OIL & GAS LAW

Overview & Update
Trends & Developments

Sponsored By:

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18 October 1996
Wichita, Kansas

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Oil and Gas Law--Overview & Update

Overview

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PART I

Oil and Gas Law--Overview & Update

Overview

I. TECHNICAL CONSIDERATIONS

A. Petroleum Geology

1. Porosity
2. Permeability
3. Reservoir Structure

B. Reservoir Mechanics

1. Pressure Changes
2. Displacement Process

II. OWNERSHIP/DEVELOPMENT RIGHTS

A. Surface Boundaries

1. Ownership of oil and gas initially determined by surface boundaries.
2. Ownership of the land includes ownership of all the oil and gas found within the surface boundaries of the land.

B. Rule of Capture

1. Person drilling a well bottomed within the surface boundaries of their land obtains title to all oil and gas produced by their well--even though some of it is drained from adjacent lands.
2. To perfect ownership of oil and gas it must be

brought to the surface and "captured."

3. Person causing the drainage is protected so long as the well is within the surface boundaries of their property.

C. Correlative Rights

1. Limitation on the Rule of Capture.

2. Cannot take action which will injure the reservoir so other owners in the common resource are unable to exercise their opportunity to capture.

3. "Along with the prevention of waste, the KCC is directed to prevent the unfair or inequitable taking of natural gas from a common source of supply. This concept of equitable recovery of a common pool is known as correlative rights. Correlative rights means that each owner or producer in a common source of supply is privileged to produce that source only in a manner or amount that will not (a) injure the reservoir to the detriment of others, (b) take an undue proportion of the obtainable oil or gas, or (c) cause undue drainage between developed leases." Mobil Exploration and Producing U.S. Inc. v. Kasnas Corp. Comm'n, 258 Kan. 796 (1995).

D. Conservation Regulation

1. General Goal: protect correlative rights and prevent waste of the oil and gas resource.

2. Regulated by the Kansas Corporation Commission in Kansas. Kan. Stat. Ann. § 55-602 (1994) (oil); § 55-702 (1994) (gas).

3. Conservation regulation techniques:

   a. Spacing - Require a minimum distance between producing wells and require wells to be drilled a minimum distance from lease or property lines.

   b. Prorationing - Control the rate of production to achieve orderly removal of the resource.

   c. Pooling - Permit separate properties to be operated as a production unit to comply with

spacing and prorationing restrictions.

(1) Kansas - Pooling must be voluntary.

(2) Other Producing States - If parties cannot agree to pool their interests, the appropriate agency can order the separate interests in the spacing unit pooled for development.

d. Unitization - Operate the entire reservoir as a single property unit. Surface boundaries used only to calculate each party's share in total production from the reservoir.

(1) Can be voluntary.

(2) Can be compulsory. Kansas - Kan. Stat. Ann. § 55-1305 (Supp. 1995) (requires at least 75% of all interest owners to agree before the remaining 25% can be forced into the program).

III. PROBLEMS ASSOCIATED WITH CONVEYANCE OF MINERAL INTERESTS

A. The Surface and Mineral Estates

1. Ownership of minerals underlying land can be conveyed separately from the overlying surface interest.

2. Two basic issues:

a. What minerals have been conveyed?

b. What are the relative rights of the surface owner and the owner of the mineral estate?

B. Surface Use

1. To determine what right a mineral interest owner has to use the surface to support mining of the mineral, consider the following:

a. Does the deed creating the interest address the issue? If it does, the express terms of the deed will govern.

b. If the deed does not address the issue, the mineral interest owner will be given the

implied right to make reasonable use of the surface to develop the granted minerals--the "reasonable use" doctrine.

2. Reasonable use doctrine still undefined in most states, including Kansas.

   a. However, if mining operations cannot accommodate a competing surface use, the surface use must give way.

   b. When representing real estate developers, must determine whether any minerals have been severed from the surface estate. The existence of the mineral estate will often impair any safe use of the surface for development.

3. Although the mineral owner may have the right to use the surface, a separate issue is whether the mineral owner must pay for such use.

   a. Most oil and gas producing states hold that reasonable use can be made of the surface without payment for disruption of the surface.

   b. This has been changed by statute in some states.

   c. Issue undecided in Kansas.

4. See generally D. Pierce, "Toward a Functional Mineral Jurisprudence for Kansas," 27 **Washburn L. J.** 223 (1987).

C. Defining What "Minerals" Are Conveyed

1. **A** conveys to **B** "all the minerals in Section 30." Who owns the minerals? Answer: **A** owns some, **B** owns some.

2. Since the owner of the minerals also obtains the right to use (often without further payment) the surface to mine the minerals, courts have tended to limit the scope of conveyances of "all minerals" or "oil, gas, and other minerals."

3. Common interpretive limits (designed to keep certain minerals with the surface owner--unless the conveyance **expressly** conveys them):

a. Surface Destruction Test - Include substance in the grant only if it can be extracted without significant destruction to the surface.

b. Community Knowledge Test - Include substance in the grant only if it was generally known to exist at the time of the conveyance.

c. Construe Against Grantor - Construe deed against the grantor so as to pass the greatest estate possible to the grantee.

d. Ejusdem Generis - If the grant or reservation is of "oil, gas, or **other minerals**" limit the reference to "other minerals" to substances similar to oil and gas.

e. Tests used vary considerably from state-to-state.

4. If you have property which is subject to a "mineral" or "other mineral" conveyance, must evaluate the case law of the state to determine, in light of the express language used, whether a mineral resides with a particular party.

IV. COMMONLY CREATED OIL AND GAS PROPERTY INTERESTS

A. The Mineral Estate

1. Divided Interests.

2. Undivided Interests.

3. Term Interests.

4. Defeasible Interests.

5. Defeasible Term Interests.

6. Life Estate.

7. Depth Severances.

8. Substance Severances.

9. Nonparticipating Interests.

10. Combinations of the listed interests.

B. The Leasehold Estate

1. Usually the mineral interest owner transfers their development rights to a person or entity specializing in oil and gas development.

    a. Instrument used to transfer development rights called an "Oil and Gas Lease."

    b. The lessee developer obtains the mineral interest owner's right to enter the premises and conduct exploration, development, and production operations.

2. Lessor still owns the mineral interest; subject to the contractual terms of the oil and gas lease.

3. Three forms of landowner compensation under the lease:

    a. Bonus - upfront money paid to induce landowner to enter into the lease.

    b. Delay Rental - money paid to landowner to delay development of the lease for a specified period of time.

    c. Royalty - landowner paid a share of production when oil or gas are produced from the land. Traditional royalty is 1/8th of the oil produced and 1/8th of the value of gas produced and sold.

4. Can divide up lease much like the mineral interest.

5. Leasehold interest is called the "working interest." Lessee has the right to enter the property and "work" the lease.

6. Lessee often assigns non-operating rights out of the lease to third parties.

    a. Overriding Royalty - a right to a share of oil and gas from the leased land.

    b. Production Payment - like and overriding royalty but limited to payment of a specified amount of money or production.

    c. Net Profits Interest - share of **net** profits instead of a share of the gross production.

C. **Basic Structure of the Oil and Gas Lease**

1. Granting Clause.

2. Habendum (Term) Clause.

3. Drilling/Delay Rental Clause.

4. Royalty Clause.

5. Miscellaneous Express Covenants.

6. Judicially-Defined Implied Obligations - express lease clauses are affected by judicial attempts to balance the relative positions of the lessor and lessee under the standard **relationship** created by the oil and gas lease.

   a. The "Prudent Operator Standard."

   b. Implied covenants to explore and develop.

   c. Implied covenant to market.

   d. Implied covenant to protect against drainage.

   e. Implied covenant to operate and manage the lease efficiently.

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V. **DEVELOPMENT SEQUENCE**

A. Exploration

1. Landowner enters into oil and gas lease with developer.

2. Developer may also obtain leasehold rights to develop from other lessees through a "Farmout Agreement."

   a. Farmout Agreement is a contract where a lessee agrees to assign its working interest in a lease to a developer in return for the developer's agreement to drill a well on the lease.

   b. Farmor usually retains an overriding royalty which can be "converted" to a working interest once the farmee recovers all its development costs from the well ("Payout").

3. Developer may decide to leverage its risk in drilling a well by sharing it with others.

   a. Assign fractional working interests to investors.

   b. Assign non-operating interests to investors.

   c. "Promoter" will sell interests in the venture and often the promoter will make money even though the well is dry.

      (1) May get a free ride. Quarter-for-a-third deal: three investors each put up 1/3 the cost of drilling and completing a well in return for a 1/4th working interest in the lease and well equipment.

      (2) May get a free ride **plus** profit on the sale of working interests. For example, enter into a turnkey drilling arrangement that costs $100,000. Sell a 1/4th working interest to three investors at $50,000 each. Not only does the promoter get a free ride in the well, also makes $50,000 even if the well never produces.

4. Often many trade creditors involved. Drilling contractor, well logging company, etc.

5. Developer often contracts with independent contractor (drilling company) to have the well drilled.

   a. Daywork drilling contract.

   b. Footage drilling contract.

   c. Turnkey drilling contract.

B. Production

1. If more than one working interest owner, they will most often enter into an Operating Agreement (also called a Joint Operating Agreement or "JOA") which designates one working interest owner as the "operator" and addresses how operations will be conducted.

2. Operating agreement specifies each parties ownership in production from the property.

3. If lease not large enough to meet spacing or prorationing requirements, may need to enter into pooling agreements with other leasehold owners in the drill site area.

C. Marketing

1. Transporters.

   a. Sales at the lease.

   b. Sales off the lease.

2. Production purchasers.

   a. Division Orders; Transfer Orders.

   b. Gas Sales Contract.

VI. THE BASIC DOCUMENTS OF THE TRADE

A. Mineral Deed

B. Oil and Gas Lease

C. Assignment

D. Pooling (or Unitization) Agreement

E. Division Order

VII. THE DOCUMENT GENERATING THE MOST RECURRING ISSUES: THE OIL AND GAS LEASE

A. The Function of the Lease

1. Authorizes a developer to come onto the "leased" land to explore for, develop, and produce oil and gas.

2. The developer, the "lessee", generally has no obligation to develop the leased land during the "primary term" of the lease.

   a. The lease is more in the nature of an "option" to develop the land if the lessee so desires.

b. However, following the primary term of the lease, the lease will terminate automatically unless the lessee obtains production from the leased land.

3. The lease specifies the rights of the parties regarding such critical issues as:

   a. Rights to use the surface of the land.

   b. Development rights and obligations.

   c. Events that will cause the lease to expire.

   d. Each party's economic benefits arising out of development.

4. The lease is the base document that establishes the rights and obligations of the lessor and lessee for a potentially long period of time.

   a. Many leases granted in the 1920s are still in effect by continued production from the leased land.

   b. Although the underlying minerals are not transferred by the lease document (at least not in Kansas), the potential duration of the lease, the significant rights it grants to the lessee in the oil and gas, <u>and the rights it gives to the lessee in the surface of the land</u>, require that the transaction be entered with great care.

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B. The Lease Document

1. The oil and gas lease will typically have several clauses that address one or more of the following three topics:

   a. What rights are being <u>granted</u> to the lessee by the lessor. These are the "granting clause" issues.

   b. What is the <u>duration</u> of the rights that are granted? When, and under what circumstances, will the lease terminate? These are the "habendum clause" issues.

   c. How will the economic benefits generated by development be shared between the lessor and

lessee? These are the "royalty clause" issues.

2. The bargaining goals of the lessor and lessee can be summed up as follows:

   a. The lessor wants to grant the fewest rights, for the shortest duration, for the maximum compensation possible.

   b. The lessee wants to obtain the maximum rights possible, for the longest duration, for the minimum compensation possible.

3. Once the bargain is struck, and the lease is signed, the parties will be bound by the express terms of the oil and gas lease.

   a. Other documents may, or may not, modify the terms of the lease.

      (1) Pooling agreements.

      (2) Division orders.

   b. To the extent the lease does not address an issue, there are three ways a court might get involved to define the rights of the parties:

      (1) Interpretation.

         (a) Not necessarily the meaning the parties may have actually intended.

         (b) Look for the intent <u>as expressed in the document</u>; if it is clear, that intent will control the rights of the parties.

      (2) Implied covenants.

      (3) Declare the document ambiguous and consider "extrinsic" evidence--information not contained in the lease that can be used to ascertain the parties' intent.

C. Recurring Granting Clause Issues

1. The "scope" of the lessee's right to use the surface.

a. Express easements.

b. "Reasonable use" concept.

2. Lessor right to use gas produced from the land for specified purposes is a granting clause issue.

a. The "free gas clause" issue.

b. Scope of the right?

(1) A single house.

(2) Multiple houses.

(3) Agricultural issues.

(4) Use only on the leased land.

3. Limitation on lessor's free use of the surface of leased land.

a. Subject to the lessee's "easement" rights created by the lease.

b. Lessee uses that interfere with existing or future uses of the land.

4. New issues: landowner environmental liability for polluting substances disposed of on the leased land.

D. Recurring Royalty Clause Issues

1. How should royalty be calculated?

2. What must the lessee do with production once it is extracted from the ground?

3. How do you value the oil or gas that is extracted from the ground?

4. What collateral lessee business activities are there in which the lessor is entitled to participate?

a. The lessor will want to try and participate in any lessee business activity that enhances the value of production.

b. The lessee may be willing to permit the lessor

to share in certain post-extraction business activities (such as transporting production from the wellhead to a sales point in the field), if the lessor is willing to share in the post-extraction costs associated with the activity.

5. What costs can be deducted from the lessor's share of production, or production value, to ascertain the royalty due?

6. Must the lessor sign a Division Order as a condition to being paid their royalty?

E. Recurring Development Disputes

1. Throughout the life of the lease the lessee (and lessor) will be considering whether the conditions specified in the lease to extend it beyond the primary term are being fulfilled.

2. Failure to meet the conditions specified in the lease can cause it to terminate--automatically.

3. Habendum clause: "so long as".

   a. Payment of delay rental.

   b. Commence drilling of a well.

   c. Cessation of production.

   d. Failure to produce in "paying quantities."

4. Don't forget K.S.A. §§ 55-201, 55-202, and 55-206 (1994) (potential for attorney fees where a demand for a release is made before pursuing other legal remedies).

5. "Implied covenant" variety of development disputes:

   a. Obligation to further develop a known reservoir.

   b. Obligation to explore for unknown reservoirs?

   c. Obligation to protect against drainage.

VIII. DEVELOPMENTS IMPACTING OIL & GAS LEASING

A. Granting Clause[1]

1. **Right to Dispose of Produced Water:** Unless expressly limited in the oil and gas lease, or some other document (such as a deed in the chain of title):

   "[T]he granting clause in an oil and gas lease includes an implied covenant to dispose of the salt water produced during operations by utilizing a saltwater disposal well drilled on the leased premises without additional compensation to the lessor."

   a. NOTE: This assumes the salt water is being produced <u>from the leased land</u>. If it is being produced from land other than the leased land, its disposal would not be covered by the implied right.

   b. To dispose of off-lease water the parties typically enter into a separate saltwater disposal agreement. The parties did this in <u>Colburn v. Parker & Parsley Development Co.</u>, 17 Kan. App.2d 638, 842 P.2d 321 (1992), but the disposal operation included on-lease and off-lease saltwater. A dispute arose over whether the lessee had to pay a per-barrel disposal fee for the on-lease water.

      (1) HELD: The agreement was ambiguous so the court looked outside of the express terms of the agreement for guidance as to its intended meaning. Court focused on the interpretation placed on the agreement by the original parties in which the lessee paid a disposal fee for both on-lease and off-lease water.

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[1]<u>See generally</u> David E. Pierce, "Incorporating a Century of Oil and Gas Jurisprudence into the 'Modern' Oil and Gas Lease," **33 Washburn Law Journal** 786, 768-801 (1994) ("The Granting Clause: The Most Under-Drafted Clause").

(2) The net effect was the lessee broadened its disposal rights under the agreement by acquiring the right to dispose of off-lease water; at the same time it narrowed its disposal rights by requiring payment for disposal of on-lease water.

2. **Free Gas Clause:** Courts will not impose a geographic limit on the clause unless the express terms so provide.

a. "If gas is produced on this lease the lessors . . . shall be furnished free gas for agricultural purposes or uses."

b. HELD: Lessor may use the gas for agricultural purposes or uses taking place off of the leased land. Lauck Oil Co. v. Breitenbach, 20 Kan. App.2d 877, 893 P.2d 286 (1995).

c. Court refused to imply a geographic limitation from that contained in the printed free gas clause which stated: "[L]essor to have gas free of charge from any gas well on the leased premises for stoves and inside lights in the principal dwelling house on said land . . . ."

d. The court counseled: "If Lauck wished to limit Breitenbach's agricultural use of the gas from the well, it should have negotiated for such a limitation in the lease."

e. THE NEXT CASE: What limitations are there on the lessor's gas use? Can they build a fertilizer plant and take all the well's production so long as it is an "agricultural" purpose or use?

(1) The court held the language of the clause was not ambiguous as to the geographic limits of the use.

(2) If the parties contemplated using gas to run irrigation pumps, can this fact be used to limit the scope of "agricultural purposes or uses" to similar types of activities?

(3) This might be a place where an implied obligation to perform and enforce contracts in "good faith" would serve as

an interpretive limit on the lessor's gas use. Cases concerning limits on output and requirements contracts could serve as guides for fashioning reasonable limits on what the lessor can do with the gas.

B. Habendum Clause--"Guillotines and Time Bombs"[2]

1. **Limitation and Expansion of the Habendum Clause:** In this section we are addressing provisions which define, limit, or expand the duration of the lessee's granted interest.

   a. Typically the lease will run for a stated period of time (the "primary" term) followed by an indefinite period of time measured by production (the "secondary" term)--"for so long as oil or gas is produced."

   b. The drilling/delay rental clause can cut the primary term short unless delay rental is paid or drilling is conducted by a critical date.

   c. The commencement/operations/ completion clause, cessation clause, dry hole clause, shut-in royalty clause, force majeure clause, and similar provisions can expand the term of the lease even though the required production under the habendum clause is not being obtained.

2. **Commencement/Operations/Completion Clause:** Clause expanding the duration of the lease "[i]f the lessee shall commence to drill a well" required actual drilling prior to the termination date of the lease. Hall v. JFW, Inc., 20 Kan. App.2d 845, 893 P.2d 837 (1995).

   a. Lessee caused the following to take place in an effort to "commence to drill a well" on the leased land:
   "[S]taking of the well location, an elevation survey, the signing of a written contract with Duke Drilling, an agent of Duke Drilling

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[2]See generally David E. Pierce, "Incorporating a Century of Oil and Gas Jurisprudence into the 'Modern' Oil and Gas Lease," **33 Washburn Law Journal** 786, 801-815 (1994) ("The Habendum Clause: Guillotines and Time Bombs").

digging drilling pits and leveling the location, and the drilling of a water supply well." In addition, JFW had obtained an approved intent to drill from the KCC.

b. HELD: "Commence to drill" requires something more than "operations" for drilling--it requires actual drilling on the leased land prior to the end of the primary term.

c. The precise terms of the lease can make a difference. Court distinguishes between a clause requiring the lessee to "commence to drill" and a clause requiring the lessee to "commence operations for the drilling of a well" or "commence drilling operations." It remains to be seen whether something less than actual drilling will satisfy these "operations" type of clauses.

d. What if the drilling/delay rental clause provides for one standard and the commencement/operations/completion clause uses a different standard? Did the parties intend a different result? That actual drilling would be required in one situation while something less than actual drilling would satisfy the other situation?

e. Since the commencement/operations/completion clause is a "savings" clause, it should operate to expand rights under the habendum clause. Therefore, if the habendum clause does not require actual drilling, there is no need to resort to savings clauses.

(1) Some lease forms commonly used in Kansas provide they will continue so long as oil or gas is produced "or the premises are developed or operated."

(2) This creates the possibility that a lessee's activity (preparations for drilling as opposed to actual drilling) may satisfy the habendum clause even though it may not trigger the savings provisions of the commencement clause.

3. **Cessation of Production Clause:** Efforts to reroute a saltwater disposal pipeline constituted "re-working operations" under cessation clause.

a. The lease contained a cessation of production clause which would continue the lease in effect "if Lessee commences additional drilling or re-working operations within sixty (60) days from the date of cessation . . . ."

b. HELD: Good faith actions of lessee in commencing actual work to reroute saltwater disposal line necessary to restore production from well, taken within 60-days of the cessation of production, satisfied terms of cessation clause. Pro-Chem, Inc. v. Lassetter Petroleum, Inc., 17 Kan. App.2d 85, 837 P.2d 823 (1990), published by order of Kansas Supreme Court (1992).

c. Lessor argued lessee was required to truck saltwater from well while re-routing the disposal line. Court found: "These is nothing in the record to establish that a prudent operator would have continued to operate the well and carry the saltwater away by truck."

4. **Cessation of Production--Buying a Lawsuit:** Habendum clause providing lease would continue so long as oil or gas is produced, or "the premises are being developed or operated", would not save a lease on which there had been no production or development activities for 23 months.

a. Leavell Resources acquired the "lease" in 1990 and spent $20,532,42 reworking a well on the lease and sold oil production from the well for $8,681.

b. However, the "lease" had already terminated because there had been no production or other activity on the lease from February 1988 through July 1990 when Leavell Resources obtained its assignment.

c. Leavell Resources didn't buy a lease, the lease had already terminated--instead it bought a lawsuit. Eichman v. Leavell Resources Corp., 19 Kan. App.2d 710, 876 P.2d 171 (1994).

d. Court permitted Leavell Resources to remove the lease equipment because the "reasonable time" in which to remove them commenced not in 1989 (when the lease terminated) but rather

following the court's judgment--at least in this case.

e. The court noted:

"We hold that when an oil and gas lease is terminated by court judgment because of failure of the lessee to satisfy the provisions of the habendum clause, and where the lessee defends the action in good faith, the lessee has a reasonable time to remove leasehold equipment after entry of judgment."

5. **Shut-In Royalty Clause:** Common form of shut-in royalty clause required lessee to demonstrate "no" market, as opposed to a "limited" market, existed for the gas before the clause can be relied upon to extend the lease. Tucker v. Hugoton Energy Corp., 253 Kan. 373, 855 P.2d 929 (1993).

a. The lease provided:

"Where gas from a well or wells, capable of producing gas only, is not sold or used for a period of one year, lessee shall pay or tender, as royalty, an amount equal to the delay rental . . . payable annually at the end of each year during which such gas is not sold or used, and while said royalty is so paid or tendered this lease shall be held as a producing property . . . ."

b. If there is an available market for the gas, and you don't plan to avail yourself of the market, you better be talking to your lessor to obtain written authorization to shut the well in--unless you have sufficient authority to act under your specific shut-in clause.

(1) If the local gatherer is not offering an acceptable deal, the lessor is likely to be willing to forgo a sale to await a better deal.

(2) The lessee needs flexibility under the shut-in clause to accept or reject marketing opportunities in accordance with the mutual interests of the lessor and lessee.

c. The court stated:

> "The 'shut-in' royalty clause applies to circumstances where 'a well capable of producing a profit is drilled but for the time being no market for the gas exists. However, once a market for gas is secured, that mutual interest no longer exists because the lessor's interest is in securing royalty payments from production, while the lessee's interest is divided between receiving revenues and minimizing expenses associated with that production. Thus, the 'shut-in' royalty serves the interests of both parties only in situations where no market exists for the gas."

d. The court defines the lessor's interest too narrowly by limiting it to the sale of gas to generate a royalty. Surely the interest of the lessor and lessee coincide when it comes to selling the gas for an inadequate price under monopsonistic conditions.

e. The court may have been concerned that the lessee had an adequate market available for the gas but consciously chose to meet the demand with other wells that were not burdened by high operating costs. However, the court's holding seems to suggest an across-the-board rule that could apply regardless of the lessee's motivation in rejecting an available market.

6. **Interaction of the Cessation and Shut-In Royalty Clauses--A Warning from Oklahoma:** Shutting-in a lease may trigger the cessation of production clause requiring action under a savings clause within the time frame specified in the cessation clause--60 days, 90 days, 120 days, whatever.

a. Santa Fe minerals overproduced wells on their leases during the winter months and shut them in during the summer months to avoid exceeding their annual allowable established by the Oklahoma Corporation Commission. The goal, and effect, was to maximize their gas sales prices during the high demand winter months.

b. The cessation clause of each lease provided:

"If, after the expiration of the primary term of this lease, production on the leased premises shall cease from any cause, this lease shall not terminate provided lessee resumes operations for drilling a well within sixty (60) days from such cessation, and this lease shall remain in force during the prosecution of such operations and, if production results therefrom, then as long as production continues."

c. In Pack v. Santa Fe Minerals, 869 P.2d 323 (Okla. 1994), the trial court and Oklahoma Court of Appeals held the leases terminated when Santa Fe shut the wells in for over 60 days without resuming operations.

   (1) The Supreme Court, however, reversed, holding the lease was maintained by the unique interpretation of the habendum clause under Oklahoma law: all that is required is a well "capable" of production--at all times the Santa Fe wells were "capable" of production.

   (2) A different result could be obtained in Kansas and Texas since "production" under the habendum clause requires the actual physical severance and marketing of the oil or gas--a mere capability of production is not sufficient.

d. In Kansas, a shut-in royalty clause similar to that contained in the Tucker v. Hugoton Energy Corp. case would seem to prohibit the lessee from engaging in such a winter/summer marketing program.

   (1) Since the lessee has a market available to them, they could not rely upon the savings provisions of the shut-in royalty clause.

   (2) This would force the lessee to rely solely on the cessation of production clause which may limit a cessation to a relatively short period of time, such as 60 days.

   (3) The best course of action would probably be to try and obtain a clarifying amendment from the lessor(s) approving

such marketing programs.

e. How should be reconcile the shut-in royalty and cessation clauses? In addressing this issue previously, I have noted:

"If the lessee shuts-in the lease [that has a 60-day cessation clause], will the lease terminate 61 days following the shut-in? Courts could harmonize such lease clauses by limiting operation of the cessation clause, and the sixty-day action period, to situations where there is a permanent cessation of production in paying quantities. This is essentially what the Court did in the Pack case. Unfortunately, the circumstance that will make it difficult for courts to arrive at such a logical conclusion is the explicit language often contained in cessation clauses. For example, the clause in Pack stated: 'If . . . production on the leased premises shall cease from any cause . . . .'" D. Pierce, **7 Oil, Gas & Mineral Law Section Newsletter** 8-9 (January 1995).

C. Royalty Clause: Can't We All Just Get Along?[3]

1. No: Garman v. Conoco, Inc., 886 P.2d 652 (Colo. 1994).

a. Certified question:

"Under Colorado law, is the owner of an overriding royalty interest in gas production required to bear a proportionate share of post-production costs, such as processing, transportation, and compression, when the assignment creating the overriding royalty interest is silent as to how post-production costs are to be borne?"

b. Answer:

"[A]bsent an assignment provision to the contrary, overriding royalty interest owners

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[3]See generally David E. Pierce, "Incorporating a Century of Oil and Gas Jurisprudence into the 'Modern' Oil and Gas Lease," **33 Washburn Law Journal** 786, 815-833 (1994) ("The Royalty Clause: Can't We All Just Get Along?").

are not obligated to bear any share of post-production expenses, such as compressing, transporting and processing, undertaken to transform raw gas produced at the surface into a marketable product."

c. Limitation:

"Our answer is limited to those post-production costs required to transform raw gas into a marketable product. . . . [M]any different types of expenses may be involved in the conversion process. Upon obtaining a marketable product, any additional costs incurred to enhance the value of the <u>marketable</u> gas . . . may be charged against nonworking interest owners. To the extent that certain processing costs enhance the value of an already marketable product the burden should be placed upon the lessee to show such costs are reasonable, and that actual royalty revenues increase in proportion with the costs assessed against the nonworking interest."

d. Rationale:

"In our view the implied covenant to market obligates the lessee to incur those post-production costs necessary to place gas in a condition acceptable for market. Overriding royalty interest owners are not obligated to share in these costs."

(1) The court holds it will extend implied covenant protection to the overriding royalty interest owner.

(2) "[T]he duty to market, always undertaken in good faith, may be limited when compliance would be uneconomical or unreasonable. [But] The marketing obligation does not depend on whether production would be more economic if nonworking interest owners were obligated to share in these post-production costs."

e. Court rejects the defendant's industry custom argument holding that royalty owners and overriding royalty owners often are totally unaware of industry practices.

f. A new wrinkle in the analysis:

"Allocating these costs to the lessee is also traceable to the basic difference between cost bearing interests and royalty and overriding royalty interest owners. Normally, paying parties have the right to discuss proposed procedures and expenditures and ultimately have the right to disagree with the course of conduct selected by the operator. Under the terms of a standard operating agreement nonoperating working interest owners have the right to go "non-consent" on an operation and be subject to an agreed upon penalty. . . . This right checks an operator's unbridled ability to incur costs without full consideration of their economic effect. No such right exists for nonworking interest owners."

g. The two specially concurring justices peaked at the terms of the assignment to arrive at their conclusion. The assignment stated, in part:

"Assignee does hereby agree to pay to Assignor . . . a sum representing four (4) per cent of the market value . . . of all oil, gas, and casinghead gas produced, saved and marketed from any of the above described lands . . . .

