CONSENTS TO ASSIGN AND PREFERENTIAL RIGHTS TO PURCHASE - RESTRAINTS ON LIQUIDITY AND ... .VALUE?

§ 1.01 Introduction- Consents and Preferential Rights to Purchase

The due diligence checklist for every acquisition of oil and gas properties includes "consents to assign" and "preferential rights."[1] These restraints on alienation must be identified and addressed by both the buyer and seller as part of the evaluation of the title that will pass and the assessment of the contractual commitments and exposure to the beneficiaries of these provisions.[2] Who created these restraints and why?

The inclusion of the preferential right to purchase in the Ross-Martin Form 610 Model Form Operating Agreement–1956 (Section 18) reflected the attitude of the larger oil companies at that time of "drill, hold, deplete." They generally did not visualize themselves as sellers and, if another owner in the contract area wanted to sell, the ability of the "holders" to increase their holdings, and not coincidentally exclude any new undesirable co-owners who did not measure up to their standards for "partners," was part of the value they attributed to the asset. Things change. Today, many well-funded and technically competent oil and gas companies enter into exploration and development projects with publicly declared exit plans of three to five years. For them, liquidity is a stakeholder mandate.

Over the years, preferential rights have lost favor as, presumably, producers came to identify themselves as both buyers and sellers and, as such, came to recognize that the costs associated with these provisions outweigh the benefits. A telling marker for the decline in popularity of the preferential right is the 1989 version of the AAPL Form 610 Model Form Joint Operating Agreement. All prior editions of this model form (1956, 1977 and 1982) included the preferential right to purchase provision as part of the boilerplate. This provision was often deleted by the parties, but if not deleted, the preferential right was imposed by default on the contract area. In the 1989 and subsequent editions of this form, the provision is still included in Article VIII.F as an option, but there is a box to be checked and the preferential right to purchase will not constitute part of the agreement unless the parties take the affirmative act of checking the box. Even if most new operating agreements do not include the preferential right provision, there are still many properties encumbered by these restraints because, once imposed, they live for the life of the lease(s) burdened by them.

Consents to assign, on the other hand, are trending upward. They never were, and still are not, part of the preprinted oil and gas lease forms prepared by the producer industry[3] and, despite their proliferation, not consistently part of the checklists devised for the benefit of lessors.[4] As more lessors negotiate for the ability to exert control regarding the identity of successors to the lessee's rights and the terms on which these successors will own and operate the leases, more consent to assign provisions are

[1] The title and its reference to "restraint on value" ponders the effect of these restraints on the oil and gas producer's assets, thus the discussion will generally be framed from the producer's perspective.
[2] This discussion of consents to assign and preferential rights to purchase is derived from, and updates portions of, 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).
[3] See KANES FORMS™ R-Producers 88 (4/76-04) Paid Up and Pound Printing Company © Producers 88 (4/76) Revised Paid Up With 640 Acres Pooling Provision; *See also* 7 Patrick H. Martin and Bruce M. Kramer, Williams & Meyers, Oil and Gas Law, §699.7 (LexisNexis Matthew Bender 2009).
[4] *E.g.*, Judon Fambrough, *Hints on Negotiating an Oil and Gas Lease,* Real Estate Center, Texas A&M University (2015); but see John B. McFarland, *Checklist for Negotiating an Oil and Gas Lease, http://www.gdhm.com/wp-content/uploads/2016/08/jbm-ogleasechecklist.pdf,* which does discuss the issue of consents.

injected into the commerce of oil and gas assets. The trend is a challenge to all oil and gas producers and an acute challenge to the companies with stakeholder mandates for liquidity.

§ 2.01 Consents to Assign- Generally

Oil and gas leases are not the only contracts within the "package" in an oil and gas acquisition that may include a restriction on transfer that calls for a "consent" from a counterparty. The possible contracts housing these "consent" restrictions include contracts with service providers, purchasers of production, creditors, equipment leases, joint operating agreements with co-owners, and instruments that constitute part of the owner's chain of title, such as farmouts, subleases and, of course, the essential source of the producer's title and value, the underlying oil and gas lease. This discussion is limited to the consent requirements directed at the transfer of the right of exploitation and ownership of the oil and gas reserves in and under privately owned lands.

§ 2.02 Why Create Them?

Today most lessor generated lease forms include consent requirements for transfers by the lessee and more and more of the bolt-on addendum requests generated by lessors include one. Why have consent requirements climbed the lessor's wish list from being a rare request to its current status? Part of the answer is that oil and gas leases are now seen as negotiable. There was a time when the preprinted form, with "Producers 88" appearing at the top and the perception that its terms were "standard," comforted lessors. The terms were standard and the royalty was always 1/8 and the best any lessor could do was to chisel a few extra dollars as bonus. The royalty is no longer assumed to be 1/8 and all other terms are open for negotiation.

What is the lessor protecting with a consent provision? The most understandable purpose for this requirement, from the lessee's point of view, is the lessor's desire to assure that the lessee is financially strong and a competent operator. The original lessee can flatter itself with the thought that the lessor wants all successor owners to measure up to this initial suitor. Other purposes include preventing low net revenue interests, i.e., the creation of overriding royalty or net profit burdens that diminish the lessee's rewards for (and thus discourage) development. Low net revenue interests also expedite the date on which producing properties reach their economic limit, i.e., when operating costs exceed the revenues accruing to the working interest.

There may be other purposes that lessees can understand, but lessees will have a hard time intentionally signing up for the use of consent requirements by lessors to extract monetary payments or to reset the lease royalty fraction or other lease terms to the "market" as of the date of the request for the consent.[5]

[5] All of the following purposes for a lessor consent are stated by Professor Pierce without judgment or any pejorative color: "The lessor's task is to protect their economic interests without creating an unlawful restraint against alienation. The lessor's economic interests fall into five categories:
(1) The lessor's reliance on the reputation, skill, and financial position of the original lessee;
(2) the lessor's desire to share in any increased value of the leasehold;
(3) the lessor's desire to prevent the creation of excessive noncost-bearing interests which may discourage development;
(4) the lessor's desire to know the current owners of the leasehold; and
(5) the lessor's desire to avoid a large number of recorded transactions which will increase abstracting fees for routine transactions such as secured farm loans. David E. Pierce, "Analytical Approach to Drafting Assignments," 44 S.W.L.J. 943, 950 (1990).

§ 2.03 Consents to Assign – Enforceability and Enforcement

For any restraint on alienation, enforceability is a threshold issue. For restraints on alienation of mineral rights, the enforceability analysis requires perilous decision-tree scaling and a respect for swirling winds. The factors that bear on the analysis of enforceability and the attendant rights and remedies associated with them, each of which may have more or less impact in a given jurisdiction, include:

- The differentiation among the types of restraints as disabling, promissory and those restraints requiring forfeiture as the consequence of a breach.
- The differentiation between restraints on alienation of real property estates from the restraint on alienation of contract rights.
- Weakening respect for rules of law and canons of construction that defeat the intent of the original contracting parties.

With regard to the last point, there is a stiff wind blowing against any rule of law or canon of construction that is perceived to defeat the intent of the parties. In addressing the effect of the Rule Against Perpetuities, Professor Kramer spoke to the nature of rules of law as inherently "intent defeating":

> While the court splintered in its analysis, all agreed that the overriding obligation of the court is to give effect to the intention of the parties. This ignores the fact that the Rule, by definition, is intent-defeating. The real issue is not the intent of the parties but the classification of the interests created by the original deed. If the Rule, with its modifications, applies to the interest created, the intent of the parties is irrelevant. The majority, however, in seeking to carry out the intent of the parties, does violence to 1000 years of property law with ramifications far beyond the oil and gas context.[6]

Likewise, the rules regarding restraints on alienation, when they are applied, will inevitably void the intent of the original parties.

Canons of construction, which are different from rules of law,[7] are also showing signs of erosion, if not attack. The Texas Supreme Court recently acknowledged its intentional path toward abandonment of canons of construction for conveyances in order to better serve the "intent of the parties":

> Over the past several decades, we have incrementally cast off rigid, mechanical rules of deed construction. We have warned against quick resort to these default or arbitrary rules. And we do so again today by reaffirming the paramount importance of ascertaining and effectuating the parties' intent. We determine that intent by conducting a careful and detailed examination of a deed in its entirety, rather than applying some default rule that appears nowhere in the deed's text.[8]

§ 2.04 The Restraint- Name Your Bondage

Restraints on alienation are grouped into three groups: disabling, promissory and those requiring forfeitures. A disabling restraint simply accords no effect to any attempted transfer (e.g., "The rights of

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[6] Bruce M. Kramer, *Property and Oil and Gas Don't Mix: The Mangling of Common Law Property Concepts*, 33 Washburn L.J. 540, 541 (1994).

[7] *Id.,* at 564.

[8] Wenske v. Ealy**,** 521 S.W.3d 791, 792 (Tex. 2017).

lessee are not assignable without the prior written consent of lessor."). A promissory type of restraint reflects a promise by the owner not to alienate (e.g., "The rights of lessee shall not be assigned without the written consent of lessor."). The forfeiture type of restraint makes the termination of the grant as the consequence for any transfer (e.g., "Any transfer of an interest in or rights under this lease by lessee shall result in a forfeiture of all rights granted hereunder."). Generally, the common law regarding real property provides that (i) disabling restraints are void, (ii) promissory restraints are enforceable but breaches only result in claims for actual damages and (iii) the forfeiture variety, if properly drafted, can be enforceable.[9]

If these real property "rule of law" ground rules are still relevant,[10] the forfeiture type of restraint is the only one that is worth considering by an oil and gas lessor or any other grantor who means to use a consent requirement as a means of protecting property rights. The disabling type is a non-starter – it is void. The promissory type can yield damages in theory, but rarely will damages result from a breach, and it is not foreseeable how damages will ever result immediately upon the breach. At best, the holder of this type consent right is left smoldering (or maybe seething) about the breach, waiting for the bad consequence that was meant to be protected by the consent right, while monitoring the statute of limitations on the breach. Limitations may run before the damages arrive.

The case of *Palmer v. Liles,*[11] exemplifies the ineffectiveness of the promissory consent. This consent iteration[12] was contained in an agreement among working interest owners in oil and gas properties and one co-owner sold to a third party without seeking the consent. The party asserting the breach viewed the provision as a preferential right to purchase and couched the damage claim as being "the damages he suffered … as a result of his not owning the percentage transferred…"[13] This argument was deemed "untenable" and rejected.[14] The consent requirement, which was ignored, was neither a preferential right to purchase nor did it yield damages.

The forfeiture type consent restraint, when used in a real estate lease in Texas, will create a condition subsequent (not a limitation) and the grant will not terminate without a reentry by the landlord or an action to declare the forfeiture.[15] However, the case of *Outlaw v. Bowen*[16] casts doubt on whether Texas will enforce a forfeiture type consent requirement when a real property estate is encumbered. The consent under examination in *Outlaw* was contained in a mineral deed conveying an undivided mineral interest and provided:

> ". . . no conveyance or assignment of [the conveyed interest] shall ever be made except in whole and that any attempt to convey or assign any portion less than the whole thereof . . . <u>shall operate to forfeit</u> the entire [interest] conveyed . . . herein, and any such conveyance . . . shall be null and void."

[emphasis added] The court found no enforceable penalty within that restraint and the interest conveyed by the deed was held in fee simple, free of the restraint.[17]

§ 2.05 The Restrained- Name Your Captive

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[9]William E. Burby, Handbook of the Law of Real Property § 191 p. 427 (Hornbook Series, West Publishing Co.1965).

[10] *See* the discussion at note 19, *infra*, regarding Restatement of Property § 3.4 and the role "justification" can play in the defense of these restraints.

[11]677 S.W.2d 661 (Tex. App. - Hou. [1st Dist.] 1984, writ ref'd n.r.e.).

[12] The rights of the parties hereto shall not be assigned without the written consent of the other parties, which consent shall not be unreasonable withheld." *Id*., at 663.

[13] *Id*., at 663.

[14] *Id*.

[15] Reynolds v. McCullough, 739 S.W.2d 424, 1432-433 (Tex. App.-San Antonio 1987, writ denied).

