Oil and Gas Industry Update: Commodity Price Volatility

March 2020

Baker Botts hosted a webinar with Mark Finley of the Baker Institute on March 10, 2020 that addressed select policy and legal issues arising from recent commodity price volatility. For those unable to join, Baker Botts' Energy team has summarized five key topics raised in the webinar.

KEY ISSUE

1. **Force Majeure and Related Doctrines.** Price volatility may render businesses unable or unwilling to perform their long-term contractual obligations. These circumstances may also trigger excuse of contractual performance through force majeure and related doctrines. Force majeure generally refers to the excusing of performance because of traditional "acts of God" (e.g., hurricanes, fires) or human events beyond control (e.g., riots, wars). Energy contracts routinely enumerate events that would excuse performance if such events prevented a party from being able to perform. Whether events such as the current downturn in oil prices and the growing COVID-19 crisis will be considered a force majeure event hinges on such issues as (i) review of the specific the contractual provisions; (ii) careful analysis of the governing law; and (iii) the extent to which such events prohibited a party from being able to perform.

   For parties reviewing these provisions, special attention should be devoted to what events are specifically included or excluded, whether there are unforeseeability or reasonable control requirements, the extent to which performance must be impeded, and relevant notice obligations. Regardless of whether a party is seeking to invoke or avoid force majeure provisions, the scope of the provision could impact re-negotiation of the performance at issue.

   Additionally, governing law matters. Most states surveyed, including Texas, will only use common law elements to fill in the gaps in contract provisions. However, courts in New York and California have also injected common law elements such as unforeseeability and reasonable control requirements, even when expressly omitted from the contract. These concepts are also factors in similar defenses such as the doctrines of impossibility and commercial impracticability.

   In the specific context of a commodity price drop, one Texas court recently held that a downturn in the oil and gas market is not such an unforeseeable occurrence that would justify application of the force majeure provision. *See TEC Olmos, LLC v. ConocoPhillips Co.*, 555 S.W.3d 176, 183

(Tex. App.—Houston [1st Dist.] 2018, pet. denied). This decision aligns with other authorities in Texas, New York, and Delaware that have refused to excuse performance based on pure economic hardship. And while not addressed directly, one California case has questioned whether economic downturn in the market for a product—a normal risk common to many business transactions—can constitute a valid excuse for the nonperformance of a contract under a force majeure theory. *San Mateo Community College Dist. v. Half Moon Bay Ltd. Partnership* (1998) 65 Cal.App.4th 401, 414 [76 Cal.Rptr.2d 287, 294], as modified (July 1, 1998).

For international businesses, force majeure is treated similarly in the UK, where it generally suspends the affected party's liability for contractual non-performance. In an English law governed contract, because of the limited remedies provided by the common law doctrine of frustration, the precise scope and effect of a force majeure event (e.g., foreseeability, requirements to mitigate, etc.) will depend on the specific contract provisions. An economic downturn could amount to a force majeure event, but only if it is clear from the wording used in the contract that the parties intended this. For a party to rely on force majeure the triggering event must be beyond the reasonable control of the affected party and must be the *sole* cause of the affected party's failure to meet its contractual obligations. *See Seadrill Ghana Operations Limited v Tullow Ghana Limited* [2018] EWHC 1640 (Comm).

2. **Material Adverse Change Clauses.** Exogenous, macro events such as pandemics and commodity price shocks can prompt parties to closely examine the terms of material adverse effect or material adverse change (MAC) provisions in contracts, as it may be the case that one party would prefer to "call a MAC" and exercise related termination, indemnification or similar rights tied to such an occurrence. Historically, persuading a court that a MAC occurred has been very challenging and many, if not most, MAC provisions contain carefully worded exceptions related to deterioration of general market conditions or commodity prices. Nonetheless, in situations where it is unclear whether a MAC provision applies, parties from time to time will seek to leverage that uncertainty, for example, to reopen price negotiations or negotiate a mutual termination of an agreement. Any consideration of whether a MAC has occurred, however, will depend on the facts and circumstances and the specific language negotiated in the contract.

