Coronavirus/Covid-19 and “Force Majeure” Under Long-Term Asian LNG Contracts

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The increasing divergence between oil prices and spot liquefied natural gas (LNG) prices has created strong incentives for Asian buyers under long-term LNG contracts to seek price adjustment and other forms of LNG contract flexibility such as diversion rights and quantity flex. While the commercial realities of a buyer’s market and low Henry Hub pricing has led to many ‘buyer friendly’ changes to contract terms, force majeure (FM) clauses have remained relatively unchanged and often follow long-established forms. However, the current Coronavirus outbreak has begun to test the limits of those clauses with reports of some Chinese buyers claiming FM on the basis that the outbreak has prevented the buyer’s performance of the LNG contracts altogether. There are also reports of sellers rejecting such claims.

Therefore, what is FM and what are the implications for Asian buyers and sellers of LNG?

What is FM?

Under English law (a common choice for long-term Asian LNG contracts), FM is a form of relief that is available only if and to the extent provided in the relevant contract. Therefore, much depends on the specific terms of each FM clause. Whilst there is no standard form of FM clause, in general terms long-term LNG contracts typically require the following elements to be satisfied:

• The party claiming FM must have acted as a “Reasonable and Prudent Operator” (however that is defined).

• An FM event has occurred that is not reasonably within the control of that party, could not have been prevented or mitigated and which has prevented or hindered, curtailed or delayed some aspect of performance. Usually the FM clause will give a nonexhaustive list of such events, as well as a list of events that in any event do not qualify for FM.

• The party claiming FM must promptly give notice of the FM event, of the performance that has delayed or prevented by it, of the expected duration of such delay or prevention and a statement of the actions to be taken to resume performance. Typically, the nonaffected party has a right of inspection to verify the FM event.
• The parties shall seek to arrange for substituted performance.

If the above requirements are satisfied and substituted performance cannot be arranged, then FM relief may be available. If the requesting party is the buyer, then its obligation to take LNG may be suspended for so long as the conditions for FM are satisfied, and the seller may be entitled to sell to third party buyers the LNG the buyer would otherwise have taken.

Once the conditions for FM are no longer satisfied, performance of the contract is required to resume.

**What is an FM Event?**

Typically, the nonexhaustive list of FM events stated in an FM clause includes matters such as specified extreme weather events, natural disasters, civil disorder, sanctions, radioactivity, strikes, acts of governmental authorities that are generally applicable in the relevant country, and changes in law. Importantly in present circumstances, epidemics are also often specified; but since such lists are usually nonexhaustive, the absence of such an express reference may not be determinative.

However, the list of matters that cannot be FM events frequently includes:

• The ability of the buyer to obtain better terms from other sellers.
• Changes in the market or demand for LNG or natural gas.
• Events affecting downstream customer facilities.
• Acts of governmental authorities that are applicable solely or primarily to the requesting party.

**Does the Coronavirus Outbreak Qualify as FM?**

This will depend both on the wording of each specific FM clause and on whether the facts satisfy the required elements. However, it is possible to envisage circumstances in which the outbreak may satisfy the requirements for FM. For example, depending of the terms of each contract, if generally applicable governmental action to control the outbreak results in the mandatory closure of receiving terminals, and if proper notice of FM is given and substituted performance cannot be undertaken, then it may be that FM relief could be available. However, sellers will no doubt rigorously investigate whether all of the required elements for FM are indeed satisfied.

Downstream issues may also affect buyers’ ability to take LNG. There are reports that the Coronavirus may be significantly impacting industrial activity in China, thus reducing the demand for gas. If the buyer’s storage facilities are not clearing quickly enough such that taking a full cargo lot of LNG is not physically possible, where do the parties stand? It may be that this amounts to events that are outside the control of the buyer preventing it from performing the contract. However, if (for example) the relevant FM clause excludes changes in the demand for gas or events affecting downstream facilities, then this situation may nevertheless not qualify as FM.

The present outbreak emphasizes that FM clauses are vital provisions in LNG contracts, and that care must be taken at the drafting stage to ensure a suitable balance of protection between the interests of the buyer and seller.
Alternatives to Declaring FM?

More recently drafted long-term LNG contracts in Asia often include a number of other potential means by which a buyer can mitigate risk. These include exercising downward quantity tolerance, amending the applicable annual or quarterly delivery program, exercising a cancellation right or a right to divert a cargo to an unconstrained port. Some of these clearly require longer lead times to effect due to notice periods, but some can be done in a relatively short time frame depending on the relevant drafting (e.g., diversion). Accordingly, buyers who may be potentially unable to claim FM may well have other avenues available to achieve relief. Exercising one or more of these options is clearly preferable to failing to take the cargo and suffering the take or pay consequences (even if appropriate make-up rights provisions are available). They are also preferable to being required to sell the cargo at spot prices to mitigate the take or pay risk, particularly given the current low spot price relative to long term contract prices. Again, however, there will likely be no shortage of buyers and sellers poring over their contracts to determine their rights and then disagreeing about them. The best protection for both buyers and sellers is to do that review early and clearly understand their rights in relation to FM and other means of relief.

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