

Global commodity price falls and challenges to sale contracts

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INTRODUCTION

The dramatic fall in global commodity prices has resulted in historically low prices in the first months of 2015 (see box, *Global commodity price falls: commercial background*). Price fluctuations and market volatility present various opportunities and significant challenges to those engaged in global trade, but particularly to those in the price sensitive commodities markets where even relatively small shifts in the market can result in considerable loss or profit for traders. Traders seek to manage, exploit and mitigate the volatility of the markets through the contracts they enter into.

In the current economic climate, buyers facing a large and increasing gap between previously agreed long-term sale contracts and the more favourable spot deals on offer in the prevailing market are more likely to default. In such circumstances, contractual disputes (genuine or constructed) proliferate as buyers look to challenge sale contracts to avoid remaining tied into uncompetitive contracts. This is not new to the commodity trade. For example, in 2010 and 2012, significant price falls in the iron ore and coal markets resulted in widespread and high profile defaults from Chinese buyers who then re-purchased products at lower prices. Many immediately defaulted again to take further advantage of continuing falling markets. The number of distressed cargoes in the Asia-Pacific market increased quickly, in turn encouraging traders to conclude fire sales, which did little to stem the tide of surplus product (and consequently falling prices).

This article considers the areas buyers are likely to challenge to escape an unprofitable contract. This includes challenging:

- Whether the buyer is under a contractual obligation to perform.
- Whether the seller is in breach of contractual conditions or warranties.
- Whether the seller has shipped contractual goods.
- Whether the seller is in breach of its delivery obligations.
- Whether the seller is in breach of its documentary obligations.

This article also examines the default and notice provisions a buyer must comply with before seeking to terminate a contract.

Many of the world's main commodity trade associations (for example, the Grain and Feed Trade Association (GAFTA), Federation of Oils, Seeds and Fats Associations (FOSFA), Refined Sugar Association (RSA) and London Metal Exchange (LME)) are based in London and issue standard form contracts that the parties can adopt (amended or unamended). These provide for disputes to be arbitrated before experienced members of the trade. The contracts are governed by and decided in accordance with English law, even where parties are based on opposite sides of the world. Accordingly, this article assumes that English law is applicable to the sale contract.

BUYER UNDER A CONTRACTUAL OBLIGATION

Spot contracts: main issues

The first (possibly most obvious) question buyers will examine is whether they are, in fact, under any contractual obligation to perform at all. In assessing whether the parties are bound contractually, it is necessary to consider the standard English law principles of offer and acceptance that apply to commodity contracts, as to any other contract subject to English law. However, in a classic spot deal where the speed of the market requires the parties to agree the main terms and leave details (some of which may be important) to be discussed and agreed later, the question of whether and precisely when the parties entered into a formal contract is often open to argument. It is not uncommon for parties seeking to escape contractual obligations to seek to take advantage of a perceived lack of clarity in the contract negotiation process. Such process is often conducted through brokers and between parties in different jurisdictions who may be communicating in a language in which they are not necessarily fluent.

The Commercial Court decision in *Proton Energy Group SA v Orlen Lietuva* highlights the principles to be applied in deciding whether a binding contract has been reached between traders. The disputed contract concerned the sale of crude oil mix. A rapid series of "quick fire" e-mail exchanges (common in the commodity trade) culminated in a one word e-mail from buyers to sellers stating: "confirmed". The buyers subsequently refused the cargo and did not open a letter of credit. The sellers argued that they were in repudiatory breach of contract and claimed damages.

The judge held that the question to be decided was whether the parties had agreed on all the terms they objectively regarded as essential for the formation of legally binding relations between them. The judge decided that there was a contract, having reviewed the various exchanges between the parties. The sellers had made a firm offer that the buyers had accepted with the word "confirmed". On the facts, the judge decided that this demonstrated an intention to be bound. Although there were continuing discussions, these only related to ancillary details left to further negotiation. An e-mail from the sellers stated that "all other contractual terms not indicated into the offer shall be discussed and mutually agreed between parties upon contractual negotiations". This further indicated an intention to be bound. The judge rejected the argument that this meant no contract had been agreed and contractual negotiations were still to come. The performance of the contract was required within strict time constraints (a vessel had to be nominated within days, with delivery taking place within a couple of weeks). The offer was made in such terms that acceptance was required the same day. The nature of the deal therefore required the parties to make a binding commitment immediately, even if details remained to be discussed and agreed later.