"Said overriding royalty shall be computed and paid on the basis of the market price for oil, gas and casinghead gas prevailing in the field where produced for oil, gas and casinghead gas of like quality . . . . [emphasis mine]

"In computing the amounts to be paid Assignor hereunder as above provided, Assignee shall have the right to deduct from the value of the oil, gas, casinghead gas, or the proceeds thereof, upon which said overriding royalty is computed the full amount of any taxes required to be paid on such oil, gas and casinghead gas for or on account of the production or sale thereof, including the so-called gross production or severance taxes."

(1) The specially concurring justices thought the express provision for deduction of taxes excluded all deductions except

those enumerated--taxes.

(2) The specially concurring justices also noted: "The record before us does not contain facts that provide a basis for determining whether transportation includes gathering or whether compression is necessary to make the gas marketable."

(3) The specially concurring justices did not focus on the need to determine the market value of the production "in the field where produced."

2. TXO Production Corp. v. Oklahoma, 903 P.2d 259 (Okla. 1994), as amended on reh'g, Oct. 5, 1995.

a. Royalty owner cannot be charged for proportionate share of compression, dehydration, and gathering because such costs are deemed "necessary to make the product marketable under the implied covenant to market."

b. The oil and gas lease required TXO to pay royalties on gas as follows:

"The lessee hereby agrees to deliver or cause to be delivered to the Commissioners of the Land Office of the State of Oklahoma, or their successors, without cost into pipelines, a royalty of one-eighth (1/8) part of the oil or gas produced from the leased premises and one-eighth (1/8) part of all casinghead or drip gas or gasoline or other hydrocarbon substances produced from any well or wells on said premises, or in lieu thereof, pay to lessor the market value thereof, as the Commissioners may elect."

c. The Commissioners elected to be paid the market value of the gas which the court concluded meant the market value "without cost into pipelines":

"Thus, TXO may not deduct any costs for the royalty payment which results from processes necessary to get the product into pipelines."

d. However, in addition to the express lease language, the court noted:

"This [no deduction of costs] is further supported by and seen in this Court's approach to the implied covenant to market owed by TXO as explained in Wood . . . ."

e. Quoting from Wood v. TXO Production Corp., 854 P.2d 880 (Okla. 1992):

"We interpret the lessee's duty to market to include the cost of preparing the gas for market. . . . We find that in Oklahoma the lessee's duty to market involves obtaining a marketable product."

f. Applying Wood to the present dispute:

"The post-production costs deducted by TXO were for compression, dehydration and gathering. Clearly, under Wood, Commissioners were not chargeable with a portion of the costs of compression because such costs are borne by the lessee under its duty to obtain a marketable product. . . . If the processes of dehydration and gathering are necessary to prepare the product for market, then the costs of these processes may not be deducted under the royalty provision of the subject lease."

(1) Court concluded that dehydration "is necessary in order to make the product marketable and involve costs incident to delivering the product into pipelines" and therefore dehydration costs are not deductible.

(2) Court concluded that gathering "occurs prior to the product being placed into the purchaser's pipeline" and "[a]s such, gathering is not a deductible expense under the teaching of Wood."

3. Dealing with Garman and TXO:

a. Should a lessee, before they engage in their own marketing activities, seek defensible third party offers to purchase the gas at the wellhead in order to establish that the "raw" gas was indeed "marketable" at that point?

b. Such offers could also serve as a benchmark for testing whether the subsequent value-enhancing services would cause: "actual

royalty revenues [to] increase in proportion with the costs assessed against the nonworking interest."

c. The critical issue seems to be when does gas become "marketable."

(1) Perhaps the best evidence it has become marketable is when somebody is ready, willing, and able to buy it in an arms-length transaction.

(2) Seeking purchasers might also give the lessee an opportunity to put the lessor in an estoppel situation. Could the lessee give the lessor the option of selling their royalty/ overriding royalty share to the wellhead purchaser or market their gas with the lessees share--under a separate marketing agreement providing for an express allocation of costs for such value-enhancing services.

(3) If the gas is marketable at the wellhead, shouldn't lessees try and cut off the lessor's ability to share in value-enhancing activities, such as processing?

(4) The focus will soon shift from deduction of costs to affiliate transactions.

4. Sternberger v. Marathon Oil Co., 257 Kan. 315, 894 P.2d 788 (1995).

a. Royalty owners can be charged for their proportionate share of reasonable gas gathering costs.

b. The oil and gas lease required Marathon to pay royalties on gas as follows:

"To pay lessor for gas of whatsoever nature or kind produced and sold, or used off the premises, or used in the manufacture of any products therefrom, one-eighth (1/8), at the market price at the well, (but, as to gas sold by lessee, in no event more than one-eighth (1/8) of the proceeds received by lessee from such sales), for the gas sold, used off the premises, or in the manufacture of products therefrom, said payments to be made monthly."

c. Court held the leases were unambiguous and required the lessee to pay royalty based upon the market value of gas "at the well."

d. The court found:

"[T]hat where royalties are based on market price 'at the well,' or where the lessor receives his or her share of the oil or gas 'at the well,' the lessor must bear a proportionate share of the expenses in transporting the gas or oil to a distant market."

e. The court's analysis is labored.

(1) Court made no suggestion it was in any way overruling its holdings in Gilmore v. Superior Oil Co. and Schupbach v. Continental Oil Co.; however, its rationale in Sternberger is hard to reconcile with the result in Gilmore and Schupbach.

(a) Court effectively treats the "at the well" language in Gilmore and Schupbach as being ambiguous. In Sternberger such language is held to be unambiguous.

(b) In Gilmore and Schupbach the court seems to impose a broad implied marketing obligation on the lessee. In Sternberger the court acknowledges the gas was "marketable" at the wellhead "other than the lack of a purchaser at that location."

(2) The issue never addressed by any of the courts is the issue that defines the royalty obligation: what is the market value of the gas at the well? Giving the lessor 1/8th of that value fulfills the lessee's royalty obligation.

(3) Since no sale took place at the wellhead, need to workback to that value by deducting any costs that enhanced the value of the gas at the place of sale. Note this would arguably include marketing, gathering, compression,

dehydration, and any other costs taking place beyond the wellhead.

(4) Marathon only sought to collect a small portion of its gas gathering expenses associated with the initial construction of the pipeline. Arguably, the royalty clause would permit Marathon to deduct any value-adding service provided beyond the wellhead. Therefore, the real inquiry ought to be not what Marathon paid for the pipeline, but rather what is the value of the pipeline service provided each day to take the gas to market.

Heritage

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D. Express and Implied Covenants

1. **Forfeiture Inappropriate Remedy for Breach of Minimum Royalty Covenant:** Failure by lessee to pay minimum royalty when due did not cause the lease to automatically terminate, nor would the facts support a forfeiture of the lessee's interest. M & C Oil, Inc. v. Geffert, 21 Kan. App.2d 267, 897 P.2d 191 (1995).

   a. Minimum royalty clause provided:

   "It is agreed that the royalty each year, commencing with the year of August 1, 1979, shall not be less than Two Thousand ($2,000.00) Dollars and if in any lease year the royalty does not equal said sum of $2,000.00, the lessee agrees to pay the lessor the difference between said sum of $2,000.00 and the royalty received; such payment to be made within thirty (30) days of the close of the lease year."

   b. Another clause in the lease provided:

   "In addition to the 1/8th Royalty Interest, the Lessor shall receive 7 1/2% of 8/8th Over-riding Royalty Interest, which shall be free & clear of any operating expenses."

   c. From 1979 to 1992 production generated royalty in excess of $2,000/lease year. In 1993 there was a shortfall and the lessee failed to make the required payment within 30 days of the close of the lease year. The lessor asserted

the lease terminated. The court held the lessee merely breached a covenant to pay and damages would adequately compensate the lessor under the facts.

d. Court also held that production credited to the "over-riding royalty" should not be consider in calculating the $2,000 minimum "royalty" payment.

e. The court clarifies when it is appropriate to apply the Thurner v. Kaufman, 237 Kan. 184, 699 P.2d 435 (1985), cancellation/ forfeiture remedy for breach of an express or implied covenant.

(1) Look for "flagrant or reprehensible" conduct on the part of the lessee.

(2) Look for situations where an award of damages will not compensate the lessor properly for the lessee's breach.

2. Cancellation of Lease Proper Remedy for Lessee's Failure to Diligently Market Production

a. Texaco's failure to market gas from well for four years was a breach of its implied covenant to diligently market production which, under the facts, supported the trial court's order canceling the lease. Danne v. Texaco Exploration and Production Inc., 883 P.2d 210 (Okla. App. 1994).

b. Texaco failed to produce gas from a well for four years due to a mistake concerning the status of a gas contract. In June 1991 Texaco discovered the contract had been released in December 1988 and therefore Texaco could have marketed the gas as early as December 1988.

c. The court held the lease did not expire automatically.

(1) In Oklahoma the habendum clause is not a special limitation on the grant but a condition subsequent creating only a right of entry in the grantor.

(2) The court distinguished termination during the primary term, which can result in automatic loss of the lease (e.g.

failure to pay delay rental), from a failure to maintain the lease during the primary term (e.g. production in paying quantities), which requires a suit for cancellation and a forfeiture analysis.

(3) Failure to make timely shut-in royalty payments will not result in automatic termination unless the lease <u>expressly</u> and <u>clearly</u> provides for automatic termination.

d. Texaco tendered shut-in royalty to two of the lessors for the period in which the well was not producing. They accepted the shut-in royalty and royalty on production once it commenced.

(1) The court held that as to those two royalty owners they were estopped from seeking cancellation of the lease.

(2) Since the lease did not expire automatically, the lessor's acceptance of benefits may estop them from asserting lease termination.

e. The court held the lease terminated as to the lessor who refused to accept benefits under the lease because Texaco <u>failed to diligently market production from the well</u>. The court stated:

"Though we have held that a lease cannot terminate automatically in the secondary term of the lease, this holding should not be construed to imply that failure to satisfy the terms of the habendum clause can never result in forfeiture of the lease. Rather, such forfeiture can result if an action is brought and it is demonstrated that the lessee either failed to produce in paying quantities or failed to market the product with due diligence in breach of the implied covenant to market the product."

f. Focusing on the diligent marketing obligation, the court stated:

"Capability of production alone, however, without a significant attempt to market the product, will not suffice to hold the lease

because there is a covenant to market the product with due diligence implied in each oil and gas lease. . . . The efforts to secure a market for production must be assessed according to the facts and circumstances of each case."

g. The Court of Appeals in Danne concluded the trial court properly evaluated the facts and circumstances and concluded cancellation of the lease was the appropriate remedy.

IX. DEVELOPMENTS IMPACTING MINERAL OWNERSHIP AND OPERATIONS

A. What is a Mineral?

1. **Who Owns Montana "Scoria"?**[4] If it is "exceptional" scoria it belongs to the owner of the "mineral" interest; if it is "ordinary" scoria, it belongs to the owner of the "surface" interest. Farley v. Booth Brothers Land & Livestock Co., 890 P.2d 377 (Mont. 1995).

   a. Scoria is a term used to refer to "baked roof rock," which is comprised of shale, sandstone, and clay, that results from burned coal outcroppings.

   b. Evidence at trial indicated it was used primarily for constructing roadways. Evidence offered (but rejected) on appeal indicated it could also be used for the manufacture of "mineral wool."

   c. Quoting from Miller Land & Mineral v. Highway Commission, 757 P.2d 1001 (Wyo. 1988), the court identified the interpretive problems it hoped to avoid:

      "The courts which have held that the general reservation of "all minerals" is inherently ambiguous have traveled over a long and tortuous path in a complex and hopeless search to discover the particular minerals the parties intended to reserve. The only reliable rule which surfaces from the confusing and inconsistent approaches taken by

[4]One of the pressing issues of the day.

those courts attempting to ferret out the subjective intent of the parties is the word "mineral" means what the court says it means. The result is title uncertainty and the need to litigate each general reservation of minerals to determine which minerals it encompasses."

d. The court noted the Oklahoma approach to the issue in Holland v. Dolese Company, 540 P.2d 549 (Okla. 1975), where the Oklahoma Supreme Court held:

"[S]ubstances such as sand, gravel and limestone are not minerals within the ordinary and natural meaning of the word unless they are rare and exceptional in character or possess a peculiar property giving them special value, as for example sand that is valuable for making glass and limestone of such quality that it may profitably be manufactured into cement. Such substances, when they are useful only for building and road-making purposes, are not regarded as minerals in the ordinary and generally accepted meaning of the word."

e. The court also quoted from the Texas case of Heinatz v. Allen, 147 Tex. 512, 217 S.W.2d 994 (1949):

"In the case at bar, the limestone being quarried was a general part of the soil and subsoil. That limestone had no peculiar property so as to be rare and exceptional in character. It was not an exceptional substance and is comparable to sand and gravel. The quarry operation destroyed the surface for its normal uses, such as cattle grazing. The limestone was not included in the reserved mineral right. To hold otherwise would negate much of the substance of the transaction . . . . It would destroy the general intent of enjoyment of the surface. The limestone is not part of the minerals, under the reserved mineral rights in the deeds here involved."

f. The court concluded that scoria used for constructing roadways was not "rare and exceptional in character" and therefore was not a "mineral" which would be part of the

mineral estate. Instead, the scoria belonged to the owner of the surface estate.

B. Mineral Lapse Statute

1. Under Kansas law, "an interest of any kind in coal, oil, gas or other minerals" will "lapse" if "unused" for a period of 20 years, "unless a statement of claim is filed . . . ." Kan. Stat. Ann. §§ 55-1601 and 55-1602 (1983).

   a. The lapse can be prevented by filing a "statement of claim" which will constitute a "use" of the interest which restarts the 20-year lapse period from the date the statement is filed.

   b. If the statement is not filed within the 20-year period, and the interest is not otherwise "used," the interest can be "extinguished" <u>if the interest owner fails to file a statement within 60 days after statutory notice is given concerning the lapse</u>. Kan. Stat. Ann. §§ 55-1604 and 55-1605 (1994).

   c. Once the interest is "extinguished," Kan. Stat. Ann. § 55-1602 indicates "the ownership shall revert to the current surface owner"--<u>assuming the interest owner cannot demonstrate the interest was not, in fact, "used" during the 20-year time frame</u>.

2. <u>Scully v. Overall</u>, 17 Kan. App.2d 582, 840 P.2d 1211 (1992). Overall owned a mineral interest which had not been used, nor had any statement of claim been filed, during the relevant statutory periods. Scully, the surface owner, followed the statutory procedure and gave Overall notice the mineral interest had lapsed. Overall promptly responded by filing a statement of claim.

   a. Scully argued once the notice is given, the interest will be extinguished <u>unless the mineral interest owner can demonstrate it has in fact been used during the 20-year period</u>.

   b. Court rejects this interpretation noting the statute expressly permits the interest owner to preserve their interest by filing a statement of claim within 60 days from the lapse notice.

3. Regardless of the outcome of the statutory lapse process, a quiet title action will typically be required to foreclose the possibility the interest owner can demonstrate they actually "used" the interest within the 20-year period at issue.

C. INDEMNITY AGREEMENTS

1. Most operating agreements contain provisions by which the non-operators indemnify the operator in certain situations and the operator indemnifies non-operators in certain situations.

2. Indemnity arrangements are becoming more common in oil and gas leases and unitization agreements; they have been more common in assignments and farmout agreements.

3. In Zenda Grain & Supply Co. v. Farmland Industries, Inc., 20 Kan. App.2d 728, 894 P.2d 881 (1995), the court reviews the principles that will be used to interpret indemnity agreements. The court in Zenda construed the following clause in a grain elevator operating agreement:

   "The ASSOCIATION agrees to indemnify, protect and save MANAGER and DOUBLE CIRCLE harmless from and against any and all claims, actions, loss or damages, including reasonable attorney's fees, arising in any way on account of this agreement or services performed thereunder in the operation of ASSOCIATION'S business."

   a. The Association sued Double Circle for breach of contract and negligent management. Double Circle asserted the indemnity clause protected it against any claim the Association may raise. The court characterized the issue as whether the clause would protect Double Circle from the consequences of its own negligence.

   b. Court held the language was not adequately "clear and unequivocal" to encompass Double Circle's own negligence.

4. The court noted the basic rule in Kansas that a party can contract away responsibility for its own negligence.

   a. However, it must be done in "clear and unequivocal terms."

b. Contracts exempting a party from their negligence "are not favored by the law and are strictly construed against the party relying on them."

c. Although a general clause may cover a party's passive negligence--when the indemnifying party has control over the operations or premises on which the incident took place--a general clause will not relieve the party seeking indemnity from their active negligence.

d. In this case the court found Double Circle had control over the operations so the limited passive negligence exception would not apply.

5. Although Kansas has not adopted an "express negligence" rule, which requires that the word "negligence" be used in the indemnity agreement, the verbiage employed must convey the negligence message in clear and unequivocal terms.

a. Holding the language in this case was not "clear and unequivocal" on the issue, the court in *Zenda Grain* counsels attorneys drafting such clauses to consider *Corral v. Rollins Protective Services Co.*, 240 Kan. 678, 732 P.2d 1260 (1987), for guidance.

b. In *Corral* the court upheld a limitation of liability for "defective performance or operation or from improper installation or servicing" to include:

"'[L]oss or damage, irrespective of cause or origin, [that] results, directly or indirectly to persons or property from performance or nonperformance of obligations imposed by this Agreement *or from negligence, active or otherwise, of Rollins, its agents and employees*.'" (Emphasis by the court).

c. The Supreme Court held this language to be "clear and unequivocal."

6. Applying these teachings to the operating agreement in the oil and gas context, provisions where an operator indemnifies non-operators, in general terms, may protect non-operators from their own passive negligence since the operator will in most instances have control over the activity giving

rise to claims.

a. However, general language by which non-operators indemnify the operator will not cover the operator's negligence unless they meet the "clear and unequivocal" language test.

b. Query whether an agreement to be liable only for matters resulting from the operator's "gross negligence or willful misconduct" is "clear and unequivocal" in conveying the message the operator will not be liable for its negligent conduct?

7. Consider the following language in a non-"consumer" services agreement:

"Customer's obligation to indemnify as provided in this paragraph will apply whether the basis for any Claim against Provider is in statutory or common law strict liability, negligence, nuisance, trespass, or any other statutory, tort, contract, or other theory. Customer's obligation to indemnify will not be limited or affected by Provider's strict liability, statutory liability, concurrent negligence, or sole negligence."

X. ISSUES UNDER THE OIL ROYALTY CLAUSE

A. The Traditional Focus: Gas

1. Most disputes under the royalty clause have concerned gas.

2. Reasons for gas disputes:

a. Cannot economically produce gas into a storage tank at the lease.

b. Long-term contracts traditionally used to market gas production.

c. Regulation, primarily at the federal level, that has dramatically impacted the basic assumptions of the parities to long-term contracts.

B. The Relative Simplicity of Oil

1. Accounting for oil production has been much simpler, and less contentious, than gas.

2. Reasons for the relative calm regarding oil:

   a. Can economically produce oil into a storage tank at the lease.

   b. Short-term contracts traditionally used to market oil production.

   c. Federal regulation of the oil market has been much less extensive than that encountered in the gas market.

C. Current Oil Clause Issues

1. How do we calculate the royalty due?

   a. Share of production?

   b. Market value of production?

   c. Proceeds from sale of production?

   d. Posted price of production?

   e. Other specified formulas?

2. What deductions can be taken from the gross production before royalty is calculated?

   a. Separation, dehydration, removal of impurities?

   b. Gathering, transporting, trucking?

   c. Taxes?

   d. Other expenses associated with marketing?

3. What is the lessee's oil marketing obligation?

   a. Express obligations?

   b. Implied obligations?

4. What body of contract law governs the lessee's performance under the oil royalty clause?

a. General "oil and gas" contract law?

b. Article 2 of the Uniform Commercial Code?

c. Agency law?

d. Special statutory provisions?

XI. ANALYSIS OF THE OIL ROYALTY CLAUSE

A. Survey of Kansas Blue Print Forms

1. Form 88--(Producers) (KsOkCoNe) (1981) Rev. Bw

"3. The royalties to be paid by lessee are: (a) on oil, and other liquid hydrocarbons saved at the well, one-eighth of that produced and saved from said land, same to be delivered free of cost at the wells or to the credit of lessor in the pipe line to which the wells may be connected; . . . ."

2. Form 88--(Producers) Kan., Okla. & Colo. (12-63) Rev. Bw

"3. The lessee shall deliver as royalty, free of cost, to lessor at the wells or to the credit of lessor into the pipe line to which lessee may connect its wells, the equal one-eighth (1/8) part of all oil (including but not limited to distillate and condensate) produced and saved from the leased premises, or at the lessee's option may pay to the lessor for such one-eighth (1/8) royalty the market price at the wells in the field or area for oil of like grade and gravity prevailing on the day such oil is run into the pipe line or into storage tanks."

3. Form 88--(Producers) Kan. Okla. & Texas 1942 Rev. 2-70 Bw

"3. The royalties to be paid Lessor are: (a) on oil one-eighth of that produced and saved from said land, the same to be delivered at the wells or to the credit of Lessor into the pipe line to which the wells may be connected; Lessee may from time to time purchase any royalty oil in its possession, paying the market price therefore prevailing for oil of like grade and gravity in the field where produced on the date of purchase; . . . ."

4. Standard Producers 88 Rev. 3-66 B

"3. Whenever the lessee elects to produce and save any leased substances for sale or use off of the leased premises or premises unitized therewith, as royalty thereon the lessee may do any one of the following:

a. deliver to the credit of lessor at the wellhead or place of operation an undivided one-eighth of such leased substances; or

b. pay the lessor one-eighth of the net proceeds received by the lessee from the sale of such leased substances; or

c. pay the lessor one-eighth of the market value at the wellhead or place of operation of such leased substances.

In determining the amount payable under b or c, the lessee may deduct all charges and expenses incurred in making such leased substances marketable or marketable more economically or transporting such to a market."

B. Calculating the Royalty Due

1. Single basis for determining royalty: "one-eighth of that produced and saved . . . ."

2. Optional basis for determining royalty: "one-eighth . . . of all oil . . . produced and saved . . . , or at the lessee's option may pay to the lessor for such one-eighth (1/8) royalty the market price . . . ."

   a. Is this an option to "purchase" the royalty oil or is it an optional basis for satisfying the royalty obligation?

   b. Lease forms are also used which give the lessor the option.

3. Option to purchase royalty oil: "one-eighth of that produced and saved . . . ; Lessee may from time to time purchase any royalty oil in its possession . . . ."

4. Other variants.

C. Deductions in Calculating Royalty

1. "[O]ne-eighth of that produced and saved . . . same to be delivered free of cost at the wells or to the credit of lessor in the pipe line to which the wells may be connected; . . . ."

2. "[D]eliver as royalty, free of cost, to lessor at the wells or to the credit of lessor into the pipe line to which lessee may connect its wells, the equal one-eighth (1/8) part of all oil . . . produced and saved . . . , or at lessee's option may pay to lessor for such one-eighth (1/8) royalty the market price at the wells in the field or area . . . ."

3. "Lessee may from time to time purchase any royalty oil . . . paying the market price therefore prevailing for oil . . . in the field where produced on the date of purchase . . . ."

4. Voshell v. Indian Territory Illuminating Oil Co., 137 Kan. 160, 19 P.2d 456 (1933).

   a. Due to reduced demand for oil from McPherson County, crude oil purchasers refused to purchase any oil other than that produced from their own leases.

      (1) "There was a custom of "posting" the price which these buying and transporting pipe-line companies would pay, and that posted price was generally regarded as the market price for oil in that area." Voshell, 137 Kan. at 160-61.

      (2) The lessee had been paying their lessors royalty based upon the posted price in the field.

      (3) "Appellant [lessor] argues that the "posted price" should be regarded as the market price." However, "nobody was paying the "posted price" except the limited few who were fortunate enough to have pipe-line connections in the field." Voshell, 137 Kan. at 164.

   b. The lease provided:

      "To deliver to the credit of lessor, free of cost, in the pipe line to which he may

connect his wells, the equal one-eighth part of all oil produced and saved from the leased premises." Voshell, 137 Kan. at 161.

c. Lessor asserted that when their lessee could no longer sell oil in the field "it became defendant's [lessee's] duty to build sufficient tanks on the leasehold to save and care for all the oil being produced thereon." Voshell, 137 Kan. at 162.

(1) The court's response: "We think not."

(2) "The lease contract was manifestly formulated on the assumption of both lessor and lessee that pipe-line facilities would be available in the vicinity to which wells developed on the premises could be connected. Sale and division of the proceeds of the oil runs were contemplated." Voshell, 137 Kan. at 162.

d. Court relied upon Scott v. Steinberger, 113 Kan. 67, 231 P. 646 (1923), quoting the following passage:

"'We think the parties contemplated, and the provision should be construed, that gas, if produced, should be measured and the price determined at the place where the wells were connected with pipe lines, and not at some distant market that might be found at the end of a pipe line remote from the field where the cost of transportation might equal or exceed the value of the gas produced. . . . The place of measurement and for fixing the lessor's share was at the connection with the pipe line. If there was a market price at the point of delivery, that would control, but if there was no market price there, then the lessor would be entitled to the reasonable value thereof, to be ascertained upon competent evidence.'"

Voshell, 137 Kan. at 163 (quoting Scott, 113 Kan. at 69).

(1) Scott concerned gas royalty calculation.

(2) The Scott lease provided: "[Lessee] shall deliver to the credit of [lessor]

free of cost in the pipe lines to which he may connect his wells one-eighth of all oil produced and saved on said premises, and shall pay the market price for same in cash if [lessee] shall so desire; and shall pay to [lessor] one-eighth of all gas produced and marketed."

e. The lessee in Voshell arranged to transport its oil to a purchaser in El Dorado and paid $0.125/barrel to transport the oil from the McPherson field to El Dorado.

(1) The lessee paid royalty using the McPherson field posted price minus $0.125.

(2) The lessor claimed royalty based upon the McPherson field posted price without deduction for transportation.

(3) The court held the lessor "failed to show any damage in excess of the amount tendered him--the selling price at El Dorado less the cost of transportation."

(a) "[T]he value of plaintiff's royalty oil at the time and place it was turned into the pipe line was not shown . . . ." Voshell, 137 Kan. at 165.

(b) "Just what was plaintiff's oil worth in the Voshell field at that time? It could not be sold at all." Voshell, 137 Kan. at 164.

(c) "'If there was a market price at the point of delivery, that would control, but if there was no market price there, then the lessor would be entitled to the reasonable value thereof, to be ascertained upon competent evidence.'"

Voshell, 137 Kan. at 163 (quoting Scott, 113 Kan. at 69).

5. Molter v. Lewis, 156 Kan. 544, 134 P.2d 404 (1943) (syllabus):

"Under an oil and gas lease, in which the

lessee covenants 'To deliver to the credit of lessor, free of cost, in the pipe line to which he may connect his wells, the equal one-eighth part of all oil produced and saved from the leased premises,' it is the duty of the lessee, without cost to the lessor, to use all reasonable efforts to have pipe lines connected with producing wells which he drills on the lease. If after using such efforts he is unable to get a pipe line connected to the wells on the lease, and to prudently operate the lease transports the oil by truck from the wells on the lease to a pipe line, the lessor should pay the reasonable charges for the transportation by truck of his one-eighth share of the oil."

D. Lessee Marketing Obligations

1. Molter v. Lewis, 156 Kan. 544, 134 P.2d 404 (1943).

   a. Lessee was unable to obtain a pipeline connection to its oil wells so it arranged to have its oil, and that of the lessor, trucked to various sales points. The lessor objected to the lessee deducting the cost of transporting the oil.

   b. The oil and gas lease provided:

      "'To deliver to the credit of lessor, free of cost, in the pipe line to which he may connect his wells, the equal one-eighth part of all oil produced and saved from the leased premises.'" Molter, 156 Kan. at 544.

   c. The amount of the trucking charge was stipulated by the parties to have been "reasonable."

   d. The court observed:

      "Under an oil and gas lease such as we have here the proper development of the leased premises by the lessee places upon him the duty, among other things, of marketing the oil produced. This is sometimes spoken of as an implied covenant of the lessee of the lease. This is a covenant that the lessee should perform with the diligence of a prudent operator. There is no difficulty about that when the lessee can get pipe lines extended to

the wells on the leasehold. In this case the trial court found plaintiffs [lessees] had endeavored to get pipe lines extended to the wells on the lease in question, but were unable to do so until in November, 1941. In the meantime there was production which had to be taken care of. It is the duty of the lessee to see that the oil is marketed, but this general duty does not mean that the lessee must pay the transportation charge of the lessee's [lessor's?] share of the oil from the well to some distant place. His contract is to deliver the oil to the lessor at the well."

Molter, 156 Kan. at 547-48.

e. The court's syllabus stated:

"[Under the lease form at issue] it is the duty of the lessee, without cost to the lessor, to use all reasonable efforts to have pipe lines connected with producing wells which he drills on the lease. If after using such efforts he is unable to get a pipe line connected to the wells on the lease, and to prudently operate the lease transports the oil by truck from the wells on the lease to a pipe line, the lessor should pay the reasonable charges for the transportation by truck of his one-eighth share of the oil."

Molter, 156 Kan. at 544.

2. Voshell v. Indian Territory Illuminating Oil Co., 137 Kan. 160, 19 P.2d 456 (1933) (see discussion in subsection II.C.).

