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Legality of Take-or-Pay Clauses under Chinese Law

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Although in line with the customary rules in energy and chemical sectors, take-or-pay (TOP) clause bears a risk of illegality in certain circumstances. In this article, Llinks compliance service team analyzes the legality issue of TOP clause by reference to its practice experience and major relevant precedent cases.

I. What is a Take-or-Pay Clause

Take-or-pay clause originates from bulk energy contracts such as gas supply and electricity supply. Take natural gas supply contract as an example, TOP clause generally states that: (i) on the premises that the seller fulfills the obligation of "supply-or-pay", the buyer shall, within the specified period, purchase and take delivery of the goods in accordance with the TOP amount agreed by both parties; (ii) if the actual purchase quantity fails to meet the agreed quantity, the buyer shall fill the gap by increasing the purchase quantity or making payments. The increase of the purchase quantity (the replenishment) may be completed in the order in which it occurs within the specified time according to the contract.

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The key of the TOP clause is the buyer's unconditional and irrevocable payment obligation. The essence is to create a binding relationship between buyers and sellers, so that buyers and sellers can share market risks, balance the economic interests of both parties, and stabilize supply and demand. With regard to natural gas supply, sellers often need to heavily invest in production, transportation, facility construction and equipment installation. Therefore, the TOP clause emerged to mitigate sellers' risks of heavy investment. In the natural gas supply industry chain, the TOP clause between the upstream and the middle stream is often cascaded down to the middle stream and the downstream to ensure the smooth development of the whole industrial chain. The cash flow of the operating income secured by the buyer's TOP obligation enhances the certainty of the financing of energy projects. Thus, the TOP contract provides an indirect guarantee for energy project financing and thus helps reduce the financing cost of energy projects.[1]

Although widely used in energy and chemical supply sectors, the buyer's payment obligations under the TOP clause are very onerous, and the rights and obligations between the buyer and the seller look unbalanced. In addition, because of its exclusive nature, combined with other restrictive clauses and seller's market position, a TOP clause may have the effect of excluding or restraining competition. For all these reasons, a TOP clause bears risks of illegality.

II. Freedom of Contract Principle

Pursuant to the doctrine of freedom of contract prescribed by the Contract Law, parties to a contract can conclude, perform, modify and terminate the contract on their own will, provided that their will does not violate mandatory provisions of law. The doctrine of freedom of contract corresponds to the principle of private law autonomy in the civil law, that is, the law acknowledges the autonomy of civil parties in civil activities and guarantees their free will. Based on the principle, the parties to the contract can, in principle, freely agree on either the content or the form of the contract or both; and an effective contract formed in accordance with the law manifests the actual will of both parties to the contract, which should be legally binding on both of them.The doctrine of freedom of contract is embodied in Article 4 of the Contract Law that the parties are entitled to enter into a contract of their own free will according to law, which shall not be tampered with by any third parties.

According to the freedom of contract principle and Article 4 of the Contract Law, TOP clause reflects the seller and the buyer's free will to dispose of their rights and obligations respectively. Therefore, a TOP clause is generally acknowledged by Chinese law and the law enforcement practice by administrations and courts. For example, in case of the dispute over the gas supply contract between Xianglu Petrochemical Co., Ltd. and Linde Gas (Xiamen) Co., Ltd.[2], Linde requested Xianglu for a full payment for the gap between the actual purchase quantity and the minimum TOP quantity. Linde's claim was fully supported by the court. In IPO review of issuers such as Nanjing Zhongyou Hengran Petroleum Gas Co., Ltd., the China Securities Regulatory Commission did not challenge the validity of the TOP clause, but focused on the issuer's default risk by examining the issuer's ability to fully perform TOP obligations.

III. Legality

Notwithstanding the foregoing analysis, the TOP clause may present illegality risks under certain circumstances.

1. Fairness Principle

As one of the basic principles of contract law, the principle of fairness has a significant impact on the effectiveness of contracts. When courts adjudicate disputes arising from the TOP clause, they will consider all aspects from a comprehensive perspective to decide whether the rights and obligations are fairly allocated between the parties.

TOP clause is not unconscionable per se. An unconscionable contract describes a situation where the rights and obligations of the parties are significantly imbalanced and the consideration obviously is inadequate. In contrast, a TOP clause is normally commercially justifiable. Nevertheless, when the contractual parties in remarkably different market positions have unequal bargaining power, unreasonable quantities, price, and remedies may therefore be included in the TOP clause. As a result, such TOP clause might constitute a violation of the principle of fairness. The aggrieved party may request the court or the arbitration institution for the modification or revocation of the clause due to the violation of the principle of fairness.

