



The status of prepayment provisions

We have recently advised on a number of contracts for the sale and purchase of quantities of steel which have contained prepayment provisions. A typical clause would provide for the prepayment of, for example, 5% of the contract price within two working days after the date of contract, with the balance payment to be effected five days after presentation of the usual shipping documents.

What is the status of a prepayment of this nature in cases where the buyer makes the prepayment but then does not perform its contractual obligations? Can the seller simply forfeit the prepayment; or, does it only form a fund which the seller holds by way of security and from which he is entitled to deduct any damages which he has suffered as a result of the buyer's breach; or, might it be entirely ineffective if it is treated as a penalty provision? A number of important consequences will flow from the determination of how the payment is to be classified.

It is clear that where a payment is made by way of deposit, then it is generally treated as security for completion of the contract. If the amount of the deposit is excessive, then it may be treated as a penalty. But otherwise, the seller would be entitled to forfeit the deposit without having to prove any loss in the event of the buyer's failure to perform the contract.

However, if the payment is described as a prepayment (rather than a deposit), and the contract makes no provision as to the circumstances in which the prepayment might be forfeited, then a buyer is likely to be entitled to recover the prepayment (although the seller would be able to deduct any claim for damages which it had).

The effect of this is that if a payment is described as a deposit then, provided that it is not excessive, it can usually be forfeited by the seller even though the contract does not specifically provide that. If the payment is described as a prepayment, then it probably cannot be forfeited, unless there is clear

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wording in the contract which provides for that. Therefore if it is the intention of the parties that a payment made in advance as security for performance of the contract is to be forfeited in the case of the buyer's breach, it must be described as a deposit, or the contract must set out clearly that this is what the parties intend.

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Australian mining tax and BITs

The new mining tax proposed in Australia has been controversial from the beginning. It was announced on 2 May 2010, as part of a government review of the entire tax system.

Reaction was strong. Miners attacked it, claiming that it would make the Australian minerals sector the highest taxed in the world, seriously eroding competitiveness. Investors seemed to agree, with mining stocks being hit hard. The media reported that AU\$16bn had been wiped off the value of mining companies in the two days after the announcement.

The Resources Super Profits Tax ("RSPT") would have replaced production royalties levied by Australian states with a 40% tax on profits in excess of ordinary commercial rates of return: so-called "super profits". In return, the government would refund 40% of capital investment in mining activities through tax credits.

One major concern was how investment and exploration would be

affected. Projects including Xstrata's AU\$600m extension of the Ernest Henry Copper mine in Queensland, Cape Lambert Resources' AU\$400m magnetite iron ore project in Western Australia and Fortescue's AU\$10.5bn Solomon Hub and AU\$7bn Western Hub iron ore projects in Pilbara, Western Australia were put on hold or under review.

Perhaps the most controversial aspect of the RSPT was its application to existing mining projects: potentially, it breached Australia's obligations under various bilateral investment treaties ("BITs"). Broadly, BITs establish clear rules on the scope of investment protection and treatment that States must provide to foreign investment in their territories, protecting all kinds of investments including real estate, capital projects and equity investments.

Like most countries, Australia has entered into numerous BITs. At last count, it had 22 BITs and 6 Free Trade Agreements which, with one or two exceptions, protect against unfair and inequitable treatment, including discrimination against foreign investors and the taking of actions or decisions inconsistent with a foreign investor's legitimate expectations.

"Legitimate expectations" may be based on representations, public and private, from a host State to a foreign investor about the legal and commercial environment that will exist throughout the life of an investment. This could be particularly relevant in the context of the RSPT given the long history of efforts by successive Australian governments to attract foreign investment in mining operations.

The comments of then Australian Prime Minister, Kevin Rudd, that particular mining companies were substantially foreign-owned, that their profits were going overseas, and that Australians deserved a larger share of mining profits, caused particular concern, potentially providing a basis for claims by foreign investors on grounds that the tax had discriminatory motives.

