Commodities

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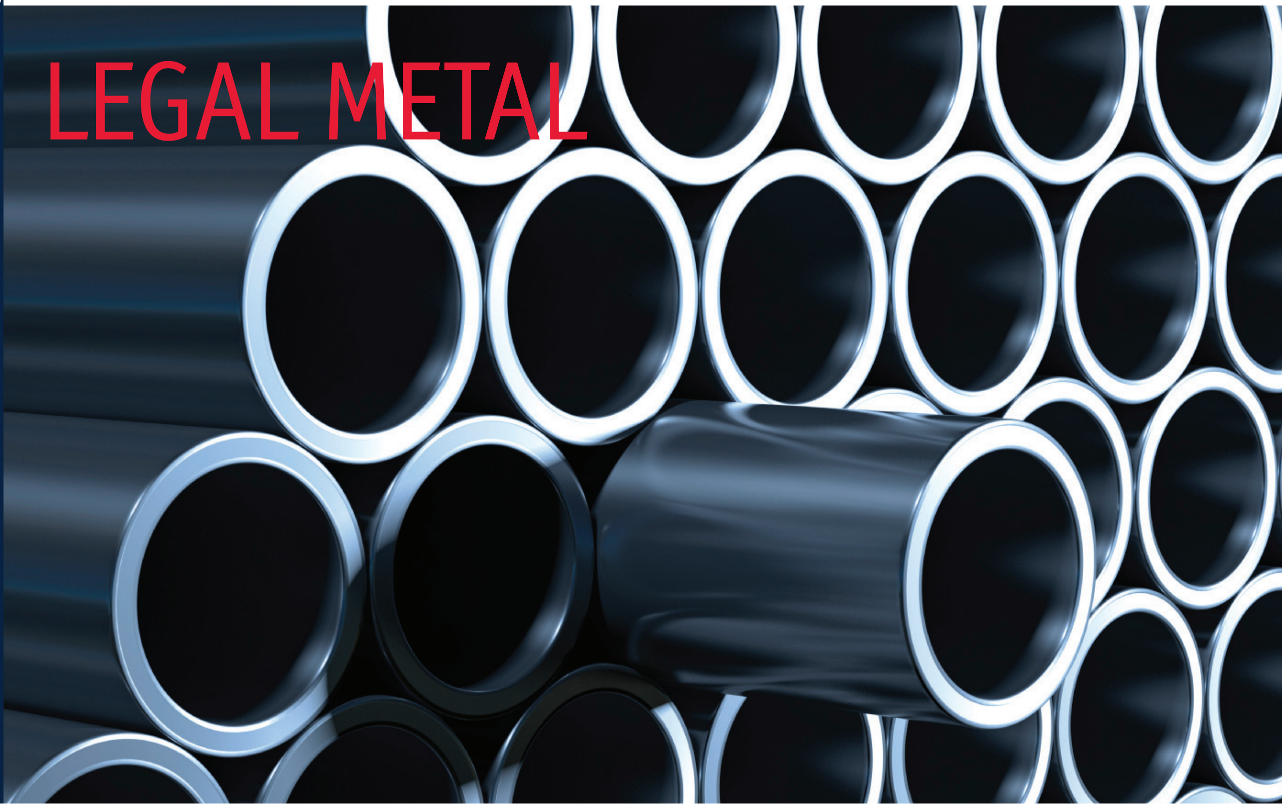
LEGAL METAL



