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Part II: Force Majeure Clauses and Physically-Settled Power Hedges Under the ISDA North American Power Annex

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KEY POINTS

- The ISDA Power Annex has special provisions dealing with Force Majeure
- These special provisions trump the Force Majeure provisions in the 2002 ISDA Master Agreement
- The Power Annex definition of Force Majeure lacks clarity
- The party claiming relief must remedy the Force Majeure "with all reasonable dispatch"

Introduction

In the wake of COVID-19's rapid spread throughout the country and around the world, many project developers and their hedge providers have been analyzing force majeure provisions to determine whether performance under their existing contracts may be excused. In Part I of this series of articles, "Force Majeure Clauses and Financially Settled Transactions Under the ISDA Master Agreement" ("Part I"), Katten highlighted the key aspects of the standard force majeure provision found in the 2002 ISDA Master Agreement and explained some of the factors that market participants should consider in assessing force majeure claims in the context of financially-settled power transactions. In this article, we perform the same analysis for physically-settled contracts governed by an ISDA North American Power Annex (the "Power Annex") as incorporated into either the 1992 ISDA Master Agreement (Multicurrency — Cross Border) or the 2002 ISDA Master Agreement (any such ISDA Master Agreement, as modified by incorporation of the Power Annex, an "ISDA Master Agreement").[1]

History of the Power Annex

The Power Annex was published jointly by the International Swaps and Derivatives Association, Inc. ("ISDA") and the Edison Electric Institute in 2003 as a tool to enable parties to transact in wholesale physical energy under ISDA Master Agreements, thus allowing market participants to document physical power purchases and sales as well as financially-settled power transactions under a single agreement. The Power Annex has gained wide market acceptance and has been incorporated by ISDA into the 2005 ISDA Commodity Definitions.

[1] Please note that the force majeure language found in the Master Power Purchase & Sale Agreement published by the Electric Edison Institute is substantially similar to the language used in the Power Annex, and therefore, the analysis set forth in this article may also be helpful in assessing force majeure claims under the Master Power Purchase & Sale Agreement.

Force Majeure and the Power Annex

The Power Annex has its own force majeure provision that applies to all Power Transactions[2] entered into under an ISDA Master Agreement. This provision, which is found in clause (b)(iii) of the Power Annex, expressly overrides Section 5(b)(ii) (*Force Majeure Event*) of the 2002 ISDA Master Agreement with respect to Power Transactions.[3]

In relevant part, clause (b)(iii) of the Power Annex (the "FM Provision") reads as follows:

> "**Force Majeure**. To the extent either party is prevented by Force Majeure from carrying out, in whole or in part, its obligations under any Power Transaction and such party (the "Claiming Party") gives notice and details of the Force Majeure to the other party (the "non-Claiming Party") as soon as practicable, then, unless the terms of the Product specify otherwise, the Claiming Party shall be excused from the performance of its obligations with respect to such Power Transaction (other than the obligation to make payments then due or becoming due with respect to performance prior to the Force Majeure)."

Accordingly, the FM Provision only provides relief from performance if all of the following conditions are met: (1) an event or circumstance constituting a Force Majeure has occurred; (2) the Force Majeure prevented the claiming party from performing in whole or in part; (3) the claiming party provided notice and details as soon as practicable; and (4) the terms of the Product[4] do not exclude Force Majeure as a defense to performance. The sub-sections below analyze each element in greater detail.

(1) Has a Force Majeure occurred?

The first step of the analysis is to determine whether a Force Majeure has occurred. Clause (i)(iv) of the Power Annex defines Force Majeure as follows:

> '"Force Majeure" means an event or circumstance which prevents the Claiming Party from performing its obligations under one or more Power Transactions, which event or circumstance was not anticipated as of the date the Power Transaction was agreed to, which is not within the reasonable control of, or the result of the negligence of, the Claiming Party, and which, by the exercise of due diligence, the Claiming Party is unable to overcome or avoid or cause to be avoided. Force Majeure shall not be based on (i) the loss of Buyer's markets; (ii) Buyer's inability economically to use or resell the Product purchased hereunder; (iii) the loss or failure of Seller's supply; or (iv) Seller's ability to sell the Product at a price greater than the Contract Price. Neither party may raise a claim of Force Majeure based in whole or in part on curtailment by the Transmission Provider unless (i) such party has contracted for firm transmission with a Transmission Provider for the Product to be delivered to or received at the Delivery Point and (ii) such curtailment is due to "force majeure" or "uncontrollable force" or a similar term as defined under the Transmission Provider's tariff; provided, however, that existence of the foregoing factors shall not be sufficient to conclusively or presumptively prove the existence of a Force Majeure absent a showing of other facts and circumstances which in the aggregate with such factors establish that a Force Majeure as defined in the first sentence hereof has occurred. The applicability of Force Majeure to the Power Transaction is governed by the terms of the Products and the Related Definitions contained in Schedule P.'