[16]285 S.W.2d 280 (Tex. Civ. App. - Amarillo 1955, writ ref'd n.r.e.).

[17] *Id*., at 283.

Different rules govern the enforceability of restraints on alienation of an estate in land than govern the assignment of a contract and contract rights. Restraints on the assignment of contractual rights are generally enforced.[18] On the other hand, some restraints on the conveyance of land are, or at least historically have been, void --the benefits to society resulting from the free alienability of real estate winning out over the intent of the parties that created the restraint. The historic rule is stated by Burby[19] as follows:

> Except to the extent permitted by statute, a direct restraint upon the alienation of an estate in fee, or an equivalent interest in things other than land, is void. Promissory and forfeiture types of restraints are valid in the case of life estates and less than freehold estates.

Even before any consideration of where oil and gas leases and conveyances, with their unique characteristics, fall on the "estate in fee" and "freehold" grids, a trending softening of the rule for restraints on real property must be acknowledged. The most recent statement of the rule in the Restatement of Property[20] invites a "strong justification" aimed at the "reasons" to validate even disabling restraints. This is a significant departure from the unequivocal declaratory sentences used by Burby.[21]

If we have different rules for contracts than for real property estates and, within the latter, different rules for fee estates and "estates less than freeholds,"[22] what about oil and gas leases?[23] Oil and gas leases certainly embody contractual agreements but the primary function of the instrument is to convey a real property estate or at least rights in and to real property. The characterization of what an oil and gas lease is[24] and does in a given jurisdiction may influence, if not determine, the answer on enforceability. Specifically, there may be a different analysis in states that have adopted the "ownership theory" versus a qualified ownership or license or *profit a prendre* characterization.[25] Even after the states are divided according to their ownership versus *profit a prendre* orientations, as with many oil and gas law issues, there still may be variations within each group and, even within a single jurisdiction, the rules governing enforceability may not be clear or consistently applied.

Even though Oklahoma is a "*profit a prendre*" state, in the case of *Shields v. Moffitt*,[26] the Oklahoma Supreme Court invalidated a disabling restraint in an oil and gas lease[27] without any reference

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[18] *See* RESTATEMENT (SECOND) OF CONTRACTS § 322 (AM. LAW INST. 1981) cmt. a ("In the absence of statute or other contrary public policy, the parties to a contract have power to limit the rights created by their agreement. The policy against restraints on the alienation of property has limited application to contractual rights.").
[19] William E. Burby, Handbook of the Law of Real Property § 191 (Hornbook Series, West Publishing Co.1965).
[20] *See* RESTATEMENT (THIRD) OF PROP.: SERVITUDES § 3.4 cmt. d (AM. LAW INST. 2000) ("A prohibition on transfer of property without the consent of another is an unreasonable restraint on alienation unless there is a strong justification for the prohibition, and, unless the consent can be withheld only for reasons directly related to the justification for the restraint….").
[21] Burby, note 8, *supra.*
[22] *Id*.
[23] *See* Luke Meier and Rory Ryan, "The Validity of Restraints on Alienation in an Oil and Gas Lease" 64 Buff. L. Rev. 305 (2016); Benjamin Robertson, Katy Pier Moore, and Corey F. Wehmeyer "Consent to Assignment Provisions in Texas Oil and Gas leases: Drafting Solutions to Negotiation Impasse" 448 Tex. Tech. L. Rev. 335 (2015) for more detailed discussions of these issues.
[24] Howard R. Williams & Charles J. Meyers, Manual of Oil and Gas Terms (7th ed., Matthew Bender 1987) ("The very name, 'lease,' is unfortunate as it tends to give the impression to the uninformed that the "oil and gas lease" is of the same genus as the common law 'lease' of land, whereas, except in Louisiana [citations omitted] the dissimilarities are more important than the similarities.").
[25] Professor Bruce Kramer has grouped Arkansas, Colorado, Kansas, New Mexico, North Dakota and Texas as "ownership" states and California, Indiana, Louisiana, New York, Oklahoma and Wyoming as *profit a prendre* states. Bruce M. Kramer, *Property and Oil and Gas Don't Mix: The Mangling of Common Law Property Concepts*, 33 Washburn L.J. 540, 541 (1994).
[26] 683 P.2d 530 (Okla. 1984).
[27] ("This lease may be assigned only with the written consent of the lessors.") *Id*.

to the "ownership" and "*profit a prendre*" issues. The *Shields* court relied on *Lohmann v. Adams,*[28] which involved a deed to land, but the *Shields* court held the disabling restraint void without any distinction between deeds and oil and gas leases: "In *Lohmann v. Adams*, [citation omitted] we expressly determined that restraints upon alienation where there are no provisions for forfeiture or reversion are "disabling restraints" and void...."[29]

There is an argument to be made that an oil and gas lessor has a valid interest to protect with a consent requirement, but the *Shields* court did not recognize any such redeeming motive:

> Neither do we pass upon the validity of a suitably limited provision restraining alienation of a fee where imposed in reasonable protection of some interest in the premises retained by a grantor or third person, for the reason that <u>no such peculiar interest is here shown</u>.[30]

[emphasis added] The *Shields* opinion leaves an opening for the enforceability of a consent provision that is couched with forfeiture consequences:

> We likewise express no view herein as to what effect a forfeiture or penalty clause might have resulted had it accompanied the clause in the lease purporting to restrict right of sale without the consent of the plaintiffs/assignors.[31]

Arkansas falls in the "ownership" group and the federal court (applying Arkansas law) that decided the case of *Walls v. Petrohawk Properties*, LP,[32] was cognizant of the difference between landlord tenant law and oil and gas law in Arkansas. The consent requirement contained in the oil and gas lease under review was a promissory restraint[33] and the case turned on the reasonableness of the lessor's refusal to consent. The advocates cited *Warmack v. Merchants Nat'l Bank of Fort Smith,*[34] a landlord tenant case, and the court gave a scrupulous footnote to mark its discernment regarding differences between landlord/lessors and the grantors of oil and gas leases:

> Although *Warmack* does not involve an oil and gas lease, the parties have not cited, and the Court has been unable to find, a case involving the reasonableness of an oil and gas lessor's withholding of consent to assignment of a lease. Therefore, the Court will consider the law of the *Warmack* case as persuasive, not controlling, authority.[35]

Texas is firmly in the "ownership" group[36] and based on its willingness to invalidate conveyances (and the intent of the parties) when the Rule Against Perpetuities is violated,[37] one might expect Texas to take a strict stance on "consent to assign" restraints. No Texas cases were found enforcing or invalidating a consent to assign provision in an oil and gas lease or conveyance of an oil and gas lease.[38] In the recent

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[28] 540 P.2d 552 (Okla. 1975).
[29] 683 P.2d at 534.
[30] *Id*., citing "Validity of Restraint, Ending Not Later Than Expiration of a Life or Lives in Being, on Alienation of an Estate in Fee," 42 A.L.R.2d 1243 (1955).
[31] *Id*.
[32] 2012 WL 113266 (E.D. Ark. Jan. 13, 2012.)
[33] "Lessee shall obtain written consent from Lessor before assigning lease to a third party which consent shall not be unreasonably withheld." Id.
[34] 612 S.W.2d 733 (Ark.1981).
[35] 2012 WL 113266, at 4, fn 2.
[36] *See* Texas Co. v. Daugherty, 176 S.W. 717 (Tex. 1917); A.W. Walker, "The Nature of Property Interests Created by an Oil and Gas Lease in Texas: Part 1," 7 TEX. L. REV. 1 (1928).
[37] *See* Peveto v. Starkey, 645 S.W.2d 770 (Tex. 1982).
[38] The case of *Knight v. Chicago Corp,* 183 S.W.2d 666 (Tex. Civ. App. - San Antonio 1944), aff'd, 188 S.W.2d 564 (Tex. 1945) held that a unitization agreement, gas processing and sales agreement and the conveyance of a production payment to service companies did not require a consent under the specific language of the lease. Similarly, *In Clayton Williams Energy, Inc. v.*

Texas case of *Carrizo Oil & Gas, Inc. v. Barrow-Shaver Res. Co.*,[39] the consent requirement was in a farmout letter agreement. The consent was specific to the letter agreement[40] and did not address the ability of the farmoutee to convey the interests in oil and gas leases ultimately earned under the letter agreement. The court applied contract analysis in validating the restraint, giving wide latitude to "freedom of contract":

> We cannot change the contract simply because we or one of the parties comes to dislike its provisions or thinks something else is needed in it.[41] Parties to a contract are masters of their own choices and are entitled to select what terms and provisions to include in or omit from a contract.[42]

The *Thedford Crossing* case cited in the quotation involved a restraint on the assignment of a contract for the purchase and sale of real estate, which like the farmout agreement, was an executory contract rather than a conveyance of real estate.

§ 2.06 Consent Requested – Set Me Free

If the examination of a given consent requirement goes beyond the "enforceable" threshold, there is another set of variables to face, including how much discretion the holder of the consent right has in granting or denying the consent.

[1] No Criteria Stated

The absence of any expressed conditions for the granting or refusal of the requisite consent begs the question of whether the consent can be denied for no reason or for a bad reason. The answer to this question will vary from state to state. Most states impose an implied duty of good faith in the performance of all contracts,[43] which presumably would require that good faith be exercised in the granting or denying of required consents; however, the cases dealing specifically with consent requirements in real estate related contracts should be reviewed in each jurisdiction. In the case of *Boone v. Kerr-McGee Oil Industries*,[44] the Tenth Circuit, applying Oklahoma law, stated the duty of good faith in the following terms:

> Where discretion is lodged in one of two parties to a contract or a transaction, such discretion must, of course, be exercised in good faith. That simply means that what is done must be done honestly to effectuate the object and purpose the parties had in mind in providing for the exercise of such power. All the authorities are to this effect.[45]

Even if a duty of good faith is in play, the correlation of good faith to reasonableness and how that duty otherwise affects a pending request for a consent is not always clear.

BMTO O & G TX, L.P., 473 S.W.3d 341, 351 (Tex. App. – El Paso 2015, pet. denied 2016), the consent contained in an oil and gas lease expressly exempted transfers to "AMI partners" and the challenged transfer was determined to fall within that exception.

[39] 516 S.W.3d 89 (Tex. App. Tyler –petition filed 2017)(because a petition to the Texas Supreme Court has been filed, this opinion remains subject to the appeal).

[40] "The rights provided to BSR under this Letter Agreement may not be assigned, subleased or otherwise transferred in whole or in part, without the express written consent of Carrizo." Id.

[41] citing Thedford Crossing L.P. v. Tyler Rose Nursery, Inc., 306 S.W.3d 860, 867 (Tex. App.–Tyler 2010, pet. denied).

[42] 516 S.W.3d at 95.

[43] Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 Harv. L. R. 369 (1980).

[44] 217 F.2d 63 (10th Cir. 1954)

[45] *Id*., at 65.

In California, "every contract calls for the highest degree of good faith and honest dealing between the parties,"[46] yet prior to legislation in 1989[47] there were cases going different directions, depending on the date of the lease, on whether consents in real estate leases containing no standard or criteria required the landlord to respond reasonably to a request for a consent.[48] The 1989 legislation provides that "a restriction on transfer executed on or after September 23, 1983"[49] with regard to "a lease or sublease of real property for other than residential purposes"[50] may not be unreasonably withheld.[51] When the duty to not unreasonably withhold consent applies, the failure to state a reason in writing satisfies the tenant's burden of proof on unreasonableness.[52] On the other hand, "[i]f a restriction on transfer executed before September 23, 1983, requires the landlord's consent for the tenant's transfer but provides no standard for giving or withholding consent, the landlord's consent may be unreasonably withheld."[53] No cases were found suggesting whether a California oil and gas lease will be a "lease… for other than residential purposes" under this statute.

