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Long-term LNG agreements and short-term volatility: buyers beware?

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Jeremy Richmond KC and William Mitchell of Quadrant Chambers consider how arbitrations may play out where sellers deliberately fail to supply liquefied natural gas under long-term agreements so they can sell into the spot market at a profit.

Even the most pessimistic buyer would have struggled to predict the price shock to commodity markets following the war in Ukraine. What if unforeseen market movement under a long-term sale and purchase agreement (SPA) creates an arbitrage opportunity for a party if it is willing to breach the agreement? Does the innocent buyer have adequate protection? Could it recover from the contract-breaking seller? Long-term SPAs commonly contain arbitration clauses. As such, these are all issues with which arbitral tribunals (and those who advise parties to arbitrations) commonly have to grapple in this market sector.

The first part of this article considers how standard contract clauses relating to pricing, damages and remedies may respond in such a scenario; and whether such conduct is likely to amount to a breach which could escape the scope of typical liquidated damages clauses. The second part of the article considers whether conduct by the contract breaker could also give rise to non-contractual causes of action for the innocent buyer against a contract-breaking seller in such circumstances – particularly in light of the developing jurisprudence on economic duress in English law.

Price reopeners

Where a price spike gives rise to an arbitrage possibility (where LNG is diverted from one market to another that offers a better return), a seller may be less likely to consider breaching the contract if it can revise the price via a price reopener clause. A reopener clause will usually identify a trigger, set out a procedure for adjustment negotiation and dispute resolution, and provide criteria for the pricing revision.

The trigger might be an objective benchmark, for example if the reference price moves more than a certain percentage. Often, a vaguer benchmark is preferred by the parties so that unforeseen circumstances are more likely to be caught, notwithstanding the increased likelihood of disputes.

For that reason, triggers are frequently pinned to whether market conditions have “substantially changed as compared to what it reasonably expected”, or if the buyer cannot maintain a “reasonable marketing margin”. Sometimes it is additionally required that the change has created hardship for one of the parties – in which case it is unlikely to be available to the seller in the situation considered here.

What will be a substantial change? In the well-known *Gas Natural v Atlantic LNG* arbitration, the tribunal concluded that "change" in the price reopener meant a meaningful departure from a parallel movement between the price formula and the market value of natural gas. This was the type of change the price reopener was intended to address. "Substantial" meant a change which was material, had occurred consistently over a meaningful period, and was reasonably expected to persist. These factors have continued to be popular with tribunals.

Accordingly, where a price spike occurs but it is still pinned in the same way to the underlying index used in the pricing formula, sellers are unlikely to be able to benefit from the price reopener clause and the risk of breach is higher.

In *Superior Overseas Development Corporation*, the price reopener was triggered on a "substantial change in the economic circumstances [leading to] substantial economic hardship". In the Court of Appeal, Waller LJ held that the word "substantial" must be given the same meaning in both instances and it meant "real" or something more than day-to-day difficulties. Further, the clause would offset all the hardship, and not leave a party on the borderline of substantial hardship. Donaldson LJ cautioned that as the parties choose to use a word, rather than a formula, it was not for experts to import one. Rather, the task ought to have been to gather the facts and then consider whether the change/hardship had been substantial.

Faced with a potential arbitrage opportunity, a bullish seller may attempt to force a buyer to agree to a significant price revision under a price reopener clause or face short or non-delivery. In appropriate circumstances, the buyer may wish to agree to pay the contractual price or part of the revision and seek to defer any further revision to be determined by negotiation or dispute resolution after delivery. This "deliver now, argue later" approach may secure delivery, leaving open the possibility buyers may resist further increase, in exchange for additional risk.

Wilful misconduct

Sometimes, a SPA will contain capped damages clauses that will not apply where the loss is caused by a breach of contract that arises "as a result of wilful misconduct". Such a clause is likely to be highly beneficial to a buyer facing arbitrage.

In English law, there is no general prohibition on wilful misconduct and therefore where the parties carve out such conduct the usual principles of construction will apply. Where the contract does not itself define "wilful misconduct" it will usually mean knowingly, intentionally or recklessly committing misconduct: see *Energy Works (Hull)*.

To benefit from this exclusion from the cap, the buyer will also need to show that the seller's conduct was misconduct, in other words that the conduct did in fact amount to a breach of contract. This may be difficult: a seller may for instance avoid a breach by manipulating the delivery schedule.

Buyers should be alert to this possibility when considering when to negotiate future delivery quantities, how to deal with a dilatory response to those negotiations, and how to deal with notices of delay.

The buyer may also be presented with an alternative reason for the breach that they consider unlikely. If so, the best strategy for achieving early disclosure should be considered carefully in light of the applicable arbitral rules.

Sole or exclusive remedy for underdelivery?

SPAs frequently include a clause providing for a contractual remedial regime in the event of underdelivery. For example, the regime may provide that it constitutes "the buyer's sole and exclusive remedy in damages or otherwise for [the seller's breach]" or that fulfilment of the remedy "shall be in full satisfaction and discharge of all rights, remedies and claims howsoever arising…"

If the arbitrage breach falls within its scope, then any perceived inadequacy to one party will not prevent its operation and it is very unlikely to be found commercially absurd (*James Kemball*). Accordingly, the disagreement will commonly centre on whether the claim is in fact caught or, alternatively, is for some other reason permissible on the proper construction of the clause.

