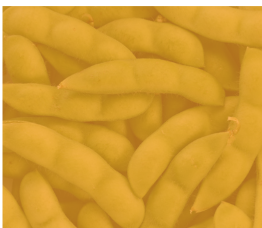
Commodities

March 2017



Welcome to the Spring edition of the Commodities Bulletin.

Our first article comes from Partner Sarah Taylor. She considers the implications of two recent English Court of Appeal decisions, which should offer reassurance to commodities traders who rely on letters of credit to secure payment under their sale and purchase contracts.

Next Partner Jeremy Davies reports on a recent English Commercial Court decision with potentially serious consequences for counter-signatories to letters of indemnity.

Third is an article from Partner Brian Perrott and Associate Prashant Kukadia, on a recent case in which they acted for Bunge SA. They successfully recovered sums due under an arbitration award following applications to the English Commercial Court for both a worldwide freezing order and a committal order. The case illustrates the benefits of an English law, London arbitration dispute resolution clause in commodity contracts, demonstrating the range of enforcement options available and the supportive attitude of the English courts towards arbitration as a means of dispute resolution.

Our final article comes from Partner Robert Finney and Associate Ellie Kirby. They tell you what you need to know about the EMIR margin requirements for uncleared OTC derivatives. Later this month, on 14 March 2017, Robert will be co-hosting a Legal and Regulatory round table event with Partner Marc Weisberger, giving commodities counsel and regulatory specialists an opportunity to discuss current legal, compliance and management issues with industry peers.

We will also be hosting our spring series of commodity breakfast seminars in London, on 21 March and 11 April 2017. Please contact events@hfw.com if you would like to attend.

Should you require any further information or assistance on any of the issues dealt with here, please do not hesitate to contact any of the contributors to this bulletin, or your usual contact at HFW.

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Standby letters of credit – still the lifeblood of international commerce?

In 1978 Kerr J famously said that irrevocable obligations assumed by banks are the "lifeblood of international commerce"[1]. The accuracy of this description was tested recently before the English Court of Appeal. The court remained unwilling to depart from the principle that if a compliant demand is made under a standby letter of credit, an issuing bank must pay, subject to only very limited exceptions.

Introduction

A key purpose of the widespread use of letters of credit to finance commodity transactions is the comfort it gives to the seller that it will receive payment. In two English law cases decided this year, banks sought to avoid their payment obligations under a standby letter of credit (SBLC) SBLC, without success. This article will consider the cases and the steps that beneficiaries should take to ensure that an SBLC is enforceable.

The facts

In the first case, *National Infrastructure Development Co Ltd v Banco Santander*[2], the bank was appealing against summary judgment given in favour of the beneficiary (NIDC) of four SBLCs. The bank raised several arguments on appeal, including one that the demand for payment was fraudulent.

The SBLCs provided that the presentation of a demand would be conclusive evidence that the amount claimed was "due and owing" to NIDC by its contractor. The bank argued that NIDC did not believe in the validity of its claim, because a claim for damages for premature abandonment of the underlying contract was not a claim in law that money was "due and owing". The Court of Appeal held that this argument was misconceived:

1. The beneficiary's belief that payment was "due and owing" should activate payment. The test is not whether the demands were decided by a tribunal or otherwise to be correct in law.
2. An ongoing arbitration concerning the underlying contract did not mean NIDC's demands were dishonest.
3. It could not be fraudulent to make a demand that one was entitled to make.

The Court of Appeal concluded that there was no evidence of fraud and the bank had to honour the demand for payment.

In the second case, *Petrosaudi Oil Services (Venezuela) Ltd v (1) Novo Banco SA (2) PDVSA Servicos SA (3) PDVSA Services BV*[3], the beneficiary, Petrosaudi, appealed the English Commercial Court's decision that its demand for payment had been fraudulent. The court had held that Petrosaudi was not entitled to call for payment of invoices under the SBLCs issued by the bank, because the underlying invoices were disputed. The underlying contract contained a "pay now, argue later" clause, but this conflicted with a provision of Venezuelan law, which governed the contract. Venezuelan law required completion of a verification procedure authorising the bank to pay, or an arbitration award to the same effect.