Negotiating physical metal trading contracts - points to consider

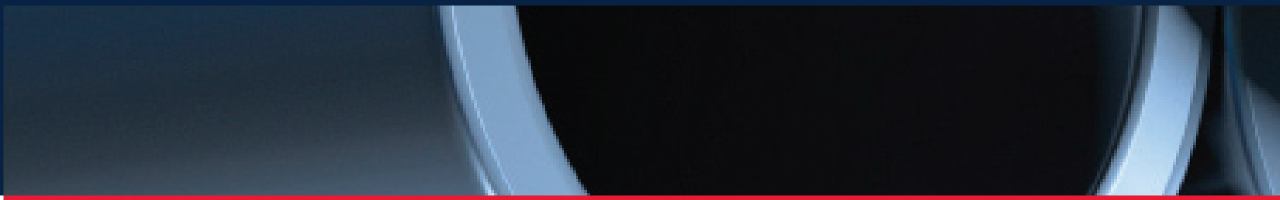
Sales of physical metals are usually documented on the basis of a metal producer's bespoke standard terms and conditions. There is currently no market-leading standard physical metals contract, in contrast to the relatively sophisticated standard contracts which have been developed for trades of hydrocarbons and coal. Nor is there any industry body pushing for metals contracts standardisation, which is perhaps surprising when one considers the high value of metals being traded.

Generally, producers' terms are often strongly biased in favour of the producer. A trader's ability to negotiate the terms will depend to a great extent on the balance of power between the parties but it is not unreasonable to seek amendment to certain key terms where necessary.

Metals producers' standard contracts - common issues

Misuse of Incoterms

- Contracts may refer to Incoterms which do not correlate to the express obligations of the parties set out in the contract terms.
- A contract may describe itself as being on a CFR/CIF basis, which may be contradicted elsewhere in the contract, for example if there is a provision for risk and possibly also title to pass at the discharge port.
- We have seen contracts which are purportedly on an FOB basis, but require the FOB buyer to pay export dues and charges, and also to arrange collection from the warehouse of the seller.



Quality specifications

- Quality specifications can often be confusing. Traders should check that the following issues are covered:
  - Material - LME brand or not?
  - Local specifications - are these required?
  - Origin - is this stated and what is needed?
- Producers' terms can be unclear and poorly worded, for example: *"Claims in respect of the quality shall be honoured by the Seller provided there is the Seller's fault in it per the Incoterms..."*

Quality assessment

- For hydrocarbons, other energy commodities and softs it has become increasingly common for "final certificates" regarding quality to be issued at, or shortly prior to, the point of delivery. Such certificates are usually to be binding on the parties, absent fraud or manifest error.
- The metals market adopts a slightly different approach, which is partly driven by the fact that quality specification is not normally a major issue in metals contracts (unless the wrong grade of material is provided): quality claims are frequently allowed to be made up to (90) days after delivery of the material, failing which any such claims will be barred.
- At the time of a notification of a claim, the seller or both parties may agree to instruct an independent surveyor who will assess the quality of the material, and issue a final and binding certificate.
- If such a post-delivery inspection is agreed, it is important that the buyer does not use the metal but keeps it stored separately so that it is easily identifiable and can enable tests of a sufficiently large sample to be carried out. This may be difficult if the buyer has limited storage availability.

Risk and title

- This is perhaps the most important issue to focus on when reviewing a physical metals contract.
- Do not assume that risk and title are linked. Instead it is possible that risk will pass at physical delivery, but title will only pass on full payment.
- Contracts frequently state that risk will pass in accordance with Incoterms – which under an FOB contract is when the material has been placed on board the vessel nominated by the buyer (2010 version).
- A sample title clause from a metal producer's terms provides that *"the title in the Material to be delivered shall pass from the Seller to the Buyer upon receipt of payment for material in full in the Seller's correspondent account ..."*
- This retention of title can create a problem where there is a chain of contracts which may not be on back to back terms, especially if another contract in the chain links risk and title and states that they pass on loading. It is very important therefore to check that contracts are back to back.
- Where a seller is trading on FOB terms this can also create issues when the seller seeks to assert title when it has no contract with the carrier, as the buyer will have arranged the freight.

