IEL DEAN'S LECTURE

David F. Asmus

February 22, 2018

It is a great honor to have been chosen to deliver this address. Many thanks to the Institute for Energy Law for making me a part of this long tradition.

Looking at those who have delivered this address before, I realize that it is very august company that I am keeping. I will try to live up to the standards they have set by delivering an address that is both educational and, I hope, at least mildly entertaining.

Those of you who have heard me speak in the past know that I usually speak about deals – how to structure them, how to draft for them and how to avoid pitfalls in them. But, sometimes the practical is not as fun as the unusual, so today we will take a detour into Texas case law. Not just any case law, but <u>surprising</u> case law. My topic today is my top ten surprise Texas oil and gas law cases.

It is important to provide some definition around this topic before I proceed.

To start, in contrast to the usual oil and gas talk, I will not be discussing cases about oil and gas leases. While there are certainly fascinating and unusual cases analyzing oil and gas leases, including royalty cases, a perennial favorite, there are, simply put, far too many of these cases, and they tend to drown out some of the more interesting cases that focus on areas where many of us spend a greater share of our legal careers.

Secondly, while oil and gas case law has over one hundred years of history in Texas, I do not. My list will focus on cases that have been decided during my career, with more emphasis on the more recent period. This should not be read as any indication that our courts' decisions have become increasingly surprising (though I also will not vouch that they have not…).

Thirdly, my definition of "surprise" does not mean that no one knew the case was coming, or that all Texas attorneys were surprised by the outcome, but rather, that either the outcome easily could have been different, or the result conflicted with a common practice at that time. This is what makes these types of cases both fun, from the academic standpoint, and vexing, from the practical one.

Finally, these cases are my favorites, not anyone else's. There are certainly worthy cases that are not on this list.

With that, with apologies to retired talk show host David Letterman, and with due haste to finish in a timely manner, here are my "Top Ten Surprise Texas Oil and Gas Law Cases":

10. ***ExxonMobil v. Valence Operating Co.*, 174 S.W.3d 303 (Tex. App.—Houston [1st Dist.] 2005, pet. denied)**

We will be starting with a fairly low-impact surprise. Valence is a case about a standard operating agreement maintenance of uniform interest clause, a basic oil and gas contract provision that had long been ignored, as much as honored, in farmouts and conveyances across Texas. ExxonMobil entered into a depth limited farmout, and the farmee drilled additional well targeting that depth. Valence brought this action challenging the conveyance to the farmee and seeking to recover its share of the additional capital costs for certain of these wells and penalties incurred as a result of non-consenting in others.

In this operating agreement, the parties had struck the language that read "For the purpose of maintaining uniformity of ownership in the oil and gas leasehold interests covered by this agreement,"[1] which no doubt made it even easier to bypass the clause, though the operative provisions remained the same. ExxonMobil argued that the deletion of the purpose language meant that the parties did not need to maintain a uniform interest. It also argued that certain other language of the section meant that it did not apply to its particular farmout. It did not, to its credit, argue that numerous other owners did not follow maintenance of uniform interest clauses. The Houston Court of Appeals, relying on an analysis of the parties' intent, as reflected in the operating agreement, stated:

> Because the plain language of the MOI provision in the JOA required that ExxonMobil not partition its interest in unit 16, but that it convey either its entire interest or an equal undivided interest in all leases, wells, equipment, and production in the contract area, ExxonMobil breached the MOI provision of the JOA by conveying its interest in a portion of Unit 16 … while retaining its interest in those formations beneath the Cotton Valley Sand.[2]

The Texas oil and gas community was reminded that maintenance of uniform interests mean what they say.

Plain drafting 1, clever lawyers 0

9. ***John Wood Group USA, Inc. v. ICO, Inc.*, 26 S.W.3d 12 (Tex. App.—Houston [1st. Dist.] 2000, pet. denied)**

Many a commercial manager has said "we have a deal" after signing a letter of intent with a counterparty, and many a lawyer has cringed at those comments. Although Texas law had been clear for some time by the 1990s that parties could have a binding deal without a final, definitive agreement, many letters of intent continued to rely on disclaimers such as "subject to a definitive agreement," the effect of which was ambiguous, if not wholly unhelpful.