The court remained unwilling to depart from the principle that if a compliant demand is made under a standby letter of credit, an issuing bank must pay, subject to only very limited exceptions.

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The court had held that Petrosaudi's certification under the SBLC was fraudulent as, under Venezuelan law, the bank had no present obligation to pay.

Petrosaudi appealed. The issue in dispute was whether it had been open to Petrosaudi to certify that the counterparty was "obligated to pay", and thus demand the payment from the bank, when the sums were in dispute. The Court of Appeal allowed Petrosaudi's appeal:

1. The meaning of the words "obligated to pay" had to be considered in the context of the certificate to be tendered under the SBLC. The SBLC was separate to the underlying contract, made with a different counterparty, and had

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1 *RD Harbottle v National Westminster Bank* [1978] QB 146

2 [2017] EWCA Civ 27

3 [2017] EWCA Civ 9, [2017] All ER (D) 92 (Jan)

a different governing law (English law).

2. According to the underlying contract, the counterparty was obligated to pay Petrosaudi. This obligation was not immediately dischargeable due to the provision of Venezuelan law, but the obligation existed nevertheless.
3. The SBLC did not require the award of a tribunal or evidence that Venezuelan law had been complied with. The SBLC was governed by English law.

Why these decisions should offer reassurance

These decisions reinforce the English law principle that exceptions to the rule that an issuing bank must pay under an SBLC are limited and difficult to prove. If you have concerns about the reliability of your counterparty, requiring them to provide an SBLC from a reliable bank and governed by English law remains a good way of securing payment.

HFW perspective

If you are the beneficiary of a SBLC, you should insist that it contains clear wording to the effect that presentation of a demand by you will be conclusive evidence that the amount claimed will be "due and owing". In order to rely on the strength of these decisions, you should also ensure that English law governs the SBLC, even if it does not govern the underlying contract.

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hfw Trade finance: potential pitfalls for counter-signatories signing letters of indemnity

The recent English Commercial Court case of *Euro-Asian Oil SA v Credit Suisse AG and others*[1] is a cautionary tale with wider consequences for parties who counter-sign letters of indemnity (LOIs).

Background

Euro-Asian Oil SA (Euro-Asian) purchased a cargo of ultra-low sulphur diesel from Abilo (UK) Limited (Abilo), the fourth in a series of similar transactions between them. The transactions were financed by way of letters of credit, which provided standard wording for LOIs to be presented in lieu of bills of lading.

Credit Suisse AG (Credit Suisse) had financed Abilo's purchase of the cargoes and agreed to be jointly and severally obligated with Abilo under the LOIs. It counter-signed the LOIs with Abilo.

The LOIs were presented to Euro-Asian's banks in lieu of the bills of lading, under the letters of credit which those banks had opened for Euro-Asian to pay for the purchase of the cargoes from Abilo. The banks paid out and Euro-Asian claimed against Credit Suisse, and another defendant, in relation to the fourth transaction, for breaches of warranties and undertakings in the LOIs that it had signed.

The relevant clauses in the LOIs warranted that:

1. Abilo had marketable title to the cargo free and clear of any encumbrance.
2. Abilo had the full right and authority to:
    - Transfer title to the cargo to Euro-Asian.
    - Effect delivery of the cargo to Euro-Asian.
    - Locate and surrender to Euro-Asian the full set of 3/3 original bills of lading.

Unfortunately, and without Credit Suisse's knowledge, the previous transactions between Euro-Asian and Abilo had proceeded in an irregular fashion, characterised by Euro-Asian during trial as a 'carousel', whereby Abilo presented documents under a letter of credit for one cargo which had already been discharged under a prior transaction and used by the oil terminal to issue a holding certificate for the purposes of the back to back transaction. The carousel arrangement rendered the warranties in the LOIs untrue. The court found that Euro-Asian was aware of the carousel by the end of May 2010 but Credit Suisse only became aware in January 2011, in the aftermath of the breakdown in the relationship between Euro-Asian and Abilo.

