THE 'BACK-TO-BACK' ILLUSION – MANAGING RISK AS A MIDDLE PARTY IN A STRING TRADE

In the trade of certain commodities, it is common for goods to change hands multiple times – both physically and legally – before reaching the end receiver. Parties in the middle of 'string' or 'chain' trades of this nature tend to share a common goal: to ensure that the rights and obligations on one side of that chain mirror those on the other, enabling them to pass any potential liabilities arising seamlessly, in both directions, with only the financial terms of each trade being different.

Whilst this is a commercially rational objective, in reality, that mirror is rarely perfect. Differences in contract wording, notice provisions and time limits, as well as the form, manner and speed at which correspondence is passed on, can create important gaps, and therefore incremental exposure, when a dispute arises.

This guide examines the reasons why achieving a true 'back-to-back' position is difficult, and the practical steps that can be taken to manage risk.

What does ‘back-to-back’ mean?

When a transaction is described as being ‘back-to-back’, this means that the contractual terms on which the underlying goods have been bought by a party are substantially replicated in the terms on which they have been sold by that party – with typical key differences between the ‘back-to-back’ contracts being the identities of the seller and buyer, the price of the goods, and the time by which payment must be remitted. A string or chain contract might look as in the diagram below, where each box represents a separate, independently enforceable contract for the sale and purchase of the same underlying goods: aligned, liability may fall on a middle party in the chain at the point of misalignment, because that party will not be able to pass the liability along the chain.

What ‘back-to-back’ does not mean, however, is that the contracts are the same or can be automatically bypassed or amalgamated, such that the Receiver can simply bring its claim against the Supplier. They are each separate, independently enforceable agreements, with each party in the chain taking performance risk on their direct counterparties. The fact that their commercial terms were negotiated with the intention of mirroring each other does not alter that position.

Contract 1	Contract 2	Contract 3	Contract 4
Party A – Party B	**Party B – Party C**	**Party C – Party D**	**Party D – Party E**
(Supplier) – (Buyer)	(Seller) – (Buyer)	(Seller) – (Buyer)	(Seller) – (Receiver)

Where contracts are materially ‘back-to-back’, a claim or liability arising at one end of the chain should be able to flow from link to link down the chain. For example, a claim for off-specification goods brought by the Receiver against Party D under Contract 4 can be met by Party D bringing an equivalent claim against Party C under Contract 3, and so on until the claim reaches the Supplier under Contract 1. However, where the contracts at each link of the chain are not

In other words, the party in the middle of two contracts (e.g., Party B, Party C and/or Party D) is not a mere conduit – it is a principal to two separate contracts, each of which imposes its own obligations on that party as buyer or seller (as applicable) and carries its own risks. When a gap opens between the two contracts, whether by design, oversight or events, the risk is for that middle party to bear alone.

Why is true ‘back-to-back’ difficult to sachieve?

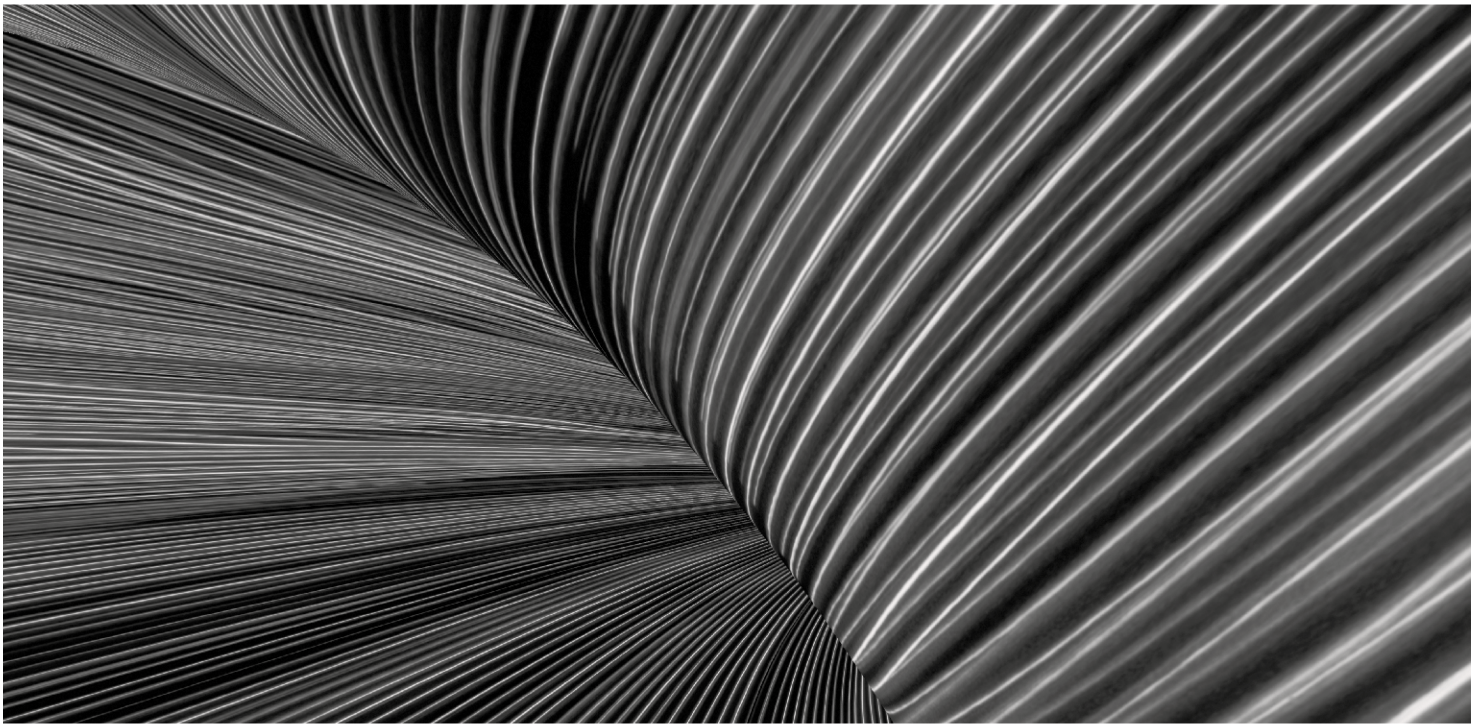
Even where parties negotiate carefully to align their upstream and downstream contracts, a number of structural features make perfect alignment difficult. We discuss some of the key issues below.

