Commodities

July 2016

Welcome to the Summer edition of our Commodities Bulletin.

Counterparty insolvency is unfortunately a significant risk for trading parties in the current economic climate. In our first article, Partner Sarah Taylor looks at issues to consider before triggering an Event of Default clause.

It is not uncommon in the trading sector to ask for credit support in the form of an "on demand" parent company guarantee or a corporate guarantee from a company in the same group. How valuable are such guarantees – are they really "on demand"? Partner Paul Aston and Associate Myung Ahn Kim give guidance in our second article.

With oil majors increasingly diversifying into renewables, Senior Associate Fergus Saurin reviews the current status of renewables in the PRC.

HFW recently acted for Cargill in their successful application to the UK Supreme Court in the Global Santosh. The point at issue concerned the definition of charterers' "agents". Our next article first appeared in Fairplay in June 2016 and gives the reflections of the HFW lawyers involved in the case, led by Partner Brian Perrott.

Despite the recent Brexit vote, the United Kingdom remains part of the EU. Partner Robert Finney identifies some key regulatory developments for commodities businesses.

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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Events of Default clauses – practical issues to consider

Most trading contracts contain specific terms setting out the consequences of a counterparty insolvency or other default. This article explores whether, and in what circumstances, it may be sensible to invoke rights under such clauses or whether it can be better to adopt a more "wait and see" attitude. We also look at drafting options prior to finalising contract terms.

When considering how to respond to a counterparty event of default (EOD), relevant considerations will include potential consequences:

- For the performance of this contract.
- For other contracts with the same counterparty.
- For related contracts with other counterparties – particularly if there is a supply chain.

In addition, decisions will need to be taken on the basis of what other practical options are available, if any.

It should always be remembered in relation to insolvency that under English law, insolvency of itself does not give the other party the right to terminate the contract without express contractual provision to this effect. The insolvent party's action (or in-action) must amount to a repudiatory breach in order for a right to terminate the contract to arise.

The starting point, once an EOD has occurred, is to see whether the contract terms provide options for the non-defaulting party, or whether the consequences of an EOD are dictated without flexibility.

Automatic Early Termination (AET) clauses

AET clauses offer little or no flexibility. They are usually triggered without any action, not even a notice from the non-defaulting party. When an AET clause is triggered, the contract (and possibly all contracts between the contracting parties) will terminate. For physical supply contracts, trade finance agreements and financial transactions which hedge an underlying physical supply, the consequences of such termination may well be as adverse to the non-defaulting party as to the defaulting party. This is particularly the case where the EOD is an insolvency event (precisely the circumstances in which AET clauses were designed to operate) as the non-defaulting party may be left with significant unsecured claims in the insolvency proceedings. Such claims are usually long in resolution, and rarely result in more than a low percentage recovery.

Other EOD clauses, whilst not operating automatically, provide only for termination (with a resultant loss calculation or claim in damages). Again, this may place the non-defaulting party in an equally, if not more, difficult position than contract performance, depending on the circumstances.

Exercising the right to terminate

When deciding whether to exercise a right to terminate, the non-defaulting party should consider the following questions:

- Neither party will perform if the contract is terminated – is this realistic in a chain?
- If insolvency proceedings have already commenced, is it advantageous to terminate and be an unsecured creditor?
- Will termination actually lead to claims from other counterparties such as freight providers – is performance a better option?
- How risky would performance be – is there a risk of arrest/attachment of vessel/cargo by a third party creditor?
- Will any security bite on termination – and what is the form of security? A bank guarantee may still perform notwithstanding insolvency proceedings but a parent company guarantee may be of little value if the parent company is also affected by insolvency.

Cross default clauses

The above considerations deal with the consequences of terminating the affected contract. In addition, it is increasingly common for contracts to have a cross default clause. It may not be legally or commercially attractive for the non-defaulting party to trigger an EOD clause in one contract if the consequences are that other contracts with the defaulting party will thereby also be the subject of an EOD. (This is another reason why AET clauses can be problematic – the decision is taken out of the hands of the parties.)

Contractual chains

Where the non-defaulting party is in the middle of a chain, terminating its supply or sale contract may trigger a breach of contracts made with other counterparties. Consideration should be given to the following scenarios where goods are in transit:

- Supplier in default
  - Can alternative cargo be sourced?
  - What are the underlying freight terms (if purchasing FOB)? Can load discharge port/laycan options be exercised to minimise loss?
  - Can the supplier perform?
- Buyer in default
  - Where are the goods?
  - Can an alternative buyer be found?
  - What are the underlying freight terms (if selling CIF/CFR)? Can alternative discharge port options be exercised to minimise loss?
  - If the contract is terminated, there is a risk that the cargo will quickly become known in the market as distressed, which will have obvious price implications for any alternative sale.

