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Paper 3

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I. SURVEY OF THE CONTRACTS AND PROPERTY RIGHTS

A. The Development Phase

The development, production, and marketing of oil and gas are accomplished through a series of commonly encountered contracts that create myriad property interests and contractual relationships. During the exploration and development phase the primary focus is on identifying property rights in the oil and gas mineral estate and ensuring the necessary rights are brought under the developer's control through an oil and gas lease. Pooling agreements and unitization agreements may impact the underlying ownership in a pooled or unitized area. Multiple owners of leasehold interests may enter into operating agreements to coordinate development of leased land. New property interests may be created in the leasehold estate through assignments. Development rights in oil and gas leases may change hands through assignment or farmout agreements. Division orders may further define the rights of the parties to their interests in production. The one common attribute of all these agreements, in the development context, is they seek to define the development rights–the oil and gas property interests–of each party involved in the development process.

The major non-ownership relationship at the development phase is the drilling contract. The drilling contract is designed to allocate the risks of exploring for oil and gas between the drilling contractor and the developer. The developer frequently leverages the financial risks of exploration and development by sharing them with other investors, typically through an operating agreement. Once a producing well has been completed, the parties move from the development phase to the production phase.

B. The Production Phase: Progression from *Real* Property to *Personal* Property

As we move from the development phase to production and marketing, the focus shifts from ownership of development rights (real property) to ownership of the extracted oil and gas (personal property). This transformation from real to personal property is a major prelude to many of the issues producers face at the marketing phase of the process. Careful study of the foundational documents (oil and gas lease, pooling agreements and orders, unitization agreements and orders) often reveal the precise moment when the "real" becomes the "personal."

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1. Oil and Gas Lease

Depending upon the applicable state law, the lessor/mineral interest owner either owns the oil and gas beneath their land "in place,"[1] or they own the exclusive right to go onto the property to drill and try and capture the oil and gas and reduce it to possession.[2] Regardless of the mineral owner's rights, the royalty clause of the oil and gas lease typically defines the respective rights of the lessor and lessee in produced oil and produced gas. Consider the operation of the following royalty clause:

> 3. The royalties to be paid by Lessee are as follows: **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 shall have the option to purchase any royalty oil in its possession, paying the market price therefor prevailing for the field where produced on the date of purchase. **On gas, including casinghead gas, condensate or other gaseous substances**, produced from said land and **sold or used off the premises** or for the extraction of gasoline or other products therefrom, ***the market value at the well of one-eighth of the gas so sold or used***, provided that on gas **sold at the wells** the royalty shall be one-eighth of ***the amount realized*** from such sale. . . .[3]

Under this clause production of oil will result in the lessor and lessee each owning a share of the oil. This means that often a separate contract will be required to acquire oil from the lessee, and from the lessor. If a third-party purchaser is involved (someone other than the lessee), they will typically have at least a division order contract with the owners of the oil (lessor and lessee) authorizing the purchaser to take possession of the oil and, in return, pay a stated sum of money for the oil. In the sample clause if the lessee elects to purchase the lessor's oil, instead of delivering the oil to the lessor, or to lessor's credit with a third-party purchaser, the lessee will typically document its election through a division order with the lessor.

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[1]A "possessory" interest in real property; a "corporeal" right to the thing (oil and gas) as it exists in the reservoir.

[2]Therefore the oil and gas while in the reservoir is an "incorporeal" or "non-possessory" interest. No present possessory interest in the thing (oil and gas) exists until it is brought to the surface. Note that once the oil and gas becomes possessory under this theory, the owner possesses an interest in personal property, not real property. The "interest" in real property is the right to enter the property to try and capture the oil and gas. This is like an easement; one of those "incorporeal hereditaments;" a right in land capable of being inherited but not the land itself. The right is technically a *profit a prendre* which includes an easement plus the right to remove the mineral from the land. More precisely, it is an affirmative *profit a prendre* in gross.

[3]AAPL Form 675 Oil and Gas Lease, Texas Form–Shut-In Clause, Pooling Clause, JOHN S. LOWE, ET AL., FORMS MANUAL TO ACCOMPANY CASES AND MATERIALS ON OIL AND GAS LAW 2-2 (4th ed. 2004) (Form #2-1) (emphasis added).

When the production concerns gas,[4] the relationship between the lessor and lessee is fundamentally different. Because the lessor owns none of the gas being produced,[5] they have nothing to sell or transfer to the lessee, or to a third party. Their gas royalty rights in such a case are to be paid a sum of money in accordance with the covenants expressed in the royalty clause: in our example, an amount of money measured either by the "market value" or the "amount realized" depending upon whether the gas is "sold at the wells" (amount realized) or "sold or used off the premises" (market value).[6]

2. Pooling Agreements

In some situations a pooling agreement, entered into by the affected lessors and lessees, may seek to state a single basis for calculating royalty from all leases contributing acreage to the pooled area. Pooling agreements should be contrasted with "declarations" of pooling. The declaration of pooling is merely evidence the lessee is exercising authority to pool, granted by a pooling clause in an oil and gas lease. The declaration will not alter the basis for calculating royalty under the oil and gas lease because it is merely the lessee's unilateral exercise of authority to pool granted by the terms of the oil and gas lease.

However, if the lease lacks a pooling clause, or the pooling authority granted by the lease is too narrow, the lessee may seek additional pooling authority directly from the lessor through a pooling agreement. The terms of the pooling agreement must then be analyzed to determine whether the basis for determining royalty provided for in the underlying oil and gas leases has been changed. The pooling agreement may also contain details regarding the marketing of pooled production.

3. Unit Agreements

When a field-wide unit is formed, the lessors and lessees enter into a Unit Agreement; the lessees will also enter into a separate Unit Operating Agreement. Because the lessors are a party to the Unit Agreement, there is the potential the royalty provisions of their oil and gas leases can be altered. Many unitization projects use some version, or adaptation, of the American Petroleum

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[4]The sample clause includes "condensate" under the "gas" royalty clause: "On gas, including casinghead gas, ***condensate*** or other gaseous substances . . . ." However, many oil and gas leases address "condensate" under the "oil" royalty clause. Many leases do not mention whether condensate should be addressed under the "oil" or "gas" royalty clause. It is also possible to encounter leases that have a separate royalty clause for condensate.

[5]It is possible to encounter oil and gas leases where the lessor has retained the right to take their share of gas in kind. In those cases the analysis will be similar to that under the oil royalty clause. Also, where the oil royalty clause does not provide for a share of oil as a royalty, the analysis will be similar to a gas royalty clause analysis.

[6]*See generally* David E. Pierce, *Resolving Division Order Disputes: A Conceptual Approach*, 35 ROCKY MTN. MIN. L. INST. 16-1, 16-4 to 16-19 (1989) ("§ 16.02 Ownership of Production Under the Oil and Gas Lease").

Institute's Model Form of Unit Agreement.[7] The effect of the Unit Agreement on the lessors' lease rights is addressed in the following provisions of the Unit Agreement:

> **1.3 Unitized Substances** are all oil, gas, gaseous substances, sulphur contained in gas, condensate, distillate, and all associated and constituent liquid or liquefiable hydrocarbons other than Outside Substances within or produced from the Unitized Formation.
>
> . . . .
>
> **3.1 Oil and Gas Rights Unitized.** All Oil and Gas Rights of Royalty Owners in and to the lands described in Exhibit A, and all Oil and Gas Rights of Working Interest Owners in and to said lands, are hereby unitized insofar as the respective Oil and Gas Rights pertain to the Unitized Formation, so that Unit Operations may be conducted with respect to the Unitized Formation ***as if the Unit Area had been included in a single lease executed by all Royalty Owners, as lessors, in favor of all Working Interest Owners, as lessees, and as if the lease contained all of the provisions of this agreement.***
>
> . . . .
>
> **3.3 Amendment of Leases and Other Agreements.** The provisions of the various leases, agreements, division and transfer orders, or other instruments pertaining to the respective Tracts or the production therefrom are ***amended to the extent necessary to make them conform to the provisions of this agreement, but otherwise shall remain in effect.***
>
> . . . .
>
> **6.1 Allocation to Tracts.** All Unitized Substances produced and saved shall be allocated to the several Tracts in accordance with the respective Tract Participations effective during the period that the Unitized Substances were produced. ***The amount of Unitized Substances allocated to each Tract, regardless of whether the amount is more or less than the actual production of Unitized Substances from the well or wells, if any, on such Tract, shall be deemed for all purposes to have been produced from such Tract.***
>
> **6.2 Distribution Within Tracts.** The Unitized Substances allocated to each Tract shall be distributed among, or accounted for to, the parties entitled to share in the production from such Tract in the same manner, in the same proportions, and ***upon the same conditions as they would have participated and shared in the production from such Tract, or in the proceeds thereof, had this agreement not been entered into, and with the same legal effect. . . .***
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> . . . .

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[7]The Third Edition (January 1970) of the Model Form of Unit Agreement can be found at JOHN S. LOWE, ET AL., FORMS MANUAL TO ACCOMPANY CASES AND MATERIALS ON OIL AND GAS LAW 6-32 (4th ed. 2004) (Form #6-4).

6.4 Failure to Take in Kind. If any party fails to take in kind or separately dispose of such party's share of Unitized Substances, Unit Operator shall have the right, but not the obligation, for the time being and subject to revocation at will by the party owning the share, to purchase or sell to others such share; however, all contracts of sale by Unit Operator of any other party's share of Unitized Substances shall be only for such reasonable periods of time as are consistent with minimum needs of the industry under the circumstances, but in no event shall any such contract be for a period in excess of one year. . . .

. . . .

8.1 Use of Unitized Substances. Working Interest Owners may use or consume Unitized Substances for Unit Operations, including but not limited to the injection thereof into the Unitized Formation.

8.2 Royalty Payments. ***No royalty, overriding royalty, production, or other payments shall be payable on account of Unitized Substances used, lost, or consumed in Unit Operations.***

The practical effect of these unit agreement provisions is that production from anywhere within the unit area will continue the leases in effect, each lease will participate in unit production based upon the unit tract participation factors, but production "used, lost, or consumed in Unit Operations," will not be subject to a royalty obligation. However, the other terms of the underlying oil and gas lease, such as the royalty fraction and whether royalty will be calculated based upon "market value" or "amount realized," will not be altered by the unitization, because such alteration is, in the terms of the Unit Agreement, not "***necessary to make them conform to the provisions of this agreement***" and therefore shall "***otherwise shall remain in effect.***"[8]

4. Operating Agreements

Among working interest owners, the bridge between production and marketing is the operating agreement. For example, the A.A.P.L. Form 610–1989 Model Form Operating Agreement[9] defines each working interest owner's interest in production through two seemingly inconsistent provisions. The first is commonly referred to as the "ownership" clause and provides:

B. Interests of Parties in Costs and Production:

Unless changed by other provisions, all costs and liabilities incurred in operations under this agreement shall be borne and paid, and all equipment and materials acquired in operations on the Contract Area shall be owned, by the parties

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[8] *Id.* at ¶ 3.3.

