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Annual Review of developments in English oil and gas law

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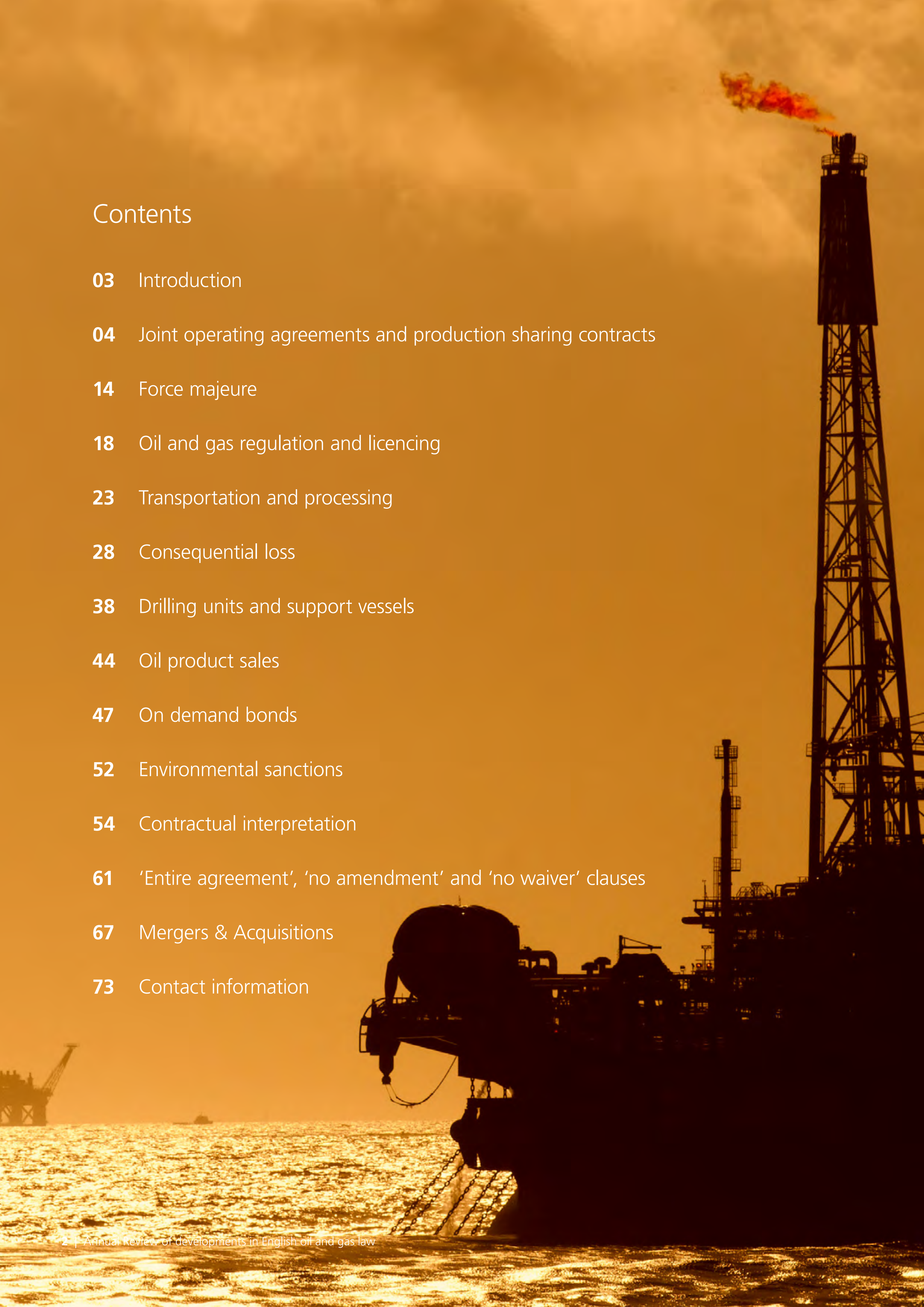


Contents

Introduction

Welcome to the 2016 edition of the CMS Annual Review of developments in English oil and gas law

The economic climate for oil and gas transactions has remained difficult since the last edition of this Annual Review was published a year ago. However, CMS has continued to advise on many interesting transactions and disputes in the oil and gas sector.

This Annual Review has been collated to be relevant to you and your colleagues, with a direct focus on recent legal developments that impact the types of issue that oil and gas lawyers deal with on a daily basis.

We hope that you find this Annual Review interesting and it helps you navigate some of the challenges ahead. If you have any queries about it, please do not hesitate to contact us.

Bob Palmer
Partner
T +44 20 7367 3656
E bob.palmer@cms-cmck.com

From the editor

There was no shortage of material for inclusion in the 2016 Annual Review. In the past year we have seen the Supreme Court decide on the enforceability of forfeiture clauses (*Cavendish Square Holding B.V. v Makdessi*), yet more decisions on the scope of consequential loss clauses, of which there was no shortage of authority in the inaugural Annual Review last year, and much more.

With the continued disruption in the oil and gas markets, it seems likely that there will continue to be many more cases for future editions.

Phillip Ashley
Partner
T +44 20 7367 3728
E phillip.ashley@cms-cmck.com

Joint operating agreements and production sharing contracts

The past twelve months have provided some further interesting decisions on the interpretation of joint operating agreements ('**JOAs**').

With the current economic climate resulting in a renewed focus on default clauses, the widely awaited Supreme Court decision in *Cavendish Square Holding B.V. v Makdessi* [2015] UKSC 67 might prove to be one of the most important decisions for the oil and gas industry in the past decade. In addition, in *Adamantine Energy (Kenya) Limited v Bowleven (Kenya) Limited* [2016] EWHC 130 (Comm) the Commercial Court provided an insightful decision on voting to move to the next exploration stage.

In relation to dealing with the execution of productions sharing contracts ('**PSCs**'), the Commercial Court decision in *Monde Petroleum SA v WesternZagros Ltd* [2016] EWHC 1472 (Comm) provides some useful guidance to dealing with intermediaries and individuals with relationships to the relevant government ministry.

Forfeiture in JOAs

In probably one of the most eagerly awaited Court decisions of recent times by oil and gas practitioners, on 4 November 2015, the Supreme Court handed down its decision in *Cavendish Square Holding B.V. v Makdessi* [2015] UKSC 67. In doing so, the Supreme Court sought to clarify the scope of the rule against penalties – 'an issue which has not been considered by the Supreme Court or the House of Lords for a century'. A key clause in dispute before the Supreme Court, as allegedly penal, was a share forfeiture clause in a sale and purchase agreement. As most oil and gas industry JOAs contain forfeiture clauses for default, the decision is likely to have broad implications for the industry.

Facts

Makdessi sold part of his shareholding in an advertising and marketing company (the '**Company**') to Cavendish Square Holding B.V. ('**Cavendish**'). The share sale agreement contained clauses requiring Makdessi to protect the valuable goodwill of the Company, as well as restrictive covenants against competition. If Makdessi breached these covenants, he stood to forgo payments for his shares of c.US$ 44 million (the '**withholding clause**'), and be required to sell his remaining shares (valued at c.US$ 75 million) at a substantial undervalue 'to effect a decoupling' (the '**forfeiture clause**'). During proceedings, Makdessi, who was chairman of the Company, acknowledged that he had been in breach of the clauses and also in breach of his fiduciary duties to the Company. The issue was whether the withholding clause and forfeiture clause were unenforceable on the grounds that they offended the rule against penalties.

The Court of Appeal found the forfeiture clause penal. The issue was appealed to the Supreme Court.

Decision

The Supreme Court, sitting as a panel of seven judges (as opposed to the usual five), upheld the enforceability of the forfeiture clause and withholding clause.

Although their Lordships differed in their reasoning, there were common threads that led to their unanimous decision to allow the appeal:

- the importance of establishing whether the clause under consideration is a primary or secondary obligation;
- the application of the rule against penalties to forfeiture clauses;
- the applicability of the approach of *Jobson v Johnson* [1989] 1 WLR 1026 in enforcing penalty clauses to the extent they are not penal, i.e. the ability of the Court and tribunal to force a sale or 'wither' as penal clauses; and
- the new test for establishing whether a secondary obligation offends the rule against penalties.

Primary and secondary obligations

Their Lordships reiterated that the rule against penalties does not apply to the enforceability of primary obligations. Its scope is strictly limited to establishing the enforceability of secondary obligations.

A primary obligation is an obligation to perform the terms of the contract. A secondary obligation is a contractually agreed remedy for a failure to perform a primary obligation, such as a liquidated damages clause.

It was recognised by the Supreme Court that establishing whether an obligation is primary or secondary can be difficult. Four of their Lordships identified the forfeiture clause in question as 'primary' and three identified it as 'secondary'.

In essence, Lords Neuberger and Sumption decided that just because a clause becomes effective upon breach of a primary obligation does not mean that the clause in question is a secondary obligation. It might amount to a primary obligation that is contingent upon an event occurring that might also amount to a breach. Lords Neuberger and Sumption observed that:

> *'[m]odern contracts contain a very great variety of contingent obligations. Many of them are contingent on the way that the parties choose to perform the contract. … The potential assimilation of all of these to clauses imposing penal remedies for breach of contract would represent the expansion of the Courts' supervisory jurisdiction into a new territory of uncertain boundaries, which has hitherto been treated as wholly governed by mutual agreement.'*

It appears, however, from Lords Neuberger and Sumption's reasoning that a clause must be primary (not subject to the rule against penalties) or secondary (subject to the rule against penalties). It cannot be a primary obligation, which due to a relationship with a default provision is subject to the rule against penalties.

Application of penalty rule to forfeiture clauses

Although four of their Lordships decided that the forfeiture clause was 'primary' (and so not subject to the rules against penalties), all seven continued to assess the enforceability of the clause as if it were 'secondary' (and so subject, in principle, to the rule against penalties). The next question, therefore, was whether the penalty rule applied to forfeiture clauses.

All of their Lordships were of the view that the rule against penalties can, in principle, apply to forfeiture clauses. In so deciding, their Lordships have approved the Court of Appeal decision in *Jobson v Johnson* insofar as that decision related to that issue. A second aspect of that case did not meet with the approval of the Supreme Court (see below).

Possibility of enforcing penalty clauses to the extent that they are not penal

The second key aspect for which *Jobson v Johnson* was authority is that in the event that a forfeiture clause was decided to be penal it could be scaled down to reflect the actual loss suffered by the non-defaulting party. As a consequence, it would be enforced to the extent that it was not penal.

By a majority of 5:2, the Supreme Court decided that a clause that offended the rule against penalties could not be enforced and, as such, could not be 'partly enforceable'. Insofar as the Court of Appeal in *Jobson v Johnson* is to be treated as a penalty case, it was 'wrong' in the 'scaling down' approach to the form of relief that it adopted. Even the minority on this point noted that a 'scaling down' offer to sell Makdessi's remaining shares at a fair or market price would go further than anything endorsed by the authorities.

Lords Neuberger and Sumption observed that the Court of Appeal in *Jobson v Johnson* were, as a matter of legal analysis, treating the clause in question as a forfeiture and not a penalty, and granting relief from forfeiture on appropriate terms, although in doing so they purported to be treating it as a penalty clause, because they were constrained to do so in the light of the pleadings. They added that so far as the relief granted in *Jobson v Johnson* is concerned, the decision was entirely orthodox if it is treated as a relief from forfeiture case (see the final paragraphs below).

The New Test: what makes a clause penal?

Having identified that a forfeiture clause might be a 'secondary obligation' to which the rule against penalties may apply, the Supreme Court proceeded to establish the test for what would make a secondary obligation penal. In this respect, the Supreme Court revisited the existing test that suggested that a clause would be penal if it were not a 'genuine pre-estimate of loss'.

Lords Neuberger and Sumption decided that the breach of restrictive covenants meant that Cavendish could no longer trust Makdessi. 'Loyalty is indivisible' and its absence can introduce significant business risk which cannot be measured simply by provable consequences of the breach. This loss of trust meant that the business was worth considerably less to Cavendish. It was a 'perfectly respectable commercial case' for Cavendish not to be obliged to pay for valuable goodwill where Makdessi's skill and connections were no longer available to the Company—indeed they were being used instead to benefit a competitor.

In this context, Lords Neuberger and Sumption thought that the old dichotomy between a 'genuine pre-estimate of loss' and a penalty was not the correct test. In the judgment of Lords Neuberger and Sumption:

> *'The real question when a contractual provision is challenged as a penalty is whether it is penal, not whether it is a pre-estimate of loss. These are not natural opposites or mutually exclusive categories. A damages clause may be neither or both. The fact that the clause is not a pre-estimate of loss does not therefore, at any rate without more, mean that it is penal. To describe it as a deterrent (or, to use the Latin equivalent, in terrorem) does not add anything. A deterrent provision in a contract is simply one species of provision designed to influence the conduct of the party potentially affected. It is no different in this respect from a contractual inducement. Neither is it inherently penal or contrary to the policy of the law.'*

Lords Neuberger and Sumption (with whom Lord Carnwath agreed) held that the 'true test' should be:

> *'whether the impugned provision 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. The innocent party can have no proper interest in simply punishing the defaulter. His interest is in performance or in some appropriate alternative to performance.'*

Lord Hodge (with whom Lord Toulson agreed) believed that the correct test for a penalty is whether the sum or remedy stipulated as a consequence of a breach of contract is exorbitant or unconscionable when regard is had to the innocent party's interest in the performance of the contract.

Lord Mance's separate, and detailed, judgement concurred with much of what Lord Hodge said (and Lord Toulson also agreed with the former's judgment). According to Lord Mance:

> *'What is necessary in each case is to consider, first, whether any (and if so what) legitimate business interest is served and protected by the clause, and, second, whether, assuming such an interest to exist, the provision made for the interest is nevertheless in the circumstances extravagant, exorbitant or unconscionable. In judging what is extravagant, exorbitant or unconscionable, I consider … that the extent to which the parties were negotiating at arm's length on the basis of legal advice and had every opportunity to appreciate what they were agreeing must at least be a relevant factor.'*

Lord Mance and Lord Toulson were of the view that the word 'unconscionable' in this context means much the same as 'extravagant'.

In addition to the above, Lords Neuberger and Sumption were of the opinion that '[i]n a negotiated contract between properly advised parties of comparable bargaining power, the strong initial presumption must be that the parties themselves are the best judges of what is legitimate in a provision dealing with the consequences of breach'.

Judges: Lord Neuberger, Lord Mance, Lord Clarke, Lord Sumption, Lord Carnwath, Lord Toulson, Lord Hodge

Dissenting (in part) Judge: Lord Toulson

Comment

It has long been recognised that forfeiture clauses in oil and gas JOAs might offend the rule against penalties and be unenforceable. The OGUK Guidance Notes to the OGUK Model Form JOA states:

'the use of forfeiture as a penalty for default under a JOA may be seen as a penalty and may give rise to potential issues under insolvency legislation. The arguments regarding the issue of a penalty are well-known…[p]arties have different opinions on the strength of these arguments and the approach of the Courts to such clauses may also vary over time.'

Establishing whether a forfeiture clause in a JOA, or farm-out agreement, is a primary or secondary obligation might not be straightforward. The Supreme Court apparently found this issue complex, itself being divided 4:3. The question is likely to be critical, as if a clause is primary, the rule against penalties simply will not apply. As the Supreme Court decided, the categorisation is a question of substance and not form.

A JOA forfeiture clause has the natural feeling of a secondary obligation, its purpose being to regulate the management of underlying interests in a licence or PSC (or other concession).

However, it is questionable whether a JOA forfeiture clause that decouples the relationship of the parties in the event that one party displays characteristics of a party unable or unwilling to take the venture forward is really so different to the 'primary' forfeiture obligations in *Cavendish v Makdessi*. In the context of forfeiture clauses in a farm-out agreement, the similarity with *Cavendish v Makdessi* might be even more striking.

The difficulty in distinguishing primary and secondary obligations was foreshadowed by Lord Denning MR, in *George Mitchell v Finney Lock Seeds* [1983] 1 All ER 108:

> *'I do hope that we shall not often have to consider the new-found analysis of contractual obligations into 'primary obligations', 'secondary obligations' and 'anticipatory secondary obligations'. No doubt it is logical enough, but it is too esoteric altogether. It is fit only for the rarefied atmosphere of the House of Lords. Not at all for the chambers of the practitioner. Let alone for the student at the university.'*

In relation to establishing whether a secondary obligation is a penalty, although the three tests established by their Lordships are worded differently, in substance it is submitted that they amount to – more or less – the same thing:

- what is the 'primary obligation' to which the 'secondary obligation' seeks to secure performance?
- is the clause in question disproportionate, unconscionable or exorbitant by reference to the innocent party's legitimate interest in the enforcement of that primary obligation?

If JOA forfeiture clauses are secondary obligations, there were a number of observations about the forfeiture clause in *Cavendish v Makdessi* that are of relevance:

- in a commercial context, there was a 'strong initial presumption' that the parties themselves are the best judges of what is legitimate in a provision dealing with the consequences of breach;
- carefully negotiated arrangements are unlikely to be regarded as 'exorbitant or unconscionable' (even if those arrangements are disproportionate or illogical) if the primary obligation breached is of basic importance. It is arguable that the payment and decommissioning security provisions that typically trigger default under a JOA are of such importance; and
- 'saving the business' or 'saving the project' may be a powerful legitimate interest for the imposition of a forfeiture obligation upon breach in excess of the likely direct loss that could be ascertained.

However, notwithstanding the welcome that commercial parties could give to the decision of the Supreme Court, there remain reasons for caution in drafting and enforcing JOA forfeiture provisions.

There remains no clear authority that English law will treat as enforceable any of the categories of forfeiture clause commonly found in oil and gas JOAs. That said, the decision of the Supreme Court appears to reduce the risk identified in the OGUK Guidance Notes that such provision might not be enforceable.

The low legal risk option in drafting JOAs remains to avoid using the type of uncompensated forfeiture provisions that are most at risk of offending the rule against penalties. However, in a volatile commodities market the alternative options available themselves result in significant commercial risk to the non-defaulting parties – perhaps requiring the purchase of an asset at a price that already is (or might rapidly become) 'out of market' within weeks of forfeiture. Further, there remain real practical and legal problems with withering provisions – which require an ability to assess the value of an asset at a specific time and ability to obtain regulatory approval for the transfer of the interest in the underlying asset on potentially multiple defaulting occasions. Unfortunately, there remains no easy option for drafters to adopt.

In drafting forfeiture provisions in JOAs, consideration should be given to the following:

- whether the clause in question is drafted as a primary or a secondary obligation (this distinction is key, albeit hard to make; English law will look to the substance rather than the form to decide if the provision is primary or secondary);
- the commercial context in negotiations between parties of equal bargaining positions with the benefit of legal advice and the 'strong initial presumption' that, in such circumstances, the forfeiture clause will be enforceable;
- the legitimate interest or justified commercial rationale to impose that obligation. If there is such a strong legitimate interest, parties should consider whether this can be properly recorded in the agreement or recitals;

— whether the process of forfeiture assists an argument of proportionality (for example, grace periods for remedying defaults); and

— the proportionality of those consequences by reference to the legitimate interests being protected.

Other issues with forfeiture clauses

Notwithstanding the 'good news' concerning the enforceability of forfeiture clauses arising out of *Cavendish v Makdessi*, a number of comments by the Supreme Court might yet result in fresh areas for controversy. Of particular concern is the Supreme Court's treatment of the Court of Appeal 'scaling down' in *Jobson v Johnson* as an example of equitable relief from forfeiture (and the view expressed that if *Jobson v Johnson* were a true relief from forfeiture case, the approach in scaling down was 'appropriate').

It has been traditionally thought that the remedy of equitable relief will result in additional time for a defaulting party to pay and avoid forfeiture. In the context of time for payment being of the essence, or the relevant agreement granting a period to remedy default in any event, the traditional remedy of equitable relief, in the form of further additional time to pay, would be of little assistance, as the authorities suggest that equity would not intervene to grant equitable relief.

However, if equitable relief amounts to a broader remedy than additional time to pay, it raises the question of whether a defaulting party might seek equitable relief from its default by requesting a sale of its interest, administered by the Court, or a Court induced withering of its interest. As equitable relief applies to primary and secondary obligations, it might create complications for forfeiture clauses in JOAs.

Voting to next exploration phase

Background

In *Adamantine Energy (Kenya) Limited v Bowleven (Kenya) Limited* [2016] EWHC 130 (Comm), the Commercial Court considered whether the parties to a sale and purchase agreement (the '**SPA**') concerning interests in Kenya had validly voted on moving into the next exploration stage. In deciding the vote was invalid, the Commercial Court considered that where there was no realistic prospect of completing the minimum work obligations in the underlying production sharing contract (the '**PSC**') on time, and where an application for extension of the existing exploration phase was pending, the vote served no contractual purpose or was premature.

While this decision ultimately fell on the specific drafting of the PSC and SPA in dispute, it provides insight into an important issue concerning votes to enter into subsequent exploration phases under PSCs.

Facts

Adamantine Energy (Kenya) Limited ('**Adamantine**') entered into a PSC with the Kenyan government in respect of largely unexplored land in Northern Kenya. The PSC provided for an initial exploration period ('**IEP**'), during which Adamantine was obliged to carry out minimum work obligations. It also provided for an option to proceed to a first additional exploration period ('**1AEP**') at the end of the IEP, provided the minimum work obligations in the IEP had been fulfilled. In order to exercise this option, Clause 2(3) of the PSC required Adamantine to make an application to the government no later than one month prior to the expiry of the IEP.

Under the SPA, Adamantine assigned 50% of the participating interest in the PSC to Bowleven (Kenya) Limited ('**Bowleven**') in return for Bowleven's agreement to 'carry' the minimum cost under the PSC of each of the exploration phases. The SPA contained a 'drill or drop' provision at Clause 8, providing that there should be a management committee meeting 'not later than three (3) months before expiry of [the IEP]' at which Bowleven and Adamantine vote on whether to proceed into 1AEP. In the event that one party voted to proceed while the other voted not to proceed, the withdrawing party was obliged to assign its participating interest to the other at no extra cost.
The relevant clause stated:

> *'8. DRILL OR DROP*
>
> *8.1 Not later than three (3) months before expiry of each Exploration Period (or any extension thereof pursuant to Clause 2.5 of the PSC), [Adamantine] and [Bowleven] shall hold a meeting of the Management Committee pursuant to Clause 5 of the JOA at which the Parties shall discuss, in good faith, and then vote on whether they jointly wish to proceed into the next Exploration Period and also the portion of the Contract Area to be surrendered pursuant to Clause 3 of the PSC.*
>
> *8.2 If the Parties agree to proceed into the First Additional Exploration Period or the Second Additional Exploration Period (as applicable), [Adamantine] shall give notice to the Government, on behalf of the Parties, of their intention to do so pursuant to Clause 2.3 or 2.4, respectively, of the PSC and [Bowleven] shall, not less than one (1) month prior to the expiry of the then current Exploration Period, deliver to [Adamantine] (i) a*

Bank Guarantee for fifty percent (50%) of the value of the Phase 2 Work Programme or Phase 3 Work Programme, as applicable (as set out in column 3 of Schedule A); and (ii) a PSC PCG Guarantee for the remaining fifty percent (50%) in value of such applicable Work Programme.

…..8.4 If either Party votes against proceeding into the next Exploration Period, but the other Party votes to proceed, the other Party may require, at any time thereafter before the expiry of the then current Exploration Period, the first Party to assign its fifty percent (50%) Participating Interest in the PSC for nil consideration…'

The Phase 1, Phase 2 and Phase 3 Work Programmes referred to were defined in Schedule A of the SPA and corresponded, so far as material, with the minimum work obligations undertaken to the government in the PSC for the IEP, 1AEP and a second additional exploration phase ('**2AEP**') respectively.

As the IEP was due to expire on 26 May 2015, three months prior to that expiry was 25 February 2015. However, delays to the completion of the minimum work obligations meant that the obligations would not be completed by 26 May 2015. This led to a formal application by the parties for an extension of the IEP.

On 25 February 2015, the parties met, Adamantine voted to proceed to 1AEP, and Bowleven also voted to proceed but on the condition that the extension to the IEP was granted. Adamantine did not accept the conditional vote, treated it as a 'no' vote, and sought a High Court order that Bowleven transfer its 50% participating interest to it.

Decision

The Commercial Court decided that what happened on 25 February 2015 was not a valid 'drill or drop' vote under the SPA, and that Bowleven therefore did not have to transfer its participating interests under the PSC.

The Commercial Court considered that the starting point in construing Clause 8 of the SPA is that the vote that it contemplates is a vote on whether to invoke rights under Clause 2(3) of the PSC. Although the wording of Clause 8.1 involves a vote on 'whether [the parties]…wish to proceed into the next Exploration Period', this is not simply a decision on whether to proceed into a further exploration period in principle or in the abstract. Exploration Period (capitalised) was a defined term in the SPA, which gave the words the same meaning as in the PSC. In the PSC 'Exploration Period' was defined by reference to the IEP, 1AEP and 2AEP. The decision required by Clause 8 of the SPA was therefore whether to enter into 1AEP, as defined in the PSC, by invoking the rights under Clause 2(3) of the PSC. This conclusion was reinforced by the terms of Clause 8.2 of the SPA which linked the voting decision required by Clause 8.1 to the invocation of rights under the PSC.

In this context the Commercial Court reasoned:

- What is contemplated as being required by Clause 8 is not, therefore, simply a vote on whether to invoke such rights under Clause 2(3) of the PSC as may exist at some indefinite point in the future. It is a vote on whether to invoke such rights as they may exist under Clause 2(3) of the PSC three (3) months later by giving a notice two (2) months later.
- It follows that there can be no requirement for a Clause 8 vote at a time when there is known to be no realistic possibility of invoking rights under Clause 2(3) of the PSC arising three (3) months later, due to the minimum work commitments not being completed.
- As a fact, both parties knew that there was no realistic prospect of completing the IEP seismic data acquisition required under the minimum work commitments of the PSC by 26 May 2015 and therefore there was no realistic possibility of invoking rights under Clause 2(3), unless the requested extension to the IEP was granted.
- It follows that what happened on 25 February 2015 was not a vote contemplated under Clause 8, as there was no realistic Clause 2(3) right to invoke.

The Commercial Court accepted that 'the position would be different if there had been a real possibility of the minimum work obligation being completed by 26 May 2015, such that a notice one (1) month earlier might give rise to a right to move into the 1AEP pursuant to the Clause 2(3) notice. If such a possibility had been in prospect on 25 February 2015, Adamantine would have been entitled to a drill or drop decision so as to be able to make the forward planning arrangements during the following three (3) months for that contingent eventuality. But if, as was the case, there was no such realistic possibility, there was no contingent eventuality of an effective Clause 2(3) notice to be considered.'

In reaching the conclusion that the vote was not valid, the Commercial Court considered it relevant that any different interpretation would have created odd commercial consequences. For example, if the government had not granted an extension, there would have been no 1AEP to move into, and no purpose to a vote, whereas if an extension was granted, it would have been possible to have the 'drill or drop' vote at a later point in time once more technical information was available to aid the decision making.

Judge: Popplewell J

Comment

Whilst the facts of *Adamantine v Bowleven* may seem special or even unique, the circumstances considered by the Commercial Court are remarkably common in the oil and gas industry where extensions to periods to carry out minimum work commitments are regular occurrences.

Although the Commercial Court appeared to take support for its approach from the commercial sense of Bowleven's construction of the SPA, Bowleven primarily benefited from the drafting of an SPA that clearly placed the parties' obligations to vote on moving into the next PSC period in the express context of rights existing under the PSC. This linking of the drafting of the SPA with the PSC allowed the Commercial Court to establish the natural and ordinary meaning of the parties' respective rights under the SPA from the suite of relevant contractual documents. In this respect, the decision of the Commercial Court might serve as useful guidance to drafters of such provisions on the importance of aligning provisions in transactional documents.

Interestingly, the AIPN (2012) Model International JOA requires any proposal to extend the Exploration Period or move to a new Exploration Period to be brought before the Operating Committee (but does not provide for a specific time period for a vote) and the Oil and Gas UK Model JOA requires that the 'Operator shall convene a special meeting' not less than ninety (90) days prior to the latest day upon which notice may be given to continue or extend the licence. The AIPN Model International JOA and Oil and Gas UK Model JOA both use language that link the extension in question to the underlying licence or PSC/contract. It may be arguable, by analogy, that the holding of such meetings and votes under such JOAs also requires the existence of a realistic prospect of a further/extended term being available.

Misrepresentation in termination negotiations

The Commercial Court has recently decided that a contracting party to an oil and gas related consultancy service agreement could be held liable for the misrepresentations made to another contracting party when those misrepresentations were made by a third party (*Monde Petroleum SA v WesternZagros Ltd* [2016] EWHC 1472 (Comm)).

Facts

In early 2006, WesternZagros Ltd ('**WZL**'), sought to negotiate and thereafter enter into an Exploration and Production Sharing Agreement (the '**PSA**') with the Kurdistan Regional Government ('**KRG**'). Following an impasse in negotiations, WZL were directed to Mr Yasser Al-Fekaiki, sole Director of Monde Petroleum SA ('**Monde**'), who had family connections within the KRG, to assist in lobbying for WZL support within the KRG.

Subsequently, WZL and Monde entered into a Consultancy Services Agreement (the '**CSA**'). The CSA allowed for monthly payments together with success fees which could be triggered by achieving 'milestones' linked to the PSA seismic program and ratification of the PSA (in the form of a confirmation and support Letter of the government of the Republic of Iraq). If ratification was achieved and subject to the milestones being reached, the PSA gave Monde the right to acquire a 3% working interest in the PSA.

In May 2006 a PSA was signed between WZL and the KRG (less than two (2) weeks after the execution of the CSA). However, at that stage the PSA had yet to be ratified. Prior to or during the PSA negotiations, Monde (unbeknown to WZL) had formed an arrangement with Bafel Talabani ('**Bafel**'), son of the President of Iraq and a Commander of the KRG's Counter Terrorism Group, who had been involved in the PSA negotiations.

In March 2007, after concerns regarding performance and rumours of a 'fall from grace' in the region, WZL faxed a Notice of termination to Monde. However, the Notice of Termination did not provide the requisite thirty (30) day notice period in accordance with the termination provisions of the CSA. In April 2007, a Termination Agreement was sent to Monde. Monde refused to sign.

There was then a change in relationship between Bafel and Monde. Bafel made a series of telephone calls to Mr Al-Fekaiki. Monde argued that Bafel advised that if it signed the Termination Agreement it would benefit through a new agreement between WZL and a politically controlled entity under which Monde would receive payment indirectly and would be no worse off than if the CSA had continued. Monde also argued that Bafel promised that Monde would receive an immediate payment of all outstanding sums due to it by WZL if it signed the Termination Agreement. Four days after Monde's initial refusal, Mr Al-Fekaiki signed the Termination Agreement, on behalf of Monde.

Issues

The Commercial Court was faced with deciding a multitude of arguments such as whether Monde was estopped from denying the validity of the Termination Agreement, whether WZL served the Termination Notice in bad faith, and whether in serving the Termination Notice WZL breached implied terms of the CSA. Ultimately, in terms of the misrepresentation point, the Court had to decide whether Monde was induced by Bafel to conclude the Termination Agreement as a result of his misrepresentations. If the answer to that question was yes, then the Court would then have to decide if Bafel was acting on behalf of WZL when the misrepresentations were made.

Decision

The Commercial Court concluded that Monde had been induced into signing the Termination Agreement by Bafel's misrepresentations. Bafel knew that his representations were false and that Monde would rely upon them to enter into the Termination Agreement.

There was no evidence that WZL had given actual authority to Bafel to negotiate on its behalf. It was for Monde to establish that WZL was legally responsible for Bafel's representations and that WZL either (i) actually authorised Bafel to make those representations, or (ii) by its words or conduct represented or permitted it to be represented to Monde that Bafel had that authority. The only direct evidence on this point came from WZL's Chief Executive Officer who informed the Court that WZL did not give any such authority to Bafel. However, the Commercial Court did not find WZL's witness evidence persuasive and went as far as to state the evidence was not credible.

The Court confirmed that conferring such authority does not have to be proved by direct evidence and instead can be inferred from circumstantial evidence. In assessing such circumstantial evidence the Court will carefully consider what was said by the third party to the other contracting party and the surrounding conduct. In this case it was evident that the third party, Bafel, was trying to negotiate a financial arrangement with WZL. The Commercial Court found in the course of those negotiations, WZL effectively asked Bafel to 'clear the decks' by getting Mr Al-Fekaiki to sign the Termination Agreement on behalf of Monde.

