

SPAIN, HASTINGS, WARD, CAREY & CHAMBERS



Preferential Rights And AMI Clauses In Oil And Gas Transactions

This article explores issues related to preferential rights and area of mutual interests clauses found in joint operating agreements and other oil and gas contracts, particularly in the context of an acquisition of properties.



This article considers some of the potential issues related to preferential right to purchase and area of mutual interests clauses (PRPs and AMIs) in oil and gas

agreements, especially joint operating agreements, that often arise in the context of modern package sale transactions. Quite often, the language of the PRPs and AMIs does not adequately address the issues that arise in today's business environment. Unfortunately, oil and gas assets are routinely sold with little or no attention given to the effects of the transaction on the applicable PRPs and AMIs. To make matters worse, these clauses often received inadequate scrutiny in the context of the original transactions in which they were drafted. In view of the problems these poorly drafted clauses can cause down the road, perhaps decades later, including costly litigation, we will address some of the primary concerns below.

Preferential Rights Clauses

A preferential right or "pref right" is essentially a right of first refusal. The Texas Court of Appeals has defined a preferential right as "...a preemptive right, which requires a property owner to first offer the property to the right holder at the stipulated price and terms in the event the owner decides to sell the property."² Historically, the use of preferential rights clauses in oil and gas agreements was fairly common, and indeed every version of the A.A.P.L.'s Form 610 Model Form Operating Agreement (the "Model Form")³ has contained a PRP, although the 1989 form, recognizing the industry trend away from the use of preferential rights clauses, contains a box that must be checked to include the clause part of the joint operating agreement. That latest form's PRP (Article VIII(F)) reads as follows:

Should any party desire to sell all or any part of its interests under this agreement, or its rights and interests in the Contract Area, it shall promptly give written notice to the other parties, with full information

concerning its proposed disposition, which shall include the name and address of the prospective transferee (who must be ready, willing and able to purchase), the purchase price, a legal description sufficient to identify the property, and all other terms of the offer. The other parties shall then have an optional right, for a period of ten (10) days after the notice is delivered, to purchase for the stated consideration on the same terms and conditions the interest which the other party proposes to sell; and, if this optional right is exercised, the purchasing parties shall share the purchased interest in the proportions that the interest of each bears to the total interest of all purchasing parties. However, there shall be no preferential rights to purchase in those cases where any party wishes to mortgage its interests, or to transfer title to its interests to its mortgagee in lieu of or pursuant to foreclosure of a mortgage of its interests, or to dispose of its interests by merger, reorganization, consolidation, or by sale of all or substantially all of its Oil and Gas assets to any party, or by transfer of its interests to a subsidiary or parent company or to a subsidiary of a parent company, or to any company in which such party owns a majority of the stock.

There are two generally recognized purposes for parties including a PRP in their joint operating agreements, namely to provide a way to increase one's interests in the contract area and to exercise some control over who your fellow investors are:

... First, it assures its holder an opportunity to acquire further interests in a contract area. In joint operating agreements, each owner believes that the other interests in the subject property are of some value. The preferential right, therefore, assures each owner the opportunity to purchase those valuable rights should a co-owner of an interest decide to sell his interest to a third party. It thus allows those owners, who may have been at risk in exploratory efforts which contributed to the development of the property, to have an opportunity to acquire an additional interest in the property before a third party who did not participate in such risk.

Secondly, and perhaps more importantly, the preferential right to purchase ensures that the owners retaining their interest in the contract area have some degree of control in excluding undesirable participants who may not have the necessary financial ability to bear their share of expenditures or who might frustrate development with management and engineering philosophies which current owners oppose.⁴

Other purposes may also be served by the use of PRPs, such "as a relatively inexpensive means to preserve the right to acquire ancillary facilities, improve access or land positions, or for other reasons."⁵

