THE OIL & GAS
“CONTRACTING COMPASS”

1 – POINTING THE COMPASS TOWARD PAYMENT PROVISIONS
INTRODUCTION

Welcome to the “Contracting Compass” series – a Brodies oil and gas initiative to provide insight on issues of English law relevant to oil and gas contracts. Recognising that the landscape of the contract is sometimes difficult to navigate, we have chosen the theme of the “Contracting Compass” to reflect that the series will provide continuing commentary on English law in order to maintain your awareness of key points in the landscape.

As shown in the image below, we have changed the directional points of the compass.

Why label the compass in that way? Because navigating the landscape requires knowledge of the law, an understanding of how language should be drafted in light of the law, and recognition of how that language will work in practice – whether it relates to contract performance or the ultimate commercial concern of payment.

Each seminar in the series will feature a white paper on a single topic on which the four points of the compass will focus. In this paper the compass points in the direction of Payment Provisions, with that topic divided into three separate parts:

- Part 1 – Payment Rights under the Contract;
- Part 2 – Set Off and Retention of Title Remedies; and
- Part 3 – Guarantees, Letters of Credit etc. (instruments beyond the contract for protecting payment).

We hope you find this paper to be of use and if you are interested in attending our accompanying seminar series, please don’t hesitate to contact us directly.

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PART 1 - PAYMENT RIGHTS

**Issue 1 - “Clear Language is the Cornerstone”**

Where the foundation of any commercial relationship is the contract, the cornerstone of that foundation will be clear language. Clear language is, in fact, more than the cornerstone – the presence or absence of clear language will often determine whether the foundation is one of granite or shifting sand. When parties create a contract, clear and unambiguous language is imperative to avoid unintended consequences or unwanted interpretation. This is particularly true in relation to payment terms. For instance:

- as a supplier, you will want to ensure that:
  - you get paid and on time;
  - you not only recover your costs/investment in carrying out the work but you also recover an acceptable element of profit on top.

- as a customer, you will want to ensure that:
  - you don’t pay in excess of the price originally quoted for the work;
  - you don’t pay for work not carried out or not carried out to the standard required under the contract.

Given these competing concerns, something as fundamental as payment may be a challenge to negotiate and difficult to clearly draft. Why is it difficult to be clear when the issue is so important? Because when faced with a contentious issue on which it is difficult to find common ground in principle, the parties will often attempt to convince themselves that a compromise can be achieved through creative drafting.

Unfortunately, creative drafting is not always synonymous with clear drafting. Clear language creates the most robust position at law, however when clear language is proposed in the cut and thrust of negotiation, it often invites push back from the counterparty. On balance, if you have commercial leverage you can be clear. If you do not, then you may face commercial pressure to compromise the language in order to get the issue and the contract across the line.

However, when the commercial reality of having a contract with compromised and unclear language meets the legal reality of a dispute, the English courts have been consistently unsympathetic. To put a fine point on the attitude of the courts, if the parties do not have the guts to spell it out clearly, the courts will not do it for you. The landscape of the law is littered with examples, on the one hand, of a party being undone by unclear language of its own creation or, on the other hand, it being subjected to significant commercial loss by omitting contentious language when, if used, the words would have clearly spelled out the commercial intent.

In the following paragraphs, we will focus on a few cases and legal principles which illustrate the importance of clear drafting in respect of payment rights. As we cover the law, we will also interpose some references to specimen language in order to put the law in proper commercial context.
Relevant Law

Transocean Drilling U.K. Limited (“Transocean”) v. Providence Resources, Plc (“Providence”), [2014] EWHC 4260 (Comm) is an English High Court case of recent vintage. The opinion published early last year caused considerable concern in the supply chain because the court determined that detailed language in the contract for excluding consequential loss was not adequate to protect a drilling contractor from a claim for the operator’s spread costs (i.e. costs the operator had incurred by making payments to other contractors during drilling unit downtime attributable to mechanical failure).

On reflection, however, it is unfortunate that the consequential loss issue has commanded so much attention. An equally, if not more fundamental issue was also considered by the court – namely, whether Transocean was entitled to be paid during the period of downtime.

The day rate drilling contract between Providence and Transocean provided for rate to be paid for a number of hours each month in the event of downtime attributable to equipment breakdown. Providence failed and refused to pay such rate due to Transocean’s breach of various other provisions of the contract relating to the condition of critical equipment. Transocean argued that the rate provisions of the contract were the complete code.

