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A PRACTICAL GUIDE TO HEDGING: SHOULD YOU HEDGE OR ALREADY BE HEDGED WHEN YOUR COUNTERPARTY DEFAULTS?

Hedging is an issue that is central to the business of many commodity traders. It is also a topic that is the subject of increasing focus in the legal industry, both in its deployment in argument in disputes and in commentaries on the available case law.

In this briefing, Damian Honey and Michael Buffham set out a practical guide on what a party should be expected to do, or have already done, to hedge its losses when its counterparty defaults.

Hedging losses: the challenge

The English courts have traditionally been reluctant to hold that hedging losses are recoverable on the basis of principles of causation and remoteness.

Causation is a factual question. In the context of hedging, the issue is whether there is a link between the physical transaction, the breach and the hedge. It can be particularly difficult to establish a clear causal link between a physical and paper trade, as traders often aggregate trades into a complex book of trades.

The challenge in relation to **remoteness** is that of foreseeability. Losses must flow naturally from the ordinary course of events or have been in the contemplation of the parties when entering into the contract. This may require actual knowledge of the counterparty's hedging policy. Alternatively, foreseeability could be inferred from the circumstances and evidence, such as the practice of the trade in the particular commodity and the experience and expertise of the particular parties. For instance, in the oil industry where hedging is more commonplace, a major oil trader will inevitably know that another major oil traders hedges. The position may not be so clear cut in contracts between less sophisticated traders in certain parts of the world where hedging is not such a widespread practice.

Hedging losses: the current law

In recent years, case law has started to develop clarifying how the English Court will take into account hedging losses when assessing recoverable damages. By way of a short summary, the cases provide as follows:

- *Addax Ltd v Arcadia Petroleum Ltd*[1] concerned hedging in the context of oil trading. The Court held that hedging losses/costs could in principle be recovered following breach of a physical contract between commodity traders (although they were not in fact awarded). The Court stated, *"… if the direct loss to [Addax] is that which represents their net position with [Addax's supplier], it is wrong in principle to ignore part of what actually happened by describing it as either too remote or as a consequential loss. The costs of the hedging devices are an integral part of the calculation of the net position".*
- *Trafigura Beheer BV v Mediterranean Shipping Co*[2] concerned a claim for damages for rollover costs incurred in relation to a contract for the physical sale of copper. It was held that hedging losses were not recoverable in the circumstances. The Court stated, *"…There is no evidence on which I could conclude that a shipowner such as MSC would reasonably foresee that if there was misdelivery of a cargo of copper in containers then…. the shipper would hedge against possible fluctuations in the price of the copper… with the consequent possibility of… hedging losses".*
- *In Choil Trading SA v Sahara Energy Resources Ltd*[3], Sahara delivered an off-spec naptha cargo. Choil resold the cargo and so made no physical loss, but it did make a loss in closing out hedges entered into in respect of the trades. It was held that hedging losses were recoverable in the circumstances, because they represented a reasonable attempt at mitigation and were "part and parcel" of the parties' dealings. The Court stated that *"… It was reasonable for [Choil] to protect itself against those losses by hedging in the way that it did".*

1. [2000] 1 Lloyd's Rep 493
2. [2007] 1 CLC 594
3. [2010] EWHC 374 (Comm)

"The review of case law demonstrates that the recoverability of hedging losses is highly fact-specific."

- *In Glencore Energy UK Ltd v Transworld Oil Ltd*[4], following breach by Transworld of a crude oil supply contract, Glencore closed out its hedges and made a gain. The Court held that damages for physical loss were offset by hedging gains because *"Glencore not only did but was required to mitigate its loss by closing out its hedges"*. In addition, *"…Hedging is on the evidence an integral part of the business by which Glencore entered into this contract for the purchase of oil, and since the closing out on early termination established a lower loss than would otherwise have been incurred, that has to be taken into account when determining recoverable loss"*.

- *Parbulk AS v Kirsten Marine AS*[5] concerned hedging arrangements entered into in respect of a shipbuilding contract. It was held that hedging losses were recoverable. The Court found, *"… The Defendants knew of and had available to them the Loan Agreement containing the hedging obligations … When this is taken together with the express provision of … the Charter, which further put them on notice, I am entirely clear that the Claimant's entry into the hedging arrangements was indeed reasonably foreseeable, and hence not too remote"*.