Issues Related To PRPs

A number of issues related to PRPs have been litigated, some of which will be summarized here. For example, most courts have held that the

rule against perpetuities does not apply to a PRP.⁶ Further, courts have held that the PRP is a covenant that “runs with the land.”⁷ Also, the notice to the PRP holder does not have to explain how a sale price was allocated to a specific property in order to be proper notice.⁸ In *Fasken Land and Minerals, Ltd. V. Occidental Permian Ltd.*, a case concerning a \$3.5 billion transaction for oil and gas assets in Texas, the PRP holders of the Midland Farms Unit (the “MFU”) were notified that the allocated value of the MFU was \$63 million for purposes of exercising the PRP. When litigation ensued about the allocation, the Fasken entities took the position that the PRP notice letter must provide “full information.” The actual language of the PRP in the MFU unit operating agreement only required that the notice give an allocation to the MFU if it was part of a package deal, and said nothing about explaining the basis for the allocation. Accordingly, the Court held that information explaining the allocation was not required: “While it is undisputed that OPL provided no information to Fasken concerning the basis for the \$63 million allocation of the purchase price attributable to the MFU, no such information was required by Article 24.1 for purposes of providing written notice of the proposed transaction. Therefore, the trial court did not err in failing to declare the notice was invalid on this ground.”⁹

How A PRP Is Exercised

Courts have also held that in order to exercise the PRP, the holder must agree to purchase the interest on the same terms that it is being offered and cannot, for example, try to purchase some leases but not others.¹⁰ In *Samson Resources Co. v. Amerada Hess Corp.*, Amerada and Samson were parties to three separate JOAs containing PRPs and maintenance of unit ownership provisions. Amerada notified Samson that it was selling three wells covered by the PRPs, and Samson responded that it would purchase only one of the wells. Litigation ensued after Amerada would not agree to sell Samson only the one well. The Court explained how

the PRP should work: “Therefore, Amerada’s offer to DLB became its offer to Samson as preemption holder. In order to accept the offer, Samson had to fully meet the terms of the deal between Amerada and DLB as to the interests covered by the preferential right to purchase.” The Court held that the maintenance of unit ownership provisions in the JOAs required Amerada to “sell its entire interest in all the leases or an equal undivided interest in all the leases covered by each JOA” (which requirement the package deal satisfied) and, likewise, “Samson was required to accept that condition and purchase Amerada’s entire interest under each applicable JOA.” Accordingly, as to the JOAs for which Samson agreed to purchase all of Amerada’s interest, specific performance was affirmed, but not as to the others.

A PRP holder that stands by and watches while the PRP is not honored may be estopped from later enforcing it.¹¹ In *Mulvey v. Mobil Producing Texas and New Mexico Inc.*, Mulvey bought interests subject to a 1951 joint operating agreement (the “JOA”) that included a PRP to purchase any leases sold to another party. Other parties to the JOA, Mobil and Arco, entered into farmout agreements with Pecos Development Corporation, which completed two gas wells and earned an interest from Arco and Mobil. Neither Mobil nor Arco complied with the PRP by giving notice to Mulvey prior to entering into the farmouts. Mulvey successfully force pooled one of the two wells in an administrative proceeding before the Texas Railroad Commission and was allocated a percentage of production. When he later brought a civil suit and alleged that the PPR was violated, the Texas Court of Appeals held that Mulvey was on notice of the farmout agreements and therefore estopped from asserting the PRP:

Included in the record is a signed and dated document titled “Assignment of Interest in Production” in which Pecos assigns an undivided one-

twelfth interest in the 71-1 well to Mulvey. The document explicitly refers to Pecos' farmout agreement with Mobil and Arco and notes that "Assignee [Mulvey] represents and warrants that the interest assigned hereby is free and clear of all liens and encumbrances of any kind or character."

Mulvey clearly has, through this assignment, recognized and benefited from the very farmout to Pecos by Mobil and Arco of which he now complains. We conclude that he is estopped from making this complaint and therefore his grounds for appealing the summary judgment of the trial court, at least with regard to the 71-1 well, are unfounded....¹²

The Court's holding was consistent with the general rule of law it recognized, namely that "[a] preferential right to purchase, or right of first refusal, in particular is affected by an inconsistent action, as such a right can be automatically terminated by lapse of time or by conduct of the offeree clearly inconsistent with an intention to purchase."¹³

Triggering The PRP Clause

Probably the most fundamental issue regarding PRPs is what transactions trigger the clause; for example, does a merger or sale of stock triggers the PRP? One commentator has summarized the two lines of authority regarding what constitutes a sale for purposes of a PRP:

In one line of authority, the courts have placed emphasis on the presence of an arm's-length transfer that, if completed, would put the property beyond the reach of the preference right holder. This line of

authority holds that a sale occurs when a transaction occurs in which the disposition of the property, while not falling within the technical definition of a sale, has the same practical effect as a sale. These courts hold that if a transaction accomplishes what a direct sale would accomplish, then the PRP is applicable. In a second line of authority, courts have held that if sophisticated parties intend to include all possible dispositions as sales, the drafters could have included the many possible dispositions in the PRP.¹⁴

Turning to the question of mergers and stock sales, under the 1977, 1982 and 1989 A.A.P.L. 610 forms, the language of the PRP specifically excludes a disposition by merger, reorganization, consolidation, or sale of all or substantially all of the assets to a subsidiary or parent or subsidiary of a parent, or to any company in which one party owns a majority of the stock. And under the older forms, although the language did not address the point, there is case law holding that the PRP can be avoided by transferring the interest to a wholly owned subsidiary and thereafter selling the subsidiary.¹⁵

Another common scenario in which the question of whether the PRP is triggered is package sales. For instance, a company may package for sale its interest in leases covered by a joint operating agreement containing a PRP with other assets not covered by the PRP. Unlike the examples considered above, this scenario is not explicitly addressed by the Model Form PRP. There is little case law on this issue in the specific context of oil and gas PRPs, and since courts may seek to draw some general principles from other real property cases, we will consider some of those cases below.

It is well-established that a package sale does trigger the PRP. “Once a seller has given a holder a preemptive right to purchase a particular piece of property, that seller cannot defeat that right by selling that property to a third person as part of a larger transaction.”¹⁶ Package sales have been held to trigger the PRP in sales of land, equipment, and stock.¹⁷ There is a split in authority as to the remedy to the PRP holder in a package sale. Again, there is little case law in the specific context of oil and gas and the authorities considered below may not provide adequate analogies to oil and gas package deals, but are nevertheless likely to be considered by courts facing similar issues in oil and gas cases.

Remedies In PRP Litigation

The case law decisions fall into two different camps. Several courts have held that the party to the PRP is entitled to an injunction prohibiting the sale, or if the sale has already occurred, the purchaser may be ordered to re-convey the property back to the owner. For example, in a case where a lessor leased a half-acre of its 94-acre farm and the lease included a PRP as to the half-acre in the event the lessor sold it, the Supreme Court of Iowa explained that a package sale of the entire farm could be enjoined, or if the conveyance were completed, a re-conveyance could be ordered:

Since the landlord breached the tenant’s preferential right by selling the demised premises as part of the larger tract, the tenant can obtain relief which will maintain the status quo ante until the end of the lease term, when the preferential right expires. This may be accomplished by enjoining the landlord from conveying the demised premises to the purchaser, or, if the landlord has already conveyed, by requiring the purchaser to reconvey those premises to the landlord.¹⁸

However, this rule does not permit specific performance, which would require an apportionment between the property covered by the PRP and the rest of the property to be conveyed in the package sale. The New Jersey Court of Appeals has explained the reasoning behind the majority rule in a case concerning a package sale of lots of land that included lots affected by a PRP:

The weight of authority is opposed to the Michigan rule of apportionment of the price, nor can such a rule be supported in logic. In order to apportion, a court would not only have to remake the parties’ agreement, but would also be forced either to indulge in the unwarranted assumption that every acre of the parcel was of equal value, or to engage in the cumbersome and invariably unsatisfactory task of weighing expert testimony on the comparative values of the two parcels. We believe that the above New York and Pennsylvania cases express the sounder view in denying the optionee specific performance as to the whole property or the part covered by the option. We hold that an option of first refusal as to a portion only of a tract may be exercised only if the owner determines to sell that portion for a separate consideration; and the attempted sale of the whole tract for a single price is no indication of an intention or desire to sell the portion alone....¹⁹

Further, the PRP holder is typically not required to exercise his PRP as to the entire package, but only those properties covered by the joint operating agreement.²⁰ Of course, in most oil and gas package sales, there will be an agreed price allocation,

distinguishing it from the land sales considered above and weighing in favor of the remedy of specific performance.