Retention of title clauses

- As a variant on the "title passing on payment" clause, it is common to see clauses by which the seller purports to retain title in the goods, for example: *"All goods or documents delivered under this contract remain the property of the Seller and are to be held in trust by the Buyer until receipt by the Seller of full contractual payments".*
- Such clauses are common in the metals market, and the classic English retention of title clause case (*Aluminium Industrie Vaassen BV v Romalpa Aluminium Ltd*) - was (as you can see from the title!) based on a metals transaction.
- Retention of title clauses are more suited to a bilateral relationship between producer and user, and so create difficulties in a trading environment.
- On buying material under such a clause the buyer cannot give any clean warranty of title if seeking to onsell the goods, unless and until

full payment has been received by the seller.

- Retention of title clauses can also create issues for financiers of material as it creates difficulties as to the taking of security interests over material stored at the warehouse of the buyer.

Retention of title - enforcement difficulties

- A further difficulty with retention of title clauses is the extent to which they can be enforced if the buyer defaults and does not pay.

- A well-drafted retention of title clause should set out requirements for segregation of material at the buyer's premises. Consider also if the clause is sufficiently wide to maintain the effectiveness of the clause and allow the seller to pursue the buyer in circumstances where:

    - The material is not segregated and has been co-mingled with other material.

    - The material has been processed at the premises of the buyer and the new product produced has been onsold to a new purchaser.

- The above questions involve, to some extent, questions of law of the jurisdiction in which the metals are located, and whether such clauses can be maintained and enforced in the event of a party's insolvency.

- A simpler solution therefore, and one favoured in other commodity markets, is to link risk and title together, and to pursue a debt claim in the event of non-payment.

Contract structure and boiler plate issues

- In our experience, it is very unusual to see master agreements in the metals market – some traders have attempted to bring in more sophisticated contracts from other commodities, but there is not much current traction on this issue.

- Event of Default clauses are not common in metal producers' general terms and conditions ("GTCs"), neither are clauses attempting to define remedies in the circumstances of a default.

- Force Majeure provisions are commonly used and often very producer friendly. A particular issue to note and perhaps to resist are the extension of Force Majeure clauses upstream ie. to the failure of supply of materials to the producer for any reason being a Force Majeure event.

- Finally, the form of the contracts can be muddled. Frequently a 'confirm' incorporating GTCs is used. Those GTCs may well incorporate Incoterms, and also the contract itself may be based on a previously performed contract.

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Regulatory changes in the mining sector in Sub-Saharan Africa - a snapshot of the potential impact for investors

There have been a number of regulatory developments within the Sub-Saharan mining sector in recent months. New codes and amendments to existing regulations in a number of countries have set revised parameters to be taken into account by both existing and future investors. A common theme of such changes is the increased participation of the state in the mining sector, with governments keen to retain a greater share of revenue from mining.

The new regulations

In September 2011, both Angola and Guinea introduced new mining codes. The new Guinean code provides for the state to be granted, at no cost, an automatic interest upon the issuance of a mining title (15% in relation to bauxite, iron ore and gold, although less for certain other minerals), with a further option to require an additional, paid-up shareholding in the investing company up to a maximum of 35%. Similarly, in consideration for granting mining rights in Angola, its new code provides that the State will obtain a 10% share of the company conducting the mining activities.

Until now, the regulation of the mining sector in the Sub-Saharan region has been piecemeal, with an emphasis on tax concessions aimed at attracting investment. Now that the mining industry is firmly established, and the politics of the region more stable, there has been a shift towards limiting existing tax concessions. In Guinea, existing tax exemptions on dividends have been cut (from 15% to 10%), whilst Angola has placed a cap of 50% on the amount

of revenue which can be re-invested towards operational costs, with the remaining 50% having to be used to pay taxes and investors (previously, with no limit on investment, companies were able to direct large revenues towards reinvestment, thereby reducing the amount of tax payable to the State).

Surrounding countries are following the trend towards 'nationalising' areas of the mining sector. In November 2011, the Zambian government doubled its royalty rates for the export of copper, nickel, manganese and iron ore, while the DRC has suspended issuing any new mining licences until it completes a review of the industry. The DRC government is intending to push through a minimum 35% government ownership threshold for future mining projects while the Ministry of Indigenization for Zimbabwe has proposed that all mineral development enterprises must be 51% owned by indigenous Zimbabweans.

