

COVID-19: U.S. OIL AND GAS UPSTREAM SUPPLY CHAIN DISRUPTIONS AND FORCE MAJEURE

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Oil, Gas & Resources Alert

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The COVID-19 global pandemic and the decline of oil and gas prices have added stress and economic uncertainty to a strained oil and gas industry. Recently, in response to the COVID-19-related market disruption, China's largest natural gas and liquefied natural gas ("LNG") importers have [declared force majeure](#) to provide relief and excuse performance from their contractual obligations. Major suppliers are contesting these assertions of force majeure. China is the world's leading gas and LNG importer, and the resolution of these disputes may be significant to the oil and gas industry on an international scale. It remains to be seen whether these declarations of force majeure will withstand legal scrutiny. The effects of suspending supplier contracts could have significant aftershocks on the oil and gas industry's upstream sector.

Due to the integration of the oil and gas supply chain, force majeure has been a useful tool, particularly for the oil and gas upstream sector. Much of the recent case law relating to force majeure in the United States relates to the ripple effect that stems from a disruption in production that flows to the downstream segment. Upstream contracts, including exploration and production sharing agreements, joint operating agreements, oil and gas leases, farmout agreements, unitization agreements, and the like, are interrelated to a high degree. The looming possibility of force majeure declarations could add disruptions to the U.S. oil and gas exploration production sector.

This alert briefly discusses primary force majeure considerations for upstream U.S. oil and gas contracts, why there is not a one-size-fits-all approach, critical first steps to preserving force majeure claims for U.S. upstream contracts, COVID-19 considerations, and alternative remedies to force majeure that may apply in the context of U.S. oil and gas production. K&L Gates' robust oil and gas team is prepared to work with our clients to think through and plan for disruptions caused by the current pandemic.

1. PRIMARY FORCE MAJEURE CONSIDERATIONS

As the world responds to the challenges presented by COVID-19, oil and gas companies may be faced with force majeure declarations, or may believe that a force majeure event has occurred, thus excusing performance of a contractual obligation if faced with unforeseen events beyond its control. In the event of such developments, the nature and enforceability of contractual rights and obligations of the parties should be determined. Some common questions regarding force majeure in the oil and gas industry include:

- Can my lease terminate due to low commodity prices caused by decreased demand due to COVID-19?
- Must I continue noncommercial or mandatory drilling programs?

Are early termination penalties under drilling, fabrication, and procurement contracts enforceable?

Must I continue to take delivery under transportation, processing, and sales contracts?

Are payment deadlines extended?

2. DECLINING COMMODITY PRICES AND FORCE MAJEURE AS A REMEDY TO UNECONOMIC OPERATIONS AMID THE COVID-19 PANDEMIC

Force majeure is governed by the language of the contract. Force majeure clauses can vary greatly. A case-by-case, fact-specific analysis and examination of the individual contract language is required to determine whether the circumstances present a force majeure event.

The impact of supply chain disruptions in the oil and gas industry due to COVID-19 could be heaviest in states like Texas, where oil and gas production makes up a significant portion of the Texas economy. This could lead to more litigation around force majeure in oil and gas producing states. The decline in oil prices amidst the COVID-19 pandemic may place further strain on producers and render drilling plans uneconomic, creating the potential for an increased frequency in raising force majeure defenses to excuse nonperformance under various upstream oil and gas agreements.

Knowing and understanding the choice-of-law provisions in these agreements is important. For example, in the event that a force majeure clause is ambiguous, the Texas courts have held that contract language will govern.¹ In Texas, force majeure is an affirmative defense, and the burden of proof is placed on the party claiming the defense. In the context of farmout agreements, Texas courts have refused to expand the interpretation of force majeure provisions to include significant price fluctuations. For example, a Texas court has explained:

A force majeure clause does not relieve a contracting party of the obligation to perform, unless the disabling event was unforeseeable at the time the parties made the contract. An economic downturn in the market for a product is not such an unforeseeable occurrence that would justify application of the force majeure provision, and a contractual obligation cannot be avoided simply because performance has become more economically burdensome than a party anticipated.²

However, the Texas court further explained that if a force majeure provision includes consideration of market fluctuations, then "[t]here was no unforeseeability requirement when a specified force majeure provision expressly states that conditions that make operations uneconomic constitute force majeure."³

3. CRITICAL FIRST STEPS TO PRESERVING FORCE MAJEURE CLAIMS AND COVID-19 CONSIDERATIONS

As noted, generally, a force majeure clause is governed by contract law. In many jurisdictions, the interpretation of a force majeure clause will be governed by the four corners of the contract. However, it should be noted that in many jurisdictions force majeure clauses are construed against excusing performance. Companies should carefully consider structuring these clauses for any contracts that are presently being negotiated to protect against any challenges that may arise, either directly or indirectly, from COVID-19. In both executed and non-executed contracts, a comprehensive review should be performed to analyze potential scenarios where force majeure is triggered in interrelated agreements.