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[2] Under the 2005 ISDA Commodity Definitions, "Power Transactions" are defined as "transactions between the parties for the purchase or sale of a Product…on a spot or forward basis or as an option to purchase, sell or transfer a Product…"

[3] As noted in Part I, the standard-form 1992 ISDA Master Agreement (Multicurrency — Cross Border) does not include a force majeure provision; however, market participants may incorporate the force majeure provision from the 2002 ISDA Master Agreement by adhering to the ISDA Illegality/Force Majeure Protocol. In any such case, the parties should expand clause (b)(iii) of the Power Annex to clarify that the Force Majeure Event provisions incorporated by means of the ISDA Illegality/Force Majeure Protocol are not applicable to Power Transactions.

[4] The Power Annex defines "Product" as electric capacity, energy or other product(s) related thereto specified in a Power Transaction by reference to a Product listed in Schedule P or is otherwise specified by the parties in a Power Transaction.

Unfortunately, the definition of Force Majeure provides less clarity than many standard force majeure provisions found in other agreements. No specific types of force majeure events that are relevant to power transactions are cited, and the definition even lacks the traditional reference to "acts of God." This absence of affirmative examples of "Force Majeure" can be especially problematic, as New York courts have generally held that force majeure provisions should be interpreted narrowly, because they are aimed narrowly at events that neither party could foresee or guard against in the agreement. *See, e.g., In re Cablevision Consumer Litigation*, 864 F.Supp.2d 258, 264 (E.D.N.Y. 2012); *Kel Kim Corp. v. Central Markets, Inc.*, 70 N.Y.2d 900, 902 (1987). "[W]hen the parties have themselves defined the contours of force majeure in their agreement, those contours dictate the application, effect, and scope of force majeure." *Id.* (citing *Route 6 Outparcels, LLC v. Ruby Tuesday, Inc.*, 931 N.Y.S.2d 436 [3d Dept. 2011]. Furthermore, although New York courts have held that the party claiming a *force majeure* event has the burden of proving its existence, this definition does not provide any context for discharging that burden. *See Phillips P.R. Core, Inc. v. Tradax Petroleum, Ltd., 782 F.2d 314, 319 (2d Cir. 1985) (applying New York law).*

Therefore, in assessing whether a force majeure has occurred, market participants should pay special attention to the text of the relevant force majeure provision. Under clause (i)(iv), a Force Majeure will not occur unless each of the following conditions are met: (a) the event or circumstance was not anticipated as of the date of the Power Transaction; (b) the event or circumstance is not within the reasonable control of, or the result of negligence of, the claiming party; (c) the claiming party is unable to overcome or avoid or cause to be avoided such event or circumstance by the exercise of due diligence; (d) the event or circumstance does not fall within one of the categories of events expressly excluded from the definition of Force Majeure; (e) the event or circumstance prevented the claiming party from performing its obligations; and (f) Force Majeure applies to the Power Transaction as governed by the terms of the Products and the related definitions.[5]

(a) Was the event or circumstance anticipated as of the date of the power transaction?

The definition of Force Majeure states that the relevant event or circumstance must not have been ***anticipated*** by the parties. The use of the term "anticipated" is relatively unusual in the context of force majeure clauses, and although we are not aware of any cases directly on point, it almost certainly gives the claimant more flexibility than it would have under a more customary standard, such as foreseeability. On the other hand, however, the definition of Force Majeure does not include a pre-approved list of events that automatically qualify as a force majeure;[6] as a result, the claimant retains the burden of demonstrating that even the most unforeseeable events were not anticipated by the parties. Collectively, these features highlight the fact-specific nature of this analysis — not only do market participants need to develop an in-depth understanding of the relevant event or condition giving rise to the (potential) force majeure, but they must view it through the lens of the specific facts and circumstances at the time that the Power Transaction was first entered into and then apply their findings to the definition of Force Majeure in a manner that is consistent with the interpretive techniques used by New York courts in assessing force majeure clauses.

For example, a project developer claiming a Force Majeure due to supply-chain issues caused by the COVID-19 pandemic will likely rely heavily on the term "anticipated," and argue that had the parties anticipated COVID-19 or other pandemics they could have simply added them to the list of items expressly excluded from the definition of Force Majeure. A non-claimant will likely respond after carefully assessing each grace period and other similar term in the related ISDA Master Agreement; extensions of grace periods, milestone completion dates and other similar terms, as well as the basis on which the claimant originally requested these terms, may enable the non-claimant to formulate a credible defense to the claimant's argument that the parties did not anticipate supply-chain delays due to COVID-19.[7]

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[5] The requirements described in items (e) and (f) of this paragraph are essentially duplicative of certain requirements contained directly in the FM Provision; as a result, this article addresses these requirements in the context of the FM Provision under sections (2) and (4), below.

