avoid giving any "get out of jail free cards" to its seller. For example:

- Keep strictly to every time limit, whether it is the opening of a letter of credit, nominating a vessel or naming a port of loading. Diarise all deadlines and, if possible, take your actions early. Check that the content of each notice is exactly what the contract requires.
- Any letters of credit must adhere strictly to the contract requirements. Even the smallest of mistakes in the letter of credit – e.g. a spelling error in the name of the loadport – could allow a seller to legitimately refuse to perform the contract. Again, try and open the L/C well ahead of the final deadline in order to allow time to correct any mistakes, but remember – a seller does not need to tell you why the L/C is uncontractual.

- What do you need to do before the seller is required to perform? Make sure any conditions precedent to the seller's performance are done on time and correctly. Then, call on the seller to perform and keep the pressure on him to perform.

- If the seller shows signs of default – take care and consider taking legal advice. A good claim for default can be easily lost through waiver, sending inconsistent messages or jumping "too soon". All correspondence and discussions with the (perhaps) defaulting seller should be centrally controlled. An ill-advised "yahoo" conversation can ruin a good claim!

- After a default, a buyer should realistically weigh settlement against claiming in arbitration (will any award be paid?); consider mitigation (i.e. how to minimise loss and how to demonstrate you have done so); check all relevant time limits for making a claim; and whether security for the default claim could be obtained through action in advance of litigation/arbitration.

(2) Can what is grown be sold?

A problem caused by droughts, often considered less, but having an equally significant impact, is the quality of crop produced. Not only does the crop yield less, but much of what is produced may be of a poor quality, and not what the contract required.

Sellers and Buyers alike need to be aware of this. In the event that the crop is not of the requisite quality, consider your options. As Seller, are there allowances for quality set out in the contract or are poor quality goods rejectable under the contract? Often this question is not easy to answer from the contract wording. Sellers should be aware that crop failure in terms of quality is very rarely excused by Force Majeure or similar clauses, so usually the Seller will be liable for damages for breach. As Buyer, can you reject? Do you want to or can you buy alternative goods if you need them to sell on to your buyer? Can you reach a negotiated discount?

(3) Export restrictions

The Russian export prohibition of August 2010 and the Ukrainian export restrictions of late 2010/ early 2011 are still at the forefront of many people's minds. These arose as a result of similarly poor weather and weak crop yields. While current forecasts suggest that the total Russian grain production will not be quite as low as in 2010, there have already been rumours of a possible imposition of export restrictions and/ or tariffs.

For a seller, export restrictions are not easy to deal with. Many GAFTA arbitrations arising out of the fallout of the Ukrainian export restrictions are still ongoing. In the event that export restrictions are put in place – whether in Russia, the Ukraine or elsewhere – there are a number of issues a Seller needs to be aware of:

- **(4) What is the correct price under the contract?** Get to know the rules early on and check regularly for changes. Where export restrictions are put in place, the requirements for obtaining licences and the deadlines for doing so can change within the day. Appoint someone within your organisation to be in charge of keeping up to date with the rules.

- Any applications for export licences or approvals should be done as promptly and as precisely as possible. In the event a dispute arises, a Court or arbitrators would not look kindly on delays caused by the seller or incorrect applications which resulted in the refusal of a licence.

- If you do not have enough goods to satisfy all your commitments, consider whether you can (or are legally required to) buy more from elsewhere. Are there goods already cleared for export available or afloat? A seller must usually make reasonable endeavours to fulfil its contract, even if by alternative means, so make sure sufficient enquiries are made.

- Consider taking legal advice! The imposition of export restrictions and the accompanying law is complex and must be negotiated carefully.

Finally, the pricing of the contract itself can be key in a rising market. Many contracts are not based on a fixed price but on floating prices linked to exchanges and fixing a flat price can be linked to the bill of lading date. What happens when a seller, by its own breach, delays loading of a vessel and, as a result, the contract price rises?

This was the question brought before the English Court in *The "Ninae" (Petroplus Marketing AG v Shell Trading International Ltd* [2009] EWHC 1024). The parties concluded a FOB contract for the sale of high sulphur fuel oil and light cycle oil, to be lifted in one lot between 21-25 June 2008. The price of the sulphur fuel oil was the average of the Platts mean quotation on the bill of lading date, the two preceding and the two following quotations. The contract also included a clause providing that payments were to be made without set-off, counterclaim or deduction.

In the event, a vessel was nominated by buyers and loading instructions were given on 24 June 2008 but loading did not start until 3 July 2008. Loading completed two days later and a bill of lading dated 5 July 2008 was issued. By this time, the market price had risen considerably.

The delay was assumed to be due to a breach by the sellers. Nevertheless, the sellers claimed the higher price based on the actual bill of lading date, which the buyers refused to pay, contending that the sellers should not be entitled to benefit from their own breach and that the clause should be read such that the bill of lading date must be contractually compliant (i.e. between 21-25 June 2008).

The Court rejected the buyers' argument. It held that it was clear from the contract that the parties "*intended that the price should be calculated and paid by reference to the bill of lading date notwithstanding late delivery*". The parties had established the mechanism for payment which would be ineffective if the buyers could withhold payment by challenging the calculation of the price by reference to the bill of lading date.

The case left open the issue of whether the Seller was in breach for the delay in loading and what damages might be due as a result.

Conclusions

Much of this alert deals with issues which have arisen in the commodities business before and with which traders will be very familiar. It is clear, however, that the expertise from previous defaults and prohibitions will have to be used again this year.