In *John Wood Group*, the signed letter of intent spelled out all of the essential terms of a sale, and in the absence of some appropriate qualification, likely would have bound both parties. However, in contrast to a number of other cases, the parties in *John Wood Group* clearly stated "[i]t is understood and agreed that this letter is an expression of the parties'

[1] *Valence* at 311.
[2] *Id* at 314.

mutual intent and is not binding upon them except for the provisions of paragraph ….”[3] ICO argued that the letter agreement was ambiguous and a jury should decide if the parties intended to be bound. The Houston Court of Appeals (1st Dist.) distinguished other cases that looked at the issue as a fact question. Noting that "[w]here that intent [to be bound] is clear and unambiguous on the face of the agreement, it may be determined as a matter of law," the court found that in this case, as a matter of law, the parties lacked mutual consent to be bound.[4] The non-binding language meant what it said.

Plain drafting 2, clever lawyers 0

8. ***Dresser Indus., Inc. v. Page Petroleum, Inc.*, 853 S.W.2d 505 (Tex. 1993), *Enserch Corp. v. Parker, 794 S.W.2d 2 (Tex. 1990)* and *Ethyl Corp. v. Daniel Const. Co.*, 725 S.W.2d 705 (Tex. 1987)**

Why, you might ask, are these clearly important cases ranked so low on my list? Principally because they unfolded slowly, over a six year period, and the basic change, though important, was not a complete surprise. Nonetheless, these three cases disrupted some long established practices among drafters of oil and gas instruments. *Ethyl*, the first case, adopted officially in the State of Texas the express negligence rule, ending a long period in which "clear and unequivocal" language was deemed to be sufficient. One can question why "express" is better than "clear and unequivocal." In any case, the court was clear in its rationale:

> As we have moved closer to the express negligence doctrine, the scriveners of indemnity agreements have devised novel ways of writing provisions which fail to state the true intent of these provisions. The intent of the scriveners is to indemnify the indemnitee for its negligence, yet be just ambiguous enough to conceal that intent from the indemnitor…. We hold the better policy is to cut through the ambiguity of those provisions and adopt the express negligence doctrine.[5]

Dresser, and *Enserch*, its less-well known cousin, in turn confirmed that if a party is to be indemnified against its own negligence, not only must the indemnity be written in express terms, but it also must be conspicuous. In addition, releases and waivers must be handled in the same manner as indemnities. The result, of course, is that Texas law is now known worldwide as the law that requires capitalization and bolding.

Plain drafting 3, clever lawyers 0. I will leave this count for the moment, but do not worry, we will return.

7. ***Virginia Power Energy Mktg., Inc. v. Apache Corp.*, 297 S.W.3d 397 (Tex. App.—Houston [14th Dist.] 2009, pet. denied)**

[3] *John Wood Group* at 15.
[4] *Id*. at 16.
[5] *Dresser* at 707-708.

Virginia Power is a NAESB gas sales case. Following each of Hurricanes Katrina and Rita, Apache declared force majeure and did not deliver a significant share of its contracted quantities of natural gas to Virginia Power. One of the two delivery points was inaccessible, and Apache's source of gas that it was using to supply the contract was shut in. These facts in and of themselves may not have led to litigation, if not for the following:

> To cover the shortfall between the contracted-for-amounts and that actually delivered by Apache, VPEM purchased additional gas on the Intercontinental Exchange "spot market," at $2.25 million more than it would have paid under its contract with Apache. However, after completing the anonymous spot-market purchases made necessary following Apache's force majeure declaration, VPEM discovered that the seller in several of those spot-market transactions was, in fact, Apache.[6]

Oops. Needless to say, Virginia Power deducted what it considered an overpayment from other payments owed to Apache, and the lawsuit was on. Virginia Power had two main assertions: (i) the requirement in the force majeure clause that an impacted party make reasonable efforts to resolve the force majeure event required the seller to make delivery at an alternate delivery point and (ii) that Apache could not internally designate a source of supply for the contract, which was not specified in the contract, and then use a force majeure event effecting that source to excuse deliveries.

