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Contractual Arbitrage in Today's Gas and LNG Markets

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While long-term gas and liquefied natural gas (LNG) contracts are customarily structured around risk allocation dynamics, substantive and/or temporal constraints in the contractual terms can often limit a party's ability to introduce meaningful change or secure relief in varying market environments.

The ongoing and escalating gas market events in 2022 have shined a spotlight on this point, raising questions about the efficacy of traditional long-term gas and LNG sale and purchase agreements (SPAs) in dealing with such extreme price and demand volatility. The impact of significant spot market price fluctuations has also prompted an evolving course of conduct by seller counterparties in the operation of these contracts, provoking increasing incidents of contractual arbitrage, missed cargo shipments, and partial loadings. This has naturally impacted the reliability and certainty of supply for buyers in a market where alternative supply is tight and short-term spot purchases are often considerably more expensive than the price paid under long-term contracts.

For buyers, their downstream customers, and their shareholders, a seller's calculated economic decision to breach its delivery obligations under the SPA can undermine the contractual bargain that was struck between the parties at the time of entering the contract. While the specific wording and governing law of a particular contract are the principal features of any legal analysis, one can draw on some common themes across long-term gas supply agreements. For example, SPAs typically contain clear and detailed provisions regarding the sale and purchase of gas and LNG, including that parties are to agree upon an annual programme of deliveries from seller to buyer. They also typically provide for what is to happen if the seller is unable to supply a particular quantity or load a particular cargo of LNG on schedule, and what steps parties must take in such circumstances. It is here that the current market is witnessing a spike in arbitrage cases and a rise in disputes.

Likewise, in long-term pipeline gas contracts, there are also defined delivery obligations, often expressed as daily, monthly, seasonal and annual quantities that will be delivered by a seller and taken by a buyer (or, if not taken, then paid for). Where a seller fails to make available the quantities it is obliged to deliver, contractual penalties will often apply in the form of price discounts.

A penalty regime may be sensible for smaller missed quantities, but, where large quantities remain undelivered over an extended period, this raises questions – subject to the contractual provisions and the governing law – about whether such events are truly contemplated by a contract and how to address them.

Liquidated Damages?

Sellers are reportedly seeking to arbitrage the current market conditions. Publicly available information records instances of sellers declaring volumes and cargoes unavailable and then purporting to invoke limitation of liability provisions in their SPAs, claiming that the penalty for failing to deliver is simply to pay an amount of damages that equates to a percentage amount of that cargo's contractual value.[1]

Missed cargoes are often described as "crimes of opportunity", since spot cargoes are, at their heart, opportunity driven.[2] This is especially true in the current LNG market, where sale opportunities into Europe – where supply has been significantly contracted since at least mid-June 2022 – are plentiful, and at a time when spot prices remain artificially high. It follows that, in today's market price environment, a seller may be engaging in an internal calculus of whether:

i. To deliver and receive the contract price as consideration

ii. Not to deliver and instead reschedule the cargo to a later date, but, in so doing, free up quantities for short-term market sales

iii. Not to deliver at all and pay a financial sum in the form of liquidated damages, to compensate the buyer for the failure to make available the relevant quantity

Of particular interest for this piece is option iii. In circumstances where a seller has failed to perform its primary obligation under the SPA (i.e. the delivery of gas), various questions may arise: for instance, will the seller seek to invoke a liquidated damages provision providing for a penalty payment for the non-delivery, based on a percentage of the value of the missed delivery or some other capped amount? If such a provision exists, are there any qualifications to its application? If such a provision applies, is it expressed as an exclusive remedy for the buyer? Are there any exceptions identified in the contract pursuant to the applicable governing law? Finally, if it can be shown that the failure to deliver was the result of a calculated, strategic, commercial decision by the seller, could that be described as wilful default or misconduct under the SPA?

