



# COMMODITIES BULLETIN

## **New defaults?**

Commodity prices are falling or stagnating, and stockpiles, including of iron ore and coal in China, are rising. In commodity trading, there seems to be an increasing number of defaults, similar to those which occurred in 2008, where counterparties in long-term contracts refuse to perform or manufacture excuses not to do so. There also appear to be more quality disputes, where, in normal circumstances, the parties would reach a commercial settlement.

This article briefly considers how a non-defaulting party may protect itself against a default, and what should be done when a default occurs.

## **Protecting against default**

The first step is to ensure that long-term contract terms are evidenced in writing. If they are not, then all correspondence with the counterparty (including email, IMs and other electronic communications) should be

collected to ensure that the best record of the contract terms is available. If terms were agreed over the telephone, recordings of the relevant conversations should be obtained, and, if no recordings are available, those who participated in the calls should be asked to record in writing their recollection of what was discussed and agreed.

When all the relevant material has been collected, the contract should ideally be “stress tested” to identify possible areas of weakness which a party hoping to default might exploit. If there are any such areas, further material should be collated to ensure that the best evidence can be deployed in the event of a default.

Common arguments put forward by a defaulting party are that the individual who signed the contract terms was not authorised to do so, that the party who entered into the contract did so as agent and not as principal, and that there has been a breach of the contract which allows it to be terminated. Other excuses include alleged inability to perform due to changed



economic circumstances (sometimes described as “price majeure”). When stress testing a contract, each of these common excuses should be considered to assess whether they might have any merit. This enables a party to anticipate arguments and prepare to meet them, including by preparing communications with the counterparty in a way that shores up possible areas of weakness.

The next step is to ensure that the non-defaulting party complies with the strict terms of the contract. A potentially defaulting party should be given no excuse, no matter how small, to terminate the contract. Small things matter: nominations should be made on time; shipment periods should not be missed; quality and quantity certificates should be issued correctly; and, very importantly, commodities being sold should comply with the contractual specification. A problem in one of these areas could leave the door open for a counterparty to terminate a contract on legitimate grounds.

### When a default occurs

The natural temptation following a default is to seek a commercial resolution. A common example is where the counterparty asks for more time. It is very important in such circumstances to ensure that, if more time is given or another concession made, it is granted under a reservation of rights in respect of the counterparty’s breach of contract.

If there is a good commercial reason to allow more time and not to hold the counterparty in default, then the additional time given should be set out in writing and linked to existing contractual obligations. Periods

for performance of contractual obligations are frequently extended without the terms of the extension being recorded in writing, which makes it difficult to ascertain what has been agreed.

The next stage is to ensure that any commercial settlement discussions are undertaken on a without prejudice basis. This can sometimes seem odd, as it requires multiple messages to be sent, both “open” and “without prejudice”. However, it enables the counterparty to be held in breach of contract whilst the settlement discussions continue. If the commercial discussions are unsuccessful, the innocent party is then in a position to rely on its contractual rights.

Finally, it is important not to jump at a breach of contract. Acting too soon could have adverse consequences for the innocent party, which could find itself in breach for having prematurely terminated the contract. If a counterparty is in repudiatory breach of contract, or if an event of default (other than an insolvency event) has occurred, the innocent party should normally write to the counterparty, calling upon it to cure the breach by a certain date, failing which the contract will be terminated.

Finally, it is important to follow the strict requirements of a contract with regard to sending notices. If a notice of termination is not sent in the correct form to the correct address, it may be invalid.

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### Can FOB buyers pass demurrage liability to sellers?

The decision of the High Court in *Great Elephant Corporation v Trafigura Beheer BV & ors* (27 June 2012) illustrates the problems often faced by FOB buyers when seeking to pass on to their sellers demurrage liability incurred by the buyers under voyage charters.

A cargo of crude oil was loaded at the AKPO FPSO Terminal in Nigeria, which is operated by Total Upstream Nigeria Limited. Trafigura, the FOB buyer, chartered a ship to carry the cargo. The seller, Vitol, had bought from China Offshore Oil (Singapore) Pte Limited (“COOSL”). COOSL had in turn contracted with Total as the ultimate supplier.

The relevant person in Nigeria’s Department of Petroleum Resources (“DPR”) left before the vessel arrived, so Total obtained clearance to load by telephone. The authority in Lagos subsequently revoked this clearance and refused to issue the necessary cargo documentation. On completion of loading, the vessel was unable to leave Nigeria because she had not received the cargo documents. To have done so would have been an offence under local law.