Further, the individual controlling Abilo had close links with the relevant individual traders at Euro-Asian. In fact, the individuals involved in the transactions at Euro-Asian were receiving commission on the back of them. This information was kept not only from those controlling Euro-Asian but crucially, from Credit Suisse.

1 [2016] EWHC 3340 (Comm)

The crisis point came when Abilo made a complying presentation under the letter of credit for the fourth transaction, despite both Euro-Asian's protestations that an underlying fraud was being committed and Euro-Asian's failed attempt to secure an injunction in Geneva to prevent payment of the funds under the letter of credit.

Judgment

The lengthy judgment deals with a number of issues, including the definition of a CIF contract, Euro-Asian's involvement in the so-called "carousel" and third party indemnities.

In relation to the LOIs, the court found that by countersigning the relevant LOIs, Credit Suisse was *"exposing itself to some risk"* and that *"in signing the letters of indemnity and acting in this way it was no longer a letter of credit bank."* Credit Suisse was held to be liable for Euro-Asian's losses, despite having no relevant knowledge of the convoluted underlying transactions.

The court ultimately found that Abilo shouldered the majority of the responsibility for Euro-Asian's losses and assessed Credit Suisse's overall contribution to the loss at 20%, pursuant to the Civil Liability (Contribution) Act 1978.

The court denied Credit Suisse permission to appeal at the ancillary hearing but leave has since been sought from the Court of Appeal.

How does this affect me?

The current ruling has wider implications for transaction specific trade finance. Although Credit Suisse was not aware of the underlying carousel and that the warranties given in the LOIs were incorrect, by countersigning the LOIs it assumed the risks and responsibilities of them being incorrect.

The current ruling has wider implications for transaction specific trade finance.

JEREMY DAVIES, PARTNER

To avoid this risk, banks should conduct further due diligence regarding underlying transactions. Additionally it may be possible for a bank to countersign a separate indemnity, affirming that it will be jointly and severally obligated only if the warranties and representations in the relevant LOI are all correct at the time of signature. Ultimately however, banks may simply find this kind of financing less attractive going forward.

HFW acted for Credit Suisse. The case handlers were Jeremy Davies and Patrick Myers.

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hfw Enforcement: criminalising the non-payment of arbitration awards

Failure to adhere to a London arbitration award or English court judgment can, if certain steps are taken, lead to criminal implications for the defendant and the defendant's directors.

What are the key points?

In *Bunge SA v Huaya Maritime Corp*[1] HFW assisted with the enforcement of a LMAA arbitration award. The defendant, a Marshall Islands entity called Huaya Maritime Corp (Huaya), had participated in the arbitration and lost. Despite numerous demands, Huaya failed to pay the fairly modest award due to the claimant, Bunge SA (Bunge).

After investigation, HFW found that Huaya had a Chinese parent company which had opened up a number of subsidiary companies in various jurisdictions with limited or no reporting requirements, subsequently ceased using them, and had potentially dissipated assets once a liability (such as an arbitration award against them) had accrued.

Using this evidence, HFW secured a worldwide freezing order (WFO) from the English High Court. Importantly a WFO has two key aspects:

1. Disclosure obligations which require the respondent, within 24 hours of service of the WFO, to disclose its assets up to a certain value and subsequently to include that information in an affidavit and serve this on the applicant within 48 hours of service of the WFO.

1 [2017] EWHC 90 (Comm)[1978] QB 146

These types of freezing orders, and consequent contempt orders, although potentially last-resort remedies for enforcement, can be effective. In the present case, after service of the freezing order and committal order, Bunge received payment in full of the award, interest and costs from Huaya...

BRIAN PERROTT, PARTNER

2. A penal notice which states: *"If you [the respondent] disobey this order you may be held to be in contempt of court and may be imprisoned, fined or have your assets seized. Any other person who knows of this order and does anything which helps or permits the Respondent to breach the terms of this order may also be held to be in contempt of court and may be imprisoned, fined or have their assets seized."*

Upon Huaya's failure to comply with the disclosure obligations under the WFO, HFW pursued Huaya and Huaya's director for contempt of court.

