Navigating choppy seas - handling counterparty decline and default in times of crisis

Christian Benedictsen-Nislev
Partner, MBA, LL.B.

The ongoing COVID-19 crisis has made companies in the transport sector increase their focus on management of counterparty risk due to disruption of international supply chains and trade patterns. This newsletter examines more closely relevant legal aspects when renegotiating contracts with counterparties as well as the remedies available when counterparties decline or default.

Introduction

The impact of COVID-19 continues to be perceptible across the globe, also for businesses involved in the international sale of goods, transport and logistics. Governments worldwide have implemented burdensome and thorough measures to minimize the spread of COVID-19 such as travel restrictions, quarantines and business closures etc. which have also interrupted supply chains. Port congestion, delay in loading and unloading, as well as lack of personnel required to provide transport or logistics services result in severe delays or makes it impossible to perform such services. Border closures and travel restrictions are limiting the flow of workers and goods, causing severe losses for passenger transport and the travel industry. Furthermore, COVID-19 has contributed to a dramatic plunge in oil prices. These matters have a severe impact on the transport sector across Europe and the rest of the world.

The growing uncertainty for the short-term prospects in international commerce has led to an increased focus

on counterparty risk. In this newsletter, we discuss the matters which should be taken into consideration when dealing with a counterparty in decline or in default.

The newsletter is based on a presentation given to the Maritime Development Center earlier this month (the presentation may be accessed here.

Working with your partners to keep them afloat

The impact of COVID-19 tends to affect most industries and companies. To use an old saying, "we are all in the same boat" when it comes to reducing the spread and commercial impact of the virus outbreak. In our experience over the past months these words have rung true in many business relationships, resulting in suspensions of contractual obligations and renegotiations of contracts between traditional counterparties in international trade and transport.

However, it is important to adopt a considered approach when engaging in such contract renegotiations.

First, any agreed changes should be documented in clear and detailed wording in the contract.

Secondly, any requirements for the variation of the contract should be observed, including e.g. that changes are made in writing and signed by the parties.

Thirdly, contract renegotiations provide a good opportunity for reviewing the financial stability of the counterparty and consider whether additional risk management measures should be adopted. This could include stricter contractual obligations for the counterparty as well as security for timely performance by way of prepayment or parent company guarantees. The following clauses are likely to be relevant in renegotiations and should be reviewed prior to finalizing the amended contract:

- Payment rights and credit periods
- Liability clauses
- Force majeure and hardship clauses
- Event of default and termination clauses
- Security clauses
- Insolvency clauses

International trade – payment terms and retention of title

A retention of title clause in contracts for the sale of goods is a useful remedy for sellers of goods in international trade. Depending on the circumstances, such clauses entitle the company to "claw back" products sold and delivered to a counterparty for which payment remains outstanding. Such a clause will protect the company in disputes with the counterparty's creditors.

The terms of retention of title clauses should be carefully reviewed to ensure that they provide the company with the best possible security for the amounts owed by the counterparty. Further, various legal requirements apply for the retention of title to remain valid with respect to sold goods, including that the goods are carefully described and identified in the contract. If the goods have been incorporated into other products (e.g. equipment installed onboard a vessel), the retention of title will cease. Further, the prospects of enforcing

retention of title clauses over goods sold may differ depending on the jurisdiction where the goods are situated. Legal advice should be sought where relevant to ensure that the company's position is protected.

Sellers of goods should also insist on payment on delivery where possible rather than extending credit to the buyer. The seller may insist that the buyer puts up a letter of credit for the payment of the goods to ensure that the seller will receive payment from the issuing bank on the fulfillment of objective criteria (e.g. documentary evidence that goods have been shipped to the buyer). The terms of the letter of credit must be carefully drafted to ensure the seller's ability to demand payment as agreed and, on the day agreed under the contract.

Counterparties in decline

Failure to pay on time, or failure to deliver services or goods as agreed and, on the day agreed are common indications that a contractual counterparty may be experiencing financial difficulties. If a company's counterparty exhibits such behavior, the company should carefully consider that counterparty's circumstances. Perhaps the renegotiation of one or several contracts be needed to assist the counterparty going forward. However, the company should also consider the available means for securing its position, should the counterparty's situation deteriorate further.

Various security rights and remedies are relevant for companies involved in international trade and transport. These include

- Maritime liens
- Carrier's lien over cargo
- Repairman's lien over items undergoing repair
- Warehouseman's lien over goods in storage

Under Danish law, the Danish Merchant Shipping Act sets out a comprehensive list of the categories of claims secured by a maritime lien. If a claim is comprised by the provisions on lien under the act, three important characteristics apply; i) protection against third parties without registration; ii) priority ahead of all other encumbrances and; iii) a short limitation period.