3. Hamilton v. Empire Gas and Fuel Co., 117 Kan. 25, 230 P. 91 (1924).

a. Lease royalty clause provided: "To deliver to the credit of [lessor] . . . , free of cost, in the pipe line to which it may connect its wells, the equal one-eighth part of all oil produced and saved from the leased premises."

b. Oil produced into lease tanks was tested to determine water and impurities before being turned into purchaser's pipeline. A deduction was made to account for the volume of the oil stream that constituted water and basic

sediment. The lessor and lessee were then credited with the remaining portion of the production stream that consisted of oil.

c. The lessor objected to the volume deduction. The court rejected the lessor's arguments and found:

"By this method the lessors receive and are paid for one-eighth of all the oil produced and saved from the lease. This is all their lease provides that they shall receive." Hamilton, 117 Kan. at 38.

d. The oil and water stream was subsequently delivered to a dehydration system that resulted in a more efficient recovery of marketable oil--as opposed to the "steaming" process that had been used to treat the oil on the lease. Apparently the lessee allowed the lessor to share in the benefits associated with the dehydration system.

e. The Hamilton case contains an extensive discussion on oil handling at the lease tanks.

XII. WHAT LAW APPLIES? "OIL & GAS" LAW OR UCC ARTICLE 2?

A. Value and Proceeds--Cash vs. Goods

1. Greenshields v. Warren Petroleum Corp., 248 F.2d 61 (10th Cir. 1957), cert. denied, 355 U.S. 907 (1957).

a. The lessor refused to sign a gas purchaser's "Stipulation of Interest" and then asserted that the purchaser converted the lessor's gas when it was delivered by the lessee to the purchaser's pipeline.

b. Rejecting this claim, the court stated:

"Whether or not title passes upon the occurrence of production must be determined from the language of the lease . . . . In the Producers 88 lease here under consideration, it is provided that the lessor shall receive a portion of the gross proceeds at the market rate of all gas, contrasting with the

provision of his receipt of one-eighth part of all oil produced. It is well settled that the provision concerning the payment for gas operates to divest the lessor of his right to obtain title in himself by reduction to possession and that thereafter his claim must be based upon the contract with the one to whom he has granted that right. His claim can only be for a payment in money and not for the product itself."

Greenshields, 248 F.2d at 67.

2. What about the following clause?

"3. The lessee shall deliver as royalty . . . one-eighth (1/8) part of all oil . . . produced and saved from the leased premises, or at the lessee's option may pay to the lessor for such one-eighth (1/8) royalty the market price . . . ."

B. Share of Production--Sale of Goods

1. Perhaps the most common form of royalty clause gives the lessor a share of oil production.

   a. The lessor owns an actual portion of the oil when it is produced.

   b. E.g., Molter v. Lewis, 156 Kan. 544, 545, 134 P.2d 404 (1943): Lessee produced 27,545.26 barrels of oil "of which one-eighth, 3,443.15 barrels, belonged to the defendants [lessors] as the owners of the royalty interest in the lease."

2. The transaction effecting a passage of title from lessor to the production purchaser is a sale of goods governed by the Uniform Commercial Code.

   a. See generally David E. Pierce, Resolving Division Order Disputes: A Conceptual Approach 16-1, 16-46 (1990) ("The Division Order as a Sale of Goods").

   b. "A contract for the sale of minerals or the like (including oil and gas) . . . is a contract for the sale of goods within this Article [2] if they are to be severed by the seller . . . ." U.C.C. § 2-107(a).

(1) When the oil is severed by the lessee, a portion of the production becomes the property of the lessor.

(2) The lessee may buy the oil pursuant to an express lease clause:

> "3. The royalties to be paid Lessor are: (a) on oil one-eighth of that produced and saved from said land . . . Lessee may from time to time purchase any royalty oil in its possession, paying the market price therefore prevailing for oil of like grade and gravity in the field where produced on the date of purchase; . . . ."

(3) The lessee may buy the oil without an express lease clause; to the extent the oil and gas lease does not address the terms of the sale, is it an UCC issue or an oil and gas law issue?

c. When the lessor sells their oil to a third party, the transaction will be a sale of goods.

d. Often, the lessee will be selling the lessor's oil, along with the lessee's oil, to a third party; UCC issue or an oil and gas law issue?

e. Does the lessee have authority to dispose of the lessor's oil?

(1) Express authorization in the royalty clause.

(2) Implied contract analysis. Wolfe v. Texas Co., 83 F.2d 425 (10th Cir. 1936), cert. denied, 299 U.S. 553 (1936); Cook v. Tompkins, 713 S.W.2d 417 (Tex. Ct. App. 1986).

(3) Agency analysis. Wolfe v. Texas Co., 83 F.2d 425 (10th Cir. 1936), cert. denied, 299 U.S. 553 (1936) (alternative theories of implied contract, agency, and ratification).

(4) Implied sale of the oil to the lessee with the purchase price to be determined by a sum of cash generated by the

lessee's subsequent sale?

Selected Case & Legislative Developments

OIL & GAS LAW
Royalty Calculation

Lessee can deduct compression costs to calculate royalty.

Judice v. Mewbourne Oil Company
39 Tex. Sup. Ct. J. 533 (1996)

Mewbourne Oil Company entered into oil and gas leases with Judice which contained the following royalty clause:

> "Lessee covenants and agrees . . . [t]o deliver to the credit of Lessor . . . three thirty-seconds . . . of the market value at the well of all gas produced . . . ."

Judice sued Mewbourne asserting Mewbourne had improperly calculated Judice's royalty due by deducting a proportionate share of compression costs. The trial court and court of appeals held this provision was ambiguous and accepted the jury finding that the parties intended that royalty be calculated without deduction for compression charges.

In Judice v. Mewbourne Oil Company, 39 Tex. Sup. Ct. J. 533 (1996), the Texas Supreme Court reversed, holding royalty was to be based on the unambiguous language "market value at the well" which means: "value at the well, net of any value added by compressing the gas after it leaves the wellhead." Id. at 535. Therefore, "the royalty owners are required to bear their proportionate share of post-production compression costs." Id. at 534. The court noted that "value at the well means the value of the gas before it has been compressed and before other value is added in preparing and transporting the gas to market." Id. at 535.

As is the common practice in the United States, the parties entered into "Division Orders" that also addressed the basis on which their royalty would be calculated. Division orders covering two of the wells at issue stated:

> "Settlement for gas sold shall be based on the gross proceeds realized at the well by you [the Judices]. For gas used off the leases, settlement shall be based on market value at the well."

The court held these division orders were ambiguous, as to "gas sold," because the reference to "gross proceeds" contemplated the

Division Order

gross price received by the lessee while the "at the well" language contemplated the net price received. Therefore, for "gas sold" the interpretation issue was properly submitted to the jury which found against Mewbourne. However, the court held the division order was not ambiguous as to "gas used off the leases." Also, the court held another form of division order was unambiguous which required "[s]ettlement for gas sold . . . based on the net proceeds realized at the well by you . . ."; even though it contained a lengthy provision expressly authorizing the deduction of costs that had been struck. The court stated:

> "The language in the division order, even in the face of the handwritten deletions, unambiguously provides that royalty is based on net proceeds at the well. 'Net proceeds' expressly contemplates deductions, and we note once again that 'at the well' means before value is added by preparing the gas for market. . . . The handwritten deletions in the division order do not alter the effect of the remaining language."

OIL & GAS LAW
Royalty Calculation

Lessee can deduct transportation costs to calculate royalty.

Heritage Resources, Inc. v. NationsBank
39 Tex. Sup. Ct. J. 537 (1996)

In a second major royalty case the Texas Supreme Court relied upon royalty clause language requiring calculation of royalty "at the well" as the basis for holding that Heritage Resources, Inc., the lessee, could deduct transportation costs to ascertain the royalty due NationsBank, the lessor. Each royalty clause contained an express provision prohibiting the deduction of costs "from the value of Lessor's royalty." For example, one lease provided:

> "Lessee covenants and agrees . . . [t]o pay the Lessor 1/4 of the market value at the well for all gas . . . produced from the leased premises; provided, however, that there shall be no deductions from the value of Lessor's royalty by reason of any required processing, cost of dehydration, compression, transportation, or other matter to market such gas."

In Heritage Resources, Inc. v. NationsBank, 39 Tex. Sup. Ct. J. 537 (1996), the court held the royalty clauses were unambiguous and the basis for valuing royalty was "market value at the well" and not the value at a downstream point of sale. Therefore, since the lessor did not contest the reasonableness of the transportation costs to move the gas from the wellhead to the point of sale, and there was no evidence presented concerning comparable sales at the

well, the royalty should be calculated by deducting transportation costs from the point-of-sale value to arrive at a presumed market value "at the well."

The court dealt with the additional lease language, "that there shall be no deduction from the value of Lessor's royalty", in two ways: First, that the language was intended to guarantee the Lessor the market value at the well by prohibiting any sort of net-back or work-back calculation that would yield a value less than the wellhead market value. Id. at 539-40. Second, that the language is mere "surplusage" since, "applying the trade meaning of royalty and market value at the well", the lessee could fully discharge its royalty obligation by paying an amount equal to "market value at the well", which it did in this case. Id. at 538.

The Heritage and Judice cases illustrate the significance the Texas Supreme Court places on "at the well" language in the royalty clause. These cases also illustrate the rather literal approach the Court takes toward contract interpretation.

OIL & GAS LAW
Promissory Estoppel

Offer to enter into farmout agreement became irrevocable upon offeree's detrimental reliance.

Strata Production Company v. Mercury Exploration Company
916 P.2d 822 (N.M. 1996)

Mercury Exploration Company owned an oil and gas lease on land located in New Mexico. Mercury offered Strata Production Company the opportunity to drill a well on Mercury's leased land and earn an assignment of 100% of the leasehold interest, purportedly owned by Mercury, in the leased land. This "farmout" agreement did not require Strata to drill on the lease, nor did Strata give any consideration for Mercury's agreement to farm out its lease to Strata. Essentially, Mercury made Strata an offer to enter into a unilateral contract which could be accepted by Strata only by performing the act of drilling on the Mercury leases.

Strata obtained farmouts from Exxon and Mobil of leased land adjacent to the Mercury lease. All three farmouts encompassed an area that Strata called its "Red Tank Prospect." The Strata/ Mercury farmout was entered into effective August 28, 1991; on October 29, 1991 Strata began drilling a well on the Exxon farmout acreage. In November 1991 Strata discovered that Mercury did not own 100% of the leasehold interest in the farmout acreage. In December 1991 Strata completed a successful well on the Exxon farmout acreage which indicated the Mercury farmout acreage should be productive. In January 1992 Strata drilled on the Mercury farmout acreage and ultimately completed two successful wells.

Strata subsequently sued Mercury for damages arising out of Mercury's inability to convey Strata 100% of the leasehold interest. Mercury was only able to obtain and convey 83% of the leasehold interest. The court awarded Strata $616,555.22 in damages representing Strata's expectation interest associated with the 17% leasehold interest Mercury could not convey.

In Strata Production Co. v. Mercury Exploration Co., 916 P.2d 822 (N.M. 1996), Mercury argued that its farmout with Strata was structured as a unilateral contract which Mercury could modify or revoke at any time prior to Strata commencing its performance. Mercury argued that when Strata discovered in November that Mercury lacked title to 100% of the leasehold, Mercury's farmout offer was thereby amended to offer only the 87% of the leasehold Mercury owned. Mercury therefore contended its revised offer of 87% was accepted by Strata when it commenced operations on Mercury's acreage in December. Strata responded arguing it had changed its position, in reliance on Mercury's offer, in October when it drilled on the Exxon portion of Strata's Red Tank Prospect.

The New Mexico Supreme Court held for Strata finding that Strata had began drilling on the Exxon farmout acreage in reliance upon its ability to capitalize on any discovery by drilling on adjacent acreage comprising its Red Tank Prospect, which included the Mercury farmout acreage. Once drilling began on the Exxon tract, Mercury's offer to enter into a unilateral agreement to develop the Mercury farmout acreage became irrevocable and Strata accepted the original offer (to deliver a 100% leasehold interest) when it drilled on the Mercury farmout acreage in December.

The court listed the "essential elements" of promissory estoppel as follows:

> (1) An actual promise must have been made which in fact induced the promisee's action or forbearance; (2) The promisee's reliance on the promise must have been reasonable; (3) The promisee's action or forbearance must have amounted to a substantial change in position; (4) The promisee's action or forbearance must have been actually foreseen or reasonably foreseeable to the promisor when making the promise; and (5) enforcement of the promise is required to prevent injustice.

Every jurisdiction in the United States recognizes some form of promissory estoppel. The basic rule followed by U.S. common law jurisdictions is represented by the Restatement (Second) of Contracts § 90(1) which provides:

> A promise which the promisor should reasonably expect to induce action or forbearance on the part of the promisee or a third person and which does induce such action or forbearance is binding if injustice can be avoided only

by enforcement of the promise. The remedy granted for breach may be limited as justice requires.

Louisiana, with a civil law tradition, has a similar provision at article 1967 of the Louisiana Civil Code. The basic concept is that although a promise cannot be enforced as a "contract", it may be enforceable under a promissory estoppel analysis.

OIL & GAS LAW
Take-Or-Pay Gas Contract

Take-or-pay gas contract did not create an "output contract" subject to the good faith and proportionality restrictions of the Uniform Commercial Code.

Lenape Resources Corp. v. Tennessee Gas Pipeline Co.
1996 Tex. LEXIS 40 (Tex. April 18, 1996)

During the 1980s and early 1990s the "take-or-pay wars" were fought doggedly in American courts and, to a lesser extent, in tribunals abroad. The ingredients for the conflict included long-term gas purchase contracts with pricing mechanisms that failed to clearly account for changes in the market for gas; coupled with fundamental regulatory changes imposed by the Federal Energy Regulatory Commission and, in some cases, state governments. The "take-or-pay" contract typically requires the purchaser to take a minimum volume of gas during a designated period, usually one year. If they fail to "take" the minimum volume of gas, they are required to make a cash payment to the producer/seller measured by the volume, and contract price, of gas they failed to take.

In Lenape Resources Corp. v. Tennessee Gas Pipeline Co., 1996 Tex LEXIS 40 (Tex. April 18, 1996), the Texas Supreme Court had to determine whether the typical take-or-pay contract is an "output contract" subject to special provisions of the Uniform Commercial Code. Tennessee Gas, the gas purchaser, argued that its contract with Lenape was a classic output contract and that Lenape had improperly increased its output--and therefore Tennessee Gas' take-or-pay obligations--in violation of the good faith and proportionality provisions of § 2-306 of the U.C.C. which provides, in part:

> A term which measures the quantity by the output of the seller or the requirements of the buyer means such actual output or requirements as may occur in good faith, except that no quantity unreasonably disproportionate to any stated estimate or in the absence of a stated estimate to any normal or otherwise comparable prior output or requirements may be tendered or demanded.

According to Tennessee Gas the improper increase in output occurred

when Lenape drilled additional wells on acreage that had been dedicated to Tennessee Gas under their gas contract. The wells proved to be quite productive and apparently increased Tennessee Gas' 1993 gas purchase obligation from a previous twelve-year annual high of $300,000 to $89,000,000.

The Texas Supreme Court rejected Tennessee Gas' arguments and held that its contract with Lenape was not an output contract under the U.C.C. The court relied upon two theories for its decision. First, that since the contract required Tennessee Gas to purchase "eighty-five percent (85%) of Seller's delivery capacity", and the purchaser was not obligated to take any quantity of gas (presumably because they could "pay" money instead of taking gas), the quantity produced was not under the seller's sole control so it was not an output contract. Second, even if it were an output contract, the parties nevertheless "agreed to quantity obligations that differ from those imposed by section 2-306." These would be the same take-or-pay obligations that were measured by the 85% of Seller's delivery capacity.

Four justices dissented. They would hold that the contract was an output contract subject to the U.C.C. and remand the case to determine whether Lenape's increased tender of gas was in bad faith or was unreasonably disproportionate to prior output.

COMMENT: The majority in Lenape stated:

> An output contract is one in which the buyer agrees to buy the seller's entire output of production. Under a take-or-pay contract, the buyer does not have to buy any production. The take-or-pay contract provides for alternative performance by the buyer: either purchase a specified quantity of gas or pay the producer for the right to purchase that quantity of gas in the future. . . . Because of this alternative performance, the pay option under a take-or-pay contract is not a payment for the sale of gas. . . . Rather it is a payment for the exclusive dedication of reserves for a fixed period of time.

The court seems to have fallen prey to the incantation of the "alternative performance" contract analysis. The court elevates a liquidated damages provision of the contract to the level of the underlying purpose of the contract: to sell and purchase gas. Tennessee Gas did not enter into the contract to pay money to Lenape for the privilege of not taking Lenape's gas. The "pay" provision is designed to provide an incentive for Tennessee Gas to take gas Lenape tenders, and failing that, a remedy.

Similarly, Tennessee Gas does not control its contractual obligations through its nominations or its obligation to pay for gas it fails to take. The contract determines the critical volumes

that will be produced and the contract measures those volumes by what the seller can lawfully withdraw from wells it drills on the dedicated acreage--"[a] term which measures the quantity by the output of the seller . . . ." Although it is doubtful the volumes actually produced by Lenape (or most producers under a dedicated-acreage gas contract) would be deemed to be in bad faith or disproportionate under U.C.C. § 2-306, the underlying obligation would still appear to create an output contract.

ENVIRONMENTAL LAW
Third Party Defense

Court recognizes significant defense to "current owner" liability under hazardous substance cleanup statute.

New York v. Lashins Arcade Co.
1996 U.S. App. LEXIS 19178 (2d Cir. Aug. 5, 1996)

The Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA") has the dubious distinction of being the United States law most likely to inflict grave economic harm, or ruin, on the unsuspecting, guiltless, faultless investor. The statute was designed to ensure real and personal property contaminated with a hazardous substance was cleaned up--with the cost of the cleanup being paid, whenever possible, by someone other than the government. To accomplish these goals, CERCLA imposes liability on persons having a statutorily-defined association with either the contaminated property, or a hazardous substance that is contributing to the contamination. The statutorily-defined association is not fault-based, nor is it dependent upon causation. Instead, for example, the "current owner" of the contaminated property is held liable as are the "owners" of the property at any time in which disposal of the contaminating substance took place--even though neither owner had knowledge or anything to do with the contamination.

CERCLA provides for three statutory defenses to liability, two of which are, by definition, quite limited: the "act of God" and "act of war" defenses. However, the third statutory defense, found at CERCLA § 107(b)(3), can be raised if the problem was "caused solely by . . . an act or omission of a third party other than . . . [a third party] whose act or omission occurs in connection with a contractual relationship, existing directly or indirectly, with the defendant . . . ." During the first decade of CERCLA's existence this "third party" defense was interpreted narrowly because the phrase "contractual relationship, existing directly or indirectly" was given a very broad reading. In 1986 CERCLA was amended to add a definition of "contractual relationship" which stated it would include: "land contracts, deeds, or other instruments transferring title or possession . . . ." Many practitioners took this to mean that merely being in privity with

someone in a chain of title could give rise to a "contractual relationship."

However, in recent years some federal courts, with the leadership of the United States Court of Appeals for the Second Circuit, have focused on the "in connection with" language in § 107 (b)(3) and required that the disabling "contractual relationship" be "in connection with" the handling or disposal of hazardous substances. The Second Circuit has again written the most recent chapter in this area in the case of New York v. Lashins Arcade Co., 1996 U.S. App. LEXIS 19178 (Aug. 5, 1996). Lashins Arcade purchased a shopping center in 1987; the groundwater beneath the shopping center had been contaminated by a tenant operating a dry cleaning business from 1958 to 1971. Lashins Arcade had nothing to do with the property until it bought it in 1987. Apparently the parties that caused the pollution didn't have assets sufficient to reimburse the State of New York for the cleanup so New York sued Lashins Arcade as a liable party under CERCLA.

The court noted that as the current owner of the contaminated property, Lashins Arcade was liable to pay for the cleanup under CERCLA unless it could sustain its third party defense. The court held that Lashins Arcade could rely on the third party defense because its only contractual relationship with a third party was the seller of the property and that contract "clearly did not 'relate to hazardous substances'" and therefore was not "in connection with" the contamination problem. However, the statute also requires that a party asserting the third party defense "exercise due care with respect to the hazardous substance concerned, taking into consideration the characteristics of such hazardous substance, in light of all relevant facts and circumstances . . . ." Although the court found that Lashins Arcade had exercised due care under the circumstances, it noted that this is a highly factual inquiry that must be done on a case-by-case basis.

The Lashins Arcade case could be representative of a growing judicial effort to inject some equity into the CERCLA liability scheme. The courts may be becoming impatient with a U.S. Congress that has failed, after numerous attempts during the past 15 years, to amend CERCLA to take the edge off its no-fault, no-causation, system of retroactive status liability.

KANSAS CASES

Commission Changes to Hugoton Basic Proration Order Upheld

Production from the Kansas Hugoton Gas Field has been regulated by the Kansas Corporation Commission ("KCC") under a Basic Proration Order ("BPO") since 1944. Development in the field is controlled by assigning a production allowable to each well

based on the acreage attributable to the well and the well's ability to produce under defined conditions--its deliverability. In 1986 the BPO was amended to permit the drilling of an infill well on any production unit exceeding 480 acres. Although the ownership configuration of the production unit would not be disturbed, if an infill well was drilled on an existing unit, one-half of the unit acreage would be attributable to the existing well and the other one-half to the infill well. This meant that the infill well had to have a deliverability at least as high as the existing well or the production unit would suffer a loss of total allowable. In 1992 OXY USA, Inc. filed an application to amend the BPO which resulted in extensive hearings before the KCC and ultimately an order instituting fundamental changes to the BPO. Several parties, including OXY, attacked the KCC's revised BPO. The order was appealed to the District Court which upheld the order and in Mobil Exploration & Producing U.S. Inc. v. Kansas Corporation Comm'n, 908 P.2d 1276 (1995), the Kansas Supreme Court affirmed the District Court.

The parties impacted by the Hugoton Field BPO can be divided into two camps: Producers that are in an over-produced status that have marketed gas as it is produced from their leases and producers that are in an under-produced status due, in many cases, to contract and other marketing problems. The parties can also be divided into producers that are anxious to pursue infill development and producers that fear BPO adjustments could trigger unnecessary offset drilling and further development obligations. Typically the over-produced producer is also the party favoring additional infill drilling incentives.

In an attempt to ensure the orderly development of the Hugoton Field, the KCC made the following changes to the BPO:

1. The infill well and existing well will each have an acreage factor equal to 0.65 (instead of 0.50) times the total acreage of the production unit--assuming a standard production unit of 640 acres.

2. No well will be assigned an allowable in excess of the volume of gas it is capable of producing which is determined by taking the average of the well's three highest producing months during the preceding 12-month period.

3. If a well has not produced its allowable, the underage will be carried forward and added to the well's allowable for the next month. When the well's underage exceeds nine times its current allowable for the preceding January, the excess underage is "canceled."

4. Underage from a production unit containing an infill well can be produced as unit underage from either the original well or the infill well.

5. For underage canceled in 1994 or subsequent years, the underage must be produced by the end of the following calendar year or it will be permanently canceled.

6. For underage accrued prior to 1994 it must be produced by December 31, 2003 or it will be permanently canceled.

Although many challenges were raised by various parties to the KCC's order, the court held the KCC's actions were within its broad power to regulate the Hugoton Field in order to "prevent waste, meet market demand, and protect correlative rights" which "includes the power to create production incentives in order to accomplish these objectives."

Lease Assignment Conveyed AMI Participation Rights

In 1986 Slawson and Sun entered into an operating agreement to drill the Tiller #1-9 well. Simultaneously the parties entered into a participation agreement establishing an area of mutual interest ("AMI") which included the Tiller #1-9 well site. In 1988 Slawson assigned its leasehold interest in the Tiller #1-9 well to Vintage. In 1991 Sun elected to deepen the Tiller #1-9 well and acquired leases on adjacent acreage to form the required expanded spacing unit. Sun acknowledged that under the AMI it must offer either Slawson or Vintage the opportunity to participate in the newly acquired leases. Slawson subsequently brought suit in a Kansas federal district court asserting it was entitled to participate under the AMI because those rights had not been assigned to Vintage. The trial court held for Vintage.

In Slawson Exploration Co. v. Vintage Petroleum, Inc., 78 F.3d 1479 (10th Cir. 1996), the court, applying Kansas law, affirmed the trial court. The court noted the assignment from Slawson to Vintage conveyed:

> All right, title and interest in an to those certain oil, gas and mineral leases, described in Exhibit "A" attached hereto and made a part hereof, in and to the entire estates created by the leases . . . together with identical undivided interests in and to all the property and rights incident thereto, including but not limited to all rights in, to and under all agreements, leases, permits, easements, right-of-way, licenses, joint operating agreements, pooling and spacing orders, communitization agreements, and other instruments in any way related thereto.

The court found that this clause, standing alone, made it clear that Vintage would receive whatever rights Slawson had that were "related" to the Tiller #1-9 well lease; to include the disputed AMI participation rights.

However, the Exhibit "A" limited the assignment, as to the Tiller #1-9 well, "to the spacing unit for the Tiller #1-9 well . . . ." The court found that "Exhibit A renders paragraph 1 of the Assignment . . . ambiguous." The court then resolved the ambiguity based upon the parties' stipulations and Slawson's statement that they limited their assignment to the Tiller #1-9 well spacing unit because Slawson owned other acreage adjacent to the Tiller spacing unit which it planned to develop. Apparently the court concluded this was an admission by Slawson that it did not intend to otherwise limit the scope of the Tiller #1-9 well assignment: "the sole purpose of the quoted portion of Exhibit A was to clarify the location and dimension of the Tiller #1-9 spacing unit . . . ." Therefore, Vintage received all of Slawson's rights in the Tiller #1-9 spacing unit, including the AMI participating rights in dispute.

PART II

Trends & Developments:

Natural Gas Regulation & Environmental Regulation

"It is the sense of the Congress that natural gas consumers and producers, and the national economy, are best served by a competitive natural gas wellhead market."

Energy Policy Act of 1992, § 202
Public Law No. 102-486, 106 Stat. 2866
(October 24, 1992)

Natural Gas Regulation

I. THE COMMERCE CLAUSE AND NATURAL GAS

The U.S. Congress is given the authority:

"To regulate commerce with foreign nations, and among the several States, and with the Indian Tribes."

A. States Cannot Restrict Interstate Commerce in Natural Gas

1. An Oklahoma law prohibited the transportation of natural gas to any point outside the State of Oklahoma.

2. Kansas Natural Gas Co. wanted to build a pipeline from its wells in Oklahoma to Kansas so it could market its gas in Kansas and Missouri.

3. The United States Supreme Court, in West v. Kansas Natural Gas Co., 221 U.S. 229 (1911), held the Oklahoma law violated the Commerce Clause of the U.S. Constitution. The court stated:

   "[N]o state can by action or inaction prevent, unreasonably burden, discriminate against, or directly regulate, interstate commerce or the right to carry it on."

   West, 221 U.S. at 262.

B. States Unable to Regulate Interstate Sale of Natural Gas

1. Kansas Natural Gas Co. transported gas from Oklahoma for sale to local distribution companies (LDCs) in Kansas and Missouri. The LDCs would then resell the gas to the local communities in which they operate.

2. The sale by Kansas Natural to the LDC was essentially a wholesale transaction. The sale by the LDC to its customers was a retail transaction.

3. Kansas Natural increased its sales price to its customers (the LDCs) without obtaining the consent of the state public utility commission. The United States Supreme Court, in Missouri v. Kansas Natural Gas Co., 265 U.S. 298 (1924), held the transaction was:

   "[F]undamentally interstate from beginning to end . . . . The paramount interest is not local but national, --admitting of and requiring uniformity of regulation."

   Missouri, 265 U.S. at 309-310.

4. Although Congress had not addressed the matter, the Court held the states could not act. The fact Congress had not regulated the area suggested, by negative implication, that it should remain unregulated. The Court articulated this "negative commerce clause" analysis stating:

   "The contention that, in the public interest, the business is one requiring regulation, need not

be challenged. But Congress thus far has not seen fit to regulate it, and its silence, where it has the sole power to speak, is equivalent to a declaration that that particular commerce shall be free from all regulation."

Missouri, 265 U.S. at 308.

C. Filling the "Regulatory Gap"

1. Since wholesale rates were unregulated (states couldn't regulate and the federal government had not acted to regulate this area), consumers were at the mercy of the interstate pipeline.

2. State regulation of the LDC (the retail transaction) would not help since the state commission would have to permit the LDC to pass through its purchased gas costs (what it paid the pipeline for gas in the wholesale transaction) in the LDC's retail consumer rates-- otherwise the LDC would go out of business.

3. The negative commerce clause analysis left a regulatory gap which Congress would act to fill with the Natural Gas Act of 1938.

II. NATURAL GAS ACT OF 1938 (NGA)

A. Filling the Regulatory Gap

1. Although a state may lack authority to regulate an interstate matter, Congress can confer jurisdiction upon the states to act.

2. The NGA recognized the areas states were thought to have regulatory authority under the interpretation of the Commerce Clause in vogue in the 1930s. Therefore, the first section of the NGA defines the scope of federal and state jurisdiction over natural gas activities.

3. NGA § 1(b), 15 U.S.C. § 717(b), provides, in part:

"The provisions of this Act shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of

natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to the natural gas companies engaged in such transportation or sale . . . ."

4. Immediately following the express grant of federal authority in § 1(b), is the following grant of residual authority to the states:

   "The provisions of this Act . . . shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas."

   NGA § 1(b), 15 U.S.C. § 717(b).

5. Therefore, the federal government has exclusive regulatory jurisdiction under the NGA over the following:

   a. Transportation of natural gas in interstate commerce;

   b. Sale in interstate commerce of natural gas for resale;

   c. Companies engaged in such transportation and sales; and

   d. Facilities used to conduct the regulated interstate activities.

