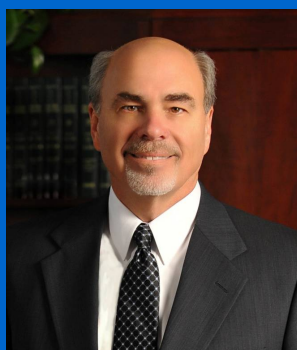




Surviving Low Oil Prices (Part 5) Force Majeure - *Excuse Me Please*

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Negative Prices for May Futures Sales

The law of supply and demand is simple – when more than needed is produced the value of the product will fall. In the case of the current oil price the word “fall” is inadequate to describe the decline. A more suitable word would be “plummet” or “collapse”. Early trading of WTI plummeted on Monday morning to \$11.54/Bbl. Then by days end, crude prices collapsed into negative territory for the first time in history, to settle at -\$37.63/Bbl. for May deliveries. That’s correct, some sellers had to *pay* \$37.63/Bbl. for a purchaser to take their May deliveries. No one wants more oil because market demand has collapsed as a result of the closing of our economy. Even if someone wanted to buy low (to later sell high), we are running out of places to store oil. Unless these oversupply and storage issues get corrected soon, don’t be surprised if the prices spiral even lower into negative territory for limited times.

The oil market was clearly not impressed with the 10 MMBbl/day cut in oil production. It was not enough to cover the 30 MMBbl/day excess over worldwide demand. As we all now know, the spread of COVID-19 and economic shut down has plunged much of the world into a period of dramatic uncertainty. The price of oil is certain to stay low until market demand increases back to pre-Covid19 levels. And the US producer has little or no control over this decline caused by Stay-at-Home Orders, mixed with OPEC+ dumping more oil on this depressed market.

So, is there anything in the lease contract or the law that allows an operator to limit the amount of oil produced in this depressed market, and produce later when prices get back to normal? One would think that this historic economic uncertainty would trigger a force majeure clause designed to give relief when an event is “beyond the control” of the lessee. But that is not always the case. Many states are currently considering pro-ration orders to mandate reduced production. The Texas Railroad Commission (TRRC) - which regulates oil and gas in Texas - heard arguments on Tuesday, April 14, for and against the issuance of governmental orders reducing production allowables from wells in Texas. New Mexico and Oklahoma have also set hearing dates to consider what, if anything, can be done by the state to reduce the oil glut. The New Mexico State Land Commissioner just announced an emergency rulemaking that allows producers to shut-in for 30 days.



In this article we will take a look at force majeure issues and evaluate whether these historic and unimaginable market conditions can trigger a force majeure excuse *via* the lease or whether governmental orders can come to the rescue.

Does Force Majeure Excuse My Obligations?

1. The Lease Force Majeure Clause

The term “force majeure” translates literally from French as “superior force.” The force majeure clause (“*FM Clause*”) was put in contracts to cover extreme situations, where conditions are beyond the control of a party. A mineral lease normally contains a FM Clause, but there is no standard form. The clause in each lease must be read and interpreted. A typical FM Clause might read as follows:

“When drilling, reworking, production or other operations are delayed or interrupted by force majeure, that is, by storm, flood or other acts of God, fire, war, rebellion, insurrection, riot, strikes, differences with workmen, or failure of carriers to transport or furnish facilities for transportation, or as a result of some law, order, rule, regulation, requisition or necessity of government, Federal or State, or as a result of any cause whatsoever beyond the control of the Lessee...”

The typical FM Clause covers the delay or interruption of “production” for “any reason beyond the control of the Lessee.” It is undisputed that these extreme market conditions and downward spiral in price is “beyond the control” of the lessee. The lessee does not “control” Covid-19, governmental Stay-at-Home Orders or the foreign countries that continue to produce into an oversupplied market.

As broad as the typical FM Clause is, they do not specifically cover “an economic downturn” in the market price. As written, the clause generally does not cover a “pandemic” or unprecedented “financial hardship” caused by “unforeseen” conditions in the market. Courts generally make a strict interpretation of a FM Clause. If the specific condition is not written in the FM Clause, the courts may not recognize that event as a force majeure condition. Simply put, courts do not always recognize something as a force majeure event just because it is “beyond the control” or was “unforeseeable”.

Pandemics can cause a variety of issues for businesses that ultimately impact the ability to perform. As we are seeing now, it may no longer be prudent to produce wells until depressed prices rebound. Companies may also face a workforce shortage as employees become unable to work due to sickness or quarantine (whether self-imposed, imposed by the business or an applicable governmental order). These

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workforce shortages in affected regions can have a ripple effect to regions unaffected by the pandemic. The lack of essential supplies or raw materials from one region of the world can also halt production of business elsewhere. These types of uneconomic events and workforce shortages should be added to any future FM Clause.