In Ohio, "all commercial transactions [must] be conducted in a commercially reasonable manner and with good faith,"[54] yet in the case of *Harding v. Viking Int'l Resource Co., Inc.*,[55] an Ohio court upheld the ineffectiveness of an assignment made in violation of a consent requirement[56] contained in an oil and gas lease without any discussion of any duty of good faith or reasonableness: "The State of Ohio enforces anti-assignment clauses where there is clear contractual language prohibiting an assignment."[57] Likewise, in the case of *Love v. Beck Energy Corp.*[58] an Ohio court held that there was no implied duty to be reasonable or any other impediment to the lessor, whose consent was required, from demanding monetary compensation as a condition for the consent:

> Beck Energy, as a sophisticated party that has entered into many leases, could have insisted that Roy Mason's handwritten anti-assignment clause contain language that the lessor could not withhold consent arbitrarily or unreasonably. Given that the language was not included in the lease, either Beck Energy did not request the addition of such language or Mason refused to agree to such language.
>
> Consequently, the anti-assignment clause provides that consent can be withheld for any reason, including monetary compensation. Therefore, the Loves had the right to withhold consent until they were monetarily compensated. As such, this leads to the conclusion that it would not have been a futile act for Beck Energy to request the Loves' consent.[59]

Texas does not impose a generalized duty of good faith on the performance of contracts,[60] and in Texas, any impetus on the lessor to behave reasonably should be found in the express terms of the

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[46] Nelson v. Abraham, 29 Cal. 2d 745, 750-51, 177 P.2d 931, 934 (1947).
[47] West's Ann.Cal.Civ.Code § 1995, et seq (2017).
[48] *See* Kendall v. Ernest Pestana, Inc., 163 Cal. App. 3d 11, 209 Cal. Rptr. 135, 136 (1984), *vacated*, 40 Cal.3d 488, 709 P.2d 837, 221 Cal. Rptr. 818 (1985).
[49] West's Ann.Cal.Civ.Code § 1995-270 (2017).
[50] *Id*., §1995- 020.
[51] *Id*., § 1995-250(a).
[52] *Id*., §1995-260.
[53] *Id*., § 1995- 270(b).
[54] Miles v. N. J. Motors, Inc., 44 Ohio App. 2d 351, 338 N.E.2d 784 (1975).
[55] 1 NE3d 872 (OH App. 2013).
[56] "The rights and responsibilities of the Lessee may not be assigned without the mutual agreement of the parties in writing.'' *Id*., at 873.
[57] *Id*., at 876.
[58] No. 14 NO 415, slip op., 2015 WL 1453338 (Mar. 31, 2015).
[59] *Id*., at 8.
[60] English v. Fischer, 660 S.W.2d 521, 522 (Tex. 1983).

contract. The case of *Carrizo Oil & Gas, Inc. v. Barrow-Shaver Res. Co*.[61] specifically negates any implied duty of good faith or reasonableness in the consent context:

> While some jurisdictions impose an obligation of good faith and fair dealing in contract disputes, Texas does not. [citing *English v. Fischer*]. Rather, under Texas law, a consent-to-assignment provision that fails to set a standard by which to measure consent, such as reasonableness or good cause, allows a lessor to withhold consent arbitrarily.[62]

Apparently, Colorado is also among the jurisdictions that will not imply a duty of good faith in the performance of all contracts.[63]

[2] Reasonableness

Whether the reasonableness standard comes from an implied duty of good faith or expressly from the instrument imposing the consent requirement (e.g., "which consent shall not be unreasonably withheld"), this standard diminishes the discretion of the holder of the consent right and almost inevitably creates a fact question for any dispute that arises.[64] Facts and circumstances will generally dictate what is reasonable. However, in the case of *Walls v. Petrohawk Properties, LP*[65] the court held that, as a matter of law, the refusal to consent ("which consent shall not be unreasonably withheld") was unreasonable when the lessor failed to state a reason for the refusal:

> Plaintiff did not provide Petrohawk with a fair, solid, or substantial cause or reason for her failure to consent to the assignment of the Lease to Exxon. Plaintiff did not state specific concerns of any nature about Exxon. A fair, solid, or substantial reason for refusing to consent to the assignment might include a concern about the financial stability of Exxon, or about Exxon's practices regarding production or marketing of gas from wells.[66] …. The Court finds that a reasonable jury could not find that the Plaintiff reasonably withheld her consent to assignment of the Lease to Exxon. In other words, Plaintiff unreasonably withheld her consent to the assignment.

Multiple definitions of reasonableness are offered in the case of *Mitchell's, Inc. v. Nelms,* cited in *Walls*, where a commercial real estate lease provided that "Lessor agrees not to unreasonably withhold his consent."[67] The court gave a litany of possible "reasonableness" tests without basing the decision exclusively on any one. In *Mitchell's, Inc.*, the appellant (seeker of consent) tried to equate unreasonableness to "arbitrary" and that argument yielded the "fair, solid and substantial cause or reason" test that the *Walls* court embraced. The *Mitchell's, Inc.* opinion also dangled Webster's Dictionary as being relevant:

> Webster's New International Dictionary, 2d Edition, defines "Unreasonable" as: "Not conformable to reason; irrational; also, not governed or influenced by reason. Beyond the bounds of reason or moderation; immoderate; exorbitant. [68]

Other possibilities mentioned in *Mitchell's, Inc.* include "the term 'unreasonable' conveys the same idea as irrational, foolish, unwise, absurd, silly, preposterous, senseless, and stupid" and "the

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[61] 516 S.W.3d 89 (Tex. App. Tyler –petition filed 2017).
[62] *Id*., at 97.
[63] *See* Shoemaker v. Mountain States Tel. & Tel. Co., 38 Colo. App. 321, 325, 559 P.2d 721, 724 (1976). *Cf.* Eastern Tunneling Corp. v. Southgate Sanitation Dist., 487 F. Supp. 109, 113 (D. Colo. 1980) (applying Colorado law).
[64] Ridgeline, Inc. v. Crow-Gottesman-Shafer #1, 734 S.W.2d 114, 116 (Tex. App. - Austin 1987, no writ).
[65] 2012 WL 113266 (E.D. Ark. Jan. 13, 2012.)
[66] citing Mitchell's, Inc. v. Nelms, 454 S.W.2d 809, 814 (Tex. Civ. App. - Dallas 1970 writ ref'd n.r.e.).
[67] Mitchell's Inc., 454 S.W.2d at 811.
[68] *Id*., at 814.

determination of what is ‘unreasonable’ is one where, under the evidence presented, there is no room for difference of opinion among reasonable minds.”[69]

In *Mitchell’s, Inc.*, the lease agreement entitled the lessor to receive 50% of the rental under any sublease to the extent that the rental exceeded $1,250 per month and the agreement included the following example for calculation purposes: “For example, should a sublease provide for payment of $1,500 per month as rental lessee shall be obligated to pay lessor $500 per month plus one-half of the difference between $1,250 and $1,500, or an additional $125 per month.”[70] The proposed sublease matched the example exactly with a $1,500 monthly rental, yet the rejection of the sublease communicated by the lessor’s attorney required “very substantially more rental”[71] as a condition to the consent. Ultimately, the refusal by the lessor in *Mitchell’s, Inc.* to grant consent was sustained by the trial court in a bench trial as being reasonable and the appellate court affirmed this result.[72]

§ 2.07 Creating Consent Requirements

[1] Do We Have To Do This?

Why would an oil and gas lessee accept a lease containing a consent requirement? The obvious answer is “commercial forces” -- this lessor has the leverage to impose the provision. Maybe the acreage is critical, because of the size or location of the tract; the market in this neighborhood dictates the provision- every lease will contain one; or the competition is hot—if I do not accept it, a competitor will. Regardless of the perceived market forces, the lessee should consider the cost and alternatives to owning a lease that is not freely transferable.

The lessee can always refuse to accept a consent requirement in lease negotiations, but an additional alternative to “just say no” may be force pooling. A potential lessee would not likely create a force pooling action solely over the “consent to assign” issue, but if a force pooling action is inevitable, lessees perplexed by a lessor’s insistence on a consent provision should keep in mind that the rights acquired through force pooling are generally freely transferable. If a mineral owner elects to become a “lessor” under Okla. Stat. tit. 52 § 87.1 (e), the Oklahoma force pooling statute, the rights acquired by the applicant will be transferable to a successor in interest. The “leases” resulting from force pooling proceedings in Oklahoma or other states do not culminate in actual leasing transactions or lease documents but instead entail payments of “bonus” and “royalty” but otherwise reflect a theoretical leasing transaction and all parties’ rights are transferable with their attendant ownership rights.

Likewise, the rights of an improving cotenant are freely transferable.[73] If the lessee already has a lease or leases covering undivided interests in the subject tract, depending on the size of the interest owned by the negotiating lessor, the lessee may determine that it is better to have the rights of an improving cotenant, which are freely transferable, than the lessee’s rights under an oil and gas lease that are not freely transferable.

[2] Limiting the Restraints of the Consent Requirement

If the grantee decides to accept a consent requirement in an oil and gas lease or conveyance of leases, that grantee should try to impose standards for the granting of consents in order to mitigate the burdens (monetary and otherwise) imposed on the grantee and its rights by the restraint. The most

[69] *Id*.
[70] *Id*., at 811.
[71] *Id*., at 812.
[72] *Id*., at 815.
[73] Penny v. Penny, 247 Ala. 434, 24 So. 2d 912 (1945).

common approach is to expressly adopt the reasonableness requirement ("not unreasonably withheld" or "not unreasonably withheld, delayed or conditioned") or specify objective conditions that either make approval of certain transfers mandatory or exempt certain transfers from the consent requirement.

The prior discussion gives a flavor of the issues that can arise when "reasonable" is the issue-- at least adversarial perspectives on facts and circumstances and, at worst, a jury trial to resolve the factual issues. The term is not self-defining, but "reasonable" is a ubiquitous contractual standard that is certainly, from the grantee's side, an improvement over an unequivocal veto right in the consent holder. Further, the obligation to not unreasonably withhold consent has been construed as an enforceable covenant, the breach of which could result in damages.[74]

However, the optimum provision from the grantee's view contains objective, black and white standards that allow the purchase and sale process or other transactions to proceed without title objections or delay. If the aim of a consent provision is to assure that the next lessee is financially strong and a competent operator, then these criteria should control the consent process. The following oil and gas lease provision, from the form used by a major bank trust department, hinges the consent to the financial strength, reputation and technical capability of each assignee:

> No assignment of this lease, or interest therein, may be made without written approval of Lessor….Lessor shall not unreasonably withhold approval of an assignment of this lease, it being the Lessor's intent that the Leasehold Estate shall be held and developed by financially sound Lessees of good reputation and technical capability.

While this provision neither states a precise mathematical standard for the balance sheet or capitalization of an assignee nor does it preclude the possibility of fact questions in the dispute resolution process, it does narrow the discretion of the lessor/consent giver more than a mere "reasonable" standard.

If the commercial issue of lessee strength and competence is a driver for the lessor and results in the lessor requiring that the original lessee be a major or large independent oil company, it is understandable that this lessor would not want to see the lease conveyed to a different character of lessee—one with whom the lessor would never have entered the original leasing transaction. On the other hand, it is ironic to see the "financial strength/ competence" condition for assignments imposed in a lease where the original lessee is a broker, flipper or a company that does not operate.

[a] Alternative to Consent Restraint

The consent requirement at best allows the lessor to maintain the status quo. The lessor is stuck with the incumbent lessee, and the successful veto of a proposed transaction does not enhance the lessor's position. If a transfer does not relieve the incumbent lessee from past or future compliance obligations and liabilities, what does the lessor lose with the transfer? Consider whether continuing liability by the incumbent lessee appeases the lessor's concerns. Rather than contentious negotiations over the consent provision, lessors may get more protection from language that provides that (i) no assignment will relieve the original lessee from all obligations arising under the lease both prior to and subsequent to any transfer by the lessee, and (ii) each assignee of an interest in the lease shall become jointly and severally liable for full performance with the original lessee and all of the original lessee's successors in interest. In this context, the selling lessee will approach the lessor for a release of liability rather than a consent to the sale.

If a lessor is withholding consent based on the buyer's financial strength, an indemnity from the seller to the lessor may address the issue. A request for indemnity was the condition imposed by Exxon in

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[74] Mitchell's Inc., 454 S.W.2d at 813.

