Articles + Publications | April 29, 2020

Locke Lord QuickStudy: Pulling the Trigger on Force Majeure: An Update from the Midstream Energy Perspective

Locke Lord LLP

WRITTEN BY

David E. Harrell | Monika Dziemianczuk | Derrick Carson, FCIArb

RELATED OFFICES

Houston

Last month we provided a Locke Lord LLP QuickStudy outlining Texas law on force majeure in light of COVID-19 and the oil price war.While the price war may have reached a cease-fire, the pandemic and its effect on the global oil market remain. This supply glut permeates the energy spectrum, but midstream companies in particular are getting squeezed from both ends—producers threatening not to fulfill their upstream commitments and facing a lack of downstream storage.Against that background, several clients have asked us to update our more general comments from last month with a view tailored to the midstream energy business. In so doing, we do not intend to repeat our prior observations, which may be found here, but instead, offer market observations and industry-specific guidance from case law to supplement our previous force majeure analysis.

Market Observations

Overall, force majeure issues are growing in frequency and importance. We have seen a rash of premature force majeure notices to midstream companies that in effect say: “We are not stopping performance just yet, but want you to know we might,” as well as an increase in the number of actual force majeure notices. Further, with Oklahoma now petitioning President Trump to declare a COVID-19 oil price emergency and Continental Resources giving notice that it would not fulfill contracts, we may be seeing just the tip of the iceberg.[1]

Midstream companies seem to be experiencing several types of force majeure issues.One is from producers that are considering shutting in production and are thus seeking relief from minimum volume commitments (“MVC”) or similar revenue commitments.Many of these notices are paired with requests to renegotiate rates and extend contract durations in exchange for other concessions. But as producers continue to feel the price/storage squeeze, the risk that they will shut-in production and simply claim force majeure is real. Further, lack of storage capacity is affecting those midstream companies that purchase and sell oil in addition to transporting it. With U.S. crude oil prices dipping into the negative for the first time, suppliers are effectively paying others to remove the product, an act that for some arguably “constitute[s] waste.”[2] Desperate to combat the storage-capacity crisis, companies are now considering hiring costly U.S. vessels to stow gasoline or ship fuel overseas after realizing that “nearly 85% of worldwide onshore storage was full as of last week.”[3]

We are also seeing notices given under gas purchasing and processing agreements.Some of these notices are a

natural result of oil-related issues, where associated gas would be shut-in when a producer shuts-in its oil wells. But there also appears to be additional market turmoil with parties on either side of these transactions seeking relief. Opportunistic "price majeure" is a contributing factor to this market turmoil, though unsurprising given the overall depressed nature of natural gas prices. Other force majeure notices stem from issues affecting the industry as a whole.

Interestingly, two areas where we have not seen as many notices as one might have expected are COVID-19 specific (*e.g.*, related to government "stay-at-home" orders or personnel shortages) and contractor notices on construction projects. The fact that energy and construction are both "essential services" under Texas' stay-at-home order is no doubt a large part of the reason. In addition, force majeure under most construction contracts merely grants the contractor additional time to complete the project, so many contractors are opting to base their notices upon "unforeseen conditions" or other provisions that might, if applicable, allow the contractor to claim entitlement to more money, in addition to more time.

Midstream-Specific Case Law

Although we cited to several midstream energy cases in our prior QuickStudy, our intent here is to amplify and expand on that case law and encourage readers to consider this additional information in light of our prior comments.

Read your contract!

We cannot emphasize enough the importance of analyzing each contract on its own. Force majeure claims, particularly under Texas law, live and die by the contract's language. The case of *Kodiak 1981 Drilling P'ship v. Delhi Gas Pipeline Corp.*, 736 S.W.2d 715, 721 (Tex. App.—San Antonio 1987, writ ref'd n.r.e) illustrates this very point. In *Kodiak*, a natural gas purchaser was excused from performance under a contract's force majeure clause that included a "partial or entire failure of the gas supply or market" when prices collapsed due to "an unprecedented combination[sic] of factors." *Id.* The *Kodiak* case stands in marked contrast to a litany of cases holding that price fluctuations, even in the extreme, generally do not constitute force majeure events. *See, e.g.*, *TEC Olmos, LLC v. ConocoPhillips Co.*, 555 S.W.3d 176, 184 (Tex. App.—Houston [1st Dist.] 2018, pet. filed) ("Because fluctuations in the oil and gas market are foreseeable as a matter of law, it cannot be considered a force majeure event unless specifically listed as such in the contract."); *Valero Transmission Co. v. Mitchell Energy Co.*, 743 S.W.2d 658, 663–64 (Tex. App.—Houston [1st Dist.] 1987, no writ) ("[A] sudden or significant change in price, or the fact that one of the parties may gain or lose during a particular period of the contract, is not sufficient to constitute an extraordinary, unforeseeable event that would excuse performance under the force majeure clause.").

