CR Sugar Trading Ltd v China National Sugar & Alcohol Group Corp [2003] APP.L.R. 01/31

JUDGMENT : Mr Justice David Steel : Commercial Court. 31st January 2003

Introduction

1. There are three applications before the court:
   a. An appeal by the Claimant (Sellers), CR Sugar Trading Limited ("CR"), against an Arbitration Award of the Sugar Association of London dated 11th February 2002. The appeal is brought pursuant to the provisions of Section 69 of the Arbitration Act 1996 with the permission of Thomas J.
   b. An application by CR to remit the award, in the event the appeal was not allowed, to correct the amount awarded to the Respondent (Buyers), China National Sugar and Alcohol Group Corporation ("CSW"). This application was made under Section 68 of the Arbitration Act 1996. As a result of an agreement between the parties, it is no longer controversial.
   c. An application by CSW to strike out an application notice issued by CR purporting to seek relief under Section 5 of the Financial Services Act 1986. This application would only arise in the event that the appeal was unsuccessful and, accordingly, it is to the appeal that I turn first.

Background

2. The claim arose out of contracts for the sale by CR to CSW of two lots of 75,000 mt (+/- 5%) of raw sugar in bulk, those sales each being C & F, free out, 1 main safe South China port. All the other terms were as per the standard form of the Sugar Association of London for such contracts. Payment was to be made by letter of credit. CSW refused to establish the letters of credit. CR ultimately held them in default and claimed damages in the sum of U.S.$19,653,085. It was this claim that was referred to a panel of arbitrators of the Sugar Association.

3. The outcome of the arbitration was that CSW succeeded on one of their defences, namely that the contracts were unenforceable by virtue of certain provisions of the Financial Services Act 1986. It is in the face of this conclusion that, in the event of the failure of the appeal, the application notice issued by CR arises, in that it seeks relief from the court in respect of the unenforceability of the sale contracts pursuant to other provisions in the same Act.

4. The commercial relationship between the parties had extended over several years, beginning in 1994. CSW was a Chinese Government owned company. Initially its business had been the distribution of sugar and sugar products within China. But, by the material time, it had also become an importer and exporter of sugar into and out of China. In addition, for a period in 1995 and 1996, it also carried out tolling operations i.e. importing raw sugar then exporting the refined product. Those tolling operations were not physically carried out by CSW but arrangements for the purpose were entered into with Chinese domestic refineries owned and operated by third parties.

5. CR was an English company in the business of international sugar trading, based in London. Over the years, CSW granted a series of "put" options to CR, whereby CR purchased the right to sell quantities of raw sugar to CSW. CR paid very substantial premiums for these "put" options. The strike price under these options was pitched at a very low level, indeed below any market spread anticipated by the parties. The value for CR of these "put" operations was that it gave their New York affiliate, called CHRIST, physical contracts which permitted it to open hedging positions on the New York futures market. While the market spread remained above the strike price of the "put" options, CR did not of course exercise them. Meanwhile CHRISTI were able to trade futures for their own account and to do so profitably. At the expiry of the respective "put" options, they were "rolled over" (i.e. the declaration date was extended) for which CR paid CSW further premiums.

6. For several years during this relationship, CSW possessed import quotas for raw sugar granted by the Chinese government. But, in 1996, those import quotas were suspended because of the glut of sugar that had arisen in China as a consequence of smuggling. So far as tolling was concerned, it appears that CSW applied to the Ministry of Foreign Trade and Economic Cooperation in February 1997 for permission to toll 100,000.00 mt of raw sugar. The application was approved, but not until the 8th October 1997. However, the Respondent did not in fact engage in any tolling thereafter because, by that time, the differential between the raw and white sugar prices on the internal market had narrowed (and in any event there was insufficient time before the expiry of the approval on the 30th December 1997 to do so).

