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Interpretation of quality clause in naphtha contract, damages for breach and hedging issues

Choil Trading SA v Sahara Energy Resources Ltd [2010] EWHC 374 (Comm)

Background Facts

S was the seller and C the buyer under an FOB Port Harcourt sale of naphtha. The contract provided "Quality: PHRC naphtha quality" and the specs referred to in the quality clause were taken from an analysis of a sample provided by S's seller, Port Harcourt Refinery Company ("PHRC"). In pre-contract exchanges between the parties, the contractual significance of which was disputed, S stated that the product was to be sold "as is".

C then on-sold the cargo to P. The contract between C and P provided as part of the specification "Mtbe mg/kg 50ppm max". MTBE is Methyl Tertiary Butyl Ether, a man-made substance which is not a by-product of the production of naphtha. That on-sale was on terms that if the cargo did not meet the specification, P could renegotiate the price and C had no obligation if the cargo was off spec.

According to reports subsequently produced by SGS from composite samples both from the ship's tanks and from the shore tank, the MBTE content was considerably higher than the limit in the contract between P and C. As a result, P rejected the cargo. In mitigation of its losses, C then sold the cargo to B and commenced proceedings against S to recover its losses, including its hedging losses.

Commercial Court Decision

Liability

Mr Justice Christopher Clarke held that the exchange which referred to the product being sold on an "as is" basis formed part of the contract but disagreed with S's argument that this meant there was no warranty as to quality at all. Rather, he held that the quality provision ("PHRC naphtha quality") was inconsistent with such an interpretation and that "as is" meant that the naphtha received would have whatever characteristics a cargo supplied ex PHRC should have. Therefore, since such a cargo would not normally contain such quantities of MTBE, the naphtha did not comply with the contractual standard and the judge concluded that S was in breach of the implied condition that the cargo would comply with its description and of the implied term that it should be of satisfactory quality.

Damages

The starting point for the calculation of damages is S.53(3) of the Sale of Goods Act 1979 which provides:

"In the case of breach of a warranty of quality such loss is prima facie the difference between the value of the goods at the time of delivery to the buyer and the value they would have had if they had answered the warranty".

S relied on the application of this prima facie test and said that the relevant time for assessing values was on delivery to C i.e. shipment. C however argued (a) this rule could be displaced where the circumstances required it, and the relevant time should be a date after the final analysis was received (some two weeks after shipment), when it became clear P would reject the goods and C would have to find a substitute buyer as this was the first opportunity for C to understand the extent of the contamination and (b) that its damages were then to be assessed by reference to the difference between the value of a sound cargo represented by the sub-sale to P and its actual (contaminated) value represented by its mitigation sale to B. Whilst the Court agreed with submission (a) it rejected submission (b) on the basis that prima facie damages are not to be measured by reference to any particular sub-sale save when such sub-sale was in the contemplation of the parties at the time the contract was concluded, which was not the case here as C was buying for re-sale generally.

On the basis of the evidence presented to the Court it concluded that in fact the cargo as supplied, in its contaminated state, was worth no less, and ironically more, than a cargo in a sound condition (largely due to the fact that physical values rose during the period in which C were seeking an alternative buyer once P rejected the cargo). That was not however the end of the matter as C also claimed hedging losses.

Hedging losses

When P rejected the naphtha, C was left in a long position so they sold an equivalent quantity of Brent because there was no live naphtha market for hedging purposes and the naphtha market was likely to follow the Brent market. The effect of this exercise was that if the market fell, C would profit on the hedge but lose on the physical. However, the market rose and C lost on its hedging position.

The Court concluded that the hedging position taken by C was reasonable and foreseeable (referring to dicta in *Addax v. Arcadia Petroleum* [2000] 1 Lloyd's Rep. 496) and C's hedging losses represented losses attributable to a reasonable attempt to mitigate C's losses. The Court therefore concluded that C was entitled, by way of damages, to their hedging losses less the increase (over sound value) in the physical price of the cargo which it received by virtue of the mitigation sale to B.

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