Oil & Gas Law

Class 25:

L'ee Contracts (4 of 4):
JOAs (2 of 2) –

Marketing & Balancing of Production / Pref. Rights

Up To Now, & Tonight …

- Assignments of the Oil & Gas Lease
- Farmout Agreements
- **Joint Operating Agreements**
  - **Operational**
  - **Business**
    - **Marketing**
    - **Balancing**
    - **Pref. Rights**

The Right to Share Production

- JOA is a form of "contractual co-tenancy"
  - each party's right to take production is subject to … ***what ?***
- JOA: Sec. VI.G (pp. 10-11)
  - ¶1: "Each party shall take in kind or separately dispose of its proportionate share of all oil and gas produced …"
  - ¶3 w/ GBA: If a party fails to take its proportionate share of ***oil,*** the Operator "shall have the ***right*** … but ***not*** the obligation …" to either purchase it or sell it to others ...
    - "… at the best price obtainable in the area …"? ***NO !!!***
  - ¶4 w/ GBA: If a party's disposition of ***gas*** causes deliveries not equal to a party's proportionate share, they balance or account per a Gas Balancing Agreement
  - No GBA: co-tenancy

Gas Imbalances

- 3 General Causes
  - Lack of sale / market; or failure of buyer to take
  - "**Split stream**" conditions
  - JOA participants timing the market
- Types of Imbalances
  - Temporary
  - Permanent
  - Cyclical (Seasonal / Bus. Cycle / Pricing)
- Types of balancing
  - In-kind
  - Cash balancing – periodically
  - Cash balancing – upon depletion

Gas Balancing Agmt ("GBA")

- Ex. E to the JOA
  - … ***IF*** it is used; it's totally optional
- 7 key clauses of the GBA
  - 1. intent of each party to take their share
  - 2. Op. obligation to keep records / furnish statements
  - 3. right of underproduced party to take ***XX%*** more than its ownership share to make up imbalance
  - 4. ***obligation to pay royalties and taxes***
  - 5. price for recouping
  - 6. cash balance –depletion / periodically; on transfer?
  - 7. apply to each well separately, or to reservoir, or to other grouping?

GBA: Example

- Chuck B #1 well in Utopia, TX – 1,000 MMBtu / mo.
- 4 owners
  - Chuck (30%); Moe (15%); Larry (25%); Curly (30%)
- From Jan. through June, Curly's buyer can only take 1/3 of Curly's share
- ***Curly's share … and how much is he selling?***
- ***In 6 mos, how much underproduced?***
- ***In July, Curly's buyer can take more, Curly wants to make-up … how much can he take?***
- ***Assume that from Jan. – June, the price was $3/MMBtu, and that in July, the price is $5/MMBtu … how much, net, does Curly get?***

What If There Is NO GBA?

- Balancing in kind is preferred method, ***unless the equities dictate otherwise*** **(p.8)**
- Harrell – finds one (or more) of those alleged equities … ***what were they?***
- **What would others be?**
- **OK: the "Sweetheart Gas Act"**
  - -- requires all producing / selling parties to account for, and share their market with, the non-producing parties

Weiser-Brown

- ***Issue?***
- Conveyance of interest that is over / underproduced **CAN** change the nature and scope the parties' rights
- ***Is the obligation to account to underproduced party / right to receive an accounting from an overproduced party a covenant running with the land" or a personal covenant?***

Underproduced Pty's Liability Theories vs. Operator / Overproduced Party

- ***What are they?***
- Fiduciary duty
- Trustee
- Agent
- Duty of fair dealing and / or good faith
- JOA obligation on Operator to operate in good and workmanlike manner
- Joint venture / partnership
- Co-tenancy

One More GBA Issue

- ***What if the GBA is only signed by some, but not all, of the parties to the JOA?***

One Other Approach …

- Marketing Letters
- “we’re willing to market your share of production, but only on our terms”
    - -- if party doesn’t like / accept them, they can either go out of balance or market it themselves
    - -- more trouble than it’s worth
    - -- more liability / hassle to do it

