

Report to Congress on Cotton Contracts

In the 2014 Department of State, Foreign Operations, and Related Programs Appropriations Bill, 2014 (S. Rept. 113-81), Congress noted the drop in the world cotton price resulted in default, or risk of default, for some U.S. cotton contracts, and in some countries legal redress may be lacking. The Committee requested the Secretary of State to report on the extent of such risks on a regional basis, and including actions taken by the Governments of Vietnam, Bangladesh, and Thailand to address such defaults, and an assessment of respective judicial systems to resolve cases in a fair and impartial manner.

The Department of State has prepared this report on cotton contract defaults, and submits it to the Committee on Foreign Affairs and the Committee on Appropriations of the House of Representatives, and the Committee on Foreign Relations and the Committee on Appropriations of the Senate.

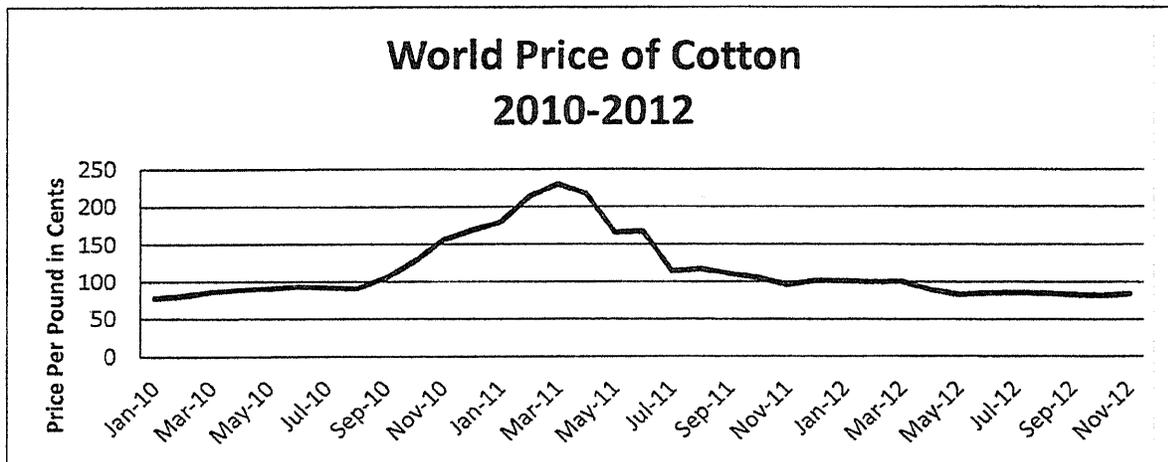


Figure 1: Statistics from the National Cotton Council

By January 2011, a reduced world cotton crop contributed to a tighter global supply situation. A wave of panic buying ensued as mills scrambled to secure available supplies from cotton exporting countries. The resulting spike in world cotton prices in early 2011 and their subsequent decline in the latter half of the year contributed to a dramatic increase in contract defaults as buyers reneged on their higher-priced contracts to buy cheaper cotton at current prices.

As one of the top global exporters, U.S. firms were severely affected. According to the U.S. cotton industry, by September 2012, nearly four million exported bales worth nearly \$1 billion were in default or were at risk of default.

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Global cotton contract disputes are typically litigated at the International Cotton Association (ICA). In 2012, a record 247 cases were filed, many of which were breach of contract cases. The U.S. cotton industry, however, has told the U.S. government that the difficulty with cotton contract default cases is not the decision, but rather the enforceability of the awards. The ICA maintains a List of Unfulfilled Awards (commonly known as the "Black List") which lists firms that have failed to fulfill awards arising out of breach of contract cases decided at the ICA. The U.S. industry also maintains its own Default List.

Defaults occurred in many countries, and as noted in the congressional request, the U.S. cotton industry reported significant problems in Thailand, Bangladesh, and Vietnam.

THAILAND

As of July 3, 2014, 23 Thai companies remain on the ICA's List of Unfulfilled Awards, as well as one firm on a default list maintained by the American Cotton Exporters Association. U.S. firms have informed the U.S. government that enforcing international arbitration awards is nearly impossible. Embassy Bangkok's Country Commercial Guide (CCG) specifically notes arbitration pitfalls in describing the Thai judicial system as follows:

"Thailand has a civil code, commercial code, and a bankruptcy law. Monetary judgments are calculated at the market exchange rate. Decisions of foreign courts are not accepted or enforceable in Thai courts. Disputes such as the enforcement of property or contract rights have generally been resolved through the Thai courts. Thailand has an independent judiciary that generally is effective in enforcing property and contractual rights. The legal process is slow in practice, however, and litigants or third parties sometimes affect judgments through extra-legal means. In addition, companies may establish their own arbitration agreements. Thailand signed the Convention on the Settlement of Investment Disputes Between States and Nationals of Other States in 1985, but has not yet ratified the Convention. Thailand is a member of the New York Convention and enacted its own rules on conciliation and arbitration in the Arbitration Act of 2002. The 2002 Arbitration Act adopted the principles under the United Nations Commission on International Trade Law (UNCITRAL). The Arbitration Office of the Ministry of Justice administers these procedures."

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U.S. industry reports the Government of Thailand has played little to no role in the resolution of the contract disputes. As foreign court decisions remain unenforceable in Thai courts, U.S. firms seeking to export cotton to Thailand should be prepared to engage in lengthy, often opaque court battles domestically should the need for enforcement of arbitral awards arise.