Performing the contract

If the non-defaulting party is to consider performance (and if the EOD is one of insolvency, this may not be possible under local insolvency rules), it is also important to consider whether one or more of the following can be negotiated with the party in default:

- Security
  - This is unlikely to be an option if the counterparty is in financial difficulty but may be possible for other types of default.
- Assignment
  - If only one group entity is in default, assignment to another entity or even an unrelated entity might be possible. But – parties should be aware that local insolvency rules may prohibit this.
- Contract amendments
  - Suspend performance.
  - Amend payment terms.
  - Amend transfer of title provisions.

Drafting considerations

Consideration should be given when drafting EOD clauses to giving flexibility to the non-defaulting party to elect to perform, possibly on amended terms, in certain specified circumstances, rather than merely providing for termination on notice. For the reasons explored in this article, it may be more advantageous to the non-defaulting party to suspend performance, or to amend delivery or payment terms, rather than to terminate the contract. This is particularly so where the relevant contract is in the middle of a contractual chain.

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hfw Credit support: do you have on demand guarantee or not?

In many transactions in the trading sector, a parent company guarantee or a corporate guarantee from a company in the same group is asked for, and given, by way of credit support. Typically, no fee is paid to the guarantor for provision of the guarantee; it is not ordinarily in the business of giving financial instruments; and, it does not receive any counter security from the buyer for providing the guarantee.

This article and the legal principles covered in it apply only to that type of guarantee, and not to guarantees given by a financial institution, or to letters of credit.

The Marubeni principle

Commercial parties involved in the trading sector may be unaware of the key principle that where a guarantor is not a bank, there is a strong presumption in English law against giving the words "on demand" the effect of creating an independent/demand guarantee or indemnity.

That principle was confirmed in *Marubeni Hong Kong and South China Ltd v Government of Mongolia* [2005] EWCA Civ 395 [2005] 1 WLR 2497, which gave its name to the principle.

Post-Marubeni decisions

One indication of the complexity of this area of the law and the difficulty in identifying whether a guarantee is a demand guarantee or not is the number of decisions since *Marubeni*, in which the courts have gone into great detail, scrutinising the contractual language used by the parties to establish whether it was sufficient to rebut the *Marubeni* presumption.

You can make the position more certain by including clear, express wording to the effect that the parties intend the guarantee to be an independent, on demand guarantee and by referencing the Uniform Rules for Demand Guarantees.

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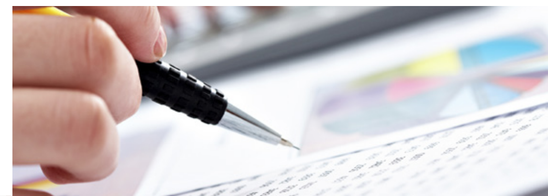
In 2008[1], the Court of Appeal held that where a corporate guarantee (CG) contains clear words to indicate the parties' intention to make it an independent/demand guarantee or indemnity, the Marubeni presumption may be rebutted and the CG may still be construed as payable on demand.

The wording of the CG was scrutinized by the court and the following provisions were deemed as significant in indicating an on demand liability:

- *As principal obligor'.*
- *'Not merely as surety'.*
- *'If … the guaranteed moneys are not paid in full on their due date … immediately upon demand unconditionally pay to the lender the guaranteed moneys'.*

1 *IIG Capital LLC v Van der Merwe* [2008] EWCA Civ 542



Further, the "guaranteed moneys" were defined as *"all money liabilities which are* **now or may at anytime hereafter be due**, *owing or payable or* **expressed to be due** *owing or payable to the lender from or by the borrower…')*,. The court held that the wording "expressed to be due", in conjunction with other operative wording, was sufficient to create an on demand guarantee.

However, in 2010[2] the court considered a CG as conditional/secondary despite the use of guarantee wording widely used in the market. This was because it appeared iIn a clause drafted on the premise that a default by an underlying obligor had already occurred. This made it a secondary, rather than a primary obligation and so it was not an on demand guarantee.

In 2011[3], the Court of Appeal ruled certain advance payment guarantees were on demand, including, because they were irrevocable and unconditional, payable on demand and governed by the Uniform Rules for Demand Guarantees.