For a binding contract to exist, and to be enforced, the terms must be certain. Parties must ensure that their agreement is complete,



does not lack essential terms and is otherwise not uncertain, vague or ambiguous. Where the parties intend to contract but leave ancillary details to be agreed at a future date (as often happens in the commodity trade), it is important to ensure that the agreement does not lack important or fundamental components as it will otherwise be considered incomplete and will only amount to an "agreement to agree". These agreements are usually held to be unenforceable, giving a buyer an easy way of exiting an unprofitable deal.

If a contract is not evidenced in writing, it will be necessary for the arbitrators or the court to review all the relevant exchanges between the parties. It will also usually be necessary to obtain detailed witness statements from the parties involved. In these circumstances, a buyer will do everything possible to argue that no contract was agreed, and could potentially allege that:

- Signatories to the agreement were not authorised to bind the company.
- Such signatories had exceeded their authority.
- The terms of the contract were significantly different from those the seller argues are applicable.

In a falling market, the seller is well advised to set out contractual terms unambiguously from the outset and to ensure that the counterparty has the necessary authority to sign on behalf of the company, so that the above arguments can be avoided or robustly rejected.

Force majeure

It is common for international trade contracts to contain clauses allowing suspension or termination on the occurrence of a force majeure event. Market price falls are occasionally cited as falling within such clauses, excusing non-performance. The position under English law is that price falls do not usually constitute a force majeure event. Price fluctuations are common in the commodity markets and therefore lack an essential characteristic intrinsic to force majeure, namely that the event must not be reasonably foreseeable at the time of contracting.

SELLER IN BREACH OF CONTRACTUAL CONDITIONS AND WARRANTIES

Assuming that the buyer is bound by a sale contract, it is necessary to consider which breaches of the contract will entitle the buyer to terminate, and those that will not.

Traders need to allocate risks and expenses involved in the sale and transportation of goods from one country to another. The International Chamber of Commerce (ICC) publishes standard international commercial terms (Incoterms) for international sales. The terms most commonly used in the commodity trade are "Free on Board" (FOB) and "Cost, Insurance and Freight" (CIF) terms. Many of the key terms in FOB and CIF contracts are treated as conditions, such as clauses relating to:

- Shipment (including the time and place of shipment).
- The tender of documents.

The general rule is that if the seller is in breach of a condition, the buyer can terminate the contract, even if the harm caused by the breach is minor. Conditions may be express or implied (for example, under the Sale of Goods Act 1979, as amended (Sale of Goods Act)). Conditions must be distinguished from both:

- Warranties, the breach of which gives rise to damages for the innocent party.
- Innominate terms, the breach of which will only entitle a buyer to terminate if the breach goes to the root of the contract.

Many buyers who are seeking to escape a bad bargain in a falling market will therefore focus on defining the seller's breach as a breach of condition.

Consequently, sellers must ensure that they strictly comply with the terms of the contract, in particular with conditions, to avoid presenting a buyer with the opportunity to exploit any breach and terminate the contract. In practical terms, this means that a seller should ensure that:

- The goods correspond to the contractual specification.
- Shipment periods are complied with.
- Any documents are issued in compliance with the contract.
- Any nomination, appropriation or other notice obligations are met.

SELLER SHIPPED CONTRACTUAL GOODS

Contractual terms relating to the goods

It is of obvious importance in international trade, particularly in the commodity trade, where goods are sold between parties on opposite sides of the world and often sold in transit before a buyer can examine them, that the seller complies strictly with the obligation to ship precisely the goods that they agreed to sell to the buyer.

To promote commercial certainty, contractual terms relating to the goods are viewed as fundamental to the contract so that their breach gives the buyer the option to reject the goods and terminate the contract.

English law implies three types of conditions into all sale contracts:

- The goods must correspond with their description (*section 13, Sale of Goods Act*).
- The goods must be of satisfactory quality (*section 14, Sale of Goods Act*), which includes their:
 - state;
 - condition;
 - fitness for all purposes for which goods of the kind in question are commonly supplied;
 - appearance and finish;
 - freedom from minor defects; and
 - safety and durability.
- Goods sold by sample must correspond with the bulk and be free from any qualitative defect that would not be apparent on reasonable examination of the sample (*section 15(2), Sale of Goods Act*).

Allowances/margins

It is common place in the commodity trade for the parties to agree allowances, margins or price adjustments without which the seller would otherwise be in breach of contract. It will not usually be possible for a buyer to terminate a contract where such margins or adjustments apply. The parties, by including the margin, will usually be taken to have agreed that the relevant clause is not to be treated as a condition of the contract. This restriction can lead to a buyer seeking to categorise a breach with respect to quality as a breach of contractual description (a condition that gives rise to the right to terminate).