- *Transpetrol Maritime Services Ltd v SJB (Marine Energy) BV*[6], concerned a tanker voyage charterparty dispute, in which charterers were oil traders. There were certain deficiencies with the vessel which resulted in the loss of oil major approvals. This in turn caused charterers to struggle to on-sell their cargo of VGO. Owners said that charterers had failed to mitigate their losses by failing to hedge once they knew of the potential oil major approval difficulties. The hedging that would have had to take place was of a complex nature. The Court found it was too imprecise a tool and saw no reason why the charterers should have had to do it, noting that the *"obligation to mitigate is not a heavy one"*.

- In the recent case of *Vitol SA v Beta Renewable Group SA*[7], it was held that Vitol was unable to claim hedging losses when it hedged gasoil futures in relation to a biofuel contract which Beta breached. On analysis, the claim was a loss of profit claim, based on what the buyer would have sold the cargo for, and the profit it would have earned on the hedge, had the contract been performed. The Court held that this was not a fair or proper basis of compensation. The appropriate measure of damages is set out in section 51(2) of the Sale of Goods Act 1979, being the difference between the market value and contract price of the biofuel.

4. [2010] EWHC 1734 (Comm)
5. [2010] EWHC 900 (Comm)
6. [2011] 2 Lloyd's Rep 331
7. [2017] EWHC 1734 (Comm)

Your counterparty defaults: what are you expected to do or already have done?

The review of case law demonstrates that the recoverability of hedging losses is highly fact-specific. Predicting how a court or tribunal will apply the principles of causation and remoteness in the specific circumstances of a particular case can be difficult. However, some general guidance can be discerned from the case law, by considering the scenarios in which hedging may become relevant in a dispute.

Scenario 1: Your counterparty defaults and you have entered into hedges. If those hedges when closed out result in a loss, can you recover that loss in damages?

The case law shows that if the loss is caused by the breach and was foreseeable (for instance, if the counterparty actually knew that hedging was a part of the business or hedging is so widely acknowledged in the industry that it must have been in the contemplation of the parties), hedging losses may be recoverable. Ultimately, it depends on the particular circumstances of the case, the knowledge of the parties and the trade concerned.

Scenario 2: Your counterparty defaults and you have hedges in place. Do you have to give credit for any gain you make on those hedges by setting off against losses incurred on the physical trade?

The decision in *Glencore Energy UK Ltd v Transworld Oil Ltd* suggests that a party must close out any hedges it has executed in mitigation of its losses and any gains must be off-set against its damages claim. In principle, this seems straightforward enough. If a party has entered into hedges in respect of the trade as part of its trading strategy, then it is reasonable to expect them to close out those hedges in order to minimise its losses in the event that the physical trade is not performed. This simply requires that the hedges be used for the purpose for which they were executed and any gains be off-set against the damages claim.

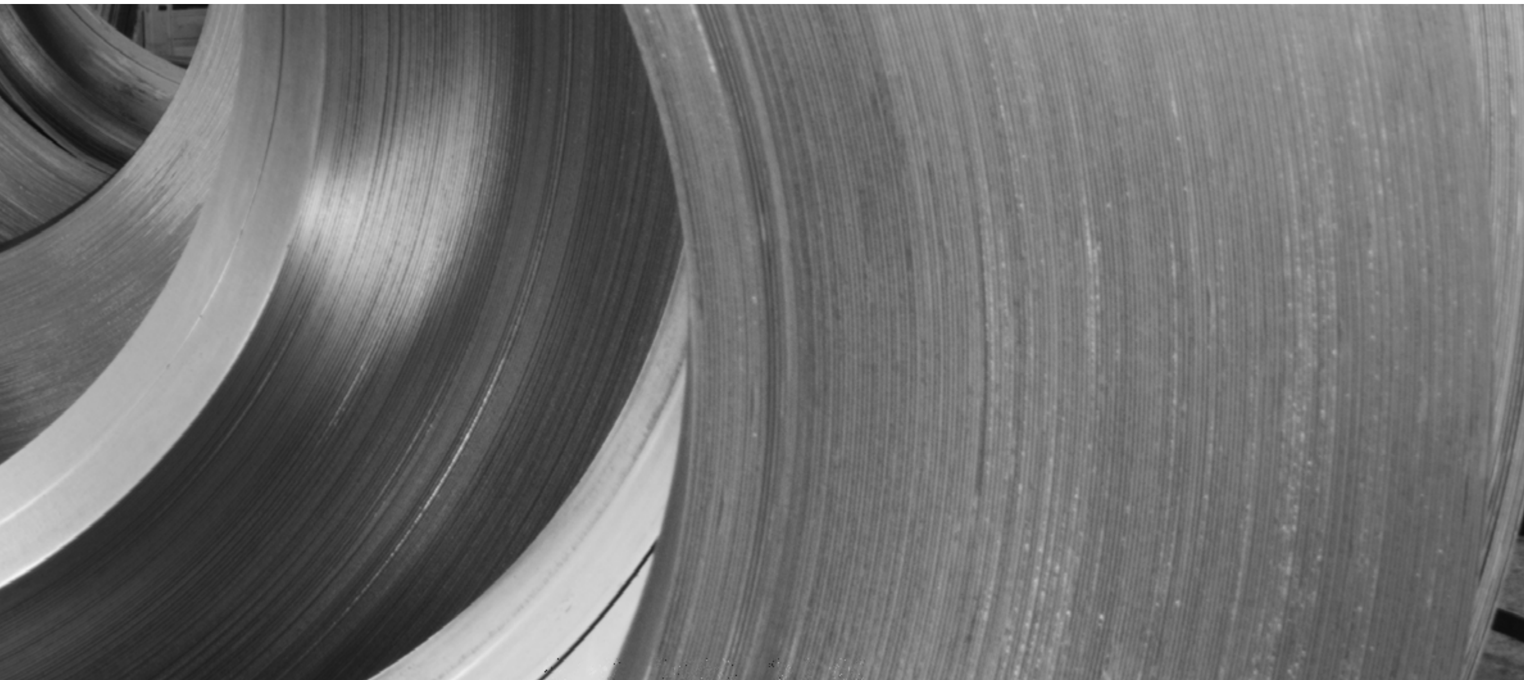
A more difficult question is what credit must be given where the trader keeps a complex book of aggregated trades. It may be difficult for a defendant to argue that a particular hedge was executed for the purpose of the relevant physical trade, in which case it may be hard to equate the gain from a close out with the loss on the physical trade.

