

Grain Contracts

Managing Counterparty Insolvency

Insolvencies occur in all industries including grain and, therefore it is good business practice to be prepared to deal with an insolvent counterparty.

The best preparation is to avoid dealing with counterparties that are at risk of becoming insolvent. However, even with the best preparation it is likely that you may have to deal with an insolvent counterparty at some point.

This guide is the 'before and after' of insolvencies.

WHAT IS INSOLVENCY?

There are two primary definitions of insolvency:

1. the inability to meet liabilities as they fall due; and
2. a shortfall of assets to liabilities.

Whilst the first definition is more commonly used both are relevant; as without support from another party the second definition will result in an occurrence of the first.

This guide focusses on the first definition of insolvency. For a company faced with insolvency the inability to meet liabilities as they fall due is not the result of a short-term incident but more an inability to meet obligations over an extended period. Being unable to meet creditor liabilities for one day due to cashflow timing is not an event of insolvency. However, it is cause for concern and risk evaluation and mitigation action may be required.

Insolvencies are dealt with differently between companies and individuals. This guide focusses on company insolvencies.

An event of managed insolvency can also occur if the company is voluntarily wound up or has applied to be wound up. These

arrangements usually occur when a business ceases trading or is undergoing a restructure and there has been full provision for liabilities. As a result of the full provision this form of insolvency is not considered a risk.

WHAT IS THE RESULT OF INSOLVENCY?

The following are some of the possible results of insolvency:

- Prior to Amendments on 1 July 2018 to the Corporations Act 2001 (Cth) once an insolvency occurred contracts enter automatic default. With the amendments the administrator can choose (based on value to the insolvent business) which contracts to execute or conversely to enforce. For more information please review this [GTA Member Update](#)
- Directors and officers of the insolvent entity may face civil and criminal action as a result of the insolvency;
- Creditors of the business have different orders of priority in regard to subsequent payments from the entity;
- a different party takes control of the



- business and large costs are incurred;
- payments to suppliers prior to the insolvency event may be forcibly repaid to the entity; and
- usually a great length of time passes before the affairs of the entity are resolved.

Insolvencies are unpleasant experiences for all parties and best avoided if possible. It is very rare to be an unsecured creditor to an insolvent business and receive full recovery of your claim.

PRIMARY RISKS IN A GRAIN INSOLVENCY

There are two main risks in a grain insolvency – **delivery risk** and **market exposure risk**.

Delivery risk is the failure to receive payment for product that has been delivered to the counterparty.

The other, less obvious, risk is the change to market position created by default on contracts. This is the change in the financial position as a result of the market movement in price of the original contract price as compared to the market price on the day you close the position out.

Exposure from the first risk is obvious. However, exposure under the second risk is not as obvious unless you run a counterparty position report. A counterparty position report shows the exposure you have on all counterparty contracts against the current market. It shows the risk you bear if they were to default on their contract obligations at a point in time.

COUNTERPARTY DEPENDENCY

Your risk with a default is not just with the buyer of your grain. The delivery risk is associated with the buyer, but the market exposure risk may be with sellers, buyers and other counterparties. Your ability to meet trade obligations are not reliant solely on sellers and buyers but on all the counterparties involved in the delivery process.

Some are obvious such as freight companies and / or storage companies, but others such as financiers require broader thinking. You need to evaluate your risk to all counterparties and include it in your management processes.

Reducing risk

There are many methods of reducing insolvency exposure. Some examples are:

- **Elimination** – only sell cash before delivery and only contract for immediate delivery. However, this strategy must be considered against the potential limited ability to generate a business return.
- **Evaluation** - investigate the viability of your counterparties. Look at the strength of its balance sheet, look at its length of time in business, look at its record of profitability and payment performance, look at its management/ownership professional reputation and talk to parties that deal with the company.
- **Risk mitigation** – these are many actions available to limit the counterparty risk.

These include:

- credit and trading limits;
- credit insurance;
- retention of title clauses;
- personal guarantees;

Key points

- Understand the exposure you have to each counterparty
- Consider your exposure from the other counterparties such as freight and storage companies
- Establish evaluation and risk management business processes

- payment instruments (such as Letter of Credit, bill for collections, etc);
- counterparty insurance;
- offsetting positions; and
- the inclusion of the GTA Trade Rules and contract clauses relating to insolvency in your contracts.

Ongoing measurement

Don't set and forget. Actively monitor your counterparties and watch for signs of concern. Are they:

- paying late;
- increasing their payment terms.
- Increasing restrictive business practices and reducing flexibility;
- Are insurers reluctant to provide cover to them;
- do they refuse to release current information on their businesses; and
- are other suppliers refusing to deal with them?

Watch and act; or at least return to your business evaluation process. If you are becoming uncomfortable with a counterparty start taking some action to mitigate ongoing risk.

WHO CAN BE INVOLVED IN THE INSOLVENCY?

When company insolvency occurs, there are three types of parties that may become involved in the

management of the business. They have different powers and obligations.

Administrators – are usually appointed by the entity's board of directors to prevent the entity trading while insolvent. The administrator will assume the running of the business and incur debts and will attempt to maximise the return for all creditors.

Secured / Unsecured Creditors – A secured creditor is someone who has a 'security interest', such as a mortgage, in some or all of the company's assets. As a result, the secured creditor has additional rights compared to an unsecured credit. These rights may include liens that guarantee the proceeds from any property serving as collateral for their claim.