7. As regards the expressed purpose of the options, even during the currency of the 6th option, which had been granted on the 23rd April 1997, CSW for its part had made it plain that it regarded the arrangement as a mechanism for both parties to make profit i.e. with CSW receiving premiums and the CR Group profits from the New York futures market. Indeed, it is difficult to see what commercial purpose, from the perspective of an importer, there would be in selling a "put" option. Thus it is not surprising that, putting to one side the absence of any contemporary import or tolling licences, CSW had sent a fax on the 23rd April 1997 containing the following observation:- *"We hope that this contract still be a tool to make profit for both of us in the future, not to commit between us to deliver the physicals. This is our basic thought about this contract by now."*

8. The two material "put" options granted to CR by CSW, which generated the contracts sued upon when the options were exercised, were the 7th and 8th options dated respectively the 23rd September 1997 and the 6th February 1998. The granting of the 7th option was confirmed by the claimant in the following terms:-

   "Ref our recent discussions we have pleasure in confirming the following business concluded today;

   1) Sugar and Wine Beijing (SW) have granted to CR sugar Trading Ltd London the option for CR to sell to SW 75,000 mt 5% more or less Sellers option, omnibus cane raw sugar in bulk, shipment July/15 September 1998, price 11.50 c/lb FOBS basis 96 degrees. Option declarable by CR latest 15 June 1998……

Sellers grant to Buyers the option, declarable immediately upon Sellers declaring the option, not to take delivery of physical sugar, but to take over from Sellers a 'long' position of 75,000 mt 5% plus/- July 1998 NYSCE No 11 futures at 11.50 c/lb…….

4) Sellers understand that the buyer may not wish to receive physical sugar in this period. Sellers will, as they have in the past, make every endeavour to ensure that the result of this operation is profitable to the Buyers. In case the market is below the strike price of the option (11.50 c/lb), and in case the Buyer does not wish to take delivery of either physical sugar or futures, then the Seller will work with Buyer with a view to postpone the option at no loss to Buyer. In any case Seller guarantees that, if Buyer wishes, this option may be postponed into October/15 December 1998 at no cost to Buyer. But we expect, as in the past, to be able to pay you a premium to postpone the option, if you so wish."

9. By the second half of February 1998, the market had come down substantially. CSW received the following request from CR to execute sale contracts in accordance with the options but accompanied by significant assurances:-

"We have asked you very kindly to sign contracts covering our optional sales to you (75,000 mt 5% July/September 1998 basis11.50 c/lb FOBs, and 75,000 mt 5% October/December 1998 basis 11.00 c/lb FOBs). These contracts are to enable us to arrange for financing of the futures which we hold against these options, and which are costing us a lot of margin financing. Our banks would not understand the optional nature of these contracts, nor the price which is based on any futures to which will be added costs if we/you decide to ship, so we have drawn up the contracts as straight sales. We hereby state irrevocably that these straight contracts at C & F prices do not in any way change the contracts between us, which remain exactly as they were before, namely optional contracts which we will only ship in 1998 if you so wish, and which we will postpone into next year, if you do not wish us to ship in 1998, or we will cancel if/when the market goes above the 'strike prices' of 11.00 c//b.

Thanks very much for your help and assistance which is highly appreciated."

10. Things were brought to a head in June 1998 when negotiations between the parties led to a memorandum of agreement, signed by them on the 15th July 1998. That memorandum reads as follows:-

"The following agreement has been reached between Buyer and Seller during the meeting:

1) Buyer fully recognises the two optional sales made by Seller to Buyer, which are:

A) 75,000 mt 5% M/L S/O raw sugar, basis price 11.50 c/lb FOBs, min pol 96 degrees in bulk. Shipment July/September 15, 1998. The shipment has been postponed from July/Sept 15, to October 15, 1998 at no cost to Buyer.

B) 75,000 mt 5% M/L S/O, raw sugar price 11.p00 c/lb FOBs, min pol 96 degrees in bulk, shipment Oct/Dec 15,1998.

If the above options are declared, then the sales will be transformed into cost and freight free out, one main safe S.China port per vessel price by taking the basic price FOBs plus the cheapest combination of physical premiums and freight from any origin to China prevailing at time of declaration…..

Buyer shall honour the above contracts and shall undertake to give Seller priority to execute the sales as soon as Chinese Government permits Buyer to import sugar for consumption or tolling.

