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Energy & Natural Resources

Client Alert

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# Long-term supply (and off-take) agreements: some recent themes

*This Client Alert seeks to highlight certain recurring issues and themes arising in the context of long-term commodity supply and off-take agreements. It draws upon the recent collective experience of our lawyers as well as developments in the law.*

We focus on the following key topics:

## A. Agreements to agree

- The long-term supply (or off-take) agreement ("LTSA") should not have too many 'open ended' provisions that require further agreements between the parties in order for the agreement to work in practice as they may jeopardise the contractual force of the agreement.
- Always try to provide a default mechanism in case parties cannot agree.
- English law will sometimes fill the gaps with implied terms based on previous dealings between the parties, market practice or reasonableness.

## B. Price review (price reopener) clauses

- Consider whether your LTSA requires a price review clause – the usual answer is 'yes', because significant changes can occur in reference prices, markets, and/or economic dynamics over the term of a LTSA.
- The usual structure is that one party can invoke the price review, then there will be a time-limited negotiation process and then a final determination (e.g. by arbitrators or expert) or termination if no agreement can be reached.
- Hard-wiring a regular annual/quarterly price review is increasingly common.

### C. Entire agreement clauses

- These are a common ‘boilerplate’ clause seeking to prevent reference to material outside the written contract.
- They can be ineffective or have unintended consequences, so drafting appropriately is key.

### D. Unforeseen events

- The length of LTSAs mean that the force majeure provisions must be carefully thought through, not just lifted from a standard short/spot contract.
- Similarly, standard sanctions, material adverse change and compliance clauses need to be adapted for LTSAs to cater for likely significant changes over time.

### E. Operations and logistics

- Delivery scheduling, transport, storage, quality, documents, customs, laytime and demurrage provisions are often insufficiently set out in LTSAs.
- When agreeing a LTSA, parties often assume a high degree of logistical and operational cooperation, but provisions must be robust enough to deal with the uncooperative party looking for an exit strategy.

### F. Termination and suspension of obligations

- Typically, LTSAs provide for a detailed list of termination events, plus a range of options such as single shipment rejection or suspension, which are short of complete termination.
- Also, anti-technicality or ‘cure’ provisions may be added to avoid unjustified or quick terminations.

### G. Damages and remedies for breach

- The LTSA draftsperson needs to consider a damages limitation provision as a priority because long-term contract breach generally equates to significant damages.
- Consider a formulaic approach to damages for certain breaches as well as limitation.

### H. Dealing with government entities – state immunity

- If your counterpart is a state entity, work out what provisions are required to overcome state immunity.

### I. Dispute resolution

- What type of dispute resolution will be fit for purpose in case of a dispute?
- Remember disputes come in different sizes – default on the whole LTSA or demurrage on one shipment: is your clause suitable for all the potential disputes?
- Interim remedies may be vital to reduce damage or secure your position: is the clause specific enough to facilitate such remedies?

**A. Agreements to agree** The duration of LTSAs makes it difficult to legislate and draft for every single eventuality that may arise in the future. It is particularly difficult to draft fully and with specificity around all operational and commercial eventualities. It is common therefore for the parties to LTSAs to leave certain requirements and/or terms open for negotiation, discussion, review and/or agreement in the future. This feature of LTSAs manifests itself very commonly with respect to several aspects of performance including scheduling, volumes and, in some instances, even pricing.

The practical difficulties these 'open ended' arrangements present are numerous: the parties must negotiate with each other from time to time and on an on-going basis to agree terms that are necessary for the parties to move forward and perform the overall bargain over the long term. From a legal perspective, there can be numerous problems.

An agreement to negotiate is not in and of itself a contract as it is too uncertain to have any binding force. That is, in general terms, an 'agreement to negotiate' or an 'agreement to agree' cannot impose any obligations to negotiate or reach an agreement.[1] If a LTSA leaves too many of its terms open for agreement in the future, or misses out essential terms entirely, or fails to prescribe a default mechanism by which the terms can be imposed in the absence of agreement, it risks lacking the certainty needed to make it binding, meaning that there might be no LTSA at all.[2]

Having said that, the clear trend as far as English law is concerned is for the courts and arbitral tribunals to do their utmost to uphold such contracts, if needs be by implying terms in order to 'fill in the gaps' in the agreed terms or even by filling the gaps themselves. The courts have shown themselves as reluctant to use uncertainty as a ground for refusing to enforce agreements that the parties appear to have intended to be binding. This is especially the case where the parties have reached agreement on the essential components or 'cardinal terms' of a LTSA, thereby demonstrating that they intend to be legally bound by the contract, but have left some components open for discussion and agreement in the future.[3]

There are a number of ways in which the law seeks to address these issues and to uphold contracts such as LTSAs which bind the parties but which require agreement in the future with respect to terms.

1. *Statutory powers and implied terms* The *Sale of Goods Act 1979* will come into play in many instances; for example, it allows the courts to imply a price where the contract fails to stipulate one. Section 8(2) of the Act provides that the buyer must pay a reasonable price where the price is not fixed by the contract, left to be determined in a manner agreed by the contract (e.g. by negotiation) or determinable based on a course of dealing between the parties.