In other jurisdictions, which include California and Texas, specific performance has been permitted as to the property covered by the PRP. For instance, where a landowner of a 100-foot wide tract leased the west seventy-five foot of the tract with a PRP, the Supreme Court of Michigan held that the lessor's sale of the entire tract violated the PRP and the lessee was entitled to specific performance:

Defendants insist, however, that there is no mutuality here because plaintiffs never made a tender nor accepted the offer contained in the option. But such acceptance by plaintiffs was made impossible by the defendants. Defendant Randall sold to the defendants Powers without notice to plaintiffs and sold the property covered by the option together with the adjacent parcel for one stipulated price so that plaintiffs, even now, cannot know what amount to tender for the parcel covered by their option. Under like circumstances the supreme court of California has held that it is competent for the court to fix the option price, afford the optionee an opportunity to accept and thereupon specifically enforce the resulting contract.²¹

Similarly, in a case concerning a 390.43-acre farm, of which four acres were affected by a PRP, the Supreme Court of North Dakota affirmed specific performance, not at market value, but at the price the seller was willing to accept from a bona fide purchaser in accordance with the language of the PRP:

The language of the clause in question in this case sets the price which the tenant must pay as the price that Johnson and Sand, as owners of the four-acre tract, were willing to accept from a bona fide purchaser. While it is true that no separate valuation was placed upon the four-acre tract under lease to Berry-Iverson while the Lockens were negotiating their purchase of the 390.43-acre farm from Johnson and Sand, there is no question but that the Lockens were 'bona fide purchasers' of the four-acre tract of land, as that term is used in the 'option to purchase' clause in the lease. The Lockens' offer of \$58,000 was accepted by Johnson and Sand. Such amount, on a pro rate apportionment basis is \$149.84 per acre.²²

Although the Court explained that it did not believe merely apportioning the price on a proportionate basis was generally the proper way to value the property covered by the PRP, it found that the evidence supported the trial court's pro-rata apportionment.

One Texas Court of Appeals, in a case concerning a sale of land, similarly looked to the language of the PRP and the terms of the sale of the entire tract to arrive at an apportionment. The PRP stated that the sale price would not be less than \$750/acre, the evidence showed that the entire tract was sold, without honoring the PRP, at \$650/acre, and the Court granted specific performance at \$750/acre.³ These jurisdictions, in light of their willingness to order specific performance where apportionment was possible, should favor specific performance in oil and gas package sales where there is a price allocation. Even with a price allocation, however, it is uncertain how these courts will address challenges

to the reasonableness of the allocations, i.e., parties may allege that the allocation was designed to prevent the successful exercise of the PRP.

Package Sale Transactions

Since the Model Form does not address package sales, and in view of the split in the case law on whether specific performance and apportionment are available in other real property contexts, significant attention should be given to PRPs in the drafting of joint operating agreements, which will often mean amended the form PRP. At a minimum, the following issues might arise in the context of a package sale should be considered in drafting the PRP language:

- What information is required in the notice of a package sale?
- What is required in the notice regarding allocation of the purchase price to the properties covered by the PRP in the joint operating agreement?
- What will be the mechanism, if any, for challenging the purchase price allocation?
- Does the exercise of the PRP only require the holder to exercise as to the properties covered by the PRP in the joint operating agreement?
- What are the PRP holders' remedies for enforcement?

PRPs And Fractional Interests

In addition to package sales, another common practice is the sale of fractional interests. Although these sales may violate the maintenance of uniform interest provision, that provision is often ignored. As an example, a participant in the joint operating agreement may sell its interests in only certain of its leases covered by the joint operating agreement, or may sell all or a portion of its interests

above or below a certain depth or in a certain geographic area. These transactions raise the question as to what affect these vertical and horizontal divisions have on other parts of the joint operating agreement. Does a participant who only owns shallow rights in the lands covered by the joint operating agreement still enjoy the PRP as to all properties sold, including deep rights? The courts have not squarely addressed these issues, and again, the better approach is to address the issue explicitly in the PRP language in the joint operating agreement.

