

OVERVIEW OF OIL AND GAS CONTRACTS¹

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I. Background

There is a job somewhat unique to the American oil and gas industry called a "landman." A landman, historically, ran records at the parish or county courthouse relating to the subsurface mineral rights associated with a proposed drilling location, and then went out and negotiated leases from the landowners who controlled those rights. As such, landmen were the point of contact between the operator and the mineral rights owner. For many, especially in the early years of petroleum development, landmen were the face of the upstream oil and gas industry.

Over the years, landmen became more sophisticated at drafting and negotiating a variety of oil and gas contracts. Many had law degrees. In the late 1980s, as American oil and gas companies began to look more and more to international opportunities to explore for hydrocarbons, landmen were recast as "petroleum negotiators," since oil and gas property rights owned by sovereign nations were uncomplicated.

To this day, landmen play a heightened role in oil and gas contracts. Many of the customary practices that are used in the oil and gas business today have been developed by landmen, oftentimes through their trade associations, the American Association of Petroleum Landmen (AAPL) and, later, the Association of International Petroleum Negotiators (AIPN). Indeed, a cursory review of the AIPN website (<http://www.aipn.org/mcvisitors.aspx>) shows that some sixteen different model contract forms have been developed under the auspices of the AIPN. These forms range from confidentiality agreements to service contracts to gas sales agreements – and they all reflect, to some extent, industry custom in the crafting of oil and gas contracts.

This portion of the seminar is designed to introduce Ohio lawyers to some of the more common oil and gas contracts, and the issues that most frequently come to pass during negotiations of those contracts. Those contracts can be grouped, generally, into the following five categories: (1) granting instruments, (2) purchase and sale (and finance) agreements, (3) joint ventures, (4) service agreements and (5) hydrocarbon marketing agreements. Granting instruments, which include mineral lease agreements, are discussed in depth in other portions of this continuing education course. The focus of the expert panel discussions and papers herewith will be on some of the specific contracts commonly found in the other four areas of an oil and gas law practice.

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II. Contracts Commonly Found in the Oil and Gas Industry

A. Granting Instruments.

"Granting" instruments are used in the oil and gas business to define those documents that create, by "grant" or "reservation," a mineral interest. 1 Williams & Meyers, at § 202.2. That is, the landowner may, by an instrument usually described as a mineral deed, create in the name of another person a mineral interest. Alternatively, the landowner may convey the land, but retain for himself a mineral interest. That mineral interest normally includes development and executive rights, i.e., the right to drill for and produce hydrocarbons and the right to execute a hydrocarbon lease. *Id.*

In the international context, mineral interests in the conventional sense are not always granted. One may, pursuant to the granting instrument, obtain the right to drill and produce, but not necessarily own the hydrocarbons so produced. As a result, the classification of the different types of agreements between host countries and international oil and gas companies does not easily fall into the same analytical framework normally understood in the U.S. as "granting instruments." Nonetheless, those contracts providing private rights to explore and produce oil and gas are typically discussed under this heading.

There are three basic arrangements for development of hydrocarbons between host countries and multinational oil companies: (1) the concession (or lease), (2) the production sharing agreement, and (3) the service agreement. Each of these types of agreements provides for different levels of control granted to the producing company and for different compensation arrangements and different levels of state oil company involvement. Often granting instruments will be a hybrid of these various types of agreements.

The characterization of these contracts could be further reduced to two fundamental forms: Those that pass title to the hydrocarbons at the wellhead (or, in jurisdictions that do not follow the "rule of capture," *in situ*) and those that do not. Generally, concession agreements deliver title to the producer at the point of capture. Other forms of granting instruments do not. In addition, concession agreements tend to leave considerably more control of operations in the hands of the producers than do other forms of granting instruments. In the end, these labels are important only insofar that they provide a useful analytical framework.