2. *Terms implied by trade custom* Trade custom is sometimes invoked by parties seeking to imply terms into a LTSA. The reason such an argument

rarely succeeds is that the balance of proof lies with the party seeking to rely on a trade custom. It is difficult to demonstrate that a trade custom is so well established as to enable a term to be implied into a LTSA.

3. *Implied terms arising through the parties' course of dealings* Where agreement on a particular term is necessary in relation to a LTSA that has been part performed, the parties' course of dealings to date will arguably serve as a useful reference point for determining the term to be agreed or the approach that they must take towards agreeing it. Hence, the precedent one sets through conduct in the performance of a LTSA can be important.

4. *The application of 'reasonableness' as a standard and a determination by a court or tribunal with respect to the appropriate term* As a last resort, where the parties cannot agree terms, or terms are missing from a LTSA, the courts may try to assess what is a reasonable version of a particular missing provision.[4] The courts are particularly willing to do so where terms are simply missing, rather than just left 'to be agreed'. It is well established that, in cases where the parties have agreed on an arbitration or valuation clause in wide enough terms, the courts will give full weight to their intention to create legal relations. However, in order for this approach to be workable (and thus for the LTSA to remain binding), the LTSA would need to be drafted so as to ensure that the dispute resolution mechanisms within the LTSA are broad enough to capture all disputes, including any failures to agree a term which may require agreement.[5]

*Suggested best practice* As a minimum, we recommend ensuring that the dispute resolution mechanisms are broad enough to empower the relevant court or tribunal to determine any missing terms or terms that require agreement in the future, but cannot be agreed by the parties. Alternatively, and as is sometimes the case, the parties may agree another mechanism for determining disagreements with respect to terms, such as referral of the issue to a neutral third party for an expert determination. The latter is particularly important in the context of more 'minor' elements of the contract, such as matters relating to scheduling, volumes and logistics.

**B. Price review (price reopener) clauses** Parties to LTSAs should appreciate that while the pricing terms agreed when the deal is concluded may reflect the parties' agreement at that time, over time those pricing terms may no longer be considered appropriate by one or both parties. The parties may wish, therefore, to have the right to reopen or renegotiate the pricing terms in appropriate circumstances. This is particularly common in LTSAs for natural gas and LNG. Although they may take any number of forms, price reopener clauses commonly seek to address the scenario where the pricing clause could be considered to be unfair or cause hardship to one party. Such a scenario might arise, for example:

1. Where an index or other pricing source ceases to exist or the methodology behind it changes;
2. Where a reference source for pricing is no longer widely used in the market to price the relevant commodity: an example of this would be in the natural gas market, where oil-linked pricing clauses, which were once commonly agreed between sellers and buyers under LTSAs, might now be argued by buyers to be inappropriate in the current era of relatively lower gas prices;
3. Where changes occur within a market that the parties did not anticipate, for example, where there is unforeseen liberalisation in the market that is used to determine prices, leading to additional competition and therefore lower prices; or
4. Where the economic dynamics and/or market prices themselves have altered since the contract was made.

These examples are not exhaustive and the terms of any price reopener clause are for the parties to negotiate. All price reopener clauses will have a 'trigger' that the party seeking to reopen the agreed price will need to satisfy in order to invoke the clause. It is important that this aspect of the clause is drafted with care, although there is a tension between the desire to be precise and the very purpose of price reopener clauses which is to seek to address market developments that the parties may not necessarily have envisaged when the deal was struck.

Typically, the legitimate invocation of a price reopener clause would start a process of negotiation between the parties, but if the parties wish arbitrators or a court to have the power to impose new pricing terms if the parties do not reach agreement, it will be advisable to specify this expressly in the contract. The aim here is to avoid disputes as to whether there is any jurisdiction to do so.

Of course, once arbitrators are empowered to set a new basis for pricing, the pricing effectively passes into the hands of third parties who – while they may be both legally eminent and guided by the evidence of the parties' respective expert witnesses – are most unlikely themselves to be experts in the relevant market. A price reopener clause therefore creates inherent uncertainty for the parties because it puts a fundamental term of the contract – the price – into the hands of third parties and outside the complete control of the parties. This can lead to unpredictable results: in one LNG price arbitration, the tribunal determined a new approach to pricing that neither party had requested.[6] The parties may wish to consider setting parameters on the extent of the freedom that arbitrators/courts have to vary the initial price. In a LTSA, even minor changes to pricing can result in high value changes to the economics of the transaction in the long term. Most arbitral rules restrict the possibility of appeal to the supervisory national court and most systems of national law would not, in any event, be likely to entertain findings regarding price made on the basis of expert evidence.

Parties to LTSAs may equally wish to hard-wire periodic pricing reviews into their contracts, perhaps on an annual or quarterly basis. Such periodic reviews are more appropriate when the parties wish to agree, not so much on the fundamentals of pricing, but on the premia/discounts that will apply from time to time. Again, it is advisable for a LTSA to specify what will happen if the parties do not reach agreement: for example, will the relevant elements of the price be referred to arbitrators or the court for determination, or are deliveries in the relevant year/quarter to be missed?