Transocean described all rates (inclusive of Operating Rate, Standby Rate, Repair Rate, Fishing Rate, Redrill Rate, Force Majeure Rate, and Adverse Weather Rate) as a comprehensive coverage of all possible scenarios and circumstances that may arise in the context of the contractual relationship between the parties. Transocean contended that the variable amounts of rate applicable to differing scenarios and circumstances reflected an agreed allocation of risk. Transocean further argued that such allocation of risk was clearly not fault based. Transocean referred to circumstances, for example, where Transocean gets a reduced rate (i.e. Standby Rate) notwithstanding that delay is due to Providence’s actions or fault. Likewise, Transocean highlighted that there are periods where substantial rate applies (i.e. Redrill and Fishing Rates) notwithstanding that delays are caused by negligent acts or omissions of Transocean.

Why did the Court reject Transocean’s argument? Because none of the language of the contract to which Transocean had referred, as described above, contained an express and explicit statement of the commercial intent of the parties to (i) have a complete code for allocating risk in the Rate section and (ii) have such complete code apply notwithstanding a breach of contract by Transocean.
The Court based its conclusion on a two-step analysis.

- In the first step, it considered the following general principles of contract interpretation.

  **First Principle** – English cases have established the precedent that “unless a contract contains clear language to the contrary, it will not be construed as enabling a party to take advantage of its own breach of contract”.

  **Second Principle** – English cases have held that “it is open to the parties to a contract for sale of goods or for work or labour to exclude by express agreement a remedy for its breach (i.e. such as abatement) which would otherwise arise by operation of law. But in construing such a contract one starts with the presumption that neither party intends to abandon any remedies for a breach arising by operation of law, and clear express words must be used in order to rebut this presumption”.

  [Note: Abatement is a remedy which enables a person who buys goods, or who contracts for work or labour, to defend a claim for the contractual remuneration by showing how much less the goods or services are worth by reason of the breach of contract of the other party.]

- In the second step, the Court referred to *Sonat Offshore SA v. Amerada Hess [1998] 1 Lloyd’s Rep 145*, an English Court of Appeal case which considered very similar facts and contractual provisions and also applied each of the above two principles. The Court highlighted that when the Court of Appeal had applied the principles in *Sonat*, it had reached the same conclusion that the Rates were not a complete code and relied upon the following four additional points of reasoning to support this conclusion.

  (i) Contracting parties in a commercial world are not likely to contract to pay something for nothing, particularly if the failure to perform by the payee is due to his own negligence or default.

  (ii) Applying principle (i), if the commercial intent of the parties is to make continuing and regular payments throughout a defined period of time, one would expect to find an express term that provided for such payments related to the period during which the payments were to continue, rather than one related to the work etc. for which the payment is to be made.

  (iii) In the absence of an express term to pay in the circumstances of (ii) then an obligation to pay in the absence of work being performed etc. will only be inferred if there is no other reasonable alternative. The Court will not, of course, look for remote or fanciful avenues in order to construe the clause contrary to the sense of principle (i) above.

  (iv) In construing clauses of an agreement providing for payments for work performed, services rendered or materials, equipment and supplies furnished, express words or necessary intentions proven are required before the scope of such clauses can be extended to exclude rights and liabilities arising under other clauses in that agreement. This will particularly be the case where the agreement contains numerous clauses dealing in detail with such rights, duties and liabilities.

Reflecting on the above legal principles, let’s turn our attention to LOGIC General Conditions of Contract for Mobile Drilling Rigs, Edition 1 for commercial context.
Drafting Tips

LOGIC General Conditions for Mobile Drilling Rigs

Clause 13.1 makes explicit reference to company paying “for the performance and completion of the Work”. If the rate provisions of the contract should operate as a complete code then it is necessary to remove this language. Likewise, if the parties have a commercial intent for payment to be made in certain circumstances where the contractor is in breach, the additional language at the end would be required.

“For the performance and completion of the WORK Except as otherwise provided in the CONTRACT, the COMPANY shall pay or cause to be paid to the CONTRACTOR the amounts provided in Section III – Remuneration at the times and in the manner specified in Section III and in this Clause, all of which shall be deemed to be earned by the CONTRACTOR notwithstanding the negligence, breach of duty (whether statutory or otherwise) or other failure of any nature of the CONTRACTOR GROUP and shall apply irrespective of any claim in tort, under contract or otherwise at law and shall not be recoverable by COMPANY as damages for any of the same or by way of abatement or otherwise howsoever.”