[9] A.A.P.L. Form 610–1989 Model Form Operating Agreement ("MFOA"), JOHN S. LOWE, ET AL., FORMS MANUAL TO ACCOMPANY CASES AND MATERIALS ON OIL AND GAS LAW 5-19 (4th ed. 2004) (Form #5-3).

> as their interests are set forth in Exhibit "A."[10] ***In the same manner, the parties shall own all production of Oil and Gas from the Contract Area*** subject, however, to the payment of royalties and other burdens on production as described hereafter.[11]

Production from wells located within the Contract Area will be owned by each working interest owner in proportion to their percentage ownership in the contract area. Therefore, if **A** has a 90% interest in the Contract Area, and **B** a 10% interest, any oil or gas produced from the Contract Area will be owned 90% by **A** and 10% by **B**.

Presumably each owns an undivided interest in each barrel or Mcf produced from the contract area. Apportionment among the working interest owners is accomplished by having each owner take their interest "in kind." For example, the "Taking Production in Kind" portion of the operating agreement provides, in the 1989 form, for an election: "Option No. 1" where the parties have agreed to a "Gas Balancing Agreement" and "Option No. 2" where the parties have rejected any attempt to enter into a gas balancing agreement. If we assume, as is often the case, the parties express their intent *not* to have a gas balancing agreement, then the guiding language will be as follows:

> ***Each party shall take in kind or separately dispose of its proportionate share of all Oil and Gas produced from the Contract Area*** . . . .
>
> Each party shall execute such division orders and contracts as may be necessary for the sale of its interest in production from the Contract Area . . . .
>
> ***If any party fails to make the arrangements necessary to take in kind or separately dispose of its proportionate share of the Oil and/or Gas produced from the Contract Area***, Operator shall have the right, subject to the revocation at will by the party owning it, ***but not the obligation***, to purchase such Oil and/or Gas or sell it to others at any time and from time to time, for the account of the non-taking party. . . .[12]

If the operator elects to market the non-taking party's gas, express provisions of the operating agreement will define the parties' rights. However, if the operator elects *not* to market the non-taking party's gas (which the operator clearly has the right to refuse to market–under the contract), the parties are thrown into the fitful common law world of disproportionate gas takes and gas balancing.[13]

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[10]Exhibit "A" describes the Contract Area and the "Percentages or fractional interests of parties to this agreement . . . ." MFOA Art. II, § A.(1) & (4), p.1, lines 60-65.

[11]MFOA Art. III, § B, p.2, lines 10-13 (emphasis added).

[12]MFOA Art. VI, § G, p.11, lines 27-40 (emphasis added).

[13]*See generally* David E. Pierce, *Defining the Role of Industry Custom and Usage in Oil & Gas Litigation*, 57 SMU L. REV. 387, 423-435 (2004) ("B. Disproportionate Takes and Gas

C. The Marketing Phase: *Sale* or *Service*?

Determining who has title to the oil or gas[14] at any given time will have a major impact on determining the rights of the parties to a marketing agreement. It will also determine, as noted in section II. of this article, which body of contract law must be applied to the transaction to define the parties' rights and obligations. This is perhaps nowhere better illustrated than the relationship created by a "division order."

1. Division Orders

Perhaps the most significant "marketing" agreement is the division order. Courts have struggled with division orders because they can be used for varying purposes, and judicial pronouncements frequently fail to account for these variations.[15] Division orders have been used to accomplish one or more of four basic goals:

(1) Establish the precise percentage of production the interest owner is claiming in the extracted oil or gas;

(2) Provide additional guidance on how and when the percentage of production will be calculated and paid;

(3) Establish the basic sales relationship between the interest owner and the production purchaser when the interest owner has title to a share of the extracted oil or gas; and

(4) To change the basis for calculating royalty or overriding royalty stated in the underlying document, such as an oil and gas lease, non-participating royalty conveyance, assignment.

Most of the disputes, and the resulting legislation, have focused on the fourth goal where the lessee is attempting to amend the oil and gas lease terms using a division order.[16] The goals expressed in

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Balancing Issues"); David E. Pierce, *The Law of Disproportionate Gas Sales*, 26 TULSA L. J. 135 (1990).

[14]Who "owns" the oil or gas as a matter of property law.

[15]*See generally* David E. Pierce, *Resolving Division Order Disputes: A Conceptual Approach*, 35 ROCKY MTN. MIN. L. INST. 16-1 (1989).

[16]When the underlying goal of requiring a division order is to alter the lessor's rights under the oil and gas lease, some courts have refused to give effect to the amending terms. *E.g.*, Holmes v. Kewanee Oil Co., 664 P.2d 1335 (Kan. 1983), *cert. denied*, 474 U.S. 953 (1985) (oil and gas lessee's attempt to change "market value" royalty obligation to a "proceeds" obligation); Maddox v. Gulf Oil Corp., 567 P.2d 1326 (Kan. 1977), *cert. denied*, 434 U.S. 1065 (1978) (oil and gas lessee's attempt to eliminate common law right to interest on unpaid royalty). Many states now provide by statute: "A division order may not alter or amend the terms of the underlying oil or gas lease." MONT. CODE ANN. § 82-10-110 (2) (2009).

items (1) and (3) above are generally viewed as legitimate and are often incorporated by statute.[17] Goal (2) encompasses situations that are not addressed in the oil and gas lease,[18] but may in any event have a significant impact on the economic interests of the parties. To the extent the division order is limited to the goal expressed in item (1), it should be enforceable.[19]

The erratic jurisprudence regarding the relationship created by the division order[20] can best be explained by first ascertaining the goal the lessee was seeking to accomplish with the division order. If the goal was to protect the lessee from guessing at the lessor's fractional entitlement, or to allow a third-party[21] to purchase the production, chances are a traditional contract analysis will be employed.[22] However, if the goal is to use the division order as a modifying document to change the terms of the lease, courts will most likely reject a contract analysis and find that the document is ineffective to change the lease terms.[23] Sometimes courts will arrive at a middle ground, holding the division order is a contract that will modify the lease, but then deny full effect to the contract terms by permitting revocation--even when the document expressly makes the division order irrevocable.[24]

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[17]*E.g.*, MONT. CODE ANN. § 82-10-110 (1) provides: "As used in this section, the term "division order" is limited to mean an instrument executed by the lessor of an oil or gas lease to authorize the sale of [item (3) above] and direct the distribution of proceeds from the sale of [item (1) above] oil, gas, casinghead gas, or other related hydrocarbons."

[18]Although these terms may not "amend" the lease obligations, they could certainly "alter" the terms and thereby come within a prohibition that the division order "may not *alter* or amend the terms of the underlying oil or gas lease." MONT. CODE ANN. § 82-10-110 (2) (2009) (emphasis added).

[19]However, if the division order reflects the wrong royalty fraction, and the benefit of the error flows to the party tendering the inaccurate division order, it may have no effect. Gavenda v. Strata Energy, Inc., 705 S.W.2d 690 (Tex. 1986).

[20]Professor Smith has observed that division order jurisprudence suffers from "too many cases saying too many things without clearly articulating the legal theories used." Ernest E. Smith, *Royalty Issues: Take-Or-Pay Claims and Division Orders*," 24 TULSA L. J. 509, 535 (1989).

[21]"Third-party" would include anyone that does not already have a contractual relationship with the interest owner; such as a crude oil purchaser.

[22]*E.g.*, Blausey v. Stein, 400 N.E.2d 408 (Ohio 1980) (third-party purchaser division order).

[23]*See* cases cited *supra* note 16.

[24]*E.g.*, Exxon Corp. v. Middleton, 613 S.W.2d 240, 250-51 (Tex. 1981). Texas has since addressed many division order issues by statute. *See* TEX. NAT. RES. CODE ANN. § 91.402 (Vernon Supp. 2010).

When analyzing division order cases the most important inquiry is to determine: First, is the dispute between a lessor and lessee; and Second, does it concern "gas." Under most oil and gas lease royalty clauses, the lessor does not own any of the gas. Also, there is already a contract between the lessor and lessee (the oil and gas lease) addressing how the lessor's royalty rights will be calculated in the event there is gas production. Because the lessee owns all the gas as it is produced, and the lessee already has an agreement with the lessor concerning their respective rights in the gas, there is little reason for the lessee to demand the lessor to enter into a division order. This is not, however, the case if the production is "oil." In that case there is a legitimate basis for a division order to effect a sale of the lessor's share of oil to the lessee.

When the division order is between a lessor and a non-lessee purchaser for oil or gas, there will often be an independent basis for the division order. First, if the production is oil, the division order will function as the basic contract evidencing the sale of the lessor's oil "goods" to the non-lessee purchaser. Second, even if the production is gas, the division order will function as a contract regarding the lessor's agreement with the gas purchaser to undertake the responsibility for distribution of production proceeds. This relationship is not a "sale" but rather a "service." Prior to entering into the division order, the purchaser owed no duties to the lessor, and the lessor owed no duties to the purchaser. However, once the purchaser enters into the division order, under many state payee statutes, and the common law, the purchaser undertakes the distribution of the lessor's share of production proceeds in accordance with the division order.

For example, assume a lessee produces gas which, under the oil and gas lease, is all owned by the lessee when produced. The lessee enters into a sales contract with a gas purchaser. Under K.S.A. § 55-1614 the gas purchaser could discharge all of its obligations by paying 100% of the gas proceeds to the lessee. The Kansas production proceeds payment statutes define the obligated "payor" as the lessee "[i]f the first purchaser [gas purchaser] makes payment to a third party [lessee] for distribution to payee [lessor], the first purchaser [gas purchaser] is a payor as to the third party [lessee] to whom payment is made . . . ."[25] In the event the gas purchaser enters into a division order requiring payment of a portion of the production proceeds to the lessor, it is undertaking "payor" duties directly to the lessor, in addition to the other covenants contained in the division order. The lessor and gas purchaser would seem to have a classic bilateral contract in this situation with the parties each altering their pre-existing legal status in return for the promises of the other party.

2. Other *Sales* Contracts

In addition to the division order, the operator of a well, or individual working interest owners, may enter into contracts which in effect "sell" the oil or gas. Sometimes it may be difficult to ascertain whether a sale has taken place. For example, an agreement to exchange a volume of oil produced in one location for delivery of oil at another location can be a sale. What might at first glance appear to be a contract for gathering or processing "services" may in fact be a sale of the production with payment being a return (re-delivery at a stated location) of a stated fraction of the production, or its value. This is another area where the "ownership" of the production at any given moment will be critical to determining whether a sale has taken place.