[6] Many force majeure clauses include long, enumerated lists of events or circumstances that, by definition, constitute a force majeure. Typical lists include events like fire, flood, war, acts of God, or acts of government and may include public health related events such as epidemics, plagues, diseases, emergencies or outbreaks.

[7] Market participants should not feel obligated to retain the original definition of Force Majeure; if, during the original negotiation of the ISDA Master Agreement, both parties are in agreement that a specific future event or condition should or should not constitute a Force Majeure, the definition of Force Majeure should be modified accordingly.

(b) Was the event or circumstance within the reasonable control of, or the result of the negligence of, the claiming party?

The definition of Force Majeure also states that the relevant event or condition cannot have been within the reasonable control of, or due to the negligence of, the claiming party. This element also requires a careful assessment of the relevant facts and circumstances surrounding the force majeure claim. Many events that fall within the general meaning of force majeure are, by definition, outside the control of any given party. This is the case for things like floods, acts of God, public health related events such as epidemics like COVID-19, plagues, diseases, emergencies and outbreaks. Other events, however, could conceivably be within the control of, or due to the negligence of, a party to a Power Transaction (e.g., consider a large fire caused by the negligence of the claimant).

(c) By the exercise of due diligence, can the claiming party overcome or avoid or cause to be avoided such event of circumstance?

Due diligence has been defined as "such measure of prudence, activity, or assiduity, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent person under the particular circumstances, but depending on the relative facts of the special case." *See Black's Law Dictionary 457* (6th ed.1990). As mentioned in other sub-sections, this is a fact-specific analysis; however, the exercise of due diligence would not require the claiming party to take all actions, regardless of cost, to resolve the issue. Consider the example of a power plant that is awaiting receipt of component parts manufactured in an area of China that has temporarily shut down the relevant factories due to COVID-19. If the claiming party is able to locate alternative parts from a different source for a price generally comparable to the price it has with its existing supplier, then the due-diligence standard might require such party to use the alternate supplier. That outcome could change, however, if the alternate supplier charges a significant premium. Either way, it should be noted that New York courts have generally held that "financial considerations" alone do not qualify as a force majeure event. *See Macalloy Corp. v. Metallurg, Inc.*, 728 N.Y.S.2d 14, 14 (1st Dep't 2001).

(d) Does the event or circumstance fall within one of the categories of events expressly excluded from the definition of Force Majeure?

The definition of Force Majeure expressly excludes the following events and/or circumstances:

> "(i) the loss of Buyer's markets; (ii) Buyer's inability economically to use or resell the Product purchased hereunder; (iii) the loss or failure of Seller's supply; or (iv) Seller's ability to sell the Product at a price greater than the Contract Price. Neither party may raise a claim of Force Majeure based in whole or in part on curtailment by the Transmission Provider unless (i) such party has contracted for firm transmission with a Transmission Provider for the Product to be delivered to or received at the Delivery Point and (ii) such curtailment is due to "force majeure" or "uncontrollable force" or a similar term as defined under the Transmission Provider's tariff; provided, however, that existence of the foregoing factors shall not be sufficient to conclusively or presumptively prove the existence of a Force Majeure absent a showing of other facts and circumstances which in the aggregate with such factors establish that a Force Majeure as defined in the first sentence hereof has occurred."

Consequently, the events or circumstances described above cannot, in and of themselves, result in the occurrence of a Force Majeure. Note, however, that market participants should not feel obligated to accept the definition of Force Majeure in its current form. For example, parties currently negotiating ISDA Master Agreements may want to consider adjusting the Force Majeure definition as may be necessary to reflect their specific circumstances in relation to COVID-19. Any such adjustment, of course, should only be made after assessing the corresponding force majeure provisions in other, associated contracts.

(2) Has the event or circumstance prevented the claiming party from performing its obligations?

The FM Provision expressly requires the claiming party to have been prevented from performing a contractual obligation. There consequently needs to be a causal effect between the event giving rise to the Force Majeure and the ability to perform by the party seeking relief. An event or condition that only delays or hinders a party's performance or otherwise makes such performance burdensome is not, in and of itself, sufficient. *See*, *e.g.*, *Phibro Energy, Inc. v. Empresa De Polimeros De Sines Sarl*, 720 F. Supp. 312, 318 (S.D.N.Y. 1989) (Under force majeure, "[m]ere impracticality or unanticipated difficulty is not enough to excuse performance"). Accordingly, whether such event prevented performance necessitates a fact-specific analysis.