Cedyco Corp. v. Petroquest Energy, LLC[75] to Exxon's consent to transfer rights created under a sublease of oil and gas leases. The seller refused to give the indemnity and the sale failed, but without a breach of the sale agreement by the seller.[76]

[b] Not These Transactions

The lessee should try to limit the consent requirement to the narrowest set of transactions possible. If a competent and financially strong operator is the issue, perhaps any of the following could happen without undermining this principle: 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. Whether any of these transactions requires consent depends on the language of the consent requirement, but a persuasive argument can be made in the negotiation context that these are not legitimate threats to the lessor's position.

The quoted provision from the trust department lease set forth above targets an "assignment of this lease, or interest therein." Presumably, that would snare, at least in Texas, a partial assignment of working interest or an assignment of overriding royalty but some states may be willing to make significant distinctions between assignments and subleases. Bruce E. Cryder and R. Clay Larkin, in their article "*Consent Provisions in Natural Resources Agreements*"[77] suggest that a sublease will not be an "assignment" of anything:

> An assignment of a lease passes a party's entire interest in the leased premises to a third party.[citation omitted] In most cases discussed in this chapter, the contemplated assignment is of a lessee's interest. In order to constitute an "assignment," the transfer must be of the lessee's entire interest in the estate and must be for the entire duration of the lease. [citation omitted] If any lesser interest is transferred, the transfer will be deemed a sublease, not an assignment. [citation omitted] In determining whether a transfer constitutes an assignment, courts will look only at the extent of the interest transferred, and the language used by the parties to the transfer will not be determinative.

This distinction should cause grantors to avoid "assignment" as the operative word for the qualifying event or at least make it only one of several alternative characterizations of what the grantor is worried about.

The grantee negotiating the language of a consent requirement should attempt to exclude liens and the exercise of remedies under liens from the events that require consent. The provision from the trust department lease quoted above should not apply to the creation of a mortgage lien in Texas[78] or other "lien theory" states but the same provision could apply to a mortgage lien in a "title" state.[79] But even if a mortgage does not trigger the provision, the foreclosure will, and a lien does not fully serve its purpose if the foreclosure is clouded from the inception.

[c] Other Limitations

Consider whether the lessor must have a perpetual consent right. Perhaps it can be a personal obligation owed only to the signatory lessor or limited to that lessor's ownership tenure. If not, then

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[75] 497 F.3d 485 (5th Cir. 2007).
[76] *Id*., at 489.
[77] 30 Energy & Min. L. Inst. 3-60 (2009)
[78] *Carroll v. Edmondson*, 41 S W2d 64, 65 (Tex. Comm'n App. 1931).

[79] *see* Cryder and Larkin, at 65.

maybe the consent requirement need apply only while the encumbered mineral interest is owned by a single owner. What the lessee cannot countenance is a prolific (either as a parent or conveyancer) lessor whose ownership of the encumbered mineral interest succeeds to a double digit number of successors. If the mineral ownership becomes fractionated, as a practical matter, the selling lessee will be frustrated if seeking unanimous consent from multiple fractional owners.

§ 2.08 Consents in the Market- The Transferee's Perspective

The most conventional approach regarding consents in the purchase and sale agreement covering oil and gas leases (PSA) is to label needed consents as "title defects;" require the seller to identify them on a schedule to the PSA; require the seller to attempt to secure them, perhaps with "commercially reasonable" efforts; and if a needed consent is not on the table at closing, the lease falls out of the sale and seller retains it.[80] The seller will likely require a provision negating any obligation on its part to make monetary payments or undertake indemnity obligations as inducements for the needed consents. The PSA may provide for a period of time during which seller will continue efforts to procure the consent and, if the consent appears within the deadline, the lease will be conveyed with the same effective date as was applicable for the rest of the package. In this process, it is the seller who requests, and if the conditions are met, is entitled to the consent. The prospective buyer does not have an action against one who withholds consent, not being a party to the lease.[81]

The approach taken in a PSA may vary depending on how prevalent consent requirements are within the sale package. When there are many, a pragmatic buyer may allow for triage based on "hard consents" and "soft consents," with a hard consent usually being one of the forfeiture type. One definition of a soft consent is:

> …where the failure to obtain such consents to assignment or comply with such similar restrictions on assignment would not cause the assignment of a Conveyed Interest to be void or the termination of a Lease under the express terms thereof….

The hard and soft differentiation is prelude to the buyer agreeing that, while the seller is required to pursue all consents, "soft consents" will not ultimately result in a delayed closing or a price adjustment in the absence of threatened litigation.

Occasionally, a provision along the lines of the following is found in the definition of Permitted Encumbrances:

> Required Consents (A) if such consents are obtained from the appropriate parties prior to Closing, or (B) if arrangements can be made, prior to Closing, on terms satisfactory to Buyer to allow Buyer to receive substantially the same economic benefits as if all such consents had been obtained;…

This raises the possibility of the buyer accepting a sublease or nominee arrangement and receiving less than good record title. Even this generous compromise by the buyer should be carefully measured against the language of the consent provision to confirm that no breach results from the transfer of these "economic benefits."

[80] *See* David Patton, "Covenants Between Signing and Closing and Closing Conditions in Oil and Gas Asset Purchase and Sale Agreements," *Oil & Gas Agreements: Purchase and Sale Agreements,* Paper No. 9, Page Nos.9-10 (Rocky Mt. Min. L. Fdn. 2016).
[81] Oliver Resources PLC v. Int'l Finance Corp., 62 F.3d 128, 131 (5th Cir. 1995).

Energy lenders may show more or less lenience than asset buyers in giving value to leases containing consent requirements depending on whether the consents are limited to few leases or are predominant in the collateral package; the relative value of the lease(s) encumbered by consent requirements; and the precise language of each consent requirement, including the precision with which it addresses liens and foreclosures. The financial strength of the borrower and how vigorously banks are competing for this kind of credit also may be factors. Most energy loans are not made with enforcement of remedies as Plan A, but there is always due diligence and underwriting aimed at threats to value.

Lenders may actually be oblivious to consent issues if they do not affect high value leases. Typically, energy lenders rank the collateral properties in descending order of value and do not even review the title of the properties below some value cut-off, perhaps at 80% or 90%. No title issues, including consents, will be identified for these lower value properties in a lending context. In some instances, lenders adopt a surprisingly sanguine posture on the subject of consent requirements because they recognize how rare the exercise of the foreclosure remedy is and, if the credit goes south, view their liens primarily as a trump in the borrower's bankruptcy proceeding equating to "first lien secured lender." When oil and gas leases containing consent provisions are sold pursuant to Bankruptcy Code §363, lessors are given notice and the assets are generally sold free and clear of the consent issue without any price penalty.[82] If the lessor has grievances that it would have otherwise asserted as a basis for refusing the consent, those grievances are claims in the bankruptcy and there is a new owner of the lessee's interest in the lease free and clear of the lessor's claims.

§ 3.01 Preferential Rights to Purchase- Generally

A first option or preferential right to purchase (PRP) may be created in many contexts. The device is certainly not limited to oil and gas ownership or even to real property. The structure, which has been labeled a "dormant option,"[83] allows the holder of the right to preempt a sale of property or rights by stepping forward and matching the price that the owner of the encumbered property has negotiated with a third party. This PRP right differs from an option in that the holder cannot force a sale, but merely has the right to match the negotiated price if the seller of property or rights that are subject to the PRP agrees to sell. The owner of the encumbered property who wants to liquidate is faced with the prospect of engaging buyers in negotiations for the sale when the prospective buyer knows that, after the negotiations, due diligence, procurement of financing and whatever other contingencies are necessary for the buyer to bind itself to a sales contract, the prize can be claimed by the holder of the PRP. How buyers and sellers of oil and gas assets encumbered by PRPs deal with this issue is discussed below, but the threat to the seller's value should be obvious.

Seller and buyer must comply with the specific PRP provision that burdens the property. The following discussion will focus on the preferential right to purchase language contained in the AAPL Form 610 Model Form Operating Agreement.[84] As mentioned earlier, the provision was in the first iteration of that agreement in 1956. There have been some modifications in the PRP in the AAPL model form through the various versions of that agreement and reference will be made to the relevant changes

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[82] *See* Mitchell A. Ayer and David W. Cias, "Consents to Assignment in Oil and Gas Leases," Advanced Oil, Gas & Energy Law Course ch.19 (State Bar of Texas 2016) for a discussion of the treatment of consents in bankruptcy.

[83] A.G.E., Inc. v. Buford, 105 S.W.3d 667, 673 (Tex. App.—Austin 2003, pet denied).

[84] *See* Everard A. Marseglia, Jr., "Preferential Purchase Rights: The Problem with Packages," *36th Annual Ernest E. Smith Oil, Gas & Mineral Law Inst. (2010)* for discussion of the preferential right provisions in the A.I.P.N. Model Form Operating Agreement; also see Fred R. Pletcher and Anthony A. Zoobkoff, "ROFR Madness! Rights of First Refusal in Mining and Oil and Gas Transactions" 56 RMMLF-INST 4-1 (2010) for discussion of PRP provisions in Canadian Association of Petroleum Landmen's CAPL Operating Agreement.

under the respective headings below. The AAPL Form 610-1989 Model Form version (Article VIII.F)[85] provides 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 sale, which shall include the name and address of the prospective purchaser (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 prior 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 right 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 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 any one party owns a majority of the stock.

§ 3.02 Preferential Rights to Purchase- What Triggers the Right?

The operative word in the first sentence of the PRP is "sell," but that word should not cause the PRP to be limited to cash transactions. The case of *Cherokee Water Co. v. Forderhause*[86] suggests that virtually any transfer for value will be a "sale." In *Forderhause*, the Texas Supreme Court held that the granting of an oil and gas lease was a "sale" that triggered a PRP. This PRP was created in a deed that conveyed the surface to Cherokee Water Co. and reserved the minerals to the plaintiff's predecessor in title. Cherokee Water Co. also was granted the ". . . first option to purchase the oil, gas and other minerals herein reserved, at the same price and on the same terms as Grantor has agreed to sell to a third party."[87] The Texas Supreme Court characterized the oil and gas lease as the "sale" of a fee simple determinable and held that it triggered the PRP.[88] The same analysis allowed the court in *Anderson v. Armour and Co*[89]. to treat an exchange of land as triggering the holder's right under a PRP that is prefaced with "[i]n the event the Lessor desires to sell the premises…."

A different result was reached in the case of *Panuco Oil Leases, Inc. v. Conroe Drilling Co.*[90] with regard to a "drill to earn" arrangement. A transaction through which the operator earned additional interests in oil and gas leases by bearing the cost of deepening a well was determined not to be a "sale," as that term was used in the agreement creating the PRP, and therefore was not covered by the PRP provision.[91] Since the *Panuco* opinion is not easily reconciled with the *Forderhause* opinion and has never been cited in any other decision, it is difficult to give much weight to it.

[85] The AAPL Form 610-1989 Model Form - Horizontal Modifications version of Article VIII.F included minor changes that are discussed in Section 3.02 *infra*.
[86] 641 S.W.2d 522 (Tex. 1982).
[87] 623 S.W.2d 435 (Tex. Civ. App. - Texarkana 1981), rev'd on other grounds, 641 S.W.2d 522 (Tex. 1982).
[88] 641 S.W.2d. at 525.

[89] 205 Kan. 801, 473 P.2d 84, 86 (1970)
[90] 202 F. Supp. 108 (S.D. Tex. 1961).
[91] *Id*., at 114.

The following change was made in the "AAPL Form 610-1989 Model Form - Horizontal Modifications" that became available in 2013 and the provision was not changed for the new AAPL Form 610- 2015 Model Form:

> "…full information concerning its proposed [delete sale] [insert disposition], which shall include the name and address of the prospective [delete purchaser] [insert transferee] (who must be ready, willing and able to purchase)….

This substitution of "disposition" for "sale" acknowledges transfers beyond "sales" are covered. Of course, the first sentence of all the AAPL versions still read "[s]hould any party desire to sell…."

§ 3.03 Preferential Rights to Purchase- The Exclusions

There are some events and transactions that are excluded as triggers of the AAPL model form PRP. Some are expressly carved out from the coverage and other events and transactions arguably do not or should not fall within the ambit of the language.