6. The states are given exclusive regulatory jurisdiction under the NGA over the following:

   a. Production of natural gas;

   b. Gathering of natural gas;

   c. Transportation of natural gas in <u>intrastate</u> commerce;

   d. Sale in interstate commerce of natural gas for direct use by the purchaser and <u>not</u> for resale; and

   e. Local distribution of natural gas.

7. The NGA defines interstate commerce as:

"[C]ommerce between any point in a State and any point outside thereof, or between points within the same State but through any place outside thereof, but only insofar as such commerce takes place within the United States."

NGA § 2(7), 15 U.S.C. § 717a(7).

B. The Regulatory Agencies

1. Although the NGA recognizes in § 1(b) that states can regulate certain natural gas activities, the NGA does not purport to establish any sort of regulatory program for states to implement. It merely acknowledges their power to act.

   a. Therefore, any matter reserved for state regulation will be addressed by each state's law and administered by the state's regulatory agency.

   b. The state regulatory agency, depending upon the state, will be called either the public utility commission, public service commission, or corporation commission (as in Kansas with the "Kansas Corporation Commission").

   c. Many states divide the regulation of the production and gathering functions from the transportation and distribution functions and place them in separate agencies. Others merely have separate divisions addressing these functions within a single agency.

2. Federal regulatory authority under the NGA is divided among various administrative agencies.

   a. Initially, the Federal Power Commission (FPC) was given authority to administer the NGA. However, under the Department of Energy Organization Act of 1977, 42 U.S.C. §§ 7101 to 7352, the authority of the FPC was transferred to the Department of Energy (DOE) and the Federal Energy Regulatory Commission (FERC).

   b. The FERC is an independent regulatory agency within the DOE; the DOE has no review authority over the FERC's actions. The FERC's members are appointed for fixed terms by the President, subject to Senate confirmation.

Judicial review of final actions of the FERC is in the United States Courts of Appeal. 42 U.S.C. §§ 7171, 7172, 7192; 15 U.S.C. § 717r (b) [NGA § 19(b)].

c. 42 U.S.C. § 7172(a) gives the FERC authority to establish, review, and enforce rates and charges under the NGA, and the authority to issue certificates of public convenience and necessity, and abandonment certificates, and to control the establishment of physical connections under § 7 of the NGA.

d. Although the FERC is given authority over any construction activity that requires a NGA § 7 certificate, 42 U.S.C. § 7172(f) provides:

"No function described in this section which regulates the exports or imports of natural gas or electricity shall be within the jurisdiction of the Commission unless the Secretary [of Energy] assigns such function to the Commission."

e. The Secretary of Energy initially delegated approval authority for exports and imports to the Economic Regulatory Administration (ERA). However, in 1989 the Secretary delegated the authority previously exercised by the ERA to the Assistant Secretary of Fossil Energy in the DOE (Fossil Energy).

f. Following the 1989 delegation order, the NGA authority over exports and imports is divided as follows:

(1) When the project requires the construction of jurisdictional facilities in the U.S., the FERC does not approve the import decision, but merely exercises jurisdiction over the siting and construction of the necessary facilities.

(2) Fossil Energy determines whether the import is "consistent with the public interest" under NGA § 3 and determines the conditions that will be imposed and issues the order authorizing the importation of the gas.

C. The "Public Utility" Regulatory Model

1. Transportation of natural gas in interstate commerce is viewed as a classic natural monopoly that should be encouraged, but regulated.

2. The goal of regulation: to ensure consumers receive quality service, upon fair terms, at a reasonable price.

3. The public utility model relies upon comprehensive regulation of industry participants to provide a desired level of service at a controlled price.

   a. The need for comprehensive control is premised on the ability of one or more of the industry participants to monopolize the commodity being sold or the service being provided.

   b. If it is more efficient to provide the commodity or service through a monopoly, then the monopoly will be permitted to operate--but it will be regulated as to the activities it can (or must) pursue, the level of service it must provide, and the amount it can charge for the service or commodity.

   c. In return the monopoly is generally given what often amounts to an exclusive franchise to provide the service and an opportunity to earn a regulated rate of return on its investment.

D. The NGA Utility Model: Entry, Exit, Service, and Rates

1. **Entry:** The "§ 7(c)" Certificate Requirement controls entry into the federally regulated NGA activities. NGA § 7(c), 15 U.S.C. § 717f, provides, in part:

   "No natural-gas company . . . shall engage in the transportation or sale of natural gas, subject to the jurisdiction of the Commission [FERC], or undertake the construction of extension of any facilities therefor, or acquire or operate any such facilities or extensions thereof, unless there is in force with respect to such natural-gas company a certificate of public convenience and necessity issued by the Commission authorizing such acts or operations . . . ."

a. To qualify for a certificate, the FERC must find:

"[T]he applicant is able and willing properly to do the acts and to perform the service proposed . . . and that the proposed service . . . is or will be required by the present or future public convenience and necessity . . . The Commission shall have the power to attach to the issuance of the certificate . . . such reasonable terms and conditions as the public convenience and necessity may require."

b. The certificate requirement has traditionally served as a considerable regulatory barrier to new entrants into NGA-regulated activities.

c. Many of the revolutionary changes made by the FERC and Congress in recent years have been designed to either eliminate, or streamline, the certificate process. These changes will be discussed later in this Outline.

2. **Exit**: Under the utility model you must obtain permission to enter and exit the business. This is closely related to the "service" obligation. Since you are engaged in activities "affected with a public interest" the public will determine when you will enter the business and whether it is appropriate for you to get our of the business. NGA § 1(b), 15 U.S.C. § 717(b), provides:

"No natural-gas company shall abandon all or any portion of its facilities subject to the jurisdiction of the Commission, or any service rendered by means of such facilities, without the permission and approval of the Commission first had and obtained, after due hearing, and a finding by the Commission that the available supply of natural gas is depleted to the extent that the continuance of service in unwarranted, or that the present or future public convenience or necessity permit such abandonment."

a. For example, in Sunray Mid-Continent Oil Co. v. Federal Power Comm'n, 364 U.S. 137 (1960), the Court held that when Sunray entered into a 20-year gas sales contract with United Gas Pipeline Company it had undertaken a service obligation under NGA § 7(c). Therefore, Sunray could not quit providing the service at the end of the 20-year contract, unless it

obtained an abandonment of its service obligation from the FPC under NGA § 1(b).

b. Many of the revolutionary changes made by the FERC and Congress in recent years have been designed to either eliminate, or streamline, the abandonment process. These changes will be discussed later in this Outline.

3. **Service:** An important component of the NGA § 7 certificate process is ensuring that the entity requesting a certificate is capable of rendering the "service" that will promote the "public convenience and necessity." NGA § 7(e), 15 U.S.C. § 717f(e), provides the certificate will be granted only:

"[I]f it is found that the applicant is able and willing properly to do the acts and provide the service proposed."

a. NGA § 7(a) provides the Commission with authority to order the natural gas company to extend services to others when "necessary or desirable in the public interest." However, the Commission cannot compel the natural gas company to extend service "when to do so would impair its ability to render adequate service to its customers."

b. A major concern as the NGA's traditional entry and exit requirements are modified or eliminated is determining how the "service" obligation will be addressed. Who is going to make sure there is gas to burn on the coldest day of the year? This question is addressed later in this Outline.

4. **Rates:** Rates charged for a certificated service must be "just and reasonable" and cannot be "unduly discriminatory, or preferential." NGA §§ 4 & 5.

a. Under NGA § 4(c) the natural gas company must file all:

"[S]chedules showing all rates and charges for any transportation or sale subject to the jurisdiction of the Commission, and the classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner affect

or relate to such rates, charges, classifications, and services."

b. NGA § 4(b) provides:

"No natural-gas company shall, with respect to any transportation or sale of natural gas subject to the jurisdiction of the Commission, (1) make or grant any undue preference or advantage to any person or subject any person to any undue prejudice or disadvantage, or (2) maintain any unreasonable difference in rates, charges, service, facilities, or in any other respect, either as between localities or as between classes of service."

c. As will be noted in later sections of this Outline, as the FERC and Congress reduce the areas in which there is a certificate requirement, it also reduces the instances in which FERC must set rates for a service or commodity. Instead, the rate will often be set by market forces.

E. Regulation of Independent Producers Under the NGA

1. In 1954 the United States Supreme Court, in Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954), held that the sale of gas by an independent producer (unaffiliated with the pipeline purchaser) to an interstate pipeline, was a "sale for resale" subject to regulation under the NGA.

2. The court thought it was necessary to have federal jurisdiction over the gas producer because a major component of the pipeline's recoverable costs (operating costs) was the price it paid for gas at the wellhead.

3. However, note that the production of gas is not a natural monopoly--the producing segment of the gas industry is, and always has been, structurally competitive.

4. It should also be noted that Congress, in the NGA, gave the pipeline companies a powerful tool to ensure they were able to purchase gas from producers at a reasonable price: Congress gave the interstate pipelines monopsony purchasing power by refusing to make them common carriers of gas. Instead, they could, and would for fifty years,

deny access to the pipeline's transportation services.

5. Since the pipeline could control access to its facilities, this resulted in a monopoly not only over the transportation function, but also over the merchant function of buying and reselling gas.

   a. Since gas producers could not gain access to the interstate pipelines, they were forced to sell gas at or near the field of production to an available pipeline.

   b. The pipeline would then take title to the gas and resell it to its customers.

   c. However, as a regulated cost-of-service activity, the pipeline could not buy low and sell high. Instead, the prices paid for gas would be rolled-in to the pipeline's overall cost of providing the service and consumers would be charged a rate reflecting the pipeline's weighted average cost of gas (the "WACOG"), transportation costs, and the cost of meeting its service obligations.

6. After the Court's ruling in the Phillips case, the contract price negotiated between the pipeline and producer was subjected to federal price regulation to ensure the producer recovered only its cost-of-service plus a reasonable rate of return.

7. As a result of the Phillips decision, the FPC was forced to regulate thousands of gas producers as public utilities.

   a. The FPC initially attempted to use the traditional cost of service rate making approach applied to interstate pipelines. This proved unworkable.

   b. Shifted to area-wide rate making. See Permian Basin Area Rate Cases, 390 U.S. 747 (1968).

   c. Eventually shifted to nation-wide rate making. See Shell Oil Co. v. Federal Power Comm'n, 520 F.2d 1061 (5th Cir. 1975), cert. denied, California Co. v. Federal Power Comm'n, 426 U.S. 941 (1976).

d. However, each time the FPC came up with a new approach to the ratemaking process, it proved to be too little, too late, to entice producers to sell their gas into the interstate market.

e. Severe shortages of gas serving the interstate markets caused Congress to pass the Natural Gas Policy Act of 1978.

III. CONGRESSIONAL RESPONSES TO THE NGA: 40 & 50 YEARS LATER

A. Natural Gas Policy Act of 1978 (NGPA)

1. Regulation under the NGA tended to keep gas prices below the value of gas as reflected by the unregulated intrastate market. This caused producers to sell to the intrastate market whenever possible while consumers in the interstate market demanded more low-priced gas.

2. Since the interstate market was unable to attract adequate supplies of gas to meet the demand, Congress passed the NGPA to extend price regulation to the intrastate market, providing for phased deregulation of some gas sold in the interstate market, and to provide price incentives to encourage the discovery and development of new gas reserves.

3. The NGPA abandoned cost-of-service rate making for setting gas prices. Instead, the NGPA established a schedule of "maximum lawful prices" that could be charged for various types and vintages of gas.

4. Except for certain categories of gas, the NGPA maximum lawful prices would expire between 1979 and 1987.

5. The NGPA also removed NGA certificate (entry/exit) regulation for certain categories of gas.

6. The NGPA exempted certain gas sales and transportation transactions from NGA jurisdiction.

   a. § 311 of the NGPA attempted to integrate the intrastate, interstate, and LDC gas transportation systems by permitting each

segment (interstate pipeline, intrastate pipeline, LDC) to haul gas for one another without pursuing burdensome regulatory procedures.

b. However, it remained purely optional with each segment whether it desired to deal with one or more of the other segments.

B. Natural Gas Wellhead Decontrol Act of 1989 (WDA)

1. Phased out all natural gas price regulation as of January 1, 1993.

2. Phased out all NGA certificate (entry/exit) regulation, as it applies to natural gas sales, as of January 1, 1993.

3. The WDA completes the deregulation of natural gas sales began by the NGPA.

IV. THE LEGACY OF THE NGA/PHILLIPS/AND THE NGPA

A. Combined Impact of the NGA and the Phillips Decision

1. Divided the industry into three distinct segments:

   a. **Production:** oil and gas companies explore for and extract gas which they sell at or near the field where it is produced.

   b. **Transportation/Resale:** pipeline buys gas from producer at or near the field where produced and transports and sells it to either:

      (1) Another pipeline;

      (2) A "local distribution company" (LDC); or

      (3) An "end user," such as a factory.

   c. **Distribution:** an LDC buys the gas from the pipeline for resale to LDC customers.

2. Producers were seldom able to deal directly with end users and LDCs because they were dependent upon the pipeline to move their gas from the point of

production to the point of ultimate consumption or resale.

3. Since the pipelines were not common carriers, they could refuse to transport gas even though the producer (or end user, LDC, or an upstream or downstream pipeline) was willing to pay a transportation charge and there was pipeline "capacity" (space) available to move the gas.

4. Pipelines were therefore able to maintain a regulated monopoly over the gas merchant function as well as the transportation function.

B. Impact of the NGPA

1. One goal of the NGPA was to provide price incentives to spur producers to find new reserves and contract for their sale to pipelines. The NGPA worked.

2. Coming off of a gas-short existence, pipelines entered into long-term contracts with producers that provided the pipeline would pay the NGPA "maximum lawful price" for the gas.

   a. Producers insisted that if their gas reserves were to be dedicated to a particular contract, the pipeline must agree to take a minimum quantity of gas--or pay for it if not taken.

   b. As pipelines scrambled to add gas to their dwindling supply portfolios, consumer prices began to rise gradually as the higher-cost gas was rolled-in with the pipeline's existing lower-priced gas.

   c. However, as the pipeline's weighted average cost of gas (WACOG) increased, some consumers, particularly high-load high-volume industrial customers, began to switch to lower-cost substitutes for gas, such as fuel oil.

3. As supplies were being aggressively acquired by the pipelines, and as prices continued to escalate under the formula prescribed by the NGPA, the demand for gas fell precipitously.

   a. Pipelines were unable to resell, at regulated prices, all the gas they had contracted to take.

b. Producers had made investment decisions based, in part, upon the NGPA pricing mechanism and their gas contracts with pipelines which agreed to take stated volumes of gas, or pay for them, at NGPA prices.

c. This gave rise to the torrent of take-or-pay litigation which has occupied some of the nation's best legal talent for over a decade while effecting the transfer of billions of dollars among the impacted parties--and their attorneys.

V. RESTRUCTURING FOR EFFECTIVE COMPETITION

A. The FERC's Prescription for an Ailing Regulatory System

1. The FERC's responses to a regulatory system out of sync with reality (the market), would aggravate the pipelines' problems. FERC's "cure" would kill some of the patients, but the Commissioners felt they had to commence treating an ailing regulatory system.

2. The cure was to inject competition into the system where the natural monopoly rationale for regulation did not apply.

   a. The one remaining natural monopoly requiring public utility regulation would be the interstate <u>transportation</u> of natural gas.

   b. The <u>merchant</u> role of the interstate pipeline would not be subject to public utility regulation (or protection) and, for all practical purposes, pipelines would cease serving a merchant function and focus solely on providing transportation services.

3. The merchant function would be provided by gas producers, marketers, brokers, and end-users, in a new competitive environment.

4. To achieve its goal, the FERC had to attack existing regulatory enclaves that impeded demand, supply, and access to transportation.

B. Liberating the Demand Side of the Equation

1. FERC attempted to address the demand bottleneck by eliminating regulatory and contractual restrictions which, directly or indirectly, prevented an end user or LDC from seeking alternative gas supplies.

2. FERC Order No. 380

   a. FERC found that minimum charges imposed upon a pipeline's gas sales customers, regardless of their gas purchase levels, made it economically impossible for such customers to shop around for lower priced gas supplies.

   b. Order 380 focused on the imposition of a "minimum commodity bill" for variable costs (those that vary with the level of service - the primary variable cost being purchased gas costs). The customer had to pay for a minimum amount of gas even though they didn't take any gas.

      (1) The minimum bill was designed to compensate the pipeline for having the reserves available to provide the full contracted service.

      (2) The pipeline would generally contract with producers for the reserves necessary to provide the level of service its customers demanded.

      (3) The minimum bill mechanism was the primary means used by pipelines to recoup their take-or-pay payments to producers.

3. FERC Order No. 436

   a. Provided the firm sales customers of a pipeline the option to convert firm sales service to firm transportation service.

   b. Order 436 also allowed firm sales customers to reduce the amount of gas they had contracted to purchase from the pipeline (contract demand "CD" reduction vs. contract demand "CD" conversion).

4. FERC Order No. 500

a. Recognizing the value of having pipelines provide backup gas supply service to its customers (sales and transportation customers), pipelines were given the authority to impose a charge for maintaining gas supplies for backup service (identified by many different names: e.g. future gas supply charge, gas inventory charge).

b. This is essentially a minimum bill. FERC described the difference between this minimum bill and the Order 380 situation as follows:

"The minimum commodity bill was an attempt to deal with this (take-or-pay) problem, but its design did not work well as competition increased. One central problem was that the minimum bill was not the result of voluntary selection from a menu of services that enabled the customer to obtain exactly the level of supply security it desired at a charge known in advance. The principles underlying future gas supply charges, as adopted here, are intended to remedy this problem."

5. Congress has acted to reduce the demand bottleneck by:

a. Eliminating restrictions on the use of gas for certain purposes. See Pub. L. No. 100-42, 101 Stat. 310 (1987) (repealing portions of the Powerplant and Industrial Fuel Use Act of 1978 (PIFUA), Pub. L. No. 95-620, 92 Stat. 3289 (1979), which restricted the use of gas to generate electricity and as a fuel for other major fuel burning facilities).

b. Eliminating pricing mechanisms which discouraged industrial use of gas as a fuel source. See Pub. L. No. 100-42, 101 Stat. 310 (1987). In 1978, as part of the Natural Gas Policy Act, Congress required the imposition of "incremental pricing" to raise the cost of gas to levels that approached the "appropriate alternative fuel costs."

C. Liberating the Supply Side of the Equation

1. Even though FERC was able to open up new markets for gas (Demand), and provide access to such new markets (Transportation), two impediments on the Supply end of the pipeline had to be addressed:

   a. Gas reserves tied-up by long-term contracts; and

   b. Gas reserves tied-up by the service and abandonment requirements of NGA § 7(b) & (c).

2. Abandonment: Exit and Re-Entry

   a. Traditional Approach - gas subject to service obligation even though the gas sales contract terminated (or the underlying oil and gas lease terminated). To obtain abandonment of the service obligation, must initiate proceeding under NGA §7(b) and demonstrate the needs of the new (proposed) gas sale customers are greater than the needs of the existing customers.

   b. FERC attempted to reduce the regulatory burden of the abandonment requirement by:

      (1) Using pre-granted abandonment when the service is certificated.

      (2) Granting limited-term abandonments.

      (3) Authorizing abandonment "legislatively" by rule when certain conditions exist.

   c. The test for determining whether the public convenience and necessity would be served by abandonment was changed by FERC to compare the needs of existing customers with the benefits freeing-up the gas would offer to the market as a whole.

      (1) FERC took the view that the market benefits will, in most every case, exceed the needs of the existing customers.

      (2) This permits a generic (legislative vs. adjudicatory) approach to abandonment.

d. FERC Order No. 490 - permit party to an expired contract to abandon the service without a §7(b) proceeding - merely give 30 days notice to other party and "report" the abandonment to FERC within 30 days after it occurs.

(1) Applied to expired or terminated contracts where there was a NGA service obligation.

(2) Applied to contracts to the extent a pipeline had exercised its contractual authority to reduce takes below the specified level.

(3) Applied to contracts where the parties mutually agreed to abandonment.

(4) Producers were granted blanket certificates to resell the abandoned gas.

e. FERC Order No. 451 - authorized abandonment if the "good faith negotiation" procedure resulted in a termination of the gas contract. Also gave producers blanket sales certificates.

f. FERC Order No. 436 - authorized expeditious Commission action on abandonment requests to facilitate take-or-pay settlements between producers and pipelines.

3. Long-Term Contracts - FERC Order No. 451

a. Order 451 permits producers with old low-priced gas contracts (NGPA §§ 104 & 106) to force their pipeline purchaser into negotiations to raise the price of the gas to an amount which more nearly represents the current market value of the gas.

b. Pipeline has a reciprocal right, against the producer triggering the GFN process, to bring to the table any high-priced gas which is sold with old gas. Pipeline can force the producer to negotiate to reduce the high-priced gas to a price which more nearly represents the current market values.

c. Effect of Order 451 will be to arrive at new contracts which reflect the current market environment or the termination of existing contracts to permit the parties to bargain with others.

d. Order 451 grants abandonment of old sales where the parties fail to agree and provides blanket certification of new sales.

D. Opening Access to Transportation so Supply can Meet Demand

1. "Special Marketing Programs" (SMPs) were early attempts by FERC to provide access to pipeline transportation facilities.

   a. Designed to permit producers and pipelines to compete for customers which could readily switch to competing fuels.

   b. Designed to permit producers to market increased gas volumes while providing pipeline benefits in the form of:

      (1) Reduced take-or-pay liability; and

      (2) Increased throughput.

   c. Permit the sale of gas at discounted prices, or provide transportation services, to permit gas transactions at unit prices below the pipeline's weighted average cost of gas (WACOG).

      (1) Often the pipeline's WACOG exceeded the cost of competing fuels - such as #2 or #6 fuel oil.

      (2) The pipeline's "captive customers," those that could not switch to alternative energy sources (most LDCs and their residential customers), generally had to purchase gas at the pipeline's WACOG - they were prohibited from purchasing SMP gas. Only customers currently using alternate fuels could buy SMP gas.

2. In Maryland People's Counsel v. FERC, 761 F.2d 768 (D.C. Cir. 1985) (MPC I) and 761 F.2d 780 (D.C. Cir. 1985) (MPC II), the court held SMPs which gave one class of customers discounted gas prices (MPC I) or access to transportation to facilitate direct sales (producer to end user) (MPC II), while denying it to another class of customers, violated the NGA's prohibition of "undue discrimination."

3. FERC responded with Order No. 436.

E. Eliminating the Transportation Bottleneck - FERC Order No. 436

1. Pipeline given the option to seek a "blanket certificate" to provide transportation services.

2. Under the non-Order 436 regime, FERC must approve all transportation transactions and specifically authorize the pipeline to provide the service.

3. Two types of transportation authorization:

   a. Certificate of public convenience and necessity issued under NGA § 7(c).

   b. "Self-implementing" transactions "on behalf of" intrastate pipelines or LDCs pursuant to NGPA § 311.

4. Primary benefit of an Order 436 (Part 284) Blanket Certificate:

   a. "Blanket" certificate of public convenience and necessity authorizing transportation by pipeline on behalf of others (e.g., interstate pipelines, end users, producers) without having to obtain a prior certificate for each transaction.

   b. Generic authority to engage in NGA § 7(c) transactions and generic authority to abandon the service once the transaction is completed.

   c. The Order 436 blanket certificate authorizes pre-granted abandonment upon the expiration of the underlying transportation agreement.

   d. This reduction of regulatory review of transportation functions would allow the pipeline to react quickly to transportation

requests and compete for gas sales and transportation business.

e. Other major Order 436 incentives:

(1) Freedom to discount transportation rates within a minimum and maximum rate band approved by FERC.

(2) Availability of "optional expedited certificates" to construct facilities necessary to provide transportation services. Eliminates the traditional protracted §7(c) certificate process - but the pipeline's stockholders must assume the risk that the new facility will not generate enough income to recoup their construction investment.

f. FERC fashioned its subsequent orders to provide pipelines with additional incentives to accept an Order 436 blanket certificate.

5. Public interests, previously protected by case-by-case review of § 7(c) transactions, were protected by the pipeline agreeing to specific blanket certificate conditions specified in Order 436.

6. The major condition is that pipelines must provide transportation on a non-discriminatory "open-access" basis.

7. Other Order 436 Conditions:

a. Pipeline must offer firm and interruptible service.

b. Pipeline capacity must be allocated on a "first-come, first-served" basis.

c. Employ generic rate conditions in developing their transportation rates with the primary goal that rates must be "cost-based".

VI. THE MOST RECENT CHAPTER IN FERC'S RESTRUCTURING: ORDER 636

A. Finishing the Work Began in its Previous Orders

1. Order 636 is the latest in FERC's attempts to ensure open access is provided to all shippers on an equal basis with the transporting pipeline.

2. Order 636 requires the "unbundling" of pipeline services so shippers can shop, package, and purchase the precise services they need.

3. The concern was that the pipeline "sales" service would not be comparable to a third party's sales service because the pipeline sale may include unidentified transportation-related services.

   a. Studies indicated that customers were relying primarily on pipeline sales to meet their peak demand periods and that they reserved firm capacity on the pipelines throughout the year to ensure access to gas during peak periods.

   b. Off-peak demand, however, was satisfied primarily through the purchase of gas from non-pipeline sources and moving the gas relying upon interruptible transportation.

4. The FERC's concerns regarding its post-Orders 436/500 creation were articulated as follows:

   "The Commission finds that the pipelines' bundled, city-gate firm sales service give pipelines an undue advantage over other gas sellers because of the superior quality of the 'no-notice' aspect of the transportation embedded within the bundled, city-gate, firm sales service when compared to the firm and interruptible transportation available for the gas of non-pipeline gas sellers. . . . In order to secure a more efficient marketplace, the Commission must address the lack of equality in transportation (and storage) services, the pipelines' dominance in the peak period sales, the lack of flexibility in pipelines' sales pricing, and the pipelines' remaining service obligation simultaneously."

   These are the issues addressed by Order 636.

5. The goal is to break out all transportation-related services, such as storage, and provide a menu with regulated rates at which services can be packaged and bought, or sold, by any party to ensure effective competition

   a. Once a complete menu of services is provided, the gas user can evaluate the level of service they desire.

   b. This is how the FERC plans to deal with the "service" obligation. It will be up to the gas user to package the supply and transportation services it desires to determine the level of risk they desire to accept--or not accept--regarding supply interruptions.

B. The Workings of FERC Order 636

1. Although Order 636 provides guidelines on how restructuring will take place, the details for each pipeline will be found in the orders pertaining to their individual restructuring proceeding, and reflected in their tariffs.

2. These pipeline-specific tariffs have been completed and all observers agree that the industry performed quite well under the new regime during the unusually cold winter of 1993-94. Gas got to where it needed to go at reasonable prices.

VII. PROBLEMS CREATED BY RESTRUCTURING

A. Costs Associated with Reliance on the Prior Regime

1. Pipeline gas supply contracts with producers were a major problem associated with Orders 380, 436, and 500.

   a. Order 636 authorizes pipelines to recover the full cost of all prudently incurred gas supply "realignment costs."

   b. Generally, the bulk of realignment costs (cost of terminating take-or-pay and other gas supply agreements) can be recovered from firm transportation shippers on the pipeline either in the form of an exit fee paid by a sales customer or a reservation fee surcharge paid by firm transportation shippers. Other options for the firm service holder include remaining a sales customer of the pipeline or take an assignment of the pipeline's existing contracts.

2. In addition to gas contract costs, Order 636 addresses the "stranded asset" problem.

   a. Pipelines will have assets they have acquired in the past to provide customers with the standard pre-Order 636 bundled sales service. For example, storage rights and capacity the pipeline holds on upstream pipelines.

   b. Stranded assets will be treated like other costs incurred by the pipeline and will be recoverable, if they were prudent, in a general rate filing under the NGA.

B. Realignment of Costs Through Cost Classification (Rate Design)

1. This will be a problem for the LDCs but a blessing for high load gas customers.

2. Order 636 adopts the "straight fixed variable" (SFV) method of classifying costs which means all of the pipeline's fixed transmission costs and storage costs will be billed to firm transportation customers as a "reservation charge" (if the

customer was receiving sales service instead of transportation, this would be called the "demand charge").

3. Prior to Order 636, U.S. pipelines used a "modified fixed variable" (MFV) method of cost classification which included some of the pipeline's fixed costs (return on equity and related taxes) in the "volume charge" (if the customer was receiving sales service instead of transportation, this would be called the "commodity charge").

   a. This meant that high volume customers were generally paying a disproportionate percentage of the fixed costs associated with the pipeline.

   b. In effect, high volume, industrial and commercial customers were subsidizing the cost of providing services to low volume customers, such as residential and small commercial consumers.

4. Reservation (demand) charges are typically based upon two components:

   a. The maximum daily (peak-day) entitlement to service (the "R-1" or "D-1" rate); and

   b. The maximum annual entitlement to service (the "R-2" or "D-2" rate).