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[25]KAN. STAT. ANN. § 55-1614(c)(1) (2005).

3. Other *Service* Contracts

Services that are frequently contracted for include trucking, gathering, treating, processing, storage, and further distribution up to the refinery for oil, and up to the end user for gas. Sometimes it is difficult to determine whether production is being sold, or is merely being given in-kind as a payment for a service. For example, the obligation to re-deliver 87% of the production to the lessee may indicate 13% of the production has been retained as a gathering, treatment, or processing fee. The same sort of net-back could, however, reflect a sale with payment being 87% of the proceeds from a defined sale by the purchaser. The terms of the contract will determine whether a sale or service has taken place.

II. THE ROLE OF THE UNIFORM COMMERCIAL CODE IN MARKETING

The Uniform Commercial Code ("UCC") plays a major role in defining the parties' rights and obligations when there is a "sale" of goods and a "security" arrangement designed to secure a party's performance of its contractual obligations. Article 2 of the UCC addresses the contract formation, interpretation, and performance aspects of the sale of oil and gas once it is produced. Article 5, concerning letters of credit, addresses a common device for obtaining a *third party's* agreement to pay money in the event a party to the transaction fails to perform. Article 9 focuses on how to obtain a special property interest in collateral *owned by a party* to the transaction to secure their performance.

A. Sale of "Goods" and Article 2

1. "Sale" vs. "Service"

Any UCC discussion must begin with basic definitions. Article 2[26] deals with "transactions in goods"[27] "Goods" are defined to include:

> 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 if they are to be severed by the seller but until severance a purported present sale thereof which is not effective as a

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[26]The National Conference of Commissioners on Uniform State Laws and the American Law Institute approved revised text for Article 1 of the UCC in 2001, and Article 2 in 2003. As of 2010 thirty-seven states have adopted revised Article 1; but no state has adopted revised Article 2. In this article citation will be to both versions with a description of any material changes. To check the current status of your state's laws on these subjects go to http://www.nccusl.org and click on the "Final Acts & Legislation" link.

[27]The "transactions" we are concerned with are "sales" of goods. The UCC provides: "A 'sale' consists in the passing of title from the seller to the buyer for a price . . . ." UCC § 2-106(1) (revised version same as original).

transfer of an interest in land is effective only as a contract to sell.[28]

Therefore, once oil or gas is extracted from the ground, a contract to sell the oil or gas is a sale of goods governed by Article 2. For example, once oil is produced, under the most common form of lease, the lessor and lessee each own their respective fractions of the produced oil. Therefore, a division order between a lessor and a purchaser of their oil would constitute a contract[29] for the sale of goods because the seller (lessor), for a price, is passing title from the seller (lessor) to the buyer (crude oil purchaser).[30]

When the transaction does not meet the definition of a "sale," because there is no "passing of title" from the seller to the buyer "for a price," the non-sale transaction will most often be a "service." Services are not governed by UCC Article 2, but instead will be governed by non-UCC contract law. For example, a "gathering" agreement, or "processing" agreement, can be structured as either a sale or a service. In some instances a net-back arrangement may be structured as a service "fee" or it may be the "purchase price" agreed upon for the sale of production. The documents must be carefully examined to determine whether a "sale" or "service" is involved. In many states this classification will determine whether many contract formation and performance issues are governed by the UCC or "general" contract law. It can also impact issues such as the applicable statute of frauds and statute of limitations.[31]

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[28]UCC § 2-107(1) (revised version same as original).

[29]"Contract for sale" is defined by the UCC as including "both a present sale of goods and a contract to sell goods at a future time." UCC § 2-106(1) (revised version same as original).

[30]In many instances the purchaser will not be a third-party but rather the other party to the oil and gas lease, the lessee. When the lessor has oil to sell, the lessee should be able to purchase it like any other purchaser. Often the only document evidencing the sale will be a division order. Frequently the oil and gas lease will contain specific language authorizing the purchase and defining some of the terms of the sale. For example, one form of lease provides: "Lessee shall have the option to purchase any royalty oil in its possession, paying the market price therefor prevailing for the field where produced on the date of purchase." AAPL Form 675 Oil and Gas Lease, Texas Form–Shut-In Clause, Pooling Clause, JOHN S. LOWE, ET AL., FORMS MANUAL TO ACCOMPANY CASES AND MATERIALS ON OIL AND GAS LAW 2-2, ¶ 3 (4th ed. 2004) (Form #2-1).

[31]For example, in Kansas a sale of goods has a four-year statute of limitations while the non-sales statute of limitations for a contract is five years if in writing and three years is not in writing. The "Kansas Comment" to the Kansas version of UCC § 2-725 provides:

> This section introduces a uniform statute of limitations for sales contracts and takes these contracts out of the general statute of limitations of the state. Article 2 adopts a four-year period as most appropriate to modern business practice. Unlike other Kansas statutes dealing with contracts limitations periods (compare K.S.A. 60-511(1) (five-year statute of limitations for actions based on written contracts) with K.S.A. 60-512 (1) (three-year statute of limitations for actions based on oral contracts), this section does not distinguish between written and unwritten contracts. Subsection (1) permits the parties by agreement to reduce the limitation period to not less than one year.

2. "Mirror Image" and "Battle of the Forms"

One of the most significant areas where traditional contract law has been modified for Article 2 sales is the rule that any purported acceptance of an offer that is not on the "mirror image" terms of the offer, is not an "acceptance" but rather a "rejection." Under non-sales law this gave rise to the "last shot" rule that the party "firing" (making) the "last shot" (offer), preceding someone's performance, will have a contract on their "last shot" terms. This is because performance following receipt of the last un-rejected offer was viewed as an act of acceptance.

However, if the non-conforming offer concerns a contract for the sale of goods, a special provision of Article 2, designed to mitigate the "mirror image" rule, will often give rise to a contract *before* the act of performance that would have otherwise been the acceptance. UCC § 2-207 is designed to mediate the "battle of the forms" when parties to a sale exchange documents that contain diverging terms but they nevertheless proceed with the transaction as though they are in agreement. The first subsection of § 2-207 provides:

> A definite and seasonable expression of acceptance or a written confirmation which is sent within a reasonable time operates as an acceptance even though it states terms additional to or different from those offered or agreed upon, unless acceptance is expressly made conditional on assent to the additional or different terms.[32]

Assuming the battling forms satisfy a "definite and seasonable expression of acceptance," they will give rise to a contract even though the acceptance document "states terms additional to or different from those offered . . . ." This has generally been interpreted as giving rise to a contract so long as the terms the parties chose to focus on agree ("expression of acceptance"), even though many of the other terms, although important, do not agree but were not a focus of the negotiations. For example, if the parties specifically negotiated the volume, price, and delivery of gas, a contract could arise as to those terms even though other terms, such as warranties and indemnities, do not agree.

The second subsection of § 2-207 addresses the effect of these other terms, where the offer and acceptance do not agree:

> The additional terms are to be construed as proposals for addition to the contract. Between merchants such terms become part of the contract unless:
> (a) the offer expressly limits acceptance to the terms of the offer;
> (b) they materially alter it; or
> (c) notification of objection to them has already been given or is

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KAN. STAT. ANN. § 84-2-725(1) (1996).

[32]UCC § 2-207(1) (original version). As will be discussed later, § 2-207 has been significantly changed by the 2003 revisions to Article 2.

given within a reasonable time after notice of them is received.[33]

The key provision is that the additional terms are mere "proposals" which will not become part of the contract unless there is additional assent to the proposal. Their existence will not prevent the formation of a contract, but they will not become part of the contract that is formed.[34]

Major controversy has focused on the effect of having "different" material terms in the accepting document.[35] This has given rise to two responses to different terms: one approach favors the offeror and is known as the "drop out" rule; the other favors the accepting party, and is known as the "knock out" rule. Under the drop out rule the different terms in the acceptance merely "drop out" of the deal and have no effect on the offer. Under the knock out rule the different terms in the acceptance do not become part of the deal, but they "knock out" the similar but differing terms contained in the offer.[36]

The third subsection of § 2-207 provides:

> Conduct by both parties which recognizes the existence of a contract is sufficient to establish a contract for sale although the writings of the parties do not otherwise establish a contract. In such case the terms of the particular contract consist of those terms on which the writings of the parties agree, together with any supplementary terms incorporated under any other provisions of this Act.[37]

This subsection provides for situations where the terms of the documents do not reflect an "expression of acceptance" on the basic deal but the parties nevertheless proceed as though they have a contract. This can also arise when one of the parties seeks to use a defensive clause designed to prevent the formation of a contract under subsections (1) or (2). For example, subsection (2) allows the offeror to prevent the formation of a contract by stating, in the offer: "this offer is expressly limited to the terms of the offer."[38] Similarly, subsection (1) allows the

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[33]UCC § 2-207(2) (original version).

[34]If the offer and acceptance documents pass between "merchants" then any non-material term can become part of the contract unless the other party objects to the "additional" terms "within a reasonable time . . . ." UCC § 2-207(2)(b) (original version). The significance of this provision hinges on what is a "material" term.

[35]For a collection and analysis of cases lining-up the competing approaches in various states, see *Richardson v. Union Carbide Industrial Gases, Inc.*, 790 A.2d 962, 966-968 (N.J. Super. 2002) (identifying the "knock out" rule as the majority rule and adopting the rule as the law in New Jersey).

[36]*See generally* E. ALLAN FARNSWORTH, CONTRACTS § 3.21, pp. 161-170 (4th ed. 2004) (section titled "Battle of the Forms" with the specific discussion of the "knock out" rule at pp. 164-165).

[37]UCC § 2-207(3) (original version).

[38]UCC § 2-207(2)(a) (original version).

accepting party (the offeree) to prevent the formation of a contract by stating, in the acceptance: "acceptance is expressly made conditional on assent to the additional or different terms."[39] When the third subsection is triggered, the offeree is effectively able to cancel out the offeror's terms much the same way as does the "knock out" rule under subsection two.[40]

The 2003 revisions to § 2-207 make major changes and, in effect, adopt an analysis very similar to the original version of subsection three of § 2-207 by providing:

> [I]f (i) conduct by both parties recognizes the existence of a contract although their records[41] do not otherwise establish a contract, (ii) a contract is formed by an offer and acceptance,[42] or (iii) a contract formed in any manner is confirmed by a record that contains terms additional to or different from those in the contract being confirmed, the terms of the contract, are:
>
> (a) terms that appear in the records of both parties;
> (b) terms, whether in a record or not, to which both parties agree; and
> (c) terms supplied or incorporated under any provision of this Act.[43]

Once a contract is found to exist, § 2-207 identifies how the terms of the contract will be ascertained. It is not necessary to distinguish "material" from non-material terms. Instead, the analysis will focus on identifying terms that are found in both records and terms upon which the parties agree. Professor Farnsworth offers the following interpretation of the "parties agree" element of the test:

> [B]y asking a court to determine under (b) whether a party "agrees" to the other party's terms, the revised section gives courts discretion in including or excluding terms in a manner different from the more mechanical rules of the original section. A court might, for example, find that parties agreed to arbitration even though the arbitration provisions in their forms differed in minor respects.[44]

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[39]UCC § 2-207(1) (original version).

