

Force Majeure Events Commercial and Legal Consequences

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at the 1998 New Zealand Petroleum Conference

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Abstract

Major contracts in the petroleum sector commonly include a 'Force Majeure' provision, which may relieve a contracting party for failure to perform in certain circumstances. However, if there is a major disruption to performance, there will often be some doubt about whether the clause applies, what it means if it applies, whether the contract even remains in existence and what rights and duties the contracting parties have.

Using as an example an important gas resource, from which the seller supplies gas in accordance with one or more contracts to users and downstream purchasers, we can consider the consequences if the supply is disrupted. The disruption may be sudden or more gradual, complete or partial, anticipated or without warning and may be brief or long term. The remedies may vary in degrees of technical difficulty, risk and expense.

The parties to the supply contracts, and others who may be affected by the downstream impacts, will have numerous questions to consider. They include:

- Is the disruption caused by a 'force majeure' event, as defined in the supply contract(s)?
- Are all the relevant contracts on the same terms?
- If restricted supplies are available, which buyers are entitled to priority in delivery?
- Does the event so destroy the basis of the contracts (or some of them) that they cease to have any effect?

- What obligations do the supplier and downstream parties have, in contract or otherwise, to each other and to others? Gas supply failure may lead to claims of negligence, breach of contract or failure to comply with environmental or safety obligations.

While a gas supply contract serves as an excellent context for considering these questions, the same issues will arise in many other contracts for the supply of goods and services. The parties to any major contract in a high risk industry need to understand what the limitations are to the force majeure clauses which are included in their contracts, and what other risk management and contingency plans they need to provide.

Background

This paper reviews the possible legal and commercial effects of a major disruption to New Zealand's national energy supply and distribution system. It is common to refer to major disruptive events as "force majeure" events, because that is a useful label to describe events over which operators have little or no control.

The same label, force majeure, is often used to describe the exceptions provisions which appear in many contracts, and which are intended to govern the relationships between the contracting parties if a force majeure event occurs.

The label may be useful in referring to a certain type of event, or a certain type of clause, as a very general matter. However, the simple label conceals a much more detailed range of disruptive possibilities and a complex web of potential rights and obligations between those who may be involved or affected by a major disruptive event.

We can take as an example an event which disrupts the supply of Maui gas at a point upstream of the Oaonui production station outlet, and we can consider some of the consequences which would flow from such an event. While this is a useful example, the issues will be very similar for any disruption to the supply of gas or electricity in New Zealand. Indeed, many of the same issues will arise in any contract for the provision of goods or services.

If the event is a partial failure of equipment, or a down-rating of the delivery system, then gas may still be available but in reduced quantities. Whether the disruption is complete or partial, it may be remedied promptly or it may last for several months or a year. Each combination of these possibilities will have its own consequences for managing the shut-down or reduction in supply, rationing limited supplies to service particular users and resuming supplies to the various users in a way which is justifiable with reference to whatever criteria are adopted.

Force Majeure in Contract

The expression "force majeure" is derived from the French legal system, where it has a particular meaning and set of rules. No damages are recoverable from a party who has been prevented from performing their contract by force majeure [Article 1148 of the French Civil Code]. An event will not be force majeure unless:

1. it makes performance of the contract impossible;
2. it was unforeseeable; and
3. it was irresistible, both in its occurrence and its effects.

In French law, this concept has been interpreted much more narrowly than similar rules, such as the doctrine of frustration, in the common law system which we follow in New Zealand.

The expression "force majeure" has no particular legal meaning in New Zealand. The usual practice is to describe or define for the purposes of the individual contract what is meant by a force majeure event. In addition, the contract must set out the agreement of the parties upon what consequences will follow if a force majeure event occurs.

The Appendix to this paper includes some examples of typical force majeure clauses. In summary, the general effect is:

1. neither party will be liable if it is prevented from performing its operation by a force majeure event;
2. a force majeure event is something external to the parties (such as an "act of God", or disruption to their equipment or machinery);
3. the event should be both beyond their control and such that they could not have prevented the event, or the consequent failure in performance, by the exercise of due diligence;
4. an obligation to pay money will not be suspended by a force majeure event;
5. the party affected by the force majeure must notify the other party and use due diligence to remove the disruption and resume performance of its obligations.

In reality, this form of force majeure provision leaves open a number of issues for possible dispute between the parties to the contract. In addition, it has little or no bearing on the relationship between the original supplier and others who may be in the supply chain or affected by the disruption to the supply chain.