[1] The "Exclusions by Omission"

[a] Gifts and Involuntary Transfers

The premise of the AAPL model form PRP, "[s]hould any party desire to sell,…" is a voluntary sale. This should exclude gifts (notwithstanding any charitable tax deduction or collateral gratification), the passage upon death, including distributions from estates and trusts, and forced sales (condemnation and foreclosures)."[92] In *Exeter Exploration Co. v. Fitzpatrick*,[93] conveyances by individual working interest owners into trusts created for the benefit of their children were not sales and did not trigger the PRP.

The "desire to sell" phrase was determinative in the case of *Draper v. Gochman*,[94] which construed a PRP in a real estate lease that was prefaced with "desires to sell or dispose of his interest" to apply only to a voluntary disposition:[95]

> We are constrained to hold, however, that 'desire to sell' as here used was intended to cover a voluntary act on the part of Baxter, covering either an offer on his part to sell, or the willingness on his part to accept an offer from a third person. There is no evidence that he ever expressed a willingness or desire to sell. He never fixed a price for which he was willing to sell. What he presumably did have was a desire to borrow money, rather than a desire to sell the property.[96]

While the majority position is clearly consistent with *Draper*,[97] there are cases to the contrary. In the case of *Price v. Town of Ruston*,[98] a premise of "desire to sell" did not prevent the holder of the right from asserting the right to buy the property from the successful bidder at a foreclosure:

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[92]*See* Robert K. Wise, Andrew J. Szygenda, and Thomas F. Lillard, "First –Refusal Rights Under Texas Law," 62 BAYLOR L.REV. 433, 454 (2010) and cases cited therein; *see also* Gary B. Conine , Originally Authored, Alex Ritchie, Updated and Revised " *Property Provisions of the Operating Agreement – Interpretation, Validity, and Enforceability*, *Joint Operations and the New AAPL Form 610-2015 Model Form Operating Agreement* (Rocky Mt. Min. L. Fdn. 2017).
[93] 202 Mont. 209, 661 P2d 1266 (1983).
[94] 400 S.W.2d 545 (Tex. 1966).

[95] *Id*.
[96] *Id*., at 547.
[97] Professor Conine states: "The majority of decisions on the subject appear to conclude that the preferential right to purchase does not apply to involuntary 'sales.'" Gary Conine, *Property Provisions of the Operating Agreement - Interpretation, Validity,*

> We agree with the district judge that it would do violence to the intention of the parties to the contract if the word 'desire' should be construed literally…. The expression 'in the event the party of the second part shall desire to sell,' meant in the event the Elks' Lodge should be about to sell, whether willingly or because of financial inability to hold the property.[99]

In *Cities Serv. Oil Corp. v. Estes*,[100] the PRP was triggered by "shall receive a bona fide offer satisfactory to it" with no "desire to sell" language, and the court held that a judicial sale triggered the PRP. In *Richfield Oil Corp. v. Sec.-First Nat'l Bank*,[101] the PRP was triggered by "shall receive from a third party at any time during the term of this lease or during any extension thereof a bona fide offer to purchase the leased premises" and the court held that that a sale by the administrator of a deceased owner's estate triggered the PRP.

The changes in the AAPL 1989 form expressly exempt foreclosures and deeds in lieu of foreclosure from triggering the PRP. This treatment implicitly casts a cloud on, but does not determine the status of, foreclosures under the prior forms. To the extent the *Draper* analysis resounds in a given jurisdiction, a foreclosure will not trigger the PRP under prior versions of the AAPL form.

[b] Sales of Entities and Change of Control

The first portion of the AAPL preferential right provision grants a PRP only if a party disposes of "part or all of its interest in the Contract Area." A party's "interest in the contract area" is an interest in oil and gas leases, and on its face, this provision only applies to the sale of assets. In Texas and Louisiana, these provisions have been construed literally to have no application to entity transactions. On the other hand, the Wyoming Supreme Court adopted a holistic "form versus substance" approach and held that the structuring of entity deals to avoid the PRP was ineffective and the PRP was nevertheless triggered.

The typical avoidance technique is a two-step process that requires the seller to form a wholly-owned subsidiary and then transfer a package of properties into the subsidiary. The seller then sells the stock of the subsidiary to the purchaser who is interested in the package of properties. The original transfer of the properties by the seller to the newly formed subsidiary is in the nature of a "reorganization" that is excluded from the model form PRP provision.[102] This is essentially the approach taken by Tenneco in connection with the divestiture of some of its assets in 1989. In both *Galveston Terminals, Inc. v. Tenneco Oil Company*[103] and *Tenneco Inc. v. Enterprise Products Co.*[104] these "two-step" transactions were held not to trigger the PRP. In the *Galveston Terminals* case, the First District Court of Appeals in Houston was willing to review "substance over form" and denied summary judgment to Tenneco by recognizing fact issues in the PRP holder's characterization of the two-step transaction as a sale of assets:

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and Enforceability, 19 Texas Tech L. Rev., 1263, 1318 (1988), citing Annotation, *Rights of Holder of First Refusal Option on Real Property in the Event of Sale at Foreclosure or Other Involuntary Sale,* 17 A.L.R.3d 962 (1968). None of the decisions discussed in this annotation deal with the AAPL language. Most of them seem to tum on "desires to sell" language similar to the operative language in the *Draper* case.

[98] 132 So. 653(La. 1931).
[99] *Id*., at 655.
[100] 155 S.E.2d 59 (Va. 1967).
[101] 323 P.2d 834 (Cal. Ct. App. 1958).
[102] Note that changes in the 1989 AAPL form PRP allows a "transfer of its interests to a subsidiary or parent company or to a subsidiary of a parent company…" supplementing "reorganization" as a basis for the initial "first step."
[103] 904 S.W.2d 787 (Tex. App. - Houston [1st Dist.] 1995) *set aside without reference to merits*, 922 S.W.2d 549 (Tex. 1996).
[104] 925 S.W.2d 640 (Tex. 1996).

> The character of a legal transaction depends on the intent and purpose of the parties. [citations omitted] A contract regarding real property is construed as a whole. [citations omitted] The courts will look to each and all of the parts of the written instrument, as well as the surrounding circumstances, to determine the intent and purpose of the parties. [citations omitted] In order to ascertain the intention of the parties, all of the instruments that are shown to be component parts of a single transaction should be read together. [citations omitted][105]

This reasoning was expressly disapproved by the Texas Supreme Court in *Tenneco, Inc. v. Enterprise Products Co.*:

> We expressly disapprove of the court's reasoning in *Galveston Terminals*. Sound corporate jurisprudence requires that courts narrowly construe rights of first refusal and other provisions that effectively restrict the free transfer of stock . . . viewing several separate transactions as a single transaction to invoke the right of first refusal compromises the law's unfavorable estimation of such restrictive provisions." [citations omitted].[106]

Enterprise, the PRP holder, had used three arguments and categories of evidence to attack the two-step transaction: (1) Tenneco had offered the properties as an asset sale before settling on the stock sale approach, (2) press releases characterizing the transaction as a sale by Tenneco of ". . . its natural gas liquids business . . ." and (3) evidence that both parties had treated the transaction as an asset sale rather than a stock sale for tax purposes. The documents effectuating the transaction determinatively established that it was a stock sale, not an asset sale, and neither tentative early structuring, press releases nor tax positions could alter the transaction documents.[107] The Texas Supreme Court was not bothered by the overt structuring solely to avoid application of the PRP.

In *Fina Oil and Chemical Co. v. Amoco Production Co.*,[108] a Louisiana appellate court followed the Texas position and allowed the entity structuring to avoid the application of the PRP, but this court did not invite the use of the maneuver to deliberately circumvent a PRP:

> [W]e find [no] proof in the record for Fina's conclusion that MW was created to circumvent Fina's rights under the JOAs.
> The record contains overwhelming evidence that Amoco had a legitimate business purpose as its goal in the creation of MW. The affidavits and depositions of Amoco executives and Amoco's investment banking consultants from Morgan Stanley & Co. attest that the goal was one of reorganization of Amoco, not circumvention of preferential rights.[109]

The court also worked in a "sauce for the goose" rebuttal to Fina's position by reminding Fina that it was the seller who participated in the entity structuring that allowed it to sell to Tenneco in the transactions that led to *Tenneco, Inc. v. Enterprise Products Co.*[110]

Wyoming rejected the "two step" process in *Williams Gas Processing--Wamsutter Co. v. Union Pacific Resources Co.*,[111] where the buyer and seller had scrupulously followed the prescription from *Tenneco, Inc. v. Enterprise Products Co.*:

[105] 904 S.W.2d at 791.
[106] 925 S.W.2d at 646.
[107] *Id*., at 646.

[108] 673 So.2d 668 (La. 1996).
[109] *Id*., at 674.
[110] *Id*., at 675-676.

> We will not argue with UPRC's denomination of this transaction as a "merger" for whatever other purposes that may serve. However, for purposes relevant to the resolution of this case, we hold that it was a "sale."[112]

In the *Tenneco, Inc. v. Enterprise Products Co.* opinion, the Texas Supreme Court essentially said that lawyers know how to draft "change of control" provision and if anybody wants one, they should insert it:

> [I]t says nothing about a change in stockholders. The Enterprise Parties could have included a change-of-control provision in the agreements that would trigger the preferential right to purchase. None of the agreements among the parties contained such a provision. We have long held that courts will not rewrite agreements to insert provisions parties could have included or to imply restraints for which they have not bargained. [citations omitted][113]

In *Williams v. UPRC*, the Wyoming court expressly responded to the Texas Supreme Court's line of thought on the missing "change of control" provision issue:

> Were we to adopt the arguments propounded by UPRC, we would render the contract rights Williams bargained for, at arm's length, meaningless. UPRC contends that Williams could have bargained more aggressively, for example, for a "change of control provision." That may be correct, but that argument does not erase the rights that Williams ***did*** bargain for and received.
> …. By our decision, we do not rewrite the agreement between UPRC and Duke in any way. However, we will not utilize that agreement in such a manner as to say—"Well, yes, in light of what transpired in 1998 in this case (and in 1996 in the *Tenneco* and *Fina* cases), UPRC did come up with a viable means of rendering the 1993 agreement between it and Williams virtually meaningless."[114]

[c] Sales to Co-Owners

A sale by one party to an operating agreement to another party presumably triggers the PRP rights of the other parties, except that changes in the 1989 AAPL form expressly exempt a "sale…of all or substantially all of its Oil and Gas assets to any party…." In prior versions of the AAPL forms, there is no express language that would exclude a sale to a party who already owns an interest in the contract area, and the exclusion added in 1989 simply highlights the coverage of the provision to a sale to a party of less than "all or substantially all of [seller's] assets to a party."

The case of *Texas Company v. Graf* [115] holds that a sale from one co-owner to another did not trigger a PRP, but the language of the PRP is distinctive from the AAPL language. In that case, two cotenants in the ownership of oil and gas leases originally signed the agreement that created the PRP, which was presumably an operating agreement, but it was dated in 1937 and predated the AAPL forms. Subsequently, there were three cotenants, and one of them contracted to buy out another of them. The third cotenant asserted his PRP right to participate in the acquisition. The court held that one cotenant could sell to another without triggering the preferential right because the provision was meant only to prevent the entry of outsiders.[116]

The court did not go into a detailed deconstruct of this PRP, which provided:

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[111] 25 P.3d 1064 (Wy. 2001).
[112] *Id*., at 1072.
[113] 925 S.W.2d at 646.
[114] *Id*., at 1072-1073.
[115] 221 S.W.2d 865 (Tex. Civ. App. - Fort Worth 1949, writ ref'd n.r.e.).
[116] *Id.* at 866.

…[S]hould either party desire to sell its interest in said premises, or any part thereof, and finds a purchaser, or purchasers, who are ready, able and willing to purchase the same, the other party shall have an option to purchase the interest of the party so desiring to sell for the amount of any bona fide offer made by any third party, or parties…If said option to purchase at such price is not exercised within such five-day period, then the party so desiring to sell may dispose of its interest, or interests, to a third party, or parties, as it desires.