[40]The offeree, by proposing terms that prevent the writings of the parties from "agreeing," negates not only the offeree's terms, but also those of the offeror.

[41]"Record" is defined as "information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form." UCC § 1-201(31) (revised version).

[42]Revised UCC § 2-206(3) provides: "A definite and seasonable expression of acceptance in a record operates as an acceptance even if it contains terms additional to or different from the offer."

[43]UCC § 2-207 (revised version).

[44]E. ALLAN FARNSWORTH, CONTRACTS 170 (4th ed. 2004)

This avoids the "all-or-nothing" results under either the "knock out" or "drop out" rules and allows the court to fashion, when feasible and consistent with the intent of the parties, a hybrid provision with elements to which both parties indicated agreement.

Although § 2-207, whether original or revised, is commonly viewed in the context of a battle of the "forms," the analysis is not limited to "form" documents but applies to any actions between the parties that give rise to contract-formation issues. The major change made by the revised § 2-207 is, in the words of Professor Farnsworth: "intended to give no preference to either the first form, as did UCC-O [original] 2-207 or the last form, as did the common law."[45]

With the shift to a shorter-term gas sales cycle, deals will often be made quickly through an exchange of documents purporting to be an offer and acceptance. As a sale of goods, these transactions will be governed by Article 2 of the UCC. Disputes over the existence and terms of a contract almost always arise in these settings after some degree of performance has taken place. In such cases the issue will be whether a contract exists under the first two subsections of § 2-207 or the third subsection. Depending upon which subsection applies, the contract may be driven by either the offeror's terms[46] or terms on which the forms of the parties agree, plus any terms provided by the gap-filler provisions of the UCC. If either party finds these situations unacceptable, they must be prepared to police the documents they receive to ensure unacceptable offers or "acceptances" are rejected and the contracting process restarted until there is true agreement, or performance following the issuance of *your* new offer.[47]

B. "Security" for the Sale or Service

When describing "security" transactions to my students I often use the example of going to the bank to borrow money to buy a car. The bank looks into your credit history and finds that you have always paid your bills in a timely manner. The bank therefore agrees to enter into a contract, the "note," whereby the bank agrees to give you a sum of money in return for your promise to pay it back in accordance with the terms of the note. However, your good credit history, honorable

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[45] *Id.*

[46] Assuming a contract was formed under the § 2-207(1) & (2) analysis and the "knock out" rule does not apply.

[47] If all prior offers are *clearly rejected*, this allows the party issuing the next document to be the new offeror (thereby "restarting" the process). If the other party performs after receiving this new offer, and without tendering any sort of conflicting terms in response to the offer, the UCC will recognize the resulting contract. UCC § 2-204(1) (original version) states: "A contract for sale of goods may be made in any manner sufficient to show agreement, including conduct by both parties which recognizes the existence of such a contract." UCC § 2-204(1) (revised version) is more explicit and states: "A contract for sale of goods may be made in any manner sufficient to show agreement, ***including offer and acceptance***, conduct by both parties which recognizes the existence of such a contract, the interaction of electronic agents, and the interaction of an electronic agent and an individual." (Emphasis added).

reputation, and unconditional promise to pay in accordance with the terms of the note, are not enough. The bank wants "security" in the event you fail to live up to your promise to pay. In the event you breach your contract (the note), the court wants first claim, "priority," to an asset in your possession to help ensure the bank is fully compensated. In this case, because the bank is loaning money so you can buy a car, the bank wants a "security interest" in the car so it can seize the car, and in most cases sell it, so the proceeds can be used to compensate the bank for damages it has suffered in conjunction with your breach of contract.

This article examines a frequently used security device where a third party contractually agrees to pay money in the event a party to the contract fails to perform: the letter of credit. This section also addresses the creation of a "security interest" in the subject matter of a contract, such as gas or oil that is being sold, or the accounts receivable and proceeds associated with a resale of the oil and gas.

1. Letters of Credit and Article 5

There are two basic types of letter of credit: the "commercial letter of credit" and the "standby letter of credit." The commercial letter of credit is a method of payment; the standby letter of credit is more of a backup security device in the event the applicant defaults in its performance of a contract. Each facilitate commerce by allowing a contracting party (*beneficiary* of the letter) to rely upon the issuing party (usually a bank–the *issuer*) to either pay, or stand ready to pay, if certain conditions specified in the letter of credit are met.[48] The commercial letter of credit eliminates many excuses for non-payment by specifying the specific events that must occur as a condition to payment. Issues concerning performance of the contract, such as the conformity of the goods, can still be raised for example by the buyer (the *applicant*), but while these issues are being determined the seller (beneficiary) will have received full payment from the issuing bank.[49]

The standby letter of credit can be used to secure more than merely an obligation to pay money. For example, the obligation to deliver certain volumes of gas to a certain location on a certain schedule, can be supported by a standby letter of credit where the issuing bank agrees to pay in the event the gas is not delivered as required by the contract. This is an instance where the buyer seeks the bank's ability to pay where the obligation is something other than payment of a purchase price. In this situation the bank's obligation may be tied to a liquidated damages provision of the contract. The seller in such a transaction may require a letter of credit from the buyer to secure the buyer's promise to pay for all volumes delivered.

Letters of credit are the product of their own unique body of law supplemented by formalized standards of practice. The most important supplementary standards are the Uniform Customs and Practices for Documentary Credits (UCP 600) and the International Standard Banking Practice for the Examination of Documents under Documentary Credits (ISBP), ICC Publication No. 645. These were prepared and adopted by the International Chamber of

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[48]The relevant letter of credit definitions are found at UCC § 5-102.

[49]The only conditions to payment will be those specified in the letter. Typically these include a demand for payment (the draft), accompanied by an appropriate invoice, bill of lading, and insurance certificate.

Commerce. Their importance is most pronounced in Article 5 itself where, for example, at § 5-104 it provides:

> A letter of credit, confirmation, advice, transfer, amendment, or cancellation may be issued in any form that is a record and is authenticated (i) by a signature or (ii) in accordance with the agreement of the parties or the standard practice referred to in 5-108(e).

Section 5-108(e) requires that: "An issuer shall observe standard practice of financial institutions that regularly issue letters of credit." Official Comment number 2 to § 5-104 explains "standard practice" stating:

> An authentication agreement may be by system rule, by standard practice, or by direct agreement between the parties. The reference to practice is intended to incorporate future developments in the UCP and other practice rules as well as those that may arise spontaneously in commercial practice.

Therefore, to properly advise clients in this area counsel must be familiar with Article 5 plus all relevant practices and the unique body of interpretive law that has developed around letters of credit.

2. Security Interests and Article 9

Many oil and gas marketing transactions are sales on credit. There will often be a monthly cycle where oil or gas are delivered to a purchaser who will then have a period of time to make the necessary calculations and pay for the delivered oil or gas. The amounts involved can be enormous. The attendant risk can also be enormous, particularly when the oil or gas may be sold by **A** to **B** so **B** can turn around and sell it to **C**, and so forth. The oil or gas is no longer in the possession of the buyer (**B**) so the seller (**A**) is placing primary reliance on **B**'s promise to pay, plus whatever security **A** can obtain from **B** to secure **B**'s promise to pay. As noted in the previous section, **A** could require **B** to obtain a letter of credit to either pay the amounts due ("commercial" letter) or to secure payment by **B** in case **B** defaults ("standby" letter). **A** may also seek to obtain rights in property owned by **B** to secure **B**'s payment obligations–"collateral."

The hallmark of Article 9 is providing a system to alert the world that a creditor has rights in the debtor's collateral. This protects persons purchasing assets from a debtor and other creditors who are seeking a security interest in the debtor's assets. The creditor's goal is to first take the necessary action to create a "security interest." This will be followed by the necessary action to "perfect" the security interest to establish a priority to the debtor's property that is subject to the security interest.

"Security interest" is defined by § 1-201(37) as: "an interest in personal property or fixtures which secures payment or performance of an obligation."[50] The first step is determining how to create the "interest" in the debtor's various types of "personal property and fixtures." The

[50]UCC § 1-201(37) (original version; revised version substantially similar).

debtor's property that is subject to the security interest is called "collateral."[51] Much of the challenge under Article 9 concerns properly classifying the debtor's collateral so: (1) a security interest can be created in the proper collateral; and (2) the proper steps can be taken to perfect the security interest in the collateral. Collateral can consist of tangible personal property, such as "goods" which is defined to include "all things that are movable when a security interest attaches."[52] This is also further defined by categories of goods such as "equipment."[53] It can also include intangible personal property that has been placed into many different Article 9 categories, such as: "accounts,[54] chattel paper,[55] commercial tort claims,[56] deposit accounts,[57] documents, [58] general intangibles, [59] instruments, [60] investment property, [61] letter-of-credit rights,[62] letters of credit, money," that are excluded from the definition of "goods."[63] There are also specialized classifications, such as "inventory" which include various categories of "goods,

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[51]UCC § 9-102(12).

[52]UCC § 9-102(44). The definition also expressly includes things that may not be movable, such as "fixtures" and "standing timber that is to be cut and removed under a conveyance or contract for sale . . . ." The definition expressly excludes: accounts, chattel paper, commercial tort claims, deposit accounts, documents, general intangibles, instruments, investment property, letter-of-credit rights, letters of credit, money, or ***oil, gas, or other minerals before extraction***." (Emphasis added). The intangible items are covered by other provisions of Article 9, the real property interests in "oil, gas, or other minerals before extraction" would be covered by mortgage law.

[53]"'Equipment' means goods other than inventory, farm products, or consumer goods." UCC§ 9-102(33). "Inventory," "farm products," and "consumer goods" each have their own definitions. UCC § 9-102(23) (consumer goods); (34) (farm products); (48) (inventory).

[54]UCC § 9-102(2).

[55]UCC § 9-102(11).

[56]UCC § 9-102(13).

[57]UCC § 9-102(29).

[58]UCC § 9-102(30).

[59]UCC § 9-102(42).