The burden of proof will be on the defendant alleging that the claimant did or should have closed out hedges and seeking that any gain be set-off against the damages claim. In the absence of any clear evidence about which hedges were entered into for specific trades, it may be hard for the defendant to satisfy this burden.

Scenario 3: Your counterparty defaults and you have not already entered into hedges. Are you expected to enter into hedges in order to mitigate your loss?

This proposition is rather more novel, as there does not appear to be any authority directly supporting a requirement to hedge in order to mitigate loss. However, the existing case law does provide some guidance on how the Court might approach this issue.

In *Transpetrol Maritime Services Ltd v SJB (Marine Energy) BV*, owners argued that charterers should have hedged in order to mitigate their losses. However, the Court dismissed this argument by holding that the obligation to mitigate was not a heavy burden and, in the circumstances, charterers were not expected to enter into complex hedging arrangements. It was observed that criticism, made with hindsight after an emergency, does not come well



from those who themselves created the emergency[8].

Choil Trading SA v Sahara Energy Resources Ltd contains some interesting commentary about the extent to which a party might be expected to hedge[9]. The Court concluded that, *"in the trade in which both parties operated hedging was an every day occurrence. Anyone in Choil's position would have been expected to hedge ... It did not require any special knowledge to realise that hedging was what Choil was likely to do. It was regarded as a normal and necessary part of the trade"*.

Glencore Energy UK Ltd v Transworld Oil Ltd concerns the close out of existing hedges in mitigation of losses, rather than establishing new hedges in mitigation. However, the Court's reasoning may give an indication of the considerations that would apply in the latter case. The Court noted that hedging was an integral part of Glencore's business and that because closing out on early termination established a lower loss than would otherwise have been incurred, that had to be taken into account when determining recoverable loss[10].

If a party is a sophisticated trader and hedging is part and parcel of their business and so routine in the relevant trade that it is to be expected that an innocent party will hedge as soon as their counterparty defaults, it is more likely that the innocent party will be expected to hedge in mitigation. Conversely, if the innocent party has no hedging capability at the relevant time or the case concerns a cargo that cannot practically or easily be hedged in the circumstances, it seems unlikely that hedging should be expected in mitigation. The case law shows that the burden of mitigation is not a heavy one and that the innocent party must only do what is reasonable. If that party has taken other reasonable steps to minimise its losses, it may be very difficult to argue that it should also have hedged.

Scenario 4: Your counterparty defaults and you have **not** entered into hedges (either before or after the breach). Are you expected to do so such that a failure to hedge means the physical loss was (fully or partially) not caused by the breach?

