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# The Eurozone and Commodity Contracts 2

6 September 2012

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This *Alert* is the second in our series that considers the impact of the Eurozone crisis on the international commodities markets, and follows Alert no. 2012/169 titled, "The Eurozone and Commodity Contracts 1", dated 18 July 2012.

Since that *Alert* was published, the possibility of a **Eurozone Exit** or **Eurozone Break-up** continues to receive attention in news articles and trade commentary around the world.

This second Eurozone *Alert* will consider whether a Eurozone Exit or a Eurozone Break-up could bring a commodity sales contract to an end under the English law doctrine of "frustration". It also looks at whether these events could trigger "Force Majeure" and "Material Adverse Change" provisions in commodity sales contracts.

**Frustration**

Under English law, it is generally accepted that a contract is frustrated when without default of either party, a contractual obligation, which is or becomes significant, becomes incapable of being performed because the circumstances in which the performance is called for renders it radically different from that envisaged by the parties at the time of contracting. Where a contact is frustrated, the law declares both parties to be discharged from further performance and brings the contract to an end immediately.

Generally, as a result of frustration, the parties are discharged from all future obligations and liability arising from the contract. These are not given a close-out value and the parties are free to 'walk away' without any compensation being paid for the loss of those future obligations (although buyers will be required to pay for any benefits received by way of part-performance, and sellers will be required to reimburse buyers for any pre-payment).

Parties are free to make sufficient provision in their agreements which would limit and narrow the scope of the doctrine, e.g. through "Force Majeure" provisions.

We consider below whether specific Eurozone-related circumstances may lead to a contract being frustrated.

*Redenomination*

Redenomination of payment obligations itself is unlikely to render the contract impossible to perform. As a result, it is unlikely that redenomination would meet the conditions for frustration, even in circumstances where redenomination renders the contract more expensive to perform.

It is also unlikely that the depreciation in the value of the currency into which the obligation has been redenominated would be regarded as sufficient to frustrate a contract. It has been argued that the depreciation in value of the new national currency might disrupt the equivalence of performance on each side. The position may depend on the extent of the depreciation, but it generally appears to us that the better view is that such events should not be regarded as potentially frustrating risks, but as fundamental commercial risks to be borne by the parties.

Further, it is quite possible that UK or EU legislation would provide for: (a) contracts to continue to be valid and binding, and (b) the introduction of the new currency not to operate to frustrate contracts.

*Payment in the contractual currency becomes illegal*

The English common law provides that: (a) if a contract is governed by English law, (b) if that contract is to be performed abroad, and (c) if performance becomes illegal under the law of the place of performance, then the contract will not be enforced in England.

As we noted in the first *Alert*, an exiting state may introduce exchange controls that make payment in euros illegal. Thus if payment is required to be made in the exiting state and performance in euros has been made illegal in the exiting state, performance of that agreement is likely to be frustrated.

*Disappearance of EURIBOR or another euro-based reference rate*

Some commodity sales contracts provide for default interest to be calculated using an interest rate based on EURIBOR or other euro-based rates.

Where such a rate is no longer available, or is no longer relevant because of a redenomination of the underlying obligation, an English court is, in our view, unlikely to find that the relevant contract as a whole has been frustrated. A court might in these circumstances determine that a term is implied into the agreement to the effect that the original rate shall be replaced with the next most appropriate rate. Of course, the issue will then become one of identifying which is the most appropriate replacement rate source.

**Force Majeure**

A “Force Majeure” clause will usually temporarily release a party that is fully or partly prevented from performing its obligations under one or more contracts for a period of time, and to the extent that such Force Majeure event prevents such performance. It may also allow the parties to terminate the contract if the Force Majeure continues, possibly with the terminated obligations being replaced by an obligation on the appropriate party to make a close-out payment based on the replacement value of the terminated obligations.

Force Majeure is not a concept of English law, and therefore to apply under English law, the relevant commodity contract must expressly include a Force Majeure provision, as none will be implied by an English court. Parties will need to examine the precise wording of a Force Majeure clause to determine whether it would apply to a Eurozone Exit or Eurozone Break-up.

In order to claim Force Majeure, the scope of Force Majeure in the relevant contract would need to extend beyond the scope of physical performance to include events affecting performance of financial obligations. This is highly unusual in commodity sales contracts, although payment obligations are included within the scope of Force Majeure provisions in some standard contracts used in commodity trading, e.g. the 2002 ISDA Master Agreement. If contracts are being entered into in euros, careful thought should be given to extending the scope of the Force Majeure provisions in the contract to ensure that the parties are adequately protected.

**Material Adverse Change**

In English contract law, there is no principle of “material adverse change”, and therefore to apply, the relevant commodity contract must expressly include a material adverse change provision (a “MAC” clause). Where a MAC clause is included in the relevant commodity contract, whether a Eurozone Exit or a Eurozone Break-up will constitute a material adverse change will

depend on how broadly the term is defined. Where a MAC clause is triggered by a party, this will usually result in the other party having the right to demand additional collateral or performance assurance, or the right to terminate the contract.

MAC clauses may include specific, objective triggers such as the counterparty failing to maintain a specific credit rating. They may in addition, or alternatively, include more broadly drafted triggers, such as that the counterparty has, in the other party's opinion, an "impaired ability to perform" its obligations.

A Eurozone Exit or a Eurozone Break-up is unlikely to be specifically included in the definition of "material adverse change" in a pre-existing contract. But these events are likely to cause the prospects of some counterparties to worsen. This might lead to ratings downgrades or other adverse events that trigger "objective" MAC clauses. It might trigger more subjective and broadly drafted MAC clauses as well.

Whether this would in fact happen will depend on the wording of the MAC clause and the impact a Eurozone Exit and Eurozone Break-up may have on the party in question. Once again, careful consideration should be given to the scope and extent of any MAC clause being negotiated between counterparties.

**Risk Mitigation**

In addition to those measures listed in The Eurozone and Commodity Contacts 1, the following steps can be taken to minimise the level of legal uncertainty following a Eurozone Exit or Eurozone Break-up:

- *Preclude the application of the doctrine of frustration* – Where an event, which would otherwise be a "frustrating" event, has already been fully dealt with by other provisions in the contract, e.g. illegality or Force Majeure provisions, the doctrine of frustration is less likely to be applied. This is because a court is likely to hold that the event had already been anticipated and provided for in the contract itself. Therefore, to reduce the risk of a contract being discharged on grounds of frustration, with no value being given to future obligations, parties to a contract could add appropriate illegality and/or Force Majeure provisions. It is important these provisions are "full and complete" and are adequate to cover the situation, as otherwise the doctrine of frustration will not be precluded.

- *Including a tailored MAC clause* – Where the contract does not contain a MAC clause, the parties to the contract should consider introducing such a clause.

- *Express exclusions* – Where the intention of the parties is that a contractual provision should not be invoked upon the occurrence of certain consequences of Eurozone events, these should be expressly excluded. For example, if parties to a contract wished to be absolutely certain that a Eurozone Exit would not be used to excuse non-payment or non-performance by claiming Force Majeure, the definition of Force Majeure should be amended to expressly state that this is the intention of the parties.

## Conclusion

Andrew Bailey, Director of UK Banks and Building Societies at the UK's Financial Services Authority, has been quoted as warning that: "*Good risk management means planning for unlikely but severe scenarios, and this means that we must not ignore the prospect of the disorderly departure of some countries from the Eurozone*".

This statement is as applicable to commodity traders as it is to banks.


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