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CORONAVIRUS AND FORCE MAJEURE: ADDRESSING EPIDEMICS IN LNG AND OTHER COMMODITIES CONTRACTS

To Our Clients and Friends:

On 30 January 2020, the Director-General of the World Health Organization declared that the outbreak of novel coronavirus (2019-nCoV) met the criteria for a Public Health Emergency of International Concern (“**PHEIC**”).^[1] In order to qualify as a PHEIC, an event must: (i) be extraordinary; (ii) constitute a public health risk to other States through the international spread of disease; and (iii) potentially require a coordinated international response.^[2] Since the PHEIC regulations were enacted 15 years ago, a PHEIC has been declared only on five previous occasions: swine flu (2009); polio (2014); zika (2016); and ebola (2014 and 2019).^[3]

Coronavirus is taking a tremendous human toll and our thoughts go out to those affected. Recent reports also suggest that coronavirus is beginning to impact commercial operations as facilities are shut down or production is curtailed, workforces are sent home, and demand falls. In particular, recent press coverage suggests that this issue has arisen in the LNG market, with Chinese buyers citing the impact of coronavirus in connection with the failure to take delivery of LNG.^[4]

Coverage also suggests that there are concerns about a tightening of demand and the potential effect of coronavirus on the supply chain for other critical commodities such as coal and iron ore.^[5]

As the effects of coronavirus continue to impact the markets, contractual counterparties will look to the terms of their contracts where they are unable to perform. One possibility that has already been reported in the LNG markets (and is being discussed in the iron ore markets) is a declaration of force majeure.

This client alert examines common formulations used in force majeure provisions in LNG sale and purchase agreements (“**SPAs**”), considers the scope of force majeure clauses under English and New York law, and identifies points that clients should consider when negotiating and seeking to enforce force majeure clauses.

Force Majeure Clauses in LNG Sale and Purchase Agreements

The concept of a communicable disease crisis (we address the distinction between “epidemics” and “pandemics” below) is sometimes included in force majeure clauses in LNG SPAs and has been seen in contracts for delivery into various global markets, including Europe and Asia. Where included, however, it is typically still set out as part of a non-exhaustive list of events which may constitute force majeure provided that the general requirements for force majeure are also met. These usually require performance to have been prevented, hindered (or impaired), or delayed due to an event not within the reasonable control of the party seeking to claim force majeure, acting as a reasonable and prudent operator. They

may also require that the event be unforeseen and that the claiming party has endeavoured to overcome or to mitigate the force majeure event, using reasonable diligence. In addition, some LNG SPAs require the event to have affected the relevant facilities in a specific way, such that the facilities are damaged or not capable of being operated due to the relevant event, in order for force majeure to be available as a remedy. Finally, since a force majeure clause is typically drafted as a general test with (more often than not) a non-exhaustive list of examples, the LNG SPA will contain a long list of excluded events (such as financial hardship, lack of demand or economic downturns). These types of qualifiers and exclusions mean that the occurrence of an epidemic, on its own, may not trigger force majeure relief.

References to “quarantine restrictions” are also sometimes included in non-exhaustive lists of force majeure events. Whilst we expect such clauses were likely intended to cover the quarantine of vessels, it remains to be seen whether this may also be relied upon where a party is unable to operate a facility due to quarantine restrictions affecting its workforce.

Under LNG SPAs there may also be limitations on the period or the quantities of LNG in respect of which an affected facility can continue to claim force majeure relief where the contract contains optionality as to delivery locations.

There is considerable divergence among LNG SPAs on the treatment of volumes which have been excused for force majeure. Some LNG SPAs require volumes to be taken at a later date (or require a buyer to use reasonable endeavours to take volumes at a later date) in order to restore the overall quantity delivered to the contracted quantity. Typically, these restoration quantities would be taken at the market price at the time of actual delivery, which may be either higher or lower than the time of the force majeure event. Naturally, this can create winners and losers depending on market fluctuations and may lead to assertions of arbitrage against the party claiming force majeure. Capacity and scheduling issues will also need to be addressed.