Even if the TOP clause is not deemed as unconscionable, it does not mean that the supplier can fully claim all the rights agreed under the clause. In the dispute over the sale and purchase of the contract between Praxair (Shanghai) Industrial Gas Co., Ltd. and Changxing Kaihong New Wall Materials Co., Ltd.[3], the defendant Changxing Kaihong signed the Product Supply Agreement with the plaintiff Praxair, which stipulated that the defendant shall purchase from the plaintiff every month a minimum quantity of oxygen agreed by both parties. According to the TOP clause, if the defendant fails to meet the minimum purchase obligation for any given month, it shall nonetheless pay the plaintiff the price calculated based on the minimum agreed-upon quantity multiplied by the unit price of the product. The agreement also stipulated that the liquidated damages for the early termination of the agreement would amount to the remaining months of the agreement multiplied by the monthly minimum purchase quantity, and multiplied by the unit price of the product. The agreement commenced on March 31, 2011 and ended on March 30, 2016. However, the defendant never reached the requirement of the minimum purchase quantity, and stopped placing order from the plaintiff since September 2013. Since then the defendant was in arrears with the payment. The plaintiff terminated the contract on April 30, 2014. As of the date of termination of the contract, according to the Product Supply Agreement, the deficiency in purchase price was RMB 1,770,629.71. The plaintiff claimed the above shortage in payment and the liquidated damages of RMB 1,336,760 from the defendant on the ground of the defendant's fundamental breach of contract. The court ruled that the defendant shall pay the plaintiff the outstanding invoiced amount of RMB 419,359 and the liquidated damages of RMB 307,455.

In the above case, the court acknowledged the validity of the TOP clause agreed by the parties, but rejected the full amount of liquidated damages claimed by the plaintiff. Instead, the court adjusted the amount based on an overall consideration of various factors such as the performance of the contract and the profits of industry, and deducted factors including costs from the damages, so as to avoid the plaintiff's actual compensation in excess of its foreseeable benefits deriving from the contract (if fully performed). The plaintiff claimed the payment of RMB 1,770,629.71, which the defendant should pay to the plaintiff for the period from September 2013 to April 30, 2014 under the TOP clause. The amount of money supported by the court was RMB 419,359, 23% of the amount claimed by the plaintiff. Also, the plaintiff claimed a liquidated damages of RMB 1,336,760, the total amount that the defendant should purchase from the plaintiff in the remaining month after the contract was terminated. Nevertheless, the court only supported RMB 307,455.

2. Force Majeure

Force majeure is the statutory exemption stipulated in the Contract Law. If it is impossible to perform a contract due to force majeure, the defaulting party may exempt some or all of its liability depending on the influence of force majeure. In a TOP contract, force majeure may reduce or exempt the buyer's payment obligation or the seller's supply obligation. According to the Contract Law, force majeure refers to an objective situation that cannot be foreseen, avoided, or overcome. The scope of the definition of force majeure in contracts with the TOP clause is often not limited to the statutory scope, and may include some foreseeable circumstances, such as the change of laws, expropriation and so on. The parties under the TOP contract may freely negotiate to determine the scope of force majeure.

When calculating the deficiency, the quantity of goods which the buyer cannot take delivery of due to force majeure can be deducted from the minimum purchase amount. In the dispute over gas supply contracts between China Aluminum Co., Ltd. Guizhou Branch and Guizhou Guanghui Natural Gas Co., Ltd.[4], part of defendant's Guizhou Aluminum factory was forced to shut down in 2015 due to the local government's urban zoning adjustment. The court held that Guizhou Aluminum did not breach the obligation in the TOP clause because the failure was caused by the force majeure event of rezoning. Moreover, in this case, the court calculated the loss of the plaintiff by multiplying the outstanding contract price by the average net profit percentage of the year according to the principle of fairness.

3. Antitrust Law

The TOP clause does not necessarily have anti-competitive effect. Nevertheless, if combined with other restrictive clauses, or in case of the dominant market position held by the supplier, the TOP clause may lead to a violation of the PRC antitrust laws.

The quantity specified in the TOP clause is usually based on the actual demand of the buyer. If the agreed amount is basically equal to the buyer's demand, and the buyer purchases the quantity within the agreed time limit, there is no need for the buyer to purchase from other suppliers. Even if the agreed purchase volume does not account for 100% of the buyer's demand (for example, only 60%), the possibility that the buyer will shift to other suppliers for the remaining demand is greatly reduced due to factors such as cost of product substitution, product compatibility and stability. Therefore, the TOP clause can result in a lock-in effect on the buyer, which limit the buyer's choice of trading counterparties. If the seller has a dominant position in the relevant market, such lock-in effect may be aggravated in eliminating and restricting competition in the relevant market. In addition to administrative penalties for abuse of market dominance under antitrust laws, the supplier may also face civil liabilities under antitrust laws.