More recently, in 2012[4], the Court of Appeal has signalled a change in approach. It was required to consider a document described as a payment guarantee. The first instance court had cited 20 authorities in a long judgment, holding that it was not an on demand guarantee. The Court of Appeal unanimously overturned that decision and encouraged a different approach. It focused on the commercial context of the transaction rather than the detail of the drafting. It concluded in particular that a document will almost always be a demand guarantee where it:

- Relates to an underlying transaction between parties in different jurisdictions.
- Is issued by a bank.
- Contains an undertaking to pay "on demand" (with or without the words "first" and/or "written").
- Does not contain clauses excluding or limiting the defences available to the guarantor.

HFW perspective

Commercial parties in the trading sector should be extremely careful when taking or relying on a CG from a non financial institution in circumstances where:

- No fee is paid to the guarantor for provision of the guarantee.
- It is not ordinarily in the business of giving financial instruments.
- It does not receive any counter security for providing the guarantee.

You can make the position more certain by including clear, express wording to the effect that the parties intend the guarantee to be an independent, on demand guarantee and by referencing the Uniform Rules for Demand Guarantees.

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2 *Vossloh Aktiengesellschaft v Alpha Trains (UK) Ltd.* [2010] EWHC2443 (Ch), [2011] 2 All ER (Comm) 307

3 *Meritz Fire & Marine Insurance Co Ltd v Jan De Nul NV & another* [2011] EWCA Civ 827 (21 July 2011)

4 *Wuhan Guoyu Logistics Group Co Ltd and another v Emporiki Bank of Greece SA* [2012] EWCA Civ 1629 (7 December 2012)

hfw The growth of renewables in China: what are the implications

The PRC's reliance on conventional thermal power generation, especially coal fired power-stations, is well publicised not just within the Asia-Pac region but globally. While coal is likely to remain the PRC's primary source of energy for the immediate future, the PRC's stated commitment to tackling climate change and a swift transition to a low carbon and climate resilient economy implies a comprehensive shift away from thermal power generation in favour of renewables. This transition will present both challenges and opportunities in the physical commodities space.

There are signs that the focus is already shifting away from coal as a power source. Between 1994 and 2014 the PRC's consumption of coal doubled, reaching more than four billion tonnes a year. However, according to figures released by the PRC's National Bureau of Statistics, coal consumption in 2015 fell 3.7% from 2014 levels (which themselves were down 2.9% from 2013 levels). Further, under the 13th Five Year Plan adopted on 16 March 2016, the PRC signaled its intention to reduce carbon emissions by 18% from 2015 levels by 2020 and earlier in the year, the PRC's National Development and Reform Commission (NDRC) and the National Energy Administration (NEA) banned new coal-fired power projects approvals in nine regions and slowed the pace of approval and construction of new projects in 15 others.

At the same time, there is growing legislative and regulatory support for renewables. The NDRC promulgated a directive setting out detailed measures for a minimum quota system for the purchase of renewable power by power grids. The directive, which was foreshadowed by President Xi Jinping in last year's US-China Joint Presidential

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Statement on Climate Change, sets an annual minimum purchase guarantee for PRC power companies for wind and large-scale solar generation. This is intended in part to help attract investment in renewable projects by guaranteeing an end market.

One of the other aims of the quota system is to address the worsening wastage of renewable power due to grid bottle necks, limited long distance grid capacity, slow power demand growth and a sharp increase in renewable power generating capacity. In this regard, according to recently published data, nearly 10% of the PRC's solar capacity remained untapped during the first half of 2015, and 15% of windpower remained unused. With this in mind the NEA recently banned new wind farm constructions in regions with the worst power grid problems, and required the regional governments to develop plans to reduce the output of coal fired plants to aid absorption of the unused renewable capacity.

While many predict that these developments will create a sustained downward pressure on coal, other commodities that are core to the renewables sector such as copper, and the construction sector more generally, such as iron ore, may well benefit from recent developments in the regulatory framework within the PRC and a gradual (or not so gradual) transition to low carbon energy alternatives.

The key for those involved in the sector will be navigating this regulatory framework, closely monitoring developments in a rapidly evolving market and working within the PRC's new energy paradigm.

In practical terms this means for some that if, for example, you are in the process of negotiating a long term coal supply contract, you should be considering the PRC's present and potential future renewables policy alongside other more traditional risk considerations (e.g. counterparty creditworthiness, supply side risk and so on). For others, it will mean reviewing their mid and long-term sale portfolios to assess the likely impact of these policies. They will want to identify any pressure points or increased risks in the underlying transactions (as a result of the structures employed, specific contractual terms agreed or otherwise) and to take remedial action. More positively, they will also look to take full advantage of any new opportunities.

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hfw End of "the line" – all about nexus

The following article was published in Fairplay on 28 June 2016 and is reprinted here by kind permission.