5. Volume (commodity) charges are based upon the amount of gas that flows through the pipeline.

6. Consider the following rate schedule which would be indicative of the approach followed by interstate pipelines prior to Order 636:

MFV	R-1	$2.00 per MMBtu for maximum daily entitlement to service
	R-2	$0.20 per MMBtu for maximum annual entitlement to service
	V/C	$0.25 per MMBtu for actual volumes transported

   a. Assume a shipper wants to purchase firm transportation that will ensure they can move up to 10,000 MMBtu/day to meet their expected peak demands with a total annual entitlement

of 2,920,000 MMBtu. Note this indicates the shipper has an 80% "load factor" (2,920,000 divided by 365 days = 8000 MMBtu/day average).

b. During the month the shipper takes 240,000 MMBtus of gas (an 80% load factor for the month). Under the rate schedule, the shipper would be billed as follows:

R-1	$ 20,000	($2.00 x 10,000)
R-2	$ 48,667	($0.20 x 2,920,000 x 1/12)
V/C	$ 60,000	($0.25 x 240,000)
	$128,667	Total

7. A similar transaction under the post-Order 636 regime would employ a straight fixed variable cost classification where the "R-2" factor has been eliminated and instead all fixed costs are recovered in the daily capacity reservation charge --the "R-1" factor.

SFV

R-1 $6.00 per MMBtu for maximum daily entitlement to service

V/C $0.05 per MMBtu for actual volumes transported

R-1	$ 60,000	($6.00 x 10,000)
V/C	$ 12,000	($0.05 x 240,000)
	$ 72,000	Total

8. Our 80% load factor customer is a big winner in the shift from MFV to SFV. Their unit cost for the transportation of gas went from $0.54/MMBtu to $0.30/MMBtu.

9. However, consider the impact on a customer with a 20% load factor, such as an LDC which serves temperature-sensitive residential customers with a daily demand requirement of 10,000 MMBtu and an annual entitlement of 730,000 MMBtu. During the month they take 60,000 MMBtus (a 20% load factor for the month).

MFV

R-1	$ 20,000	($2.00 x 10,000)
R-2	$ 12,167	($0.20 x 730,000 x 1/12)
V/C	$ 15,000	($0.25 x 60,000)
	$ 47,167	Total

SFV

R-1	$ 60,000	($6.00 x 10,000)
V/C	$ 3,000	($0.05 x 60,000)
	$ 63,000	Total

a. Although their volume charge goes from $15,000 to $3,000, their reservation charge goes from $32,167 to $60,000.

b. Order 636 makes it more expensive to reserve space year-around to ensure the LDC is able to meet their service obligations on the coldest day of the year.

c. Our 20% load factor customer is a big loser in the shift from MFV to SFV. Their unit cost for the transportation of gas went from $0.79/MMBtu to $1.05/MMBtu.

10. Order 636 provides some flexibility to mitigate "significant" cost shifts for individual customers. If a customer "class" will ultimately suffer a 10% or greater increase, the SFV method can be phased-in over a four-year period.

11. Should the impact of these shifts be discounted by positive benefits received under other Orders such as Orders 380, 436, 500, etc.?

C. Meeting the "Service" Obligation Becomes a Matter of Choice for the LDC; No-Notice Transportation

1. The risk of having a choice is that you have the capacity to make the wrong choice. In the public utility arena the risk is even greater because the LDC's actions may (as a practical matter) be evaluated with the perfect vision of regulatory hindsight.

2. Making sure the LDC is able to supply their customers with all the gas they want on the coldest day of the year is now the responsibility of the LDC, not the interstate pipeline.

3. LDCs (and other large gas users) now have the ability to structure gas supply, storage, and transportation services to best fit the needs of their customers, at the most competitive price.

4. Prior to Order 636 LDCs relied upon the pipeline's bundled sales service which included the gas commodity and the pipeline's transportation and storage rights to move gas to the city gate of the LDC.

5. Under Order 636, pipelines that offered sales service prior to Order 636 are required to offer a "no-notice" transportation service to all firm shippers.

   a. No-notice transportation service allows the customer to purchase a daily contract entitlement that allows the customer to have delivered at any time a quantity of gas up to the contract entitlement.

   b. The gas commodity that is moved under the no-notice service can be purchased from the pipeline or a non-pipeline supplier.

   c. There are no nominations, scheduling penalties, or other limitations that are associated with traditional firm transportation services. However, the higher quality of this service is reflected in its cost.

   d. The LDC's ability to package their needed services will be enhanced by Order 636 provisions requiring pipelines holding firm capacity on upstream pipelines and contract storage to offer to assign these rights to their firm shippers.

D. Capacity Release and Reallocation Under Order 636

1. Order 636 permits shippers to reallocate their unneeded firm capacity by notifying the pipeline and having the availability of capacity advertised on the pipeline's electronic bulletin board.

2. The bidder making the best offer for the capacity (not to exceed the maximum tariff rate chargeable to the releasing shipper) will be assigned the capacity and revenues generated by the reassignment will be credited to the releasing shipper's account.

E. Market Centers and Pooling Areas

1. Pipelines are prohibited from imposing tariff conditions which inhibit the development of market centers and pooling areas.

2. A market center is created when there is an interconnection of two or more pipelines, thereby expanding the range of available gas supplies and gas purchasers.

3. Order 636 requires pipelines to provide firm shippers with flexible receipt points and delivery points--this should aid in the creation of market centers.

4. The straight fixed variable rate design should also assist in the creation of market centers since the variable cost component of the transportation charge will not reflect fixed costs (return on equity and taxes) that could vary markedly from pipeline to pipeline.

5. A pooling area is a point where gas is aggregated by merchants to effect sales and administer deliveries to the pipeline.

F. Competition for LDC Industrial Customers--The Bypass Problem

1. As end users of gas seek to exercise their new ability to buy gas directly from producers and have it transported to their facilities, conflicts have arisen between their current LDC supplier and the area interstate pipeline (or imported gas suppliers).

2. Bypass occurs when an existing LDC customer obtains a direct connection with an interstate pipeline (or an imported gas supply)-- bypassing the LDC.

3. The bypassing customer is able to contract with other gas suppliers and have the gas transported to them through their connection with the interstate pipeline.

4. The FERC now favors bypass and has used its jurisdiction over interstate transportation to facilitate bypass in the face of LDC and state public utility commission opposition.

5. The courts have upheld the FERC's actions in this area. See, e.g., Cascade Natural Gas. Corp. v. FERC, 955 F.2d 1412 (10th Cir. 1992).

6. Responding to this problem, many state public utility commissions are allowing their LDCs more flexibility in negotiating with their large customers to try and avoid a bypass.

   a. Many LDCs now offer transportation services in addition to a sales service.

   b. Many LDCs have the ability to discount their services to keep their customers on the system so they make some net contribution to system costs.

7. By-pass is one of the catalysts that will prompt state regulators to provide open-access services at the state and local level.

G. The Potential Gathering Bottleneck--Federal or State Jurisdiction?

1. To enjoy the benefits of Order 636, the producer or marketer must first get their gas to the interstate pipeline. This typically means the gas must travel through a gas gathering system that connects the wellhead to a pipeline receipt point.

2. Under the Natural Gas Act, jurisdiction over the "production or gathering of natural gas" is reserved to the states. NGA § 1(b), 15 U.S.C. §717 (b).

3. However, when the gathering is conducted by the interstate pipeline (which it often has been), the FERC has asserted jurisdiction over the pipeline's gathering activities since they were closely associated with the transportation function.

   a. The pipeline's gathering costs were typically included with the pipeline's transportation costs which were rolled into the sales rate charged to the local distribution company.

   b. To effectively control these costs the FERC exercised jurisdiction over the gathering function.

4. After Order 636, gathering costs cannot be rolled into the sales rate nor can they be rolled in with other transportation costs.

   a. The end result is that customers using the particular service (gathering) should bear all the costs associated with the service.

   b. Therefore, gathering costs cannot be recovered from customers using the pipeline solely for transportation. Only those who use the service can be charged for the service--and the rate will be set accordingly.

   c. One (unacknowledged) reason producers want FERC to continue their regulation over gathering is so FERC at least has the capacity to allow some gradual phase out of the cross-subsidization of gathering.

5. The interstate pipelines have wanted to be free of FERC jurisdiction so they can sell their systems to unrelated third parties (spin-off) or to an affiliated marketing entity (spin-down).

   a. The asset is more valuable if it is not subject to NGA regulation.

   b. In any event, the owner of the gathering system, in some situations, will be competing against unregulated gathering systems (those that have never had an ownership link with an interstate pipeline).

6. Order 636 requires pipelines offering gathering to provide a separate rate for gathering services.

7. The FERC's response to the spin-off and spin-down issue has been to require, as a condition to approving the transaction, that the shippers and pipeline negotiate new contracts to govern gathering services after the system is sold.

   a. If the parties are unable to agree upon a new contract, a "default contract" would apply.

   b. The default contract would be for a term not to exceed two years at rates no higher than the rate charged by the pipeline prior to selling the system (subject to an escalation formula).

8. The FERC has indicated its intention to get out of the gathering regulation business once a gathering system is sold by the interstate pipeline.

9. The dilemma for the producer is two-fold:

   a. The ability to gain any access to the gathering facility; and

   b. The fee that will be charged for use of the facility.

10. The producer's situation is made more difficult by inadequate (and in many cases a total absence of) state regulation to fill the void.

    a. Another reason producers don't want states to regulate the spun-off interstate systems is that it will probably result in state-wide regulation of all gathering systems--large and small. Many producers don't want <u>their</u> small systems regulated--only the larger systems they want to use.

    b. In many situations, ownership of a gathering system will give the gathering system owner the ability to control all the gas behind the gathering system.

       (1) If a producer wants to market their gas, they will have to do it on the gatherer's terms.

       (2) Often the gatherer will offer a net-back pricing mechanism to ensure they have a no-risk profit margin on gas they have under their control.

11. Effective regulation at the state level will require a guaranteed right of access to the system on reasonable terms.

"The Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA") has the dubious distinction of being the United States law most likely to inflict grave economic harm, or ruin, on the unsuspecting, guiltless, faultless investor."

VIII. THE BASIC PROBLEM: "STATUS" LIABILITY

A. Environmental Fix-It Statutes

1. Several statutes require that parties having some defined connection with an environmental problem "fix" the problem.

   a. "Fixing" environmental problems is often technically difficult.

   b. "Fixing" environmental problems is usually very expensive and liability is not limited to the fair market value of the property impacted by the problem.

2. "Superfund"--Comprehensive Environmental Response, Compensation and Liability Act (CERCLA), 42 U.S.C. §§ 9601 to 9675 (1988) (pay for cleanup costs associated with responding to a release or threat of a release of hazardous substances).

3. "RCRA"--Resource Conservation and Recovery Act (RCRA), 42 U.S.C. §§ 3001 to 3020 (1988) (require cleanup of hazardous wastes that present an "imminent and substantial endangerment" to health or the environment.

4. "CWA § 311"--Federal Water Pollution Control Act ("Clean Water Act"), 33 U.S.C. § 1321(f)(2) (West Supp. 1992) (pay for cleanup costs associated with

responding to a discharge of oil or hazardous substances into waters of the United States).

5. "OPA"--Oil Pollution Act of 1990 ("OPA"), 33 U.S.C. § 2702 (West Supp. 1992) (pay for cleanup costs and damages associated with responding to a discharge or a substantial threat of a discharge of oil into waters of the United States).

6. State law counterparts.

B. Liability Without Fault

1. The environmental statutes impose "strict liability".

2. If the problem exists, you must address it--even though the problem was not your "fault".

3. Liability is based upon <u>status</u> instead or fault, contribution, or causation.

4. The goal then becomes avoiding the <u>status</u> required to connect you with a problem.

C. Status Liability Under CERCLA

1. Under CERCLA, cleanup liability is imposed on persons that have a certain status with a "facility."

   a. The term "facility" is defined broadly to include "any site or area where a hazardous substance has been deposited, stored, disposed of, or placed, or otherwise come to be located . . . ." CERCLA § 101(9)(B), 42 U.S.C. § 9601 (9)(B) (1988).

   b. The statute specifically includes "any building, structure, installation, equipment, pipe or pipeline . . . , well, pit, pond, lagoon, impoundment, ditch, landfill, storage container, motor vehicle, rolling stock, or aircraft . . . ." CERCLA § 101(9)(A).

   c. However, the statute specifically excludes "any consumer product in consumer use or any vessel." CERCLA § 101(9)(B).

2. The eight status categories for liability under CERCLA include the following:

a. Current owners of the facility. CERCLA § 107 (a)(1), 42 U.S.C. § 9607 (a)(1) (1988).

b. Current operators of the facility. CERCLA § 107(a)(1), 42 U.S.C. § 9607 (a)(1) (1988).

c. Owners of the facility "at the time of disposal of any hazardous substance" at the facility.

(1) "Disposal" is defined broadly in CERCLA § 101(29), by incorporating the definition found in § 1004(3) of RCRA which provides:

"The term 'disposal' means the discharge, deposit, injection, dumping, spilling, leaking, or placing of any solid waste or hazardous waste into or on any land or water so that such solid waste or hazardous waste or any constituent thereof may enter the environment or be emitted into the air or discharged into any waters, including ground waters." RCRA, § 1004(3), 42 U.S.C. § 6903(3) (1988) (emphasis added).

(2) This definition has been applied broadly in a CERCLA context to hold that liability can be imposed on owners or operators of property whenever hazardous substances were 'leaking' into the property; even though the owner did not engage in any affirmative conduct resulting in the leaking. Nurad, Inc. v. William E. Hooper & Sons Co., 966 F.2d 837, 844, 846 (4th Cir. 1992).

d. Operators of the facility at the time of disposal of any hazardous substance at the facility. CERCLA § 107(a)(2), 42 U.S.C. § 9607(a)(2) (1988).

e. Persons who "arranged for" the disposal, treatment, or transport for disposal or treatment, of hazardous substances at the facility. CERCLA § 107(a)(3), 42 U.S.C. § 9607(a)(3) (1988).

f. Persons who created (generated) hazardous substances which have been brought to the facility for disposal or treatment. CERCLA § 107(a)(3), 42 U.S.C. § 9607(a)(3) (1988).

(1) Although CERCLA § 107(a)(3) refers only to any person who "arranged for" disposal, treatment, or transport, it covers two categories of "arrangers."

(2) One category is for persons who arrange for disposal of "hazardous waste owned or possessed by such person".

(a) This category would encompass the persons who created or generated the hazardous substance.

(b) The generator might arrange to dispose of their own hazardous substances, or they might contract with a third party to arrange for its disposal.

(c) In either case, the generator of the hazardous substance will be a potentially liable party with regard to any facility to which the hazardous substance is taken.

(3) The second category of arranger would encompass the third party that contracts with the generator to dispose of hazardous substances "owned or possessed . . . by any other party or entity . . . ."

g. Persons who transported the hazardous substances to the facility--but only when the transporter selected the facility. CERCLA § 107(a)(4), 42 U.S.C. § 9607(a)(4) (1988).

h. Arguably there is an eighth potential category of liability, created by CERCLA § 101(35)(C), which provides in part:

"[I]f the defendant obtained actual knowledge of the release or threatened release of a hazardous substance at such facility when the defendant owned the real property and then subsequently transferred ownership of the property to another person without disclosing

such knowledge, <u>such defendant shall be treated as liable under section [107(a)(1)]</u> 9607(a)(1) of this title and no defense under section [107(b)(3)] 9607(b)(3) of this title shall be available to such defendant." CERCLA § 101(35)(C), 42 U.S.C. § 9601(35)(C) (1988) (emphasis added).

(1) This section seems to impose liability on a person who would otherwise not be liable under CERCLA § 107(a)(1)-(4).

(2) For example, assume Acme Oil Company acquired property in 1950, after all active and passive disposal on the property had ceased. Also assume that during Acme's ownership no hazardous substances were disposed of on the property. In 1990 Acme sells the property to Minor Oil Company and a hazardous substance release is discovered in 1992 that related to activities on the property prior to 1950. Acme should be able to escape liability for cleanup since it is not the current owner or operator of the facility, nor was it an owner or operator "at the time of disposal" of the hazardous substance.

(3) However, suppose one of Acme's employees obtained "actual knowledge" of a release or threatened release of a hazardous substance at the facility while Acme owned the property.

(4) If Acme fails to disclose this information to its transferee (Minor Oil Company), § 101(35)(C) states Acme would have the same liability as a current owner or operator under § 107(a)(1).

(a) It is not clear whether the statute contemplates only a release or threatened release that occurs while Acme owns the property.

(b) However, the statute does not expressly limit when the release or threatened release could have taken place.

(c) Therefore, the release arguably could have taken place before Acme obtained the property and Acme merely became aware of the prior release during its ownership.

D. Triggering CERCLA Liability

1. Liability is triggered under CERCLA when there is a "release" or "threatened release" of a "hazardous substance" which causes the incurrence of cleanup costs.

2. CERCLA defines "release" to include:

   "[A]ny spilling, leaking, pumping, pouring, emitting, emptying, discharging, injecting, escaping, leaching, dumping, or disposing into the environment (including the abandonment or discarding of barrels, containers, and other closed receptacles containing any hazardous substance or pollutant)." CERCLA § 101(22), 42 U.S.C. § 9601 (22) (1988).

3. "Environment" is defined to include "surface water, ground water, drinking water supply, land surface or subsurface strata, or ambient air . . . ." CERCLA § 101(8), 42 U.S.C. § 9601(8) (1988).

4. "Hazardous substance" is defined broadly to include substances and wastes listed under the Clean Air Act, Clean Water Act, Toxic Substances Control Act, Resource Conservation and Recovery Act, or the special listing procedure provided for in § 102 of CERCLA. CERCLA § 101(14), 42 U.S.C. § 9601(14) (1988).

   a. However, the definition specifically excludes:

      (1) Petroleum; including crude oil and any fraction of crude oil.

      (2) Natural gas, natural gas liquids, liquefied natural gas, or synthetic gas usable for fuel.

   b. This is known as the "petroleum exclusion."

E. Defining the Scope of CERCLA's Petroleum Exclusion

1. The oil industry's front-line defense to CERCLA liability has been the "petroleum exclusion" which specifically exempts certain substances from CERCLA's "hazardous substance" designation.

2. Although CERCLA § 101(14) defines hazardous substances broadly, it also provides:

   "The term does not include petroleum, including crude oil or any fraction thereof which is not otherwise specifically listed or designated as a hazardous substance . . . and the term does not include natural gas, natural gas liquids, liquefied natural gas, or synthetic gas usable for fuel (or mixtures of natural gas and such synthetic gas)."

   CERCLA § 101(14), 42 U.S.C. § 9601(14) (1988).

3. The petroleum exclusion has been interpreted by the U.S. Court of Appeals for the Ninth Circuit to include:

   "[U]nrefined and refined gasoline even though certain of its indigenous components and certain additives during the refining process have themselves been designated as hazardous substances within the meaning of CERCLA."

   Wilshire Westwood Associates v. Atlantic Richfield Corp., 881 F.2d 801, 805 (9th Cir. 1989).

4. The scope of the exclusion becomes less clear when dealing with waste oil.

   a. For example, in Southern Pacific Transportation Co. v. California (Caltrans), 790 F. Supp. 983 (C.D. Cal. 1991), the court concluded that:

      "[U]sed petroleum products are covered by the petroleum exclusion, provided that CERCLA-listed hazardous substances have not been added to the petroleum product during its use, nor have the concentrations of CERCLA-listed hazardous substances in the petroleum product been increased by its use."

   b. The court concluded that the petroleum exclusion would apply to a mixture of

petroleum and soil that was placed on the plaintiff's property.

5. In Cose v. Getty Oil Co., 4 F.3d 700 (9th Cir. 1993), the court refused to extend the petroleum exclusion to crude oil tank bottoms that were disposed of as a waste material.

   a. In 1974 Don Cose purchased a 40-acre parcel of undeveloped land from Getty Oil for $50,000. In 1987, when Cose was in the process of developing the property for housing, an environmental engineering firm assessing the land discovered oily wastes on the property that had a 10.5 ppm concentration of Chrysene (a CERCLA "hazardous substance").

   b. The concentration of Chrysene in crude oil in the region was 28.0 ppm.

   c. The engineering firm identified the waste as hazardous and recommended that it be removed from the site before it was developed. Cose filed suit under CERCLA seeking its cleanup costs from Getty Oil.

   d. Getty Oil produced crude oil from wells in the Tafts-Fellow area of Kern County, California. The oil was transported to its Avon refinery by pipeline and pumping stations located at twelve-mile intervals along the pipeline. The crude oil was stored at the pumping stations in tanks and heated to reduce its viscosity. The oil was then pumped farther along the pipeline.

   e. This case concerns disposal of the "tank bottoms" at a "sump facility" for the Tacy pumping station which was subsequently sold to Cose.

      (1) The court defined tank bottoms as follows:

      > "When crude oil is stored in tanks, suspended sedimentary solids in the crude oil settle to the bottom. Because water is heavier than oil, it separates from the oil and also collects at the bottom of the tank. The bottom layer of the tank is

known as basic sediment and water, or 'crude oil tank bottoms.'"

(2) Getty Oil would drain the tank bottoms and dispose of them in nearby sumps at each pump station. Getty closed the pumping station in 1968 when a new pipeline was constructed over a different route.

f. In defining the scope of the petroleum exclusion, the court stated:

"If a specifically listed hazardous substance is indigenous to petroleum and is present as a result of the release of petroleum, such substance will fall within the petroleum exclusion <u>unless</u> it is present at a concentration level that exceeds the concentration level that naturally occurs in the petroleum product."

g. However, in this case the concentration of the Chrysene in the tank bottoms was 62.5% <u>lower</u> than the concentration found in the crude oil.

h. Nevertheless, the court held that the tank bottoms were not "petroleum" nor were they a "fraction" of petroleum. Instead the court seemed to be most influenced by the fact that the tank bottoms had bee discarded as a waste. The court noted that the crude oil tank bottoms were not used "for producing useful products" but rather were "simply discarded waste."

i. The court concluded, stating:

"Because we conclude that the crude oil tank bottoms here at issue are not 'petroleum' and therefore not subject to CERCLA's exclusion, the Chrysene found within the Gravel Pit's environmental samples is properly viewed as an independent 'hazardous substance,' rather than as a component of petroleum. Liability is imposed under CERCLA <u>regardless</u> of the concentration of the hazardous substances present in a defendant's waste, <u>as long as</u> the contaminants are listed 'hazardous

substances' pursuant to 40 C.F.R. §302.4(a)."

j. Therefore, Getty Oil could be held liable for cleanup costs under CERCLA.

1. In United States v. Western Processing Co., Inc., 761 F. Supp. 713 (W.D. Wash. 1991), the court held that sludge (tank bottoms) from leaded gasoline tanks, a diesel oil tank, and an unleaded gasoline tank, and the rinse water from washing out the tanks, were not covered by the CERCLA petroleum exclusion.

   a. The court noted that the sludge contained "a rust-like scale of corrosion products from the oxidation of steel in the tank walls."

   b. This caused various hazardous substances to be formed which are not ordinarily found in refined or unrefined petroleum.

   c. The court also noted that the "tank bottom sludge is contaminated waste product, and not a petroleum fraction, as that term is used in the statute."

2. The petroleum exclusion will not protect against liability when there are other substances that are hazardous and mixed with petroleum.

   a. For example, if waste oil is pumped from a reserve pit which has also contained waste solvents or thread dope cans, the mixture does not qualify for the petroleum exclusion if the solvents or thread dope material adds hazardous substances to the oil.

   b. As noted by the U.S. Court of Appeals for the Third Circuit in United States v. Alcan Aluminum Corp., 1992 U.S. App. LEXIS 10366 (3d Cir. 1992):

      "EPA has distinguished between oil that naturally contains low levels of hazardous substances and oil to which hazardous substances have been added through use. Although EPA has extended the petroleum exclusion to the former category of oily substances, it has specifically declined to extend such protection to the latter category. In EPA's words: 'EPA does not consider

materials such as waste oil to which listed CERCLA substances have been added to be within the petroleum exclusion.'"

I. GETTING AROUND THE PETROLEUM EXCLUSION

A. Basic Limits

1. The petroleum exclusion offers no protection when the material at issue is not petroleum, but instead is merely associated with the development, production, processing, or marketing of petroleum.

   a. For example, if the contents of reserve pits contain buckets with lead-based thread dope residue, the presence of the lead can satisfy the "hazardous substance" requirement.

   b. United States v. Hardage, Case No. CIV-86-1401-W, Slip Op. at 4-5, 7 (W.D. Okla. April 15, 1991) (liability based in part on disposal of thread dope buckets containing thread dope residue which consisted of a lithium grease base and lead).

2. Also, other statutes may apply to fill the void left by the petroleum exclusion.

   a. Oil Pollution Act of 1990.

   b. Resource Conservation and Recovery Act.

   c. State Law.

B. Liability Under the Oil Pollution Act of 1990

1. The Oil Pollution Act of 1990 (OPA), 33 U.S.C.A. §§ 2701 to 2761 (West Supp. 1992), imposes liability upon the owner or operator of a facility from which there is a discharge, or substantial threat of a discharge, of "oil" into "waters of the United States." OPA § 1002(a), 33 U.S.C. § 2702(a) (West Supp. 1992).

2. If the necessary nexus with "waters of the United States" can be established, the actual, or threatened, discharge of oil will require the facility owner or operator to clean up the affected area and pay a broad range of damages provided for by the Act.

3. OPA § 1002(b), 33 U.S.C. § 2702(b) (West. Supp. 1992), provides for CERCLA-like cleanup costs but goes beyond CERCLA's compensation scheme and establishes a statutory basis to compensate private interests for injury to real or personal property, to include lost profits and impairment of earning capacity.

4. However, OPA liability applies only to incidents that occur after August 18, 1990, the effective date of the Act. OPA § 1017(e), 33 U.S.C.A. § 2717(e) (West Supp. 1992). OPA § 1020, Public Law No. 101-380, 104 Stat. 484, 506, provides: "This Act . . . shall apply to an incident occurring after the date of the enactment of this Act [August 18, 1990]."

5. The relationship between the OPA and CERCLA is demonstrated by the OPA's definition of "oil":

   "'Oil' means oil of any kind or in any form, including, but not limited to, petroleum, fuel oil, sludge, oil refuse, and oil mixed with wastes other than dredged spoil, but does not include petroleum, including crude oil or any fraction thereof, which is specifically listed or designated as a hazardous substance under . . . [CERCLA] and which is subject to the provisions of that Act . . . ."

   OPA § 1001(23), 33 U.S.C.A. § 2701(23) (West Supp. 1992).

6. Therefore, if the petroleum substance falls within CERCLA's petroleum exclusion, it may be subject to the OPA's liability provisions--assuming the discharge involves an "incident" occurring after August 18, 1990 and involves "waters of the United States."

C. Liability Under RCRA's "Imminent Hazard" Authority

1. Even though the problem may escape CERCLA and OPA liability, it may be subject to action under RCRA's "imminent hazard" authority.

2. Under RCRA § 7003, 42 U.S.C. § 6973 (1988), the Administrator of the EPA can bring suit against any "past or present" generator or transporter, or any "past or present" owner or operator of a facility, who has contributed to disposal or handling of any "solid waste or hazardous waste," which "may

present an imminent and substantial endangerment to health or the environment . . . ."

3. The court is authorized "to restrain such person from such handling, storage, treatment, transportation, or disposal" and to "order such person to take such action as may be necessary."

4. Citizens have similar powers under RCRA § 7002 which provides:

   "[A]ny person may commence a civil action on his own behalf . . . against any person . . . including any past or present generator, past or present transporter, or past or present owner or operator of a treatment, storage, or disposal facility, who has contributed or who is contributing to the past or present handling, storage, treatment, transportation, or disposal of any solid or hazardous waste which may present an imminent and substantial endangerment to health or the environment . . . ."

   RCRA § 7002(a)(1)(B), 42 U.S.C. § 6972(a)(1) (B) (1988).

5. The efficacy of the RCRA § 7002 remedy is demonstrated by the case of Zands v. Nelson, 779 F. Supp. 1254 (S.D. Cal. 1991) (property owner had cause of action against prior owners of property, lessees who operated gasoline station on the property, and contractor that installed underground storage tanks).

   a. The citizen suit provision does not provide for payment of damages or cleanup costs to private parties.

      (1) At one time it was thought it could be argued that the court's authority under § 7002 to "order such person to take such other action as may be necessary" could include an order to reimburse a third party for cleanup expenses they have already incurred. However, this was rejected by the United States Supreme Court in Meghrig v. KFC Western, Inc., 116 S. Ct. 1251 (1996).

      (2) Apparently the EPA has been successful in making a similar argument under RCRA § 7003. J. Battle and M. Lipeles,

Hazardous Waste 139 (2d ed. 1993) (citing United States v. Aceto Agricultural Chemicals Corp., 872 F.2d 1373 (8th Cir. 1989).

b. However, it does authorize the assessment of civil penalties and the recovery of attorneys fees. RCRA § 7002(a)(2), 42 U.S.C. § 6972(a)(2) (1988) (civil penalties) and § 7002(e), 42 U.S.C. § 6972(e) (1988) (attorney fees).

c. In Zands the court held that gasoline leaking from an underground storage tank, and the contaminated soil, constitute disposal of a solid waste. Once the gasoline ceases to be a useful product, it becomes a solid waste subject to RCRA.

d. The court in Zands also held that RCRA § 7002 (a) supplements the federal underground storage tank statutes found at 42 U.S.C. §§ 6991 to 6991i (1988).

e. The court found that RCRA and CERCLA are distinct statutes.

(1) Therefore, CERCLA's petroleum exclusion limitations do not similarly limit RCRA's scope.

(2) As the court noted: "[W]hereas CERCLA has an explicit exclusion for petroleum, no such similar exclusion exists in RCRA."

f. The court also held that the "mere creation of solid waste, and the subsequent abandonment of it in the ground, will support a cause of action under section 6972(a)(1)(B) [RCRA § 7002(a)(1)(B)]."

g. In holding that the parties who created the waste were subject to RCRA the court stated:

"The Court simply will not accept defendants' interpretation of the statute which would allow individuals to create solid waste, and avoid the requirements of RCRA by never making any attempt to clean up the mess."