Inspection certificates

Commodity contracts invariably provide that the price is payable on sight of an inspection certificate issued at shipment by an independent inspection agency. Where payment is made by letter of credit, these certificates are usually tendered by the seller to the buyer's bank before payment. The contract often makes these certificates final and binding on the parties. The buyer has assurance that the goods shipped accord with the contract. The seller has protection against a buyer subsequently alleging that the

goods were defective. A valid certificate that the goods meet the contractual specification is conclusive evidence that the seller has complied with its obligations.

The options for a buyer seeking to avoid a certificate final clause are limited. It is important a seller ensures that any contractually agreed testing procedures are adopted by the inspection agency; otherwise the use of incorrect testing methods will mean that the certificate does not bind a buyer. Many commodity contracts incorporate specific sets of standard and approved rules relating to testing procedures that, if followed, will limit challenges from buyers.

However, if a certificate is said to be "final as to quality", it may not protect the seller if the goods supplied are of the wrong description. Much turns on the precise wording of the contractual clause and the certificate itself (see above, *Contractual terms relating to the goods*).

Buyers successfully challenged the certificate final issued on shipment in the *Bow Cedar* case, heard by FOSFA. Sellers sold 500 tonnes of groundnut oil FOB to the buyers. The contract provided: "weight and quality final at loading as per certificate of independent surveyors". The shipment was certified regarding samples of crude groundnut oil and given an analysis regarding acidity and moisture. On discharge, the shipment was in fact a mixture of groundnut oil and soybean oil. The buyer claimed damages, being the difference between the value of sound oil and the sale price of the mixture. The sellers relied on the certificates as being final and conclusive. The Commercial Court held that it was clear from the form and layout of the certificates that what was in fact being certified was the result of the chemical analysis undertaken and not the commodity being analysed. Even if the certificates did certify the commodity (which the judge thought they did not), the certificates were final as to the quality and not the identity of the commodity itself. The certificate was accordingly not binding on the buyers.

SELLER IN BREACH OF DELIVERY OBLIGATIONS

Seller's delivery obligations

A seller has the basic duty to deliver the goods in accordance with the terms of the contract of sale (*section 27, Sale of Goods Act*). In international commercial sales, this duty is discharged through physical delivery of the goods. The buyer is also under a documentary duty to tender contractual documents. These duties are independent of each other. A buyer looking for a way out of the contract will carefully review the seller's conduct in respect of both obligations.

CIF contracts. The duties of a CIF seller are to ship (or procure the shipment of) goods in accordance with the contract or, where necessary, appropriate such goods to the contract (see below, *Appropriation of goods to the contract*). The seller has the obligation to procure or prepare shipping documents that must be tendered to the buyer, or as the buyer directs, in accordance with the contract. The CIF seller is under no duty to ensure physical delivery of the goods at destination, although he must not take active steps to prevent delivery.

Provisions on the timing of delivery in international trade contracts are of the essence. Unless the parties have agreed otherwise, failure by the seller to deliver within the delivery period will entitle the buyer to terminate the contract.

FOB contracts. In a basic FOB contract, the buyer is required to present a ship at the load port in time to enable it to complete loading within the stipulated period for delivery. Assuming the buyer has complied with their contractual obligations regarding nomination of the vessel, and subject to the vessel arriving within the time set out in the contract, the seller must load the complete cargo before the end of the delivery period. Alternatively, the contract may provide for loading to be at the buyer's option, which

in practice usually requires the seller to have the cargo ready for loading immediately on the vessel's arrival at the load port.

A failure by the seller to load the complete cargo within the delivery period (or to have the cargo ready for loading on the vessel's arrival) may provide the buyer with grounds to reject the delivery and terminate the contract.

Laycan periods

In CIF contracts, buyers often overlook or misapply provisions relating to a laycan period (that is, a period of time within which the vessel should arrive at the load port, ready to load). A laycan period must be distinguished from a shipment period (see *SHV Gas Supply & Trading SAS v Naftomar Shipping & Trading Co Ltd [2006] 1 LLR 163*). In the case of delay by the seller, subject to the precise wording of the contract, damages in the form of demurrage may be recoverable, whereas termination of the contract is unlikely to be available to the buyer.