1 See, for example, https://www.reuters.com/business/energy/gazprom-singapore-misses-lng-deliveries-indian-customer-sources-2022-07-19/

2 See, for example, https://www.squirepattonboggs.com/-/media/files/insights/publications/2022/01/are-traditional-asian-lng-contracts-equipped-to-deal-with-extreme-price-and-demand-volatility/are-traditional-asian-lng-contracts-equipped-to-deal-with-extreme-price-and-demand-volatility.pdf

As these authors noted in a recent piece, with spot prices remaining high, paying a percentage penalty for non-delivery can be a relatively minor price for a seller to pay, compared with the windfall profits available on the spot market.[3]

While sellers' commercial/financial objectives are obvious in the current climate, buyers are in many cases simply seeking to apply the terms of their SPAs as agreed. These may, subject to the contractual wording and governing law, prevent sellers from relying on a limitation of liability provision in the event that they breach their delivery obligations in order to obtain better sales prices elsewhere, or for other commercial reasons. Of course, sellers or buyers may on occasion have a contractual right to choose between performing contractual obligations and invoking a limitation of liability provision.

Fo long-term buyers, this has provoked significant difficulties in managing and optimising their supply portfolios, fulfilling downstream contractual obligations, and potentially replacing missed deliveries in an effort to mitigate their losses. However, serious problems arise as a result of the stark difference between prices under long-term contracts prices and today's spot market prices. In response to these shortfall events, buyers would be well advised to consider the available legal protections offered by reference to the specific language of the liquidated damages clause, the wider contractual context, and the objective purpose of the clause in order to assist as a possible point of leverage in the discussions or dispute that may follow.

In undertaking an analysis, buyers may seek to evaluate the extent to which there are any qualifications or criteria to be satisfied under the terms of the liquidated damages provision. For example, is the shortfall event qualified by "availability" of the quantity? If so, a factual enquiry into the available production or shipping arrangements may be required to determine the availability or otherwise of the missed delivery.

Another consideration might be whether or not the clause applies to situations covered by the *force majeure* provisions. That is, does a liability limitation or related remedy provision make any contractual link to the *force majeure* provision? If so, the *force majeure* provision may provide for other remedies if the seller's ability to perform has been prevented, hindered, delayed, or impeded. Alternatively, does the clause envisage the remedy of performance before contemplating liability? In other words, is there an obligation to seek to reschedule the particular cargo or quantity before the penalty payment is properly engaged? Further, is any obligation to reschedule subject to any legal qualification, such as using "reasonable endeavours" or "consent to reschedule not to be unreasonably withheld"? This analysis will need to be carried out on a case-by-case basis, by reference to a variety of factors,[4] but may represent a good starting point for the affected buyer in the consideration of its commercial and legal options.

Could Wilful Misconduct/Default Be Alleged?

While often a creature of contract,[5] the concept of wilful misconduct has also been considered by the English and New York courts, as well as courts in prominent civil law jurisdictions.

While 2022 has witnessed a sharp increase in the number of market examples, contractual arbitrage is by no means a new phenomenon in the gas and LNG industry. For some time, parties have sought to find contractual room to manoeuvre, in an effort to secure windfall profits to bolster their economic position. This is best described by a leading text on gas and LNG sales and transportation agreements, which states that "…the most likely circumstance where wilful misconduct might be alleged in the context of the seller's shortfall would be where the seller has made a deliberate decision to shortfall the buyer in order to sell gas to a third party on more advantageous terms, and to take whatever shortfall liability the sales contract specifies as the inevitable consequence of doing so."[6] This is unsurprising in markets where long-term contract prices are often fully or partially indexed to commodity pricing other than spot gas pricing in the destination market.

In all cases, the relevant contractual language must be the starting point for any enquiry into what a seller may or may not be able to do, and what – if any – remedy will be available. Different liability provisions contain different language regarding exceptions to liability caps or limitation. A provision that excludes acts of wilful misconduct from liability limitation – or qualifies in some way what constitutes a default under the contract – may (in prescribed circumstances) be effective in seeking to deprive the seller of the economic advantage created by the liquidated damages provision when the seller deliberately, knowingly or recklessly shortfalls deliveries to the buyer. This may particularly be the case where wilful misconduct is a defined term in the contract, or where the contract ascribes meaning to it as a concept independent of – or in addition to – the underlying governing law.

Buyers should, therefore, carefully examine the terms of:

i. Any wilful misconduct/default definition

ii. Any wilful misconduct/default provision

iii. The relationship between any such definition or provision and any remedy, limitation of liability, and liquidated damages provisions

Some SPAs may provide more detailed wording in this respect than others. For example, some clauses may identify a link between the seller's decision not to supply/deliver a particular quantity with an economic comparison of the contract price under the SPA with other prices in the market, or may make a more general reference to other commercial motivations for failure to deliver.