On the first point, the court concluded that because the parties had agreed in their confirmation upon a specific delivery point, Apache was not required to deliver to another delivery point, even as a mitigation step following force majeure. This is despite a UCC provision requiring substitute performance where a commercially reasonable substitute is available and could be viewed as a surprise.

On the second point, in contrast, the court interpreted the force majeure event of "loss of or failure of Seller's gas supply" to mean loss of any gas supply that was available to supply the contract, irrespective of Apache's internal designations and customer rankings. Apache's argument that industry practice recognized internal designation of supply sources fell on deaf ears in the court in the face of the plain words "gas supply."

Under the NAESB form, unless the seller designates a source in the confirmation, its obligation is to deliver gas, not specific gas.

6. ***Seagull Energy E&P, Inc. v. Eland Energy, Inc.*, 207 S.W.3d 342 (Tex. 2006)**

Many oil and gas companies have been lulled into believing that once they sell their working interest in a joint operating agreement, they are released from most future obligations under that agreement, unless they have otherwise agreed. This case was an important reminder that, in fact, unless your operating agreement is drafted that way, the law works the other way around.

---

[6] *Virginia Power* at 401.

Eland acquired an interest in two offshore blocks and agreed to be bound by two operating agreements. A couple of years later it sold its interest, and its purchaser subsequently defaulted on cash calls. Seagull, the operator, sought to recover these costs from Eland.

Eland asserted that as it no longer owned an interest in the leases, it was no longer liable for expenses. It pointed out that expenses were allocated under the operating agreement by "participating interests." At that point, it had no participating interest. The court begged to differ with this technical analysis, noting that "as a general rule, a party who assigns its contractual rights and duties to a third party remains liable unless expressly or impliedly released by the other party to the contract."[7] This rule, of course, has been in the common law for a long, long time, but may have slipped from the consciousness of assignors such as Eland until they were reminded by *Seagull*.

The Seagull case may have limited practical impact because in that case, the operating agreement was silent regarding the impact of assignment, while the AAPL form operating agreement most in use at present, the 1989 form, states that "No assignment or other disposition of interest by a party shall relieve such party of obligations previously incurred hereunder with respect to the interest transferred…." This implies that the transferring party is relieved of other obligations. A subsequent court of appeals case, *Indian Oil Co., LLC v. Bishop Petroleum Inc.*, 406 S.W.3d 644 (Tex. App.—Houston [14th Dist.] 2013, pet. denied) has made exactly that distinction.

5. ***Coastal Oil & Gas Corp. v. Garza Energy Tr.*, 268 S.W.3d 1 (Tex. 2008)**

Fracking is big business in Texas, and that no doubt played a part in the Texas Supreme Court's seminal decision on fracking as trespass.

The courts of Texas have a history of clearly indicating that slant hole wells bottoming on another lease constitute trespass. The Supreme Court expanded on that analysis in 1961, in *Gregg v. Delhi-Taylor Oil Corp.*, 344 S.W.2d 411 (Tex. 1961), where it stated, in examining a proposed hydraulic fracturing of a well on a very small parcel:

> The pleadings allege a physical entrance into Delhi-Taylor's leasehold. While the drilling bit of Gregg's well is not alleged to have extended into Delhi-Taylor's land, the same result is reached if in fact the cracks or veins extend into its land and gas is produced therefrom by Gregg. To constitute a trespass, 'entry upon another's land need not be in person, but may be made by causing or permitting a thing to cross the boundary of the premises.'[8]

In 1992, in its opinion in *Geo Viking, Inc. v. Tex-Lee Operating Co.*, 817 S.w.2d 357, 365 (Tex. App.—Texarkana 1991), writ denied, 839 S.W.2d 797 (Tex. 1992), that was later withdrawn (with express disclaimer as to any view on fracking), the court directly stated that "[f]racing under the surface of another's land constitutes a subsurface trespass." With this background, the lawyers for the Garza Energy Trust group of

[7] *Eland* at 347.
[8] *Gregg* at 416.

plaintiffs no doubt thought that they had a good claim when they asserted trespass after Coastal drilled a well 467 feet from its lease line and then conducted a major fracking operation in the well.