6. Before a person can be ordered to take action under § 7002, there must be a showing that the person

"contributed" or "is contributing" to the past or present disposal giving rise to the suit.

a. In Zands the court held the contribution issue is a factual issue which cannot be resolved, in this case, by summary judgment.

b. However, the court does hold that each of the defendants could be a contributor under the statute. The court observed:

"Here, the defendants are individuals who owned the land during which time the gasoline allegedly leaked, individuals who operated the pumps during which time the gasoline allegedly leaked, and individuals responsible for the installation of the piping and pumps for the gasoline tanks that allegedly leaked. None of these individuals are so far removed that it can be said that, as a matter of law, they did not contribute to the leakage."

D. Liability Under State Statutes and Common Law

1. Another matter to always consider when dealing with federal environmental statutes is that they uniformly provide for more stringent state regulation.

2. For example, CERCLA § 114(a) provides:

"Nothing in this chapter shall be construed or interpreted as preempting any State from imposing any additional liability or requirements with respect to the release of hazardous substances within such State."

CERCLA § 114(a), 42 U.S.C. § 9614(a) (1988).

3. Some state remediation statutes may not contain a "petroleum exclusion."

4. For example, Mont. Code Ann. § 75-10-701(6) defines "hazardous or deleterious substance" to include CERCLA hazardous substances, RCRA hazardous wastes, and "any petroleum product." Mont. Code Ann. § 75-10-701(6)(d) (1991). "Petroleum product" includes:

"[G]asoline, crude oil (except for crude oil at production facilities . . .), fuel oil, diesel oil or fuel, lubricating oil, oil sludge or refuse, and

any other petroleum-related product or waste or fraction thereof that is liquid at standard conditions of temperature and pressure (60 degrees F and 14.7 pounds per square inch absolute)."

Mont. Code Ann. § 75-10-701(10) (1991).

5. Similar considerations exist under RCRA, the OPA, and each of the other federal environmental statutes, as well as state tort law.

6. Even the state's oil and gas "conservation" statues might give rise to liability:

   a. For example, in West Bay Exploration v. AIG Specialty Agencies, 915 F.2d 1030, 1032 (6th Cir. 1990), the dispute concerned a lessee's operation of glycol dehydrators and the release of condensed water vapor containing trace amounts of hazardous substances.

   b. Although the waste in West Bay may have been "exempt" under RCRA's associated waste exemption, it nevertheless became the focus of an expensive cleanup under a Michigan state law prohibiting "waste."

7. With regard to the use of state tort law, see Branch v. Mobil Oil Corp., 788 F. Supp. 531 (W.D. Okla. 1991) (nuisance action for pollution relating to past operation of oil and gas wells, gathering lines, tank batteries, and salt-water and waste pits).

II. RCRA's ASSOCIATED WASTE EXEMPTION

A. Basic Limits on the Exemption

1. As noted previously, the petroleum exclusion offers no protection when the material at issue is a waste associated with the development, production, processing, or marketing of petroleum.

2. Also, as Zands v. Nelson demonstrates, RCRA cleanup liability can exist even though the petroleum-related waste is non-hazardous.

B. Defining the Scope of the Exemption

1. The main thrust of RCRA is on the regulation of hazardous waste.

2. If waste is classified as hazardous under RCRA, it must be stored, treated, and disposed of in accordance with RCRA's detailed requirements. See, e.g., 40 C.F.R. Part 262, Part 263, and Part 264 (1992).

3. However, RCRA § 3001(b)(2)(A) provides, in part:

   "[D]rilling fluids, produced waters, and other wastes associated with the exploration, development, or production of crude oil or natural gas or geothermal energy shall be subject only to existing State or Federal regulatory programs in lieu of this subchapter [until EPA completes a study on whether such wastes should be regulated as hazardous wastes]."

   RCRA § 3001(b)(2)(A), 42 U.S.C. § 6921(b)(2)(A) (1988).

4. Pursuant to § 3001(b)(2)(A), EPA completed its study of oil and gas wastes and in 1987 delivered to Congress its report titled: **Management of Wastes from the Exploration, Development, and Production of Crude Oil, Natural Gas and Geothermal Energy.**

5. In July, 1988 EPA issued its decision to exempt many, but not all, exploration and production wastes from RCRA's hazardous waste provisions. Regulatory Determination for Oil and Gas and

Geothermal Exploration, Development and Production Wastes, 53 **Fed. Reg.** 25446 (July 6, 1988).

6. However, even though a waste is classified as an "exempt" waste and therefore non-hazardous under RCRA, it does not necessarily mean the waste will be considered non-hazardous under CERCLA.

   a. Generally speaking, RCRA regulates the present handling and disposal of hazardous wastes; CERCLA seeks to clean up inactive hazardous waste sites by holding parties connected with the problem liable for cleanup costs.

   b. Although RCRA exempts certain wastes from regulation as a "hazardous waste" (such as oil and gas wastes, mining wastes, and household wastes), these wastes can still become the target of a CERCLA cleanup action. But see M. Gibson and D. young, Oil and Gas Exemptions Under RCRA and CERCLA: Are They Still "Safe Harbors" Eleven Years Later? 32 **So. Tex. L. Rev.** 361, 370-383 (1991) (arguing that exempt oil and gas wastes under RCRA were intended by Congress to also be exempt under CERCLA); S. Lansdown, Plugging and Abandoning Issues Encountered by Sellers and Buyers of Producing Properties: A Major's Perspective, **The Landman** 13 (Jan./Feb. 1992) ("The RCRA exemption for drilling fluids, etc., is applicable under CERCLA.").

7. Cases to date suggest that the exemption of wastes under RCRA will not provide protection from CERCLA cleanup liability. B.F. Goodrich Co. v. Murtha, 958 F.2d 1192, 1201-02 (2d Cir. 1992) (RCRA household waste exemption); Idaho v. Hanna Mining Co., 699 F. Supp. 827, 833 (D. Idaho 1987), *aff'd*, 882 F.2d 392 (9th Cir. 1989) (RCRA asbestos mill and mine waste exemptions); Eagle-Picher Indus. v. EPA, 759 F.2d 922, 927 (D.C. Cir. 1985) (RCRA mining waste and fly ash exemptions); United States v. Hardage, Case No. CIV-86-1401-W, Slip Op. at 10-13 (W.D. Okla. April 15, 1991) (RCRA oil and gas associated waste exemption).

8. Therefore, even though a waste can be lawfully managed in a certain way under RCRA, it may not be an acceptable management technique when CERCLA liability is considered.

9. An otherwise "lawful" disposal of oil and gas wastes for RCRA purposes may create, from a business planning point of view, unacceptable CERCLA risks.

III. LIABILITY IN THE OIL AND GAS CONTEXT

A. Ownership Concepts

1. Although "owner" or "operator" status plays a major role under the CERCLA liability regime, the statute defines "owner or operator" to mean, in the case of a facility, "any person owning or operating such facility." CERCLA § 101(20)(A), 42 U.S.C. § 9601 (20)(A) (1988).

2. Courts have concluded, from this non-definition, that Congress intended the terms to be given their "ordinary" meaning. Edward Hines Lumber Co. v. Vulcan Chemicals Co., 861 F.2d 155, 156 (7th Cir. 1988).

3. This has been coupled with an interpretive guide to "generally resolve ambiguities in CERCLA's language in favor of imposing the most expansive liability . . . ." United States v. A & N Cleaners and Launderers, Inc., 788 F. Supp. 1317, 1331 (S.D.N.Y. 1992).

4. In most cases this will result in a broad inclusive interpretation of the terms "owner" and "operator."

5. Therefore, in most situations, particularly in the oil and gas context, there will be the potential for multiple CERCLA "owners."

6. "Owner" under CERCLA will not be limited to those with a fee simple absolute in property. United States v. A & N Cleaners and Launderers, Inc., 788 F. Supp. 1317 (S.D.N.Y. 1992) (lessee of property held to be a CERCLA "owner").

7. Instead, any person holding one of the "sticks" in the "bundle" could attain the status of CERCLA "owner."

   a. At a minimum, the "stick" will probably have to give the holder some right of control over the facility involved.

b. However, the right need not be exclusive, nor must it necessarily entail control over the disposal activity creating the problem.

8. For example, the owner of a pipeline easement has the right to use the burdened land but so does the surface owner and its licensees--so long as their use does not interfere with the pipeline's granted rights.

a. Although the grantor of the easement may not be able to build permanent structures over the easement, they might be able to authorize the storage of drums filled with hazardous waste in or near the easement boundaries.

b. Although the easement owner lacked the authority to use the surface of the property for the storage of hazardous wastes, it nevertheless can be an "owner" of the land encompassed by the easement.

B. Mineral Owners and Surface Owners

1. The mineral interest owner typically has an express or implied right to make reasonable use of the surface of land to explore for, develop, produce, and market the granted minerals.

2. The "surface" owner retains the balance of rights in the property and can also use the surface--so long as its use does not interfere with the mineral interest owner's rights.

3. Operations conducted under the mineral interest owner's implied easement can give rise to potential CERCLA liability for the surface owner.

a. For example, if the "facility" is an abandoned pit used in conjunction with oil and gas operations, the "owners" of the pit may include the surface owner, mineral owner, and the mineral owner's oil and gas lessee.

b. Since the pit is not presently being used by the mineral owner, the surface owner would be the current "owner" of the pit.

c. However, at the time of disposal, the "owner" of the pit would arguably include the mineral interest owner and its lessee.

d. Similarly, while the pit was being used in conjunction with oil and gas operations, the pit would be "owned" by the mineral interest owners and their lessees.

4. Although the mineral owner may have a right to use the land for operations, the surface owner still has an ownership interest in the land and may have the exclusive right to the land when it is not being used for operations.

5. The risk to the surface owner is demonstrated by the court's ruling in Quaker State Corp. v. U.S. Coast Guard, 681 F. Supp. 280 (W.D. Pa. 1988), where the surface owner was held to be an "owner" under the Clean Water Act and therefore responsible for cleanup of an oil containment pit.

   a. The court held the owner of the surface, at the time the discharge was discovered, is the "owner or operator" liable for cleanup costs under CWA § 311(f).

   b. Therefore, the surface owner of the land where the pit was located, was the "owner" of the pit under § 311 of the Clean Water Act.

6. The surface owner can also impact the liability of the mineral interest owner.

   a. If pits are being used by the mineral interest owner, the mineral interest owner, and their lessee, will be CERCLA owners of the pits.

   b. If the surface owner uses the pits for the disposal of hazardous substances, or they become the local community's illegal disposal site, the mineral interest owner, and their lessee, can become owners of a CERCLA facility.

7. The ownership issue will most likely be resolved by considering the authority of each party to control activities at the CERCLA facility. See generally Nurad, Inc. v. William E. Hooper & Sons Co., 966 F.2d 837, 842-43 (4th Cir 1992).

   a. For example, prior to leasing, the mineral interest owner has the authority to use the surface to conduct operations.

b. The mineral interest owner, through its contractor (the oil and gas lessee), selects a drill site and creates a pit which is used in conjunction with its lessee's oil and gas operations.

c. The lessee and the mineral interest owner (through its lessee) each have the authority to control use of the land where the pit and wellsite are located, to pursue mineral development.

d. The surface owner has a concurrent right to use the land where the pit and wellsite are located, so long as it does not interfere with mineral operations.

e. Once mineral operations cease, the surface owner will again have total control over the area; subject to the mineral interest owner's right to use the site at a later date to support mineral operations.

f. Therefore, there are three parties that have varying degrees of "authority to control" the facility at varying times. All three would appear to be candidates for CERCLA owner status.

8. For existing rights, the surface owner, and the mineral owner, should police activities of other interest owners that may impact their ownership interests.

   a. For example, the surface owner might have a basis to object if the mineral interest owner, their lessee, or their drilling contractor, throw hazardous substances into drilling pits.

   b. The surface owner would argue this is not "reasonable use" and therefore exceeds the mineral interest owner's implied easement rights.

   c. In light of the potential CERCLA liability that might be imposed upon the surface owner, a court would likely side with the surface owner to prevent the on-site disposal of hazardous substances.

9. As operations progress, and operating areas are created, the mineral interest owner will want to

ensure the surface owner, and third parties, do not use the operating areas for waste disposal.

10. When creating new rights in the future, each party should consider how their environmental ownership risks can be magnified by the rights being granted to the other party.

11. The terms of the mineral deed, or a contract properly referenced in the deed, should carefully define the surface easement rights of the mineral interest grantee.

12. It is possible that under some pooling statutes a landowner may be forced to permit development on their property even though they have not conveyed or leased the mineral interest. See 2 B. Kramer & P. Martin, **The Law of Pooling and Unitization** § 20.06[1] (3d ed. 1992).

    a. The Oklahoma forced pooling process in effect requires the nonconsenting surface and mineral owner to suffer the environmental risk associated with unit development on their property.

    b. One option the targeted surface and mineral owner might pursue is to request provisions in the pooling order to leverage some of the environmental risks.

    c. Oklahoma Statutes Title 52, § 87.1(e) provides, in part:

       "Where . . . such owners have not agreed to pool their interests and where one such separate owner has drilled or proposes to drill a well on said unit . . . the Commission . . . shall, upon a proper application therefore and a hearing thereon, require such owners to pool and develop their lands in the spacing unit as a unit. . . . All orders requiring such pooling shall be made after notice and hearing, and shall be upon such terms and conditions as are just and reasonable and will afford the owner of such tract in the unit the opportunity to recover or receive without unnecessary expense his just and fair share of the oil and gas." Okla. Stat. Ann. tit. 52, § 87.1(e) (West 1991).

d. Owners of the tract where the well is to be located could argue that the Commission's order should require the drilling parties to indemnify them against environmental liabilities associated with development.

e. Potential CERCLA liability alone would seem to make such "terms and conditions" in a pooling order "just and reasonable."

C. Nonparticipating Interests

1. Royalty conveyances will not create any risk for the grantor of the interest since the grantee of a royalty interest has no right to conduct operations on the property.

2. However, the grantee of a royalty interest is not free of all risk.

3. Although they lack authority to control activities on the property, there is a possibility they could be considered to have "arranged for disposal" of wastes associated with activities necessary to generate the royalty.

4. Even under this theory the royalty interest owner should only be liable for wastes generated during the existence of their interest. However, their liability could extend to disposal sites located off the leased premises if the wastes were generated during the existence of their interest.

5. This risk for nonparticipating interests increases as courts hold that royalty, and other nonexecutive mineral interest owners, have the ability to force their grantors to develop the property for their mutual benefit.

6. There is also a risk that courts will not apply an "authority to control" analysis for defining the scope of CERCLA ownership.

7. Instead, courts might be inclined to impose liability on any person having an ownership interest in the property; particularly if they have received significant income from the property as a result of oil and gas operations.

8. However, it should be remembered that it is ownership of a "facility" that gives rise to CERCLA liability.

   a. It can be argued that the right to merely receive passive income from an oil and gas well does not rise to the level of ownership of the "facility."

   b. The thing that is owned is a right to receive either a money payment or a share of production, not the property used to generate the cash or the production.

D. Parties to the Oil and Gas Lease

1. For purposes of CERCLA liability oil and gas lessees can be an "owner" an "operator" as well as a "generator" and "arranger" and in some cases a "transporter."

2. The lessor will always be an "owner" of the leased premises and in many instances it may have liability coextensive with that of its lessee.

   a. Is the lessee the "contractor" for the lessor for the purposes of conducting development on the leased premises?

   b. If so, the lessor will also be liable for off-site disposal practices of its lessee.

   c. Note: the contractor theory does not fit well since the lessee is typically under no obligation to develop the leased premises.

3. Lessee needs to be careful in acquiring oil and gas leases to ensure the property does not have existing environmental problems.

4. Lessor needs to be careful that it does not permit its lessee to conduct operations on the property that can create new environmental problems or aggravate existing problems.

E. Development Agreements

1. Assignments: Any transfer of an interest in contaminated property can give rise to new liability in the "current owner" or "current

operator." New owner or operator can create new problems on the property or aggravate existing problems.

2. Farmouts: The farmee is becoming a current owner and operator of the property. The farmor runs the risk of liability on the property arising out of the farmee's activities.

3. Operating Agreements: In addition to partnership theories of joint liability, the operator will most likely be viewed as the contractor acting on the behalf of the parties to the operating agreement.

   a. All parties are "owners" of area encompassed by the "contract area."

   b. All parties may be viewed as CERCLA "operators" even though operations are conducted through their designated contractor, or contractors hired by the operator.

4. Pooling and Unitization Agreements: The major risk is that a court will find a cross-conveyance of interests so that each party having an interest in the pooled or unit area is deemed to own a portion of all other leases contributed to the area.

5. Drilling and Other Service Contracts: Although they may be independent contractors, the operator will have a direct contractual relationship with them and will therefore be responsible for contamination they create on site. May even have liability for their off-site disposal practices.

F. Leveraging Liability with the Oil and Gas Lease--Adjustments to Traditional Clauses

1. Granting Clause

   a. Lessors may want to try and reduce the scope of activities conducted on the leased land.

   b. You would rather have the dehydrator and compressor placed on somebody else's land. You would prefer that your land not be used to support activities on "neighboring lands" nor to "manufacture" or treat the oil and gas.

   c. You may want to include statements such as:

"Lessee will not use the leased premises to conduct any processing or treatment of production [that requires the use of a hazardous substance or causes the generation of a hazardous substance.]"

d. You may also want to control whether pits can be used on the property and, if they are, how pit contents will be handled. Can they be disposed on site or must they be hauled somewhere else?

2. Royalty Clause

a. Do you really want to own part of the actual oil coming out of the ground? Although there is no federal environmental liability currently attached to the ownership of oil (as opposed to ownership of the oil facilities), it may create problems for the lessor in the future.

b. Since lessors seldom actually market their share of oil, it may be better to not have the right to take oil in kind.

c. As an additional benefit, an oil purchaser would not need you to sign any sort of division order since you would not "own" any of the production.

3. Assignment and Surrender Clauses

a. Under the typical form of assignment clause the lessee can freely assign the property and eliminate any liability to lessor "thereafter accruing."

b. The lease may also have a surrender clause that permit the lessee to release the lease and avoid any subsequent liabilities.

c. Although you could try and limit assignments of the lease, I think the best approach is to permit assignment but keep the lessee on the hook for any liability caused by its assignees.

d. Consider the following clause:

Limitation on Assignment and Surrender. Regardless of the other provisions contained

in this lease, LESSEE can assign or surrender all or any part of this Lease. However, as to the assigned or surrendered lands, Lessee will remain obligated for the proper performance of all express and implied Lease obligations. Lessee's liability for the non-performance of lease obligations, including the obligation to indemnify Lessor, will be in addition to the liability of any assignee obtaining an interest through the Lessee or any assignee obtaining an interest through Lessee's assignee.

Any person or entity obtaining an assignment of rights in the Lease: (1) Is deemed to have accepted liability for the non-performance of any express or implied Lease obligations, including the obligation to indemnify Lessor, accruing prior to the date of assignment; and (2) Is liable for the proper performance of express and implied lease obligations, including the obligation to indemnify Lessor, from and after the date of assignment. The liability of Lessee and all assignees transferred an interest in the Lease is joint and several.

G. Leveraging Liability with the Oil and Gas Lease--The Indemnity Clause

1. The lessor and lessee cannot get together and, by agreement, try to *transfer* CERCLA liability from lessor to lessee.

2. However, the lessor and lessee can agree that if the lessor is held liable, the lessee will reimburse the lessor for any amounts the lessor must pay to the state or federal government, or third parties.

3. CERCLA § 107(e), 42 U.S.C. § 9607(e) (1988) provides, in part:

(1) No indemnification, hold harmless, or similar agreement or conveyance shall be effective to transfer from the owner or operator of any . . . facility or from any person who may be liable for a release or threat of release . . . to any other person the liability imposed under this section. *Nothing in this subsection shall bar any agreement to insure, hold harmless, or indemnify a*

party to such agreement for any liability under this section.

4. However, the obligation of a lessee to indemnify is only as good as the lessee's ability to pay. **Should consider whether to require the lessee to back-up its promises with a bond, letter of credit, or other form of security.**

5. A benefit to the lessor, however, may be obtaining a responsible lessee to indemnify for any losses associated with operations conducted by the lessee *and existing oil and gas sites on the property.*

6. As with any lease provision, the lessor must have some bargaining power and be willing to refuse to lease unless they can obtain the assurances they feel are necessary.

7. In conjunction with the indemnity clause, you may want a general provision addressing the lessee's environmental responsibilities. For example:

   Lessee agrees to conduct its operations in strict compliance with all federal, state, and local environmental, health, and safety laws. [Lessee will remove all drilling wastes and related development or production wastes from the leased land and properly dispose of them at an approved site off the leased land. The obligation to remove wastes from the leased land applies only to wells drilled and operations conducted on the leased land pursuant to this lease.]

PART III

Ethics & Professional Responsibility

ETHICS AND THE TRANSACTIONAL LAWYER: PROFESSIONAL RESPONSIBILITY IN THE CONTRACTS CONTEXT

"Some day someone will read what you have written, trying to find something wrong with it."[1]

I. THE ETHICS OF "PRIVATE LAW-MAKING": DRAFTING CONTRACTS

A. Drafting Technique: The Uninformed use of Forms

1. A proper drafting process:

a. Pre-Drafting

(1) Understand the client's situation and goals.

(2) Consider requirements, limitations, and opportunities presented by local law: the "validation" process.

(a) Choice-of-law issues.

i) Consider the law of the states

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[1]David Mellinkoff, Legal Drafting: Sense & Nonsense 15 (West 1982).

to which the transaction has an appropriate nexus.

ii) Consider the default rules.

iii) Consider the benefits of a choice-of-law clause.

(b) Identify the applicable contract law.

i) Sale of goods?

ii) Non-UCC transaction?

iii) Consumer transaction?

iv) Special subject matter?

v) Special policy considerations?

(3) Address special requirements of the transaction.

b. Drafting

(1) State the transaction, applying the appropriate law, as accurately and simply as the circumstances permit.

(2) Use a functional format that enhances the clarity of the document.

(3) The goal is a document that effectively communicates the instructions the parties to the business relationship must follow.

c. Post-Drafting

(1) Edit, revise, test.

(2) Ensure post-drafting procedures are followed to protect the effectiveness of the contract.

(a) Authority to sign? Proof?

(b) Recording?

(3) Consider the ultimate administration of the contract.

(a) Can the client administer it?

(b) How will the client administer it?

(c) Periodic reviews?

(4) Advice for when things go wrong.

(a) Other party fails to perform.

(b) Client fails to perform.

2. "[T]he drafting process must begin with the attorney collecting the necessary facts and then 'thinking' about the transaction. Although this seems like an obvious requirement, too often the thought process begins and ends by selecting a likely 'form' for the transaction; a form which too often becomes the mold into which the deal is poured."

   1 David E. Pierce, Kansas Oil and Gas Handbook § 5.14, at 5-17 (1986).

3. "[O]nce the drafting process has been conducted regarding a particular subject, such as a mineral deed, it is not necessary to go back and 'reinvent the wheel' each time. Instead, it will be a matter of updating your research and consciously applying it to new facts. The major drafting problem, however, seems to be that many attorneys have never really 'invented the wheel;' they continue the process of using forms without independent analysis of why certain language is included in their documents."

   1 David E. Pierce, Kansas Oil and Gas Handbook § 5.16, at 5-18 (1986).

4. Rule 1.1 Competence provides:[2]

   "A lawyer shall provide competent representation to a client. Competent representation requires the

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[2]Unless otherwise noted, all Rule references are to the Kansas version of the Model Rules of Professional Conduct contained in Kansas Supreme Court Rule 226. 1995 Kan. Ct. R. Annot. 245, Rule 226.

legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation."

a. "Some important legal skills, such as the analysis of precedent, the evaluation of evidence and legal drafting, are required in all legal problems."

   Comment to Rule 1.1.

b. "Competent handling of a particular matter includes inquiry into and analysis of the factual and legal elements of the problem, and use of methods and procedures meeting the standards of competent practitioners."

   Comment to Rule 1.1.

c. "A legal draftsman who allows himself to be less than fully informed on both the underlying policies to be expressed and their background is not discharging his central responsibility."

   Reed Dickerson, The Fundamentals of Legal Drafting 9 (2d ed. 1986).

5. Rule 1.4 Communication provides, in part:

"(b) A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation."

a. "The client should have sufficient information to participate intelligently in decisions concerning the objectives of the representation and the means by which they are to be pursued . . . ."

   Comment to Rule 1.4.

b. For example, in a mineral conveyance does the client want to convey natural gas found in coal seams? Do they want to convey limestone and other solid minerals?

c. Use of a form often places the attorney in the position of making fundamental business decisions for their client without the

attorney, or their client, being aware of the situation.

6. Rule 2.1 Advisor provides, in part:

"In representing a client, a lawyer shall exercise independent professional judgment . . . ."

a. This may be the Rule most often implicated by the use of forms.

b. Has the attorney exercised their "independent professional judgment" to determine whether each term of a selected form effectively addresses the client's situation?

c. Or is the attorney effectively delegating these professional tasks to the party that drafted the form?

7. A note on billing: If the attorney applies proper drafting techniques for each transaction, it will require more time and cost the client more money in the short-term.

a. The time-saving, cost-cutting benefits of the "uninformed use of forms" flow to the client.

b. However, these benefits are at the expense of the client's long-term interests <u>and, equally important, they are obtained at the risk of the attorney who may be held liable for trying to save their client money--or save themself some time.</u>

c. In many situations, fees will be based on the time required to properly address the transaction.

d. In routine matters, where the attorney has invested the time to "invent the wheel," they may not be able to practically charge the first client for the full time required to invent. In that situation, the attorney may decide to charge a flat fee for preparation of the document and recoup their initial time investment from several clients.

(1) The guide is whether the fee is "reasonable." Rule 1.5(a).

(2) A major part of establishing a reasonable fee is ensuring the client has been informed, in the engagement letter, the basis for the fee. Rule 1.5(b).

e. The attorney should ensure their fees fully reflect the time required to properly apply the drafting process, and that the client knows going into the transaction how they will be billed--including an estimate of how much it is likely to cost.

(1) "When developments occur during the representation that render an earlier estimate substantially inaccurate, a revised estimate should be provided to the client." Comment to Rule 1.5.

(2) A major part of the attorney's client "communication" obligation is to provide the client with information that will permit the client to make "informed decisions regarding the representation." Rule 1.4. Accurate information concerning the cost of their legal services is a must for the client to make "informed decisions."

B. Drafting Technique: Zealous Representation in the Drafting Context

1. "As negotiator,[3] a lawyer seeks a result advantageous to the client but consistent with requirements of honest dealing with others."

Preamble to the Model Rules of Professional Conduct.

2. Drafting on the edge: Is it required?

a. The attorney's ethical limitations:

(1) "A lawyer shall abide by a client's decisions concerning the <u>lawful objectives</u> of representation . . . ."

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[3]This is the closest the Model Rules get to describing the attorney when functioning in the drafting context. The other categories are the attorney "as advisor" and the attorney "as advocate."

Rule 1.2(a) (emphasis added).

(2) "A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent . . . ." Rule 1.2(d).

(3) "It is professional misconduct for a lawyer to . . . (c) engage in conduct involving dishonesty, fraud, deceit or misrepresentation . . . ." Rule 8.4.

(4) Peter Siviglia observes in his book "Writing Contracts:"

(a) "[C]ommercial transactions are not adversarial proceedings. The goal is not to win; the goal is to do a deal that conforms to the intent of the parties. Thus, while the attorney must at all times represent the interests of the client, the attorney must not seek to gain an advantage contrary to the terms of the deal from a mistake by the other lawyer. An obvious example--and surely one that begs correction--is the inadvertent omission of a word . . . . Do unto the other lawyer as you would have that lawyer do unto you." Peter Siviglia, Writing Contracts 55 (1996).

(b) "[C]orrect drafting errors of the other attorney." Id.

(c) "[B]ecause the object of a contract is to reflect accurately the intent of all parties, I view this principle as an ethical obligation."[4] Id.

(d) "Allowing errors that one detects to remain uncorrected serves but two

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[4]It is: ABA Comm. on Ethics and Professional Responsibility, Informal Opinion 86-1518 (1986) (Lawyer whose client would be advantaged by inadvertent omission of important provision from contract to which client had previously agreed should bring error to attention of other party's lawyer and may do so without consulting his own client.).

demons: a perverse desire to gain an improper advantage; litigation that should never be spawned. The client is ill represented by this type of practice." Id.

b. The attorney's self-imposed ethical limitations:

(1) "[A] lawyer may withdraw from representing a client if withdrawal can be accomplished without material adverse effect on the interests of the client . . . ." Rule 1.16(b).

(2) "[A] lawyer may withdraw from representing a client . . . if . . . a client insists upon pursuing an objective that the lawyer considers repugnant or imprudent . . . ." Rule 1.16(b)(2).

c. Practical enforcement realities: even if it is "legal," will it work? Will a court enforce it?

(1) "In rendering advice, a lawyer may refer not only to the law but to other considerations such as moral, economic [business], social and political factors, that may be relevant to the client's situation." Rule 2.1.

(2) What sort of backlash might the provision create for the client--even if it is fully enforced by the courts?

d. When drafting on the edge the client must be fully informed of the risks associated with provisions a court may not enforce.

e. The client may not bring the matter up; should you? Must you?

