Commodities

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QINGDAO: JUDGMENT IN *MERCURIA V CITIGROUP* IN LONDON'S COMMERCIAL COURT

The much anticipated judgment in the first leg of the *Mercuria v Citigroup* litigation was handed down this afternoon (Friday 22 May) in the Commercial Court in London.

Background

The dispute involves US$270 million of metal bought by Mercuria from Dezheng Resources, stored in warehouses at Qingdao and "repo'd" to Citi (ie. sold with the intention that Citi would resell the same or equivalent metal back to Mercuria at a future date). In late May 2014, it came to light that a quantity of such metal may not have existed or may have been pledged multiple times. The parties agreed for the purposes of this trial that at the time of this discovery, Citi had title to and risk in the metal. Citi also accepted that under the contractual documents, it warranted good title and a right to possession of the metal being sold on the date of each forward sale to Mercuria.

On 9 June 2014, Citi served bring forward notices purporting to exercise a contractual right to bring forward the sale date of all the metal to the following banking day. On 11 July 2014, Mercuria served its own notice declaring a termination event, which if effective, would have required Citi to deliver equivalent metal to Mercuria before Mercuria was obliged to pay the price. On 22 July 2014, Citi purported to deliver the metal to Mercuria by tendering warehouse receipts issued to Citi, endorsed in blank. Citi did not issue release instructions to the warehouse operators who did not attorn either by issuing their own release confirmation or new warehouse receipts made out to Mercuria.

The proceedings, commenced by Mercuria, were to determine whether Citi's notices were valid, whether Mercuria's termination event notice was valid, and, ultimately, whether Mercuria was contractually obliged to pay to Citi US$270 million notwithstanding that no-one knows whether the metal is in the warehouses at Qingdao, which remain under lockdown.

Transaction No. 6

One issue was the status of "Transaction No. 6" – the forward sale leg of which fell to be performed on 3 June 2014 – after the parties became aware of the alleged fraud, but before the bring forward notices or the termination event notice had been served. Citi sent Mercuria an invoice for this transaction and Mercuria paid under reservation of its rights. The day after payment, Citi delivered to Mercuria the warehouse receipts for the metal endorsed to Mercuria. Mercuria sought delivery of the metal but the warehouse operator explained it could not access the warehouse so the goods were unavailable. To date, Mercuria has been unable to obtain an acknowledgment of its status as owner of the metal from the warehouse operator. Neither Mercuria nor Citi has tried to get the warehouse operator to attorn in respect of the metal for the other 17 transactions.

Delivery under English law

By the time the matter came to trial, Citi accepted that, even if its bring forward notices were valid, and it was entitled to payment in full prior to delivery to Mercuria, if it could not subsequently give good delivery of the metal then Mercuria would have a right to repayment. Accordingly, Mercuria had a "circuity of action" defence. This meant that unless Citi could show that it could give good delivery, Mercuria would not be liable to pay Citi notwithstanding the terms of the contracts which provided otherwise.

Under English law, a warehouse warrant or receipt is not a document of title (and is therefore crucially different from a bill of lading). It has long been the case, that where a third party has possession of goods, a seller must obtain an "attornment" or an acknowledgment from that third party in order to deliver the goods and transfer title to a buyer. Citi argued that, although it had not given actual delivery to Mercuria, delivery was "deemed" to have occurred under the terms of its contracts with Mercuria. This argument was based on the provision in the forward sale confirmations that delivery (a defined term) could take place *"without the need for any confirmation from the owner/operator of the Storage Facility"*. This is in contrast to the sale confirmations (where Mercuria was delivering to Citi) which did not contain this wording.

The Judge found that, looking at the confirmations and the (in some instances contradictory) provisions of the Master Agreement together, he could not construe them as requiring only delivery of documents rather than delivery of metal. The Judge determined that Citi, having risk and title to the metal, could not make delivery regardless of the presumed existence of the metal and Citi's good title to it. The wording in the confirmations on which Citi relied was rejected as being inconsistent with the overall commercial scheme of the transactions.

Assignment

Citi's alternative case was that under the contractual documents where it was *"unable to deliver the Metal sold to it by Counterparty"* it was entitled to satisfy the transactions by assigning its rights to Mercuria. The Judge found that Citi was not entitled to do this because any inability to deliver metal would have arisen as a result of the problems at Qingdao which were termination events (and Citi was not permitted to assign its rights after a termination event).

The result

The consequence of the Judge's findings against Citi is that Citi did not make valid delivery of the metal under the one forward sale known as Transaction No. 6. Had Mercuria terminated the transaction, it would have had a claim for the price paid. However, since Mercuria had attempted to obtain delivery from the warehouse operator which issued the receipt, its claim was limited to non-delivery (rather than a claim for the price paid).