Market dominance refers to the market position in which the operator has the ability to control the price, quantity or other trading conditions of commodities in the relevant market, or to hinder or influence the ability of other undertakings to enter the relevant market. To determine whether an undertaking has a dominant market position, the court or the administration usually considers the following factors such as certain advantages of the undertaking in the market (such as market share, technology, resources, capital, etc.), lack of threats and impacts from other undertakings in the market, and the ability to independently control market product prices and supply in market competition. An undertaking with market dominance may use its dominant position to enforce or exclude competition in order to maintain or increase its competitiveness in the relevant market, which is deemed as abuse of market dominance. It usually manifests as enforcing unfair trading conditions to the counterparts of the transaction, including predatory pricing, refusal of transactions, exclusionary trading, tying sale, price discrimination, etc. Among them, exclusionary trading is most closely related to the TOP clause.

In the case of the abuse of market dominance by Eastman (China) Investment Management Co., Ltd.[5], the investigated party (Eastman (China) Investment Management Co., Ltd.) signed a sales agreement in relation to alcohol ester dodecanol film forming auxiliaries with six direct-sales customers including the minimum purchase quantity clause and the TOP clause. The minimum purchase quantity clause stipulated the minimum annual purchase amount of the buyer. The TOP clause stipulated that if the buyer fails to meet the minimum annual purchase quantity, it shall be within the remediation period place orders and pay for the deficiency or make up for the difference in purchase price. The Shanghai Municipal Market Regulation Administration concluded that (1) the parties had a dominant position in the relevant market in this case; (2) the TOP clause involved in the case has produced the effect of locking in customer demand; (3) the implementation of the TOP clause by the parties has produced significant anti-competitive effects. In determining the demand lock-in and anti-competitive effects of the TOP clause involved, the reasons given by the Shanghai Municipal Market Regulation Administration were as follows: the agreed minimum purchase requirement in the TOP clause took up a very high percentage of the customer's total demand (Eastman set the minimum purchase requirement above 80% of certain customers' annual demand in five contracts, and above 60% of the customers' annual demand in all six contracts), in combination with substitution costs, product compatibility, product quality stability and other factors, as well as the agreement on liability for breach of the TOP clause, the TOP clause in this case locked most of the needs of customers with certain influence in the relevant market. Moreover, Eastman and the customers reached the agreement on Most Favored Nation ("**MFN**") clauses and supplementary discount terms. The MFN clauses and supplementary discount terms further locked in customer needs. Based on the above facts, coupled with the facts that customers' demand for related products was stable, that locked demand accounted for a high

proportion of total market demand (20% market share in 2015), and that it was extremely difficult to break into the locked demand part, the TOP clause and the MFN clause had a significant effect to exclude and restrict competition in relevant markets. In conclusion, Eastman's conduct constituted abuse of market dominance provided in Article 17 of the Antitrust Law that "without justification, an undertaking restricts transaction counterparties to exclusively trade with itself or undertakings designated by it". Therefore, the Shanghai Municipal Market Regulation Administration imposed a fine of RMB 24,378,711.35 on Eastman.
It is worth noting that, as mentioned above, Eastman also included MFN clauses in the agreements with the buyers. Such a clause further enhanced the effect of Eastman's lock-in effect on the buyers. That was also an important factor for the antitrust enforcement administration to reach the conclusion that Eastman's activities constituted abuse of market dominance, to be more specific, exclusionary trading. The MFN clause is an optimal conditional clause derived from a rule commonly seen in international economic and trade relations. With the development of long-term economic trade and commercial practice, the operators in the upstream and downstream of the industry have agreed on the terms of "optimal trading conditions" to maintain trading relationship, that is, the conditions of the transaction given by one party to the other party will not be inferior to the conditions given to third parties. Similar to the TOP clause, the MFN clause does not necessarily by itself violate antitrust laws. It is necessary to analyze its impact on competition in light of the specific circumstances of the case. In the Eastman case, the Shanghai Municipal Market Regulation Administration concluded that Eastman gave the counterparty an additional discount on the MFN price. Such remarkable privilege was barely possible for other competitors to offer as they had significantly less financial resources than Eastman. In practice, the buyer was indeed locked in by such trading conditions and only purchased from Eastman. Thus, such policy had a significant effect of exclusionary trading. The combination of the TOP clause and the MFN clause "reaffirmed" the fact that Eastman abused market dominance.

In addition, a dominant undertaking's engagement in the TOP clause (including the combination of the TOP clause and other clauses) may not only constitute the abuse of market dominance, but also a vertical monopoly agreement regulated in antitrust laws, which means even undertakings without a dominant market position should also pay attention to the use of TOP clause.

IV. Summary

In summary, according to the principle of freedom of contract, the TOP clause is generally supported by PRC laws, regulators and courts in most cases. As a common practice in energy and chemical sector, TOP clause contributes to the stability of the industrial chain, risk sharing and project financing. However, under special circumstances, the court may adjust the agreed obligations of the seller and the buyer under the TOP clause in accordance with the principle of fairness and in the event of a force majeure event. If the seller has a dominant position in the relevant market, and the implementation of the TOP clause brings about an effect of significantly excluding and restricting competition in the relevant market, the seller would face administrative penalties as well as civil liabilities due to violation of antitrust laws by enforcing the TOP clause.

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