Early arrangements to develop mineral reserves were in the form of concessions and leases. Characteristics of such agreements were: (1) a grant of rights for mineral development over large areas, (2) for a relatively long period of time, (3) providing to the operator nearly exclusive control over the schedule and manner in which mineral reserves were developed, and (4) reserving to the mineral rights owner very few rights in the way of control, other than to receive a royalty payment based upon the disposition of the hydrocarbons produced.

In the United States, disputes over lease operation began to arise over the lack of development and over sales of hydrocarbons at below-market value. Under the old lease forms, producers frequently held large leaseholds with minimal production for long periods of time, allowing other portions of the lease to languish until such time that the producer had the interest or finances to develop the property further. Moreover, producers would often sell themselves the royalty share of the hydrocarbons produced at below-market prices, or enter into long-term, fixed price contracts that would not reflect market value, dedicating the royalty share of production therewith.

State courts, looking at the advantage held by producers in these early leases, eventually dealt

with these problems by imposing covenants of good faith dealing that ran in favor of the royalty owners, requiring producing companies to prudently administer the property. Thus, even though the lease may not provide a contractual remedy for imprudent operations, royalty owners were able to seek legal recourse, including lease cancellation, for a producing company's failure to develop the property or to prudently market the royalty share of production. Eventually, lessors became sophisticated enough that they were able to include specific development and market value provisions in the lease. To this day, however, most state courts continue to include implied covenants as part of the producer's lease obligation.

B. Asset Purchase Agreements

Deals to purchase producing assets or leaseholds are often very complex, and take a great deal of time. There are multiple communications between the parties and vast resources in time and money are commonly invested investigating an asset purchase. Internal coordination during negotiations can be poor (especially where personal agendas differ). As a result, it is one of the more frequent areas for "inadvertent contracts" to be created. The "due diligence" phase of the deal – after letters of intent have been executed, but before the deal is closed – can be particularly problematic.

The term "due diligence" is commonly used to refer to the buyer's examination of the seller's records and properties in an effort to verify title and confirm that the assumptions on which the purchase price is based are accurate. The term comes from the provision commonly contained within purchase and sale agreements that provides that the buyer will have access to, and the right to examine, the pertinent files, books, records and properties of the seller. This process is required because, in the oil and gas business, the seller typically does not warrant title to the assets being acquired. Accordingly, the buyer is charged with knowledge of all defects or deficiencies that could have been discovered through the exercise of "due diligence" in the examination of the official title records and the files, books, records and properties of the seller. "Due diligence" as a term has come into such common usage in the oil and gas industry that in some purchase and sale agreements, the examination is merely referred to as the buyer's due diligence without further definition except as to which of the records the seller will make available for examination.

Planning the due diligence review requires a balancing of the need to discover all material information about the properties against the time and cost of an exhaustive review. Decisions regarding the scope of the investigation into legal and contractual matters should be made jointly by the buyer and the buyer's attorney. Both should understand the buyer's objectives and how the buyer computed the purchase price. The buyer's acquisition philosophy or the source of the buyer's capital may dictate the buyer's tolerance level for risk in the form of unpleasant surprises later. Typically, the due diligence review will focus on the properties in descending order with the most valuable property receiving the most attention.

Although a buyer and seller will often assume they are not bound until the formal agreement is executed, contractual obligations may arise based on correspondence or informal communications. The mere fact that the parties to an informal agreement intend that the same shall be later reduced to a formal contract will not necessarily prevent the informal agreement from being binding in the event the formal contract is never signed. Under common law, where a future contemplated writing is not a condition precedent to a contract and if the parties intended to be bound regardless of a formal writing, a contract is held to exist. *See Coulter v. Anderson*, 357 P.2d 76 (Colo. 1960). This is consistent with civil law (La. Civ. Code art. 1947), which sets forth that only when the parties contemplate a certain form will that particular form be critical to a meeting of the minds.