There is no authority to support the proposition that the innocent party should be expected to hedge such that, if the counterparty defaults and no hedges are in place, the failure means that the physical loss was caused by the decision not to hedge rather than the counterparty's breach of contract. However, it is an argument that is increasingly being deployed by defendants, in an attempt both to reduce damages and to obfuscate and raise doubts about a claimant's case and credibility or otherwise cause time and costs to be spent responding to hedging arguments, taking the focus off the claimant's own positive case and creating pressure to settle or drop claims.

Although the decision will turn on the particular circumstances of the case, it is suggested that

8. See paragraph 76 of the judgment
9. See paragraphs 156 to 164 of the judgment
10. See paragraph 78 of the judgment

“The role of the Court is not to dictate to a party what bargain it should have made, but to interpret the relevant contracts in accordance with established legal principle.”

it would be surprising if the Court were to hold that a failure to hedge means that the loss is not caused by the breach of contract. The Courts have traditionally applied the measure of damages in the Sale of Goods Act in quantifying physical loss and, although case law has developed indicating how the Courts will approach claims for hedging losses, it would be a significant step to take this further and deny damages for physical loss as a result of a failure to hedge. To do so would essentially entail the Court dictating hedging strategies and deciding that it is unacceptable for a party to leave a position open and to speculate on market movements. Although market speculation, such as buying on a fixed price and selling on a floating price, may lead to losses, it can also lead to significant trading gains. The argument goes beyond mitigation and does not merely say what a reasonable party should have done when it was left exposed, but states that the contractual arrangements entered into by the innocent party break the chain of causation such that the defaulting party is not liable for their own failure to perform.

The role of the Court is not to dictate to a party what bargain it should have made, but to interpret the relevant contracts in accordance with established legal principle. This is a very difficult argument for a defendant to sustain, but given the complexity of hedging issues and the possibility that a failure to respond properly will result in wasted time and costs and raise credibility issues, a claimant faced with such a defence should properly consider the issues raised and their own actions and hedging capabilities at the relevant time and be prepared to justify the decisions taken.

How can I maximise my chances of the court accepting my argument on hedging?

1. **Be clear** about how your losses are quantified. Mistakes are easily made when assessing hedging losses and, if the analysis is flawed at the outset, it can significantly undermine your claim later.

   For example, if you are claiming a physical loss as well as a hedging loss, it is important to bear in mind that you must not duplicate the market loss in quantifying the physical and hedging claims. The classic formulation for physical loss in a sale of goods claim is the difference between the contract price and the market price at the time of the breach – the rise or fall in the market price causes the loss. If a hedging claim is based on the difference between the purchase price and close out price of the relevant hedge, the loss is also calculated by reference to the rise or fall in the market. Claiming both a physical and a hedging loss quantified on this basis would result in the market movement being counted twice, leading to double-recovery.

   A more appropriate way of quantifying the hedging loss would be to assess the actual costs incurred as a result of rolling, closing out or selling the relevant hedges. This would not result in market movements forming part of the calculation and would not give rise to double-recovery with a physical loss.

2. **Documentary evidence:** Evidencing the loss can be difficult. Ideally, full and complete documentary evidence should be provided demonstrating the hedges executed, the action

taken and the costs incurred in closing out, rolling or selling the hedge. That said, it is not always easy or possible to produce documentary evidence for the loss. It may be that the claimant is a trader who keeps a complex book of aggregated trades, which makes it very difficult to show that a particular hedge was entered into for a particular physical transaction and therefore prove that the breach of the physical contract caused the paper loss.

3. **Witness evidence:** A clear witness statement explaining what has been done and how the documents prove the loss can be extremely helpful. Judges and arbitrators are experts in legal principle and may well have heard hedging claims before, but they do not always have practical experience of hedging, or may never have come across the particular products and trading strategies being employed. The more transparent and clear you can be in explaining the hedging arrangements and the loss, the greater the chance that the judge or arbitrator will understand, accept and award the loss being claimed.

Conclusions

1. **Whatever the context** in which hedging arises, the issues you face will be highly fact-specific and the outcome will turn on the particular circumstances of the case and the available evidence. The case law provides some guidance on how the courts will apply the principles of causation and remoteness to hedging issues.
2. **In certain circumstances**, hedging losses may be recoverable and hedging gains may need to be off-set against damages claims. There may also be circumstances in which a party is expected to hedge in mitigation of its losses, although it is perhaps a step too far to suggest that a failure to hedge will mean that losses are not recoverable on the basis that they are not caused by the breach.
3. **In all cases**, it is crucial to understand the hedging arrangements that are used and how losses or gains are to be quantified and evidenced so that your position can properly be explained to the court or tribunal. This will maximise the chances that your case will be understood and accepted.

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