SECTION 1

THE COMMERCIAL FOUNDATION OF TRADE INSURANCE

CHAPTER I **THE COMMERCIAL FOUNDATION OF TRADE INSURANCE**

CHAPTER II **SYNOPSIS**

CHAPTER I

1. TRADING ORGANISATIONS

Sole Traders
Partnerships
Private Companies
Public Companies
Public Corporations
Subsidiaries of Foreign Firms

All of these may act as exporters and may apply for export credit insurance facilities in the country in which they carry on their operations.

They normally fall into two categories

(a) manufacturers who sell direct to their overseas customer who is responsible for payment to the manufacturer. It is the manufacturer who has the insurable interest and who requires the insurance cover; and

(b) export merchants who carry on business under various descriptions such as export houses, confirming houses or merchant shippers. The export merchant receives the orders from overseas and distributes them among various manufacturers, pays the manufacturer, ships the goods and invoices the foreign buyer for payment. In these circumstances, it is the export merchant who requires the insurance cover.

It is important to note that credit insurance cover is normally only available to the party who is the principal in the transaction. Such cover is not normally available for agency activities and commissions.

2. FORMS OF CONTRACT AND HOW CONTRACTS ARE MADE

(a) in some types of business, especially in the commodity trade, model contract forms applying to specified goods and/ or transactions are in existence and will apply if the parties to the contract so agree;

(b) exporters and importers may embody general terms of business into their contracts;

(c) uniform conditions of a general character have been issued by such bodies as the International Chamber of Commerce or the Vienna Sales Convention and some contracts will make reference to these in the contract documents;

(d) the importance of well drafted general terms of business can hardly he exaggerated and these should be printed on acceptance forms, price lists, offers, catalogues, etc;

(e) contracts for the international sale of goods exhibit a characteristic which is not present in contracts for the sale of goods in the home market. They are entwined with other contracts, in particular with the contract of carriage by sea or air under which the goods are exported, and the contract of insurance by which they are insured. In many export transactions the delivery of the shipping documents to the buyer or his agent plays, as will be seen, an important role in the performance of the contract of sale; the shipping documents consist normally of the bill of lading, the marine insurance policy and the invoice and thus represent elements of the three contracts referred to. The situation is even more involved when payment is made under a bankers' documentary credit because this frequent method of payment in the export trade requires the addition of two further contracts to the export transaction, namely the contracts of the bank with the buyer and seller respectively. In short, the export transaction presents itself to the business man as a natural and indivisible whole and he is apt to pay little attention to its constituent parts, like the motorist who thinks of the components of his car only when he notices a fault in them. We have to analyse the individual contracts, which constitute the export transaction because this is the best method of appreciating the functioning of the

machinery of exports as a whole. From this point of view, the contract for the sale of goods abroad is the principal and central legal arrangement involved in the export transaction and all other contracts, such as contracts of carriage, insurance and credit, have a supporting and incidental character.

(f) in recent years there has been an increasing tendency to make contracts by using the fax machine. While this is generally acceptable, care should be taken to confirm by letter, especially where the fax paper used is likely to deteriorate or fade altogether as time passes.

Verbal contracts should not be relied upon. When made, they should be confirmed in writing within a reasonable period of time.

3. ESSENTIAL ELEMENTS OF A CONTRACT

For purposes of export credit insurance

(a) it should be legally enforceable in both the country of the buyer and the seller and should state the applicable law;

(b) it must define what is to be exported and/or what services are to be provided;

(c) there should be evidence of an offer and acceptance;

(d) it must state when the export/service is to take place;

(e) it must show the destination;

(f) it must show the terms of delivery;

(g) the price of the goods and/or services must be clearly shown

(h) the responsibility for payment must be clearly identified:

(i) the terms and method of payment must be clearly shown

(j) the currency of payment must be identified and it should be made clear which party is to be responsible for exchange rate fluctuations between offer and acceptance;

(k) it is advisable to include reference to the resolution of any disputes which may arise, e.g. the rules of conciliation and arbitration of the Court of Arbitration of the International Chamber of Commerce;

(1) it is advisable to check that the person signing the contract has the authority to commit the purchaser;

(m) it should also be noted that the payment under the contract must not be contingent upon factors which are fundamentally outside the exporter's control, e.g. if payment is dependent upon the buyer receiving payment under another contract.