Buyer has recognised, as well as Seller, that sugar import into China may not be permitted by the Chinese Government in the near future. Therefore if Buyer requests the above sales to be postponed further Seller should agree in principle to postpone and not force to deliver."

11. It is against this background that the tribunal concluded that, during the "good times", the parties were suffering from what they described as "myopic euphoria". In its view, the parties intended that the options would be rolled over as long as it suited them so that the money making scheme could continue and there would be no need to consider the possibility of physical delivery. However, as the tribunal put it, the parties were labouring under the delusion that the disastrous fall in the market which ultimately ensued could not happen. This tribunal summarised its conclusion as follows:-

"……Behind the long and complicated tale lies a classically simple and familiar story. It is evident to us that all parties were deluded, even blinded, into believing that they had found the secret of beating the casino. In the conditions of what they believed to be a buoyant market, everyone was induced to believe that, with an intelligent and proactive exploitation of such conditions, the parties could only gain and could never lose.

…….It is our assessment of the totality of the evidence before us that, while the parties may at the time have recognised the theoretical possibility of loss, they genuinely believed that, in practise, such possibility was so remote as to be something which could safely be put to one side. Thus, the parties agreed that, in conditions in which it might not be possible for the Respondent to take physical delivery in China (because no import or tolling licenses might be available), this would in practise present no difficulties because, for all practical purposes, the optional sales could always be rolled forward at a profit or, at worst, no loss, or left to lapse."

12. But in fact, despite agreed extensions, the options were eventually exercised by CR on the 11th February 1999, some three days before they expired. The "put" options thereby became sale contracts.

Section 69

13. This accordingly was the background to the argument on the enforceability of the options and the underlying sale contracts. The advertised purpose of the options had formed the focus of an argument advanced by CSW at the arbitration that, either by contract or by estoppel, CR were precluded from exercising the "put" options and

enforcing the resulting sale contracts if CSW did not want the sugar. That issue (entitled "the not forcing delivery issue") was decided against CSW and there is no cross appeal.

14. The tribunal held, however, that the contracts on which CR founded their claim against CSW were *"investment business"* and that, because CR was a company carrying on business in the United Kingdom without being authorised under the Financial Services Act 1986 to conduct "*investment business*", the contracts were unenforceable pursuant to Section 5(1)(a) of the Act. It is in regard to this issue that CR has been given leave to appeal.

The 1986 Act

15. The staring point is to examine the scheme of the Financial Services Act 1986. By virtue of Section 3, those who carry on investment business in the United Kingdom must obtain authorisation. It is common ground that CR was not authorised under the Act and was not an exempted person. The consequence of a lack of authorisation is that a contract made by a person in the course of carrying on business in contravention of Section 3 is unenforceable at the election of the other party. (Under Section 5 (3) of the Act, there is limited power vested in the Court to allow a contract to be enforced despite the fact that it had been entered into in the course of carrying on investment business in contravention of Section 3. This is a topic to which I will revert.)

16. Investment business is defined by Section 1 (2):- *"In this Act "investment business" means the business of engaging in one or more of the activities which fall within the paragraphs in Part II of that Schedule and not excluded by Part III of that Schedule."*

For present purposes the relevant part of Part II of the Schedule is paragraph 12, namely:- *"Buying selling subscribing for or underwriting investments or offering or agreeing to do so either as principal or agent".*

The critical word "investments" is in turn defined as "any right, asset or interest falling within any paragraph in Part I of Schedule 1 to the Act". These include:-

"(7) Options to acquire or dispose of:-

(a) any investment falling within any other paragraph of this part of the schedule…..

(8) Rights under a contract for the sale of a commodity or the property of any other description under which delivery is to be made at a future date and at a price agreed upon when the contract is made."

It follows that both commodity contracts for future delivery and options to acquire or dispose of commodities for future delivery are within the scope of "investments".

17. Appended are some "notes". These have statutory effect and explain the circumstances in which paragraph (8) applies. They read as follows, so far as material:-

"(1) This paragraph does not apply if the contract is made for commercial and not investment purposes.