[60]UCC § 9-102(47).

[61]UCC § 9-102(49).

[62]UCC § 9-102(51).

[63]UCC § 9-102(44).

other than farm products . . . ."[64]

"Attachment" of the "security interest" is the first step in achieving secured status. The property interest we call a "security interest" is created, in most cases, when the debtor signs a "security agreement,"[65] granting rights in collateral owned by the debtor, and the creditor extends credit to the debtor.[66] To be effective against third parties, the attached security interest must be "perfected." An unperfected secured creditor will not be able to realize against the collateral until after all other lien creditors (including secured creditors who perfected their interest in advance of the creditor) have been satisfied out of the collateral. The most notable of the "lien creditors" will be the trustee in bankruptcy who is deemed to have the equivalent of a judicial lien as of the date of the bankruptcy filing.

Perfection is accomplished by filing a financing statement that identifies the debtor, the collateral, and the creditor.[67] Priority matters are addressed by an intricate set of rules found at UCC §§ 9-317 through 9-339. As with the letter of credit, anyone dealing with creating or perfecting a security interest must be thoroughly familiar with Article 9, any specialized state property law (including lien laws), and federal bankruptcy law.

3. Bankruptcy Issues

Recent events highlight the magnitude of credit extended in the routine marketing of oil and gas. For example, in the recent "SemCrude" Bankruptcy,[68] a group of related production purchasers, buying oil and gas in eight states, were unable to pay for oil and gas delivered to them by producers because they had experienced "catastrophic trading losses" exceeding $2.4 billion.[69] The major producer losses were caused by SemCrude's failure to pay for oil runs taken from June 1, 2008 through July 22, 2008, the date of SemCrude's Chapter 11 petition. Producers in Kansas alone had $132 million at risk for the 52 days of production.[70]

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[64]UCC § 9-102(48). "Farm products" are defined at UCC § 9-102(34).

[65]UCC § 9-102(73) ("'Security agreement' means an agreement that creates or provides for a security interest.").

[66]UCC § 9-203(a) ("A security interest attaches to collateral when it becomes enforceable against the debtor with respect to the collateral . . . .").

[67]*See generally* UCC §§ 9-308 through 9-316.

[68]Although separate voluntary petitions under Chapter 11 of the Bankruptcy Code were filed by SemGroup, L.P., and certain direct and indirect subsidiaries of SemGroup, the debtors will be collectively referred to in this article as "SemCrude."

[69]Mull Drilling Co. v. SemCrude, L.P., 407 B.R. 82, 89 (Bankr. D. Del. 2009) (adversary proceeding).

[70]The author was an expert witness tendered by the "Kansas Producers" in the *Mull Drilling* adversary proceeding.

The situation of the unpaid producers was further complicated by a group of SemCrude lenders that extended $2.55 billion in credit to SemCrude with security interests in substantially all of SemCrude's property.[71] Producers in Kansas and Texas asserted they had security interests in the production they sold pursuant to a non-uniform provision of Article 9 of the Uniform Commercial Code. For example, Kansas Statutes Annotated § 9-939a seeks to create a purchase money security interest in production sold to a purchaser. It also seeks to provide for automatic perfection and a super-priority over other interests in the sold production. Although the details of the Texas statute vary somewhat, it seeks to accomplish the same goals as the Kansas statute.[72]

The efforts of the Kansas and Texas legislatures to protect their production owners when selling oil and gas to a purchaser were thwarted by the choice of law provisions of Article 9. UCC § 9-301 (law governing perfections and priority of security interests), in conjunction with § 9-307 (defining location of a corporate debtor), directed that the law of Delaware be applied to determine perfection and priority issues. Because the Kansas and Texas producers did not create and perfect their security interests in accordance with Delaware law, their security interests would not have priority over those of lenders who followed Delaware law.[73]

As is often the case, a second tier of litigation, involving royalty owners, is unfolding. Several Kansas oil royalty owners have sued their lessee asserting the lessee must make them whole for SemCrude's failure to pay for royalty oil.[74] Although these cases are currently at the discovery phase, the outcome will most likely turn on identifying who owned the oil at the time of sale and the "seller" under the crude oil sales contract with the SemCrude entity.[75]

The SemCrude experience highlights the significant risk associated with selling production on credit and the difficulty in fashioning laws to protect the unsecured producer creditor.

III. THE IMPACT OF REGULATION ON MARKETING

Regulation has had a profound influence on oil and gas marketing. The past has much to

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[71] *Mull Drilling*, 407 B.R. at 90.

[72] The Texas statute, TEX. BUS. & COM. § 9.343, was the object of a separate adversary proceeding in *Arrow Oil & Gas, Inc. v. SemCrude, L.P.*, 407 B.R. 112 (Bankr. D. Del. 2009).

[73] *Mull Drilling*, 407 B.R. at 108 (the Kansas Producers); *Arrow Oil & Gas*, 407 B.R. at 137 (the Texas Producers).

[74] Woodard v. McCoy Petroleum Corp., Case No. 2009 CV37 and Schwartz v. McCoy Petroleum Corp., Case No. 2010 CV 10, 13th Judicial District, Kingman County, Kansas District Court, Division 4.

[75] The author is an expert witness tendered by McCoy Petroleum Corporation in the *Woodard* and *Schwartz* cases.

do with the present when it comes to marketing. Regulation has impacted the construction, ownership, and operation of the pipelines that move oil and gas from wellhead to refinery and end user; the same regulation has determined the marketing patterns for oil and gas. Although the players who own, operate, and use the marketing network have changed through the years, the basic physical realities of steel from wellhead to refinery or end user have not.

A. The Regulatory History of Oil

When it comes to marketing, the regulatory history of oil is largely defined by the *actions* of John D. Rockefeller and the *reactions* of state and federal governments. The actions of Mr. Rockefeller through his Standard Oil Trust were designed to control all forms of oil transportation, whether by rail or pipeline, and to ensure other producers could not compete with the Standard Oil Companies.[76] Standard Oil's competitive advantage was provided by the discriminatory accommodations of railroads and pipelines to ensure that Standard Oil's oil shipments received preferential rates and more favorable terms of service while its competitors were denied the same services or paid higher rates for service. Although on the surface it appeared that Standard Oil entities were paying the same rates, there would often be secretly negotiated "rebates"[77] and "drawbacks"[78] with transporters resulting in considerable discrimination in favor of Standard Oil and against its competitors. Historian Daniel Yergen describes the situation as follows:

> The size, efficiency, and economies of scale of Rockefeller's organization enabled it to extract rebates–discounts–on railway freight rates, which lowered its transportation costs below what competitors paid, providing it with a potent advantage in terms of pricing and profit. . . .
>
> Standard, however, did not stop with rebates. It also used its prowess to win "drawbacks." A competing shipper might pay a dollar a barrel to send his oil by rail to New York. The railroad would turn around and pay twenty-five cents of that dollar back, not to the shipper, but to the shipper's rival, Standard Oil. That, of course, gave Standard, which was already paying a lower price on its own oil, an additional enormous financial advantage against its competitors. For what this

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[76]Standard Oil Company of New Jersey v. United States, 221 U.S. 1, 31 (1911) (on November 16, 1906 the Roosevelt (Theodore) Administration filed a 170-page complaint against the network of Standard Oil companies).

[77]If the published shipping rate were $1.05/barrel, Standard Oil would pay the $1.05 but receive a rebate from the pipeline or railroad of $0.05 so the effective rate would be $1.00. Competitors would not receive the rebate and would therefore be disadvantaged in competing with Standard Oil entities by $0.05/barrel.

[78]A drawback is simply a rebate paid to Standard Oil on oil shipped *by its competitors*; using the example in the previous footnote, the shipper would pay Standard Oil $0.05 for every barrel of oil transported for a non-Standard Oil entity. This would cause Standard Oil's competitors to pay more for their services to subsidize Standard Oil so it can better compete against them.

practice really meant was that its competitors were, unknowingly, subsidizing Standard Oil. Few of its other business practices did as much to rouse public antipathy toward Standard Oil as these drawbacks–when eventually they became known.[79]

The regulatory response to this situation, at both the state[80] and federal[81] levels of government, was to make oil pipelines "common carriers" and require them to publish their rates and terms of service in a tariff which could not be lawfully altered to discriminate for, or against, any shipper. In 1906, the same year suit was filed against the Standard Oil entities, Congress passed the Hepburn Act which amended the Interstate Commerce Act of 1887 ("ICA"). The ICA regulated the transportation of oil by railroads; it was amended to include "the transportation of oil or other commodity, except water and except natural or artificial gas, by means of pipe lines . . . ."[82]

The regulatory pattern under the Hepburn Act has been to treat oil pipelines as common carriers, available to all shippers willing to pay the published tariff rates and comply with the published tariff terms of service. The tariff has been the basic regulatory tool to ensure equal access to oil transportation facilities on a non-discriminatory basis. Unlike many other forms of "common carrier" or "public utility" regulation, there is no *certificate* requirement nor any *abandonment* requirement. Oil pipeline regulation has therefore been described as "pure rate control unaccompanied by other restraints on entrepreneurial freedom."[83] As will be seen in the next section, the regulatory development for natural gas has been quite different from that of oil

B. The Regulatory History of Gas

The regulation of oil was driven primarily by the perceived harm the existing system inflicted on *producers*;[84] the regulation of gas was driven primarily by the perceived harm the existing system inflicted on *consumers*. In fact, part of the unspoken design of the natural gas regulatory system was probably that pipeline monopsony purchasing powers should be preserved, *in order to put the squeeze on producers*, because any gas acquisition savings would be passed

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[79]DANIEL YERGEN, THE PRIZE 39 (Simon & Schuster 1992).

[80]*E.g.*, 1905 KAN. SESS. LAWS ch. 315 & ch. 340.

[81]Hepburn Act, 34 Stat. 584 (1906).

[82]34 Stat. 584, § 1 (1906).

[83]Plantation Pipe Line Co. v. Colonial Pipeline Co., 104 FERC ¶ 61,271, Docket No. OR03-4-000, 2003 WL 22110837 at *8, ¶ 28 (Sept. 11, 2003).

[84]Although the first casualty of monopolization is always a competing producer, the second casualty will be the consumer that suffers from high rates for lower levels of service. It appears the focus with oil was on the producer casualties as opposed to the consumer–although in time, unchecked, the consumer would have been impacted as profoundly.

through to the ultimate consumers of the gas. This was possible because Congress refused to make gas pipelines "common carriers," but instead regulate them as "public utilities" so any savings in purchased gas costs at the producer level would be passed on to their customers.[85] By refusing to make the pipelines common carriers, they remained private facilities and closed to producers, or others, for transportation services. This gave the pipeline company a monopoly over not only the transportation of gas, but also the marketing of gas. This was the state of affairs created by the Natural Gas Act of 1938 and remained such until the Federal Energy Regulatory Commission began to chip away at this closed-access regulatory regime in the 1980's.