Other LNG SPAs simply remove the volume from the contract quantity, leaving the seller with additional volumes to market. Whilst this may be attractive for both sellers and buyers during periods where prices are high and cargoes can be diverted, it is likely to be less attractive in the current environment of oversupply and low prices.

Extended force majeure must also be considered in the context of an ongoing health crisis. Termination for extended force majeure appears as a remedy in many LNG SPAs (although where the LNG SPA underpins the financing of a liquefaction facility, financiers may have pushed back on this provision). The inclusion of a termination right may actually prevent a seller from triggering a force majeure claim if the continuation of the contract is more valuable to it where it is fixed with high prices (notwithstanding the possible force majeure event).

However, neither the presence of remedies nor the inclusion of a reference to epidemic or quarantine, of itself, guarantees relief. Instead, these provisions must be read and interpreted with the rest of the force majeure clause and the remainder of the contract. We consider this further below.

The Position Under English Law

“Force majeure” is not a term of art under English law. Accordingly, a force majeure clause in a commercial contract will be construed in each case on its own terms.[6] As the English Court of Appeal explained recently:

“[T]he question is one of construction ... and the answer to that question is determined by the language of the clause which the parties have chosen, having regard to the context and purpose of the clause.”[7]

The usual rules of contractual interpretation under English law apply to the interpretation of force majeure clauses. The court must ascertain the objective meaning of the language which the parties have chosen to express their agreement, and consider not only the wording of the particular force majeure clause but must also consider the contract as a whole and, depending on the nature, formality and quality of drafting of the contract, give more or less weight to elements of the wider context in reaching its view as to that objective meaning.[8] Market practice may also be relevant to the exercise of interpretation, provided that it is clearly evidenced.[9] In practice, however, market practice may be difficult to prove and a recent English case has confirmed that evidence of market practice after a contract is concluded will not result in terms being implied into a contract.[10]

Force majeure clauses typically cover events that “*prevent*” a party from performing its contractual obligations or that “*hinder*” or “*delay*” performance. Therefore, when invoking force majeure clauses in response to events that prevent performance, it is usually necessary to establish that performance has become legally or physically impossible. Mere difficulty or unprofitability generally will not suffice.[11] By contrast, clauses that refer to a party being hindered or delayed have been construed more widely, although a change in economic circumstances or a market downturn affecting profitability or the ease with which obligations can be performed is still unlikely to qualify as a force majeure event in the eyes of the law,[12] and, as noted above, is commonly expressly carved out of force majeure relief in a well-drafted contract to avoid misuse of the clause. In either case, causation is key. In a recent case, the English High Court held that where there are multiple potential causes, some falling within a force majeure clause and some without, the force majeure must be the sole cause of the failure to perform the obligation.[13]

The Position Under New York Law

New York law on the interpretation of force majeure clauses generally aligns with English law. As with all contractual disputes, the terms of the agreement and the intent of the parties control a court’s analysis. Force majeure clauses will only limit damages where circumstances beyond the parties’ control have frustrated the parties’ “*reasonable expectation[s]*.”[14] Force majeure clauses are construed narrowly, and “*the general words are not to be given expansive meaning; they are confined to things of the same kind or nature as the particular matters mentioned.*”[15] Moreover, some courts have held that the event must not only be included in the force majeure clause; it “*must be unforeseeable as well,*” although others have refused to impose an unforeseeability requirement where one cannot be found in the parties’ agreement.[16]

Notwithstanding these principles, New York courts will take account of well-established business practices in order to determine the parties' intent, particularly in highly technical industries such as oil and gas. In a recent decision on questions certified by the Second Circuit Court of Appeals, the New York Court of Appeals confirmed that, consistent with the practices of other "oil jurisdictions" such as Texas and California, force majeure clauses "*must be construed with reference to both the intention of the parties and the known practices within the industry.*"^[17]

Accordingly, the terms of the relevant contract are the starting point in any analysis of a force majeure event. But industry custom is important too, particularly in contracts relating to well-developed, technical industries such as oil and gas, where the parties' intent may be gleaned from established practices. In all cases, however, force majeure clauses are construed narrowly and their terms will not be expanded beyond events of the same kind or nature as those listed in the parties' agreement.