[emphasis added] Although the court did not expressly make the point, the references in this provision to third parties shows the intent to limit the application to sales to third parties rather than parties bound by the respective operating agreement. For the reason stated above, the AAPL forms reflect a different intent without expressly addressing the subject of transfers to co-owners.

[d] Transfers of Overriding Royalties

There has been some controversy about whether the AAPL form PRP covers the transfer of an overriding royalty. In the case of *IMCO Oil & Gas Co. v. Mitchell Energy Corp.*,[117] the preferential right in an operating agreement was held to be triggered by the sale of an overriding royalty by Mr. L.C. Kung. The subject overriding royalty had previously been conveyed to Mr. Kung by Westland Oil Development Co. subsequent to Westland's execution of the operating agreement containing the PRP. The plaintiff, IMCO, was the buyer under a purchase agreement covering both Westland's working interest and Mr. Kung's overriding royalty. Mitchell Energy exercised its preferential right and IMCO challenged the exercise on multiple bases, including the inapplicability of the preferential right to the overriding royalty. The court upheld Mitchell's summary judgment on all points, including the holding that the transfer of the overriding royalty was subject to the preferential right, giving weight to an unspecified provision in the operating agreement: "The very terms of the 1972 Operating Agreement expressly provided that any overriding royalty created by a party would be subject to the terms of the agreement."[118] The court did not cite to the "very terms" it was invoking, but presumably, the unnamed provision is the "subsequently created interest" provision, which does not specifically address the coverage of the preferential right provision to subsequently created overriding royalties, but does address the interplay between subsequently created overriding royalties and the operator's lien, the non-consent penalty and mandatory assignments among the parties to the operating agreement.

In *El Paso Production Co. v. Geomet, Inc,.*[119] the court found support for the coverage of an overriding royalty within the PRP provision itself:

> The overriding royalty interest, as a right to payment from production in the land and leases constituting the Contract Area, is clearly "rights and interests" in that land and those leases. The Joint Operating Agreement states "all rights and interests in the Contract Area" are subject to the preferential right to purchase.[120]

The creation of overriding royalties after an operating agreement is in place is unusual because of the treatment of "subsequently created interests" in all of the AAPL model form operating agreements. But when overriding royalties are conveyed subject to an operating agreement, the cases that have

[117] 911 S.W.2d 916 (Tex. App. - Fort Worth 1995, no writ).
[118] *Id.* at 921.

[119] 228 S.W.3d 178 (Tex. App. - Dallas 2007, pet. denied)
[120] *Id.*, at 182; *See also Coral Prod. Corp. v. Central Resources,* 273 Neb. 379, 730 N.W.2d 357, 373 (2007) (applying Texas law) (PRP covers overriding royalties but remanded for determination of "whether EXCO's transfer of overriding royalty interests to Zecchi [EXCO's CEO] constituted an arm's-length transaction."

addressed the issue have found that the transfer (if for value and at arm's length) will trigger the PRP. The application of the PRP provision to the grant of an overriding royalty and each subsequent conveyance of an overriding royalty would have implications not only for all of those geologists and employee royalty pools that are conveyed overriding royalties after an operating agreement is executed, but also for many mezzanine lenders and pension funds for whom overriding royalties and "net profits overriding royalties" constitute part of the financing transaction.

[2] The Express Exclusions

[a] Mortgages and Remedies Under Mortgages

There is no PRP under the 1989 model form 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." The phrase "or to transfer title to its interests to its mortgagee in lieu of or pursuant to foreclosure of a mortgage of its interests," was inserted in 1989. Obviously, PRPs under prior forms do not have this exclusion.

[b] All or Substantially All Assets

Note that there have been changes in this portion of the PRP provision in 1977 and again in the 1989 AAPL form. In the 1956 version, the exemption was only for sales of all of the seller's assets. The 1977 change inserted "or substantially all." The 1989 change allows the exemption for "all or substantially all of its Oil and Gas Assets." If a buyer successfully navigates to acquire assets encumbered by PRPs under any of the AAPL forms, using a special purpose "single asset" entity for the acquisition of those assets should be considered. The PRP will not be a problem upon divestiture because the next sale will be of "all or substantially all" of that entity's assets.

Much of the authority delineating what "all or substantially all assets" means is the result of statutes requiring stockholder approval for sales of "all or substantially all…."[121] Because the focus of these statutes is stockholder protection, the courts apply factors that are not necessarily instructive for the construction of the AAPL form, e.g., whether the company would continue as a profitable enterprise or expects future growth even after the sale.[122]

Must the sale of "all or substantially all of its assets" be accomplished in a single sale to a single buyer? The grouping of properties into strategic packages is the optimum process to maximize value in a divestiture, thus even if the seller is selling everything, there may be multiple buyers and closings. Where the PRP provides: "no preferential right to purchase in those cases where any party wishes to …dispose of its interests by … by sale of all or substantially all of its Oil and Gas assets …," there is no requirement of a single sale. Presumably, a sale of encumbered property will be exempt from the PRP if seller is in progress to sell all or substantially all of its Oil and Gas assets. With reference to "sale of all or…," the last sentence of Article I of the 1989 AAPL form provides: "Unless the context otherwise clearly indicates, words used in the singular include the plural, … the plural includes the singular, and any gender includes the masculine, feminine, and neuter." The reference to "sale" should mean "sales." In *Coral Prod. Corp. v. Central Resources,*[123] the court (applying Texas law) held that the sale was exempt on this basis and relied on the "singular includes the plural" tenet. It was sufficient that "…Central clearly intended to exit the oil and gas business when it placed all of its assets for sale at the same time." [124] While it was not determinative, in *Coral* the seller also did some triage by sequencing a closing on the

[121] *E.g.*, Delaware General Corporation Law § 271).
[122] *E.g.*, Hollinger Inc. v. Hollinger Int'l, Inc., 858 A.2d 342 (Del. Ch. 2004).
[123] 273 Neb. 379, 730 N.W. 2d 357 (2007).
[124] *Id*., at 369.

assets that were not encumbered with the PRP first, so that the encumbered properties were, as of that closing date, all of the oil and gas assets of the seller.[125]

§ 3.04 Preferential Rights to Purchase - Package Sales

The most common approach to selling producing oil and gas assets is to package multiple properties for sale, and the application of the PRP right to these package sales has generated a considerable volume of litigation. Yet, remarkably, the AAPL model form PRP provision was never modified to address the issues that cause the litigation. The AAPL drafting committees over the years have allowed the courts to develop the gap-filler for what the agreement does not say about package sales. Early on, it was suggested that the failure of the model form provision to address multi-property sales reflected the intent that the provision not cover them.[126] We are well past any serious consideration of this premise. There has been too much litigation on the subject, and too many revisions to the AAPL language narrowing application of the PRP incrementally over the years without mention of package sales, to permit any inference regarding the intent to exclude package sales. If any deduction follows from the absence of express treatment of package sales, the conclusion should probably be that any intent to exclude them would be expressly stated.

Properties can be packaged together for a variety of reasons. Theoretically, a seller may offer properties for sale as a group when those properties are operated independently from each other, but that kind of random aggregation is rare and probably short-sighted. If there is no operational nexus (e.g., shared infrastructure or common field office) between them, it is likely the separate parts are worth more than the forced package. If a seller is divesting properties that are geographically separated, typically separate packages are assembled, with the divisions and groupings aimed at enhancing value by addressing potential buyers' parameters for acquisitions.

If a group of properties is packaged together based on commercial drivers and the whole is worth more than the sum of the parts, the buyer cannot tolerate a partial acquisition within that package. At least the buyer cannot tolerate a contract that forces it to close on a "doily." Likewise, the seller cannot tolerate the exercise of a PRP that allows the holder to acquire a piece while the buyer is excused from closing on the remnant of the package, leaving the seller with a doily. If the buyer is excused from closing by the exercise of a PRP, the seller should likewise have "no exercise of PRPs" as a condition to closing. Frequently, the conditions to closing are couched in terms of title defects affecting certain value thresholds, but if the composition of the package is truly integral, those "value threshold" conditions to closing do not necessarily address the doily issue.

The buyer will always want the full benefit of the bargain reflected in the purchase and sale agreement, and thus be rooting for no exercise of PRPs. Beyond that desire, the most obvious reason for the buyer to require an intact package at closing is operational integrity. Maybe it is shared infrastructure like gathering or processing, or a future enhanced recovery project or maybe it is nothing more than a need for critical mass in a given area. The seller would not care who paid the price or received the properties in the sale of personal property or undeveloped oil and gas leases, so long as the price was paid. However, the dynamics of selling producing oil and gas assets are different. The issues regarding the assumption of obligations by and indemnities from the next owner make the identity, competence and financial strength of the successor a critical issue to the seller.

[125] *Id*., at 371.
[126] Reasoner, *Preferential Purchase Rights in Oil and Gas Instruments*, 46 Tex. L. Rev. 57, note 10 at 72 (1972); Abright, "Preferential Right Provisions and Their Applicability to Oil and Gas Instruments," 32 S.W.L.J. 803, 816 (1978).

For their respective reasons, both buyers and sellers want package sales to be exempt from the exercise of PRPs or, failing that, they want to strongly discourage the exercise of PRPs. Holders of PRPs also have their agendas. The issues presented by package sales include:

(i) Can the PRP holder be forced, under the ambit of "same terms and conditions," to acquire more than the property encumbered by the PRP or to undertake obligations not related to the property if the buyer is committed to these matters on an "all or nothing" basis;

(ii) Can the PRP holder insist on acquiring more than the property encumbered by the PRP because the buyer has that right under the "terms and conditions";

(iii) Must buyer and seller allocate itemized portions of the purchase price to the property encumbered by the PRP in order to "tee up" facile exercise of the PRP by the holder; and

(iv) Can criteria for the buyer, which the buyer satisfies and the holder is inherently unable to satisfy, be contractually established in the purchase and sale contract to effectively preclude exercise of the PRP?

The discussion of how the PRP applies to package sales starts with the case of *West Texas Transmission, L.P. v. Enron Corp.*[127] even though the facts of the case did not involve a package sale. The case did, however, impose a very literal construction of the phrase "all terms and conditions" to preclude an effective exercise by the holder who could not meet all of the conditions of the sale agreement. In this case, the holder's PRP covered an undivided one-half interest in a gas pipeline. The purchase agreement provided that the seller's obligation to sell was conditioned on the Federal Trade Commission approving the sale. The holder signed a letter exercising its PRP under "the same terms and conditions" as agreed to by seller and buyer. After the FTC had begun its scrutiny of the transaction, the holder attempted to avoid the FTC approval process. At this point, buyer and seller executed a second agreement and the litigation followed. The holder sought specific performance of the transaction and asserted that it need only meet the price provisions of the purchase agreement in order to exercise its PRP. The Fifth Circuit held that a party exercising the PRP must meet all conditions agreed to by the buyer and may not simply match the purchase price for the property subject to the preferential right:

> Under language comparable to that used [here], the owner of property subject to a right of first refusal remains master of the conditions under which he will relinquish his interest, as long as those conditions are commercially reasonable, imposed in good faith and not specifically designed to defeat the preemptive rights. [citations omitted] [128]

The citations that follow the quoted language from the *West Texas Transmission* case include only one Texas case and that case does not support the requirement that the conditions submitted to the preferential right holder must be commercially reasonable, imposed in good faith or designed for purposes other than defeating the preemptive rights. In view of the Fifth Circuit's reliance on non-Texas cases and Texas' refusal to impose a duty of good faith in contracts generally,[129] the language quoted above from the *West Texas Transmission* case may not be authoritative.

[127] 907 F2d 1554 (5th Cir. 1990) *cert. denied* 499 U.S. 906 (1991).
[128] *Id*., at 1563.
[129] *See English v. Fischer*, note 59 *supra*.