**C. Entire agreement clauses** LTSAs are usually subject to lengthy commercial and legal negotiations. A practice has therefore developed of including entire agreement clauses in the boilerplate sections of LTSAs as a matter of course. These clauses are often treated as 'standard' and do not always attract as much attention as other terms, yet they can have unintended consequences. They are frequently invoked to exclude facts arising in the course of the performance of LTSAs over a long time and hence to try to avoid arguments about waiver, estoppel and implied terms arising through a course of dealing.

*Limitations to the effectiveness of entire agreement clauses* Entire agreement clauses are intended to ensure that the terms governing the parties' rights and obligations are set out in a single contractual document. This gives the parties certainty.

There are, however, limitations to the effectiveness of entire agreement clauses:

1. Implied terms are not, generally, excluded by an entire agreement clause. So a separate exclusion clause will usually be needed in a LTSA. That said, entire agreement clauses have been found effective in excluding terms which might otherwise have been implied by trade custom;[7]

2. Liability for misrepresentation will not be excluded unless the clause states expressly that the parties have not relied on any representations or statements other than those set out in the contract;

3. A party can still rely on the remedy of rectification if there has been a unilateral or common mistake as to the contract terms and the contract is not a true representation of the parties' agreement;

4. 'Estoppel by convention' can still be invoked to allow a party to enforce a pre-contractual agreement.[8] The effect of this form of estoppel is to prevent a party from denying the existence of a shared or agreed assumption as to facts or law which the parties have previously acted on; and/or

5. There may be a lack of clarity as to whether an older agreement between the parties has been superseded. If a LTSA is intended to supersede a previous contract between the parties, we recommend either entering into a standalone termination agreement, or dealing expressly in the LTSA with the status of the two agreements.

*Suite of contractual documents* The agreement between the parties may consist of a suite of different contracts. In that case, it is important that the entire agreement clause does not limit the effect of the incorporated contracts. Consider starting the clause with a statement such as "this Contract and the documents referred to herein constitute the entire agreement between the parties…".

However, this approach might lead to difficulties when incorporated contracts are terminated, amended, assigned or novated. Best practice is therefore to append a copy of the incorporated terms to the LTSA, and to provide that "this Contract and the documents appended thereto (in the form appended thereto, without amendment) constitute the entire agreement between the parties...".

*Best practice for drafting entire agreement clauses* A well-drafted entire agreement clause in a LTSA will:

1. State that "the Contract" or "the Agreement" (a defined term) contains the entire agreement between the parties and supersedes any previous agreements;

2. Acknowledge that the parties have not relied on any pre-contractual statements or representations other than those set out in the contract (unless, of course, the parties want to specifically rely on a particular pre-contractual statement); and

3. Exclude liability for statements and, crucially, representations made outside of the executed contract.

**D. Unforeseen events** The duration of LTSAs makes it extraordinarily challenging to legislate for every type of factual eventuality that may arise in the future. Issues (operational or commercial) affecting the parties' ability to perform may arise which could not have been foreseen by even the most experienced commercial parties.

There are a number of ways to ensure the parties to a LTSA are protected from unforeseen events.

*Force majeure* The English law doctrine of frustration will relieve the parties of their contractual obligations only in the rare circumstance where performance of the contract becomes impossible. Given this high threshold, it is rare that any English law LTSA would be considered to be frustrated, and so parties to a LTSA will invariably agree force majeure clauses that will allow some relief from performance where certain defined events occur.

Unlike many civil law jurisdictions, under English law there is no doctrine of force majeure that will come into operation automatically where a party's performance of the contract is affected by an extraneous event. Although the term 'force majeure' is generally understood by parties to encompass any event beyond the parties' control which could not reasonably have been foreseen, what constitutes force majeure in any particular contract will depend entirely on how that term is defined in the contract. Equally, what force majeure means for the parties' rights and obligations under the contract essentially comes down to what the express terms of the contract provide.

While always important, the wording of a force majeure clause is particularly important in a LTSA, given that the parties' rights and obligations endure for a long period of time. Thought must be given to the events included in the clause: a list of specific examples of force majeure events followed by the words "or any other causes beyond a party's reasonable control" will generally ensure that a wide range of events can be caught[9]; whereas it has been held that the words "the usual force majeure clauses to apply" is likely to be void for uncertainty[10], particularly where any implied trade custom is excluded by an entire agreement clause. Economic events which lead to bankruptcy or an inability to pay, or that make the LTSA uneconomical to perform (whether for reasons personal to the party or due to a collapse in the economy[11]) are not generally to be considered force majeure events and are often expressly excluded as examples of force majeure.

A force majeure clause in a LTSA will normally be expressed to be for the benefit of both parties, allowing the affected party to suspend and/or terminate the contract on the occurrence of events beyond its reasonable control. However, in practice, as the party with the duty of physical delivery of the goods (and because the buyer's inability to make payment is commonly excluded from the definition of force majeure), it is the seller that is much more likely to invoke the force majeure clause. The party claiming force majeure bears the burden of proving that the relevant event falls within the definition of force majeure and the clause will usually require notice to be given to the other party. Care must be taken to comply with any deadline for such notices in the force majeure clause and with the formalities of any 'Notices' clause.