Rate Provisions of the Contract

Consider the following:

- delete any references to “as compensation for the performance of the operations” or “in full consideration of the satisfactory performance by the Contractor in complying with its obligations”. This can be replaced with “as compensation for making the Drilling Unit available to Company”.

- attempt to repeat the insertion contained in the amended General Conditions Clause 13.1, thereby making it clear that the rates form a complete code. Such language could follow the lines of:

“It is the intention of the parties that [except where this CONTRACT expressly provides no compensation is payable,] one or another of the specified rates shall be earned at all times throughout the duration of the CONTRACT. For the avoidance of doubt, such rates or any fees earned under the CONTRACT shall not be recoverable by COMPANY as damages or by way of abatement or otherwise howsoever and shall apply notwithstanding the negligence, breach of duty (whether statutory or otherwise) or other failure of any nature of the CONTRACTOR GROUP and irrespective of any claim in tort, under contract or otherwise at law”

*the wording in square brackets would be inserted in the event that anything was expressly agreed otherwise in the CONTRACT i.e. if a particular breach were to result in no rate being applied.
Issue 2 – In the absence of payment, can you terminate?

In Issue 1 above, we have considered the circumstance of a payee’s breach and a payor rightfully refusing to pay. However, what if the payee is not in breach and the payor is wrongfully refusing to pay? Can the payee terminate for non-payment?

Relevant Law

It is often assumed, incorrectly, that a failure to fulfil an obligation as important as payment under a contract will allow the aggrieved party to enforce rights at law to terminate the contract at will. Why is this assumption incorrect?

Because, at law (albeit with some exceptions), the obligation to make payment (on time) will likely not be regarded as a condition, namely an essential term, of the contract (which you can treat a breach of as repudiatory). Further, Section 10(1) of the Sale of Goods Act 1979 states that unless a different intention appears from the terms of the contract for the sale of the goods, stipulations as to time of payment are not of the essence of the contract. Where lapse of time is not essential to the substance of the contract you may simply be faced with seeking remedies other than termination. We will discuss those remedies shortly.

The issue comes down to whether time is of the essence in respect of (a) the contract as a whole but more specifically (b) its payment provisions. If the timing of payment is “of the essence” then non-payment would amount to a material breach of contract justifying termination.

A clause in the contract providing that time should be of the essence should be used where performance by a certain date is important. In the absence of such a provision the payee will be unable to terminate the contract on the grounds that the time limits were not complied with, unless timely payment was implied.

Having either express provision entitling the payee to terminate for non-payment or repeated acts of non-payment or setting out that time is “of the essence” in the performance of such obligations, allows the payee to exit the contract and avoid having to continue to perform in the short term whilst not getting paid for that performance.

Such clauses can be used to great effect – a mere 10 minute delay in making payment of the purchase price was sufficient to allow termination where the contract stipulated that completion had to take place before a specified date and time, and that time was to be of the essence of the contract – Union Eagle Limited v Golden Achievement Limited 1997 CPC 16.

So, the conclusion is that if you are the one getting paid you want to have express termination rights for non-payment by directly setting that out or providing that time is of the essence – either form of wording should take you to the same outcome. But, what if you don’t have any express provision?

Time can be made of the essence by implication or through the service of reasonable notice. By definition if you are relying on implication you are going to involve yourself in a potentially risky dispute likely to require a court decision so better to serve a notice (which can be done without prejudice to any primary position that time is of the essence by implication).
The serving of a notice, by itself, does not elevate the payment term in the contract into a condition (breach of which is repudiatory). This is because you cannot unilaterally vary the contract by converting a non-essential term into an essential one. So the payee can only terminate if the failure of the payor to comply with the notice goes to the heart of the contract so as to deprive the payee of a substantial benefit to which he was entitled under the terms of the contract – *Re Olympia & York Canary Wharf Ltd (No 2) 1993 BCC 159*.

If the payor fails to make payment by the stipulated date the payee is entitled to terminate the contract after serving a notice giving a reasonable time to complete. Once the notice is served both parties are bound by its terms and if the payor fails to make payment in terms of the notice then the payee can terminate. The big “but” to all of this is that you have to determine what a reasonable period of time is. That is fact specific. Get it wrong and your purported termination is in itself a repudiatory breach exposing you to a claim for damages. In assessing what is a reasonable period of time to complete you should therefore err on the side of caution. If you have constantly pressed for payment you can rely on this fact to reduce the amount of time in your notice you might otherwise need to provide – *Stickney v Keeble 1915 AC 386*.

