ARE YOUR BUSINESS AGREEMENTS FINANCIAL CRISIS PROOF?

The Current Financial Crisis

We live in worrying, uncertain times. Mervyn King, the Governor of the Bank of England, stated recently:

"We have been through a big global financial crisis, the biggest downturn in world output since the 1930s, the biggest banking crisis in this country's history, the biggest fiscal deficit in our peacetime history, and our biggest trading partner, the euro area, is tearing itself apart without any obvious solution. The idea that we could reasonably hope to sail serenely through this … strikes me as wholly unrealistic."

Unfortunately Mr King's list of financial woes is nowhere near exhaustive. He made no mention, for example, of:

- America's US$15.5 trillion cumulative budget deficit, now more than 100% of US GDP and growing at a clearly unsustainable 10% per year. In the US fiscal 2012 borrowing is likely to be in excess of US$1.2 trillion and the interest payments on the cumulative debt alone amount to some US$430 billion annually.
- Japan's cumulative budget deficit is now more than 200% of GDP. This level of debt has only been sustainable to date because Japan's baby boomers have put a very large proportion of their significant savings into buying JGB's (Japanese government bonds). As that group begins to retire (and spend rather than save) it is difficult to see how Japan will be able to service such a large debt in the medium term, especially given that the size of its working population, uncushioned by immigration, is expected to dramatically collapse over the next 25 years.
- The demographic trends and unfunded pension obligations in many industrialised countries are grim. In many such countries the ratio of those still of working age to those retired is set to move from around 3 or 4 to 1 to less than 2.5 to 1 within the next 15 years. Given the size of the accumulated government debts many of these countries have, it is hard to see how many of them will be in a position to fund such burgeoning pension obligations even ignoring the sharply escalating healthcare costs they will inevitably incur with such rapidly aging populations.
- The UK's public debt is also much higher than the oft quoted figure of about 65% of GDP. If the costs of the financial sector intervention in 2008/2009 are factored in it is over 148% of GDP – and that figure does not include non-funded obligations such as pension liabilities. Without bank bailouts the cumulative debt now stands at just over £1.02 trillion, the interest payments on which were £43 billion in the 2011/2012 tax year – £1,800 for every household in the UK. In May 2012 alone the UK government had to borrow £17.9 billion.
- When total debt (household, corporate and government) is looked at, the UK is the most indebted nation in the world – total debt in the UK is more than 4.7 times GDP[1].
- The Bank of England (BoE) has created some £325 billion of new electronic money since early 2009 in a process called quantitative easing. It now holds more than 20% of all UK government debt. £325 billion is about 6.5 times the amount of sterling notes and coins in circulation. This new money nominally sits in accounts which large financial institutions hold with the BoE and was created and put there in exchange for such institutions selling to the BoE UK government bonds and certain other assets. QE is widely considered to have propped up the price of such assets and made the costs of lending for the UK Treasury (and the rest of us) lower than would otherwise have been the case. No one knows precisely what the consequences of QE will be. The big unanswered question is whether such money will eventually start to flow into the real economy and create material inflation. The BoE hopes that the QE money can just be quietly artificially destroyed again by the BoE selling back into the market the bonds and other assets it bought. However money creation on this scale has never been tried before in peace time and there are reasons to doubt that the demand for the assets the BoE has bought will be strong enough to make such a strategy work, in the medium term.
- The UK is not alone in adopting QE – the US Treasury has created a staggering US$2.1 trillion since early 2009.
- The BoE now believes that there will be no growth at all in the UK in 2012.

The worrying thing for business is that it is simply impossible to know how all these issues are going to play out in practice. As the Governor of the Bank of England himself admitted on 26 June 2012: "There is just enormous uncertainty out there, I have no idea what is going to happen in the euro area".

1 Source – *Endgame: The End Of The Debt Supercycle And How It Changes Everything* – John Mauldin.

The Risks

Given the extraordinarily turbulent financial times we live in the question then arises as to how a prudent board of a company should look to manage such risks. The first thing is to identify such risks. In our view they include at least an increased risk of the following occurring:

- substantial swings in exchange rates between currencies – for example, if some or all of the PIGS were to leave the euro the euro could greatly strengthen against the pound or the dollar;
- a sudden move from low to high inflation (perhaps more than 10%);
- deflation - a sudden collapse of asset prices, the demand for which is materially determined by the availability of credit, (e.g., real estate);
- a sudden move from low to high interest rates (again perhaps more than 10%);
- particular countries leaving the euro;
- major financial institutions (such as banks or insurance companies) failing;
- a sudden material decline in the availability of credit and credit insurance;
- sudden insolvency of trading partners – be they customers, suppliers, joint venture partners, service providers, landlords, tenants or a whole host of other business partners;
- sudden collapse in demand from customers;
- imposition of restrictions on imports/exports, including increases in duties.