The early marketing pattern that developed with natural gas had the gas purchaser typically constructing their pipeline to the gas well. Therefore, the point of delivery was at or very near the point of extraction; "at the well." This is not surprising since the physical realities of gas are such that a pipeline structure must exist between the gas well and the ultimate consumer of the gas. Pipeline companies, as public utilities, viewed it as merely part of their necessary fixed assets to acquire the gas they needed to fulfill their service obligations; as part of their rate base, they would earn their regulated rate of return on the wellhead to end user pipeline investments.

It is interesting to observe that the one constant in the regulation, de-regulation, an re-regulation process is that the physical network of steel from wellhead to end user remains the same; only the entities owning or operating various segments of the network change. We have not discovered any more efficient or economical means to move gas from the wellhead to the end user without having pipelines connecting the source of the gas with the consumer of the gas.

Therefore, the regulatory history of gas has been largely one of changing the legal regimes so that different, typically non-utility, entities can own, operate, or have access to, various segments of the gas pipeline network. I have summarized this regulatory history as follows:

1911 to 1954 "Regulatory Gap" Period

1911 *West v. Kansas Natural Gas Co.*, 221 U.S. 229 (1911).
Oklahoma law prohibiting interstate transportation of gas violates commerce clause.

1924 *Missouri v. Kansas Natural Gas Co.*, 265 U.S. 298 (1924).
State public utility commission cannot regulate prices charged in a sale (at wholesale to a local distribution company–"LDC") for resale (by LDC to its retail customers). Rise of the "negative commerce clause."

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[85]Interstate pipeline companies do not make their money by buying gas at a low price and reselling at a higher price. Instead the cost of gas merely becomes one of their "costs of service" which they have an opportunity to recover through their public utility rate making formula. A major determinant of profitability is the volume of gas they are able to move through the pipeline. Keeping the purchased gas cost component low assists the pipeline company's profitability because it encourages consumption (through lower prices) which, in turn, requires higher levels of throughput (volumes) to meet demand.

1935 During formative stages of the Natural Gas Act the commerce clause was interpreted narrowly to restrict federal regulation of "local" activities--such as the production and in-state transportation of oil and gas.

1938 Natural Gas Act of 1938, 15 U.S.C. §§ 717-717w ("NGA").

Federal Jurisdiction:
(1) interstate transportation;
(2) sale for resale.

State Jurisdiction:
(1) "production or gathering";
(2) "local distribution";
(3) all other transportation or sale of natural gas.

Public Utility Regulatory Regime:
(1) entry ("certificate of public convenience and necessity");
(2) "cost-of-service" rates and terms of service;
(3) service obligation;
(4) exit ("abandonment").

1954 to 1984 Regulation of Structurally Competitive Natural Gas Sales Markets

1954 *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672 (1954).
Sale by an independent producer is a "sale for resale" under the NGA. Therefore, the price a producer charges for gas sold to an interstate pipeline, and the terms of the sale, are subject to federal regulation as a public utility. Individual "cost-of-service" rate making.

1968 *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968).
Substitute individual rate making with *area-wide* cost-of-service rate making.

1976 *California Co. v. Federal Power Commission*, 426 U.S. 941 (1976).
Denying review of shift to *nation-wide* cost-of-service rate making.

1978 Natural Gas Policy Act of 1978, 15 U.S.C. §§ 3303-3432 ("NGPA").

(1) Regulation extended to all "first sales" of natural gas (including *intra*state sales);
(2) phased deregulation of certain categories of gas (from 1979 through 1987);
(3) abandoned cost-of-service rate making and replaced it with "incentive pricing" through a schedule of "maximum lawful prices";
(4) abandoned entry/exit regulation for certain categories of gas;
(5) removed regulatory impediments for pipelines that wanted to ship gas for other pipeline segments.

1938 to 1978 Segmented Industry Functions

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

Transportation /Merchant: private right to transport gas on pipeline gives pipeline the ability to buy and sell gas with no competition from producers and end-users. (One buyer and reseller; not thousands.)

Local Distribution: LDC buys gas from pipeline for resale to its customers.

1984 to 1994 Federal Energy Regulatory Commission (FERC) Begins the Process of Creating a Competitive Wellhead Market for Gas

Key Elements:

(1) provide *open access* to transportation;
(2) eliminate historical constraints on *demand* for gas;
(3) eliminate historical constraints on *supply* for gas.

1984 FERC Order 380. Liberate demand by eliminating the "minimum bill."

1985 FERC Special Marketing Programs ("SMPs"). Provide alternatives to customers able to shop. Held to violate NGA's prohibition on "undue discrimination." *Maryland People's Counsel v. FERC*, 761 F.2d 768 (D.C. Cir. 1985) (*MPC I*, discounted gas prices) and 761 F.2d 780 (D.C. Cir. 1985) (*MPC II*, access to transportation).

1985 FERC Order 436. Provide open access to interstate pipelines for all customers willing to pay the shipping fee; also provided for various demand and supply liberating programs.

1987 Repeal portions of Powerplant and Industrial Fuel Use Act liberating demand for gas (allowing it to be used as a fuel in major fuel burning facilities).

Repeal portions of NGPA which required "incremental pricing" of gas which would make it less attractive (more expensive) as a fuel source.

1987 FERC Order 451. Liberate supply by creating a process to obtain the voluntary release of above- and below-market gas from long-term contracts.

1988 FERC Order 490. Eliminate exit (abandonment) requirements for producers.

1989 Natural Gas Wellhead Decontrol Act of 1989, Pub. L. No. 101-60, 103 Stat. 157 ("NGWDA"). As of January 1, 1993 phases out all NGPA gas price regulation and NGA gas sales entry/exit regulation.

1992 FERC Order 636. Complete open access and eliminate pipeline's merchant role.

1993 All federal gas price and gas sales regulation terminated by NGWDA.

1994 FERC begins the process of allowing interstate pipelines to "spin-down" (sell to an affiliate) or "spin-off" (sell to non-affiliated buyer) gathering systems that were previously operated as part of the interstate pipeline.

C. Affiliate Transactions

Although affiliated companies have always operated in the oil and gas industry, one of the major developments following open access to interstate pipelines was the creation of affiliated companies to conduct businesses that were once the sole province of the pipeline companies. For example, a producer that has been selling gas at the wellhead for years to its regulated interstate pipeline purchaser discovers: (1) the producer, and others, now have access to the pipeline that connects their well to the end user; and (2) the traditional pipeline purchaser is getting out of the gas purchase and resale business. The producer now has the ability to sell to new purchasers at the wellhead, or any number of points between the wellhead and the end user. The producer also has the ability to engage in other business enterprises it may be uniquely suited for–such as seeking to market other producers' gas as it seeks to market its own gas supplies.

These new business activities of aggregating supply, packaging supply, seeking out downstream buyers, gathering, treating, processing, storing, delivering to end users, and guaranteeing levels of service to end users, or intermediate marketers, are all new risks that are different from the gas exploration and production business. The prudent business planner will seek to isolate these risks in separate corporate entities.[86] The use of separate corporate entities to conduct various segments of the natural gas business also assists in distinguishing when one set of contracting parties have completed one business relationship and when a different set of contracting parties have entered a second business relationship.

The expectation in the oil and gas industry is that separate corporate entities will be treated as separate corporate entities, and such corporate separateness will be disregarded only when their use is fraudulent. Corporations were invented to isolate and control business risks. Frequently, for example, a properly-advised corporate client will use subsidiary corporations to conduct various business enterprises to isolate the risk of one line of business from another. Justice Souter noted, in an unanimous Supreme Court opinion:

> It is a general principle of corporate law deeply 'ingrained in our economic and legal systems' that a parent corporation (so-called because of control through ownership of another corporation's stock) is not liable for the acts of its subsidiaries. . . . 'A corporation and its stockholders are generally to be treated as separate entities.'[87]

Typically, the corporate separateness between affiliated companies will be disregarded only when

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[86] *See generally* Judith M. Matlock, *Payment of Gas Royalties in Affiliate Transactions*, 48 INST. ON OIL & GAS L. & TAX'N 9-1 (1997).

[87] United States v. Bestfoods, 524 U.S. 51, 61 (1998).

there is a factual basis for piercing the "corporate veil."[88]

However, regardless of how legitimate the operations of an affiliated company may be, they will be the object of intense scrutiny and intrigue by royalty owners, working interest owners, and other parties to agreements who suspect improper self-dealing at their expense.[89] It doesn't take a whole lot of advocacy skill to hammer the theme: "you can get a pretty sweet deal when you negotiate with yourself." The best way to counter these claims is to ensure all transactions with an affiliated company are defensible and that the deal is no less favorable to the complaining party than if they had been conducted with a non-affiliated entity. Many times an affiliated marketing entity, a "marketing affiliate," will be buying gas from not only the affiliated company but also from non-affiliated companies. In these cases the transactions with non-affiliates can provide the "arms-length" base line for comparing affiliate transactions.

However, often the challenged affiliate transaction is an attempt to accomplish another goal, such as moving a royalty valuation point to a location downstream from the initial inter-affiliate sales point.[90] In these cases the complaining party seeks to have the court disregard the separate corporate entities and treat them as one so the first transaction is not between the affiliated producer and the affiliated gas marketer, but rather the subsequent marketer transaction with its purchaser. Therefore, if the first transaction was a sale at the wellhead,[91] and the marketing affiliate then moved the gas to an unrelated intermediate marketer or an end user,[92] the

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[88]As noted by Justice Souter in *Bestfoods*:

> But there is an equally fundamental principle of corporate law, applicable to the parent-subsidiary relationship as well as generally, that the corporate veil may be pierced and the shareholder held liable for the corporation's conduct when, inter alia, the corporate form would otherwise be misused to accomplish certain wrongful purposes, most notably fraud, on the shareholder's behalf.

524 U.S. at 62.

[89]I have served as an expert witness for companies seeking to defend against claims of improper self-dealing between affiliated companies. The goal has been to explain why and how the oil and gas industry uses affiliated entities for different segments of the exploration, development, production, and marketing businesses.

[90]*See* David E. Pierce, *The Renaissance of* ***Law*** *in the* ***Law of*** *Oil and Gas: The Contract Dimension*, 42 WASHBURN L. J. 909, 935 (2004).

[91]Assume this sale was for $3.00/Mcf which is a defensible wellhead sales value; there are wellhead sales by non-affiliated entities at this price to the marketing affiliate.