Both legally and commercially there are strong incentives for everyone involved in the supply chain to look beyond their contractual force majeure provisions. They should ensure that all of their contracts and public statements are soundly based and that they have taken suitable protective and contingency measures to recognise the possible occurrence of disruptive events and manage their impacts.

Other Contract Issues Between Buyer and Seller

If the seller has only one buyer and a single contract, there will be only two parties to dispute the meaning of the force majeure provisions. However, if the seller has two or more contracts, and is forced to reduce production, then the first issue will be what (if any) conflict between the two buyers can and should be managed by the supplier. There may be good reasons to keep the reticulation system going, by shedding major petrochemical or power generation users, but that may only be possible if the contracts allow for it.

If the disruption is caused by inadequate maintenance, or its effects could have been mitigated by installing redundant equipment or alternative supplies, then the force majeure clause will not operate, so that the seller will not be relieved of its obligations. The seller will be in breach of contract for failure to perform and will be subject to whatever damages and other remedies the buyer can enforce. Of course, that may do little or nothing to restore the supply any more quickly, so that all participants in the supply network have an incentive to protect themselves with effective contingency plans.

On the other hand, if the disruption is major, and seems likely to be enduring, then the legal effect may be that the contract is no longer able to be performed. There is no doubt that the contracting parties may agree to provide in the contract for some allocation of the risks of disruption by external events - that is the effect of the usual force majeure clause. However, if the disruption goes beyond what the parties have provided for, then the contract is said to be "frustrated", and is simply cancelled. There is provision for adjusting outstanding compensation in accordance with the extent to which the contract was performed, but otherwise the parties have no rights or responsibilities towards each other.

Few force majeure clauses are explicit about the time for which the clause may operate to suspend the parties' obligations, and the point at which parties should be completely relieved from their obligations. This is likely to be a fertile field for argument if one or other party sees some advantage in cancelling the contract and starting again. In our Maui example, an earthquake which destroyed the platforms might be regarded as frustrating the contract, while lightning damage to the Oaonui production station, repairable in a few weeks, would not. Somewhere, probably between the two, there is a grey area open to dispute.

Issues Beyond Contract for Buyer and Seller

If the seller is unable to perform because of some event which it claims to be force majeure, it will not be open only to a simple claim from the buyer in contract. The disruption will undoubtedly have an impact on users throughout both the gas and the electricity markets, and from there into the rest of the community. The first buyer (who may be a wholesaler) will sell to distributors or consumers, and will have contractual arrangements with its own customers. To the extent that it has undertaken obligations to its own customers which are not reflected in its contract with the original supplier, it will be exposed to claims for failure to perform. The fact that the original supplier is unable to provide gas is not necessarily a force majeure event for the purpose of downstream suppliers, because their customers may legitimately point out that the original source of the gas is not referred to in the contract.

Thus, the intermediate supplier may be under an obligation to procure alternative sources of supply, regardless of the expense. To the extent that there is a downstream effect which extends into the electricity sector, the same considerations must apply with even more force.

It is almost inevitable that a wholesaler which is coming under attack from its own customers or others will seek to impose any costs or liabilities back to the original producer if it can do so. However, the wholesaler is not justified in claiming unlimited losses - it is under an obligation to mitigate the damage which it suffers. That must include limiting its exposure to contractual and other claims by downstream users and ensuring that it has contingency plans in place.

Even if the contract includes provisions which exclude or limit the liability of the seller to the buyer under every conceivable circumstance, regardless of fault, those provisions will not necessarily prevent the buyer succeeding in a claim. Clauses of that type will be interpreted very restrictively. In addition, they will be no protection against claims for breach of the Fair Trading Act 1986 or other statutes covering safety and environmental obligations. In these respects, the seller will have responsibilities to the buyer just as if there is no contract between them.

Liabilities Beyond The Contract

It is trite to point out that the only parties whose respective liabilities to each other can be limited by the contract, are those who are parties to the particular contract. The effectiveness of those contractual limitations will depend on the circumstances and on the terms of the contract.

There will be a range of parties affected by disruptions to the energy system who may have other legal bases for claims (or, conversely, a supplier which cannot deliver energy in the quantities and at the quality expected of it may be exposed to liability in a number of ways).