3. **Securities Litigation and Disclosure Considerations.** Energy businesses should not expect a near-term uptick in securities and shareholder litigation, since those suits typically follow company-specific news (with the possible exception of companies whose IPO occurred less than 3 years ago, and whose stock is now trading below the IPO price, who could face Section 11 claims). But we do expect the plaintiff's securities bar to be watching what companies are saying now about the impact of the declines on their individual companies, and to be ready to pounce on any future company-specific news and stock drop related to this crisis. The advice on your disclosures at this time is the same advice you should always follow: go back to first principles, and make sure your disclosures are materially accurate and complete. If you're giving information that's your belief or opinion rather than a pure fact, make that clear and include cautionary language as appropriate. When applicable, make sure you are meeting the applicable standards to rely on the protections afforded to forward-looking statements. And think about whether you

have prior disclosures that now need to be updated or corrected; the duties in this particular area can differ by circuit. Disclosure obligations are complex, and the caselaw is not uniform across the circuits, so each disclosure decision should be carefully evaluated.

4. **Delayed Midstream Construction.** Price volatility could also impact large hydrocarbon transportation projects, including pipelines and associated facilities, especially if there is disruption in the upstream or downstream sectors. Midstream companies may desire to delay construction activities until such time as the underlying issues are resolved. These delays could impact various pipeline easement agreements and increase landowner disputes.

Delays caused by certain force majeure events may temporarily excuse the performance of a pipeline easement holder's express obligations under its pipeline easement agreement. Otherwise, most pipeline easement holders are obligated to maintain the timelines and deadlines set forth in the easement agreement, just as they would be required under any other contract. Temporary construction easement agreements typically set forth deadlines by which both initial construction of the pipeline and subsequent construction activities must be completed. If construction is not completed within the stated timeframes, then the agreement terminates pursuant to its terms, at which point the landowner may consider negotiating another temporary construction easement, perhaps on more favorable terms. This self-availing remedy is more typical than other easement remedies, such as abandonment, which would require the landowner to prove an intent to abandon and terminate the right.

In certain situations, landowners may also seek a court order awarding monetary damages for breach of the easement agreement under the same theories that would apply in typical breach of contract actions. However, if the easement at issue was conveyed for a public purpose, whether by condemnation or consent, the landowner is generally estopped from recovering in a later proceeding any damages that reasonably could have been foreseen at the time of conveyance. *See Lenox Barbeque & Catering, Inc. v. Metro. Transit Auth. of Harris Cty.*, 489 S.W.3d 529, 534–35 (Tex. App.—Houston [14th Dist.] 2016, no pet.).

5. **Insolvency, Creditworthiness and Bankruptcy.** The upstream, midstream, downstream and oilfield service sectors of the oil and gas industry are not strangers to dramatic price drops and have repeatedly shown resilience. In times of uncertainty, industry veterans are astute at evaluating various issues to protect their own liquidity and value, on one hand, and managing the decline in liquidity and value of their counter-parties and partners, on the other. Below is a high-level summary of some important issues in the areas of liquidity preservation, credit support and restructuring.

Liquidity Preservation. Not surprisingly, energy companies have a high and increasing need for liquidity. Cash is king and companies within the energy sector quickly evaluate sources and uses of cash. They evaluate whether sources of liquidity can be disrupted and whether uses of liquidity can be deferred. Based on the severity of one's own situation, or the perception of the severity of a counter-party's, competitor's or partner's situation, industry participants frequently evaluate and prepare a critical path timeline—a liquidity runway so to speak—of potential defaults (and cross-defaults) in credit agreements and indentures, as well as defaults (and cross-defaults) in key operating and revenue-generating contracts. Grace periods are calculated. Cash forecasts are shortened, typically to 13-week increments to provide greater visibility. Ability to draw credit lines (or lack thereof) are evaluated. So too are cash anti-hoarding clauses in loan documents and off-cycle borrowing base redetermination rights. Loan covenants are compared to forecasts for compliance and to determine the amount of time available to address issues before they become problems. Forbearance or amendments in credit facilities may become necessary.