Buyers on CIF terms must therefore exercise caution when declaring sellers in default for late shipment. Many commodity contracts provide sellers with an automatic right to serve notice of extension of the shipment period against deductions to the purchase price. For example, clause 10 of FOSFA Contract 11 provides as follows:

"When the contract shipment period does not exceed 31 days the period of shipment can, at the request of the shipper, be extended by an additional period not exceeding 8 days, provided notice is given to the Buyer by any means of rapid written communication, of his intention to claim such extension not later than the first business day following the last day of the original contract shipment period. Successive Buyers must pass on this notification with due despatch. The Seller need not state the number of additional days claimed, but the contract price shall be reduced as follows by: ½% for 1, 2, 3 or 4 days, 1% for 5 or 6 days, 1 ½% for 7 or 8 days. If the Seller requests an extension and fails to ship within the 8 days, the original contract shipment period shall be considered to have been extended by 8 days and the contract price reduced by 1 ½%."

If the buyer seeks to terminate the contract for late delivery before the seller exercises any right to serve notice to extend the shipment period, then the buyer will be in repudiatory breach of contract.

Nomination of the vessel

CIF contracts require a seller to:

- Ship on board the carrying vessel goods that correspond to the contract description and quality.
- Contract with a carrier.
- Present shipping documents.

These basic obligations are invariably supplemented by specific terms that require the seller to provide additional details to enable the buyer to ensure that arrangements are in place to receive the goods at the port of discharge.

A seller will usually be required to provide notice of nomination of the vessel that is to undertake the carriage. For example, under GAFTA Contract No. 100 (GAFTA 100) (clause 9), the seller must nominate the intended carrying vessel to the buyers "at a date agreed between the parties but in any event prior to the commencement of loading".

If the contract specifies a date or time by which the notice of nomination must be given, it is well established that this is to be treated as a condition of the contract. It follows that if the seller is late in giving the notice of nomination, the buyer will be entitled to reject that nomination and will not be obliged to accept the delivery.

The seller is generally entitled to remedy a non-compliant nomination by making a further nomination, provided that the

second notice is given within the time specified in the contract. Clause 9(b) of GAFTA 100 provides, "Sellers are entitled to substitute the nomination(s) provided that the substituting vessel (s) complies with the terms of this clause."

Appropriation of the goods

CIF commodity contracts require the seller to appropriate goods to the specific contract with the buyer. This is done by way of a formal notice of appropriation served on the buyer. Such notices require identification of the vessel in addition to the approximate quantity of goods loaded. The date of the bill of lading and port of shipment may also be required.

A notice of appropriation must be served on the buyers within a time limit specified in the contract. The appropriation clause of GAFTA 100 (clause 11) stipulates that notice must be served "within 10 consecutive days from the date of the bill(s) of lading". A seller who fails to provide notice of appropriation within the relevant period will be in breach, entitling the buyer to terminate the contract. A buyer wishing to reject the notice must do so as soon as possible after receipt, by providing written notice to the seller.

A valid notice of appropriation cannot be withdrawn by the seller. However, a defective notice can be rectified, but only if the contractual time limit for serving the notice has not expired. Again, buyers must exercise caution. Purporting to terminate before the relevant time for appropriation has expired and before the seller has exercised any right to cure the defective notice may be a repudiatory breach.

SELLER IN BREACH OF DOCUMENTARY OBLIGATIONS

International trade contracts commonly provide for payment to be made against the tender of documents. In times of market volatility, parties will carefully scrutinise the documents tendered, as any deficiencies in either the timing of tender or the content of the documents could provide grounds for rejection.

Commodity contracts typically call for the tender of:

- A commercial invoice.
- Bills of lading.
- Marine insurance policy.
- Certificates of origin, quality and weight.

Documentary breach arises if those documents are not in conformity with the sale contract. Strict compliance with documentary obligations is important and often a fertile ground for buyers seeking to exploit sellers' breaches.

If the contract specifies a fixed date or period for the tender of documents, or at least specifies a time that can be precisely ascertained from the terms of the contract, the courts are likely to treat such terms as conditions. A failure to tender documents within that time could provide grounds for a rejection by buyers.

Equally, a tender that does not include all of the documents required by the contract will be defective and give the buyer grounds to reject the goods, subject to any contrary provision in the contract. For example, GAFTA 100 (clause 12) requires sellers to present a guarantee, countersigned by a recognised bank, for any missing documents to be delivered at a later date. This however does not extend to defective documents.

A tender that includes documents that are on their face defective may also entitle the buyer to reject the documents. If a clean bill of lading is required, a claused bill will be defective. A bill of lading

that has been incorrectly dated will also be defective. GAFTA contracts (for example, clause 6 of GAFTA 100) provide: "The bill(s) of lading to be dated when the goods are actually on board. Date of the bill(s) of lading shall be accepted as proof of date of shipment in the absence of evidence to the contrary". It is open to a buyer to obtain "evidence to the contrary" in appropriate cases. If a buyer establishes that the vessel did not arrive at the load port until after the contractual shipment period, but the bill of lading was dated on the last day of the shipment period, this would amount to a breach allowing the buyer to reject the documents.