On 24 June 2010, Julia Gillard replaced Kevin Rudd as Prime Minister. The RSPT was one of the reasons for this political change. On 2 July 2010, the Gillard-led government announced a deal with miners under which the proposed RSPT would be replaced by a Minerals Resources Rent Tax ("MRRT"). Whereas the RSPT applied to all types of mining,

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the MRRT applies only to iron ore and coal. Gold, nickel, copper and other metals mining will remain under the current royalty-based tax system. Small miners with less than AU\$50m in profit will be exempted. The MRRT will only kick-in when returns on investment reach 12%, compared with 5% under the RSPT. Finally, existing projects will be valued at market, rather than book, value.

The debate over the RSPT, and the now proposed MRRT, has caused some concern that Australia is no longer considered a safe place to invest. Australia's BITs continue to provide comfort to foreign investors: in the event that miners' concerns are not met when the MRRT is eventually implemented, foreign investors may well pursue BIT-based claims. Potential claimants include foreign-controlled companies with operations or direct investments in Australia, including joint ventures, and foreign investors with minority investments in Australian mining companies, including private equity firms, hedge and mutual funds.

Whilst investment treaties cannot prevent host States from implementing measures that adversely affect foreign investors, they do impose a requirement that fair compensation be paid in the event the host State breaches the protections afforded by BITs.

BIT claims are determined by international arbitration under rules such as those of the International Centre for Settlement of Investment Disputes ("ICSID"), an organ of the World Bank, or UNCITRAL. The arbitration is held in a neutral venue by an independent tribunal of arbitrators chosen by the investor

and host State. An award in favour of an investor can be enforced almost anywhere around the globe against assets of the host State.

The protection afforded to investors by investment treaties has increasingly been used as a defensive weapon, especially by investors willing to take on assets or projects in challenging and risky locations. As the new Australian mining tax shows, investors are now also increasingly relying on investment treaties where they feel they are being treated unfairly by western governments.

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“In a clear sign that the financial market around iron ore is set for continued growth, the Japanese steel industry, the second largest in the world, has begun to hedge prices through the use of derivatives.”

China and Japan: new opportunities in derivatives

In a clear sign that the financial market around iron ore is set for continued growth, the Japanese steel industry, the second largest in the world, has begun to hedge prices through the use of derivatives. June saw Mitsui, the Tokyo trading house, conclude Japan's first iron ore swap with Credit Suisse. The swap is reported to have been for 10,000 tonnes of iron ore per month in the second half of 2010. Though this first swap was relatively small, both Mitsui and Mitsubishi, Japan's largest trading house, are believed to be considering much larger iron ore hedges next year. The swaps allow trading houses, which act as middlemen between ore producers and the steel industry, to hedge the price of the commodity and avoid the volatility of quarterly contracts.

Growth in the market has been slow until now. Although the first market for iron ore derivatives was created by Deutsche Bank and Cr dit Suisse in 2008, most deals have been conducted in London and did not involve consumers such as steelmakers or trading houses like Mitsui.

Furthermore, there has been a clear reluctance to engage in the market in China, the world's largest steel producer and consumer of iron ore. The Assets Supervision and Administration Commission, which controls state owned assets including steel mills, last year threatened to renege on similar airline fuel derivatives. The China Iron and Steel Association and the China Chamber of Commerce of Metals, Minerals and Chemicals

Importers and Exporters have also previously stated their opposition to iron ore swaps, reflecting a traditional distrust of hedging in the Chinese state.

However, changes in the industry's contract structure have made iron ore swaps more attractive. Earlier this year the big three ore producers abandoned the 40 year old system of setting prices annually, replacing it with quarterly contracts reflecting the volatile spot market. Swaps are an attractive way of controlling the increased price volatility this price structure brings. Last month's Mitsui deal represents the move of the conservative Japanese steel industry towards the use of iron ore derivatives and sources have speculated that China will inevitably follow. The China Iron and Steel Association has also recently made encouraging comments, indicating that there may be flexibility in its stance for the future.