The effect of a party invoking a force majeure clause will be different from contract to contract but in a LTSA it is likely to involve a period of suspension, with a right of termination (either mutually or for the non-affected party only) typically following a long period of suspension. Although termination due to prolonged force majeure is usually stated to be without liability to either party, upon termination of a LTSA for force majeure it may be appropriate for there to be payments between the parties. This will depend upon the extent to which the parties have invested capital in the means of production of the goods or in infrastructure in order to perform the LTSA and how the risk of the loss of such capital has been agreed to be borne between the parties in this scenario.

*Sanctions clauses* While a number of sanctions regimes have been relaxed in recent times, e.g. Cuba, Burma and Iran, the imposition of hard-hitting multilateral sanctions against other regimes, e.g. Sudan, Syria and particularly Russia, highlight the unpredictable and far-reaching effect that sanctions can have on LTSAs.

In the past, sanctions may have been addressed as one of a long list of events within a force majeure clause. Now, LTSAs will commonly include a standalone sanctions clause; some of which will still allow the parties to terminate the LTSA without liability; or alternatively, to permit suspension or attach liabilities to certain actions. A standalone sanctions clause is advisable and while sanctions are sometimes considered a 'boilerplate' legal issue, their importance should not be downplayed. The increasing use of sanctions to address foreign policy challenges and the move towards more hybrid and nuanced sanctions measures make sanctions a more complex area requiring greater attention, not less. A party will often have a universal sanctions clause that it will try to insert into all of its agreements, but it is highly unlikely that both parties' sanctions clauses will be compatible or that the more stringent clause is capable of dilution. As a result, parties can end up agreeing to ever-changing obligations they have little understanding of but which have far-reaching effects on their supply chain/on-sale contracts.

*Material adverse change* As mentioned above, unforeseen economic events will not usually be considered force majeure events. That does not mean that a LTSA should ignore them. The risk of a counterparty's insolvency including the downgrading of a counterparty's credit status is largely unpredictable, yet they cannot be considered uncommon for commodities players in today's economy and particularly when transacting over a long term. The serious effect of such issues on a LTSA means they tend to be dealt with specifically, either within an 'events of default' or 'material adverse change' ("MAC") clause linked to the parties' suspension or termination rights.

**E. Operations and logistics** Operations and logistics provisions are necessarily detailed provisions. They are often relegated to the schedules of a LTSA. Although high-level commercial concerns tend to take priority at the deal-stage, defects in the operational and logistical provisions can often cause parties significant issues once the ink has dried. Therefore, although operational and logistical issues are sometimes viewed as secondary, their importance should not be underestimated when drafting and agreeing LTSAs.

Operational and logistical issues include key aspects of a LTSA such as: scheduling delivery, arranging transport, storage, warehouse management, invoicing, preparing documents, dealing with customs, laytime and demurrage, etc. Operational and logistical provisions are important to a LTSA because:

1. They go to the purpose of the LTSA: they determine the practicalities of supplying the product in exchange for the price in the way intended by the parties; and

2. When disputes occur, counterparties can seek to exploit the everyday provisions to exert pressure on the other party.

Problems can also arise in LTSAs when the practicalities are not fully understood at the time of contracting. It is therefore important that contingencies are built into the LTSA. Such contingencies may involve an obligation to discuss the issue with the other party for a certain period of time followed by expert/legal determination.

LTSAs can be further complicated by additional arrangements that one or both parties have with third party logistics companies. These contracts are often also long-term in nature and are interdependent on the LTSA, meaning that problems under one will usually lead to problems under the other. The likelihood of exposure to a counterparty's losses under such arrangements in the event of non-performance of the LTSA should also be assessed and it may be appropriate for liability caps to be negotiated for inclusion in the LTSA.

**F. Termination and suspension of obligations** The circumstances in which a party might wish to terminate a LTSA are numerous. These could include where the counterparty fails to perform (e.g. non-payment, non-delivery of goods, non-acceptance of goods), where the counterparty becomes insolvent or where there is a change in the control or ownership in the counterparty. A desire to terminate might also be triggered by a counterparty's breaches of ancillary obligations relating to sanctions or anti-corruption.

At common law, whether a right to terminate a contract exists upon a counterparty's breach will depend upon the nature of the term that has been breached and how it is classified. A 'condition' is a term that goes to the root of the contract and the breach of which will entitle the innocent party to terminate the contract. In a LTSA contemplating performance over a long period of time, terms that are obviously 'conditions' are likely to be rare and many terms are more likely to be 'intermediate terms', i.e. terms a breach of which will only entitle the innocent party to terminate if that party has been deprived of substantially the whole benefit of the contract. Such breaches may be difficult to identify with confidence in a LTSA. Further, English law tends to view LTSAs as 'severable' contracts, such that even a serious breach affecting one delivery would not automatically give the innocent party a right to terminate the entire contract, unless it can be said to also amount to a repudiation of the whole contract[12]. For this reason, one-off breaches of the contract – e.g. a seller's failure to deliver a particular shipment – will rarely be sufficiently serious to justify termination of a LTSA.

Furthermore, some terms of a LTSA can be expected to be classified as 'warranties', the breach of which would not give rise to a termination right at all. A classic example would be the buyer's obligation to make payment of the price, which is usually presumed to be a warranty unless the time of payment is made 'of the essence'[13]. Some eventualities that a commercial party might expect to be a breach may (absent an express term to that effect) not be breaches of contract at common law at all, e.g. a counterparty's insolvency.

