

COVID-19 and its potential impact on LNG trading: force majeure

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8 May 2020



Background

In recent years, driven by the impact of macroeconomic environment and environmental protection policies, China has gradually become one of the major natural gas importers. However, the exploration, development, production, transportation and other processes of natural gas can be greatly affected by natural factors such as lightning, earthquake and flood and social factors such as large-scale epidemic, government intervention and even changes in the international social, political and economic environment. At the beginning of 2020, the sudden outbreak of the Coronavirus Disease 2019 (COVID-19) has sounded the alarm, reminding Chinese energy enterprises to pay attention to the adverse effects of various potential factors on contract performance. It is of great significance to incorporate force majeure clauses in an international sale and purchase contract of liquefied natural gas (LNG) to effectively prevent, control and resolve market risks.

Taking this COVID-19 epidemic as an example, to determine whether this COVID-19 epidemic falls within the definition of “force majeure”, first of all, it should be based on the force majeure clause in the contract. Secondly, if there is no force majeure clause in the contract or the force majeure clause does not cover this COVID-19 epidemic, it should be judged according to the applicable law stipulated in the contract or the law of the country most closely related to the contract (the determining factors include the place where the contract is concluded, the place where the contract is performed, the place where the freight is paid, the country of the settlement currency, the language of the contract, etc.).

In practice, the laws of common law countries are often used as the basis for the determination of the rights and obligations of parties to the contract. On one hand, common law plays a leading role in international commercial activities. On the other hand, the seller's country is more likely to be responsible for preparing the goods and transporting the goods to the ship when determining the closest principle of the contract, especially in an international LNG sale and purchase contract involving CIF or FOB. Based on the normal practice of China's LNG import, a large number of energy enterprises connect with the seller at common law countries, such as Australia, Malaysia, the United States, etc.

Meanwhile, it is also very important to understand the provisions of the law of the People's Republic of China (China Law) on force majeure in order to determine whether the COVID-19 could be a force majeure event.

China Law

Under China law, several laws and regulations have made relevant and specific provisions on force majeure, including Contract Law of the People's Republic of China (China Contract Law), General Rules of the Civil Law of the People's Republic of China (China General Rules of Civil Law) and other laws and regulations.

Force majeure is defined under Article 117 of China Contract Law as “the objective circumstances that are unforeseeable, unavoidable and insurmountable.” For a defaulting party who cannot fulfil its contractual obligations due to the force majeure event, Article 117 of China Contract Law regulates that the liabilities shall be exempted in part or in whole in light of the effects of the force majeure, except as otherwise provided by law. Therefore, regardless of whether the contract includes an express force majeure provision, an event amounting to force majeure could exempt a party from its legal liability. However, force majeure is not necessarily the only cause of failure to perform the contractual obligations. In some cases, the court will consider the influence proportion of the non-force majeure factors on the consequences of the event to determine the liability for compensation. In this case, the force majeure can only partially exempt the party affected by the force majeure from the liability for breach of contract.

To further assist Chinese local companies in handling contractual disputes arising out of the COVID-19 outbreak, on 30 January 2020, the China Council for the Promotion of International Trade (the CCPIT) released a statement confirming that the CCPIT is empowered and offers to issue force majeure certificates to companies based in China who are unable to fulfil their international contractual obligations due to the COVID-19 outbreak. Besides, on 10 February 2020, Zang Tiwei, spokesman of the Standing Committee of the National People's Congress and director of the research office, stated that for the parties who are unable to perform the contract as a result of the COVID-19, it is unforeseeable, unavoidable and insurmountable force majeure.

Nevertheless, it is still unclear how such certificates will fit within the contractual force majeure regime that the parties have agreed. It is also very important to consider the causation between the force majeure event and the potential results. According to the judicial practice of China, the applicable relationship between the contractual force majeure clause and the force majeure clause as stipulated by the law is as follows - the force majeure clause stipulated in the contract shall not affect the direct reference to the legal provisions. If the scope stipulated in the force majeure clause in the contract is less than the statutory scope, the parties may still invoke the statutory legal provisions to claim the exemption. If it is greater than the statutory scope, the excess part shall be deemed as the agreement between the parties to establish another exemption clause. Therefore, setting force majeure clauses in the contract can maximize the freedom of will of both parties to the contract, so as to meet the needs of exemption of the party affected by force majeure in specific circumstances.

