



THE BENEFITS OF DIGITAL CONTRACTS VS PAPER CONTRACTS



Why is a digital contract better than a paper contract?

In my first serious job I worked for a Dutch shipowner as a junior office dogsbody. It was all very new and exciting but also so very traditional; not that much had changed since ships had wooden hulls and sails. When a trade was done my job was to create the contract. We used printed standardised documents, like the NYPE46 and Amwelsh53, which were based on the then exhausted coal trades from Wales, and the only way to buy these base documents was under license from their creators, and the paper came in all sizes and shapes. As juniors, we would spend hours filling in these forms using pens, rulers and eventually typewriters to create Charter Parties. It was tedious manual work and there was no white out; mistakes meant crossing out (if the owner would accept it) or starting all over again! Once I felt it was right, I would send it for checking and signatures, and more often than not they came back with errors weeks later and I had to start again. It wasn't until late in the 90s that computers changed all that.

Soon after computer use became widespread, contract-generating platforms brought us more efficiency, but we were still only generating reference contracts for signatures. The digitalisation of the process of creation, agreement, and execution of a contract changes that.

In this paper, we will explore the current and future needs of the commodity and freight markets in the contracting space, and what advantages the business can get from properly digitalised, automated workflows.

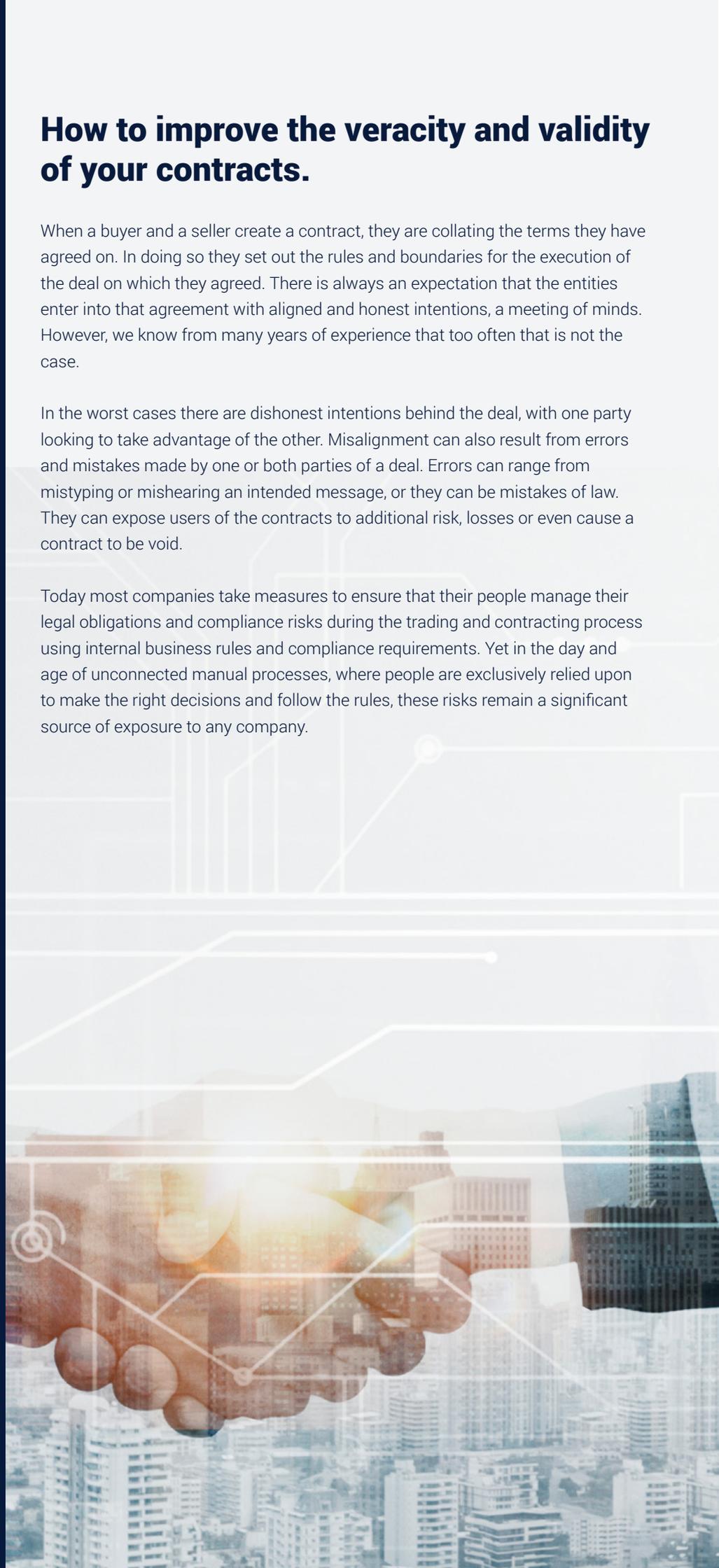
Tony Faneco, CCO of Chinsay

How to improve the veracity and validity of your contracts.

When a buyer and a seller create a contract, they are collating the terms they have agreed on. In doing so they set out the rules and boundaries for the execution of the deal on which they agreed. There is always an expectation that the entities enter into that agreement with aligned and honest intentions, a meeting of minds. However, we know from many years of experience that too often that is not the case.

In the worst cases there are dishonest intentions behind the deal, with one party looking to take advantage of the other. Misalignment can also result from errors and mistakes made by one or both parties of a deal. Errors can range from mistyping or mishearing an intended message, or they can be mistakes of law. They can expose users of the contracts to additional risk, losses or even cause a contract to be void.

Today most companies take measures to ensure that their people manage their legal obligations and compliance risks during the trading and contracting process using internal business rules and compliance requirements. Yet in the day and age of unconnected manual processes, where people are exclusively relied upon to make the right decisions and follow the rules, these risks remain a significant source of exposure to any company.