Fair Trading Act

Any transporter or supplier of energy or services will be liable for breach of the Fair Trading Act 1986 if, by its conduct, it has misled its customers or the public generally as to the nature, quality or suitability of the energy or service that it provides. Thus, users who can show that they have depended upon uninterrupted supplies of high quality electricity, in reliance on the promotions of the energy industry, may seek to hold responsible those who have convinced them that they do not need to establish their own protection or contingency plans.

Negligence and Related Actions

In general, anyone who acts negligently and who causes damage to another, in circumstances where the damage is foreseeable and the person causing it has a "duty of care" to the victim, may be liable for the damage caused. In this case, there is no need for the parties to be in a contractual relationship with each other.

Consumer Guarantees Act

The Consumer Guarantees Act 1993 provides that, on any supply of goods or services, there are certain implied guarantees of quality and fitness for purpose. Although the Act primarily applies to protect consumers who do not use the goods or services in a business, it can apply where the customer is a business if it has not been excluded by contract.

Claims have already been initiated seeking remedies under the Consumer Guarantees Act in respect of the supply of electricity. While there may be some argument about whether the supply of electricity is a supply of goods or services for the purposes of that Act, it certainly falls within the general scheme of the Act. Remedies for failure to comply with the implied guarantees may include damages for any loss or damage to the consumer resulting from the failure.

Obligations to Shareholders

All company managers and directors have responsibilities to carry out their functions diligently, conduct the affairs and protect the assets of the company faithfully and report fairly and fully to shareholders and others interested in the financial state of the company. These obligations include reporting on any contingent liabilities for losses which may be incurred by the company. To fulfil these requirements, directors must have a proper assessment and understanding of the risks faced by the company. They must also have adequate contingency plans to protect the company's assets and undertaking and to manage any claims made against it.

Environmental, Safety and Building Legislation

The Resource Management Act, the Health and Safety in Employment Act and the Building Act all require that those who have a part to play in workplace safety, environmental management and building performance must ensure that they do nothing which would compromise compliance with the relevant legislation. Obviously, erratic energy supplies can create failures in protection systems and other services in a variety of ways, ranging from the direct potential hazard of shutting down electricity or gas supply equipment, loss of power to monitoring and control systems in factories and other premises, failure of sewage or other effluent management systems and partial shut down of the dairy industry with the consequential need to deal with millions of litres of perishable milk. The defence of 'due diligence' is recognised as a means of avoiding successful claims in these areas, but the defence is only effective if companies, directors and employees have really made proper efforts to implement compliance and contingency plans.

Balancing Rights and Claims

It should be obvious that there is potentially a web of competing rights, claims and obligations. If the companies involved have made no attempt at contingency planning, and coordinating their individual responses, then they will find themselves in an emergency trying to resolve these issues. For example, users may have priorities for supply by contract, but these apparent rights may conflict with the needs of safety and

public health.

No doubt the marketers of energy products and services will wish to emphasise the safety and dependability of energy supplies. However, this must be tempered with proper advice to customers about the need for contingency plans and protective measures. Suppliers must be clear about the extent of their responsibility for the quality of electricity supply. As recent events have shown, it may be wise and even quite reasonable to expect any substantial computer installation to have an uninterruptable power supply and for certain businesses to have back-up generation capacity as a matter of course.

Each company will have to consider in its own context a number of questions. If we try to answer them without that context, the answers are only of limited help. For example.

Is the disruption caused by a 'force majeure' event, as defined in the supply contract(s)?

That will depend on the contract, as well as on the extent of 'due diligence' exercised by the affected party. The consequences may be at the risk of one party, or they may be so serious that the contract is terminated.

Are all the relevant contracts on the same terms?

A review of the contracts, and management of all new contracts, will be needed to ensure that they are properly prioritised and no risks are left unallocated.

If restricted supplies are available, which buyers are entitled to priority in delivery?

Prioritising buyers and users may be a matter of contract, but will also be influenced by community and other commercial considerations including health, safety and environmental requirements.

Does the event so destroy the basis of the contracts (or some of them) that they cease to have any effect?

The same event may affect different contracts in different ways.

What obligations do the supplier and downstream parties have, in contract or otherwise, to each other and to others?

Gas supply failure may lead to claims of negligence, breach of contract or failure to comply with environmental or safety obligations.

