Trading disputes involving shipping and hedging issues

AIBL SEMINAR, Geneva 27 April 2012

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Introduction

The first thing to consider when a cargo is delivered off-spec is:

Has there been a breach of contract?

Is the cargo delivered in a condition which does not meet:

i) a condition of the contract – eg: a description of the product; or

ii) the quality specification.

Are both:

i) failure to fulfil a condition and

ii) failure to meet a quality specification, a breach of contract?

Can the buyer reject the cargo in the case of both i) and ii)?

If the buyer is going to reject, how long does it have to do so?

If the buyer does not reject, what are the buyer's rights?

Seller's obligations

- What if the Buyer rejects the cargo?
- What are the consequences if the Buyer does not reject the cargo, but later claims for damages?

Damages

- Contracts often include clauses excluding various losses.
- Typically excluded are:
  - consequential losses
  - any loss of profit
  - special losses
  - exemplary or punitive damages

Off-spec cargo – breach of contract?

- Has there been a breach of contract?
- Is the cargo delivered in a condition which does not meet:
  - i) the description of the product (a condition); or
  - ii) the quality, in which case there is a mere breach of warranty?

Section 11(2) 7& (3) of the *Sale of Goods Act* (1979)

Section 11: When condition to be treated as warranty

(2)Where a contract of sale is subject to a condition to be fulfilled by the seller, the buyer may waive the condition, or may elect to treat the breach of the condition as a breach of warranty and not as a ground for treating the contract as repudiated.

(3)Whether a stipulation in a contract of sale is a condition, the breach of which may give rise to a right to treat the contract as repudiated, or a warranty, the breach of which may give rise to a claim for damages but not to a right to reject the goods and treat the contract as repudiated, depends in each case on the construction of the contract; and a stipulation may be a condition, though called a warranty in the contract.

Breach of contract

- Both a (i) breach of the description term (condition) and (ii) a breach of the quality term (warranty) are breaches of contract.
- BUT only the first, breach of a *condition* or *description* enables the buyer to reject the cargo for failure to deliver the right cargo; the actual cargo promised, as opposed to a cargo which falls within the contractual description but breaches the quality or warranty for the exact nature of the cargo.
- A mere breach of warranty at (ii) enables the buyer to sue the seller for damages for breach of warranty, but does not entitle the buyer to reject the cargo.

Quality or Description?

- A Court will always look to the intention of the parties.
- Some Examples:

- Contract A:
  - **Description** : Jet A1
  - **Quality** : meeting Defence Standard 91-91 latest issue
- Contract B:
  - **Description** : Jet A1 meeting Defence Standard 91-91 latest issue

- So in Contract A, the Buyer cannot reject the product, but in Contract B the buyer can reject if the product does not meet "Defence Standard 91-91 latest issue". The exception to that would be if the product is so far from being Jet A1 as to be unrecognisable as that product.

Quality v Description?

- Contract C:
  - **Description:** Port Harcourt Refinery normal running production naphtha.
  - **Quality:** Naphtha of normal running production as produced by Port Harcourt Refining Company with following actual specifications as determined at loadport on the basis of samples drawn from shore tanks.
- BUT – what if the product delivered is contaminated with MTBE (methyl tertiary butyl ether) a man made oxygenate product added to gasoline to improve combustion and reduce emissions.
- Contamination with a serious level of MTBE (the contract actually specified no more than 10 parts per million and the actual contamination was 100 parts per million) means the Buyer can claim that the product is no longer "Port Harcourt Refinery naphtha quality"; it is contaminated product. The Buyer is therefore entitled to reject the cargo.

Loss

- Under English law, to be able to successfully sue for damages, the Seller must prove its loss. The Seller must prove that:
  - the breach of warranty caused a loss and
  - ascertain the value of that loss.

The buyer's rights and obligations in rejecting a cargo

- Failure to reject the cargo in a '*timely manner'* may result in the Buyer being too late to reject, but generally there is plenty of time to claim damages, provide the time limit is met. Under English Statute this is generally 6 years unless specified otherwise in the contract.

The buyer's rights and obligations in rejecting a cargo

- What are the Buyer's obligations to reject the cargo in a timely manner?
- *The UK Sale of Goods Act* (1979) says:
- **Acceptance**
  35. (1) Subject to subsection (2), the buyer is deemed to have accepted the goods -

  (a) when he intimates to the seller that he has accepted them; or

  (b) when the goods have been delivered to him and he does any act in relation to them which is inconsistent with the ownership of the seller.

The buyer's rights and obligations in rejecting a cargo

- 2) Where goods are delivered to the buyer and he has not previously examined them, he is not deemed to have accepted them under subsection (1) until he has had a reasonable opportunity of examining them for the purpose —
- (a) of ascertaining whether they are in conformity with the contract; and
- (b) in the case of a contract for sale by sample, of comparing the bulk with the sample. (….)
- The buyer is also deemed to have accepted the goods when after the lapse of a reasonable time he retains the goods without telling the seller that he has rejected them (Section 4 of the Act).
- Importantly, the buyer is not deemed to have accepted the goods merely because the goods are delivered to another under a sub-sale (section 6(b) of the Act).