Can force majeure excuse a producer's failure to comply with its MVC?

This question in particular is difficult to answer without reviewing the specific contract at issue because MVCs take many different forms and are calculated under a variety of formulas. But one core force majeure concept that will be particularly applicable in these situations: whether the producer could have taken reasonable action to satisfy its commitments, notwithstanding the force majeure event. For example, if the MVC is based on the volumes delivered over the life of a five-year contract, the producer could arguably increase volumes to meet its

commitments after the force majeure event passes. But if the MVC is calculated over a relatively short period, the producer might have a reasonable argument that it is entitled to a ratable reduction in its commitment.

A review of over a dozen gathering agreements in preparing this QuickStudy revealed that there is little uniformity in how this issue is addressed. One gathering agreement, which contained both annual and life-of-contract MVCs, granted relief on the annual MVC by allowing a ratable reduction for each day on volumes the producer was prepared to deliver but could not due to a force majeure event; it expressly provided no relief for the life-of-contract MVC. Other agreements differentiate between force majeure events affecting the gatherer's ability to gather or process and those affecting the producer's ability to deliver, leaving the clear inference that the producer's obligation to satisfy MVCs is unaffected by force majeure. While some built force majeure concepts into formulas to determine the MVC amount, others simply included relatively standard force majeure provisions, leaving them open to interpretation.

How does force majeure apply under a standard North American Energy Standards Board ("NAESB") contract?

Following the "first, read your contract" directive takes a bit more diligence when interpreting the NAESB contract because a complete NAESB contract is made up of the Base Contract, any Special Provisions, the General Terms and Conditions, and finally the Transaction Confirmation for the applicable trade. Assuming that the parties have not otherwise modified the contract in the Special Provisions or Trade Confirmation (they frequently do), the NAESB contract's standard form terms and conditions include specifically enumerated force majeure events.[4] That force majeure provision applies only to "Firm" contracts, rather than those for "Interruptible" supply, which are generally cancellable for any reason. The successful invocation of force majeure under these standard contracts depends heavily on whether the parties' obligations are limited under contract terms, the particular force majeure section relied upon, as well as the circumstances of each case.

For example, a New Jersey court declined to hold that the NAESB's force majeure provision excused performance despite a leak in a gas transportation pipeline. *Hess Corp. v. ENI Petroleum US, LLC*, 86 A.3d 723, 729 (N.J. Super. Ct. App. Div. 2014). Relying on the contract's enumerated list of force majeure events, the seller claimed the leak qualified as an "interruption and/or curtailment of Firm transportation and/or storage by Transporters." *Id.* at 726. But both the trial and appellate courts disagreed. *Id*. at 724. The parties never specified a natural gas source, transporter, or route. *Id.* at 726. Instead, the contract's seemingly open-ended language implied the seller was not limited to the damaged pipeline, and as a result, could rely on other sources, transporters, and routes to fulfill its contractual obligations. *Id.* at 728 ("Because there was nothing limiting defendant's performance . . . an interruption . . . was irrelevant to defendant's obligation."). Defendant's sole requirement under the contract was to "provide plaintiff with a specific amount of gas . . . regardless of how it got the gas to the delivery point," and therefore, force majeure did not apply. *Id.* at 729.