Conclusion: Coordinated Contingency Plans

Events during the first three months of 1998 have demonstrated the fragility of New Zealand's energy supply systems. Those events have included the need to reduce production at the Huntly Power Station because there was little cooling capacity in the Waikato River, thereby prejudicing voltage support for the northern portion of the North Island; the failure of the Mercury Energy cables to the Auckland central business district; severe electricity spikes in the Huntly District caused by an 11,000V line contacting a 400V line; disruption to gas supplies in Palmerston North and Levin when vandals closed the supply valves. Consumers had to wait for the pipelines to be purged before supplies were restored.

In each of these events, there were losses and in many cases other damage throughout the affected systems. There were some contingency plans in place, and others which were hastily arranged. They showed varying degrees of effectiveness, generally in proportion to the effort which had gone into preparing and implementing the plans before the disruptions occurred.

It should be clear from these experiences that no participant in the energy system can implement a contingency plan alone - interdependence

is a fact and cooperation is essential. Any board of directors which cannot report to its owners that it understands and has provided for the contingencies of energy disruption has not fulfilled its obligations. Any company whose customers do not clearly understand what the company can do for them, and what the customers can and must do for themselves, may face claims from disaffected users. In both cases they are leaving themselves open not only to serious commercial damage, but also to personal liability for directors and managers.

As the poet John Donne said, in a different context,

"No man is an island ... Never seek to know for whom the bell tolls; it tolls for thee".

Author

Gavin Adlam is an independent legal adviser and consultant to the energy and resources sector, on new technology projects and on utilities restructuring. He spent 18 years in a national law firm, where he was involved as an adviser to petroleum exploration, mining and service companies ranging in size from multi-nationals to small enterprises. His clients included both New Zealand and overseas companies, operators and non-operators. He has also assisted with advice and submissions on reforms to taxation, resources and minerals law. He advises on permit applications and procedures, farmouts, royalties, joint ventures, contracts for the supply of gas, lpg, electricity and geothermal steam and on construction projects.

Appendix: Sample Force Majeure Clauses

Extract from Maui Gas Contract

Force Majeure

13.1 If either party to this Contract shall fail to perform any obligation hereby imposed upon it, and such failure is caused by acts of God, strikes, lockouts or other industrial disturbances, acts of the Queen's enemies, sabotage, wars, blockades, insurrections, riots, epidemics, landslides, lightning, earthquakes, floods, storms, fires, washouts, arrests and restraints of rulers and peoples, civil disturbances, explosions, breakage of or accident to machinery or lines of pipe, freezing of wells or delivery facilities, well blowouts, craterings, the order of any court or governmental authority, the necessity for making repairs to or reconditioning wells, machinery, equipment or pipelines (not resulting from the fault or negligence of such party), or any other act or omission occasioned by any cause beyond the control of the party invoking this Article, and being such that by the exercise of due diligence such party could not have prevented such failure, that failure shall not give rise to any cause of action based on breach of the obligation of such party hereunder, but such party shall use reasonable diligence to put itself again in a position to carry out its obligations hereunder. Nothing contained herein shall be construed to require either party to settle a strike or lockout or other industrial disturbance by acceding against its judgment to the demands of opposing parties.

13.2 No such circumstance or occurrence affecting the performance of this Agreement by any party shall continue to relieve the party affected thereby from liability or to hold in abeyance a cause of action, after the expiration of a reasonable period of time within which by the use of due diligence such party could have remedied the situation preventing its performance, nor shall any such circumstance or occurrence relieve any party from its obligation to make payment of amounts then due hereunder nor shall any such circumstance or occurrence affected thereby from liability or hold in abeyance a cause of action unless such party shall give notice of such circumstance or occurrence in writing with reasonable promptness; and like notice shall be given upon termination of such circumstance or occurrence.

Extract From General Procurement Contract

14.3 Force Majeure

14.3.1 Neither party will be liable for any act, omission, or failure to fulfil its obligations under this Agreement if and to the extent that such act, omission or failure arises from any cause reasonably beyond its control, or the effect of which it could not reasonably have predicted or avoided. Those events may include but shall not be limited to acts of God, strikes, lockouts, riots, acts of war, epidemics, governmental action superimposed after the date of this Agreement, fire, communication line failures, power failures, earthquakes or other disasters (called "Force Majeure").

14.3.2 The party unable to fulfil its obligations due to Force Majeure will immediately:

1. notify the other in writing of the reasons for its failure to fulfil its obligations and the effect of the failure; and
2. use all reasonable endeavours to avoid or remove the cause and perform its obligations as soon as possible.

Last modified: 7 March 2002