In this regard, a claim comprised by maritime lien will provide a substantial security to the party having provided the service to the vessel, including for example salvage services, if the shipowner is in decline and unable to pay for the service in question. Maritime lien will therefore generally secure payment from a counterparty through its high priority in relation to the vessel.

For carriers and storage facility operators, liens over goods in their possession will provide strong security for outstanding freight and storage fees. Maintaining possession of the goods is key to ensure that the lien persists. Invoking liens in other jurisdictions may be complex, and suitable legal advice should be sought to ensure the best position vis-à-vis the counterparty and its creditors.

The counterparty may also seek to invoke a force majeure clause to avoid liability for the failure to perform a contract. Further, if no sensible solution can be found, the company needs to consider its options with respect to terminating the contract and recover any losses suffered from the counterparty. The relevant legal issues in relation to these points are considered further below.

Force majeure

The impact of COVID-19 has resulted in widespread attempts to invoke force majeure clauses to avoid liability for failure to perform contractual obligations. A counterparty in financial difficulties may seek to do exactly that. However, the use of a force majeure clause by a counterparty should be carefully considered and potentially rejected where appropriate.

The key issue in this regard is whether the circumstances referred to by the counterparty constitute a force majeure event under the contractual clause. Only under limited circumstances will the virus outbreak itself have prevented contractual performance. Instead, the regulatory measures adopted by governments and authorities to prevent the spread of COVID-19 will be the actual cause of the inability to perform the contract. If so, the force majeure clause will only apply if it refers specifically to such measures as a force majeure event.

If the clause was drafted before the outbreak of COVID-19, it is unlikely that an outbreak of coronavirus is specifically referred to. However, it may refer to events such as pandemics, epidemics and work stoppages, in which case the clause could be invoked depending on the circumstances.

Further, for contracts concluded during or after March 2020, it will be difficult to argue that the impact of COVID-19 was unforeseeable when the contract was entered. Invoking a force majeure clause tends to require the occurrence of an unforeseeable event and in relation to such contracts, counterparties may therefore be prevented from invoking the force majeure clause.

For additional information on relevant legal issues relating to force majeure clauses, please see our previous newsletter which may be found here.

Termination and claims for damages

If a counterparty's failure to perform its contractual obligations continues, and the parties are unable to find an appropriate solution, it may eventually be relevant to consider whether the contract should be terminated and damages for incurred losses and costs should be sought recovered from the counterparty.

Under Danish law, the termination of a contract generally requires that the counterparty has breached the contract, and that the breach constitutes substantial or fundamental non-compliance or non-performance. A careful analysis should be carried out prior to the termination of a contact. If a company unlawfully terminates a contract, the counterparty may hold the company liable for damages.

Counterparties should be notified of any termination of a contract. The planned termination should also be communicated internally throughout the company's organisation. Further, a claim for damages should be calculated and forwarded to the counterparty before commencing enforcement proceedings.

What to do if a counterparty defaults?

If the financial situation of a counterparty deteriorates to the stage where it becomes unable to pay its debts as they fall due, the company will enter into a form of insolvency proceedings (such as reconstruction or liquidation proceedings).

When a counterparty risk materialises for a company in this manner, the debts and obligations owed by the counterparty to the company will be significantly affected. The company may be a secured creditor, its claims

may have priority in the insolvency ranking and/or it may be able to invoke a retention of title clause or one of the security rights available to certain parties in the transport industry. Otherwise, it is unlikely that the company will recover more than a small fraction of the outstanding amounts from the counterparty.

If the company has sold goods to the counterparty, only delivered to the counterparty after the liquidation proceedings have been commenced, the goods must be redelivered to the company.

Further, if the company owes any amounts to the counterparty, the company may be able to set off such debt against the amounts owed by the counterparty to the company.

Timing is essential when dealing with counterparties in default. Where international trade and transport is involved, the matter may be further complicated by the fact that goods and services have been delivered in various jurisdictions. Appropriate action should be taken without delay to ensure the company's position.

Further information and assistance

DLA Piper's team of lawyers with expertise in international trade, transport and logistics as well as insolvency are available to assist with all legal issues relating to counterparty default.

Services	Energi og infrastruktur, International handel, investeringer, reguleringer og compliance, Forsikringsretlige tvister, Retssager, voldgift & undersøgelser, Kommercielle kontrakter, International insolvensret
Sectors	Energy and Natural Resources, Consumer Goods and Retail, Shipping, transport and logistic, Industrials