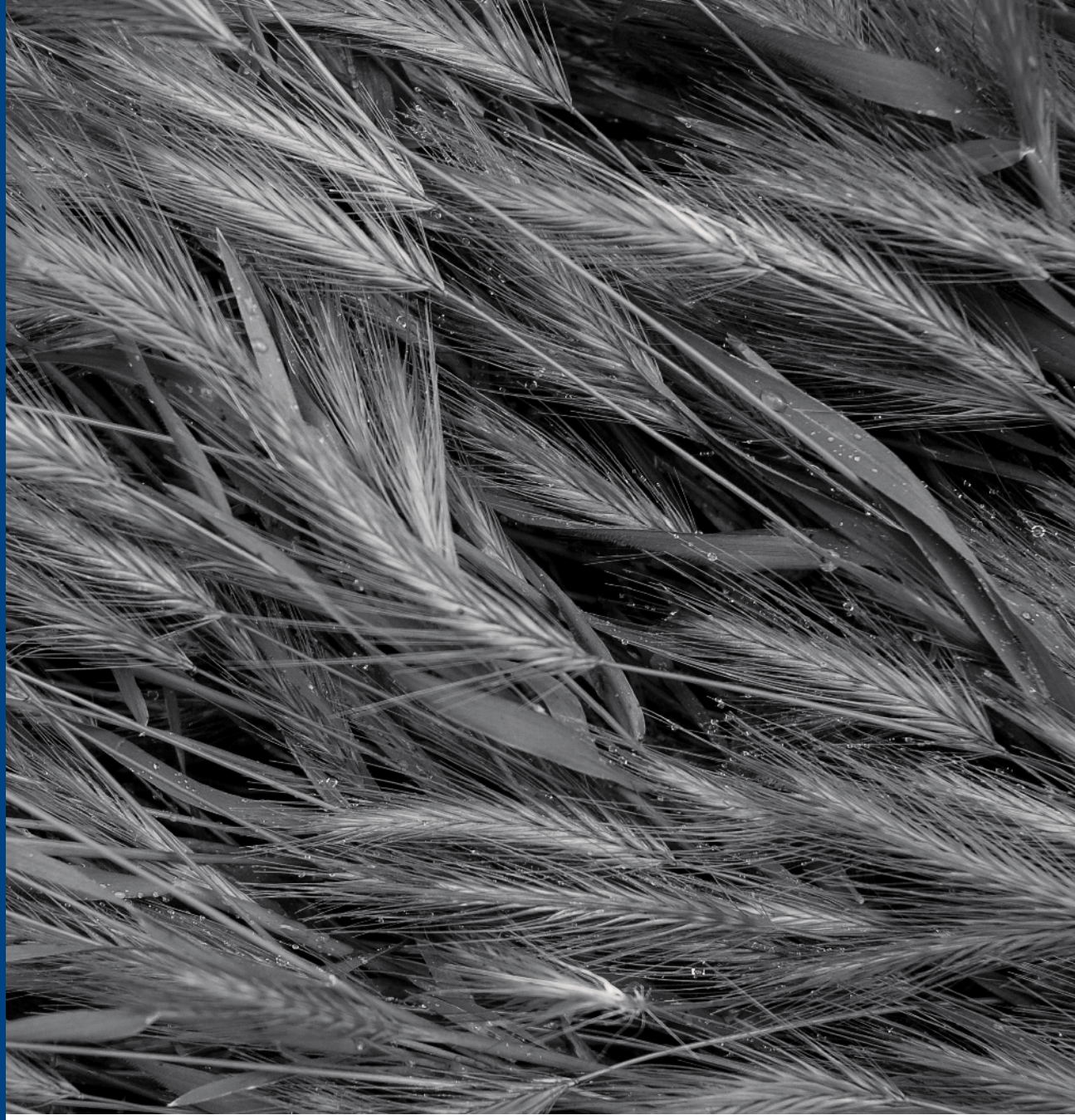
COMMODITIES BULLETIN
JULY 2022



Welcome to the July 2022 edition of the HFW Commodities bulletin.

Welcome to the July 2022 edition of the HFW Commodities bulletin, which is taking the opportunity to celebrate the promotion to Senior Associate of three members of the team. Stephanie Morton opens with an article about new legislation to address the challenge of deforestation. Philip Kelleher then considers the risks to commodities traders of providing letters of indemnity to obtain discharge of cargo before original bills are available. We close with an article from our Geneva office on digitalisation in trade finance prepared by newly-promoted Anne-Marie Pearce and Head of Finance, Olivier Bazin. You can find out more news about the Commodities team, including where to meet us next, on the back page.