Different contract terms

In many trades, contracts are not negotiated and concluded in a single, comprehensive document. Instead, they are formed through the process of agreeing a recap – a short communication setting out the key commercial terms of the trade (product, quantity, price, delivery window, load/discharge ports, etc.), which usually includes a reference to particular standard form general terms and conditions (“**GTCs**”). In the context of the oil trade, examples include the ADNOC GTCs, the BP GTCs or the Shell GTCs. The GTCs supply a detailed contractual framework for the trade, whilst the recap supplies the limited transaction-specific terms such as the specific product, loading range, quantity and price, that the broader GTCs do not contemplate.

However, it is common for one or both parties to seek to vary the GTCs by imposing their own ‘special’ or ‘additional’ terms on top of these, either through provisions attached to the recap or through a subsequent exchange of correspondence in which each party puts forward its own preferred language. That exchange is known as the classic legal ‘battle of the forms’. This is a familiar feature of commodity trading, and a recurring feature of contractual uncertainty.

The English law position on which terms prevail is well established in principle, though its application to any given set of facts is often disputed. As a general rule, the terms that constitute the ‘last shot’ before performance commences will be those incorporated into the contract. A party that performs following receipt of the other side’s terms without rejecting them or reserving its position will ordinarily be taken to have accepted those terms.



The practical consequence of this is that the terms applicable to the trade may not be those intended by the parties at the outset, but may instead turn on the sequence of communications leading up to the commencement of performance – a sequence that can be imprecise and confusing, especially when there have been several rounds of detailed back-and-forth between the parties with some 'special' terms only partially rejected.

Under English law, a court or tribunal will try to give effect to the language of a contract as a whole. 'Special' terms will not be construed without reference to incorporated GTCs and it is only where two provisions on the same subject matter cannot be read together, i.e., they are genuinely irreconcilable, that 'special' terms will be given precedence. This threshold is not easily met, and parties should not therefore assume that their bespoke language will automatically override standard form GTC provisions.

In the context of string trades, this can result in exposure for middle parties, who may have agreed particular provisions in their purchase contract, whilst having negotiated using different language in their sale contract. The exchanges with their counterparts on each side may then result in different 'last shots', so that whilst the key terms and GTCs underpinning both contracts are the same, each has slightly different 'special' terms.

The practical implication is a chain that appears 'back-to-back' at the level of the recap and standard-form GTCs, but which reveals material differences when its terms are reviewed in the context of a dispute.

That difference is compounded where the contracts at each link incorporate different GTCs altogether. Different GTCs may address the same subject matter (e.g. vessel nomination, quality claims, force majeure, limitation of liability, etc.) but do so in ways that are not identical. Language matters – even provisions that appear substantially similar can produce a different outcome on the same facts based on small variances in wording.

A worked example: the off-specification claim

Consider a practical scenario using the chain diagram above. Party A supplies a cargo of crude oil to Party D through Parties B and C. On arrival, the cargo is found to be off-specification. Party D claims against Party C under Contract 3. Party C, in turn, seeks to pass that claim to Party B under Contract 2, and Party B to Party A under Contract 1.

