

## COVID-19: CORONAVIRUS FORCE MAJEURE DECLARATIONS BY LNG BUYERS: A NEGOTIATING TOOL OR A LEGITIMATE CASE OF FORCE MAJEURE FOR LNG SPAS GOVERNED BY ENGLISH LAW?

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### Energy, Infrastructure and Resources Alert

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Before the COVID-19 coronavirus outbreak, Asian spot liquefied natural gas (LNG) prices were already at historic lows due to a warm winter and oversupply. Now, with multiple Chinese cities under quarantine, drops in local demand in China have resulted in further price declines, pushing prices to record lows.

In response to the epidemic, major Chinese buyers are reportedly instructing their immediate LNG deliveries to either delay their arrival (for example, by decreasing LNG vessel speeds) or to wait in anchorages on arrival. These companies are apparently also considering diversion solutions (including to terminals outside China) and, of most concern to LNG suppliers, declarations of force majeure.

Consultancy firm, Poten & Partners said on Friday, 7 February 2020 that at least five LNG cargoes had been diverted from China already, and another 30 due to land there in February could face diversions, delays, or force majeure declarations. We further understand that with mild winter conditions in Asia and high gas inventory in Europe, the usual 'sinks' for excess demand do not currently exist in the LNG market to readily absorb these excess cargoes.

On 6 February 2020, one of China's biggest LNG buyers was reported to have declared force majeure for LNG deliveries from at least three suppliers, marking the first official declaration of force majeure by an LNG buyer due to the COVID-19 coronavirus outbreak. In response, LNG sellers have been reported to have rejected the force majeure declaration. Both have apparently disputed the legal basis of the declaration. Indeed, it has been speculated that the force majeure declarations would be used as a negotiating tool to seek price reductions for cargoes (which, if linked to oil-indexed prices, could be up to two or three times higher than current spot prices). Notwithstanding that a force majeure claim might be unfounded, where a cargo is turned away, the supplier will inevitably be left to sell the affected cargoes on the already-oversupplied spot market and seek contractual redress from the LNG buyer later, possibly only after a lengthy arbitration process has been completed.

Although no further buyers have been reported to follow suit since the LNG buyer's declaration noted above, if more buyers did follow suit and start refusing deliveries or cancelling their purchases due to force majeure, LNG exporters could be forced to cut production, which would send shockwaves up the natural gas value chain.

Under English law, LNG buyers could seek to argue that the circumstances caused by the COVID-19 coronavirus constitute either (a) a force majeure event as set out in the underlying contract or (b) a frustrating event under English common law. As there is a very high bar to establish that a contract has been frustrated and the remedy available for frustration — termination of the LNG sale and purchase agreement (SPA) for the full remaining term — is much more extensive than we expect buyers (who have spent considerable time and funds negotiating long-term LNG SPAs for security of supply) would want, in this alert we will focus on issues relating to force majeure only.

## FORCE MAJEURE AND LNG SPAS

Force majeure refers to unexpected external circumstances that prevent a party to a contract from meeting their contractual obligations. Whether the delay and disruption resulting from the COVID-19 coronavirus is a force majeure event will depend on the particular wording of the LNG SPA. In English law, force majeure is a contractual term that arises solely on the basis of the express provisions which are included in the contract — it cannot be implied.

Although the specific language of each clause will vary from contract to contract, industry LNG SPAs tend to adopt a fairly consistent approach to force majeure, at least in respect of the items applicable in the face of an epidemic, and the associated government responses, that affect performance<sup>1</sup>. Based on such a typical force majeure clause, the affected party would usually have to show that:

a force majeure event has occurred which is beyond its reasonable control;

the force majeure event could not have been avoided or mitigated by the affected party taking reasonable steps; and

the force majeure event causes or results in the affected party being unable to perform, or being delayed in performing, any of its obligations under the LNG SPA.

Declaring force majeure is only the beginning of a process. When a buyer issues a force majeure notice citing the COVID-19 coronavirus as the cause, the buyer will bear the burden of proof to show that the current circumstances fall within the ambit of their contractual force majeure provisions.

Interestingly, the China Council for the Promotion of International Trade (CCPIT) recently announced that it would provide force majeure certificates to Chinese companies in an attempt to protect them from breach of contract claims as a result of the COVID-19 coronavirus outbreak. According to its website, businesses that have failed to perform on contracts on time or fail to fulfil any international trade contract can apply to the council for a certificate. We understand that most of the applicants for CCPIT certificates to date have been exporters rather than importers. Whilst CCPIT certificates may be distributed to domestic companies by the Chinese government, the mere existence of such a certificate does not of itself prove force majeure under English law, and the buyer would still need to establish that the current circumstances fall within the ambit of their contractual force majeure provision.

The choice of wording in the force majeure clause will affect its interpretation under English law. For example, use of the word "prevented" has been interpreted to reflect rendering delivery either physically or legally impossible, as opposed to the usage of words like "hindered" or "impeded", which were interpreted to only mean the interposing of obstacles that would be really difficult to overcome<sup>2</sup>. It is normally not enough to show that

performance has merely been made more difficult. For instance, although it may be more challenging for a Chinese buyer to secure unloading services at a terminal (for example, where quarantine or other containment measures result in a lack of manpower at the receiving terminal), strictly speaking, the buyer needs to show that it was actually *prevented* from taking the relevant cargo, unless a lower threshold has been agreed in the contract.