Rulings by the UK's highest court, the Supreme Court, are relatively rare and very significant. The recent decision in the *Global Santosh (NYK Bulkship (Atlantic) NV v Cargill International SA.)* is therefore an important one for the global shipping industry, in which many contracts are governed by English law.

The decision, in favour of Cargill, dealt with a dispute which dated back to 2008 and involved a mistaken arrest of a vessel in Nigeria and a delay in discharging a cement cargo by third parties. The dispute focused on the allocation of risk between owners and charterers of the vessel and how this was addressed in the charterparty.

As a result of this decision, with which many in the shipping industry will already be familiar, it is recommended that charterparties stipulate clearly how the risk of an arrest and events of delay are allocated between owners and charterers.

Background and implications

The case centred on an off-hire clause. NYK time-chartered the vessel to Cargill. She was then sub-chartered and sub-sub-chartered and carried a cargo of cement to Port Harcourt in Nigeria.

Following a lengthy delay in discharging, and both vessel's and cargo's arrest, Cargill as time charterers withheld hire from NYK for the period of time the arrest order was in place. This was on the basis of their interpretation of the off-hire clause in the charterparty which *"suspended"* the payment of hire if the vessel was *"detained or arrested"*.

However, NYK took the view that the proviso in the off-hire clause *("unless such capture or seizure or detention or arrest is occasioned by any personal act*

The Supreme Court approached the dispute from a different angle, focusing more on what occasioned the arrest and its connection to the functions performed under the charterparty (i.e. the nexus test).

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or omission or default of the Charterers or their agents…") applied and that hire continued to be payable for the duration of the arrest order. The case went from London arbitration right through to the Supreme Court on appeal.

The Supreme Court recognised the difficulty of the issue, but ultimately preferred the reasoning of the original London arbitrators. They found that the proviso in the off-hire clause had not been triggered because the arrest was not *"occasioned"* by parties acting as Cargill's agents. This was because there was an insufficient *"nexus"* or a disconnect between the occasion for the arrest and the functions or rights or obligations to be performed by parties acting as Cargill's agent. The vessel was therefore off-hire throughout the period of the arrest.

The chartering community will welcome the decision, as it reduces a significant business risk for them. However, owners will be disappointed with it, as they may not receive hire if their vessel is arrested for reasons over which they have little or no control.

The legal view

The Supreme Court's decision provides welcome clarity. Previous decisions had meant that any party to whom charterers directly or indirectly delegated an obligation (including sub-charterers, sub-sub-charterers and receivers), could potentially be classified as charterers' agents at all times.

The Supreme Court approached the dispute from a different angle, focusing more on what occasioned the arrest and its connection to the functions performed under the charterparty (i.e. the nexus test). The nexus test rests on the definitions of "occasion" for the arrest (in this case for unpaid demurrage/absence of discharge) and the performance of "functions" by third parties on behalf of charterers. The broader the definitions, the broader the application of the nexus test and so the broader the application of the off-hire proviso. In this case the definitions (and therefore the proviso) were rightly held to be narrow, as a broad interpretation was held to be *"impossible to justify"*.

Parties should therefore ensure that the off-hire clause in their charterparty properly captures the level and breadth of risk contemplated.

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EU regulatory round-up – Summer 2016

Although the UK has voted to leave the EU, it remains part of the EU for the immediate future. Furthermore, under most models for the UK's future relationship with the bloc, doing business with Europe will entail compliance with EU regulatory standards – at least where that business includes instruments the EU treats as energy or commodities (or related) derivatives.

Compliance with domestic regimes the EU assesses as "equivalent" is an alternative. For example, after protracted negotiations, equivalence or "substituted compliance" arrangements between European and US regulators are now being finalised and Switzerland is implementing its Financial Market Infrastructure Act and has already been assessed as equivalent in certain respects.

This article contains a round up of recent regulatory developments affecting commodity market participants.

Securities Financing Transactions Regulation (SFTR)

Record-keeping and certain other obligations have applied from January 2016 but the SFTR will really begin to bite on 13 July 2016, when requirements take effect for prior disclosures and express consent before financial instruments received as collateral can be reused, even in existing transactions. Reporting of securities and commodity repo and sell-buyback transactions (and certain other transactions) will be phased in from 2017.

New Market Abuse Regulation (MAR) finally comes into force

MAR will apply from 3 July, replacing the 2003 Market Abuse Directive (MAD) MAR is wider in scope than MAD in terms of products and trading venues covered, widens the insider dealing and manipulation offences, and widens the obligation to report suspicions of breach. It also imposes new obligations such

as requirements in respect of market soundings, a capital markets practice which MAR defines in such wide terms it could impact solicitation and other pre-trade communications in relation to potential transactions involving commodity derivatives.