Eventually, after Total had paid a fine of US\$12 million and agreed to the “severe disciplining” of its personnel at the terminal, the Ministry of Petroleum Resources agreed to release the vessel with the necessary paperwork. The vessel had spent 45 days off Nigeria and the ship’s owner claimed demurrage from Trafigura under the charterparty.



The Court held that the DPR's refusal to issue the cargo documentation resulted in the vessel being prevented from leaving the terminal, both practically and by law. The first seven days' delay was caused by the lack of documentation. Subsequent delay was caused by an abuse or arbitrary exercise of power by the Minister amounting to "arrest or restraint of princes." Demurrage therefore counted at half the full rate under the vessel charter. The delay was not within the reasonable control of Total and therefore not within the reasonable control of the charterer. The Judge commented that, given the verbal clearance obtained by Total prior to commencement of loading, Total was not culpable.

Trafigura sought to pass its demurrage liability to the vessel's owners on to Vitol, alleging they had caused the delay by a failure to "comply with all laws, rules, regulations... and by laws applicable and necessary for the performance ... of its obligations under the contract", as the contract required. The Court found that Vitol's failure (through Total) to do so caused the first week's delay. Thereafter, the delay was caused by the improper actions of the Minister. A submission on behalf of Trafigura that even if the Minister exceeded his powers, Vitol's breaches were an effective cause of Trafigura's loss, was rejected.

Trafigura argued that Vitol was in breach of section 12(1) of SOGA because it had no right to sell the oil. The Court disagreed. The DPR's right was to detain the vessel after title to the oil had passed on shipment. The effect of the DPR's right was to disturb Trafigura's possession of the oil, not to prevent Vitol from having

the right to sell. The DPR did not have superior title to Vitol. Trafigura's claim that Vitol had also breached Section 12(2)(a) of SOGA because the goods were not free from undisclosed charges or encumbrances at the time when property passed was similarly rejected.

The Court found that Vitol had breached the implied term of quiet enjoyment arising under section 12(2)(b) of SOGA, but that that breach only caused the first week's delay. After that, the underlying reason for the vessel's inability to leave Nigeria was the unlawful demand by the Minister for the payment of a fine. The implied term did not extend to interference with possession resulting from an unlawful demand.

Trafigura further claimed Vitol was in breach of its representation and warranty that it had the power, authority and legal title to the crude oil to be delivered and had taken all necessary action to sign and deliver the contract and perform its obligations under the contract. The Court agreed.

The contract included a force majeure clause. The Court concluded that Vitol's breaches of contract were caused by an unforeseeable act or event which was beyond its reasonable control. Vitol could rely on the force majeure clause and was not liable to Trafigura.

Although strictly unnecessary, the judge briefly considered Vitol's claims against COOSL. The contract between Vitol and COOSL incorporated the definition of FOB in Incoterms. COOSL was obliged to "clear the goods for export". A2 of Incoterms defines this obligation as

follows: "The seller must obtain at his own risk and expense any export licence or other official authorisation and carry out, where applicable, all customs formalities necessary for the export of the goods". The Court found that "must" meant an absolute duty, not merely one of best endeavours and therefore COOSL was in breach of its obligations to Vitol under Incoterms. COOSL's argument that Vitol's possession had not been disturbed, because it had immediately passed on possession to Trafigura, was rejected. Otherwise an intermediate seller in a string contract would have no protection where there was interference with a sub-buyer's possession.

The result was that Trafigura had a liability in demurrage under its charterparty which it could not pass on to its supplier under its purchase contract. Given that Trafigura's claims were made on several alternative bases, it is difficult to avoid the conclusion that the only way to avoid such liability is to have a specific clause in all related sale contracts providing for any demurrage liability, whether arising out of the Seller's fault or otherwise, to be payable by the Seller. Of course, whether such a clause would ever be commercially acceptable is another question entirely.

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## Commodities Breakfast Seminars

Our Autumn series of breakfast seminars, covering current issues affecting commodities trading, will take place on 25 September, 9 and 23 October 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](mailto:events@hfw.com).

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## Innovation in International Trade Seminar

On 3 October 2012, HFW will be hosting an Innovation in International Trade seminar at the Beau Rivage Hotel in Lausanne. A number of HFW lawyers will be speaking, including [Chris Swart](#), [Damian Honey](#), [Brian Perrott](#), [Janet Butterworth](#) and [Stephen Thompson](#). Please contact [events@hfw.com](mailto:events@hfw.com) for more information.

## Conferences & Events

[Australian Grains Conference](#)  
Crown Conference Centre,  
Melbourne  
(31 July and 1 August 2012)  
[Chris Lockwood](#), [Hazel Brasington](#)  
and [Stephen Thompson](#)

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