It is also noteworthy that at common law there is no right of suspension of a contract on the grounds of the counterparty's breach: where a breach gives the innocent party the right to terminate it must elect between terminating the contract and affirming it, i.e. waiving the right to terminate and continuing to perform.

It is for all these reasons that it is advisable to include in a LTSA a termination clause that defines certain 'events of default' and which provides expressly that the non-defaulting party will have a right of termination and/or suspension upon their occurrence. There is a presumption that express grounds for termination would be in addition to the parties' right to terminate at common law, and so clear language would be needed for the express grounds of termination to be interpreted as an intention to give up such rights[14]. There are a number of events which would typically be defined as events of default under LTSAs:

1. *Non-payment* As the buyer's obligation to pay the price is usually presumed not to be a condition of a contract, most LTSAs will accordingly vary this position by providing that failure by a party to make any payment due under the LTSA on the due date will be an event of default where it is not rectified within a certain number of days following written notice. It might also be stated that sums that are subject to a bona fide dispute will not trigger an Event of Default.

2. *Non-performance* In some LTSAs, a failure to deliver or to take delivery must occur with respect to a defined number of shipments, e.g. per contract year, before an event of default occurs.

3. *Insolvency* As the counterparty's insolvency does not give rise to a right of termination at common law, the risk of having to continue to trade with an insolvent counterparty is a real one, absent an express right of termination. Therefore, insolvency-related events such as administration or liquidation with respect to the parties (or their security providers, e.g. parent companies who provide guarantees) will usually trigger an event of default. Many LTSAs will include a MAC clause allowing a seller or even both parties to demand additional security (e.g. prepayment, a parent company guarantee or letter of credit) where there are concerns regarding the creditworthiness of the counterparty. This may be done either by reference to objective criteria, such as a credit downgrade, or more subjective criteria, such as the reasonable concerns of the beneficiary of the requesting party. Where the counterparty fails to provide performance assurance, the requesting party may be able to treat such failure as an event of default and to exercise termination or suspension rights accordingly.

4. *Other* Breaches of sanctions and anti-bribery provisions may well trigger an event of default. It may be appropriate for a change of control in one or both parties to trigger an event of default, for example, where there is a concern that a party may be acquired by a competitor.

*Suggested best practice* We recommend ensuring that events of default are clearly considered and defined in order to avoid ambiguity as to the circumstances in which a right of suspension or termination upon the counterparty's breach will arise. This is all the more the case because a notice of termination that is given without justification is in itself likely to be a repudiation of the contract: that notice might be treated by the (otherwise defaulting) counterparty as a basis for terminating the contract and holding the (otherwise performing) party, who issued the purported notice of termination, to be in default.

**G. Damages and remedies for breach** The recent decision of the Supreme Court in *Bunge SA v Nidera BV*[15] reinforces the applicability of the compensatory principle in the assessment of damages in sale of goods contracts. The Supreme Court held that in the absence of a contrary agreement, damages must always seek to compensate for the value of the rights lost by an innocent party. Any contractual agreement to the contrary, and in particular any provision seeking to create a code for the calculation of damages, must be very comprehensive and clearly worded if it is to act as a complete code and thus override the compensatory principle.

*Liquidated damages* When agreeing liquidated damages provisions in a LTSA, the following key points should be considered:

1. *Is it proportional?* A provision which imposes a penalty in the event of breach of contract is not enforceable in English law. The Supreme Court recently clarified that a penalty is "a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation".[16] The current law therefore requires any compensatory amount (or remedy) agreed by the parties under the contract to be proportional, as compared to the innocent party's interest in the performance of the contract. Whether this is the case can still turn on the construction of the clause itself. Importantly for LTSAs, while clarifying that a contractual provision may in some circumstances be a penalty, the Supreme Court recognised that the rule of penalties was not intended to extend to all substantive obligations mutually agreed under a contract and stated that contractual obligations which are contingent on the way a contract is performed should not generally be considered penalties.[17]

2. *Is it sufficiently comprehensive to override the compensatory principle?* In *Bunge v Nidera*, the wording of the clause meant that the claimant was not allowed to calculate damages by reference to the contractual mechanism without regard to a supervening event which would have prevented the contract from being performed.

3. *Is it sufficiently clear to limit the duty to mitigate?* *Bunge v Nidera* also clarified that clear and express words are needed in order to limit the innocent party's duty to mitigate. The duty to mitigate applies even where the contractual damages mechanism assumes that the innocent party will purchase or sell against its counterparty in the market. Accordingly,

damages could be affected by a successful hedging policy which operates to reduce the loss suffered [18], or an offer from the defaulter which the innocent party should have accepted.

4. *Is there a right of set-off?* LTSAs sometimes include clauses limiting the right of set-off. Even if this is the case, one should consider whether to include a specific right of set-off in the termination/damages clauses that would entitle the innocent party to set-off the losses and costs due to the defaulting party against any amounts accrued and owed by it to the defaulting party at the date of termination. Any rights of assignment, for example the right of a third party financier to proceeds of payment, should be considered carefully in this context.