The take away from this is, where you are the one to be paid, try to cater for express termination rights that can clearly be exercised with confidence than place reliance on a notice in which you need to gauge the reasonableness of the time given for late performance.

**Drafting Tips**

It is important to note that none of the LOGIC model contracts have language which would give the contractor the right to terminate the contract in the event of the company’s failure to pay. In the absence of such language, the following could be considered as a Special Condition:

“(a) CONTRACTOR shall have the right by giving notice to terminate the CONTRACT at such time or times as CONTRACTOR may consider necessary for any of the following reasons:

(i) in the event of COMPANY becoming bankrupt or making a composition or arrangement with its creditors or a winding-up order of COMPANY being made or (except for the purposes of amalgamation or reconstruction) a resolution for its voluntary winding up passed. However CONTRACTOR may not terminate under this provision if COMPANY continues to fulfil its obligations under the CONTRACT; or

(ii) in the event that COMPANY does not pay, or refuses to pay, any amounts due to CONTRACTOR under this CONTRACT within sixty (60) days of receipt of a correctly prepared invoice; [or

(iii) in the event that the COMPANY does not keep the ESCROW ACCOUNT in funds as per the minimum level set out in Appendix 1.1 to Section I – Form of Agreement. However the CONTRACTOR may not terminate under this provision if the COMPANY tops up the ESCROW ACCOUNT to the required minimum level within five (5) days of receipt of a reminder notice from the CONTRACTOR of its default.]

In the event CONTRACTOR terminates this CONTRACT under the provisions of this Clause 22.4(a), COMPANY shall have no rights of recourse against CONTRACTOR (whether under this CONTRACT or otherwise at law).
(b) In the event of termination in accordance with Clause 22.4 CONTRACTOR shall be entitled to payment as set out in Section III – Remuneration for WORK performed up to the date of termination including the early termination fee (calculated by multiplying the remaining days in the term, the term for the purposes of this calculation being 55 days, by the Operating Rate in Section III – Remuneration) together with other sums due under this CONTRACT and the COMPANY shall pay for the demobilisation of the DRILLING UNIT to the Demobilisation Port or equal distant location.”

**Issue 3 – What about late payment?**

In Issue 2, we have considered the circumstance of wrongful failure to pay. However, what if the payor is late?

**Relevant Law**

We have already talked about termination as a remedy for non-payment. But what is there to say about late payment?

Let’s consider:

1) interest;
2) damages and
3) liquidated damages.

The contract may contain an express term that provides for the payment of interest to the payee in the event that timely payment is not made. Interest should in theory compensate the payee for the fact that it is not paid when it should be. Provided that the rate is enforceable the rate agreed between the parties will be applied. Provided it is not construed as a penalty, the rate will be enforceable and not struck down by the Courts for being too high. In fixing a rate parties should bear in mind the current base rate of 0.5% per annum. One suitable yardstick might be to ask what the anticipated borrowing costs are for the party who will not receive timely payment so that an indication is given of the cost to put that party into the same position they would have been in but for the delay in payment.

If the contract does not provide for payment of interest, or indeed if the interest provided for in the contract is not deemed to be “a substantial contractual remedy”, statutory interest can apply in terms of the Late Payment of Commercial Debts (Interest) Act 1998 which applies throughout the UK for qualifying contracts for the provision of goods or services. The current applicable rate is 8% per annum over the base rate.

Section 8 of the Act provides for contract terms being void to the extent they purport to exclude the right to statutory interest in relation to the debt, unless there is a substantial contractual remedy for late payment of the debt. Absent other remedies for late payment in the contract a derisory rate of interest clause could be declared void and statutory interest would be substituted. There is some case law to the effect that 5% per annum is a “substantial contractual remedy”. LOGIC sets the default rate at 3% and that has been the most commonly used.
Chronic non-payment threatens liquidity which ultimately no amount of interest can adequately compensate for. Where a payment term is breached, even where the term is not regarded as a condition of the contract and the breach itself is minor, the non-defaulting party can claim damages to restore them to the position they should have been in but for the late payment. This remedy exists at law but can be tailored appropriately in the contract to cover or exclude certain heads of loss.

