Natural Resources Briefing

June 2012

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Rise in defaults of coal and iron ore contracts in Asia

There have been a number of recent news reports that the incidence of Asian consumers of thermal coal and iron ore defaulting on their contracts over the last 2 weeks of May 2012 is on the rise, which is a cause for concern among suppliers.

On 28 May 2012, the Financial Times reported that this was sending prices sharply down. This could have a snowball effect on prices.

The reported reasons being put forward by analysts and traders for these defaults are twofold, either: (a) the buyers do not need the raw materials due to weak demand and high inventories; or (b) they do need the shipments but are defaulting to take advantage of falling prices and are hoping to rebook the same goods at a lower cost in the future.

It is recommended that suppliers take a close look at their contracts in anticipation of defaults with a view to mitigating, or avoiding, their impact.

It is our experience that the common *reasons* used by buyers to reject cargoes are: (a) allegedly off-specification products; or (b) discrepancies between load port and the discharge port surveys; and (c) alleged delays (both in transit and in customs).

Regardless of the merits of the buyers' purported reasons, a supplier faced with such a situation needs to ensure that all its rights are protected and that it has in place mechanisms to minimise, or avoid, loss.

Suppliers must act fast to avoid the possible multiplication of loss that might be caused by a disputed cargo remaining at the quay, or worse still in the carrying ship, in a declining market whilst the parties argue over whether the cargo has been validly rejected and who should therefore deal with the cargo. US$100,000s of losses can quickly turn into losses of US$1,000,000s. The sensible approach is frequently for the parties to agree to a without prejudice joint disposal of the cargo, and to argue about their internal differences later. This can "*fix-in*" the loss at a fraction of the loss

that might be sustained in a falling market where the cargo is not on-sold and help mitigate demurrage claims, if any.

In a situation where the buyer rejects the cargo due to it allegedly being off-specification, or due to unfavourable customs authority survey results, the supplier should ensure that the cargo is re-sampled and re-surveyed by an independent umpire as soon as possible (provided this is permitted by the contract, which it usually is). If this survey is not carried out promptly, the buyer may be able to raise objections as to the reliability of a later survey, or the supplier may lose the right to a survey altogether.

Armed with the results of the umpire analysis, the supplier would then be able to negotiate a settlement with the buyer, or agree a rapid on-sale to avoid the consequences of a declining market.

Depending on the results of the negotiations with the buyer, the supplier may then have to consider its options and weigh the risks and benefits of either affirming or terminating the contract. However, we would sound a note of caution here. Whilst termination may be permitted as a strict matter of the law, doing so and suing for damages against a counterparty in an unfavourable jurisdiction is not something that should be entered into lightly.

Should you like to discuss any matter relating to the above, please get in touch with a member of our Commodities team (see below), or your regular contact at Watson, Farley & Williams.

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