Ghana increased taxes on the mining sector in its government's 2012 Budget. Its corporate tax rate for mining companies is set to rise from 25% to 35% while a 10% windfall profit tax is to be introduced for these companies too. Like the measures in Angola, mining project costs are to be ring-fenced so that they cannot be offset for any gains made on the same project, limiting payable tax.

Finally, another feature of the new regulatory regimes is an emphasis on transparency and anti-corruption practices.

Previous position

There is a consensus between Sub-Saharan governments that hitherto lenient (or non-existent) regulation of mining investors enabled tax loopholes to be exploited by some companies. Ministers in Zambia believe that an audit of the sector will highlight as much as $1 billion in evaded taxes.

Increased investor demand has now given governments power which was absent when granting licences just a few years ago. In order to attract international investors, it was then commonplace to grant long-term tax exemptions: up to eight years from starting up in Guinea, and up to a decade in the DRC. The continued rise in metal prices (most obviously gold) in the past decade and realisation by regional analysts that the countries have missed out on the opportunity to benefit, combined with increased demand for underdeveloped mining resources, means such tax incentives need no longer be offered.

Potential effect on investors with current and future contracts in the region

Investors in the African mining sector should reassess their current contracts as the trend of resource nationalism continues. Issues may arise where significant sums have been invested in a project now subject to a new code. Increased state participation in shareholding and tax recovery may deter future investors, concerned both that a local government with a shareholding could exercise a constraining decision-making authority and that profits may be affected by increased taxes.

However, a decision from investors to incorporate state participation as part of their planning may facilitate a profitable long-term position in the region. It may be seen as an acceptable cost in return for social stability, local appreciation and access to large untapped resources. The codes do also provide greater transparency on the concession of rights and taxes, allowing those in the mining sector a clear understanding of the parameters.

Current solutions

For companies with an existing presence, as well as new companies looking to establish themselves in the region, a comprehensive due diligence programme is a necessary first step towards establishing the feasibility of trading in this region. This will allow investors to establish what regulatory requirements are in place before any significant cost outlay has been incurred. The process can also reveal the practical effects of the implementation of the new laws and regulations.

Those with existing projects should look at their agreements to see if there are any contractual provisions for protection against or exemption from the introduction of new regulations which may impact on the financial viability of existing projects. Changes in the regulation of the mining sector may also trigger applicable compensation and/or indemnity clauses.

For those negotiating contracts going forward, one contractual method of protecting against such risks is the incorporation of a stabilisation clause, which operates to lock into the contract the investment conditions existing at the time of contracting. Another important contractual clause is the applicable law and jurisdiction clause. It is preferable for any related investment contracts to avoid incorporating local law clauses, and provide for a neutral venue/law to resolve any disputes.

Another protection against legislation change is political risk insurance,

although this should be approached with caution. Providers alert to any new legislation can be expected to react with high prices for new policies. In addition, companies must ensure that the various effects of the new regulations would be caught under the policy. For instance, enforced shareholding and participation may be covered, whereas the introduction of new taxes may not.

Summary

Potential investors can limit their exposure to changes in legislation with pre-emptive measures. Perhaps most obvious is the commission of a thorough due-diligence process before investing, encompassing the range of activities being considered. Crucial to this is access to local advisers with the ability to give an opinion and insight on local law and the political situation.

In light of the implementation of new laws and regulation in the mining industry across many Sub-Saharan African states, existing and prospective investors should assure themselves of the implications for any mining activity being undertaken or contemplated. HFW has undertaken a number of due diligence enquiries for companies in pre-licensing negotiations in the region, as well as providing contractual analysis and advice for companies advancing beyond the tendering process.

In addition to a regular due-diligence programme, contractual mechanisms are available to limit the impact of any post-contractual regulatory changes.