Where this sort of problem most frequently occurs is where parties correspond with each other regarding terms to an agreement during the negotiation stage. The question often arises as to whether the parties meant to contract by their correspondence or whether they were simply setting terms of an agreement to be entered into after all the particulars had been determined. Whether or not such correspondence creates a contract depends on the circumstances of the particular case. An important element as to whether correspondence has created a binding agreement depends on whether the correspondence induced reliance by another party. If it did, the court may find that a contract was formed by such correspondence. Further, a court may consider whether correspondence created a contract depending upon the prior course of dealing between the parties. In *Ellis Canning Co. v. Bernstein*, 248 F.Supp. 1212 (D. Colo. 1972), the court noted that "whether there has been a meeting of the minds is a question of fact to be determined from all of the evidence in the case.... [I]t is well settled that a contract may result from a series of letters determining the various matters step by step. It is not important that all the terms be set out in one instrument. If, from the correspondence, the intent of the parties to contract may be clearly inferred, it is sufficient." *Id.*

The most commonly litigated document generated during the negotiation of oil and gas asset sales is the so-called "letter of intent." A letter of intent is a pre-contractual written instrument that reflects preliminary agreements or understandings of one or more parties to a future contract. The letters of intent are customarily employed to reduce to writing a preliminary understanding of the parties. Letters of Intent are an inevitable part of complex oil and gas transactions, especially prior to undertaking due diligence. Both parties will want some sort of understanding of the deal before they incur the cost of due diligence.

Letters of intent will typically impose obligations on the parties, but may indicate that the proposed transaction is subject to a later closing event in a specific form. Oftentimes the letter of intent will contemplate that the buyer can walk away after the due diligence process, but in so doing, forfeit a security deposit. Litigation more often comes to pass on letters of intent when the seller decides to withdraw the assets from sale than when the buyer withdraws.

C. Joint Ventures

The first joint venture document commonly negotiated is the confidentiality agreement. Those who have geo-science data have a competitive advantage over those who do not. As a result, companies and independent geoscientists seek to protect that advantage when negotiating for terms on a joint project. This agreement essentially kicks off serious discussions. Considering their importance and commonplace use, and considering how hastily these agreements are often crafted, it is a wonder they are not more commonly litigated.

When confidentiality agreements are litigated, it is usually the non-use/non-competition portion of the agreement that becomes the subject of dispute. It is important to recognize that most jurisdictions have a public policy against non-competition agreements, and will interpret these agreements narrowly. In Louisiana, if the agreement is too broad (e.g. "the Gulf of Mexico") or too long (e.g. 10 years), the courts will strike them down as being against public policy. Further, both disclosing and receiving parties should know that there are laws that govern misappropriation of trade secrets, notwithstanding the existence of a contractual agreement to treat information with confidence. In the United States, for instance, there is the Uniform Trade Secrets Act, as well as state statutory or tort-based remedies for misappropriation of trade secrets.

The non-competition agreement will often times be set forth as part of an "area of mutual interest" (AMI) agreement. These agreements also commonly accompany a purchase and sale agreement

when an operator sells a partial interest in a leasehold, or a “study and bid” agreement between companies looking to jointly bid on an offshore federal lease. The purpose of the AMI is to allow companies to conduct the evaluation phase of a project without one party usurping for its own use the jointly developed geological information. They can operate like an option contract, however, and when open ended, large acreage AMI agreements are an invitation for later litigation. It is easy to forget about an inactive AMI, as they can be buried in field files for years, out of sight and mind.

Once a company has obtained the rights to operate and develop properties, it is then faced with a new challenge: how to operate. Most companies are skittish about incurring a substantial amount of risk on one exploration project. As a result, joint ventures have become the rule rather than the exception in oil and gas investment. Only the very large companies, such as Exxon or Royal Dutch Shell, will undertake major exploration and production initiatives 100% on their own.