Iron ore is the world's second largest commodity by volume, and there is huge potential for growth in the related derivatives. The Chinese iron ore market is currently worth around US\$100bn a year and accounts for nearly 70% of the international iron ore market. The present world market in iron ore derivatives has been estimated at around US\$300m, but industry insiders have predicted that it will grow to around US\$200bn by 2020.

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Market influences: repudiation and damages

The market collapse in the latter half of 2008 resulted in the renegotiation or unwinding of many long-term S&P and shipping contracts in the metals industry, as in all commodities markets. We are seeing a limited number of these contractual disputes before the courts/tribunals. The recent English Commercial Court decision in *Zodiac Maritime Agencies Ltd v Fortescue Metals Group Ltd* (April 2010) is an example, illustrating two issues that typically arise in such disputes: whether the contract was properly terminated and if so, what is the appropriate measure of damages.

The case concerned the termination of a five year charterparty between the Australian iron-ore supplier, F, and the shipowners, Z. Under the charter, five consecutive shipments were performed into the Chinese market during 2008. However in late 2008, F's customers terminated their freight contracts and F was forced to seek a 'suspension' of the charterparty with Z in January 2009. Z accepted F's conduct as a repudiation of the contract. In response, F took Z's acceptance as a repudiation.

As to the repudiation issue, the judge preferred Z's evidence and found that F's communications and conduct evidenced an intention not to be bound by the contract. In particular, F discussed its difficulties with Z; F emailed Z informing them that it would not be able to honour its freight commitments; F announced to the Australian Securities Exchange that it had suspended all its consecutive voyage charterparties; and, when the vessel returned to F's terminal, it failed to load any cargo. Z's main witness

had also drafted a contemporaneous statement of his discussions with F, which the judge accepted and which had real force when considered along with the written exchanges - this shows how important record-keeping can be and why it is sensible to take early legal advice on matters such as the repudiation of long-term contracts.

Having found that F had repudiated the charterparty, the Court considered damages. The normal measure of damages is the difference between the contractual rate for the remainder of the charter period and the market rate. To measure market rate, an "available market" is required.

F argued that there was no demand from charterers generally on the prescribed route for charters of about 4 ½ years and thus no available market. The judge agreed. There were no reported fixtures in that category of charter, and neither party's expert witness was aware of any unreported fixtures. Furthermore, Z had marketed the vessel for similar business and received no approaches, and had itself previously argued that there was no available market. An alternative route, such as Brazil-China rather than Australia-China, did not constitute an "available market".

Since there was no "available market" in January 2009 when the charter ended, the normal measure of damages did not arise. The Court then considered Z's argument that the later emergence of an available market, in February 2010, should be used to measure damages for the remaining balance of the charter period. This argument was rejected. An owner finding itself in Z's position has a duty to mitigate its losses, but this duty does not extend to a requirement



continually to check for an available long-term market after each spot charter. Neither can it claim damages by reference to any such market rate.

Therefore, because there was no “available market” the Court looked at whether Z must give credit for any other income. After the termination of the charterparty with F, Z had reassigned the vessel as a substitute for another of its charters expected to run for 14 years. The Court agreed with F that this charter should be taken into account in assessing Z’s loss, as it was “part of a continuous dealing with the situation in which Z found itself”. This saw a considerable saving for F.

This case shows that when the market moves, market participants are well advised to seek early legal advice on all relevant issues including those addressed in this case: on repudiation and (arguably just as importantly) on mitigation - and also on evidence gathering.

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The future of the Indian market

Whilst predictions are for China’s voracious demand for metals to slow after the 2010 Shanghai World Expo, India’s demand is forecast to grow and accelerate. Its growing population, increasing urbanisation and affluence has led to an explosion in the need for automobiles, real estate and infrastructure, all of which heavily depend on steel. Assisted by market liberalisation and reforms, steel production in India is expected to reach 124m tons by 2012 and perhaps even 275m tons by 2020. This could make it the world’s second largest steel maker.