As a result, HFW secured a committal order against the director on the basis that he was the "directing mind" of Huaya and so must have known about its obligations under the WFO. The director was sentenced to 18 months' imprisonment in his absence. The implication of this is that if the director ever travels to the UK, he will be arrested and imprisoned.

How will this affect me?

Commodities clients regularly opt for English law, London arbitration clauses in their contracts and many standard form contracts, including GAFTA and FOSFA, do so.

These types of freezing orders, and consequent contempt orders, although potentially last-resort remedies for enforcement, can be effective.

In the present case, after service of the freezing order and committal order, Bunge received payment in full of the award, interest and costs from Huaya – possibly as Huaya and the director became aware of true and severe ramifications of the committal order.

HFW perspective

A further interesting part of the proceedings was that throughout, the English court was keen to support Bunge in its application on the basis that Huaya took the benefit of participating in arbitration in London (supervised by the English courts) and then when the award was not its favour, refused to comply. The court took a dim view of this.

When negotiating dispute resolution clauses in their contracts, commodities clients should keep in mind the supportive approach of the English courts to arbitration and the enforcement options available to them once an award has been secured.

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New EMIR margin requirements for uncleared OTC derivatives come into force – are you compliant?

On 1 March 2017, EU rules governing the mandatory posting of collateral for uncleared derivatives came into effect. From that date all in-scope counterparties are required to exchange variation margin. A phased implementation for initial margin requirements will start on 1 September 2017 and continue to September 2020. However, the largest counterparties in OTC derivatives markets were required to exchange both initial and variation margins with effect from 4 February 2017.

The financial industry has been concerned about its ability to meet the 1 March deadline for posting variation margin (VM). On 23 February 2017 the European Supervisory Authorities - ESMA, the EBA and EIOPA (the ESAs) - issued a statement on the implementation date for the exchange of VM, aimed mainly at smaller firms who might not have been able to comply fully with the requirement from 1 March and what they expect should be the approach to these firms by national competent authorities (NCAs). At the same time, the UK's NCA, the Financial Conduct Authority (the FCA), published a statement on its approach to firms who have not met the 1 March deadline.

In this article we examine the rules in respect of exchanging VM and initial margin (IM). We update you on the recent statements made by the ESAs and the FCA and consider what this means for counterparties who were subject to the requirement to exchange VM from 1 March 2017.

What requirements apply, to whom and from when?

The 2012 European Market Infrastructure Regulation (EMIR) requires both IM and VM to be exchanged in respect of uncleared over the counter (OTC) derivatives transactions by financial counterparties (FCs) and NFCs - non-financial counterparties whose average positions, calculated in accordance with EMIR, exceed specified clearing thresholds. The margin requirements apply to transactions entered into by counterparties each of which has, or belong to groups that have, uncleared OTC derivatives with an aggregate average notional amount exceeding the threshold specified for a phase-in date that has been reached. However, where the margin requirements also apply to existing outstanding transactions if new transactions are documented under the same master agreement or other netting arrangement.

The table below summarises the thresholds and phase-in dates:

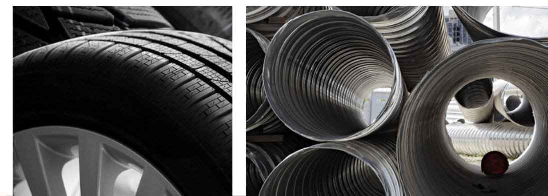
Uncleared OTC derivatives (aggregate group notional amount)	IM requirement applies from	VM requirement applies from
> €3 trillion	4 February 2017	4 February 2017
> €2.25 trillion	1 September 2017	1 March 2017
> €1.5 trillion	1 September 2018	1 March 2017
> €0.75 trillion	1 September 2019	1 March 2017
> €8 billion	1 September 2020	1 March 2017
< €8 billion	Exempt	1 March 2017

Note that these requirements will apply only to new transactions entered into after the relevant phase-in dates and transactions under existing master agreement or other netting arrangement.