- **34.** Unless otherwise agreed, when the seller tenders delivery of the goods to the buyer, he is bound on request to afford the buyer a reasonable opportunity of examining the goods for the purpose of ascertaining whether they are in conformity with the contract and, in the case of a contract for sale by sample, of comparing the bulk with the sample.

Independent Inspector

- In oil trading contracts, the product is inspected by an independent inspector who produces a certificate of quality which:
  - entitles the buyer to reject, if the product is off-spec and in breach of description; and
  - records the actual quality of the product delivered for purposes of measuring damages.
- What if the independent inspector gets it wrong?
- In *Alfred Toepfer v. Continental Grain Co*. Ct App [1974] Lloyd's Rep p11-16, the High Court composed of Denning L, Cairns LJ and Roskill LJ held:

  "Where a certificate is to be conclusive as to the quality of goods, the buyer will be precluded from recovering damages from the seller, if, contrary to the statement contained in the certificate, they are not of the contract quality, even if, in fact, the person giving the certificate has been negligent in making it."

Summary

- A buyer is allowed to reject goods where they fail to meet a condition of the contract, such as description, and allowed a reasonable time to do so.

- Once “a reasonable time” has elapsed and the buyer has not rejected the goods, the only remedy is to sue for damages.

- *NB - if the goods are only in breach of the quality and not description, then the goods cannot be rejected, although resultant damages may be claimed.*

Breach of warranty

The *Sale of Goods Act* 1979 says at Section 53:

- (2) The measure of damages for breach of warranty is the estimated loss directly and naturally resulting, in the ordinary course of events, from the breach of warranty.
- (3) In the case of breach of warranty of quality such loss is prima facie the difference between the value of the goods at the time of delivery to the buyer and the value they would have had if they had fulfilled the warranty.

The measure of damages

- Devlin J said in Kwei Tek Chao v British Traders and Shippers Ltd [1954] 2 QB 459,489:
  - *" What is contemplated is that the merchant buys for re-sale, but if the goods are not delivered to him he will go out into the market and buy similar goods and honour his contract in that way. If the market has fallen he has suffered no damage; if the market has risen the measure of damages is the difference in the market price. If, for example, a man sells goods of special manufacture and it is known that they are to be re-sold, it must also be known that they cannot be bought in the market, being specially manufactured by the seller. In such a case the loss of profit becomes the appropriate measure of damage..... the measure of loss of profit on re-sale is the right measure."*

Exclusion clauses

KG Bominflot Bunkergesellschaft Für Mineralöle mbh & Co KG v. ***Petroplus Marketing AG***

- Clause 18 of the contract:
  - "*There are no guarantees, warranties or representations, express or implied, or (sic) merchantability, fitness or suitability of the oil for any particular purpose or otherwise, which extend beyond the description of the oil set forth in this agreement*."
- The judge at first instance held:
  - Because the word "condition" was not included in clause 18, conditions ordinarily implied by the Sale of Goods Act did not form part of the exclusion clause above. The implied conditions survived the clause.
  - The implied condition that Bominflot wanted to have included in the contract was that the goods should have been fit to stand the voyage in a standard shipping contract and arrive intact and merchantable.
  - The trial judge agreed.

Exclusion clauses

- On appeal Rix LJ held that:
  - no such condition could be implied
  - if such condition could be implied, it would not be excluded by clause 18 which merely excluded warranties, guarantees or representation and the word condition had to be specifically mentioned

- Rix LJ said that had he not been bound by the firm line of authority to the effect that to exclude conditions one had to mention conditions specifically he would have ruled that excluding warranties, guarantees and representations would be enough to also exclude conditions.

Don't exclude too much!

- *Eg: " Neither party shall be liable for any consequential, indirect or special losses or special damages of any kind arising out of or in any way connected with the performance of or failure to perform the agreement. Neither the seller nor the buyer shall in any circumstances be liable for;*
  - *more than the difference between the contract price and the market price;*
  - *any loss of profit;*
  - *cost of overheads thrown away;"*
- The Seller will generally wish to limit liability by excluding losses, whereas
- The Buyer will generally wish maximise what it can claim by way of damages due to problems with delivery or off-spec products.
- While this cuts both ways (ie: the Seller will limit its own recoverable losses as well as the Seller's recoverable losses), the Seller will generally have limited losses to recover in most typical Sale Contract situations.