Managing The Risks

There are many things that business can do to manage such risks. Some responses – such as hedging currency or interest rate risks and strictly limiting the amount of credit given to customers – are always part of any prudent business's arsenal. However business also needs to carefully consider their inventory levels of key components and products and their fall-back position if their preferred suppliers do cease trading.

Another important aspect of a company's response to such uncertainties is to ensure that its business contracts give it the best protection and flexibility to manage such risks. The remainder of this article considers how business agreements can be tailored to manage these risks.

Currency Risks

If a company pays for products or services in one currency (purchase currency) but earns income from the sale of those products, either by themselves or as component parts, in another currency (sale currency) then if the purchase currency appreciates against the sale currency the company may see its margins squeezed or disappear, unless it has hedged that risk or can pass on its increased costs to its own customers.

Ideally, where it has market power, the company can reduce such risks by pricing its purchases in the currency in which it conducts most of its sales. However that route is not open to all and so many companies will look to hedge such risks by forward buying the purchase currency at a specified exchange rate. This is a prudent part of business risk management but it is only part of the story.

If the purchase currency appreciates too much against the sale currency then the company may well wish to simply switch to an alternative supplier. Accordingly long term international supply agreements need to provide escape routes for the purchaser in the event of material currency movements. Such escape routes could take several forms:

- The imposition of a price ceiling for the contract goods in the buyer's currency.
- On the occurrence of a triggering event (such as reaching a price ceiling or a specified exchange rate) either a simple right to terminate or possibly suspend performance (unless the parties can agree modified pricing) or to convert an exclusive purchasing arrangement into a non-exclusive one with no minimum order commitments and possibly provision for an IP licence from the supplier.
- Short duration contracts may be suitable but obviously create their own risks if the purchaser is on the hook to downstream supply obligations.
- The right to terminate the contract on short notice or for convenience.

Businesses also need to carefully consider their own contractual ability to pass on their increased prices to their own downstream customers. Where commercially feasible it is clearly desirable not to be locked into fixed prices but instead to provide for a mechanism to increase prices when the input costs materially increase.

Inflation

Inflation is damaging for business in numerous ways. It squeezes demand as incomes typically lag price inflation. It pushes up interest rates, which then typically leads in turn to a fall in asset prices. It erodes the real value of cash. Additionally as with an adverse exchange rate move, a business can face the risk of being contractually locked into low sales prices which precludes it from being able to pass on supply side cost increases. Ways of dealing with inflation risk include those methods of managing input costs referred to above (see under the heading Currency Risks) and in addition the following:

- Avoid getting locked into fixed sale prices in the first place – provide some mechanism for price increase in the event of material increases in input costs. Many contracts do provide for RPI increases but often provide for a cap on the permissible price increase, which may not provide adequate protection if prices increase materially over a short period of time. Also RPI based increases may simply fail to reflect the inflation position in a foreign country.
- Include in downstream sales contracts a provision providing either for the right not to accept orders or for their termination on short notice or for convenience.

Shorter duration downstream sale contracts may help manage these risks but many suppliers will wish to lock their customers in for as long as possible.

Late Payments

Another area where high inflation can be an issue is in relation to the late payment of contractual payments/debts. Well-drafted contracts frequently provide that late payments bear interest, determined by reference, for example, to a certain percentage over the base rate of a central bank such as the Bank of England – although even that formulation is beginning to look outmoded in the current financial climate, which saw in January 2012 interbank lending rates – and hence commercial interest rates available from banks – rise significantly above base rate.

Where the contract does not itself provide for interest then the payee in respect of the late payment may be able to take the benefit of the Late Payment of Commercial Debts (Interest) Act 1998, as amended by the Late Payment of Commercial Debts Regulations 2002 (SI 2002/1674) (Late Payments Act). The Late Payments Act implies into a qualifying contract a term providing for simple interest, currently at 8% above the Bank of England base rate on overdue commercial payments. A payment will be overdue if it is made after the date the parties agreed that payment for the goods or services would be made.

The Late Payments Act does not apply however:

- where the contract already provides a substantial remedy for the late payment of debts;
- in relation to consumer credit agreements;
- if the contract is a mortgage, charge or other security agreement.