*Limiting liability* Many LTSAs include a clause excluding or limiting liability for certain losses. The most common example is an exclusion for indirect or consequential losses or expenses. Whether damages are recoverable will depend on the application of the rule in *Hadley v. Baxendale*[19]. This rule provides for two categories of loss: 'direct' loss (losses which arise naturally, according to the usual course of things from the breach of contract itself); and 'indirect' or 'consequential' loss (losses that may reasonably be supposed to have been in the contemplation of the parties at the time they made the contract, as a probable result of the breach).

Whether the loss is direct or indirect (or too remote and not recoverable at all) depends on the facts of each case and the construction of the clause. The same type of loss, for example, loss of profit/hedging losses, may potentially fall into different categories of loss as a result. For example, the interpretation of an exclusion for loss of profit will differ if loss of profit is listed as a distinct category of loss (in which case the clause will be effective to exclude liability for any loss of profit) as opposed to a clause in which 'loss of profits' is listed as a type of consequential loss (in which case the clause will likely exclude liability for loss of profit falling within the definition of indirect/consequential losses only).[20]

The Court of Appeal has recently delivered a judgment in *Transocean Drilling UK Limited v Providence Resources Plc*[21] which provides further guidance as to the interpretation of exclusion clauses. *Transocean* emphasises freedom of contract between commercially comparable parties and makes it clear that the parties must always look at the actual language in the exclusion clause as their starting point. While exclusion clauses will often be construed against the party seeking to rely on them, that approach to interpretation may not apply where the clause is mutual, the meaning of the words are clear, both parties were of equal bargaining power, and the exclusion is part of a complex system for allocating loss. *Transocean* concerned a 'knock for knock' regime in a contract for hire of a semi-submersible drilling rig, but the factors considered by the Court of Appeal will apply similarly to parties entering into LTSAs. As a general proposition, we submit that commercial parties should nowadays expect that the courts will be reluctant to get involved in assisting one way or the other in the construction of limitation and exclusion clauses, and so careful drafting is crucial.

*Suggested best practice* While not common, or indeed always possible, a prescribed formula for the assessment of damages is worthy of consideration. One of the arguments in favour of a formulaic approach to calculating damages is that it provides clarity and enables an innocent party to calculate losses based upon pre-agreed terms and to move on quickly. It has been argued that this approach sits more comfortably with commercial parties and avoids the need for the courts and tribunals to take into consideration complex factual matters relating to the breach and any supervening events and circumstances. In any event, to be effective, exclusive remedies require very clear drafting, as do monetary and other limitation/exclusion clauses. Advance consideration as to what types of loss may or may not be recoverable as damages is essential.

**H. Dealing with government entities – state immunity** LTSAs for the supply of natural resources often involve dealings with government entities. It is therefore not unusual for issues of state immunity (a.k.a. sovereign immunity) to be raised in the context of LTSAs.

*What is state immunity?* State immunity is a doctrine of international law which can shield governments and quasi-governmental entities from legal proceedings and enforcement action.

The traditional view in most jurisdictions used to be that states could never be sued in a foreign court without their consent. A few countries still maintain this approach, notably China, Hong Kong, Russia and Portugal. However, most jurisdictions today recognise that states do not have automatic immunity from suit for activities of a commercial nature – including most sales of goods and shipping transactions – as distinct from sovereign activities.

*When will state immunity apply?* Under English law, state immunity will apply to governments and government departments. A head of state may also enjoy immunity. However, for immunity purposes, a state-owned entity will not generally be considered subject to state immunity unless, as it was expressed by the Privy Council in 2012 in the *Gécamines* case,[22] the entity is "so closely intertwined and confused" with the operations of the state that it is for all significant purposes effectively an "organ" of the state. It is therefore usually preferable to enter into a LTSA with a state-owned entity (which will not generally have immunity) in preference to a state department (which will).

*What are the exceptions to state immunity under English law?* In England and Wales, the State Immunity Act 1978 provides that the courts have no jurisdiction to hear claims against states unless one of a number of statutory exceptions applies. Those exceptions are complex but in effect include a broad range of situations, including where:

1. The proceedings relate to a commercial transaction;

2. The proceedings relate to a contractual obligation to be performed in the UK;
3. There is a valid court jurisdiction or arbitration agreement in the relevant contract; or
4. The state has submitted to the jurisdiction of a court (albeit that this does not necessarily extend to a waiver of state immunity in enforcement proceedings).

The *State Immunity Act* also allows *enforcement* against state-owned property in England that is used or intended to be used exclusively for commercial purposes. The Supreme Court has recently clarified the commercial purposes exception, ruling that the origin of the asset is irrelevant. The test is whether the asset is currently being used or is earmarked to be used by the state entity for commercial purposes.

