HFW

COMMODITIES | JUNE 2023

A NEW DECISION ON HEDGING: THE IMPACT OF INTERNAL HEDGING ON DAMAGES

What has happened?

The recent decision of the Commercial Court in Rhine Shipping DMCC v Vitol SA [2023] EWHC 1265 (Comm) identified as crucial the distinction between internal and external hedging in assessing whether sale contract hedges should be taken into account when determining damages.

Background

The dispute related to a voyage charter between Rhine Shipping DMCC ("**Rhine**") (as disponent owner) and Vitol SA ("**Vitol**") (as charterer). The parties agreed that Vitol was liable to Rhine for unpaid demurrage. The trial was therefore only concerned with Vitol's counterclaim, for breach of the charter due to the vessel's delay in proceeding to one of the loadports. There was a dispute as to whether Rhine was liable for the increased price that Vitol had to pay to the seller of the cargo (**TOTSA)**.

A key issue in the case was whether Vitol's hedging arrangements should be taken into account when assessing damages.

Vitol had entered into a number of internal swaps within its own internal risk management system (the "Risk System") to hedge against increases in the purchase price under the TOTSA contract caused by any delay in loading the vessel. The swaps were not with external counterparties and were purely internal.

After it became clear that the pricing dates under the TOTSA contract would be later than anticipated, the internal swaps were rolled so that the pricing dates of the internal hedge matched the delayed anticipated dates for pricing under the TOTSA contract. The rolling of the swaps generated a "gain" of US$2,871,971 against the TOTSA trade in the Risk System and there was a corresponding loss for the internal counterparty to the swap.

Vitol had to pay TOTSA an additional US$3,674,834 because of the late loading of the cargo. The loss recorded on the Risk System for the TOTSA purchase was US$802,863 (US$3,674,834 less US$2,871,971, the "gain" generated by the swaps).

The Court had to decide whether the internal system of hedging entered into by Vitol reduced the loss that could be claimed from Rhine.

Decision

Could the "gains" made on rolling the swaps be taken into account?

The Court found that the swaps were entirely internal to Vitol and not akin to the conclusion of a contract between two separate legal entities. There was no external hedge that related directly to the relevant transactions in the case, although the Court accepted that the likely position was that the risk generated by the rolling of the swaps was offset within the Risk System by opposite risks which had originated with other physical trades.

The Court reviewed previous authorities[1] and concluded that:

> "*hedging is capable of being taken in to account, at least if undertaken in a reasonable attempt to mitigate loss…*

[1] Including *Glencore Energy UK Ltd v Transworld Oil Ltd* [2010] EWHC 141 (Comm) and *Choil Trading SA v Sahara Energy Resources Ltd* [2010] EWHC 374

...

Where a party has entered into a hedging transaction with a third party (an "external hedge"...) and has done so in consequence of the breach in order to mitigate its loss, [previous case law][2] suggests that profits made on such a hedge are to be brought into account in reduction of the loss...Similarly, if such a hedge turns out to be loss-making for the claimant, it may be that the loss is recoverable from the defendant as a cost incurred in pursuit of reasonable mitigation".

If transactions in relation to the rolled swaps had been entered into due to the breach of the charter and had been with third parties, the profits made on them would have been taken into account in the reduction of Vitol's loss. However, here the swaps were internal and could not be legally recognised as binding contracts as an entity cannot contract with itself. They were internal arrangements which transferred risk between Vitol portfolios and were regarded as not affecting Vitol's profit or loss.

The Court noted that a trader of Vitol's size may not have to hedge externally because its book of business is large enough to find other transactions that carry opposite risks. However, the other transactions were not entered into for the purposes of hedging the transaction in question. They were separate and independent from each other and were not entered into in order to mitigate or hedge risk – they were transactions entered into in the course of ordinary trading.

Consequently, any "profits" on the internal swaps could not be brought into account to reduce the loss suffered under the charter.

Was the loss too remote?

Rhine argued that the claim for US$2,871,971 (the alleged "gain" on the swaps") was too remote to be recoverable. In effect, its argument was that it was not reasonably foreseeable that Vitol would not hedge its losses externally. Rhine argued that if internal hedging did not operate to reduce Vitol's loss (from a legal perspective), it was not reasonably foreseeable that Vitol would trade on that basis, so that Rhine should not be liable for the sum of US$2,871,971 as Vitol's losses would have been reduced by this sum had it hedged externally rather than internally.

However, the expert evidence established that Vitol's internal hedging processes were common for such a large trading house. Internal hedging by Vitol was therefore reasonably foreseeable to Rhine as a carrier. The relevant losses were within the reasonable contemplation of the parties at the time of contracting and recoverable.

Comment

Court judgments relating to hedging are relatively rare and so it is helpful to have guidance from this latest decision. The case highlights the importance of how parties manage risk in relation to sale contracts. If transactions are hedged internally as part of a global risk portfolio, there is a much higher chance that such hedges will be considered independent transactions which cannot be taken into account in the assessment of damages to reduce loss. The Court's decision on foreseeability, that internal hedging by a large oil trader should be reasonably foreseeable to a shipowner, is also informative.

For more information, please contact the author(s) of this alert

BRIAN PERROTT
Partner, London
T +44 (0)20 7264 8184
E brian.perrott@hfw.com

LEE FORSYTH
Senior Associate, London
T +44 (0)20 7264 8799
E lee.forsyth@hfw.com

[2] See, in particular, *Swynson Ltd v Lowick Rose LLP* [2018] AC 313

© 2023 Holman Fenwick Willan LLP. All rights reserved.

Whilst every care has been taken to ensure the accuracy of this information at the time of publication, the information is intended as guidance only. It should not be considered as legal advice. Holman Fenwick Willan LLP is the Data Controller for any data that it holds about you. To correct your personal details or change your mailing preferences please email hfwenquiries@hfw.com