(2) A contract shall be regarded as made for investment purposes if it is made or traded on a recognised investment exchange or made otherwise than on a recognised investment exchange but expressed to be as traded on such an exchange or on the same terms as those on which an equivalent contract would be made on such an exchange.

(3) A contract not falling within Note (2) above shall be regarded as made for commercial purposes if under the terms of the contract delivery is to be made within seven days.

(4) The following are indications that any other contract is made for a commercial purpose and the absence of any of them is an indication that it is made for investment purposes

(a) either or each of the parties is a producer for the commodity or other property or uses it in his business;

(b) the seller delivers or intends to deliver the property or the purchaser takes or intends to take delivery of it."

18. The tribunal, having examined the notes to paragraph 8 of Schedule 1 Part 1 of the Act, considered that there was on one "*indication"* which emerged, by virtue of Note (4), namely the intention of the parties that there would be no delivery. This pointed to the conclusion that the contracts were made for investment rather than commercial purposes. The tribunal recognised that that intention was only an indication and was not conclusive. But "*having reviewed all the evidence before us*" considered that it was "*determinative"* in the circumstances of the present case.

19. The issues of law on which permission to appeal was granted are somewhat diffuse and are set out in paragraph 13 the appellant's application notice which reads as follows:-

"What is the true construction of Note (4) to paragraph 8 in Schedule 1 Part 1 of the Financial Services Act 1986 and in particular:

a) what is meant by the term ""uses [the commodity] in his business" in sub-paragraph (a)? In particular, is it limited to cases where a party manufactures or processes the commodity in question in facilities which he himself owns and operates?

b) what is meant by "delivers" in subparagraph (b) where the contract? Is a delivery of documents a sufficient "delivery" for these purposes?

c) what is meant by "intention to deliver" in subparagraph (b) where the contract is (i) a "put" option granted to the claimant? And in particular is there a sufficient intention when the intention is to deliver only if market conditions so dictate? Or (ii) a C & F contract?

d) By reference to what point in time must one assess the seller's "intention to deliver" the goods in subparagraph (b)? In particular what is the correct point in time when there is a "put" option which, on the exercise of the option, becomes a bilateral contract of sale?"

Use in business

20. The first point taken by the appellant is that the tribunal was wrong to accept the submission made by CSW that neither of the parties was "a producer of the commodity…or uses it in his business" within the meaning of Note 4 (a). The appellant submits that even a sugar trader is a "user" of sugar in his business whether or not he owns or operates a refining or manufacturing installation.

21. I take this point quite shortly. As is apparent from the background set out above, CR was a sugar "trader" and CSW an importer and distributor of sugar. Whilst CSW had engaged in tolling in the mid 90's, this had ceased and, in any event, the refining operations were conducted by third parties. The tribunal concluded that, in these circumstances, both parties were engaged in the business of purchase and sale of sugar and did not "use" sugar in their businesses.

22. In my judgment, to the extent that the issue is one of law at all, the tribunal was right. The tribunal stated that to say that a trader "uses" sugar would constitute an "odd turn of phrase". This is surely so. In its ordinary meaning, the verb "to use" connotes the process of putting into service or consuming material. This was not the activity of either party. Indeed the presentation of "use" in contradistinction to "produce" reinforces this analysis.

23. It was convincingly submitted by CSW that this construction is entirely consistent with the overall purpose of the Note, namely to give guidance as to whether the relevant contract was made for commercial purposes rather than investment purposes. The outcome of the employment of the guidance should be to identify contracts with a clear commercial purpose: see Note 1. These are likely to arise in circumstances where a producer or a manufacturer enters into contracts for forward delivery to hedge his own exposure: see **Guide to Financial Services Regulations: Rider, Abrams and Ashe QC 3RD Ed** para 325. Those who simply buy and sell material are more likely to be indulging in market speculation than those who produce or consume material.

Intention regarding delivery

24. I now turn to Note 4 (b). Here CR challenges the finding that it, as seller, did not intend to deliver the sugar and CSW, as buyer, did not intend to take delivery of it.