It is vital to include in any waiver of state immunity clause a specific waiver of immunity from execution as well as immunity from suit.[23]

*Recommendations and contract drafting tips* We set out below some drafting tips to follow when contracting with a state or quasi-governmental entity:

1. Include an express waiver of immunity from both suit and execution;
2. Extend the waiver of immunity expressly to both commercial and sovereign acts;
3. Ensure that a waiver against execution specifies the classes of assets in respect of which the state waives immunity, and includes assets which serve sovereign purposes;
4. Check the enforceability of the waiver in the relevant jurisdiction with local lawyers and, in particular, check whether the state's national law entitles it to waive its immunity;
5. Ensure that the jurisdiction clause provides that the parties are subject to the jurisdiction of a court or arbitration tribunal forum in a country such as England which will not recognise state immunity where the state acts in a commercial capacity;
6. Include a warranty by the state/state-owned entity that it is not acting in a sovereign capacity when entering into the contract;
7. Include a suitable address for service clause providing for service in the jurisdiction (which may be the state's embassy or consulate); and
8. Include a warranty that the individual signing the contract does so with the full authorisation of the state/state-owned entity.

*Other issues when dealing with government entities* These are some other issues to bear in mind when negotiating and contracting with state entities:

1. *Pro-state legislation* It is not unheard of for a government to legislate in order to improve a state-owned entity's position under a particular high-value LTSA. For example, a government may change the law in order to enable a state entity to either declare force majeure or rely on an illegality clause in order to escape from a contract. Four ways in which to minimise this risk are to:

    (a) Avoid including a change in the law within the force majeure clause;

    (b) Avoid including illegality as an express termination event;

    (c) Consider including a severability clause so that if part of a contract becomes void due to illegality, the remainder of the contract will continue in force; and

    (d) Include an undertaking by the state that it will not change the terms of the contract by legislative action without the consent of the other party to the contract.

2. *Possible bribery and corruption risks* We recommend a wide-ranging anti-bribery and anti-money laundering clause.

3. *Sanctions* We suggest that you include a comprehensive sanctions clause that provides a clear mechanism for your company to walk away from the contract without liability in the event that sanctions make it difficult or impossible to perform the contract.

**I. Dispute resolution** There are a number of questions to consider when drafting a dispute resolution clause in a LTSA:

1. Most fundamentally, is dispute resolution through the courts or an arbitration process preferred?

2. Would a fast-track procedure be appropriate in certain cases?

3. Would expert determination be useful to resolve certain types of dispute?

4. Is it appropriate to provide for a pre-dispute procedure before a party can commence arbitration or litigation proceedings?

5. Should the parties have the right to apply for interim remedies?

*Arbitration or litigation* Many parties continue to choose arbitration as their preferred dispute resolution forum. Enforceability is the paramount driver behind choosing arbitration rather than litigation. The widespread ratification of the New York Convention means that arbitration awards are easier to enforce around the world than court judgments. In our experience, awards from administered arbitrations, such as ICC and LCIA arbitrations, tend to be even more straightforward to enforce under the New York Convention than awards from ad hoc arbitrations.

*Fast-track procedures* The parties may wish to provide a two (or more) track system for the resolution of disputes. For example, small disputes could be dealt with by a sole arbitrator pursuant to a fast-track process. Such a process might also lend itself to the resolution of issues requiring urgent determination. Some arbitral institutions have published fast-track procedures e.g. the Singapore International Arbitration Centre's Expedited Procedure (SIAC Rule 5.1). Others have chosen not to publish fast-track rules, but have expressed their support for fast-track procedures agreed by the parties (e.g. the LCIA).

The key elements in a fast-track arbitration are the limited number of procedural steps and the imposition of strict time limits, especially for appointing arbitrators and filling submissions. The tribunal will generally also be under a strict time constraint for the issuance of the award and may comprise only a sole arbitrator.

An alternative to a clause which provides that disputes regarding low value matters be determined through a fast-track procedure is to provide that such disputes be determined by a different arbitral forum. For example, the BP 2015 GTCs and Shell 2010 GTCs provide that disputes concerning amounts less than USD 100,000 shall be referred to a sole arbitrator and the proceedings conducted in accordance with the LMAA Small Claims Procedure.

*Expert determination* A further alternative would be a clause providing that certain types of dispute be determined by an expert through a binding dispute resolution process. This process might lend itself to disputes of a technical or mathematical nature, such as a quality dispute or the assessment of a liquidated claim. The ICC administers expert proceedings under its Rules for the Administration of Expert Proceedings. However, as an expert's jurisdiction will depend entirely on the provisions of the LTSA. Careful drafting is needed.

*Pre-commencement procedures* LTSAs often include a requirement for the parties to take certain steps, such as engaging in mediation or holding 'good faith' settlement discussions, prior to the commencement of a formal dispute resolution process.

The courts have held that an agreement to follow a pre-arbitration procedure can give rise to an enforceable obligation provided certain requirements are met. Although these requirements will be determined based on the facts of the case, there is no checklist of 'minimum ingredients'. The key consideration is that the wording be clear, and that the steps to be taken are sufficiently discernible, for the pre-arbitration procedure to constitute an enforceable obligation. It may be helpful to impose a time limit on the pre-arbitration procedures, following which either party can refer the dispute to arbitration.

A vaguely worded pre-arbitration procedure is, in our experience, likely to become the subject of a dispute, as one party may rely on it to prevent the other from commencing proceedings where the required 'discussions' or other procedures have not taken place to its satisfaction.

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*Interim remedies* The Arbitration Act 1996, as well as the rules of numerous institutional bodies, provide that arbitral tribunals can grant interim measures. The interim remedies provided for in arbitral rules tend to be discretionary and certain rules of evidence must be followed.