(n) reference may be made to certain internationally recognised standard terms, e.g. INCO Terms, 1990, Vienna Sales Convention 1980 to be applicable to the contract. For major contracts involving the supply of capital goods and or services on extended payment terms, the following additional factors apply:

(i) Performance Milestones

Where progress payments are involved, the contract terms of payment should provide for payments to be linked to clearly defined performance milestones so that an exporter's entitlement to be paid can be objectively established.

(ii) Governing Law

Whilst it has often been a requirement that contracts be governed by the law of the buyer's country, the possibility of having the contract governed by the law of a jurisdiction with which the exporter is more familiar should not be overlooked. A legal adviser expert in the governing law of the contract should be retained by an exporter.

(iii) Provision for Amendments

It is also appropriate to include a suitable method for amending the contract, especially when it relates to a complex project with an extended performance period. Negotiating amendments will be difficult if the contract does not contain an accurate scope of work

including narrative and drawings. It should not be assumed that amendments can be negotiated whilst the contract is being performed. No amendments should be made to the contract without the prior written consent of the E.C.A. and any amendments must be proved to have been validly executed under the relevant law.

If a material amendment relating to the implementation of the contract is agreed after the contract is signed, it is important that such amendment he incorporated in the contract.

(iv) Penalties

The contract should provide for penalty, payments to the exporters if payments of principal and interest are not made at due date.

(v) "Entire Agreement" Clause

If a contract consists of a series of documents including correspondence between the exporter and buyer, a statement of each document to be included in the contract should be agreed to and signed by both parties.

4. TERMS OF TRADE DELIVERY (INCLUDING INCO TERMS)

It is advisable to use INCO Terms 1990 for ocean transport as our basic model while recognising that there exist some variations in terminology and practice to take account of other means of transport, such as overland and air transportation

FAS
Free alongside ship
(named port of shipment)

FOB
Free on board
(named port of shipment)

CFR

Cost and freight

(named port of destination)

CFR landed

Cost and freight

(named port of destination)

CIF - cargo insurance obtained by seller cost, insurance and freight ... (named port of destination)

CIF landed - cargo insurance obtained by seller

Cost, insurance and freight

(named port of destination)

DES

Delivered ex ship

(named port of destination)

DEQ

Delivered ex quay

(duty paid) ... (named port of destination)

It is important to note:

(a) ECAs normally base their cover on gross invoice value; and

(b) cover normally commences from date of contract or date of shipment.

Shipment is usually defined as the handing over of the goods to the first carrier for through carriage to the place where the buyer is to accept them. They are not regarded as shipped if the exporter retains the legal right to stop their carriage before they leave the

country from which they are to he exported. This is a particular concern in relation to containerisation.

5. METHODS OF PAYMENT IN INTERNATIONAL TRADE

There are six basic methods of payment utilised in International Trade:

(i) Pre-payment;
(ii) Irrevocable Confirmed Documentary Credit (CIDC);
(iii) Irrevocable Documentary Credit (IDC);
(iv) Cash Against Documents (CAD)/Documents Against Payment (D/P)
(v) Documents Against Acceptance (D/A); and
(vi) Open Account (O/A).

These payment terms are listed in order of risk in descending order - open account representing the highest risk for an exporter.

(i) Pre-Payment for Goods

Description

Pre-payment for goods prior to shipment under an export contract is, for the exporter, the safest method of payment in International Trade given that payment will be received prior to the goods being shipped. Buyers, however, are generally unwilling to adopt this method of payment as they effect payment prior to receiving the goods.

For an exporter, there is no post shipment credit risk. However, the exporter may be exposed to a credit risk in the pre - shipment phase. An exporter may be manufacturing to specifications and the buyer repudiates or cancels the contract prior to the agreed payment date.

In any event, it is important to ensue that such payments are irrevocable.

(ii) Payment under an Irrevocable "Confirmed" Documentary' Credit (CIDC);

(iii) Payment under an Irrevocable Documentary Credit (IDC).

Description

An Irrevocable Documentary Credit is a definite undertaking of an overseas bank (issuing bank) to pay a specified sum of money against the presentation of stipulated documents by the exporter (beneficiary) provided that the terms and conditions of the Credit are complied with.