Monde sought, and was entitled to, damages as a result of the misrepresentations. However, although Monde was entitled to claim damages for any loss caused by the misrepresentations, the court found that Monde had suffered no such loss. Any damages recoverable by Monde from WZL for the misrepresentations had to be assessed on the basis that WZL could and would have immediately served an effective Notice of Termination, by utilising the 'termination for convenience' provision contained in the CSA, which would have brought the CSA to an end.

Judge: Popplewell J

Comment

Although it turns on a unique set of facts the case nevertheless provides a warning to industry practitioners when dealing with intermediaries, or other third parties, in connection with contractual discussions and particularly when discussions involve foreign governments.

The case serves as a reminder that the courts can, in certain circumstances, find, on the basis of circumstantial evidence alone, that a third party's misrepresentations were made with the authority and on behalf of that contracting party. Parties must be live to all representations made by third parties. Clear boundaries should be set regarding third party involvement and any conduct by the third party which could be construed adversely and on behalf of a contracting party should be addressed as soon as such conduct is identified.

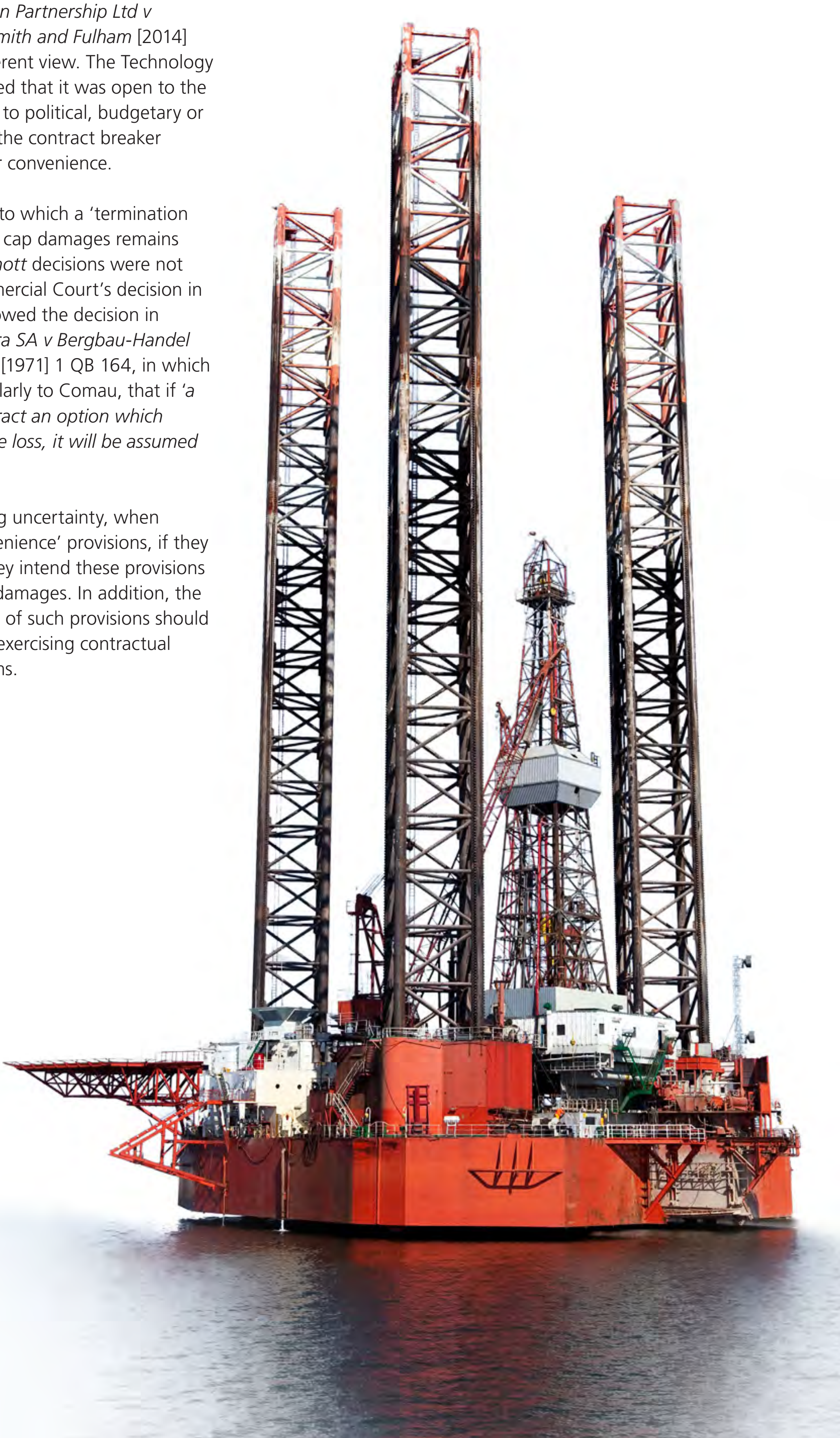
A final point of interest relates to the protection afforded, in this instance, to WZL as a result of the inclusion of a 'termination for convenience' provision. Although Monde was successful in establishing a claim for damages in misrepresentation, as WZL could have terminated for convenience, the Commercial Court decided that the 'termination for convenience' provision effectively provided a cap to recoverable damages. As the 'termination for convenience' provision did not contain a termination fee, the damages were zero.

The impact of 'termination for convenience' provisions on damages have been the subject of conflicting judicial decisions in recent years. The Commercial Court in *Comau UK Limited v Lotus Lightweight Structures Limited* [2014] EWHC 2122 (Comm) decided that when assessing damages, for breach of contract, it must be assumed that a contract breaker will perform a contract in the least onerous way possible, and therefore by implication, will terminate immediately if it has a right to do so under a 'termination for convenience' provision. Importantly, it was not necessary in Comau for the contract-breaker to evidence that it would have exercised its right to terminate for convenience. Instead, the very fact that there was such a provision contained in the contract was enough to prevent the claimant from establishing any loss incurred by them. This line of authority logically leads to the conclusion that any fee for 'termination for convenience' will work as a contractual cap on damages for misrepresentation or wrongful termination. If there is no fee, damages will be zero.

However, the Technology and Construction Court in the later decision of *Willmott Dixon Partnership Ltd v London Borough of Hammersmith and Fulham* [2014] EWHC 3191 (TCC) took a different view. The Technology and Construction Court decided that it was open to the claimant to show by reference to political, budgetary or economic considerations that the contract breaker would not have terminated for convenience.

As a consequence, the extent to which a 'termination for convenience' provision will cap damages remains unclear. The *Comau* and *Willmott* decisions were not cited as authority in the Commercial Court's decision in Monde. Instead the court followed the decision in *Maredelanto Compania Naviera SA v Bergbau-Handel GmbH* (*The* '*Mihalis Angelos*') [1971] 1 QB 164, in which the Court of Appeal held, similarly to Comau, that if '*a defendant has under the contract an option which would reduce or extinguish the loss, it will be assumed that he would exercise it*.'

It may assist parties in reducing uncertainty, when drafting 'termination for convenience' provisions, if they outline the extent to which they intend these provisions to limit ordinarily recoverable damages. In addition, the consequences of the existence of such provisions should be considered carefully when exercising contractual rights or seeking to bring claims.



Force Majeure

In *Scottish Power UK Plc v BP Exploration Operating Company Ltd and others* [2015] EWHC 2658 (Comm) the Commercial Court considered whether a contractual notification requirement is a condition precedent or an intermediate term, in relation to a force majeure claim in a natural gas sale and purchase agreement. In contemplating the issue of whether a notification provision is an intermediate term the Commercial Court addressed an issue rarely considered: whether even if notification is not a condition precedent to claiming force majeure, a material breach of the notification provision may, in any event, prevent force majeure from being claimed.

Facts

In summary, Scottish Power UK Plc ('**Scottish Power**') entered into four long-term agreements (on materially identical terms) for the sale and purchase of natural gas (the '**Agreements**'). It agreed to purchase from the sellers (BP Exploration Operating Company Limited, Talisman Sinopec North Sea Limited, ENI TNS Limited and JX Nippon Exploration and Production (UK) Limited (the '**Andrew Owners**' or '**Sellers**')) natural gas produced from the Andrew Field.

One of the questions before the Commercial Court was whether the Andrew Owners were precluded from relying on a force majeure provision as a defence to liability for the first 11 days of the shutdown by their alleged failure to comply with one of the multiple notification steps in the provision.

The force majeure clause (Article 15.2) in the Agreements stated:

> *'The Parties shall, except where otherwise specified in this Agreement, be relieved from liability under this Agreement:*
>
> *(1) In the case of the Seller, to the extent that owing to Force Majeure it has not delivered the quantities of Natural Gas which it should have delivered under this Agreement or has not performed any one or more of its obligations under this Agreement ...'*

Article 15.4 of the Agreements imposed a number of requirements on a party claiming relief under Article 15.2 on the ground of force majeure:

> *'A Party, when claiming relief under Clause 15.2 shall: –*
>
> *(1) within ten (10) Days of the failure or inability to fulfil in [sic] obligation hereunder for which relief is sought, notify the other Party thereof and shall within five (5) Working Days of such notification provide an interim report which shall furnish such relevant information as is available appertaining to the event including the place thereof, the reasons for the failure and the reasons why obligations under this Agreement were affected, and give an estimate of the period of time required to remedy the failure;*

(2) within twenty (20) Working Days of such notification, if requested, provide a detailed report which shall amplify the information contained in the interim report and contain such further explanation and information relevant to the event causing the failure as may be reasonable [sic] required;

(3) upon request, as soon as is reasonably practicable, give or procure access at the risk of the Party seeking access, for a reasonable number of representatives of the other Party to examine the scene of the event causing the failure and/or the installation, machinery or equipment which has failed, provided that the reasonable costs of transportation to the scene shall be at the expense of the Party seeking access, if such event is agreed or adjudged to give rise to relief from liability under Clause 15.2, and shall otherwise be at the expense of the Party seeking relief;

(4) subject in the case where the Seller or the Buyer is seeking relief under Clause 15.2(1) or Clause 15.2(2) (as the case may be) to the provisions of Article 7, take as soon as reasonably practicable all reasonable steps to rectify the cause of the failure and to recommence performance of its obligations under this Agreement ...;

(5) keep the other Party informed, on an ongoing basis, of the actions being taken under Clause 15.4(4).'

The Andrew Owners maintained that they complied with Article 15.4(1) by notifying Scottish Power of their claim of force majeure by a letter dated 16 May 2011 and by providing an interim report to Scottish Power on 20 May 2011. They admitted, however, that they did not provide a further detailed report pursuant to Article 15.4(2) which Scottish Power contended was a condition precedent (or subsequent) to a successful claim for relief under Article 15.2.

In the alternative, Scottish Power argued Article 15.4(2) was an intermediate term. It argued that even if Article 15.4(2) was not a condition precedent such that any failure to comply with its terms precluded force majeure relief, a sufficiently serious failure would do so.

Decision

Is Article 15.4(2) a condition precedent?

The Commercial Court considered the (differing) authorities relating to notice provisions in force majeure clauses, but concluded that they were of limited assistance to interpreting the clause in question. It found that 'consideration of how Courts have construed differently worded clauses in different contracts is necessarily of limited assistance.' Instead, the focus was on the precise terms of the Agreements with which the present case was concerned and to ascertain their meaning applying the ordinary principles of contract interpretation.

It was decided that Article 15.4(2) was not a condition precedent (or a condition subsequent) and non-compliance with it did not result in the force majeure claim failing. The basis for the decision was as follows:

— There were no words in the Agreements to stipulate that non-compliance would preclude a claim for relief on force majeure grounds. The Agreements did not say, as it easily could have, that a party must do the things stipulated in Article 15.4 in order to claim relief under Article 15.2. The absence of such language was considered to be all the more significant in light of the fact the Agreements were detailed, elaborate and clearly drafted by professionals.

— The use of the word 'shall' in Article 15.4 signifies that the requirements of the clause are mandatory as they are contractual obligations. It does not say or imply anything about what the consequence is intended to be of failing to perform those obligations. The Commercial Court noted that if, for example, the clause had used the word 'may' rather than 'shall', it would be impossible to argue that compliance was a condition precedent to a claim for force majeure relief but the inverse does not follow.

— The time within which Article 15.4(2) requires a detailed report to be provided does not commence until notification of a force majeure event has been given. By this time, the period of non-performance may already have ended.

— The Commercial Court did not consider this to be a case where it was so clear that reasonable people entering into the contract would have intended Article 15.4(2) to be a condition precedent even though it was not expressly stated. The Commercial Court stated that '*it seems far from obvious that reasonable people in the position of the parties would have thought it appropriate to make compliance with this requirement a condition of the right to claim relief for Force Majeure. Certainly, it is not so obvious that they would have thought it unnecessary to say so expressly.*'

- There is considerable room for uncertainty about whether Article 15.4(2) has been complied with. This conclusion was reinforced when the Commercial Court widened the focus to look at other provisions of Article 15.4. The Commercial Court said that it would be a strong thing to agree that, for example, failure to keep the other party informed, at any stage, of actions being taken to rectify the cause of a party's failure to perform its obligations under the Agreement should have the result that the party automatically loses its right to claim relief. It was also added that there was nothing in the language of Article 15.4 which provides any basis for treating any of its sub-clauses differently such that some of the requirements were conditions precedent to a successful claim for relief yet others were not.
- In the Court's view, it cannot be said that Article 15.4 gives no worthwhile protection if the only sanction for non-compliance is the remedy of damages.
- It was not considered that making compliance a condition precedent is inherently more sensible or commercially reasonable than not doing so.

Is Article 15.4(2) an intermediate term?

In *Bremer Handelsgesellschaft mbH v Vanden Avenne* [1978] 2 Lloyd's Rep 109 Lord Wilberforce identified three factors relevant to whether the clause in question was a condition precedent, the third of which was 'general considerations of law'. In discussing that factor, Lord Wilberforce said:

> *'Automatic and invariable treatment of a clause such as this runs counter to the approach, which modern authorities recognise, of treating such a provision as having the force of a condition (giving rise to rescission or invalidity) or a contractual term (giving rise to damages only) according to the nature and gravity of the breach. The clause is then categorised as an innominate term.'*

Counsel for Scottish Power drew the Commercial Court's attention to various authorities and referred to the *Bremer* case as authority for the proposition that a clause requiring notice to be given of an event relied on as constituting force majeure may be an intermediate term: see e.g. Chitty on Contract Law (31st Edn, 2012) at para 12-039.

Interestingly, the Commercial Court accepted that a clause which requires a party wishing to claim relief from liability on the ground of force majeure to follow a certain procedure (such as giving notice to the other party) is capable in principle of constituting an 'intermediate term' in the sense that, although a breach of the clause will not automatically deprive the party of the right to claim the relevant protection, a sufficiently serious breach will have that consequence.

Significantly, in reaching this decision, the Commercial Court noted that if, however, the label 'intermediate term' is used to describe such a clause, it is important to recognise that this designation is not being used in the same sense as when classifying contract terms for the purpose of deciding whether a breach of a particular term gives the innocent party a right to terminate the contract.

However, while the Court accepted that a clause which requires a party wishing to claim a particular contractual benefit or protection to follow a certain procedure (for example, giving notice to the other party) is capable in principle of constituting an 'intermediate term', in this case it held that Article 15.4(2) was not.

The Commercial Court decided that classification of a term as an intermediate term is, unless the parties have agreed its status, a matter of law for the Court and not a question of interpretation of the contract. The Commercial Court went on to say that there is no rule of law whereby the consequence of a breach of a procedural requirement specified in the contract is the loss of the right to claim relief on the ground of force majeure. The only basis on which a sufficiently serious failure to comply with Article 15.4(2) could be treated as precluding a claim for force majeure relief, even though a less serious failure would not, is if this is what the parties have agreed, on the proper construction of the contract. For similar reasons to those discussed in relation to Article 15.4(2) being a condition precedent, the Commercial Court held that there was no reason to infer that there were any circumstances in which the parties must be taken to have intended the language of Article 15.4(2) to mean that the failure to provide a further, detailed report, would prevent a party from claiming force majeure relief.

Judge: Leggatt J

Comment

Disagreements relating to whether notification provisions amount to a condition precedent to claiming force majeure are a well-trodden ground for oil and gas lawyers. However, debates concerning whether a notification provision might amount to an 'intermediate term' are less common.

Whilst the decision of the Commercial Court might create an additional level of uncertainty concerning the conditionality of claiming force majeure, it largely reinforces the approach that if it is intended that giving a specified notice should be a pre-requisite to being able to claim for force majeure, this should be clearly articulated in the contract; otherwise, it is unlikely that the non-performing party will be precluded from relying on a force majeure defence. In addition, if notice provisions are intended to create conditionality, the notice provisions and how to fulfil them should be clearly set out so that parties are in no doubt as to whether the requirements have been fulfilled.

Although the decision does create the potential for a notice provision being an intermediate term, the test of whether it does so is one of law rather than contractual construction. As the decision of the Commercial Court illustrates, there may be limited circumstances in which English law would decide a notification provision is an 'intermediate term'.

Oil and gas regulation and licensing

This year saw a revolution in the regulation of the United Kingdom oil and gas industry. The Energy Act 2016 and implementation of 'maximising Economic Recovery' will likely affect exploration, development, production and decommissioning strategies on the United Kingdom Continental Shelf ('**UKCS**').

Energy Act 2016 and MER UK

The United Kingdom oil and gas industry is undergoing its biggest regulatory reform in a generation. Implementing the recommendations of the Wood Review, the Infrastructure Act 2015 amended the Petroleum Act 1998 to create the principal objective of maximising the economic recovery of UK petroleum ('**MER UK**'), and commenced the creation of the Oil and Gas Authority (the '**OGA**'). That task will be completed when the relevant provisions of the Energy Act 2016 (the '**Act**') come into force.

The MER UK Strategy

The strategy for MER UK (the '**MER UK Strategy**') underpins this regulatory reform. The first MER UK Strategy came into force on 18 March 2016. It '*is intended to lead to investment and operational activities that, on an expected basis, add net value overall to the UK*'. The aim is to make a 'bigger pie', rather than each company seeking a 'bigger slice' and the OGA's view is that, to achieve MER UK, the industry must accept that all companies will not always be in a better position individually. This aspect of the new regime will require the industry as a whole to come to terms with a radically different approach to decision making and expectations.

MER UK Strategy scope

The MER UK Strategy sets out a series of obligations that are generally binding when '*relevant persons*' carry out '*relevant functions*'. Relevant persons are:

— The Secretary of State;

— The OGA;

— Holders of, and operators appointed under, offshore petroleum licences; and

— Owners of, and persons planning and carrying out the commissioning of, upstream petroleum infrastructure.

Relevant functions are, broadly, the planning and carrying out of upstream activities under a petroleum licence, either as licence holder or operator, or on their behalf.

MER UK Strategy structure and key provisions

The MER UK Strategy consists of: five safeguards, a Central Obligation, sixteen supporting obligations; and nine required actions and behaviours. Five principles are also set out in the strategy document but do not form part of the MER UK Strategy itself – they are described as intended '*to clarify the nature of the obligations created by the Strategy*'. Despite that, the MER UK Strategy is a relatively short, high level document and so also provides for the OGA to make more detailed plans setting out how MER UK obligations will be met.

Safeguards

The safeguards try to ease the tension between a flexible, high level approach and certainty. They appear in the final version of the MER UK Strategy even before the Central Obligation and supporting obligations, having been brought forward from their location in earlier drafts to emphasise the importance placed on them by the OGA. The whole MER UK Strategy is to be read in accordance with the safeguards and these include, for example, confirmation that compliance with the MER UK Strategy will not require conduct that otherwise conflicts with applicable laws, nor will it require '*any person to make an investment or fund activity (including existing activities) where they will not make a satisfactory expected commercial return on that investment or activity*'. This latter safeguard is intended to address significant industry concerns regarding the impact of this new regime, although there remains uncertainty as to the extent to which this new regime will affect investment decisions and priorities.

Central Obligation

The Central Obligation requires that: '*relevant persons must, in the exercise of their relevant functions, take the steps necessary to secure that maximum value of economically recoverable petroleum is recovered from the strata beneath relevant UK waters*'. This is a mandatory duty (albeit to be read subject to the safeguards).

Required actions & behaviours

The following binding behaviours apply to relevant persons when carrying out the Central Obligation and the supporting obligations:

— **Timing**
All obligations must be complied with in a timely fashion.

— **Collaboration**
Among other things and where relevant, persons must consider whether collaboration with other relevant persons and those providing services relating to relevant functions in the region could reduce costs, increase recovery of economically recoverable petroleum or otherwise affect their compliance with the obligation in question.

— **Cost reduction**
The obligations set out in and deriving from the MER UK Strategy require that the full lifecycle costs of the recovery of petroleum, including decommissioning, and operations relevant to such matters be reduced as far as possible.

— **Relinquishing assets**
Where after a reasonable period a relevant person has decided not to ensure maximum value of economically recoverable petroleum or is unable to secure alternative investment or funding, they shall relinquish the licence.

Plans

It was originally anticipated that the MER UK Strategy would set out in some detail how OGA anticipates that the industry should work to achieve MER UK. However, it seems that the detail will instead be contained in subsidiary plans or strategies that will be produced in due course. Work on these is being undertaken on seven core areas by MER UK Boards, constituted under the MER UK Forum, where industry, government and the OGA have come together to work on the practical application of the high level aims and priorities now set out in the legislation and the MER UK Strategy. The first of these, the Decommissioning Strategy, was published on 30 June 2016.

The Energy Act and the OGA

The Act received Royal Assent on 12 May 2016. For the oil and gas industry, the Act completes implementation of the key recommendations of the Wood Review for a new regulatory regime:

— already an Executive Agency of BEIS, the OGA becomes a Government Company, to increase its independence from government;

— Schedule 1 of the Act transfers certain regulatory functions from the Secretary of State to the OGA in order that it can regulate the industry; and

— the OGA receives new enforcement powers to enable it to meet its mandate of achieving MER UK (although these parts of the Act have not yet been brought into force).

Although the Act provides for OGA to be independent from government (in so far as is possible for a regulator) it sets out various matters to which the OGA must have regard in the exercise of its duties. These include:

— Minimising future public expenditure;

— Security of supply;

— Storage of carbon dioxide;

— Collaboration;

— Innovation; and

— Ensuring a stable system of regulation.

OGA Powers under the Act

Access to information and disclosure

The OGA may request petroleum related information or samples relevant to its functions. Failure to comply could result in sanctions. This will arguably give the OGA access to information on almost all activities in the UKCS, subject only to legal privilege. The OGA must not disclose any information obtained except to certain other departments, regulators and public bodies. Recipients may only use information to the extent necessary to carry out their functions. This may have been intended to give comfort to stakeholders providing commercially sensitive information to the OGA, but still leaves scope for considerable transfer of information across government.

Meetings

The OGA must now be given fourteen (14) days' advance written notice (or as much notice as possible) of any meeting involving a relevant person which may relate to MER UK or activities under a licence, to enable OGA to attend if it wishes. A written summary of the meeting must be provided to the OGA within a reasonable period afterwards. The OGA may impose sanctions for non-compliance. As drafted, these requirements evidently cover many (perhaps most) industry meetings. However, given the potential administrative burden on the OGA, it will probably limit the requirement to notify to certain pre-defined categories of meetings or those where it has expressed a specific interest.

Sanctions

Once in force, the OGA will have a range of options to address breaches of a 'petroleum related requirement', including a failure to follow the MER UK Strategy or a breach of a licence. These will include enforcement notices, financial penalty notices, removal of operators, and revocation of licences. Parties can appeal to the First Tier Tribunal where sanctions are imposed. The OGA must consult and issue guidance on what it will consider when deciding on a financial penalty. That process is underway and is expected to conclude during Summer 2016. The OGA's stated intention is that the regime should be transparent, consistent and targeted.

Dispute-resolution

The OGA will have discretion to give non-binding recommendations on disputes, acting on its own initiative, or where a dispute is referred to it by a relevant party. Where it decides to act, the OGA will issue a timetable and request further information or meetings; failure to comply will risk sanctions. The OGA's non-binding recommendation must take into account the MER UK Strategy and the priorities placed on it under the Act. In practice, the OGA is likely to apply its limited resources only if significant value or important project timescales are at issue. Although the OGA has stated that it will not directly intervene in existing commercial arrangements, it remains to be seen what impact a non-binding recommendation from the OGA may have on such arrangements. Guidance on the dispute resolution process is expected later this year.

Decommissioning

The Secretary of State must approve an abandonment programme under the Petroleum Act 1998 before any decommissioning of an installation or pipeline is commenced. The Act will require relevant persons to consult the OGA before submitting an abandonment programme to the Secretary of State, and requires the Secretary of State to consider representations from the OGA when deciding whether to approve a programme. The Secretary of State may impose conditions or require amendments to programmes in order to reduce costs, particularly as regards timing and collaboration. Alternatives to decommissioning, such as re-use or preservation, must be considered by the OGA.

Fees and levies

The OGA has the power to charge fees for the carrying out of certain functions, which will be determined by regulations. The Oil and Gas Authority (Levy) Regulations 2016 (effective 1 April 2016) set the levy for the period from 1 April 2016 to 31 March 2017. Under these Regulations, licensees for production licences where the licensee is entitled to carry out works for the purpose of getting petroleum or is getting petroleum from that area is due a levy of £64,951.96, while exploration and production licenses without an approved plan to get or convey petroleum are due £6,808.65.

The OGA's priorities

The OGA's overall aim is to achieve the maximum extension of field life, ensure that decommissioning is executed in a safe, environmentally sound and cost effective manner and ensure that the UK gains a competitive industrial capability.
In support of MER UK, the OGA Corporate Plan 2016-

2021 has a focus on revitalising exploration, driving development and infrastructure, and ensuring the right technology and regulatory conditions are in place to support this. The OGA indicated in its Corporate Plan that it will adopt a tripartite approach to achieve MER UK:

1. Regulating oil and gas, and carbon storage;
2. Influencing industry culture, commercial behaviour, and promoting collaboration; and
3. Promoting investment in the UKCS, creating value, and developing the industry.

Comment

The UKCS is a mature basin with a high cost base and, while cooperation in the oil and gas industry is not a new concept, there is now a renewed focus on increased collaboration to reduce costs and increase recovery. The OGA is keen to contribute where it can, and has followed an initial UK Government £20m Seismic Acquisition Program in 2015, by awarding a second £20m seismic campaign to PGS and WesternGeco on 13 July 2016, with the aim of stimulating more accessible data and so encouraging exploration to promote the MER UK and the Central Obligation.

However, there remain a number of significant challenges for the industry. It is not yet clear how Theresa May and her new government will approach the oil and gas sector, with Oil and Gas UK commenting that they '*want to work with Mrs May and her administration to ensure a sustainable future for this vital industrial sector that supports hundreds of thousands of jobs*'. The emphasis placed on cooperation in the new regulatory regime gives rise to potential competition law risks that the OGA and industry stakeholders will need to navigate. Arguably the most difficult challenge for the industry will be adapting to this collaborative, cooperative climate in an economic environment that has significantly reduced the appetite and resources available for new investment decisions. Behaviours can be notoriously difficult to change, but the industry is under pressure and appears to recognise that some change is required – with its new status and powers, it may be that the OGA has the weight behind it to create a lasting shift.

Extension of petroleum licence terms

The OGA has recently used its powers to extend the Initial Term of a UKCS seaward production licence. With low hydrocarbon prices continuing, attracting investment to carry out exploration work remains a challenge to many companies with seaward production licences on the UKCS. The decision by the OGA suggests that it is willing to play its part to assist oil companies in weathering current adverse market conditions.

Facts

IOG North Sea Limited ('**IOG**') (part of the Independent Oil and Gas group), held a 100% interest in Licence P.1609, Block 9/21a which comprises the Skipper oil discovery which it acquired from Alpha Petroleum Resources in 2015.

Following the acquisition of Licence P.1609, and in light of the lower oil price environment, IOG sought to extend the Initial Term of the licence term and thereby provide IOG with further time to drill an appraisal well on the acreage once economic conditions allowed.

Licence P.1609, which was granted in February 2009, incorporated the model clauses contained in the Petroleum Licensing (Production) (Seaward Areas) Regulations 2008 (S.I. 2008/225). Model Clause 7 states:

> '7.—(1) This clause enables an extension to be made to the Initial Term or as the case may be to the Second Term ('the relevant term').
>
> (2) At any time not later than three months before the expiry of the relevant term the Licensee may, subject to payment of the sums specified in Schedule 2 and to performance of the terms and conditions herein contained, give notice in writing to the Minister that he desires that term to be extended for a further period.
>
> (3) Where notice is given in pursuance of paragraph (1) of this clause, the Minister may in his discretion direct in writing that the relevant term be extended; and paragraph (2) of this clause shall apply to that term as so extended.
>
> (4) An extension given by a direction in pursuance of this clause shall be for a period, and subject to such conditions, as the Minister may determine.
>
> (5) Where a relevant term is extended in pursuance of this clause, clause 3 shall apply in respect of that term as so extended.
>
> (6) Where the Initial Term is extended by a period in pursuance of this clause, the Second Term shall (without prejudice to paragraph (2)) be reduced by the same amount; and where the Second Term is extended by a period in pursuance of this clause, the Third Term shall be reduced by the same amount.'

Decision

The OGA, acting on behalf of the Secretary of State for the Department of Energy and Climate Change (the '**Minister**'), exercised its discretion under Model Clause 7 to permit an extension to the Initial Term of Licence P.1609, such that the Initial Term will run in total for a period of almost eight years.

Although the OGA's reasons were not published, the extension until the end of 2016 will allow IOG extra time to drill a well to appraise its Skipper oil discovery, which will help:

— determine an optimum field development plan for the Skipper field;

— give IOG more time to negotiate with its lenders and contractors; and

— delay in *spudding* the well so as to enable IOG to benefit from an improvement both in environmental conditions (the end of the North Sea winter storm season) and economic conditions, including low oil prices.

Comment

In the current market, oil companies are seeking extensions to Initial Terms of a significant number of licences, production sharing contracts and similar agreements across the globe.

The ability of the relevant regulator (or national oil company) to assist an oil company seeking an extension will likely depend upon the terms of the relevant licence (or agreement) in question, or the powers that it is granted under the underlying statutory framework.

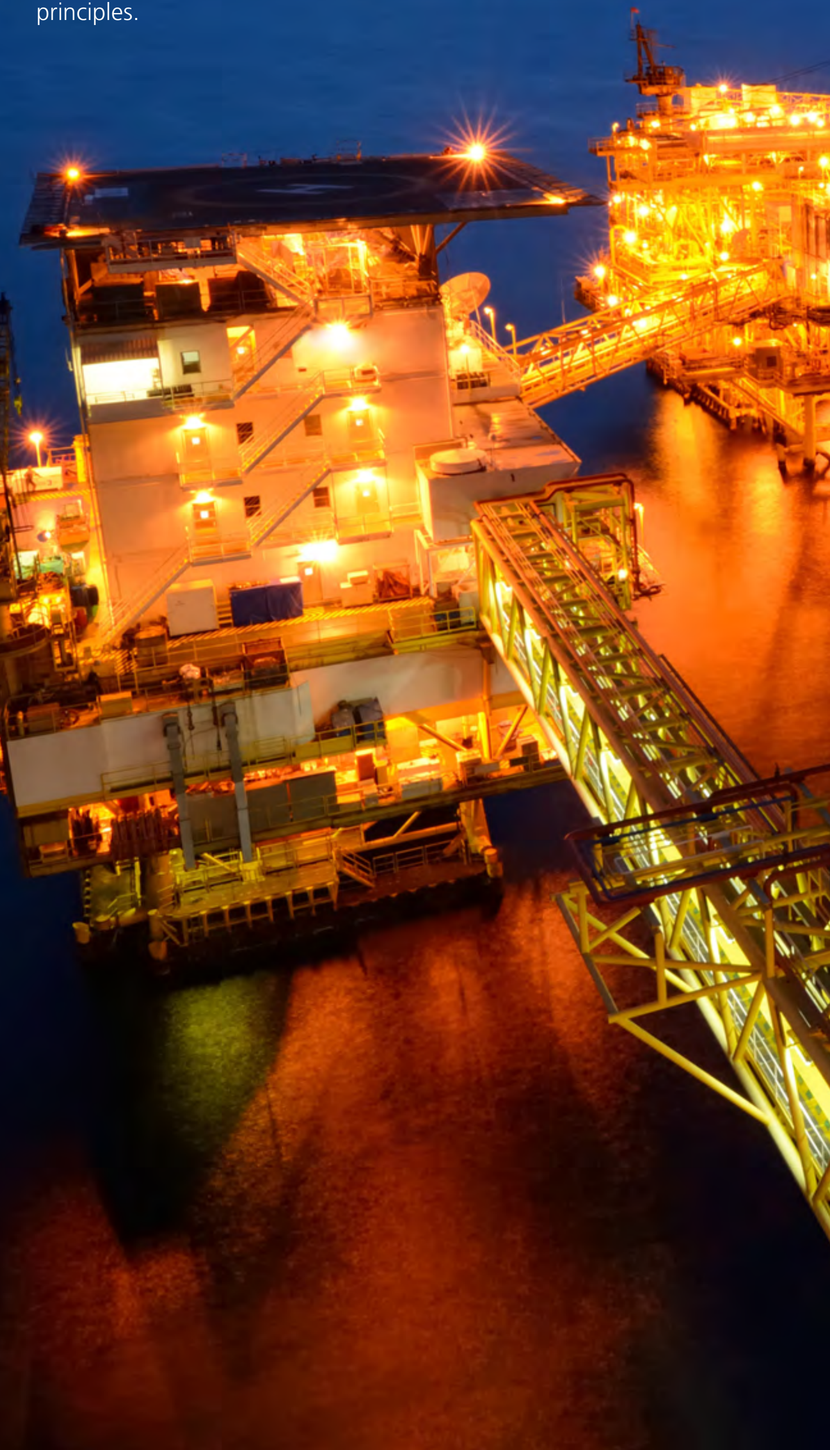
In the United Kingdom, more recently granted seaward production licences contain express provisions anticipating circumstances where oil companies wish to seek an extension to the Initial Term or Second Term. An oil company is not entitled to an extension as a matter of right. The terms of the licences grant the Minister 'discretion' to 'direct in writing that the relevant term be extended'.