<u>One Other Approach … (cont'd.)</u>

- 3 key points
- ==============================
- 1: party authorizes Operator to both market ***<u>AND</u>*** to adjust for gas balancing
- 2: Operator will "endeavor" to market
  - -- prices as are "reasonably available" [compare to JOA's "best prices obtainable in the area"]
  - -- no obligation to curtail Operator's sales of its own production
- 3: party indemnifies Operator for everything, incl. sole and concurrent negligence (but not gross, since it's against public policy and invalid)

Preferential Purchase Rights – Intro 1

- a/k/a … **“Pref. Right” or “PRP”**
- JOA: Sec. VIII.F.
- Generally, 2 types:
  - Right of First Refusal (“ROFR”)
    - Right to match a legitimate offer from 3rd party
  - Right of First Offer (“ROFO”)
    - Right to be contacted first, before prospective seller goes out to solicit 3rd party offers

Preferential Purchase Rights – Intro 2

- Most parties don't want them … some might in some cases, but not in others
- ***What are the benefits / costs (or pros / cons) of pref rights?***
- ***Purposes?***
- ***Since one party's $$ are the same as another's, why don't sellers like these clauses?***

Pref. Rights – Issues

- 1. Form of Transaction
- 2. Value
  - A. “package sale”
  - B. price allocations
- 3. Rescinding the notice
- 4. So-called “2-step” transactions
- 5. Allocating ownership

Pref. Rights – 1. Transaction Form

- ***Would any of these be considered a "sale"?***
  - ***… an exchange of leased lands for a piece of the Houston Texans (football team)?***
  - ***… an exchange for an ownership share of the Houston Astros, the worst team in baseball last year?***
- **Proposed sale includes "governing law in Wyoming" clause – Pref. Right holder exercises but says that governing law will be TX;** ***Is this a valid exercise of the Pref. Right?***

Pref. Rights – 2A. Package Sales

- ***Scenario:***
  - ***Seller and 3rd party reach agreement on deal where 3rd party will buy seller's interest in 7 properties for $10 million; pref rt only applies to 1 of the 7 properties***
- ***Does the buyer have to buy all 7 properties?***
- ***same or different iresult if (a) only 1 property is being sold, (2) the Pref. Right applies a portion of the acreage, and (3) the property being sold is in Wyoming?***

Pref. Rights – 2B. Price Allocation

- ***Scenario:***
  - ***Seller and 3rd party reach agreement on deal where 3rd party will buy seller's interest in 7 properties for $10 million***
  - ***6 of the 7 properties are unexplored raw acreage; the 7th one (the one with buyer's Pref. Right attached) is producing and has demonstrable reserves***
  - ***The 6 raw properties are each valued at $0.5 million, the 7th / producing property is valued at $7 million, based on an assumption that oil and gas prices will rise over the next X number of years***
- ***Can the buyer exercise its Pref. Right, but at a lower price?***
- Navasota: pp. 15 – 18