Commodity market participants should note that:

- "Inside information" is extended to cover information related to spot and forward physical commodity contracts.
- Manipulation provisions will apply to such contracts (except wholesale energy products within the scope of REMIT) where the manipulation affects financial instruments or, conversely, where the manipulation of financial instruments affects physical commodity contracts (including wholesale energy products).
- The new benchmark manipulation offence will cover a full range of energy, commodity, freight and related benchmarks as well as financial benchmarks. It is much broader than the criminal offence introduced in the UK following the LIBOR scandal. (Separately, an EU Benchmark Regulation adopted in May 2016 will regulate benchmark administrators, impose obligations on contributors and restrict use of unauthorised benchmarks.)

MiFID II – details for commodities firms emerge

From January 2018, MiFID II will replace, update and extend the 2004 Markets In Financial Instruments Directive (MiFID). MiFID II will:

- Broaden the range of commodity contracts treated as "financial instruments".
- Extend "financial instruments" to include EU emission allowances.
- Impose requirements on "organised trading facilities" (OTFs), a newly defined category of trading venue.

In consequence, from January 2018, MAR will cover an even broader range of commodity instruments traded on a broader range of venues, and also emission allowance and related auctioned products.

Among the most controversial issues arising from MiFID II are:

- The narrowing of the exemptions for commodities business.
- The introduction of commodity position limits in respect of all commodity derivatives listed on an EU trading venue (regulated market, multi-lateral trading facility or OTF).

Key details were left to be determined by regulations to be adopted by the European Commission. After much delay, the Commission has recently finalised many of those regulations. Most will apply directly only to firms authorised under MiFID or trading venues, but they may affect market participants more or less indirectly – for example, commodity position reporting. Others will have a significant effect on commodity businesses – for example, the Commission's definitions of commodity-related terms result in more commodity derivatives being captured by MiFID II than many had hoped.

The Commission sent several draft regulations back to the European Securities and Markets Authority (ESMA), requesting that ESMA tighten certain requirements. These included draft regulations on position limits and the ancillary activity exemption for commodity firms.

ESMA's revised draft on position limits reduces to 2.5% the minimum position limit for derivatives with food-stuffs as the underlying commodity. Limits will apply to OTC contracts equivalent to venue-traded derivatives even if the terms differ slightly, and limits for non-spot months will be adjusted if the open-interest on which they would normally be based diverges significantly from deliverable supply.

The scope of the ancillary activity exemption is critical to commodity firms, even firms outside the EU who wish to deal with EU counterparties. It will replace the existing exemptions for ancillary activity and own-account commodity dealing. At present it remains in draft because ESMA and the Commission cannot agree on its terms. ESMA proposed a combination of market share and main business tests, comparing speculative commodity derivatives activity of a corporate group with the overall market and with the group's total commodity derivatives activity. The Commission wants a capital employed test but ESMA has rejected that idea. What approach the Commission will now adopt, and how long it will take to finalise the regulation, are unclear.

And finally...

To end on two positive developments:

- MiFID II will not come into effect until 3 January 2018 – formalities to confirm the delay are complete, but both regulators and firms have a huge amount to do before then.
- The current exemptions for commodity dealers under the Capital Requirements Regulation (CRR) have been extended to December 2020. (Under the CRR, commodity dealers are exempt from complying with the requirements for large exposures and the requirements for own funds. The extension is intended to allow time for the development of an appropriate prudential regime for commodity dealers.)

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Brexit update

Following our April Brexit bulletin[1] looking at how a vote for the UK to leave the EU might affect the Commodities sector and the bulletin update on 24 June[2], we shall continue to update clients on the implications of developments as they take shape. We are planning a forum for those in the commodities sector to discuss and work together on the challenges and opportunities ahead. The first meeting of this forum is likely to happen in September, when the likely route to Brexit and the shape of a post-Brexit relationship with the EU will be somewhat clearer. Invitations will go out in the next few weeks. Please feel free to contact marketing@hfw.com if you would like to attend.

In the meantime, we have assembled a team of sector specialists should you require further information and support:

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Conferences and Events

AGIC
Melbourne
26-27 July 2016
Attending: Stephen Thompson

AIE Energy Conference
Perth
24-25 August 2016
Presenting: Simon Adams

Argus European Crude 2016
Geneva
12 October 2016
Presenting: Sarah Hunt

1 http://www.hfw.com/Commodities-Bulletin-April-2016
2 http://www.hfw.com/BREXIT-Next-steps-for-out

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