However, the exercise of such discretion is unlikely to be without limitation. Whilst there remains a perennial debate over whether a UKCS licence should properly be construed as a contract or statutory licence, it might make limited legal difference when it comes to the limitations on the Minister's discretion:

— If a statutory licence, the Minister's discretion will be constrained by the usual public law considerations – including that discretion must be exercised 'reasonably' (*Associated Provincial Picture Houses Ltd. v Wednesbury Corporation* [1948] 1 KB 223)

— If a licence is a contract, the Minister's discretion will be restrained by the principle that contractual discretion must be limited by 'concepts of honestly, good faith and genuineness, and the need for the absence of arbitrariness, capriciousness, perversity and irrationality' (*Socimer International Bank Ltd v Standard Vank London Ltd* [2008] 1 Lloyd's Rep 558)

As the OGA develops the MER Strategy, it is likely to play a significant role in its exercise of discretion on whether to grant extensions to licensees with seaward production licences permitting extensions to terms. However, the OGA will remain obliged to exercise its discretion in accordance with the relevant legal principles.



Transportation and processing

As the UKCS and other basins mature, disputes concerning transportation and processing are likely to increase in frequency. In addition, onshore access for pipelines continues to raise issues concerning land owner compensation.

- In *Scottish Power UK Plc v BP Exploration Operating Company Ltd & Ors* [2015] EWHC 2658 (Comm) the Commercial Court grappled with the relationship between the words in the contract and commonly accepted industry standards for operating.
- In *Perenco UK Limited Southern Gas Networks PLC v Mr William Henry Bond* [2016] EWHC 1498 (TCC) the Technology and Construction Court was required to consider the relationship between notification for compensation provisions in multiple agreements relating to adjacent pipelines.

Impact of shut-in of production on gas sales agreements

In *Scottish Power UK Plc v BP Exploration Operating Company Ltd & Ors* [2015] EWHC 2658 (Comm) the Commercial Court was required to consider the impact of a shut-in of production, for the purposes of tie-in works, on the respective rights of producers/sellers and buyers under related gas sales agreements. In deciding that the buyers were entitled to compensation for the period of the shut-in, the case highlights some of the dilemmas likely to face the North Sea industry in implementing MER UK alongside existing contractual obligations.

Facts

Scottish Power UK plc ('**Scottish Power**') entered into four long-term agreements (on materially identical terms) for the sale and purchase of natural gas (the '**Agreements**'). It agreed to purchase from the sellers (BP Exploration Operating Company Limited, Talisman Sinopec North Sea Limited, ENI TNS Limited and JX Nippon Exploration and Production (UK) Limited (the '**Andrew Owners**' or the '**Sellers**') natural gas produced from the Andrew Field.

The obligation to deliver an amount of natural gas in accordance with Scottish Power's proper nomination was contained in Article 6.12 of the Agreements, which provided that:

> *'the Seller shall deliver on each Day at the Delivery Point the quantity of Natural Gas properly nominated by the Buyer under this Agreement for delivery on such Day.'*

Article 16 established a regime whereby, when an under delivery occurred on any day, the quantity of gas which the Sellers had failed to deliver was classified as Default Gas and the Buyer would become entitled to receive a like quantity of gas in a subsequent month at the Default Gas Price, which was 70% of the Contract Price.

The provision at the centre of the dispute was Article 16.6, which stated:

> *'The delivery of Natural Gas at the Default Gas Price and the payment of the sums due in accordance with the provisions of Clause 16.4 shall be in full satisfaction and discharge of all rights, remedies and claims howsoever arising whether in contract or in tort or otherwise in law on the part of the Buyer against the Seller in respect of underdeliveries by the Seller under this Agreement, and save for the rights and remedies set out in Clauses 16.1 to 16.5 (inclusive) and any claims arising pursuant thereto, the Buyer shall have no right or remedy and shall not be entitled to make any claims in respect of any such under delivery.'*

The agreements also provided a reasonable and prudent operator ('RPO') standard at Article 7.1:

> *'Throughout the Contract Period the Seller will, in accordance with the Standard of a Reasonable and Prudent Operator, provide, install, repair, maintain and operate those Seller's Facilities which are (in the opinion of the Seller and the other Sellers) necessary to produce and deliver at the relevant times the quantities of Natural Gas from the Andrew Field which are required, in accordance with the terms of this Agreement, to be delivered to the Buyer at the Delivery Point.'*

A RPO was defined in Article 1 as:

> *'a Person seeking in good faith to perform its contractual obligations and, in so doing and in the general conduct of its undertaking, exercising that degree of skill, diligence, prudence and foresight which would reasonably and ordinarily be expected from a skilled and experienced operator engaged in the same type of undertaking under the same or similar circumstances and conditions, and the expression the 'Standard of a Reasonable and Prudent Operator' shall be construed accordingly.'*

Production of natural gas was shut-in for a period of over three and a half years, between 2011 and 2014, so that work could be done to tie-in a nearby oil and gas field to the Andrew platform.

In summary, the Andrew Owners broadly accepted that their failure to deliver gas to Scottish Power was a breach of Article 6.12 of the Agreements. It was common ground that the sole remedy for any breach of that clause was Default Gas under Article 16. However, it was Scottish Power's case that, during the relevant period, the Andrew Owners were also in breach of their obligation under Article 7.1 to operate the Sellers' Facilities for which it was entitled to separate damages. The Andrew Owners denied that they were in breach of Article 7.1 but argued that, even if they were, Default Gas was also the sole remedy for the alleged breach of that clause.

Decision

Liability

It was Scottish Power's position that the Andrew Owners were to carry out, in accordance with the RPO standard, five activities in relation to the relevant facilities. In order to carry out any of these activities to the required standard, the Andrew Owners had to carry them out in the first place. On that basis, Scottish Power argued that if they were not operating the facilities at all, they could not be operating them in accordance with the RPO standard.

However, the Commercial Court rejected Scottish Power's contention for the following reasons:

- The language of Article 7.1 was not language which parties would naturally have used if they intended to impose two distinct obligations – one absolute and the other qualified.
- Scottish Power's interpretation arguably leads to an unreasonable result. For example, it may be necessary to cease operating the facilities for a period while repairs are carried out. If the obligation to operate the facilities was an absolute one as Scottish Power asserted, the Andrew Owners would be subject to two mutually inconsistent obligations and would be in breach of the clause whatever they decided to do. The Court stated '*to place the* [Andrew Owners] *in a situation where they must violate the contract in order to perform it is not something that rational parties would have intended.*'

That said, the Commercial Court went on to find the Andrew Owners in breach of the RPO obligation for the following, contract specific, reasons:

- The natural and ordinary meaning of the words '*a Person seeking in good faith to perform its contractual obligations*' in the definition of RPO meant that the RPO obligation related to performing the Agreements and not wider industry concerns relating to best practice.
- Whilst, the impact of the Andrew Owners' obligations under the Petroleum Act 1998, Gas Act 1995 and the Industry Code of Practice on Access to Upstream Oil and Gas Infrastructure on the UK Continental Shelf ('**ICOP**'), concerning good practice relating to tie-ins and BEIS ability to intervene to grant third party access, were considered by the Commercial Court, meant that the Andrew Owners

did act '*as a reasonable operator in their position would have done, take account of and seek to comply with the provisions of ICOP*', '*[t]here was nothing in the language of the definition [of RPO] to support*' an interpretation that ICOP or statutory obligations had a role to play in deciding whether the Andrew owners had acted in accordance with the RPO standard for the purpose of the Agreements.

— As the decision to shut-in production was a purposeful decision not to provide services to provide, install, operate and maintain the Seller's Facilities during the tie-in period it was a breach of the RPO clause giving rise to a separate claim under Article 7.1.

Damages

The Andrew Owners maintained that in the event of a breach of the RPO standard in Article 7.1 the agreements provided for a comprehensive remedial framework in such circumstances where there was an under-delivery of natural gas, i.e. Scottish Power's only remedy could be Default Gas. Scottish Power claimed that it was entitled to bring a separate claim for damages, which it accepted in Court would have to be reduced to account for any double recovery with Default Gas.

In this respect, the Commercial Court recognised that Default Gas was not a remedy at the election of the parties. The word 'shall' in the Default Gas provision meant that, in the circumstances of underdeliveries, Default Gas automatically accrued. Against this background the Commercial Court decided:

— The Agreements did not provide a complete code for remedies available for the breach of the RPO provision. In certain circumstances, general damages would be available.

— However, where the compensation claim related to underdeliveries '*the remedy of Default Gas, is the sole remedy available for the loss*' – effectively meaning that the Andrew Owners' position prevailed.

In reaching this conclusion, the Commercial Court undertook a detailed analysis of this issue. It accepted that there was more than one possible interpretation and therefore considered the differing interpretations based on the commercial purpose of the clause.

Judge: Leggatt J

Comment

This case brings into stark clarity the issues that the industry may face in the next few years between balancing obligations under the new Energy Act 2016 to be maximising economic recovery from the UKCS ('**MER UK**') and complying with existing contractual arrangements.

The Commercial Court was unwilling to use the factual matrix to expand the scope of the Andrew Owners' RPO obligation beyond the natural and ordinary meaning of the words, which required the Andrew Owners to '*perform its contractual obligations*'. In this respect, the approach of the Commercial Court arguably sought to apply the principles in *Arnold v Britton* [2015] UKSC 36 (see page 54) by placing an emphasis on the natural and ordinary meaning of the words and less emphasis on the factual matrix behind the parties' agreement. As a consequence, the Andrew Owners' arguments that it acted as an RPO due to the shut-in being for the purpose of facilitating a tie-in so as to accord with ICOP were not of relevance to deciding if there was a breach of Article 7.1.

The Commercial Court's decision suggests that sellers with similar clauses, in the same position as the Andrew Owners, might in the future be placed in the invidious position of having a contractual RPO obligation to continue performance of sale and purchase agreements, whilst having a regulatory obligation concerning MER UK that requires it to shut-in production for a period so as to facilitate tie-in of additional fields to further the government's stated policy objective of maximising economic recovery on the UKCS. The creation of such conflicting obligations are a significant issue for operators.

Onshore pipelines – nothing goes without saying

In the recent case of *Perenco UK Limited Southern Gas Networks PLC v Mr William Henry Bond* [2016] EWHC 1498 (TCC) the Technology and Construction Court refused to imply a term into a deed concerning compensation to the land owner for 'sterilisation' so as to make the compensation provisions work in unison with another agreement that offered compensation for an adjacent pipeline on the same land. The decision of the Technical Construction Court illustrates the strict approach to implying terms into such agreements.

Background

Mr William Henry Bond is the owner of land adjacent to a clay mine.

On 1 June 1994 Mr Bond entered into a deed with British Gas plc ('**BG**') that granted an easement to BG to run a subsurface pipeline across land owned by Mr Bond (the '**BG Deed**'). The relevant easement could have been acquired under Schedule 3 to the Gas Act 1996, but the parties elected to agree a deed. Southern Gas Networks Plc ('**SGN**') is the successor to BG.

On 23 September 1994, BP Exploration Operating Company Ltd. ('**BP**') also entered into a lease (the '**BP Lease**') with Mr Bond for the subsoil of a strip of land to run their pipeline. This pipeline ran roughly in parallel to the BG pipeline. The rights to run the pipeline could have been compulsorily acquired under the Pipelines Act 1962. Perenco UK Ltd. ('**Perenco**') is successor in title to BP.

It was not in dispute that the effect of the presence of the pipelines was to 'sterilise' the extraction of clay and other minerals from the land in question.

As is usual, the BG Deed and the BP Lease each provided for compensation to Mr Bond in circumstances where he was in a position to extract the clay or other minerals but was prevented from doing so due to the relevant pipeline.

In relation to the BG Deed, the effect of these provisions was that if Mr Bond wished to work any minerals, he had to give 30 days' notice of his intention to do so to SGN. SGN could then give a counter-notice requiring Mr Bond to leave the minerals unworked. In that case, SGN would become liable to pay compensation to Mr Bond. If no such notice was given within the 30 day period, Mr Bond could work the minerals and would not be liable for damage caused so long as he does so '*in the manner proper and necessary*'. However, SGN may give a counter-notice 'at any time' and after the expiry of the 30 day period, in which case works could not then be started or, if started, would then have to stop and compensation be paid.

The BP Lease incorporated a different clause which required Perenco to give a counter-notice within 3 months to pay compensation if it did not want to divert its pipeline.

The compensation terms were different between the BG Deed and BP Lease, as the BG Deed provided for compensation for minerals that could not be exploited whereas the BP Lease provide for compensation based on the diminution in value of the land. However, there was a provision in each agreement that prevented double compensation – which would have allowed Mr Bond to receive only the greater amount and BG and BP would each pay half of that amount.

Mr Bond gave the notice required to Perenco and SGN. Perenco, under the BP Lease, provided its counter-notice within the required 3 month period and paid Mr Bond £287,525 (plus interest) as compensation, being its assessment of the diminution in value due to the presence of its pipeline.

SGN's position was that it was not obliged to, and therefore did not serve a counter-notice as it could serve a counter-notice '*any time*'. As the service of the counter-notice was the trigger provision for the payment of compensation SGN argued that it therefore followed that it did not come under any obligation to pay compensation.

Mr Bond disagreed and stated he was entitled to compensation under both the BG Deed and BP Lease. His view was that if SGN were entitled not to pay compensation merely by not serving a counter-notice, the BG Deed needed an implied term in order for it to make commercial sense. His argument was put as follows:

> *'The Claimant contended that a term should be implied into the BG Deed to the effect that in circumstances in which a notice has been served …and the proposed mineral workings will cause damage to both the gas pipeline under the BG Deed and the oil pipeline under the BP Lease, and an election has been made under paragraph 2(2)(b)(ii) of the BP Lease to pay compensation, then the grantee under the BG Deed shall be deemed to have also served a counter-notice in order to engage the compensation provisions of the 'mining code'….. The Claimant also contend that the implied term would deem a counter-notice to have been served (as opposed to require), as this would represent a more commercial approach and avoid the need to require specific performance.'*

Whilst contending that no compensation was payable, SGN in their skeleton argument, estimated compensation of £2,382,817 which was therefore significantly higher than Perenco had paid.

Arbitration

As required by the agreements the dispute as to the level of compensation and the timing of any notice from SGN was referred to arbitration which found in favour of Mr Bond. This was on a contention that there was an implied term requiring SGN to serve a counter-notice to trigger the payment of compensation.

Perenco and SGN then appealed.

Decision

On appeal, the Technology and Construction Court referred to *Marks and Spencer v BNP Paribas Securities Services Trust Company (Jersey) Limited* [2015] UKSC 72 (see page 54) and reiterated Lord Neuberger's statement of principle which he derived from Lord Simon's speech in *BP Refinery (Westenport) Pty Ltd. v Shire of Hastings* (1977) 180 CLR 266. These state that for a term to be implied, the test must be satisfied:it must be reasonable and equitable;

1. it must be necessary to give business efficacy to the contract, so that no term will be implied if the contract is effective without it;
2. it must be so obvious that it goes without saying;
3. it must be capable of clear expression; and
4. it must not contradict any express term of the contract.

Taking into consideration *Marks and Spencer v BNP Paribas* and the facts in dispute, the Court decided that there was no implied term. The Court considered that if BP and BG had contemplated the particular scenario in the putative implied term put to them by Mr Bond, they might have agreed some other provisions to cater for it. However it was not at all clear either that they intended something other than what was expressly agreed and which would have put them in a worse position than reliance on their statutory rights.

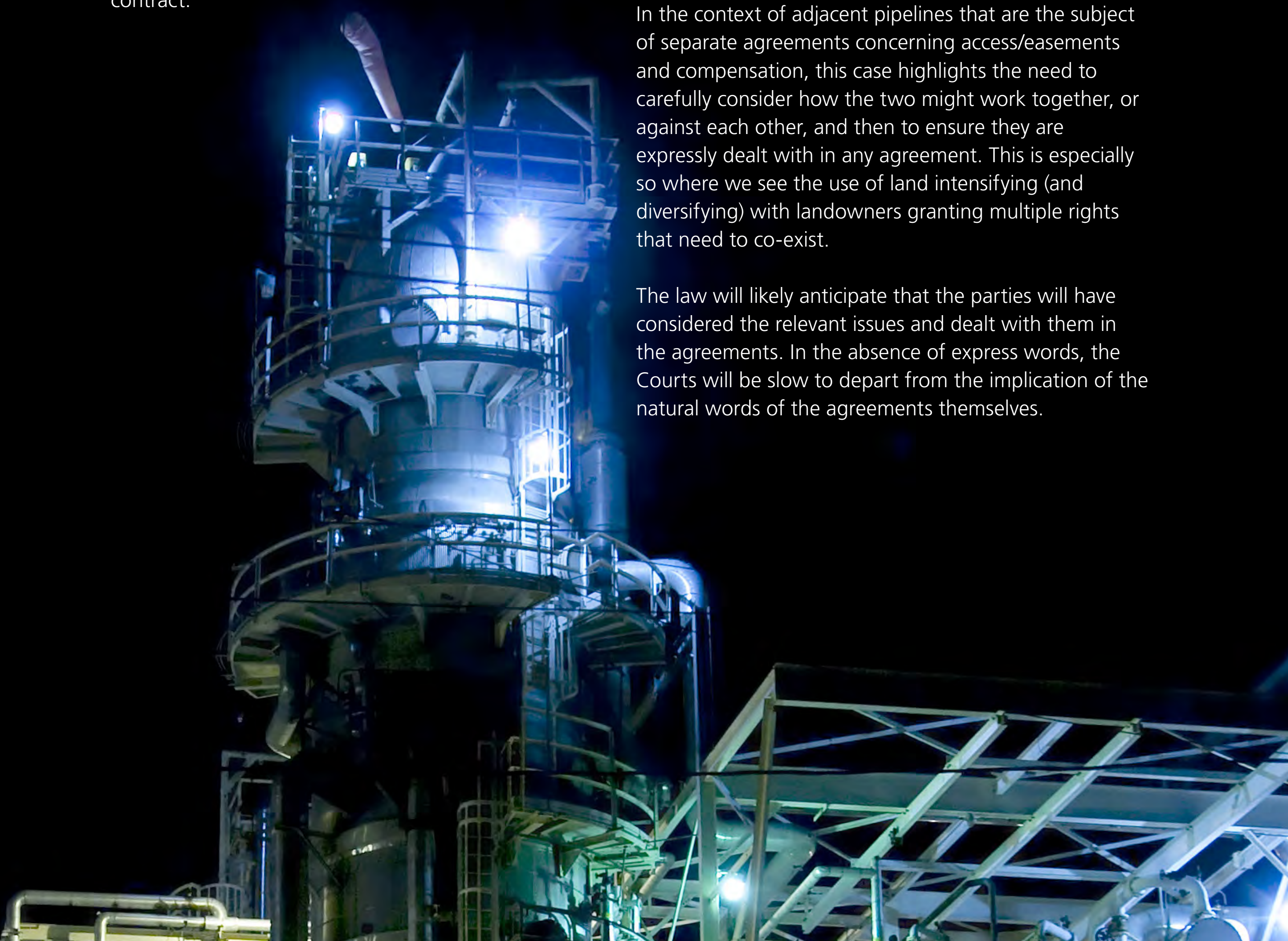
The Technical and Construction Court was of the opinion that it would have been very simple for the parties to have agreed express wording to deal with the situation now contended for by Mr Bond and the fact that they did not do so was very telling. This was especially so where it was clear that the statutory provisions had been considered, and amended, and where the document itself 'worked' without the need of any further implied terms.

Comment

The decision of the Court illustrates that following *Marks and Spencer v BNP Paribas* the Courts are applying a strict approach to implying terms into agreements. As a consequence, absent statutory intervention, it will be difficult to imply a term into an agreement that was subject to extensive negotiation between legally advised parties.

In the context of adjacent pipelines that are the subject of separate agreements concerning access/easements and compensation, this case highlights the need to carefully consider how the two might work together, or against each other, and then to ensure they are expressly dealt with in any agreement. This is especially so where we see the use of land intensifying (and diversifying) with landowners granting multiple rights that need to co-exist.

The law will likely anticipate that the parties will have considered the relevant issues and dealt with them in the agreements. In the absence of express words, the Courts will be slow to depart from the implication of the natural words of the agreements themselves.



Consequential loss

The past twelve months has seen further case law which is of critical importance to the industry and once more highlights the difficulty of construing consequential loss clauses:

— In *Transocean Drilling UK Ltd v Providence Resources plc* [2016] EWCA Civ 372 the Court of Appeal overturned the Commercial Court's decision on its interpretation of whether a specific amendment to the LOGIC Model Form consequential loss clause excluded a claim for 'spread costs'.

— However, in the Singapore High Court case of *Transocean Offshore Ltd v Burgundy Global Exploration Corp* [2013] 3 SLR 1017 Transocean sought a restrictive interpretation of a consequential loss clause, which might be said to be inconsistent with its own successful case in *Transocean Drilling UK Ltd v Providence Resources plc.*

— In *Scottish Power UK Plc v BP Exploration Operating Company Ltd and others* [2015] EWHC 2658 (Comm) the Commercial Court considered the proper interpretation of contractual exclusion clauses for 'loss of use, profit and production' in a natural gas sale and purchase agreement. In doing so, it made some interesting comments in relation to consequential loss clauses in the context of the oil industry.

— In *University of Wales v London College of Business Ltd* [2015] EWHC 1280 (QB) the Mercantile Court considered an exclusion clause for loss of profit contained in an agreement between the parties.

Exclusions for 'loss of use' and wasted costs

The Court of Appeal recently overturned the Commercial Court's decision in *Transocean Drilling UK Ltd v Providence Resources plc* [2014] EWHC 4260 (COMM), by deciding that a 'consequential loss' clause prevented a claim for 'spread costs' from being brought against a contractor (*Transocean Drilling UK Ltd v Providence Resources plc* [2016] EWCA Civ 372).

Importantly, the decision seems to turn on the specific wording of the clause in dispute. It is also worthy of attention that the contractors lack of a right to receive the Repair Rate during a breakdown was not appealed.

Facts

Transocean Drilling UK Ltd ('**Transocean**') provided the drilling unit GSF Arctic III (the '**Rig**') to Providence Resources plc ('**Providence**') pursuant to a drilling contract dated 15 April 2011 (the '**Contract**'). The dispute related to the financial consequences of delays which occurred to the drilling of an appraisal well in the Barryroe Field off the south coast of Ireland between November 2011 and March 2012.

The delays occurred following problems with the blow out preventer ('**BOP**') stack, between 18 December 2011, when operations were first interrupted as a result of problems with the alignment of the BOP, and 2 February 2012 when the Rig was ready to resume operations. This period was described by the parties as the '**Disputed Period**'.

Transocean claimed remuneration of US$13,035,083.97 and £3,516,758.45 in accordance with the rates provided for in the Contract together with reimbursables. Only a small part of this amount arose in respect of the Disputed Period.

Providence contended that:

— in respect of the remuneration claim for the Disputed Period, it was not liable for periods of delay caused by breaches of contract by Transocean; and

— in respect of the balance of the remuneration claim, it was entitled to set off its counterclaim, which was for wasted costs comprising spread costs of other contractors left idle during the Disputed Period.

The Commercial Court found for Providence on both points. Transocean was not entitled to payment during periods when it was not providing the work due to breakdown of the BOP. Further, Providence was entitled to set-off spread costs. Transocean appealed the spread costs set-off issue.

Decision

The appeal decision focussed on the term excluding liability for Consequential Losses (Clause 20 of the Contract), which provided that recovery by either party of the following liabilities was excluded (emphasis added):

> *'(i) any indirect or consequential loss or damages under English law, and/or*
>
> *(ii) to the extent not covered by (i) above, loss or deferment of production, loss of product,* ***loss of use (including, without limitation, loss of use or the cost of use of property, equipment, materials and services including without limitation, those provided by contractors or subcontractors of every tier or by third parties)****, loss of business and business interruption, loss of revenue (which for the avoidance of doubt shall not include payments due to [Transocean] by way of remuneration under this CONTRACT), loss of profit or anticipated profit, loss and/or deferral of drilling rights and/or loss, restriction or forfeiture of licence, concession or field interests.'*

Providence sought to argue that the Commercial Court's interpretation of Clause 20 was correct. In summary:

- As an exclusion clause it should be construed *contra proferentum*.
- In construing such a contract the law starts with the presumption that neither party intends to abandon any remedies for its breach arising by operation of law, and clear express words must be used in order to rebut this presumption *(Gilbert-Ash (Northern) Ltd v Modern Engineering (Bristol) Ltd* [1974] AC 689).
- As a consequence, sub paragraph (ii) of the Consequential Loss clause must be construed in the context of it being a specifically defined incursion into the territory of the first limb of *Hadley v Baxendale* [1854] EWHC J70, and should therefore be approached by treating the enumerated types of loss as incremental incursions into that territory, construed narrowly to limit the scope to specific categories narrowly defined rather than a widespread redefinition of excluded loss.
- Further, sub paragraph (ii) of the consequential loss clause listed losses of a genus, which relates to loss of income or benefit. The words loss of use should be read in this context and construed *ejusdem generis*.
- The words in parenthesis relate to the words 'loss of use' and Providence did not lose the use of the spread.
- If the clause were construed against Providence, it would render its meaning so wide as to mean that Providence would have no remedy in the event of total non-performance by Transocean. The Court will not readily construe a clause as having this effect because to do so is to render the primary performance obligations in the contract effectively devoid of contractual content, there being no sanction for non-performance.

The Court of Appeal rejected Providence's arguments. In doing so it made some important points concerning the construction and interpretation of 'consequential loss' exclusion clauses:

- The starting point to interpreting all clauses is the natural and ordinary meaning of the words used. In this instance, the words in brackets after 'loss of use' made it clear that 'loss of use' was intended to have a wide meaning and so Clause 20 was sufficiently broad to cover spread costs.
- The *contra proferentum* principle has no part to play in interpreting the meaning of the exclusion clause where the meaning of the words is clear (nor does it have a role to play in relation to a clause which favours both parties equally, especially where they are of equal bargaining power).
- The principle in *Gilbert Ash (Northern) Ltd v Modern Engineering (Bristol) Limited* [1974] AC 689 that a party should not be taken to have surrendered valuable contractual rights in the absence of clear language is to say no more than the surrender of rights must be apparent from the language used (fairly construed). That principle also has no part to play in interpreting a clause where the meaning of the words is sufficiently clear, particularly in the context of an exclusion clause where the question is not whether the parties intend to abandon common law rights, but the extent.

In considering the wording of the particular clause in question, it was not apparent to the Court of Appeal *'why the nature of the clause calls for a narrow construction in order to limit its scope'*. It considered the construction of the clause adopted by the Commercial Court 'strained' and thought it *'wrong to treat the words in brackets as limited by the general expression'* (i.e. loss of use). On the contrary, the Court of Appeal considered that the words in brackets were to *'clearly explain and amplify the meaning of the expression'*. The natural and ordinary meaning of the words used in the brackets accurately described *'spread costs'* in this scenario and therefore Transocean's liability for these losses should be excluded, consistent with the agreement of the parties.

The Court of Appeal considered Providence's argument that a broad interpretation of the clause might exclude all losses. It held that it was open to contracting parties to exclude all losses should they elect to do so, and, second, that such an argument would have no impact on an express agreement to exclude 'loss of use or cost of use of property… etc.' That said, if necessary the Court of Appeal would have decided that Clause 20 does not exclude liability for a deliberate repudiation.

Judges: Moore-Bick LJ, McFarlane LJ, Briggs LJ

Comment

'Consequential loss' clauses

It is not entirely apparent from the Court of Appeal's decision whether the words in brackets, following the words 'loss of use', that Transocean argued were a description of spread costs, were determinative of the dispute. The issue is important, as 'loss of use' is excluded in numerous drilling unit contracts. However, the specific words in brackets were incorporated through special conditions and are, perhaps, less usual. It seems likely that they were copied from the International Association of Drilling Contractors model form more widely used in the United States and inserted into a clause that otherwise followed the LOGIC Model Drilling Rig General Conditions of Contract form.

It is arguable that the Court of Appeal decision, in its binding *ratio*, goes no further than confirm that English law will uphold the natural and ordinary meaning of the words in a contract where there is only one sensible meaning (see *Arnold v Britton* [2015] UKCS 36 at para 15). In the context of the Court deciding that alternative interpretations were 'strained', it reached the only decision that it considered open to it.

However, a more expansive interpretation of the decision might result in a development of the recent approach adopted by the Courts to exclusion clauses. The decision arguably creeps into the principle in *Gilbert Ash*, so as to suggest that where exclusions or limitations are mutual, a less restrictive approach might be taken by English law.

Further, the suggestion by the Court of Appeal that the nature of the scope of exclusions in question suggests an intention to *'differ from typical exclusion clauses'* towards a more complete code of mutual liability sharing between sophisticated commercial parties arguably sits poorly with the Court of Appeals own decision in *Seadrill v Gazprom* [2010] EWCA Civ 691.

We understand that an application to appeal to the Supreme Court has been filed. It remains to be seen whether the Supreme Court will entertain an appeal. However, the decision of the Court of Appeal is doubtless of importance to the oil and gas industry. In the interim, the decision may not be determinative of the interpretation of 'consequential loss' exclusion clauses that do not contain similar words to those in brackets or where the parties are not of equal bargaining power. As a consequence, this area of law will doubtless continue to develop.

'Repair Rate' and 'Breakdown'

The issue of whether Transocean was entitled to the Repair Rate during certain periods of breakdown was not appealed.

It is likely that this is because: (i) the Commercial Court found, as a matter of fact, that Transocean had failed to *'carry out all of its obligations under the Contract and shall execute the WORK with all due care and diligence and with the skill to be expected of a reputable contractor experienced in the types of work to be carried out under the Contract'*; and (ii) as a consequence, the Court of Appeal would have been bound by its decision in *Sonat Offshore SA v Amerada Hess* [1998] 1 Lloyd's Rep 145 that it is inherently unlikely that a party intended to pay, or the contractor to exact, payment when due to the contractor's lack of care whether the duty of care was contractual or tortious.

As a consequence of the Commercial Courts finding of fact concerning Transocean's failure to carry out the Work with due care and skill, it would not have proven productive for Transocean to appeal the Commercial Courts finding against it concerning its obligation to 'maintain' the drilling unit.

Clause 4.1 of the General Terms required that *'[t]he Drilling Unit and all other equipment, materials and supplies hereinafter specified as being provided by [Transocean] shall be in good working condition and together with the personnel, shall be provided and maintained by [Transocean]'*. The Commercial Court decided that this meant that Transocean was obliged to maintain the drilling unit as adequate to conduct the Work. The simple breakdown of the drilling unit was a breach of this obligation.

