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GTA Industry Briefing Document

Managing Insolvency

In the

Grain Industry

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Insolvency - Before and After

Insolvencies occur frequently in the grain industry and businesses need to prepare for them. The best preparation is to attempt to avoid dealing with counterparties that are likely to enter insolvency but even with the best preparation it is likely that you will have to deal with an insolvent counterparty. This paper is meant to be a brief guide to a before and after situation with insolvencies.

What is insolvency?

There are two primary definitions of insolvency:

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

The first is the more commonly used expression of insolvency but both are relevant. Unless there is support from another party the second definition will lead to an occurrence of the first.
We will focus on the first as this is the most commonly used cause of an insolvency event. This tends not to be a short-term incident but an inability to meet obligations over an extended period. Being unable to meet creditor liabilities for one day due to cash timing is not an event of insolvency but it is cause for concern. Insolvencies are slightly different between companies and individuals. This paper is restricted to company insolvencies.
An event of insolvency can also occur if the company is wound up or applied to be wound up. Other than the previously mentioned conditions, this usually occurs to cease trading or restructure when there has been full provision for liabilities and so it is not a risk.

What is the result of insolvency?

The following are some of the possible results of insolvency:

- once an insolvency occurs contracts enter into automatic default and although a financial obligation remains the obligations under the contract may change dramatically, depending on the terms of the contract;
- 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;
- 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.

The delivery risk is the loss of product that has been delivered to the counterparty. It is the value of the receivable.

The other, less obvious, risk is the market position created by the loss of the contract. Usually this is the long or short that occurs in your position for the market movement in price from the original contract price to the market price where you close the position out.

The first risk is obvious each day from review of your receivables but the second 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.

Counterparty dependency

Your risk with a default is not just with your customers. The delivery risk lies with customers but the market exposure risk is with suppliers, customers and other counterparties. Your ability to meet trade obligations are not reliant solely on the suppliers and customers but on all the counterparties involved in the delivery pathway.

Some are obvious such as freight companies 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 risk. Some examples are:

- Elimination – only sell cash before delivery and only contract for immediate delivery. This may reduce your ability to make money in trading.
- Evaluation - investigate the viability of your counterparties and gain greater comfort that your risk is low. Look at the strength of their balance sheet, look at their length of time in business, look at their record of profitability, look at their management/ownership professional reputation and talk to parties that deal with them.
- Risk mitigation – these are any actions you can take to limit the risk you are prepared to accept with a counterparty. They include credit limits, trading limits, credit insurance, retention of title clauses, personal guarantees, types of payment instruments (such as Letter of Credit, bill for collections, etc), counterparty insurance and offsetting positions. Include 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? Are they increasing their payment terms? Are insurers reluctant to cover them? Do they refuse to release current information on their businesses? Are other suppliers refusing to deal with them? Watch and take action or at least return to your 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 in its own right. It will attempt to maximise the return for all creditors.

Receivers – are appointed by secured creditors and will attempt to maximise the return for secured creditors. 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 for the knowledge of the grain Trade Rules and business practices to be passed across 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.** If you hear a rumour of insolvency find out. 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 market position for you. Although you have a right of washing out the contract, the price you use may not be the price you achieve in the market. 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 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 for the same delivery period and for the same delivery point. I strongly recommend that your supporting documentation for the washout has all of these characteristics being identical, even if it is more effort for your preparation of the support. 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.

4. **Submit your claim.** The administrator will have a form that you need to complete that substantiates your claim as a creditor. Your receivables, including washout invoices, are part of the supporting documentation. I encourage you to include the invoices themselves, 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 sec 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 day's notice. This is the only effective opportunity to replace an administrator with someone better qualified. It is also a valuable source of knowledge of what is going on. It also allows you to see what other counterparties may have 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 to understand what happens in the business and how to improve the chance of recovering funds. It is a complicated process and often administrators have no, or little, 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 work on your risk. As a minimum continue to liaise with the administrator regularly. Do you have any of your mitigation steps that you need to work on? Are you taking steps to recover costs from any personal guarantees?

The GTA Insolvency Trade Rules

Rule 17.6 is the GTA insolvency default clause.
Section 1 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 period the fair value date is the day after notice, otherwise the non-defaulting party has the option of the day after notice was received or the day after the event of insolvency.

Fair value is clarified in rules 17.7 through to 17.10.
Refresh yourselves with the rules any time an insolvency event arises.

Current issues in insolvency

Some companies include a right of offset clause in all of their contracts. This permits a legal right to offset liabilities and receivables in normal business activity and also in case of insolvency. This is established in law. Although it has not been tested in law, it is the usual practice for administrators to allow the offset of liabilities and assets, as it speeds up the payment process for the net amount.

GTA introduced retention of title in most contracts within the last few years. Retention of title has much legal history but the process for the GTA clause has not been tested yet. The administrator of Grain Partners is in the process of applying for a court interpretation of the current clauses.

Conclusion

The process through an insolvency is complicated, painful and slow. As shown there are steps you can take to enhance your position in the event of an insolvency but it is likely to be an interruption to your business from a management point of view, even if you largely recover your losses.
The most efficient process you can have is to try and avoid potential insolvencies, but in my experience you cannot eliminate them without dramatically restricting your trading ability.
At least now you are better armed to respond when the situation arises.