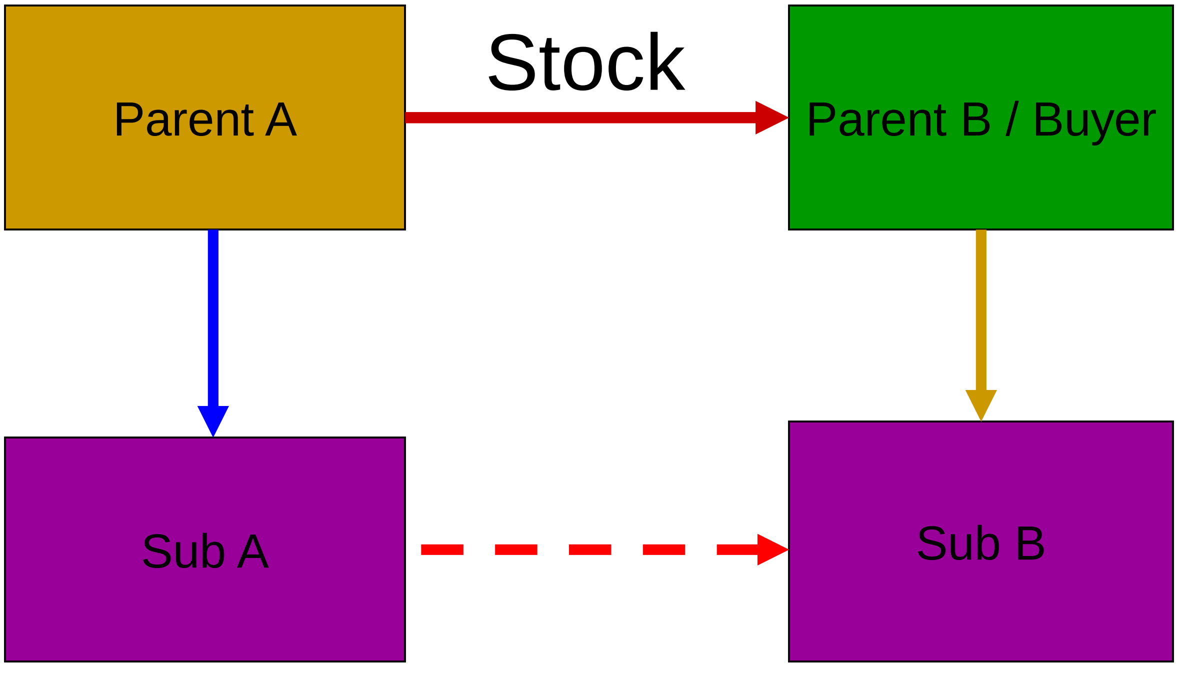
Pref. Rights – 2B. Price Allocation

- ***Scenario:***
  - ***Seller negotiates a deal with a buyer at $1,000 per acre***
  - ***Buyer: "we have a deal"; but she has to "run it by senior management"***
  - ***Management elects not to do the deal because commodity prices fall***
  - ***1 month later, a different buyer comes along and offers $800 per acre***
  - ***Can the seller give the pref right notice at $1,000 per acre, based on the fact that the first buyer had agreed to that price?***
- **Foster v. Bullard: see Navasota p. 17**

Pref. Rights – 3. Rescinding notice

- Navasota case
- Once a pref right has been offered and accepted, it’s considered a done deal
- The offer cannot be rescinded or changed, even if it has not yet been accepted

Pref. Rights – 4. "2-step" transactions



- Transaction circumvents the Pref. Right (whether intentionally or not)

Pref. Rights – 4. "2-step" transactions

- Tenneco v. Enterprise (p. 1030)

Pref. Rights – 5. Allocations

- **A: 40%** **B: 30%** **C: 20%** **D: 10%**
- 1. B sells the property for $1 million; A, C and D all exercise their pref rt … ***how much do they each pay and how much do they get?***
- **A: 4/7** **C: 2/7** **D: 1/7**
- 2. same facts, but only C and D decide to exercise the pref rt … ***how much do they each pay and how much do they get?***
- **C: 2/3** **D: 1/3**

Pref. Rights –

Legal Theories Used / Tried to Defeat

- Statute of Frauds
- Rule Against Perpetuities
- Doctrine of not unreasonably restraining / limiting alienation and sale
- An "agreement to agree"
- Waiver
- Mutual mistake
- Unilateral mistake
- Unconscionability

NEXT WEEK …

- **Tues., April 22: *LAST CLASS !!!***
  - Supplemental materials posted (4)
  - ***ALSO … Garza excerpts – pp. 67-79 (middle of pg. – majority + start of dissent) & 88-97 (dissent + notes following***
  - **Discuss final exam**
- **Thurs., April 24**
  - Optional Review Session
  - Bring questions (as broad as possible)