Receivers – are appointed by secured creditors and will attempt to maximise returns on their behalf. Secured creditors have priority over unsecured creditors and so the receiver has priority over administrators. Often an administrator and a receiver are concurrently appointed to an insolvency.

Liquidators – are appointed once the creditors determine that a business is incapable of being sustainable and must be liquidated. The liquidator has the power to recover preferential payments to creditors and pursue directors and officers for losses if the business was trading while insolvent.

The **creditor committee** – is a small group of creditors that are appointed by the creditors to advise the administrator/liquidator during the administration or liquidation.

It is important to promote knowledge of the GTA Trade Rules and business practices to the administrator, particularly if the administrator does not have experience in the grain industry.

What you need to do if a counterparty is insolvent?

GTA has a number of contract clauses and Trade Rules that cover insolvency. Make sure you are familiar with the ground rules.

1. Find out.

Investigate any rumour of insolvency. The sooner you know the sooner you can begin reducing your exposure. Talk to the company or check with the ASIC website to see if an administrator has been appointed. If you have received a communication from the company or administrator, read it carefully. The date you become aware of an insolvency is important!

2. Correct your position.

The loss of a contract will create a change in market position for you. Although, the administrator may allow you the right to wash out the contract, the washout settlement may be less than current market value. Sometimes a major player's insolvency may dramatically move the market price and a day's difference could be enormously expensive. If you are running a Mark To Market (MTM) reporting system, perform your washout and remove the old contract from your position reporting to correctly state your exposure.

3. Calculate your washout.

This is the difference in the market price to the contract price on the day following either:

- (i) the day of notice from the administrator or the day you first became aware of the insolvency event; or
- (ii) the day of the event of insolvency.

The market price used needs to be for the same commodity, delivery period and delivery point. It is recommended that your supporting documentation for the washout has all these characteristics being identical. The washout invoice is not subject to GST as it is a financial instrument and it can be in your favour or the insolvent party's.

Key points

- **Actively monitor and watch for warning signals**
- **Understand the parties and their role in an insolvency**
- **Be proficient in the GTA Trade Rules and Contracts**

4. Submit your claim.

The administrator will provide a form to complete that substantiates your claim as a creditor. Your receivables, including washout invoices, are part of the supporting documentation. You are encouraged to include the invoices, proof of delivery and copies of the signed contracts. Proof of the market prices on the day of washout is also essential. Most people use a broker confirmation of the market prices.

5. Attend meetings.

Under Section 436E(2) of the Corporations Act, the first creditor meeting must be held within five business days after appointment of the administrator and there must be two days' notice. This is the only effective opportunity to replace an administrator with someone more qualified. Creditor meetings are also a valuable source of knowledge and also provides information on other counterparties. This may be important as there can be consequential ripple effects from an insolvency event.

6. Try to get an expert on the creditor committee.

The creditor committee is an inexpensive means of helping the administrator understands the grain value chain and methods to improve the chance of recovering funds. It is a complicated process and often administrators generally have little, or no experience in the grain industry. They may not be aware of issues that can dramatically alter the distributions that can be achieved.

7. Continue to pursue.

After the administrator has been appointed and meetings held it is important to continue to manage exposure to the insolvent business. As a minimum continue to regularly liaise with the administrator, implement your mitigation steps and take steps to recover costs from any personal guarantees.

THE GTA INSOLVENCY TRADE RULES

Rule 17.6 is the GTA insolvency default clause. The Definitions section for the GTA Trade Rules (check) defines an insolvency event. It covers the situations previously discussed as well as broader coverage, including an application for court appointment of controller/administrator, a secured creditor taking possession of the asset and similar items.

Section 2 refers to the notification of default and the trigger of the date for fair value of the washout. Written notice should be given within two days of the event of insolvency. If written notice is received within the 2-day period, then the fair value date is the day after notice. If notice is not received within the period, the non-defaulting party has the option of:

1. the day after notice was received; or
2. the day after the event of insolvency.

Fair value is clarified in rules 17.7 through to 17.10.

Refer to these rules any time an insolvency event arises.

Other issues in insolvency

Some companies include a 'right of offset' clause in all of their contracts. This permits a right, established in law to offset liabilities and receivables in normal business activity and in case of insolvency. Although untested in law, it is the usual practice for administrators to allow the offset of liabilities and assets, as it is beneficial in speeding up the settlement process.

GTA has introduced retention of title in standard GTA contracts. Retention of title has much legal history but the process for the GTA clause has not been tested yet.

GTA TRAINING AND DEVELOPMENT

GTA offers unique grain industry specific [Training and Development](#) programs to increase your knowledge and skills across the grain value chain. These courses can be taken individually or combined into the Diploma in Grain Management.

There is a specific course Trade Rules and Contracts (DGMRUL501A) that will help all participants in the supply chain to better understand the risks involved in grain marketing.

Growers are encouraged to attend and participate in these programs. Just as it makes sense to undertake training and development in growing grain, it also makes sense to undertake training in grain marketing and risk management to minimise your business risk and improve profitability.

CONCLUSION

An insolvency process is complicated, painful and slow.

There are steps you can take to enhance your position in the event of an insolvency. These are onerous from a management point of view, even if successful and you largely recover your losses.

The most efficient process is to try and avoid or at least limit exposure to potential insolvencies.

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Key points

- Understand the impact to your market position
- Calculate the washout value
- Actively manage your involvement in the insolvency proceedings

