

Insight

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Take or Pay - to take or not to pay, that is the question?

The recent case of *M&J Polymers Ltd. v Imerys Minerals Ltd.* (the "*Polymers Case*") is the first English case to have explicitly considered the question of whether a take-or-pay clause could fall foul of the English law rule which prohibits contractual penalties.

Significance of the case

In addressing this question the *Polymers Case* raises some interesting questions as to the enforceability of take-or-pay clauses and the extent to which sellers should be comfortable with the take-or-pay commitment.

This article provides a brief overview of take-or-pay clauses in general, the background to the case, the rule against penalties, the findings of the Commercial Court and implications of the decision for the energy sector.

Take-or-pay clauses in energy sector contracts

The energy sector has been traditionally characterized by long term take-or-pay contracts between sellers who make a significant upfront capital investment in the relevant asset and buyers who require a regular and committed supply. The concept of take-or-pay has been a useful mechanism for assuring cash flow to sellers and for providing collateral security to lenders for capital intensive projects in the energy sector. The take-or-pay concept also benefits buyers who get the benefit of a regular and, if required, flexible supply. The key principle underpinning the take-or-

pay regime is that in the event a buyer is unable to take the minimum quantity, the buyer is nonetheless required to pay for such minimum quantity. In many long term sale agreements the buyer may well have the opportunity to recover such amounts paid for but not taken through a concept of "make-up" (as discussed later).

Although the concept of take-or-pay is most usually seen in the context of long term gas sale agreements, other contractual arrangements in the energy sector, where a single producer, transporter or seller contracts with one or a number of counterparties may also structurally reflect the concept of take-or-pay. For example, send-or-pays obligations as commonly used in gas transportation agreements.

Background to the case

M&J Polymers (the claimant) was supplying chemical dispersants to *Imerys Minerals* (the defendant). The supply contract contained a take-or-pay clause requiring the defendant to either take-or-pay for a minimum quantity of the product. Specifically the supply contract provided that the defendant would pay for minimum specified quantities, "even if they together have not ordered the indicated quantities during the relevant monthly period".



This article addresses the following key questions:

- Can take-or-pay clauses be considered as contractual penalties?
- What is the English law rule against penalties?
- Would a failure to pay a minimum payment under a supply contract constitute a debt?
- What principles should be considered when preparing a take-or pay provision?
- What are the implications of this case for the energy sector?

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A dispute arose between the parties regarding the quality of the product. The supply contract was terminated by the defendant who had claimed that the product was not within the agreed specification (the court found this to be a wrongful termination). In the period prior to the termination of the supply contract, the defendant was taking less than the required minimum quantity of product and not paying the minimum amount specified for such minimum quantity.

The issues before the Commercial Court included whether:

- (i) the sums due to be paid by the defendant to the claimant for the period prior to what was accepted as repudiatory breach of the supply contract, were recoverable as a debt equalling the price of the minimum quantities of product which the defendant was to purchase (or pay for) under the supply contract; and
- (ii) the take-or-pay clause constituted a penalty and that the claimant should be limited to a general claim in damages for breach of the defendant's obligation to order the specific minimum quantities.

The rule against penalties

The laws of England and Wales do not permit the enforcement of a contractual provision which imposes a penalty on a party in default. The law does however permit the recovery of liquidated damages. Two parties to a contract may (and within the scope of the parties freedom of contract) as part of the agreement between them, fix the amount which is to be paid by way of damages in the event of breach. Whether such sum is or is not in fact recoverable from the party in breach depends on whether the amount provided for in the agreement constitutes liquidated damages (which may be recoverable) or a penalty (in which case it will not be recoverable).

The law regarding liquidated damages and penalties is the product of a number of authoritative decisions culminating in the well known case of *Dunlop Pneumatic Tyre Co. v. New Garage Motor Co.*, where a series of rules were outlined to help ascertain whether a stipulated sum amounted to liquidated damages or a penalty.

The following broad rules emerge:

1. The sum stipulated in the contract must be a *genuine pre-estimate of the damage* which would arise from breach of the contract;
2. The provisions and sum stipulated in the contract must *not have the primary purpose of deterring breach of contract* (often, described as 'should not be *'in terrorem'*');;
3. The circumstances must be *viewed as at the time when the contract was made*; and
4. A stipulated sum will be a penalty if it is *extravagant and unconscionable in comparison with the greatest loss* that could conceivably be proved to have followed from the breach.

It is normally insufficient to establish that a provision is penal by simply identifying situations where the application of the provision could result in larger sums being recovered than the actual loss.

Findings of the Commercial Court

In connection with issue (i) before the Commercial Court (as summarised above), the claimant in the *Polymers Case* argued that the failure by the defendant to pay the minimum payment under the supply contract constituted a debt and consequently the law of penalties did not apply. Burton J. viewed this as "too simplistic".

In considering issue (ii) (as summarised above), Burton J. considered a series of cases cited by the claimant and concluded that "*as a matter of principle, the rule*

against penalties may apply [to a take-or-pay clause]". However, he went on to determine that a take-or-pay clause was not the "*ordinary candidate for such a rule*".

Burton J. referred to the following principles to assist in determining whether a take-or-pay clause would offend the rule against penalties:

1. Whether the take-or-pay clause was *oppressive*;
2. Whether the take-or-pay clause was *commercially justifiable*;
3. Whether the *primary purpose* of the take-or-pay clause was *to deter breach of contract*; and
4. Whether the parties enjoyed *equal bargaining power*.

On application of these principles, Burton J. concluded that the take-or-pay clause in question did not offend the rule against penalties in this case.

Implications for the energy sector

Should the energy sector be concerned by Burton J's decision that the rule of penalties may apply to take-or-pay provisions? The answer to this question is probably no. However Burton J. did conclude that in certain, albeit extreme, cases a take-or-pay provision may be found to be a penalty.

This does provide potential buyers with the possibility of constructing an argument in order to avoid liability under a take-or-pay provision. In order to protect themselves sellers should ensure that take-or-pay obligations are not "*oppressive*" but are a "*genuine pre-estimate of loss*" which has been incurred by the seller as a result of setting aside the relevant product for the buyer. Sellers must also take extra care in circumstances where it could be viewed that the parties do not have equal bargaining power. However that being said, companies operating within the energy sector are usually sophisticated and commercially experienced entities and this argument is unlikely to hold any significance.

We note that in the *Polymers Case*, the supply contract did not contain a “make-up” provision. Such provisions are quite standard in the energy sector and particularly in the gas industry. The inclusion of make up rights would allow a party to argue that a take-or-pay provision acts as a pre-payment for future product (provided that the product is taken within a specified timeframe). The inclusion of make-up rights in a supply contract would make it significantly more difficult for a buyer to argue that a take-or-pay clause is a penalty.

What is more of a concern is that Burton J. did not accept the argument that the take-or-pay amount outstanding under the supply contract constituted a debt and consequently the law of penalties did not apply. Burton J. found that the defendant had breached an obligation to order certain minimum quantities of product. Under this argument the failure by the defendant to order minimum quantities of product constituted a breach of the agreement and consequently damages were payable. Burton J. then concluded that the amount outstanding was not a penalty. However this does leave the question, if a take-or-pay obligation is not a debt, will sellers have to demonstrate that they have complied with the rules relating to mitigation before they can claim damages for failure of a buyer to take minimum quantities of product under a supply contract?

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