[92]Assume this sale was for $4.00/Mcf which represents the value of the gas at the location where sold. Value could also be attributed, without regard for location, to additional covenants made by the marketing affiliate, such as an enforceable agreement to have certain volumes available at certain times.

complaining party would seek the value associated with the subsequent downstream sale by the marketing affiliate, instead of the sale by the producer to the marketing affiliate.[93]

The bottom line is that the use of separate corporate entities are useful and prudent ways of doing business; there is no inherent "foul play" when affiliates deal with one another. However, when transactions between affiliates take place, the parties must ensure those affected by the transaction will be treated no less favorably than if the transaction were between non-affiliated entities.

IV. CONCLUSION

Many of the issues regarding the production and marketing of oil and gas can be resolved by simply ascertaining: who *owns* the oil or gas at any given moment. For example, when the oil and gas emerges from the ground, who owns it? What documents must we examine to answer this question? What can each party do with the oil and gas? Does the gas gatherer "own" the gas, or are they merely providing a "service" to move the gas from point A to point B? Does the gas processor "own" the gas, or are they merely providing a "service" to separate the liquefiable hydrocarbons from the gas and redeliver the components back to the owner? This basic "property" concept of ownership will often determine basic "contract" concepts, such as what body of law will apply to determine the rights of the parties to the production? Will Article 2 of the Uniform Commercial Code apply or "general" contract (non-Code) law? Can a security interest be created in the property interest? If so, how will the property interest be classified for Article 9 purposes?

The oil and gas industry presents a wonderful opportunity to explore the complexities of property law and contract law. As this article demonstrates, the best way to deal with these complexities, as with most areas of the law, is to ascertain the essence of each relationship and each transaction and then build from this foundation. Complex legal problems compel us to start with an understanding of the basic principles on which the complexities of the law are constructed.

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[93]The royalty owner, and their attorney, will seek out a fraction of $4.00 vs. $3.00. However, this difference in value is not attributable to the presence of an affiliate, it is attributable to the *location* of the gas.

Common Contractual, Property & Security Issues

By

David E. Pierce

Professor of Law

1

The Development Phase

- Myriad Property Interests and Contractual Relationships
- Oil & Gas Lease
- Pooling Agreements; Unit Agreements
- Operating Agreements
- Assignments
- Farmout Agreements
- Division Orders

2

The Production Phase

- Moving from the development phase to the production and marketing phase.
- The transformation from **real** property to **personal** property.
- Review of the operative documents to identify when real property becomes personal property.

3

Oil & Gas Lease

- Defines which party owns the production.
- "**On oil**, one-eighth ***of that produced*** and saved . . . ."
- "**On gas** . . . the ***market value*** at the well of one-eighth of the gas so sold or used, provided that on gas sold at the wells the royalty shall be ***one-eighth of the amount realized*** from such sale."

4

Oil & Gas Lease

- **Condensate**: Oil? Gas? Separate clause?
- Authority in the lease for **lessee** to buy the lessor's oil?
- **"Lessee shall have the option to purchase any royalty oil *in its possession*, paying the market price therefor prevailing for the field where produced on the date of purchase."**

5

Pooling Agreements

- Agreements vs. Declarations
- If the lessor is a party to the agreement, there is a chance it could alter the lessor's lease rights.
- Some pooling agreements may try to unify the basis for calculating royalty.

6

Unit Agreements

- Lessor is a party to the Unit Agreement.
- Leases "amended to the extent **necessary to make them conform to the provisions of this agreement, but otherwise shall remain in effect**."
- API Model Form of Unit Agreement

7

Operating Agreements

- **Ownership Clause**: Each working interest owner "owns" a share of each barrel of oil and Mcf of gas in proportion to their ownership in the Contract Area.
- **Take-In-Kind Clause**: "Each party shall take in kind or separately dispose of its proportionate share of all Oil and Gas produced from the Contract Area."

8

The Marketing Phase

- Importance of title to oil and gas at any given time during the marketing process.
- Possession vs. Title (Ownership).
- Sale vs. Service

9.

Division Orders

- Perhaps the most significant marketing agreement.
- Law applied varies upon the **goal** sought to be achieved with the division order.

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Division Orders

- (1) Establish the owner's share of the extracted oil or gas.
- (2) Provide details on how and when production will be calculated and paid.
- (3) Establish the basic sales relationship between owner and buyer.
- (4) Change the basis for calculating royalty or overriding royalty stated in the underlying document.

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Division Orders

- **What is (are) the goal(s) trying to be achieved by the division order?**
- **Who is the dispute between?** Lessor and Lessee? Lessor and Non-Lessee Purchaser?
- **What is the substance involved?** Oil? Gas? Condensate?

12

Division Orders

- **Non-Lessee Purchaser**:
- **Oil**: lessor owns the extracted oil, classic sale of goods situation.
- **Gas**: contract in which the purchaser agrees to undertake the responsibility for distribution of proceeds. (a service)

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Division Orders

- Structuring the sale or service transaction using a division order, will trigger "***the law of* division orders**."
- Avoiding division order baggage:
- "Contract for Sale of Oil"
- "Contract for Sale of Gas"
- "Contract to Provide Payment Services"

14

Other *Sales* Contracts

- Gathering, treatment, or processing activities may be part of a "sale."
- What might at first glance appear to be a contract for gathering or processing **"services"** may in fact be a **"sale"** of the production with payment being a return (re-delivery at a stated location) of a stated fraction of the production, or its value.

15

Other *Service* Contracts

- Sometimes it is difficult to determine whether production is being ***sold***, or is merely being given in-kind as a payment for a ***service***.
- For example, the obligation to re-deliver 87% of the production to the lessee may indicate 13% of the production has been retained as a gathering, treatment, or processing **fee**.

16

Other *Service* Contracts

- The same sort of net-back could, however, reflect a **sale** with payment being 87% of the proceeds from a defined sale by the purchaser.
- The terms of the contract will determine whether a sale or service has taken place.

17

Role of the UCC

- **Article 2** (the "sale" of oil or gas)
- **Article 5** (the "letter of credit")
- **Article 9** (the "security interest")

18

"Sale" vs. "Service"

- **Article 2 applies to a "sale" of "goods."**
- **UCC § 2-107(1)** (original & 2003 revised):
- "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 ***if they are to be severed by the seller*** but until severance a purported present sale thereof which is not effective as a transfer of an interest in land is effective only as a contract to sell."

19

"Sale" vs. "Service"

- Once oil or gas extracted from the ground, they become "goods" governed by UCC Article 2.
- *E.g.*, production of oil under most oil and gas leases gives the lessor and lessee each **a share of the extracted oil**.
- The lessor and lessee, under the division order, are the **sellers** of the severed oil.

20

"Sale" vs. "Service"

- If there is no "passing of title" from seller to buyer "for a price" the transaction will in most cases be a "service" instead of a "sale."
- Net-back arrangements may be structured as a service "fee" or as the "price" for the sale of production.

21

"Sale" vs. "Service"

- Important to make the distinction:
- Article 2 has special contract rules not found in the general law (non-Article 2 law) of contract.
- The impact may be as basic as the statute of limitations.

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"Sale" vs. "Service"

- UCC § 2-725 provides for a **4-year SOL** without regard for whether the agreement is oral or in writing.
- Kansas:
- Non-sales contract in writing has a **5-year SOL**.
- Non-sales contract not in writing has a **3-year SOL**.

23

"Sale" vs. "Service"

- UCC § 2-725 also provides express authority to shorten the SOL from 4 years down to 1 year.
- **"By the original agreement the parties may reduce the period of limitation to not less than one year but may not extend it."**
- In many states this is not possible under the non-UCC SOL.

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"Sale" vs. "Service"

- UCC § 2-725 is one area where the 2003 revisions have been extensive.
- To determine the status of the Article 1 and Article 2 revisions in your jurisdiction, see http://www.nccusl.org and click on the "Final Acts & Legislation" link.
- Website of the National Conference of Commissioners on Uniform State Laws.

25

"Sale" vs. "Service"

- Article 2 modification of the **"mirror image" rule** of general contract law.
- Common law: an acceptance that varies from an offer is a rejection and counter-offer; if it is followed by performance by the other party, a contract is formed on the terms of the last, un-rejected offer prior to performance.
- **The "last-shot" rule.**

26

"Sale" vs. "Service"

- **UCC § 2-207 "battle of the forms"**
- Recognize that parties frequently exchange forms that have all sorts of inconsistent terms, but they nevertheless intend to create a contract on the terms they actually focused on in their negotiations.
- **Exchange forms, perform, is there a contract? If so, on what terms?**

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"Sale" vs. "Service"

- Is there a contract? **UCC § 2-207(1)**:
- "A ***definite and seasonable expression of acceptance*** . . . operates as an acceptance even though it states ***terms additional to or different*** from those offered or agreed upon, ***unless acceptance is expressly made conditional on assent to the additional or different terms***."

28

"Sale" vs. "Service"

- What are **the terms** of the resulting contract?

  "The ***additional terms*** [what about the "**different terms**"?] are to be construed as ***proposals*** for addition to the contract. ***Between merchants*** such terms become part of the contract ***unless***:

  (a) ***the offer expressly limits acceptance to the terms of the offer***;

29

"Sale" vs. "Service"

"The ***additional terms*** are to be construed as ***proposals*** for addition to the contract. ***Between merchants*** such terms become part of the contract ***unless***:

(b) they ***materially alter*** it; or

(c) ***notification of objection to them has already been given or is given within a reasonable time*** after notice of them is received.

30

"Sale" vs. "Service"

- **The role of "different" terms.**
- Will the offeror get a deal on their basic terms?
- **"Knock Out" rule**: different terms in the offeree's proposal will cancel out ("knock out") the offeror's differing terms.
- **"Drop Out" rule**: different terms in the offeree's proposal will simply drop out of the deal.

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"Sale" vs. "Service"

- What if there is **no "expression of acceptance"**? **[neither party agrees]**
- What if "**acceptance is expressly made conditional** on assent to the additional or different terms"? [**offeree** action]
- What is the "**offer expressly limits acceptance** to the terms of the offer"? [**offeror** action]

32

"Sale" vs. "Service"

- If a contract is not formed under UCC § 2-207(1) & (2), § (3) provides:

"**Conduct by both parties which recognizes the existence of a contract is sufficient to establish a contract for sale although the writings of the parties do not otherwise establish a contract.**

33

"Sale" vs. "Service"

- The "terms" of this § (3) contract include:

"In such case the terms of the particular contract consist of **those terms on which the writings of the parties agree, together with any supplementary terms incorporated under any other provisions of this Act.**"

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"Sale" vs. "Service"

- **2003 Revisions to § 2-207**:
- The solution is to recognize formation of the contract under terms similar to the original § (c) provisions of § 2-207.
- The "terms" of the contract follow a "knock-out" analysis resulting in terms that agree plus supplemental terms provided by the UCC.