Drafting Tips

In light of the increased risk of global health crises, it is likely that this issue will continue to be widely and explicitly addressed in force majeure clauses within commodities contracts. As contractual language is the predominant factor in interpreting force majeure clauses, contracting parties should carefully consider how they draft such provisions to allocate risk appropriately.

Notwithstanding the increased frequency of disease outbreaks, absent express contractual protection, courts are likely to continue to construe force majeure clauses narrowly. We pause to note that parties should be mindful of the distinction between epidemics, which are local or regional, and pandemics, which are epidemics with global reach. When drafting force majeure clauses, the parties should consider the point at which the outbreak of a communicable disease would sufficiently impact their business relationship so as to trigger a force majeure clause.

When drafting force majeure clauses to account for disease outbreaks, the following complicating factors should be considered: (i) the difficulty of distinction between natural and political events; (ii) whether the event has a direct or indirect effect on performance, and the extent to which it affects performance; (iii) inability to perform versus desire to escape performance due to unprofitability; (iv) the types of mitigating actions that an affected party should undertake and (v) the possibility of an extended force majeure event. ***First***, force majeure clauses often distinguish between natural and political events.^[18] Although of natural origin, the economic impact of an epidemic will flow in large part from governmentally imposed quarantines and travel restrictions. To avoid claims that a natural event force majeure clause has not been triggered because the prevention or hindering of performance is the result of government intervention, contracts should be clear on any distinction between natural and political events, or make express provision for government-imposed measures responding to the outbreak of infectious disease. ***Second***, parties should consider the real extent to which performance needs to be prevented by the event claimed as force majeure or the extent to which there could be a combination of events that prevent performance. Where a facility is unable to operate due to workforce unavailability, consider the extent to which it must be shown that this is a result of the force majeure event. ***Third***, force majeure clauses typically contain language on the exercise of reasonable diligence or efforts to overcome an event. Rather than rely on case law to interpret what these measures might or might not involve,

specific examples could be included. ***Fourth***, as stated, a typical force majeure clause will usually only offer protection where performance is genuinely hindered, prevented or delayed. Where an event leads to reduced demand (and potentially reduced prices in a spot market), the stakes can be raised for a variable-price seller or a fixed-price buyer. Force majeure clauses should be crafted carefully or such risks should be otherwise addressed. ***Fifth***, epidemics pose a relatively high risk of creating an extended force majeure event. Contracting parties should consider whether termination rights should be included, and whether to set a minimum duration for a force majeure event before a party may elect to enforce any termination rights.

[1] World Health Organization, *Statement on the second meeting of the International Health Regulations (2005) Emergency Committee regarding the outbreak of novel coronavirus (2019-nCoV)* (Jan. 30, 2020), available at [https://www.who.int/news-room/detail/30-01-2020-statement-on-the-second-meeting-of-the-international-health-regulations-\(2005\)-emergency-committee-regarding-the-outbreak-of-novel-coronavirus-\(2019-ncov\)](https://www.who.int/news-room/detail/30-01-2020-statement-on-the-second-meeting-of-the-international-health-regulations-(2005)-emergency-committee-regarding-the-outbreak-of-novel-coronavirus-(2019-ncov)).

[2] See International Health Regulations, art. 1(1) (2005).

[3] See James Gallagher, *Coronavirus declared global health emergency by WHO*, BBC News (Jan. 31, 2020), available at <https://www.bbc.co.uk/news/world-51318246>.

[4] See Stephen Stapczynski, *China LNG Force Majeure Rejected as Virus Chaos Sparks Dispute*, Bloomberg News (Feb. 7, 2020), available at <https://www.bloomberg.com/news/articles/2020-02-07/china-lng-force-majeure-rejected-as-virus-chaos-sparks-dispute>; Alaric Nightingale & Alex Longley, *When God Appears in Contracts, That's 'Force Majeure'*, Bloomberg News (Feb. 6, 2020), available at <https://www.bloomberg.com/news/articles/2020-02-06/when-god-appears-in-contracts-that-s-force-majeure-quicktake>.