Frequently several companies will participate in a mineral venture, although one party will have primary responsibility for the project (the “operator”). A contract or several contracts will set out the terms of their joint participation and detail, among other things, how and when the various operational stages take place and how the project risks, expenses, and production will be allocated. These agreements are generally based upon Model Form Joint Operating Agreements (JOA), such as those promulgated by the AAPL or the AIPN. JOAs can run 50 or more pages long, not including the accounting procedures, which may be another 20 pages. One common strategy co-venturing parties use is to cross out sections they don’t want to apply, or to add sections at the end they do want to apply. Either practice can lead to trouble if they are not coordinated with other language in the contract. But adding a section at the end can be especially problematic if that section conflicts with other provisions left in the contract – an easy thing to happen when dealing with 50 page documents.

D. Service Agreements

Drilling contracts are the most important service contracts; they often determine the economics of an oil and gas deal. This is especially true for shale production, where drilling and completion costs are high and mechanical failure risk is not casually borne.

Generally, drilling contract work is undertaken either on a “turnkey” or a “daywork” basis. In the former case, the drilling contractor, for a set price, agrees to take some or all the risk associated with mechanical failure in drilling a well to a certain depth. This form of contract is popular with small producers, who are willing to pay the driller a premium to ensure that they won’t have to face huge cost overruns associated with delays or mechanical failures. The driller, on the other hand, will want to be sure that the costs are predictable before agreeing to a turnkey contract. It is for this reason that normally turnkey contracts are restricted to shallow onshore wells. For the producer, the biggest issue in the turnkey contract, next to the price, will be the track record of the driller. There are many drilling engineers who set up shop as a turnkey company with no resources whatsoever. These start-up companies can underbid other contractors because, notwithstanding what the contract says, they really intend to take no risk. They rent their equipment and subcontract the work, and this works fine if everything goes smoothly. But if there are delays or mechanical problems, the under-financed start-up may seek to renegotiate the deal, or may walk off the job, leaving the producer with environmental problems and a pack of unpaid and unhappy subcontractors.

In daywork drilling contracts, the producer pays the drilling company a “day rate” for being on the job. Accordingly, should there be delays due to weather, mechanical problems, failed equipment and so forth, the drilling company continues to rack up significant fees. It is common for a drilling company to charge lower “standby” rates during delay periods, such as occurs during a “fishing” expedition when

equipment gets stuck down hole. Long fishing expeditions are times of considerable angst for producers -- they face fees not only from the fishing tool company who tries to retrieve the stuck equipment, but they also incur fees for standby time from the driller. As each day passes, and costs increase, the stakes grow larger for the producer as it decides whether to abandon the well.

The most hotly disputed issue on daywork drilling contracts is the issue of who was in charge at the time something went wrong. Producers usually have a “company man” on location during drilling, and the driller will contend that this person is ultimately responsible for all decisions on location. Producers, on the other hand, argue that the contractor provides the equipment and expertise, and knows best how to handle situations that arise during drilling. Even more troubling is that only circumstantial evidence is available to problem solve --- it is impossible to see two miles down-hole to know exactly why, for instance, a perforating gun is stuck. The result is that drillers and producers may find themselves in litigation later, during which process a team of experts swear the other company was or should have been in charge when the problems arose, and that the damages resulted from the imprudent choices made by that company under the circumstances.

The major issue to be negotiated (other than the day rate) in a drilling contract is that of risk allocation. The driller will want the producer to be responsible for nearly anything that can go wrong (*see, e.g.* the IADC form contract). The producer normally is willing to indemnify the driller for certain damages, such as those caused by the producer’s own acts or equipment. On the other hand, the producer will seek to avoid responsibility for the actions of the contractor or subcontractor. Many jurisdictions require, as a matter of public policy, that each party be responsible for its own behavior, as least insofar as such behavior causes personal injury. *See e.g.* the Louisiana Anti-Indemnity Statute. On the other hand, some jurisdictions consider indemnification in drilling contracts to be something to be negotiated as part of insurance coverage. *See e.g. Dresser Industries, Inc. v. Page Petroleum, Inc.*, 853 S.W.2d 505 (Tex. 1993). Similarly, under general maritime law, the rule is that a contract requiring indemnification for a party’s own negligence is enforceable if appropriately worded. *See Corbette v. Diamond Drilling Co.*, 654 F.2d 329 (5th Cir. 1981).