(1) For example, an indemnity provision which indemnifies the client against their sole or concurrent negligence.

(2) For example, a forum selection clause designed to avoid the possibility of removal to federal court and determine all disputes in a designated state district court.

f. All provisions which may potentially assist your client should at least be considered--even though they may be rejected because of the legal or business risks they carry with them.

3. Negotiating on the edge.

a. Attorneys are often intimately involved with the give-and-take required to move a transaction from preliminary negotiations to final agreement.

b. The attorney's ethical limitations:

(1) "Rule 4.1 Truthfulness in Statements to Others provides:

"In the course of representing a client a lawyer shall not knowingly: (a) make a false statement of material fact or law to a third person; or (b) fail to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by or made discretionary under Rule 1.6."

(2) "A lawyer is required to be truthful when dealing with others on a client's behalf, but generally has no affirmative duty to inform an opposing party of relevant facts. A misrepresentation can occur if the lawyer incorporates or affirms a statement of another person that the lawyer knows is false. misrepresentations can also occur by failure to act." Comment to Rule 4.1.

(3) "In dealing on behalf of a client with a person who is not represented by counsel, a lawyer shall not state or imply that the lawyer is disinterested. When the lawyer knows or reasonably should know that the unrepresented person misunderstands the lawyer's role in the matter, the lawyer shall make reasonable efforts to correct the misunderstanding." Rule 4.3.

(a) "During the course of a lawyer's

representation of a client, the lawyer should not give advice to an unrepresented person other than the advice to obtain counsel." Comment to Rule 4.3.

(b) This can particularly be a problem in the corporate context: "In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when it is apparent that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing." Rule 1.13(d).

(c) Note that the attorney is not functioning as an "intermediary" because the attorney does not represent both parties. Rule 2.2.

(4) "In representing a client, a lawyer shall not communicate about the subject of the representation with a party the lawyer knows to be represented by another lawyer in the matter, unless the lawyer has the consent of the other lawyer or is authorized by law to do so." Rule 4.2.

(a) Contact with a represented party, regarding the matter at issue, must be carefully managed by all the lawyers involved.

(b) Avoid "communications" where the client is used to make the unauthorized contacts. For example, language in a letter is prepared by the attorney, given to the client, and then sent by the client to the represented party. See generally ABA Comm. on Ethics and Professional Responsibility, Formal Op. 95-396 (1996).

(5) "It is professional misconduct for a lawyer to . . . (c) engage in conduct involving dishonesty, fraud, deceit or misrepresentation . . . ." Rule 8.4.

c. The attorney's self-imposed ethical limitations:

(1) "Too often lawyers--or, perhaps, just too many lawyers--believe that when they draft an agreement, they must prepare the document to reflect only the interests of their client. They pay little, if any, attention to the legitimate concerns of the other party." Peter Siviglia, Writing Contracts 51 (1996).

(2) "[A]n appreciation of and an effort to honor the legitimate concerns of the other party in the drafting process is essential . . . to the efficient consummation of a transaction and the proper representation of one's client. . . . The attorney, therefore, does not compromise the client's interest by preparing a fair agreement; in fact, by doing so, the attorney furthers that interest." Peter Siviglia, Writing Contracts 54 (1996).

C. The Evolution of Model Rule 1.2(d)

1. The current version of the Rule provides:

"A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent . . . ."

2. Discussion Draft of Rule 4.3 (January, 1980), which was rejected, provided:

"A lawyer shall not conclude an agreement, or assist a client in concluding an agreement, that the lawyer knows or reasonably should know is illegal, contains legally prohibited terms, would work a fraud, or would be held to be unconscionable as a matter of law."

3. The Comment to Discussion Draft Rule 4.3 provided: "[A] lawyer is not absolved of responsibilities for a legally offensive transaction simply because the client takes the final step in carrying it out. For example, a lawyer who prepared a form contract containing legally prohibited terms is involved in a transaction in which the form is used, even though the lawyer does not participate in the

specific transaction."

4. Final Proposed Draft of Rule 1.2, which was rejected, provided:

"A lawyer shall not counsel or assist a client in conduct that the lawyer knows or reasonably should know is criminal or fraudulent, or in the preparation of a written instrument containing terms the lawyer knows or reasonably should know are legally prohibited . . . ."

5. The Comment to Final Proposed Draft Rule 1.2 provided:

"Law in many jurisdictions prohibits various provisions in contracts and other written instruments. Such proscriptions include usury laws, statutes prohibiting provisions that purport to waive certain legally conferred rights and contracts provisions that have been held unconscionable as a matter of law in the controlling jurisdiction. A lawyer may not employ these terms. On the other hand, there are legal rules that simply make certain contractual provisions unenforceable, allowing one or both parties to avoid the obligation. Inclusion of the latter kind of provision in a contract may be unwise but it is not ethically improper, nor is it improper to include provisions whose legality is subject to reasonable argument."

6. Analysis of the final version of Rule 1.2:

   a. Intent to exclude drafting altogether?

   b. Is the deliberate inclusion of an unenforceable clause prohibited?

      (1) Is it "criminal"?

      (2) Is it "fraudulent"?

   c. "The fact that the drafters enumerated 'the preparation of a written instrument' as something additional to criminal or fraudulent conduct suggests that they did not regard the practice as fraudulent." Scott J. Burnham, Drafting Contracts § 4.7, 65 (2d ed. 1993).

7. Is Rule 8.4 broader: "engage in conduct involving dishonesty, fraud, deceit or misrepresentation;"?

II. MULTI-JURISDICTIONAL PRACTICE

"At present, . . . highly qualified . . . attorneys commit misdemeanors every day they go to work by practicing in jurisdictions where they are not licensed."[5]

A. The Problem:

1. "As a matter of law and ethics, a lawyer is obligated not to engage in the practice of law in any jurisdiction in which he has not been granted either permanent admission or permission to appear pro hac vice. Admission to practice in one state is not automatic admission to practice in another state."

   Lawyers' Manual at § 21:2001 (1995).

2. One exception that could apply:

   "However, a lawyer may practice before a federal court or agency without securing either permanent or temporary admission to practice in the jurisdiction in which the court or agency is located if the rules of the court or agency so permit."

B. Guidance from the Model Rules of Professional Conduct

1. RULE 5.5 Unauthorized Practice of Law

   "A lawyer shall not:

   (a) practice law in a jurisdiction where doing so

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[5] Bar Admissions Program Looks at In-House Corporate Counsel, 2 ABA/BNA Lawyer's Manual on Professional Conduct 404 (Feb. 5, 1986) [hereinafter cited as **"Lawyer's Manual"**].

violates the regulation of the legal profession in that jurisdiction; or

(b) assist a person who is not a member of the bar in the performance of activity that constitutes the unauthorized practice of law."

2. RULE 8.5 Jurisdiction

"A lawyer admitted to practice in this jurisdiction is subject to the disciplinary authority of this jurisdiction although engaged in practice elsewhere."[6]

3. Comment to RULE 8.5

"In modern practice lawyers frequently act outside the territorial limits of the jurisdiction in which they are licensed to practice, either in another state or outside the United States. In doing so, they remain subject to the governing authority of the jurisdiction in which they are licensed to practice. If their activity in another jurisdiction is substantial and continuous, it may constitute practice of law in that jurisdiction. See Rule 5.5."[7]

4. RULE 1.1 Competence

"A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation."

C. Guidance from the Model Code of Professional Responsibility

1. CANON 3

A Lawyer Should Assist in Preventing the Unauthorized Practice of Law

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[6]The current ABA version of this Rule contains a choice of law provision regarding lawyers who are admitted to practice in more than one jurisdiction.

[7]This comment has been deleted from the ABA's 1993 amendment to the Rule.

2. Ethical Consideration EC 3-9 provides:

"Regulation of the practice of law is accomplished principally by the respective states. Authority to engage in the practice of law conferred in any jurisdiction is not per se a grant of the right to practice elsewhere, and it is improper for a lawyer to engage in practice where he is not permitted by law or by court order to do so. However, the demands of business and the mobility of our society pose distinct problems in the regulation of the practice of law by the states. In furtherance of the public interest, the legal profession should discourage regulation that unreasonably imposes territorial limitations upon the right of a lawyer to handle the legal affairs of his client or upon the opportunity of a client to obtain the services of a lawyer of his choice in all matters including the presentation of a contested matter in a tribunal before which the lawyer is not permanently admitted to practice."

3. Disciplinary Rule DR 3-101(B) provides:

"A lawyer shall not practice law in a jurisdiction where to do so would be a violation of regulations of the profession in that jurisdiction."

D. The Essential Issues:

1. When does someone "practice law"?

2. When does such practice take place "in a jurisdiction"?

E. Defining the Practice of Law

1. Courts have deliberately refused to define the term.

2. "We believe it is sufficient to state that those acts, whether performed in court or in the law office, which lawyers customarily have carried on from day to day through the centuries must constitute the practice of law."

State Bar of Arizona v. Arizona Land Title & Trust Co., 90 Ariz. 76, 366 P.2d 1, 9 (1961), reh'g denied, 91 Ariz. 293, 371 P.2d 1020 (1962).

3. General guidelines:

   a. Litigation. If not admitted to practice in the state where the litigation is taking place, the appropriate steps to be admitted pro hac vice must be taken. See, e.g., K.S.A. § 7-104 (1991) (applies to business "in the courts or before any board, department, commission or other administrative tribunal or agency . . . .").

      (1) Must have a matter pending before a judge who can make the determination whether out-of-state counsel should be allowed to participate.

      (2) No similar procedure in the non-litigation context.

   b. Non-litigation. If not admitted to practice in the state, you must ascertain what that state regards as the "practice of law."

4. Cases indicate that drafting documents and rendering opinions constitute the practice of law.

5. Negotiating and drafting contracts on behalf of a corporate employer:

   a. "[S]ince a corporation may act only through its duly authorized directors, officers, employees, and agents, an inside counsel who negotiates and drafts a contract on behalf of his employer is not likely to be deemed practicing law."

      David G. Ebner, Crossing the Border: Issues in the Multistate Practice of Law, 35 **Rocky Mountain Mineral Law Inst.** 2-1, 2-6 (1990) [hereinafter cited as "Crossing the Border"].

   b. "It is generally recognized that an out-of-state lawyer may perform services outside the state of his admission as a full-time employee of the client (as house counsel, for example), or on an occasional basis incidental to representation being provided in the state of admission, or in assisting a locally admitted lawyer." Geoffrey C. Hazard, Jr. & W. William Hodes, **The Law of Lawyering** § 8.5:101 at 968-969 (2d ed. 1994) [hereinafter cited as "**Law of Lawyering**"].

6. Special rules for multistate transactions:

   a. New Jersey courts have permitted a limited amount of out-of-state practice when it is incidental to a transaction having a nexus with a state in which the attorney is licensed.

   b. The rationale:

      "Multistate relationships are a common part of today's society and are to be dealt with in a commonsense fashion. While the members of the general public are entitled to full protection against unlawful practitioners, their freedom of choice in the selection of their own counsel is to be highly regarded and not burdened by technical restrictions which have no reasonable justification."

      Estate of Waring v. Sykes, 47 N.J. 367, 221 A.2d 193, 197 (1966).

7. Professors Hazard and Hodes offer the following hypothetical in their treatise:

   "Lawyer L is licensed only in State X. He and his client travel to neighboring State Y to engage in a complex set of negotiations with representatives of Company Y, headquartered in Y. The company is represented by a lawyer licensed in Y, and eventually a contract is signed, after L insists that certain amendments be made. The contract states that it is considered to be a contract under the laws of Y, should a choice of law question later arise.

   Case law in Y has consistently held that drafting or negotiating contracts is per se the practice of law when done by a layman."

   Law of Lawyering, §5.5:203 at 817.

8. The Hazard/Hodes solution to the hypothetical:

   a. "It does not follow that L has violated the rules against unauthorized practice in State Y. The transaction is not wholly localized, for it has a nexus to State X, where L's client is headquartered and L is licensed. Although there are but few recent decisions reflecting contemporary practice, the accepted

understanding in the legal profession is that L's conduct is proper."

b. "If, on the other hand, the transaction was simply a conveyance of real estate in State Y, and L, the out-of-state lawyer, drafted the deed and mortgage, that would be a localized transaction and would probably constitute unauthorized practice."

c. "If L's activities constitute the unauthorized practice of law in State Y, he will have violated Rule 5.5(a) *in State X*. . . . Furthermore, the lawyer on the opposite side, by not insisting upon the participation of an in-state lawyer, has assisted this violation, and has violated both Rule 5.5(b) and Rule 8.4(a) *in State Y*."

Law of Lawyering § 5.5:203 at 817-818.

9. The "practice of law" in Kansas:

a. "'The main general test is unlawful practice of law cases seems to be whether or not an attorney-client relationship exists. That is, whether the person whose conduct is under scrutiny represented or implied he had legal knowledge beyond that of a layman and provided "professional" assistance to a "client."

State v. O'Keefe, 235 Kan. 1022, 1034 (1984) (mandamus action against Judge O'Keefe, Jr. and various non-lawyer inmates of the Kansas State Penitentiary who were representing other inmates in various legal proceedings).

b. In re Wilkinson, 251 Kan. 546, 553 (1992) (suspended attorney can work as a law clerk for licensed attorney but "[a]ny contact with a client is prohibited.").

F. The Kansas Analysis

1. Constitutional Authority: Kansas Constitution Article 3, § 3 (original jurisdiction in proceedings in quo warranto).

2. Statutory Authority:

a. K.S.A. § 60-1202(1) (quo warranto against person known to "unlawfully hold or exercise

any public office, or shall claim any franchise within this state . . . .").

b. K.S.A. § 7-103 (Supreme Court adopt rules regulating admission to the bar, discipline, and disbarment).

c. K.S.A. § 7-104 (admission of attorneys to appear with local counsel in state courts or "before any board, department, commission or other administrative tribunal or agency, of this state . . . ."). See also Kansas Supreme Court Rules 1.01(f), 116, 705(b).

d. K.S.A. § 7-106 ("deceit or collusion" treble damages disbarment statute--private right of action).

e. K.S.A. § 7-111 (disbarred or disciplined "[f]or destroying, secreting, fraudulently withdrawing, mutilating, or altering any paper or record belonging to the files or records in any action or proceeding.").

f. K.S.A. § 7-106 (1991): "An attorney or counselor who is guilty of deceit or collusion, or consents thereto, with intent to deceive a court or judge, or a party to an action or proceeding, or brings suit or commences proceedings without authority therefor, is liable to be disbarred, and shall forfeit to the injured party treble damages, to be recovered in a civil action."

3. Supreme Court Rules:

a. Rules 201 through 227 contemplate the regulation of attorneys admitted to the Kansas Bar.

b. Rules 701 through 710 deal with qualifications for admission to the Kansas Bar and the admissions process.

c. Rule 705 Temporary Permit to Practice.

d. Rule 706 Temporary Licensure for Attorneys Performing Legal Services for a Single Employer.

e. Rule 709 Legal Interns.

f. Rules 801 through 809 deal with continuing legal education requirements.

4. The Kansas statutes and rules do not address the unauthorized practice of law by someone who is not admitted to the Bar.

5. Common Law Guidance: State v. Perkins, 138 Kan. 899 (1934).

a. Perkins asserted that since he had been admitted to practice law in Missouri he should be entitled to appear in the courts of Kansas.

b. The Supreme Court's reply:

"The license or permission to practice law in one state is not extraterritorial." 138 Kan. at 902.

c. Legal basis for bringing action against Perkins:

"Our constitution (art. 3, § 3) gives this court original jurisdiction in proceedings in quo warranto, and our statute (R.S. 60-1602) [now K.S.A. § 60-1202 (1994)] authorizes such actions when any person shall usurp, intrude into, or unlawfully hold or exercise any public office or shall claim any franchise within this state. While an attorney at law is not a public officer in the sense that term is ordinarily used, he is nevertheless "an officer of the court" . . . and as such is part of the judicial system of the state, and he obtains that position under and by virtue of the constitution and laws of the state relating to that office and to the judicial branch of our government. Also, his authority, or permit, or license to act as an attorney at law is a privilege "in the nature of a franchise from the state conferred only for merit" . . . and revocable on his violation of his obligations and duties."

d. The Court in Perkins adopts the following statement of the rule by the Illinois Supreme Court:

"'Having power to determine who shall and who shall not practice law in this state, and to license those who may act as attorneys and

forbid others who do not measure up to the standards or come within the provisions of the rules, it necessarily follows that this court has the power to enforce its rules and decisions against offenders, even though they have never been licensed by the court. Of what avail is the power to license in the absence of power to prevent one not licensed from practicing as an attorney? In the absence of power to control or punish unauthorized persons who presume to practice as attorneys and officers of this court, the power to control admissions to the bar would be nugatory. And so it has been held that the court, which alone has authority to license attorneys, has as a necessary corollary ample implied power to protect this function by punishing unauthorized persons for usurping the privilege of acting as attorneys.'"

Perkins, 138 Kan. at 904.

6. The procedural mechanism:

"A proceeding in the nature of quo warranto in this court by the state on the relation of the attorney-general is appropriate to inquire into the authority of one who engages in the practice of law in this state. The ancient writ was a demand made by the state on some individual to show by what right he exercised some franchise or privilege appertaining to the state which, according to the laws of the land, he could not legally exercise except by some grant of authority."

Perkins, 138 Kan. at 905.

7. Reasoning for taking action:

Consider this statement by the Supreme Court of Connecticut: "The practice of law is not a craft or a trade; it is a profession the main purpose of which is to aid in the doing of justice according to law between the state and individual and between man and man. The occasions upon which an attorney may be required to act touch, in many instances, the deepest and most precious concerns of men, women, and children. They may involve the liberty, the property, the happiness, the character and the life of his client. Obviously, one not possessing an adequate degree of intelligence and education cannot perform this kind of service, nor should he

be permitted to attempt to do so. . . .

"The ultimate purpose of all regulations of the admission of attorneys is to assure the courts the assistance of advocates of ability, learning, and sound character and to protect the public from incompetent and dishonest practitioners."

Rosenthal v. State Bar Examining Committee, 116 Conn. 409, 165 Atl. 211, 213, (1933).

G. Texas Statutory Definitions of the Practice of Law

1. Texas Government Code § 81.101 (West 1988) provides:

"(a) In this chapter the "practice of law" means the preparation of a pleading or other document incident to an action or special proceeding or the management of the action or proceeding on behalf of a client before a judge in court as well as a service rendered out of court, including the giving of advice or the rendering of any service requiring the use of legal skill or knowledge, such as preparing a will, contract, or other instrument, the legal effect of which under the facts and conclusions involved must be carefully determined.

"(b) The definition in this section is not exclusive and does not deprive the judicial branch of the power and authority under both this chapter and the adjudicated cases to determine whether other services and acts not enumerated may constitute the practice of law."

2. In 1989 the Texas Legislature adopted the following statute:

"(a) A person, other than a person described in Subsection (b), may not charge or receive, either directly or indirectly, any compensation for all or any part of the preparation of a legal instrument affecting title to real property, including a deed, deed of trust, note, mortgage, and transfer or release of lien.

"(b) This section does not apply to:

(1) an attorney licensed in this state;

(2) a licensed real estate broker or

salesman performing the acts of a real estate broker pursuant to The Real Estate License Act . . . ;

(3) a person performing acts relating to a transaction for the lease, sale, or transfer of any mineral or mining interest in real property.

. . . ."

Texas Government Code § 83.001 (West Supp. 1995).

a. Section 83.003 states:

"This chapter does not prevent a person from completing lease or rental forms that:

(1) have been prepared by an attorney licenses in this state and approved by the attorney for the particular kind of transaction involved . . . ."

b. Section 83.006 states:

"A violation of this chapter constitutes the unauthorized practice of law and may be enjoined by a court of competent jurisdiction."

H. Practicing Law <u>In</u> a Jurisdiction

1. The place where the work is performed is an important factor.

2. "While a state obviously has a legitimate interest in protecting its citizens from incompetent and unethical legal representation by persons not licensed to practice law within its borders and to protect its reputation by prohibiting lawyers licensed in other states from establishing practices solely to advise clients on the laws of such other states, such interests are much less clear if a transaction is negotiated outside the state by citizens of different states, or even by a citizen of the state who has left the jurisdiction for purposes of the negotiation. A state's attempted regulation of the lawyers involved in such transactions presents extremely close questions of constitutional law and the permissible extraterritorial reach of state legislation."

<u>Crossing the Border</u> at 2-11.

3. North Dakota Ethics Opinion No. 93-04, Feb. 26, 1993: "An out-of-state lawyer serving as general counsel to a domestic insurance company may provide legal services to its North Dakota-domiciled affiliate even though he is not licensed in North Dakota, so long as he provides the services from outside the state of North Dakota.

   Lawyers' Manual at § 1001:6703 (1994).

4. Pennsylvania Ethics Opinion No. 91-58, May 13, 1991: "A lawyer who wishes to represent a company and it subsidiaries before administrative agencies in Pennsylvania and in negotiations of PUC contracts in the state must become duly licensed in Pennsylvania because conducting such extensive legal activities that require a continued presence in the state and knowledge of applicable state law is tantamount to practicing law."

   Lawyer's Manual at § 1001:7305 (1992).

5. Kansas Ethics Opinion No. 80-27, Aug. 27, 1980: "An attorney may draw wills in conformity with Oklahoma law while practicing in the state of Kansas. While the state may question the propriety of this, for ethical purposes, the preparation of a will for a resident of Oklahoma is not the practice of law in Oklahoma, unless the attorney goes to Oklahoma to draw up the will."

   Lawyer's Manual at § 801:3802 (1986).

   a. The Kansas opinion evaluated whether the activity would be viewed as improper under Kansas law.

   b. The inquiry today would be whether the activity in Kansas would be viewed as improper under Oklahoma law. Oklahoma may not be willing to take such a liberal view of Kansas attorneys drafting wills for Oklahoma residents.

6. Consider the observations of Professor Stephen Gillers who teaches ethics at New York University School of Law:

   "A lawyer who gives advice in a state in which she is not admitted may transgress unauthorized practice rules even though she could give the same client the same advice by phone, fax, or modem from

her desk. 'In' is the critical term here. Geography is destiny."

Stephen Gillers, "Conflict of Laws: Real-World Rules for Interstate Regulation of Practice," 79 **American Bar Association Journal** 111 (April 1993) [hereinafter cited as "Real World Rules"].

7. Professor Gillers proposes a relaxed unauthorized practice rule which recognizes the multistate nature of most transactions. However, even Professor Gillers would prohibit "preparation or documents affecting an interest in real property . . . ." Real World Rules at 111. This prohibition would even apply to in-house counsel.

I. Some Guidelines

1. The unauthorized practice rules are intended to ensure ethical behavior and competence in local law.

2. Do not hold yourself out as willing or able to handle matters in a state in which you are not licensed.

3. Matters of federal law will generally not require local licensing.

4. Matters of purely local law should be avoided as their complexity increases--or as the likelihood of disputed issues increases.

   a. Examine the law of the state impacted by the legal work to determine whether it is expressly permitted.

   b. Drafting conveyances and similar documents have traditionally given rise to *per se* violations.

   c. If the matter gives rise to a controversy, counsel for the other party may try to make your representation an issue.

5. Do as much of your work as possible within the state where you are licensed.

6. Remember that regardless of your status, you will be held to the same standard of care as an attorney licensed to practice in the jurisdiction.

J. Bar Admission for In-House Counsel

1. Must in-house counsel be admitted to the Bar of the state in which they work as in-house counsel?

2. Hypothetical question put to the chief justices of the fifty state supreme courts:

   "Is it unauthorized practice of law for an attorney working for a corporation in your state, which has offices in other states, to furnish legal advice, draft documents, and/or interpret and give legal advice with respect to both state and federal law if s/he is not licensed in your state, but is licensed in another jurisdiction?"[8]

   Daniel A. Vigil, Regulating In-House Counsel: A Catholicon or a Nostrum? 77 **Marquette Law Review** 307, 308 (1994) [hereinafter cited as "Regulating In-house Counsel"].

   a. Sixteen jurisdictions responded.

   b. Those indicating it would not be unauthorized practice of law: Alabama, Nebraska, and South Dakota.

   c. South Dakota's reply stated: "We are of the view that the rule is that a corporation may use a staff attorney to conduct its own legal affairs, and that a staff attorney, so long as his or her practice is restricted to rendering legal services to his or her employer, and does not include making appearances in the Court of the State of South Dakota, need not be licensed in any jurisdiction." Regulating In-House Counsel at 309-310.

   d. Those indicating it would be unauthorized practice of law: Georgia, Illinois, Massachusetts, Missouri, and West Virginia.

   e. Those indicating no formal action would be taken: Indiana and Rhode Island.

   f. Those with temporary or limited licenses: Kansas (See Kansas Supreme Court Rule 706--

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[8]It is not clear, the way the question is posed, whether the attorney will be physically in the state when they perform the work.

must have been licensed in another jurisdiction, following examination, for five years prior to making application), Ohio, Minnesota, Michigan, Kentucky, and South Carolina.

g. For the jurisdictions that failed to respond to the question, the author of the article examines the available law and suggests what he thinks would be the answer. See Regulating In-House Counsel at 310-311, 314-315, 317-319.

K. Helpful Recent Commentary

1. Symposium: Ethics and the Multijurisdictional Practice of Law, 36 South Texas Law Review 657-1197 (1995).

2. Charles W. Wolfram, Sneaking Around in the Legal Profession: Interjurisdictional Unauthorized Practice By Transactional Lawyers, 36 S. Tex. L.R. 665 (1995).

III. REPRESENTING THE ORGANIZATION

> *"[A] lawyer's first task--often a difficult one--is to identify the client who will be entitled to his loyalty, to zealous representation, and to the protection of the confidentiality rule."*[9]

The Situation:

David has been in-house counsel to the Acme Corporation (a fictitious entity) for several years. David has developed an excellent working relationship with Forrest, a vice-president of Acme. On Tuesday, November 28, 1995, Forrest was informed by one of Acme's production managers (Dock) that for several years Acme has been disposing of waste material on-site which was thought to be non-hazardous. However, upon closer review of the waste, it clearly appears it is classified as a hazardous waste under the federal Resource Conservation and Recovery Act (RCRA). David has indicated that due to the type and quantity of the waste placed on site, Acme is obligated to report under the federal Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) and similar state law statutes.

CERCLA § 103(a) requires that: "Any person in charge . . . shall, as soon as he has knowledge of any release . . . of a hazardous substance from such . . . facility in [specified] quantities . . , immediately notify the National Response Center . . . ." Failure to report immediately "as soon as he has knowledge of such release" is a crime punishable by imprisonment for up to 3 years. [CERCLA § 103(b)(3)]. Violation of § 103(a) can also give rise to a civil penalty of "$25,000 per day for each day during which the violation (or failure or refusal) continues . . . ." [CERCLA § 109(c)]. There is also a bounty "of up to $10,000 to any individual who

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[9]Geoffrey C. Hazard, Jr. & William Hodes, **The Law of Lawyering**, § 1.12:102 at 387 (2d ed. 1994) [hereinafter cited as **"Law of Lawyering"**].

provides information leading to the arrest and conviction of any person for violation subject to a criminal penalty under this chapter, including any violation of [§ 103] . . . ." [CERCLA § 109(d)].

Forrest has informed David that the way Acme will respond to the problem is to cease on-site disposal of the waste immediately. Next, it will comply fully with RCRA to have the waste it is generating properly disposed of as a hazardous waste. Finally, it will also remove the waste it has disposed of on-site and have it properly disposed of as a hazardous waste. David asks Forrest about the CERCLA reporting obligation. At 8:30 a.m. on November 29, 1995 Forrest instructs David that no report will be made--but that Forrest has committed all the company resources necessary to rectify the problem and, if it is discovered that the situation presents a true health hazard, Acme will then report.

At 9:30 a.m. on November 29, 1995 Dock contacts David and wants to know how he should handle the reporting problem. Dock also wants to know if he could be held personally liable for the problem and whether the company will stand behind him in the event the Environmental Protection Agency takes action.

A. The Initial Problem: Who is the Client?

1. The "entity" (Acme Corporation)?

2. All of the individuals that represent the entity (Acme, Dock, and Forrest)?

3. The entity <u>and</u> the individuals that represent the entity (like Dock and Forrest)?

4. The entity and <u>some</u> of the individuals that represent the entity (like Forrest)?

B. Guidance from the Model Rules of Professional Conduct (An Outline of the Rule and Comment)

1. RULE 1.13 Organization as Client

"(a) A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.

"(b) If a lawyer for an organization knows that an officer, employee or other person

associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law which reasonably might be imputed to the organization, the lawyer shall proceed as is reasonably necessary in the best interest of the organization. In determining how to proceed, the lawyer shall give due consideration to the seriousness of the violation and its consequences, the scope and nature of the lawyer's representation, the responsibility in the organization and the apparent motivation of the person involved, the policies of the organization concerning such matters and any other relevant considerations. Any measures taken shall be designed to minimize disruption of the organization and the risk of revealing information relating to the representation to persons outside the organization. Such measures may include among others:

(1) asking reconsideration of the matter;

(2) advising that a separate legal opinion on the matter be sought for presentation to appropriate authority in the organization; and

(3) referring the matter to higher authority in the organization, including, if warranted by the seriousness of the matter, referral to the highest authority that can act in behalf of the organization as determined by applicable law.