Perhaps to their surprise, the Supreme Court dismissed this claim, based upon some very high level policy arguments. For one, the court noted, a plane flying two miles above the plaintiff's land would not be trespassing, so "[t]he law of trespass need no more be the same two miles below the surface than two miles above."[9] Secondly, the court readily dismissed the slant hole cases by reference to the rule of capture:

> [T]he rule of capture determines title to gas that drains from property owned by one person onto property owned by another. It says nothing about the ownership of gas that has remained in place. The gas produced through a deviated well does not migrate to the wellbore from another's property; it is already on another's property.[10]

If you can follow those mental gymnastics, which purport to distinguish drilling into a neighboring tract from fracking into a neighboring track, you are doing better than I am. Certainly the dissent in *Coastal* had a significant issue with the reasoning. The court majority opinion also noted that if trespass supplanted the rule of capture, the Railroad Commission's role might be supplanted, an unusual factor to play a role in a private trespass claim.

Finally, the court got to the crux of the issue with three arguments that really appear to underpin its decision. One is that "the material facts are hidden below miles of rock, making it difficult to ascertain what might have happened."[11] The court is noting that it simply (at the time) was unable to determine the effective length of the fractures, and how much they might have drained. Another is that "hydraulic fracturing is not optional; it is essential to the recovery of oil and gas in many areas . . . hydraulic fracturing cannot be performed both to maximize reasonable commercial effectiveness and to avoid all drainage. Some drainage is virtually unavoidable."[12] The third, and most interesting, is that "the law of capture should not be changed to apply differently to hydraulic fracturing because no one in the industry appears to want or need the change," with the court then reciting the numerous amicus curiae briefs it had received in this case.[13] The reality of the state's oil and gas industry did not allow for any other decision.

This issue is not yet put to rest, in other states at least, as the *Briggs*[14] case in Pennsylvania shows.

4. ***In re Sabine Oil & Gas Corp.*, 734 Fed. Appx. 64 (2d Cir. 2018)*; In re Sabine Oil & Gas Corp.*, 567 B.R. 869 (S.D.N.Y. 2017), aff'd, 734 Fed. Appx. 64 (2d Cir. 2018)*; In***

[9] *Id*. at 11.
[10] *Id*. at 14.
[11] *Id*. at 16.
[12] *Id*.
[13] *Id*.
[14] *Briggs v. Southwestern Energy Production Company*, 184 A.3d 153 (Pa. 2018)

***re Sabine Oil & Gas Corp.*, 550 B.R. 59 (Bankr. S.D.N.Y. 2016), aff'd, 567 B.R. 869 (S.D.N.Y. 2017), aff'd, 734 Fed. Appx. 64 (2d Cir. 2018)*; In re Sabine Oil & Gas Corp.*, 547 B.R. 66 (Bankr. S.D.N.Y. 2016), aff'd, 567 B.R. 869 (S.D.N.Y. 2017), aff'd, 734 Fed. Appx. 64 (2d Cir. 2018)**

For some time, gas (and oil) gatherers have included dedication language, "running with the land" clauses and other provisions in their gathering contracts indicating that the contracts were tied to each producer's properties. Their understanding was that these provisions made the arrangements property interests that were not subject to rejection as executory contracts in a bankruptcy.

Two such gatherers found themselves in bankruptcy court opposing a motion by Sabine to reject their gathering agreements as executory contracts. Both agreements dedicated Sabine's property to the performance of the agreement and expressly stated that the agreement was a covenant running with the land. The Bankruptcy Court in *Sabine* looked at Texas law of real covenants, which indicated that for a covenant to run with the land, it must (i) touch and concern the land, (ii) related to a thing in existence or specifically bind the parties and their successors and assigns, (iii) be intended by the original parties to run with the land and (iv) be subject to notice to the successor to the burden. The court concluded that the gathering agreement covenants did not qualify because, among other things, the gathering agreements were service contracts dealing with severed production, which is not real property, and therefore did not "touch and concern the land." In addition, the court observed that at least some Texas courts required horizontal privity for covenants to run with the land, and the gatherers did not receive real property rights in the oil and gas properties, so there was no "horizontal privity" between the producers and the gatherers.

It is clear, in the Second Circuit, at least, that under Texas law, parties cannot simply create a real covenant by drafting. Something more is required for a gathering agreement to be anything other than an executory contract.

