February 2012

Problems up the chain

It seems likely that in the coming months traders will face a heightened risk from insolvency events affecting shipowners or time charterers. On 2 February 2012, the Baltic Dry Index fell to 662, lower than the rate of 663 which was reached at the nadir of the financial crisis in December 2008, and its lowest rate since 1986. This collapse in the dry freight market has been attributed partly to reduced demand (which may increase following the Chinese New Year celebrations), but more to an oversupply of new tonnage. Market analysts do not expect a significant rebound in freight rates in the short term. It is therefore reasonable to expect an increase in the number of insolvencies of shipowners and time charterers.

The insolvency of time charterers could create a number of problems for traders as cargo owners and as voyage or trip time charterers. These include:

- Owners seeking to exercise liens over cargo.
- Owners seeking to exercise liens over sub freights otherwise payable to charterers.
- Owners seeking to exercise liens over demurrage otherwise payable to charterers.
- Owners withdrawing vessels from time charterers during voyages due to non-payment of hire by charterers.
- Owners seeking to renegotiate hire or freight rates.
- Bunker suppliers bringing claims and exercising other remedies on account of charterers not paying invoices.

What can traders do to protect themselves in these circumstances? Below we address two of the possible issues.

Liens over cargo

If head charterers become insolvent and stop paying hire, shipowners may send a notice of

lien to the voyage charterer or cargo owners refusing to allow discharge pending payment of the hire. Owners rarely have any contractual right to delay or suspend the voyage – they are usually still obliged to sail to the discharge port. Depending on the extent of the rights given to owners in their head time charterparty, and on any other rights given to them by the local law at the discharge port, shipowners will usually not be permitted to sell the cargo but only to keep it in their possession. This immediately presents a problem to the shipowners since they will need to reemploy the ship and will not want to keep the cargo on board for a long time. In some jurisdictions, shipowners will be allowed to discharge the cargo and keep it under their control in a bonded warehouse.

Even if shipowners are entitled to lien cargo under the charterparty, they may not be entitled to do so under the contract of carriage evidenced by the bills of lading. Unless the head charterers own the cargo, the shipowners would breach their bill of lading contract with the cargo owners if they exercised a lien over the cargo. This could give the cargo owner the right to arrest the ship at the discharge port. A stalemate may therefore develop with the vessel standing off the port and refusing to enter while the hire is unpaid. A commercial settlement is usually reached in these circumstances, but cargo owners should be aware that the shipowners' rights are often much more limited than their notices of lien may suggest.

Liens over sub-freights

If head charterers become insolvent and stop paying hire, shipowners may also send a notice of lien to the voyage charterers demanding that it pays freight directly to head owners rather than to the time charterers. Such an immediate cash payment would clearly be preferable for shipowners to joining the queue of creditors in any liquidation of the time charterers.

This creates an obvious problem for the voyage charterers. If they pay the shipowners, they may remain obliged to pay freight to their time charterer counterparty, and, if the lien is ultimately found to have been improperly exercised, could be obliged to pay twice. The best course is typically for the voyage charterers to pay freight into an escrow account – or even into court – and then leave the shipowners and time charterers to resolve between themselves which of them is entitled to it. However, voyage charterers cannot follow such an approach without either reaching agreement with the shipowners and time charterers or obtaining an order from a court or arbitral tribunal.

Voyage charterers should always act with caution in such circumstances. Such situations rarely offer easy solutions.

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Contractual delivery period in GAFTA contracts

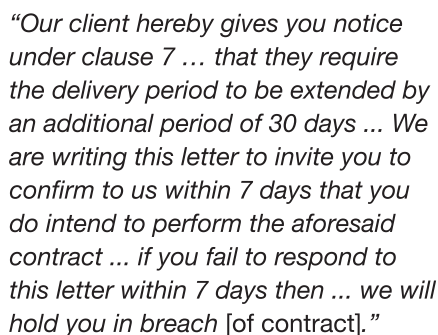
In *PEC Limited v Thai Maparn Trading Co Limited* (13 December 2011), the Commercial Court considered what constitutes a valid notice extending the delivery period under a GAFTA standard form FOB contract.