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"Sale" vs. "Service"

- With the shift to a shorter-term gas sales cycle, deals will often be made quickly through an exchange of documents purporting to be an offer and acceptance.

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"Sale" vs. "Service"

- If you don't like the outcome of a § 2-207 analysis, the client must be prepared to police the documents they receive to ensure unacceptable offers or "acceptances" are rejected ***and the contracting process restarted*** until there is true agreement, or performance following the issuance of your new offer.
- **"Restarting" the process.**

37

"Security" for the Sale or Service

- You have provided your unconditional promise to perform (*e.g.* pay in accordance with the "note").
- The promisee (bank) wants more; they want some "security" in the event you don't live up to your promise.
- The bank wants a special, preferred right that attaches to collateral owned by the promisor to secure payment of the note.

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"Security" for the Sale or Service

- **Letters of Credit and Article 5**
- Two basic types of letter of credit:
  - (1) ***Commercial*** Letter of Credit
  - (2) ***Standby*** Letter of Credit
- Commercial Letter (method of payment)
- Standby Letter (back-up security device)

39

"Security" for the Sale or Service

- Letters of credit are the product of their own unique body of law supplemented by formalized standards of practice.
- The most important supplementary standards are the Uniform Customs and Practices for Documentary Credits (UCP 600).
- International Chamber of Commerce, Publication No. 645.

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"Security" for the Sale or Service

- **Security Interests and Article 9**
- Many oil and gas marketing transactions are sales on credit.
- **A** sells oil or gas to **B** and **B** resells the product to **C**.
- The product is typically no longer available to secure **B**'s obligation to pay, alternative collateral to secure the obligation?

41

"Security" for the Sale or Service

- How can you create an interest, a "security interest," in the debtor's [**B**'s] various types of "personal property and fixtures"?
- The debtor's property subject to the security interest is called "collateral."

42

"Security" for the Sale or Service

- Article 9: Rules for properly **classifying the debtor's collateral** so--

  (1) a **"security interest"** can be created in the collateral; and

  (2) proper steps can be taken to **"perfect"** the security interest in the collateral.

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"Security" for the Sale or Service

- **"Collateral"** can consist of tangible personal property, such as "goods" which is defined to include "all things that are movable when a security interest attaches."
- "Goods" and "intangible" personal property each broken up into many distinct categories such as "equipment" and "accounts."

44

"Security" for the Sale or Service

- **"Attachment"** of the **"security interest"** is the first step in achieving secured status.
- The property interest we call a "security interest" is created, in most cases, when the debtor signs a **"security agreement"** granting rights in collateral owned by the debtor, and the creditor extends credit to the debtor.

45

"Security" for the Sale or Service

- **"Perfection"**
- To be effective against third parties, the attached security interest must be **"perfected"**.
- Perfection is accomplished by filing a **"financing statement"** that identifies the debtor, the collateral, and the creditor.

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"Security" for the Sale or Service

- Perfection is necessary to ensure the secured creditor has **"priority"** over other creditors and transferees, including the most notable statutory lien creditor: the trustee in bankruptcy.
- Priority issues are also addressed through an intricate set of rules in Article 9.

47

Bankruptcy Issues

- Huge sums of credit extended by producers to production purchasers.
- In a 52-day period Kansas producers extended $132 million in credit to SemCrude.
- SemCrude also had financing from banks for $2.55 billion, secured by substantially all of SemCrude's property.

48

Bankruptcy Issues

- SemCrude suffered a $2.4 billion trading loss.
- Unable to pay for the production it had taken from the producers.
- SemCrude proceeds into Chapter 11 protection.
- But, Kansas and Texas had specific "non-uniform" provisions in Article 9 of the UCC to protect their interests – so they thought.

49

Bankruptcy Issues

- **Adversary Proceedings**
- ***Mull Drilling Co. v. SemCrude, L.P.*** (Kansas producers).
- ***Arrow Oil & Gas, Inc. v. SemCrude, L.P.*** (Texas producers).
- What effect will the Kansas and Texas statutes have regarding the Banks' security interests?

50

Bankruptcy Issues

- Goal of the Kansas and Texas statutes:
- Look at how producers do business and fashion the creation and perfection of a security interest around what they do – or fail to do.
- K.S.A. § 9-939a
- Tex. Bus. & Com. § 9.343

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Bankruptcy Issues

- Unfortunately, the Kansas and Texas procedures did not comply with Delaware law which applies the "uniform" provisions of the UCC in this area.
- **Choice-of-law:** jurisdiction where the debtor is incorporated.
- Here that was Delaware, and in some cases Oklahoma – but in no case Kansas or Texas.

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Bankruptcy Issues

- **The second tier of litigation:**
- Royalty owners want their lessees to make them whole.
- Who owns the product being sold?
- Who are the parties to the sales contract?

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Impact of Regulation on Marketing

- Regulation has had a profound influence on oil and gas marketing.
- Although the players who own, operate, and use the marketing network have changed through the years, the basic physical realities of steel from wellhead to refinery or end user have not.

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Impact of Regulation on Marketing

- **The Regulatory History of Oil**
- Actions of John D. Rockefeller and the reactions of state and federal governments.
- Discriminatory rates and practices associated with the transportation of oil.
- "Rebates" and "drawbacks."

55

Impact of Regulation on Marketing

- Regulatory responses: **make oil pipelines common carriers.**
- Interstate Commerce Act of 1887 amended in 1906 by the **Hepburn Act** to include "the transportation of oil or other commodity, except water and ***except natural or artificial gas***, by means of pipe lines. . . ."

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Impact of Regulation on Marketing

- Parallel actions taken by many state governments: e.g. 1905 Kan. Sess. Laws ch. 315 & ch. 340.
- Basic regulatory tool: **the filed tariff**.
- **Hepburn Act**: no certificate or abandonment requirements as are imposed on gas pipelines under the Natural Gas Act of 1938.

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Impact of Regulation on Marketing

- **The Regulatory History of Gas**
- Hepburn Act: legislative response to **protect *producers***.
- Natural Gas Act: legislative response to **protect *consumers***.
- NGA: Concerned with monopoly sales power of natural gas pipelines.

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Impact of Regulation on Marketing

- Basic decision not to make gas pipelines common carriers.
- Fits with the consumer-protection motive by retaining pipeline monopsony purchasing power (over producers) because as a public utility the benefits of such lower gas acquisition costs will be passed-through to the consumer.

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Impact of Regulation on Marketing

- **Resulting marketing pattern**: sales at or near the point of production; pipeline takes title to the gas and resells it to the ultimate end user.

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Impact of Regulation on Marketing

- Shifting from a ***private facility*** to a ***common carrier facility*** model:
- The **physical structures** remain the same.
- The **parties using** the physical structures have changed as the regulatory system has given them access to such structures.

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Impact of Regulation on Marketing

- The regulatory history of gas has been largely one of changing the legal regimes so that different, typically non-utility, entities can own, operate, or have access to, various segments of the gas pipeline network.

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Impact of Regulation on Marketing

- **Pages 25-27** of the Article:
- A Brief Regulatory History of Natural Gas Regulation.
- **1911 to 1954** "Regulatory Gap" Period
- **1954 to 1984** Regulation of Structurally Competitive Natural Gas Sales Markets
- **1984 to 1994** FERC Begins the Process of Creating a Competitive Wellhead Market

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Impact of Regulation on Marketing

- **1938 to 1978 Segmented Industry Functions**
- Production
- Transportation/Merchant
- Local Distribution

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Impact of Regulation on Marketing

- **1984 to 1994 Breaking Down the Segmented Industry Functions**
- Provide Open Access to Pipelines and other Facilities
- Eliminate Artificial Restraints on Demand
- Eliminate Artificial Restrains on Supply

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Affiliate Transactions

- Upswing in the use of affiliates, "marketing affiliates," as new opportunities became available for gas producers to engage in downstream activities previously the province of the owner of the closed-access pipeline systems.

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Affiliate Transactions

- These new business activities of aggregating supply, packaging supply, seeking out downstream buyers, gathering, treating, processing, storing, delivering to end users, and guaranteeing levels of service to end users, or intermediate marketers, create new risks that are fundamentally different from the gas exploration and production business.

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Affiliate Transactions

- The prudent business planner will seek to isolate these risks in separate corporate entities.
- Also helps to identify when one set of contracting parties have completed one business relationship and when a different set of contracting parties have entered a second business relationship.

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Affiliate Transactions

- Basic function of the corporation: isolate an control business risks.
- ***United States v. Bestfoods***, 524 U.S. 51 (1998).
- Traditional piercing the "corporate veil" analysis.
- Basic premise: corporate separateness will be honored absent fraud.

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Affiliate Transactions

- Always the object of intense scrutiny and intrigue by royalty owners, working interest owners, and other parties who suspect improper self-dealing at their expense.
- **Best defense (and offense):** non-affiliated transactions that can be compared with the results under the affiliated transaction.
- Major issue: comparing "apples with apples."

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Affiliate Transactions

- In the royalty setting the goal of attacking the affiliate transaction is often associated with trying to change the ***location*** where royalty will be calculated.

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Affiliate Transactions

- For example, assume you have a lease requiring royalty based upon market value or proceeds "**at the well**."
- An affiliated marketing company purchases the gas "at the well" and then resells it after it is gathered and processed, at a location **downstream from the wellhead**.

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Affiliate Transactions

- By attacking the initial sale at the wellhead, the royalty owner is often merely trying **to move the royalty valuation point** to, for example, "at the interstate pipeline" instead of "at the well."
- This could be the result if the initial affiliate transaction is ignored and the sale by the affiliated marketing company is treated as the first sale by the affiliated production company.

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Affiliate Transactions

- The best defense in these situations would seem to be refocusing the world on the claimed harm associated with the affiliate transaction: whether **the sale at the wellhead**, by the affiliated producer to the affiliated purchaser, was at a price comparable to what it would have been had the purchaser, or seller, been a non-affiliated entity.

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Conclusion

- Many of the issues regarding production and marketing of oil and gas can be resolved by simply ascertaining: who ***owns*** the oil or gas at any given moment.
- This often requires a tracing of the oil or gas as it flows through the production and marketing process to determine when it transitions from **real property** to **personal property**.

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Conclusion

- This basic **"property"** law concept will often dictate the basic **"contract"** law that must be applied, such as whether the transaction is a "sale" of "goods" or a non-sales transaction.
- The transaction (the contracts) impacting the property must also be carefully analyzed to determine whether a **"sale"** or **"service"** is at issue.

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