Similarly, a buyer's bank can only refuse payment under a letter of credit where the documents do not conform to its terms. In *Fortis Bank and Stencor v Indian Overseas Bank*, the buyers sought to escape the contract on the basis of non-compliant documents in a falling steel market. When the documents were presented to the buyers' bank, various discrepancies were identified and the sellers' documents were rejected. In particular, certain letters of credit required a certificate from the sellers confirming "that the negotiating bank has been advised to despatch original shipping documents only by air courier service to the LC Opening Bank at our cost". Stencor had in fact presented certificates using the following wording: "that the negotiating bank has been advised to despatch original shipping documents only by air courier service to the LC Opening Bank at issuing bank's cost". By failing to comply strictly with the requirements of the letter of credit, the sellers gave the bank (and the buyers) a justifiable reason to refuse the documents and payment under the contract.

DEFAULT AND NOTICE PROVISIONS

If a buyer can identify a seller's breach entitling him to terminate the contract, it is important that the buyer complies strictly with the relevant default and notice provisions in the contract. Invariably, the buyer will be required to serve notice of default on the seller before terminating.

The GAFTA default clause provides that "in default of fulfilment of contract by either party, the following provisions shall apply: [T]he party other than the defaulter shall, at their discretion have the right, after serving notice on the defaulter to sell or purchase, as the case may be, against the defaulter, and such sale or purchase price shall establish the default price". Default clauses in other trades are broadly similar. For example, the FOSFA default clause states that "[I]n default of fulfilment of this contract by either party, the other party at his discretion shall, after giving notice, have the right either to cancel the contract, or the right to sell or purchase, as the case may be against the defaulter...".

If a contract provides that all notices must be served on the other party by a certain time in a certain manner, then this is how the notice must be served. If the buyer fails to serve such a notice, he may be taken to have waived any right to terminate. Alternatively, if a notice is incorrectly served or served prematurely, there is a significant risk that the buyer will be in repudiatory breach of contract and liable to the seller (see *Gulf Agri Trade FZCO v Aston Agro Industrial AG*). In a falling market, it is essential for a buyer seeking to escape the contract to ensure strict compliance with notice and default provisions (including timing and method of serving requirements), to ensure that a seller in breach is not "let off the hook".

The question for many traders is now to determine when prices will recover. As soon as prices start to rise, sellers will seek to take advantage of rising markets and buyers will seek performance. In circumstances where one party is keen to escape the contract and the other equally determined to hold that party to performance, it is essential for both parties to stay on top of their contracts and to be familiar with their obligations well in advance.

GLOBAL COMMODITY PRICE FALLS: COMMERCIAL BACKGROUND

The figures of the recent global commodity price falls are remarkable. Crude oil prices have attracted the most media attention with falls of 50% since the summer 2014. Falling oil prices are replicated across the sector. The Bloomberg Commodity Index, which tracks 20 commodity prices, continues to reflect a downward trend.

From 2010 until mid-2014, world oil prices remained static, at around US\$110 a barrel. Since June 2014, prices more than halved as a result of:

- Weak demand from Europe.
- A fall in demand from China.
- A significant increase in US production (largely driven by fracking) with production levels at their highest for 30 years.

Brent crude oil fell below US\$50 a barrel for the first time since May 2009, and US crude was recently down to below US\$48 a barrel.

The situation is similar in other sectors. Copper prices, which peaked in 2011, have dropped by nearly 40%. Iron ore prices have fallen from a peak of nearly US\$200 a tonne in 2011 to about US\$61 a tonne in 2015. European sugar prices, which spiked at EUR740 a tonne in January 2013, fell to EUR525 a tonne in July 2014. Global prices also dropped significantly.

Agricultural commodities have declined to their lowest prices for four years. Global supplies have rebounded as a result of:

- Successive price spikes resulting from poor rainfall.
- Drought (which resulted in the 2010 Russian cereals ban).
- Underwhelming crop yields.

The US, the world's largest agricultural products exporter, has had two consecutive years of record-breaking crops, with similar patterns in Canada and Europe. The unrest between Russia and Ukraine has, to date, had a limited impact on global grain markets.

Looking further ahead, the pricing trajectory relevant to each sector naturally depends on specific factors relevant to those markets. It is notable that opinions regarding the evolution of prices are more divergent within each sector than it has been for many years.

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