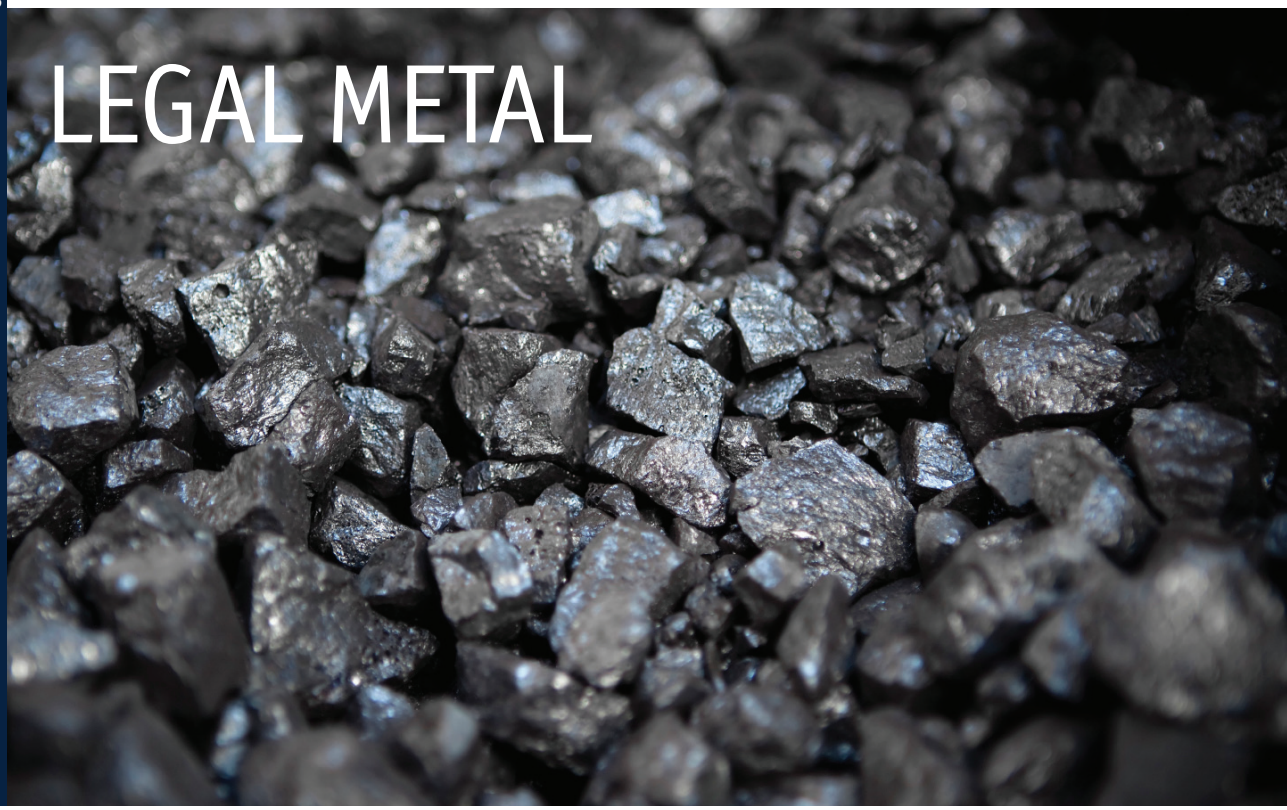
Commodities

December 2012

LEGAL METAL



Iron ore buyers' defaults - contractual protections

According to published market sources, this year has seen weakening demand for iron ore. This softening has been led by China, the world's largest importer of iron ore, which represents 60% of the global seaborne market. During the middle months of this year, various press reports highlighted increasing numbers of defaults by buyers of iron ore and thermal coal in that market. In many such instances, suppliers were being asked to defer cargoes or to enter into price renegotiations. Those defaults have come against a backdrop of rising inventories and falling prices in China, caused by weakening domestic demand. This is an unwelcome development for miners, traders and shippers alike.

In these continuing market conditions, it pays to revisit your supply and carriage contracts to ensure they provide as much protection as possible in the event of counterparty default. If any terms were agreed verbally, it is safest to ensure they are recorded in a written recap.

There are three contractual mechanisms for defaults that you may want to consider at the outset of a deal.