When traders, credit, risk & compliance, managers, legal and contract teams engage internally to create, approve, and sign contracts, they pull data from several sources. Increasingly, businesses are using electronic systems to manage the sources of this data, but they are limited in scope, delivering solutions to a specific group within a business. Unfortunately, these siloed systems usually do not allow the easy reuse of data. This means those users involved in creating offers, trading, and constructing contracts still need to consult systems to manually seek the details needed to minimise risk and create compliant contracts.

In some commodity trades users only refer to executed contracts or standard general terms and conditions in emails designed to “trade capture”. These unstructured emails which are often not even validated by the counterparty are filed or passed to execution and finance teams and are dangerously deemed to be acceptable to manage the risks they contain. We have experienced situations where disputes have had to be managed through arbitration or legal proceedings where evidence of a contract is incomplete or missing completely.

Legally speaking

Mr K. Murali Pany, Managing Partner at JTJB LLP Singapore, explains what is essential for the formation of a valid contract:



An unequivocal offer

An offer is a promise, or other expression of willingness, by the ‘offeror’ to be bound on certain specified terms upon the acceptance of these terms by the person to whom the offer is made (the ‘offeree’).



An unqualified acceptance

An offer is accepted by the unconditional and unqualified assent to its terms by the offeree. This assent may be expressed through words or conduct, but cannot be inferred from mere silence save in very exceptional circumstances. If there is any variation from the terms of an offer there is no contract, and this would constitute a counter-offer.



Consideration

A promise contained in an agreement is not enforceable unless it is supported by consideration, or it is recorded in a written document executed as a deed. Consideration is something of value (as defined by law), requested by the party making the promise (the ‘promisor’) and provided by the party which receives it (the ‘promisee’). It could consist of either some benefit received by the promisor, or some detriment to the promisee.



Intention to create a legal relationship

This concerns whether parties have an intention to enter into an agreement which is legally enforceable. In the case of agreements in a commercial context, the courts will generally presume that the parties intended to be legally bound.

Over-the-counter, traded contracts.

Constructing a valid contract in the “over-the-counter” (OTC) market, or in a market where all the terms are negotiable or where no exchange exists for establishing prices and terms of a trade, is an extremely complex process. It has to combine essential legal requirements, government regulations and business requirements to be valid, mitigate risk and increase the chances of success resulting from the execution of the transaction.