With the growth in the steel and other industries comes higher risk and exposure to global prices and fundamentals. Futures trading is gaining support as a way of managing these risks. Much of the infrastructure required for domestic futures trading is now in place, including two major commodities exchanges - the Multi Commodities Exchange (MCX) and the National Commodity and Derivatives Exchange (NCDEX). These markets have a range of commodities, but liquidity varies. The average daily volumes of commodity futures traded at MCX grew from US\$4,630m in April 2009 to US\$7,060m in February 2010. During the same period, volumes on the NCDEX grew from US\$750m to US\$820m.

However, hedging has always been a difficult subject in India, with domestic prices bearing little resemblance to the international market. At present, the Indian futures market is relatively undeveloped when compared to the markets in the West, for two main reasons:

First, the majority of hedging of base and precious metals is still done overseas and in foreign currency, for example on the London Metal Exchange. Bigger Indian companies interested in futures are used to trading in overseas markets like London and consider the Indian futures markets too immature. Smaller Indian firms are not sufficiently aware of the benefits of futures trading as a risk management tool.

Second, the political situation is complicated. Futures trading has some powerful advocates in India, for example the Reserve Bank of India has published quite a lot of information about using hedging for risk management. However, the government has on occasion banned the use of some commodities futures contracts because it believed that futures had been pushing up food prices. Even within the commodities sector itself, there is a mixed view of the benefits of hedging.

It is widely expected that commodities futures will become increasingly important in India over the next few years, owing to increasing support for deregulation of the industry in India, improving education as to the benefits of domestic commodities trading, and the establishment of a range of different exchanges and markets.

Indian based banks and other champions of the commodities futures markets are focused on the vast potential offered by domestic participants not yet aware of the benefits that hedging can offer them. With the correct regulatory approach and targeted information, the Indian markets should continue to grow at an even faster rate.



This may encourage some of the more significant Indian players who currently favour the international markets to return, and in the longer term may prove attractive to international players.

Some say that there is an artificial scarcity in supply created by Indian steel companies which is causing domestic steel prices to increase: an increase in the central excise by 2% earlier this year should have translated into an increase in steel prices of not more than Rs 600 per tonne, but there are reports that some steel producers have increased the price by more than Rs 1,200 per tonne, and expectations are that steel prices will rise further.

One of the gripes of potential domestic participants in the futures markets is that futures trading is responsible for the rise in steel prices: with a huge difference between physical and futures prices, and reports of speculators getting away with fat profits through paper trading with no exposure to the underlying commodity. This might give the government a reason to ban futures trading in relation to steel and other metals, but such action seems unlikely given that there is

no conclusive evidence attributing futures trading to inflation and price escalation.

Trading in commodity options contracts has been banned since 1952, but India's market for commodity derivatives cannot be complete without regulatory changes to introduce commodity options trading. Regulation is bound to change and will have an effect on the futures markets. Given the internal conflicts and differing views of domestic banks, commodities exchanges, government and participants, it is hard to predict which way the pendulum will swing. If the government takes a conservative approach, they may expand the range of bans on futures commodities trading, which already includes some food products. Were they to include metals amongst these then this would simply push Indian investors back towards the overseas markets, slowing the burgeoning growth in the domestic markets in which metals trading is already a significant factor.

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Conferences & Events

LME Metals Seminar 2010

Queen Elizabeth II Conference Centre, London
(11 October 2010)
Andrew Ridings, Brian Perrott, Luke Zadkovich and Janet Ching

Middle East Steel 2010

Park Rotana, Abu Dhabi
(11-12 October 2010)
Simon Cartwright

ISTA Annual Lunch

The Brewery, London
(3 December 2010)
Andrew Ridings and Brian Perrott

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