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Plunging Oil Prices: Options for Long-term Project Participants affected by the Price Collapse

Plunging oil prices over the past six months have left many participants in long-term energy projects looking at very different deals from the ones they signed. Having hovered around US$115 per barrel in June 2014, prices have recently slumped below the US$50 mark, with Gary Cohn, Goldman Sachs' COO, suggesting on 26 January that they could slip as low as US$30.

As a result, a number of high-profile projects worldwide are likely to be or have already been shelved or cancelled. Within the last week, Shell has announced a US$15 billion cut in capital spending over the next three years, while BP has announced plans to cut capital expenditure by US$4–6 billion this year. Similarly, Statoil has stated that it has returned three licences for exploration off the coast of Greenland, while Premier Oil has delayed its final decision on the US$2 billion Sea Lion project off the Falkland Islands until oil prices recovered.

What does this plunge in prices mean for a joint venture partner or investor who has, for example, agreed substantial capital commitments for years to come on the basis of, say, a US$80 barrel of oil?

Summary

This Insight considers some options available to participants in ongoing long-term projects whose economics have been altered by the drop in oil prices.

Looking first at contracts governed by the law of a common law jurisdiction, the authors note that the options available will likely lie within the four corners of the contract, with very limited exceptions (though US laws offer slightly more latitude than English law).

Yet in many civil law jurisdictions, the doctrine of hardship may provide relief for participants plagued by plunging oil prices. Where performance of contractual obligations becomes excessively onerous or the contractual balance is fundamentally altered, victims of changed circumstances may be entitled to a contract amendment to restore the equilibrium.

The doctrine of hardship is recognised in countries in the Middle East (such as Qatar, Iraq and the UAE), North Africa (*e.g.*, Algeria, Libya and Egypt), Europe and South America. Although its application is subject to limitations (and attitudes regarding its application to price changes vary in different national laws), it is nonetheless an option which should be considered by participants in projects affected by the plunging oil prices.

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Michael Polkinghorne
Partner, Paris
+ 33 1 55 04 58 00
mpolkinghorne@whitecase.com

Alan Burke
Partner, London
+ 44 20 7532 2114
alan.burke@whitecase.com

David Baker
Partner, London
+ 44 20 7532 2307
david.baker@whitecase.com

Tom Cameron
Associate, Paris
+ 33 1 55 04 16 54
tom.cameron@whitecase.com

White & Case LLP
19, Place Vendôme
Paris, France 75001
Tel: + 33 1 55 04 15 15

White & Case LLP
5 Old Broad Street
London EC2N 1DW
Tel: + 44 20 7532 1000

Changed circumstances in common law jurisdictions

The rule of thumb in common law jurisdictions is that the parties will be held to the contract they have made, which will generally be taken to represent their allocation of risk. They are thus likely to have to look within its four corners to find relief from the drop in oil prices, for example for any price adjustment or contractual equilibrium clause.

Absent such protections, the 'extra-contractual' options available to parties to common law contracts are extremely limited. Even where available, such options typically result in termination, rather than the contractual modification which may be more appealing to participants in long-term projects (a key distinction from civil law systems, where this option may be available, as discussed below).

English law

Under English law, the doctrine of frustration allows for termination of a contract when an event occurs after contract formation which makes it physically or commercially impossible to fulfil the contract or fundamentally alters the nature of the obligation undertaken by a party.

Yet the doctrine is applied only in very narrow circumstances, as a result of the English courts' reluctance to allow parties to appeal to the doctrine to escape a bad bargain. Thus the doctrine has been applied in instances of prevention of performance by expropriation, the outbreak of war, or destruction by fire or explosion of a contract's subject matter. By contrast, a difference between the expected and actual cost of performance is not usually sufficient to frustrate a contract (*Palmco Shipping Inc v. Continental Ore Corp*), especially not if it is a risk contractually allocated by the parties.

US laws

Doctrines under US laws offer slightly more latitude for a court or tribunal to grant a party affected by changed circumstances some relief, though the courts remain extremely – and understandably – reluctant to modify a freely negotiated contract.

Under New York law, for example, the doctrine of commercial impracticability applies where an unexpected event occurs making contractual performance commercially impracticable, providing that the risk of the unexpected event has not been contractually allocated (Section 2-615 of the New York Uniform Commercial Code (the "**UCC**")).

This doctrine may assist parties affected by the plunging oil prices, though the threshold for its application is a high one. The courts have made clear that increased cost of performance alone will not suffice to make contractual performance commercially impracticable (*e.g., W.R. Grace and Co. v. Local Union* 759, 461 U.S. 757). Instead, price changes must be "*especially severe and unreasonable*" before relief can be granted (*Louisiana Power & Light Co. v. Allegheny Ludlum Industries*), while an Official Comment on the UCC has suggested that the "*essential nature of performance*" should be altered before the doctrine applies.

Even where a party has met this high threshold for the doctrine's application, there appears to have been only one case (*Aluminum Company of America v. Essex Group Inc.*) in which the American courts have been ready to amend the parties' contract for the future, the likely preference for many participants in long-term projects. Even the decision in that case has been the subject of considerable criticism.