AMI Clauses

Whereas PRPs place restrictions on sales of real property interests, AMIs regulate the acquisition of certain real property interests. "In [an] area of mutual interest agreement, the parties attempt to describe a geographic area within which they agree to share certain additional leases acquired by any of them in the future."²³ In the context of a joint operating agreement, the AMI may add value to a party's investment by assuring that party of a right to share proportionately in new acquisitions in the area of interest. One commentator describes the purpose of AMIs this way:

The purpose of the area of mutual interest clause is to insure every party to the operating agreement an opportunity to acquire a proportionate interest in any acquisitions within a specified area encompassing the contract area, regardless of the state of development of the newly acquired acreage. In simplified form, the area of mutual interest clause requires that any party acquiring any oil and gas interest within the contract area or within the prescribed distance from its perimeter give notice of the

acquisition and its terms to all other parties to the operating agreement, who then have an option for a specified period to elect to participate in the acquisition. As characteristic of options, this creates a continuing offer which becomes a bilateral contract of sale only when accepted by the optionee in the manner and within the time prescribed.²⁴

The Model Form does not contain an AMI clause, primarily because its operation extends beyond the contract area. AMI clauses are more commonly associated with farmouts, participation agreements, exploration agreements and joint ventures. Consequently, the language of AMIs varies greatly and what little case law is available construing AMIs tends to turn on facts peculiar to the case rather than providing generally applicable principles. Notwithstanding, the increase in package sales in the industry, as discussed above in connection with PRPs, also raises issues about AMIs. These clauses tend to be largely overlooked during transactions, and often are the fruit of poor drafting to begin with, so that the problems that arise are rarely addressed by the language of the AMIs themselves.

A common scenario is that, through acquisitions, a company is an AMI participant to two or more AMIs whose geographic areas overlap in part. This raises the obvious issue of how the participant can honor its competing obligations under the overlapping AMIs (assuming the overlapping AMIs involve different parties). The respective parties to each AMI have an expectation of receiving a specific percentage in a newly acquired lease, but if the acquirer has to honor two or more AMIs, the percentages will be diluted, thus violating all of the competing clauses. This problem is merely illustrative of the sorts of issues that may arise under often poorly drafted AMIs. The best

advice is to draft AMIs that address the sorts of issues to be expected in package sale and overlapping AMI situations, or in transactions involving pre-existing agreements with AMIs, to at least take the time to determine the legal problems that might be raised by the contemplated transaction. To this end, the checklist below references some of the issues to consider in drafting an AMI² or in reviewing AMIs as part of due diligence as part of a contemplated acquisition:

- The geographic area should be specifically described. A map outlining the area can be attached as an exhibit to the agreement. The language should specifically address the lands on the perimeter and just outside or contiguous to it. It should satisfy the applicable statute of frauds.
- Does the geographic area include all depths?
- Should there be a mechanism for expanding the AMI if further seismic work demonstrates that the applicable formations extend outside the AMI area?
- The duration of the AMI should be specifically stated, preferably at the beginning of the provision. The drafters should consider whether the rule against perpetuities might apply.
- Do all parties to the joint operating agreement enjoy the benefits of the AMI for all purposes? And are they all bound by it as well? For example, can a party who only owns shallow interests exercise the AMI as to a deep interest? Does a party that abandons its interests in a certain geographic area continue to enjoy AMI rights in that area?
- Is the AMI a covenant running with the land?

- How does the AMI apply to related parties and affiliates?
- Does the AMI cover acquisitions from third parties only, or also from other participants in the joint operating agreement?
- What sort of acquisitions are covered by the AMI (what triggers the AMI)? Does it cover non-operating interests, facilities, farmouts, and if so, when does the AMI right vest?

Conclusion

Two of the more commonly overlooked provisions in joint operating agreements, the PRPs and AMIs, are also two of the most likely to lead to headaches and potentially costly litigation. The drafting stage is obviously the best time to address and hopefully prevent the litigation. As discussed above, the PRP problems that are arising in modern transactions are not addressed by the A.A.P.L. form, and therefore should be addressed by the drafting lawyers. AMIs, for which there is no recognized form, are often poorly drafted and ignore a host of issues like those in the bullet-list above. These issues should also be considered at the due diligence stage. If they present areas of potential liability, that consideration needs to be taken into account in negotiations for any acquisition of affected properties.

¹*Fasken Land and Minerals, Ltd. v. Occidental Permian Ltd.*, 2005 WL 1539260 at *8 (Tex.App.–El Paso June 30, 2005).