Any trade starts with an unequivocal firm and valid offer (to sell) or bid (to buy).

That is to say that someone authorised to buy or sell gives their counterparty a proposal that can be accepted within a specified period. The counterparty can choose to make a valid counter-proposal or to give an unqualified acceptance of the proposal given, by doing so committing themselves to the deal, subject to other essential approvals and the agreement of the contract.

These trades can result from a significant number of interactions: bids, offers, counter-offers, contract amendments and addendums, all of which have the potential to cause misalignment or misunderstandings as to the formation and terms of the contract. In unstructured emails and Word documents it is sometimes difficult to identify errors that are regularly written into a contract for another team to execute, causing an undesired outcome for at least one of the parties. We regularly come across trades where the executed contracts are reused for several years after the error has occurred, effectively “grandfathering” these risks.

In the fast-paced commodity trading world, users do not have time to check the details of trades. Product specifications, protective clauses, banking details and validity of a trading partner can change without a trader



being alerted to the change. We have often heard of traders concluding deals involving partners which are no longer credit-worthy or which have become sanctioned without knowing or checking on their updated status. This exposes the company to significant, yet avoidable, risk.

These are just a couple of the many risks trading companies look to avoid by establishing processes, yet so long as these types of trades are done, and we rely on human actions to manage them, errors will be made. Digitalising the negotiation to contracting workflow changes that.

A digital workflow for contracting changes all that.

Workflows are now regularly digitalised, allowing businesses to sequence tasks and to give users access to the necessary and most up-to-date information to make or automate decisions when they need to be made. The digitalised workflow minimises human intervention and uses controlled and inter-connected data across systems, ensuring that successive tasks are performed based on accurate information before the process moves to the next stage.

Digital workflows allow businesses to “tollgate” their processes where internal or external validations or approvals need to be sought before the deal can progress. Ensuring the right checks and balances are put in place helps apply internal legal, credit, risk, and compliance controls seamlessly and when they are needed. Traditional trading business can be fast-paced, but approval processes are cumbersome manual tasks. Often traders are required to type standardised business cases, pulling together the data of the trade, of competitive offers and making recommendations from a number of sources. They often find this to be a frustrating and time-consuming task and a significant source of stress for traders who shortcut, or ignore the process until they have time (i.e. after the deal is done).

Data handled via a phone, in an email or in a Word documents is unstructured and lacks consistency and standardisation. This makes it difficult for it to be reused without it being translated by a functional specialist. It was not long ago that the customers of an airline would call a travel agent and book a flight, receiving a many-page typed paper ticket full of codes and abbreviations a layman would not understand. Today that process is digitalised. Customers can now easily choose, book, and pay for a flight online via a platform. At each stage you are provided or prompted to provide standardised data which results in an e-ticket matching your passport and credit card details.

This is an example of a simple digital workflow connecting data, provided by external and internal systems, and resulting in a digital or e-contract between the airline of your choice and yourself.

A digital workflow for the contracting process can be created to make use of master data, or data derived from another system which is known to be correct. By integrating systems users are given only correct data to choose from and at the time they need it, ensuring compliant behaviour.

Managing Trading losses and Rogue trading:



Nick Leeson

In 1995 ran up USD 1.3 B in losses at Barings on uncontrolled Nikkei futures losses.



Jerome Kerviel

in 2008 booked losses of USD 6 B at SocGen by exceeding his trading limits.



Liu Qibing

in 2005 shorted 200,000 mts of copper on the LME, prices rose substantially, and he vanished after the trade went wrong.

These are just a few of the most infamous rogue traders who thwarted internal controls to conclude and to cover up trades and the losses before being spectacularly found out. But losses incurred through non-compliance by traders are generally smaller, less newsworthy, and more frequent than might be expected.

Like a chain, risk management is only as strong as the weakest link within an organisation. Whether intentionally exploited or not, many losses result today from employee's non-compliance with company controls established to minimise risk. These are regarded as operational losses and are all too regularly accepted as a cost of doing business. We are talking to companies who are managing suppliers, vetting, KYC, approvals, business cases, reporting etc., through manual checks which, when ignored or assumed correct, expose these businesses to unnecessary risks.

