International Cotton Association (ICA) Rules – what are they and how do they work?

Arthur Spellson, Australian Cotton Shippers Association

In the last edition of Australian Cotton and Grains Outlook, the Australian Cotton Shippers Association (ACSA) article discussed the challenges being faced along the textile industry supply chain because of the COVID-19 pandemic. The article discussed the demand destruction we are seeing as a result of widespread lock downs, economic slowdown, falling consumer confidence and discretionary spending. We are seeing this play out on a macro level as governments talk of recessions and high unemployment levels, but we are also seeing it at an industry level as demand for cotton falters, the cotton price falls and merchants have trouble executing forward contracts with buyers.

We have often considered ourselves lucky in the "upstream" end of the supply chain, essentially from grower through to cotton spinners, as we have the benefit of including, if we choose to and our customer agrees, International Cotton Association (ICA) Rules and Arbitration in our contract terms. During the COVID-19 crisis the importance of the ICA and its terms have been highlighted, especially when we look further downstream and see the issues garment manufacturers (many of which are also our spinning mill customers) are having with brands and retailers.

While growers, merchants and spinning mills have the benefit of ICA terms, garment manufacturers have no such terms governing their contracts with brands and retailers. As a result, when some brands and retailers have been dishonouring contracts, garment manufacturers have not had a standard process for managing disputes and enforcing contracts. This has the potential to impact us all as the effects get passed down the supply chain. This consequence goes all the way down the line with many ACSA members currently working with buyers to renegotiate contract terms in the current environment.

So what are the ICA Bylaws & Rules and how do they work?

Essentially the ICA Bylaws & Rules regulate the sale and purchase of raw cotton. The rules have changed with time, after being created 180 years ago, but their aim remains the same – to create a safe trading environment. While there are many rules and bylaws the ones which are most relevant to us now are Rules 237 and 238 which relate to Closing Contracts.

Rule 237

1. If for any reason a contract or part of a contract has not been, or will not be, performed (whether due to a breach of the contract by either party or due to any other reason whatsoever) it will not be cancelled.

2. The contract or part of a contract shall in all instances be closed by being invoiced back to the seller in accordance with our Rules in force at the date of the contract.

To simplify the terminology, what Rule 237 means is that neither party can simply walk from a contract. There is a process for closing a contract and the key to that process is invoicing back (or washing out to put it in Australian terminology).

Rule 238

Where a contract or part of a contract is to be closed by being invoiced back to the seller, then the following provisions will apply:

1. If the parties cannot agree upon the price at which the contract is to be invoiced back to the seller, then that price will be determined by arbitration, and if necessary, appeal.

2. The date of closure is the date when both parties knew, or should have known, that the contract would not be performed. In determining that date the arbitrators or appeal committee will take into account:

    a. the terms of the contract;
    b. the conduct of the parties;
    c. any written notice of closure; and
    d. any other matter which the arbitrators or appeal committee consider to be relevant.

3. In determining the invoicing back price, the arbitrators or Technical Appeal Committee shall have regard to the following:

    a. the date of closure of the contract as determined in paragraph (2) above;
    b. the terms of the contract; and
    c. the available market price of the cotton which is the subject of the contract, or such like quality, on the date of closure.

4. The settlement payable on an invoicing back will be limited to the difference (if any) between the contract price and the available market price at the date of closure.

5. Any settlement due and payable on an invoicing back of a contract closed in accordance with Rules 237 and 238 will be calculated and shall be paid regardless of whether the party receiving or making the payment is considered to be responsible for the non-performance and/or breach of the contract.

To summarise, an invoice back (washout) price needs to be determined and agreed – essentially the price at which cotton can be resold or replaced with the difference between the original price and replacement price invoiced back (positive or negative) for buyer or seller. It is important to note that it is irrelevant who is “responsible” for the non-performance or breach of the contract. Any settlement, or invoice back amount, is to be paid regardless of who is responsible for the closure and in some cases, due to market movements, the innocent party may have to pay money to the party which has not honoured the contract.

The overall aim of the process is that both parties stay whole, as in that neither party is financially worse off as a result of the closure of the contract. Australian growers and merchants go through this process on a semi regular basis when they washout contracts due to things like lack of water or crop failure. These discussions are usually orderly in Australia with both parties working it out between themselves.

Where the challenge can lie and where the ICA sometimes comes in, especially when a large sum is payable by one party to another, is in agreeing on the invoice back price and then getting the invoiced party to pay up. When the parties cannot agree on a settlement via invoice back the ICA Arbitration process is used, and ICA Arbitrators work through all the facts and establish the invoice back price and settlement.

The ICA issues what is referred to as an “Award” or ruling, which details the financial settlement required to close out the contracts. Very importantly, via the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958, these ICA Awards are enforceable by law in basically all the countries in which we trade. If a party to a contract is issued an award by the ICA and is owed money by another party, they can enforce that award in their local courts and pursue payment.

Another method the ICA uses to enforce awards is the issuing of the ICA List of Unfulfilled Awards. This list, often referred to as the Default List or blacklist, names any party that does not honour an ICA Award. Assuming the offending party wishes to continue in the cotton business they do not want to be placed on this list as, under the ICA Rules, members of the ICA are not permitted to do business with entities or subsidiaries of the listed businesses which are on the ICA List of Unfulfilled Awards. This can essentially cripple a business as nearly all global cotton traders are members of the ICA.

The current trading environment is difficult for everyone with many businesses being pushed to their limits. During these times counter party risk and contract sanctity is more important than ever. Everyone in the Australian cotton value chain, specifically in our case growers and merchants, needs to manage counter party risk and be careful when entering into contracts. All parties need to understand the contracts they are signing and make sure the contracts are written so that the rights of both parties are protected. ICA Bylaws & Rules play a significant role in this and help to protect the parties to a contract. That said, the best form of protection is for us all to be very careful who we enter into contracts with in the first place.

If you are looking for some good bed time reading the ICA Bylaws & Rules can be found at the following link https://www.ica-ltd.org/media/layout/documents/rulebooks/2019-11-rulebook-en.pdf.

July 2020

Ends