First, price adjustment clauses. These provide for an agreed, pre-determined mechanism to revise the price of the deal when the relevant market moves to a sufficient extent. The key to these clauses is being specific and precise, uncertainty as to when the price adjustment takes effect is an obvious route to a dispute. It is therefore best to peg the adjustment mechanism to an exact percentage margin relative to the contract price, or a well established market index. It is worth remembering that unless there is express provision in the contract, a change of economic circumstances does not give a party the excuse not to perform, even if the effect is that the contract becomes significantly more expensive than was anticipated.

Second, insolvency clauses. These provide for the termination of the contract upon a party suffering a specified insolvency event. Typically, they provide for a wash out of all the transactions between the parties, with all sums due aggregated and netted.

The advantage is that any losses are crystallised and the non-defaulter knows the amount he is owed, albeit any recovery may depend on the outcome of insolvency proceedings. A variation on this is to allow for the suspension of obligations under a contract, for example the obligation to continue with deliveries of cargo under a COA, pending the cure by the defaulting party of the materially adverse change in their financial standing.

Third, rights of set-off/retention of title clauses. Set-off allows for sums due under separate transactions to be set-off against outstanding sums upon a default. Set-off rights can be "one way", where only the non-defaulter can set-off sums they owe, or "mutual", where both parties can net their outstanding debts under different trades. However these rights are only of real value where there are payments being made in opposite directions, such as in multiple transactions where the parties find themselves on opposite sides in different trades (primarily in paper trading and sometimes in physical trading) and in certain carriage contracts. In sale contracts, sellers/suppliers may prefer to secure a 'no set-off' clause in their contractual negotiations, which interacts effectively with a retention of title clause. This contractual exclusion of set-off rights has recently been upheld as enforceable as a matter of English law[1]. There are contractual mechanisms to protect buyers in this scenario as well.

One common issue suppliers face is how the rejection of one cargo affects the remainder of a long term supply agreement. If each delivery is separate enough to constitute an individual contract, then a seller can hold a buyer in breach in respect of one rejected cargo whilst the rest of the agreement remains in place. In these circumstances, the seller should be careful of treating a single default as a repudiation of the entire deal. A struggling buyer may seek to capitalise on this by alleging the seller was the party that wrongfully terminated. As a rule of thumb, defaults on at least 50% of the shipments are required before the whole agreement can be terminated, however this is subject to the particular circumstances of each case.

If a breach becomes unavoidable, you need to be sure you can fall back on effective dispute resolution provisions in the contract. In the first instance, there should be clear governing law and jurisdiction clauses, providing for specified arbitration and/or litigation procedures. Alternative Dispute Resolution (ADR) provisions (such as mediation) are becoming more common, but recent case law[2] has emphasised that to be considered binding, such provisions should set out obligations as certain and unequivocal as traditional jurisdiction clauses, not merely express the parties' intention to resolve their differences. In these tough market conditions, we are seeing more of our clients seeking early advice on devising and implementing effective ADR strategies.

Whilst the current iron ore market has given us cause to highlight the above contractual protections and risk mitigation strategies, the same points can be made in respect of other metals and steel markets experiencing difficult trading conditions.

For more information please contact Luke Zadkovich, Associate, on +44 (0)20 7264 8157 or luke.zadkovich@hfw.com, or Ian Mathew, Associate, on +44 (0)20 7264 8035 or ian.mathew@hfw.com, or your usual contact at HFW.

1. See: *FG Wilson (Engineering) Ltd v John Holt & Company (Liverpool) Ltd* [2012] EWHC 2477 (Comm)

2. See: *Wah (Aka Alan Tang) & Anor v Grant Thornton International Ltd & Ors* [2012] EWHC 3198 – analysed in our forthcoming Dispute Resolution Bulletin.

Hurricane Sandy disruptions: can you rely on force majeure provisions?

Hurricane Sandy caused disruption and delays when it struck the east coast of the USA back in October 2012.

Since then, several parties have looked at their contracts to see whether their force majeure provisions apply to allow them to suspend or terminate obligations. In this article we summarise the English law answers to some of the more common legal questions raised by events such as this.

Is my contract frustrated?

This depends. A frustrating event is an unforeseen event, beyond the control of either party, which (in the case of severe adverse weather) makes performance under the contract impossible.

A careful contractual and factual analysis will need to be undertaken. However, a contract cannot be frustrated if the contract makes provision for the event in question, usually by way of a force majeure clause.

Can I rely on force majeure?

A party can only rely on force majeure if it is provided for in the contract. If there is no such provision, you cannot rely on it.

Does my force majeure clause contemplate hurricanes?

Each contract is different. Some contracts will expressly name specific events as being force majeure events. Others will contain wording that is intended to cover natural disasters.

I want to serve notice of force majeure. What should I do?