The IDC sets out strict terms and conditions, which must be complied with. The Issuing bank substitutes its creditworthiness for that of the overseas buyer (applicant). Provided the terms and conditions of the IDC are met, the Issuing bank is irrevocably committed to paying. An Irrevocable Documentary Credit cannot be amended or cancelled by the Issuing Bank without the consent of all the parties (i.e. beneficiary, applicant).

The IDC is advised to the exporter (normally by their bank) who, after shipment takes place, prepares the documents required under the IDC (i.e. bill of exchange for the value of the shipment, bill of lading, commercial invoice and any other documents required) and presents the documents to their bank for negotiation. The exporters bank will negotiate the documents and claim reimbursement for the value of the documents from the overseas Issuing bank.

In transactions involving the use of an IDC, ECA's risk moves from the credit - worthiness of the overseas buyer to the creditworthiness of the Issuing bank and country risk.

(iii) "Confirmed" Irrevocable Documentary Letter of Credit

The IDC may specifically provide for it to be "confirmed" by the exporter's bank. The Confirming bank substitutes its creditworthiness for that of the overseas Issuing bank and provides a definite undertaking that payment will be made to the exporter provided that the terms and conditions are complied with. For example, an IDC is issued by the Bank of China in favour of an exporter who banks with the ANZ. The ANZ "confirms" the EDC.

Aside from pre-payment, an IDC confirmed by a reliable bank is the most secure payment mechanism for an exporter. The exporter has no post shipment risk though the bank may wish to insure the business.

There remains a pre-shipment risk, the extent of which will vary, depending on the point in time during the pre-shipment period when the Letter of Credit is opened and confirmed.

General

An LC is a relatively secure payment mechanism provided that the exporter can strictly comply with its terms and conditions (i.e. documentation risk). In practice, IDCs are often very expensive for a buyer to establish and, whilst offering both the exporter and the buyer protection, are being relied upon less as a mechanism to finance international trade. This trend is likely to continue as parties seek less costly alternatives.

(iv) Cash Against Documents (CAD)/Documents Against Payment (D/P)

Description

The exporter presents shipping documents to their bank for presentation to the overseas buyer for immediate payment, using the buyer's bank as an intermediary. The buyer's bank is authorised to release the documents only upon payment. This is a "collection" style method of payment normally transacted through the banking system. In some cases, an agent of the exporter will assume the collecting role of the overseas bank, although this is not common.

Generally, the exporter retains title to the goods - the buyer cannot take delivery of the documents of title (i.e. bill of lading) until such a time as the collection is paid. Documentary collections offer a compromise for the exporter and buyer in that it provides a payment term which falls somewhere in between open account and trading under an IDC. The goods are shipped but the buyer may only obtain possession of the documents of title (e.g. the bills of lading) after making payment for the goods. CAD/DP provides the protection of the Banking system (release of negotiable documents) and is usually the payment method used when companies move from IDC terms.

The exporter is exposed to limited risk in that the buyer cannot take delivery of the goods until payment has been made. However, for the ECA the risk of non-acceptance (repudiation) by the Buyer remains a very important consideration. If a buyer chooses not to take delivery (and,

therefore, does not make payment), the exporter may still incur quite considerable costs for the demurrage, storage, customs fees, insurance and, possibly, repatriation of the goods if a suitable alternative buyer cannot be found in the original country of destination.

The potential for contract repudiation needs to be considered, particularly where the goods involve price volatile commodities eg wool and hides, and where it is difficult to on-sell the goods in the event of the buyer refusing to pay.

(v) Documents Against Acceptance

Documents against Acceptance (D/A) are similar in their nature to Documents Against Payment (D/P) except that there is a usance term (e.g. Payment is due 90 days from date of the Bill of Exchange or 180 days from Bill of Lading date). There will usually be a Bill of Exchange drawn by the exporter on the buyer or a Promissory Note.

Negotiable documents are released to the buyer only upon acceptance by the buyer of the Bill of Exchange for payment on a future date. The buyer's bank (collecting bank) is under no obligation to make payment on the due date and the credit risk is solely against the buyer.

Once the Bill of Exchange is accepted by the buyer, and negotiable documents released by the collecting bank, the exporter loses control of the goods. The buyer has the right to refuse payment on the due date for payment as has their bank if for instance, there are insufficient funds to meet the payment. Hence, the ECA’s risk lies firmly on the integrity and financial standing of the buyer in honouring the commitments under the export contact.