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3 *Global Arbitration Review*, 27 July 2022, published thereafter at https://www.squirepattonboggs.com/-/media/files/insights/publications/2022/07/force-majeure-issues-in-todays-european-gas-market/force-majeure-issues-in-todays-european-gas-market.pdf

4 Including, for example, the specific wording of the SPA and the governing law of the contract.

5 Whereby the parties expressly define wilful misconduct in scope and application.

6 Roberts, P. *Gas and LNG Sales and Transportation Agreements, Principles and Practice*, 5. ed., ¶15-014.

Some contracts may go further and expressly provide that a seller's decision not to deliver must be made by the seller's senior management.

If the SPA in question is silent on these issues, parties may need to consult the position under the applicable governing law.

Under English law, there is no general rule to prevent exclusion or limitation of liability in case of gross negligence or wilful misconduct. However, in order to limit liability for deliberate (or wilful) breaches of duty, the parties would need to stipulate such limitation in "clear words".[7] The relevant authorities further explain that, for a party to be guilty of wilful misconduct, it must know that it is committing – and intends to commit – a breach, or be reckless in the sense of not caring whether its act or omission is or is not a breach.8

Under New York law, a limitation on liability provision will be set aside "when the conduct at issue involves gross negligence or willful misconduct".[9] However, New York law sets a high bar for what actions constitute wilful misconduct.10 Under New York law, a breach of contract that is "motivated exclusively by [a party's] own economic self-interest" is insufficient to constitute wilful misconduct.11

In many civil law systems, including Germany,[12] France[13] and Switzerland,[14] parties cannot contractually agree to exclude or limit liability for loss or damage that was caused intentionally or by gross negligence – such exclusion or limitation of liability would be unlawful and, therefore, void.

Civil law systems generally distinguish between different levels of negligence, including ordinary negligence (*culpa levis*) and gross negligence (*culpa lata*), where these terms are used to describe the level of responsibility of the party that caused loss or damage, rather than the type of conduct. While the term "wilful misconduct" does not usually feature in civil codes, it refers to the type of conduct that embodies an element of will or intention. Therefore, in civil law systems, the equivalent of liability for wilful misconduct would be closer to liability for intent (*dolus*) than liability for gross negligence.

A good understanding of these issues is critical for any buyer seeking to evaluate whether a provision can function to deprive the sellers of the economic advantage of selling at elevated spot prices, by requiring them to pay normal damages for losses, that is, an amount of damages over and above any liquidated damages-capped amount. The authors of this piece are involved in advising on a number of these issues at the present time in the European, U.S., and Asian markets. If you have any questions regarding the subject matter of this bulletin, please contact the authors.

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7 *Photo Production Ltd. Respondents v. Securicor Transport Ltd. Appellants*, [1980] 2 W.L.R. 283 (House of Lords); *Gilbert Ash (Northern) Ltd v. Modern Engineering (Bristol) Ltd* [1974] AC 689 (House of Lords).

8 See for example *National Semiconductors (UK) Ltd v UPS Ltd* [1996] 2 Lloyd's Law Rep 212.

9 *Morgan Stanley & Co. v. Peak Ridge Master SPC Ltd.*, 930 F. Supp. 2d 532, 544 (emphasis added); see also *Kalisch-Jarcho, Inc. v. City of N.Y.*, 58 N.Y.2d 377, 384 (1983); *Gross v. Sweet*, 49 N.Y.2d 102, 106 (1979).

10 New York courts may also refer to such actions as "wilful acts" depending on which terms are used in the relevant contractual provisions. See *Metropolitan Life Ins. Co. v. Noble Lowndes Int'l, Inc.*, 84 N.Y.2d 430, 434-435.

11 *Metropolitan Life*, 84 N.Y.2d at 438-9; see also *Fabrique Innovations, Inc. v. Fed. Ins. Co.*, 354 F. Supp. 3d 340, 352 (S.D.N.Y. 2019) (noting that the wilful misconduct exclusion does not apply where there is no evidence that a party was motivated by anything other than economic self-interest).

12 Under *German Civil Code*, Section 276(3), parties cannot exclude liability for intent. In standard term contracts, liability cannot be excluded in cases of gross negligence. *German Civil Code*, Section 309(7)(b).

13 *French Civil Code*, Article 1231-1.

14 *Swiss Code of Obligations*, Article 100(1).

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