BANGLADESH:

As of July 3, 2014, Bangladesh tops the ICA's List of Unfulfilled Awards with 98 companies. Additionally, four Bangladeshi companies are on the American Cotton Exporters Association Default List. As noted below, although Bangladesh's private sector attempts to assist in dispute resolution, many firms report enforcement of arbitral awards remains extremely difficult. U.S. industry reports the Government of Bangladesh met with some of the defaulting firms to encourage resolution, though again, the discussions did not translate into payment of awards. Embassy Dhaka's Country Commercial Guide (CCG) further explains the ongoing risks of contract and arbitration enforcement:

A fundamental impediment to investment in Bangladesh is a weak and slow legal system in which the enforceability of contracts is uncertain. The judicial system does not provide for interest to be charged in tort judgments, which implies there is no penalty for delaying proceedings. In a significant milestone, the Caretaker Government in 2007 separated the country's judiciary from the executive, but the executive has retained strong influence over the judiciary with control of judicial appointments. Reforms of other pillars of the justice system including the police, courts, and legal profession are also necessary. In lower courts, corruption is widely perceived as a serious problem. The High Court's previous reputation for impartiality has also been brought into question in recent years. Bangladeshi law allows contracts to refer dispute settlement to third country forums for resolution. Bangladesh is a signatory to the International Convention for the Settlement of Disputes (ICSID) and it acceded (on May 6, 1992) to the United Nations Convention for the Recognition and Enforcement of Foreign Arbitral Awards. Bangladesh is also a party to the South Asia Association for Regional Cooperation (SAARC) Agreement for the Establishment of an Arbitration Council, signed November 13, 2005, which aims to establish a permanent alternative dispute resolution center in one of the SAARC member countries. A provision of the U.S.-Bangladesh Bilateral Investment Treaty permits submission of investment disputes to ICSID for third party settlement. The ability of the Bangladeshi judicial system to enforce its own awards is weak, and there is no reason to believe that enforcement of foreign judgments would be stronger.

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The Bangladesh Export Promotion Bureau is sometimes helpful in facilitating dispute settlement for export related transactions. Major Bangladeshi trade and business associations can also help to resolve transaction disputes.

If U.S. firms are able to effectively mitigate default risks, however, the market for U.S. cotton remains strong, as continued in the Bangladesh CCG:

U.S. raw cotton exports to Bangladesh increased from \$145 million in FY 2010 to \$352 million in FY 2011, with much of the increase due to high cotton prices in early 2011. U.S. cotton exports to Bangladesh, however, declined to \$87 million in FY 2012, as many Bangladesh companies defaulted on contracts with U.S. suppliers following a sharp fall in cotton prices in 2011. While Central Asian countries and India have emerged as major competitors, Bangladesh importers recognize the advantages of more consistent quality standards from U.S. suppliers...as it is a growing market for Extra Long Staple (ELS) and superior quality cotton.

VIETNAM:

As of July 3, 2014, Vietnam had 42 companies on the ICA and 11 on the American Cotton Exporters Association Default List. U.S. firms have noted that engagement by the Government of Vietnam has been insignificant. As noted below in the Vietnam Country Commercial Guide, while international arbitration awards are recognized in Vietnam, similar to Thailand and Bangladesh, enforcement is incredibly difficult.

Dispute Settlement. *The hierarchy of Vietnamese courts include: (1) Supreme Court; (2) Provincial Courts; and (3) District Courts. The courts operate in five divisions: criminal, civil, administrative, economic, and labor. Parallel to the court systems is the People's Procuracy, which is responsible for supervising the operation of judicial authorities. The People's Procuracy can protest a judgment or ask for a review of a case. In addition, Vietnam has a system of independent arbitration centers, established under the Commercial Arbitration Ordinance (2003), which can grant enforceable arbitral awards. Foreign and domestic arbitral awards are legally enforceable in Vietnam, although in practice it can be hard to ensure enforcement. Vietnam is a party to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards, meaning that foreign arbitral awards rendered by a recognized international arbitration institution should be respected by Vietnamese courts without a review of the case's merit. Under the investment chapter of the Bilateral Trade*

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Agreement between Vietnam and the United States, Vietnam gives U.S. investors the right to choose a variety of third-party dispute settlement mechanisms in the event of an investment dispute with the Government of Vietnam. Vietnam has not yet acceded to the Convention on the Settlement of Investment Disputes between States and Nationals of other States (ICSID), but has asked the United States to provide advice in this area as part of the U.S. technical assistance program designed to assist Vietnam to implement the BTA. The Ministry of Planning and Investment (MPI) has submitted a proposal to the Government of Vietnam to join the ICSID, which is still under consideration. Vietnam's legal system, including its dispute and claims settlement mechanisms, remains underdeveloped and ineffective in settling disputes. Negotiation between the concerned parties is the most common means of dispute resolution. Under the 2005 Civil Code, all contracts are "civil contracts" subject to uniform rules over all contractual relations, including those with foreign businesses. In foreign civil contracts, parties are allowed to choose foreign laws as reference for their contractual agreement, provided that the application of the law does not violate the basic principles of Vietnamese law. In addition, commercial contracts between businesses are also regulated by the 2005 Commercial Law. According to the World Bank, it takes an average of five years to resolve a bankruptcy in Vietnam.

As with Bangladesh, the demand for U.S. cotton continues to grow in Vietnam:

For the sixth consecutive year, the United States remained the largest supplier of cotton to Vietnam. In 2012, Vietnam sourced 126,600 metric tons (about 30 percent) of its total cotton imports from the United States, making it the 4th largest market for U.S. cotton at a value of \$248 million. In fact, in value terms, Vietnam jumped from the 7th largest market in 2011 to the 4th largest market for U.S. cotton in 2012, surpassing Indonesia, Korea, and Thailand.

In summary, the judicial systems in Thailand, Bangladesh, and Vietnam have typically been ineffective at enforcing arbitration decisions. The judicial situation has not significantly improved since the initial defaults, which suggest that, if defaults were to occur again, sellers would still have difficulty in enforcing any arbitration decisions.