While parties are free to specify in the contract a choice of law, courts will ignore such provisions in favor of the public policy of the jurisdiction where the incident took place. An Oklahoma producer may have a master service agreement with a Pennsylvania drilling company for all their drilling in any state, but if they drill in Ohio, Ohio’s indemnification laws will likely apply regardless of what the two companies may agree between themselves. Given the complications of public policy, as well as difficult to understand indemnity language contained in drilling contracts, a producer should be careful to ensure that it has not inadvertently taken on risk for which it has no insurance. The producer should also be aware that in no jurisdiction may a party contractually insulate itself from its own intentional acts or acts of extreme recklessness.

Indemnification language can be especially complex when the drilling contract contains “pass through” provisions. These provisions can create scenarios where indemnification obligations pass through from subcontractors directly to the producer or the driller, even though the damages may have been incurred due to the fault of the contractor or subcontractor. The provisions can be especially onerous for small subcontractors, who, due to a poor bargaining position, may be compelled to undertake extraordinary risks by agreeing to a pass through just to get a small job.

At the end of the day, what is most important during this give and take negotiation over risk allocation is that there are no gaps in insurance coverage, and that there are no places of double coverage.

E. Hydrocarbon Marketing Agreements

The marketing of oil and gas will be a critical issue in determining the viability of a project. In the United States, companies typically do not undertake marketing efforts until after discovery of proven reserves. This is because in the United States there is an extensive pipeline and highway infrastructure that provides markets in and around most oil and gas fields. As a result, marketing efforts typically need not be undertaken until there is a successful discovery.

Crude oil is an international commodity with generally readily available markets. It is a portable, mostly fungible and relatively easily stored and marketed. In the United States there are two principal crude oil contracts: those selling crude on the spot market and those selling crude under a duration or term contract. Forms for selling crude tend to be simple.

Natural gas, on the other hand, is not so easily stored or transported. What's more, much of the gas produced is "associated" with oil production (also called "casinghead" gas), and as a result, cannot be shut in when there is no market for the gas. Yet producers are under obligations to the State to not flare the gas. As a result, natural gas producers have historically sought complex, long-term contracts with delivery and take-or-pay schedules to ensure that all production is sold, and that the costs associated with the infrastructure build out necessary to market that gas would be recoverable. These contracts, considered "outputs" contracts under civil law (where the buyer agrees to take and pay for all the production provided by the seller) typically dedicate the production from a particular reservoir or field to that contract. They are also sometimes referred to as "reservoir depletion" contracts. They were the source of a series of high stake "take or pay" lawsuits in the 1980s between producers and pipeline companies.

Another type of traditional gas sale agreement is what is referred to in civil law as a "requirements" contract (the seller agrees to supply all the daily-required needs of the buyer up to a certain amount). This sort of "warranty" contract is more common today between pipeline companies and their customers, the end users. But producers at one time commonly entered into this sort of agreement to get a better price. Producers have over time found it problematic to warrant the delivery of reserves because of the unpredictable nature of reserves and the cost of development. Accordingly, producers generally avoid warranty contracts today.

III. Conclusions.

The oil and gas industry has a well-established pattern for transacting business, such that custom frequently controls the provisions that make their way into contracts. It is important for the oil and gas practitioner to understand these customs not only for their role in the development of form contracts, but also for the role they play in negotiations. Custom also sets expectations and perceived standards of fairness. A petroleum negotiator who has the task of getting another negotiator to forego rights normally granted by custom will have a difficult time completing the deal.