Commodities

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COMMODITIES BULLETIN

Who wants to live forever? Events of Default under the ISDA Master Agreement

The latest in a growing number of decisions on the interpretation of the 1992 ISDA Master Agreement (the "Master Agreement") was handed down by the English Court of Appeal earlier this month. The appeal from the judgment in *Lomas v JFB Firth Rixson* was heard with those from *Pioneer Freight Futures Company Limited (in liquidation) v Cosco Bulk Carrier Company* and two others. ISDA was granted permission to intervene. Judgment was delivered on 3 April 2012.

The most interesting issue arising in the appeal concerned the interpretation of Section 2(a)(iii) of the Master Agreement, which states that if a party is affected by an Event of Default (as defined in Section 6), the other party is under no obligation to make payment of sums which would otherwise fall due on that date. Section 2(a)(iii) therefore suspends a Non-Defaulting Party's payment obligations to protect it from the credit risk of paying a party that may be unable to fulfil its payment obligations in return. The Court of Appeal's judgment provided guidance on the effect of this suspension and, in particular, whether it extinguishes the obligation to make payment or suspends it and, if so, for how long.

In the High Court in *Lomas*, Briggs J held that Section 2(a)(iii) is suspensory in nature but that if the Event of Default remains at the expiry date of the transaction, the obligations of the Non-Defaulting Party are extinguished. However, in another High Court matter, *Marine Trade v PFF*, Flaux J held that if there is an Event of Default on the date when payment would have fallen due, the Non-Defaulting Party never has an obligation to pay.

In *Lomas*, the Court of Appeal confirmed that Section 2(a)(iii) is suspensive and that suspension of payment obligations continues indefinitely, or at least until such time as the Non-Defaulting Party chooses to designate an Early Termination Date, regardless of the

final payment date of any particular transaction. This overturns the High Court's finding that payment obligations suspended by Section 2(a)(iii) are extinguished on the last date for payment, and a finding in the Cosco case that transactions whose term has expired at the time of early termination are not to be taken into account when calculating the amount due on early termination.

The Court of Appeal also provided helpful clarity on Section 2(c) netting, which had been the subject of conflicting first instance decisions. In *Marine Trade*, Flaux J held that amounts which would otherwise be owed to a Defaulting Party should not be taken into account for the purposes of netting so that a Non-Defaulting Party was entitled to payment on a gross basis. In *PFF v TMT (No.2)*, Gloster J had reached the opposite conclusion. The Court of Appeal confirmed that Gloster J's interpretation was correct, with the result that calculation of amounts that would otherwise fall due on the same date should to take place on a net basis. The Section 2(a)(iii) suspension of payment takes effect only once the net amount payable has been determined. Section 2(c) netting does not however apply to payments falling due on different dates.

Several aspects of Gloster J's analysis in *PFF v TMT (No.1)* and *PFF v TMT (No.2)*, in which HFW acted for PFF, were also approved: first, that the Master Agreement provides for netting of payments both throughout the life of transactions under Section 2(c) and on Early Termination or Automatic Early Termination under Section 6; and second, that the Master Agreement distinguishes between payment and debt obligations. The debt obligation arises irrespective of whether a party is affected by an Event of Default and remains in existence. Section 2 only addresses the obligation to pay, which can be suspended by an Event of Default.

The Court of Appeal's judgment has clarified several much-debated aspects of the Master Agreement and has provided clarity to derivatives traders. The judgment has been welcomed by ISDA and, to the extent that it protects the expectation interest of parties who enter into derivatives transactions, should be welcomed by the market in general. It is not yet known whether there will be an appeal to the Supreme Court.