Transocean disagreed. On Transocean's case the obligation to maintain the Drilling Unit was circumscribed by the 'due care and diligence' obligations such that the Repair Rate would be due unless a breach of 'due care and diligence' could be established. Transocean pointed out that if the Commercial Court were correct, due to Transocean's obligations to maintain the rig in working order, the Repair Rate would only apply in very limited circumstances, such as: (i) damage by heavy weather; or (ii) damage caused by third party equipment.

Unfortunately, due to the Commercial Court's finding of fact, on 'due care and diligence', the Court of Appeal did not consider whether a failure to maintain the drilling unit in working order, absent a breach of 'due care and diligence', would result in Transocean being unentitled to remuneration.

As the words in Clause 4.1 concerning maintenance were incorporated from the LOGIC Model Drilling Rig General Conditions of Contract, the issue of whether a simple breach of maintenance obligations occurs upon a breakdown, regardless of the standard of the contractors care, are of significant importance to the industry. In the context of the current market, it might not be long before another case is required to revisit this point.

Exclusions of loss: 'consequential loss' decisions from overseas

The decision in *Transocean v Providence* is not the only ongoing dispute concerning the meaning of the words in a 'consequential loss' clause. In a dispute with a long litigation history, a Singapore Court considered a 'consequential loss' clause in another drilling unit contract in *Transocean Offshore Ltd v Burgundy Global Exploration Corp* [2013] 3 SLR 1017. However, in that dispute it is Transocean that sought a restrictive interpretation to the 'consequential loss' clause by reference to some of the principles rejected by the Court of Appeal.

Facts

Transocean Offshore Limited ('**Transocean**') brought a case against Burgundy Global Exploration Corporation ('**Burgundy**') relating to an offshore drilling contract for the provision of a semi-submersible rig (the '**Drilling Contract**'). Burgundy failed to pay a deposit for the rig into an escrow account, which Transocean claimed resulted in a repudiatory breach of the escrow agreement (the '**Escrow Agreement**') entitling Transocean to validly terminate the Drilling Contract and claim damages in the sum of US$105,937,952, representing Transocean's loss of net profits under the Drilling Contract. Notably, the Drilling Contract and the Escrow Agreement provided for different dispute resolution mechanisms. Under the Drilling Contract, disputes were to be referred to arbitration whereas the Escrow Agreement contained a jurisdiction clause in favour of the Singapore Courts.

Burgundy argued that Transocean was precluded from making any claim against it for loss of profits upon repudiatory breach by reason of the wording of Article 19.1 of the Drilling Contract, which provided as follows (emphasis added):

> *'For the purposes of this sub-clause 19.1, the expression 'Consequential Loss' shall mean any indirect or consequential loss howsoever caused or arising whether under contract, by virtue of any fiduciary duty, in tort or delict (including negligence), as a consequence of breach of any duty (statutory or otherwise) or under any other legal doctrine or principle whatsoever whether or not recoverable at common law or in equity. Consequential Loss shall be deemed to include, without prejudice to the foregoing generality, the following to the extent to which they might not otherwise constitute indirect or consequential loss:*
>
> *a. loss or damage arising out of any delay, postponement, interruption or loss of production, any inability to produce, deliver or process petroleum* ***or any loss of or anticipated loss of use, profit or revenue...'***

Interestingly, Transocean argued that the clause should be read restrictively *contra proferentum* against Transocean and that a strict *ejusdem generis* approach should be applied in reviewing the wording of Article 19.1.

Decision

The Singapore High Court found in favour of Transocean.

The Singapore High Court decided the Singapore law principles of interpretation of exclusion clauses found in the Singapore Court of Appeal decision of *Singapore Telecommunications Ltd v Starhub Cable Vision Ltd* [2006] 2 SLR(R) 195 ('**Singapore Telecommunications**') should be applied, which states that:

> *'... The focus on the purpose of the contract and the circumstances in which it was made is particularly apt where exemption clauses are concerned. The general rule should be applied that if a party otherwise liable is to exclude or limit his liability or to rely on an exemption, he must do so in clear words; any ambiguity or lack of clarity must be resolved against that party: per Lord Hobhouse in Homburg Houtimport BV v Agrosin Private Ltd [2004] 1 AC 715 at [144]. The principle that exemption clauses must be construed strictly entails, as this Court held in Hong Realty Pte Ltd v Chua Keng Mong [1994] 2 SLR(R) 90 ('Hong Realty') at [19], that the application of such clauses must be restricted to the particular circumstances the parties had in mind at the time they entered into the contract.'*

Applying these principles to the Drilling Contract, the High Court decided that if Article 19.1 was not intended to apply to the contracting parties *inter se* where the loss of profits suffered were the net profits that one party would otherwise have earned under the Drilling Contract had both parties performed their respective obligations. Article 19.1 therefore did not exclude any claim by Transocean for loss of net profits of this nature.

In reaching this conclusion, the Singapore High Court referenced a passage from *Oil and Gas Infrastructure and Midstream Agreements* (Langham Legal Publishing, 1st Ed, 2009) ('**Oil and Gas Infrastructure**'), relied upon by Transocean, on the purpose of 'consequential loss' clauses in oil and gas contracts. The Singapore High Court considered that was a '*helpful starting point in construing the intentions of the parties with respect to the scope of Article 19.1*'. Oil and Gas Infrastructure states:

> *'Whether as part of the liabilities and indemnities clause, or, due to its importance, as a separate clause, there will almost always be a provision to the effect that neither party is to have any liability to the other for consequential losses. This is usually non-controversial because of the magnitude of the potential losses if, for instance, the operator were to lose significant production because of the contractor's default, or the contractor were to lose future business because of an ill-timed suspension. …*
>
> *Even if there were no such clause, the Court might well hold that some losses of the kind specified as consequential losses are not properly claimable; however the Court will be seeking to determine whether the losses are too remote to be permissible as contract claims, and this is probably not the test the parties are aiming to apply, or the result they want to achieve. Therefore, the clause will no doubt exclude claims for some categories of loss that might well otherwise be awarded, and that is its importance: limitation and certainty.*
>
> *To achieve this certainty the parties need to give careful consideration to the types of loss the phrase 'consequential losses' is to cover, and how they are to be defined in the contract. The definition will usually include loss of product or production, loss of revenue, and loss of profit. It is useful to add loss of or under contract, since this will preclude a claim by the operator for damages payable under a dependent oil or gas sale or transportation agreement which may arise due to late completion, or a claim by the contractor for losses arising from cancellation of a subsequent contract or a subcontract due to the operator's default. The greater the detail, the greater the clarity.'*

The Singapore Court reasoned that:

— The structure of Article 19.1 is inclusionary: the general limb defines the term 'Consequential Loss' in terms of the general law on indirect and consequential losses and there is a further enumeration of a list of categories of losses that are covered by the term 'Consequential Loss', without prejudice to the scope of the general limb.

— In the context of contractual exclusion of liability, the English Court of Appeal has construed the phrase 'consequential loss' as confined to loss or damage falling within the second rule in *Hadley v Baxendale* [1854] EWHC J20. The English approach was followed by the Court of Appeal in *Singapore Telecommunications*.

— Based on this line of authorities, the same narrow construction applied to the phrase '*any indirect or consequential loss howsoever caused or arising*' in Article 19.1.

— The general limb of Article 19.1 thus only applied if Transocean's loss of net profits under the Drilling Contract fell within the second rule in *Hadley v Baxendale* where Burgundy's liability following a termination of the Drilling Contract was concerned.

— However, as stated in the passage in Oil and Gas Infrastructure, parties in the oil and gas industry may also delineate how 'consequential loss' is to be defined. They may include specific categories of loss that might otherwise be classified as direct loss under the first rule in *Hadley v Baxendale* and would hence not be excluded under the general definition of consequential and indirect loss.

— Under the Drilling Contract, the term 'Consequential Loss' in Article 19.1 is likewise given an expansive and detailed definition that is not limited to the confined meaning of the term as ordinarily understood under general principles of interpretation of exclusion clauses. Sub-clause (a) of Article 19 deems that 'Consequential Loss' additionally includes, *inter alia*, '*any loss of or anticipated loss of use, profit or revenue*', and sub-clause (d) includes '*loss of bargain, contract, expectation or opportunity*' within the exclusion.

— The phrase '*any loss of or anticipated loss of...profit*' should be construed in the light of the overall genus of losses contemplated (*ejusdem generis*) in sub-clause (a), i.e. losses flowing from disruptions or delay to production or processing of petroleum. Sub-clause (a) was only intended to cover loss of profit attributable to causative events related to production issues, e.g. loss of profits from an inability to perform third party contracts of sale or delays in production due to breakdown of the rig.

- The quantum of losses flowing from production issues and the consequential effects on third party contracts are often of an open-ended magnitude that cannot be fully anticipated by the parties at the time of entering into the initial contract of hire and it is common in the industry for parties to seek to expressly limit liability for this particular category of losses.
- If the parties had intended to exclude any losses of profits howsoever caused, it was open for the parties to unequivocally exclude this as a separate, free-standing category; but on a *contra proferentum* construction, in the absence of such an unmistakable indication of the parties' intentions, the most commercially sensible interpretation that does not depart from the meaning of the words used in clause (a) is that the exclusion was limited to loss of profits arising from production issues related to the Drilling Rig.
- Further, as a more general point, if Burgundy's interpretation of Article 19.1 was correct and sub-clause (a) and (d) were construed to cover any loss of profits that either party would have or anticipated to have made from the Drilling Contract, the exclusion would effectively undermine the commercial purpose of the Drilling Contract by giving the parties virtually no effective recourse against the other for a breach of the Drilling Contract apart from the recovery of (at most) reliance losses.
- As Transocean pointed out, this would be tantamount to negating the contractual bargain by excluding all expectation losses under the Drilling Contract. It was highly unlikely that the parties would have intended this result, particularly as the Drilling Contract was of a capital intensive nature and was a contract of substantial value.

As a consequence, Transocean was not prevented from seeking its loss of profits for repudiatory breach of contract.

Judge: Ang J

Comment

The case was later appealed by Burgundy to the Singapore Court of Appeal on a number of grounds, including that the damages that were awarded to Transocean for losses of profit were losses under the Drilling Contract and not the Escrow Agreement and should therefore be settled by arbitration (*Burgundy Global Exploration Corp v Transocean Offshore International Ventures Ltd and another appeal* [2014] SGCA 24). On appeal it was decided that the High Court had erred in its judgement that damages could be recovered by Transocean under the Drilling Contract.

The Court of Appeal found that there was no legal basis for allowing Transocean to recover the losses it suffered from a breach of the Drilling Contract in an action for breach of the associated Escrow Agreement. Any dispute regarding a breach of the Drilling Contract should be settled by arbitration and therefore the damages awarded to Transocean should reflect the loss of the security it suffered as a result of Burgundy's breach of the Escrow Agreement.

However, it is perhaps of interest that the approach taken by Transocean in the Singapore High Court with regard to the *contra proferentum* and *ejusdem generis* interpretation of exclusion clauses, appears to be at direct odds to its successful approach in the Court of Appeal in *Transocean Drilling UK Ltd v Providence Resources plc* [2016] EWCA Civ 372. Due to the nature of the appeal, the Singapore Court of Appeal did not comment on the Singapore High Court's *contra proferentum* interpretation of Article 19.1 or provide any further discussion on the topic.

Although the Court of Appeal in *Transocean v Providence* did decide, *obiter*, that the 'Consequential Loss' clause in that case would not have been construed to exclude damages for a repudiatory breach, its reasoning was different to the Singapore High Court. The reasoning of the Singapore High Court is almost entirely consistent with the approach the Commercial Court in *Transocean v Providence* subsequently rejected by the Court of Appeal.

Exclusions for loss of use, profit and production

In *Scottish Power UK Plc v BP Exploration Operating Company Ltd and others* [2015] EWHC 2658 (Comm) the Commercial Court considered the proper interpretation of contractual exclusion clauses for 'loss of use, profit and production' in a natural gas sale and purchase agreement. The Commercial Court found against Scottish Power and made some interesting comments in relation to consequential loss exclusion clauses in the context of the oil industry.

Facts

Scottish Power entered into a long term agreement for the sale and purchase of natural gas (the '**Sale and Purchase Agreement**') from the owners of an oil and gas field known as the 'Andrew Field' some 230km north east of Aberdeen in the North Sea (the '**Sellers**'). The Sellers were found by the Commercial Court to have breached the Sale and Purchase Agreement by failing to produce gas from the Andrew Field during a period of shut-in largely related to a project to tie-in an adjacent field to existing infrastructure. As an additional claim to its contractual Default Gas claim, Scottish Power claimed to recover general damages for the additional costs it had incurred in sourcing replacement gas from third parties at a higher price than provided for by the Sale and Purchase Agreement.

Amongst other defences, the Sellers relied upon Article 4.6 of the Sale and Purchase Agreement which provided that:

> *'…neither Party shall be liable to the other Party for any loss of use, profits, contracts, production or revenue or for business interruption howsoever caused and even where the same is caused by the negligence or breach of duty of the other Party.'*

The Sellers argued that Scottish Power's claim was one for 'loss of use' or 'loss of production' as it concerned Scottish Power's inability to use gas produced from the Andrew Field or a lack of production of gas by the Sellers from the Andrew Field. Alternatively, the Sellers argued that Scottish Power's purchase of replacement gas at a higher price had mitigated the loss of profit and revenue it would have otherwise suffered had it been unable to source replacement gas. Existing authority (see below) had suggested that a claim for costs incurred in mitigating or avoiding a loss was to be classified in the same way as the loss avoided for the purpose of an exclusion clause. The Sellers argued that Scottish Power's claim could on this basis also be classified as a claim for loss of profit or revenue.

Decision

Although the Commercial Court decided that general damages were not available to Scottish Power, it did go on to reach a decision on the Sellers' Article 4.6 defence. The Commercial Court rejected both of the Sellers' arguments. In interpreting Article 4.6 the Commercial Court drew a distinction between three types of losses:

1. The normal or basic measure of loss for a failure to supply goods, being the difference between the contract price and the market price of the goods at the time or times when they ought to have been delivered;
2. Secondary losses which go beyond the normal or basic measure of loss, for example if replacement goods are unable to be found with the result that the purchaser's ability to trade is affected; and
3. More remote losses which would not in ordinary circumstances be expected to arise. These losses have in the past been referred to by the Courts as 'consequential' and 'indirect' losses (falling within the second limb of the rule in *Hadley v Baxendale* [1854] EWHC J70) and require both parties to have specific knowledge as to the risk of such losses at the time of entering into the contract.

The Commercial Court considered it clear that Article 4.6 did not intend to exclude the normal measure of loss for a failure to supply gas, but was aimed at secondary losses going beyond the usual measure. As the words 'consequential' and 'indirect' were not used in the clause, there was no need to limit the exclusion to the third category of remoter types of loss mentioned above. Accordingly, the references to 'loss of use' and 'loss of production' were interpreted by the Commercial Court as being directed to the future use by Scottish Power of gas to be supplied from the Andrew Field for its own business and the production of other products from it (such as electricity).

The Commercial Court also applied this distinction to the alternative argument proposed by the Sellers that the costs incurred in purchasing gas at a higher price and mitigating its loss of profit and revenue were also excluded by Article 4.6. The Commercial Court noted that if this argument were to work, it would have the 'conjuring trick of extracting from an exclusion of liability for secondary losses (only) an exclusion of liability for the normal loss flowing from a breach of contract as well'. In this way, a loss that is incurred in mitigating a loss that is excluded by Article 4.6 must not itself be regarded as a loss that is also caught by the exclusion. Only those mitigation costs which are beyond the normal measure of loss were intended to be excluded by Article 4.6.

Judge: Leggatt J

Comment

Although the decision of the Commercial Court is *obiter* (as a finding on this point was not strictly necessary), taken together, these cases emphasise that prior to the Court of Appeal decision in *Transocean v Providence* the Commercial Court continued to interpret exclusion clauses narrowly. It remains to be seen whether this approach entirely survives *Transocean v Providence*.

The reasoning reaches the same conclusion as *Glencore Energy UK Ltd v Cirrus Oil Services Ltd* [2014] EWHC 87 (Comm), where the Commercial Court decided that a clause that excluded recovery of 'loss of profits' for the sale of refined crude did not exclude damages for a failure to deliver.

In the context of oil and gas sale and purchase contracts, direct 'loss of profit' and 'loss of use' seem to be being consistently interpreted to mean losses arising under potential downstream arrangements and not a loss of bargain for the contract in question. In this respect, the Commercial Court's decision is arguably consistent with *Transocean v Providence* where the Court of Appeal commented, obiter, that the 'consequential loss' clause would not apply to a repudiatory breach.

Underlying the Commercial Court approach appears to be a concern to ensure that an alleged wronged party is not left devoid of contractual remedy in the event that its counter-party fails to perform its contractual obligations – unless such arrangement has been clearly and unambiguously agreed.

This case is currently awaiting appeal that is listed to be heard on the 5-6 October 2016 in the Court of Appeal.

Exclusion clauses: Loss of 'future or anticipated' profit

In *University of Wales v London College of Business Ltd* [2015] EWHC 1280 (QB) the Mercantile Court considered an exclusion clause for loss of profit contained in an agreement between the parties for the validation of qualifications. Although this is not an oil and gas industry case, it forms part of the important series of decisions emanating from the Courts concerning exclusion clauses that seek to cover 'loss of profit' or 'anticipated profit'.

Facts

The London College of Business (the '**LCB**') had entered into an accreditation arrangement with the University of Wales (the '**University**') whereby students enrolled in certain LCB courses would receive, upon completion of their course, a degree qualification from the University. In return, the LCB was to pay to the University certain accreditation fees.

The LCB fell behind with the payment of accreditation fees and the University sought to terminate the arrangement. The LCB disputed the termination and claimed £25 million in damages, alleging that the University's decision had destroyed its business. In defence of the LCB's claim, the University relied on the following exclusion clause in the agreement between the parties (referred to as the '**Validation Agreement**'):

> *'17. LIABILITY*
>
> *…*
>
> *17.3 … Neither party shall have any liability whatsoever to the other whether in contract tort or otherwise for any losses or damages:*
>
> *17.3.1 which were not reasonably foreseeable by the parties or either of them at the date of this Agreement; or*
>
> *17.3.2 to the extent to which they are attributable to any intervening act, omission or event; or*
>
> *17.3.3 which represent loss of any anticipated or future business, revenue, goodwill or profit.'*

Decision

In deciding in favour of LCB, the Mercantile Court gave the exclusion clause a restrictive interpretation. It decided that the reference to loss of business and profit was limited to losses arising from other contracts or business which LCB or the University might have had with third parties outside the Validation Agreement. The clause was intended to prevent the LCB or the University from claiming that, in addition to loss of profit or business under the Validation Agreement, it had also suffered damage to its general business reputation and been deprived of the opportunity to grow its business in other ways.

In explaining its reasons, the Mercantile Court sought to confirm that '*the normal principles of contractual construction apply to exclusion and limitation clauses as they apply to other contractual terms*' and that '*in cases where there is uncertainty about the parties' intention, and therefore about the meaning of the clause, such uncertainty will be resolved against the person relying on the clause*'.

Notably, the Mercantile Court referenced the finding that the *contra proferentem* rule of construction comes into play only if the words used are found to be equally capable of bearing two different meanings, and are therefore ambiguous. However, if the application of the normal principles of construction provides a clear meaning, the Court must give effect to it and is not entitled to strain the construction to avoid the result.

The Mercantile Court found that the wording of Clause 17.3.3 was clear and that the context of the sub clause within the wider clause helped to ascertain its meaning. While Clause 17.3.1 excludes liability for breaches caused by the other party, Clause 17.3.2 merely states familiar rules of remoteness and causation. Clause 17.3.3 is concerned with the business harm that a party might suffer more generally as a result of the counter-party's breach.

Judges: His Honour Judge Keyser Q.C. sitting as a Judge of the Commercial Court

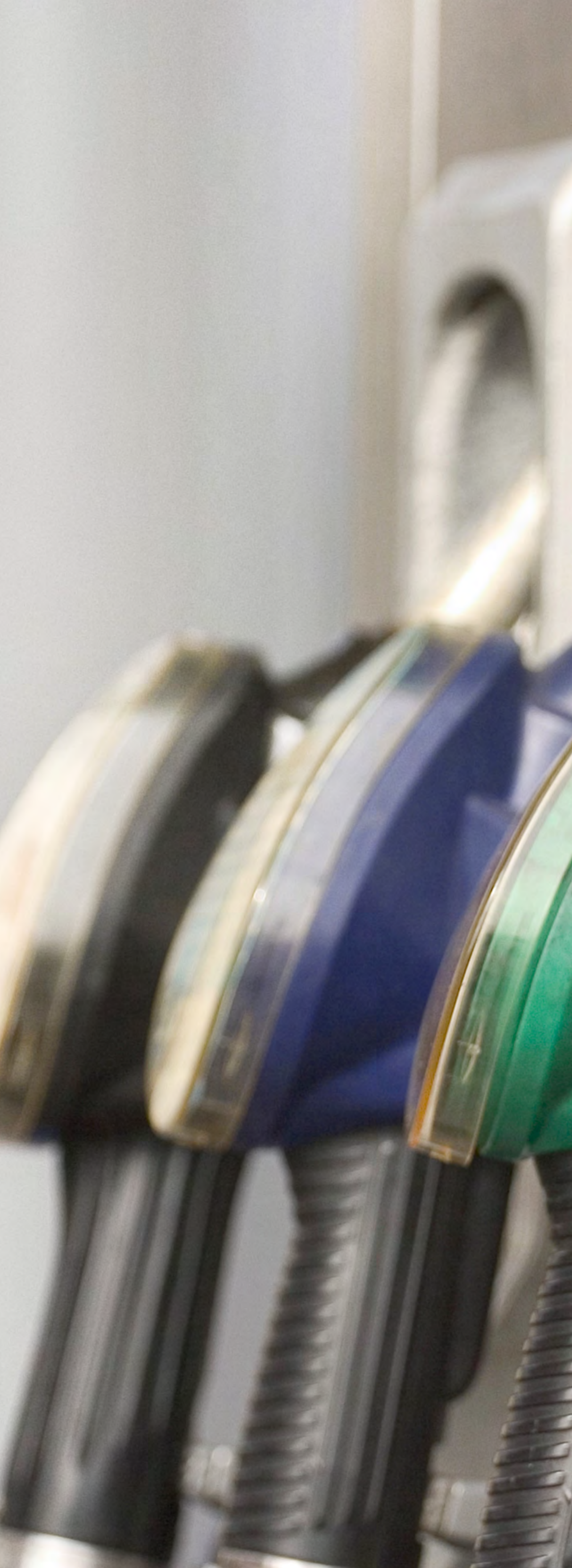
Comment

The Mercantile Court's reasoning was arguably closer to the Court of Appeal's in *Transocean v Providence* than the Commercial Court's decision in that case. In particular, the Mercantile Court emphasised the importance of the natural and ordinary meaning of the words and the limitation on the scope of the *contra proferentem* rule.

However, notwithstanding what some might argue were clear words in the contract, the Mercantile Court still reached the conclusion that not all loss of profit were excluded for all breaches. Arguably this is inconsistent with the natural and ordinary meaning of the words used.

In respect of the result, the Mercantile Court appeared to adopt a closer approach to the Commercial Court, *obiter*, in *Scottish Power UK Plc v BP Exploration Operating Company Ltd and others* [2015] EWHC 2658 (Comm), so as to ensure that an exclusion clause does not have the impact of excluding all claims for loss and damage in the event of total non-performance.

The decision of the Mercantile Court is a stark reminder of the importance of drafting exclusion clauses clearly, with consideration for remedies in the event of complete failure of performance. It remains the case that few contracts appear to adequately address losses for total failure of performance in the face of an exclusion for anticipated loss of profits.



Drilling units and support vessels

The vast majority of oil and gas expenditure is in the supply chain, so decisions that impact drilling units and support vessels are of significant interest.

— In the oil and gas industry, drilling units and support vessels are often secured through letters of commitment. In *Novus Aviation Limited v Alubaf Arab International Bank BSC* [2016] EWHC 1575 (Comm) the Commercial Court considered the enforceability of a letter of commitment that was not executed.
— In *Imperator I Maritime Company v Bunge SA and Bunge SA v C Transport Panamax Ltd ('The Coral Seas')* [2016] EWHC 1506 (Comm) the Commercial Court highlighted issues concerning the fitness of vessels to operate in warm weather locations that might have a wider impact in the oil and gas industry where drilling units and vessels are required to operate in a variety of environments.

Enforceability of Letters of Commitment

Transactions in the oil and gas sector regularly use letters of commitment, especially when dealing with the chartering of marine vessels, including drilling units. In *Novus Aviation Limited v Alubaf Arab International Bank BSC* [2016] EWHC 1575 (Comm) the Commercial Court considered the enforceability of a letter of commitment that was unsigned by one of the parties and sought to make the completion of the transaction *'conditional upon satisfactory review and completion of documentation'*.

Facts

Novus Aviation Limited ('**Novus**') is a company that arranges finance for the acquisition and leasing of commercial aircraft. Alubaf Arab International Bank BSC(c) ('**Alubaf**') is a bank incorporated in Bahrain.

In and around March 2013, Novus was in discussions to finance the purchasing of a number of aircraft for Malaysia Airlines ('**MAS**'). As is common with these transactions, Novus would purchase aircraft to be used by MAS and lease them to MAS on a 12 year lease. The rental would repay Novus' costs and debt. At some point the aircraft would be sold, allowing the investment to be recouped with a profit.

Alubaf expressed an interest in joining this transaction. The structure discussed was that Alubaf would provide the vast majority of the equity funding for the aircraft transaction and Novus would arrange the debt funding element.

In accordance with its usual practice, following discussions, Novus sent Alubaf a letter of commitment for signature. The letter was signed and returned to Novus. However, subsequently, Alubaf's board of directors decided to not proceed with the transaction for financial reasons. Novus claimed Alubaf had committed a repudiatory breach of the letter of commitment.

Novus was unable to establish that it had counter-signed the agreements. Alubaf argued that there was no agreement as:

- The commitment letter was not intended to be legally binding and/or was void for uncertainty;
- Although Mr Abdullah (Head of Risk and Compliance at Alubaf) signed the commitment letter, he did not have authority to bind Alubaf to provide funding for the transaction; and
- There was, in any event, no binding contract made because it was not counter-signed by Novus and returned to Alubaf before Alubaf withdrew from the transaction.

Decision

The Commercial Court decided that the commitment letter was enforceable.

The intention to create legal relations test

The Commercial Court recounted that the leading case on the test of whether a binding contract is formed is the Supreme Court decision in *RTS Flexible Systems Ltd v Molkerei Alois Muller GmbH & Co KG* [2010] UKSC 14 where it was decided:

> *'Whether there is a binding contract between the parties and, if so, upon what terms depends upon what they have agreed. It depends not upon their subjective state of mind, but upon a consideration of what was communicated between them by words or conduct, and whether that leads objectively to a conclusion that they intended to create legal relations and had agreed upon all the terms which they regarded or the law requires as essential for the formation of legally binding relations.'*

The Commercial Court applied this test and found that it was plain from the terms of the commitment letter that it was intended to create legally binding relations and any possible doubt about that conclusion is dispelled by the provision headed 'Governing Law', which stated:

> *'This Commitment Letter Agreement (<u>including the agreement constituted by your acceptance of its terms</u>) and any non-contractual obligations arising out of or in connection with it (including any non-contractual obligations arising out of the negotiation of the Transaction) shall be governed by, and construed in accordance with, English law. The courts of England have non-exclusive jurisdiction to settle any dispute arising out of or in connection with this Commitment Letter Agreement.'* (our emphasis added)

Faced with the clear implication of the governing law provision, counsel for Alubaf fell back on an argument that some parts of the commitment letter – in particular the provision dealing with confidentiality – were intended to create legally binding obligations but that other parts – and in particular the provisions headed 'Equity' and 'Time of the Essence' on which Novus specifically relied – were not.

However, the Commercial Court concluded that it was not realistic to discriminate among the substantive terms of the letter of commitment and to construe only some but not others as intended to be legally binding. If that had been the intention, the Court would have expected to have seen a clear distinction.

Certainty

Alubaf also argued that the letter of commitment was too uncertain as to be legally binding. In particular, the completion of the transaction contemplated by the letter of commitment was '*conditional upon satisfactory review and completion of documentation*'. There was no objective standard by which the law could judge whether the documentation was '*satisfactory*' – therefore the alleged agreement in the letter of commitment must fail for want of certainty.

The Commercial Court reiterated that finding a document lacked sufficient certainty as to create legal relations, where the parties had intended to make a contract, was '*one of last resort*'.

The Commercial Court did not consider the letter of commitment lacked sufficient certainty. To the contrary, Alubaf's right to reject documentation as not '*satisfactory*' was not devoid of objective standard of assessment. It is well established that contractual discretion must be exercised in good faith for the purpose for which it was conferred, and must not be exercised arbitrarily, capriciously or unreasonably.

Authority

Alubaf raised a number of arguments as to Mr Abdullah's lack of authority to execute the letter of commitment. These included, amongst other things, that the bank had specific signing procedures that were shared with Novus, and a single signature was not sufficient to satisfy these procedures.

The Commercial Court rejected this technical argument, on the basis that the procedures did not clearly exclude a single signature. Further, if Mr Abdullah considered that more than one signature were required he would have arranged it.

However, in any event, Novus were entitled to rely upon Mr Abdullah's apparent authority – which made questions of actual authority '*academic*'. On the basis of communications between the parties Novus could reasonably assume that Mr Abdullah was duly authorised.

Execution

The third ground on which Alubaf contended that it was not bound by the commitment letter was that Novus allegedly failed to sign and return the documents. Alubaf argued that the presence on the signature block of the words 'accepted' on its behalf meant that a signature was required.

The Commercial Court recounted that acceptance of an offer can be communicated by conduct. Although Novus had not counter-signed the letter of commitment, upon receiving a signed copy from Alubaf it proceeded to the next steps required to progress the transaction. Further, Alubaf did not question the absence of a counter-signed letter of commitment. It had, also, communicated with Alubaf that it had removed the aircraft from the market for the benefit of Alubaf given the commitment letter. On this basis, it had accepted the letter of commitment by conduct or communication. In the Commercial Court's view there was nothing in the letter of commitment that prevented acceptance in this way.

It is perhaps of interest that a management agreement also considered by the Commercial Court, which had only been signed by Alubaf was not found to be binding because (i) it was expressed to only come into existence upon execution (ii) therefore (unlike the letter of comfort) this provision would need to have been waived by the parties – it was not simply a matter of acceptance in a different form and (iii) the facts suggested that whilst issues under the letter of commitment were progressed, there was no performance of the management agreement.

Summary

It followed from the above, that (i) the letter of commitment was legally binding (ii) Alubaf was bound by the terms of that letter (iii) the decision of Alubaf's board not to proceed with the transaction was not due to the documents not being 'satisfactory' but financial reasons and (iv) Alubaf therefore committed a repudiatory breach of the letter of commitment.

Judge: Leggatt J

Comment

Letters of commitment are common in the oil and gas industry. The decision of the Commercial Court raises a number of important issues:

- The absence of a signature to a letter of commitment need not be fatal to its enforceability. Much will depend upon whether the letter expressly requires execution by both parties to come into existence. In the absence of express requirements, the conduct of the parties or other communications between them may be sufficient for the agreement to come into existence. However, an express provision requiring '*execution of this Agreement*' (sometimes found in counter-party provisions) will mean that signature or waiver of the provision requiring execution will be needed.
- Once an intention to be legally bound is demonstrated, it is difficult to argue that a letter of commitment lacks sufficient certainty to create legal relations.
- Where completion of the underlying obligation that is the subject matter of a letter of commitment is conditional upon a party agreeing subsequent documentation to be '*satisfactory*' to them, that party's right to reject that documentation as unsatisfactory is circumscribed by a requirement to exercise that discretion in good faith for the purpose for which it was conferred, and such right must not be exercised arbitrarily, capriciously or unreasonably.
- It follows, that if such words are used in a letter of commitment, in the event of a dispute, disclosure and other evidence will be required to ascertain a party's decision making process concerning the exercise of its discretion not to proceed with the transaction due to the documentation not being '*satisfactory*'.
- If it is found that the refusal to take the transaction forward is for purposes other than those contemplated by the clause, it will be a breach of contract.
- Careful thought should therefore be given to the decision making processes and their recording and the reasons for deciding not to proceed with a transaction where the decision to do so is at the subjective discretion of that party.