Texas law has occasionally provided parties relief from liability under the NAESB contract's force majeure provisions, but the success of the defense turns on the facts. *Virginia Power Energy Mktg., Inc. v. Apache Corp.* demonstrates the effect of this force majeure provision on two agreed-upon delivery points following successive hurricanes. 297 S.W.3d 397, 405–06 (Tex. App.—Houston [14th Dist.] 2009, pet. denied). The seller invoked force majeure as a result of Hurricanes Katrina and Rita for each delivery point but for different reasons. *Id.* at 401. With respect to the first delivery location, the hurricanes significantly damaged a pipeline and ultimately

precluded delivery, so the seller successfully invoked force majeure because the hurricane, an enumerated event, resulted in "breakage or accident or necessity of repairs to . . . lines of pipe" and thus hindered performance. *Id.* at 404. The second delivery location, although undamaged, received only half of its commitment, and the seller claimed the hurricanes caused a "loss or failure of [] gas supply." *Id.* at 405. The contract, silent on the source of "gas supply," led the court to find a question of fact existed regarding the loss or failure of gas supply and whether that loss prevented the seller from fully performing at the second delivery location. *Id.*

There are additional nuances in the NAESB contract that parties must scrutinize. For instance, the force majeure provision contains a number of specific carve-outs unique to the NAESB contract.[5]So, for example, if a party cannot perform due to the loss of interruptible service, it cannot claim force majeure unless primary, in-path, firm transportation is also curtailed. Another is the exact product being purchased. In this regard, "firm delivered gas" arguably shifts all risk upstream of the delivery point to seller, so force majeure would apply only where there is no gas flowing into the delivery point, as opposed some gas flowing that the seller could buy for delivery to buyer.

Is lack of storage a force majeure event?

While we found no case law specifically addressing a market-based reason for lack of storage, in our view it could constitute a force majeure event given the right contract and circumstances. For example, the NAESB standard contract includes "interruption of firm transportation and/or storage by Transporters" among enumerated force majeure events. The contract defines "Transporter(s) as: all Gas gathering or pipeline companies, or local distribution companies, acting in the capacity of a transporter, transporting Gas for Seller or Buyer upstream or downstream, respectively, of the Delivery Point pursuant to a particular transaction." So downstream storage issues could potentially provide a basis for force majeure. But as the *Hess Corp.* and *Virginia Power* cases demonstrate, the analysis does not stop at recognizing an event as a named force majeure event; the facts must support the finding that the event truly prevented performance.

Other contracts are less likely to include "lack of storage" as an enumerated event, so the analysis will likely turn to whether the lack of storage fits within the typical catchall of "any other event beyond a party's control." As we noted in our previous article, those claims must overcome the additional hurdle of lack of foreseeability, which often proves difficult. *See generally TEC Olmos, LLC v. ConocoPhillips Co.*, 555 S.W.3d 176 (Tex. App.—Houston [1st Dist.] 2018, pet. filed).

What kind of "government intervention" can constitute force majeure?

Although your enumerated force majeure events may include government intervention, such as "government orders, rules, or regulations," an act of government does not automatically suspend performance. The key factors to consider include not only the contract language but also the surrounding events and actions of both the government entity and respective parties. For example, when a party fails to comply with regulations that fall squarely within its control, acts of government rarely excuse performance; in that instance, the invocation of force majeure is a dead-end. *See e.g.*, *Red River Res. Inc. v. Wickford, Inc.*, 443 B.R. 74, 80 (E.D. Tex. 2010) (Texas Railroad Commission severance order did not qualify as a force majeure event when compliance with the regulation was within the lessee's reasonable control); *Moore v. Jet Stream Invs., Ltd.*, 261 S.W.3d 412, 422 (Tex. App.—Texarkana 2008, pet. denied) (Texas Railroad Commission severance resulted from lessee's failure to provide financial assurance and therefore was not a force majeure event).