In any potential force majeure situation, critical first steps to preserve a force majeure claim include:

1. Determining what constitutes a force majeure event;
2. Determining what obligations may be suspended by the force majeure event;
3. Determining the "Notice of Force Majeure" requirement;
4. Documenting the evidence of the force majeure event (including evidence that the force majeure event and its effect on obligations are unforeseeable and beyond the party's control); and
5. Taking steps to overcome the force majeure event and documenting those steps.

With regard to COVID-19 specifically, a review of a force majeure clause should take into account whether, and how, the specific contract language defines a public health emergency. Certain requirements, such as a formal declaration from a government body, may be required. Force majeure may be less stringent in other contracts, and the mere impact of a public health emergency may be sufficient. For example, whether a detrimental drop in oil prices related to COVID-19 is a triggering event for a force majeure clause is a fact-specific question, the answer to which is determined from the language of the clause.

Even if the force majeure clause does not mention a public health emergency, it could be implied by other language in the clause. In particular, language regarding material adverse changes, or effects from circumstances beyond a party's control, may apply to the COVID-19 pandemic, including, travel restrictions, reduction in workforce, and other factors contributing to supply chain disruptions. By the same token, the degree to which performance under the contract will be excused will depend on the specific language of the clause.

It is important to consider the litigation risk in declaring force majeure to excuse performance. For example, what obligations might your counterparty claim are excused by the event? Will a potential government bailout be sufficient to constitute mitigation? What actions will satisfy the obligation to mitigate damages? What are the reputational costs to declaring force majeure?

4. ALTERNATIVE REMEDIES TO FORCE MAJEURE

Common Law

Beyond force majeure, some states, including Texas, may provide noncontractual, common law defenses like "frustration of purpose" and "impossibility of performance" to excuse nonperformance under a contract. There can

be differences in how these defenses are defined and applied. Generally, frustration of purpose may be a defense where an unforeseen event undermines the nonperforming party's obvious purpose in entering into the contract. Alternatively, impossibility may be a defense to a failure-to-perform claim when an unforeseen event makes contractual performance objectively impossible.

Article II of the Uniform Commercial Code

In the absence of a force majeure clause, a party should consider whether the Uniform Commercial Code ("UCC") is applicable. The UCC may apply if the contract is for the sale of goods. Section 2-615 provides excuse by failure of presupposed conditions, which includes impracticability. Under the UCC, nonperformance can be excused where performance is rendered impracticable. The mutual intent of the parties can, however, override the application of the UCC. Additionally, the UCC includes notice provisions with which one must comply in order to assert impracticability of performance.

Upstream Alternatives to Force Majeure

Most oil and gas leases have savings clauses that may prevent the lease from expiring when production stops, due to mechanical reasons, lack of a market, or temporary unprofitability. In some circumstances, clauses such as shut-in clauses, workover clauses, and continuous development clauses can keep a lease, joint operating agreement, or other production-related contract in force during times of nonproduction. In the context of drilling obligations, a holistic view of the contract may help to understand what obligations may be excused or modified by alternative remedies to nonperformance provided under the contract. Careful analysis of early termination penalties under drilling contracts should be performed to determine whether these penalties could apply or be discharged. In addition, although leases may lapse if production becomes unprofitable, the reasonably prudent operator standard may apply and allow the lease to continue to be valid.

CONCLUSION

In summary, whether COVID-19 and its related impacts constitute a force majeure event is a fact-specific inquiry governed by the contract language. Oil and gas operating companies should evaluate their interrelated agreements related to production to assess the potential for supply chain disruptions, whether asserting force majeure or facing a declaration of force majeure. K&L Gates is happy to help guide you through the force majeure analysis.

¹ *Va. Power Energy Mktg., Inc. and Dominion Res., Inc. v. Apache Corp.*, 297 S.W.3d 397, 402 (Tex. Civ. App.—Houston [14th Dist.] 2009, pet. denied).

² *TEC Olmos, LLC v. ConocoPhillips Co.*, 555 S.W.3d 176, 183 (Tex. App. 2018) (review denied) (citation omitted).

³ *Id.*

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