Finally, the Commercial Court's decision reiterated that, unlike other jurisdictions, it remains very difficult to attack an agreement by questioning the authority of the individual signing it. It is therefore important for companies to ensure that individual employees are aware of the consequences of their actions and scope of their authority.

Marine Vessels and Drilling Units – Venturing into warm waters

Marine Vessels, including drilling units, sometimes work in environments that are potentially hostile to their performance. Warm water may result in a number of undesirable effects. In *Imperator I Maritime Company v Bunge SA and Bunge SA v C Transport Panamax Ltd ('**The Coral Seas**')* [2016] EWHC 1506 (Comm) the High Court considered whether it was a defence to claim under a performance warranty that under-performance resulted from the time-charterer's instructions to keep the vessel in a warm water location.

Facts

By consecutive time charters on the NYPE 1946 form (as amended) with additional rider clauses, the MV ANNY PETRAKIS (the '**Vessel**') was chartered by its then owners to Bunge SA (the '**Head Charterers**') for about 23 to 25 months. Under an agreement dated 5 October 2007, ownership of the Vessel was transferred to Imperator I Maritime Company (the '**Owners**') and the charterparties were novated accordingly. The Vessel was renamed The Coral Seas.

Subsequently, the Head Charterers fixed the Vessel to C Transport Panamax Ltd (the '**Sub-Charterers**') under a sub-charterparty, the terms of which were effectively back-to-back with the head charterparties (except rates), for a time charter with one or two laden legs, at the Sub-Charterers' option.

The charterparties each contained the following terms:

> *'Clause 29*
>
> *(b) Speed Clause*
>
> *Throughout the currency of this Charter, Owners warrant that the vessel shall be capable of maintaining and shall maintain on all sea passages, from sea buoy to sea buoy, an average speed and consumption as stipulated in Clause 29(a) above, under fair weather condition not exceeding Beaufort force four and Douglas sea state three and not against adverse current. [In the case of the sub-charterparty the equivalent provision concluded '… not exceeding Beaufort Force 4 and Douglas Sea State 3 with not against adverse current (sic)'].*
>
> *(c) Weather Routing and Speed/Consumption Deficiencies*
>
> *Charterers may supply Ocean Routes advice to the Master [the sub-charterparty stated 'May supply Ocean Routes or equivalent advice'] during voyages specified by the Charterers. The Master to comply with the reporting procedure of the routing service selected by Charterers ...'*

In accordance with the Sub-Charterers' instructions, the Vessel discharged cargo at Praia Mole (Tubarao) Brazil, completing her first laden leg. The Vessel then sailed for Guaiba Island (near Rio de Janeiro). It was immediately apparent on departure from Guaiba Island that the Vessel's performance had fallen off significantly, as a result of which it became necessary for her to call to take on emergency bunkers at Jakarta on 14 March 2008.

An underwater inspection found light fouling of the flat bottom and heavy fouling of the propeller by barnacles. The propeller was cleaned underwater. The Vessel then proceeded to Mawan (People's Republic of China) completing her second laden leg.

The Sub-Charterers thereafter made deductions from hire, asserting their right to set-off damages for breach of the continuing speed warranty contained in clause 29(b) of the charterparties. The Head Charterers took the same stance against the Owners. Each claim was referred to London arbitration under LMAA terms pursuant to the BIMCO dispute resolution clause contained in each of the charterparties. The references were determined concurrently by common arbitrators.

Arbitrators' Award

The arbitrators decided:

- that the Vessel did not maintain the warranted speed, resulting in an increased length of voyage of 90.345 hours;
- that the cause of the Vessel's reduced speed was underwater fouling of the Vessel's hull and propeller by marine growth which developed during the Vessel's lengthy stay in tropical waters at Guaiba Island; and
- that the marine growth could not be regarded as unusual or unexpected, but constituted fair wear and tear incurred in the ordinary course of trading.

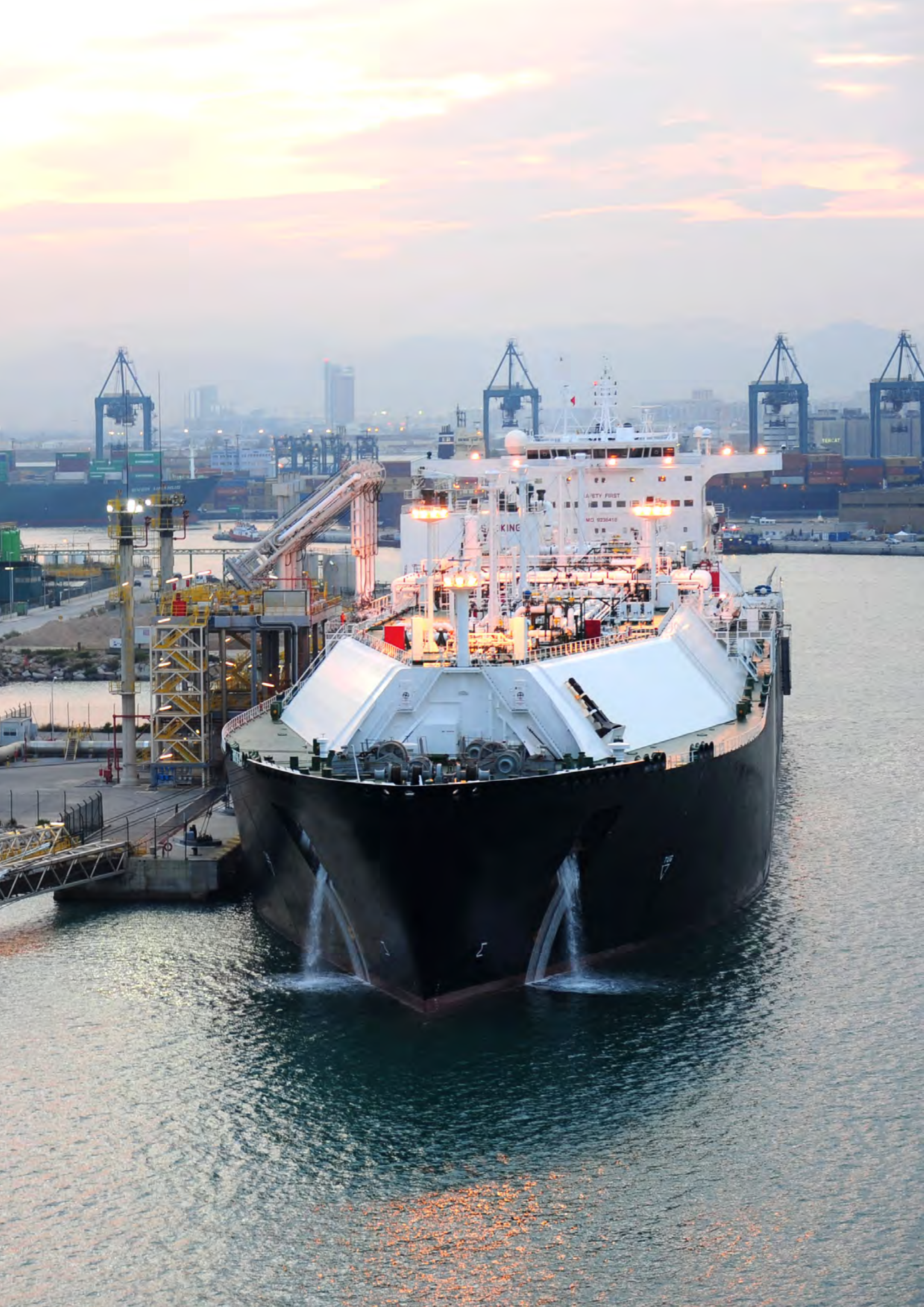
The arbitrators further decided that, on a true construction of the charterparties, the speed warranty applied to all sea voyages, including those after a prolonged wait in tropical waters and that it was the Owners/Head Charterers that had assumed the risk of a fall-off in performance as a result of bottom fouling consequential upon compliance with the Head Charterers'/Sub Charterers' lawful orders.

The Owners appealed the above finding of law to the High Court.

Decision

The question under appeal to determine was:

> *'Where under a time charter the owner warrants to the time charterer that the vessel shall maintain a particular level of performance throughout the charter period, and the time charterer alleges underperformance in breach of that warranty, is it a defence for the owner to prove that the underperformance resulted from compliance with the time charterer's orders?'*



The Owners contended that the arbitrators' reasoning was wrong, being directly contrary to the principle of law as stated in Time Charters 7th Ed. (2014) paragraph 3.75 as follows:

> *'Where the owners give a continuing undertaking as to performance of the ship, and the ship has in fact underperformed, it is a defence for the owners to prove that the underperformance resulted from their compliance with the charterers' orders: see The Pamphilos [2002] 2 Lloyd's Rep 681 per Colman J., at page 690. In that case, the ship's failure to achieve the promised performance resulted from marine fouling, which was in turn the result of the owners' complying with the charterers' order to wait for 21 days at a tropical port.'*

The Commercial Court rejected the Owners appeal for the following reasons:

— The speed warranty in clause 29(b) of the contract was expressed in wide and unqualified terms. As the warranty was that the Vessel '*shall be capable of maintaining and shall maintain on all sea passages*' the specified performance, it was clear that the warranty was not limited to the Vessel's capacity as newly built, but related to her actual continuing performance.

— Further, the parties included an express restriction on the extent of the performance warranty, limiting it to passages under fair weather conditions. It would have been open to the parties also to have excluded the performance warranty in respect of voyages after the Vessel had been waiting in warm water ports, and such clauses are now commonly included in time charters. The Owners were therefore seeking to construe the warranty as containing a restriction which the parties chose not to include.

— Marine fouling is a usual and expected risk. The fact that the Owners were seeking to avoid liability on the warranty in relation to a risk they have assumed, demonstrates that holding them liable is neither unfair nor flouts business common sense.

For the above reasons, the Court considered that the proposition stated in paragraph 3.75 of Time Charters is too widely stated. Where a vessel has underperformed, it is not a defence to a claim on a continuing performance warranty for the owners to prove that the underperformance resulted from compliance with the time charterers' orders unless the underperformance was caused by a risk which the owners had not contractually assumed and in respect of which they are entitled to be indemnified by the charterers.

Judge: Phillips J

Comment

The decision of the Court is consistent with the Supreme Court's decision in *ENE Kos Ltd v Petroleo Brasileiro SA (No. 2)* [2012] 2 AC 164 where Lord Sumption stated that:

— Owners are not entitled to an indemnity from charterers against things for which they are being remunerated by payment of hire;

— There is therefore no implied owner indemnity in respect of '*ordinary risks and costs*' associated with performance;

— The purpose of the implied owner indemnity is to protect them against '*losses arising from risks or costs which they have not expressly or implicitly agreed in the charterparty to bear*'; and

— Owners will usually be taken to have contractually assumed the risks for their own negligence/breach of contract and the consequences of marine fouling that is incidental to the service for which the vessel was required to be available.

In the context of sophisticated oil and gas industry contracts, drilling units will usually include a 'country of operation' clause that permits the drilling unit to be used in a specified location. The drilling unit owner/contractor will then give a warranty that the drilling unit can satisfactorily operate in that location. If the drilling unit is to be used elsewhere it will usually trigger a change of country of operation clause, which will require the parties to use reasonable endeavours to negotiate any required changes to be included, such that the owner/contractor's financial situation should neither be adversely affected nor advantaged by the change of country of operation.

This case is an important reminder that changing the location of operations can impact more than the taxation position of the parties. Absent agreement dealing with the impact of differing water or climatic condition, the drilling unit owner/contractor will, on most contract terms, be liable for underperformance caused by the change in agreed location.

Oil product sales

Supreme Court rules in 'most spectacular legal shipping imbroglio this century' – Difficulties remain with retention of title clauses

In a case described by Lloyd's List as 'the most spectacular shipping legal imbroglio of the century', the Supreme Court has confirmed that a bunker supply contract containing a retention of title clause in favour of the supplier, and which allows the purchaser to use or consume the goods before title is passed, will not fall within the scope of the Sale of Goods Act 1979 (the 'SGA'). As a consequence, the buyer was not entitled to rely on section 49 of the SGA to withhold payment in the event that valid title was not passed.

In a further twist, over-ruling FG Wilson (Engineering) Ltd v John Holt & Co (Liverpool) Ltd [2014] 1 WLR 2365 (often referred to as 'Caterpillar'), the Supreme Court decided that if the contract had been within the SGA, payment may still have been required. As a consequence, it seems likely that a failure to pass title in goods may no longer amount to a complete defence for a buyer against the payment of the purchase price.

The implications of the decision are likely to be profound.

Facts

PST Energy 7 Shipping LLC and Product Shipping and Trading S.A (together the '**Owners**') entered into a bunker supply contract with OW Bunker Malta Limited ('**OWBM**'), a company which is part of the OW Bunker Group. The supply contract was on OW Bunker's standard terms.

OWBM did not itself physically supply the Owners with the bunkers, but instead placed a supply order with its Danish parent company, OW Bunker & Trading AS ('**OWBAS**'). The contract between OWBM and OWBAS was also subject to OW Bunker's standard terms. OWBAS in turn placed an order for the bunkers with Rosneft Marine UK Limited ('**RMUK**'), and RMUK placed an order with its related company, RN-Bunker Ltd.

The bunkers were delivered to the Owners' vessel on 4 November 2014, and RMUK subsequently paid RN-Bunker. However, none of OWBM, OWBAS or the Owners paid their counterparts. At around the same time, OWBAS filed for an in-court restructuring in Denmark, which constituted an event of default under OWBAS' financing arrangements. ING Bank N.V. ('**ING'**), as the assignees of OWBM's contractual rights, claimed payment for the bunkers from the Owners for OWBM. RMUK, having become aware that it might not receive payment from OWBAS, sent a demand for payment to the Owners.

The Owners disputed liability to OWBAS, arguing that OWBM had not paid for the bunkers and was therefore not in a position to transfer property and title in the bunkers to the Owners. The Owners maintained that the bunker supply contract was subject to the SGA, arguing that OWBM was in breach of the mandatory implied term (section 12 of the SGA) that the seller has the right to sell goods, or will have the right at the time that title in the property passes. If section 12 of the SGA applied, a failure to pass title would allow the Owners to withhold payment.

The Arbitrators, Commercial Court and Court of Appeal found in favour of OWBM, although on differing interpretations of the nature of the obligations in the contract. All decided that the SGA did not apply.

The Owners appealed to the Supreme Court. Approximately 1,000 parallel arbitrations with approximately £900 million in dispute awaited the result.

Decision

The Supreme Court affirmed the decision of the Arbitrators that the contract was not one to which the SGA applies and held in favour of OWBM/ING. There were two issues before the Supreme Court:

— Was the contract within section 2(1) of the SGA?

— If so, what was the consequence?

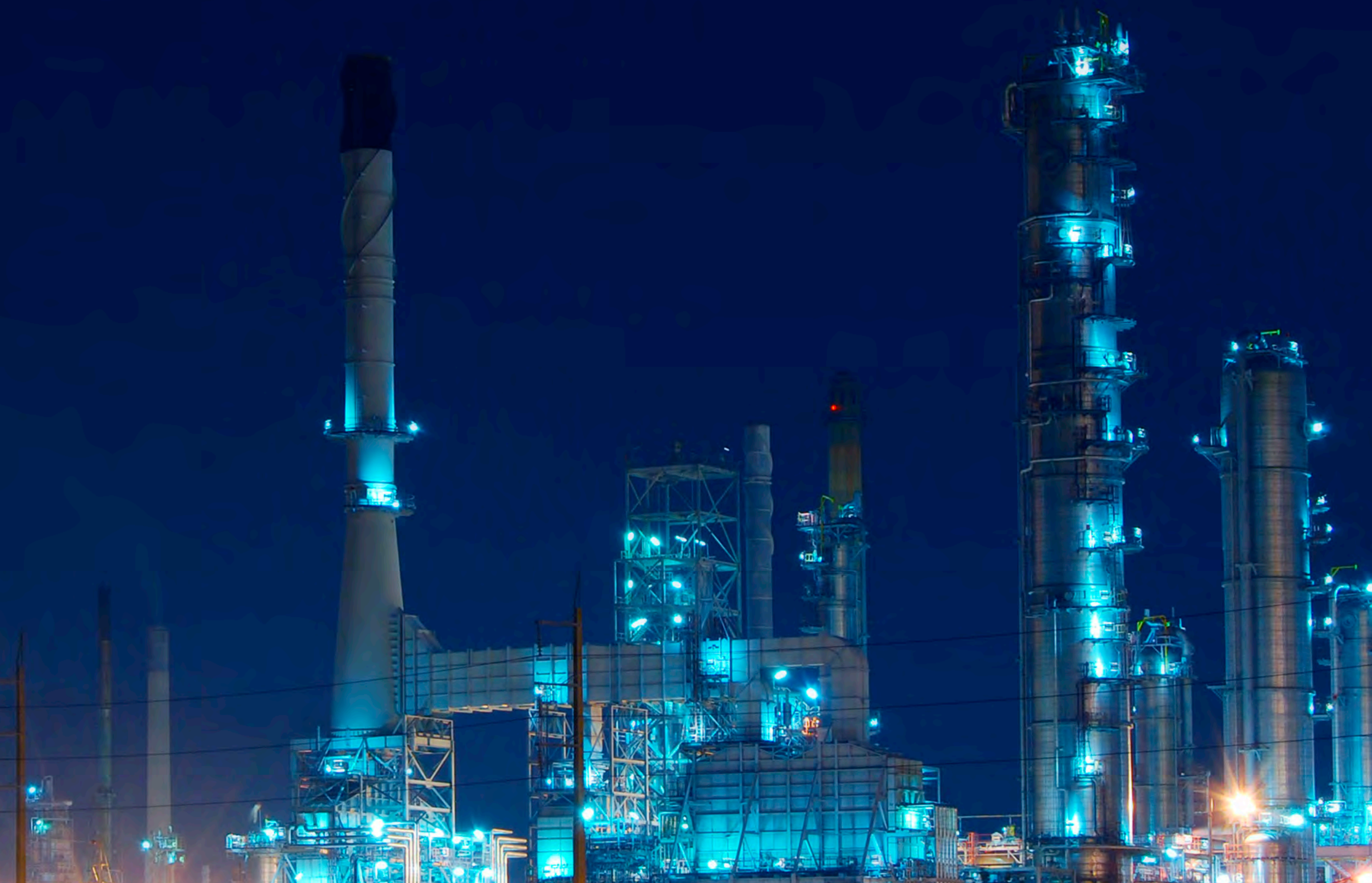
Was the contract within s2(1) SGA?

The Supreme Court decided that OWBM's contract with the Owners was not a straightforward agreement to transfer ownership of the bunkers for an agreed price. Rather, the contract was an agreement with two aspects: (i) it allowed consumption of the bunkers prior to payment and without any title passing in the bunkers consumed, and (ii), insofar as bunkers remained unconsumed, the contract provided that the title to the bunkers must be transferred to the Owners in return for payment of the contract price.

The Supreme Court further reasoned that the contract between OWBM and the Owners fundamentally offers a feature which a contract falling within the scope of the SGA would not offer, namely the liberty to consume goods before having acquired title in them and without having paid for them. OWBM was obliged to pass the title in the goods not consumed on payment for all of the goods (whether consumed or not), and this does not make the contract a contract for sale. This case was '*sui generis*', and not able to be 'shoe-horned' into those cases which would ordinarily fit within the SGA.

As the contract could not be classified as a contract of sale within the SGA, the Supreme Court rejected the application of the SGA to the contract between OWBM and the Owners. It did however accept that, as regards bunkers consumed and remaining at the time of payment, the contract may contain implied terms (implied by common law rather than statute) which would be similar to those found in the SGA regarding description, quality, etc.

The Supreme Court's reasons differed from those of the Court of Appeal. The latter held, rather confusingly, that the contract could be analysed as a contract of sale to the extent that it provided for the transfer of property in any part of the bunkers remaining at the time of payment, and thus section 12 of the SGA applied to any bunkers not consumed at the time of payment. The Supreme Court rejected this analysis, saying that this is '*to divide up a single agreement covering the supply of all the bunkers (gasoil and fueloil) at a single price for each, irrespective of what happened to them*'. The Supreme Court held that none of the bunkers fell within the terms of the SGA.



What would the position have been had the contract been one within the SGA?

The Owners argued that, had the contract been classified as a contract of sale within the SGA, authorities on section 49 of the SGA would preclude a claim by OWBM/ING for the price of the bunkers which had been consumed. Section 49 allows a seller to bring a claim against the buyer for non-payment of the price of the property which had been passed in a contract of sale, and the case of *Caterpillar* decided that a claim for the price of goods sold can only be made in accordance with section 49. As set out above, the Supreme Court decided that this was not such a case.

Further, the Supreme Court's decision was that, had the contract between OWBM and the Owners been one of sale, the Supreme Court would have over-ruled the *Caterpillar* case and held that section 49 does not prevent a claim for payment of an agreed price under a contract of sale.

Judges: Lord Neuberger, Lord Mance, Lord Clarke, Lord Hughes, Lord Toulson

Comment

The decision of the Supreme Court is significant to a range of industries that adopt similar terms to those found in bunker supply contracts. The logical conclusion of the Supreme Court's decision is that where goods are supplied under contracts which include a retention of title clause and a credit period, together with the right to consume all or some of the goods during the credit period, the contract may not be covered by the SGA. Contracts on similar terms should therefore be reviewed in light of the fact that the SGA may not apply to them.

The striking commercial consequences of the decision can be seen from its financial result. In the usual course of events the Owners would have paid OWBM, which would have taken a small margin, whilst passing the remainder of the price paid up the value chain to its own seller. However, in the event of insolvency, rather than the price paid being passed through the chain of title, it will be passed to ING – as OWBM's creditor. OWBM and its creditors will have the benefit of the full price of the bunkers – rather than the margin that it would have originally retained under the transaction.

In a perhaps even more striking conclusion, by suggesting that *Caterpillar* was wrongly decided, the Supreme Court has opened up the prospect of a claim for a price (or damages) in the event of a failure to pass valid title – suggesting that it would have overturned a proposition that was considered by many as trite law.

Unfortunately, the *obiter* of the Supreme Court will leave the High Court and Court of Appeal in a difficult position. Strictly speaking, the Supreme Court's comments on *Caterpillar* are non-binding. As a matter of law, the High Court and Court of Appeal remain bound by *Caterpillar* – which the Supreme Court has indicated is wrong.

Whilst it is important to reiterate that the case was an appeal limited in scope to specific points of law and to a set of assumed facts, other contracts or strings of transactions might well result in similar conclusions.

In the interim two key areas arise for the drafters of commodities contracts: (i) it is critical to consider whether the existence of a retention of title clause along with the fact that the goods may be consumed/used prior to payment might result in the SGA not applying (and the consequences of that for the positions of the parties); and (ii) section 49 of the SGA cannot be relied upon by buyers to mean that the seller will have no remedy if it fails to pass valid title – meaning that express contractual words might be needed to achieve the outcome of *Caterpillar.*

On demand bonds

On-demand bonds/guarantees appear to have become more prevalent in the oil and gas industry. The significant financial consequences of calling on an on-demand bond mean that any developments in the case law are important to those using them. In Lukoil Mid-East Ltd v Barclays Bank plc [2016] EWHC 166 the Technology and Construction Court considered implied requirements to calling on on-demand bonds and, in MW High Tech Projects UK v Biffa Waste Services [2015] EWHC 949 the Technology and Construction Court considered the grounds upon which calls may be restrained.

Implied requirements for calling on-demand bonds

Background

In *Lukoil Mid-East Ltd v Barclays Bank plc* [2016] EWHC 166 the Technology and Construction Court considered the circumstances in which an on-demand security might impose implied requirements for the form of a demand made under the security. As a consequence of the decision, parties should give careful consideration to the form of any demand to be made under such securities and not assume that the absence of any stated form of demand means that no specific requirements apply to the making of a demand.

Facts

Lukoil Mid-East Ltd ('**Lukoil**') entered into a contract with Baker Hughes Asia Pacific Limited ('**Baker Hughes**') for the drilling and completion of 23 production wells in an oil field in South East Iraq (the '**Contract**'). As security for performance of the contract, Baker Hughes arranged for an on-demand bank guarantee to be issued by Barclays Bank plc ('**Barclays**') in favour of Lukoil for USD $7,115,034 (the '**Bank Guarantee**'). By paragraph 4 of the Bank Guarantee Barclays undertook to pay up to the maximum amount of the guarantee at Lukoil's:

> *'[4]..first written request submitted to [Barclays] before the expiry date if [Baker Hughes] fails to fulfil the Contract provisions, on the condition that no amendment has been made to the Contract concluded between [Lukoil] and [Baker Hughes] impacting the timely performance of the Works under the Contract'.*

Further under paragraph 5 it was agreed:

> *'We hereby agree that no amendments nor addenda to the Contract, nor any contractual documents made by you and [Baker Hughes] shall relieve us from our responsibilities under this Guarantee, and we hereby waive the right to be notified of such amendments or addenda.'*

Shortly before its expiry, Lukoil made a demand for the full amount of the Bank Guarantee. The demand referred to failings on the part of Baker Hughes to perform the Contract but made no reference to whether amendments had been made to the Contract. Barclays declined to honour the demand, claiming that Lukoil was required to state expressly in the demand that no amendment had been made to the contract impacting the timely performance of the Works. The Bank Guarantee itself was silent as to the form any demand was to take.

By the time Lukoil had received Barclays' letter declining payment, the guarantee had expired. Lukoil could not therefore make a fresh demand and brought proceedings to enforce payment under its original demand.

Decision

Barclays' position was arguably supported by previous case-law which had held that an on-demand security drafted with conditional language carried with it an implied requirement that any demand under the security expressly state the fulfilment of those conditions. In *Esal (Commodities) Ltd v Oriental Credit Ltd* [1985] 2 Lloyd's Rep 546 a bond which required payment '*on your written demand in the event that the supplier fails to execute the contract in perfect performance*' required a demand to state that the supplier had failed to execute the contract. Likewise, in *IE Contractors v Lloyds* [1990] 2 Lloyd's 496 a bond that obliged the bondsman to pay '*unconditionally, the said amount on demand, being your claim for damages brought about by the above named principal*' required a demand to state that it was a claim for damages brought about by the contractors.

Barclays therefore contended that the condition stated in the guarantee as to amendments required a statement to be made in the demand that no relevant amendment had been made to the Contract.

In rejecting Barclays' arguments, the Technology and Construction Court identified that there is (at least) a tension between Barclays' case in relation to paragraph 4 and the existence of paragraph 5. The law is required to interpret the Bank Guarantee as a whole and any individual words, clauses or provisions that it contains are to be interpreted in context. In reaching its conclusions, the law will not willingly endorse or adopt an interpretation that is commercially absurd unless compelled to do so by very clear words.

Due to paragraph 5 of the Bank Guarantee, no amendment to the Contract, even if it impacted the timely performance of the Works under the Contract, could affect Barclays' responsibilities under the Bank Guarantee. In other words, an amendment to the Contract which impacted the timely performance of the Works under the Contract was irrelevant to whether or not Barclays' obligation to pay under the Bank Guarantee is triggered. Therefore, the principled justification that underpinned the requirement that facts be stated in cases such as *Esal* and *I. E. Contractors* was absent.

In addition, Barclays' submission that it is a pre-requisite that a valid demand should include a statement about such amendments is directly contrary to the clear intention of paragraph 5 of the Bank Guarantee which is not merely that such amendments are irrelevant to Barclays' obligation but also that Lukoil is not obliged to inform Barclays of them.

For these reasons, the Technology and Construction Court decided that to interpret paragraph 4 of the Bank Guarantee as imposing upon Lukoil an obligation to state in the demand that no amendment had been made to the Contract impacting the timely performance of the Works would be to require Lukoil to declare something that was irrelevant to Barclays' obligation and which was unnecessary to enable Barclays to know whether its obligation to pay had been triggered.
For that reason alone, it considered that Barclays' interpretation lacked any commercial or principled legal justification.

However, there was a further reason for rejecting Barclays' arguments: Given the mechanism for altering the scope of the Works (with their expected impact upon timely performance of the Works either as originally defined or later amplified), it would be almost inconceivable that, in the course of a huge construction contract such as the Contract, there would be no changes to the scope of the Works that would impact on timely performance. It is almost inconceivable that, on Barclays' construction, Lukoil would ever be able to make the statement that was required to constitute a valid demand. The Bank Guarantee would therefore be rendered virtually useless on Barclays' interpretation. That pushed the interpretation offered by Barclays beyond the realms of being unjustified into the realms of commercial absurdity.

Judge: Stuart-Smith J

Comment

The decision of the Technology and Construction Court provides a helpful reminder that calls under on-demand securities may sometimes be required to state expressly that certain conditions have been fulfilled despite no prescribed form of demand being specified. Parties considering the making of calls under on-demand securities should give careful thought to whether any such implied requirements apply in their circumstances. The grounds on which calls under on-demand securities can be challenged under English law are very narrow, but the Courts will take a strict approach to any requirements for the making of a demand. Any failure to abide by them will invalidate the demand.

However, the case also provides an interesting example of the law ultimately disregarding words in an on-demand guarantee which appeared to serve no purpose and potentially have been left over from the wording of more traditional forms of guarantee. As the Court decided, such a situation is one which arises not infrequently in practice.

It may have been that the words relied upon by Barclays were a historic relic from more traditional guarantees where amendments to the underlying contract automatically released the guarantor. Parties would be advised to consider whether such wording is appropriate to the guarantee in question, in most guarantees concerning EPC contracts it will not be appropriate and should be removed, or to have fresh documents drafted consistently with modern practices, so as to avoid uncertainty and reduce the scope for challenge.

Restraining calls under on-demand securities

Challenging the obligation to pay under on-demand securities has traditionally required high hurdles concerning a 'fraud' on the security to be proven or an express prohibition of calling the on-demand security in the underlying contract. However, a number of recent cases have questioned this approach. In *MW High Tech Projects UK v Biffa Waste Services* [2015] EWHC 949 the Technology and Construction Court restated that traditional approach and declined to follow earlier cases which had adopted a broader approach of the grounds on which parties can seek to challenge calls under on-demand securities under English law.

Facts

In 2010 West Sussex County Council contracted with Biffa Waste Services ('**Biffa**') for the management and disposal of waste generated in its area. The contract was a Materials Resource Management Contract dated 28 June 2010 (the '**MRMC contract**'). One of the requirements of the MRMC contract was that a waste treatment plant (the '**Plant**') should be designed and constructed near Horsham. On the same day, Biffa entered into a contract with MW High Tech Projects UK (**'MW High Tech**') for the design, construction, installation, commissioning and testing of the Plant (the '**EPC Contract**').

The EPC Contract required MW High Tech to provide a Retention Bond. Clause 43.6 of the contract imposed a condition precedent to a call under the Retention Bond as follows:

> *'It shall be a condition precedent to the Employer's right to make a call upon either the Performance Bond or the Retention Bond that the Employer has first called upon the Parent Company Guarantee…in respect of the same matter. In the event that the Guarantor has not accepted in writing each and every aspect of such a call on the Parent Company Guarantee…made by the Employer, including any requirement to make payment within ten (10) Business Days of receipt of a notice from the Employer pursuant to Clause 1 of the Parent Company Guarantee…then such condition precedent shall be discharged.'*

Clause 22 provided for liquidated damages for delayed completion. Clause 22.3 required that, provided a notice has been issued, the MW High Tech shall, upon Biffa's demand, pay or allow to Biffa liquidated damages, at the relevant rate.

Clause 50.1 of the EPC Contract said:

> *'On termination of this Contract under Clause 49 (Termination on Contractor Default) the provisions of Part 2 of Schedule 10 (Compensation on Termination) shall apply.'*

The works were delayed and Biffa sought to terminate the EPC Contract due to the passing of a long stop date. It then sought to recover amounts alleged to be due in respect of liquidated damages for delay under an on-demand Retention Bond.

Biffa made a demand for the payment of liquidated damages under Clause 22 of the EPC Contract on 5 December 2014. However, due to the provisions in the EPC Contract governing the service of notices, the demand was only deemed to have been served on 12 December 2014. By this stage, the EPC Contract had been terminated. MW High Tech argued that the demand under Clause 22 was invalid as upon termination that clause became inoperative.

In accordance with Clause 43.6, Biffa duly made a demand under the parent company guarantee for the liquidated damages it had demanded under Clause 22. Biffa then proceeded to call the Retention Bond in the absence of any acceptance of the demand by MW High Tech's parent company.