Common Law¹

Generally, there is no legal exemption for force majeure under the common law. Both parties of the contract can agree on what is the force majeure event and the corresponding consequences in the contract. If an extreme event is beyond the scope of the force majeure event stipulated in the contract, or the contract does not make any agreement on the force majeure, the party who is prevented from performing its obligations will not be able to invoke the agreed force majeure exemption. For example, under Hong Kong law, force majeure will only apply if there is an express force majeure clause in the contract. Nevertheless, the common law doctrine of frustration may provide parties with relief to certain extent in the absence of a specific express contract provision.

As abovementioned, unlike China Law, the common law jurisdictions (including but not limited to Hong Kong, the United Kingdom, Singapore and other countries/ regions) do not have the implied application of the principle of force majeure. Furthermore, the application and handling of force majeure cases are entirely dependent on the contract.

First, the parties who claim to delay or exempt themselves from performing their obligations because of COVID-19 need to consider whether the contract includes force majeure clauses. If so, whether COVID-19 is a force majeure event will depend to a considerable extent on the construction and interpretation of the relevant provisions of the contract. For example, force majeure clauses in some LNG sale and purchase contracts specifically include such expressions as "outbreak of disease", "epidemic", "civil emergency" or other similar expressions. Without such expressions, the party may consider whether it includes general expressions of "Acts of God", "Acts of Government", or "other than the situation of the parties' control" and consider that the COVID-19 epidemic is related to such general expressions.

¹ The application of law between countries/regions in the common law system will also be different. The author only discusses it from a general point of view, but not specifically for a certain country/ region.

It is important that, generally, the parties who wish to invoke the force majeure clause under the common law shall prove that the force majeure event is the key reason for the failure of performance of the contract. That is to say, if it can be proved that other factors hinder or delay the performance of the contract (such as the delayed performance from the party whose performance is hindered, or the external force from the third party, etc.), the non-performing party may not be able to exempt or delay the performance according to the force majeure clause. It is worth noting that this is different from the application of legal force majeure under China Law. China Law excludes the legal force majeure from the scope of exemption. The common law is stricter in this perspective.

Issues worth taking into consideration

As LNG contracts are usually heavily negotiated and amended, there is a great variance in contractual provisions. Parties seeking to rely on or may be affected by the force majeure provision should carefully consider the wording of the clauses to determine what actions to take in response to any disruptions as a result of the COVID-19. For long-term LNG sale and purchase agreements, where annual contract quantity commitment can be postponed to later in the year, affected parties may still have to perform its contractual obligations albeit at a later point in the contract year.

Accordingly, description of force majeure provisions should be specific, clear and unambiguous, and be listed as far as possible according to previous industry experience. Especially in the LNG international purchase and sale contract using CIF or FOB trade terms, if the force majeure clause does not include the force majeure event that may occur at the receiving port, then when the force majeure event occurs at the receiving port, it will be difficult for the buyer to claim the existence of force majeure against the seller. In addition to the losses caused by the above events, the buyer would still need to perform its obligations under the contract.

In addition, the receiving port should be defined specifically. Take the COVID-19 epidemic as an example. If the terms do not clearly stipulate the scope of the receiving port in China, the buyer may not claim the existence of force majeure even if one or several (but not all) ports in China are closed due to the COVID-19 epidemic.

In addition, due to the chain characteristics of the natural gas industry, in order to achieve the safe transmission of the risk of force majeure, when determining the terms of force majeure, it is necessary to consider the situations where force majeure events occur in upstream and downstream that may affect the performance of the obligations of the LNG contract, such as whether the loss of downstream resources and facilities, serious accident damage or inability to operate should be force majeure.

It is also important to specify the form, submission method and time limit of the documents to be submitted by the party affected by the force majeure, and clearly stipulate the consequences of the force majeure, which is conducive to the adjustment of the rights and obligations of both parties after the occurrence of the force majeure event.

In the process of LNG contract negotiation and signing, sometimes it is hard to predict the potential risks of the contract. Parties should therefore pay extra attention to terms related to the force majeure in the contract, so as to systematically reduce the adverse consequences that the contract party may bear. The applicable legal situation of international trade and cooperation contracts especially in LNG area involving multiple jurisdictions is usually complex and consulting legal experts on such specific situations when dealing with legal issues is always important and crucial for major energy enterprises.

The author would like to thank Zoe Guan, Dannie Liang and Mary Li for their contributions to this article.

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