ALISTAIR FEENEY
Global Head of Commodities

THE EVOLVING LEGAL LANDSCAPE ON DEFORESTATION RISK

STEPHANIE MORTON
SENIOR ASSOCIATE, LONDON

"In order to implement the Act, further secondary legislation will be required. This means that some important aspects of the new regulatory regime remain to be determined."

Forests are of crucial importance to society and the environment which we inhabit. Not only are they critical sources of food and biofuel, but they are also fundamental to tackling climate change and supporting biodiversity.

Over the past three decades, over 178 million hectares have been lost worldwide.[1] Although the rate of loss is declining, it remains a substantial concern which governments are under pressure to address. At the COP26 climate summit, 141 states pledged to end deforestation by 2030.

Role of Commodities

Unfortunately, a large proportion of deforestation is driven by the production of key global commodities. These include cattle, soy, palm oil, timber and coffee. Steps to tackle deforestation will therefore necessarily involve these commodities.

To date, we have seen numerous voluntary coalitions between public and private organisations. These include initiatives such as the Tropical Forests Alliance which aims to support companies transitioning to deforestation-free supply chains. Another notable example is the Roundtable on Sustainable Palm Oil which provides a framework for certifying sustainable palm oil.

Additionally, we are now seeing numerous legislative efforts aimed at curbing deforestation in supply chains. These are likely to be accompanied by sanctions for non-compliance. In this article, we consider the UK's law on forest risk commodities and other important developments.

UK Law on Forest Risk Commodities

On 9 November 2021, the UK passed the Environment Act 2021 (the **Act**) into law. Amongst other things, this Act aims to tackle the use of illegally produced 'forest risk commodities' ( ) in UK supply chains.

The Act provides that, in relation to FRCs, regulated persons must:

- not use that commodity (or a product derived from it) in their UK commercial activities unless relevant local laws were complied with in relation to that commodity.
- establish and implement a due diligence system in relation to that commodity (or a product derived from it) in their UK commercial activities.
- file an annual report on the actions taken by the person to establish and implement a due diligence system in relation to that commodity.

It is worth noting that the illegal nature of the FRCs will be determined by reference to the local law in effect where the source organism was grown. In this case, the source organism is the organism from which the FRC was produced. So for palm oil, we would be referring to the local laws in the country where the oil palms are grown to determine legality.

In order to implement the Act, further secondary legislation will be required. This means that some important aspects of the new regulatory regime remain to be determined.

For instance, secondary legislation will be required to establish:

- The criteria for determining who is a "regulated person". It is expected that these will be determined by reference to turnover and commodity volume.
- Which commodities are to be considered "forest risk commodities". The main commodities being considered are beef, cocoa, coffee, leather, maize, palm oil, rubber and soy. It is possible that the government will adopt a phased approach to including new FRCs.
- The enforcement regime and sanctions for non-compliance. The proposed maximum penalty under consultation was £250,000, however the majority of consultees considered this to be too low. It remains to be seen what measures are adopted by the government.

The public consultation on secondary legislation concluded in March 2022. In their recently published response, the UK Government has committed to implementing due diligence through secondary legislation at the earliest opportunity.

Future Development

The UK is not the only region seeking to introduce regulations to tackle deforestation. On 17 November 2021, the European Commission also proposed a regulation on deforestation-free products. This proposal forms part of the broader European Green Deal and aims to curb deforestation and forest degradation provoked by EU consumption and production. We published a briefing on the draft regulation last year.[2]

In light of these developments, we expect to see new regulations in force in both the UK and EU tackling deforestation in supply chains. These developments underline the need for companies to create and implement systems to assess and mitigate deforestation risks in supply chains. We will be continuing to monitor this area as it evolves.

STEPHANIE MORTON
Senior Associate, London
T +44 (0)20 7264 8133
E stephanie.morton@hfw.com

Footnotes

1 *Global Forest Resources Assessment 2020 Main Report*, Food and Agriculture Organization of the United Nations (2020)

2 https://www.hfw.com/EC-introduces-draft-law-seeking-to-ban-imports-and-exports-from-regions-at-risk-of-deforestation

PHILIP KELLEHER
SENIOR ASSOCIATE, HONG KONG

"While the use of LOIs may avoid delays and reduce demurrage liabilities for the trader, it can still give rise to risk."