The issue that commonly arises is that interim remedies (such as injunctions) are often most needed in cases of urgency. Yet it can take a while for a tribunal to be constituted:  in some instances weeks or months. The ICC and LCIA nowadays provide for emergency arbitrators to be appointed immediately to determine an interim application, but this is not the case in every type of arbitration. It is submitted that the dispute resolution clause in a LTSA should contain a provision that provides for the appointment of a tribunal in an emergency, the handling of applications for interim relief speedily, and above all that neither party shall be restricted from seeking interim relief in the courts of the seat of the arbitration.

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1 *Courtney & Fairbairn Ltd v Tolaini Brothers (Hotels) Ltd* [1975] 1 W.L.R. 297; *Walford v Miles* [1992] 2 AC 128 *cf. Hillas & Co v Arcos Ltd* [1932] All ER Rep 494.

2 *May & Butcher v R* [1934] 2 K.B. 17 cf. *Foley v Classique Coaches Ltd [1934] 2. K.B. 1.*

3 *Pagnan SpA v Feed Products Ltd* [1987] 2 Lloyd's Rep. 601. *See also RTS Flexible Systems Ltd v Molkerei Alois Müller GmbH & Co KG (UK Production)* [2010] UKSC 14 and *MRI Trading AG v Erdenet Mining Corporation LLC* [2013] EWCA Civ 156.

4 *Mamidoil-Jetoil Greek Petroleum SA v Okta Crude Oil Refinery AD* [2001] EWCA Civ 406. *See also Furmans Electrical Contractors v Elecref Ltd* [2009] EWCA Civ 170 where the standard of reasonableness was used to make good the parties' failure to specify the number of hours per day for which services were to be supplied.

5 *Queensland Electricity Generating Board v New Hope Collieries Pty Ltd* [1989] 1 Lloyd's Rep. 205, 210 and *Sudbrook Trading Estate Ltd v Eggleton* [1983] 1 A.C. 444.

6 *Gas Natural Aprovisionamientos, SDG, S.A. v. Atlantic LNG Company of Trinidad and Tobago, 2008WL 4344525 (S.D.N.Y Sept. 16, 2008).*

7 *Exxonmobil Sales and Supply Corporation v Texaco Limited* [2003] EWHC 1964 (Comm).

8 *Mears Ltd v Shoreline Housing Partnership Ltd* [2015] EWHC 1396 (TCC).

9 *P.J. Vander Zijden Wildhandel NV v Tucker & Cross Ltd* [1975] 2 Lloyd's Rep. 240; *Cf. Tillmanns Co v S.S. Knutsford* [1908] 2 K.B. 385. Cf. in cases of economic difficulties: *Tandrin Aviation Holdings Ltd v Aero Toy Store Llc & Anor* [2010] EWHC 40 (Comm).

10 *British Electrical and Associated Industries (Cardiff) Ltd v Patley Pressings Ltd* [1953] 1 W.L.R. 280.

11 *Thames Valley Power Limited v Total Gas & Power Limited* [2006] 1 Lloyd's Rep 441.

12 *See* s. 31(2) Sale of Goods Act 1979.

13 *See* s. 10(1) Sale of Goods Act 1979.

14 *Stocznia Gydnia SA v Gearbulk Holdings Ltd* [2009] EWCA Civ 75.

15 [2015] UKSC 43.

16 *Cavendish Square Holding BV v Talal El Makdessi*; *Parking Eye Limited v Beavis* [2015] UKSC 67, at 32.

17 Ibid. at 42 and 73. The Supreme Court in *Cavendish v Makdessi* specifically considered provisions for termination upon insolvency, contractual payments due on exercise of an option to terminate, break-fees chargeable on the early repayment of a loan or the closing out of futures contracts in the financial or commodity markets, provisions for variable payments dependent on the standard or speed of performance and 'take or pay' provisions in long-term oil and gas purchase contracts to be the sort of clauses that would usually be outside the scope of the penalties regime.

18 *Choil Trading SA v Sahara Energy Resources Ltd* [2010] EWHC 374. 13. Likewise, if hedging is an expected, reasonable action to take in that particular market, any profit/savings made by the innocent party in closing out a hedge can be considered proceeds of mitigation when calculating damages, potentially resulting in a lower damages award: *Glencore Energy UK Limited v Transworld Oil Limited (The "Narmada Spirit")* [2010] EWHC 141 (Comm). See Also *Fulton Shipping Inc of Panama v Globalia Travel SAU, "The New Flamenco"* [2015] EWCA Civ 1299, in which the sale of the vessel at the time of breach rather than at the end of the charterparty was considered an act of mitigation. As it resulted in a monetary benefit to owners, that benefit should have been deducted from the damages claimed by owners.

19 (1854) 9 Exch 341.

20 *See Polypearl Ltd v E.ON Energy Solutions Ltd [2014]* EWHC 3045 (QB) for a detailed discussion on this issue, including a more detailed summary of the law.

21 [2016] EWCA Civ 372.

22 *La Générale des Carrières et des Mines Appellant v F.G Hemisphere Associates LLC* [2012] UKPC 27.

23 *SerVaas Incorporated v Rafidian Bank and others [2012] UKSC 40.*