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Chartering by conduct and London arbitration proceedings: the importance of documents

Identifying contractual documents for the purposes of bringing claims in arbitration can cause difficulties, particularly where parties have traded for several years. In *Finmoon Limited and another v Baltic Reefer Management Ltd and others* (17 April 2012) the English High Court was required to decide several questions arising from such circumstances: (1) whether claimants had entered into a contract of affreightment ("COA") with Baltic Reefer Management ("BRM"); (2) whether BRM had contracted as principal or as an agent for the other respondents; and (3) whether arbitration had been validly commenced. The Court also considered the circumstances in which a bill of lading is a mere receipt, rather than the contract of carriage, in a cargo receiver's hands.

COA

The claimants transported cargoes of bananas on vessels owned by individual one-ship owners (the second to ninth respondents) under a COA signed by BRM. For the period in question, no signed COA was executed. Various claims arose for damage to cargo. The claimants started twelve arbitrations in London. The respondents argued that, whilst there were individual charterparties between the registered owners of the vessels and the claimants, BRM had contracted as agent only and no COA had been concluded.

The Court found that a valid COA was in place by the conduct of the parties looked at as a whole. The fact

that the claimants were unable to point to a specific point in time when the COA came into existence was not a fatal flaw to finding a contract by conduct.

Principal or agent?

BRM, having signed the COA and affixed its company seal as "owners" without qualification, was found to have been contracting as principal and not as agent for the registered owners. The Court also noted that it would be difficult to conceive of a COA creating contractual obligations for one or more members of a group of shipowners where that group was not identified with any precision.

Bills of lading

The bills of lading were issued by ships' agents at the loadport. The second claimant was named as the consignee. The bills of lading incorporated arbitration clauses from variously dated charterparties, but no charterparties bearing the relevant dates had ever been drawn up, and the Court found that no such charterparties in fact existed.

The Respondents submitted that they were not bills of lading within the scope of section 2(1) of the Carriage of Goods by Sea Act 1992 because they were "straight" bills - i.e. they could not be negotiated. Once issued, the bills of lading were released to the named shipper, who returned them to the loadport agents marked "NULL AND VOID". The owners were instructed to draw up new bills of lading at the discharge port, with the consignee's agent's details. The arbitral tribunal had found that, there never being any intention of negotiating the loadport bills of lading, they were mere receipts, and the consignee never became their lawful holder.

The High Court reversed this finding, observing that the practice of surrender, cancellation and reissue of bills of lading is not uncommon. For example, this practice may be used when a shipment is to be split between a number of sub-buyers, or to ensure that bills arrive at the discharge port in time to avoid any delay in discharge. It is well established in English law that a contract of carriage may not only be contained in but also evidenced by a bill. The Court found that although the loadport bills ceased to have validity, they were replaced by the discharge port bills, which were issued on behalf of the owners and became valid bills binding on the owners and containing or evidencing the original contract of carriage.

Arbitration

The final issue considered by the Court was whether arbitration had been validly commenced against BRM under the COA. Section 14(4) of the Arbitration Act 1996 provides as follows:

"… arbitral proceedings are commenced in respect of a matter when one party serves on the other party or parties a notice in writing requiring him or them to appoint an arbitrator or to agree to the appointment of an arbitrator in respect of that matter."

The Court found that the modern view of this statutory provision is that it should be interpreted broadly and flexibly. The test is whether it is clear on objective grounds that arbitration in respect of the relevant dispute has been commenced. Notice commencing arbitration will not be invalidated if, as happened in this case, the claimants referred to the wrong contractual document.

The Court held that it was plain that the disputes submitted to arbitration were the claimants' claims for damage to the cargoes of bananas that were carried on the disputed voyages. The Court observed that, at most, the error made by the claimants was to refer in the notices commencing arbitration to charterparties of specific dates, being the dates that the respondents themselves had inserted in their bills of lading as being the contracts of carriage pursuant to which the damaged cargoes were carried.

The result of the judgment is that the claimants may now proceed with their claims for damage to twelve cargoes of bananas in the London arbitration, as originally commenced against all respondents.