The following steps should be taken:

- Are you entitled to rely on the force majeure provision? Check that you are not obliged to perform by other means. For example, a contract may oblige a seller to source goods from an alternative source, or give a seller the option of sourcing goods from multiple ports. If this is the case, you may be obliged to look to other ports in the USA.
- Pay careful attention to the notice provisions, usually within or just after the force majeure clause.
- Check whether a certain period of time has to pass before you are entitled to rely on force majeure.
- Be sure to include all the information mentioned in the clause.
- Serve it in the correct way. For example, if the contract calls for notices to be sent by fax, do not attempt to serve by email.

My counterparty claims they cannot perform and serves notice of force majeure. What should I do?

The following steps should be taken:

- Is your counterparty entitled to serve a notice of force majeure? Check whether your counterparty is obliged to perform by other means, and whether they are obliged to accept goods sourced by other means or alternative ports.
- Has your counterparty complied with the notice provisions? Check method of service, content and timing.

I have served (or have received) a notice of force majeure. Can I cancel?

Again, this will depend on the wording of your contract.

Some contracts state that if the force majeure event continues beyond a specified number of days, the contract (or perhaps one or more portions or shipments) may be cancelled. If you are entitled to cancel, ensure that the required number of days have passed and that the notice provisions are complied with when sending a cancelling notice.

I can perform, but Hurricane Sandy has made my contract more expensive for me. Can I claim that the contract is frustrated?

No. English law does not recognise the concept of "economic frustration". The English courts have consistently stated that commercial men are expected to know that the future is uncertain and that, for example, prices will fluctuate.

If I cannot claim "economic frustration", can I rely on my force majeure clause?

No. The force majeure provisions only apply to those events that are expressly set out in the clause. However, it is possible to deal with unforeseen economic circumstances by way of a Hardship Clause.

For more information please contact Alice Marques (pictured below), Associate, on +44 (0)20 7264 8471 or alice.marques@hfw.com, or your usual contact at HFW.

A version of this article previously appeared in Steel First, 7 November 2012.

"Some contracts state that if the force majeure event continues beyond a specified number of days, the contract (or perhaps one or more portions or shipments) may be cancelled."

Update on the London Metal Exchange sale - FSA and Court approval

On 5 December 2012, the High Court in London sanctioned the scheme of arrangement set up to facilitate the sale of LME Holdings to Hong Kong Exchanges and Clearing Limited (HKEx). This was the final hurdle in the transaction and binds all LME members to the deal. The green light from the Court follows on from the formal approval of the transaction last week by the UK Financial Services Authority (FSA).

HKEx had already announced plans to raise HK$7.75 billion (US$1 billion) via a share issue to fund the LME purchase. The Hong Kong Government has said it will buy some 5.8% of the new shares and maintain its position as HKEx's largest single shareholder.

The purchase of LME will be HKEx's first overseas venture and will add the group's first commodities-based contracts. For its part, the LME has expressed its hopes that the takeover will attract more Chinese members to the exchange given that China is the largest buyer of many of the metals traded on it.

At the time of writing the transaction was expected to become effective on 6 December 2012.

For more information, please contact Robert Finney, Partner, on +44 (0)20 7264 8424 or robert.finney@hfw.com, or your usual contact at HFW.

Conferences & Events

International Steel Traders Association (ISTA) annual luncheon
London
(7 December 2012)
Robert Wilson, Luke Zadkovich, Alice Marques and Ian Mathew

ICC Winter Trade Finance Conference
HFW Friary Court, London
(11 December 2012)
Robert Wilson, Craig Neame and Spencer Gold

International Trading Contracts: Description vs Quality: what recourse does a Buyer have?
Swissotel, Geneva
(11 December 2012)
Sarah Hunt

LMA: Bills of Lading
Hotel Pullman, Dubai
(12-13 December 2012)
Simon Cartwright, Sam Wakerley, Yaman Al Hawamdeh and Nejat Tahsin

Capital Links Forum: 4th Annual Global Derivatives Forum
New York City, US
(17 December 2012)
Brian Perrott

HFW Mining Claims Seminar
HFW Friary Court, London
(22 January 2013)
Paul Wordley, Rebecca Hopkirk, Nigel Wick, Peter Schwartz, Toby Savage and Rupert Warren

Lawyers for international commerce hfw.com

HOLMAN FENWICK WILLAN LLP
Friary Court, 65 Crutched Friars
London EC3N 2AE
United Kingdom
T: +44 (0)20 7264 8000
F: +44 (0)20 7264 8888