3. ***Tenneco Inc. v. Enter. Products Co.*, 925 S.W.2d 640 (Tex. 1996)**

Contractual interpretation revolves around determining the intent of the parties. Sometimes contract language does not tightly define a concept, forcing courts to think about how far they are willing to go in separating "objective intent" as set out in the four corners of the document from the apparent subjective intent of the parties. One of the areas where loose language has caused problems for many decades is in the area of preferential right to purchase, where drafters have routinely ignored the distinction between an asset transfer and a change in control, resulting in such odd constructs as preferential rights that apply to "any transfer of all or a portion of an [asset], directly or indirectly."

Tenneco Oil brought this issue to a head by cleverly structuring its series of sales in the late 1980s as equity rather than asset sales. It dropped the relevant assets into various newly created special purpose subsidiaries (with such affiliate transfers generally being exempted by the terms of preferential right provisions), and then sold each of those subsidiaries rather than packages of assets. It asserted that the preferential rights did not apply to such equity sales.

In 1995, in *Galveston Terminals, Inc. v. Tenneco Oil Co.*, 904 S.W.2d 787 (Tex. App.—Houston [1st Dist.] 1995), vacated pursuant to settlement, 922 S.W.2d 549 (Tex. 1996), the Houston Court of Appeals (1st Dist.) viewed this structure, which involved transfer of assets to a subsidiary, and then sale of that subsidiary to a purchaser, as a single transaction, that in fact if not form transferred assets, and therefore triggered preferential rights.

The Texas Supreme Court had other ideas, however. In *Tenneco v. Enterprise*, which presented a substantially similar situation involving another of Tenneco's sales, the court held that the two steps of the transaction should not be collapsed, as preferential rights that restrict equity transfers should be narrowly construed. The Supreme Court noted that the plain language of the preferential right said nothing about a change in equity ownership, and concluded that it did not apply to a change in equity ownership. Further, according to the Court, "The Enterprise Parties could have included a change-of-control provision in the agreements that would trigger the preferential right to purchase …. We have long held that courts will not rewrite agreements to insert provisions parties could have included or to imply restraints for which they have not bargained."[15] The "Texas Two-Step" was born.

It had to happen. Plain drafting 3, clever lawyers 1.

The *Tenneco v. Enterprise* case has not been universally loved. In a broadly similar case, *Williams Gas Processing–Wamsutter Co. v. Union Pac. Res. Co.*, 2001 WY 57, ¶ 13, 25 P.3d 1064, 1071 (Wyo. 2001), the Wyoming Supreme Court stated:

> UPRC suggests that we adopt a standard of review that would require this Court to narrowly construe rights of first refusal and other provisions that effectively restrict the free transfer of stock. *Tenneco, Inc. v. Enterprise Products Company*, 925 S.W.2d 640, 646 (Tex. 1996). We decline to adopt such a standard…. The very purpose of such contracts is to restrict the free transfer of property … and it hardly seems logical to treat them more restrictively because they actually achieve the bargained for purpose.[16]

2. ***<u>Carrizo Oil & Gas, Inc. v. Barrow-Shaver Res. Co.</u>*, *516 S.W.3d 89 (Tex. App.—Tyler 2017, pet. granted)***

All of us were schooled in the concept that the final definitive written agreement reflects the deal of the parties. This is why entireties clauses were created. As a result, the *Carrizo* case may have been a surprise to many.

In *Carrizo*, the parties negotiated a farmout agreement that contained a consent to assignment clause. At some point during the negotiation, Carrizo struck the "shall not be

---

[15] *Tenneco* at 646.
[16] *Williams* at 1071.

unreasonably withheld" language that was previously included in the draft. Barrow-Shaver argued for its restoration but ultimately gave up, and the agreement was signed in a form that included no statement as to why consent could be withheld. When Barrow Shaver sought thereafter to assign its interest, Carrizo demanded a $5 million payment for the consent. Barrow-Shaver filed suit.