Further, the force majeure event set out in the contract must be the true cause of the buyer's inability to perform<sup>3</sup>. Thus, the inability of the buyer to perform must be caused by the COVID-19 coronavirus outbreak and not due to a lack of storage capacity at the receiving terminal or reduced downstream demand.

Finally, the party claiming force majeure relief must show that there are no alternative means for performing its obligations and that it has taken reasonable steps to mitigate or avoid the effects of the force majeure event.

## **APPLICATION TO THE COVID-19 CORONAVIRUS EPIDEMIC**

It is typical for force majeure clauses in LNG SPAs to contain a list of specific events which might constitute force majeure. Notwithstanding that an event is included in this list, it will still be necessary for the buyer to fulfil the abovementioned preconditions that the event is outside its reasonable control and that it was the actual cause of it being unable to take delivery of any applicable cargoes.

One of the specific events commonly listed in LNG SPA force majeure clauses is an "epidemic". Whether the level of "epidemic" has been reached is a question of fact, which may be supported by expert evidence. It is worth noting that as of 31 January 2020, World Health Organization (WHO) has classified the COVID-19 coronavirus outbreak as a Public Health Emergency of International Concern, the same declaration used for the H1N1, Zika, and Ebola epidemics.

It is also common for LNG SPA force majeure clauses to include relief for unforeseen "acts of government". As noted above, Chinese authorities have ordered lockdowns, extended public holiday periods, and closed factories in an effort to contain the spread of the virus. One consequence of these restrictions is a lack of manpower at Chinese discharge ports. Whilst the unloading of LNG may not seem like a labour intensive process, without the necessary personnel, the discharge is simply not possible. Such personnel would include a wide range of specialised labour, from onshore personnel operating the receiving facilities to maritime pilots who have to board LNG tankers and work with the crew at the vessel's bridge to help the vessel navigate port waters and berth safely. However, where these actions fall short of completely shutting down the receiving terminals or their ports, it may be more difficult for LNG buyers to substantiate force majeure claims under this head of relief. Though, should the Chinese authorities order key LNG-receiving terminals to be shut down or quarantined, such a force majeure claim may become more credible.

LNG suppliers should also consider whether any applicable exclusion clauses are included in their LNG SPAs. In this respect, it is not uncommon for LNG SPA force majeure clauses to exclude "changes in market conditions" or "changes in downstream demand" from the scope of force majeure protection. One of the reasons that Chinese buyers are delaying or diverting their contracted cargoes is that domestic demand (such as demand from Chinese industry and the power sector) has been much lower than usual, leading to insufficient ullage in receiving terminal storage tanks to receive the shipped LNG cargoes. In the face of an express clause excluding market-based claims, it would be difficult for a buyer to substantiate a force majeure claim on this basis alone.

If the buyer's claim for force majeure is substantiated, the result would usually be that delivery of LNG cargoes would be suspended, and the buyer would be released from any penalties that would otherwise arise as a result of its failure to take the contracted LNG cargo(es).

If the force majeure is prolonged, then provisions in mid-term or long-term LNG SPAs may allow one party (or either of them) to terminate the LNG SPA. For example, in circumstances where the force majeure event extends beyond a certain period (e.g., one year) and/or affects more than a specified volume (e.g., 50% of the annual contract quantity). As the COVID-19 coronavirus is still in its early days, it may be premature for parties to consider exercising termination rights (which would apply in respect of the whole contract rather than just individual cargoes) at this stage.

## NEXT STEPS

Whether Chinese LNG buyers have a valid claim under their English law LNG SPA will depend on a range of factors, including how extreme the circumstances of the COVID-19 coronavirus outbreak and associated governmental restrictions become in China, the reasons that those circumstances prevent the buyer from being able to take their contracted LNG cargoes, and the express terms of their LNG SPA force majeure clause. However, if city-wide quarantines are enforced in the relevant discharge ports, or if receiving terminals and/or ports are completely shut down, Chinese buyers may very well be able to bring credible force majeure claims against their LNG suppliers.

LNG suppliers with deliveries to China in the coming months should:

review their downstream LNG SPAs and ascertain how the force majeure might apply to the current circumstances in China;

review their upstream LNG SPAs (if any) and ascertain whether downstream force majeure circumstances might qualify as force majeure under their upstream LNG SPA;

if a force majeure declaration is received, request information and evidence from the LNG buyer about their grounds for claiming force majeure (including whether or not they are claiming it is a consequence of a downstream force majeure claim being declared against them) and consider whether any back-to-back force majeure notices need to be given under its upstream arrangements; and

make contingency plans (or review existing ones) in anticipation of receiving volume cancellation notices, including considering alternative destinations or buyers that could be approached to sell stranded volumes.

If you would like to find out more about how your LNG SPAs and offtake agreements with Chinese buyers could be impacted by this development, please contact our LNG lawyers, or visit our practice page on the web.

## Notes

[1] See, for example, clause 15 of the BP MSA (2019), clause 12 of the Trafigura MSA (2017), clause 13 of the AIPN MSA (2012).

[2] See, for example, *Tennants (Lancashire) Ltd v CS Wilson & Co Ltd* [1917] A.C. 495.

[3] See, for example, *Seadrill Ghana Operations Limited v Tullow Ghana Limited (Seadrill)* [2018] EWHC 1640 (Comm).

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