²The A.A.P.L. refers to the American Association of Professional Landmen. The A.A.P.L. issued its first form joint operating agreement in 1956, and the form has been subsequently amended.

²John R. Reeves, *Compendium of Cases Construing The Model Form Operating Agreements*, 52 Rocky Mountain Mineral Law Institute 11-1 (2006).

³J.R. Cooney and L.P. Ausherman, *Preferential Purchase Rights In Mineral Agreements*, 37 Rocky Mountain Mineral Law Institute 9 (1991).

⁴Andrew B. Derman, *The New And Improved 1989 Joint Operating Agreement: A Working Manual*, Section of Natural Resources, Energy, and Environmental Law, American Bar Association, at 107 (1991) (“Although preferential purchase provisions may appear to extend beyond 21 years they do not violate the rule against perpetuities as they are not an interest in real property, but rather only a contract right.”); *Power Gas Marketing & Transmission, Inc. v. Cabot Oil & Gas Corp.*, 2008 Pa. Superr 54 (Ct. App. Pa. 2008); *Producers Oil Co. v. Gore*, 610 P.2d 772 (Okla. 1980); *Larson Operating Co. v. Petroleum, Inc.*, 84 P.3d 626, 633-34 (Kan. 2004).

⁵*First Permian, L.L.C. v. Graham*, 212 S.W.3d 368, 372 (Tex.App.–Amarillo 2006, pet. denied).

⁶*Fasken Land and Minerals, Ltd.*, 2005 WL 1539260 at *8-9.

⁷*Id.* at *9.

⁸*Samson Resources Co. v. Amerada Hess Corp.*, 41 P.3d 1055, 1059 (Okla. Ct. App. 2001).

⁹*Mulvey v. Mobil Producing Texas and New Mexico Inc.*, 147 S.W.3d 594, 607-08 (Tex.App.–Corpus Christi 2004, pet. denied).

¹⁰*Id.* at 608.

¹¹*Id.* at 607-08.

¹²Timothy C. Dowd, *Preferential Rights To Purchase In Oil And Gas Transactions*, 49 Rocky Mountain Mineral Law Institute 5 (2003).

¹³*Tenneco Inc. v. Enterprise Products Co.*, 925 S.W.2d 640 (Tex. 1996).

¹⁴*Unlimited Equip. Lines, Inc. v. Graphic Arts Centre, Inc.*, 889 S.W.2d 926, 935 (Mo. Ct. App. 1994); *see also Myers v. Lovetinsky*, 189 N.W.2d 571, 575 (Iowa 1971) (“The decisions recognize in this kind of case, apparently without exception, that the landlord breaches the tenant’s preferential right by so doing.”).

¹⁵*Id.* (equipment); *Myers*, 189 N.W.2d at 576 (land); *Ollie v. Rainbolt*, 669 P.2d 275, 280 (Okla. 1983) (stock).

¹⁶*Myers*, 189 N.W. at 576; *see also Ollie*, 669 P.2d at 280.

¹⁷*Guaclides v. Kruse*, 170 A.2d 488, 494 (N.J. Ct. App. 1961).

¹⁸*McMillan v. Dooley*, 144 S.W.3d 159 (Tex.App.–Eastland 2004, pet. denied).

¹⁹*Brenner v. Duncan*, 27 N.W.2d 320, 322 (Mich. 1947).

²⁰*Berry-Iverson Co. of North Dakota, Inc. v. Johnson*, 242 N.W.2d 126, 135 (N.D. 1976).

²¹*Foster v. Bullard*, 554 S.W.2d 66, 67, 71 (Tex.Civ.App.–Austin 1977, writ ref'd n.r.e.).

²²*Westland Oil Dev. Corp. v. Gulf Oil Corp.*, 637 S.W.2d 903, 905 (Tex. 1982).

²³Gary B. Conine, *Property Provisions of the Operating Agreement – Interpretation, Validity, and Enforceability*, 19 TEX. TECH L. REV. 1263 at 1345 (1988).

²⁴For additional considerations, see Allen D. Cummings, *Old Area Of Mutual Interest And Dedication Agreements – New Problems*, 52 Rocky Mountain Mineral Law Institute 27 (2006).