As an alternative to damages for breach of a payment provision which requires losses to be proven and a causal link to be demonstrated between the late payment and the loss suffered, the payee could consider using a liquidated damages clause. Although traditionally used by the party who is receiving performance by way of provision of goods or services, there is no reason in principle why such a provision could not be deployed by the payee. The function of such a clause is to fix the sum which is to be paid on breach irrespective of the actual damage suffered by reason of that breach. Provided the clause is a genuine pre-estimate of loss, it will be enforced by the Courts and not struck down as a penalty. In fixing a basis for claiming Liquidated Damages, judgment needs to be exercised to ensure the provision is compensatory and not penal.

**Drafting Tips**

Language in LOGIC is uniform across all of the model contracts. The provision is the following:

“Interest shall be payable for late payment of correctly prepared and supported invoices. The amount of interest payable shall be the current Bank of England Base Rate plus the percentage specified in Appendix 1 to Section I - Form of Agreement calculated on a daily basis or in the absence of such percentage, Bank of England Base Rate plus three percent (3%) from the due date for payment until actual payment.”

**Issue 4 – “When” and “How” price should be paid**

A properly drafted suite of payment terms should, in essence, clearly cover two concerns – (i) when price should be paid; and (ii) how price should be paid.

**When price should be paid**

Your contract must, at minimum, address the first concern - whether payment will be made in a single lump sum (either payable at the beginning or end of the contract, or in staged lump sum payments) or made over the term of the contract. This will, of course, very much depend on the nature and complexity of the contract.

The price could be paid fully, in one lump sum (e.g. for payment of goods, on receipt of all of the required goods) or as each delivery of goods or services takes place, or in regular instalments (weekly, monthly or annually) perhaps with some sort of reconciliation being performed at regular intervals to tally with actual goods or services delivered. For more complex contracts, there may be structured payment terms, with once only elements of the price being paid when the supplier has met certain specific requirements (often by a predetermined deadline, known as a “payment milestone”), and ongoing payments being made on a monthly or quarterly in arrears basis, for services intended to be delivered on a regular or routine basis throughout the term of the agreement.
The once only payments may, of course, be distributed in such a way that they benefit both parties by covering supplier cost at their lowest level and ramp up to reflect the delivery of value to the customer, as the contract works progress. They may also be designed to mitigate risk by holding back a suitable proportion of the price until the customer can be sure that the contract has been properly performed.

In most cases, payment will be conditional upon the receipt of an invoice or statement. If so, the contract should state when such invoice/statement may be issued by the supplier and when (assuming the work has been properly performed) the customer will pay it (note that public sector customers ought to pay their suppliers within 30 days of receipt of a valid invoice). The contract should also make clear what sort of information should be included in the invoice (a customer will want the invoice to be as detailed as possible and will often ask for a full description of the works carried out/goods or services provided and related price and any supporting evidence, particularly if any extra costs have been incurred etc.).

**How price should be paid**

Turning to the second concern of how price should be paid, it will most commonly be by bank transfer but it may include other forms of payments, e.g. cheque. The form of payment may be critical (as addressed in more detail under Part 3 below), however the type of payment may be equally, if not more important.

Currency may be of paramount concern where the contract involves the export of goods or materials to an overseas jurisdiction, the performance of services in an overseas jurisdiction, or the presence of the counterparty in an overseas jurisdiction.

It may also be critical to consider the place where such currency is received. This decision, as well as the type of currency, may be driven by a number of legal, regulatory and commercial factors, such as local regulatory requirements, local tax laws, global tax structure (and tax efficiencies within such structure), foreign exchange rules, international transfer pricing requirements, local content requirements, and custom clearance requirements.

Therefore, an informed legal adviser must recognise at the outset of any commercial relationship that making a decision as seemingly simple as how to be paid may be an exercise which requires input from sophisticated professional advisers. Likewise, the process of receiving and distilling this input into clear contract terms may also be a challenge which the capable commercial lawyer must carefully manage.
PART 2 - SET OFF AND RETENTION OF TITLE

Set off and retention of title rights are respectively two sides of the same coin. Why? It is a cliché, and unduly simplistic to say that possession is 9/10th of the law. However, possession does give you leverage.

If services are rendered and payment is the prize, then rights of set off give you, the purchaser, some measure of control over when possession of this valuable currency is transferred, if at all. Set off is a legal mechanism which enables one party to effectively keep one hand on the purse string until a contractual dispute is settled.

If goods are provided and ultimately ownership of the property is the prize, then retention of title rights will give you, the supplier, some measure of control over when title to this valuable commodity is transferred.