In the case of *Abraham Investment Company v. Payne Ranch, Inc.,*[130] the Amarillo Court of Appeals asserts that the Fifth Circuit did not limit itself to Texas law in the *West Texas Transmission* case:

> The Fifth Circuit Court in *West Texas Transmission, L.P.*, based upon a combination of Texas law and the law of other jurisdictions, set out three exceptions to the unequivocal acceptance rule of option agreements. The exceptions provide that a seller may not impose an offer upon the rightholder that is commercially unreasonable, that is offered in bad faith, and that is "specifically designed to defeat" the preferential right.[131] However, after a careful reading of *West Texas Transmission, L.P.*, we note that the Fifth Circuit created these exceptions based in a large part upon the law of other jurisdictions. Thus, rather than following these exceptions, we will directly follow Texas law… Equitable relief will be granted when the offeree failed to accept the offer within an option agreement if such failure resulted from fraud, surprise, accident, or mistake.[132] Equally, estoppel principles may apply if the offeror's conduct prevented the offeree from properly making his acceptance. *Id.*[133]

The imposition of a standard of good faith is clearly not Texas law and recent Texas Supreme Court authority suggests that "reasonableness" is also not an automatic overlay to contracts in Texas, even when the Fifth Circuit is writing. In *Samson Expl., LLC v. T.S. Reed Props., Inc.*,[134] the supreme court invoked a much earlier Fifth Circuit position on reasonableness:

> To argue that we must enforce only reasonable contracts, or contracts which reasonable men enter into, mistakes our function. We can and do enforce unreasonable contracts if they be clear. Unreasonable men make reasonable contracts and reasonable men may make unreasonable contracts." *Howell v. Union Producing Co.*, 392 F.2d 95, 115 (5th Cir. 1968).[135]

Despite the criticism of the *West Texas Transmission, L.P.* opinion regarding when and how the conditions of a sale will be or not be binding on the holder, the case did allow conditions beyond price to disqualify the holder from executing. That is instructive to buyers and sellers as they structure package sales.

The facts of *McMillan v. Dooley,*[136] included a package sale and present an interesting hypothetical regarding the holder's obligation to take the whole package. The opinion in this case is not instructive for at least two reasons: (i) the PRP did not include the "all terms and conditions" language and instead required the holder to match "the price offered,"[137] and (ii) the holder in *McMillan* did not timely respond to the notice triggering the PRP right,[138] which limits the holding to the issue regarding the sufficiency of the notice. These distinctions ordinarily would have precluded any instruction about how PRPs apply to package sales, but the court nevertheless wrote a lengthy opinion with *dicta* aimed at

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[130] 968 S.W.2d 518 (Tex. App. - Amarillo 1998, rev. denied).
[131] 907 F.2d at 1566-67.
[132] *Id.*, at 272-73.
[133] 968 S.W.2d at 526-527.

[134] 521 S.W.3d 766 (Tex. 2017).
[135] *Id.*, at 781.
[136] 144 S.W3d 159 (Tex. App.- Eastland 2004, pet. denied).

[137] *Id*., at 164.
[138] *Id*., at 181.

some of the difficult issues attendant to package sales, including "… Dooley was not required to accept the other leases in order to exercise his preferential purchase right as to the Dooley Lease…" [139]

In this case, the stated purchase price for the lease encumbered by the PRP was $306,543, but the original buyer agreed to incur plugging costs of $20,000 on other properties. The trial court determined that seller and buyer breached the PRP and held that the holder had the right to buy the encumbered property for $326,743, in effect "grossing up" the price of this property to acknowledge assumed liabilities elsewhere in the package. Because of the holding that the PRP holder did not timely respond to the valid notice, the appellate court avoided the issues surrounding the Solomonic "grossing up," which computation was based in part on evidence about projected salvage value[140] and estimated plugging costs.[141] Certainly, parties dealing with PRPs in the commercial milieu will not be able to navigate the "grossing up" calculation if that is necessary to apply a PRP right against a complicated package sale that includes give and take between valuable assets and assumed liabilities.

The buyer and seller had a chance to create an "organic package" in *Navasota Res., L.P. v. First Source Texas, Inc.*,[142] where the Buyer agreed to: (i) buy 19.9 percent of the owner's outstanding shares of stock; (ii) buy 33.33% of the owner's working interest in the property encumbered by the PRP; and (iii) enter into a large area of mutual interest comprising thirteen counties in East Texas. However, the holder was given a notice that would allow it to purchase the leasehold interest, *i.e.* one-third of the owner's net leasehold acreage at a cost of $700.00 per net acre. The holder timely exercised its PRP on these terms. Immediately after the exercise, seller sent a notice rescinding the offer under the PRP provision and attempting to force the holder to buy the stock and enter into the large AMI. The litigation resulted, and the court made the following points:

- The tender of the notice under the PRP constituted an offer, and the holder's timely acceptance resulted in a contract. The seller was not allowed to reformulate or restate the terms after the holder said "I'll take it."[143] The misfire on the initial notice prevents any holding on the proposition that "same terms and conditions" can equate to the "whole package."

- The holder could not be required to purchase shares of stock or enter into the large AMI (this is *dictum* in view of the holdings set forth above).

- The PRP as set forth in the AAPL Model Form is not an unreasonable restraint on alienation.[144]

- Specific performance was available to the holder, which allowed it to buy the encumbered property at the price allocated under the notice tendered. (Buyer and seller attempted to relegate the holder to monetary damages.)[145]

A better template for the "organic package" may be presented by *FWT, Inc. v. Haskin Wallace Mason Prop. Mgmt., L.L.P.*,[146]where the PRP[147] was reserved by FWT in connection with the sale of a

[139] *Id*., at 180.
[140] *Id*., at 183.
[141] *Id*., at 169.
[142] 249 S.W.3d 526 (Tex. App.--Waco, 2008, *pet. denied)*.
[143] *Id*., at 537.
[144] *Id*.
[145] *Id*., at 541.
[146] 301 S.W.3d 787 (Tex. App.—Fort Worth 2009, pet. denied).

six-acre tract of land to Haskins Wallace, which proceeded to build a galvanizing plant on the site. The owners of Haskins Wallace (using a different affiliate company) built similar facilities on adjacent land and ultimately agreed to sell the assets of both galvanizing businesses for $16,500,000; to lease the six-acre tract subject to the PRP for $25,000 per month for five years with two additional five-year options and an option to purchase the six-acre tract for $2,500,000; and to sublease the adjacent property on which the other galvanizing plant was located. The proposed buyer did not offer to purchase the assets of the businesses independent from the real estate assets and the notice letter to the holder specified that the purchase of one "bundle of assets is contingent upon the purchase of another."[148] The holder responded with: "This letter is to advise you that FWT, Inc. hereby elects to exercise its right of first refusal in the Deed."[149] The reference to the "Deed" rather than the offer made in the notice letter is conspicuous. Seller responded by sending the holder the "Closing Checklist" for the entire transaction and this identified or confirmed the disconnect sufficiently for the holder to file a declaratory judgment action.

The *FWT* opinion acknowledges the general rule that the holder cannot be forced to buy assets in addition to the encumbered property, but identifies an exception. The criteria are:

- Good faith, et al—The *FWT* opinion embraced the *West Texas Transmission* requirements that the imposition of the "package" is not in bad faith, is commercially reasonable and not designed to defeat the PRP.
- Significant relationship within the package- The *FWT* opinion distinguished *McMillan v. Dooley* on the basis that the *McMillan* package "consisted of three unrelated leases" as opposed to the galvanizing facilities where "the business assets and property that FWT has been offered to purchase are significantly related…." The *FWT* opinion also distinguished *Navasota* on the basis that the "additional" property (the part of the package not subject to the PRP) was not sufficiently related to the burdened property to force the holder to take the whole package.[150]
- No Feuding PRPs- The *FWT* opinion also noted that *McMillan* involved PRPs in the "extra properties" and that holders of those PRPs were asserting rights.

The holder was entitled to acquire assets in the package beyond the encumbered property in *Fordoche, Inc. v. Texaco, Inc.*[151] In this case, the sale package included oil and gas leases and units encumbered by the PRP but also "(1) tangible facilities purportedly owned by [seller] exclusively or not subject to the preferential right to purchase, i.e., equipment, structures, and other tangible interests related to each unit; (2) rights of way; and (3) pipeline rights of way."[152] The court found the notice to the holder insufficient in that, *inter alia*, seller "was obligated to first offer to appellants the same thing it offered to EnerVest *at the same price*."[153] [emphasis in opinion]. The case was decided on the deficiency of the notice, but part of the deficiency flowed from the offer to the holder of the encumbered assets but not the infrastructure that contributed to the value of the encumbered property.

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[147] Even though this was a real estate deal, the drafter of this PRP may have used the AAPL form as a guide: "In the event Grantee desires to sell, lease or otherwise convey all or any part of the Property and shall have a bona fide offer from a third party who is ready, willing and able to purchase the Property at a price acceptable to Grantee, then Grantee shall furnish to Grantor written notice of the name of the prospective purchaser and the terms and conditions of such offer... *Grantor shall have 20 days after receipt of the notice in which to elect to purchase, lease or otherwise accept such conveyance, as the case may be, at the same price and under the same terms and conditions offered by the prospective purchaser.* " *Id*., at 790. [emphasis in opinion].
[148] *Id.*
[149] *Id.*
[150] *Id*., at 799 ("Also, like in *McMillan*, the assets that First Source demanded that Navasota additionally acquire were unrelated to the asset the subject of the joint operating agreement and preferential right.")

[151] 463 F.3d 388 (5th Cir. 2006) (applying Louisiana law).
[152] *Id*., at 397.
[153] *Id.*

§ 3.05 Complying With the Provision- The Mechanics

[1] The Notice

The AAPL form requires a “proposed sale” and an “offer.” The seller cannot trigger the holder's right (and start the clock ticking) merely by announcing that seller is seeking to obtain a specific price and offering holder the opportunity to preempt the sales process by paying that price. The “ready, willing and able” requirement suggests that the buyer is bound to a contract, but conceivably there could be a writing that expresses the buyer’s position that falls short of an executed binding agreement, but it must be at least a legal offer susceptible to acceptance by the seller.[154] The contract language always matters. In *Henderson v. Niteschke,*[155] the contract language provided "if Lessor receives an acceptable bona fide offer ... Lessor shall forthwith give notice .... " Under this language, the preferential right ripens into an enforceable right when the owner forms the intent to accept the offer. Similarly, in *Peters v. Smuggler - Durant Mining Corporation,*[156] the court held that the preferential right contained in a mining lease was triggered by the "selling" party executing a non-binding expression of intent.

To trigger the holder’s PRP under the AAPL 1989 form, the seller must give a notice that complies with the following:

> …full information concerning its proposed sale, which shall include the name and address of the prospective purchaser (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.

If there is a signed purchase and sale agreement, certainly delivery of a copy of that agreement will embody everything required to trigger the right: name and address of the buyer, price, legal description and “all other terms of the offer.” But what if buyer or seller does not want the entire purchase and sale agreement disseminated? Can they redact provisions that do not constitute terms of the offer for the encumbered property? Maybe, but when a group of properties are sold under a single contract, the redactor takes on a perilous task in deciding what terms do not fall into “all terms” of the offer. Certainly, the curiosity and suspicions of the holder grow with the amount and location of the redactions.

The four items, name and address, price, land description and “all other terms,” are the extent of “full information.” In F*asken Land and Minerals, Ltd. v. Occidental Permian Lt*d.,[157] the holder wanted to know how the allocation of the purchase price attributable to the encumbered property was calculated, but that “behind the curtain” information was not within “full information.”[158]

The 1989 form added the requirement for the notice of “a legal description sufficient to identify the property,” thus presumably under prior forms the use of code words like prospect names or well names could suffice if they communicated sufficiently. However, in *Fordoche*, the notice failed to sufficiently describe the property being sold even though the notice included well names, well numbers and references to unit designations and sands from which production was flowing.[159] Regardless of what form is applicable, there is no excuse for not including a full legal description. The point is to punctuate the holder’s right and close the sale rather than to engage in jousts over compliance issues.

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[154] Jones v. Riley, 471 S.W.2d 650 (Tex. Civ. App.—Fort Worth 1971, writ ref’d n.r.e.).
[155] 470 S.W.2d 410, 413(Tex. Civ. App. -Eastland 1971, writ refd n.r.e.)
[156] 910 P.2d 34, 3 8 (Colo. App. - 1995) *aff'd* 930 P.2d 575 (Colo. 1997)
[157] 225 S.W.3d 577 (Tex. App.- El Paso 2005, pet. denied).
[158] *Id*., at 590.
[159] Fordoche, 463 F.3d at 396.