2. Re-drafting the Lease Force Majeure Clause

Some FM Clauses do include “unforeseen” conditions as triggering a force majeure event. However, the courts have not consistently ruled on whether an “unforeseen” event triggers a FM Clause. The US Third Circuit and the Fifth Circuit have reached differing results regarding whether an unforeseen condition is a force majeure event. Generally, absent a specific provision covering the event, an economic downturn in the market is not an unforeseeable occurrence that would justify application of the force majeure provision. If this is the court’s interpretation, then a contractual obligation won’t be avoided simply because performance has become more economically burdensome than anticipated. For example, in *TEC Olmos, LLC v. ConocoPhillips Co.*, 555 S.W.3d 176 (Tex. App. 2018) the court held that an unforeseen economic downturn in the oil industry did not trigger the FM Clause contained in a farmout.

The hallmark of a well-written agreement is that it is not limited to normal situations, but also covers the unexpected or catastrophic situations. Lawyers are often criticized for being too wordy. But this is an example where your lawyer’s wordiness and creativity is needed to draft a clause that adequately covers these other triggering conditions. In drafting a FM Clause, be specific in naming triggering events but always use of the phrase “including, but not limited to...”, for an indication that the listing was not exclusive. Some courts have held that failure to list a type of foreseeable event in the contract shows the parties accepted the risk from such events and waived the right to use the occurrence of that event as a valid excuse.

The take-away from these uncertainties is that it may be time to revise the FM Clause used in your leases and contracts. Among other items, it is advised that you start, where possible, inserting words that include, but are not limited to, an (a) “economic downturn”, (b) “unforeseen decrease in production prices or availability of storage” and (c) “delays, curtailment of production or cessation of operations caused by or related to any pandemic, epidemic, related quarantine or unforeseeable economic events”. A “catch-all” or broad provision covering things “beyond the control” likely will not trigger a force majeure event unless the type of event is specifically listed in the clause. In years past it was SARS, the Swine Flu and Ebola. Today it is Covid-19. Tomorrow it will be a disease with a different name. You can include these disease names, but don’t limit force majeure to the specifically named diseases, because new ones will come in the future.



Will the Government Help if my Lease Doesn't

Force Majeure from Governmental Order

A. Lessee Shall "Comply with Law"

In addition to a FM Clause requiring compliance with laws, many agreements contain a clause that the lessee will "comply with, all applicable laws, ordinances, rules and regulations..." (a "**Compliance Clause**"). Even if a contract does not contain a similar clause, general law should provide the rule that each party to the contract will obey and comply with all applicable laws and regulations. Therefore, if a governmental order impacts the producer's operations, its ability to get workers to the job, travel restrictions or proration orders restricting production, the a lessee should be justified in complying with the law - even if it means that operations or production must be curtailed.

B. Pro-Ration Orders

As noted above, the Texas Railroad Commission (*TRRC*) heard arguments on Tuesday, April 14, for and against the issuance of a governmental order reducing the amount of production allowables affecting wells in Texas. The last time the TRRC issued orders to reduce allowables was in 1973. No decision has been rendered. Other states, including New Mexico and Oklahoma, have set hearing to consider taking action to limit production allowables.

Should the TRRC or other state issue orders restricting the amount of oil or gas allowed to be produced, such an order should constitute a force majeure event or trigger a Compliance Clause. Failure to reduce production in compliance with any governmental proration order would likely constitute a violation of law and should provide a defense to any claim that production cannot be curtailed. If Texas reduced production allowables, other states might follow suit. Stay tuned!

C. Stay-in-Place Orders

There are so many Shelter-in-Place Orders that it is hard to keep up with the next round of what we are not to do. It appears that oil and gas operations have been deemed "essential" and are therefore exempt from these orders. But many workers are covered by Shelter-in-Place Orders and advised or required to not venture to the workplace. Should you have a situation where a governmental order has prevented or delayed operations, or made operations more hazardous, because a worker is sheltering-in-place, then your FM Clause or Compliance Clause should excuse the action or inaction caused by compliance.

In addition to a force majeure clause, many leases and related agreements contain a clause that the lessee will "comply with, all applicable laws, ordinances, rules and regulations..."

Failure to reduce production in compliance with any governmental proration order would likely constitute a violation of law and should be a force majeure or compliance excuse to any claim that production cannot be curtailed.

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D. Notice Provisions

Some FM Clauses require that you give the other party to the contract written notice of the condition or facts that you claim trigger a force majeure event. If you intend to rely on a force majeure condition to excuse performance (including production or operations) be sure to carefully the agreement to determine if you are required to give notice of the event. If it is required and you fail to give the required notice, the otherwise valid force majeure event may not be enforceable.

E. Other General Laws

If your lease or other contract does not contain a FM Clause, general law of the particular state may provide an excuse for non-performance. There are several legal theories that some states have adopted to excuse a party from contractual obligations, including but not limited to the following:

- a. Frustration of Purpose
- b. Doctrine of Impossibility
- c. Commercial Implacability
- d. Unforeseeability

These theories have not been adopted in all states, but where allowed may provide an additional excuse for non-compliance with normal obligations during these abnormal times. Like the FM Clause, all these independent have similar high standards to meet, and are designed to cover extreme situations.

We are clearly living through one of the most unusual and unforeseen times in modern history. If these impossible economic hardships and uncertain times do not trigger a legal basis for suspending production obligations, I'm not sure what would.

Next Issue:

In the next issue we will look closer at production in “paying quantities,” and the impact on temporary low prices.

Please feel free to contact me if you have any questions or need additional advice.

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