DISCHARGE WITHOUT ORIGINAL BILLS OF LADING: LETTERS OF INDEMNITY FROM THE CHARTERER/ TRADER'S PERSPECTIVE

What's the problem?

When goods are discharged from a ship, only the lawful holder of the relevant bill of lading (BL) is legally entitled to delivery of them. However, original BLs can be slow to progress through the banking chain and may not be available before the cargo is ready to be discharged, particularly for short voyages. When this happens, in order to avoid delay, traders will often ask the vessel owner/carrier to discharge the cargo without original BLs. This gives rise to a problem. If delivery is not made in accordance with the BL, a vessel owner may face substantial claims from the lawful holder, including for the value of the goods. As a result, no sensible owner will agree to discharge cargo without production of the original BL unless they are indemnified, by agreement, for the consequences of doing so. This is done by provision of a letter of indemnity (LOI).

The LOI: the usual requirements

Under an LOI, the issuer will usually agree to:

- indemnify the recipient, their servants or agents, for any liability, loss, damage or expense incurred as a consequence of delivering the cargo without original BLs.
- provide the recipient with sufficient funds to defend any proceedings brought in connection with such delivery.
- provide on demand such security as may be required to prevent arrest/detention or secure release of the vessel.

The LOI will typically be governed by English law and subject to the exclusive jurisdiction of the English courts.

What are the risks? A case example

While the use of LOIs may avoid delays and reduce demurrage liabilities for the trader, it can still give rise to risk.

The Navig8 Amertrine [2021] EWHC 3132 (Comm) illustrates some of the risks involved when instructing a carrier to discharge without original BLs. In that case, the claimant (time charterer), C, sub-chartered the vessel to the defendant, A, for a single voyage from Thailand to Singapore. A was also the seller of the cargo.

The original BLs were unavailable at the discharge port and so A instructed C to discharge the cargo without production of the BLs to one of its buyers, B. In return, A issued an LOI to C. C complied with A's instructions and delivered the cargo to B.

B's bank then alleged that they were the lawful holders of the BLs and requested delivery of the cargo. As security for their claim, the bank arrested the vessel in Singapore. C called upon A under the LOI to provide security to release the vessel, which A failed to do. Accordingly, C applied to the English Court for a mandatory injunction to enforce the terms of the LOI.

In deciding the claim for final relief, the English Court ordered A to: (1) provide C and/or the owners with sufficient funds to defend the Singapore proceedings; (2) provide security to secure the release of the vessel in Singapore; and (3) indemnify C for any loss, damage or expense caused by the arrest. Where, as it happened, the vessel had already been released upon provision of security by owners, A remained under an obligation to put up substitute security[1]. The English Court further ordered A to pay damages to the claimant arising from the detention of the vessel in Singapore.

Minimising the risks

Plainly, issuing an LOI has its risks for trader/charterers. In the case example above, A found itself involved in expensive litigation with a costly outcome. However, LOIs are an essential document in international trade and it would be uncommercial

to advise that they should be avoided at all costs. There are some steps traders can take to minimise the risks they face:

- Where possible traders should seek to:
  - narrow the delivery instruction to a named receiver only, i.e. not use 'or to such party as you believe to be or to represent [the receiver] or to be acting on behalf of [the receiver]'.
  - address the LOI to the immediate contractual counterparty and exclude the Contracts (Rights of Third Parties) Act 1999.
  - limit the level of liability under the LOI.
  - limit the validity period of the LOI.
- In circumstances where a buyer asks its seller to issue an LOI, a seller should seek to preserve a right of recourse against its buyer in the event of a call on the LOI. This can be done by inserting an appropriately worded indemnity provision in the sale contract or alternatively, by seeking a back-to-back LOI from the buyer at the time of the request. Where possible, the LOI should be counter-signed by a bank.

PHILIP KELLEHER
Senior Associate, Hong Kong
T +852 3983 7739
E philip.kelleher@hfw.com

Footnotes

1 The Bremen Max [2009]) 1 Lloyd's Rep 81

DIGITALISATION IN TRADE FINANCE: THE ROLE OF THE DIGITAL AGENT

OLIVIER BAZIN
PARTNER, GENEVA

ANNE-MARIE PEARCE
SENIOR ASSOCIATE, GENEVA

Sucafina's sustainability-linked senior secured borrowing base facility is one of the most significant on the coffee market. However, it was not only the size of the facility (now at US$740 million), nor its well-developed sustainability KPIs that projected it to victory at this year's TXF Perfect 10 Deal of Year Awards, where it won Overall Commodities Finance Deal of the Year.[1] This facility is also making waves because it is one of the first to appoint a digital agent, Komgo, to enhance the collateral management process through use of Komgo's blockchain powered platform.