MW High Tech sought to challenge the call on the basis that Biffa's demand under the parent company guarantee lacked an adequate contractual basis (as it was made under Clause 22 rather than in accordance with Schedule 10). It argued that in order for the condition precedent to be satisfied, the demand under the parent company guarantee was required to be a '*valid*' demand.

Decision

In considering MW High Tech's challenge, the Technology and Construction Court noted the recent cases which had sought to broaden the scope for challenging calls under on-demand securities. The Court conveniently

summarised the English law position as follows:

- There are two established exceptions to the rule that the Court will not intervene. The first is where there is obvious fraud known to the bank. The second exception is where the terms of the underlying contract preclude the beneficiary from making a call.
- There have to date been two matters of principle that have been developed in relation to this second exception.
- The first principle is that the beneficiary's right to drawdown must be precluded by the express terms of the underlying contract. However, there is no principle or reason why the beneficiary's right could not be precluded by an implied term in the contract.
- The second principle is that, when considering whether or not to grant an injunction, it is not sufficient that there is a seriously arguable case that the beneficiary was not entitled to draw down. It must be positively established that he was not entitled to draw down under the underlying contract.
- If and to the extent that the subsequent decisions suggest that a less rigorous test is to be applied those authorities should not be followed.

In summary, the Technology and Construction Court decided that on principle and authority '*the only established exceptions to the rule that the Court will not intervene should be where there is a seriously arguable case of fraud, or it has been clearly established that the beneficiary is precluded from making a call by the terms of the contract*.'

The Court noted that MW High Tech's argument was in effect an attempt to extend the *Sirius International Insurance Company v FAI General Insurance Ltd* [2003] EWCA Civ 470 line of cases beyond instances where the underlying contract contained specific restraints on calling on the security, to instances where the call could be shown to have been made without an adequate contractual basis. It was an attempt to imply a qualification into the EPC Contract that calls made under the Retention Bond are required to have an adequate contractual basis or otherwise be '*valid*'.

The Court rejected MW High Tech's argument, noting the proposed validity requirement did not meet the usual tests for the implication of terms under English law (in particular, such a term would be uncertain in scope and was not necessary to make the contract work). The Court noted:

> *'Even if the call in this case could be described as 'ill founded', there is no suggestion that it was fraudulent, and there is nothing new or remarkable in calls on guarantees being controversial, objectionable, or misconceived. There is, to my mind, no reason in favour of imposing any further qualification on the requirement that there be a call on the Parent Company Guarantee, and potent reasons against it. It would encourage protracted satellite litigation at short notice to try and establish whether or not the call on the Parent Company Guarantee was not merely controversial, but misconceived; and such an approach is inconsistent with a typical approach to the acknowledged end point, which is a call on the retention bond. The notion that there should be a preliminary dispute about whether the underlying demand is justifiable goes directly against the normal approach to on-demand bonds: pay now, argue later.'*

Judge: Coulson J

Comment

This decision is an important departure from the wider approach adopted in the *Simon Carves Ltd v Ensus UK Ltd* [2011] EWHC 657 (TCC) and *Doosan Babcock v Comercializadora De Equipos Y Materiales Mabe Limitada* [2013] EWHC 3201 (TCC) cases. In addition to the Court's express indication that those two cases are not to be followed, the conclusions reached by the Court also support a narrower approach. In *Doosan Babcock* the underlying contract between, in that case, a contractor and a sub-contractor contained no express qualifications on the contractor's ability to call on the on-demand performance security provided by the sub-contractor. However, the Court in that case sought to impose a restriction by reference (among other things) to the general principle that a party should not benefit from its own wrong. The Technology and Construction Court's decision in the present case suggests that any such implied restrictions of this type should be rejected. Unless it is clear from the contract that the parties intended recourse to an on-demand security to be restricted in some way, the Court should only intervene where the requirements of the fraud exception have been satisfied.

The *Simon Carves* and *Doosan Babcock* decisions had been thought by some to have diluted the strength of on-demand bonds governed by English law, which have historically been held in high regard and are popular on international projects (irrespective of the law governing the underlying contracts). The present decision, together with the Privy Council's decision in *Alternative Power Solution Ltd v Central Electricity Board* [2014] UKPC 31 should go a considerable way to easing these concerns. Although authoritative guidance will be needed from the Court of Appeal before the broader grounds of challenge suggested in *Simon Carves* and *Doosan Babcock* can safely be disregarded, it seems that English law is now well on the way to returning to its traditionally robust approach to on-demand securities.

Environmental sanctions

In an environmental sanctions case relevant to the oil and gas sector, Thames Water Utilities Limited was fined £1 million (in respect of two related offences) arising from a pollution offence during 2012 and 2013. This appears to be part of a consistent trend towards higher fines for environment offences following the principles and the tariff-based approach of the Environmental Offences Definitive Guideline published by the Sentencing Council in July 2014. This is thought to be the first fine to reach the £1 million mark under this sentencing regime.

The Guideline

Since July 2014 the courts in England and Wales, when sentencing specified environmental offences, must consider the Environmental Offenses Definitive Guideline (the '**Guideline**'). The Guideline applies regardless of when the offence was committed and obliges the Magistrates' Court and the Crown Court to follow a 12 step decision-making process when determining which level of fine to impose. The Guideline applies to the following specified offences and some general offences:

- The unauthorised deposit of waste or harmful deposit, treatment or disposal of waste under Section 33 of the Environmental Protection Act 1990; and
- Illegal discharges to air, land and water, including operating without a permit, contravention of a permit condition and non-compliance with enforcement notices, under Regulations 12 and 38(1),(2) and (3) of the Environmental Permitting (England and Wales) Regulations 2010 (as amended).

Thus all oil and gas organisations with environmental permits which experience occurrences of illegal discharges under the environmental permitting regulations should consider the Guideline with care and assess its implications for business.

Facts

It was alleged that between July 2012 and April 2013, Thames Water Utilities Ltd ('**Thames Water**') repeatedly discharged polluting matter from a sewage treatment works into the Grand Union Canal in Hertfordshire.

The Environment Agency ('**EA**') brought a prosecution against Thames Water. In May 2015, Thames Water pleaded guilty in Watford Magistrates' Court to two offences under the Environmental Permitting (England and Wales) Regulations 2010.

The case was remitted to the Crown Court for sentencing.

Decision

On 4 January 2016, St Albans Crown Court ordered Thames Water to pay a fine of £1 million, plus £18,113.08 costs (and a victim surcharge of £120).

The Court explained that the reason for the level of fine was due to the fact that the time had 'now come' for very large organisations to *'bring about the reforms and improvements for which they say they are striving because if they do not the sentences passed upon them for environmental offences will be sufficiently severe to have a significant impact on their finances.'*

Level of fine

The Guideline requires a step-by-step approach to the calculation of a fine based upon the degree of culpability of the offender and the harm caused by the offence and upon the size of the offending organisation, assessed by reference to its turnover. Organisations are divided into four categories, micro, small, medium and large. Large organisations are identified as those with a turnover or equivalent of '£50 million and over'. There is no definition of 'very large organisations'. The Guideline, however, makes it clear that the starting point and range of fines suggested do not apply to very large organisations and where the turnover of an organisation greatly exceeds £50 million it may be necessary to move outside the suggested range to achieve a proportionate sentence.

It was in another similar case *R v Thames Water Utilities Limited* [2015] EWCA Crim 960 that the Court of Appeal determined Thames Water to be a very large organisation, taking into account its turnover of £1.9 billion and its profit of £346 million for the year ending 2014.

It is therefore not inconceivable that in any sensible dialogue most oil and gas defendant companies would be described as at least 'very large' if not more.

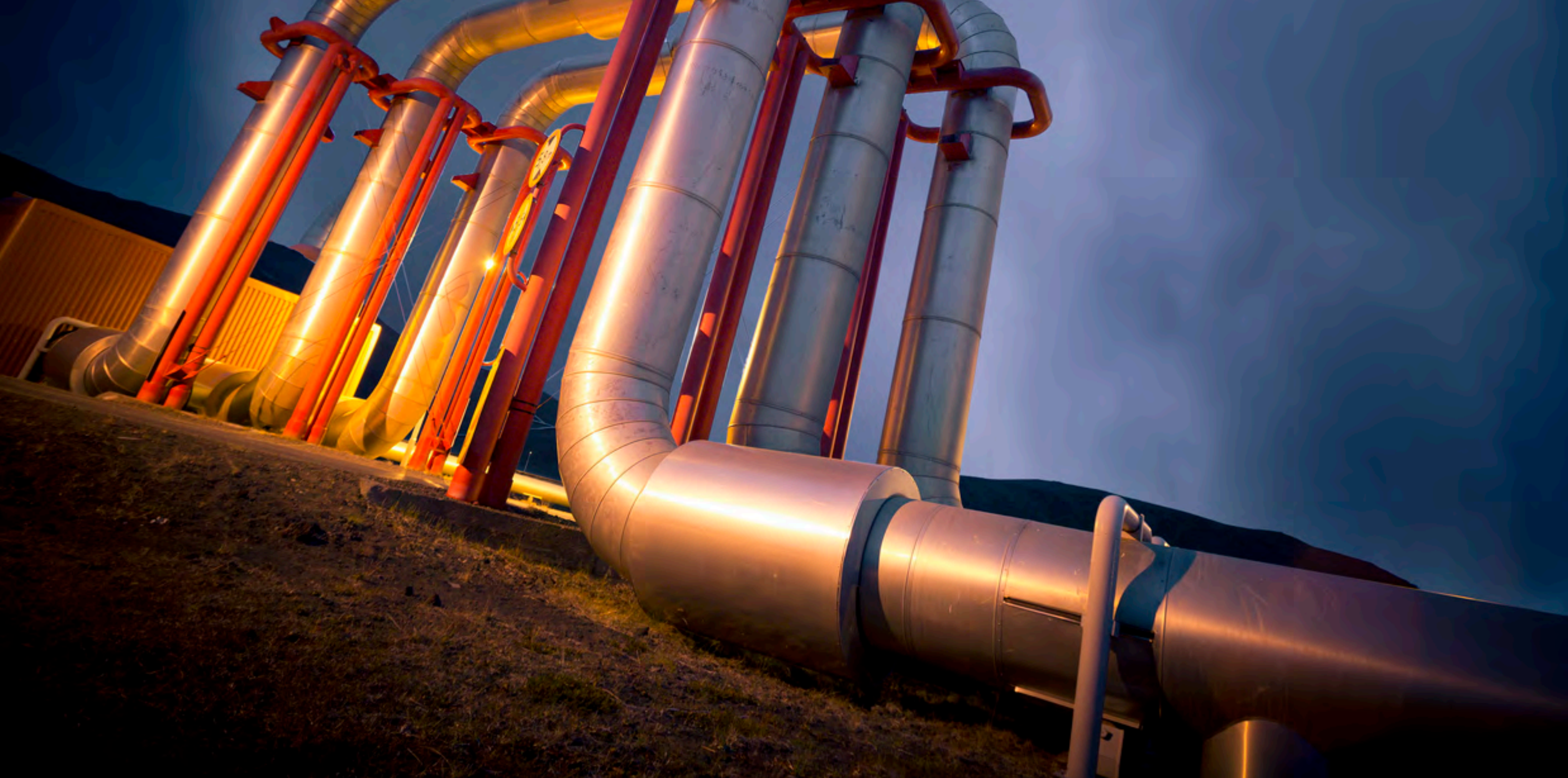
Under the Guideline, a 'large' organisation (meaning any with a turnover or equivalent of £50 million or above) can expect fines ranging anywhere from as low as £7,000 to as much as £3 million per offence, depending on level of harm and culpability.

Judge: HHJ Bright QC

Comment

It is relatively clear from this and other recent sentencing decisions that the lower courts share the Court of Appeal's view in that fines for environment offences generally have been too lenient. From the judge's reported commentary in this case and in other recent cases we are seeing, the lower courts are taking on board the message that the level of fine should be high enough so that boards of companies and their shareholders will take notice. It remains to be seen how much further the courts will go in practice. At least in theory the Court of Appeal has stated that a fine could be equivalent to '100% of a company's pre-tax net profits.'

As Thames Water has been determined previously to be a very large organisation within the meaning of the Guideline (i.e. generally outside of the large company fine ranges), a fine of £1 million for two offences is perhaps towards the mid to lower end of the expected scale. However, in this case, the EA conceded that Thames Water had fully co-operated with its investigation and had since invested £30,000 in replacing equipment involved in the illegal discharges. Thames Water also pleaded guilty (and we imagine did this fairly quickly) in the lower courts which may have resulted in an up to one third discount of the fine that would have been imposed. From the reports of the case it does not appear that the EA pursued a Proceeds of Crime Act application against Thames Water.



Contractual interpretation

The past twelve months have arguably seen a radical realignment on the English law approach to contractual interpretation:

— In *Arnold v Britton and others* [2015] UKSC 36 the Supreme Court emphasised the importance of the natural and ordinary meaning of the words in preference to commercial common sense of the result.

— In *Marks and Spencer plc v BNP Paribas Securities Services Trust Company (Jersey) Limited* [2015] UKSC 72 the Supreme Court unanimously clarified the requirements that must be satisfied before a term can be implied into a contract, stressing the strict standards that the law will apply.

Although not oil and gas cases, these cases were referred to in many of the decisions included in this year's Annual Review.

Supremacy of the natural and ordinary meaning

In the recent case of *Arnold v Britton and others* [2015] UKSC 36, the Supreme Court sought to refocus English law on upholding the natural and ordinary meaning of the words used in a contract. After the recent extension of 'commercial sense' cases leading to more adventurous constructions, the Supreme Court has arguably returned to a more conservative approach to interpreting contracts.

Background

Commercial common sense as an aid to interpretation was propagated by Lord Hoffmann, first in *Investors Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 WLR 896 and then more recently in *Chartbrook Ltd v Persimmon Homes Ltd* [2009] 1 AC 1101. This approach was developed further by the Supreme Court in *Rainy Sky S.A. & Ors v Kookmin Bank* [2011] UKSC 50. In *Rainy Sky* the Supreme Court held that, where language used in a contract has more than one potential meaning, it is generally appropriate to adopt the construction that is most consistent with business common sense. Since *Rainy Sky*, parties routinely argue commercial common sense in support of their construction of disputed terms in contracts.

The recent decision in *Arnold* follows Lord Neuberger's comments in *Marley v Rawlings* [2014] UKSC 2. In *Marley* Lord Neuberger described Lord Hoffmann's approach as 'controversial' and highlighted academic commentary at the time which suggested that adopting Lord Hoffmann's approach to contractual interpretation diminished the difference between interpretation and rectification of contracts. The difference is key because interpretation of contracts requires the Court to determine the meaning and effect of a contract whereas rectification involves giving the contract a different meaning from that which it appears to have on its face and will result in the change of actual words used.

Facts

Oxwich Leisure Park is on the Gower Peninsular, and contains 91 chalets, each of which is let on very similar terms. The five leases before the Supreme Court were granted between 1978 and 1991, either for a premium (of less than £20,000) or in return for the lessee constructing the chalet. Each of the 91 chalets was let on a lease which was for a term of 99 years from 25 December 1974 and reserved a rent of £10 per annum increasing by £5 for each subsequent period of 21 years. Para (2) of the recital of each lease contains the statement that the chalets on the Leisure Park were intended to be subject to leases '*upon terms similar in all respects to the present demise*'.

Twenty-five of the chalets were said by the current owner of the Leisure Park and the landlord under the leases to be subject to leases containing a service charge provision in clause 3(2), which requires the lessee to pay for the first year of the term a fixed sum of £90 per annum, and for each ensuing year a fixed sum representing a 10% increase on the previous year – i.e. an initial annual service charge of £90, which increases at a compound rate of 10% in each succeeding year. The issue on this appeal was whether this interpretation of clause 3(2) in those 25 leases was correct.

Of the 25 leases in question, 21 were granted between 1977 and 1991. Prior to the grant of most of those 21 leases, the other 70 chalets had been the subject of leases granted from the early 1970s. In each of those 70 leases, clause 3(2) was a covenant by the lessee:

> *'To pay to the Lessor without any deduction in addition to the said rent a proportionate part of the expenses and outgoings incurred by the Lessor in the repair maintenance renewal and the provision of services hereinafter set out the yearly sum of Ninety Pounds and value added tax (if any) for the first three years of the term hereby granted increasing thereafter by Ten Pounds per Hundred for every subsequent three year period or part thereof.'*

The effect of this clause, at least on the face of it, was that the initial service charge of £90 per annum was to be increased on a compound basis by 10% every 3 years, which is roughly equivalent to a compound rate of 3% per annum.

The 21 leases had slightly different versions of clause 3(2), but the clause can be set out in the following form (with the words shown in bold included in 14 of the 21 leases, but not in the other 7):

> *'To pay to the Lessor without any deductions in addition to the said rent* ***as*** *a proportionate part of the expenses and outgoings incurred by the Lessor in the repair maintenance renewal* ***and renewal of the facilities of the Estate*** *and the provision of services hereinafter set out the yearly sum of Ninety Pounds and Value Added tax (if any) for the first Year of the term hereby granted increasing thereafter by Ten Pounds per hundred for every subsequent year or* ***part*** *thereof.'*

To complicate matters a little further, the service charge clause in 4 of these 21 leases (being 3 of the 7 which did not include the words in bold in the preceding quotation), had the word 'for' before '*the yearly sum of Ninety Pounds*.' These 4 leases also included a proviso to the effect that, so long as '*the term hereby created is vested in the [original lessees] or the survivor of them*', clause 3(2) would be treated as being in the form set out above. This proviso has ceased to have effect as these 4 leases are no longer vested in the original lessees.

Finally, the service charge clause in 4 of the 70 leases referred to above was varied pursuant to deeds of variation executed between October 1998 and August 2002 so as to be identical to that set out above, including the words in bold.

Decision

Rules of construction

Lord Neuberger, giving the leading judgement, summarised that when interpreting a contract the Court should identify the intention of the parties by reference to what a reasonable person having all the background knowledge which would have been available to the parties would have understood them to be using the language in the contract to mean. He then set out the following aids to construction:

- The clause in dispute should be given its natural and ordinary meaning.
- Any other relevant provisions of the agreement should be taken into consideration.
- The overall purpose of the clause in dispute and the agreement should be considered.
- Facts and circumstances known or assumed by the parties at the time that the document was executed are admissible.
- Commercial common sense can be applied.
- The subjective evidence of any party's intentions should be disregarded.

Commercial common sense – restricted

Lord Neuberger (with whom the majority agreed) emphasised the following restrictions to using commercial common sense as an aid to depart from the actual language used in a contract:

- Commercial common sense and surrounding circumstances should not be invoked to undervalue the importance of the language of the provision which is to be construed.
- The clearer the natural meaning of the words in the contract the more difficult it is to depart from it.

- Commercial common sense is not to be invoked retrospectively. The mere fact that the natural meaning of a contract leads to a disastrous result for one party is not a reason for departing from the natural language.
- The purpose of interpretation is to identify what the parties have agreed not what they should have agreed. A Court should be slow to depart from the natural meaning simply because it appears to be an imprudent term for one of the parties, even at the time that they entered into it. There must nevertheless be a basis in the words used and the factual matrix for identifying a rival meaning.
- When interpreting a contract, only those facts or circumstances which existed at the time that the contract was made and which were known or reasonably available to both parties should be taken into account. It was not right to take into account a fact or circumstance known only to one of the parties.
- When an event occurs which, judging from the language used, was plainly not intended or contemplated by the parties, the Court will give effect to the intention of the parties, if it is clear what the parties would have intended in that situation.

In the judgement of Lord Neuberger, when one turns to clause 3(2) of each of the 91 leases, the natural meaning of the words used, at least until one considers the commercial consequences, was clear. The first half of the clause (up to and including the words 'hereinafter set out') stipulates that the lessee is to pay an annual charge to reimburse the lessor for the costs of providing the services which he covenants to provide, and the second half of the clause identifies how that service charge is to be calculated.

An alternative approach would involve the Court inventing a lack of clarity in the clause as an excuse for departing from its natural meaning, in the light of subsequent developments.

Despite the unattractive consequences, particularly for a lessee holding a chalet under one of the 25 leases, the Supreme Court decided that the consequences were the only natural and ordinary meaning of the words. Had inflation turned out differently, there would be no issue.

The fact that a Court may regard it '*unreasonable to suppose that any economist will be able to predict with accuracy the nature and extent of changes in the purchasing power of money*' over many decades (to quote Gibbs J in *Pennant Hills Restaurants Pty Ltd v Barrell Insurances Pty* Ltd [1981] HCA 3, (1981) 145 CLR 625, 639) is nothing to the point. People enter into all sorts of contracts on the basis of hopes, expectations and assessments which no professional expert would consider prudent, let alone feel able to 'predict with accuracy.' Many fortunes have been both made and lost (and sometimes both) by someone entering into such a contract.

In the only dissenting judgement, Lord Carnwath recognised that there is often a tension between the principle that the parties' common intention should be derived from the words they used and the need to avoid a nonsensical result.

Lord Carnwath emphasised that in *Rainy Sky* Lord Clarke had specifically rejected the previous proposition that unless the natural meaning of the words produces a result so extreme as to suggest that it is unintended, the Court must give effect to that meaning. Lord Clarke's view in *Rainy Sky* was that it was only if the words were unambiguous that the Court had no choice in the matter.

Judges: Lord Neuberger, Lord Sumption, Lord Carnwath, Lord Hughes, Lord Hodge

Dissenting Judge: Lord Carnwath

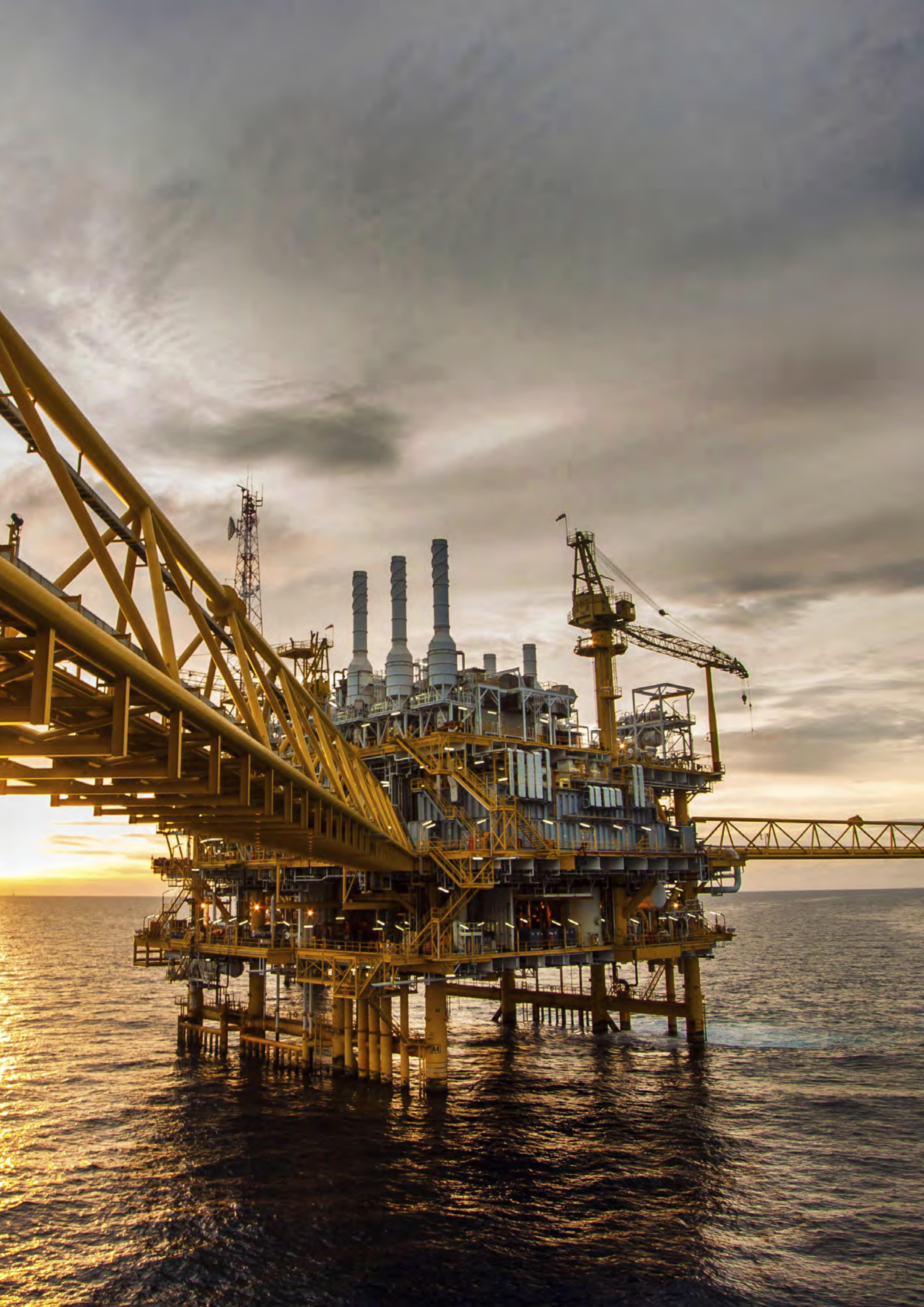
Comment

The decision in *Arnold* is arguably a significant departure from the approach previously adopted by the Supreme Court in the decisions of Lord Hoffmann. It emphasises the importance of the actual words used in a contract. The Court highlighted that, unlike commercial common sense, the parties have control over the words they use in a contract and are focused on the issue covered by a provision when agreeing the words of that provision.

Lord Neuberger's intention to change the trend of contractual interpretation was signposted in *Marley v Rawlings* [2014] UKSC 2, which was a case relating to a will. The fundamental principles of interpretation of wills and contracts are identical. In *Marley* Lord Neuberger described Lord Hoffmann's approach as 'controversial'.

In summary, Lord Hoffmann's approach to interpreting contracts was arguably akin to interpreting the contract as a conversation between the parties. Understanding a conversation requires the words to be understood in the context in which they are spoken, and an acceptance that even when a person 'misspeaks' the meaning of what they are seeking to convey is readily understandable. Lord Hoffmann therefore placed an emphasis on the factual background ('factual matrix') to the contract and the commercial sense of the outcome.

Lord Neuberger's approach on the other hand arguably requires a commercial contract to be treated as a legal document that has been agreed between sophisticated parties that have specifically chosen the words used.



It follows that one has to interpret the contract in stages with the natural and ordinary meaning of the words on the page being the starting point. Lord Neuberger's approach in *Marley, Arnold and Marks and Spencer plc* (below) emphasises the importance of the actual words used in a contract. Unlike commercial common sense, the parties have control over the words used in a contract and are focused on the issue covered by a clause when agreeing the wording.

It is conceivable that Lord Neuberger's approach may result in additional claims for rectification of a contract in the alternative to a claim for interpretation of a contract. A key practical effect of this is that when seeking rectification, parties are entitled to rely on evidence of the parties' negotiations at the time the contract was entered into, which would not be the case in a claim for contractual interpretation. However, the test for rectification remains strict and, arguably, more difficult to overcome than the 'red ink' approach to construction adopted by Lord Hoffmann in *Chartbrook Ltd v Persimmon Homes Ltd* [2009] 1 AC 1101.

It seems likely that *Arnold* marks a shift in English law's approach to determining the meaning of contracts. For the time being, parties should expect the Supreme Court to favour a more traditional iterative 'black letter' analysis of contracts that commences by focusing on the words used by the parties in the contract.

Implied terms

Background

In *Marks and Spencer plc v BNP Paribas Securities Services Trust Company (Jersey) Limited* [2015] UKSC 72, the Supreme Court unanimously clarified the requirements that must be satisfied before a term can be implied into a contract. This decision is confirmation of the Courts' traditional approach to implied terms and provides welcome guidance on this area following the confusion and academic debate that followed Lord Hoffman's Privy Council decision in *Attorney General of Belize v Belize Telecom Ltd* [2009] 1 WLR 1988.

Facts

BNP Paribas Securities Services Trust Company (Jersey) Limited ('**BNP Paribas**') were landlords and Marks and Spencer plc ('**Marks and Spencer**') tenants under four sub-underleases of different floors in a building known as The Point (the '**Building**').

Under the relevant lease, rent was payable quarterly in advance (the '**Basic Rent**'). Further, clause 8.1 of the lease entitled Marks and Spencer to determine the lease, by giving BNP Paribas six months' prior written notice (a '**break notice**') to take effect on the 'first break date', namely 24 January 2012. Clause 8.3 stipulated that a break notice would only have effect '*if on the break date there are no arrears of Basic Rent or VAT on Basic Rent*.' Clause 8.4 provided that a break notice would only take effect on the first break date '*if on or prior to the first break date the tenant pays to the landlord the sum of £919,800 plus VAT*.'

The principal issue between the parties at trial was whether it was an implied term of the lease that Marks and Spencer was entitled to be refunded a sum equal to the apportioned Basic Rent in respect of the period 24 January 2012 (when the lease expired) and 25 March 2012, given that Marks and Spencer had paid the Basic Rent (in the sum of £309,172.25 plus VAT) on 25 December 2011 in respect of that period even though the lease had expired on 24 January 2012.

Decision

In the leading judgement, Lord Neuberger reviewed the tests set out in the key authorities on implied terms. Lord Neuberger reiterated that the Privy Council case of *BP Refinery (Westernport) Pty Ltd v Shire of Hastings* (1977) 52 ALJR 20 the Privy Council had decided that:

> *'[F]or a term to be implied, the following conditions (which may overlap) must be satisfied: (1) it must be reasonable and equitable; (2) it must be necessary to give business efficacy to the contract, so that no term will be implied if the contract is effective without it; (3) it must be so obvious that 'it goes without saying'; (4) it must be capable of clear expression; (5) it must not contradict any express term of the contract.'*

Further, Lord Neuberger referred to *Philips Electronique Grand Public SA v British Sky Broadcasting Ltd* [1995] EMLR 472, in which Sir Thomas Bingham MR set out the above formulation, and described it as a summary which '*distil[led] the essence of much learning on implied terms*' but whose '*simplicity could be almost misleading*.' Lord Neuberger noted that Sir Thomas explained that:

— It was '*difficult to infer with confidence what the parties must have intended when they have entered into a lengthy and carefully-drafted contract but have omitted to make provision for the matter in issue*', because '*it may well be doubtful whether the omission was the result of the parties' oversight or of their deliberate decision*', or indeed the parties might suspect that '*they are unlikely to agree on what is to happen in a certain … eventuality*' and '*may well choose to leave the matter uncovered in their contract in the hope that the eventuality will not occur*'.

- Further '*[t]he question of whether a term should be implied, and if so what, almost inevitably arises after a crisis has been reached in the performance of the contract. So the court comes to the task of implication with the benefit of hindsight, and it is tempting for the court then to fashion a term which will reflect the merits of the situation as they then appear. Tempting, but wrong. [He then quoted the observations of Scrutton LJ in Reigate, and continued] [I]t is not enough to show that had the parties foreseen the eventuality which in fact occurred they would have wished to make provision for it, unless it can also be shown either that there was only one contractual solution or that one of several possible solutions would without doubt have been preferred* ...'

Lord Neuberger approved that summary and then provided the following guidance for applying the test:

- The implication of a term was '*not critically dependent on proof of an actual intention of the parties*' – the Court is concerned with what notional reasonable people in the position of the parties at the time of contracting would have agreed.
- Care must be taken when using the '*officious bystander*' test. It is vital to formulate the question posed by the bystander with the '*utmost care*.'
- Business necessity and obviousness are alternative requirements rather than cumulative. Only one of them needs to be satisfied, but it is likely that if one were satisfied the other would be too.
- Necessity for business efficacy involves a value judgement; it is not 'absolute necessity.' Rather, '*a term can only be implied if, without the term, the contract would lack commercial or practical coherence.*'
- A term should not be implied into a detailed commercial contract merely because it appears fair or is what the Court considers the parties would have agreed if it had been suggested to them. (Lord Neuberger noted Sir Thomas Bingham's comments in *Philips Electronique Grand Public SA v British Sky Broadcasting Ltd* [1995] EMLR 472, that the parties may have deliberately chosen not to make provision for a particular eventuality for any number of reasons; they may not have been able to agree on what should happen and so chose to leave the matter undealt with in the hope that it did not occur).
- The '*reasonable and equitable*' requirement will not usually, if ever, add anything to the analysis. If a term satisfies the other implied term requirements, it will almost inevitably be reasonable and equitable.