In sum, the doctrine of commercial impracticability (and the related doctrine of frustration of purpose) may offer some prospect of relief, but courts or tribunals applying New York law (or other US laws) are likely to remain highly reluctant to amend parties' agreements (though much will, of course, depend on the circumstances of the case in question).

The Force Majeure Clause

One possible saving grace for parties affected by the halved oil prices may be the *force majeure* clause of the agreement with their counterparty.

In common law systems, *force majeure* is a pure creature of contract (unlike in many civil law systems – such as French law – where it exists independent of parties' contract, as part of the Civil Code, allowing suspension or termination of a contract where performance is impossible owing to unforeseeable and irresistible external events).

Although *force majeure* clauses typically provide for unforeseeable events which render contractual performance impossible – such as civil war, natural disaster or epidemics – a broadly drafted clause may potentially offer some relief to a party affected by the collapse of oil prices. For example, a clause referring to an event which "*hinders*" performance (as distinct from making performance impossible) could potentially be broad enough to cover a drastic price slump of this kind, depending – of course – on matters such as the economics of the project in question. Similarly, the writers have seen clauses which go so far as to involve *force majeure* where performance is "*negatively affected*" (though it is beyond the scope of this article to consider precisely how such a clause would apply in common and civil law systems).

At the very least, parties affected by the price collapse should review this clause to check whether it may offer relief.

Changed circumstances in civil law jurisdictions

Respect for the parties' agreement is the starting point in interpreting civil law contracts, just as with common law agreements.

Nonetheless, a doctrine of hardship exists in many civil law jurisdictions, which permits courts or tribunals to alter the parties' agreement in circumstances in which unforeseeable events have made performance of that agreement more onerous (but not impossible).

One representative example of a national hardship provision is Article 171 of Qatar's Civil Code, which provides that "*if any general, exceptional events occur that cannot be foreseen as a result of which fulfilment of the contractual obligations becomes, although not impossible, onerous for the debtor such that he is at risk of incurring a substantial loss, the judge may, according to the circumstances and after weighing up the interests of the parties, return such onerous obligation to a reasonable level*", clarifying that "[a]*ny agreement to the contrary will be void.*"

The geographical spread of the doctrine is broad. Although local nuances in different national laws mean that the hardship doctrine is far from homogenous, variants are found across the Middle East (*e.g.*, Bahrain, Iraq, Kuwait, Jordan, Syria, the UAE), Africa (*e.g.*, Egypt, Libya, Algeria, Sudan), Europe (*e.g.*, France, Germany, Italy, Greece, Holland, Sweden, Finland), South America (Brazil, Argentina, Peru) and the Far East (Japan).

Though subject to limitations in different national laws (discussed below), the potential attractions of the doctrine to long-term project participants are obvious: if they can demonstrate hardship, it may be possible to preserve their contractual relationship, whilst putting in place an agreement for the future which reflects the collapsed oil prices.

Differing attitudes to price changes in different national hardship laws

As so often, however, the devil is in the detail. Variations between (and even within) national laws will determine the likelihood of hardship provisions offering relief.

First, the assessment of whether a price change is sufficient to constitute hardship may vary depending on the precise wording of the provisions of the relevant national law. For example, Qatar's Civil Code (above) refers to performance being "*onerous*" and a party being at risk of "*substantial*" loss. Other provisions use stronger language, such as "*excessively onerous*" and "*exorbitant loss*" (Bahrain, Syria, Egypt), which may set the threshold higher. Sudan's Law on Civil Transactions is more precise, stating that an event can only trigger a hardship provision where "the loss [caused by performance] *exceeds one-third of the obligation*".

Second, courts or tribunals may differ on whether a change in prices can constitute an event triggering a hardship provision.

Certainly, some national courts have considered that a change in prices is a foreseeable event and does not trigger the application of their hardship provisions. The Federal Supreme Court of Iraq, for example, relied on similar reasoning in ruling that a party could not rely on an increase in the pricing of raw materials and wages to request a contract amendment (*Decision 1289 dated 7 December 2009*).

Nonetheless, tribunals applying other national laws have considered that sufficiently severe price or currency swings may trigger the application of hardship provisions. A majority of a tribunal applying Algerian law in one 1990s UNCITRAL arbitration found that a depreciation of 35% in the value of the US dollar in comparison to the Italian lira justified the application of the hardship provision in the Algerian Civil Code, though one arbitrator strongly dissented (*Icori Estero SpA and Kuwait Foreign Trading Contracting & Investment Co.*, cited in Fred Fucci's fine article, "Hardship and Changed Circumstances as Excuse for Non-Performance of Contracts").

In the context of the oil industry, a court or tribunal may take the view that the "*history of oil is a history of booms and busts followed by more of the same*" (*International New York Times dated 14 January*). An argument could be made that the collapse in the oil prices is not an upheaval of the economic circumstances, but rather a simple market fluctuation.

The counterargument is that the speed of the fall has not been seen – leaving aside the freak events of the 2008 financial crisis – in more than a generation (since the 1986 collapse).

Much will depend on the circumstances of the project in question and the allocation of risk in the project contracts, as well as the national law applicable.

Nonetheless, the doctrine of hardship should undoubtedly be the subject of consideration by participants in long-term projects whose ability to honour their contractual commitments has been cast into question by the collapse in oil prices.

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