Borrowing base facilities – the issues

Borrowing base facilities derive their value from the assets which form the collateral pool against which banks lend. These have traditionally been managed and monitored manually by borrowers and financing banks. The consequence is that this form of facility is particularly exposed to (i) human error, (ii) high operational costs and (iii) fraud.

Borrowing bases require constant reporting by the borrower. Without a digital agent, a borrower must manually collate the relevant data and then reconcile their own internal records against reports received from the storage facilities holding borrowing base stocks. This can involve dozens of storage facilities, in multiple jurisdictions, holding large volumes of stocks. Hundreds of emails may fly between the parties before report validation by the security agent, going from the storage facilities to the borrower's logistics team to the borrower's treasury team to the security agent, and then back down the chain again if there are questions and/or discrepancies. This process does not lend itself to a cost or time efficient reconciliation of stocks, and the scope for human error or fraud is significant. Enter the digital agent.

How does using a digital agent address these issues?

The digital agent is able to connect all stakeholders to one encrypted shared ledger onto which they can upload their information. The roles and responsibilities of the digital agent will usually be documented by way of a mandate letter – unlike usual mandate letters the appointment will be by the borrower, rather than by the lenders. In turn, the facility agreement will provide that borrowing base reporting and stock reconciliations, and all communications in the ordinary course between the borrower and the security agent with respect to the transaction security will be made via the digital platform.

The key benefits to this include:

1. **Reduction in human error:** By way of example, both the borrower and the storage facility will upload their data to the platform. If there are any discrepancies between these sets of data, they will be immediately apparent. This allows the parties to resolve any discrepancies beyond tolerance thresholds before closing the report and sending it to the security agent for validation. Where this process is done manually, discrepancies can easily be missed but where clearly flagged on a central platform they can quickly be spotted.
2. **Reduced operational costs:** Manual reconciliation of documentation is very labour intensive. When each party submits its own data to the same ledger, the software will automatically reconcile the data and validate the reporting, vastly reducing the amount of time spent by the borrower on reconciliation and the bank on validation. In a podcast broadcast in November 2021[2], ING's Signe Mikelsone estimated that their report validation process had reduced from a typical 3 hours to 10 minutes since the appointment of Komgo as digital agent in Sucafina's borrowing base facility.
3. **Audit trail:** All reports generated on a digital platform are stored and available to review at any time. This allows the parties to locate

and review historic data easily, which is invaluable should issues arise or if a review of the reports is required for audit purposes.

4. **Reduced risk of fraud:** Following the recent spate of high value frauds in the commodities industry, the benefit of being able to minimise the opportunity for fraud is obvious. The advantages of moving to a single encrypted ledger are significant here:

    - The automatic reconciliation by a third party platform of data that has been inputted independently by a stakeholder significantly minimises the risk of fraud in a borrowing base, as does the ability to track the audit trail of documents.
    - When signing up to a digital platform, the parties make certain representations. For example, in the case of Komgo, all parties, including the storage facilities, represent and confirm that the information they are providing is up-to-date and true. This provides lenders with additional comfort and a potential avenue of recourse in the event of issues.
    - Digital platforms can include software which is directly targeted at reducing the risk of fraudulent documents being used. For example, Komgo's Trakk function[3] provides:
        - verification services to verify the origin of documents and the entity and individual issuing them.
        - locking services to prevent the content of a document being changed, altered or falsified.
        - visibility on the status of documents, whereby participants can enter in the activities they have performed against a document, building a real-time audit trail.

All of these functions are designed to protect documents from fraudulent activity and allow parties greater transparency on the origin and status of documents. However, it would be naïve to suggest that the risk of fraud can be eliminated entirely. Ensuring that companies have robust cyber protections and the right insurances in place will be ever more important in order to combat the risk of cyber fraud.

Future expansion

Digital platforms have wide application in trade finance and their use in borrowing bases is just one example. Other elements of financing, from monitoring KYC and counterparty risk to the issuance of documentary credits can also benefit. The key is that digital platforms provide a mechanism for parties to communicate information to each other in a secure and efficient manner.