The court could have decided the case purely on the basis of the law. The court indicates in the opinion that under Texas law, a consent to assignment provision that fails to state a standard for granting or withholding consent will allow the consent holder to withhold consent arbitrarily. However, the court chose to veer into the world of the parole evidence rule, regarding which it noted:

> '[t]he [parole evidence] rule does not prohibit consideration of surrounding circumstances that inform, rather than vary from or contradict, the contract text.' *Houston Expl. Co. v. Wellington Underwriting Agencies, Ltd.*, 352 S.W.3d 462, 469 (Tex. 2011). We may consider the facts and circumstances surrounding a contract, including the commercial or other setting in which the contract was negotiated and other objectively determinable factors that give context to the parties' transaction.[17]

So far, no surprise, but the court then continued to state :

> Negotiations of a contract can matter in determining whether it is silent on a material term. … Here the previous drafts and negotiations between the parties inform us that the consent-to-assignment provision was not silent as to the type of consent.[18]

This case no doubt correctly determined where the parties ended up in their negotiation. However, it stretched the terms of the Supreme Court cased cited, which dealt with taking into account the struck provisions in a standard form when interpreting the parties' agreement. If *Carizzo* is affirmed, the message is clear: do not raise points now that you want to be able to dispute in the future unless you are certain that you will win them, or you may be precluded from raising them at the time of a future dispute. Your old drafts may indeed come back to haunt you.

Note that Barrow-Shaver's petition was granted by the Supreme Court, and arguments have already been heard, so this one is not quite over yet.

That just leaves one case. So, what could be worse than having your old drafts come back to haunt you?

1. ***In re SemCrude, L.P.*, 864 F.3d 280 (3d. Cir. 2017); In re SemCrude, L.P., 2015 WL 4594516 (Del. 2015); In re SemCrude, L.P., 407 B.R. 112 (Bankr. D. Del. 2009)**

[17] *Carrizo* at 95 – 96.
[18] *Id*. at 96.

Or, as I might refer to it, the amazing disappearing security interest.

Back in 1983, seeking to protect producers and royalty owners from the risks of an offtaker bankruptcy, the Texas legislature adopted a non-standard provision in the Texas Business & Commerce Code, Section 9.343. This section provided what amounted to an automatic security interest in favor of interest owners over production and proceeds held by first purchasers of oil and gas, with that security interest being automatically perfected by virtue of the interest owner's recorded title instrument, which serves as a financing statement. The less sophisticated producer or royalty owner was to be put on the same footing as more sophisticated financial players. Or so we thought….

In *SemCrude*, the bankruptcy court, sitting in Delaware, where the SemCrude was incorporated and filed for reorganization, applied the choice of law rules of Delaware, the forum state, to determine that the Delaware Uniform Commercial Code (UCC) rules regarding perfection and priority applied to rights of producers in Texas production and proceeds. This reinforced the UCC's primary goal of uniformity of treatment by looking to the state where the Debtor was organized, Delaware. Delaware has no equivalent of Texas Bus. & Com. Code §9-343. You can see where this is going…. In Delaware, a creditor needs to file a financing statement or in certain circumstances, obtain possession of the collateral, in order to perfect security. The producers, of course, did not take those steps because §9-343 was supposed to protect them from the need to do so.

The Bankruptcy Court decision was, needless to say, appealed, but to no avail. The Court of Appeals had no sympathy for the producers, noting:

> Because the oil producers did not take precautionary measures to ensure payment in case of SemGroup's insolvency, all they have to rely on are local laws they contend give them automatically perfected security interests or trust rights in the oil that ended up in the hands of the downstream purchasers. But the parties who took precautions against insolvency do not act as insurers to those who took none….[19]

What is left of Tex. Bus. & Com. Code §9-343? The Court of Appeals, as is often the case, had the final word:

> [T]hese local laws apply when the debtor is located in Texas … or where the debtor is so closely involved at the wellhead that it has some preexisting interest in the oil before it is extracted from the ground so that the oil constitutes as-extracted collateral.[20]

Moral of the story: sell your crude oil to Texas corporations…. (Or file a financing statement)

<u>Epilogue</u>

---

[19] 864 F.3d at 285.
[20] *Id*. at 292.

I would like to conclude by noting that the law will continue to throw surprises our way. The art of drafting will always be, in part, trying to avoid mistakes of the past and, in part, trying to anticipate the as-yet unexpressed decisions of the future. The only thing we can be absolutely sure of is that, years from now, there will be a new list.