If all three contracts are on the same GTCs, with the same quality claim provisions and the same time limits, the claim should pass smoothly along the chain. However, if one set of 'special' terms limits recovery for off-specification goods to the difference in value between the goods as delivered and as they should have been delivered, whilst another permits recovery of losses such as the cost of blending, storage and resale at a discount, a middle party may find that it is liable to its buyer for losses that it cannot recover down the chain from its seller.

Time limits

In practice, this is one of the most common sources of exposure in contractual chains.

Different contracts may impose different time limits for the notification and bringing of claims, as well as different requirements as to the form and content of such notices/claims, sometimes with the obligations on one side of a chain being stricter than on the other. A failure to comply on either side can extinguish a middle party's rights, leaving it exposed to liability without recourse to its counterpart up or down the chain, as applicable.

Demurrage time limits

Demurrage offers a straightforward illustration of this problem. Standard form GTCs differ materially in the deadlines they impose for the submission of demurrage claims and supporting documentation – some require claims to be presented within a certain number of days following completion of discharge (with the time limit often being short – for example, 90 days) and others within a specified period following the relevant laytime calculations being issued. In extreme cases, a middle party could find itself time barred from recovering a demurrage claim downstream before it has even received the claim from its upstream counterparty.

Force majeure time limits

Force majeure is a particular pressure point. The major standard form GTCs vary considerably in what they require once a force majeure event occurs. Some demand notice "as soon as possible", others "*as soon as practicable*", whilst others impose a fixed deadline, for example "*within 14 days*" of becoming aware of the force majeure event. Accordingly, a middle party that receives a force majeure notice and passes it on promptly may nonetheless find itself faced with the argument that it has missed the deadline under its purchase contract and therefore no longer has the right to rely on the protections of the force majeure clause, even where the existence of the force majeure event itself is not in dispute.

The correspondence trap

The conduct of parties in correspondence is a source of 'back-to-back' exposure that is frequently overlooked. Parties who have carefully negotiated contracts that are genuinely 'back-to-back' can inadvertently undo this through the way that they communicate with their counterparties.

The problem arises because a party in the middle of a chain is, at any given moment, communicating with two different counterparties under two separate contracts. An agreement reached with one, perhaps an extension to a delivery window, a waiver of a notice defect, an acceptance that a particular state of affairs is satisfactory, does not automatically bind the other. Admissions also carry risk – a statement made to one counterparty, say that the goods arrived in a damaged condition, may in due course be disclosable and constitute evidence which can be deployed against the middle party in proceedings brought by their other counterparty, if that statement is inconsistent with the position the middle party has advanced there. The commercial necessity of maintaining coherent communication up and down a chain must be balanced against the legal risk of creating inconsistent positions across two separate sets of proceedings.

For this reason, middle parties in contractual chains often seek to pass on messages from their counterparties verbatim, waiting for their upstream counterparty's response before passing it downstream verbatim, and vice versa. The intention is to maintain perfect symmetry – nothing is agreed on one side that has not been agreed on the other and the factual record at each end of the chain is identical.

In practice, however, this approach has significant limitations. It introduces delay – the downstream counterparty is kept waiting whilst the middle party seeks instructions from upstream. Additionally, messages may not be passed along the chain as soon as received. Where a communication is time critical, a difference in timing between what was received and what was passed on can be significant. The downstream counterparty may receive a notice a day later than the upstream party issued it. That day could be the difference between a valid and an invalid notification.

A further and distinct risk arises from the mechanics of passing communications along the chain.

Messages are rarely forwarded verbatim – they may be paraphrased, summarised or have comments added before being passed on. Each of those changes alters the factual record. Additionally, traders will often pick up the 'phone to one another in such circumstance, and those conversations cannot be perfectly replicated.

The problem is compounded where contracts in the chain contain different requirements. Taking the example of force majeure again, an upstream contract may require that a force majeure notice contains only a description of the force majeure event, whilst the downstream contract requires that it identify the event, state its expected duration and set out the steps being taken to overcome it. A middle party in this position cannot simply forward the upstream notification verbatim if the downstream notice requires greater particularity. It must supplement the notice to comply with its obligations in the downstream contract. However, in doing so, it creates divergence between what has been communicated at each level of the chain as the notification under one contract is no longer materially the same as the notification passed along under the next contract in the chain. If a dispute later turns on the precise terms and timing of the force majeure declaration, the middle party may find itself in the position of having made statements in correspondence at each end of the chain that are not perfectly aligned with each other, not through any dishonesty, but as the inevitable consequence of performing two different contractual obligations.