Also even if English law has been stipulated in the contract the Late Payments Act will not apply (a) if there is no significant connection between the contract and any part of the UK and (b) but for that choice of law provision a foreign law would have applied to the contract.

As noted above pegging default interest rates to a central bank's base rate may not provide for an adequate rate of interest if the real cost of money becomes much higher during a period of very tight money supply, as for example occurred in the run up to collapse of Northern Rock. To cover that risk it would be prudent to provide that the interest rate applicable should either be a specified percentage figure or, if higher, for example the LIBOR rate or the retail price index, published by the Office of National Statistics.

Any numerical interest rate specified should not exceed an amount which is a genuine pre-estimate of the loss caused by late payment as a punitive interest rate may be held to be unenforceable as a penalty provision. The question of whether or not an obligation to pay a particular interest rate is a penalty is assessed by reference to the time the contract was made, not by reference to the time of the breach that triggers the obligation to pay[2] so caution is required when inserting figures very much higher than those obtainable under the Late Payments Act.

Royalty Payments

There are a number of standard ways in which royalty payments under IP licences are determined. Often the licensee either agrees to pay a specified amount per licensed item produced/sold or alternatively agrees to pay a fixed percentage of the sale price which he achieves. The former mechanism exposes both the licensor and licensee to risks. If the price achieved in the market for the licensed products increases materially then the specified fixed payment per item may begin to look like an inadequate return from the licensor's perspective. Where the price of the licensed product drops in the market place then the fixed royalty payments can begin to represent an unacceptably high proportion of the production costs for the licensee: exactly this scenario has occurred many times in the electronics industry where the price of many consumer electrical items has been subject to relentless downward pressures for many years.

Therefore if the licensor believes that the licensee's downstream prices are much more likely to go up than come down then he may be better specifying that the royalties are calculated by reference to a percentage of the licensee's sale price rather than as a fixed cost figure per licensed product produced/sold. Conversely if the view is that the licensee's prices are more likely to go down than up the licensor may be better off charging a predetermined fixed royalty amount per item produced than a percentage figure on the licensee's net selling price. Whichever route is chosen then it will always be best for the licensor to provide for a mechanism to increase the effective royalty if the prediction about pricing turns out to be wrong: this could take the form of a provision to the effect that the royalty payable would be the greater of the fixed percentage or fixed price per unit price.

Provision for minimum royalty payments, payable irrespective of the value of sales actually achieved, will also help reduce the risk that the licensee's pricing will be subject to deflation.

2 Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd [1915] AC 79.

Lease Payments

If either inflation or interest rates climb steeply many landlords will wish to have at least the option to either increase the rent they charge or terminate the lease. Many commercial leases do provide for regular rent reviews and options to terminate at regular intervals (break clauses).

Obviously given the length of many leases many landlords will be stuck with their existing arrangements for years to come. For new leases however consideration should be given to including provisions providing for some element or risk sharing between tenant and landlord in the event of material increases in interest or inflation rates. In the current difficulty commercial property market such consideration does of course need to be tempered by commercial realism.

Deflation of Asset Prices

Deflation of asset prices is likely to occur if interest rates materially increase for a sustained period as that will reduce affordability and toughen (even further) banks' lending criteria. Deflation is also likely to exacerbate the losses of creditors when an insolvent business fails. Again limiting credit lines is likely to be the safest strategy way of dealing with this risk.

Interest Rates

As with inflation, prudent businesses will want to ensure that, where possible in long term supply agreements, they can pass on at least a proportion of any increased costs, which result from materially increased interest payments, to their customers. Clauses that provide for price increases in long term supply agreements typically only deal with items such as energy and raw material costs but there is no reason in principle why such clauses could not also deal with increases in interest rates incurred in relation to certain types of loans/credit facilities used, for example, in a defined production process.

Exiting The Eurozone

Many serious commentators have voiced the view that countries such as Greece, Spain, Portugal and Italy will ultimately have to come out of the euro if they are to have any chance of achieving lasting economic growth.

A key risk for any company which sells products or services to a customer, based in a eurozone country which then exits the eurozone, is that the debt may be paid in the local successor currency, which then depreciates rapidly against the euro. Indeed a major advantage for leaving the eurozone, for countries such as Greece and Spain, would be that they could convert their euro denominated debts into their own new currencies which they could then allow to materially depreciate over a short period of time relative to the euro: the end result being a default in all but name.

Theoretically if a debt is denominated in euros – i.e., has been contractually specified to be paid in that currency – then it should be recoverable in euros, with the debtor being under an obligation to purchase that amount of euros using local currency. However for a number of reasons things may not work out like that in practice.