The European Commission set these requirements based on international agreement on terms for collateralising uncleared derivatives. In addition to setting deadlines, EMIR itself and the Commission's regulation cover a range of details, such as other phase-in periods, exemptions, trades with non-EU counterparties, margin calculation, acceptance of non-cash collateral, and segregation of IM.

What if my firm can't meet the 1 March deadline?

On 23 February 2017 the ESAs issued a statement on the implementation date for the exchange of VM, acknowledging that some mainly smaller firms were experiencing *"operational challenges"* in meeting the 1 March deadline. While stating that there could be no *"general forbearance"* or extension of the deadline, as neither the ESAs nor NCAs possess any formal powers to disapply directly applicable EU legislation, the ESAs expect NCAs (such as the FCA) to *"generally apply their risk-based supervisory powers in their day-to-day enforcement of*



These statements do not have the effect of excusing firms from being fully compliant with the requirement to exchange variation margin from 1 March 2017.

ROBERT FINNEY, PARTNER

applicable legislation". The ESAs envisaged that this would entail NCAs taking into account:

- The size of the exposure to the counterparty plus its default risk.
- The steps taken by the market participant towards full compliance, including alternative arrangements to ensure that the risk of non-compliance is contained, such as using existing collateral documents (for example, Credit Support Annexes) to exchange VM.

However, the ESAs also emphasised that they expect difficulties faced by counterparties not fully compliant by 1 March to be solved *"in the coming few months"*.

The FCA welcomed the ESAs' statement and announced its approach to firms not in a position to comply with VM requirements by 1 March. The FCA plans to take a risk-based approach to these firms and to *"use judgement as to the adequacy of progress, taking into account the position of particular firms and the credibility of the plans they have made"*.

These statements do not have the effect of excusing firms from being fully compliant with the requirement to exchange variation margin from 1 March 2017. There is no formal extension to the deadline and transactions concluded on or after 1 March 2017 remain subject to the obligation to exchange variation margin.

While these statements should reassure firms who have made best efforts to comply, counterparties should note that the FCA, and perhaps other NCAs, may at any time request to see detailed and realistic plans to achieve compliance in as short a time as practicable.

Conclusion

Given that there is no extension to the deadline to start exchanging variation margin, and the statements made by the ESAs and FCA, it is more important than ever that counterparties act now to achieve compliance. Generally, in-scope counterparties must enter into new credit support/ collateral documentation, or amend existing documentation, and procure an independent legal review of the enforceability of that documentation, including associated master or netting agreements.

Counterparties who were not fully compliant by 1 March 2017 should consider what other arrangements they can put in place to mitigate the risks of non-compliance.

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hfw Conferences and events

HFW Commodities seminar
The Address, Dubai Marina
14 March 2017
Presenting: Damian Honey, Richard Strub and Tien Tai

Commodities Legal & Regulatory roundtable
HFW London
14 March 2017
Hosting: Marc Weisberger and Robert Finney

HFW Seminar Series: Joint Venture Case Study. Part 1 - JVs - Friend or Foe?
Singapore
15 March 2017
Attending: Chris Swart and Brian Gordon

Africa CEO Forum
Geneva
20-21 March 2017
Attending: Georges Racine

SRIC Trading Forum: Commodity trading: Market evolution in response to technology revolution
Geneva
21 March 2017
Presenting: Olivier Bazin

HFW Commodities breakfast seminars
HFW London
21 March and 11 April 2017
Attending: Damian Honey

FT Commodities Forum
Lausanne
27-29 March 2017
Attending: Georges Racine, Olivier Bazin and Brian Perrott

Refined Sugar Association/Sugar Association of London Newcomers seminar
26 April 2017
Presenting: Judith Prior

3rd Annual Qatar International Arbitration Summit
Qatar
17 May 2017
Presenting: Damian Honey

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