In *Belize Telecom* Lord Hoffmann stated that the only question to be asked in the process of a implying a term was: '*is that what the instrument, read as a whole against the relevant background, would reasonably be understood to mean?*' In *Marks and Spencer plc*, Lord Neuberger stated that there has been no dilution of the test for implied terms and Lord Hoffmann's statement should not be interpreted as suggesting that reasonableness is a sufficient ground for implying a term. Construing the words used in a contract and implying additional words are different processes governed by different rules.

Lord Neuberger considered authorities that suggested that it was not traditional for advance payment of rent to be apportioned in the event of a break in the lease. In addition, his Lordship considered that whilst it '*can fairly be said [not to apportion the rent] to be capricious or anomalous, it does not begin to justify a suggestion that the contract is unworkable. Indeed, the result cannot be said to be commercially or otherwise absurd, particularly as it is entirely up to the tenant as to when that sum is paid*'. In this context, the Supreme Court refused to imply a term.

Judges: Lord Neuberger, Lord Clarke, Lord Sumption, Lord Carnwath, Lord Hodge

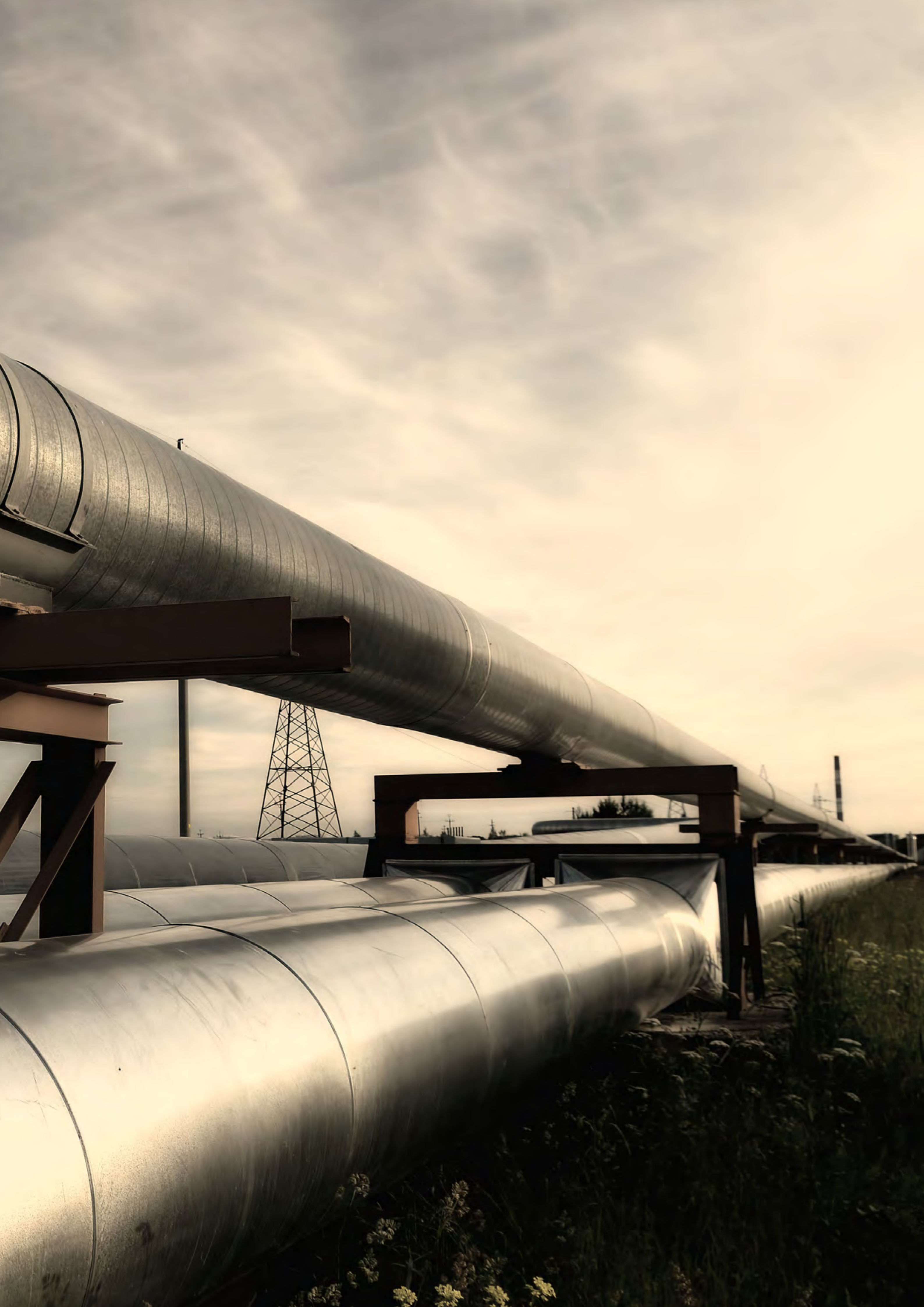
Comment

The decision in *Marks and Spencer plc* confirms that the ambiguous notion of 'reasonableness' does not play a central role in the process of implying terms. English law will instead take a strict approach of applying the traditional rules concerning implied terms.

In addition, the decision makes clear that Lord Hoffmann's approach in *Belize Telecom* that the process of implying terms into a contract was simply part of the exercise of the construction, or interpretation, of the contract, is not correct.

In *Marks and Spencer plc*, Lord Neuberger emphasised that although implying a term and construing express terms both involve determining the scope and meaning of a contract, the interpretation of a contract and the implication of a term are governed by different rules (and occur at different times) and the two processes must not be conflated.

As a consequence, it will arguably be more difficult to imply terms into contracts due to the strict tests that the law imposes. Drafters should therefore be cautious to ensure that complex commercial contracts adequately deal with all anticipated scenarios.



‘Entire Agreement‘, ‘no amendment’ and ’no waiver’ clauses

A number of recent English law cases have considered the effectiveness of informal agreements or statements made between personnel employed to manage a given project or transaction. The risk of such agreements or statements being made is typically sought to be addressed in industry contracts through the use of clauses that state that the contract is to be the ‘entire agreement’ between the parties, or that no amendment or waiver of the contract terms will be permitted unless certain formalities are complied with (such as the execution of a written document). The effectiveness of such clauses is considered in detail below.

Background

Oil and gas contracts and projects are typically administered by a team of dedicated contract managers, in-country managers, engineers and other professionals. A number of industry model forms provide for party representatives to deal with specified issues and escalation procedures in the event of non-agreement.

Throughout the course of a contract or project, these personnel will likely discuss a broad range of issues, including technical matters, financial details and the legal merits of particular positions adopted by either party. As they are appointed (or employed) by the parties and given responsibility for the management of such issues, these personnel will usually have authority to conclude agreements on behalf of the parties or to make statements which have legal effect under the relevant construction contract. Given that discussions often take place informally, risks arise that agreements or statements may be made without proper consideration or without prior approval of senior management.

The risks are illustrated by a decision last year by the English Technology and Construction Court in *Mi-Space (UK) Ltd v Bridgwater Civil Engineering Ltd* [2015] EWHC 3360 (TCC).

Facts

Mi-Space (UK) Ltd (‘**Mi-Space**’) was in dispute with its sub-contractor, Bridgwater Civil Engineering Ltd (‘**Bridgwater**’) over an interim payment which had led to Bridgwater suspending work. Settlement discussions took place via email between Mi-Space’s ‘Project Surveyor’ and a director from Bridgwater whereby Bridgwater would withdraw its existing claims and recommence work in return for a further payment by Mi-Space. Although the emails were marked ‘without prejudice’, this tag was removed in the final email exchange (as Mi-Space’s email put it) ‘*to allow you to formally accept*’.

A few days later, Mi-Space sent a contract to Bridgwater to formalise the agreement they had reached by email. Bridgwater refused to sign, claiming that the agreement by email was 'subject to contract' and not binding on the parties. Under English law, the use of the words 'subject to contract' in a document will ordinarily mean that there is no intention to be legally bound and prevent an agreement coming into existence. However, the email exchanges between Bridgwater and Mi-Space did not expressly state that they were 'subject to contract'. Bridgwater relied instead on a reference in Mi-Space's final offer email to the receipt of Bridgwater's '*formal acceptance in writing of this agreement*'. Bridgwater claimed this suggested that the parties were not to be bound until a formal written agreement had been prepared.

Decision

The Court disagreed with Bridgwater and decided that a binding agreement had been reached by the exchange of emails. There was a '*clear and properly recorded*' offer and acceptance in the email chain. The reference in the final emailed offer to a '*formal acceptance in writing of this agreement*' required only an acceptance in writing (which was sent by reply email) and was not sufficient to make the agreement 'subject to contract'. Neither did the use of the 'without prejudice' label assist Bridgwater. The Court commented that, even were that label to have been used (mistakenly) by Bridgwater to mean 'subject to contract', it had been removed from the final exchange of emails to allow Bridgwater to '*formally accept*' the agreement.

Comment

The risks posed by informal communications of this nature are frequently sought to be managed by the inclusion of various standard or 'boilerplate' clauses as follows:

- 'Entire agreement' clauses will usually seek to exclude the ability of a party to rely upon pre-execution representations or statements – see our discussion below.
- 'No amendment' clauses will usually seek to preclude the making of informal amendments to the contract unless certain formalities are followed. A popular form is to require that any amendment be '*in writing and signed by the parties*'.
- 'No waiver' clauses are similar and will usually seek to preclude any informal waiver of rights by stating that any waiver must be in writing and signed by the party concerned. Such clauses will often also state that any failure or delay in exercising rights shall not amount to a waiver.

The effectiveness of each of these mechanisms is further considered below.

Boilerplate Clauses

'Entire agreement' clauses

A simple 'entire agreement' clause is designed to preclude one party from alleging that additional documents or terms formed part of the contract between the parties which were not detailed in, or referred to by, the relevant entire agreement clause. A common way for such arguments to arise is through what is known as a 'collateral contract'. Such contracts can arise where one party to a proposed contract seeks assurances from another party before agreeing to enter into the contract. Where such assurances are given, a second and distinct contract may arise (such contract being a 'collateral contract') since the assurances provided amount to promises given in return for one party's agreement to enter into the primary contract.

Simple entire agreement clauses will usually be sufficient to prevent any collateral contract argument from succeeding. By agreeing that the primary contract is the 'entire agreement', the parties agree to exclude the prospect of any collateral or related agreements arising with regard to the same subject matter. (It is less clear whether such a clause would protect against situations falling under the rubric of estoppel under English law, whereby non-contractual understandings or representations may sometimes be enforced where they have been relied upon to the detriment of another party.)

It is clear however, that simple provisions will not be sufficient to prevent claims for misrepresentation.

In *Axa Sun Life Services Plc v Campbell Martin Ltd* [2011] EWCA Civ 133, an entire agreement clause was in a slightly broader form stating that: '*[t]his Agreement and the Schedules and documents referred to herein constitute the entire agreement and understanding between you and us in relation to the subject matter thereof.*' The clause also stated that: '*this Agreement shall supersede any prior promises, agreements, representations, undertakings or implications whether made orally or in writing between you and us relating to the subject matter of this Agreement …*'.

Despite this addition, the clause was still insufficient to exclude liability for misrepresentation. The language of the clause as a whole indicated that contractual liability was still in mind and the reference to representations was therefore limited to representations which might otherwise have had contractual or legal effect (such as through a collateral contract) rather than to liability for misrepresentation. This broader language would, however, appear to extend to claims for estoppel, which are typically based either on a joint understanding, or on representations made by one of the parties – both of which are said to have been superseded in the above clause.

In order to avoid liability for misrepresentation, entire agreement clauses are required to go further and state either that no relevant representations have been made, or that no representations have been relied upon in entering to the agreement, or more directly still, that any liability for misrepresentation is excluded.

An example of such a clause came before the High Court last year in *Thornbridge Ltd v Barclays Bank Plc* [2015] EWHC 3430 (QB). The contract in question was a banking contract, which provided that the bank's customer was: *'not relying on any communication (written or oral) of the [bank] as investment advice or as a recommendation to enter into the Transaction; it being understood that information and explanations related to the terms and conditions of the transaction shall not be considered investment advice or as a recommendation to enter into the Transaction.'* This clause was held to be effective to prevent the customer from claiming against the bank on the basis of alleged advice and recommendations provided by the bank prior to entry into the contract. That will be the case even where it is clear that both parties are aware that advice has been given or representations have been made and have been relied upon. English law's approach to freedom of contract means that the parties are able to 'rewrite history' and state authoritatively in their contract whether or not any representations have been made and/or relied upon by the parties (except for misrepresentations made fraudulently by one of the parties, where English law does not permit any exclusion of liability).

Despite the above cases, even the most well-drafted entire agreement clause may still be overcome by the conduct of the parties where such conduct indicates that the entire agreement clause should not to apply. Such a position arose in *Shoreline Housing Partnership Ltd v Mears Ltd* [2013] EWCA Civ 639 where both estoppel and misrepresentation arguments were raised in an attempt to overcome an entire agreement clause. During the course of contract negotiations, the parties had agreed certain rates, known as composite rates for repair works which were not provided for by the formal Schedule of Rates which was to form part of the proposed contract. The need for an amendment to the draft contract documents to deal with such composite rates was raised, but no amendment was thought to be necessary. The contract was signed and the composite rates were initially used and paid for under the contract. However, the employer subsequently sought to revert to the formal Schedule of Rates relying on the entire agreement clause. The clause was not drafted widely enough to include misrepresentation, but the Court of Appeal also noted that such a clause could not prevent an estoppel argument being made where the subject of such estoppel argument related to the effect of the entire agreement clause itself. As it had been agreed that the draft contract did not require amendment to include the composite rates, the effect of the entire agreement clause itself had been the subject of the understanding or representations which were alleged to support the estoppel.

The most commonly used industry standard agreements (including the LOGIC standard form contracts, the standard form AIPN JOA (2012) (the '**AIPN JOA**') and the standard form OGUK JOA (2009) (the '**OGUK JOA**') each contain slightly different entire agreement clauses – the impacts of which should be carefully considered in the light of this recent case law.

There are a few points of note in relation to the clauses of these agreements:

- None of the clauses contain an express exclusion for misrepresentation, state that representations have not been made, or contain a statement of non-reliance. As a consequence, the existing case law suggests that claims for misrepresentation will not be excluded.
- Whilst the 'entire agreement' clauses contained in the LOGIC General Conditions of Contract for Mobile Drilling Rigs Edition 1 (the '**LOGIC Drilling Agreement**') (Clause 26.6) and the AIPN JOA (Clause 20.10) are broadly similar in stating that the terms of the agreement shall supersede all prior negotiations, representations or agreement/negotiation of the parties, Clause 20.2 of the OGUK JOA states that the terms of the agreement shall supersede all '*understandings, agreements or undertakings of the parties*'. The relevant clause in the Axa Sun Life case went further and stated that the agreement superseded all '*promises, agreements, representations, undertakings or implications [between the parties] whether made orally or in writing*'. It remains to be seen whether the scope of the OGUK JOA is wide enough to exclude claims for collateral contracts and estoppel.

'No amendment' clauses

A 'no amendment' clause will typically state that no amendments to a contract will be valid unless '*made in writing and signed by the parties*'. A recent Court of Appeal decision (*Globe Motors, Inc v TRW Lucas Varity Electric Steering Ltd* [2016] EWCA Civ 396) confirms, (*obiter*), the Courts' approach over the past few years of enforcing informal amendments agreed between the parties to a contract. In this case, which related to a construction project, the Court held that in the absence of statutory or common law restrictions, parties to a contract are free to amend or alter an agreement as they see fit and the presence of a 'no amendment' clause does not in fact rule out informal amendments being agreed between the parties. The parties cannot '*effectively tie their hands so as to remove from themselves the power to vary the contract informally*'. The Court, however, did go on to comment that 'no amendment' clauses may still be taken into account when considering whether any subsequent agreements are effective in binding the parties. The Court noted:

> *'In many cases parties intending to rely on informal communications and/or a course of conduct to modify their obligations under a formally agreed contract will encounter difficulties in showing that both parties intended that what was said or done should alter their legal relations; and there may also be problems about authority. Those difficulties may be significantly greater if they have agreed to a provision requiring formal variation.'*

MWB Business Exchange Centres Ltd v Rock Advertising [2016] EWCA Civ 553 provided for a similar set of facts to *Globe Motors* in respect of whether a 'no amendment' clause could preclude an oral renegotiation. Globe Motors was heard by the Court of Appeal just prior to *MWB Business Exchange* and so the Court of Appeal reserved judgement on the case until the Court of Appeal had given its decision in *Globe Motors*. The Court of Appeal in *MWB Business Exchange* then confirmed agreement with the *obiter* comments provided in Globe Motors, Lord Justice Kitchin stating in his judgement that '*to my mind the most powerful consideration is that of party autonomy*'.

The governing principle of freedom of contract was also evident in the recent Commercial Court decision of *C&S Associates UK Ltd v Enterprise Insurance Company Plc* [2015] EWHC 3757 (Comm), where an exchange of emails between management personnel led to an enforceable agreement which was not prevented by the presence of a 'no amendment' provision.

The Court in this case found that the relevant 'no amendment' clause was insufficient to prevent such an agreement taking effect. In particular:

- The requirement for '*writing*' was broad enough to cover an agreement by email exchange. To avoid this, the clause would have to specifically carve out emails, require manuscript signatures, paper documents or both parties' signatures to be present on the same document.
- An earlier decision of the Court of Appeal in *Golden Ocean Group v Salgaocar Mining Industries* [2012] EWCA Civ 1588 could be applied by analogy, where it was held that agreement by a series of emails was capable of satisfying the requirements of the Statute of Frauds (i.e. that a contract of guarantee must be in writing and signed by or on behalf of each party). The signature blocks in the email chain between Enterprise's Head of Claims and C&S's director could therefore satisfy the requirements for the amendment to be '*signed*'.

In Energy Venture Partners Ltd v Malabu Oil and Gas Ltd [2013] EWHC 2118 (Comm) the Commercial Court has also recently clarified:

> *'…as at present advised, I incline to the view that there can be an oral variation in such circumstances, notwithstanding a clause requiring written modifications, where the evidence on the balance of probabilities establishes such variation was indeed concluded.*
>
> *In many cases, such as United Bank Limited v Asif (where the relationship between the parties was a formal banking relationship) the factual matrix of the contract and other circumstances may well preclude the raising of an alleged oral variation to defeat [a 'no amendment' clause]. In others, the evidence may establish on the balance of probabilities that the parties by their oral agreement and/or conduct have varied the basis of their contractual dealings, and have effectively overridden a written clause excluding any unwritten modification.'*

In this context, it has also been said that the emphasis placed by one party on the inclusion of a 'no amendment' clause may also be relevant (see *Virulite LLC v Virulite Distribution Ltd* [2014] EWHC 366 QBD). If the clause was shown to be of importance to one party, as a matter of evidence that may suggest that any later agreement reached informally was not intended to override the clause and form a binding agreement. Conversely, if the clause was not specifically negotiated and was merely boilerplate language introduced by lawyers (as is often the case), it may be that as a matter of evidence the parties can more easily be taken to have overridden the clause.

The decision in these cases mean that parties should not place undue reliance on 'no amendment' or 'anti-variation' clauses to protect them from informal variations. The decisions also highlight areas in which the drafting of 'no amendment' clauses can be strengthened. For example parties might:

- include within their 'no amendment' clauses a statement that any informal agreements are to be 'subject to contract' until included within a duly executed written agreement; or
- specify in their 'no amendment' clause that only specific individuals (e.g. Directors) will have authority to agree binding contractual amendments.

The wording of the clauses considered in these cases resembled that often used in many of the industry standard model forms of contract, which require amendments to be made in writing and signed by the relevant parties and the decisions detailed above should be considered when negotiating draft documents.

Interestingly, Clause 31.3 of the OGUK JOA provides that an amendment must be by 'written instrument' instead of 'in writing' and 'executed' rather than 'signed'. It is possible that reference to the execution of a written instrument in the OGUK JOA would require the parties to physically execute a hard copy variation agreement in order to amend the JOA and that agreement documented by way of email containing the sender's email signature block would not be sufficient to effect an amendment alone (although we think this unlikely). However, we would urge caution in relying upon such an argument and suggest that careful consideration is given by the parties to an agreement to the ways in which amendments to such agreement should be made.

Clause 11 of the LOGIC Drilling Agreement requires variations to be 'evidenced in writing' while Clause 20.10 of the AIPN JOA uses the wording 'written amendment' and 'signed'. Both provisions contain very similar wording to that seen in C&S *Associates* and as a result there is potential for parties to unwittingly be bound by proposed amendments contained in emails alone. Drafters should be live to this possibility and seek to consider amending the wording of model clauses to avoid this outcome if they are concerned.

'No waiver' clauses

Similar comments apply to 'no waiver' clauses. For example, in Virulite LLC v *Virulite Distribution Ltd* [2014] EWHC 366 QBD the High Court considered a clause stating that, '*[w]aiver by either party of any particular default by either party must be in writing and shall not affect or impair such party's rights in respect of any subsequent default of any kind.*' The position as quoted above from *Malabu Oil and Gas* was said to apply equally in the case of a 'no waiver' clause. The Court noted that the key question is whether the evidence of any informal waiver or agreement is '*sufficient to establish that the parties have subsequently overridden the terms of the original contract.*'

Such 'no waiver' clauses are frequently coupled with a statement that no delay in exercising any rights shall amount to a waiver. For example, the clause in Virulite also stated that, '*[n]either party's failure to exercise any power given to it under this Agreement or to insist upon strict compliance with any obligation under it … shall constitute any waiver of any rights under this Agreement.*'

A similar provision was considered by the Court of Appeal in *Tele2 International Card Company SA v Post Office Ltd* [2008] EWHC 158 (QB). In that case, the contract provided a right of termination in the event that certain parent company guarantees were not provided. When the relevant parent company guarantees were not provided in accordance with the terms of the contract, the right of termination was not sought to be exercised until nearly a year later whilst in the meantime both parties had continued to perform the contract. It was suggested that the relevant termination right was preserved by a 'no waiver' clause which stated:

> *'In no event shall any delay, neglect or forbearance on the part of any party in enforcing (in whole or in part) any provision of this Agreement be or be deemed to be a waiver thereof or a waiver of any other provision or shall in any way prejudice any right of that party under this Agreement.'*

The Court of Appeal considered this clause insufficient to preserve the right of termination in the circumstances but the judges did not provide any discussion regarding the express words used within the clause (and any shortcomings thereof). Instead, the Court considered that once the parent company guarantees had not been provided, the innocent party was put to an 'election' as to whether to terminate or proceed with the contract. By continuing to perform the contract, the innocent party had elected to affirm the contract. It was not so much a question of whether the innocent party had delayed in exercising its right of termination, but that it had made a positive decision not to terminate the contract.

It is unclear how such a clause would apply to mere delay or a failure to take action (the word 'failure' often appearing in the no waiver clauses found in the LOGIC suite of contracts) including in situations where a contract does not require any performance by the innocent party in the period between a right of termination arising and it being exercised. Absent such a clause, the right of termination could be said to have lapsed as English law will usually imply a requirement that express termination rights be exercised within a reasonable period of time. A 'no waiver' clause such as that detailed above may be sufficient to reverse this rule such that a right of termination will remain open for so long as the innocent party does not take any positive action which could be viewed as affirming the contract.

Aside from cases where the doctrine of election applies, such clauses may provide some benefit where a party otherwise seeks to rely on a delay in the exercise of rights. A company might, for example, hold off on collecting liquidated damages for fear of prejudicing the progress of the works. In ordinary circumstances, such company may be required to make a formal demand for payment of the outstanding liquidated damages before taking any recovery action, such as the liquidation of performance securities. A 'no waiver' clause similar to that detailed above might potentially avoid the need for such a demand to be made.

Interestingly, the standard waiver clauses contained in many industry standard agreements including the LOGIC Drilling Agreement (Clause 26.1), the OGUK JOA (Clause 31.4) and the AIPN JOA (Clause 20.5) are more detailed than the clause contained in *Tele2 International Card Company* and each agreement states that no waiver shall be effective unless it 'is given in writing'. Draftsmen using such industry standard agreements should carefully consider the level of protection required within their 'no waiver' clause, and, given the decision in *Mi-Space*, should be wary not to fall foul of unwittingly waiving their rights in email exchanges where this standard form wording is retained without amendment.

Comment

The analysis set out above shows that the protection often thought to be obtained through the use of commonly worded 'entire agreement', 'no amendment' and 'no waiver' clauses may not in fact be the case. Misrepresentation or estoppel arguments can often succeed despite an 'entire agreement' clause. A requirement for agreements or waivers to be 'in writing and signed' is more easily fulfilled than many parties may realise. The use of 'no amendment' or 'no waiver' clauses also remain subject to the parties ability to override the original contract, even through informal means. Careful attention to the drafting of these common clauses can overcome many of these difficulties. For example:

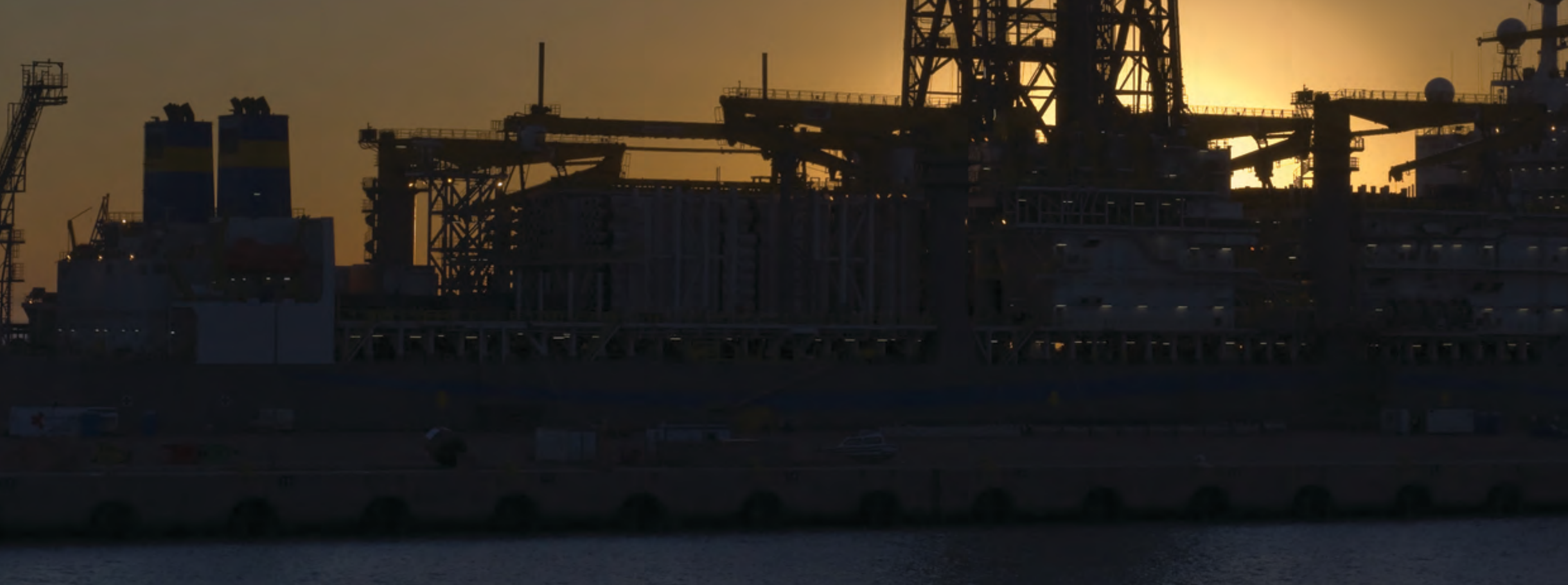
— 'Entire agreement' clauses can be drafted widely to exclude estoppels and claims for misrepresentation (save where misrepresentations are made fraudulently).

— The requirements of any 'no amendment' or 'no waiver' clause can be tightened to require paper documents or traditional manuscript signatures (although the prospect of informal agreements overriding such clauses will still remain).

— A 'no amendment' clause might also state that any amendments agreed shall be 'subject to contract' and enforceable only once certain formalities have been completed. This is a potentially stronger clause, because evidence that an agreement was actually intended by informal discussions, whilst potentially sufficient to override a simple 'no amendment' clause, may not be sufficient to override a 'subject to contract' clause (i.e. such a clause contemplates that informal agreements will be reached – albeit 'subject to contract' – and therefore reduces the scope for arguments that evidence of an informal agreement should be taken to be inconsistent with or have overridden the clause).

— Stronger still, 'no amendment' or 'no waiver' clauses might seek to state those persons or categories of people who have authority to agree amendments or waive rights under the contract. Such a clause might, for example, specify the need for the agreement of two directors. Agreements or waivers made by persons outside of those mentioned in the clause should not bind the party concerned unless by other words or conduct the party has indicated that those persons do have authority to amend or waive rights under the contract on their behalf.

Even the most well drafted clauses will, however, be capable of being waived by the parties at one level or another either expressly or through a course of dealing. Freedom of contract requires that parties cannot completely preclude themselves from making fresh agreements or amending existing ones.



Mergers & Acquisitions

Whilst M&A has faced some challenges this year, there have been a number of interesting Commercial Court decisions concerning oil and gas M&A deals:

— In *Vitol E & P Ltd v Africa Oil and Gas Corporation* [2016] EWHC 1677 (Comm), the Commercial Court was tasked with deciding whether the words '*commencement of drilling*' in an M&A sale and purchase agreement for an oil company meant '*spudding*'.

— In *Idemitsu Kosan Co., Ltd v Sumitomo Corporation* [2016] EWHC 1909 the Commercial Court was asked to decide if a 'Warranty' in a M&A sale and purchase agreement also amounted to a representation, such as to found a case for misrepresentation.

'Commencement of drilling' the same as 'spudding'?

The Commercial Court was recently tasked, in *Vitol E & P Ltd v Africa Oil and Gas Corporation* [2016] EWHC 1677 (Comm), with deciding whether the words *'commencement of drilling*' in a sale and purchase agreement for an oil company meant '*spudding*' of a well or an earlier stage in drilling operations. The decision is a timely reminder of the importance of clarity in contractual terms dealing with deferred consideration in oil and gas M&A transactions.

Background

On 18 July 2005 the Republic of Congo issued a Research Permit for the offshore area known as 'Marine XI'. The beneficiaries of the relevant Research Permit were the parties to a Production Sharing Contract (the '**PSC**') made with the Republic of Congo on 19 August 2005. Their interests in the PSC at the relevant time were Raffia Oil SARL ('**Raffia**'): 18.75%, Lundin Marine SARL ('**Lundin**'): 18.75%, SOCO Exploration & Production Congo ('**SOCO**'): 29%, Société Nationale des Pétroles du Congo ('**SNPC**'): 15%, PetroVietnam Exploration Production Corporation ('**PVEP**'): 8.5% and Africa Oil and Gas Corporation ('**AOGC**'): 10%.

The permit lasted for up to three consecutive exploration periods. In order for a second or third exploration period to be granted, the beneficiaries of the permit had to have drilled at least one 'Commitment Well' in the preceding period. If they then decided to drill another well in the same exploration period it would become known as a 'Discretionary Well'.

The second exploration period commenced on 1 April 2011 and was due to expire on 30 March 2013. By the end of 2011, a Commitment Well for that period had been drilled and accordingly the parties were then entitled to apply for a third exploration period if they so decided. However, in March 2012 SOCO proposed that the existing Work Programme and Budget be expanded so as to include the drilling of a Discretionary Well at the site known as Lideka East (the '**Well**'). Raffia was opposed to this because it had already formed the view that the Marine XI project was not going to yield significant results. Lundin took the same view but the other parties did not.

Facts

Vitol E & P Limited ('**Vitol**') was owner of Padina Energy Limited ('**Padina**'). It in turn owned Raffia. By a Sales and Purchase Agreement dated 24 January 2013 (the '**Agreement**'), Vitol sold its shares in Padina to AOGC.

It was common ground that in late 2012 the value of Raffia's interest in the PSC was about US$20 million. The cash consideration payable under the Agreement was US$12.6 million. This would increase to the extent that Vitol had to pay any cash calls in the period between execution of the Agreement and completion. There was also provision for Deferred Consideration of US$7.4 million.

The Deferred Consideration was payable only in certain circumstances. Clause 7.1 of the Agreement provided as follows:

> *'7.1 The Purchaser shall pay the Seller the Deferred Consideration if one of the following conditions is satisfied:*
>
> *(A) at any time prior to the date of expiry of the Second Exploration Period… the drilling of the Lideka East Well no longer forms part of an approved work program or budget under the Marine XI Joint Operating Agreement, as either firm or contingent expenditure; or*
>
> *(B) the drilling of the Lideka East Well is not commenced before the date of expiry of the Second Exploration Period…'*

It was common ground that it approximated to the estimated costs of the Well which AOGC would have to bear if it went ahead, which was approximately US$7.2 million.