PEC Limited ("PEC"), agreed to buy from Thai Maparn Trading Co Limited ("TMT") 22,000mt of Thai parboiled long grain rice at US$385/mt FOB Stowed Kohsichang Thailand (the "Contract"). The Contract incorporated the terms of GAFTA Contract No 120 Clause 7 of Contract 120 allows buyers to extend the contractual delivery period by an additional period of not more than 21 consecutive days, provided that they give notice no later than the first business day after the last day in the delivery period.

In this case, the contractual shipment period ended on 7 May 2008. PEC nominated a vessel but TMT indicated they would not have the cargo ready. The nominated vessel was then delayed so that no vessel was in fact presented at the loadport within the contractual delivery period. On 8 May 2008, the day after the end of the period, PEC wrote to TMT:

"As a gesture of goodwill, without prejudice to our rights, we are ready to extend the delivery period by 21 days ... if we do not receive any reply regarding the cargo readiness for loading from your side within 2 days we put you in default of the contract."

PEC's London solicitors sent a further message to TMT later the same day, including the following:



"Our client hereby gives you notice under clause 7 … that they require the delivery period to be extended by an additional period of 30 days ... We are writing this letter to invite you to confirm to us within 7 days that you do intend to perform the aforesaid contract ... if you fail to respond to this letter within 7 days then ... we will hold you in breach [of contract]*."*

On 12 May 2008 TMT responded, stating that the shipment period had already expired and they were treating the Contract as having been terminated. PEC placed TMT in default and commenced GAFTA arbitration. The First Tier Tribunal found in favour of PEC but the GAFTA Board of Appeal overturned this decision. PEC appealed the award to the Court under section 69 of the Arbitration Act 1996, on the basis of an alleged error of law in the Board of Appeal's decision.

Hamblen J dismissed PEC's appeal, agreeing with the Board of Appeal that PEC had failed validly to exercise their option to extend the delivery period. The language of their message on 8 May made clear that the extension was conditional upon TMT confirming the readiness of the cargo within two days. TMT had not done so and the Contract was never extended. PEC were giving TMT a choice to advise readiness of the cargo within two days, in which case they would extend the delivery period, or not to do so, in which case they would place them in default. PEC could not have both extended the contract and placed TMT in default.

The Judge found that the message from PEC's solicitors had left unclear whether the extension was being claimed on a conditional basis. Further, since the two messages set out different requirements for the response required, the timeframe in which it was to be provided, and the length of the extension period, the reasonable conclusion was that it was entirely unclear what PEC were claiming and on what basis.

Hamblen J described the contractual delivery period as a fundamental term of a FOB contract, observing that certainty as to the existence and duration of any extension period is as important as for the original delivery period. A notice of extension therefore had to be clear and unequivocal both as to whether an extension was being claimed and the length of such extension. This offers sound guidance to buyers using GAFTA Contract No 120.

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Common European Sales Law

In October 2011, the European Commission published a proposal for a Common European Sales Law ("CESL") as part of its attempts to facilitate economic recovery. The Commission's stated primary aim was to remove *"contract law obstacles"* to cross-border trade within the EU, such as the cost of drafting and translating sale contracts to conform with individual national contract laws. It says that these obstacles cause a lack of consumer confidence and the loss of at least €26 billion of intra-EU trade annually, with small- and medium-sized businesses and consumers particularly affected. The Commission estimates that these businesses make up 99% of companies in the Single Market, but only 9% of intra-EU trade.

The CESL is intended to provide a common regime of contract law in a *"user-friendly European contract"* applicable in all 27 Member States. It would apply to business-to-consumer and business-to-business contracts for the sale of goods or goods and services (but not to pure service contracts), provided that:

- At least one party has its habitual residence in the EU.
- In business-to-business transactions, at least one party is a SME (small or medium enterprise: namely a trader employing under 250 persons whose annual turnover does not exceed €50 million or whose annual balance sheet total does not exceed €43 million).