Relevant Law

In addressing the issue of set off the first thing to do is define it. We will do that and in so doing outline its implications. We will then comment on the extent to which it can be varied in terms of contract.

Set off arises as a right at law. It comprises four categories but for present purposes we will focus on two – legal set off and equitable set off.

Legal set off arises in the context of a court action. It can be used as a defence to an action. In that sense it must be asserted in the court action as part of the stated defence and is not available prior to litigation as a self-help remedy. It can be used to reduce or extinguish a claim where the value of the cross claim is deducted from it. To work you need both the claim and the cross claim to be liquidated debts or money demand that can be readily and easily ascertainable with certainty. Both debts must be due and payable at the time the defence of set-off is taken. Legal set off can only be used where the same parties are involved but the two claims need not arise from the same transaction or series of transactions.

Whilst useful to deploy, legal set off only applies to monetary debts and not to a claim for damages. If you want to exercise rights without recourse to litigation it is not going to provide a solution.

Equitable set off on the other hand does just that. It operates as a self-help remedy. It covers both monetary debts but also unliquidated damages. By virtue of being a self-help remedy it can be used without formality by simply deducting from the sum otherwise owed the amount of the cross claim and tendering payment for the balance. Like legal set off it can only be used where sums are due and payable. If equitable set off relates to a damages claim the quantum deducted must be based on a reasonable assessment of the loss made in good faith – The Nanfri 1978 Lloyd’s Rep 132. Its use however is restricted to the same transaction or closely related ones.

The test for its application was summarised in Bim Kemi v Blackburn Chemicals Limited (unreported Court of Appeal civil division decision – 3 April 2001). There the Court determined that there were two stages. Firstly, the cross claim has to flow out of and be inseparably connected with dealings and transactions giving rise to the subject of the claim. Secondly, the Court has to ask the question whether it would be manifestly unjust to allow a claimant to enforce payment of their claim without allowing the cross claim.

We can see from this that set off is a powerful tool that can be deployed against the payee under the contract. If applicable it provides a partial or complete defence to an otherwise sound payment claim.
Insolvency scenarios aside, the scope of applicability of set off at law can be enlarged or restricted in the contract. Rights of set off are frequently varied in contracts. The scope can be enlarged by having an express term permitting set off for any liability howsoever arising (whether for monetary debts in unrelated contracts or for damages claims). In a commercial contract a buyer of goods or services may want the ability to set off claims for debts or claims under other contracts against payment they owe for goods or services under that contract. If you are acting for the seller in such a contract negotiation you will want to attempt to resist this.

The entitlement to set off can also be excluded by express contractual provision. Again restrictions to rights of set off are commonly found in commercial agreements. Such restrictions have been deemed enforceable and not contrary to public policy (Coca-Cola Financial Corporation v Finsat International, The Times, 1 May 1996).

However as always use clear wording if you are seeking to exclude rights a party would otherwise have at law. Using the term “set off” would be a start and the absence of such terminology has resulted in a clause failing to have the exclusionary effect. Finally a word of warning, if your exclusion of set off is found in your standard form contract it will need to clear the hurdle of reasonableness under Section 11 of the Unfair Contract Terms Act 1977 (as happened in Overland Shoes Limited v Schenkers Limited 1998 CA).

Before moving on to Part 3, a brief word about Retention of Title.

These clauses are a means by which the Seller seeks to retain some control over moveable property delivered to the Buyer. Controlling moveable property you do not possess is inherently difficult but these clauses go as far as legally permissible in that direction.

They typically provide for the Buyer to be holding the goods as the Seller’s fiduciary agent pending full payment and to keep them separate from the Buyer’s other goods. They may contain a further provision to the effect that if resold, the proceeds of sale are held to the account of the original Seller.

If you are supplying materials and equipment you can provide in the contract that you retain title in such goods until they have been paid for. This is supported by section 19 of the Sale of Goods Act 1979. Such a provision may encourage payment being made for what has been supplied. In the event of your Buyer becoming insolvent, the clause may enable recovery of the materials (in so far as not used) and equipment from the business premises of your counterparty provided that these items are separately identifiable.

The limitations of such clauses are exposed where there is a failure on the part of the Buyer (who becomes insolvent) to keep these items separate and identifiable and thus an inevitable fight with a Liquidator on whether the Clause is effective or where the items are consumable and have already been used, thus no longer existing in their original form. Once materials have ceased to have their own identity or are no longer capable of being removed from whatever they are incorporated into the retention of title clause is rendered ineffective.