Even though the holder's right to acquire encumbered assets is subject to the terms of the negotiated purchase agreement (which is one of seller's primary reasons to provide the full text of that agreement), it is worth emphasizing this fact in the notice. A Catch 22 can arise with regard to the holder's satisfaction of conditions to closing. If the conditions to closing include "no exercise of PRPs," because seller wants to divest the whole package and buyer is not willing to accept less than the whole package, then the holder's exercise of the PRP may be a futile act. The exercise excuses the seller from closing with either buyer or holder and it excuses buyer from closing. Unless somebody blinks, seller is left owning the whole package.

If the notice includes the requisite information, the fact that it erroneously characterizes the holder's rights will not necessarily invalidate it or preclude it from triggering the PRP. In *McMillan v. Dooley*, despite the fact that the court ultimately believed that the holder could not be forced to take the whole package and does not have the right to insist on acquiring whole package, the notice that staked out those erroneous positions was still mechanically sufficient:

> The inclusion of the other leases in the offer presented to Dooley did not violate the express terms of the preferential purchase provision with respect to the terms of conveyance to which McDonald and the purchasers could have agreed. Accordingly, we disagree with Dooley's contention that the defendants presented him with an invalid offer. The defendants made a sufficient presentment from a mechanical perspective if they made a reasonable disclosure of the terms of the contemplated conveyance to Dooley.[160]

[2] The Response

The holder of the PRP should not expect to use a deficient notice as the basis for a subsequent assertion of rights if the notification of the sale or other information puts the holder on notice that the sale is taking place. If the holder is put "on inquiry" regarding a pending sale by any form of notice or information, rather than "lay behind the log," the holder should make the appropriate inquiry and pursue its rights.[161]

The holder in *Martin v. Dooley* who received the notice that mischaracterized the PRP, before engaging in the debate about its legal rights, should have responded by saying it "…intended to exercise its preferential purchase right subject to its objections to disputed terms."[162] After that statement, apparently requests for information or attempts to negotiate alternative provisions will not constitute a rejection of the offer or a waiver of the PRP right. If a proper notice is given, the holder must exercise the PRP (or not) on the property encumbered by the PRP. The fact that different wells or units encumbered by a PRP are allocated individual itemized values by buyer and seller does not afford the holder the ability to make a "split election" and exercise the PRP on subsets within the contract area.[163]

The notice is an offer and, even if does not accurately portray the terms of the PRP and the holder's rights, it is susceptible to acceptance. In *MRC Permian Co. v. Three Rivers Operating Co.*, [164] the notice described less than all of the sale properties that were subject to the PRP and stated the price allocated to those properties. The holder accepted and the seller's later efforts to force the holder to take

[160] McMillan, 144S.W.2d at 177.
[161]Humphrey v. Wood, 256 S.W.2d 669, 672 (Tex. Civ. App. - Amarillo 1953, writ ref'd n.r.e.).

[162] *Id.*, at 181.
[163] See Brown v. Samson Resources Co., 229 F3d 1162 (10th Cir. 2000) (Okla. law) and Samson Resources Co. v. Amerada Hess Corp., 41 P.3d 1055, 1059 (includes a reference to the "maintenance of uniform interest provision" as a basis for precluding a "split election.")
[164] 2015 WL 4639711 (Tex. App.–Dallas 2015, pet. denied) (mem. op.) (applying New Mexico law).,

all of the properties subject to the PRP "all or nothing" were unsuccessful because a contract was formed with the holder's response to the initial notice.[165]

If the holder attempts to negotiate without an unequivocal exercise of the PRP, the effort will be a rejection of the offer. For example, in the case of *Abraham Investment Company v. Payne Ranch, Inc.,*[166] Mr. Campbell, the holder of a PRP, executed a letter presented to him evidencing his agreement to purchase a ranch for the same cash price and otherwise on the same terms and conditions as offered by a potential purchaser. However, Mr. Campbell persuaded the seller to finance a portion of the purchase price and the ranch was sold on this basis. The potential purchaser sued the seller and Mr. Campbell for specific performance. The purchase agreement expressly provided that the buyer's right to buy the ranch was subject to Mr. Campbell's PRP. The court held that the potential buyer's right to purchase the ranch was, however, subject to a proper exercise of the PRP and that Mr. Campbell had not exercised the right.[167] The notice to Mr. Campbell transformed his PRP to an option, and subjected Mr. Campbell to the strict rules of options. He must accept or reject the offer as made.

A premature notice does not serve any good purpose. If the sale that actually occurs is on substantially different terms than were disclosed by the notice to the holder, the PRP is not extinguished. In the case of *Foster v. Bullard,*[168] after the notice was given to the holder, the buyer assigned the purchase agreement to a third party. After the assignment, the purchase agreement was amended. These developments effectively opened the door for the holder to exercise his PRP long after his 10-day option expired. The court held that the holder's PRP was not extinguished by the sale to the buyer: "The sale [seller] had under consideration when he wrote [holder] in January of 1969 was a trade with Hendrix. This sale never took place."[169]

While minor amendments should not require a second notice to the holder, the requirement of the AAPL language that the holder be given "all . . . terms of the offer" provides a holder the opening to challenge a sale that is not closed on the terms that were disclosed to it. Since there is usually a flurry of issues that arise immediately before (or during) the closing of the sale transaction, a written waiver from the holder is desirable because it will give seller and buyer the freedom to make the necessary adjustments as the closing approaches. The waiver should be broadly drafted to cover a sale from the seller to a specific buyer so long as it closes before a specific date. A waiver that expressly or implicitly covers only a sale on the exact terms initially disclosed to the holder may document the fact that the holder declined to exercise the PRP, but would not give any additional flexibility to alter terms of the deal. Without a written waiver from the holder, buyer and seller should be very reluctant to modify the terms of sale after the notice has been sent to the holder.

§ 3.06 Consequences of Breach of the Preferential Right to Purchase.

Both the seller and buyer are in the "target zone" for claims from the holder if the PRP provision is breached. PRP disputes can involve claims for specific performance, damages and injunctive relief. The PRP creates rights in land so that specific performance is a remedy and, if the sale has already closed and the buyer does not qualify as a bona fide purchaser, the buyer can be forced to reconvey.[170] Equitable

[165] *Id.*, at 7.
[166] 968 S.W.2d 518 (Tex. App. - Amarillo 1998, rev. denied).
[167] *Id*., at 524.
[168] 496 S.W.2d 724 (Tex. Civ. App. - Austin 1973, writ ref'd n.r.e.).
[169] *Id.,* at 735.

[170] Larson Operating Co. v. Petroleum, Inc., 84 P.3d 626 (Kan. Ct. App. 2004)

relief will be available and, in particular, available when the holder "failed to accept the offer within an option agreement if such failure resulted from fraud, surprise, accident, or mistake"[171]

In *Mobil Exploration & Producing North America, Inc. v. Graham Royalty, Ltd.,*[172] the Eighth Circuit, applying Arkansas law, affirmed the trial court's holding that both the buyer and seller were jointly and severally liable to the holder of a PRP created under an AAPL model form operating agreement. The buyer's liability arose from the conveyance being made subject to the operating agreement, but the opinion clearly states that constructive notice of the PRP, however such notice may be imparted, would make the buyer a party to the operating agreement.[173] The appellate court, reversing the trial court, also held that the purchase agreement obligated the seller to indemnify the buyer for all liabilities resulting from the breach of the PRP. The seller had argued that provisions in the purchase agreement obligating buyer to satisfy itself regarding title allocated the risk of a breach of this nature to the buyer. The court held that the breach of the PRP occurred prior to closing of the sale and provisions of the purchase agreement that allocated to seller all liabilities and damages arising before the closing, together with a provision obligating seller to obtain waivers of PRPs, caused the seller to owe indemnity obligations to the buyer.[174] The remedy sought by, and awarded to Mobil, which was seeking to enforce the PRP, was the recovery of the property from the buyer and all proceeds of production accruing since the closing to the extent those proceeds exceeded the purchase price.[175]

A wrongful attempt to exercise a preferential right exposed not only the holder but also the seller to claims in *Abraham Investment Co. v. Payne Ranch, Inc.*,[176] discussed earlier. In that case, the plaintiff was the jilted buyer who was deprived of the purchase when the holder indicated he would match the all cash purchase price and other terms agreed to by the buyer. After exercising the right, the holder successfully negotiated for seller financing. The seller and the holder, as joint defendants, argued in a summary judgment motion that the buyer had no standing to sue since the buyer was not a party or a third-party beneficiary to the agreement creating the PRP. The court sustained the buyer's standing to sue, pointing out that the buyer was suing on the purchase agreement, which set up the proper exercise of the PRP as a condition subsequent that would cause the purchase agreement to be no longer binding. The plaintiff recovered on its claim for specific performance of the purchase agreement against the seller, the holder and the holder's lienholder.

The breach of a PRP provision will be "cured" at some point by the applicable statute of limitations, but if a buyer is buying PRP-encumbered properties from a seller that has owned them for less than the applicable limitations period, this buyer should confirm historic compliance with the PRP provisions. A shorter ownership tenure without claims should not lull the buyer into complacency. In Texas, the applicable period is 4 years. *Tregellas v. Archer Trust No. Three,*[177] and in Texas, the "discovery rule" will not extend the period.[178]

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[171]Abraham Investment Co., 968 S.W.2d at 572, citing Jones v. Gibbs, 130 S.W.2d 265, 271 (Tex. Comm'n App.1939, opinion adopted).
[172] 910 F.2d 504 (8th Cir. 1990).
[173] *Id.,* at 507.
[174] *Id.,* at 508.
[175] In *Anderson* v. *Armour and Company,* 473 P.2d 84, 89 (Kan. 1970), the preferential right holder recovered money damages equal to the difference between the fair market value of the tract as of the trial (without reference to improvements made since the sale) and fair market value as of the sale date.
[176] 968 S.W.2d 518.

[177] 507 S.W.3d 423 (Tex. App.—Amarillo 2016, pet. pending)
[178] *Id*., at 432.

§ 4.01 Conclusion

A lessee negotiating leases should face the fact that "consent to assign" provisions cause problems and subtract value. The provision should not be routinely accepted. If the market allows, "just say no." If this lease is important enough that it cannot be bought without the consent provision, the provision should be as limited as possible in as many ways as possible and, when a consent is required, the standard governing the obligation to consent should be as objective as possible. The "not unreasonably withheld, delayed or conditioned," while it requires consideration of facts and circumstances, is better for the lessee than the lessor being able to veto transfers for any reason or no reason. If the lessor can deny consent without a stated reason that is connected to performance of the existing lease terms, then this lessor is a de facto "partner" of the lessee who can use every transfer as a "jubilee"[179] to extract payments and reset any term of the lease.

The asset buyer who successfully procures the needed consents to acquire leases containing "consent to assign" provisions should consider placing those encumbered assets in silo, special purpose, entities so that when it is your time to liquidate, the sale is of an entity rather than leases.

Oil and gas producers should be skeptical about creating a new preferential right to purchase. This right might make more sense for pipelines, refineries and processing plants than it does for producing properties. If the parties believe that any project is appropriate for a PRP, the parties should not simply adopt the AAPL version without tailoring the provision to the project and specifically addressing whether the asset can be sold in any manner other than a stand-alone sale and if it can be, then addressing the issues attendant to package sales.

The asset buyer who successfully purchases properties subject to a PRP should consider placing those encumbered assets in silo, special purpose, entities so that when it is time to sell, the sale is of an entity rather than leases or that entity is selling all or substantially all of its assets.

Lessors and any other owners who see benefits in either of these restraints on alienation should include "change of control" provisions to snare the "entity transactions" mentioned above.

[179] "[P]roclaim liberty throughout the land to all its inhabitants. It shall be a jubilee for you; each of you is to return to your family property and to your own clan." Leviticus 25-1 (NIV).