[5] See Deepali Sharma, *Coronavirus impact on iron ore market*, American Metal Market (Feb. 6, 2020), available at <https://www.amm.com/Article/3917527/Coronavirus-impact-on-iron-ore-market.html>; Frick Els, *Coronavirus drops iron ore shipping gauge 99.9%*, Mining.com (Jan 31, 2020), available at <https://www.mining.com/coronavirus-drops-iron-ore-shipping-gauge-99-9/>; Jun Kai Heng, Niki Wang, & Yuchen Huo, *Iron ore outlook bearish as steel demand seen weak on coronavirus*, S&P Global (Feb. 5, 2020), available at <https://www.spglobal.com/platts/en/market-insights/latest-news/metals/020520-iron-ore-outlook-bearish-as-steel-demand-seen-weak-on-coronavirus>.

[6] The English courts will not imply a force majeure clause or, where there is such a clause, imply particular events within it. However, in the absence of an express contractual provision catering for the consequences of the event that has occurred, it may still be possible for a party facing impossibility of performance to rely on the common law doctrine of frustration. The operation of the doctrine of frustration requires an unforeseen, supervening event which renders it physically or commercially impossible for a party to fulfil a contract or transforms the obligation to perform into a radically different obligation from that undertaken at the moment of entry into the contract and operates to bring

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a contract to an end “forthwith, without more and automatically.” See *Chitty on Contracts* (33rd ed.), §§ 23-001, 23-007; *J. Lauritzen AS v Wijsmuller BV (The Super Servant Two)* [1990] 1 Lloyd’s Rep 1, 8.

[7] *Classic Maritime Inc v Limbungan Makmur Sdn Bhd and another* [2019] EWCA Civ 1102 at [32].

[8] *Wood v Capita Insurance Services Limited* [2017] UKSC 24 at [10].

[9] *Crema v Cenkos Securities Plc* [2010] EWCA Civ 1444.

[10] *TAQA Bratani Ltd & Others v RockRose UKCS8 LLC* [2020] EWHC 58 (Comm).

[11] *Chitty on Contracts* (33rd ed.), § 15-156.

[12] *Chitty on Contracts* (33rd ed.), §§ 15-158 to 15-160; *Tandrin Aviation Holdings Limited v Aero Toy Store LLC and another* [2010] EWHC 40 (Comm) at [40].

[13] *Seadrill Ghana Operations Ltd v Tullow Ghana Ltd* [2018] EWHC 1640 (Comm).

[14] See *Constellation Energy Servs. of New York, Inc. v. New Water St. Corp.*, 146 A.D.3d 557, 558, (1st Dep’t 2017) (internal citation omitted) (emphasis added).

[15] *Kel Kim Corp. v. Cent. Markets, Inc.*, 519 N.E.2d 295, 297 (N.Y. 1987) (citing 18 Williston, Contracts § 1968 (3d ed. 1978)).

[16] See *Phibro Energy, Inc. v. Empresa De Polimeros De Sines Sarl*, 720 F. Supp. 312, 318 n.8 (S.D.N.Y. 1989) (citing *United States v. Brooks-Callaway Co.*, 318 U.S. 120, 122–23 (1943)); see also *Goldstein v. Orensanz Events LLC*, 146 A.D.3d 492, 493 (1st Dep’t 2017) (“[T]he clause must be interpreted as if it included an express requirement of unforeseeability or lack of control.”).

[17] *Beardslee v. Inflection Energy. LLC*, 31 N.E.3d 80, 84 (N.Y. 2015).

[18] See, e.g., World Bank, *Force Majeure Clauses – Checklist and Sample Wording 8–9*, available at <http://siteresources.worldbank.org/INTINFANDLAW/Resources/Forcemajeurechecklist.pdf> (last visited Feb. 11, 2020).



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