"(c) If, despite the lawyer's efforts in accordance with paragraph (b), the highest authority that can act on behalf of the organization insists upon action, or a refusal to act, that is clearly a violation of law and is likely to result in substantial injury to the organization, the lawyer shall follow Rule 1.16 ["Terminating Representation"].

"(d) In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when it is apparent that the organization's interests are adverse to those of the constituents with whom the

lawyer is dealing.

"(e) A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 1.7 ["Conflict of Interest"]. If the organization's consent to the dual representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders."

2. Comments to RULE 1.13:

   a. "An organizational client is a legal entity, but it cannot act except through it officers, directors, employees, shareholders and other constituents."

   b. "Officers, directors, employees and shareholders are the constituents of the corporate organizational client."

   c. "When constituents of the organization make decisions for it, the decisions ordinarily must be accepted by the lawyer even if their utility or prudence is doubtful."

   d. "However, different considerations arise when the lawyer knows that the organization may be substantially injured by action of a constituent that is in violation of law."

      (1) "In such a circumstance, it may be reasonably necessary for the lawyer to ask the constituent to reconsider the matter."

      (2) "If that fails, or if the matter is of sufficient seriousness and importance to the organization, it may be reasonably necessary for the lawyer to take steps to have the matter reviewed by a higher authority in the organization."

         (a) "Clear justification should exist for seeking review over the head of the constituent normally responsible for it."

         (b) "The stated policy of the

organization may define circumstances and prescribe channels for such review, and a lawyer should encourage the formulation of such a policy."

(c) "Even in the absence of organization policy, however, the lawyer may have an obligation to refer a matter to higher authority, depending on the seriousness of the matter and whether the constituent in question has apparent motives to act at variance with the organization's interest."

(d) "Review by the chief executive officer or by the board of directors may be required when the matter is of importance commensurate with their authority."

(3) "At some point it may be useful or essential to obtain an independent legal opinion."

(4) "In an extreme case, it may be reasonably necessary for the lawyer to refer the matter to the organization's highest authority."

(a) "Ordinarily, that is the board of directors or similar governing body."

(b) "However, applicable law may prescribe that under certain conditions highest authority reposes elsewhere; for example, in the independent [outside] directors of a corporation."

e. "There are times when the organization's interest may be or become adverse to those of one or more of its constituents."

(1) "In such circumstances the lawyer should advise any constituent, whose interest the lawyer finds adverse to that of the organization of the conflict or potential conflict of interest, that the lawyer cannot represent such constituent, and

that such person may wish to obtain independent representation."

(2) "Care must be taken to assure that the individual understands that, when there is such adversity or interest, the lawyer for the organization cannot provide legal representation for that constituent individual, and that discussion between the lawyer for the organization and the individual may not be privileged."

(3) "Whether such a warning should be given by the lawyer for the organization to any constituent individual may turn on the facts of each case."

f. "Paragraph (e) recognizes that a lawyer for an organization may also represent a principal officer or major shareholder."

C. Guidance from the Model Code of Professional Responsibility

1. There is no Canon or Disciplinary Rule addressing the matter.

2. Ethical Consideration EC 5-18 provides:

"A lawyer employed or retained by a corporation or similar entity owes his allegiance to the entity and not to a stockholder, director, officer, employee, representative, or other person connected with the entity. In advising the entity, a lawyer should keep paramount its interests and his professional judgment should not be influenced by the personal desires of any person or organization. Occasionally, a lawyer for an entity is requested by a stockholder, director, officer, employee, representative, or other person connected with the entity to represent him in an individual capacity; in such a case the lawyer may serve the individual only if the lawyer is convinced that differing interests are not present."

3. Ethical Consideration EC 5-24 states:

"[A]lthough a lawyer may be employed by a business corporation with non-lawyers serving as directors or officers, and they necessarily have the right to make decisions of business policy, a lawyer must

decline to accept direction of his professional judgment from any layman."

D. The "Entity" vs. "Group" Theory

1. The Model Rules and the Code of Professional Responsibility each adopt the "entity" theory which recognizes the corporation, partnership, and other organizations as being a separate entity from the people through which the entity acts.

2. "The basic precept of Rule 1.13 is that a lawyer representing an entity client does <u>not</u> thereby (and without more) become the lawyer for any of the entity's members, agents, officers, of other "constituents," as they are referred to in the rule; the lawyer instead represents the entity itself."

   Law of Lawyering § 1.13:102 at 387.

3. The "group" theory views the attorney as representing the entity plus certain officers and directors who have a major role in the management of the company.

   a. This theory was rejected by the Kutak Commission and the entity theory was adopted instead.

   b. Under the entity theory the interests of officers, directors, and others are considered in the context of being non-clients of the attorney.

   c. The major weakness of the group theory is that it breaks down when the interests of the various members of the group, and those of the entity, conflict.

4. Professors Hazard and Hodes observe:

   "In the face of an irreconcilable conflict of interest under the group theory, the lawyer would usually be forced to cease representing <u>any</u> member of a constituent group, including the entity itself. By contrast, the lawyer would have no formal conflict of interest under the entity theory, for he was only on one "side" to begin with. He would be required to stay loyal to his

only client--the entity; that, in turn, might well require him to be "disloyal" to a particular individual. Although in human terms such a "betrayal" might be very distasteful, it is a legally correct and necessary consequence of the well-established principles of agency law upon which the entity theory rests."

Law of Lawyering § 1.13:105 at 393.

5. The principles of agency law referred to by Hazard and Hodes are as follows:

"When an agent for a principal hires another agent for the principal, the second individual does not become a subagent of the first. Instead, the two become co-agents, and owe allegiance to their common principal rather than to one another. Hence, a corporation's lawyer is not employed "by" its officers or board of directors, but "by" and "for" the corporation acting through those agents. This explains why it is proper, indeed necessary, for an entity lawyer to turn against a co-agent, if, in the lawyer's judgment, the co-agent is harming the entity."

Law of Lawyering § 1.13:105 at 393-394.

E. Confidential Information

1. Information given to the lawyer by agents of the entity must be disclosed to the entity when disclosure would serve the best interests of the entity.

2. Confidential entity information cannot be disclosed to a "constituent" of the entity that has no need to know the information.

3. Only the client, the entity, can waive the privilege.

F. Obligations to the Constituents of the Entity

1. RULE 1.13 (d) requires the lawyer, in dealing with an organization's constituents, to "explain the identity of the client when it is apparent that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing."

2. RULE 4.3 Dealing with Unrepresented Person

"In dealing on behalf of a client with a person who is not represented by counsel, a lawyer shall not state or imply that the lawyer is disinterested. When the lawyer knows or reasonably should know that the unrepresented person misunderstands the lawyer's role in the matter, the lawyer shall make reasonable efforts to correct the misunderstanding."

3. Professors Hazard and Hodes offer the following analysis:

"Although other "constituents" within the organization--the lawyer's co-agents--are not entitled to the loyalty owed a client under the law of lawyering, fairness dictates that they be given as much consideration as possible so long as the entity does not suffer. This is especially true when individuals may not appreciate their status. High corporate officials often consider themselves to be indistinguishable from the entity, and in the normal course of events are entitled to do so. Furthermore, they are usually the ones who hired and set his salary, making it even more likely that they will incorrectly assume him to be "their" lawyer. Unless informed, they may not understand that the lawyer is a co-agent and not a sub-agent, nor will they have reason to appreciate the important distinction between those relationships. In particular, unless warned they may confide in the lawyer even when their interests diverge from those of the entity."

Law of Lawyering § 1.13:109 at 399-400.

4. The corporate constituent Miranda warning:

a. Triggered when the entity's interests may be, or are likely to become, adverse to those of one or more of its constituents.

b. The lawyer for the entity must:

(1) Advise the constituent of the conflict, or potential conflict, of interest;

(2) That the entity lawyer cannot represent the constituent;

(3) Discussions with the entity lawyer may

not be privileged and will be disclosed to the entity; and

(4) The constituent may want to obtain independent representation.

c. "Whether such a warning should be given by the lawyer for the organization to any constituent individual may turn on the facts of each case." RULE 1.13 Comment, Clarifying the Lawyer's Role.

G. RULE 1.13--A Procedural Guide for Corporate Counsel

"Rule 1.13 has been controversial largely because it has been misunderstood. It is not a rule about disclosures outside an entity, but serves primarily as an analytic tool for understanding relationships and hierarchies within and entity, and the problem of communicating with a client which in reality is only a non-existent fiction."

1. RULE 1.13(a): the client is the entity, not the constituents that act for the entity.

2. RULE 1.13(b): instructs the attorney on how to proceed when they learn a constituent is violating a legal obligation to the entity, or violating a law which may be imputed to the entity, and such action is likely to result in substantial injury to the entity.

   a. First, the overriding goal is to act in the best interest of the entity.

   b. Second, the lawyer must evaluate the seriousness of the violation and its consequences.

   c. Third, consider the nature of your position--notifying the general counsel my be sufficient.

   d. Fourth, consider any policies of the entity regarding the matter--a procedure may be specified.

   e. Fifth, any measure selected must be designed to minimize disruption of the entity and the risk of revealing information to persons

outside the entity.

f. Sixth, ask the party taking the action to reconsider the matter.

g. Seventh, advise that the entity obtain a separate legal opinion on the matter.

h. Eighth, refer the matter to higher authority within the entity, including the highest authority "if warranted by the seriousness of the matter."

i. Ninth, if the highest authority refuses to act, and the action is a clear violation of law, and is likely to result in substantial injury to the organization, "the lawyer shall follow Rule 1.16" and consider whether to terminate their representation of the entity.

3. RULE 1.13(d): entity lawyer will inform constituents that the entity, not the constituents, is the lawyer's client.

4. RULE 1.13(e): entity lawyer can represent constituents consistent with RULE 1.7 Conflict of Interest. If the entity's consent is required, the consent "shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders."

5. RULE 1.13 addresses the lawyer's obligations to protect the entity; other rules, and other statutes, may impose obligations on the lawyer to protect the public. However, the focus of RULE 1.13 is on the best interests of the client--the entity.

H. Analysis--What Should David Do? Nothing? Something?

1. We can all probably agree that David should do whatever best serves the interests of his client, Acme Corporation. [RULE 1.13(a) & (b)]. What does that require?

2. RULE 1.13(b) offers procedural options David should consider, at a minimum, since they do not involve sacrificing client confidences and help to fully define what will be the <u>entity's</u> position.

3. However, each procedural step requires a

qualitative analysis of the facts and the client's interests:

a. Before David acts, he must consider whether Forrest's action constitutes either:

(1) "A violation of a legal obligation to the organization."

(a) Is this a "competence" issue or a "loyalty" issue--or both?

(b) If it is merely a "competence" issue this may fall within the realm of business judgment which David should respect since Forrest is the party charged with making business judgments.

(c) Could there be a "loyalty" issue under the facts?

i) Perhaps Forrest is acting to maximize his own interests (protection from prosecution for past violations) at the expense of the company's interests.

ii) Note that a factor the Department of Justice considers in determining whether to treat environmental violations as either a criminal or civil matter is: "[W]hether there was an effective system of discipline for employees who violated company environmental compliance policies?" See "Factors in Decisions on Criminal Prosecutions for Environmental Violations in the Context of Significant Voluntary Compliance or Disclosure Efforts by the Violator," Dept. of Justice Guidelines, Environment and Natural Resources Division (July 1991).

(2) "[O]r a violation of law which reasonably might be imputed to the organization . .

. ."

(a) Since managing wastes associated with company operations is part of its business, a decision regarding the wastes would be within the scope of the company's business.

(b) An act, or failure to act, by a company employee would be something within the scope of their employment and therefore something "which reasonably might be imputed to the organization . . . ." [RULE 1.13(b)].

b. Once David finds he is dealing with a violation of a legal obligation to Acme, or a violation of law which might be imputable to Acme, he must, under RULE 1.13(b):

(1) Focus on the Violation: "[G]ive due consideration to the seriousness of the violation and its consequences . . . ."

(2) Focus on the Lawyer's Position: What is the "scope and nature of the lawyer's representation . . . ."?

(3) Focus on the Employee's Position: What is the employee's "responsibility in the organization . . . ."?

(4) Focus on the Employee's Motive: What is the employee's "apparent motivation . . . ."?

(5) Focus on the Entity's Policies: What are "the policies of the organization concerning such matters . . . ."?

(a) Does "such matters" refer to the substantive problem of environmental compliance? (Likely to have such a policy--and it is likely to dictate reporting).

(b) Does "such matters" refer to intra-corporate disputes over an employee's decision to act when the company's attorney advises against such action. (Less likely to have

such policies in place--or at least in a formalized, published document).

(6) Focus on: "[A]ny other relevant considerations."

(a) Suppose Acme has a number of government contracts and noncompliance may constitute a breach of contract, or give rise to debarment. For example, § 306 of the Clean Air Act provides: "No Federal agency may enter into any contract with any person who is convicted of any offense under section 113 of this title for the procurement of goods, materials, and services . . . ."

(b) Could the report give rise to potential tort actions against Acme?

(c) What if David is the designated "Environmental Compliance Officer" for the company?

i) This could make David a "person in charge . . . ." under CERCLA § 103(a).

ii) Does David have a conflict of interest in this situation? RULE 1.7(b) states:

"A lawyer shall not represent a client if the representation of that client may be materially limited by the . . . lawyer's own interests, unless:

(1) the lawyer reasonably believes the representation will not adversely affect the relationship with the other client; and

(2) the client consents after consultation. . . ."

The Comment to the RULE states: "The lawyer's own

interests should not be permitted to have adverse effect on representation of a client."

iii) Note that even if the RULE 1.7 conflict problem can be dealt with, there is still the RULE 1.6 confidentiality and RULE 1.13 loyalty issues in the event the entity/client decides not to report.

4. Once David has completed the foregoing analysis, he must ensure that:

"Any measures taken shall be designed to minimize disruption of the organization and the risk of revealing information relating to the representation to persons outside the organization." [RULE 1.13(b)].

a. The concern is always with protecting the client--e.g. "minimize disruption of the organization".

b. Also note the particular difficulty the second sentence presents when the issue concerns a reporting or other obligation to a regulatory agency--e.g. "minimize . . . the risk of revealing information relating to the representation" to outsiders.

5. If David believes that "measures" are warranted, "[s]uch measures may include among others" those listed at RULE 1.13(b)(1)-(3). However, these listed measures should be pursued in the sequence listed. For example, item (1), then (2), and if necessary (3).

a. <u>Before</u> referring the matter to higher authority, David should:

(1) Urge Forrest to reconsider the matter;

(a) This is not merely a "business" decision--it is not a decision David must accept merely because he thinks its "utility or prudence is doubtful." [Comment to RULE 1.13].

(b) Does David know "that the

creating a damaging paper trail?

organization (Acme) may be substantially injured by action of a constituent (Forrest) that is in violation of law" (CERCLA)? [Comment].

(2) Urge Forrest to seek a separate legal opinion on the matter.

(3) QUERY: In some situations the authority to obtain a separate legal opinion may be with someone other than Forrest--it may even be with David.

b. If David deems it necessary to refer the matter to higher authority:

(1) "Clear justification should exist for seeking review over the head of" Forrest. [Comment].

(2) Intra-corporate policies on such matters should be considered, and followed--if none exist, you should encourage the creation of such policies. The ABA's Comment on this issue provides:

"The stated policy of the organization may define circumstances and prescribe channels for such review, and a lawyer should encourage the formulation of such a policy."

(3) Absent intra-corporate policies, David must depend more heavily on his qualitative judgment concerning the seriousness of the matter and Forrest's motives.

(4) "If warranted by the seriousness of the matter [and relief has not been forthcoming at a lower level of authority], referral to the highest authority that can act in behalf of the organization" may be required. [RULE 1.13(b)(3)].

(a) The "highest authority" is determined by applying the "applicable law."

(b) This will typically be the law of

the place of incorporation.

6. What if the "highest authority" refuses to follow David's advice to report?

   a. RULE 1.13(c) addresses this state of affairs, but applies only when:

      (1) The action of the entity is "clearly a violation of law" <u>and</u>

      (2) "[I]s likely to result in substantial injury to the organization . . . ."

   b. Even if these conditions are met, David still cannot cause the entity to report, all David can ethically do is withdraw from representation of the entity--in the in-house context this means David quits his job.

      (1) RULE 1.13(c) states "the lawyer <u>shall</u> follow Rule 1.16 ["Terminating Representation"]."

      (2) Although RULE 1.13(c) requires the lawyer to follow RULE 1.16, RULE 1.16 does not require the attorney to withdraw, it merely establishes the analytical procedure for determining whether withdrawal might be appropriate.

      (3) RULE 1.16(a) provides, in part:

         "[A] lawyer <u>shall</u> . . . withdraw from the representation of a client if:

         (1) the representation will result in violation of the rules of professional conduct or other law; or

         . . . .

         (4) the client persists in a course of action involving the lawyer's services that the lawyer reasonably believes is criminal or fraudulent."[10]

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[10]The ABA Model Rules of Professional Conduct place this activity into the "may" category. The RULES contained in the text of this Outline, unless otherwise noted, are the version adopted by the Kansas Supreme Court and found at Kansas Supreme Court Rule

(4) RULE 1.16(b) provides, in part:

"[A] lawyer may withdraw from representing a client if withdrawal can be accomplished without material adverse effect on the interests of the client, or if:

(1) the client has used the lawyer's services to perpetrate a crime or fraud;

(2) a client insists upon pursuing an objective that the lawyer considers repugnant or imprudent;

. . . .

(5) other good cause for withdrawal exists."

c. Can or must David engage in any sort of a "noisy" withdrawal?

(1) A noisy withdrawal might include notifying third parties of the withdrawal (the relevant agencies?) and a disaffirmance of any work product David has tendered to the third parties. Note that under the facts if David were the Environmental Compliance Officer for the company there may be prior certifications, etc. to disaffirm once David is aware of the facts.

(2) Although David may elect, or be required, to withdraw, it does not necessarily give David any right to betray client confidences.

d. RULE 1.6 provides, in part:

"(b) A lawyer may reveal such information [relating to representation of a client] to the extent the lawyer reasonably believes necessary:

(1) To prevent the client from

226.

committing a crime;[11] or

(2) to comply with requirements of law or orders of any tribunal;[12] or

(3) . . . to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved . . . ."

(1) Although it is clear that each day Acme fails to report can give rise to a civil penalty claim, does the failure to report each day constitute a separate crime? Note the standard may be different for application of the Rule as distinguished from that applicable in prosecuting the defendant.

(2) What does the phrase "to comply with requirements of law" mean? Would this have more direct meaning if David was the Environmental Compliance Officer for Acme?

e. Consider RULE 1.2 which provides, in part:

"(d) A lawyer shall not . . . assist a client, in conduct that the lawyer knows is criminal or fraudulent . . . ."

(1) When does the lawyer "assist" the client in criminal or fraudulent conduct?

(2) The Comment to the Rule states, in part:

"When the client's course of action has already begun and is continuing, the lawyer's responsibility is especially delicate. The lawyer is not permitted to reveal the client's wrongdoing, except

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[11]The ABA's version of the Rule is much more limited and would permit disclosure:

"(1) to prevent the client from committing a criminal act <u>that the lawyer believes is likely to result in imminent death or substantial bodily harm</u> . . . ."

[12]The ABA's version of the Rule does not contain this provision.

where permitted by Rule 1.6. However, the lawyer is required to avoid furthering the purpose, for example, by suggesting how it might be concealed. A lawyer may not continue assisting a client in conduct that the lawyer originally supposes is legally proper but then discovers is criminal or fraudulent. Withdrawal from the representation, therefore, may be required."

f. See generally "Withdrawal When a Lawyer's Services Will Otherwise Be Used to Perpetrate a Fraud," American Bar Association, Formal Ethics Opinion 92-366 (August 8, 1992).

I. Legal Ethics vs. Legal "Rights"

If we assume Acme decides not to report, and David decides not to quit, what should David do when Dock approaches him and asks/states: "Do you think I should go along with Forrest on this reporting matter? Will the company back me up? What do you think about all this? Are you aware that I have three other operations under my control with the same problem? I've been taping my telephone conversations with Forrest and others--and I've got some documents squirreled away just in case I need some protection."

1. David is aware that Acme Corporation's policy on indemnifying employees does not cover criminal claims or intentional misconduct.

2. What are David's obligations to Dock?

   a. Ethical obligations.

      (1) RULE 1.13(d) provides:

      "In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when it is apparent that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing."

      (2) RULE 4.3 provides:

      "In dealing on behalf of a client

with a person who is not represented by counsel, a lawyer shall not state or imply that the lawyer is disinterested. When the lawyer knows or reasonably should know that the unrepresented person misunderstands the lawyer's role in the matter, the lawyer shall make reasonable efforts to correct the misunderstanding."

b. Legal obligations.

(1) Multiple attorney-client relationships?

(2) No attorney-client relationship but a "confidential relationship." See generally Fassihi v. Sommers, Schwartz, Silver, Schwartz & Tyler, P.C., 309 N.W.2d 645 (Mich. Ct. App. 1981) (per curiam) (suit by 50% shareholder in professional corporation against attorney representing the two-shareholder corporation).

(3) Corporate employee as third party beneficiary to the attorney-client contract. Kelly v. Kruse, Landa, Zimmerman & Maycock, No. 89-4033 and 89-4039, 1991 U.S. App. LEXIS 19742 (10th Cir. 1991) (unpublished opinion) (officer and director charged personally for securities law violations was third party beneficiary of attorney-client contract with corporation to provide securities law advice).

(4) California "multi-criteria balancing test." Pizel v. Zuspann, 247 Kan. 54, 795 P.2d 42 (1990) (trust beneficiaries had negligence claim against attorneys representing settlor of trust).

(5) The "reasonable expectations test." What would a reasonable person in the position of the complaining party expect of the attorney under the circumstances? Consider the test advocated by Professor Nancy J. Moore:

"Extending the logic of attorney

disqualification cases,[13] an appropriate tort-based test for determining the formation of an attorney-client relationship in legal malpractice cases would focus on the reasonable expectations of the would-be client. In a strict sense, the test in the entity representation cases would be whether individual constituents reasonably believed that the entity lawyer was representing them as well as the entity, regardless of the lawyer's intent or belief, under circumstances in which such reliance was reasonably foreseeable."

Nancy J. Moore, Expanding Duties of Attorneys to "Non-Clients": Reconceptualizing the Attorney-Client Relationship in Entity Representation and Other Inherently Ambiguous Situations, 45 **South Carolina Law Review** 659, 687 (1994).

3. What are David's responsibilities toward the regulatory agencies?

   a. Does David play multiple roles for the corporation? Lawyer, compliance officer, agency contact?

   b. RULE 3.3 Candor Toward the Tribunal, contemplates representations made during the course of a legal proceeding. RULE 3.3 provides, in part:

"(a) A lawyer shall not knowingly:

(1) make a false statement of material fact or law to a tribunal;

(2) fail to disclose a material fact to a tribunal when disclosure is necessary to avoid assisting a criminal or fraudulent act by the client;

. . . .

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[13] E.g., E.F. Hutton & Co. v. Brown, 305 F. Supp. 371 (S.D. Tex. 1969) (firm representing Hutton disqualified due to prior dual representation of Hutton and company officer Brown).

(4) offer evidence that the lawyer knows to be false. If a lawyer has offered material evidence and comes to know of its falsity, the lawyer shall take reasonable remedial measures.

(b) The duties stated in paragraph (a) continue to the conclusion of the proceeding, and apply even if compliance requires disclosure of information otherwise protected by Rule 1.6.

. . . ."

c. RULE 4.1 Truthfulness in Statements to Others is broader in scope than RULE 3.3 and provides:

"In the course of representing a client a lawyer shall not knowingly:

(a) make a false statement of material fact or law to a third person; or

(b) fail to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by or made discretionary under Rule 1.6."

d. Consider In re Carter and Johnson, Securities and Exchange Commission, [1981 Transfer Binder] **Fed. Sec. L. Rep.** § 82,847 (CCH 1981):

"When a lawyer with significant responsibilities in the effectuation of a company's compliance with the disclosure requirements of the federal securities law becomes aware that his client is engaged in a substantial and continuing failure to satisfy those disclosure requirements, his continued participation violates professional standards unless he takes prompt steps to end the client's noncompliance."

(1) "Initially, counseling accurate disclosure is sufficient, even if his advice is not accepted. But there comes a point at which a reasonable lawyer must conclude that his advice is not being followed, or even sought in good faith, and that his client is involved in a

continuing course of violating the securities laws. At this critical juncture, the lawyer must take further, more affirmative steps in order to avoid the inference that he has been co-opted, willingly or unwillingly, into the scheme of non-disclosure."

(2) "Resignation is one option . . . ."

(3) "A direct approach to the board of directors or one or more individual directors or officers may be appropriate; or he may choose to try and enlist the aid of other members of the firm's management."

(4) "What is required, in short, is some prompt action that leads to the conclusion that the lawyer is engaged in efforts to correct the underlying problem, rather than having capitulated to the desires of a strong-willed, but misguided client."

(5) The lawyer's action need not be successful to avoid the inference that the lawyer has improperly participated in the client's fraud.

(6) "Some have argued that resignation is the only permissible course when a client chooses not to comply with disclosure advice. We do not agree. Premature resignation serves neither the end of an effective lawyer-client relationship nor, in most cases, the effective administration of the securities laws. The lawyer's continued interaction with his client will ordinarily hold the greatest promise of corrective action."

e. See generally SYMPOSIUM: The Attorney-Client Relationship in a Regulated Society, 35 **South Texas L. Rev.** 571-751 (1994).

f. Assuming Acme elects not to report, and David's efforts to change management's decision are not successful: if David chooses not to resign, he will need to ensure that his future legal services to Acme will not in any way lend support to the notion that Acme is

complying with CERCLA [and the environmental laws in general?].

4. What is David's duty to investigate?

   a. RULE 1.13(b) arguably contemplates David will investigate the facts and use the resulting information to determine his subsequent course of action.

   b. A failure to investigate can result in a failure to act, causing injury to the client.

   c. Taking action without conducting a thorough investigation can result in inappropriate action that can also injure the client. E.g. Crandon v. State, 257 Kan. 727 (1995) (general counsel for State Banking Commissioner failed to investigate facts, follow RULE 1.13(b) procedures, and made disclosures to federal agency that violated RULE 1.6).

5. What if David doesn't withdraw but is fired by Acme?

   a. CERCLA § 110 provides, in part:

      "No person shall fire or in any other way discriminate against, or cause to be fired or discriminated against, any employee . . . by reason of the fact that such employee . . . has provided information to a State or to the Federal Government . . . resulting from the administration or enforcement of the provisions of this chapter."

      (1) Provides for a review of the firing before the Secretary of Labor.

      (2) Provides for the payment of claimant's attorney fees and litigation costs.

   b. RCRA § 7001 contains a substantially similar provision.

   c. But see Balla v. Gambro, Inc., 584 N.E.2d 104 (Ill. 1991) (in-house counsel could not sue his employer for retaliatory discharge associated with attorney's objection to president's decision to market defective kidney dialysis equipment).

d. Dock is the party most likely to use this statute--if he obtains some independent legal advice and reports. The employee protection statutes except only employees who "acting without direction from his employer (or agent) deliberately violates any requirement of this chapter." § RCRA § 7001(d); CERCLA § 110(d).

6. How not to do it: Crandon v. State, 257 Kan. 727 (1995). The Kansas Supreme Court comments on the RULE 1.13 procedure and the interaction of RULE 1.6 in the context of a retaliatory discharge action, brought by the former general counsel for the Office of the State Banking Commissioner (Crandon), after she reported alleged violations of federal and state law committed by the Deputy Banking Commissioner to the FDIC.

a. The trial court found:

> "The knowledge plaintiff [Crandon] had was derived from her position as the OSBC's attorney. She took no steps to present her concerns to the OSBC's head, Commissioner Dunnick, who had the authority to act against the employee alleged to be violating the law. The court found that plaintiff's reporting [to the FDIC] was contrary to the Model Rules of Professional Conduct . . . and that there was no justification for plaintiff's failure, as the OSBC attorney, to approach, counsel, and advise Dunnick on the issue. Moreover, the court found that plaintiff proceeded on her course of conduct without more than a second-hand knowledge of the facts rather than relying on her own independent investigation."
>
> Crandon, 257 Kan. at 733-734.

b. "Plaintiff's actions were those of an attorney representing herself rather than her clients." Crandon, 257 Kan. at 735.

c. The Supreme Court held as follows:

> "We conclude that, although plaintiff may have acted in the utmost good faith, she used poor judgment and did not take steps available to her that a reasonably prudent attorney would have taken prior to reporting what she suspected to be violations to the FDIC, thus destroying her effectiveness as counsel for

the OSBC and its employees and especially with the organization's head, Frankie Dunnick."

Crandon, 257 Kan. at 742.

(1) Had she followed the RULE 1.13(b) procedure, the matter would have been adequately resolved internally.

(2) Even if the matter had not been adequately resolved, the RULE 1.13(b) process would have assisted her in obtaining valuable information to decide what she should do next.

7. The ultimate guide--the lawyer's independent judgment.

a. RULE 2.1 provides, in part:

"In representing a client, a lawyer shall exercise independent professional judgment and render candid advice. . . ."

b. RULE 5.4(c) provides:

"A lawyer shall not permit a person who recommends, employs, or pays the lawyer to render legal services for another to direct or regulate the lawyer's professional judgment in rendering such legal services."

c. For general counsel and managing in-house counsel, remember that RULE 5.1(b) provides:

"A lawyer having direct supervisory authority over another lawyer shall make reasonable efforts to ensure that the other lawyer conforms to the rules of professional conduct."