Exclusion clauses

CHOIL TRADING SA v. ***SAHARA ENERGY RESOURCES LTD***

- Choil Trading SA the Claimant purchased naphtha from Sahara Energy Resources SA, the Defendant, FOB port Harcourt in Nigeria.
- Because of the problems with the shore pump, approximately 200MT of excess cargo was loaded causing the vessel's draft to exceed 9.2 metres, the maximum prescribed draft.
- The shore refused to take the excess back ashore. When the excess cargo was finally discharged back to the shore the vessel was arrested by the customs officials because certain customs formalities were not fulfilled. Significant demurrage was incurred at Port Harcourt due to the delay whilst the port refused to take back the cargo.
- Tests indicated that the cargo contained an abnormally high quantity of Methyl Tertiair Buthyl Ether (MBTE).

Exclusion clauses

- The Claimant eventually managed to resell to Blue Ocean Associates limited, but only after the P & L spreadsheet for the deal showed a loss of a total of USD 2,625,336. The Claimant resold the cargo to mitigate its losses and claimed damages including: the additional cost of further testing, additional freight that had to be paid to charter the vessel to go to a different port, deviation costs incurred at the demurrage rate whilst the vessel waited for instructions, insurance costs, the demurrage incurred whilst awaiting discharge of some of the cargo at Port Harcourt, and the difference between the sale contract price and the market price, taking into account hedging losses.
- The Claimant argued and the court agreed that the high quantity of MTBE was a breach of "implied conditions" by the Defendant. The issue then arose as to what damages should be awarded.

Exclusion clauses

- Clarke J held:
- *"Clause 13 of the 20th July terms provides:*
  - *"Neither party shall be liable for any consequential, indirect or special losses or special damages of any kind arising out of or in any way connected with the performance of or failure to perform the agreement.*
  - *Neither the seller nor the buyer shall in no circumstances be liable for; -more than the difference between the contract price and the market price; -any loss of profit; -cost of overheads thrown away; or –loss resulting from shut-down of seller's plant.*
- *I do not regard the damages so far discussed as consequential, indirect or special. Such a limitation covers damages within the second limb of Hadley v Baxendale (1854) 9 Exch 341l see Watford Electronics Ltd v Sanderson CFL Ltd [2002] FSR 19. The damages in issue constitute the difference between the sound arrived and damaged values of the goods as well as the estimated loss directly and naturally resulting, in the ordinary course of events, from the breach of warranty together with the reasonable costs of mitigation."*

Exclusion Clauses & The Sale of Goods Act

- In applying the *Sale of Goods* Act section 53 (3) measure of "*the difference between the value of the goods at the time of delivery to the buyer and the value they would have had if they had answered the warranty,*" Justice Clarke noted that this is only the *prima facie* measure. The basic measure is "*the estimated loss directly and naturally resulting, in the ordinary course of events, from the breach of warranty."* In the Prem Mala, that loss is the value of the goods, had they been sound, less whatever the buyer can sell them for. The judge noted that a number of factors naturally and directly flowed from the delivery of the off-spec cargo and awarded the Claimant's additional costs so incurred, including:
  - Additional freight involved in discharging in a different port,
  - deviation costs because of the need to wait while further testing of the off-spec product was being done
  - Additional survey costs,
  - Insurance costs, all totalling $ 505,160.36

Hedging losses

- The law on hedging losses, in a nutshell, is that hedging losses may generally be included in damages, depending on the precise wording of the contract, insofar as it is possible to clearly identify particular losses and link them to a particular deal. Hedging losses are of course, effectively a specific insurance package against violent market movements and it can generally be presumed that most oil trading companies will hedge and will be aware that their trading partners will also hedge. However, where a company can assert and prove to a Court that hedging losses are not a foreseeable part of an industry (difficult for oil traders, but MSC managed to persuade the court that it was so in **The "MSC Amsterdam" Contracts of Carriage** Trafigura Beheer BV v. Mediterranean Shipping Co., [2007] 2 Lloyds Rep 622 (Court of Appeal), then they may not be payable or included as mitigation losses. Where hedging losses were not found to be recoverable as either consequential losses or mitigation losses because they were not foreseeable to MSC.

Hedging losses

- *Addax Ltd v Arcadia Petroleum* [2000] 1 Lloyd's Rep 496 : "there is no sensible or commercial reason why the Court should not take into account the costs of the hedging instruments". In that case, the judge held that if he had been measuring the claimant's position vis-à-vis their suppliers, he would have taken into account their hedging losses as costs.
- Recalling the 2nd part of the clause used in the "Prem Mala" Choil Trading SA v Sahara Energy Resources Limited [2010] EWHC 374:
  - *"Neither the seller nor the buyer shall in no circumstances be liable for; - more than the difference between the contract price and the market price; -any loss of profit; -cost of overheads thrown away; or –loss resulting from shut-down of seller's plant."*
- The judge discounted a portion of the Claimant's hedging losses (that the Claimant was unable to fully explain based on its internal spreadsheet) and credited the Claimant with the balance of its hedging losses in analysing the Claimant's overall position in light of the Defendant's breach. The Defendant argued that the hedging losses were inconsequential, indirect or special.

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