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LME award upheld

It is rare for an award made by a London Metal Exchange ("LME") Tribunal to appear in the High Court. An example arose in November 2011 in *A.K Kablo Imalat San Ve Tic A.S. v Intamex S.A*. In this case, the Buyer appealed to the English court alleging serious irregularity in the Tribunal's award. That appeal was dismissed, showing again the Court's general reluctance to overturn an arbitration tribunal's awards, particularly when decided by commercial men.

The dispute related to a CIF sale of approximately 1,200mt of copper cathode by Intamex S.A (the "Seller") to A.K Kablo (the "Buyer"), shipped from Novorossiysk, Russia to Ambarli, Turkey. Delivery was in lots. The Buyer paid for and took delivery of the first two lots but would not do so for the third.

The pricing mechanism was stated to be: *"LME Cash settlement average price for Copper Grade A, plus a premium of US$40.00 per metric ton. QP to be mutually agreed between date of contract and ten market days following arrival at port of destination"*.

The Seller arranged for the three lots of copper to be shipped and raised provisional invoices shortly afterwards. The Buyer paid against the provisional invoices for lots 1 and 2 and took delivery. Final pricing for lots 1 and 2 was agreed several weeks later, with the Seller issuing balance invoices to reflect the differences between the provisional invoices and the final prices.

A one week extension was agreed for the Buyer to take delivery of lot 3. The Seller then issued another provisional invoice for lot 3, based on an increased price per ton to reflect the rise in the LME cash settlement price between the time the original provisional invoice had been presented and the revised delivery date. The Buyer objected to the increase and subsequently, with the LME cash settlement price having fallen slightly, the Seller revised the price down (but not back to the original level). Again the Buyer objected and informed the Seller that it would look elsewhere to buy the cargo. The Seller notified the Buyer that the contract was terminated.

The contract was subject to English law, with disputes to be referred to LME arbitration. The parties commenced arbitration proceedings. The LME Tribunal found that the Buyer's obligation to make payment was triggered by a combination of the arrival of the goods and the presentation of documents. It also found that the issuing of a provisional invoice was standard practice in the industry, with immediate payment following and any later adjustments made as necessary. There had been an agreement to vary the pricing process with respect to the timing of delivery of lot 3 only. The Buyer was in breach of contract by failing to pay the first provisional invoice for lot 3 and had repudiated the contract when it indicated that it would buy replacement goods elsewhere.

In a letter responding to the Buyer's request for clarification under the award, the Tribunal further stated that there was an *"implicit agreement"* for provisional invoices to be priced on a date requested by the Buyer, based on the previous day's LME settlement and that this agreement had been varied.

The Buyer challenged the award on appeal to the Commercial Court on grounds of serious irregularity. It argued that the Tribunal's finding that there was an implicit agreement for the parties to price provisional invoices based on the previous day's LME settlement, which had been varied by practice, had not formed a part of either party's case.

The Court confirmed that when reviewing an award from an arbitral tribunal, it should be read as a whole in a fair and reasonable way. A detailed analysis with a view to finding inconsistencies or errors was not appropriate. It would be wrong to read an LME award made by commercial men as if it had been written by a lawyer. The Court made clear that its approach was with a view to upholding rather than upsetting the award.

The Court rejected the Buyer's challenge, finding that it was based on a mis-reading of the award. The Tribunal had found that pricing was as provided for in the contract. There had been no variation on pricing regarding lot 3, although there had been a variation as to the time of delivery. Furthermore, the Tribunal had rejected the notion of any implied term. Whilst the Tribunal had acknowledged that there was material to support a course of conduct, or an implicit agreement, the Buyer's case had failed as there was no consistent pattern followed.

This decision is one of a number recently that demonstrate the Court's determination to uphold arbitration awards where possible and appropriate.

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Conferences & Events

IAMA 2012 Conference
Hong Kong
(18-20 May 2012)
Nick Longley

GAFTA Dinner
London
(7 June 2012)
Damian Honey, Brian Perrott, John Rollason and others

Coaltrans Asia
Bali
(4-6 June 2012)
Richard Wilmot, Guy Hardaker and Andrew Carpenter

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