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Oil majors approvals

In *Transpetrol Maritime Services Ltd v SJB (Marine Energy) BV (The Rowan)* (29 February 2012), the English Court of Appeal considered whether a ship owner's warranty that a vessel had oil majors approval was a continuing one or was limited to the owner's knowledge at the time of entering into a charter.

SJB (Marine Energy) BV ("Charterers") chartered a tanker from Transpetrol Maritime Services Ltd ("Owners") on a voyage charter for the carriage of oil products from the Black Sea to the US Gulf. The charter terms were recorded in a recap email which incorporated the Vitol Voyage Chartering Terms 1999 (the "Vitol Terms") with amendments.

Clause 18 in the Vitol Terms states, "Owner warrants that the Vessel is approved by the following companies and will remain so throughout the duration of this charterparty..."

Clause 18 in the recap stated, *"TBOOK VSL APPROVED BY:- BP/ EXXON/LUKOIL/STATOIL/MOH"*, "TBOOK" being an abbreviation of "to the best of owners' knowledge".

En route to the US Gulf, charterers exercised an option to call at Antwerp. Whilst there, owners invited Shell, which was not among the oil companies listed as having "approved" the vessel in the charterparty, to inspect the vessel. Shell carried out an inspection and issued a SIRE report with numerous adverse comments.

Charterers agreed to sell the cargo to Shell, subject to vetting. After reviewing the SIRE report filed by colleagues in Antwerp, Shell rejected the vessel and the cargo.

Charterers claimed damages from owners for the difference between the price originally agreed with Shell and the price ultimately obtained, on the grounds that owners were in breach of their charter warranty. Charterers argued that at Antwerp the vessel was not in a fit state to be approved by any oil major and, in particular, the five majors identified in the charter.

The English High Court found in charterers' favour, deciding that the recap should be read as consistent with Clause 18 in the Vitol Terms and so providing an express, continuing warranty of oil majors approval for the duration of the charter. The High Court concluded that owners had warranted that the vessel was approved by five oil majors and that those approvals would remain in place *throughout* the charter. It agreed with charterers that none of the five named oil majors would have continued to approve the vessel in the light of the problems identified at Antwerp.

The Court of Appeal allowed owners' appeal. Giving the leading judgment, Longmore LJ found that the wording in the recap had entirely replaced Clause 18 in the Vitol Terms, and that Clause 18 should not be used, by reference, to expand the scope of the recap wording. The recap wording did not provide a warranty that oil major approvals would be maintained for the duration of the charter, and was instead limited to the time of agreeing the charter.

The Court of Appeal held that the abbreviation "TBOOK" meant that at the date of the charter, owners had approvals from the named oil majors and knew of no facts that would cause the vessel to lose those approvals during the charter. The problems with the vessel were not known to owners when the vessel departed from the Black Sea, and only came to light at Antwerp. There was no evidence that the owners knew anything at the date of the charter that would cause the oil majors to "disapprove" the vessel or alter the terms of their approval.

The Court of Appeal's decision is a reminder that charter terms will be interpreted strictly, on the assumption that traders and ship operators have the knowledge and experience to agree terms with precision. Traders should not expect English courts, or arbitrators, to take a relaxed view of the scope of stated rights and obligations, even where terms are agreed in informal, abbreviated language in email recaps. Since oil major approval warranties should continue throughout shorter charter periods if they are to work effectively, their continuing nature should be clearly stated in the charter, in whatever form it is agreed or recorded.

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Conferences & Events

Commercial and Legal Issues Under Long Term Contracts
University of Western Australia
(4 May 2012)
Chris Lockwood

Security for claims v Enforcement of judgments and awards
HFW Geneva
(8 May 2012)
Matthew Parish

International Bills of Lading Course Practical guide for combating key commercial issues
Bonhill House, London
(14-16 May 2012)
Matthew East and Tara Johnson

HFW/Quadrant Chambers
Mock arbitration on oil trading dispute
Metropole Hotel, Geneva
(15 May 2012)
Brian Perrott and Jeremy Davies

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