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The Consequences of Not Complying with Preferential Rights to Purchase, Consents to Assign or Other Restraints on Assignment

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I. Introduction

By design, restraints on transferability restrict the liquidity of oil and gas assets, and they are never welcome in the context of asset purchase and sale transactions. Both buyer and seller would like to hear counsel advise that any restraint on assignment in the chain of title is not enforceable, not applicable this time, or otherwise can be disregarded. The disruptive effect of these encumbrances on farmouts, term assignments, and asset sales motivates buyers and sellers to structure transactions to avoid the application of the restraints, if possible, and when that is not possible, to take aggressive positions regarding the effect of these restraints.

This presentation will identify the attributes and purposes of, and discuss the compliance and enforcement issues associated with, the following restraints on transferability that have been specifically crafted for oil and gas assets: consent to assign, the "maintenance of uniform interest" provision contained in the AAPL Model Form Joint Operating Agreement (the "MUI"), preferential right to purchase (aka right of first refusal or ROFR), and the "right of reassignment" imposed by a prior owner who wants the right to reclaim the encumbered property prior to termination of the effective oil and gas lease(s).

II. Attributes and Purpose of the Restraints

A. Consents to Assign

Most consent requirements in the chain of title to oil and gas properties are created in oil and gas leases, although subleases, farmouts, or transfers of working interest may reserve to the grantor the right to approve transferees. Some of the variables for consents include: (i) absolute discretion to grant or deny consent vs. a standard of reasonableness or objective criteria to govern the suitability of successors, (ii) express statement of the consequences of non-compliance, such as voidness of the transfer or reversion of the grant, and (iii) limitations and exceptions to the events that require consent. Typically, the trigger is any assignment of the lessee's rights, but if the lessor is trying to assure a financially strong and competent operator (like the original lessee), then perhaps the following should not require a consent: partial assignments of working interest; assignments that do not involve change of operator; assignments to affiliates; assignments of overriding royalty interests, net profits interests, and production payments; liens. While any change in the ownership or management of the lessee could undermine the lessor's assumptions regarding the competence of the lessee as an operator, consent requirements are not usually drafted to be triggered by changes in the control or the equity ownership of lessees that are entities.

B. Maintenance of Uniform Interest

The MUI is a restraint on alienation that is unique to joint operating agreements, and the AAPL Model Form Joint Operating Agreement version provides as follows:

[1] Portions of this paper were adapted from Terry I. Cross, *The Ties that Bind: Preemptive Rights and Restraints on Alienation that Commonly Burden Oil and Gas Properties*, 5 Tex. Wesleyan L. Rev. 193 (1999) and Terry I. Cross, *Consents to Assign and Preferential Rights to Purchase- Restraints on Liquidity… and Value?*- Institute for Energy Law – 69th Annual Oil and Gas Law Conference (2018).

> For the purpose of maintaining uniformity of ownership in the Contract Area in the Oil and Gas Leases, Oil and Gas Interests, wells, equipment and production covered by this agreement no party shall sell, encumber, transfer or make other disposition of its interest in the Oil and Gas Leases and Oil and Gas Interests embraced within the Contract Area or in wells, equipment and production unless such disposition covers either:
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> > 1. the entire interest of the party in all Oil and Gas Leases, Oil and Gas Interests, wells, equipment and production; or
> > 2. an equal undivided percent of the party's present interest in all Oil and Gas Leases, Oil and Gas Interests, wells, equipment and production in the Contract Area.[2]

The MUI appears in all the AAPL Model Forms of Operating Agreement from the inception of the form in 1956. There have been modifications in the form, with the primary effect of confirming the application of the provision to limit transfers of non-expense bearing interests like overriding royalties, production payments, and net profits interests. The 1989 version, quoted above, clearly forbids creating "non-uniform" ownership of production.[3]

The MUI has both an overriding philosophical purpose and some incidental practical "good housekeeping" purposes. The "big picture" purpose is to protect the investment of the original risk takers by assuring that all parties with rights under the operating agreement will be similarly situated and motivated.[4] If all owners do not own uniform interests in all depths, then proposals for wells and for subsequent operations in wells will affect and motivate owners differently. The MUI assures that each party will have the same interest in all depths and (proportionate to its interest) the same amount of sunk costs in the producing and proved non-producing reserves and upside potential in the probable and possible reserves. The provisions of the operating agreement that depend on the MUI include:

1. <u>Non-Consent Penalty</u> - Protecting the right of consenting parties to receive the benefits of the non-consent penalty is a purpose of the MUI. Without the MUI, a party faced with a proposal for the drilling of a new well can attempt to negotiate farmout terms or other arrangements less harsh than the non-consent penalty provisions contained in the operating agreement (Article VI.B.(2)(b) of the 1989 AAPL form).

There is a provision, Section 26, "Restriction on Zone Transfers," in the 1955 version of the Rocky Mountain Mineral Law Foundation (Divided Interest) Form, that, as the title suggests, prohibits transfers that create differing ownership in depths within the contract area. This restriction was not included in the 1980 iteration: "That restriction fell into general disfavor over the years, because it could discourage drilling since a party might be willing to grant a farmout with respect to some, but not all, zones underlying a given tract of land."[5]

2. <u>Voting</u> - The provisions of the operating agreement regarding the voting to remove an operator and elect a substitute operator assume that each voting party owns a uniform percentage interest in the contract area. If those percentages are not uniform throughout the contract area,

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[2] Article VIII.D of the 1989 AAPL Model Form Operating Agreement.
[3] *ExxonMobil Corp. v. Valence Oper.* Co. 174 S.W.3d 303, 314 (Tex.App.-Houston (1st Dist.] 2005, pet. denied) held that a farmout that covered only non-productive acreage within the Contract Area breached the MUI.
[4] See Roach, *The Maintenance of Uniform Interest Provision: Are You at Risk?*, Southwestern Legal Foundation's 39th Annual Institute for Professional Landmen (1998).
[5] D.O. Churchill, *Revised Form 2 (Divided Interest) Rocky Mountain Unit Operating Agreement,* Rocky Mountain Mineral Law Foundation Special Institute on Pooling and Unitization of Oil and Gas Interests, Paper 5 (1980).

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