For a thorough examination of the law on set off and retention of title and their respective interactions you need look no further than FG Wilson (Engineering) Ltd v John Holt & Company (Liverpool) Ltd 2013 EWCA Civ 1232.
Drafting Tips

Set Off specimen language from LOGIC

“14.7 If the COMPANY disputes any items on any invoice in whole or in part or if the invoice is prepared or submitted incorrectly in any respect, the COMPANY shall notify the CONTRACTOR of the reasons and request the CONTRACTOR to issue a credit note for the unaccepted part or whole of the invoice as applicable. Upon receipt of such credit note the COMPANY shall be obliged to pay the undisputed part of a disputed invoice.

If any other dispute connected with the CONTRACT exists between the parties the COMPANY may withhold from any money which becomes payable under the CONTRACT the amount which is the subject of the dispute. The COMPANY shall not be entitled to withhold monies due to the CONTRACTOR under any other contracts with the COMPANY as set off against disputes under the CONTRACT, nor shall it be entitled to withhold monies due under the CONTRACT as set off against disputes under any other contract.

On settlement of any dispute the CONTRACTOR shall submit an invoice for sums due and the COMPANY shall make the appropriate payment in accordance with the provisions of Clause 14.6 and Clause 14.9 where applicable.

14.8 Neither the presentation nor payment nor non-payment of an individual invoice shall constitute a settlement of a dispute, an accord and satisfaction, a remedy of account stated, or otherwise waive or affect the rights of the parties hereunder.

In particular the COMPANY may correct or modify any sum previously paid in any or all of the following circumstances:

(a) any such sum was incorrect; or

(b) any such sum was not properly payable to the CONTRACTOR; or

(c) any work in respect of which payment has been made and which does not comply with the terms of the CONTRACT.”

Pro Forma Retention of Title Language in favour of the Seller

“1.1 Notwithstanding delivery, ownership of and title to the Equipment shall pass to the Purchaser at the date and time the Seller has received in full (in cash or cleared funds) all sums due to it in respect of:

1.1.1 the Equipment; and

1.1.2 all other sums which are or which become due to the Seller from the Purchaser on any account

(the “Ownership Transfer Date”).
1.2 After Delivery but until the Ownership Transfer Date, the Purchaser must:

1.2.1 hold the Equipment on a fiduciary basis as the Seller’s agent;

1.2.2 store the Equipment (at no cost to the Seller) separately from all other Equipment of the Purchaser or any third party in such a way that the Equipment remains readily identifiable as the Seller’s property;

1.2.3 not remove, destroy, deface or obscure any identifying mark or packaging on or relating to the Equipment;

1.2.4 maintain the Equipment in satisfactory condition insured on the Seller’s behalf for their full price against all risks to the reasonable satisfaction of the Seller; on request the Purchaser shall exhibit the policy of insurance to the Seller; and

1.2.5 hold the proceeds of the insurance referred to in Clause 5.2.4 on trust for the Seller and not mix them with any other money nor pay the proceeds into an overdrawn bank account.

1.3 After Delivery, but before the Ownership Transfer Date, the Purchaser’s right to possession of the Equipment shall terminate immediately, and the Equipment shall remain the property of the Seller if:

1.3.1 the Purchaser is the subject of a petition for sequestration or makes an arrangement or composition with his creditors or otherwise takes the benefit of any Act or other statutory or regulatory provision for the time being in force for the relief of insolvent debtors or (being a body corporate) convenes a meeting of creditors (whether formal or informal), or enters into liquidation (whether voluntary or compulsory, except a solvent voluntary liquidation for the purpose only of reconstruction or amalgamations) or has a receiver and/or manager, administrator or administrative receiver appointed of its undertaking or any part thereof, or a resolution is passed or a petition presented to any court for the winding up of the Purchaser or for the granting of an administration order in respect of the Purchaser, or any proceedings are commenced relating to the insolvency or possible insolvency of the Purchaser; or

1.3.2 the Purchaser suffers or allows any execution, whether legal or equitable, to be levied on his/its property or obtained against him/it, or fails to observe/perform any of his/its obligations under the Contract or any other Contract between the Company and the Customer or is unable to pay its debts within the meaning of Section 123 of the Insolvency Act 1986 (as amended) or the Customer ceases to trade; or

1.3.3 the Purchaser encumbers or in any way changes any of the Equipment.