Government orders may also change procedures, and as a result, affect contract obligations. In those cases, the potential to claim force majeure increases, but the result depends on how parties defined force majeure in their contract. For example, one court held that it was a question of fact whether a pipeline company was "unable, wholly or in part" to comply with a contract after a FERC Order altered purchase procedures for one of the company's major customers. *See Atlantic Richfield Co. v. ANR Pipeline Co.*, 768 S.W.2d 777, 781–82 (Tex. App.—Houston [14 Dist.] 1989, no writ). In *Atlantic Richfield*, the relevant contract defined force majeure as "an act (including the failure to take gas) of a purchaser of substantial quantities" and "any orders or regulations of any governmental body." *Id.* at 781.The FERC Order permitted a pipeline company's customer to acquire gas from cheaper markets and relieved it from payment for gas not taken, thereby decreasing the pipeline's daily contract quantity. *Id.* at 781 n.1. Claiming this constituted force majeure, the pipeline company argued it was "unable, wholly or in part" to satisfy its contract obligations, a fact question reserved for the jury. *Id.* at 781. A federal court in Oklahoma addressed a similar issue under the same FERC Order and held that it qualified as a force majeure event, but it left open as a fact question whether that same order rendered performance impracticable, either in whole or in part. *Hamilton Bros. Oil Co. v. ANR Pipeline Co.*, No. CIV-88-132-A, 1989 U.S. Dist. LEXIS 17871, at *5–13 (W.D. Okla. Feb. 20, 1989) (finding FERC Order No. 380 qualified as force majeure event, but whether it rendered performance impracticable, in whole or in part, remained a question of fact for the jury).

Compliance with notice provisions matters!

Failure to comply with contractual notice requirements can kill a force majeure defense. Our previous QuickStudy discussed the importance of diligently complying with notice requirements to avoid consequences, and this article, though tailored to midstream companies, strongly reemphasizes that proposition. Asserting force majeure based on a qualifying event that, in fact, renders performance impracticable, means nothing without proper notice. Moreover, a court will refuse to relieve a party of liability simply because of a failure to comply with the contract's notice requirements. *Superior Oil Co. v. Transco Energy Co.*, 616 F. Supp. 98, 108–09 (W.D. La. 1985) (pipeline company's failure to give notice prevented the assertion of a defense "even if those [force majeure] events it cites did constitute force majeure").

If and when you need to assert force majeure, consider the following: (1) Does my contract require me to give notice? (2) Is there a timeliness requirement to provide this notice? (3) What do I need to provide or state in my notice? Certain force majeure provisions might require "immediate notice of all pertinent facts," that a party "take all reasonable steps to prevent the occurrence," or even "six months[’] notice before the buyer can be excused." *Int'l Minerals and Chem. Corp. v. Llano Inc.*, 770 F.2d 879, 885 (10th Cir. 1985).Complying with timeliness requirements may not be enough to trigger force majeure as some contracts require additional information or descriptions of reasonable efforts. *See id.* ("Notice . . . was inadequate in that no reasons were given as to why gas consumption would be decreased."). But parties should also avoid giving notice too soon, as prospective notice, given too long before the actual event, could instead constitute evidence that an alleged force majeure event was actually foreseeable and the party giving notice could take action to avoid consequences.

No Force Majeure Clause? Explore an Alternate Avenue

As discussed in our previous QuickStudy, those without a force majeure provision may possibly ?find relief through other doctrines. For example, in contracts for sale of goods, which includes oil and gas, Article 2 of the Uniform

Commercial Code may provide additional remedies.[6] Specifically, § 2-615 of the U.C.C. exists as a makeshift "statutory force majeure" when sellers of goods find ?themselves unable to perform because of "unforeseen supervening circumstances not within the ?contemplation of the parties at the time of contracting," provided they can satisfy the following: ??(1) a contingency—something unanticipated—occurred; (2) the contingency rendered ?performance impracticable; and (3) the non-occurrence of that contingency must have been a ?basic assumption of the parties' contract or good faith compliance with a foreign or domestic ?government regulation.? ?U.C.C. § 2-615(a), § 2-615 cmt. 1.? Unlike force majeure clauses, which contemplate a specific event, Section 2-615 effectively ?allocates the risks arising from events that neither party contemplated nor allocated. The U.C.C's ??"impracticability" standard parallels the common law doctrine of commercial impracticability and ?may excuse theoretical, but prohibitively expensive performance. *See Transatlantic Fin. Corp. v. ?U.S.*, 363 F.2d 312, 315 (D.C. Cir. 1966) ("[A] thing is impracticable when it can only be done at ?an excessive and unreasonable cost.").This concept proposes that the interest of having ??"contracts enforced according to their terms is outweighed by the commercial senselessness of ?requiring performance." *Id.* Furthermore, the impracticability doctrine fosters the rationale that ?the contingency causing the breach rendered performance "so vitally different from what was ?anticipated that the contract cannot reasonable be thought to govern." *Eastern Air Lines, Inc. v. ?McDonnell Douglas Corp.*, 532 F.2d 957, 991 (5th Cir. 1976).Section 6-215, however, ?effectively curtails the cost argument, noting "[i]ncreased cost alone does not excuse ?performance unless the rise in cost is due to some unforeseen contingency which alters the ?essential nature of the performance." U.C.C. § 2-615, cmt. 4.?