Hunkering down, and responding to the hunkering down of others, becomes commonplace. Capital expenditures are cut, and we have already seen announcements on this point. Drilling programs of E&P companies are frequently deferred except as necessary to hold key acreage or to fulfill commitments to a midstream or oilfield service provider. Vendor payments are delayed, while vendors respond to delays by evaluating contract terms and state-law statutory lien rights. Adequate assurance of future performance clauses in commercial contracts, both inbound as a drain on liquidity and outbound as a source of performance, are evaluated. Critical vendors and services, including key employees, are identified. Communication plans and protocols to assuage concerns are prepared. For key human talent, employee retention and incentive programs are reviewed to ensure they continue to achieve their intended purpose. Boards, focused on making informed, value-maximizing decisions, evaluate their corporation's solvency and fiduciary duties (and who has the ability to enforce those duties as a derivative matter). D&O policies are reviewed for insolvency or bankruptcy-related riders. So too are policy renewal dates and pricing of D&O tail policies.

Bankruptcy Risk. Industry participants also assess their counter-party bankruptcy risks under contracts commonly used in the oil and gas industry. Bankruptcy provides rights and powers that do not otherwise exist outside of bankruptcy. The treatment of gathering and transportation agreements (including minimum volume commitments thereunder), joint operating agreements, joint development agreements (JOA), farmouts, production payments, and other oil and gas capital raising and risk diversification structures in bankruptcy, the priority and treatment of a counter-party's payment obligations, and steps contract counter-parties may take to improve their priority in payment over other creditors in a downside bankruptcy case (and how one may respond to such steps), are all carefully evaluated.

Common bankruptcy risks frequently addressed in oil and gas transactions include:

- the rejection in bankruptcy of unperformed contractual arrangements and associated payment obligations;
- risks of bankruptcy actions challenging the nature of property interests, unrecorded or unperfected assignments, liens and security interests and the perfection or recording of such interests in the 90-days leading up to a bankruptcy filing, commonly referred to as the "preference" period – *i.e.*, actions attempting to enhance the recovery to a bankruptcy debtor's other creditors at the expense of the original party; and

- risk of a bankruptcy debtor's non-payment of others, such as oil and gas service providers, may create, either as a legal or practical matter, an encumbrance on one's own property or a disruption in normal operations.

In light of these risks, industry participants promptly evaluate whether their assignments, real property filings, including reciprocal liens in JOAs, and rights under service contracts are in order. Buyers and sellers of hydrocarbons also evaluate their credit support options, including first-purchaser statutory lien rights that vary from state-to-state and, in light of opinions such as *In re Semcrude* and its progeny, how best to perfect those rights with UCC-1 filings in the correct location. Parties also prepare for the possible renegotiation, suspension, or termination of contracts, as well as outright breach of existing contracts. For regulated tariffs, for example, creditworthiness requirements and procedures differ from tariff-to-tariff and transportation agreement-to-transportation agreement, so parties should familiarize themselves with the provisions applicable to them. In these scenarios, a distressed party seeks relief in payment terms, while its counter-party resists a concession. A complex negotiation ensues.

For some, as debt securities drop in value, holders of a company's securities frequently organize into ad hoc groups based on lien or payment priority of their securities. They retain legal and financial advisors to interface with a company's own legal and financial advisors, and work to evaluate a company's liquidity, options and strategies for weathering the prospect of a prolonged downturn. A debt exchange or other capital market transaction may provide relief. For others, a more holistic in-court restructuring solution is required. For companies facing restructuring, value is key. Valuation models and assumptions are prepared to determine a view of the fulcrum security, the security that is not fully covered by the company's value, but also not out of the money. Business plans are updated under materially different commodity price and revenue assumptions to determine an optimal capital structure. Value is also important for obtaining additional capital, such as a debtor-in-possession financing. Restructuring support agreements are frequently negotiated to apply structure and pace to the process and to shorten the duration (and thus cost) of a court proceeding.

As participants react to the prospect of a potentially prolonged commodity price downturn, the foregoing issues are germane, either to one's own situation or to the evaluation of another's situation that may impact business in uncertain times.

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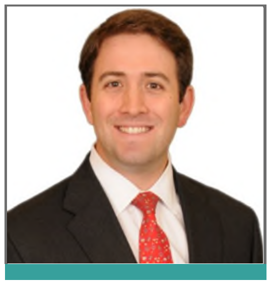

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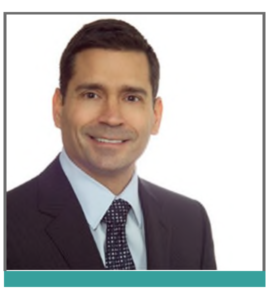

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