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English High Court: Successful Hedging Will Reduce Damages Award in Contract Breach

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The recent decision in Glencore Energy UK Ltd v Transworld Oil Ltd*, [2010] EWHC 141 (Comm), is worthy of note for parties to sale agreements governed by English law or who might be considering an English law clause in contract negotiations. Here the Court considered whether a FOB (Free On Board) crude oil sales contract remained open for performance despite product not being delivered within the specified contractual delivery window and how damages should be assessed in the event of a breach by non-delivery.*

Key Issues:

- This case considers in detail the principle of "mutual affirmation"—it confirms that English Courts are likely to find that an implied contract is in place when an express contract expires but the parties continue to deal on identical terms;

- The case affirms that damages for non-delivery of goods contracted for are assessed by the English Court in reference to the difference between the contract price and the value on the date when they should have been delivered to the claimant (and not by reference to the difference between the contract price and the date of the defendant's repudiation or the date the claimant accepted the defendant's repudiation as bringing the contract to an end); and

- Most importantly, it also represents a significant shift in how damages under trading contracts are assessed, establishing the importance of hedging to damages claims under physical contracts. In this case the High Court ruled that a claimant's damages would be reduced to take account of its gains under related hedging contracts, entered into to reduce exposure on a physical purchase. The question whether losses or gains under hedging arrangements should be taken into account when assessing damages for breach of physical contracts to which the hedging relates had been debated for many years (with the Courts typically declining to take them into account) but this case appears to establish a new rule or approach in this regard.

Summary of the Facts:

- In March 2008, Transworld sold a cargo of Nigerian crude oil to Glencore. The specified delivery window was 26-28 March 2008 with the contractual pricing period being 27 March - 2 April 2008.

- Glencore's nominated vessel arrived at the loading terminal on 28 March 2008, but was unable to load the cargo due to the kidnapping of the tug crew attending to the vessel. Glencore's vessel was directed to sail away.

- After the contractual delivery window, the vessel returned with a view to loading the cargo but Transworld declined to do so due to security concerns, arguing the contract had ended.

The High Court Ruling:

- Glencore successfully claimed damages for breach of contract, given evidence (e.g., emails between the parties) on which the Court concluded the parties had agreed that the contract would continue on the same terms (except for the delivery window), including within the agreed pricing period.

- The Court considered that the parties had "mutually affirmed" the contract, with the parties simply varying the contract to allow for later shipment.

- Another factor influencing the Court that the contract remained live was that Glencore had not closed out hedging arrangements which it had entered into to reduce its exposure on the purchase of the oil.

- Damages were assessed by reference to the difference between the contract price and the value of the oil on the date when it should have been delivered to Glencore, reduced to take account of gains under Glencore's related hedging contracts. In sum, the Court found that Glencore had reduced or mitigated its losses under the physical contract when it eventually closed out the hedging positions, and the defendant was entitled to the benefit of this mitigation. Or, in other words, the claimant was only entitled to its actual net loss.

Implications of Decision:

This case may provide useful guidance on various issues that traders in a good or commodity may face from time to time under contracts governed by English law, for example:

- How should a party ensure a contract has expired and is not "mutually affirmed" and continuing to one’s detriment?

- Conversely, how could a party seek to ensure that a contract is continuing post-expiration to its benefit or to the detriment of a supplier/customer?

- What is the best way to approach hedging in the context of a physical contract?

- How can a party maximise the damages payable to it in the event of non-delivery?

- How can a party minimise the damages payable to a claimant in the event of non-delivery?

- Where hedging is a generally accepted commercial practice in a particular commodity or market, will the failure to hedge or offer proof on hedging now be considered a failure to mitigate or properly prove up damages?

If you have any questions about the content of this advisory, please contact the Pillsbury attorney with whom you regularly work or the authors below.

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