Perhaps the most difficult situation a middle party can face is where a counterparty on one side is in breach, and maintaining their position along the chain would require it to advance a case it considers to be wrong. The instinct can be to stay 'back-to-back' – to adopt the same position across the chain and simply pass on correspondence. However, this carries risk where contracts are not perfectly aligned because, as outlined above, liability could end up resting with the middle party rather than being passed seamlessly down the chain

It is important to recognise that each contract in the chain creates its own, independent, bilateral obligations. The fact that an upstream counterparty has failed to perform does not, of itself, provide a defence to a downstream claim. A middle party that waits for its upstream counterparty to act before acting itself is not protected by that passivity – it remains independently liable for its own performance. By remaining entirely beholden to its upstream counterparty's conduct, a middle party effectively outsources its own contractual performance, but where the obligations and liabilities under each contract are not the same, the consequences of doing so can be significant.

Law and jurisdiction

Where a claim is commenced against a middle party in a string chain, it cannot automatically join its counterparty on the other side of the chain to the same proceedings. Usually, it must first commence a separate claim in the forum specified in its that contract. However, if the upstream and downstream contracts incorporate different dispute resolution mechanisms (for example, arbitration in one and court proceedings in the other), the middle party may need to manage entirely different processes simultaneously, incurring additional costs and risking different findings on the same underlying facts, as well as being at risk of perverse decisions.

This issue may not disappear where both contracts provide for arbitration under the same rules. Arbitration clauses that appear substantively the same can still diverge in ways that matter, for example if one provides for a sole arbitrator, and the other provides for a three-member tribunal. Even where the consolidation of two or more references is technically available under the applicable arbitral rules or by agreement, this becomes more difficult where the relevant provisions of the contracts across the chain are materially different.

Governing law introduces a further and sometimes underappreciated layer of risk. Where upstream and downstream contracts are governed by different laws, the implied obligations, available remedies and rules of construction that apply to each contract can differ significantly.

The worst case scenario of mismatched dispute resolution clauses and/or mismatched governing laws is a middle party facing the time and costs of pursing separate proceedings in separate forums, governed by different legal systems, despite the underlying facts of the issue being the same.

HFW Comment

It is always sensible for traders to seek to align their buy and sell contracts to the extent possible. However, the degree to which two contracts are ever truly 'back-to-back' should be viewed with clear eyes. No two contracts in a chain are ever identical and the differences between them, no matter how small they may appear at the time of contracting, can matter acutely when things go wrong. The party in the middle is not a mere conduit – it is a principal to two separate contracts, each of which imposes its own obligations and carries its own risks.

The practical discipline required to manage a 'back-to-back' position when a dispute arises is not complicated, but it requires consistent attention to the terms of both contracts simultaneously as well as to the implications of every piece of correspondence. The gaps in the 'back-to-back' protection do not open at the moment of default – they are created during the life of the trade, in the wording of notices, the drafting of responses and the decisions made under commercial pressure. By the time a dispute arises, these can be difficult to close if not managed correctly. For this reason, taking legal advice early is essential.

If you would like to discuss any of the issues raised here, please do not hesitate to get in touch. We regularly advise shipping and commodities clients on contractual chain disputes, charterparty defaults, and the management of multi-party claims.

What practical steps are available to manage exposure?

The risks described here cannot be engineered away. However, they can be managed, and the following measures represent current best practice for parties operating in the middle of string chains:

- **Align key provisions at the outset** – When negotiating upstream and downstream contracts, try to align provisions to the fullest extent possible. Incorporate the same standard form GTCs on both sides. Where bespoke clauses are negotiated or different GTCs are used, give priority to aligning core provisions, such as the off-specification and force majeure regimes, time limits, dispute resolution and governing law.
- **Compare the contracts after conclusion** – After any 'battle of the forms' has played out, take stock of the terms incorporated into each contract. Identify the material differences before performance begins or, at the least, as soon as an issue arises.
- **Monitor time limits** – Take note of all contractual time limits across both sides of the chain. Where upstream and downstream contracts impose different time limits for the notification of claims, force majeure events and/or defaults, internal processes should be geared to the shorter of the two.
- **Mirror concessions immediately** – If you agree something with one counterparty that requires a corresponding agreement from the other, secure that agreement before or at the same time, not afterwards.
- **Manage correspondence with discipline** – Treat all written communication as potentially disclosable in proceedings. Pass on commercial correspondence promptly and verbatim, to the extent possible.
- **Respond to defaults promptly and advisedly** – When an issue occurs, consider the contractual position on both sides at the outset and identify gaps. Consider acting independently where a counterparty is in breach – remember that every contract in a chain creates its own bilateral obligations. Take advice on what your contracts require of you and take steps to perform them.

If you require any further information or assistance with any of the issues dealt with in this guide, please contact the authors:

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Published: September 2026

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