A current obstacle to their wider use in international trade is the fact that the legal frameworks in many jurisdictions do not (yet) support particular activities. For example, in English law, electronic documents are not currently capable of possession or indorsement, which presents obvious limitations for their use in commodities trade and finance. However, a growing number of jurisdictions are introducing legislation to address this obstacle. For example, the Electronic Transactions (Amendment) Act was passed in Singapore last year and in the UK, the Electronic Trade Documents bill is expected to come before Parliament later this year. See our recent briefing[4] for more information on this.

Conclusion

The ability to appoint a digital agent in a facility is a significant step towards the integration of blockchain technology into the commodities finance sphere. Borrowers and lenders are increasingly recognising the benefits of adopting such technology and we are seeing, and expect to see increasingly, a growing wave of traders and banks willing to engage with this technology, to reduce risk and increase efficiency.

OLIVIER BAZIN
Partner, Geneva
T +41 (0)22 322 4814
E olivier.bazin@hfw.com

ANNE-MARIE PEARCE
Senior Associate, Geneva
T +41 (0)22 322 4831
E anne-marie.pearce@hfw.com

Footnotes

1 https://group.sucafina.com/news/news-updates/sucafina-wins-txf-commodities-finance-deal-of-year-award/

2 https://www.commoditytradingweek.com/insider/introducing-your-digital-agent-episode-1-stock-reconciliation/

3 https://www.komgo.io/komgo-solutions/corp-solutions-trakk

4 https://www.hfw.com/Electronic-trading-documents-possession-is-9-10ths-of-the-law-Apr-2022

Where you can meet the team next

Webinar: Sanctions: Managing Risk and Opportunity
7 July 2022 at 9:00am GMT

The Legal 500 (Legalease) will be hosting our experts Daniel Martin and Anne-Marie Ottaway for a special webinar session addressing evolving global #sanctions in the current complex environment. Register for this webinar here.

Webinar: Independence and Impartiality of Arbitrators in International Investment Arbitration
7 July 2022 at 4:00pm HKT

HFW is holding a co-hosted Webinar with SCIA on the topic of 'Independence and Impartiality of Arbitrators in International Investment Arbitration'. Our panel consists of Ben Bury as the moderator, Jo Delaney, Karen Cheung and Bronwyn Lincoln as the speakers. This panel will share their expertise and insights on the issues and challenges arising in relation to the independence and impartiality of arbitrators in international investment arbitration. Register for this webinar here.

Energy and Mines Summit
6-7 September 2022

Jo Garland will be speaking at the Energy and Mines Summit in Perth on a keynote panel to discuss the current state of mining's energy, ESG and climate transition and the challenges ahead. Find out more and register here.

World Litigation Forum in Amsterdam
3-5 October 2022

Simon Jerrum will be attending the World Litigation Forum at the Park Plaza Amsterdam.

For more information on upcoming HFW events, click here.

Other Team News

Congratulations to Partners Bronwyn Lincoln and Paul D Evans for their inclusion in Doyle's Guide's Leading Commercial Litigation & Disputes Resolution Lawyers 2022 – in Victoria and Western Australia respectively.

The 2022 listing of leading Commercial Litigation & Dispute Resolution Lawyers details solicitors practising in commercial litigation, dispute resolution and arbitration matters in the legal market who have been identified by clients and peers for their expertise and abilities in these areas. HFW has also been recognised as a recommended law firm in this practice area.

See more here:
https://doylesguide.com/

On The Lawyers Weekly Show, Partner Ranjani Sundar sits down with Jerome Doraisamy to discuss navigating the first year of partnership.

Ranjani delves into the importance of having mentors whom you can confide in and trust, being proactive about managing yourself and your workload, the need to be adaptable and flexible in building a practice, and her advice for those striving for partnership in a post-pandemic market.

Listen here:
https://lnkd.in/d_SxexD5

You can also find it where you get your podcasts, including:

Apple podcasts:
https://lnkd.in/dZmvuYqy

Spotify:
https://lnkd.in/dnyUXzxN

In the Global Arbitration Review's Asia-Pacific Arbitration Review 2023, Jo Delaney, Jo Garland, Nick Longley, Dan Perera and Kate Fisher consider some of the key issues that may give rise to disputes in energy transition projects in Australia.

This includes traditional solar and wind farms, as well as those involving newer technologies, such as hydrogen and storage. They also analyse disputes that have arisen from renewable energy projects in recent years.

Read the full chapter here:
https://lnkd.in/d6dzNgRa

HFW has over 600 lawyers working in offices across the Americas, Europe, the Middle East and Asia Pacific. For further information about our commodities capabilities, please visit hfw.com/Commodities

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