'Wash out' court challenged but denied

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In April and June 2007 a family operating a wheat and barley farming business in South Australia entered into various forward contracts with two different grain buyers. Unfortunately, due to a poor crop, they were unable to deliver the required quantities to fulfil their obligations under all their forward contracts. As a result, the contracts were 'washed out' which allowed the purchasers to cancel them and claim damages. The total amount claimed from the family was over $500,000.

In order to avoid liability, the family argued that the contracts were derivatives or financial products, which would require the buyers to hold an Australian financial services licence and be subject to various compliance obligations. These obligations include marketing the contracts under product disclosure statements (PDS).

The family argued that had there been compliance – and a PDS issued – they wouldn't have entered into the contracts.

What were the contractual issues?

The contracts were all subject to the trade rules of the National Agricultural Commodities Marketing Association (NACMA – now operating as Grain Trade Australia or GTA). The contracts contained a clause where if the seller suffered a production failure, the contract could be cancelled, which would entitle the grain buyer to a wash out payment.

Such a payment was to be calculated as the difference between the contract price less the market value price of undelivered grain at the time of the wash out.

Is a forward contract a derivative or a financial product?

To answer this question the Federal Court focused on sections 761D(3)(a) and 765A(1) of the Corporations Act which discuss derivatives and financial products respectively. Section 765A(1) identifies that derivatives are usually considered financial products. But it is section 761D(3)(a) that became most relevant in this case.

This section allows certain derivatives to be carved out from the financial products regime, where:

(i) The buyer and seller have respective obligations regarding the sale of tangible property at a price and on a date set in the future;

(ii) The seller can't cash out or offset the delivery obligation on the property sold; and,

(iii) Market practice or trading rules on any facility or market do not permit the seller to close out the contract by matching it up with another arrangement of the same kind, so the seller's delivery obligations are offset against counter buying obligations.

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Unfortunately for the South Australian family, the Court concluded in June 2009 that the forward grain contracts were neither a derivative nor a financial product and so not subject to the compliance obligations of the Corporations Act.

The Court's reasoning

The Court provided the following useful analysis for the three parts of section 761D(3) listed above:

- Subparagraph (i) – The Court found that the contracts fell within this subparagraph as they provided for corresponding obligations to buy and sell wheat and barley (which were tangible property).
- Subparagraph (ii) – The Court considered this issue in depth. The family attempted to argue that the wash out provision enabled them to settle wholly in cash rather than by delivery of grain. But the Court disagreed with this interpretation and found that there was a clear obligation on the family to deliver a specified quantity of goods over a particular period. This meant that the entitlement for damages was not a contractual right. The Court found that the option for paying damages was not an option given to the seller, nor was it an alternative obligation to the delivery of the property. In deciding this, the Court noted that the wash out provision only applied because of the seller's production failure and only operated if they were in default.
- Subparagraph (iii) – The Court found that the contracts were not market traded and there was no market practice permitting sellers' obligations to be closed out by matching arrangements.

The Court also found that the forward contracts were not derivatives under the general definition of 'derivative' contained in section 761D(1). The family argued that the forward contracts would fall within this subparagraph as their value was dependent on the fluctuating price of wheat and barley from time to time.

The Court rejected this argument, finding that the value of the arrangement was not an element of the contract nor a reason why the contract was entered into. If the contracts were to fall within section 761D(1), then almost all forward contracts for goods readily obtainable in the market would be caught.

The Court considered that the legislative intention, rather, was that ordinary buy and sell transactions should not be caught, otherwise a simple contract – such as for the sale of a motor vehicle with payment of the purchase price today and delivery one week later – would attract the financial product regime.

As a result, the Court concluded that the forward contracts were not derivatives and were therefore not regulated financial products. The upshot of this was that there was no obligation for the grain buyers to deliver a PDS to the family.

LESSONS LEARNT

This Court analysis will prove helpful in interpreting other more complex contractual relationships, which could be classified as derivatives and financial products.

This means that as a result of this decision, wholesale grain intermediaries should be alert to the possibility that there will be some forms of contract which may require a legal interpretation before they are entered into. This will help to avoid a later problem where a counterparty alleges Corporations Act compliance problems, arising from the 'D-word' – derivative.

Tony Stumm is a partner in the Corporate Advisory Group of McCullough Robertson. This article is not intended to provide legal advice about derivatives or financial products and should not be relied upon for legal advice. ■