Energy, Trade & Commodities

ReedSmith Richards Butler

Recovering Hedging Losses as Damages

Introduction

In recent years the commodities market has witnessed a significant increase in the use of commodity derivatives as a means of hedging against market volatility. The common experience is that commodity derivatives are a vital tool in preserving profit and managing the effects of volatility to which businesses that depend on commodities are vulnerable.

Except in purely speculative trading, commodity derivatives are invariably connected to a physical position. A commodity trader or user will commonly match his physical exposure upon the inception of a market risk by entering into a corresponding derivative, such as a future, option or swap. The latter will then act as a "hedge" against a movement in market prices and thus stabilise the profitability of his physical transaction.

As we all know, the physical transaction can occasionally fail. Such failures can arise in numerous ways including counterparty default, late delivery, damage to the commodity or its total loss. In such situations, companies can and in our experience sometimes do find themselves incurring additional costs and liabilities under derivative contracts which they are obliged to honour, notwithstanding the failure of the physical transaction.

This Client Alert examines how, if at all, a company faced with this type of loss can seek to recover its shortfall resulting from derivative commitments that it can no longer match to a physical position. Our Alert also suggests a few practical measures that companies may consider taking as a means of enhancing the prospect of a recovery against counterparties (such as suppliers, customers, traders, carriers and/or insurers).

Damages for breach of contract

Under English law, a party that commits a breach of contract becomes liable to pay in damages a sum of money that would put his counterparty into the same financial position he would have been in had the contract been properly performed. In cases which involve the supply, sale or transportation of goods the judicial authorities and statutes provide a body of guiding rules as to how damages should be measured.

All cases in which damages for breach of contract are assessed feature two basic principles of English law which restrict the type of loss that can be recovered by way of damages. Put simply, the two restrictions are:

(a) that a loss is not recoverable in circumstances where the loss claimed does not flow as the direct result of the breach of contract (the principle of "causation"); and

(b) that a loss is not recoverable if it is of a type that is too remote from the parties' agreement.

These restrictions are commonly cited by defendants as legal obstacles to the recoverability of hedging losses.

Proving a causal link between a breach and a hedging loss

The first restriction is relatively easy to understand and apply in the context of hedging losses. Indeed, the law itself does not provide any significant guidance on the issue of whether or not a hedging loss is caused by a breach of contract or not. This is not at all surprising, given that the question will always be primarily a factual one: is a particular loss or liability under a derivative contract caused by a breach of a different contract committed by another party?

For example, if in breach of a contract of carriage, a shipowner arrives later than required by the contract and produces a bill of lading date which does not match the

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February 2007

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This bulletin was originally published in July 2006

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requirements of a hedge, the recoverability of any loss suffered as a result of a mismatch between hedging and physical commitments requires proof that the mismatch arose as a result of the breach by the carrier.

Commonly, the way in which derivative transactions are recorded internally may help or hinder the claimant. Many traders in businesses that manage market risk through the use of commodity derivatives operate single “book” or consolidated “books” that record hedging positions for an entire organisation. Sometimes these arrangements make it difficult to establish a clear link between physical and derivative positions. Proving the causal connection between a loss arising under a derivative contract and the breach committed in relation to the physical position is problematic if the derivative is not clearly identifiable as relating to the physical. Clarity in the internal recording and management of hedging positions can assist a claimant in demonstrating a link between hedge and physical and thereby the causal connection necessary to establish a claim in damages.

A potential disadvantage to taking the above approach is, of course, that there may be a greater risk that any financial benefit derived from hedge must be accounted for in the computation of a loss.

Is a hedging loss too remote?

The second restriction is the subject of an extensive body of authority. This requires the application of a test as to whether the loss claimed is of a kind that arises naturally and in the ordinary course of things and that was within the parties' reasonable contemplation at the time the relevant contract was made.

Although there is no binding legal authority on this point, statements made by the judge in the case of *Addax -v- Arcadia [2000] 1 Lloyd's Rep. 493* suggest that claims for hedging losses under sale of goods contracts will not, as a general rule, fail because they are too remote.

The judge explained that “*the costs of the hedging devices are an integral part of the calculation of the net position, and if the net position is a directly relevant loss, so must the hedging costs be so regarded. To extract the costs of the hedging devices is wrong in principle and has no commercial merit ... It was I think wholly foreseeable that if the claimants took a position which was otherwise than back-to-back with their contract with the defendants, they could cover their position with one of a multitude of hedging transactions available. While the contract instrument used may well vary from trade to trade (or possibly trader to trader), the defendants must have foreseen the need for the claimants to get cover*”.

This reasoning is said to apply in practice, for example, in the oil trade, where it is thought to be customary for traders to enter into derivative contracts in order to hedge the market risk arising out of underlying physical commitments. Where such a trader is in default of a physical contract for the sale of oil it is thought to be difficult for the trader to argue that the derivatives losses suffered by his trading counterparty are too remote. Indeed, it may be arguable that the trader should be assumed to have knowledge that his counterparty would, customarily, hedge its physical position.

Shipowners commonly seek to argue that hedging losses are too remote in claims made against them by their charterers for damages under a contract of carriage. As yet, however, there appears to be no legal decision providing direct judicial guidance on this argument. A common objection made by shipowners is that they themselves are not in the business of commodity trading and should not therefore be fixed with the degree of knowledge required to overcome the legal restrictions on the recoverability of damages.

The counter argument to this is that the reasoning of the judge in Addax is relevant even in the context of contracts of carriage. A shipowner may not know about the different kinds of hedging instruments used in different trades or by different traders. However it can certainly be argued that a shipowner should at least know that, in general terms, commodity traders and users enter hedging transactions in order to protect themselves against market fluctuations.

This is especially true in the world of international trade as it is today. Indeed, it is nowadays commonplace for shipowners and others exposed to the risk of volatility in the freight market to hedge their own risk, through instruments such as Forward Freight Agreements (FFAs) which operate in a similar way to the derivatives traded on commodities exchanges. At the same time, the commodity derivatives markets are now so large that it is becoming increasingly difficult for shipowners to deny their knowledge of the general practices of their charterers in hedging risk.

Faced with the sort of arguments we have referred to above, a commodity owner or trader pursuing a claim for hedging losses against a carrier may wish to bolster his arguments by obtaining evidence from an "expert shipowner" on whether a carrier would or should ordinarily be aware that charterers and traders might enter into hedging positions in respect of cargoes being carried.

Enhancing the prospect of recovery

Recovering hedging losses as part of a claim for damages is perceived as difficult but it is increasingly accepted that proven losses of this type ought to be recoverable.

The following may be of assistance to companies that use commodities derivatives as a means of hedging loss:

- Ideally, employ an express term regulating recoverability of hedging losses, particularly in cases where the trader considers that he may be exposed to an exceptional risk;
- In the absence of such a term consider the use of an express pre-contract representation (ideally recorded in writing) stating that one or both parties propose to hedge the physical exposure;
- Maintain accurate internal systems that facilitate the proof of a link or connection between physical exposure and derivatives.