25. The threshold issue here is the time at which the intention is to be ascertained. CSW contend (and the tribunal has found) that the relevant time is when the option contracts were made. It is submitted by CR that the relevant time is when the options were exercised.

26. In support of their appeal, CR prays in aid a passage from **Benjamin: Sale of Goods 6th Ed.** Para 1 – 050: *"An option to buy goods granted to a possible purchaser is, in the strict legal sense, an offer to sell which the offeror promises for valuable consideration…..not to revoke. The owner of the goods, in popular language, is said to have "agreed to sell" them, but in law there is no such agreement unless the parties are mutually bound…… A holder of an option is free to exercise it or not as he may choose, and unless and until he does so, he has neither bought nor agreed to buy. Once an option to buy has been exercised, there is of course a contract of sale of goods within the meaning of the Act."*

27. Thus, it is submitted, once the option is exercised, it is replaced by the sale agreements. By definition, so the argument runs, in entering into those agreements, both parties intended delivery to take place, thereby giving rise to a clear indication of a commercial purpose.

28. This argument, in my judgment, is misconceived. The scheme of the Financial Services Act is to render unauthorised investment business unenforceable. Investment business includes the buying and selling of options. The construction advanced by CR would, in effect, exclude options from the scope of the Act.

29. Furthermore, the relevant time is when the contract is "made". This must mean, in the case of an option, when the option is granted not when it is exercised. Any other construction is devoid of purposive sense i.e. that a regulatory regime, designed to regulate inter alia options, only bites on options that lack commercial purpose if and when they are exercised.

30. In this regard, I agree with the terms of the guidance release No3/88 issued by the Securities and Investment Board in relation to para 8:-

> *"9… In determining a person's intentions, regard will certainly be had to any expression of those intentions, for example, in the contract itself, or which relate to a course of dealings between the parties. This does not mean that the parties can contract out of regulation under the Act; merely that an expression of their intentions is strong evidence of what those intentions are. In this context it is worth mentioning that the test of intention applies at the time the contract is made. A subsequent change of intention does not affect the status of the contract so long as it does not lead to a near agreement or doubts about the basis of the original agreement…."*

31. In the alternative, CR submits that, in considering the date of the contract for the purposes of identifying the parties' intention, the relevant agreement for present purposes is the July 1998 Memorandum. In my judgment, this point is not open to CR. I am not persuaded that it was canvassed at the hearing in the context of the Financial Services Act issues. It was not a point, in any event, on which permission to appeal was sought or given. (Furthermore, so far as the merits go, it is difficult to see how a mutual intention to effect and accept delivery can be discerned given the express provision within the Memorandum itself to the effect "*if buyer requests the above sales to be postponed further, seller should agree in principle to postpone and not force to deliver*".)

32. In the further alternative, CR argues that, albeit on the tribunal's finding CR's intention at the time of the option contracts came into existence was not to deliver, this intention was conditional i.e. unless CSW wanted delivery or

market conditions dictated. Thus, it was contended, the tribunal should have concluded there was an sufficient intention for the purposes of Rule 8.

33. If this is a proposition of law at all, it is a highly fact sensitive one. The tribunal have made extensive findings as to the intention of the parties which persistently left out the possibility of delivery. By definition, there was no intention to effect delivery since, in the parties' view, the circumstances were never going to arise.

34. The tribunal were fully justified in all these circumstances to conclude that the contracts were not shown to have been made for commercial purposes. This makes it unnecessary to consider the cross appeal to the effect the contracts were compulsorily to be regarded as made for investment purposes by virtue of Note (2).

Section 68

35. As indicated in the introduction to this judgment, CR's application under Section 68 was focused on the quantum of the counterclaim in the event that the appeal was dismissed. The appropriate adjustment has been agreed and I need say no more about it.

36. CR, however, sought to introduce a new point to the effect that the tribunal had failed to address an argument made by CR that the "investor" was CR since it was CR that paid for the "put" option and thus, so the argument ran, the contract was not unenforceable under the Act.