Interestingly, the U.C.C. contemplates "a severe shortage of raw materials or of supplies due to a ?contingency such as war, embargo . . . unforeseen shutdown of major sources of supply or the ?like, which either causes a marked increase in cost or altogether prevents the seller from securing ?supplies necessary to his performance." *Id.* Foreseeability of the contingency, however, remains ?a significant—and quite frankly—difficult obstacle to overcome due in part to the U.C.C. ?considering not only whether the contingency is "sufficiently foreshadowed at the time of ?contracting" but also whether it arises "as a matter of reasonable, commercial interpretation from ?the circumstances." U.C.C. § 2-615, cmt. 8; *see Transatlantic Fin. Corp.*, 363 F.2d at 318–19 ??("The surrounding circumstances do indicate, however, a willingness . . . to assume abnormal ?risks, and this fact should legitimately cause us to judge the impracticability of performance by ?an alternative route in stricter terms than we would were the contingency unforeseen."); *Bende & ?Sons, Inc. v. Crown Recreation, Inc.*, 548 F. Supp. 1018, 1022 (E.D.N.Y. 1982) (??"common sense" implied the parties could have reasonably foreseen a train derailment). ?

In certain circumstances, the success of this statutory defense is contingent on fulfillment of ?additional conditions. For example, Section 2-615 dictates where a seller's ability to perform is ?only partially impacted, or if the seller still has available goods, the seller will generally be ?required to provide those goods and, if applicable, allocate the available inventory among ?customers in a fair and reasonable manner. U.C.C. § 2-615(b).? This includes regular customers ?not then under contract, in addition to its own requirements for manufacture. *Id.* Similar to ?many force majeure provisions, Section 2-615 employs a notice requirement: when a seller's ?performance has been impaired, the seller must "seasonably" notify the buyer of the delay or non-?delivery, and if allocation is required, an estimate of the allocation for the buyer. U.C.C. § 2-??615(c).?

—

1. *See* Alwyn Scott, *Oklahoma asks Trump to declare coronavirus an 'act of God' to help oil producers*, Reuters:

Business News (Apr. 26, 2020, 12:58 PM), https://www.reuters.com/article/us-oil-usa-oklahoma/oklahoma-asks-trump-to-declare-coronavirus-an-act-of-god-to-help-oil-producers-idUSKCN2280OR (noting the effect of a presidential force majeure declaration on the oil industry); Jennifer A. Dlouhy & Rachel Adams-Heard, *Continental Resources declares force majeure on some oil deliveries*, World Oil (Apr. 24, 2020), https://www.worldoil.com/news/2020/4/24/continental-resources-declares-force-majeure-on-some-oil-deliveries

2. Dlouhy & Adams-Heard, *supra* note 1.

3.*See* Devika Krishna Kumar & Jonathan Saul, *Exclusive: Oil traders book expensive U.S. vessels to store gasoline, ship fuel overseas in sign of desperation*, Reuters: Business News (Apr. 27, 2020, 1:42 PM), https://in.reuters.com/article/us-global-oil-storage-tankers-exclusive/exclusive-traders-book-jones-act-tankers-for-storage-foreign-trips-as-u-s-fuel-glut-swells-sources-idINKCN2292NI (discussing the option of expensive Jones Act vessels as possible storage solutions).

4. See Section 11 for the entirety of the Force Majeure provision under the NAESB, Base Contract for the Sale and Purchase of Natural Gas

5. See NAESB, General Terms & Conditions, § 11.3.

6. Article 2 is unlikely to apply to contracts that are primarily for the provision of services. In those instances, parties should consider looking at the common law doctrine of impracticability.

RELATED INDUSTRIES + PRACTICES

- Energy