1.4 After Delivery, but before the Ownership Transfer Date, the Purchaser grants the Seller, its agents and employees an irrevocable licence at any time to enter any premises where the Equipment is or may be stored in order to inspect it, or, where the Purchaser’s rights to possession have terminated, to recover it.”
PART 3 – GUARANTEES, LETTERS OF CREDIT ETC. (INSTRUMENTS BEYOND THE CONTRACT FOR PROTECTING PAYMENT)

As the heading suggests, guarantees, letters of credit, and escrow agreements are autonomous legal instruments. If the premise of the “Contracting Compass” is to navigate the landscape of the contract, why consider documents beyond the contract? Because, notwithstanding being separate, they actually function as a seamless extension of the contract.

Letters of credit, in particular, have become more common in recent years, and also more sophisticated. There are many technical issues for you to consider beyond the scope of this paper, such as – (i) the difference between a documentary standby letter of credit and an irrevocable “on demand” standby letter of credit, (ii) the difference between a true guarantee and an “on demand” guarantee, and (iii) the difference between an “on demand” escrow agreement with single signature draw down, as opposed to dual signature.

Within the limited scope of this paper, we will only focus on “on demand” instruments – because these documents exist for the singular purpose of transferring the obligation to pay to a non-party – whether the party assuming the undertaking is a bank, an escrow agent, an insurance company or specialist surety company.

The fundamental purpose for transferring the obligation to pay is, of course, to provide payment security. One form of security is comfort that the payor remains credit worthy for its obligations and has the continuing capacity to pay, i.e. the ability to pay. The ability to pay will always be of primary importance. However, the willingness to pay may be of equal importance, if not a greater concern. In fact, it will be of paramount importance when a contract is, for example, being performed on a turnkey basis and the party performing the service or delivering the product will not be paid any measure of compensation until the whole of the contract is performed. In this case, the entire commercial proposition for the contractor will be predicated on having the comfort that all or part of the turnkey price cannot be withheld by the company in a way which would impose hardship or serious financial detriment.

In the event of that risk, or in the case of any other valid concerns about the payor being able or willing to pay, the “on demand” instrument will be a preferred choice of security. Why? Because this type of instrument, if properly drafted, will require the payor to establish a separate, dedicated account in which an advance deposit of the contract price will be made. It will also give the payee direct and unilateral access to funds from the account upon the presentation of certain documents in the form and content as specified in the instrument.

An “on demand” standby letter of credit is, for example, essentially a bank’s undertaking to pay against the presentation of documents that comply with the terms and conditions of that undertaking. The contractor has the bank’s undertaking to pay, provided it presents compliant documents, irrespective of any dispute in the underlying contract. The bank is obliged to pay if the documents presented appear to be in good order. This is known as the autonomy principle and is seen as fundamental to the successful operation of the letter of credit system.
Under English law, there are two significant exceptions to this principle:

- illegality, where payment under the credit is prohibited by law; and
- fraud.

Where an escrow or guarantee is agreed on an “on demand” basis, it will function largely in the same way as a standby letter of credit and will be founded on the same principles.

As a final point of commentary, it is worthwhile to note that the fraud and illegality exceptions are clearly founded on public policy concerns. However, English courts are reluctant to interfere with the autonomy principle and require a high standard of proof, both as to the fact of fraud and as to the bank’s knowledge. In the case of Hamzeh Malas & Sons v British Imex Industries Ltd, the Court of Appeal commented:

“If, save in the most exceptional cases, [the applicant] is to be allowed to derogate from the bank’s personal and irrevocable undertaking,......by obtaining an injunction restraining the bank from honouring that undertaking, he will undermine what is the bank’s greatest asset,......namely its reputation for financial and contractual probity. Furthermore, if this happens at all frequently, the value of all irrevocable letters of credit and performance bonds and guarantees will be undermined.”

CONCLUSION

In summary, the parties to a contract will have many rights and remedies at law in respect of payment obligations. The payee can also look beyond the four corners of the contract to on demand payment security which provides comfort in respect of a payor’s ability to pay, as well as its willingness to pay.

However, all of the foregoing will never be sufficient substitute for a clear and comprehensive “payment clause”. The importance of the payment clause cannot be overstated. Some may suggest that price is the king. However, without clear and effective payment terms, a good price is only the promise of profit – i.e. an opportunity to earn which will only to be realised when payment does in fact occur and the colour of the counterparty’s money is revealed.

The next seminar of the Contracting Compass Series will occur in May 2016, with the topical focus of dispute resolution clauses.
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