It will be noted from the second restriction that the CESL regime is intended primarily as a new cross-border sale of goods regime for consumers and small business traders. In its current form, the CESL could not be used by large businesses (more than 250 employees and an annual turnover exceeding €50 million) in contracts with other large businesses; in its current form, individual Member States would have the option of including transactions between large businesses within the scope of the CESL when incorporating it into their national law.

The CESL regime will always be optional when consumers are not

involved. Parties wishing to use the CESL regime will require *"an agreement of the parties to that effect"* in their contracts.

The Commission hopes to have the CESL agreed by 1 January 2013, but it first requires approval from Member States and the European Parliament. Although the latter has previously signalled its overwhelming support in a plenary vote on an "own-initiative" report in June 2011, a large number of Member States and EU-based organisations have objected.

In December 2011, the UK's House of Commons filed a formal Opinion stating that the Commission's proposal infringes an essential procedural requirement by failing to include enough information to enable national parliaments to assess its compliance with the principles of subsidiarity and proportionality. The Opinion also queries the quality of evidence and analysis on which the Commission relies.

UK-based organisations have raised concerns that the CESL will:

- Cause confusion and uncertainty, because it will be interpreted differently in different Member States.
- Increase the administrative burden for the Member States and companies to which it applies.
- Lead to slower and less efficient resolution of disputes than under national regimes, including because the European Court of Justice would be the final appeal court for disputes under the CESL.

The English Law Commission has criticised the CESL, particularly because it includes a two-year right to reject goods. Under the English Sale of Goods Act 1979, goods may be rejected within a "reasonable time", which the Courts have interpreted to be much less than two years. The Law Commission is also concerned that the proposal seems to depend on the CESL being adopted for domestic sales, to avoid traders using different contractual rules for domestic and cross-border trades. Rather than reducing legal obstacles, this uncertainty would further burden traders. The provisions of a CESL would also inevitably need to be tested and interpreted by the courts, since difficulties may only become apparent on practical application. It would take years for a body of case law to develop, whereas the national systems already have tried and tested systems of law and precedent in place.

The CESL may not make it past its current draft stage. Several EU Member States are expected to follow the UK in opposing the proposal. Even if the CESL is introduced, it is apparent from the limitations described in this article that it is unlikely to prevent or hinder commodities trading companies continuing to agree contracts based on their preferred national laws.

For more information, please contact Vanessa Tattersall (pictured left), Associate, on +44 (0)20 7264 8352, or vanessa.tattersall@hfw.com, or your usual contact at HFW.

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Conferences & Events

globalCOAL (in association with IECA): SCoTA v8 - discussion for credit professionals
HFW Friary Court, London
(27 February 2012)
Rebecca Lindsey and Robert Wilson

LSLC Freight Futures Seminar
HFW Friary Court, London
(29 February 2012)
Brian Perrott and Andrew Johnstone

Coaltrans Switzerland
Grand Hotel Kempinski, Geneva
(1-2 March 2012)
Rory Gogarty and Rebecca Lindsey

Managing Risk in International Commerce - Spring Update
Murooj Rotana, Al Saffa Street, Dubai
(7 March 2012)
Simon Cartwright, Damian Honey, Nejat Tahsin and Rebecca Lindsey

Carbon and Renewable Energy - EU and Australian perspectives
HFW Perth
(13 March 2012)
Chris Swart and Cheryl Edwardes

Global Grain Asia
Shangri-La Hotel, Singapore
(13-15 March 2012)
Chris Swart and Brian Perrott

Coaltrans India
Taj Palace Hotel, New Delhi
(13-14 March 2012)
James Donoghue, Simon Cartwright and Sam Wakerley

Commodities Breakfast Seminars

Our Spring series of breakfast seminars, covering current issues affecting commodities trading, will take place on 28 February, 13 and 27 March 2012. Anyone with an interest in the field is welcome to attend. The seminars will be held at HFW's London offices.

Those with enquiries about the seminars should contact our events team on +44 (0)20 7264 8503 or events@hfw.com.

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