Campbell Johnston Clark

HENRY SETIONO I OCTOBER 2023

Mitigating losses by hedging

In Rhine Shipping DMCC v Vitol SA [2023] EWHC 1265, the Commercial Court considered the relevance of internal risk management processes and the expectation of hedging when assessing damages, in a case which also offered a glimpse into how large trading houses manage their risks. Report by Henry Setiono.

When a vessel fixed to deliver a commodity like crude oil is delayed, it is expected that the cargo interest will suffer significant losses from volatile market prices. However, if the cargo interest is a large trading house with sophisticated risk management systems in place, is it reasonable to expect that, they would have had mitigated their losses arising from a delay through hedging? Although it may be reasonable to assume that there would be hedges, it is risky to assume those hedges would result in mitigating losses.

In the recent case of *Rhine Shipping DMCC v Vitol SA* [2023] EWHC 1265, the Commercial Court considered the relevance of hedging when assessing damages. It is also a glimpse into how large trading houses, like Vitol, manages its risks with these sophisticated risk-management and hedging 'tools'.

Brief Background

The dispute arose out of a voyage charter of a crude tanker between Rhine as Owners and Vitol as Charterers. Rhine's claim was for unpaid demurrage of about USD 3m. Vitol counterclaimed for Rhine's breach of the charterparty arising from the vessel's delay in arriving and loading a cargo of Djeno crude oil (the "Djeno Crude"), with losses amounting to about USD 3.6m from the significant price increase of crude due to the delay. By the time of the trial, Vitol agreed to Rhine's claim, leaving only Vitol's counterclaim to be determined.

The Court had various issues to determine but the novel issues are:

1) whether Vitol's internal system of risk management, as its means of mitigating losses, should be taken into account when assessing damage?; and

2) In the alternative, if such "hedging" was *not* to be taken into account, whether the 'un-mitigated' losses are too remote to be claimed by Vitol?

Risk management vs. hedging

On the first issue, Rhine contended that Vitol had derived a gain of about USD 2.8m from its system of "hedging" and so having mitigated its losses, Vitol should only be entitled to about USD 800k. This would be true if Vitol had undertaken an external hedge on the Djeno Crude and had derived such a significant gain (see *Glencore Energy UK Ltd v Transworld Oil Ltd* [201] EWHC 141 and *Choil Trading SA v Sahara Energy Resources Ltd* [201] EWHC 374). However, that was not what in fact occurred.

The Court found that Vitol did not 'hedge' the Djeno Crude in the traditional sense by entering into transactions with third parties. Instead, Vitol had 'hedged' the Djeno Crude internally by booking into its portfolio swaps within Vitol where the counterparty was Vitol itself based upon other (independent) trades carried out by Vitol. This process allowed Vitol to identify its overall net exposure across the company. Vitol could then decide whether it was comfortable with that exposure such as to run an unhedged position, or whether to enter into external hedging contracts.

The Judge found that these internal swaps made no difference to Vitol's financial position. Although Vitol's internal risk management systems provided for such swaps, the swaps in question were independent transactions that were not entered into for the purposes of hedging, but in the usual course of trading.

Further, it is relevant to note that these internal (notional) hedges had no legally binding effect, as Vitol could not enter into a legally binding contract itself. It followed that as Vitol did not make any actual gain or loss, these internal hedges were irrelevant to the assessment of damages in respect of Vitol's counterclaim against Rhine.

Notably, Vitol *did have* external hedges in place, but those were unrelated to the Djeno Crude position and were entered into by Vitol as part of a larger external hedge in relation to Vitol's overall net position – there was no specific hedge on the Djeno Crude position.

Remoteness

On the second issue, Rhine argues that it was unusual for a large trading house like Vitol not to have mitigating hedges in place and therefore it was not in Rhine's reasonable contemplation, when contracting, that Vitol would claim for un-mitigated losses or alternatively, that Rhine would assume the responsibility for such extent of loss. In short, Rhine argues that it was too remote a scenario where Vitol does not mitigate its loss.

The Court rejected Rhine's arguments on remoteness.

Rhine did not provide any evidence at all about a carrier's knowledge or understanding of trading or hedging arrangements made by oil traders. Instead, they were happy to rely on the experts' (oil traders) evidence, wherein the experts were agreed that, amongst other things, it is usual that Vitol would have a central desk to manage price exposure and to net off such exposure within itself. Further, although the experts agreed that it was unusual for Vitol to *not* have mitigating hedges, the Court held that "hedge" had to be understood to include internal (notional) hedges that provide no gain or loss to Vitol.

In other words, without any evidence of a carrier's knowledge or understanding of trading or hedging arrangements made by oil traders, the only available evidence for the Court to rely on, were the expert evidence of the oil traders. This led to the finding that it was within Rhine's reasonable contemplation that in risk-managing, Vitol would internally hedge and not necessarily take out a specific external hedge for the Djeno Crude position.

Commentary

This case provides a helpful and detailed consideration of the current legal position relating to hedging, and particularly internal hedges. While on its face it may be considered to be favourable for a commodity trader, in that Vitol did not have to account for a notional 'profit' from its internal swaps, presumably the reverse would also be the case; had Vitol suffered a loss on its internal swap, it would not have been able to claim this loss either.

As for the case on remoteness, the Court observed this really appeared to be a complaint that Vitol had not properly mitigated its loss by entering into external hedges. Curiously, Rhine made no case about a failure to mitigate and even specifically disavowed one. It will be interesting to see if this angle is explored further in future cases.

This case is now subject to an appeal and it will also be interesting to see if the Court of Appeal takes a differing position.

For further information, please contact:

Henry Setiono
Senior Associate
Henry@CJCLaw.com

Campbell Johnston Clark Limited (CJC) is an international law firm specialising in shipping and international trade. With almost 70 staff worldwide, CJC has offices in London, Newcastle, Singapore and Miami. The firm has a strong presence in the London and overseas shipping markets with clients and fellow practitioners alike.

CJC advises on all aspects of shipping and international trade law, from ship finance to dry shipping and comprehensive casualty handling, and everything in between. Our clients are based around the globe and include leading operators, ship owners, Fortune 500 and FTSE listed companies, start-up ventures, investment banks, private equity houses, P&I clubs, hull & machinery, and liability insurers.