Firstly, a country exiting the Euro may well introduce, at least in the short run, strict currency exchange controls, which limit the extent to which hard currencies can be moved offshore. Such exchange controls could make it impossible for a local debtor to pay euro denominated debts to overseas creditors as it would simply be impossible for it to transfer the required number of euros overseas.

Secondly, such a country could also pass a law, as part of its euro exit arrangements, providing that all euro denominated debts owed by local business/individuals could be repaid in the new local currency, notwithstanding any private contractual obligation to the contrary. It is difficult to see how such a law could be successfully challenged by the Court of Justice of the European Union as national governments are given wide powers in emergency situations by the Treaty on European Union and the Treaty on the Functioning of the European Union.

Thirdly, local enforcement measures against such a debtor may restrict the creditor's ability to recover other than in the local currency. For example winding up the debtor and selling off its assets is likely in many cases only to raise money in the local currency.

Fourthly even if a judgement is obtained for a particular sum in the local currency then delays in getting payment may materially reduce the value of the amount recovered if the local currency rapidly depreciates against the euro. Again many commentators have suggested that one of the inevitable consequences of Spain, Greece, etc. leaving the eurozone is that the euro would materially increase in value.

Such problems could be very difficult to deal with in practice and in the current climate the best strategy for many suppliers will either be to greatly reduce the credit they are prepared to offer to entities based in at risk countries or to require guarantees from solvent connected companies which are not subject to such risks.

Major Financial Institutions (Such As Banks or Insurance Companies) Failing/A Sudden Material Decline In the Availability of Credit and Credit Insurance

A likely major consequence of a euro exit by Spain, Greece and Portugal, is that many of their banks would collapse or require substantial further public funding to prop them up as depositors, who have leant euros to such banks and who would fear that they would be repaid in a new rapidly depreciating currency, simply pull all their money out. This process has already begun in Greece and Spain.

Even if such a process only involves Greece and/or Spain, the knock on effects on confidence in the entire banking system could well parallel those that led in 2007/2008 to the collapse of interbank lending with the consequent squeeze on the availability of credit. They could however be on an altogether bigger scale.

As insurance companies would then be likely to become more concerned about the cash flow of numerous businesses credit insurance would be likely to become both more expensive and harder to obtain – both phenomena will already be familiar to anyone who has conducted international trade in the last few years.

These risks provide a further incentive for business to strictly limit the amount of credit given to customers or to ensure that appropriate parent/bank guarantees are put in place or other security is given.

Where bank finance is a requirement to meet future contractual obligations then it may, in some circumstances, be prudent to provide that the non-availability of credit on reasonable commercial terms during a credit crunch is an event of force majeure, which relieves the parties of their forward contractual obligations.

Insolvency of Trading Partners

The net effect of many of the above discussed changes could well be that many suppliers, customers and other business partners suddenly become insolvent, thus leaving a business in a potentially difficult position. There are numerous ways of managing such risks which include at least the following:

- The termination for insolvency provisions of existing and contemplated agreements should be checked to ensure that they provide up to date, rapid and extensive rights to terminate on the actual or threatened insolvency of the other party.
- Limiting the amount of credit extended to customers and imposing very strict credit eligibility requirements which all the sales force must follow, with appropriate levels of mandatory sign offs for exceptions. It will also be prudent to include provisions in supply contracts, conferring on the supplier the right to change the terms on which credit is given if there is an actual or threatened material adverse change in the purchaser's circumstances.
- Ensuring that retention of title clauses in supply agreements are robust, although it should be noted that many standard credit insurance contracts will require a supplier to enforce such ROT terms before any claim under the policy is paid. Clearly the two issues of the terms of any credit insurance available and ROT provisions need to be considered together.
- Where the exposure to particular customer is particularly severe then consideration should be given to taking parent guarantees or even a charge over the purchaser's assets.
- Identifying alternative suppliers of key components or products and where necessary procuring for them necessary IP licences from the principal supplier which kick in in the event that the current supplier becomes unwilling or unable to supply in defined circumstances. Dual sourcing for business critical items should be the rule not the exception.

Conclusions

There is little doubt that business currently operates in a climate of greater worldwide financial uncertainty than has existed for very many years. The precise manner in which the various risks will play out is unknowable. The future will belong to those who learn to routinely challenge rosy financial assumptions acquired in more forgiving times and to ask the tough "what if" questions and then who take prudent proactive steps to manage the risks such questions identify. In short what business needs is that hardest to acquire of things: a different mind-set.

For further advice or assistance in relation to any of the risks covered by this article, please contact one of the lawyers listed below.

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