(vi) Open Account

In simple terms, a transaction conducted on open account terms presents the highest risk to an Exporter. The goods are shipped and the exporter sends the title documents direct to the buyer. Hence, the exporter loses control of the goods immediately. The ECA’s post shipment risk is heightened for contracts conducted on open account terms in that there is no control mechanism for payment and the ECA relies solely upon the ability and integrity of the buyer to make the payment as agreed in the contract.

Open account is favoured by overseas buyers in that it does not incur the level of bank fees associated with the other payment mechanisms. Open Account terms are usually only favoured where this is a long standing trading relationship. They are becoming more prevalent as buyers seek cheaper and more efficient ways to settle international trade.

(vii) Air Shipments

Exporting goods by air has grown in importance as it significantly reduces the delivery time to buyers. However, there are unique features of transport by air.

The air transport document (Air Waybill) is an acknowledgement by an airline company that they have received the goods to be airfreighted. The carrier has an obligation to notify the buyer of the arrival of the goods by issuing a delivery order (the authority to collect the goods.) However, the air transport document is not a document of title to the goods (unlike a Bill of Lading) and the buyer may be able to take possession of the goods without producing the Air Waybill.

The exporter does not have the security of a negotiable Bill of Lading and has limited control over the goods. The risk is no different to business being conducted on open account terms.

For goods delivered by air, use of a documentary collection (D/P or D/A) will provide the protection of the banking system. Where an overseas collecting bank has expressly agreed by prior arrangement the Air Waybill can be consigned to that bank. The airline company will seek the authorisation of that bank- prior to releasing the cargo to the buyer. Banks are generally reluctant to consent to the consignment as they are accepting responsibility for the cargo. Under such circumstances, The ECA's risk would be as for payments under D/P or D/A.

(viii) Bills of Exchange

In simple terms, a bill of exchange is a written demand for payment issued by one party (the exporter) on another party (the buyer).

A bill of exchange is also a negotiable instrument whereby a bank will be willing to buy (negotiate) them for exporters in return for providing trade finance for the

exporter. The bill of exchange (sometimes know as a 'draft') is a very common method used by exporters as a means of obtaining payment form buyers for goods shipped.

Parties Involved and their Responsibilities

(i) The Drawer

The Drawer of the bill is the exporter or the named party to whom the amount is due and undertakes responsibility for drawing the bill of exchange.

(ii) The Drawee

The Drawee will be the buyer or the named party responsible for payment. He is not liable under a bill of exchange unless he has accepted it i.e. agreed to make payment upon presentation.

In accepting a term bill of exchange, the drawee legally pledges himself to pay the bill - if he does not pay, it is classed as dishonoured by non-payment. If the drawee fails to accept, the bill, it is known as dishonoured by non-acceptance.

(iii) Usance

A bill can be drawn requesting immediate payment (at sight or on demand) or for payment at a later date (at term).

Where the bill allows for payment at a later date, the time allowed for payment is know as 'usance' and the terms of the usance (i.e. 90 days, etc.) will be determined in the original negotiations between the exporter and buyer.

Where there is a usance term involved, the buyer will usually be required to 'accept' the draft immediately which is also an unequivocal undertaking to honour the bill at maturity.

(iv) Types of Draft

Clean Bill

A 'clean bill' is probably the simplest and quickest means of settling payment. Payment is simply remitted to the exporter by mail, telegraphic transfer or bank draft. No trade documents are involved.

Documentary Collection

A documentary collection is when the exporter wishes to retain some title to the goods until at least a commitment to pay has been made by the buyer. The draft is forwarded with official trade documents ie shipping documents. customs clearance, etc.. In simple terms, the documents of title eg. the bill of lading, are not released to the buyer until either payment has been received or the draft has been 'accepted'.

(v) Protesting a bill of Exchange

In the event that a bill of exchange is not honoured – be it for non-acceptance or non-payment - the drawer may exercise his right to protest the bill. The protest is a formal certificate confirming that the bill has been dishonoured. However, this can prove to be a costly exercise in some areas of the world and it is the exporter's prerogative to give instructions to his bank whether or not a dishonoured bill should be protested.