By ensuring only approved suppliers can be traded with, integrating approvals, completing KYC checks, automating the creation of business cases and reporting via a digital workflow, a business can significantly reduce this operational risk.

Counterparty interaction

Engagement with a counterparty is rarely standardised and can take many forms. We regularly speak to traders who use WeChat, WhatsApp, email, telephone, and Word documents during their negotiations. All these interactions are unstructured and need to be reconstructed, sometimes more than once, before a contract is put in place. We also see that these trades can be done quickly over very few interactions and no legal validation is requested or given, which exposes both parties to unnecessary risk. As mentioned, the "grandfathering" of errors in contracts is regularly caused by the lack of attention paid to the terms of validation of an offer or contract.

A digital workflow which extends to your counterparty can change that. By capturing their proposals and representations during trading and automatically requesting their absolute and unqualified acceptance of the terms of an agreement before it can progress, we can ensure that a deal satisfies the basic requirements of a legally enforceable contract, at the same time protecting both parties from unnecessary risk.



Contractual disputes

Disputes regularly arise from the lack of certainty associated with various aspects of a contract, such as:



Formation of the contract

E.g. Was a binding contract concluded? Who were the actual parties to the contract? Were the parties' representatives duly authorised?



Terms of the contract & parties' obligations

E.g. Were the parties' obligations clearly and fully set out?



Representations & implied terms

E.g. Were there any representations that could affect the parties' obligations? (A representation is a statement made during contractual negotiations not intended to become a contractual term but to induce the other party to enter into the contract.)

E.g. Are there any terms to be implied by the contract? (Implied terms come in many forms, terms of law, custom of the trade, or from previous dealings for example, and may not be expressly mentioned in a contract.)

The availability of evidence, where authenticity and accuracy are not disputed, is key to resolving such disputes efficiently and economically.

Benefits beyond the paper document.

Contracts are notorious for sitting on desks or in drawers, or perhaps they are PDF versions kept in an electronic filing system. Irrespective of where they are kept, these documents can only be used as reference material. Users of contracts generally rekey information into Risk Management systems (CTRM/ETRM), into finance systems and into execution systems. By capturing structured data in a digital contract, data can be mapped and integrated into these systems, saving users time and allowing them to focus on their functional roles.

Engaging stakeholders internally and externally to create, validate and approve contracts takes time when emails, Word documents and PDFs are used. There is no sure way to ensure that there has been straight-through processing of data, which means time-consuming, line by line analysis is the only way to guarantee that a document is correct. Controlling the document creation digitally alleviates the need to do that. It doesn't matter if you are a manager approving a deal or the legal team reviewing a document, the relevant information can be displayed for your immediate and audited response. The speed of production minimises the risk of losing a deal which might be time-sensitive, and with electronic signatures a contract can be negotiated, produced and stored without ever having to leave the platform used to create it.



Digital contracting is the future.

The evolution of contract creation has surpassed its original purpose. At Chinsay we create digital workflows that allow organisations to recreate their manual trading, negotiation and contracting processes on an efficient, easy-to-use platform.

The Intelligent Contract Platform (ICP) ensures users are capturing and building up the data required to create legally valid contracts which adhere to internal compliance requirements, with complete audit trails.

Most importantly, the data is no longer confined to a reference document; it is ready to “go to work” beyond contract creation. We can reuse this data to:



Create other documentation.



Automate actions, alert users to obligations.



Integrate with adjacent essential systems.



Visualise at any level, portfolio, function, user level.



Report on, capture behaviour and contractual data.

Software is delivered to us increasingly via mobile and convenient cloud-based services and we are constantly exposed to new solutions to traditional problems. It is imperative that we keep this in mind when we employ any future technology, as anything we do today must be capable of inter-operating with these or new other solutions, today or in future. ICP does that.

*We are grateful for the input from **Mr K. Murali Pany** – Managing Partner at **JTJB LLP Singapore***

As a lawyer specialising in shipping and commercial disputes, a system that allows evidence of a contract to be obtained with little scope for disputing its authenticity or accuracy is to be highly commended.

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