37. Again I can take this point shortly:-

i. It was an argument scarcely adverted to at the hearing and, thus, it was not surprising that the tribunal expressed no views on it.

ii. It is, in any event, a hopeless point: the Financial Services Act does not distinguish between the person who is "the investor" and the other party to the transaction but only raises the issue whether one of the parties is carrying on investment business within the United Kingdom which includes the buying of an option.

Application under Section 5 of the Financial Services Act

38. In anticipation of losing the appeal, CR issued an "application notice" seeking an order pursuant to Section 5(3) of the Act that the option contracts were enforceable. This procedural device was on the face of it wholly inappropriate. It was not an arbitration application pursuant to section 67, 68 or 69 of the Arbitration Act nor did it constitute the issuance of a claim form seeking substantive relief. Nonetheless the parties invited me to consider the merits of the point.

39. I start with the terms of Section 5 (3) itself:-

"A court may allow an agreement to which sub-section (1) above applies to be enforced or money and property paid or transferred under it to be retained if it is satisfied –

a) ….. that the person mentioned in that paragraph reasonably believed that his entering into the agreement did not constitute a contravention of Section 3 above;…

c) ….. it is just and equitable for the agreement to be enforced…. "

40. The matter arose in the arbitration arose in this way. CR submitted before the tribunal that it (the tribunal) should exercise "its" discretion under Section 5 (3). The response of CWS (categorised as "absurd and wrong" by CR) was that the arbitrators had no jurisdiction to grant relief, that being reserved entirely to the court. In the event, CSW accepted the tribunal's jurisdiction to decide all the issues raised in the arbitration and these issues accordingly included:-

a. Did the Act give the tribunal a discretion under Section 5(3)?

and

b. Was this an appropriate case on the facts for such discretion to be exercised?

41. The outcome was set out in paragraph 406 of the Award:- *"The Respondent's fourth proposition (in paragraph 358 (4)) was two-fold: as arbitrators we do not have discretion to waive non-compliance with the FSA and enforce the contracts; and even if we had such discretion, any application for such waiver would fall. The Respondent argued that we are not a* ***"Court"*** *within the terms of Section 5 (3) of the FSA and that any application for the exercise of discretion within the terms of that section would have to be made to the Court, and not to us as arbitrators. We decline to make any finding as to whether we have jurisdiction to exercise such discretion under the section, and would merely observe that, even if we had such discretion, we see no basis to exercise it in favour of the Claimant and would have declined so to exercise it had we the jurisdiction to do so."*

42. CR now seeks to reopen this issue by means of its "application notice" so as to enable the court to decide (contrary to their earlier submission on jurisdiction) that this is an appropriate case (contrary to the views of the arbitrators).

43. CR faces a practical difficulty. The arbitration award is final. By definition CR have failed to overturn the award on appeal. Thus the contracts are unenforceable. Any exercise of discretion under section 5(3) would be moot since the arbitration cannot be revived nor can a claim based on the original cause of action be pursued.

44. It follows, as neatly put by Mr Jacobs QC, on behalf of CWS, that either the tribunal did have jurisdiction (in which case CR have lost) or it did not (in which case the discretion is redundant). There is no injustice in this. There is force in the supposition that CR saw potential advantages in raising the issue before a trade tribunal. However, the strategy has not borne fruit. It would now be an abuse of process to allow CR to reopen the issues and deploy all the material previously presented to the tribunal.

45. Nor in any event can CR be permitted to circumvent the prescribed manner in which an award can be challenged. If CR wished to contend that the arbitrators exceeded their jurisdiction on the Section 5 issue, CR should have applied under Section 67 of the Arbitration Act 1996. But such an application now would be (a) out of time and (b) barred by Section 73 of the Act. If CR wished, in the alternative, to seek relief from the court, it should have reserved its position before the arbitrators.

Conclusion

46. In the result:-

a) The appeal is dismissed

b) The application under section 68 is allowed by consent

c) The application notice relating to section 5 of the Financial Services Act is struck out.

TIMOTHY YOUNG QC (instructed by CLYDE & CO) for the Claimant
RICHARD JACOBS QC and RICKY DIWAN (instructed by THOMAS COOPER & STIBBARD) for the Defendant