Mercuria's argument in relation to the bring forward event notices was that Citi did not have the necessary belief that the storage facility was no longer able to safely or satisfactorily store the metal in order to issue the notices. Mercuria relied on the view expressed in some internal Citi emails at the time that the notices were a tactic to force Mercuria to engage and cooperate. In the end, the Judge distinguished between Citi's motivations for sending the notices and its belief, which he found that Citi did hold. He also found that the belief was rational and *"objectively reasonable"*. The consequence of these factual findings is that Citi's notices were valid and effective.

Under the terms of their agreement, Citi's service of valid bring forward event notices meant that Citi had a claim for the price of the metal, in the sum of US$270 million. However, because Citi could not give good delivery, it was not entitled to judgment for the price as claimed.

Whilst Citi may not be entitled to be paid the price of the metal at present, because its notices were valid, Mercuria is in repudiatory breach of the Master Agreements which Citi is entitled to (but has not yet) terminated, a right which has not been lost notwithstanding the events since June 2014, including the litigation.

A true sale?

The judgment refers in various places to the fact that Citi contended that in reality it was merely "financing" Mercuria's metal inventory. For example, the difference in price of the repurchase represented the financing cost to Mercuria in the form of interest



and the metal is described as security for such financing. Whilst no finding of true sale is made in the judgment (because Citi accepted that it had risk in and title to the metal at the time the alleged fraud was uncovered) the implications of such submissions for the wider repo market are clear: would such submissions have been made if, instead of an alleged fraud, it was a counterparty insolvency which had given rise to the litigation? Under English law, contracts are construed in substance, not just in form, and the danger of repo transactions being characterised in this way is plain.

Further claims

The judgment itself acknowledges that once the timing, nature and extent of any fraud becomes clearer, there may well be the need for further litigation to determine whether Mercuria or Citi breached warranties as to good title in relation to the metal. The judgment also notes that Citi may have claims under a Services Agreement dated 24 May 2013, under which Mercuria contracted to perform storage obligations in relation to the metal. Further, there may be insurance and/or third party claims. None of these claims are prevented by the judgment, whether in the current proceedings or in new proceedings, in England or elsewhere.

It will be open to Citi to argue in due course, if the date of any fraud can be established, that Mercuria did not give good title when it delivered the metal to Citi. However, this argument will be dependent upon establishing facts which are at present unknown. Given that the lex situs, in this case PRC law, governs the issue of title and competing interests to it if such should emerge, it is clear that this judgment whilst providing some clarity for the two parties concerned is not definitive for others caught up in Qingdao and illustrates the difficulties which a seemingly commonplace arrangement can lead to once it unravels.

For more information, please contact the authors of this Briefing:

Sarah Taylor
Partner, London
T: +44 (0)20 7264 8102
E: sarah.taylor@hfw.com

Guy Hardaker
Partner, Hong Kong
T: +852 3983 7644
E: guy.hardaker@hfw.com

HFW's London and Hong Kong offices are part of an international network of 13 offices in 11 countries. For further information about commodity related issues in other jurisdictions, please contact:

Edouard Taÿ Pamart
Partner, Paris
T: +33 1 44 94 40 50
E: eduoard.taypamart@hfw.com

Konstantinos Adamantopoulos
Partner, Brussels
T: +32 (0) 2643 3401
E: konstantinos.adamantopoulos@hfw.com

Jeremy Davies
Partner, Geneva
T: +41 (0)22 322 4810
E: jeremy.davies@hfw.com

Dimitri Vassos
Partner, Piraeus
T: +30 210 429 3978
E: dimitri.vassos@hfw.com

Simon Cartwright
Partner, Dubai
T: +971 4 423 0520
E: simon.cartwright@hfw.com

Chris Swart
Partner, Singapore
T: +65 6411 5315
E: christopher.swart@hfw.com

Nick Poynder
Partner, Shanghai
T: +86 21 2080 1001
E: nick.poynder@hfw.com

Gavin Vallely
Partner, Melbourne
T: +61 (0)3 8601 4523
E: gavin.vallely@hfw.com

Stephen Thompson
Partner, Sydney
T: +61 (0)2 9320 4646
E: stephen.thompson@hfw.com

Hazel Brewer
Partner, Perth
T: +61 (0)8 9422 4702
E: hazel.brewer@hfw.com

Jeremy Shebson
Partner, São Paulo
T: +55 11 3179 2900
E: jeremy.shebson@hfw.com

Lawyers for international commerce

hfw.com

São Paulo London Paris Brussels Geneva Piraeus Dubai Shanghai Hong Kong Singapore Melbourne Sydney Perth