It was further common ground that the underlying purpose of Clause 7.1 was to some extent at least, to protect the buyer from a situation where it had to pay full value for the shares in Raffia, namely US$20 million and a further sum of around US$7.2 million by way of its costs contribution for the Well.

Under normal circumstances, of course, one would expect a party to the PSC to have to make costs contributions. However, the position here was that both Vitol and the buyer considered that the Well was not worth drilling and was unlikely to produce any benefit. Therefore, as they saw it, any costs incurred if the Well stayed in the Work Programme and Budget and was drilled, might be wasted.

Vitol contended that '*commencement of drilling*' meant '*spudding*'. However, AOGC contended that this expression is '*not confined to operations beginning with the spudding… Rather, the words refer to a phase of operations including, in addition to the spudding of the well, various activities preparatory to, associated with or consequential upon the spudding. Such activities include, but are not limited to the procurement, mobilisation and demobilisation of machinery and services required in connection with the spudding of the well.*'

At trial the question arose whether commencement of drilling meant '*spudding*' or mobilisation of the rig.

Decision

The Commercial Court emphasised that Clause 7.1 was put in negative terms:

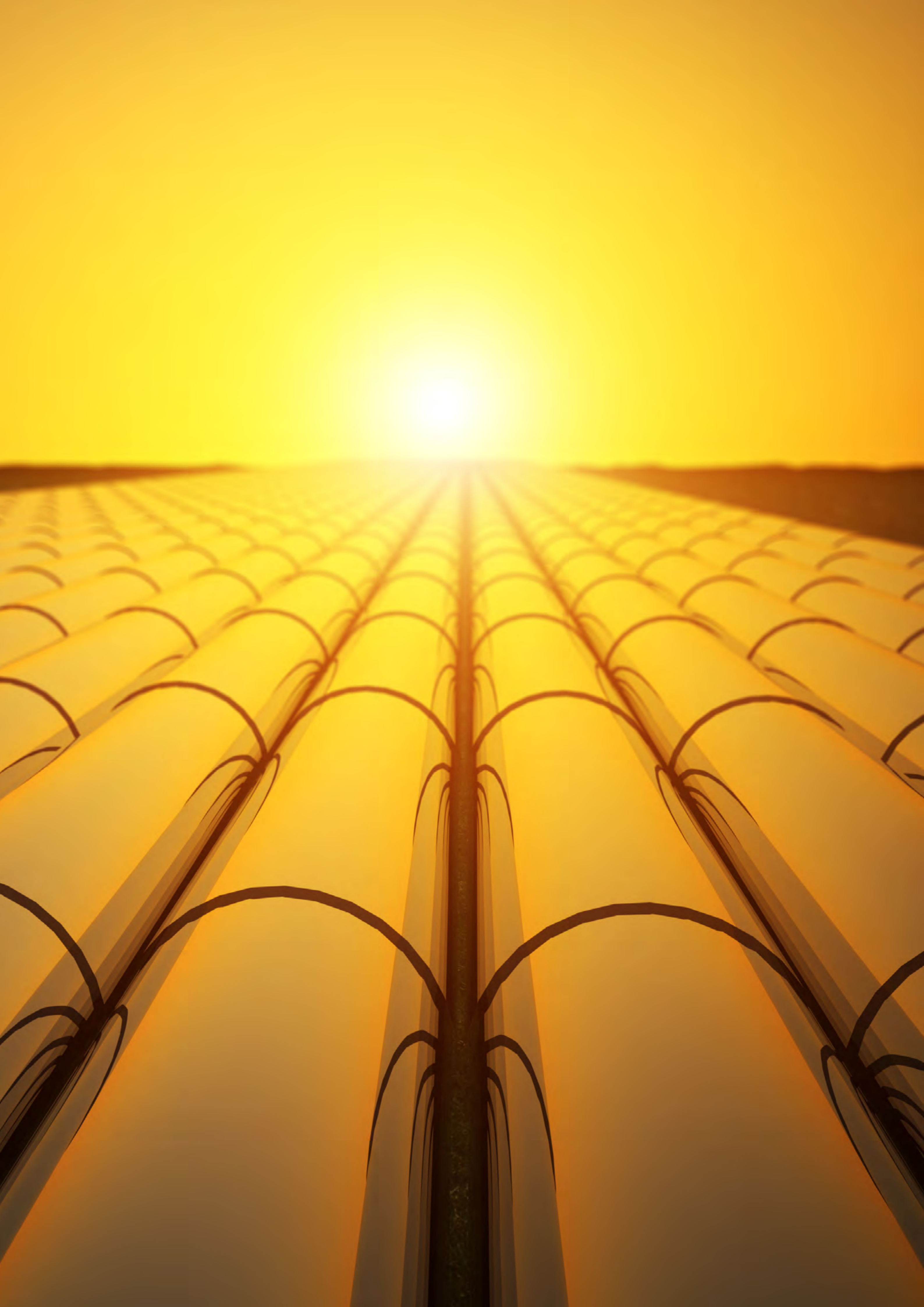
> *'Vitol is entitled to the Deferred Consideration if either the Well is removed from the WP&B or drilling thereof is <u>not</u> commenced. Otherwise it is not. But the protection afforded to the buyer is limited because it operates only up to the end of the second exploration period (i.e. 30 June 2013) and not indefinitely.*
>
> *So if the Well is not removed from the WP&B <u>and</u> drilling is commenced before the end of the second exploration period, no Deferred Consideration is ever payable – but on the other hand, AOGC will have the costs liability in respect of it. However, if the Well was not removed from the WP&B, and drilling was not commenced by the end of the second exploration period (so that the Deferred Consideration is payable in any event) but it did commence in the third period, AOGC will still incur a costs liability without any protection. It will, in effect, pay out twice.'* (Court's emphasis)

The Commercial Court considered that the most recent decision of the Supreme Court in this area, *Arnold v Britton* [2015] AC 1619, was the relevant starting point to deciding the meaning of the relevant clause.

In accordance with *Arnold v Britton*, the proper approach was to first consider if there is a 'natural' and 'ordinary' meaning of the words 'commencement of drilling'. The Commercial Court decided that there was such a meaning, and it is the physical penetration of the seabed i.e. '*spudding*'.

The Commercial Court considered that:

> *'This is to be distinguished from preparations for drilling. Drilling is itself not a momentary process and so it is perfectly sensible to speak of when drilling starts, in the spudding sense, and when it stops. That is the sense in which one would define drilling the road or the drilling of one's teeth by a dentist. I further find that 'commencement' naturally means the beginning of drilling, not the beginning of preparations for drilling.'*



The Commercial Court found that some support could be found for this approach in:

- *Excalibur v Texas Keystone* [2013] EWHC 2767 Christopher Clarke J (as he then was), when reciting the history of Garth's oil exploration at a well in Kurdistan said, at paragraph 1285: '*on 28 April 2009, Garth announced the spudding (i.e. commencement of drilling) of the first… exploration well*'; and
- *Amoco v British American Offshore Limited* 16 November 2001, where Langley J said '*……The Clause also refers to BAO ensuring that all BOP elements are new or like new at the commencement of drilling operations'. That means what it says. Not mobilisation, not commencement of the contract, but commencement of drilling. 'Prior to spud of the well' has the same connotation. It also accords with all the evidence that the well control equipment must be and is tested prior to drilling, and at no more than fortnightly intervals thereafter… Clause 10 provided for Amoco to provide BAO with a well-drilling programme prior to spudding of the well. 'Spudding' is the commencement of drilling.*'

In making its decision the Commercial Court refused to apply a number of United States court decisions. It identified:

- *Terry v Texas* (1920) 228 SW 1019 (where two oil and gas leases in question would be of no effect unless the lessee '*commenced to drill a test well…*' within 8 months); *Cromwell v Lewis* 1923 OK 1028 (where the expression in the lease was '*to commence to drill a test well*'); and *Ferrell v Russell* Creek Okl. 645 P 2d 1003, a yet further decision of the Oklahoma Supreme Court.
- Quite apart from the fact that *Terry*, as with the other US cases, is not binding authority, the Commercial Court considered that it can be seen that the result derived from case law about a different phrase.
- Furthermore, in *Caltex Oil v Commissioner of Internal Revenue* 12 January 2012, 138 TC 18, the US Federal Tax Court took a different view to *Terry*. In *Caltex Oil*, in the tax context, a right to make certain deductions in a particular tax year, depended on whether '*drilling of the well commences*' within 90 days of the end of the tax year. In this case, the site had been prepared but there had been no *spudding* within that period. The Court took the ordinary meaning of drilling as, in effect, *spudding* and defined 'commence' as 'begin' and concluded that drilling began when the drill bit penetrated the ground. It had to be noted, though, that this view was held to be consistent with the title of the relevant section in the tax statute which referred to '*special rule for spudding of oil and gas wells*'. The Court distinguished the Oklahoma cases where, for the purpose of a lease, preparatory acts were sufficient and said that those cases (most of which as quoted here concerned leases where the term referred to the commencement of 'operations for drilling') did not assist in the different contexts of interpreting federal tax law.
- All in all, the Commercial Court did not find the US cases relied upon by AOGC to be of much assistance.

Further, the fact that Clause 7.1(A)'s reference to 'drilling' being '*part of an approved work programme*' did not assist the Commercial Court. The context in Clause 7.1(A) was simply different. The contingency catered for there is the removal, effectively, of the entire drilling project for the Well because in that case, there is no prospect of AOGC ever having to incur costs in relation to it. So the fact that 'drilling' there may be interpreted in a wider sense is irrelevant. Moreover, there is of course no direct comparison because Clause 7.1(A) does not use the expression 'commencement of drilling'.

Judge: HHJ Waksman QC

Comment

It is common for oil and gas M&A transactions to have to deal with costs incurred by the seller between financial close/execution and completion.

If those costs might include the drilling of wells, or the development of a discovery, they may be substantial. If those costs might include drilling a well, they will likely evolve in incremental stages including procurement, mobilisation, *spudding*, drilling operations and demobilisation.

It is for this reason that sophisticated sale and purchase agreements traditionally use industry recognised phrases such as '*spudding*' or technical descriptions of *spudding* (or other activities) to define contractual obligations, where that event gives rise to a trigger event for liabilities to be incurred.

The use of such terms enhance contractual certainly. Although the Commercial Court was able to reach a conclusion in this case, it is a useful reminder of the importance of clear drafting when dealing with trigger points for deferred consideration.

M&A 'Warranties' are not representations

What constitutes a warranty or a representation in the context of an oil and gas sale and purchase agreement is often the source of much negotiation within the transaction documents. The recent case of *Idemitsu Kosan Co., Ltd v Sumitomo Corporation* [2016] EWHC 1909 has emphasised the importance of clarity in drafting if representations (and not merely warranties) are to be included within the agreement.

Facts

In late 2009, Sumitomo Corporation ('**Sumitomo**') and Sumitomo Corporation Europe Limited (together the '**Sellers**') entered into an agreement to sell their jointly owned subsidiary, Petro Summit Investment UK Limited ('**Target**'), to Idemitsu Kosan Co. Ltd. ('**Idemitsu**') for around $575m (the '**SPA**').

As is normal practice in agreements governing the transfer of the shares in (or assets of) oil and gas exploration and production companies, the SPA provided that the Sellers warrant numerous matters relating to the Target (including various statements as to its activities, its liabilities and finances).

Specifically, the SPA stated that '*Each of the Sellers warrants to the Buyer in respect of itself and its Relevant Shares in the terms of the Warranties in paragraph 1 and 2 of Schedule 4.*' 'Warranties' was defined as *'the warranties (*emphasis added*) given by (i) Sumitomo in Schedule 4 and Part 2 of Schedule 7; and (ii) SCE in paragraph 1 and 2 of Schedule 4.'*

As a result of the various issues affecting two oil fields, Idemitsu contended that certain matters warranted under the SPA were not true on the date of its signing. However, as the SPA contained provisions specifically limiting the liability of the Sellers in relation to, *inter alia*, warranty claims brought after a certain period (18 months in the case of the warranties at issue), Idemitsu accepted that it was time barred from making a claim for breach of warranty.

Instead, Idemitsu raised a claim against Sumitomo in the Commercial Court claiming damages for misrepresentation in tort and under s.2(1) of the Misrepresentation Act 1967, in essence claiming that the warranties given by Sumitomo under the SPA could be construed as representations.

Decision

The Commercial Court decided that the warranties did not amount to representations and therefore Idemitsu's claim must fail.

In reaching this conclusion the Commercial Court analysed the provisions of the SPA and the parties' dealings in concluding the bargain to ascertain (a) the precise nature of the warranties given by the Sellers and whether they did in fact amount to representations, and (b) whether the Sellers' conduct in presenting an Execution Copy of the SPA, offering to sign and thereafter signing it amounted to a representation of the facts (capable of being actionable as misrepresentations) contained within the SPA.

The Commercial Court began by setting out the basic and important premise that:

> *'When a seller, by the terms of the contract under which he sells, 'warrants' something about the subject matter sold, he is making a contractual promise. Nothing less. But also I think (and all things being equal) nothing more… By contracting on terms by which he warrants something… He is making a promise, to which he will be held as a matter of contract in the sense that any breach of the warranty will be actionable as a breach of contract.'*

The Commercial Court followed the decision of Mann J in *Sycamore Bidco Ltd* [2012] EWHC 3443 (Ch) (thereby rejecting the conflicting authority of *Invertec Ltd v (1) De Mol Holding BV, (2) Henricus Albertus de Mol* [2009] EWHC 2471 (Ch)). In *Sycamore* the relevant terms of the SPA were materially similar to those in the present case. In *Sycamore* the Court found that a warranty could not be a representation when the claimant relied purely on the warranties contained in the contract as amounting to the representations. The Court set out Mann J's reasoning in *Sycamore* for this conclusion with which the Court concurred:

- There is a clear distinction in law between representations and warranties which would be understood by the draftsman of the SPA. The wording and structure of the SPA demonstrated that it was apparent from the SPA itself that the warranties could not be representations as representations were referred to in a specific clause while 'Warranties' (with a capital 'W') were referred to elsewhere in the contract.
- Warranties were strictly described as warranties and nowhere in the SPA were they described as representations. Further, the SPA designated those giving the warranties as 'Warrantors' (again with a capital 'W').
- When given their natural meaning the words of the warranty provision were words of warranty not representation.
- The Disclosure Letter (referred to in the SPA) distinguished between representations and warranties — 'The disclosure of any matter shall not imply any representation, warranty or undertaking not expressly given in the Agreement …'
- Clause 8 of the SPA contained 'significant limitations on liability' in respect of the warranties. Thus significant protections would have been lost by the Warrantor under the 'Warranties' and again there was no reference to representations.

— There was a conceptual problem in characterising provisions contained within the contract as being representations relied upon in entering into the contract. In an archetypal misrepresentation claim the representation occurs prior to entering into a contract. It is the representation itself that is then said to induce a party to enter into the contract.

For the above reasons the Commercial Court found that Idemitsu's stated claim was bound to fail.
Idemitsu also sought to bring a claim that pre-contractual representations were indeed made to Idemitsu. Idemitsu relied upon the provision of a draft execution copy of the SPA to argue that it had relied upon the words therein and been induced to enter into the SPA by Sumitomo '*(i) providing the Execution Copy as the contract to be signed by both parties; (ii) offering to sign the execution Copy; or (iii) signing the Execution Copy*'. The representations that were alleged to have been made were in the statements of facts contained in Clause 6.1 (Warranties) and Schedule 4 (Seller's Warranties) of the Executed Copy of the SPA. Idemitsu argued that Schedule 4 should be read as a series of factual statements.

The Commercial Court however rejected this argument deciding it would be 'artificial and wrong' to read Schedule 4 in isolation and independent of its function which was to provide content to the warranties contained within the SPA. The Commercial Court, again preferring the *Sycamore* line of authority over *Invertec* (where Chancery Division found the Buyer had prior knowledge of the content of warranties from contract negotiations), reiterated Mann J's judgment which referred to this prior knowledge point stating, '*What the warrantors…knew they were providing, were expressed to be warranties, not representations.*' The Commercial Court in this case therefore concluded that the '*Execution Copy communicated, so far as material, no more than a willingness to give a certain set of contractual warranties in a concluded contract.*'

Judge: Mr Andrew Baker QC sitting as a judge of the Commercial Court

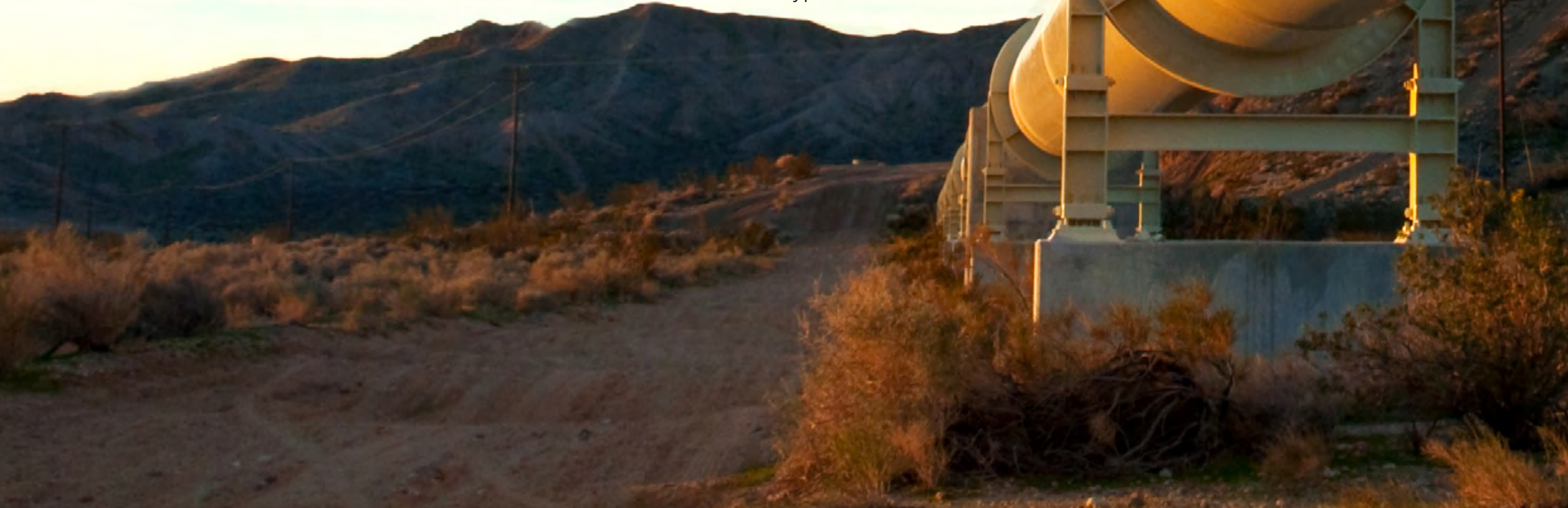
Comment

The extent of contractual warranties and representations are often hard fought elements of any negotiation concerning a sale and purchase agreement in the oil and gas industry. Their inclusion will often coincide with limitations on time periods within which a claim may be made, and might include limitations on the extent of any liability.

Where it is the parties' intention that contractual representations should be made in the sale and purchase agreement, it is common for the seller to 'warrant and represent' certain facts and matters. This might be done through the use of the word 'represent' proceeding the representations given or in the defined terms of the agreement (such as the definition of 'Warranties' if the representations and warranties are identical).

In the absence of clear drafting that specifically imports representations into the sale and purchase agreement, the *Idemitsu* case suggests that English law will not generally interpret warranties as amounting to representations. If a party wishes to provide that a breach of a warranty may also found an action for misrepresentation it would be wise to draft the sale and purchase agreement to make this clear from the natural and ordinary reading of the agreement.

It also appears evident that the representation arguments put forward by Idemitsu were a 'last resort' attempt at bringing a claim against Sumitomo. Idemitsu were contractually barred from raising claims for breach of warranty due to a 'limitation of liability' provision imposing an 18 month time limit for bringing such claims. Contracting parties should ensure that if time limits for bringing claims are to be contractually agreed then the deadlines for bringing such claims should be kept at the forefront of one's mind. Where possible, action should be taken well in advance of these deadlines if contracting parties are to avoid this type of scenario.



Contact information

Bob Palmer
Partner, Energy
T +44 20 7367 3656
E bob.palmer@cms-cmck.com

Ian Herbert
Partner, Energy
T +44 20 7367 2589
E ian.herbert@cms-cmck.com

Andrew Shaw
Partner, Energy
T +44 20 7367 2954
E andrew.shaw@cms-cmck.com

Rob Wilson
Partner, Energy Disputes
T +44 20 7367 3682
E rob.wilson@cms-cmck.com

Matthew Culver
Partner, Energy (Dubai)
T +44 20 7367 2979
E matthew.culver@cms-cmck.com

Ben Ewing
Partner, Energy (Oman)
T +968 2439 9905
E ben.ewing@cms-cmck.com

Emma Riddle
Partner, Energy Restructuring
T +44 20 7367 2563
E emma.riddle@cms-cmck.com

Valerie Allan
Partner, Energy Disputes
T +44 1224 26 7149
E valerie.allan@cms-cmck.com

Jan Burgess
Partner, Energy Health and Safety
T +44 12 2426 7151
E jan.burgess@cms-cmck.com

Norman Wisely
Partner, Energy
T +44 1224 26 7163
E norman.wisely@cms-cmck.com

Richard Sinclair
Partner, Energy
T +44 20 7367 3564
E richard.sinclair@cms-cmck.com

Phillip Ashley
Partner, Energy Disputes
T +44 20 7367 3728
E phillip.ashley@cms-cmck.com

Jonathan Woolf
Partner, Energy Corporate
T +44 20 7367 3094
E jonathan.woolf@cms-cmck.com

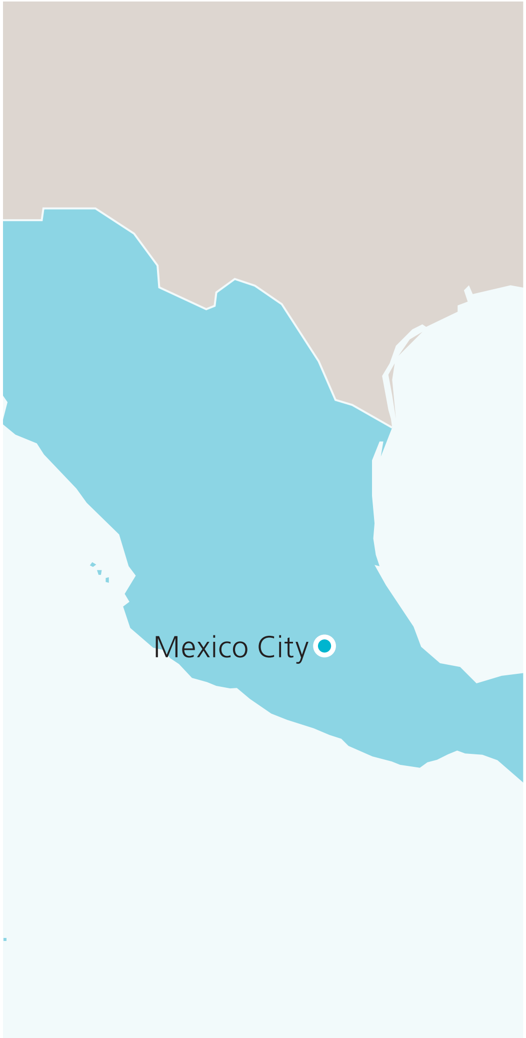
Ted Rhodes
Partner, Energy (Rio)
T +55 21 3722 9832
E ted.rhodes@cms-cmck.com

Sarah Grenfell
Partner, Energy Disputes
T +44 20 7367 3549
E sarah.grenfell@cms-cmck.com

Paul Sheridan
Partner, Energy Environment
T +44 20 7367 2186
E paul.sheridan@cms-cmck.com

Tim Elliott
Partner, Energy Asset Finance
T +44 20 7367 3289
E tim.elliott@cms-cmck.com

Lorna Dawson
Partner, Energy
T +44 12 2426 7147
E lorna.dawson@cms-cmck.com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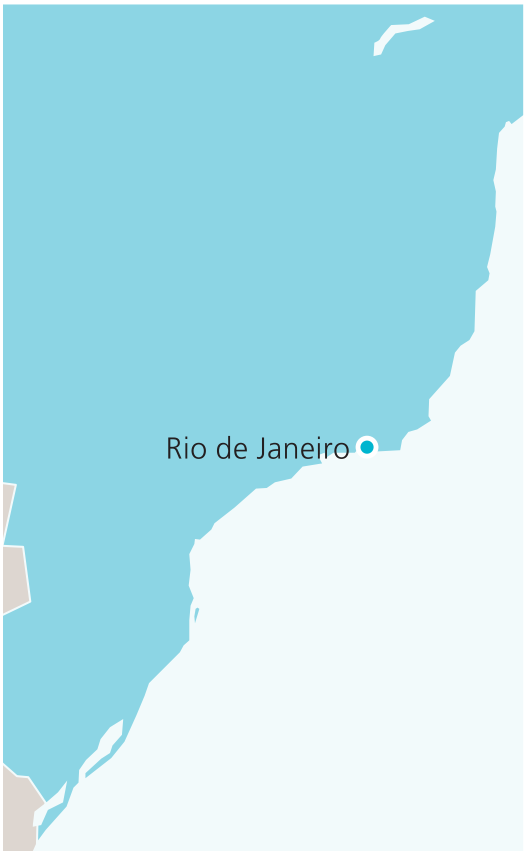
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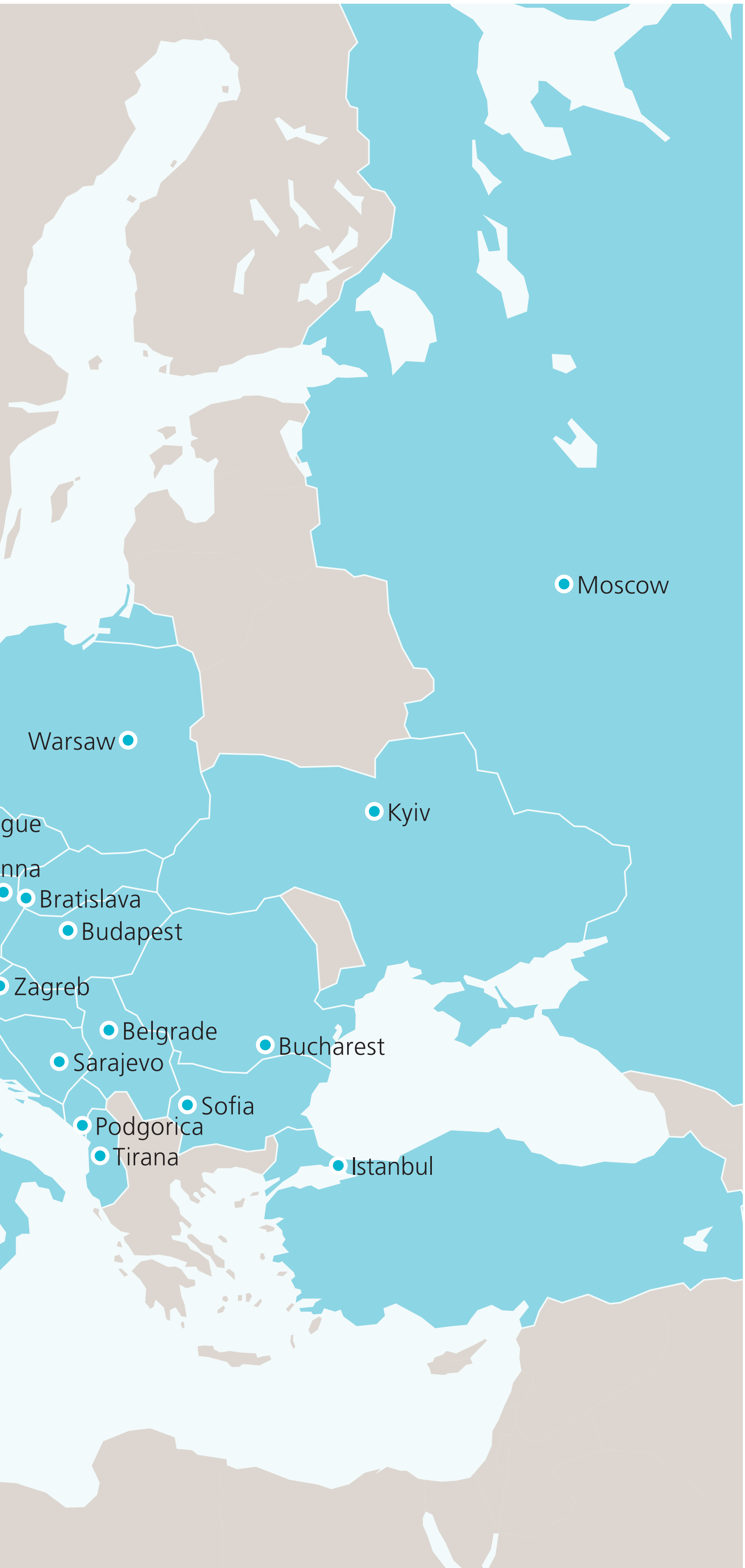
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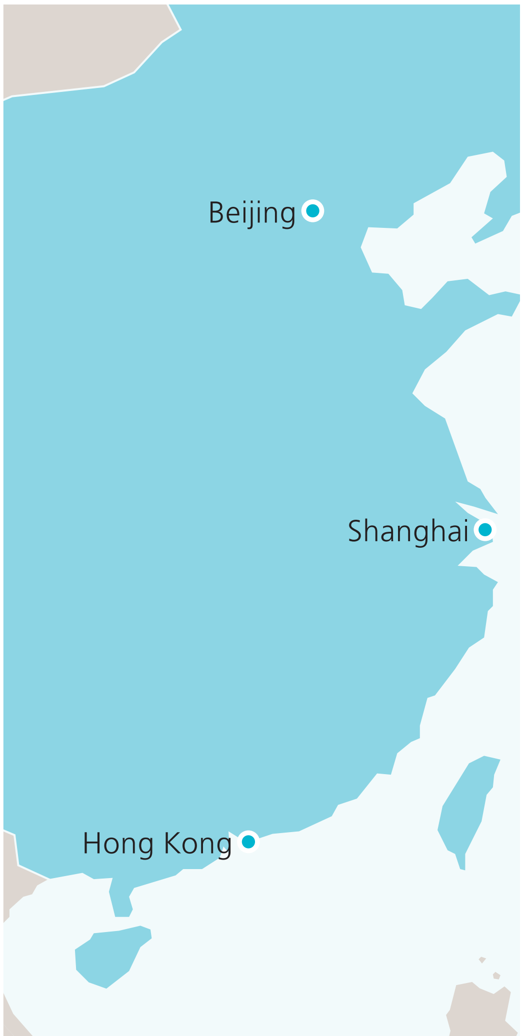
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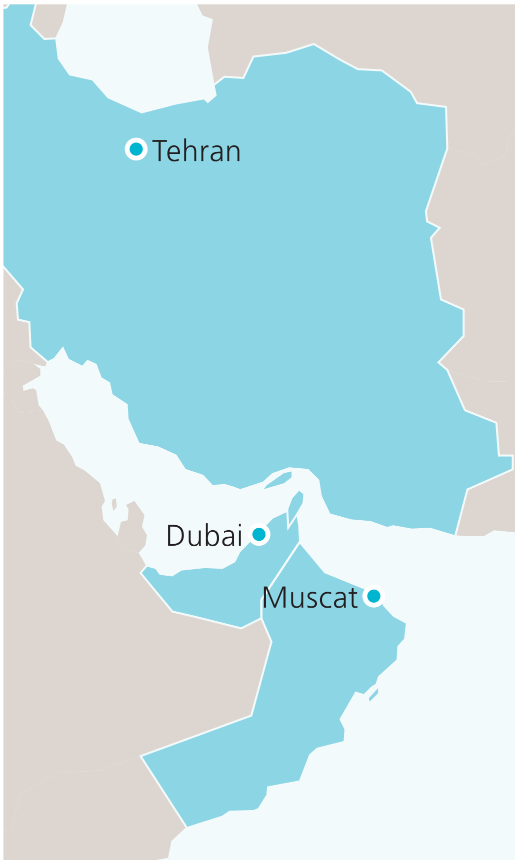
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