The contractual regime may still circumscribe the available remedies even if some other breach caused the underdelivery. In *Scottish Power*, the Court of Appeal held that the underdelivery remedy of default gas at a lower price was the only available remedy even where reason for the underdelivery was the seller's failure to operate its facility, which failure amounted to a separate breach. In the absence of an exclusion for wilful misconduct, Clarke LJ also considered it likely that would be the exclusive remedy even if the underdelivery was deliberate.

Bad news for the buyer, it would seem. However, if the buyer accepts a repudiatory breach at common law or has a separate contractual right to terminate the contract then they may argue on the true construction of the SPA, the contractual remedial regime has not survived. If so, then damages will be at large.

We have considered how the contractual machinery of typical long-term SPAs might play out in light of seller arbitrage. Although there might be some negotiating room if a price reopener applies, the buyer will likely face difficulty unless a "wilful default" exclusion clause applies or the breach is outside the scope of the remedial regime. Could the buyer have another way forward?

Widening the net

It is relatively well established that a threat to break a contract is capable of being regarded in appropriate circumstances as an improper or illegitimate threat giving rise to a cause of action for "unlawful act" economic duress (for example, *Pao On*). The UK Supreme Court has, however, considered the question of "lawful act" economic duress in two recent cases: *Times Travel v Pakistan International Airlines* and ***Law Debenture Trust Corporation v Ukraine*** (which decision was only handed down on 15 March 2023). In brief, it is now clearly established as a matter of English law that the doctrine of "lawful act" economic duress exists as a ground for the restitution of a non-contractual payment by an innocent buyer if it can show:

- the making of an illegitimate (albeit lawful) threat as a matter of English law by the other party;
- sufficient causation between the threat and the threatened party making a non-contractual payment; and
- the lack of any reasonable alternative to the threatened party giving into the threat.

The illegitimacy of the threat is not to be determined by a principle of "lack of good faith dealing" or a "range of factors" approach. Instead, a tribunal must consider the nature and justification of the demand made by the contract-breaker having regard to (among other things) the behaviour of the contract-breaker, the nature of the pressure it applied and the circumstances of the threatened party. A threat motivated by commercial self-interest would probably not amount to an illegitimate threat. On the other hand, a threat would be illegitimate if it amounted to the kind of reprehensible or unconscionable conduct which, in the context of the equitable doctrine of undue influence, would be judged to render the enforcement of the contract unconscionable. Plainly, the question of whether the conduct in question amounts to an illegitimate threat will be intensely fact and circumstance sensitive.

In the sort of cases discussed in this article, it is not difficult to see how an innocent party may well prove in the context of lawful act duress that there would be sufficient causation between the threat and making a payment under the long-term SPA; and that there was the lack of any reasonable alternative to giving into the threat. The question, however, of whether the counterparty's conduct would amount to an illegitimate threat may be harder to prove.

It may be that deliberate manipulation of delivery schedules or agreements so as to *create* a situation where the buyer has no other reasonable alternative but to accede to the threat would go far enough to be illegitimate. The buyer could argue this is analogous to the second category of duress considered by Lord Hodge in *Times Travel*, namely that the defendant has breached the contract and deliberately manoeuvred the claimant into a position of vulnerability. Relevant factors might include the degree of deceit by sellers if, say, a façade of late delivery has been maintained where sellers never intended to deliver at all at the agreed price. In any event, given the contractual difficulties set out above it is likely to be worth buyers carefully considering this further option.

Conclusion

Unless there is a wilful misconduct clause which applies to make damages at large, it will be difficult for the buyer to rely on a long-term SPA to prevent the seller exploiting a price arbitrage situation. One possible route if there is a price reopener clause might be to achieve delivery now and argue about a price revision later. Relying on escape from the contractual remedial regime is likely to be difficult even if arguable. In those circumstances the buyer may choose to cast the net more widely and attempt to obtain a remedy in one or both of unlawful act or lawful act duress.

Cases referenced

Gas Natural Aprovisionamientos SDG SA v Atlantic LNG Company of Trinidad and Tobago DC, New York 08 Civ 1109 (SD NY 2008)

Superior Overseas Development Corporation & Ors v British Gas Corporation [1982] 1 Lloyd's Rep 262

Energy Works (Hull) Limited v MW High Tech Projects UK Limited and another [2022] EWHC 3275 (TCC)

James Kemball Ltd v "K" Line (Europe) Ltd [2022] EWHC 2239 (Comm)

Scottish Power UK Plc v BP Exploration Operating Company Ltd & Others [2016] EWCA Civ 1043

Pao On v Lau Liu Long [1980] A.C. 614

Times Travel (UK) Ltd and another v Pakistan International Airlines Corpn [2023] AC 101

The Law Debenture Trust Corporation v Ukraine [2023] UKSC 11

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