(3) Did the claiming party provide notice and details as soon as practicable?

While the claiming party would not necessarily be required to provide notice and details immediately, such party should not withhold information indefinitely or for a prolonged period of time. The appropriate timing will depend on the specific facts. For example, if a situation arises which would prevent (or potentially prevent) the seller from meeting its delivery obligation in the next couple of days, notice would need to be provided almost immediately following the seller learning of such event or circumstance; however, if such situation arises during the construction period well before any delivery is required, the seller could wait several weeks before notifying the buyer and still be deemed to have satisfied its obligation. *See Cf. Rekemeyer v. State Farm Mut. Auto. Ins. Co.*, 4 N.Y.3d 468, 474 (2005) (in the insurance context, the "notice as soon as practicable" standard "contemplates elasticity and a case-by-case inquiry as to whether the timeliness of the notice was reasonable, taking all of the circumstances into account").

In addition, while the FM Provision does not explain the level of detail required, it should be detailed enough to provide the non-claiming party with a good understanding of the event or circumstance giving rise to a Force Majeure claim. Of course, it is certainly possible that the claiming party will not have sufficient detail at the time notification is required; in those situations, the claiming party would have a further obligation to provide additional details as they come to light.

(4) Do the terms of the product exclude Force Majeure as a defense to performance?

Finally, the FM Provision provides that a claiming party will be excused from performance of its obligations if the terms of the Product so specify. In most instances, the Product specified under physical offtake arrangements is Firm (LD).[8] The Power Annex refers to the definitions set forth in Schedule P: Products and Related Definitions to the Master Power Purchase & Sale Agreement published and modified from time to time by the Edison Electric Institute. Schedule P defines Firm (LD) as follows:

> '"Firm (LD)" means, with respect to a Transaction, that either Party shall be relieved of its obligations to sell and deliver or purchase and receive without liability only to the extent that, and for the period during which, such performance is prevented by Force Majeure. In the absence of Force Majeure, the Party to which performance is owed shall be entitled to receive from the Party which failed to deliver/ receive an amount determined pursuant to Article Four.'

If a claiming party argues that Force Majeure applies to a Firm (LD) Power Transaction because it is unable to deliver power from the project as a result of supply-chain concerns, the non-claiming party could arguably assert that the claiming party is still able to deliver the power to the delivery point by purchasing it in the open market, since Firm (LD) does not require the power to have been sourced from a specified project. If, however, the entire power grid was disrupted, it would be difficult to assert that Force Majeure does not apply.

[8] Schedule P contemplates other Products as well, including "System Firm" and "Firm (No Force Majeure)," although in our experience these Products are rarely used.

What Are the Consequences of Force Majeure?

Under the Power Annex, the occurrence of a Force Majeure does not lead to the termination of affected Transactions. Instead, the parties end up in a stand-off until performance is no longer prevented by the Force Majeure.[9] This situation is described in clause (b)(iii) as follows:

> "The Claiming Party shall remedy the Force Majeure with all reasonable dispatch. The non-Claiming Party shall not be required to perform or resume performance of its obligations to the Claiming Party corresponding to the obligations of the Claiming Party excused by Force Majeure."

Although this stand-off could theoretically be indefinite, the claiming party has an affirmative obligation to remedy the Force Majeure in a manner that would minimize the lasting effect such event has on the parties' reasonable expectations. While the term "reasonable dispatch" is clearly subjective, courts have held that it is not ambiguous as a matter of law. *See*, *e.g.*, *Ergon-West Virginia, Inc. v. Dynegy Marketing & Trade*, 706 F.3d 419, 425 (5th Cir. 2013) (applying Texas Law). Such courts may, nevertheless, consider extrinsic evidence to determine, as a factual matter, what "reasonable dispatch" is under the circumstances. *Id.* (holding that "reasonable dispatch" did not include a duty to try to secure replacement gas based on "highly credible" expert testimony presented to the court).

Conclusion

Due to the rapid spread of COVID-19, project developers, offtake providers and other market participants will likely be required to assess the validity of force majeure claims under their physically settled power contracts. To the degree that these transactions are documented under an ISDA Master Agreement, a careful assessment of the Force Majeure provisions in the Power Annex will be required to avoid forfeiting rights and remedies that may be available. Please contact us if you would like to schedule a consultation to determine whether a force majeure would be applicable to your outstanding Power Transactions.

[9] Clause (i)(ii) of the Power Annex expressly amends the ISDA Master Agreement so that a "failure to deliver" under a Power Transaction will not, in and of itself, result in an Event of Default under Section 5(a)(i) of the ISDA Master Agreement; however, depending on the facts and circumstances, other Events of Default and Termination Events (including Additional Termination Events) may still be actionable by the relevant party.

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